

11

Total Rewards and Compensation

After you have read this chapter, you should be able to:

- Identify the three general components of total rewards and give examples of each.
- Discuss four compensation system design issues.
- List the basic provisions of the Fair Labor Standards Act (FLSA).
- Outline the process of building a base pay system.
- Describe the two means of valuing jobs.
- Explain two ways individual pay increases are determined.

Rewarding Employees to Encourage Positive Behaviors



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A recent interview with Steve Kerr, author of the popular article “On the Folly of Rewarding A While Hoping for B,” indicated that companies often fail to properly implement positive compensation approaches. This is because active steps are not taken to make sure that rewards prompt the kinds of behaviors the company wants to see. According to Kerr, the employer has to find a way to measure job performance so that productivity can be properly supported with adequate rewards and other compensation. Companies also have to articulate what levels of performance are expected in different jobs,

especially given that many types of work present ambiguous definitions about what is “good” and “bad” performance. In addition, top leadership needs to determine how to break down mission statements in a manner that enables employees to understand how their behaviors can support the accomplishment of corporate objectives.¹

Given Kerr’s insightful comments, HR professionals need to better identify the types of behaviors that reward systems are promoting. HR professionals also need to create comprehensive compensation programs that motivate the kinds of actions needed to help organizations prosper and grow. By explicitly linking fair compensation to positive employee behaviors, companies can expect to see increased individual satisfaction and job performance.

In order to remain competitive, companies need to develop reward packages that satisfy people. These reward packages, commonly known as **total rewards**, include all the monetary and nonmonetary rewards provided by a company to attract, motivate, and retain employees. The success of a pay system depends on linking organizational objectives and strategies to compensation so that individuals are encouraged to work in a manner that benefits the company and its stakeholders. For example, Forensic Technology, a Canadian firm specializing in weapons and ballistic identification, recently improved employee retention and engagement by connecting the rewards program to broad strategic goals focusing on social responsibility, improving business operations, and becoming a valued employer.²

Critical to an effective total rewards approach to pay is the need to balance the interests and costs of the employers with the needs and expectations of employees. This can be a difficult process. On the one hand, employee payroll and benefits represent a large portion of total operating costs in some industries such as financial services, health care, education, and hospitality. On the other hand, recent surveys suggest that there is growing concern among HR professionals that total rewards programs can be used more effectively to obtain good talent in organizations, and that these programs should be more clearly communicated to employees.³ Effective management of total rewards can be accomplished by evaluating expenses and determining the value of compensation. An optimal relationship between costs and employee impact must be achieved while considering many financial and operational factors.⁴

Additionally, the concept of total rewards requires a much broader understanding of pay or compensation than has traditionally occurred in business organizations. The total rewards concept emphasizes *both* indirect and direct compensation, which strengthens a company's ability to motivate employees, particularly in challenging financial situations such as those sometimes faced by companies.⁵ Indeed, a lagging economy will likely require employers to make calculated adjustments to total rewards to reflect new business conditions.⁶ Emphasizing nonmonetary rewards such as training and development,

work-life programs, employee recognition, and career management should enable companies to remain competitive from an employment perspective despite decreasing compensation budgets.⁷ Broadly defining compensation should also help companies develop creative policies that keep employees motivated. Examples include bringing pets to work at Google, providing day-care support at Nordstrom, and honoring “your special blend” at Starbucks.⁸



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NATURE OF TOTAL REWARDS AND COMPENSATION

Because so many organizational funds are spent on employees, top management and HR executives should match total rewards systems and practices with what the organization is trying to accomplish. To do so, several decisions must be made:

- Legal compliance with all appropriate laws and regulations
- Cost-effectiveness for the organization
- Internal, external, and individual equity for employees
- Performance enhancement for the organization

Total rewards Monetary and nonmonetary rewards provided by companies to attract, motivate, and retain employees.

- Performance recognition and talent management for employees
- Enhanced recruitment, involvement, and retention of employees

Employers must balance their costs at a level that rewards employees sufficiently for their knowledge, skills, abilities, and performance accomplishments. During the past several years, total rewards have been a significant focus in HR, and different frameworks have been developed.⁹ One prominent approach has been developed by *WorldatWork*, a leading professional association that focuses on compensation.¹⁰ The model shows how a company's strategic and cultural characteristics influence various elements of compensation such as work-life, recognition, and career development—all of which ultimately strengthen the positive nature of the employment relationship and generate increased business performance.¹¹

To combine several leading approaches into a simplified view, Figure 11-1 identifies three primary groups. What the figure illustrates is that total rewards must be seen more broadly than just compensation and benefits. The importance of performance management and talent management has been discussed in detail in the previous two chapters. The focus of the next three chapters is on compensation, variable pay, and benefits.

The development of viable total reward programs containing the critical elements specified in Figure 11-1 requires companies to evaluate policies on a regular basis. After assessing current compensation paradigms using a variety of methodologies, new approaches that better reflect current demands must be developed and put into action. Finally, these new programs should be evaluated over time to determine relative effectiveness, as well as the impact on employee satisfaction.¹² The relationship between organizational culture and pay policy needs to be particularly recognized during these steps because compensation should support and complement a firm's current business values and practices.¹³

FIGURE 11-1

Total Rewards Components



Types of Compensation

One of the distinctions not formally a part of Figure 11-1 is that rewards can be either intrinsic or extrinsic. *Intrinsic rewards* may include praise for completing a project or meeting performance objectives. Other psychological and social forms of compensation also reflect intrinsic type of rewards. *Extrinsic rewards* are tangible and take both monetary and nonmonetary forms. One tangible component of a compensation program is *direct compensation*, whereby the employer provides monetary rewards for work done and performance results achieved. *Base pay* and *variable pay* are the most common forms of direct compensation. The most common indirect compensation is employee *benefits*.

Base Pay The basic compensation that an employee receives, usually as a wage or a salary, is called **base pay**. Many organizations use two base pay categories, *hourly* and *salaried*, which are identified according to the way pay is distributed and the nature of the jobs. Hourly pay is the most common means and is based on time.

Employees paid hourly receive **wages**, which are payments calculated based on time worked. In contrast, people paid **salaries** receive the same payment each period regardless of the number of hours worked. Being paid a salary has typically carried higher status for employees than has being paid a wage. However, overtime may have to be paid to certain salaried employees as well as most wage earners as defined by federal and state laws.

Base pay Basic compensation that an employee receives, usually as a wage or salary.

Wages Payments calculated directly from the amount of time worked by employees.

Salaries Consistent payments made each period regardless of the number of hours worked.

Variable pay Compensation linked directly to individual, team, or organizational performance.

Benefit Indirect reward given to an employee or group of employees as part of membership in the organization.

Entitlement philosophy Assumes that individuals who have worked another year are entitled to pay increases, with little regard for performance differences.

Variable Pay Another type of direct pay is **variable pay**, which is compensation linked directly to individual, team, or organizational performance. The most common types of variable pay for most employees are bonuses and incentive program payments. Executives often receive longer-term rewards such as stock options. There is reason to believe that performance-based policies for rewarding top managers that link equity-based incentives to performance are effective. Some companies such as Best Buy and Kimberly Clark are already using such programs.¹⁴ Variable pay, including executive compensation, is discussed in Chapter 12.

Benefits Many organizations provide rewards in an indirect manner. With indirect compensation, employees receive the tangible value of the rewards without receiving actual cash. A **benefit** is a reward—for instance, health insurance, vacation pay, or a retirement pension—given to an employee or a group of employees for organizational membership, regardless of performance. Often employees do not directly pay for all of the benefits they receive. Benefits are discussed in Chapter 13.

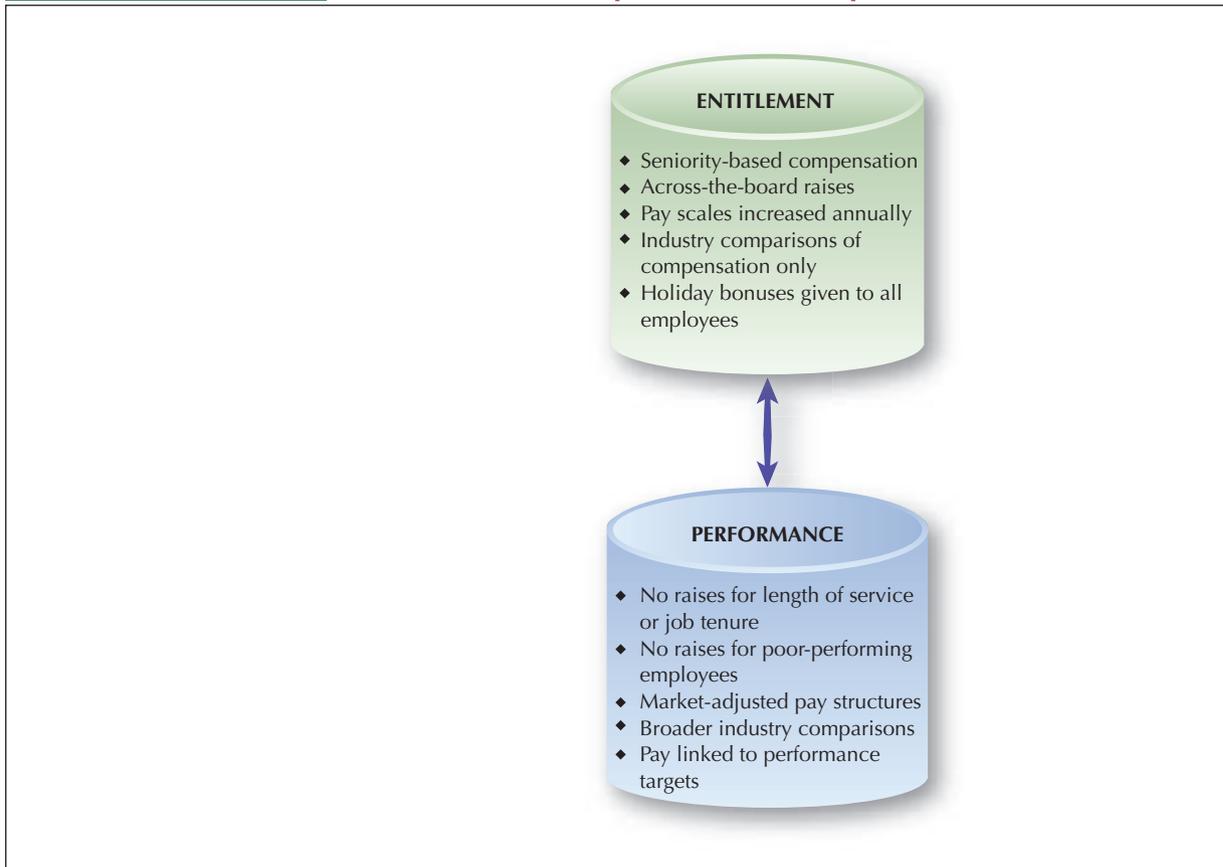
Compensation Philosophies

Two basic compensation philosophies lie on opposite ends of a continuum, as shown in Figure 11-2. At one end of the continuum is the *entitlement* philosophy; at the other end is the *performance* philosophy. Most compensation systems fall somewhere in between these two extremes.

Entitlement Philosophy The **entitlement philosophy** assumes that individuals who have worked another year are entitled to pay increases, with little regard for performance differences. Many traditional organizations that give

FIGURE 11-2

Continuum of Compensation Philosophies



automatic increases to their employees every year are practicing the entitlement philosophy. These automatic increases are often referred to as *cost-of-living raises*, even if they are not tied specifically to economic indicators. Further, most of those employees receive the same or nearly the same percentage increase each year. One of the challenges associated with cost-of-living increases is that employees are given the same adjustments without any regard for performance, a process that can undermine the purpose of compensation.¹⁵ As such, bonuses in many entitlement-oriented organizations are determined in a manner that often fails to reflect operating results. Employees “expect” the bonuses, which become another form of entitlement.

