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HOW TO CREATE AND IMPLEMENT YOUR FIRST COMPENSATION PLAN

What is a compensation plan?

A compensation plan is a formal document that outlines all the components of your company's compensation package and is designed to attract and retain people.

While salary or pay rate is the foundation of compensation, there is much more that can be included in the total compensation plan.

A compensation plan details every benefit that a person receives from a company. In addition to salaries, compensation can also include bonuses, commissions, health insurance, and retirement investments.

In 2023, Payscale's annual Compensation Best Practices Report identified remote work, a work-from-home stipend, flextime, access to mental health or wellness programs, and a four-day work week as popular employee benefits.

As well as outlining the company's benefits, a compensation plan includes the methods, practices, and intentional approach for how your organization maintains a healthy balance between financial interests and its people. It covers how to attract, develop, retain, and reward your people whilst offering competitive pay packages within a given industry and market.

A structured and well-managed compensation plan helps align compensation with business goals and creates transparency. It's a defined strategy that builds trust with your team and boosts engagement and retention.

Developing a compensation plan is also a powerful way to demonstrate that your people are your most valuable asset. As such, your goal is to pay them consistently and equitably.

What are the different types of compensation plans?

In addition to a base salary, a company's complete compensation package will include direct and indirect types of compensation. When researching how to develop a compensation plan, you need to consider a package with direct and indirect compensation components that will work for your particular organization.

Direct compensation

Direct compensation involves paying people money in return for time worked or as recognition for their achievements. Direct compensation refers to a person's base salary, overtime payments, and any incentive plans.

Indirect compensation

Indirect compensation—or fringe benefits—are the non-monetary rewards an employer makes on behalf of its people. Indirect compensation can include expenditure on pension plans, healthcare plans, and paid leave.

Direct and indirect compensation plan examples

Examples of direct compensation plans:

The four main types of direct compensation are hourly pay, salary, commission, and bonus payments. Apart from bonus pay, which is meant to be paid on top of a regular salary and based on employee or company performance, modern companies will typically choose and stay with one type of compensation plan for their business.

Hourly compensation plans

Companies that adopt an hourly compensation plan pay people a pre-agreed rate for every hour worked. A tracking system like timecards or automated software calculates people's shifts, time worked, and pay.

Salaried compensation plans

Salaried compensation plans pay people a fixed rate of money over one year, regardless of the number of hours they work. Whether organizations choose to pay people monthly or weekly will form part of the wider **company compensation strategy**.

Companies that pay a salary will also provide a range of indirect compensation in the form of benefits like annual holiday entitlement, health insurance, and retirement plans. Some companies may also pay people overtime for any extra hours worked.

Commission-based compensation plans

Companies that employ people on a commission-based basis compensate people depending on the sales volume and revenue they generate, typically per month or quarter.

Some companies may also provide their commission-based workers with a guaranteed base salary, regardless of their performance.

Commission-based compensation plans can be connected to commission fees, revenue, gross margins, or profit. As well as base salary and commissions, companies may reward exceptional performance with additional bonus payments.

Commission-based compensation plans

Implementing bonus payments can be an incentive to motivate people to excel in their roles. Companies may pay bonuses as and when certain financial or seasonal milestones are reached, such as monthly, quarterly or at the end of the financial year.

Bonus-based compensation is associated with variable pay for people who work toward precise goals, like sales targets, or business objectives. Companies usually combine such bonus payments with other types of compensation, like commissions or an annual salary.

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Examples of indirect compensation plans:

Direct compensation plans are normally complemented by elements of indirect compensation to enhance a person's remuneration package. An indirect financial compensation benefit given to a team member has financial value but is not a direct monetary payment. It is often referred to as a non-cash benefit. In certain circumstances, these non-cash benefits may be more valuable than a high salary or wage. Let's take a quick look at some examples.

The retirement savings plan model

A retirement savings plan compensation model allows your people to participate in employer-sponsored 401(k) plans that offer significant tax benefits.

In a retirement savings plan model, employees sign up for a 401(k) plan and designate a percentage of their salary to be taken out of each paycheck and automatically invested in an investment account—usually mutual funds—before tax.

Employers may choose to match part or all of their employees' contributions. The tax advantages of a 401(k) make it one of the best ways people can save money for their retirement.

