

Apples to Apples Fair Compensation Chosen Fairly

by Roxanne Krasno

Most of us know about “comparing apples to apples.” Comparing things equitably adds credibility to any decisions that result. This holds true especially when the decisions affect compensation.

Paying people appropriately is one of the most difficult tasks faced by any organization. The question “Are we paying enough to attract, motivate and retain top talent?” is asked repeatedly and the answer is often a function of whom or what is being used as a basis for comparison.

There are two basic methods of gathering comparison compensation information — surveying and benchmarking. Surveying is used to determine what practices exist, whereas benchmarking examines the effectiveness of the practices or the reasons for their use. The approaches differ in focus and in sample population, as shown below.

	Surveying	Benchmarking
Focus	What?	How? and Why?
Sample	Broad	Narrow

An organization’s approach should be based upon the type of position being examined and the availability of reliable data. Unfortunately, many organizations end up with a compensation package determined by the equivalent of comparing apples to other assorted fruit!

As a result of this inequity, some recent compensation arrangements have been challenged by corporate boards, management, employees, stockholders and the general public. Business literature has been rife with articles that critique the compensation arrangements of selected executives, often implying that either the comparison was haphazard or that the peer group was cherry-picked. Organizations need to ensure that they are not just comparing apples to apples but they are comparing the same variety of apples.

The validity of a compensation comparison is based upon the “relevant market” from which an organization recruits talent and to which talent goes when it leaves the organization. The relevant labor market may vary by position or group of positions. It also may be general in nature, industry-specific or geographically specific.

In addition to identification of the relevant market, an organization must determine its relative position within the market. Does the organization want to lag, meet or lead the market? Answers to these questions should be determined before conducting any comparisons.

Surveying

Surveying helps an organization use third-party published data to make compensation comparisons. Because surveys can differ significantly, both in methodology and in quality, it is important to use only well-established, reputable surveys. Free internet surveys may be flawed in terms of methodology and sample. When it comes to surveys, it is a sound practice to choose only the best apples from the barrel.

There are three critical points to remember when using survey data. First, make sure that there is an acceptable job match. The organization’s job should have 80% or more overlap of duties with the survey job. Second, project the survey data. Because surveys capture compensation data at various times during the year, the data must be adjusted to a common date. Survey data is often updated by a factor equal to anticipated pay increase or cost of living. This ensures that all apples come from the same crop. Third, check the data scope. Is the survey data thin (an inadequate sample that may lead to unreliability), or are there significant variances (+ 20%) in reported results between surveys? In such cases, outlying data should be culled. In a perfect world, all apples should be uniform and free of blemishes.

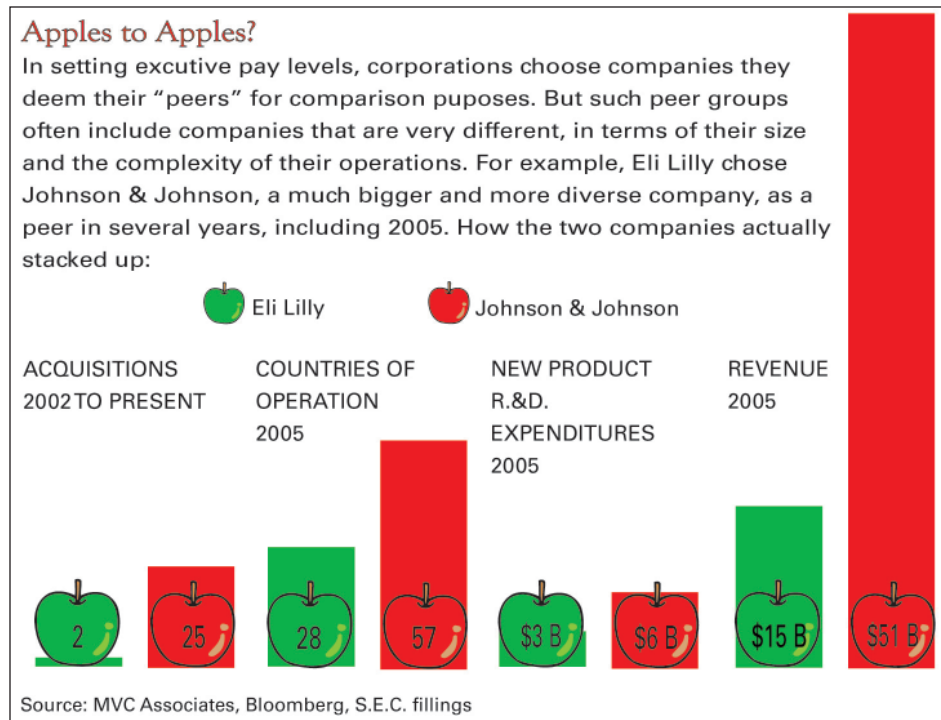
Benchmarking

Benchmarking for compensation comparison is significantly different from surveying. Instead of using third-party surveys, an organization identifies a

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collection of other organizations, or peer group, against which it can measure itself when setting compensation. The organization then utilizes peer group data to establish its own pay rates. Peer groups are a valid means of comparison if data is available. For publicly-traded organizations and non-profits, data is usually readily available from tax and Securities and Exchange Commission (SEC) filings. For privately-held organizations, data may be more difficult to acquire.

A recent study of the use of peer groups for setting executive compensation found that in some instances peer groups tend to inflate compensation (Bizjak, Lemmon and Naveen, April 2003). On November 25, 2006, *The New York Times* highlighted this issue by showing Eli Lilly's choice of Johnson & Johnson as a peer. Quite different in size and diversity, the following chart depicts how these two companies actually compare:



As a result of this non-equitable practice of peer comparison, the SEC implemented new disclosure rules on December 15, 2006. A company must now reveal its peer group and detail its compensation philosophy. Company officials also have to certify their pay disclosures. One may expect new scrutiny as the comparison process becomes more transparent. Failure to have a sound, defensible compensation comparison process can lead to materially false disclosures and significant consequences for the certifying official. It is imperative that compensation at all organization levels be set using good comparables.

