

A WorldatWork Survey Brief



Fiscal Management of Compensation Programs

A Survey of Members of WorldatWork
August, 2005

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*The Professional Association for
Compensation, Benefits and Total Rewards*

WorldatWork is the world's leading not-for-profit professional association dedicated to knowledge leadership in compensation, benefits and total rewards. Founded in 1955, WorldatWork focuses on human resources disciplines associated with attracting, retaining and motivating employees. Besides serving as the membership association of the professions, the WorldatWork family of organizations provides education, certification (Certified Compensation Professional – CCP®, Certified Benefits Professional® – CBP and Global Remuneration Professional – GRP®), publications, knowledge resources, surveys, conferences, research and networking. WorldatWork Society of Certified Professionals and Alliance for Work-Life Progress (AWLP) are part of the WorldatWork family.

WorldatWork regularly surveys its membership of compensation, benefits and total rewards practitioners regarding current issues and topics, best practices and common professional practices. The majority of WorldatWork members are at the manager responsibility level or higher, have more than 10 years of experience in the human resources profession, and work in the corporate headquarters of a company based in North America with more than 1,000 employees. The association routinely receives a voluntary response rate from members in the 15 percent to 20 percent range, a response rate that generally ensures the respondents are representative of the WorldatWork membership as a whole.

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Fiscal Management of Compensation Programs

Survey Brief ¹

WorldatWork, Hay Group, Dow Scott, Ph.D, Loyola University Chicago

Introduction and Methodology

This report summarizes the findings of a survey of WorldatWork members in November 2004 of fiscal compensation management policies and practices. A representative sample of approximately 5,000 WorldatWork members received a Web link to the electronic survey instrument requesting their participation online. After two reminders, the Web link was closed in February 2005. The HayGroup also sent a Web link encouraging its registered Web site users to complete the online survey.

More than 600 compensation professionals, typically at the manager or director level, completed the survey. The demographic profile of the survey respondents is similar to that of the WorldatWork membership as a whole. The typical WorldatWork member works at the managerial level or higher in the headquarters of a large company in North America. Ninety-five percent of *Fortune* 1000 companies employ a member of WorldatWork.

The survey queried compensation managers about:

- Their role in the compensation fiscal management process
- How compensation expenses were budgeted
- Which fiscal management tools were in place to control these expenses
- Which pay and performance links were used to distribute pay
- The effectiveness of the fiscal management policies and practices in their organizations.

The survey instrument required approximately 20 to 30 minutes to complete. Because an organization may have multiple compensation systems in place, compensation managers were asked to respond to the survey as it pertained to the managerial and professional employee population to enhance comparability across companies.

To provide a more thorough evaluation of compensation fiscal management practices, companies identified by *Fortune* magazine as one of “America’s Most Admired Companies” were compared to a sample of similar sized companies that did not achieve this designation. *Fortune’s* “America’s Most Admired Companies” list is based on an annual survey of corporate reputations and has been conducted by Hay Group since 1997. More than 10,000 executives, directors and industry analysts are involved in developing this ranking.

Key descriptive findings are highlighted in the following sections. Statistical T-tests were used to compare responses between those companies on the “America’s Most Admired Companies” list and other companies, and to make a comparison between companies whose fiscal management programs and policies were rated effective and those rated ineffective. All percentages at and above .5 are rounded up, so some totals may not equal 100 percent.

¹ This survey report is based on an article published in 2005 Third Quarter *WorldatWork Journal* by Dow Scott, Ph.D., Loyola University Chicago, and Thomas D. McMullen and Richard S. Sperling, CCP, Hay Group. Copyright 2005, WorldatWork. All rights reserved.

Executive Summary

Employee compensation is a major expenditure that can easily represent anywhere from 20 percent to 50 percent of the cost of doing business. In labor-intensive industries, such as software development, education and professional services firms, this compensation can exceed 70 percent of operating costs. High labor costs create real competitive challenges, as is currently apparent among large U.S. airlines and automakers. Thus, it is not surprising that the fiscal management of compensation programs is a key accountability for senior executives in most organizations.