The group health benefits model

Total healthcare plans tend to offer private medical healthcare and can extend to dental and vision care and the cost of short-term or long-term disability insurance.

It could also extend to the provision of access to mental health professionals, like therapists and psychologists and the introduction of mindfulness programs and meditation classes to reduce people's stress levels at work. Netflix, for example, provides its people with access "to mindfulness and meditation as well as free counseling and coaching sessions.

With a group health benefits model, employers will pay a significant amount of the monthly premium, deducting the remaining portion from their employees' pre-tax income or gross earnings.

The wellness benefits model

Popular wellness benefits can include gym memberships, access to chiropractic treatments or physical therapies, membership of onsite fitness centers and classes, perks from selected retail outlets, and vouchers for onsite catering services where people can buy nutritious meals, and snacks.

The employee share purchase plan model

Many employers offer their people the option to participate in an employee share plan. Share option grants are a popular indirect method of providing people with compensation.

There are two basic types of share options or stock options to choose from:

1. Incentive stock options or ISOs. ISOs meet certain requirements of the Internal Tax Revenue Code and may be liable for preferential tax treatment.

2. Non-statutory stock options (NSOs) which describe all other incentive stock options than ISO.s

The giving back to the community model

Many employers offer their people opportunities to take days off during the year to volunteer for causes that are close to the company's or the individual's heart. This could be to work within a charity, offer mentoring to apprentices, or devote time to an environmental cause like cleaning up a riverbank or organizing a regular beach litter pick.

The further education model

Whether someone on the team wants to further their studies with an MBA or developing their digital skills at work with online coding lessons, many companies are happy to invest in the continuing professional development of their people.

The hybrid or remote work model

In today's modern world of work, many businesses will support their people to work from home and reimburse their costs—or offer the support needed for successful hybrid working arrangements. This can extend to relocation stipends or housing options.

The vacation model

Modern companies may choose to offer paid holidays with the potential for people to buy extra days of leave as and when needed.

The family and adoption leave model

Family or parental and adoption leave—and childcare provisions—can all form part of a more comprehensive compensation package.

Why do companies need a compensation plan?

Putting a well-considered compensation plan in place helps a company organize and strategize how it will attract, engage, and retain the top talent it needs.

Effective compensation management ensures any compensation plan fits within the company's budget, is appropriate to the current job market, and meets government regulations.

With a compensation plan in place, organizations can budget for and plan their workforce in a sustainable, consistent, and predictable way.

Getting started creating a compensation plan

If your current compensation planning process sounds something like this: "What did we pay the person who quit? Let's pay the new employee what that person was making," you're not alone.

The Wall Street Journal reports that in a sampling of 7,600 companies in the United States, Canada, and the United Kingdom, "only 38 percent of employers have a formal compensation structure or philosophy guiding their pay decisions."

In terms of staffing strategies and budgets, this haphazard approach to creating a compensation plan isn't wise. When pay decisions rely on gut instincts, gender bias, and unreliable data, compensation decisions can create complications and setbacks.

Widespread concerns and legal action regarding **equitable pay** mean it's riskier than ever for employers to abstain from putting formal pay practices in place.

Replacing your ad-hoc compensation plans with a solid strategy requires you to consider what's included in the program, how compensation impacts the employee life cycle, and when—and how—you should launch your strategy. With that in mind, what's the best way to get started when creating your compensation plan?

"The key is to have well-documented and less ad-hoc pay decisions to ensure consistency while still being responsive to the market,"

Tom McMullen, senior client partner for pay consultancy Korn Ferry, told the **Society for Human Resource Management (SHRM)**

"Every compensation decision must add to the strength of the company, from rewarding those who boost the bottom line, to red-circling those whose pay is above market. You must be a warrior for company success, on all levels. And encourage managers to be the same. Lead by example,"

said **Stacey Carroll, President of HR Experts On-call**.

A complete compensation strategy includes several key elements. From an overall philosophy to a plan for regular program evaluation, you can avoid issues by ensuring your approach addresses each vital component.

