Arthur J. Gallagher & Co.
BUSINESS WITHOUT BARRIERS™

Pay Decisions:

The Good, The Bad & The Costly

Rewards NW
Professional Growth in Total Rewards

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Shari Dunn, Managing Director

Discussion Outline

- Employee compensation objectives & issues
- Basic requirements
  - Strategic pay philosophy
  - Structural
  - Administrative
  - Communication – content and delivery
- Pay decisions
  - Good
  - Bad
  - Costly

Employee Compensation Objectives

Desired Outcomes	Means
Ability to attract & retain	Competitive pay
Employee satisfaction, Reduced legal liability	Internal pay equity
Cost effectiveness	Managed salary administration
Improved employee performance	Incentive pay

Setting Compensation Plan Goals

- Most important, yet often overlooked, part of compensation management
- Guides development and maintenance of:
  - Wage & salary structure
  - Job classifications
  - Pay administration
- Supports communication

Building Blocks of Pay Strategy

(Deciding What to Link to Pay)

COMPETENCIES
Skills
Knowledge
Abilities
Intelligence

Working with others

BEHAVIORS
Traits
Collaboration
Communication
Leadership
Values

JOBS
Roles
Responsibilities
Activities
Functions
Tasks

RESULTS
Outcomes
Contributions
Productivity
Goal Achievement
Adherence to Standards

Key Compensation Issues

Issues	Conventional Wisdom	More Strategic
Inflation	Grant COLA's	Focus on labor market inflation, not CPI
"Merit" Increases	Grant percentage increases based on merit increase matrix	Make salary increase decisions based on correct pay
Pay for Performance	Define "performance" as a rating of traits, behaviors & competencies	Link pay to achievement of results-based goals

Basic Requirement # 1:

Strategic Pay Philosophy

- Legal compliance and ethical standards
- Whether to link pay to individual:
  - Performance
  - Tenure
  - Potential
- Labor market positioning
- Significance of cash relative to total rewards
- Impact of corporate or organizational success
- Long-term vs. short-term

Base Pay Philosophy

Two Basic Approaches:

1. **Entitlement**: based exclusively on length of service and the passage of time, inflationary salary increases are granted to "keep whole" the employees' earning power.

2. **Market-based:** employer determines, job-by-job, what salaries are required to be competitive with other employers.

Base Pay Philosophy

Outcomes of these Approaches:

1. **Entitlement**: long-tenured employees earn the most, regardless of performance, and often are paid far above market rates, obliterating any internal pay equity and/or cost-effectiveness.

2. **Market-based:** salaries are cost-effectively monitored and adjusted consistent with labor market supply & demand.

Employee Performance: Link to Pay?

- Decide whether base pay should be tied to performance
- Define "performance"
  - Means (skills, competencies, behaviors)
  - Ends (results, outcomes)
- Identify measurement approach
- Establish process parameters
  - Roles
  - Timing

Basic Requirement # 2:
Structural

- Base pay structure
- Job classifications based on:
  - Job-by-job labor market data
  - Internal job relativity
- Target bonus percentages (if used)

Structural Requirements

Determine Relative Internal Job Values

- Knowledge, skills & abilities required
- Supervisory responsibility
- Contacts & working relationships
- Independence of action (decision-making, problem-solving)
- Potential impact on success of company

Job Evaluation – Renewed Importance

- Core component of defining equal, similar, or equivalent jobs
- Job classification indicators:
  - ✓ Relative internal value
  - ✓ Labor market range
- Establish internal values:
  - ✓ Structured input from department/function heads
  - ✓ Current timeframe
  - ✓ Jobs, not people

Internal Job Comparison Outcomes

- Relative job leveling by department/function
- Better than a point-factor system
  - ✓ Simple, focused
  - ✓ Participative
  - ✓ Not absolute
  - ✓ Difficult to manipulate
- Each level is equated to grade in structure based on sample benchmark market data
- Non-benchmark jobs slotted based on internal equivalency

Example

Current Job Title	KSA	Supv.	Contacts	Indep.	Impact	Total
Vice President, Talent Acquisition and Development	10	10	10	10	20	**60**
Senior Human Resources Manager	10	6	10	8	20	**54**
Director, Health & Safety	8	7	10	10	16	**51**
Director, Benefits	10	4	10	10	16	**50**
Director, Divisional Human Resources	10	0	10	8	20	**48**
Employee Relations Manager	6	0	10	5	16	**37**
Manager, Learning and Development	6	7	7	5	10	**35**
Senior Human Resources Systems Analyst	6	4	7	5	10	**32**
Payroll Accountant	6	0	2	10	10	**28**
Recruiter, Call Center	3	0	5	3	10	**21**
Divisional Recruiter	2	0	5	2	10	**19**
Lead Payroll Coordinator	3	4	5	2	4	**18**
Health & Safety Manager	4	0	5	3	4	**16**
Benefits Administrator	3	0	5	2	4	**14**
Training and Communications Specialist	2	0	5	-1	4	**10**
HRIS Coordinator	0	0	5	-1	2	**6**
Payroll Coordinator	0	0	5	-1	2	**6**
Human Resources Administrator	0	0	2	-1	2	**3**