Performance Philosophy A **pay-for-performance philosophy** requires that compensation changes reflect performance differences. Organizations operating under this philosophy do not guarantee additional or increased compensation simply for completing another year of organizational service. Instead, they structure pay and incentives to reflect performance differences among employees. Employees who perform satisfactorily maintain or advance their compensation levels more than marginal performers. The bonuses and incentives are based on individual, group, and/or organizational performance.

Few organizations totally follow all performance-oriented compensation practices, but the overall trend is toward greater use of pay-for-performance systems, with more and more companies turning to performance criteria to shape rewards for all employees.¹⁶ Such plans may help to reduce employee

Pay-for-performance philosophy Requires that compensation changes reflect performance differences.

Using Rewards to Effectively Develop Talent



Even though the recent downturn in the economy has given companies some leverage when attracting and retaining employees, it is still in employers' best interests to link together pay strategies and talent management approaches in a manner that best satisfies workers. A research study determined that combining these two HR functions can pay large dividends when it comes to managing the employment environment. In fact, evidence suggests that linking compensation with talent management can increase a firm's ability to encourage people to seek employment in the company, as well as retain them once they are hired.

The key to this process is developing an "employee value proposition," demonstrating the combined benefits received by working for an organization. Another key is human resource planning that clearly shows how the organization must support its business

goals with HR programs such as talent and rewards administration. Finally, companies should evaluate the effectiveness of the reward programs offered to employees, which should include assessments of market position, competitiveness, and the use of performance-based pay.

Evaluating base pay is particularly important because employees value this component of compensation above many others, and it is critical that base pay be competitive so that the firm can retain high-performing individuals. Incentive pay is also important because it reinforces the kinds of performance that directly support corporate goals, and companies should not ignore the benefits of recognition compensation because these incentives are more immediate in nature. All of these components of compensation enable the company to more effectively manage talent.¹⁷

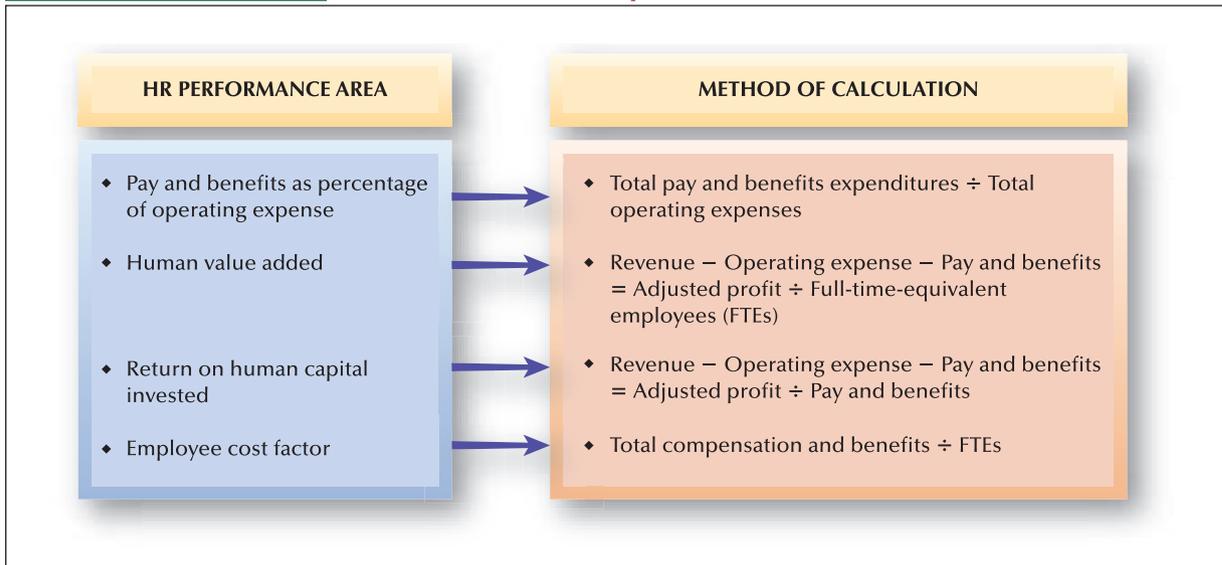
turnover and increase employee commitment, motivation, and retention.¹⁸ However, performance-based plans need to be evaluated periodically to determine whether performance is being fairly measured and linked to rewards.¹⁹ Also, merit- and performance-based systems do not always lead to increased employee performance because of inappropriate pay differentials, equity concerns, and poor teamwork. As a result, some organizations might consider using more group-based plans.²⁰

The total rewards approach reflects a more performance-oriented philosophy because it tends to place more value on individuals' performance, rather than just paying them based on having a job. When determining compensation, managers consider elements such as how much an employee knows or how competent an employee is. Some organizations use both compensation and variable pay programs as part of a total rewards approach for all levels of employees. Widespread use of various incentive plans, team bonuses, organizational gainsharing programs, and other designs links growth in compensation and variable pay to results.

Regularly communicating to employees and managers the compensation philosophy helps to reinforce the organizational commitment to it.²¹ A recent study found that communication of profit-sharing information increased knowledge, which influenced commitment and satisfaction.²² Communication also can enhance understanding and perceptions of pay policies, encouraging greater generalized pay satisfaction and career development.²³ Finally, establishing a dialogue with employees about total rewards enables them to be more involved with the development of pay systems that enhance talent and return on investment.²⁴ A company's compensation philosophy can be used to develop individual talent in an organization, a strategy covered in the HR Best Practices.

FIGURE 11-3

HR Metrics for Compensation



HR Metrics and Compensation

Employers spend huge amounts of money for employee compensation. Just like any other area of cost, compensation expenditures should be evaluated to determine their effectiveness. Many measures can be used to do this.²⁵ Employee turnover/retention is one widely used factor. It assumes that how well compensation systems operate affects employees' decisions about staying or leaving the organization. Other more specific measures are used as well, such as the ones shown in Figure 11-3.²⁶

The numbers for calculating various measures are readily available to most HR professionals and chief financial officers, but such calculations are not made in many firms. Often the importance of using these numbers is not a priority for managers or CFOs. Ideally, compensation metrics should be computed each year, and then compared with metrics from past years to show how the rate of compensation changes compares with the rate of changes in the organization overall (revenues, expenses, etc.).

Compensation Responsibilities

To administer compensation expenditures wisely, HR specialists and operating managers must work together. A typical division of compensation responsibilities is illustrated in Figure 11-4. HR specialists guide the development and administration of an organizational compensation system and conduct job evaluations and wage surveys. Also, because of the complexity involved, HR specialists typically assume responsibility for developing base pay programs and salary structures and policies. HR specialists may or may not do actual payroll processing. This labor-intensive responsibility is typically among the first to be outsourced. Operating managers evaluate the performance of employees and consider their performance when deciding compensation increases within the policies and guidelines established by the HR unit and upper management.

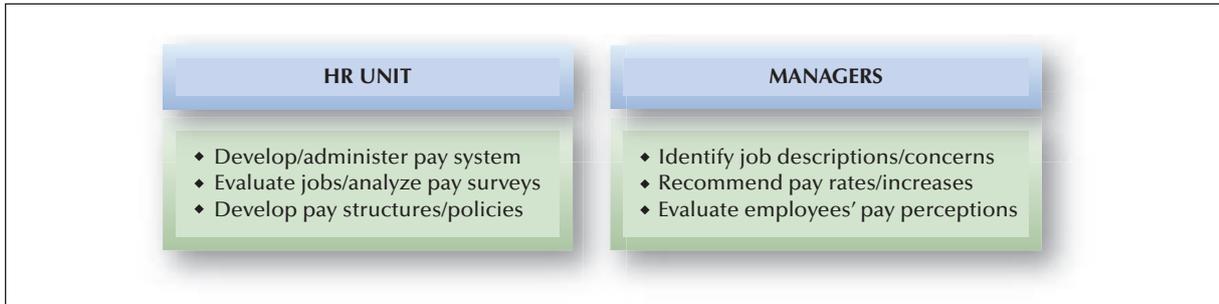


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FIGURE 11-4

Typical Division of Compensation Responsibilities in HR



COMPENSATION SYSTEM DESIGN ISSUES

Depending on the compensation philosophies, strategies, and approaches identified for an organization, a number of decisions are made that affect the design of the compensation system. Some important ones are highlighted next.

Compensation Fairness and Equity

Most people in organizations work to gain money for their efforts. Whether employees receive base pay or variable pay, the extent to which they perceive their compensation to be fair often affects their performance, how they view their jobs, and their employers. This factor may lead to lower or higher turnover rates. Pay satisfaction also has been found to be linked to organizational-level performance outcomes.²⁷

Equity The perceived fairness of what a person does (inputs) and what the person receives (outcomes) is called **equity**. Individuals judge equity in compensation by comparing their input (effort and performance) against the effort and performance of others and against the outcomes (the rewards received). These comparisons are personal and are based on individual perceptions, not just facts. A study by Salary.com found that almost 60% of the workers surveyed believed they were underpaid. But according to reviews of compensation databases, less than 20% were actually underpaid.²⁸ These findings illustrate how the perceptions of individuals are critical in how equity is viewed.

External Equity If an employer does not provide pay that employees view as equitable compared to other employees performing similar jobs in other organizations, that employer is likely to experience higher turnover. Another drawback is greater difficulty in recruiting qualified and high-demand individuals. By not being competitive, the employer is more likely to attract and retain individuals with less knowledge and fewer skills and abilities, resulting in lower overall organizational performance. Organizations track external equity by using pay surveys, which are discussed later in this chapter, and by looking at the compensation policies of competing employers.

Internal Equity in Compensation Internal equity means that employees receive compensation in relation to the knowledge, skills, and abilities (KSAs) they use in their jobs, as well as their responsibilities and accomplishments. Two key issues—procedural justice and distributive justice—relate to internal equity.

Equity Perceived fairness between what a person does and what the person receives.

Procedural justice is the perceived fairness of the process and procedures used to make decisions about employees, including their pay. As it applies to compensation, the entire process of determining base pay for jobs, allocating pay increases, and measuring performance must be perceived as fair.

A related issue that must be considered is **distributive justice**, which is the perceived fairness in the distribution of outcomes. As one example, if a hardworking employee whose performance is outstanding receives the same across-the-board raise as an employee with attendance problems and mediocre performance, then inequity may be perceived. Likewise, if two employees have similar performance records but one receives a significantly greater pay raise, the other may perceive an inequity due to supervisory favoritism or other factors not related to the job.

To address concerns about both types of justice, some organizations establish compensation appeals procedures. Typically, employees are encouraged to contact the HR department after discussing their concerns with their immediate supervisors and managers.

Procedural justice

Perceived fairness of the process and procedures used to make decisions about employees.

Distributive justice

Perceived fairness in the distribution of outcomes.

Pay Secrecy Another equity issue concerns the degree of secrecy that organizations have regarding their pay systems. Pay information that may be kept secret in “closed” systems includes how much others make, what raises others have received, and even what pay grades and ranges exist in the organization. Some firms have policies that prohibit employees from discussing their pay with other employees, and violations of these policies can lead to disciplinary action.²⁹ Several court decisions have ruled that these policies violate the National Labor Relations Act, but many employees simply avoid discussing pay with coworkers because it can make the workplace uncomfortable.³⁰

Quantitative Techniques Facilitate Compensation Management

In order to more effectively manage employee compensation, it is often necessary for HR professionals to conduct quantitative assessments of reward information. This can be a challenging endeavour because many professionals have not been given the training required to assess numerical compensation data. Despite this reality, HR persons need to understand some basic statistical concepts and calculations so that organizations can develop more competitive pay structures to attract talent, increase job satisfaction, and reduce turnover.