Compensation managers do possess a critical role in designing and administering compensation programs, although the finance function still plays a major role, especially as it relates to monitoring and controlling compensation expenditures.

With respect to compensation budgeting, this survey shows variation in the number of elements included in compensation budgets, and the level at which those elements are monitored. While almost all organizations include base salary increases, less than half budgeted for payroll slippage and recovery. Of the companies surveyed, 72 percent monitor compensation expenditures via financial reporting systems.

As indicated by previous research, the link between performance and pay is not always clear. One explanation may be tied to the type of protections a majority of organizations employ to control payouts, such as funding triggers and caps on variable pay.

Finally, most compensation managers consider their fiscal management policies and practices to be effective. Between 63 percent and 79 percent of organizations rate their programs as effective based on budgeting and planning, administration and control, role of HR working with finance and management, and timeliness and accuracy of compensation information. Revenue, employee retention and controlled labor costs are cited as the most prevalent and important criteria used in determining effectiveness.

One future direction in fiscal compensation management may be the increased use of ROI calculations to control compensation program costs. Although a majority of companies reported not assessing compensation ROI, "America's Most Admired Companies" and companies who rated their fiscal management as effective used ROI calculations more frequently.

Detailed Research Findings

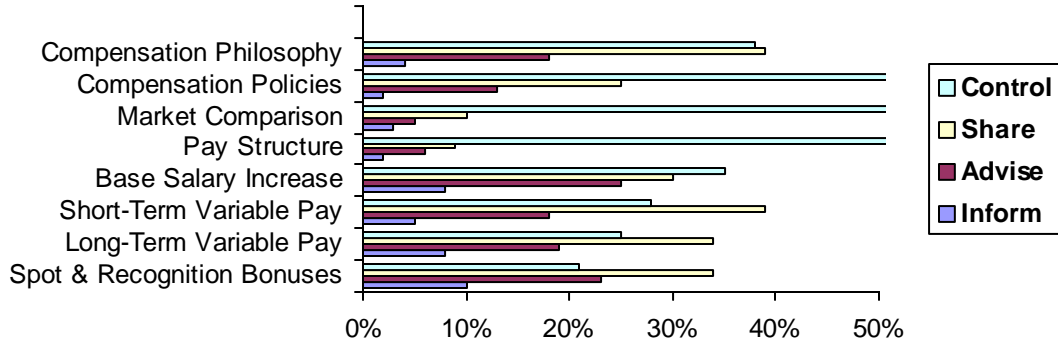
Role of Compensation and HR Managers

Compensation managers were asked to indicate their type of involvement in the design, administration and control of specific aspects of the compensation program for professional and managerial employees. For each attribute, they were asked to rate their influence on a five-point scale consisting of the following levels:

- Not involved
- Provides information to management
- Advises management
- Shares decisions with management
- Has primary accountability for the decision.

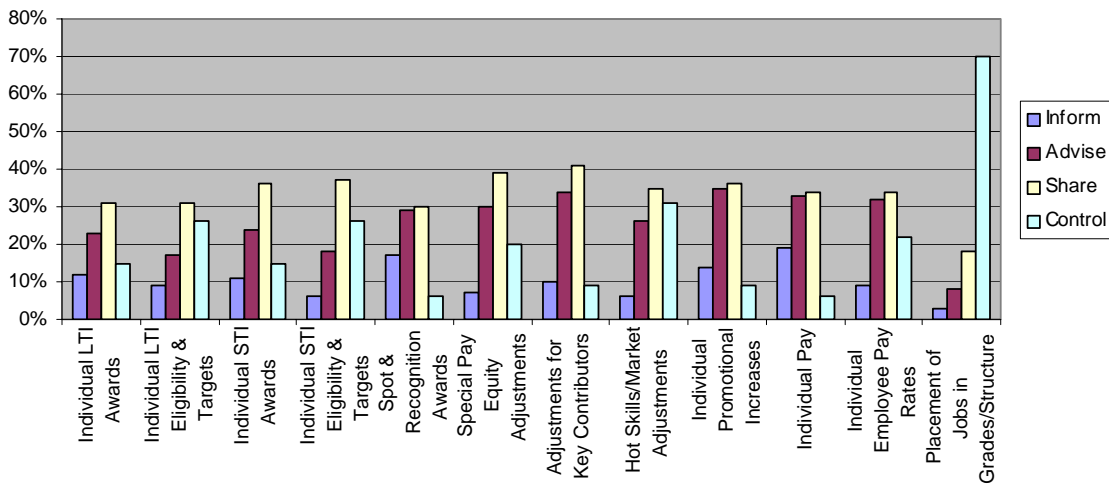
As shown in Figure 1, relative to other leaders, compensation managers have the most direct impact and responsibility for establishing the compensation philosophy, setting compensation policy, making comparisons to market data and designing pay structures. In fact, most compensation managers either share these design decisions with management or have primarily responsibility for their design. In contrast, compensation managers have the least impact on designing long-term variable pay programs, and spot and recognition bonuses.

