All the key terms you need to know about pay and salary structures

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According to R.S. Kaplan and D.P. Norton in a 2004 Havard Business Review article, the fact that a company's workforce cannot be easily replicated by competitors means that the human resource is even more valuable to a company than its tangible assets. This is in line with highly influential management expert, Peter Drucker's sentiment in a 1999 California Management Review article titled Knowledge-Worker: The Biggest Challenge, where he stated that "the most valuable asset of a 21st-century institution (whether business or non-business) will be its knowledge workers and their productivity". This shows that companies that possess high-performing employees may be able to maintain a competitive advantage over their competitors. It thus becomes crucial for companies to attract and retain top talent at all times. One way to do this is to maintain an equitable pay structure. In this article, we will define and discuss the key terms you need to be aware of when considering a pay structure.

Defining Pay Structure

A pay/salary structure is a logically-designed framework that defines salary ranges for all jobs within a company. A well-designed pay structure is key to successful remuneration practices. It establishes the basis for the effective management of relativities that are associated with pay such as making salary adjustments. It also communicates the pay potential available to employees. It is here that the company will decide to lead, lag or meet the market remuneration. Companies generally choose to ***meet*** the market, i.e. pay salaries that are equivalent to what the market median is currently paying. This is because, at this level, the company will neither be overpaying nor underpaying its employees. Some companies choose to ***lag*** behind the market, i.e. pay salaries that are below the market median, say, the market 25th percentile. This choice is normally practised by small companies that are not in a financial position to compete with the market as they either cannot afford to pay at that level, and/or cannot sustain that level of remuneration in the long run. It is also common for big popular companies that every employee would like to work for to pay at this level, as they offer value to their employees in other ways. Companies that ***lead*** the market, i.e. pay salaries that are higher than the market median, say the market 75th percentile, are more likely to retain their employees, however, such companies must ensure they can sustain that level of remuneration in the long run.

Pay Structure Criteria

Some criteria make for a well-designed pay structure.

Internal Pay Equity

Firstly, it should promote internal equity i.e. it should ensure employees feel their pay reflects the relative worth of their job when compared to other jobs within the company. Internal equity can be ensured by comprehensive job evaluation.

Job Evaluation

A job evaluation is a way of ascertaining the value and worth of a job when compared to other jobs in the company. A systematic comparison between jobs will be performed to find out their relative worth. This is done to come up with a rational and defendable pay structure. This is possible because a job evaluation does not evaluate the employee but the job, and considers current company systems and structure in place, as well as any plans that may come. Jobs are then judged as being “low” or “high” in comparison to other jobs in the company hierarchy. In this process, a job analysis must be carried out.

Job Analysis

A job analysis is a process in which the duties and responsibilities of each job in a company are determined and clearly established. A job analysis is very important to a company’s recruitment and retention policy as it uncovers the qualifications and competencies necessary for each job. It produces job descriptions that detail minimum hiring standards for jobs. This goes a long way in ensuring companies seek out the right candidates for each job, limiting the need to keep returning to the job market after a new hire proves to have been mismatched with the job. It is vital that companies get this step correct, as the practice of hiring and subsequently replacing bad hires is a very expensive one. To uncover the conditions of work necessary and the key competencies relevant for each position, interviews with staff or surveys may be conducted. The next step would be to ensure a reliable job grading system is in place.

Job Grading

A job grading system is a system that categorises jobs of equivalent worth into groupings called grades. Job grading gives the employer a foundation to base its reasoning for paying its employees different levels of pay. As all positions are evaluated using the same system, job grading ensures that work done of equal value will be rewarded similarly.

External Pay Equity

Secondly, they should promote external equity. Where the previous looked at jobs within the company, external equity looks at how comparable pay received in a particular role compares with similar roles in other companies within the market. This is an important point especially as employees can be lured to other companies by better offers. Salary surveys can be used to establish prevailing pay rates in a market.

Salary Survey

A salary survey is a process of collecting market remuneration/salary data and is usually carried out to identify what the market is paying for each position. Salary surveys allow companies to match and compare salaries they are paying their employees with those paid in the market to employees with similar responsibilities or grades. Failure to remunerate employees comparably may result in failure to attract key talent, as well as, high employee turnover because of unfair or inequitable remuneration. Therefore, every company must work to ensure that its salaries are comparable or better than what competitors are paying. A typical salary survey usually consists of centrality and variability measures.

Measures of Centrality

This includes establishing for each position and level of employment the mean, 25th percentile, median, 75th percentile and 95th percentile.

1. **Market mean –** is the total of the salaries divided by the number of employees. Essentially, this amount signifies the amount all employees being looked at would earn if they all earned the same amount.
2. **25th percentile (aka lower quartile) –** implies that 25% of the incumbents currently earn a salary equivalent to or less than the value.
3. **Market median –** implies that half (50%) of the incumbents currently earn a salary equivalent to or less than the value.
4. **75th percentile (aka upper quartile)** – implies that 75% of the incumbents currently earn a salary equivalent to or less than the value. Alternatively, it can be interpreted as showing the amount earned by the highest-earning 25% of the market incumbents only.
5. **90th percentile (aka upper decile) –** implies that 90% of the incumbents currently earn a salary equivalent to or less than the value. Alternatively, it can be interpreted as showing the amount earned by only 10% of the market incumbents.
6. **95th percentile –** implies that 95% of the incumbents currently earn a salary equivalent to or less than the value. Alternatively, it can be interpreted as showing the amount earned by only 5% of the market incumbents

Measures of Variability

Some companies assess how spread out or clustered the benefits are for each position and level of employment. To do this they use the standard deviation and/or coefficient of variation as the measure of salary variability.