Central tendency measures can be utilized to identify important numbers. Examples include mean scores (averages), median values (middle numbers in lists), and mode numbers (numbers appearing more frequently in groups). *Distribution statistics* indicate how numbers are distributed across a particular grouping. Examples include quartiles (placing numbers into quarters), percentiles

HR perspective

(placing numbers into hundredths), and frequency distribution (using histograms to show how frequently numbers occur). Finally, a number of *relationship measures* can be used to evaluate data, which include correlations that show the relationships between two or more variables and regression analyses that indicate how well a set of variables can predict another factor.

Other important issues that HR professionals must understand include internal and external validity. *Internal validity* indicates the degree to which findings are acceptable based on the use of a good research program, while *external validity* refers to the degree to which the findings will occur based on different sets of conditions. In summary, companies should encourage HR staff to seek out additional statistical materials and training, as well as provide the proper resources when necessary.³¹

Statistical Analysis The management of different fairness and equity issues requires managers to understand the various statistical methodologies that can be used to evaluate current compensation levels. For instance, HR professionals need to check how corporate pay programs compare to the compensation being offered by competing firms so that compensation can be adjusted to reflect the company's pay philosophy. HR professionals also must determine the degree to which compensation is distributed fairly within the organization based on such factors as job level, experience, training, and other human capital factors. All of these issues require a firm understanding of basic statistics. Some of the specific calculations that can facilitate compensation management are covered in the HR Perspective on the previous page.

Market Competitiveness and Compensation

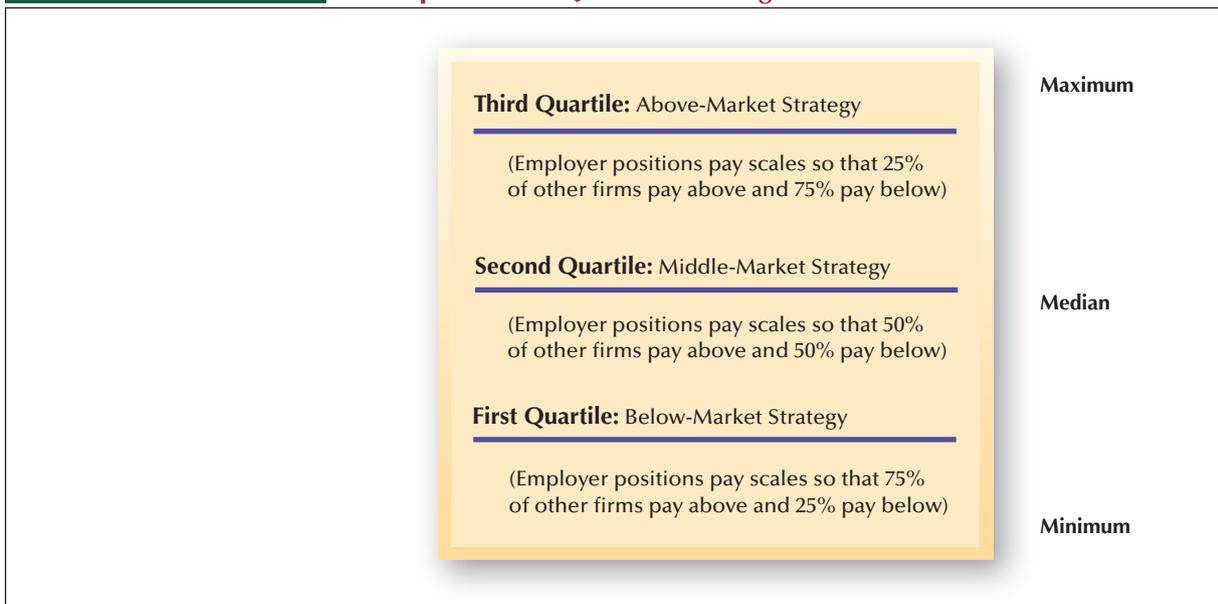
The market competitiveness of compensation has a significant impact on how equitably employees view compensation. Providing competitive compensation to employees, whether globally, domestically, or locally, is a concern for all employers.³² Some organizations establish specific policies about where they wish to be positioned in the labor market. These policies use a *quartile strategy*, as illustrated in Figure 11-5. Data in pay surveys reveal that the dollar differential between quartiles is generally 15% to 20%.

“Meet the Market” Strategy Most employers choose to position themselves in the *second quartile* (median), in the middle of the market, as identified by pay data from surveys of other employers' compensation plans. Choosing this level attempts to balance employer cost pressures and the need to attract and retain employees, by providing mid-level compensation scales that “meet the market” for the employer's jobs.

“Lag the Market” Strategy An employer using a *first-quartile* strategy may choose to “lag the market” by paying below market levels, for several reasons. If the employer is experiencing a shortage of funds, it may be unable to pay

FIGURE 11-5

Compensation Quartile Strategies



more. Also, when an abundance of workers is available, particularly those with lower skills, a below-market approach can be used to attract sufficient workers at a lesser cost. Some employers hire illegal immigrants at below-market rates because of the large numbers of those individuals who want to work in the United States. The downside of this strategy is that it increases the likelihood of higher worker turnover. If the labor market supply tightens, then attracting and retaining workers becomes more difficult.

“Lead the Market” Strategy A *third-quartile* strategy uses an aggressive approach to “lead the market.” This strategy generally enables a company to attract and retain sufficient workers with the required capabilities and to be more selective when hiring. Because it is a higher-cost approach, organizations often look for ways to increase the productivity of employees receiving above-market wages.

Selecting a Quartile The pay levels and pay structures used can affect organizational performance.³³ Individual employee pay levels will vary around the quartile level, depending on experience, performance, and other individual factors. Deciding in which quartile to position pay structures is a function of a number of considerations. The financial resources available, competitiveness pressures, and the market availability of employees with different capabilities are external factors. For instance, some employers with extensive benefits programs or broad-based incentive programs may choose a first-quartile strategy so that their overall compensation costs and levels are not excessive.

Competency-Based Pay

The design of most compensation programs rewards employees for carrying out their tasks, duties, and responsibilities. The job requirements determine which employees have higher base rates. Employees receive more for doing jobs that require a greater variety of tasks, more knowledge and skills, greater physical effort, or more demanding working conditions. However, the design of some compensation programs emphasizes competencies rather than the tasks performed.

Competency-based pay rewards individuals for the capabilities they demonstrate and acquire. In knowledge-based pay (KBP) or skill-based pay (SBP) systems, employees start at a base level of pay and receive increases as they learn to do other jobs or gain additional skills and knowledge and thus become more valuable to the employer.³⁴ For example, a printing firm operates two-color, four-color, and six-color presses. The more colors, the more skills required of the press operators. Under a KBP or SBP system, press operators increase their pay as they learn how to operate the more complex presses, even though sometimes they may be running only two-color jobs. A recent study determined that receiving SBP is related to learning and skill enhancement, which demonstrates that such pay systems can be effective.³⁵

When an organization moves to a competency-based system, considerable time must be spent identifying the required competencies for various jobs. Reliance on items such as college diplomas and degrees may need to change such that more emphasis is placed on demonstrated knowledge and competencies rather than degrees.³⁶ *Progression* of employees must be possible, and employees must be paid appropriately for all their competencies. Any *limitations* on the numbers of people who can acquire more competencies should be clearly identified. *Training* in the appropriate competencies is particularly

Competency-based pay
Rewards individuals for the capabilities they demonstrate and acquire.

important. Also, a competency-based system needs to acknowledge or certify employees as they acquire certain competencies, and then to verify the maintenance of those competencies. In summary, use of a competency-based system requires significant investment of management time and commitment.

Individual versus Team Rewards

As some organizations have shifted to using work teams, they have faced the logical concern of how to develop compensation programs that build on the team concept. At issue is how to compensate the individuals whose performance may be evaluated on team achievements.³⁷ For base pay, employers often compensate individuals on the basis of competencies, experience, and other job factors. Then many organizations use team incentive rewards on top of base pay. Variable pay rewards for teams are most frequently distributed annually as specified dollar amounts, not as percentages of base pay. Team-based incentives are discussed in Chapter 12.



Global Compensation Issues

All of the issues discussed here can become more complex when dealing with global compensation. The growing world economy has led to many more employees working internationally. Some are located and work in multiple countries, while others may be based in a home country such as the United States or Germany, but have international responsibilities. Therefore, organizations with employees working throughout the world face some special compensation issues.

Variations in laws, living costs, tax policies, and other factors all must be considered in establishing the compensation for local employees and managers, as well as managers and professionals brought in from other countries. Even fluctuations in the values of various currencies must be tracked and adjustments made as the currencies rise or fall in relation to currency rates in other countries. With these and numerous other concerns, developing and managing a global compensation system becomes extremely complex.³⁸ The components of one possible global compensation package are illustrated in Figure 11-6.

FIGURE 11-6

Possible Components of Global Employee Compensation



One significant global issue in compensation design is how to compensate the employees from different countries. Local wage scales vary significantly between countries. For instance, in some less-developed countries, pay levels for degreed professionals may range from \$15,000 to \$30,000 a year, whereas in Europe and the United States, individuals with the same qualifications are paid \$50,000 to \$80,000 a year. Lower-skilled local workers may make as little as \$300 a month in less-developed countries, whereas comparable employees make \$1,800 to \$2,500 a month in the United States and Europe. These large compensation differences have led to significant “international outsourcing” of jobs to lower-wage countries. The movement of call-center and information technology (IT) jobs to India and manufacturing jobs to China, the Philippines, and Mexico are examples.

Many organizations have started to globalize many of their pay policies in order to attract and retain the talent located within the footprint of global operations. This process requires custom-tailoring of the compensation approach to suit the needs of the central organization, while providing the proper incentives and benefits to drive motivation at local units.³⁹ For instance, Cox Communications developed a variable pay framework that provides flexibility to HR professionals to customize compensation policies to fit the needs of local worksites, and while this program is used domestically, it serves as a positive benchmark for other international companies.⁴⁰ Total rewards also can be used to motivate employees in diverse global environments because HR professionals can combine packages with the best practices of other nations to develop appropriate compensation strategies.⁴¹

Compensating Expatriates

Expatriates are citizens of one country who are working in a second country and employed by an organization headquartered in the first country. It has been estimated that the aggregate employer costs for an expatriate, including all allowances, is three to four times the expatriate’s salary. Thus, if an expatriate’s salary is \$200,000, the actual cost of employing that person is likely \$600,000 to \$800,000. The overall costs for many senior-level expatriates can be near \$1 million.⁴²

The two primary approaches to international compensation for expatriates are the balance-sheet approach and the global market approach. The **balance-sheet approach** is a compensation plan that equalizes cost differences between the international assignment and the same assignment in the home country of the individual or the corporation. Reviews have found that the balance-sheet approach can result in higher employer costs and more administrative complexity than other plans.⁴³ These considerations have led more multinational firms to use a different means. Some firms also have decreased the amount of compensation provided to expatriates using a benchmark approach, with extensive communication to boost employee support for the reduced plans.⁴⁴

Unlike the balance-sheet approach, the **global market approach** attempts to be more comprehensive in providing base pay, incentives, benefits, and relocation expenses regardless of the country to which the employee is assigned. This approach to compensation requires significant flexibility, detailed analyses, and extensive administrative effort. Almost 60% of multinational firms use this approach.⁴⁵

Many international compensation plans attempt to protect expatriates from negative tax consequences by using a **tax equalization plan**. Under such a plan, the company adjusts an employee’s base income downward by the

Balance-sheet approach

Compensation plan that equalizes cost differences between the international assignment and the same assignment in the home country.

Global market approach

Compensation plan that attempts to be more comprehensive in providing base pay, incentives, benefits, and relocation expenses regardless of the country to which the employee is assigned.

Tax equalization plan

Compensation plan used to protect expatriates from negative tax consequences.



