

The “blind spot” in compensation planning and design

Saratoga’s 2006/2007 Human Capital Effectiveness Report reveals that the average company spends \$81,000 per person on employee salary and benefits. It is the job of Compensation departments to set compensation strategy largely with an eye on keeping rewards packages competitive. Central questions for Compensation professionals tend to be:

- Are our salaries and bonuses at the average of what other companies are paying for similar skills?
- Are most companies offering similar benefits with similar features as we are?
- Do people with similar skills and performance in our company get paid the similarly?
- What level of bonuses and raises can the company afford without adversely affecting profits or earnings per share?

At PwC Saratoga we consider these types of questions to be assessors of the efficiency of compensation. These questions help determine whether a company can essentially do what it is doing today for less cost.

While these are important questions, PwC Saratoga believes they miss an essential truth. Not only does labor drive costs, but the workforce drives the top line. The workforce makes sales. It builds the products. It satisfies customers. It develops new ideas, products, and marketing pitches. The workforce is responsible for corporate output. Compensation planning and design must evaluate the effectiveness of the workforce at driving the top line.

We believe that the critical number for Compensation, HR, and executives to be evaluating is not \$81,000, but 29 cents.



The average company invests 29 cents in labor to drive a \$1 in revenue. It is this ratio that captures the essence of the linkage between compensation efficiency and compensation effectiveness. From this metric we can ask the most important of workforce questions:

- Are we investing the right amount in compensation to drive output?
- Can we reduce our investment and maintain output?
- How do we increase investment to drive output up?

The essential job of HR Compensation departments and indeed senior executives needs to be how to increase revenue relative to labor costs. Companies need more information to make these decisions. This article provides outlines, at a high level, the steps PwC Saratoga recommends that organizations take to maximize their investment in their workforce.



Assessing workforce demand for compensation

Before we journey into a discussion of assessing workforce demand for compensation, it is critical to agree on one point: Compensation does not drive output. Variable compensation, pay-for-performance, commissions, etc. do not create long-term changes in behavior. Without launching into too-radical discussions of compensation design, let us at least agree that better linking compensation to output is not simply a matter of better designing performance plans or incentive structures. What Compensation departments need is better insight into employee preferences for compensation – in the same way that marketing departments needed better insight into what cell phone and credit card buyers want.

The workforce today has very little input into the compensation process. The only time most workers have a chance to negotiate their packages is when they accept their job. After that their input is not sought.

With the feedback loop such as it is, intuitively workers have only two mechanisms to express themselves: They can decide to stay/leave and they can decide to not work very hard. Both create a drag on the top line. Both hit companies in blind spots, as processes to track and assess either issue do not exist – at least before the fact.

PwC Saratoga recommends that companies do a better job of assessing workforce demand for compensation. Companies must have a forum for employees to provide feedback on their compensation, both at a program and feature level. We must do a better job of understanding the degree to which employees value stock options and the degree to which they viewed as long-term or short-term incentives.

We must understand if the workforce understands how bonuses and raises are determined and if they perceive them as fair. We must understand if employees believe

that raising health care deductibles is better than eliminating dependent care spending accounts. Would they rather have dental insurance or another week of vacation? The ability to answer these types of questions begins with surveying, and extends into other forms of research.

In the same way that marketing department researches customer wants and needs, HR and Compensation departments must research employee wants and needs. The marketing department is trying to get customers to spend money, while HR/Compensation departments are trying to get employees to spend time. These are our two global currencies, time and money. It makes sense that we should research them in similar fashions.

For the sake of clarity, companies need to understand demand of the overall workforce (or niches within it), not just an individual's demand. PwC Saratoga is not advocating that companies move to a cafeteria approach to compensation where each individual gets to have things precisely as he or she wants. We are advocating that companies understand how to tailor reward programs to be more effective for important employee segments. How can we design reward program to achieve better outcomes, without requiring employees to resort to either leaving or not working hard?

Workforce demand model

PwC has developed a model for understanding workforce demand, and in it there are three components. Workforce demand is comprised of a) workforce preference for compensation, b) compensation transparency and c) compensation appropriateness.

- Workforce preference for compensation assesses the relative value employees place on different reward programs (e.g. salary, bonus, health care, retirement), the features of these programs (vesting periods, level



of match), and overall impact on non-compensation rewards (career pathing, mentoring programs, perks)

- Compensation transparency assesses the degree to which employees understand the reward programs. “Understanding” takes several forms, including a) Are employees aware of the programs? b) Can employees articulate the benefit that programs provide them? c) Do employees believe that programs are fairly executed? Transparency may be clouded by any one of these factors, and insufficient transparency may artificially lower the value of an otherwise important program.
- Compensation appropriateness assesses the degree to which programs fit an employee’s level of control in the organization and time horizon. Are long-term incentive programs being delivered to employees that don’t have a long-term focus? Are incentives in place based on performance criteria to which the employee feels no connection? In either case the perceived value of the reward may be artificially impacted.