Structural Requirements

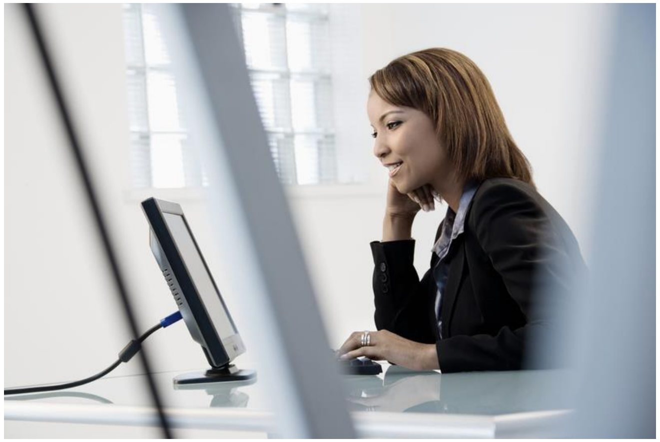
Market Pricing Guidelines

- Multiple surveys, different for different jobs
  - ✓ Industry-specific
  - ✓ Generic
- Data sourced from employers
- Sufficient sample sizes
- Current
- Job descriptions, not just titles
- Ability to match to size, location and industry

Structural Requirements

Job Classification Guidelines

- Consider both internal and external indicators
- Maintain grade difference between levels of supervision
- Do not be influenced by titles
- Review horizontally across departments to pass "smell test"
- Acknowledge that judgment is required



Structural Requirements

Designing a Pay Structure

- Series of progressive job values
- Ranges or single job values (creation of minimums and maximums are usually unnecessary)
- Create optimal number of levels
- Typical difference between levels is 10%
- Structure is designed to accommodate all positions

Structural Requirements

Structures and Administration

Traditional Structures:

- series of overlapping pay ranges
- 10% differences between midpoints
- use of thirds or quartiles
- use of minimums & maximums

Disadvantages:

- reduces control of payroll costs
- communication challenges
- poses difficulties in valuing non-benchmark jobs

Structural Requirements

Structures and Administration

Better Design:

- series of “JOB VALUES” replaces midpoints
- 10% differences between job values
- use of definitive “ideal pay” levels
- no minimums or maximums

Advantages:

- ease of administration
- clear and easy to communicate
- define and achieve pay goals

Basic Requirement # 3:

Administrative

- Designation of decision-makers
- Traditional/textbook practice
  - Position in range
  - Performance rating
- Best practice: scenario identifying “ideal pay”
- Timing considerations
  - Annual entitlement increases
  - Annual salary adjustments
  - Correction of underpay situations

Two Administrative Choices

1. **Manage pay increases (percentages)**

OR

2. **Manage actual salaries**

Typical Merit Increase Guide Chart

(not recommended)

Increase Percentage Guidelines			
Performance	**Position in Range**		
	lower third	**middle third**	**upper third**
Outstanding	**5 – 6 %**	**4 – 5 %**	**3 – 4 %**
Very Good	**4 – 5 %**	**3 – 4 %**	**2 – 3 %**
Good	**3 – 4 %**	**2 – 3 %**	**0 %**
Needs Improvement	**2 – 3 %**	**0 %**	**0 %**
Poor	**0 %**	**0 %**	**0 %**

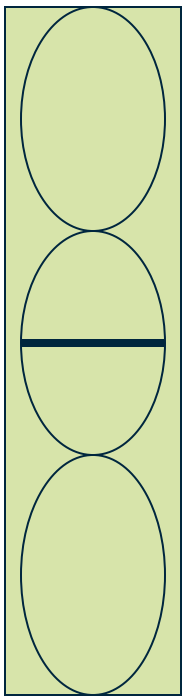
Administrative Requirements

Manage Pay, Not Pay Increases!