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amount of estimated home-country tax to be paid for the year. Thus, the employee pays only the foreign-country tax. For instance, a tax equalization plan attempts to ensure that U.S. expatriates will not pay any more or less in taxes than if they were working in the United States. Major changes in the U.S. tax law in 2006 changed the tax provisions that may affect the 300,000 U.S. expatriates working abroad.⁴⁶ Because of the variation in tax laws and rates from country to country, tax equalization too can be very complex.

LEGAL CONSTRAINTS ON PAY SYSTEMS

Pay systems must comply with many government constraints. The important areas addressed by the laws include minimum-wage standards and hours of work. The following discussion examines the laws and regulations affecting base compensation. Laws and regulations affecting incentives and benefits are examined in later chapters.

Fair Labor Standards Act (FLSA)

The major federal law affecting compensation is the Fair Labor Standards Act (FLSA), which was originally passed in 1938. Compliance with FLSA provisions is enforced by the Wage and Hour Division of the U.S. Department of Labor. To meet FLSA requirements, employers must keep accurate time records and maintain those records for 3 years. Penalties for wage and hour violations often include awards of up to 2 years of back pay for affected current and former employees.

The provisions of both the original act and subsequent revisions focus on the following major areas:

- Establish a minimum wage.
- Discourage oppressive use of child labor.
- Encourage limits on the number of hours employees work per week, through overtime provisions (exempt and nonexempt statuses).

Minimum Wage The FLSA sets a minimum wage to be paid to the broad spectrum of covered employees. The actual minimum wage can be changed only by congressional action. A lower minimum wage is set for “tipped” employees, such as restaurant servers, but their compensation must equal or exceed the minimum wage when average tips are included. Minimum-wage levels have sparked significant political discussions and legislative maneuvering at both the federal and state levels for the past decade. Consequently, a three-stage increase in the federal minimum wage occurred beginning in 2007 as part of the Fair Minimum Wage Act of 2007, which recently was set with the current minimum wage of \$7.25 an hour. Note that if a state’s minimum wage is higher, employers must meet the state level rather than the federal level. Some research suggests that minimum wage increases will create a compensation ripple effect, possibly raising the pay rates for more than 10% of jobs and encouraging companies to downsize employment.⁴⁷

Discussion also surrounds the payment of a “living wage” versus the minimum wage. A **living wage** involves earnings that are supposed to meet the basic needs of an individual working for an organization, including food, clothing,

Living wage Earnings that are supposed to meet the basic needs of an individual working for an organization.

and shelter. In the United States, many cities have passed local living-wage legislation.

Child Labor Provisions The child labor provisions of the FLSA set the minimum age for employment with unlimited hours at 16 years. For hazardous occupations (see Chapter 14), the minimum is 18 years of age. Individuals 14 to 15 years old may work outside school hours with certain limitations. Many employers require age certificates for employees because the FLSA makes the employer responsible for determining an individual's age. A representative of a state labor department, a state education department, or a local school district generally issues such certificates.

Exempt and Nonexempt Statuses Under the FLSA, employees are classified as exempt or nonexempt. **Exempt employees** hold positions for which employers are not required to pay overtime. **Nonexempt employees** must be paid overtime. The current FLSA regulations used to identify whether or not a job qualifies for exempt status classifies exempt jobs into five categories:

- Executive
- Administrative
- Professional (learned or creative)
- Computer employees
- Outside sales

As Figure 11-7 indicates, the regulations identify several factors to be considered in exempt status: salaried pay levels per week, duties and responsibilities, and other criteria that must exist for jobs to be categorized as exempt. To review the details for each exemption, go to the U.S. Department of Labor's website at www.dol.gov.

In base pay programs, employers often categorize jobs into groupings that tie the FLSA status and the method of payment together. Employers are required to pay overtime for *hourly* jobs in order to comply with the FLSA. Employees in positions classified as *salaried nonexempt* are covered by the overtime provisions of the FLSA and therefore must be paid overtime. Salaried nonexempt positions sometimes include secretarial, clerical, and salaried blue-collar positions. A common mistake made by employers is to avoid paying

Exempt employees

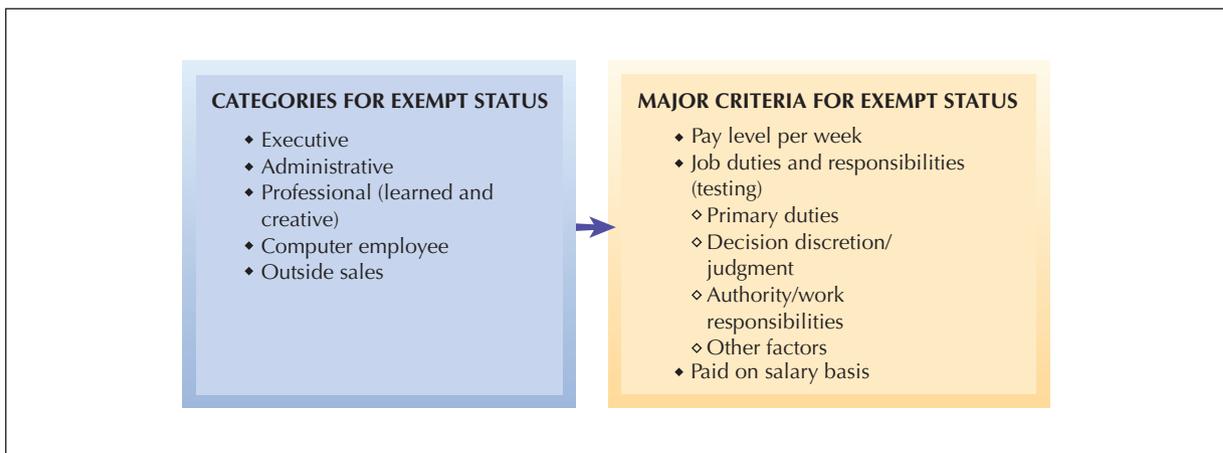
Employees who are not paid overtime.

Nonexempt employees

Employees who must be paid overtime.

FIGURE 11-7

Determining Exempt Status under the FLSA



overtime to any salaried employees, even though some do not qualify for exempt status. Misclassifying certain assistant managers is one example.⁴⁸ A number of large organizations in the United States have faced lawsuits recently over the misclassification of workers, so managers should make sure that jobs are properly classified.⁴⁹

The FLSA does not require employers to pay overtime for *salaried exempt* jobs, although some organizations have implemented policies to pay a straight rate for extensive hours of overtime. For instance, some electric utilities pay first-line supervisors extra using a special rate for hours worked over 50 a week during storm emergencies. A number of salaried exempt professionals in various IT jobs also receive additional compensation for working extensively more than 40 hours per week.

Overtime The FLSA establishes overtime pay requirements. Its provisions set overtime pay at one and one-half times the regular pay rate for all hours over 40 a week, except for employees who are not covered by the FLSA. Overtime provisions do not apply to farm workers, who also have a lower minimum-wage schedule.

The workweek is defined as a consecutive period of 168 hours (24 hours × 7 days) and does not have to be a calendar week. If they wish to do so, hospitals and nursing homes are allowed to use a 14-day period instead of a 7-day week, as long as overtime is paid for hours worked beyond 8 in a day or 80 in a 14-day period. No daily number of hours requiring overtime is set, except for special provisions relating to hospitals and other specially designated organizations. Thus, if a manufacturing firm operates on a 4-day/10-hour schedule, no overtime pay is required by the act.

The most difficult part is distinguishing who is and is not exempt.⁵⁰ Some recent costly settlements have prompted more white-collar workers to sue for overtime pay. Retail managers, reporters, sales reps, personal bankers, engineers, computer programmers, and claims adjusters have won in some cases, as being nonexempt workers.

Common Overtime Issues For individuals who are nonexempt, employers must consider a number of issues. These include the following:

- *Compensatory time off*: “Comp” hours are given to public-sector nonexempt employees in lieu of payment for extra time worked at the rate of one and one-half times the number of hours over 40 that are worked in a week. Comp time is currently not available in the private sector and cannot be legally offered to employees working for private for-profit organizations. Also, comp time cannot be carried over from one pay period to another. The only major exception to these provisions is for some public-sector employees, such as fire and police officers, and a limited number of other workers.
- *Incentives for nonexempt employees*: Employers must add the amount of direct work-related incentives to a person’s base pay. Then overtime pay should be calculated as one and one-half times the higher (adjusted) rate of pay.
- *Training time*: Time spent in training must be counted as time worked by nonexempt employees unless it is outside regular work hours, not directly job-related, or falls under various other aspects. College degree programs may not be affected by these provisions.
- *Travel time*: Travel time must be counted as work time if it occurs during normal work hours, even on nonworking days, unless the nonexempt

person is a passenger in a car, bus, train, airplane, or other similar mode of transportation. The complex clarifications regarding travel regulations affecting overtime should be reviewed by HR specialists to ensure compliance.

The complexity of overtime determination can be confusing for managers, employees, and HR professionals. To review the areas listed above and additional ones, examine sections 541, 775, 785, and other sections listed on the U.S. Department of Labor's website at www.dol.gov.

Independent Contractor Regulations

The growing use of contingent workers by many organizations has focused attention on another group of legal regulations—those identifying the criteria that independent contractors must meet.⁵¹ For an employer, classifying someone as an independent contractor rather than an employee offers a major advantage. The employer does not have to pay Social Security, unemployment, or workers' compensation costs. These additional payroll levies may add 10% or more to the costs of hiring the individual as an employee. Most federal and state entities rely on the criteria for independent contractor status identified by the Internal Revenue Service (IRS). However, the misclassification of employees as independent contractors is becoming an increasingly significant legal concern for organizations.⁵² Firms such as Wal-Mart, Allstate, Microsoft, and FedEx have settled lawsuits for misclassifying individuals as independent contractors,⁵³ although recently a court determined that FedEx had properly classified a large group of its drivers.⁵⁴

Behavioral Control Some key differences between an employee and an independent contractor have been identified by the IRS. The first set of factors consists of behavioral control factors, which indicate the extent to which an employer can control what a worker does and how a worker performs. One key area includes *business instructions given to the worker*, such as where and when to work, in what sequences, and with what tools and equipment, as well as how to purchase supplies and services. The other area is *business training given to the worker*, such as when someone must be trained to perform in a specific manner, rather than accomplishing results.

Financial Control This set of factors focuses on the extent to which an employer can control the business facets of a worker's job. Considerations include how many *unreimbursed business expenses* a worker has and what investments a worker makes independently to do the job. Other financial factors include whether a worker *provides services to other firms*, how the *business pays the worker*, and if the worker can make a *profit or loss*.

Relationship-Type Factors A number of other items can help clarify whether a relationship is truly independent or not, such as having *written contracts* and the *extent of services provided*. Also, if the employer *provides benefits*, such as insurance or pensions, it is more likely that the person is an employee, and not an independent contractor. For additional details, go to www.irs.gov.

Acts Affecting Government Contractors

Several compensation-related acts apply to firms having contracts with the U.S. government. The Davis-Bacon Act of 1931 affects compensation paid by

firms engaged in federal construction projects valued at over \$2,000. It deals only with federal construction projects and requires that the “prevailing” wage be paid on all such projects. The *prevailing wage* is determined by a formula that considers the rate paid for a job by a majority of the employers in the appropriate geographic area.

Two other acts require firms with federal supply or service contracts exceeding \$10,000 to pay a prevailing wage. Both the Walsh-Healy Public Contracts Act and the McNamara-O’Hara Service Contract Act apply only to those who are working directly on a federal government contract or who substantially affect its performance.

Legislation on Equal Pay and Pay Equity

Various legislative efforts have addressed the issue of wage discrimination on the basis of gender. The Equal Pay Act of 1963 applies to both men and women and prohibits using different wage scales for men and women performing substantially the same jobs.⁵⁵ Pay differences can be justified on the basis of merit (better performance), seniority (longer service), quantity or quality of work, experience, or factors other than gender. Similar pay must be given for jobs requiring equal skills, equal responsibilities, equal efforts, or jobs done under similar working conditions.

