

A **Dartican LLC** White Paper



Pay Transparency: The Future of Compensation Management

Executive Summary

Employee compensation is usually the single largest company expense and, therefore, organizations continually try to optimize this cost. Pay transparency, the practice of open communication of compensation philosophy and systems to employees, can be an effective lever for managing an organization's most significant expense.

Articles and studies in the compensation field show strong evidence that engagement and productivity increase when employees understand their company's compensation system, its relation to the market, and their own place within the system.

An organization's culture will determine where it will fall on a pay transparency continuum. Wherever that is, targeted actions to increase the degree of transparency may produce more efficient operations saving time and money, and help increase company revenue by improving employee engagement, discretionary effort and job satisfaction.

Pay transparency is an important trend in compensation management that warrants both focused discussion and targeted actions in most companies. In particular, in a challenging economic period, difficult decisions about compensation will be more effective when accompanied with a move towards pay transparency. This paper also provides some practical guidance in implementing a more transparent approach to communications about pay.

A compensation philosophy is the set of organizational values and beliefs that serve as the foundation for all decisions about pay.

Background

Economies around the world are slowing down, and companies are looking for ways to lower spending and improve the bottom line. Senior executives are now looking at the cost of their employees, anticipating a substantial savings by trimming personnel and instituting pay cuts across the organization.

Because compensation is typically a company's single largest expenditure, organizations are right to look in this direction for help when times are tough. But are these simple cost-cutting measures always the most effective ones? After all, employees create, deliver and maintain most of the organization's value. Losing the wrong people can cost a great deal more than the dollars gained by eliminating their salaries.

Moreover, decisions about compensation now occur in a world of information changed forever by the Internet. People today have access to unparalleled amounts of information, including information about compensation, which historically has been kept secret. Numerous websites provide salary survey data freely, and the explosion of social networks and social media spreads compensation data and conversation without any limits.

Compensation is no longer a hush-hush body of secrets. Yet, how reliable is the data about compensation that people chat, blog, Facebook and Twitter about? The answer is that there's no way to know how valid it is.

Despite this uncertainty, and perhaps even because of it, companies can no longer maintain a "take it or leave it" stance about pay. Employees and applicants form their own perceptions of the competitive marketplace and do not hesitate to ask in-depth questions. Companies have no choice but to provide context and understanding to respond to the uncontrolled sea of data online.

Compensation professionals have this expertise and perspective, based on understanding their company's overall compensation philosophy and pay systems. But it is effective communication about compensation that can create buy-in and trust. This kind of communication is known as *pay transparency*.

We should not confuse pay transparency with the idea that every person in the company knows what every other person is making. Rather, pay transparency means that every employee understands the rationale of their organization's overall compensation scheme, how they fit into that scheme and how their pay stacks up relative to other alternatives.

Pay transparency is not an all-or-nothing proposition. All organizations operate on a continuum of pay transparency, and almost no one lies completely at one end of the spectrum or the other.



Your first goal should be to find out where you are on that spectrum. Determine if that is the appropriate place to be at present, given your organization's philosophy and culture. While there is no single right spot on the spectrum, we have found that most organizations will benefit from increasing transparency, given the current economy and employees' free access to information.

Recent Writings on Pay Transparency

Much literature has emerged recently on pay transparency. Overall, it shows that knowledge of pay:

- Fosters trust in management
- Increases employee engagement
- Encourages discretionary effort
- Reduces turnover
- Creates competitive advantage

People want to work where they understand their value and feel they can trust their employers. In such an environment, they are willing to work harder, offering more of their discretionary effort toward the organization's goals. Employee trust, then, is not an end in itself but a foundation for competitive business advantage.

“The three-year Total Return to Shareholders is almost three times higher at companies with high trust levels than at companies with low trust levels.”

*WorkUSA 2002 Study,
Maureen Minehan,
Watson Wyatt*

The Knowledge of Pay Study: E-mails From the Frontline found that employees who had greater knowledge of pay also had greater pay satisfaction, engagement and more:

When managers and employees understand pay processes, organizational effectiveness measures go higher. In particular, greater pay knowledge is associated with higher levels of pay satisfaction. In turn, higher levels of pay satisfaction are positively associated with some measures of organizational effectiveness, including high levels of retention, organizational commitment, employee referrals, management trust and pay for performance perceptions. From these observations, the utility of improving pay knowledge for organizations is clear.

“A lot of the debate about pay transparency is misframed. Too often it is focused on what employees are paid and the idea that employee pay data should be made (more) public. This is not transparency... this is an invasion of privacy. An appropriately transparent pay program is one where we have clearly communicated with employees the why and the how of the organization’s pay practices.”

--Ann Bares,
managing partner of Altura
Consulting Group and author of
the Compensation Force blog

Yet, a survey on Frank Roche’s KnowHR blog indicates a resistance to pay transparency that may have more to do with performance management capabilities and the need to deliver tough messages. One blog comment indicated that a “...wise organization communicates this [compensation policy] proactively. In the absence of this proactive communication, employees are left with no choice but to draw their own conclusions about the organization’s intent and practices.” When compensation policy is secretive, employees may jump to conclusions like, “Why won’t they tell us anything? I must be getting ripped off!”