- Identify "ideal" base pay for each employee, tied to:
  - value of job (job classification midpoint) *and/or*
  - performance score (rating, goal achievement, etc.)
- Establish systematic pay adjustment scenario
  - target budget for adjustments
  - experiment with alternative scenarios
  - compute individual adjustments

Comparative Anatomy of Salary Ranges

Traditional



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Maximum

top performers

Midpoint

fully competent performers

Minimum

New hires or need to improve

Better Design*

Top Performers

1.10 of Job Value

Excellent Performers

1.05 of Job value

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Good Performers

1.00 of Job Value

New Hires/Development

.90 of Job Value

Need Improvement

.80 of Job Value

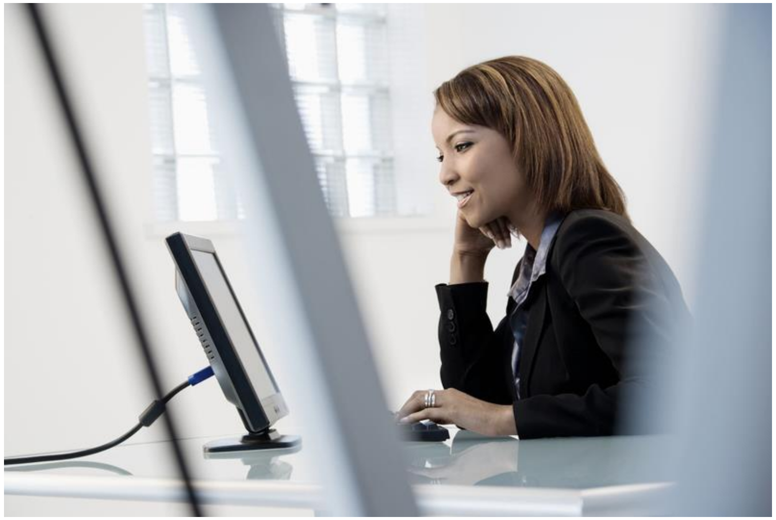
*Example only

Administrative Requirements

Cost Management

Establish how much your company can afford:

- Consider existing budget for increases
- Find out if any discretionary funds are available



Cost Impacts of Pay Mismanagement

- Actual payroll expense
  - unnecessarily high wages and salaries
  - turnover costs resulting from low pay
  - inability to recruit best new hires
- Legal liabilities
  - actual pay inequities illegally based on protected classes *(usually unintentional)*
  - failure to pay required overtime due to exemption status misclassification
- Cost of lost opportunities
  - productivity gains that could otherwise have been realized through payment of incentives
  - loss of talent

Basic Requirement # 4:

Communication: Content

- Employer's pay philosophy
- Manager vs. non-manager messaging
- "Public" messages
  - Whether performance is determinative
  - Basic pay scenario
- Private messages
  - Personalized basis of adjustment (if any)
  - Amount and timing of adjustment
  - Future reference – ways to earn more

Basic Requirement # 4:
Communication: Delivery

- "Public" messages
  - All-employee meeting presentation
  - Webinar
  - Mass e-mail
  - Intranet portal (employee policy section)
- Private messages
  - One-on-one conversation (supervisor/employee)
  - Personalized employee memo
  - HR file documentation

Base Pay Decisions: Types

- Upon hire
- Annual "review" increases
- Promotional increases
- Special equity and/or market adjustments

Big, Costly Assumptions

- Every minimally-performing employee deserves a pay increase every year
- Everyone is already paid just the right amount
- Employers are responsible for keeping employees “whole” relative to the cost-of-living
- It’s all about percentage increases
- Increase amounts symbolize performance differences even if very small, e.g. 1%

Reality

- Salary increases alone rarely reflect the true value of performance
- Large percentages of existing salaries are likely to be too high or too low
- Paternalism (COLA) is no longer feasible
- Focusing on increase percentages simply postpones the pain of dealing with reality
- Most employers need to make big adjustments to the underpaid and zero increases to the overpaid

Good Pay Decisions

- New employees' salaries based on job value
- Base pay adjustments that result in competitive, equitable actual pay levels
- Zero increases to overpaid employees
- Application of performance measures consistently and objectively (if used)
- Adjustments made as timely as affordable

Bad Pay Decisions

- Negotiated new hire pay in consideration of prior compensation
- General increases (peanut butter)
- Cost-of-living adjustments
- Increases based on “merit” increase guide charts
- Un-communicated increases
- Increases to overpaid employees

Costly Pay Decisions

- Increases resulting in too high salaries
- Increases (or lack thereof) resulting in too low salaries
- Individual increases resulting from threats to leave
- Increases to employees with sub-par performance
- Expedient increases with potential negative long-term implications
- Too high or too low salaries upon hire

Thank You

Shari Dunn | Managing Director
Arthur J. Gallagher & Co.
925-298-9233
shari_dunn@ajg.com
www.ajg.com/compensation