

## **Does It Really Matter How Employees Are Paid?**

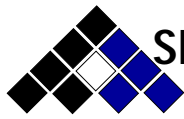
by

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As a compensation expert, I sometimes wonder if it really matters how companies go about paying their employees. Obviously, salaries or wages need to be competitive or a company will have trouble attracting employees in the first place. But, what does it mean to offer “competitive salaries or wages” and what do employees look at to decide if they are satisfied with their total compensation package (salary, bonus, retirement, benefits, and perquisites)? Is this last question complicated by the age of the employees? In other words, would a younger employee be dissatisfied by a package that an older employee would find quite satisfying? This article will attempt to answer these questions concerning the complicated and somewhat confusing topic of employee compensation.

There are fundamental rules that compensation experts assume as they go about their work of helping companies design total compensation programs. The price of labor is driven by supply and demand just like any other resource that a company utilizes. The trend of late has been that the supply of labor is decreasing and the demand is increasing. Basic economics would dictate that the equilibrium price of this resource (labor) increases under such a scenario even beyond inflationary increases. That is exactly the situation that has occurred the last few years, and it is also the trend into the foreseeable future. This fact also partially explains why certain US companies have sought to move some operations overseas to increase the supply of labor or obtain labor at lower costs. This rule suggests that the overall labor environment has much to do with compensation levels.

Another fundamental rule is that employees will always desire a greater total compensation package. The strength of that desire is dependent on how well each employee’s needs are being met by their current total compensation package. If an employee’s needs are close to being met for their chosen lifestyle, they are mostly satisfied with their total compensation package. If their needs are not being met, they will be “out the door” as soon as they find an employment situation that comes closer to meeting their needs. The tricky part of this rule is that needs are different for each employee. Lifestyle expectations tend to peak for employees when they are in their 40’s and early 50’s. Prior to this point in life, employees will somewhat forego a better lifestyle for the promise of career advancement and future earnings. After this time, their children will be out of college and employees tend to settle into a certain lifestyle and begin to focus more on their retirement. All of this seems to suggest that companies would be wise to adjust total compensation packages as their employees progress through their working “lifecycles”. It unfortunately is not that simple as government regulations

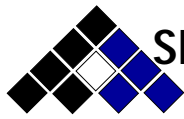


limit the amounts that can be deferred into retirement plans and most companies are limited in how much flexibility they can build into their benefits packages. Some companies offer flexible benefit plans that have different levels or types of health and other insurance coverage. Thus, employees can pick the coverage that most satisfies their needs. This rule suggests that companies should try to provide as much flexibility as possible in their total compensation packages.

What constitutes competitive salaries or an overall competitive compensation structure? The answer is it depends. It depends on the competitive labor environment in which a company operates. There is a current shortage of qualified nurses which has driven salaries for nurses higher. It depends on where a particular company is on its life cycle curve. Contrast two companies on different phases of the life cycle curve. The first company is in the growth portion of the life cycle curve with a need to increase staffing. By necessity, this company needs to put more emphasis on salaries/wages and good benefits to attract greater numbers of employees. The second company is on the mature portion of the life cycle curve with stable staffing levels and a need to drive profitability. As a result this company should strive to keep salaries in check and put in place an incentive compensation plan to motivate employees to obtain high financial performance and a retention plan to ensure that key employees remain with the company.

The competitiveness of a company's compensation structure also depends on the type of business they are in and the make up of the employees. An engineering firm that has highly schooled and skilled employees and where camaraderie among colleagues is important would implement a different total compensation package compared to a company that utilizes mainly low-skilled employees where motivation levels vary greatly among staff members and perhaps many employees are in unions. The best that a company can do is to use relevant industry information from comparable companies to benchmark compensation levels of their employees against industry compensation data. This rule suggests that companies should constantly check compensation levels for their employees against relevant industry data and talk to their employees to understand their level of satisfaction.

There are other fundamental rules about compensation that many companies tend to overlook. Employees not only look at the level of their compensation, but they also look at the compensation equity in the organization. In other words, it is not just the absolute level of compensation that matters; it is also their compensation level in relation to others at the same organizational level or with the same job title. This is particularly true for salaries or wages where the level of compensation is mostly based on job title or responsibilities (even for merit pay systems) and not on organizational or individual performance. There is the classic case of an employee being satisfied with his salary until he finds out that the person sitting in the next office has a higher salary. Employees also view compensation as recognition by their company. An employee that feels under compensated feels that the company does not properly recognize their contribution.



Employees use their compensation level as a score card to indicate how they are progressing in their career. This rule suggests that companies should be careful about determining relative compensation levels for their employees.

If a company's total compensation package has significant differentiation for employees at the same organizational level, there needs to be good reasons for that differentiation and the reasons should be well communicated to the employees. If these reasons are not communicated, the employees will create their own assumptions. I am a firm believer in pay-for-performance. The best performers should receive the best compensation even for employees with the same job title. In these days of tight labor (lower supply and higher demand), high performing employees will not tolerate a compensation structure that does not reward them with the best compensation.

Many companies are reluctant to implement a system that differentiates compensation amounts based on performance. They are concerned that such a system will alienate certain employees. But my question for these companies is who would they be alienating? The answer is that they would probably be alienating the lower performing employees. Total compensation systems should be designed to retain and reward the high performing employees. If lower performing employees are alienated, they should strive to improve their performance or perhaps move on. Such a compensation structure helps to create a "performance culture" at companies. There have been a number of studies that have corroborated the correlation between structured incentive plans that pay employees based on well thought out performance metrics upon which the employees have significant influence and the performance of the company. These studies have shown that good compensation plans result in higher customer satisfaction, more employee engagement, lower turnover, and better company results. The corollary to this is also true that dysfunctional compensation plans often result in dysfunctional organizations and poorer company results.

My clients ask me how to go about creating an effective total compensation program. An effective total compensation program always starts with considerable time spent strategizing by looking at the labor environment, examining the business needs over the foreseeable future, documenting the key performance metrics that define success for the company, looking at the demographics of current and future employees and trying to understand the needs of the various employee groups, and finally by examining the goals and objectives of the company. Too many companies rush to implement a compensation program with inadequate time spent figuring out what type of program is best for the company and the employees. The following questions should be addressed during the initial strategy work on any new total compensation program:

- Are current staffing levels adequate and how will the mix of employees (management vs. non-management, skilled vs. unskilled) change over the next 5 years?



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- Where will our future employees come from? Is the supply of new employees becoming tighter?
- What is the current turnover rate? Is this rate too high?
- Is retaining high performing, key employees a problem?
- What is the desired company financial performance over the next 5 years?
- What are the key performance metrics that define our business success?
- Will our business change over the next 5 years? What will it look like? What are the business goals for the next 5 years?
- Are our employees mostly satisfied with their compensation levels? Are they satisfied with the company benefits?
- Is our company culture changing or do we want a change of culture? Does our culture demand performance from the employees? Do we adequately measure our employee's performance?
- What do our competitor's compensation programs look like?
- What have we learned from exit interviews and interviews of prospective employees?

Compensation planning strives to seek a balance between what is good for the employees and what is good for the company. Understanding the proper balance point is critical. A compensation program that is skewed too far one way or the other will not be effective. Compensation planning should also not be performed in a vacuum. As a first step, talking and listening to the employees will help a company understand what is needed to create an effective program. Only then can the work truly begin on crafting a total compensation package that satisfies all parties.