
PAY EQUITY
IGNORE
AT YOUR
OWN RISK

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Don't leave performance ratings out of your pay equity programs just because they can be "subjective," or you could be could doing your company a disservice.

The issue of pay equity has become a high priority as legislation and media watchdogs have focused pressure on employers. Employers — federal contractors in particular — can expect increased scrutiny of their pay and employment practices and should be proactive in assessing potential equity issues.

While organizations often rely on the legal or compliance function to manage pay equity, it is vital for pay equity to be in the purview of the compensation function. Pay equity processes should not only mitigate risk but promote good pay practices. Effective pay equity management — especially when made public — means greater access to increasingly diverse talent. This article addresses

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two key issues compensation practitioners should consider: 1) Why pay inequity creates risk and 2) the importance of ensuring that remediation practices do not conflict with the legitimate objectives of compensation programs.

Why Worry About Pay Equity?

Federal contractors in the United States face a new offensive from the Office of Federal Contract Compliance Programs (OFCCP), which focuses on pay equity in nearly every audit. The agency is concerned with *systemic risk* — that is, finding cases of alleged, broad discrimination by gender, race or ethnicity across compensation programs — and, having revoked standards for its own investigations established in 2006, it allows its investigators significant latitude in proving cases.

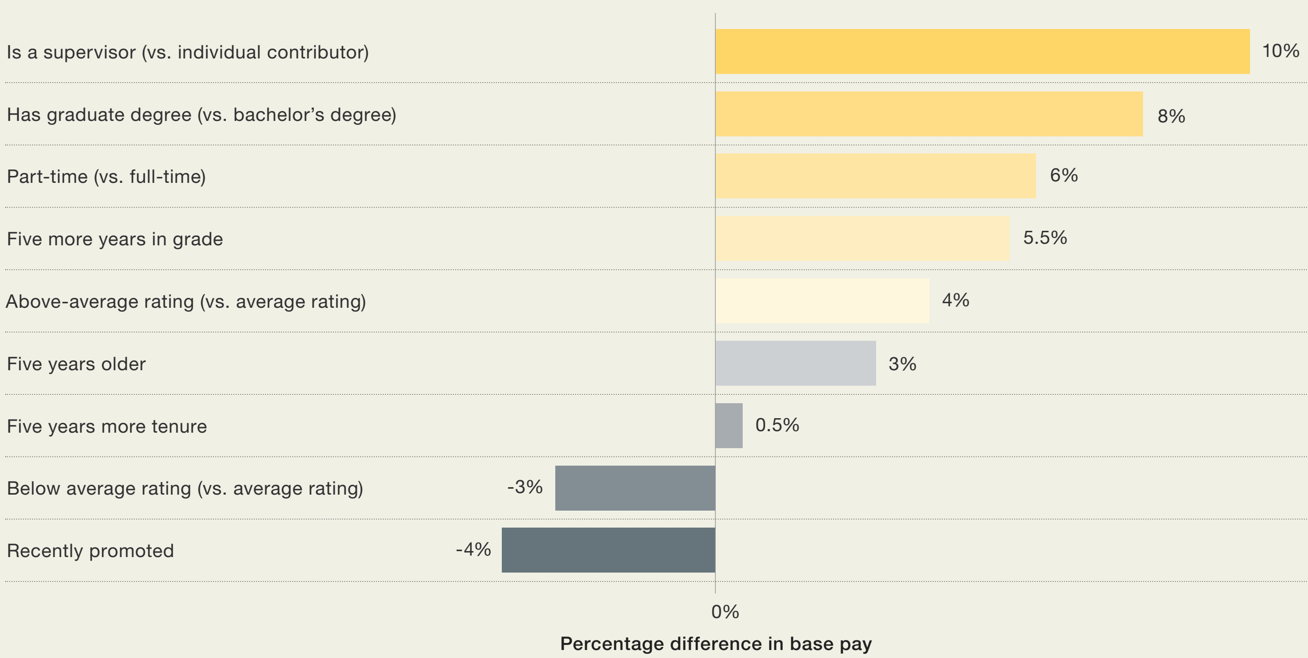
Broadly defined, systemic risk also allows the agency to consider all employment practices that may lead to compensation disparities including job assignment, new-hire pay practices and promotion opportunities. In August, the OFCCP mandated that companies submit an "Equal Pay Report" annually, which will detail summary compensation data by gender, race and ethnicity, ostensibly to allow them to more effectively target employers.

But pay equity pressure is not just a U.S. phenomenon: Countries globally are mandating that companies conduct reviews and submit reports. In this evolving climate, organizations must be ready to advise regulators on how to properly assess their compensation programs. Compensation practitioners are increasingly being asked about their policies and practices by the OFCCP and should have relevant facts ready to defend the integrity of those programs. Of course, where there is no good defense, proactive analysis should drive corrective action.

There's good reason to promote pay equity. Proactive remediation not only reduces compliance risk, but also reduces talent risk. It helps to ensure an employer's value proposition is optimized to attract, retain and motivate an increasingly diverse workforce and better access to underutilized talent pools.

