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REWARDS RISK:

how to reduce exposure & strengthen compensation effectiveness in challenging times

By Brian Levine, Mercer, and David Kuhl

QUICK LOOK

- It is more important than ever that employers proactively address potential rewards inequity.
- Work to identify and fix issues that truly exist, not to present the organization in the most favorable light, potentially obfuscating risks.
- A strong pay-equity process can serve as a check on decentralized compensation decisions.

During the past few years, organizations have focused increasingly on ensuring rewards equity across gender and racial lines. They've done so not only because it's the right thing to do, but also because it's a way to attract and retain increasingly diverse and hard-to-find talent. It also addresses the rising cost of responding to employment litigation — widely expected to increase now in light of the Lilly Ledbetter Fair Pay Act, recently signed into law — and can help protect an organization's brand and reputation, which may seriously erode when class-action lawsuits make headlines and significantly threaten profitability in today's challenging economic times.

Another key reason to ensure rewards equity is the governmental scrutiny organizations face on the

equity issue, as regulatory agencies have adopted sophisticated methodologies for compensation assessment. In the United States, this scrutiny and the risk associated with noncompliance will only intensify under the current presidential administration and Congress. In the European Union and Asia, regulations on rewards equity are emerging and becoming increasingly stringent.

Under such pressures, leading organizations are becoming more proactive in evaluating and addressing potential rewards-equity issues. Many are considering not only employee-specific pay adjustments that level the field to directly address legislation like the Ledbetter Act, but also changes in compensation and HR practices to reduce emergent bias. Given the complexities associated with pay evaluation, compensation practitioners have become more involved in such efforts.

To help those practitioners, this article reviews the compliance risk facing organizations on rewards, specifically compensation, and discusses four principles that can help mitigate that risk.

Conducting an Actionable Compensation Analysis

The first step is to compile data from company systems on factors that should legitimately impact pay outcomes as well as on protected classes that need to be assessed. After some scrubbing — for example, to ensure that birth dates and hire dates are consistent and that administrative system changes are not represented as employee status changes — the data comes together to fuel the analysis.

To that end, multiple regression models are run to identify the legitimate drivers of compensation for each workforce segment. (Segments are determined through a disciplined process whereby those who understand the various compensation practices in place come together to stratify the employee population.) Once models are run, the results can be examined to determine in which areas of the enterprise issues are concentrated (e.g., lines of business, job families, pay grades, locations).

Because the model results also provide a formula for pay determination, one can predict pay at the employee level and, if the employee is paid significantly less than that prediction, recommend pay adjustments. For those areas for which issues have been identified, specific pay adjustments should be considered.

Compliance Risk

The Office of Federal Contract Compliance Programs (OFCCP), the agency that enforces affirmative-action requirements for federal contractors in the United States, generated a record $67.5 million in financial remedies in 2008, which represents a 30-percent increase over 2007's total. According to the OFCCP, 99 percent of those remedies stemmed from cases of "systemic discrimination ... those involving a significant number of workers or applicants subjected to discrimination because of an unlawful employment practice or policy."

In effect, the agency is scrutinizing the practices of employers across wider workforce populations to generate increasing financial remedy totals. The Equal Employment Opportunity Commission (EEOC) established a similar systemic focus in 2006 in its evaluation of complaints.

Regarding the impact of specific legislation, the Ledbetter Act, signed into law by President Obama on Jan. 29, 2009, in essence resets the statute of limitations for filing pay-discrimination claims (180 days in most states) each time a paycheck is issued and is, therefore, expected to dramatically increase claims. Perhaps in anticipation of this legislation and in response to the economic downturn, complaints filed with the EEOC starkly increased in 2008.

The Paycheck Fairness Act, which has yet to pass, would dramatically increase potential awards for Equal Pay Act claims in three ways. First it would allow for uncapped compensatory and punitive damages. Second, it would significantly increase the size of class actions by requiring class members to actively opt out of a class. Third, it would make it more difficult for employers to defend against discrimination claims by eliminating the requirement for claimants to provide anecdotal evidence of discrimination and forcing employers to substantiate legitimate drivers of pay differences.

Moreover, the Paycheck Fairness Act would allow the plaintiffs to consider a wide range of statistical tests to make the most compelling case for inequity, despite legal precedent and the OFCCP's endorsement of multiple regression as providing for the most definitive test. The act does seemingly provide for a modest improvement in the OFCCP's analysis process: The agency would no longer create similarly situated employee groups (commonly referred to as SSEGs), an ad-hoc "job family"-like concept intended (but unlikely) to improve upon structures actually used by companies for managing compensation.

Given these environment forces, it is more important than ever that employers proactively analyze potential rewards

Multiple regression analysis

allows an examination to account for differences between jobs, locations, pay grades and employees, any of which can legitimately generate differences in pay outcomes.

inequity by reviewing compensation drivers, documenting the legitimacy of those drivers and implementing targeted pay changes. In doing so, there are four key principals that you should keep in mind to ensure success: 1) seek the truth, 2) don't wait for the data to be perfect, 3) support — and strengthen — your compensation philosophy and 4) do good — again and again.

1 Seek the truth.

Knowing how the organization will fare in the event of litigation or government audit will allow you to address any existing problems and mitigate related threats. For this reason, it is foolhardy to stack the deck in the organization's favor in a proactive examination. You should work to identify and fix issues that truly exist, not present the organization in the most favorable light, potentially obfuscating risks.