“Pay equity” is not the same as equal pay for equal work; instead, it is similar to an idea called comparable worth. **Pay equity** is the concept that the pay for all jobs requiring comparable KSAs should be the same even if actual job duties and market rates differ significantly. A few states and the Canadian province of Ontario have laws requiring pay equity for public-sector jobs. However, simply showing the existence of pay disparities for jobs that are significantly different has not been sufficient to prove discrimination in many court cases.

State and Local Laws

Many states and municipalities have enacted modified versions of federal compensation laws. If a state has a higher minimum wage than that set under the FLSA, the higher figure becomes the required minimum wage in that state. On the other end of the spectrum, many states once limited the number of hours women could work, but these laws have been held to be discriminatory in a variety of court cases, and thus states have dropped such laws.

Garnishment Laws

Garnishment occurs when a creditor obtains a court order that directs an employer to set aside a portion of an employee’s wages to pay a debt owed a creditor. Regulations passed as a part of the Consumer Credit Protection Act have established limitations on the amount of wages that can be garnished. Also, the act restricts the right of employers to discharge employees whose pay is subject to a single garnishment order. All 50 states have laws applying to wage garnishments.

Pay equity The concept that the pay for all jobs requiring comparable knowledge, skills, and abilities should be the same even if actual job duties and market rates differ significantly.

Garnishment A court order that directs an employer to set aside a portion of an employee’s wages to pay a debt owed to a creditor.

Lilly Ledbetter Fair Pay Act

As a result of limited time allowed under law for claiming pay discrimination based on sex, religion, color, disability, and other protected characteristics, the Lilly Ledbetter Fair Pay Act was signed by President Obama in January

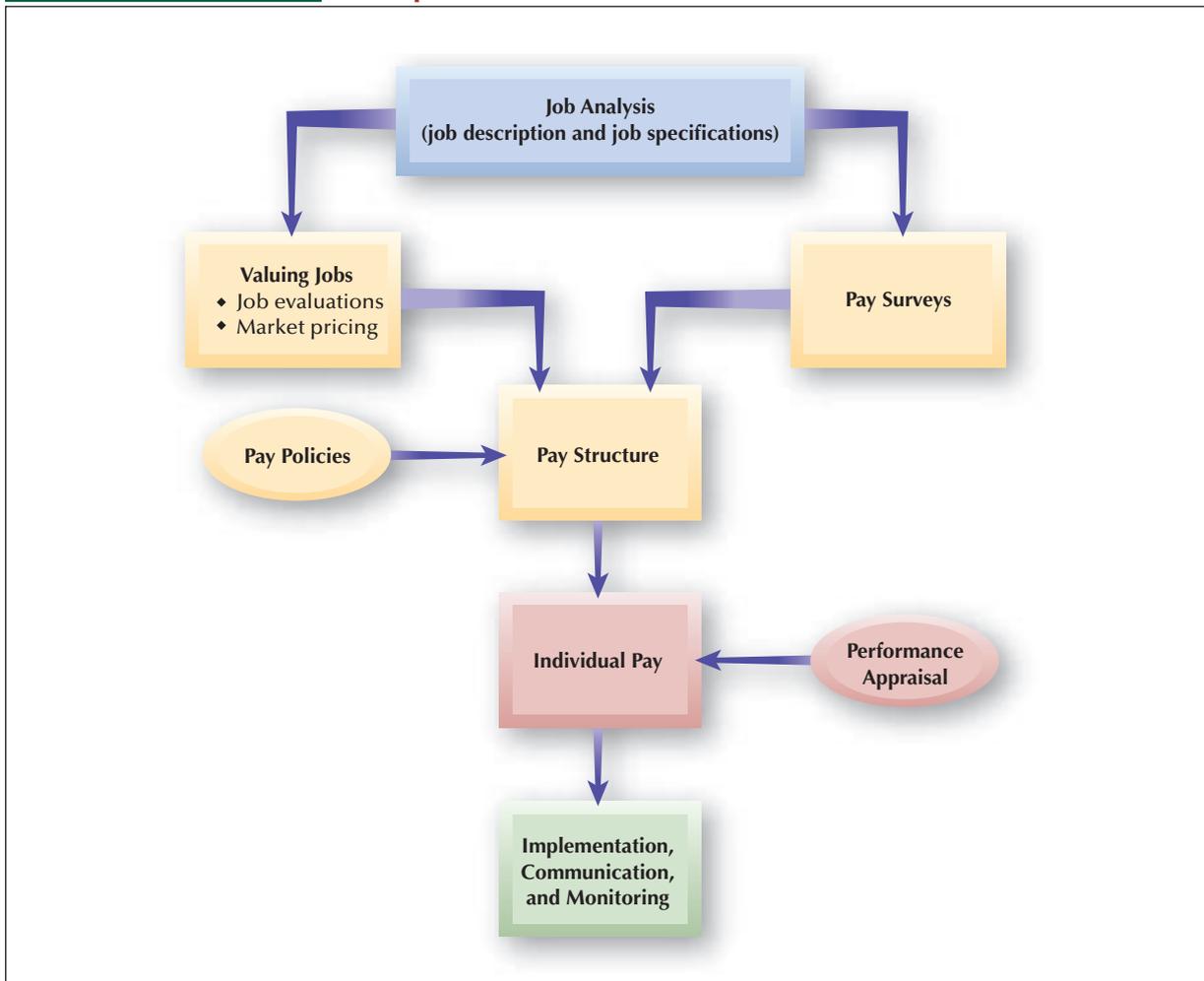
of 2009. Before the law was passed, individuals had to submit complaints of pay discrimination to the EEOC within a 180- or 300-day window, which was based on the state where the person was employed. This new legislation effectively negates any statute of limitations for filing a complaint, so claims of pay discrimination can now be made at any time after the alleged misconduct.⁵⁶

DEVELOPMENT OF A BASE PAY SYSTEM

As Figure 11-8 shows, a base compensation system is developed using current job descriptions and job specifications. These information sources are used when *valuing jobs* and analyzing *pay surveys*—activities that are designed to ensure that the pay system is both internally equitable and externally competitive. The data compiled in these two activities are used to design *pay structures*, including *pay grades* and minimum-to-maximum *pay ranges*. After pay structures are established, individual jobs must be placed in the appropriate pay grades and employees' pay must be adjusted according to length of service and performance. Finally, the pay system must be monitored and updated.

FIGURE 11-8

Compensation Administration Process



Employers want their employees to perceive their pay levels as appropriate in relation to pay for jobs performed by others inside the organization. Frequently, employees and managers make comments such as “This job is more important than that job in another department, so why are the two jobs paid about the same?” Two general approaches for valuing jobs are available: job evaluation and market pricing. Both approaches are used to determine the values of jobs in relation to other jobs in an organization, and they are discussed next.

Valuing Jobs with Job Evaluation Methods

Job evaluation is a formal, systematic means to identify the relative worth of jobs within an organization. Several job evaluation methods are available for use by employers of different sizes.⁵⁷

Point Method The most widely used job evaluation method, the point method, looks at compensable factors in a group of similar jobs and places weights, or *points*, on them. A **compensable factor** identifies a job value commonly present throughout a group of jobs. Compensable factors are derived from job analysis and reflect the nature of different types of work performed in the organization, as illustrated in Figure 11-9.

A special type of point method, the Hay system, uses three factors and numerically measures the degree to which each of these factors is required in a job. The three factors are *know-how*, *problem-solving ability*, and *accountability*.

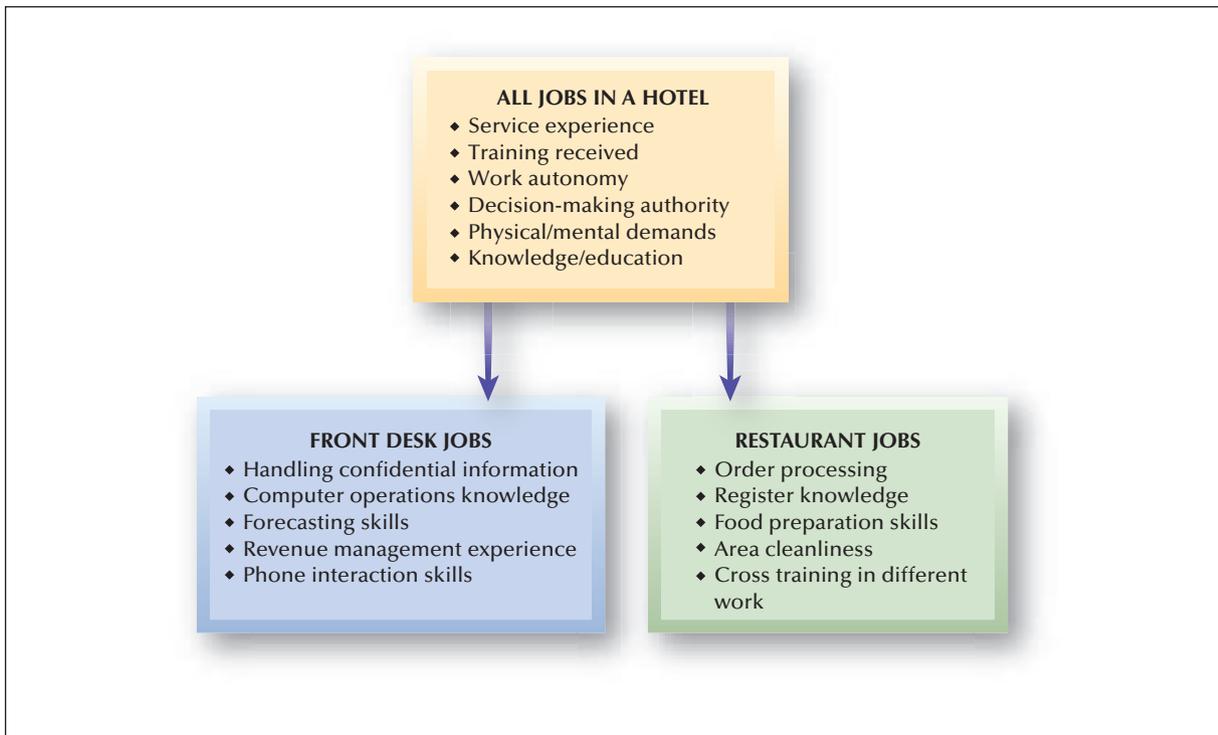
The point method is the most popular because it is relatively simple to use and it considers the components of a job rather than the total job. However, point systems have been criticized for reinforcing traditional organizational

Job evaluation Formal, systematic means to identify the relative worth of jobs within an organization.

Compensable factor Job value commonly present throughout a group of jobs within an organization.

FIGURE 11-9

Examples of Compensable Factors for Different Job Families in a Hotel



structures and job rigidity. Although not perfect, the point method of job evaluation is generally better than the ranking and classification methods because it quantifies job elements.

Other Job Evaluation Methods Several job evaluation methods are available that are used for different reasons. Common ones include the following:

- The *ranking method* is a simple system that places jobs in order, from highest to lowest, by their value to the organization. The entire job is considered rather than the individual components. The ranking method generally is more appropriate in a small organization having relatively few jobs.
- In the *classification method* of job evaluation, descriptions of each class of jobs are written, and then each job in the organization is put into a grade according to the class description it best matches. The major difficulty with the classification method is that subjective judgments are needed to develop the class descriptions and to place jobs accurately in them.
- The *factor-comparison method* is a quantitative complex combination of the ranking and point methods. Each organization must develop its own key jobs and its own factors. The major disadvantages of the factor-comparison method are that it is difficult to use and time-consuming to establish and develop.

Legal Issues and Job Evaluation Because job evaluation affects the employment relationship, specifically the pay of individuals, some legal issues are of concern.⁵⁸ Critics have charged that traditional job evaluation programs place less weight on knowledge, skills, and working conditions for many female-dominated jobs in office and clerical areas than on the same factors for male-dominated jobs in craft and manufacturing areas. Employers counter that because they base their pay rates heavily on external equity comparisons in the labor market, they are simply reflecting rates the “market economy” sets for jobs and workers, rather than discriminating on the basis of gender.