Mercer's recent research in collaboration with the World Economic Forum shows that women, for example, are underutilized

Figure 1 | **Regression Analysis Reveals the Impact of Legitimate Factors on Pay**



Note: Analysis also accounts for job and location (results not shown)

Source: Mercer

Some companies are voluntarily sharing data and information on their pay and diversity processes to attract more diverse talent, even though such action risks legal exposure (and potentially bad press).

in the potential workforce with lower rates of participation in nearly every age category, across nearly all countries. The labor force participation rate for women aged 25 to 54 in the United States was 74.5 percent in 2012, compared to 88.7 percent for men in this age group.

To appeal to sources of untapped talent, companies must be aggressive in offering engaging, equitable packages. In fact, Mercer's new "When Women Thrive, Businesses Thrive" research found that pay equity is a critical requirement to improve diversity. Yet, workplace diversity and pay equity remain challenges. Some companies are voluntarily sharing data and information on their pay and diversity processes to attract more diverse talent, even though such action risks legal exposure (and potentially bad press). Google, for example, led the pack in publishing its government-submitted reports to counter public scrutiny. It then followed the release with a commitment to improve diversity outcomes. Yahoo and others have followed Google's lead in the information and technology sector. It is conceivable that entire industries will soon be under pressure to release such statistics and explain their actions to promote diversity and equity.

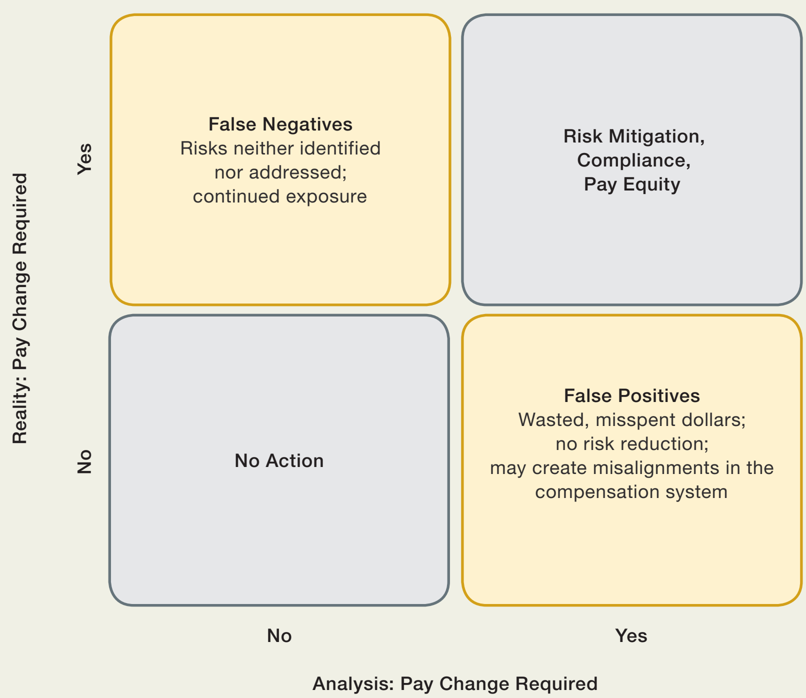
Though it is not yet the right move for every company, those that can proactively rise to the opportunity and credibly commit to ensuring equity will increasingly dominate in the talent wars.

Ensuring Alignment

Pay equity processes can reinforce or undermine compensation program strategic objectives. For example, many analyses conducted purely for legal reasons withhold subjective, documented performance as an explanation of pay differences because such ratings might be "tainted" (i.e., impacted by discrimination).

However, if performance ratings are not accounted for, employees who appear to be underpaid will generally be low performers, and pay adjustments will mainly be directed to low performers. Such an outcome can threaten the integrity of compensation programs. Compensation practitioners should insist that performance evaluation is accounted for in rewards reviews and ensure that the company is able to defend the consistency of the performance process (across raters) and its validity (through

Figure 2 | Good Pay Equity Analysis Minimizes False Negatives and False Positives



Source: Mercer

When samples get small there is little ability to account for legitimate factors (e.g., experience, education, performance) that drive differences in pay.

linkage to hard performance measures, where available).

Compensation professionals should also be engaged when employees of acquired and legacy entities are compared. Pay differences driven by legacy associations can continue for long periods (and might be legally defensible), but should not be perpetuated by proactive pay equity processes.

