INTEGRATING COMPENSATION STRATEGIES: A Holistic Approach to Compensation Design

Thomas J. Hackett
Partner
D.G. McDermott Associates, LLC

Donald G. McDermott
Partner
D.G. McDermott Associates, LLC

In this case study, a company in a high-growth industry successfully used a new integrated incentive compensation program to satisfy strategic concerns and differentiate itself in the marketplace.

We live in an innovative compensation environment in which it has become commonplace for companies to develop ever-new approaches to age-old compensation questions. The result, of course, is a myriad of new compensation designs—from cash incentives to broadbanding to competency-based pay to team incentives, and the list goes on.

It is enough to make compensation professionals look longingly at the "good old days" when it was enough to document jobs, evaluate them and place them in a pay structure that was competitive with the organization's labor market for talent. In today's environment, compensation professionals must choose from a laundry list of compensation possibilities to find the approach that makes the most sense from all perspectives.

This is where the challenge becomes most daunting. Although there has been much written about new compensation innovations as individual programs, there is less frequent discussion of the impact these programs can have when implemented in a piecemeal fashion or even in tandem as part of a strategic compensation design. As a result, compensation professionals often lack experience and insight when making some important choices about when and how to design and implement these types of programs.

Some key questions go unanswered: Which of these compensation approaches or what combination of approaches will satisfy senior management's need for effective and cost-effective compensation programs, while also silencing employee cries for equitable and significant approaches that reward employees for performance? Should these programs exist separately? Can these programs actually work against each other? This article provides some answers to these questions, using a case study to illustrate how one company developed an integrated compensation solution to a potentially crippling human resources problem.

Holistic vs. Piecemeal

Companies must heed some basic but important caveats when developing innovative compensation approaches. First, it is strategically important that companies don't become enamored with the latest and most popular approach to

EXHIBIT 1
Compensation Considerations

Issue	Things to Consider
Business Strategy	Is the compensation approach in sync with the company's five-year strategic plan?
Corporate Culture	If the company is expecting to pay for performance, do managers and employees have the willingness and ability to share the information necessary to improve their performance?
Pay Philosophy	Does the company pay below, at or above market?
Pay for Performance	Is management willing to provide above-market pay for superior performance?
Base Pay	Does the company prefer to pay at market or use a merit approach?
Pay Structure	How will the company structure its pay program—no ranges, traditional ranges or broadbanding?
Variable Pay	Which is most appropriate for the company, individual, group, team or corporate-wide incentives?
Performance Management	Is the company able to develop good job, team, or group performance measures to support any new compensation approach?
Upward mobility/turnover	Is the organization willing to pay a premium to retain highly skilled human capital?
Individual pay programs	Does the nature of the work lend itself to skill- or competency-based pay programs?
Incentive pay delivery	Can the company afford cash incentive programs?
Use of stock	Is the company willing to provide equity-based incentives at lower levels of the organization?

compensation as the answer to their problems. Instead, companies must conduct a thoughtful analysis of their situation and goals and develop the compensation approach that is best suited to help meet those goals. Exhibit 1 lists some key considerations for companies that are developing new compensation programs.

Second, it is also important for organizations to avoid implementing several compensation approaches piecemeal. Without a holistic and strategic approach to compensation design, companies may find that they have developed and implemented compensation programs that motivate behavior that is actually contrary to their ultimate objective of maximizing organizational efficiency and making the most of its human capital. In the end, this approach can leave a company no better or even worse off than it was when it launched the program. Here are some common examples of this phenomenon:

Teams vs. individuals. It is troubling to think about the number of companies that have adopted a team approach to organizing work, only to undermine those teams with the wrong compensation approach. By implementing individual incentive programs in a team environment, these companies often inhibit the willingness of individuals to cooperate with each other. Even poorly conceived and designed team-based incentives can inhibit teams from sharing information with one another if they feel they are competing for incentive dollars. What these companies fail to grasp is that effective group incentives should be tied to overall unit measures that everyone believes they can influence.

Supporting programs. Base pay programs, such as broadbanding, should be implemented with an overall corporate human resources strategy in mind. Broadbanding as a stand-alone system usually doesn't work unless it is actually an overlay to skill- or competency-based pay programs that encourage continuous learning. Companies that implement broadbanding for reasons other than as a means of supporting some other objective, like competency-based pay, often find themselves suffering from salary creep. Here's why. Broadbanding allows a progression within a job family by removing the old barriers to pay increases, such as specific job grade midpoints set at market and a maximum pay rate for a job in a specific grade with a traditional pay grade minimum.

