Employee compensation, one of the largest expenses in any organization, is also one of the least managed. While transparent data and scorecards have greatly improved the management of other aspects of performance, compensation often goes unevaluated beyond the fundamental measure of incremental costs. The invisible nature of compensation leads to problems. These include failing to differentiate pay for performance, over- and/or underpaying jobs relative to the market, having compensation spending grow faster than revenue and allowing employees to suspect they are not being paid fairly.

Using a “compensation scorecard” can greatly increase an organization’s compensation effectiveness. Since it is true that “what gets measured gets done,” it is critically important to measure and manage compensation. With the right measures in place, organizations can more effectively use what they spend on compensation to help execute their strategy.

What Is a Compensation Scorecard?

A compensation scorecard collects and displays the results for all the measures that an organization chooses to use to monitor compensation and compare compensation among internal departments or units. It can be used to:

- Help organizations detect and prevent compensation problems,
- Make compensation decisions and actions more transparent, and
- Improve the quality of compensation decisions.

The sample compensation scorecard below is a relatively basic example by Alpha Corp., a theoretical organization that chose to report each department’s average performance rating on a scale of one (low) to five (high), average merit increase, grade inflation, compa ratio, annual incentive and long-term incentive (LTI) correlation with profit growth.

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1 Grade inflation is determined by calculating the percentage change in the number of incumbents in each grade.
2 Compa ratio is actual salary divided by the midpoint of the salary range. It is a gauge of the appropriateness of the organization’s salary ranges.
3 The direct correlation between profit growth over a three-year period relative to LTI expense.
Different organizations should use different measures, units of comparison and other factors, depending on what they want to measure. Compensation scorecards are such powerful tools that they must be designed carefully to reinforce the desired outcomes that are unique to their strategy and situation. (See the sidebar, “Why Alpha Corp. Introduced a Compensation Scorecard.”)

Most compensation scorecards are issued by HR once a year, usually after the organization’s annual compensation actions have taken place. This is a less prescriptive and heavy-handed approach to pay differentiation than a forced ranking or forced distribution.

There are three steps to creating a compensation scorecard: confirm the organization’s compensation strategy; review the key elements within the compensation strategy, and decide what measures to use.

**Confirm the Organization’s Compensation Strategy**

Written or unwritten, an organization’s compensation strategy needs to be coordinated with its overall business strategy as well as its intended employment value exchange. Senior leadership should review the compensation strategy with guidance from HR.

The six fundamental compensation strategies are:

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4 The employment value exchange is the combination of rewards employees get (both intrinsic and extrinsic) and the expectations of performance and engagement that employers set for employees.
1. **Competitive**  Pay is closely maintained at a chosen market point (below, at or above market value).

2. **Performance Differentiation**  Employees are paid for performance, within a broad range of total direct compensation.

3. **Egalitarian**  Base pay is competitive and group rewards are tied to business success.

4. **Mission-Based**  Cash compensation is low, but internal equity is high and employees have a strong affiliation with the organization’s mission.

5. **Cost of Compensation**  The cost of compensation is kept at or below a certain ratio of revenue.

6. **Unstructured**  Each employee gets an individual deal, as needed, to promote retention and performance.

Alpha Corp., the example in the sidebar, uses the performance differentiation compensation strategy because it is most consistent with its desired culture and way of achieving results.

Some organizations try to use a blend of strategies, which can create chaos and lead to inequities. For example, it is impossible to consistently pay for performance and adhere rigorously to a market pay point for all jobs and employees. One strategy must take precedence. Other organizations may be rewarding the right behaviors, but with the wrong vehicle. (See the sidebar “Right Behavior/Right Reward.”)

If an organization has not updated its compensation strategy in recent years, 2010 is a good time to do so. The economy, demographics and the talent market have all changed dramatically, which has led most organizations to alter their business strategy. For example, because of the general talent shortages and the economic growth that existed between 1997 and 2007, many organizations still have a compensation strategy whose primary goal is to attract and retain employees, with less emphasis on pay for performance. In today’s environment, the strategies that were appropriate in the past may need to be refined if not revamped.

### Right Behavior/Right Reward

A common compensation problem is employing the wrong vehicle to reward a specific behavior or driver. For example, if an organization uses above-market salary increases to reward annual performance against goals, compensation can become a drag on profits. Examples of “right” rewards:

<table>
<thead>
<tr>
<th>Reward Driver</th>
<th>The Right Reward</th>
</tr>
</thead>
<tbody>
<tr>
<td>Performs job duties</td>
<td>Base salary increase</td>
</tr>
<tr>
<td>Meets annual goals and objectives</td>
<td>Salary increases and incentives (team or individual)</td>
</tr>
<tr>
<td>Demonstrates specific competencies</td>
<td>Promotion, development opportunities, special assignments</td>
</tr>
<tr>
<td>Accrue years of tenure/service</td>
<td>Service awards, vacation, pension and other benefits</td>
</tr>
<tr>
<td>Completes special projects or puts forth extraordinary effort</td>
<td>Recognition awards and spot bonuses</td>
</tr>
</tbody>
</table>

### Review the Key Elements Within the Compensation Strategy

The next step in developing a compensation scorecard is for the organization’s leadership to determine, set or confirm direction on the elements that make up the compensation strategy:
The Role of Pay is the function and prominence of pay in the overall employee value proposition relative to other elements.