Figure 1: Compensation/HR Role in Program Design



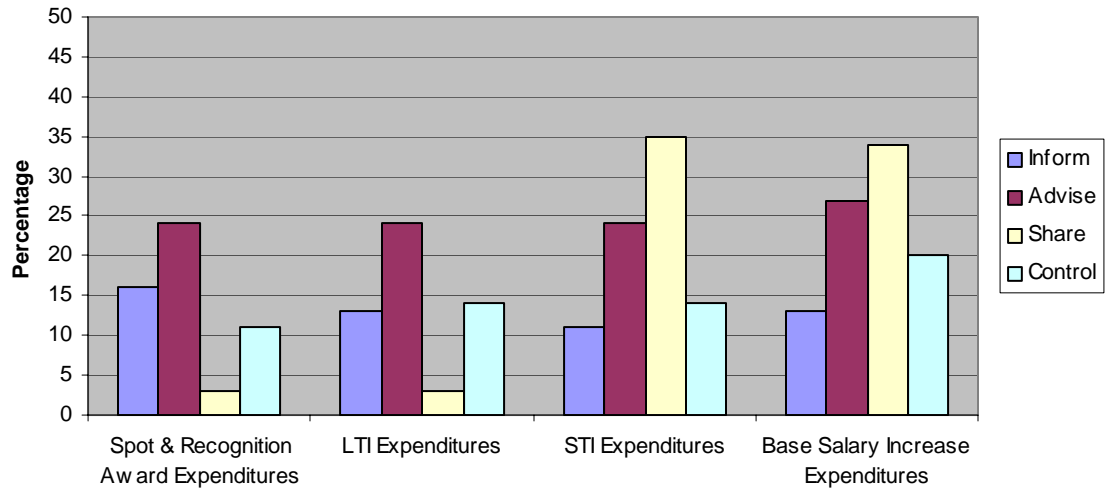
As shown in Figure 2, compensation managers' are the primary decision makers in the placement of jobs into grades or the pay structure. They also tend to have significant accountability for administering market adjustments for hot skills, making special pay equity adjustments, and establishing eligibility and target payout levels for short-term incentive programs. Compensation managers have the least amount of authority for the administration of spot and recognition awards.

Figure 2: Compensation/HR Role in Program Administration



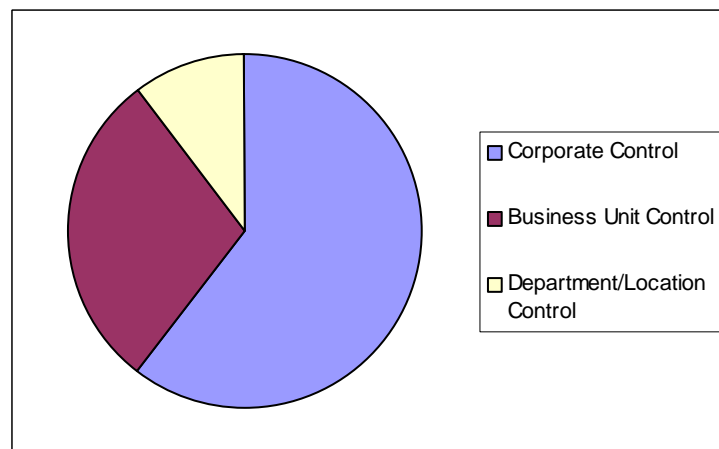
Compensation managers do not have as much fiscal management authority for monitoring and controlling compensation expenditures, as shown in Figure 3. The data indicate that compensation managers often are in an advisory role to others in this regard — most likely to the finance function, which typically controls corporate expenditures.