Under a traditional system, job incumbents at maximum could only increase salary by being promoted to the next higher grade range. In a broadbanding approach, those limitations are usually removed. Therefore, if broadbanding is implemented without being supported by a skill- or competency-based pay program to control salary movement on the basis of the incumbent demonstrating increased skills and competencies that justify a higher pay rate, salaries could increase as a matter of course through the annual merit review. Companies may then find that their cost of labor has increased without an increase in human capital contribution.

Even implementing broadbanding and skill- or competency-based pay in tandem may not be enough. Other human resources programs often have to change to support the overall goals of broadbanding and skill- or competency-based pay. For example, for continuous learning to occur, skill- and competency-based pay programs must be supported by adequate training and development budgets.

Sending consistent messages. Annual merit budgets within an organization that heavily emphasizes incentives can send employees conflicting messages by reinforcing an entitlement mentality of expecting an annual salary adjustment. That mentality can take the focus off rewards for performance improvements through incentive pay. If an organization wishes to move to a variable pay compensation system that truly rewards for annual performance, then salary adjustments should only be based on either market movement or promotions to a higher job category.

An Integrated Approach

If these are the don'ts involved in developing an appropriate compensation approach, what are the dos that will help compensation professionals develop a program that will meet company and management goals and ensure that the company is paying for performance? That was the challenge facing HomeBuilder, Inc. (a pseudonym), a publicly traded national company that develops residential properties, including single and multiple family homes, condominiums and whole communities.

The company developed an integrated compensation approach using several innovative programs to create an overall compensation design that not only pays for performance, but also supports the company's business strategy. In this situation, the key to success was the company's ability to step back and decide how to use pay programs to support business strategy. Then, the company built an integrated compensation program that drives organizational success. In the process, the company realized two important things: (1) No one program would address all its needs and (2) it was critical that the company develop multiple programs in tandem to make sure they complemented each other and supported the company's ultimate goal.

But it had not always been that way. In the past, HomeBuilder's compensation approach had been built around an annual incentive formula based on overall corporate profitability. The company fed its talent pool by recruiting new college graduates into its associates program and developing them to become builders. The associates started out as technicians and were supposed to progress to superintendents, administrators and eventually to builders. The highest position in the home-building hierarchy is the Regional Vice President who manages multiple communities.

Unfortunately, a few years ago, that approach began to show signs of strain. The company was facing increasing pressure from competitors who were raiding the company of its future talent. Entry-level associates were being recruited away just as they were maturing and ready to assume greater levels of responsibility. Base pay was not the only attraction that lured the best talent away from the company. Competitors offered potentially faster promotions and greater incentive opportunities than those available at HomeBuilder, Inc. Exit interviews revealed that the associates were frustrated with the promotional process. It seemed to take too long and there was a lack of consistency in determining what qualifications were necessary to be promoted to the next level. Finally, annual incentive awards at the associate level were not only based on a superintendent's discretion but also seemed to be arbitrary to the associates.

The net result of all this was that HomeBuilder, Inc., in effect, had become the training center for the industry. Growing defections among the associate ranks were sabotaging the company's longer term strategy to build human capital superior to its competitors. The company's goal was to have a reputation for building quality residences, on time and well within budgets. If it was successful in that goal, both its reputation in the marketplace, and the potential for its stock to appreciate in value would be assured. With that in mind, the company began looking for ways to reverse the tide of associate defections.

Finding The Solution

Recognizing the importance of finding a solution to this problem, HomeBuilder's senior management appointed a task force to address these problems. The task force consisted of first-line construction management personnel (vice presidents and builders) and Human Resources management, including representatives from training and development and compensation.

A competency-based approach. The task force's first step was to identify the skills and competency requirements for each position in the home building hierarchy. The ultimate goal of this exercise was to identify career progression opportunities that associates could understand. The rationale was that if the company could develop a system that provided associates with more direct control over their own upward mobility, the company could solve its turnover problem.

Even though identifying, defining and deciding how to measure competencies was tedious and time consuming, the outcome was a clearly defined set of competencies for each job category, as well as formal and informal ways to measure the demonstration of those competencies. Those competencies that associates could develop through training and testing were integrated into formal training programs. Skills that could only be measured through on-the-job performance were integrated into the annual performance reviews for each job category with corresponding qualifying standards of performance for the specific skill.

Next, the task force divided each job category into three levels: low (I), intermediate (II) and high (III). This way, each job category, such as superintendent, has three levels, each with its own set of discrete competencies. An associate knew exactly which competencies had to be mastered to be able to move from one level to the next. They also knew exactly what would be required to be promoted from one category to another.

Support for training. But having these distinct competencies would be of little use unless associates had access to the training resources necessary to move from one level to the next. Therefore, the task force's representatives from the Training and Development department came up with two training options for associates. Associates could (1) attend and pass identified formal in-house training courses, (2) find ways to demonstrate skills developed through on-the-job training, or (3) some combination of the two. Whatever approach they took, associates had to find a way to qualify for each level within each job category in order to move up in the career progression.