Funding Criteria are the factors that will drive compensation funding, including the balance of business results and market factors.

Job Valuation is the basis for valuing work and jobs, which defines the relative emphasis of internal versus external factors in the valuation process.

Competitive Positioning is the comparison groups/peers and the desired level of compensation delivered relative to the comparison group.

Individuals vs. Teams is the extent to which compensation will reward individuals and/or groups.

Mix of Pay is the desired mix of fixed and variable compensation elements, including what pay delivery vehicles will be used and the purpose of each.

Governance is the roles, responsibilities and decision rights of key compensation decisions.

Communication and Openness is the degree to which the organization openly communicates its compensation strategy, programs and pay opportunities.

Direction on these elements also helps determine what to include in a scorecard and what measures to use. For example, in reviewing its competitive positioning and mix of pay, an organization may choose to pay primarily in base pay and compare at the 50th percentile of similar sized organizations, or it could chose to have a significant portion of its pay be variable and target the 75th percentile when outperforming its competitors. Such decisions will affect what is measured and reported in the scorecard.

Decide What Measures to Use

Once the organization has chosen a strategy and decided the direction on strategy elements, it must select a set of measures to use to assess and manage its compensation effectiveness. (See the sidebar “Measures that May Be Included in a Compensation Scorecard.”)

Because measures usually are more visible and get more attention than an organization’s compensation strategy, it is important not to send the wrong messages by including inappropriate results in the compensation scorecard just because they are available. To illustrate, it is helpful to look at two of the most common high-level compensation strategies and the measures that would be appropriate for each.

Individual differentiation for performance within a broad market range is probably the most frequently used compensation strategy for broad-based populations. It has the value of both staying near the market overall and being flexible for rewarding performance. Of course, the problem is that to truly reward performance and stay within market, the organization must pay some people less than market in order to pay others more than market. Managers naturally try to game this strategy and pay everyone at or above market, with the highest performers getting even more. The appropriate measures for this strategy may include a comparison of the level of performance differentiation and pay differentiation and percentage over or under range.

Although it would be very common to add compa ratio or average market percentile, these measures could confuse the actual strategy. If an organization measures compa ratio or market percentile, it is reinforcing a different strategy and different behavior. For example, to keep their...
employees from looking bad on compa ratio, managers might not adequately differentiate pay for high performers.

Tightly controlling pay around a desired market positioning or maintaining egalitarian pay is another popular compensation strategy. The key measures for this strategy would include compa ratio and market percentile. In this case, an emphasis on measuring compensation expense ratios or performance differentiation would send the wrong message and promote the wrong behavior.

### Other Considerations

Most organizations’ discussions about compensation scorecards eventually turn to activity and outcome measures. It is, however, important to be cautious about trying to link outcomes directly to compensation rather than measuring if compensation actions are coordinated with the organization’s compensation strategy.

For example, some organizations once considered talent retention to be an outcome of appropriate compensation. As a result, they had a compensation scorecard measure for retention (or undesirable turnover). Since many factors in addition to compensation affect retention, a number of these organizations found themselves overpaying their employees. Some even created a culture of rewards entitlement by focusing on the retention of all employees. While high pay may handcuff the talent, it does not necessarily reinforce a culture of performance.

Another outcome that some organizations consider is productivity, measured as revenue per employee. Once again, many factors other than pay, such as staffing ratios, have more of an influence on productivity. Just like retention, productivity is an important outcome for an overall scorecard, but it may not be appropriate as a measure of compensation effectiveness.

It is, nevertheless, interesting to note that organizations should consider productivity when selecting their competitive positioning in their compensation strategy. If an organization is the most productive company in its industry, it could have higher pay position than its less productive competitors.

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### Measures that May Be Included in a Compensation Scorecard

- **Average Market Percentile** is the percentage to market for benchmark jobs.
- **Compa Ratio** is the ratio of average salary in a grade relative to midpoint.
- **Grade Inflation** is the growth or decline in average salary grade distribution.
- **Incentive Differentiation** is the average percent of target paid and the standard deviation.
- **Market to Midpoint** is the ratio of benchmark job market data to grade midpoint overall.
- **Merit Differentiation** is the average percent increase associated with each level of performance ratings.
- **Peer Pay Productivity** is the ratio of market positioning of pay to market positioning in revenue or profit.
- **Percent Over Range** is the percentage of employees over the salary range maximum.
- **Percent Under Range** is the percentage of employees under the salary range maximum.
- **Performance Distribution** is the weighted average of performance ratings and the standard deviation.
- **Performance to Pay Relationship** is the level of differentiation in pay associated with performance levels.
- **Promotions** is the percentage of people promoted and the average increase.
- **Relative Pay Productivity** is the ratio of overall pay to overall revenue and profits.
- **Turnover** is the number of terminations in one year divided by the average headcount for the year (beginning-year headcount plus end-of-year headcount divided by two).

Source: Sibson Consulting
Conclusion

The compensation scorecard is a powerful way to track and influence the use of compensation within an organization’s compensation strategy. It provides a means to ensure better management of one of the largest expenses in any organization. Rather than measure and report on everything related to compensation, it is important to use scorecard elements that reinforce the organization’s desired compensation strategy.

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