Valuing Jobs Using Market Pricing

Some employers have scaled back their use of “internal valuation” through traditional job evaluation methods. They have instead switched to **market pricing**, which uses market pay data to identify the relative value of jobs based on what other employers pay for similar jobs. Jobs are arranged in groups tied directly to similar survey data amounts.

Key to market pricing is identifying relevant market pay data for jobs that are good “matches” with the employer’s jobs, geographic considerations, and company strategies and philosophies about desired market competitiveness levels. That is why some firms have used market pricing as part of strategic decisions in order to ensure market competitiveness of their compensation levels and practices. There is also growing interest in the market pricing of critical individual skills that enable companies to reach important business goals.⁵⁹ Finally, organizations should plan to review market-based pay policies every 2 to 3 years to verify that compensation is adequately matched to market conditions.⁶⁰

Market pricing Use of market pay data to identify the relative value of jobs based on what other employers pay for similar jobs.

Advantages of Market Pricing The primary advantage cited for the use of market pricing is that it closely ties organizational pay levels to what is actually occurring in the market, without being distorted by “internal” job

evaluation. An additional advantage of market pricing is that it allows an employer to communicate to employees that the compensation system is truly “market linked,” rather than sometimes being distorted by internal issues. Employees often see a compensation system that was developed using market pricing as having “face validity” and as being more objective than a compensation system that was developed using the traditional job evaluation methods.⁶¹

Disadvantages of Market Pricing The foremost disadvantage of market pricing is that for numerous jobs, pay survey data are limited or may not be gathered in methodologically sound ways. A closely related problem is that the responsibilities of a specific job in a company may be somewhat different from those of the “matching” job identified in the survey.⁶²

Finally, tying pay levels to market data can lead to wide fluctuations based on market conditions. For evidence of this, one has only to look back at the extremes of the IT job market during the past decade, when pay levels varied significantly. For these and other types of jobs, the debate over the use of job evaluation versus market pricing is likely to continue because both approaches have pluses and minuses associated with them.

Pay Surveys

A **pay survey** is a collection of data on compensation rates for workers performing similar jobs in other organizations. Both job evaluation and market pricing are tied to surveys of the pay that other organizations provide for similar jobs.

Because jobs may vary widely in an organization, it is particularly important to identify **benchmark jobs**—ones that are found in many other organizations. Often these jobs are performed by individuals who have similar duties that require similar KSAs. For example, benchmark jobs commonly used in clerical/office situations are accounts payable processor, customer service representative, and receptionist. Benchmark jobs are used because they provide “anchors” against which individual jobs can be compared.

An employer may obtain surveys conducted by other organizations, access Internet data, or conduct its own survey. Many different surveys are available from a variety of sources. National surveys on many jobs and industries come from the U.S. Department of Labor’s Bureau of Labor Statistics, professional and national trade associations, and various management consulting companies. In many communities, employers participate in wage surveys sponsored by the local chamber of commerce or local HR associations.

Internet-Based Pay Surveys HR professionals can access a wide range of pay survey data online. In many cases, pay survey questionnaires are distributed electronically rather than as printed copies, and HR staff members complete the questionnaires electronically. It is anticipated that during the next 5 years, most pay surveys will be conducted using electronic, Web-based technology.

The Internet provides a large number of pay survey sources and data.⁶³ However, use of these sources requires caution because their accuracy and completeness may not be verifiable or may not be applicable to individual firms and employees. The HR Online discusses how to address employee questions regarding pay survey data that are accessible from the Internet.

Pay survey Collection of data on compensation rates for workers performing similar jobs in other organizations.

Benchmark jobs Jobs found in many organizations that can be used for the purposes of comparison.



Responding to Internet Pay Survey Data Questions

Employees who are dissatisfied with their pay may bring Internet data to HR professionals or their managers and ask why their current pay is different from the pay reported in the Internet data. Responding to such questions from employees requires addressing a number of areas. Salary.com includes sample explanations on its website. Points to be made in discussing employee concerns include the following:

- *Job titles and responsibilities:* Comparison should be made against the employee's full job description, not just job titles and the brief job summaries on the websites.
- *Experience, KSAs, and performance:* Most pay survey data on the Internet are averages of multiple companies and of multiple employees in those companies with varying experience, KSA levels, and performance.
- *Geographic differences:* Many pay survey sites on the Internet use geographic index numbers, not the actual data from employers in a particular area.
- *Company size and industry:* Pay levels may vary significantly by company size, with smaller firms often having lower pay. Also, pay levels may be lower in certain industries, such as retail and nonprofits.
- *Base pay versus total compensation:* Employers have different benefits and incentive compensation programs. However, Internet data usually reflect only base pay amounts.

Using Pay Surveys The proper use of pay surveys requires evaluating a number of factors to determine if the data are relevant and valid. The following questions should be answered for each survey:

- *Participants:* Does the survey cover a realistic sample of the employers with whom the organization competes for employees?
- *Broad-based:* Does the survey include data from employers of different sizes, industries, and locales?
- *Timeliness:* How current are the data (determined by the date the survey was conducted)?
- *Methodology:* How established is the survey, and how qualified are those who conducted it?
- *Job matches:* Does the survey contain job summaries so that appropriate matches to job descriptions can be made?

Pay Surveys and Legal Issues One reason for employers to use outside sources for pay surveys is to avoid charges that the employers are attempting "price fixing" on wages. One such case involved an HR group and nine hospitals in the Salt Lake City area. The consent decree that resulted prohibited health care facilities in Utah from cooperating when developing or conducting a wage survey. The hospitals can participate in surveys conducted by independent third-party firms only if privacy safeguards are met. Cases in other industries have alleged that by sharing wage data, the employers attempted to hold wages down artificially in violation of the Sherman Antitrust Act.⁶⁴



LOGGING ON

Institute of Management and Administration (IOMA)

For information on salary sources that are reviewed by the IOMA, visit the website at www.ioma.com.

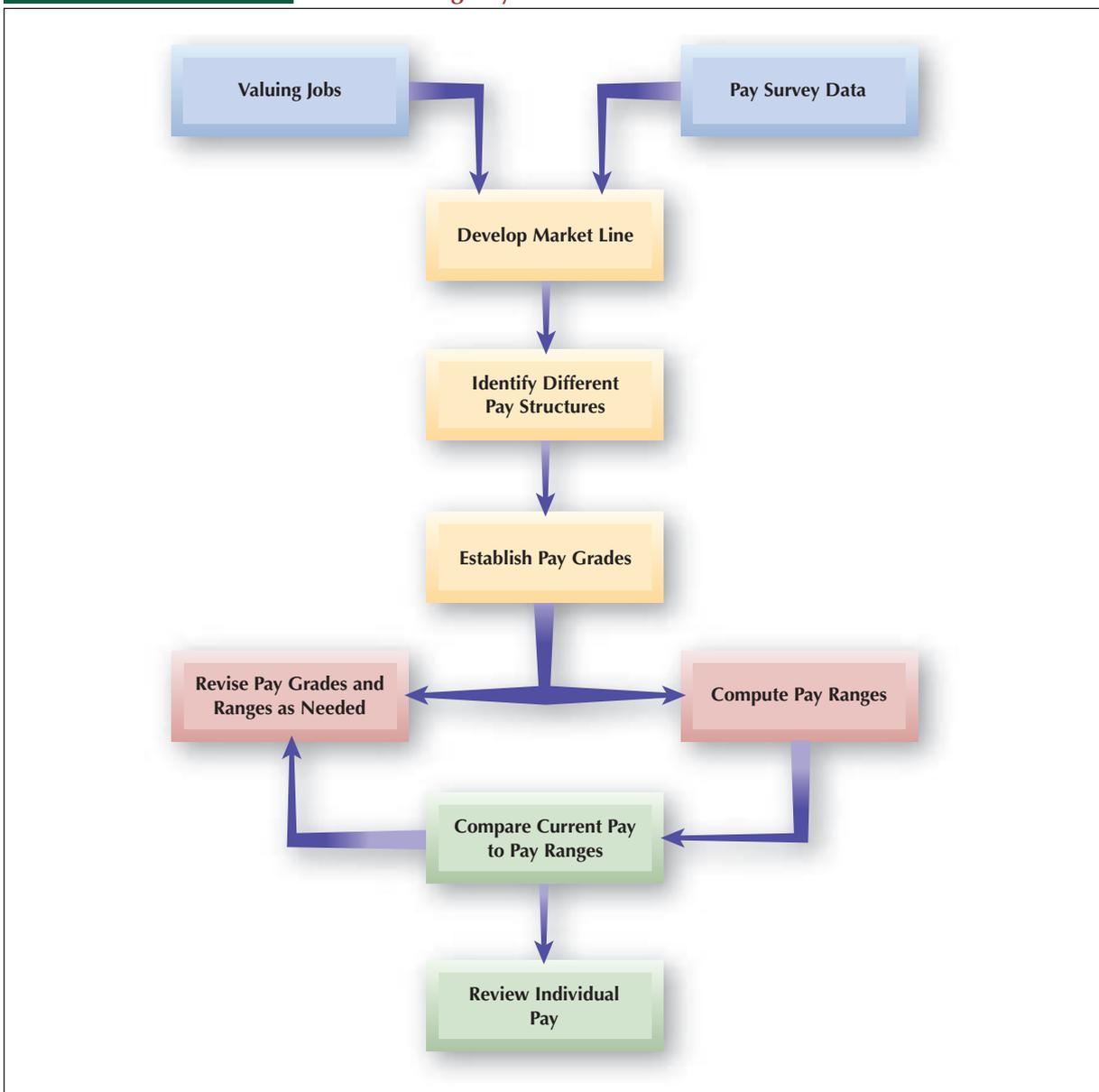
PAY STRUCTURES

Once job valuations and pay survey data are gathered, pay structures can be developed using the process identified in Figure 11-10. Data from the valuation of jobs and the pay surveys may lead to the establishment of several different pay structures for different job families, rather than just one structure for all jobs. A **job family** is a group of jobs having common organizational characteristics. Organizations can have a number of different job families. Examples of some common pay structures based on different job families include: (1) hourly and salaried; (2) office, plant, technical, professional, and managerial; and

Job family Group of jobs having common organizational characteristics.

FIGURE 11-10

Establishing Pay Structures



(3) clerical, IT, professional, supervisory, management, and executive. The nature, culture, and structure of the organization are considerations for determining how many and which pay structures to have.

Pay Grades

In the process of establishing a pay structure, organizations use **pay grades** to group individual jobs having approximately the same job worth. Although no set rules govern the establishment of pay grades, some overall suggestions can be useful. Generally, 11 to 17 grades are used in small and medium-sized companies, such as companies with fewer than 500 to 1,000 employees. Two methods are commonly used to establish pay grades: job evaluation data and use of job market banding.

Setting Pay Grades Using Job Evaluation Points One approach to determining pay grades uses job evaluation points or other data generated from the traditional job evaluation methods discussed earlier in the chapter. This process ties pay survey information to job evaluation data by plotting a **market line** that shows the relationship between job value as determined by job evaluation points and job value as determined by pay survey rates. The statistical analysis done when determining market lines focuses particularly on the r^2 levels from the regression when the data are analyzed by different job families and groups. Generally, an r^2 of 0.85 or higher is desired. (Details on the methods and statistical analyses can be found in compensation texts.)⁶⁵

A market line uses data to place jobs having similar point values into pay grades. Pay ranges can then be computed for each pay grade.

Setting Pay Grades Using Market Banding Closely linked to the use of market pricing to value jobs, **market banding** groups jobs into pay grades based on similar market survey amounts. Figure 11-11 shows two “bands” for jobs in a community bank. The midpoint of the survey average is used to develop pay range minimums and maximums, the methods of which are discussed later in this chapter.