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Develop a compensation philosophy

All leaders at your organization need to understand—and agree upon—the company's strategy and philosophy around compensation. Are you aligning pay to performance? Is it tenure-based? Are you offering incentives? Be sure to clearly define your company's goals and how the pay structure supports short and long-term goals. Our Performance and Compensation Guide covers this in more detail.

Conduct a job analysis of all positions

Study each role in your organization to evaluate each job's activities and responsibilities. Assess relative importance to other positions, and identify the skills necessary to perform the role. If there are educational requirements, make note of them, and capture the conditions under which people complete their work.

Create pay grades, assign salary ranges, and place jobs in pay grades

Pay grades allow you to categorize different types of jobs into groups with the same general pay rate based on the level of expertise required. They help establish a standard framework of compensation for an organization. SHRM offers helpful tips about how various methods (i.e., points or rank) you can use to calculate pay grades.

Communicate about the compensation programs

Once you have a program, it's imperative you communicate your approach to your team. This is key for building trust and engaging your people through pay transparency. Not only do they want to know that their current rate of pay is competitive, but they also want to plan for any professional development they might require to achieve a pay increase or future promotion.

Assess and update the program on a regular schedule

Your compensation plan needs to be regularly evaluated. At least on an annual basis, review the plan against comparable plans in your market to determine if there are instances of overpaying or underpaying any roles. Also, evaluate your payroll spend against your overall budget to assess any issues. The more data and information you have, the better you'll keep your plan current and relevant for your business.

Not only do you want your compensation plan to fit your budget and meet your team's needs, it also needs to ensure your organization complies with all federal and state regulations. Each element in your compensation strategy will help you address this and meet legal requirements.

When creating a compensation plan, companies can lighten the load for their managers and HR professionals by implementing compensation management software. The dedicated software is a planning system that streamlines a company's people data and budget planning to produce bespoke and optimized compensation packages.

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5 tips for developing your compensation plan

1. Clarify your business goals
2. Get market data
3. Build sample pay grades
4. Review past compensation issues
5. Use HR tech

Start with these five tips as you lay the foundation for your compensation plan.

1. Clarify your business goals and align them with your compensation priorities

Ask all leaders to agree on a compensation philosophy that meets organizational values, budgetary needs, and provides room for growth. For compensation plans to achieve results, the leadership team must support them and agree to adhere to the strategy for consistency and legal protection.

2. Familiarize yourself with market data sources

Look for data on what the current pay rates are in the markets where you're conducting business. You can choose to do so with a vendor's help, or conduct research from sites such as Glassdoor, Salary Expert, and the Bureaus of Labor Statistics.

3. Build sample pay grades for your top 10 mission-critical jobs

Determine your top 10 jobs, decide if you want to establish grades based on points or rank, then work through the steps to build out pay grades for each job. Use this as the basis for a framework that you can use and apply to existing jobs or those you add as the organization grows.

4. Track if you lose candidates or current employees due to compensation issues

Make sure you have a method to capture data about why candidates turn down your employment offers. The same goes for current employees who leave for another job. If people complain about low pay or lacking benefits, that information can inform changes in your overall approach. If you're losing significant talent to your competitors, it may be time to improve your compensation plan and offerings.

5. Use HR tech to streamline the process from start to finish

Compensation plans have many moving parts, and it can quickly become overwhelming to manage and share the necessary data for compensation decisions. HR technology allows HR teams and leaders to contribute to and approve compensation decisions. A system approach can also empower managers with benchmark data and, with a cloud-based HCM, you have the performance data you need at your fingertips to make the right compensation decisions.

If you're reading this, it probably means you're ready to formalize your business' compensation package. That's exciting. But it's also overwhelming. Compensation is an integral part of how a business succeeds. Not only does it impact your balance sheet, but it's an essential driver in how you engage your employees.

How compensation impacts the employee lifecycle

Analyzing the employee lifecycle is a practical way to visualize and plan how compensation relates to each step of an employee's engagement with your company.

The employee lifecycle typically includes the following stages:

Attract:

Take a strategic approach to compensation and people's potential career paths by introducing more varied and incentivizing ways to reward performance.

A competitive overall pay package and more attractive benefits positions you to successfully recruit and attract the skilled and qualified talent you need.

With your compensation package and a positive employer brand in place, you can compel active and passive candidates to join your organization through recruitment drives.