It is important to note that HomeBuilder backed up this competency-based approach to pay and career development by increasing its training budget to accommodate additional training courses. It also modified its educational reimbursement policy to include skills development seminars in addition to college-level courses. Without this willingness to invest in training, it is doubtful that the competency-based approach would have made much of an impact on associate development, satisfaction or retention.

The company backed up the pay program with additional training.

Changing the compensation structure. Once the competency-based approach to career progression was in place, the HomeBuilder task force turned its attention to developing a supporting pay structure. The first step was to conduct a market study of the subject positions and determine "going rates" for each job category in the hierarchy.

Next, to maximize flexibility, the task force used these going rates to develop salary bands. This broadbanding structure allowed for mobility within each job category, as well as substantial salary increases when an associate qualified to be promoted from one band (category) to the next higher one. The bands were developed to provide for ever increasing minimum-to-maximum band range spreads going up the hierarchy of jobs categories.

For example, the band for the technician category had a range spread of 50%, while the builder band had a range spread of 100%. The wide range spreads were necessary to accommodate movement within each job category. Since the intermediate level (II) for each category was set at market, incumbents at the Level I were paid a base salary below market. Incumbents at Level III were paid above market for mastering all the competencies required of the job category.

Allowing for adjustments. The bands also allowed for all incumbents within each category to be eligible for annual merit reviews based on the performance of the level of the job category they were in. This approach was intended to ease associates' passage through each job category. The task force estimated that it would take an average of 18 months for associates to master the skills and competency requirements for movement to the next level in a job category. Thanks to this approach, associates would be less likely to feel that their salaries had stagnated while they were learning the skills necessary for intra-category movement.

As they mastered the competencies necessary to move to the next level within the job category, associates were also eligible for an additional adjustment to bring their salaries to the "minimum" of the next level, if necessary. For example, a technician Level II who mastered all the competencies required to be moved to Level III was eligible to receive a salary adjustment to the minimum of Level III if his or her current salary was below that minimum. The compensation design provided for additional incentive to master the competencies required to be moved to the next highest level.

Overall, this structure had immediate tangible benefits for everyone in the company. For their part, managers and supervisors had a definitive set of guidelines for appraising individual performance each year. And for associates, the new program provided clear communication and signals about what they had to do to get to the next level and what they had to do to be promoted to the next highest job category. The structure also did not impose artificial limits. For example, there were no limits placed on the number of staff who could be in each category below the Vice President level.

The incentive component. With a career progression and base pay structure in place, the task force was able to turn its attention to a pay-for-performance component of the overall compensation package. To do this, the task force decided to make all associates eligible for incentive pay. However, to distinguish the new incentive from the previous incentive program, the company revised the incentive formula to provide an annual incentive pool based on overall company profitability. Because everyone in the home-building career path influenced product costs, schedules, and customer service, it made sense to include everyone in the annual incentive program. Target incentive amounts were developed for each level within each job category. Thus, incumbents at the intermediate level (II) within each category who performed well could receive total cash compensation (base salary plus bonus) greater than the market rate, assuming the company achieved its annual profit targets.

The new structure has tangible benefits for everyone.

Results

Although it took HomeBuilder almost a year to develop this new approach to compensation and career development, the company felt the program's effects much sooner. (See Exhibit 2 for a before-and-after comparison of HomeBuilder's compensation approach. Exhibit 3 illustrates the layers involved in HomeBuilder's approach to integrated compensation.) In fact, turnover diminished while the company was working on the new compensation and career development program because associates felt that the company was finally addressing their concerns.

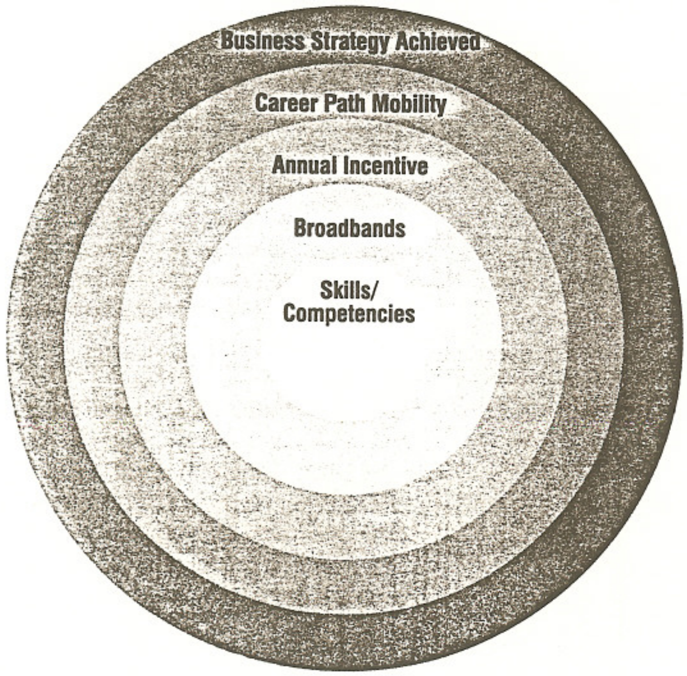
When the program was rolled out, associates were enthusiastic about the possibilities it presented, not only in the potential for additional compensation but for the potential for taking control of their own career development. Through their own efforts, associates could affect the level of their annual merit increase, annual incentive, progress through the job category band and, eventually, how fast they would be promoted. By taking responsibility for developing the required skills and competencies, associates could influence their career growth within the company. The ball was firmly in the associates' court and the associates were eager to play.