Pay Ranges

Once pay grades are determined, the pay range for each pay grade must be established. Using the market line as a starting point, the employer can determine minimum and maximum pay levels for each pay grade by making the market line the midpoint line of the new pay structure (see Figure 11-12). For example, in a particular pay grade, the maximum value may be 20% above the midpoint located on the market line, and the minimum value may be 20% below it. Once pay grades and ranges have been computed, then the current pay of employees must be compared with the draft ranges. A number of employers are reducing the number of pay grades and expanding pay ranges by broadbanding.

Broadbanding The practice of using fewer pay grades with much broader ranges than in traditional compensation systems is called **broadbanding**. Combining many grades into these broadbands is designed to encourage horizontal movement and therefore more skill acquisition. About one-quarter of all employers in one survey are using broadbanding.⁶⁶ The main advantage of

Pay grades Groupings of individual jobs having approximately the same job worth.

Market line Graph line that shows the relationship between job value as determined by job evaluation points and job value as determined pay survey rates.

Market banding Grouping jobs into pay grades based on similar market survey amounts.

Broadbanding Practice of using fewer pay grades with much broader ranges than in traditional compensation systems.

FIGURE 11-11

Market-Banded Pay Grades for Community Bank

Grade	Job	Pay Survey Summary	Pay Grade		
			Minimum	Midpoint*	Maximum
1	Mail Clerk / Messenger	\$19,167	\$15,600	\$18,703	\$22,444
	Proof Machine Operator	\$18,970			
	General Office Clerk	\$18,594			
	Receptionist	\$17,810			
2	Bookkeeper	\$22,913	\$17,966	\$22,458	\$26,950
	Loan Clerk	\$22,705			
	Customer Service Representative	\$22,337			
	Data Entry / Computer Operator	\$22,309			
	Head Teller	\$22,305			
	Special Teller	\$22,179			

*Computed by averaging the pay survey summary data for the jobs in each pay grade.

broadbanding is that it is more consistent with the flattening of organizational levels and the growing use of jobs that are multidimensional. The primary reasons for using broadbanding are: (1) to create more flexible organizations, (2) to encourage competency development, and (3) to emphasize career development.

A problem with broadbanding is that many employees expect a promotion to be accompanied by a pay raise and movement to a new pay grade. As a result of removing this grade progression, the organization may be seen as offering fewer upward promotional opportunities. An additional concern identified by a research study on broadbanding of IT jobs is that it can significantly impact salary levels and costs. Therefore, HR must closely monitor the effects of broadbanding.⁶⁷ Despite these and other problems, it is likely that broadbanding will continue to grow in usage.

Individual Pay

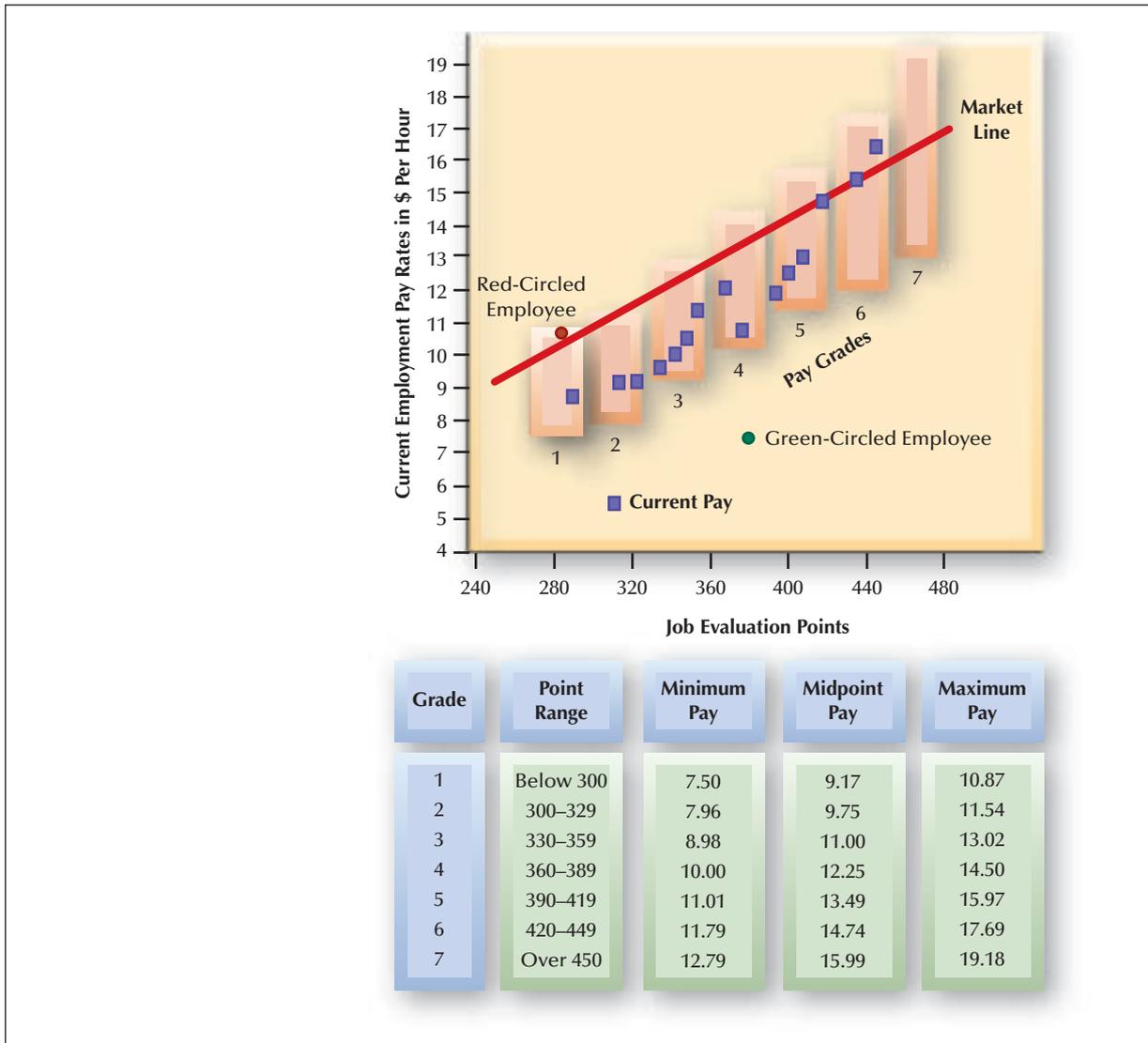
Once managers have determined pay ranges, they can set the pay for specific individuals. Setting a range for each pay grade gives flexibility by allowing individuals to progress within a grade instead of having to move to a new grade each time they receive a raise. A pay range also allows managers to reward the better-performing employees while maintaining the integrity of the pay system. Regardless of how well a pay structure is constructed, there usually are a few individuals whose pay is lower than the minimum or higher than the maximum due to past pay practices and different levels of experience and performance. Two types of such employees are discussed next.

Red-circled employee

Incumbent who is paid above the range set for a job.

Red-Circled Employees A **red-circled employee** is an incumbent who is paid above the range set for the job. For example, assume that an employee's

FIGURE 11-12 Example of Pay Grades and Pay Ranges



current pay is \$11.92 an hour, but the pay range for that person’s pay grade is \$7.96 to \$11.54 an hour. The person would be red-circled. Management would try over a year or so to bring the employee’s rate into grade.

Several approaches can be used to bring a red-circled person’s pay into line. Although the fastest way would be to cut the employee’s pay, that approach is not recommended and is seldom used. Instead, the employee’s pay may be frozen until the pay range can be adjusted upward to get the employee’s pay rate back into the grade. Another approach is to give the employee a small lump-sum payment but not adjust the pay rate when others are given raises.

Green-Circled Employees An individual whose pay is below the range set for a job is a **green-circled employee**. Promotion is a major contributor to this situation. Generally, it is recommended that the green-circled individual receive fairly rapid pay increases to reach the pay grade minimum. More frequent increases can be used if the minimum is a large amount above the incumbent’s current pay.

Green-circled employee
Incumbent who is paid below the range set for a job.

Pay Compression One major problem many employers face is **pay compression**, which occurs when the pay differences among individuals with different levels of experience and performance become small. Pay compression occurs for a number of reasons, but the major one involves situations in which labor market pay levels increase more rapidly than current employees' pay adjustments.⁶⁸

In response to shortages of particular job skills in a highly competitive labor market, managers may occasionally have to pay higher amounts to hire people with those scarce skills. For example, suppose the job of specialized information systems analyst is identified as a \$48,000 to \$68,000 salary range in one company, but qualified individuals are in short supply and other employers are paying \$70,000. To fill the job, the firm likely will have to pay the higher rate. Suppose also that several good analysts who have been with the firm for several years started at \$55,000 and have received 4% increases each year. These current employees may still be making less than the \$70,000 paid to attract and retain new analysts with less experience from outside. Making certain that pay rates for company jobs are market-based and pay raises are based on performance-based reviews are ways to mitigate salary compression.⁶⁹



LOGGING ON

National Compensation Survey (NCS)

This website provides comprehensive measures of occupational wages, employment cost trends, and benefit incidence and detailed plan provisions.

Visit the site at www.bls.gov/ncs/home.htm.

DETERMINING PAY INCREASES

Decisions about pay increases are often critical ones in the relationships between employees, their managers, and the organization. Individuals express expectations about their pay and about how much of an increase is “fair,” especially in comparison with the increases received by other employees. This is why HR professionals must be actively involved in the communication of pay increases to help manage perceptions of any changes made to employees' compensation.⁷⁰

Pay increases can be determined in several ways: performance, seniority, cost-of-living adjustments, across-the-board increases, and lump-sum increases. These methods can be used separately or in combination.

Performance-Based Increases

As mentioned earlier, some employers have shifted to more pay-for-performance philosophies and strategies. Consequently, they have adopted the following means to provide employees with performance-based increases.

Targeting High Performers This approach focuses on providing the top-performing employees with significantly higher pay raises. Some organizations target the top 10% of employees for significantly greater increases while providing more standard increases to the remaining satisfactory performers. According to a survey by Hewitt Associates, average raises for the best performers in 1 year were 9.9%, satisfactory performers got 3.6%, and low performers got 0% to 1.3%.⁷¹

The primary reason for having such significant differentials focuses on rewarding and retaining the critical high-performing individuals.⁷² Key to rewarding exceptional performers is identifying how much their accomplishments have been above the normal work expectations. The more “standard”

Pay compression Occurs when the pay differences among individuals with different levels of experience and performance become small.

increases for the average performers are usually aligned with labor market pay adjustments, so that those individuals are kept competitive. The lower performers are given less because of their performance issues, which “encourages” them to leave their organizations.