Hire:

Employ people with the skills you need to move forward, and those who share your company values. You'll save time and money by not having to replace them later.

Clear compensation plans pave the way for a smooth hiring process. Recruiters know what they can discuss with candidates, hiring managers can be clear on their budget, and candidates understand how they'll be paid relative to the prevailing market rates.

Onboard:

During the onboarding process, you want to reconfirm that new hires have made the right choice by joining your organization.

Provide training, mentoring, and company culture experiences to help new hires get started in the organization.

An organized and intentional total pay package motivates new hires to perform well from day one.

It demonstrates that, from the first day of employment, you care about your people and have taken steps to ensure they get the benefits and pay that meet their needs.

Develop:

Offer opportunities for coaching, performance management, and professional growth.

As part of their compensation, include planning for promotions and the necessary pay increases associated with changes in job levels and roles.

When your team understands pay grades, it can motivate their productivity and inspire them to strive for excellence in their work and to reach their next professional goal—and its associated pay grade.

Retain:

Build trust and establish great relationships with your top talent to ensure they stay with your organization for as long as possible.

A compensation plan needs to remain current and competitive. It's challenging to retain people if they perceive that the pay in your company compares unfavorably with what competitors offer for the same or similar positions.

"It is important that employers recognize the critical talent they have by getting pay and promotions right—or they risk losing employees to competitors that may offer better salaries and the opportunity for more career growth," Mary Ann Sardone, Mercer's North America rewards practice leader, told SHRM.

Separate:

As part of any exit interview, make sure you cover compensation. Working to examine and understand the reasons why people leave can help you identify and address potential issues.

If the trends show your people don't feel they receive adequate pay and benefits for their job, you know you need to adjust your compensation plan.

From attraction to separation, using the employee lifecycle as a guideline for your compensation process and planning will ensure that you're keeping people at the center of your program design.

At what stage of your business should you launch your plan?

The earlier an organization launches and implements its compensation plan, the more successful it will be.

In 2022, Payscale's annual Compensation Best Practices Report revealed that 86 percent of organizations said they had a compensation strategy or were working on one—a 10 percent increase over last year and a 16 percent increase over previous years.

The plan can—and should—be modified as needs change and market dynamics evolve. For example, you may want to increase compensation for those team members whose skills are in high demand in the marketplace to prevent them from being tempted by a more attractive offer from a competitor.

A good rule of thumb is to review your compensation plan annually, which also helps ensure you're legally compliant.

Giving your managers an insight into how the compensation system works will enable them to manage compensation conversations and questions in your company and be consistent in their decision-making when recruiting new hires.

When your plan is comparable to market rates, candidate perceptions of you will be more favorable, leading to better hires—and improved retention.

Once you've completed your research, covered the critical steps in creating your compensation plan, and secured leadership buy-in, your compensation plan is ready to launch.

Conclusion

Your approach to developing a compensation plan is particular to your company. How you combine direct and indirect forms of compensation positions your company in the market and can impact your reputation. It needs to be attractive and competitive enough to entice top talent to join your organization.

Creating a compensation strategy should be a process that starts with gaining buy-in on a philosophy, uses data and analytics to establish pay parameters, and continues to build trust and transparency with your workforce.

As your business grows and evolves, so should your approach to compensation. Adopting the right workplace tech stack can help take the overwhelm out of developing a compensation package.

Dedicated compensation management software can help HR leaders configure the process and make it easy to evaluate, assess, and adapt based on data and input from the larger organization, your people, and the market—and make it simple to budget and manage your workforce in a way that's sustainable, predictable, and consistent.

Meet Bob

At HiBob, we've built a modern HR platform designed for modern business needs—today and beyond.

An HR platform such as Bob offers a one-stop shop for all things HR. It sits at the center of your HR ecosystem, is fully customizable, and grows with your organization.

For managers

It provides access to data and insights to help them lead more effectively and streamline processes.

For HR

It delivers automation of many common processes, allows greater oversight and visibility of the business, and centralizes all people data in a secure, user-friendly environment.

For employees

It's the tools and information they need to connect, develop, and grow throughout their journey.

In a short time, Bob can be deployed to enable communication, collaboration, and connectivity that drives stronger engagement, productivity, and business outcomes.

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