Office of the Colorado State Auditor

Performance Audit of the Colorado Department of Personnel & Administration's 2005 Annual Total Compensation Survey Report

July 2005

Prepared by:
Milliman
1301 Fifth Avenue, Suite 3800
Seattle, Washington 98101-2606
206/504.5545

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This report contains the results of a performance audit of the State of Colorado's Department of Personnel & Administration and its 2005 Total Compensation Survey. The audit was conducted pursuant to Section 24-50-104, C.R.S., which requires the State Auditor to contract with a private firm to conduct a performance audit of the Department's Total Compensation Survey. The State Auditor contracted with Milliman, Inc. to conduct this performance audit. The report presents our observations, findings, and recommendations.

Very truly yours,

John Hankerson
Principal and Strategic Rewards Practice Leader
Milliman, Inc.

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AUTHORITY, PURPOSE, AND SCOPE

Milliman conducted this performance audit under contract with the Office of the State Auditor pursuant to Section 24-50-104(4)(b), Colorado Revised Statutes (C.R.S.). This audit evaluated the Colorado Department of Personnel & Administration's procedures and application of data with respect to the Annual Total Compensation Survey. The audit work was performed from February through April 2005. We acknowledge the assistance and cooperation extended by management and staff at the Department of Personnel & Administration.

BACKGROUND

Section 24-50-104, C.R.S., establishes the State's total compensation philosophy which is to provide "prevailing total compensation to officers and employees in the state personnel system." According to statute, total compensation includes salary, health, life, and dental insurance, retirement benefits, performance awards, incentives, premium pay practices, and leave (e.g., paid time off). The goal of this legislative philosophy is to enable the State to recruit, motivate, and retain a qualified work force by offering total compensation value that is competitive with other employers in the labor market. Statute requires the Department of Personnel & Administration (the Department) to review or conduct surveys of other public and private employers to assess prevailing total compensation practices, levels, and costs. The purpose of this survey is to determine if the State's salaries, employer contributions to benefit plans, and performance awards are comparable with other public and private employers. To make this determination, the Department uses data from market surveys that contain information on salaries and benefits for specific jobs within both the public and private sectors and compares these with state jobs.

Section 24-50-104(4)(b), C.R.S., requires the Department to report its survey findings and recommendations in an Annual Total Compensation Report. The purpose of the report is to recommend all adjustments necessary to maintain the State's salary structure, provide state contributions for group benefit plans, and provide performance awards for the upcoming fiscal year. The Department's 2005 Annual Total Compensation Survey Report determined that an increase of $97 million in salary and group benefit contributions was needed to bring the State's 31,500 employees to prevailing total compensation levels. Due to fiscal constraints, the Department recommended the General Assembly fund a minimum increase of $46.2 million.

SUMMARY OF AUDIT FINDINGS

Overall, we found that the State is not using its total compensation dollars as effectively as it could to ensure competitive total pay, to promote and reward performance, and to ensure fiscal efficiency. Although the Department conducts its survey procedures (such as job matching, data extraction, and reporting) thoroughly and effectively, the State could get more from its limited dollars, meet its statutory requirements, and have a truly market- and performance-driven system if a number of changes were made to both the State's current compensation policies and the Department's survey practices. We found:

- **The Department does not include data on variable compensation, such as bonuses and incentives, when evaluating the competitiveness of cash compensation.** Cash compensation is typically made up of two elements: base salary and variable, or incentive compensation. Currently the Department only compares state base salaries with market base salaries. We reviewed survey data for 35 state jobs to determine how much variable (or incentive) compensation is typically provided in the market. We found the market provides an average of approximately 5 percent of base salary in a cash bonus, which is not reflected in the Department's analysis of state cash compensation. If variable compensation is included in market data, state cash compensation is 5 percent or more below market.

- **Improvements are needed in the State's performance pay system to maintain the State's competitiveness as an employer.** We found the State (1) allows employees to receive base-building increases even though their salaries may already be above market levels and performance does not justify the increase; (2) has not ensured that all dollars available for salary increases are awarded on the basis of performance; rather, the State has used a portion of salary increase dollars for across-the-board increases for all state employees; and (3) has not allocated sufficient resources to its performance pay system to have a meaningful impact on employee performance. The State should restructure how it moves employees through the salary ranges by ensuring that pay range midpoints are set at competitive levels and using base-building increases to reward performance when salaries are below the midpoint and non base-building increases (bonuses and incentives) to reward performance when salaries are at or above the midpoint. By following this strategy and ensuring that all salary increases are awarded on the basis of performance rather than making across-the-board increases, the State can provide employees with more meaningful performance awards within existing resources.