Companies can model workforce demand for compensation against different impacts, and the two most identifiable are turnover and productivity. By modeling against turnover, a company is essentially determining the degree to which changes in the rewards mix will drive retention. In certain industries (or companies) experiencing high turnover, this can be a helpful model. On the plus side, modeling against turnover is easier to understand, easier to see, easier to calculate and as a result may be more credible. Its chief shortcomings are two-fold – that 1) Retention is not a great proxy for the more broad-sweeping impact of compensation on an organization and 2) in companies without a significant retention issue, there is little value to the exercise.

Companies can model against productivity. Ideally, this is a better business impact to assess, since both primary outcomes of compensation, deciding to work hard and deciding to remain at the employer,

impact productivity. The problem is determining a model that links compensation to productivity.

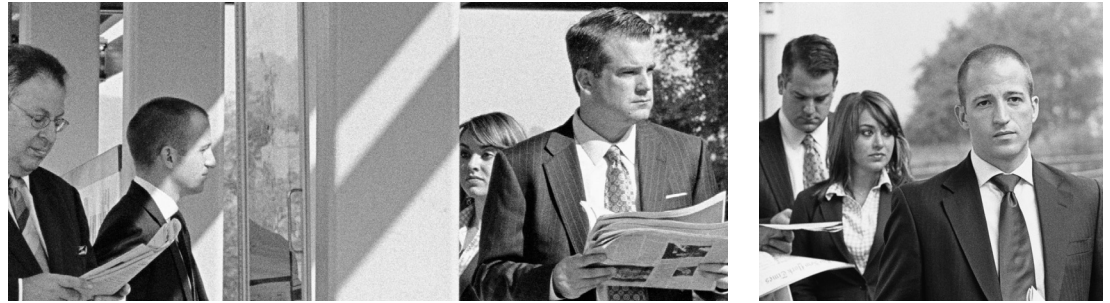
Researching workforce demand

The first technique that Compensation departments must master in order to assess workforce demand is the opinion survey. Due to the ineffectual application of the “employee satisfaction” survey, most HR and Compensation departments view such opinion gathering as “fluff,” and part of the “soft and squishy” that gives HR its reputation for not impacting the business.

In actuality and when done correctly, the opinion survey provides a platform of facts on which to make decisions that rarely exists in HR. It is precisely the opinion survey that the market research department uses to design products, or that presidential candidates use to get elected, for that matter. HR and Compensation departments need to learn how to use this tool correctly.

Changes that need to take place to make the employee survey effective are:

- 1 A dependent variable needs to be created – whether this is a single response or an index of other responses
- 2 Independent variables are only relevant to the degree that they influence the dependent variable. For example, it may not matter that employees are unhappy with being forced to shoulder a greater health care burden if it does not cause them to expect to leave
- 3 Demographic analysis must move beyond simple employee characteristics and must address pivotal employee groups and identify meaningful niches in which change can be driven
- 4 The results must render meaningful, conspicuous action. The survey must be viewed as the first step, not the end



Correctly implemented, the “opinion” survey delivers “facts.” Researching workforce demand relies on an opinion survey, in various forms. Again, the construction and execution of the survey is critical to avoid simply finding out that all employees would like a raise.

To assess employee preferences requires a conjoint analysis oriented survey. These surveys force respondents to make trade-offs among various compensation packages and features, rather than just against some abstract scale. It is not enough to rank these compensation components a 4 on an importance scale of 5. Respondents must determine at what level they would trade base pay for bonus, or health care benefits for 401 (k) match. The beauty of the survey design is that preferences can be determined for both high level compensation programs, and detail-level features (health care deductibles vs. co-payments). Surveys can also be designed to incorporate non-compensation components like improved management, flexible scheduling and career development.

Researching compensation transparency and appropriateness is conducted with a more standard opinion survey. Typically, these questions can be included in the same questionnaire as the conjoint analysis, so that there is only a single survey in the field.

Leveraging workforce demand in compensation planning and design

Once the research base has been established, building the analysis can take many forms, and we’ve outlined one here. As mentioned before, the data must be organized according relevant employee niches, whether that be by job groupings, levels, etc. For each grouping we can determine opportunities to improve compensation mix (based on preferences), transparency, and appropriateness.

From this assessment of improvement opportunities, we can develop various scenarios to better meet

employee compensation requirements. These different alternatives may be designed to have different impacts. One scenario may keep productivity (or turnover) constant, but may decrease the amount spent on employee rewards. Another scenario may keep rewards spending constant and drive higher productivity (or reduced turnover). A third scenario may increase rewards spending with a larger increase in productivity.

Summary

Saratoga believes that strategic HR functions should be focusing on the impact of Compensation programs rather than the competitiveness of the plan. If your organization is not undertaking the steps this article recommends, fear not. First, most companies have not yet taken these steps, so you are not behind the curve. Anecdotally, at a recent compensation conference presentation, only 8 to 10 individuals out of some 200 in attendance said that they have undertaken the type of analysis we outline here.

Second, the tools, techniques and methodologies we recommend are tried and tested. We advocate borrowing the skills that marketing department use to assess what functions to most effectively add to a cell phone, to determine what features to most effectively include in credit card offers. These statistical methods have been developed over the past decade and can be easily adapted to assessing how to pay employees most effectively.

By outlining the steps outlined in this article, organizations use the results to choose to drive rewards-related costs down – the 29 cents or it may choose to drive productivity up – the \$1.

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