continued on page 42

EXHIBIT 2
Out with the Old and in with the New
HomeBuilder: Before and After

	The Old Approach	The New Approach
Career progression	Associates frustrated with a promotional process that took too long and lacked consistency in determining necessary qualifications for promotions.	New competency-based structure provides clearly defined set of competencies for each job category, and formal and informal ways to measure the demonstration of those competencies. Each job category has three levels, each with its own set of discrete competencies. Associates now know exactly which competencies to master in order to move to the next level or to be promoted to the next job category.
Supporting programs	Training not tied to skills and abilities needed to get promoted.	Two training options provide formal in-house training courses and on-the-job training. The training budget increased to accommodate additional training courses. Educational reimbursement policy was also modified to include skills development seminars and college-level courses.
Base pay structure	The annual merit increase was based on arbitrary performance standards.	A broadbanding structure provided substantial salary increases for promotions from one band (category) to the next. There are ever increasing minimum-to-maximum band range spreads throughout the hierarchy of job categories to accommodate movement within each job category.
Adjustments	Job progression and promotions were haphazard and pay inequities occurred.	Associates eligible for annual merit reviews to keep pay competitive as associates worked through each job category. Associates also eligible for an additional adjustment to bring their salaries to the minimum of the next job level, if necessary.
Incentives	Awards were not as rich as competitors, were based on supervisors' discretion and seemed arbitrary.	All associates eligible for incentive with a formula based on overall company profitability. Each level within each job category has its own target incentive amounts.
Results	Associates found compensation and career progression decisions arbitrary and out of their control. The result was high turnover among associates, who left to join competitors.	Associates were excited about the program, the company's willingness to address their concerns and their ability to impact their own compensation and career progression. Turnover dropped even before the program was rolled out and dropped further once the program was in place.

EXHIBIT 3
Using An Integrated Approach to Effect Change



continued from page 40

Learning from HomeBuilder's Experience

Although each company's situation is different, there are some important lessons to learn from HomeBuilder's experience. By integrating merit pay, competency-based pay, broadbanding, career paths and an annual incentive eligibility, HomeBuilder developed a compensation program that satisfied several strategic concerns simultaneously. It not only empowered employees, it gave the company a system for ensuring that its human capital was constantly being developed.

This, in turn, provided HomeBuilder with the edge it desired to differentiate itself in the marketplace. The most obvious and immediate improvement was the cost savings realized through reduced turnover. Then, as the company was able to retain enough qualified staff, it could more easily complete jobs on time and within budget. With a more stable and productive work force, the company could commit to bringing more building projects into the pipeline without worrying about its ability to deliver those projects on time and within cost budgets.

This increased project efficiency had an important impact on the company's bottom line because the faster a project was completed, the faster the housing units could be sold. This, in addition to better cost containment, helped HomeBuilder realize its projected profit margins. The overall result was to increase the company's reputation in the marketplace and assure investors that the company would continue to grow.

It is important to remember, however, that what worked for HomeBuilder is not likely to work for every company. Therefore, compensation professionals must not yield to the pressure to implement the latest popular pay program. Instead, they need to pick and choose those that make the most sense for the company's long-term strategic goals. Even in today's tight labor markets where there is ever-increasing pressure to provide the most popular pay programs, like annual incentives, competency-based pay, and broadbands, to attract the best talent, such programs should be part of an overall human resources strategy.

Moreover, the myriad of design options give compensation professionals an opportunity to integrate several pay techniques in ways that will best support the overall business strategy of the organization while at the same time ensuring that employees are being paid for measurable performance. Compensation professionals must first encourage management to communicate specifically what the five-year business plan is and then step back and think through how the compensation plan can be designed to support the achievement of the plan, not to work against it.

And finally, it is critical for companies to identify the problems they need to address, the goals they want to pursue and the needs of their work forces before developing any compensation approach. Only then can a company expect to