Standard Deviation

This is a measure of variability or dispersion which shows the relative distance between each data point and the mean. A high standard deviation implies that the salaries are fairly dispersed and are spread far from the mean, while a low standard deviation reveals that salaries are clustered around close to the mean.

Coefficient of variation (CV)

The coefficient of variation (CV) is the ratio of the standard deviation to the mean, expressed as a percentage. The coefficient of variation expresses the degree of variation around the mean. The higher the CV the more spread out the salaries are. Conversely, the lower the CV, the less variation that exists in the salaries.

1. **Process Equity**

Thirdly, they should promote process equity. Process equity deals with how employees perceive the fairness involved in the salary and benefit system. This is mainly dictated by the openness of the system, communication of the system to employees and impartiality of the system. These are all important, and employees want to know that the pay structure is fair to all and does not favour specific employees while overlooking others.

2. **Affordability & Sustainability**

Finally, the pay structure should be affordable for the company as well as sustainable in the long run. Whilst it is desirable to acquire the best employees for the positions in the company, it is more important to ensure that the company can afford to pay the employees. Furthermore, the sustainability of the pay structure will ensure that employees do not become disgruntled in the future as a result of unpaid salaries. Failing to meet these requirements will almost guarantee that the company's valued possession, the employees, will start to look for other companies that can afford to pay them.

Salary Range

Salary ranges are pay levels defined by employers to compensate employees who perform a specific job or function and are within a certain grade. A salary range defines the minimum, midpoint and maximum pay levels a company is willing to pay a job for its employees. Salary ranges allow for differences among positions within the same grade as well as increasing levels of responsibility and performance within the same job.

Range spread usually varies based on the level and sophistication of skills required for job categories. Lower-level positions that require skills that are quickly mastered usually have narrower pay ranges than supervisory and technical positions. Narrow pay ranges and more grades allow for more frequent promotions – and a greater perception of growth and advancement – than wide ranges and few grades.

Salary Progression

Salary progression is the movement of salaries from one level to the next within the same grade or salary range. These movements may be determined by factors such as seniority, performance, assessments of skill or competence, or success in obtaining formal qualifications.

Range Penetration

Range penetration looks at how far an employee has penetrated the salary range on a scale of 0% to 100%. In other words, an employee at the grade minimum has not yet penetrated the range (i.e. 0%), whilst a person at the grade maximum is said to have penetrated the whole range (i.e. 100%).

Range Penetration=Employee Salary - Range MinimumRange Maximum - Range Minimum

i.e. Range Penetration=Employee Salary - Range MinimumRange

Salary Range Overlap

Salary ranges will usually overlap. The more they overlap, the more cost-effective it will be for career progression while less overlap will require a larger pay increase for internal promotions.

According to the Economic research institute, a 50%-60 is considered as a moderate overlap, which should be the goal of a typical pay structure. Salary overlaps above this result in substantial overlaps. This would occur if there are too many salary grades or too little difference in market rates between salary grades which it occurs may lead to paying equity issues.

Salary Packages

- Basic Salary – is the fixed amount paid to an employee before accounting for any allowances or benefits that an employee may be entitled to.
- Total Direct Cash – is made up of the basic salary plus any allowances and benefits paid directly to an employee (e.g transport allowance, lunch allowance, cell phone allowance etc).
- Total Cost of Employment – represents the total amount an employer incurs in employing an employee. This is made up of the total direct cash plus all allowances and benefits paid indirectly to an employee (eg medical aid contributions, pension contributions etc).

Cost of Living & Hardship Allowances

To supplement the pay structure, there may be a need for temporary adjustments to employees' salaries.

Cost of living adjustment

Cost of living adjustment (COLA) is an additional amount paid to an employee to compensate them for the loss of purchasing power caused by inflation.

Hardship allowance

Hardship allowance is similar to COLA; however, it is the additional amount paid to an employee for working or living in difficult conditions. The criteria deemed "difficult" differs and can include living and working in isolation, extreme climate, potentially dangerous areas and areas plagued by political instability.

Salary Compression

Salary compression or wage compression arises when the relative worth of a job or the competence and credentials of an incumbent is not reflected well by the pay received by the incumbent. This can occur when there is hardly any difference in the compensation received by differing employees irrespective of any differences in qualifications, expertise, length of service, or duties. Alternatively, it can refer to instances where employees with similar responsibilities, qualifications, skillsets and experience are paid differently. It speaks to the inequity of compensation within an organisation. The most common example of pay compression in companies is where a newcomer is recruited by a company and is paid a similar or higher salary than that paid to the company's long-serving employees. Such inequities can be rather detrimental to a workforce's morale.

Indeed, money may not be the best motivator, with studies by Timothy Judge et al showing that pay only explains 2% of the changes in satisfaction levels of employees. However, remuneration plays a role in attracting and retaining employees. Pay serves as a foundational factor, in that for employees to consider working for a company, it needs to have a stable and equitable pay structure in place. If at some point this foundation starts to crumble and pay begins to be perceived poorly or as being unfair, the pay can certainly become a demotivator and can even lead to employees leaving.

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https://thehumancapitalhub.com/articles/All-The-Key-Terms-You-Need-To-Know-About-Pay-And-Salary-Structures