Figure 3: Compensation/HR Role in Program Monitoring & Control



The level of decision centralization is another way to think about compensation program control. Smaller organizations tend to have more centralized control than larger organizations. Interestingly, compensation managers rate programs that are more centrally controlled as less effective. Programs that are rated as most effective are decentralized to the local unit level in more than 50 percent of organizations surveyed.

Figure 4: How Centralized Is the Fiscal Management of Compensation Programs?



Compensation Budgeting

Survey results indicated most organizations analyze their compensation budgets element by element (56 percent). Only 19 percent of the compensation managers analyze and budget for total remuneration, while 23 percent of organizations budgeted for base-salary only.

Figure 5 shows the budgeting process both in terms of how many organizations have certain types of compensation programs and the proportion of organizations that budget for the expenditures associated with those programs. Most of the survey participants use a wide range of compensation elements. Many organizations budget for these elements individually and there is significant variation in budgeting practices. A few of them appear noteworthy:

- While many organizations budget for internal equity, hot skills and high potential/key contributor pay adjustments and increases, many others do not. If these increases affect a significant number of employees, the amounts could be well worth budgeting.
- Many organizations budget promotion increases for replacement promotions, although such promotions do not always add costs, as the replacements tend to be paid less than the people they replace.
- A majority of participants (52 percent) do not budget for slippage, although history suggests that slippage can change payroll levels by 1 percent or more. Slippage is defined as the difference between actual year-end pay and expected year-end pay for a constant sample of jobs. It is caused by a variety of factors, including promotions, departures and new hires.

It is possible that both the high prevalence of budgeting for replacement promotions and the low prevalence of budgeting for slippage reflect a new reality. Only 19 percent of participants report paying new incumbents less than the people they replace, and 72 percent report that actual salary increase expenditures are about equal to budget. Organizations that report having effective compensation planning and budgeting processes do not show a higher prevalence of budgeting for slippage, but 41 percent say new incumbents are paid less than the people they replace, and 81 percent report expenditures being equal to budget. These organizations seem to be finding ways to identify and re-allocate slippage, even though they do not budget for it.

Figure 5: Compensation Budgeting

<u>Compensation Element</u>	<u>Percent of Organizations</u>	<u>Percent Budgeted</u>	<u>Percent Not Budgeted</u>
Base salary increases	99%	99%	1%
Promotion increases (for replacement promotions)	95%	80%	20%
Hot skills/market adjustments	94%	71%	29%
Additional adjustments fro high potential employees or key contributors	90%	65%	35%
Spot bonuses and recognition awards	89%	82%	18%
Short term incentives	87%	95%	5%
Payroll slippage and recovery (due to organization turnover)	81%	48%	52%
Long term incentives	79%	92%	8%
Diversity based adjustments	69%	36%	64%

Another interesting issue associated with compensation budgeting is what organizations do with savings that result from temporary vacancies. Twenty-five percent of organizations use these savings to reduce overall labor expenditures, 11 percent plan for vacancies and include the savings in their budgets, and 14 percent allow managers to use the savings for other purposes, as shown in Figure 6. By far, however, the most prevalent practice (50 percent) is to have no consistent policy for dealing with this type of savings. Organizations reporting effective compensation planning and budgeting are much more likely to have a consistent policy (61% do) than those reporting ineffective processes (of which 37% have a consistent policy).