- **The Department does not adequately evaluate the *value* of benefits provided to employees or integrate the value of benefits with cash compensation when assessing the competitiveness of the State's total compensation package.** Without an evaluation of the total value of benefits, the State cannot be certain of the best way to address competitive weaknesses in the State's benefit plans. In addition, an integrated analysis of salaries and benefits is essential to ensure the State is offering a "prevailing" total compensation package. In a total compensation environment, the gap created by weaker than average non-cash compensation can only be made up by above average cash compensation, either through performance or variable pay programs which provide incentive compensation.

- **The Department does not use actual pay to assess the appropriateness of pay ranges for individual jobs and the effectiveness of the State's pay administration system in delivering and maintaining competitive levels of pay across all jobs and occupational groups.** We found that state salary range midpoints, which should reflect the pay for a fully competent employee, are not competitive with the market. The Department's practice of using market range midpoints to set compensation levels does not accurately reflect competitive practice (midpoints do not reflect what employers are actually paying) and is not prevailing practice. In addition, the Department's practice of using market averages to set pay range widths is too prescriptive and restrictive and does not reflect best practices in the market. As a result, some salary ranges may be set too low or high, which can affect the competitiveness of entry-level salaries.

- **The Department spends too much time on detailed data analysis to determine salary structure adjustments, but not enough time analyzing actual pay data for an appropriate number of benchmark jobs.** Currently the Department uses detailed benchmark pay data to adjust salary structures. This process is unnecessarily time-consuming and the time spent on the process is not proportional to the value added. The Department could reach similar conclusions regarding structure adjustments and spend significantly less time on the process by using published compensation planning surveys which is a best practice in the market. In addition, the Department does not select a sufficient number of benchmark jobs to ensure compensation levels are consistent with competitive market levels. For the 2005 Total Compensation Survey, the Department matched 210 of 528 (40 percent) total state jobs with jobs in the market. Best practice for organizations that have a market-driven pay philosophy like the State's is to measure at least 75 percent of total jobs as benchmarks.

- **The Department's use of nine different occupational groups is cumbersome and does not reflect prevailing practice for employers using a market-driven pay system.** The majority of employers using a market-driven pay system use one to three occupational groups because of flexibility, ease of maintenance, and ease of communication to employees. Reducing the number of groups could streamline the annual total compensation survey process and free up resources to evaluate actual pay for more benchmark jobs.

Our recommendations and the responses of the Department of Personnel & Administration can be found in the Recommendation Locator.

Rec. No.	Page No.	Recommendation	Department of Personnel & Administration Response	Implementation Date
1	13	Purchase salary surveys that include total cash compensation and use these surveys to assess the competitiveness of state salaries.	Agree	July 1, 2007
2	16	Set pay range midpoints consistent with actual market levels and educate employees about how compensation is determined; use base-building increases to reward performance when salaries are below the midpoint and non base-building awards when salaries are at or above the midpoint. Work with the General Assembly to set a single budget amount for pay increases and allocate the entire amount to performance-based increases.	Partially Agree	July 1, 2008
3	20	Assess the true value of benefits delivered to employees and use the results to modify benefit plans or recommend higher levels of cash compensation; integrate analysis of cash and non-cash compensation.	Partially Agree	July 1, 2008
4	25	Analyze actual pay data to assess the competitiveness of state compensation levels and to recommend salary increase budgets.	Partially Agree	July 1, 2007
5	29	Evaluate its strategy for managing the State's salary structure and consider factors in addition to market averages when setting pay ranges.	Agree	July 1, 2008
6	32	Use published compensation planning surveys to develop recommendations regarding salary structure adjustments; identify at least 75 percent of total state jobs as benchmarks and analyze one-third of these jobs each year.	Partially Agree	Ongoing
7	36	Align the States' compensation program more closely with the market by reducing the number of occupational groups.	Partially Agree	July 1, 2007

BACKGROUND

Section 24-50-104, Colorado Revised Statutes (C.R.S.) establishes the State's total compensation philosophy which is to provide "prevailing total compensation to officers and employees in the state personnel system." According to statute, total compensation includes salary, health, life, and dental insurance, retirement benefits, performance awards, incentives, premium pay practices, and leave (e.g., paid time off). The goal of this philosophy is to enable the State to recruit, motivate, and retain a qualified work force by offering total compensation value that is competitive with other employers in the labor market.