Pay Adjustment Matrix A system for integrating appraisal ratings and pay changes must be developed and applied equally. Often, this integration is done through the development of a *pay adjustment matrix*, or *salary guide chart*. Use of pay adjustment matrices bases adjustments in part on a person’s **compa-ratio**, which is the pay level divided by the midpoint of the pay range. To illustrate, the following is an example of the compa-ratio for an employee called *J*:

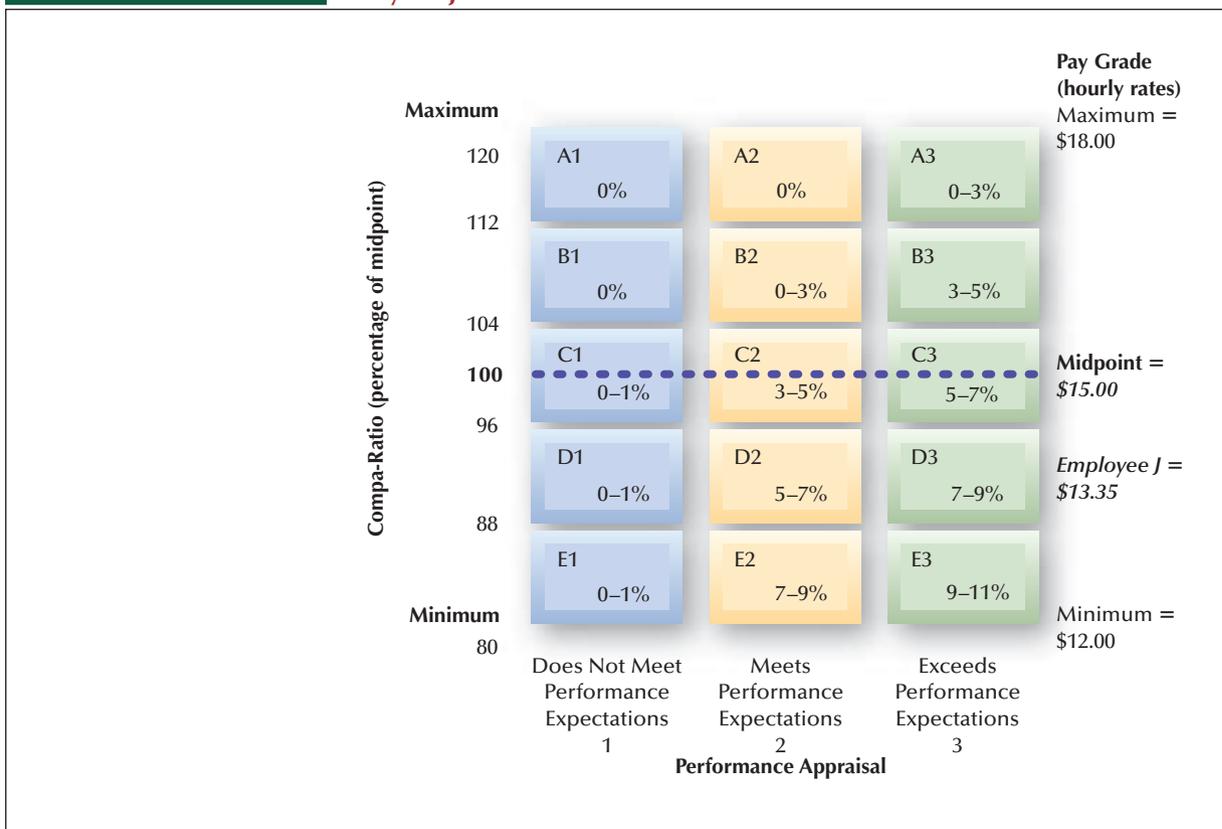
$$\text{Employee } J = \frac{\$13.35 \text{ (current pay)}}{\$15.00 \text{ (midpoint)}} \times 100 = 89 \text{ (Compa-ratio)}$$

Salary guide charts reflect a person’s upward movement in an organization. That movement often depends on the person’s performance, as rated in an appraisal, and on the person’s position in the pay range, which has some relation to experience as well. A person’s placement on the chart determines what pay raise the person should receive. According to the chart shown in Figure 11-13, if employee *J* is rated as exceeding expectations (3) with a compa-ratio of 89, that person is eligible for a raise of 7% to 9%.

Two interesting elements of the sample matrix illustrate the emphasis on paying for performance. First, individuals whose performance is below

Compa-ratio Pay level divided by the midpoint of the pay range.

FIGURE 11-13 Pay Adjustment Matrix



expectations receive small to no raises. This approach sends a strong signal that poor performers will not continue to receive increases just by completing another year of service. Second, as employees move up the pay range, they must exhibit higher performance to obtain the same percentage raise as those lower in the range performing at the “meets performance expectations” level (see Figure 11-13). This approach is taken because the firm is paying above the market midpoint but receiving only satisfactory performance rather than above-market performance. Charts can be constructed to reflect the specific pay-for-performance policies and philosophy in an organization.

Standardized Pay Adjustments

Several different methods are used to provide standardized pay increases to employees. The most common ones are discussed next.

Seniority The time spent in an organization or on a particular job, called **seniority**, can be used as the basis for pay increases. Many employers have policies that require a person to be employed for a certain length of time before being eligible for pay increases. Pay adjustments based on seniority often are set as automatic steps once a person has been employed the required length of time, although performance must be at least satisfactory in many nonunion systems.

Cost-of-Living Adjustments A common pay-raise practice is the use of a *cost-of-living adjustment (COLA)*. Often, these adjustments are tied to changes in the Consumer Price Index (CPI) or some other general economic measure. However, numerous studies have revealed that the CPI overstates the actual cost of living, and, as stated previously, COLA increases do little to recognize employees for their relative contributions to the organization.

Across-the-Board Increases Unfortunately, some employers give across-the-board raises and call them *merit raises*, which they are not. Usually the percentage raise is based on standard market percentage changes or financial budgeting determinations not specifically linked to the COLA. If all employees get the same percentage pay increase, it is legitimately viewed as having little to do with merit or good performance. For this reason, employers should reserve the term *merit* for any amount above the standard raise, and they should state clearly which amount is for performance and which amount is the “automatic” portion.

Lump-Sum Increases Most employees who receive pay increases, either for merit or for seniority, receive an increase in the amount of their regular monthly or weekly paycheck. For example, an employee who makes \$12.00 an hour and then receives a 3% increase will move to \$12.36 an hour.

In contrast, a **lump-sum increase (LSI)** is a one-time payment of all or part of a yearly pay increase. The pure LSI approach does not increase the base pay. Therefore, in the example of a person making \$12.00 an hour, if an LSI of 3% is granted, the person receives a lump sum of \$748.80 ($\$0.36 \text{ an hour} \times 2,080 \text{ working hours in the year}$). However, the base rate remains at \$12.00 an hour, which slows down the progression of the base wages.

An LSI plan offers advantages and disadvantages.⁷³ The major advantage of an LSI plan is that it heightens employees’ awareness of what their performance levels “merited.” Another advantage is that the firm can use LSIs

Seniority Time spent in an organization or on a particular job.

Lump-sum increase (LSI) One-time payment of all or part of a yearly pay increase.

to slow down the increase of base pay and thus reduce or avoid the compounding effect on succeeding raises. One disadvantage of LSI plans is that workers who take a lump-sum payment may become discouraged because their base pay has not changed. Unions generally resist LSI programs because of their impact on pensions and benefits, unless the total amount used in those computations includes the LSI.

S U M M A R Y

- The concept of *total rewards* has become a crucial part of HR management, and includes compensation, benefits, and performance and talent management.
- Compensation provided by an organization can come directly through base pay and variable pay and indirectly through benefits.
- A continuum of compensation philosophies exists, ranging from an entitlement philosophy to a performance philosophy.
- HR metrics can and should be used to measure the effectiveness of compensation.
- For compensation expenditures to be administered effectively, compensation responsibilities of both HR specialists and managers must be performed well.
- When designing and administering compensation programs, internal and external equity, organizational justice, and pay openness all must be considered.
- Decisions about compensation must always consider market competitiveness and positioning, use of competency-based pay, and team rewards.
- Compensation practices for international employees are much more complex than those for domestic employees, because they are affected by many more factors.
- The Fair Labor Standards Act (FLSA), as amended, is the major federal law that affects pay systems. It requires most organizations to pay a minimum wage and to comply with overtime provisions, including appropriately classifying employees as exempt or nonexempt and as independent contractors or employees.
- A base pay system is developed using information from valuations of jobs and pay surveys, both of which are designed to ensure that the pay system is internally equitable and externally competitive.
- The valuation of jobs can be determined using either job evaluation or market pricing.
- Once a firm has collected pay survey data, it can develop a pay structure, which is composed of pay grades and pay ranges.
- Broadbanding, which uses fewer pay grades with wider ranges, has grown in popularity.
- Individual pay must take into account the placement of employees within pay grades.
- Problems involving “red-circled” jobs, whose rates are above the applicable pay range, and “green-circled” jobs, whose rates are below the applicable pay range, can be addressed in a number of ways.
- Individual pay increases can be based on performance, seniority, cost-of-living adjustments, across-the-board increases, lump-sum increases, or a combination of different approaches.

C R I T I C A L T H I N K I N G A C T I V I T I E S

1. Discuss the compensation philosophies and approaches that have been used at organizations where you have worked. What have been the consequences of those philosophies and approaches?
2. You have been named Human Resources Manager for a company that has 180 employees and no formal base pay system. What steps will you take to develop such a coordinated system?
3. You are the HR Director for an insurance company with regional offices in several states. For each office, you want to be sure that the administrative assistants reporting to the regional manager are paid appropriately. Go to www.salary.com to find geographic pay survey data for this job in Hartford, Connecticut; Atlanta, Georgia; Omaha, Nebraska; and Phoenix, Arizona. Then recommend pay ranges,

identifying the low, median, and high rates for each pay range. To present the data, list each of the offices in order from lowest median pay to highest median pay.

4. If you had to develop a list of compensation best practices, what practices would be on your list? Develop the list, and compare your findings with those of your classmates.

HR EXPERIENTIAL PROBLEM SOLVING

You have recently been given the responsibility to update all of the company's job descriptions to comply with the Fair Labor Standards Act (FLSA) classifications. The company president believes his secretary is an exempt employee and she is not eligible for overtime pay when she works more than 40 hours in a workweek. You need to prepare a memorandum outlining the essential job functions/duties and giving an opinion about whether the secretary position qualifies for an exempt status

classification. To assist you in making this determination, go to www.dol.gov/whd/flsa.

1. What would the HR professional identify as required key essential functions for the position to qualify for an exempt classification?
2. Assuming you identify that the secretarial position would not be qualified as exempt, what approach will you take to inform the president of your determination?

CASE

Pay for Performance Enhances Employee Management at Scripps Health

Scripps Health is a long-standing and prominent nonprofit health-based organization that is based in the greater San Diego area. The organization experienced a severe financial downturn that led to increased employee discontent and turnover, as well as the exit of the firm's CEO. In an effort to fix these problems, CEO and President Chris Van Gorder implemented a new strategic plan that was used to enhance how the employees were treated.

The new strategic plan contained several components that encouraged employees to work more effectively in their jobs. For example, administrators were to utilize a more participatory leadership approach to create "buy-in" among staff members, and a natural extension of this approach was the development of a physician leadership cabinet that improved how personnel interacted with each other, and that strengthened firm coordination through widespread communication. Top managers also focused on improving individual satisfaction and productivity by enhancing work efficiency levels.

A major part of these more streamlined operations stemmed from implementation of a beneficial performance management plan. In particular, this plan outlined how managerial talent would be developed, employees would be recognized for a job well done, and motivation would be orchestrated through a competitive compensation approach.

Reorganizing the compensation policies of the organization was one of the primary areas targeted for improvement by the firm's leadership. Part of this redesign process involved periodic reviews of job content, the use of annual appraisals to enhance communication, and the assessment of experience and education to properly adjust compensation amounts. Further, the organization strives to offer competitive compensation that rests at the 65th percentile of the relevant labor markets, which positions the firm squarely in the middle between the top and bottom levels of competitive compensation. The company also tests the pay markets twice a year so that it can remain competitive with regard to compensation. Finally, workers can tap into extra money based on ratings given vis-à-vis the annual performance appraisal sessions; if employees do well on their performance reviews, they can earn as much 5% of their salaries as merit-based compensation.⁷⁴

QUESTIONS

1. Discuss how this case illustrates how compensation can be used as a method for improving employee satisfaction and motivation.
2. Identify some of the ways that performance-based pay systems should be developed based on the experiences at Scripps Health.

SUPPLEMENTAL CASES

Compensation Changes at JC Penney

This case identifies how performance management systems might be redesigned. (For the case, go to www.cengage.com/management/mathis.)

Scientific Turmoil

This case discusses the concerns associated with having a formal base pay system and communication issues that occur. (For the case, go to www.cengage.com/management/mathis.)

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