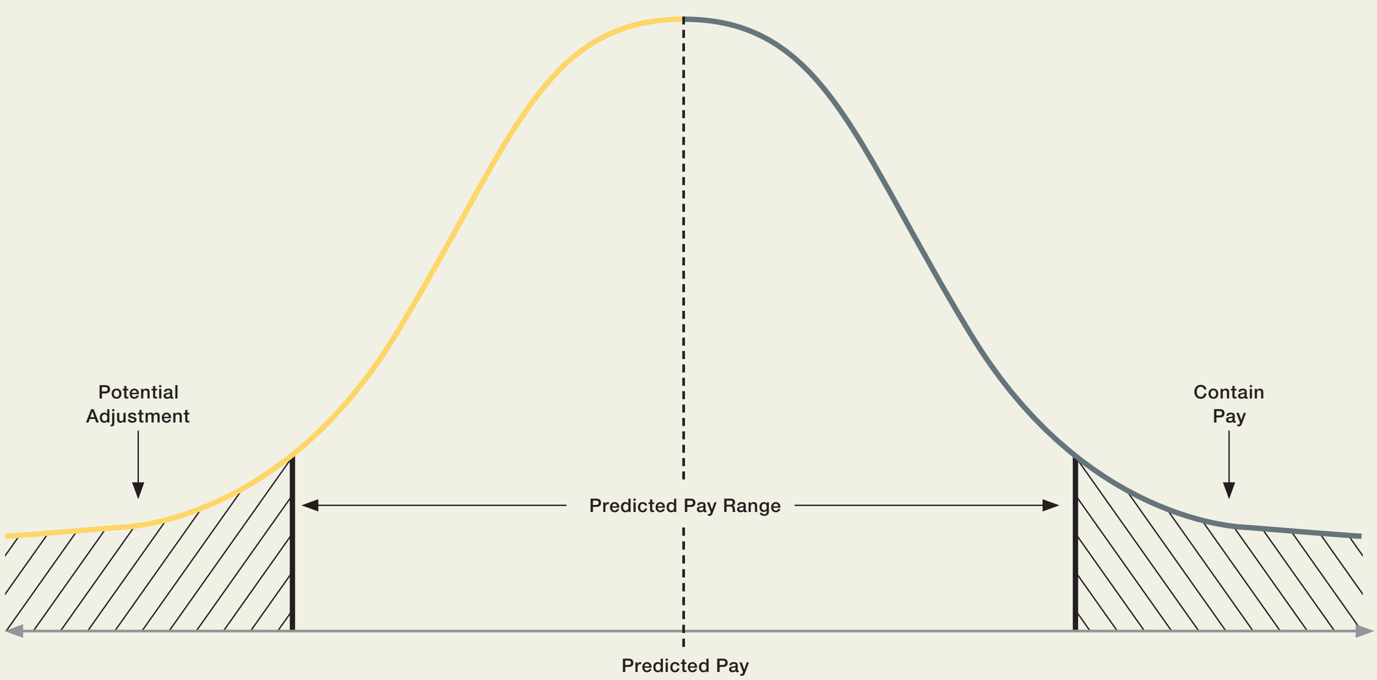
Sampling Small

Since "big numbers are bad numbers" is the adage of many professionals engaged in assessing pay equity, a common consequence is that analyses are run separately by job. Jobs are deemed appropriate for grouping because, according to Title VII of the Civil Rights Act of 1964, the standard is to look at similar employees based upon the "nature of work."

The problem with this approach is that when samples get small — and they frequently do when the unit of analysis is a job — there is little ability to account for legitimate factors (e.g., experience, education, performance) that drive differences in pay. That's particularly common with small samples when conducting a regression analysis, which remains the legal standard for assessment. Small samples also can inhibit the ability to identify areas of risk proactively and identify employees in areas for whom pay adjustments are warranted.

For proactive analysis, it makes more sense to combine into statistical models comparably paid employees — that is, employees for whom experience, education and performance similarly drive differences in pay. Factors driving differences, including job-level differences in pay, can be accounted for in the analysis. (See Figure 1.) Such larger models, which should be run without accounting for gender and race, do a much better job of mirroring an organization's legitimate pay practices and can be more effectively leveraged to assess risk by gender, race or ethnicity in narrow groups (i.e., to identify fewer false negatives in specific jobs or locations that might be targeted by the OFCCP). This approach is equivalent to using "interaction terms" (e.g., on gender, race or ethnicity controls; by job and/or location) in a regression model where the dependent variable is pay. (See Figure 2.)

Figure 3 | **Use Regression Models to Identify Outliers to Consider for Pay Adjustments**



Source: Mercer

To effectively employ this approach, engaging compensation professionals is critical. They can ensure that employees paid in a comparable manner are pooled together for analysis and can point to specific data elements to include in that analysis.

This approach has another benefit: Given that the OFCCP is looking at risk broadly — across jobs and businesses, for example — it is helpful for an organization to be able to look at risk in a variety of ways, quickly, in the context of an audit. The above approach can provide fast feedback on the risk in any work group that might be examined by an auditor.

Inevitably, this sort of modeling is complex. Robust statistical analysis should be handled by an expert to ensure companies do the best job of identifying true disparities since organizations will be allocating real dollars to fix the potential disparities that are found. (See Figure 3.) But the engagement of the compensation function is no less critical to ensuring success.

Ultimate Responsibility

The risk of pay inequity has never been more significant. Regulators are intently focused on the issue while organizations striving to acquire more diverse talent need every advantage in doing so.

Compensation practitioners are critical to effective payequity processes. They can safeguard that such processes achieve objectives without undermining the integrity of rewards programs. Their knowledge of practices and policies can guarantee that dollars spent on remediation are most effectively directed — as organizations move from "small samples" based on similarity of work to "right samples" based on how employees are paid.

It is the ultimate responsibility of the compensation function to ensure the equitable implementation of its programs. In an environment of heightened risk, now is the time for compensation professionals to assume this responsibility. ws

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