As Hay Group authors Tom McMullen and Victoria Power note in their *Human Resource Management* article, a “... reward program can serve as a motivator only if it is understood ... by employees.”

Communication is vital, but who is best suited to communicate knowledge about a company’s compensation system to an employee? McMullen and Power concluded that managers were the best choice, as they were the most trusted by employees. An organization’s HR and compensation professionals should strive to keep managers thoroughly informed about the company’s compensation system and strategy and to give them useful materials to convey that information to employees.

Importantly, *knowledge* of pay increases pay satisfaction independent of the *amount* of pay. The Hay Group quotes a rewards professional whose company worked hard to educate its employees: “Surprisingly, it’s not the value of rewards that’s the differentiator [in greater effectiveness of the program]. It’s the communication.” And the Knowledge of Pay study states, “In fact, the data even indicate that organizations that are perceived to pay

less competitively achieve higher organizational effectiveness when they share more knowledge about pay and pay processes.” This is an important net benefit to the organization and the employee alike.

Own the Data, and the Knowledge is Yours

Regardless of how deeply a company chooses to embrace pay transparency -or how much or well it communicates about the knowledge of pay- it must understand its own compensation system clearly. Employees and applicants will continue to take in more and more data online - regardless of how unreliable or out of context it may be.

Most companies have more compensation data than they need. The trick to converting this mountain of data into meaningful knowledge is to integrate it and to establish *tools and processes* that allow users to focus on interpreting, applying and communicating this information.

Wherever companies fall on the pay transparency continuum, we encourage them to define these processes and deploy data management tools to enable them. Companies should define: what data sources may be accepted and why; what data elements will be used and how; and when, in what form, and to whom knowledge of pay will be communicated. An additional benefit of pay transparency? A company will create a better foundation of knowledge to make better decisions and engage in communications effectively.

Here is an example of mastery of the data and increased pay transparency. The organization found tremendous value in regularly distributing standardized market analysis reports to the field HR organization for discussions with line managers.

Managers were frequently being pressured by employees who were bringing in “market data” that they pulled from various websites. These managers were defensively reacting to data that was not valid; without easy access to reliable survey data, they could not easily or effectively respond.

With Dartican software, the corporate compensation staff still centrally controlled the use of appropriate survey data. Yet they were able to arm line managers proactively with the data and educate them about the context of the data. This allowed the managers to easily navigate those conversations with their employees - resulting in increased productivity as well as improved employee relations.

“KnowledgePay lets me get more compensation data into managers, hands on the front line, while staying in control of the market data we use and standardizing the way it’s presented.”

-Kenneth G.,
Director of Compensation

Pay Transparency in a Tough Economy

The decision to increase knowledge of pay in your organization is strategic. Whether in a strong economy or a troubled one, the decision must be made based on driving the best business results. We conclude this paper by looking at recent events in the current market, especially the bold decisions by some companies to make across-the-board pay freezes or even pay reductions.

Across-the-board pay freezes or cuts may seem egalitarian, yet can often reveal a surprising level of oversimplification or even ignorance of a company's own compensation system or the current landscape. For example, in a company where the research and development team drives the long-term success of the overall business, does it make sense to cut their pay as much as that for support personnel? Or at all? What if one area currently lags behind its relevant labor market- a decision to cut salaries across the board will almost certainly have unintended consequences, exacerbating an already difficult situation.

Organizations with a sound grasp of data, an integrated understanding of its own compensation strategy and system, and skills in communicating knowledge of pay will be able to look at any situation in context and make decisions- even difficult compensation decisions- with greater confidence that they will achieve the desired business benefit with less negative impact.

Steps Toward Greater Transparency

Moving to greater pay transparency and an increased knowledge of pay is rather like planting a tree. The action you take now will require time to grow and mature into a significant change in your organization's culture. But if your goal is to meet current economic difficulties by increasing employee engagement, garnering greater discretionary effort and inspiring a more trusting workforce, then the time to start planting those seeds of pay transparency is now.

An economic downturn requires difficult decisions, but the studies and experience we have cited make it clear that an organization's employees will understand these decisions and will be much more engaged to help the organization pull through tough times if communications with them are more open.

“The best time to plant a tree is twenty years ago. The second best time is today.”

-Chinese proverb

Some tips to keep in mind as you do begin to move in the direction of more transparency include:

- Ground yourself in your compensation philosophy;
- Ensure consistency between levels of openness of pay communications versus your organizational culture;
- Use the pay transparency continuum concept to map out where you are versus where you need to be;
- Master the data about your jobs, employees and the external market;
- Arm the frontline managers with in-depth information; invest heavily in their education;
- Use feedback loops so that the information process is circular, not just top-down.