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Is It Time for Your Compensation Philosophy to Evolve? We Think So.

As issues like gender pay equity and pay transparency grow in prominence, a number of companies are beginning to rethink how they describe their approach to setting pay.

If you read your way through thousands of proxy statements a year, as our team does, you'll soon discover that most compensation philosophies sound pretty much the same. By and large, they include boilerplate language about linking pay and performance, managing risk and reward, aligning executive and shareholder interests, and targeting pay at or above the market 50th percentile to attract and retain key talent. While there's nothing wrong with these important aims— all of which remain highly relevant— they do little to reflect a seismic shift taking place in society and the marketplace for talent related to gender pay equity and pay transparency. In our view, these new forces will eventually compel companies to rethink and rewrite their compensation philosophies.

Why is Change Coming?

Traditional compensation philosophies, filled with terms like pay for performance, market competiveness and shareholder alignment, are largely written to satisfy the expectations of executives and investors. They are market-oriented statements centered on making the case that rewards programs are efficiently designed to achieve corporate goals. And over the past 10 years, the arrival of enhanced executive compensation disclosure requirements and Say-on-Pay votes under Dodd-Frank has only served to justify this approach.

However, most compensation philosophies, outside of promising market-aligned pay, do very little to speak to managers, broad-based employees and consumers. While there are exceptions, it's rare to find compensation philosophies that explicitly discuss aligning pay with corporate values, a desire to ensure pay decisions are made fairly, and a need for employees to have a transparent understanding for how pay decisions are made relative to performance, talent assessments and career development goals.

In other words, most compensation philosophies address business and shareholder expectations, but neglect those of employees and consumers. This is a rather glaring omission in today's business environment where companies and executives, like it or not, are routinely expected to take clear stands on a wide variety of culturally- and politically-charged issues. As calls for greater pay transparency grow louder, and pay equity laws spread to new states and countries, it is only a matter of time before companies are called out by consumers, employees and investors for failing to mention these emergent issues in the very places designed to set the tone for how pay decisions are made— compensation philosophies.

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What Might Change Look Like?

To illustrate the stark divide between where most compensation philosophies are today and where they might head in the future, Figure 1 compares two generic compensation philosophy statements we've stitched together from multiple company sources. The statement on the left reflects traditional compensation philosophies found at the vast majority of companies and the statement on the right reflects more progressive language found at a small but growing number of companies, especially in the technology sector.

Figure 1

Sample Current and Future State Compensation Philosophies

Current State	Potential Future State
We seek to create a highly competitive total rewards program that attracts, retains and motivates high-quality talent using a balance of base salary and short- and long-term incentives aligned to key business goals. Our pay programs also aim to foster a strong pay-for-performance culture that drives exceptional shareholder value while appropriately balancing risk and reward. To achieve these goals, we align cash compensation, comprised of base pay and annual incentives, to the 50th percentile of the market and equity compensation, comprised of restricted stock units and performance-based stock units, to the 65th percentile of the market.	We seek to pay all of our employees fairly, balancing a wide variety of important internal and external factors aligned to our company culture and values. These factors include internal pay equity for employees in similar roles at similar levels, external market competitiveness, strong links between pay and performance, and key individual characteristics that we ask all employees to emphasize, such as skills development and managing people and projects in alignment with our cultural expectations. We also seek to make compensation decisions in a transparent and consistent manner, which is well-understood by all employees.

We recognize the statement on the right may strike many readers as a bit far-fetched, and in the short-term, this may be true. However, we also challenge readers to imagine how each statement might play with employees, consumers and investors one, two and three years from now. As societal and legal expectations around gender pay equity and pay transparency continue to grow, it becomes easier and easier to envision a world where companies shifting their approach to include more and more of the language found in our future state example. Similarly, one can imagine the language on the left feeling increasingly out of touch.

Importantly, while we've presented the two examples above as stark contrasts in style and tone (for added effect), this is not really an either/or situation. Change can be incremental. As we noted in the introduction of this article, linking pay and performance, managing risk and reward, aligning executive and shareholder interests, and targeting pay at or above the market 50th percentile to attract and retain key talent all remain very important and relevant. Therefore, we encourage companies to find ways to appropriately layer-on discussions of fairness, transparency and cultural alignment to the existing pillars of their compensation philosophy to create a more balanced approach to pay decisions, considering both external and internal perspectives.

How Should Your Company Approach Change?

Above all else, companies must remember to be authentic when approaching the issues of pay equity and pay transparency. The only thing worse than ignoring fairness and transparency is pretending to be fair and transparent when you are not. This means your compensation philosophy should not change until you have the policies and practices in place to actually deliver on your stated goals.

As a potential starting point, once you begin to conduct annual gender pay equity assessments, it may be worthwhile to add a sentence or two to your existing compensation philosophy mentioning the fact that pay equity analyses are now an additional factor considered in pay decisions across your organization. From there, your compensation philosophy can continue to evolve at a measured pace in tandem with your pay practices. Importantly, this also means your compensation philosophy must become a living and breathing document that you review annually.

However, for companies interested in pursuing change at a faster rate, the best way to start is by finding out what you actually pay for today. This typically requires a multi-variable regression analysis across numerous factors to determine what really drives pay outcomes for your people. For example, just because you have a merit matrix and a bonus plan with an individual component doesn't mean pay-for-performance outcomes are consistent across your organization. Too much manager discretion could be getting in the way. We recommend following a three step process to accelerate change:

1. **Soul Search:** What does your compensation philosophy say today and what do you ideally want it to say in the future?

2. **Theory vs. Practice:** Conduct a detailed analysis on the real drivers of pay within your organization. How well does your current reality align with your stated goals today and your desired goals in the future?

3. **Execute Change:** Once you know the real drivers of pay within your organization, you'll be empowered to double down on what's working, eliminate what is not and add new drivers of pay.

Finally, and continuing with the theme of authenticity, your compensation philosophy should always remain tightly linked to your company culture and values. For example, if your company thrives on a highly competitive pay-for-performance culture, this shouldn't be deemphasized in your compensation philosophy simply because other issues are rising in prominence. The key is to balance the existing approaches to pay that work well for your organization against changing standards and norms around pay equity and transparency.

To learn more about how our compensation consulting group can help you rethink your compensation philosophy and evolve other elements of your talent and rewards programs, write to consulting@radford.com.

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