Figure 6: Treatment of Savings When a Position Is Not Filled When Budgeted

<u>Approach</u>	<u>All Companies</u>	<u>Not Effective Companies</u>	<u>Effective Companies</u>
Reduces overall labor costs and credited as labor saving	25%	18%	34%
A standard amount of salary savings are calculated into the salary budget (i.e., planning includes a certain number of unfilled positions)	11%	5%	17%
Business unit or operations can use the salary saving for other purposes such as employee development	14%	13%	10%
No consistent policy	50%	63%	39%

Given the commitment of financial resources associated with employee compensation, budgeting for employee salaries and wages is important. As reported by survey participants, the most important determinant of what an organization is going to budget for salary increases is what other organizations are doing (i.e., labor market movement). The organization's ability to pay, desired competitive position in the labor market and organization performance represent a second tier of criteria both in terms of prevalence of use by organizations and in the level of importance placed on them by compensation managers. The three criteria that were seldom used to determine base pay increases were cost of living, employee turnover and employee satisfaction.

Base-salary increase allocations are most often based on either a combination of individual performance and market position (56 percent of respondents) or increases based on performance only (30 percent). Far fewer organizations give all employees the same raise, sometimes called a "general increase" (12 percent), determine increases based on competitive market position alone (1 percent) or base increases on maturity curves or employee tenure (1 percent).

Pay Structure

Currently popular in the literature is the concept of total rewards. A total rewards philosophy suggests that rewards should be considered as a whole including total cash compensation, employee benefits, desirability of the work environment, and training and career development opportunities. The survey data, however, indicate that 80 percent of organizations set their cash compensation targets based only on the cash compensation marketplace — with no consideration given to the value of benefits, perquisites, work culture and training and development opportunities, thus largely ignoring the total rewards model, at least as far as setting the compensation structure is concerned. Only 4 percent of the organizations say they raise their

compensation targets in order to make-up for a weaker competitive position against their benefits, perquisites or work environment; and 10 percent of the organizations say they lower their compensation targets to offset stronger competitive positions of their benefits, perquisites or work environment. Organizations follow a variety of strategies in managing compensation within salary ranges. Sixty-three percent of organizations allow salaries to follow below the minimum of the pay range. These organizations treat below-minimum salaries in a variety of ways. Eighteen percent allow salaries below minimums only for performance reasons, 23 percent have a policy to accelerate increases until salaries are within the range, and 21 percent allow managers to determine the timeframe for moving salaries above the minimum.

Ninety percent of organizations allow salaries to exceed the maximum of the range. The most common practice (51 percent) is to freeze salaries that exceed maximums but to give lump sum merit payments or bonuses. Only 15 percent freeze without giving lump sums. In 23 percent of organizations, salary increases are allowed even when salaries exceed range maximums.

Although organizations use a number of criteria for moving individual employees through the pay range, performance versus job standards or expectations is reported as both the most prevalent criterion and the most important one. Position in range (relative position in the labor market), or performance relative to individual objectives are used frequently, but are considered less important criteria. Finally, organizations do not perceive time in the position and education level as important criteria and seldom use them to move employees through the range.

In terms of fiscal compensation management, managerial discretion in granting pay raises is an important issue. In 27 percent of the organizations surveyed, line managers determine how to use market references or compa-ratios to adjust pay. In 40 percent of the organizations, there are formal guidelines regarding market references or compa-ratios that the line manager must consider when adjusting base pay. In 33 percent of the organizations, market references or compa-ratios largely determine how base pay should be adjusted with relatively limited managerial discretion.

Pay and Performance Linkages

Previous research initiatives indicate that employees often are skeptical that better performance will lead to better compensation (Hay Group Study, Hills, Scott, Markham, and Vest, 1987). Numerous factors lead to this skepticism among employees, including:

- The relatively modest size of historic merit increase budgets
- Lack of clarity in compensation and pay for performance objectives
- Inadequate performance differentiation
- The inadequate differentiation of rewards.

“America’s Most Admired Companies,” however, do tend to find a way to provide differentiation in rewards. In 2002’s survey of WorldatWork members, *Fortune’s* most admired companies were more likely to differentiate pay for outstanding performers — typically a 2X differential versus a 1.5X differential than companies that did not receive this distinction (Scott, McMullen, Wallace, and Morajda, 2004). Therefore, with a 4-percent merit increase budget, outstanding performers in a most admired company would average 8 percent increases, while outstanding performers in a typical company would average 6 percent increases.