The point sounds obvious, but it can get lost when working with some "experts" outside of a litigation context. Such experts frequently advocate examination of employees in narrow pools to ensure that comparisons are made among those "similarly situated." While the need for apples-to-apples comparison is clear, this "small-pool prescription," which often advocates job-by-job, location-by-location and/or pay-grade-by-pay-grade analyses, ignores the advantages of modern, statistical analysis, which can account for multiple differences between employees simultaneously and can increase your power to identify real risks. An effective analysis will balance workforce segmentation against your search for truth — with key differences in compensation philosophies across segments serving as the ultimate guide for break points.

Multiple regression analysis, long the standard accepted by courts in this context, allows an examination to account for differences between jobs (e.g., market rates and responsibilities), locations (e.g., unemployment rates), pay grades and employees (e.g., experience and performance), any of which can legitimately generate differences in pay outcomes. Differences in practices between jobs, for example, to the degree that they imply different effects of various factors on pay, can be accounted for by an appropriate level of workforce segmentation prior to modeling or by specialized modeling techniques in combined models, which allow estimation of different effects for specific pay drivers. To the degree that segmentation is pursued, it should separate employee groups subject to different compensation philosophies (e.g., sales and managerial employees).

Perhaps most importantly, a job-specific or other narrow approach generally will fail to assess the very issue upon which the federal government is now focused and upon which employers face the greatest risk: systemic discrimination. By its very nature, systemic discrimination would transcend jobs, locations and/or pay grades.

2 Don't wait for the data to be perfect.

Multiple regression analysis is a starting point. The results do not imply that any specific pay changes need to be made. Results are, instead, suggestive: they point to areas where action might be critical. Following the analysis, there is research to be done on pay levels for specific employees.

Because this work is in itself a research process, one does not need every element of data available before moving ahead. Instead of focusing on the impossible task of collecting comprehensive data and/or scrutinizing data elements employee by employee, focus on a small subset of the workforce that is revealed to

be out of alignment with observed compensation norms.

For some constructs, standard, if imperfect, "proxies" can be used (e.g., age, after considering organizational tenure, can be used to account for potential prior experience). Other data might not be available for every employee — simply use all of the data available on relevant factors for whomever it is available (in an appropriately specified analysis). Education is a common example of a factor with partial availability stemming from incomplete self-reports and/or imperfect alignment of the human resource information system and recruiting system. The more readily available information that is accounted for up front, the less employee-level research that must be considered on the back end.

In conducting targeted research, ensure that data elements critical to the analysis are correct; check for situations in which pay outcomes are, in fact, legitimate (e.g., whether the person's historic performance record is subpar or whether the person is in a truly unique position); and document discoveries and decisions. After that is done, consider pay changes for employees for whom pay differences from predicted levels are still unexplained.

3 Support — and strengthen — your compensation philosophy.

In considering adjustments for specific employees who are out of alignment on compensation based on a multiple regression analysis, there is limited potential distortion of the compensation system's intent, provided that the intent matches with actualized practices. What is generally rewarded is simply reinforced, and so the integrity of the compensation system can be, in fact, strengthened. In contrast, across-the-board changes — changes based on membership in a protected class, such as increasing pay for all women in a group by 2 percent — can drastically change relative pay distributions and, in fact, create inequities. Across-the-board changes should be generally avoided.

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Compensation philosophies do need to be checked, however, against regression models. Do the models fairly represent the philosophies as intended? If not, are the modeling segments correct? If the segments are appropriate, should changes to rewards policies be considered?

For example, if rewards policies differ across lines of business or job families, do they vary as intended? To get specific, one might look at the impact of supervisory status and rank on pay, and whether the degree of the observed relationship drives inefficiencies (in this case, perhaps creating pressure to create too many supervisory roles). A strong pay-equity process — in addition to the pay-grade infrastructure and market-pricing efforts — can serve as a check on decentralized compensation and staffing decisions.

Multiple regression analysis can also point to specific policy changes to improve pay equity in the long term. Among questions that can be assessed are the following:

- Are full-time equivalent pay differences driven by full-time status and/or past leave of absence? (If so, because women are more likely to work part time and to take leave, gender equity might be at risk.)
- Do pay inequities stem from the point of hire? (If so, target initial pay-setting processes for change.)
- Do pay inequities arise from potential performance-rating bias? (If so, train supervisors to ensure that ratings are fair and that reviews are thoroughly documented and checked.)

4 Do good — again and again.

Because the workforce is dynamic — with hiring, terminations, promotions, transfers and pay changes — pay-equity processes should be ongoing. For federal contractors, annual review is required; but, for nearly all employers, annual review makes sense given the risks and associated benefits of the effort. Optimally, the review should coincide with the fiscal year-end compensation evaluation process.

In the face of the Ledbetter Act explicitly, it is important to reduce the risk that a claim will be made based upon past actions. In correctly structuring a pay-equity analysis now, one can ensure that everyone's pay is in line with norms generated on an appropriately recent basis. As a result, differences based upon past decisions will be reduced over time, as will potential claims.

Conclusion

Ultimately, knowing how your organization will fare in the context of litigation or government audit will allow you to address any existing problems and to mitigate related threats. This is especially critical given that the current regulatory environment presents significant hurdles that are likely to become more substantial. Furthermore, in the current economy, it is even more important to pre-emptively respond to reputational threats that could cost your organization investors, customers and employees. Establishing a strong review process and following a core set of principles will serve to ensure effective risk mitigation. WS

ABOUT THE AUTHORS

Brian Levine, Ph.D., is a principal with Mercer's Workforce Sciences Group in New York. He may be reached at brian.levine@mercer.com or 212-345-4194.

David Kuhl is former vice president of employee relations at UnitedHealth Group and now practices law in Minnesota. He may be reached at dkuhl1@mac.com.

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