One of the key reasons that many organizations are having a difficult time in differentiating pay for outstanding versus average performers is that they give base salary increases to virtually all employees which quickly consumes the merit budget. This study indicates that 68 percent of organizations give increases to between 95 percent and 100 percent of employees. Moreover, 95 percent of organizations give at least 80 percent of employees within the organization a salary increase.

The research shows a striking difference in how two hypothetical organizations might differentiate pay for top performers. Let's assume that two organizations, Company A and Company B, both have a 4-percent base salary increase budget. Company A provides an average 1.5X differential in base pay increase for outstanding performers (differential report in the 2002 survey) and gives 100 percent of the workforce a salary increase, whereas Company B provides a 2X differential (in line with most admired companies) and provides increases to 80 percent of the workforce. In this example, Company A is able to give outstanding performers a 6-percent pay increase while Company B can give outstanding performers a 10-percent average increase.

Variable pay programs represent another key compensation program linked to performance. The funding of variable pay programs in large part indicates how costs are controlled within the organization. The survey revealed:

- Nineteen percent of the organizations use discretionary funding, which is typically decided by management at the end of the fiscal year.
- Self-funded programs, typically financed through reduced costs or increased revenues or profitability (typically driven by formulas established in advance) are used in 23 percent of the organizations.
- In 35 percent of the organizations, a percentage of payroll is used to fund variable pay expenditures.
- Twenty-three percent of the respondents indicated that this question is not applicable or that they used a different method for budgeting variable pay.

To further ensure the fiscal management of variable pay programs, the overwhelming majority of plans make use of funding hurdles or triggers (84 percent) (e.g., a minimum level of organization financial performance before payouts will occur). In addition, more than 90 percent of organizations make use of caps or maximums on variable pay plans that protect the organization in the case of significant performance not solely produced by plan participants.

The allocation of payouts is at least partially driven by a formula, with some room for management discretion in about 41 percent of companies, but one-quarter of managers have no discretion in allocating payouts. Only 13 percent of respondents indicated management exercised significant latitude in determining individual payouts, and 22 percent of companies balance payouts by incorporating a formula and management discretion.

Effectiveness of the Fiscal Management Process

Compensation managers generally believe that compensation fiscal management processes are effective, as indicated in Figure 7. Between 63 percent and 79 percent of organizations rate their programs as effective, based on budgeting and planning, administration and control, role of HR working with finance and management, and timeliness and accuracy of compensation information. However, methods used to reduce compensation expenditures were not evaluated nearly as positively. The strategy of not filling or delay in filling open positions was the only cost reduction strategy that was determined to be widely used and effective, whereas all other strategies were rated as marginally effective (see Figure 8). This is likely due to the fact that keeping positions open has the least effect on current employees.

Figure 7: Effectiveness of Fiscal Management Methods

<u>Method</u>	<u>Ineffective</u>	<u>Marginal</u>	<u>Effective</u>
Budgeting and planning process	6%	26%	68%
Administration and control process	6%	31%	63%
Role of HR working with finance/mgt	6%	27%	68%
Timeliness of compensation information	4%	26%	70%
Accuracy of compensation information	3%	18%	79%

Figure 8: Methods for Lowering Compensation Costs

H=High; M=Medium; L=Low

<u>Method</u>	<u>Prevalence</u>	<u>Effectiveness</u>
Don't fill or delay filling open positions	H	Effective
Reduce headcount	H	Marginal
Outsource employee work	M	Marginal
Offer Retirement or severance bonuses	M	Marginal
Reduce employee benefits	M	Marginal
Delay pay increases	M	Marginal
Substitute FT employees with PT	M	Marginal
Freeze wages across the board	L	Marginal
Freeze wages except in special cases	L	Marginal
Encourage unpaid leaves of absence	L	Marginal
Reduce pay across the board	L	Marginal
Selected employee pay reductions	L	Marginal

Compensation managers also were asked how they judged the effectiveness of the compensation fiscal management process. Figure 9 shows prevalence and relative importance in criteria used to assess the effectiveness of the compensation program. Top-line business operating results is the most prevalent criterion used to measure effectiveness among the organizations studied and is considered to be a very important criterion as well. Employee retention is frequently used as a criterion but is not afforded as much importance as top-line operating results. Controlled or lowered labor cost is not as frequently used, but is considered a very important criterion by those who use this measure. Informal opinion gathering from employees or the ability to recruit new employees is typically not used and given little importance by those that use this measure.

Figure 9: Criteria Used to Judge Effectiveness

H=High; M=Medium; L=Low

Criteria	Prevalence	Importance
Top-line business operating results (i.e., revenues)	H	H
Employee retention	H	M
Controlled/lowered labor costs	M	H
Employee productivity metrics	M	M
Bottom-line business operating results (i.e., profits)	M	M
Employee satisfaction survey measures	M	M
Informal opinion gathering from senior leaders	M	M
Informal opinion gathering from employees	L	L
Ability to recruit employees	L	L

ROI calculations are a key element of almost all investment decisions. While it is common practice to use ROI in justifying capital spending decisions, it is not used nearly as frequently for the organization's multi-million dollar investment in its workforce. As shown in Figure 10, the ROI of compensation programs is NOT calculated and evaluated in the majority of organizations (62 percent) and it is done only informally by 20 percent of the organizations surveyed. It is interesting to note, that in both "America's Most Admired Companies" and organizations where fiscal management programs were rated as effective, the use of ROI evaluations was attempted more frequently than other organizations, especially those organizations in which the compensation manager evaluated their fiscal control methods as ineffective.

Figure 10: How Compensation ROI is Monitored

Method	All Companies	Most Admired Companies	Effective Companies	Ineffective Companies
Informal discussion with mgt/employees	20%	21%	19%	12%
Formal comparison of investment in human capital to financial/productivity measures	9%	21%	16%	5%
Formal assessment of employee/ mgt attitudinal data	9%	18%	12%	7%
Not applicable. No assessment attempted	62%	36%	53%	77%

Most organizations have financial reporting systems to monitor compensation expenditures (72 percent). However, of the compensation managers who deemed their fiscal management process ineffective, only 47 percent of them reported that they had a financial reporting system in place. Compensation expenditures were monitored monthly by 51 percent of the organizations studied, quarterly by 21 percent, annually by 16 percent, only as needed by 9 percent, and not at all by 2 percent of the organizations.

Respondent Demographics

As shown in Figure 11, 72 percent of the respondents represented organizations with more than 1,000 employees. Respondents from only 8 percent of the sample reported representing organizations with fewer than 100 employees. Figure 12 depicts the diverse industries represented in the sample. Manufacturing (18 percent), Finance and Insurance (16 percent), Health Care and Social Assistance (10 percent), and Professional, Scientific and Technical Services (10 percent) were the industry sectors most represented in the sample. Respondents were excluded from the analysis if more than one manager responded for a single organization (the highest ranking manager was retained) or if it was reported that the organization had fewer than 10 employees.

Figure 11: Company Size

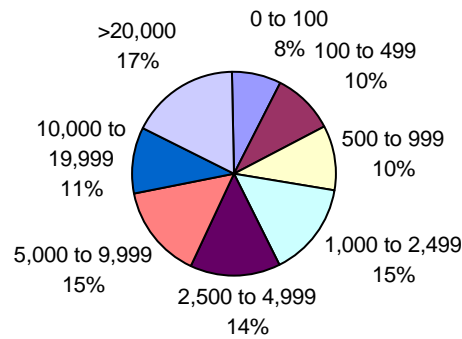


Figure 12: Industry

Manufacturing	18%
Finance & Insurance	16%
Other	11%
Health Care & Social Assistance	10%
Professional, Scientific & Technical Services	10%
Educational Services	5%
Public Administration	5%
Other Services (except Public Administration)	5%
Utilities	4%
Information	4%
Retail Trade	3%
Transportation & Warehousing	2%
Arts, Entertainment & Recreation	2%
Accommodation & Food Services	2%
Wholesale Trade	1%
Mining	1%
Real Estate, Rental & Leasing	1%

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