Statute requires the Department of Personnel & Administration (the Department) to review or conduct surveys of other public and private employers to assess prevailing total compensation practices, levels, and costs. The purpose of this survey process is to determine if the State's salaries, employer contributions to benefit plans, and performance awards are comparable with other public and private employers. To make this determination, the Department uses data from market surveys that contain information on salaries and benefits for specific jobs within both the public and private sectors. The Department uses these surveys to benchmark, or match, jobs within the state system with similar jobs outside of the state system. The benchmarking process covers jobs within each of the State's nine separate occupational groups which include:

- Enforcement and Protective Services
- Health Care Services
- Medical
- Labor/Trades/Crafts
- Financial Services
- Administrative Support and Related
- Professional Services
- Teachers
- Physical Sciences and Engineering

The Department has established a separate salary structure for each of the nine occupational groups. Individual jobs are placed in the salary structure associated with each group. Salary structures are made up of different pay ranges that apply to the various positions within the group. Each pay range includes a minimum, midpoint, and maximum salary amount. The minimum is the lowest salary paid for a specific position, while the maximum is the most that an individual in that position can earn. The midpoint represents the market value of a fully competent employee performing well in the position. The Department analyzes compensation surveys to recommend adjustments to the salary structure for each occupational group. For example, if the market indicates that range midpoints for positions in the Health Care Services occupational group have increased 5 percent since the prior year, the entire salary structure for that group will be adjusted upward 5 percent. The Department also uses compensation survey data for a separate process that reassigns individual jobs within each occupational group to new ranges. For example, if market data indicate that actual salaries for a Registered Nurse (in the Health Care Services group) increased by 10 percent over the past year, this position might be moved to a new pay range.

The adjustment of a pay structure is a separate decision from the decision to award an increase to base pay to an individual employee. The structure adjustment and the assignment of positions to a range is designed to ensure that if an employee is fully competent and performing well, the pay structure will allow him/her to be compensated competitively. The decision to actually move an employee through the structure (pay range) is governed by policies that are the result of the State's compensation philosophy. In a pay-for-performance system like the State's, best practice is to move employees through the structure based on their performance.

In addition to salary comparisons, the Department also uses surveys to compare state benefit practices and expenses with those in the market. Specifically, the Department compares the State's contribution to premium amounts to the contributions made by other employers and determines what adjustments are needed for the State to remain competitive as an employer.

Statute requires the Department to report its survey findings and recommendations in an Annual Total Compensation Report. [Section 24-50-104(4)(b), C.R.S.] The purpose of the report is to recommend all adjustments necessary to maintain the State's salary program, state contributions for group benefit plans, and performance awards for the upcoming fiscal year. According to Section 24-50-104(4)(c), C.R.S., the Department's recommendations shall reflect a consideration of the results of the annual compensation survey, fiscal constraints, the ability to recruit and retain state employees, and appropriate adjustments with respect to state employee compensation. The Department's 2005 Annual Total Compensation Survey Report determined that an increase of $97 million in salary and group benefit contributions was needed to bring the State's 31,500 employees to prevailing total compensation levels. Due to fiscal constraints, the Department recommended the General Assembly fund a minimum increase of $46.2 million.

AUDIT SCOPE

The State Auditor is required by statute to contract with a private firm to conduct a performance audit of the Department's Total Compensation Survey. [Section 24-50-104(4)(b)] The Office of the State Auditor contracted with Milliman to evaluate the Department's procedures and application of data with respect to the Annual Total Compensation Survey. The audit included the following procedures:

- Reviewed Department data to verify the results
- Reviewed surveys to ensure their appropriate use and application in terms of designing the State's wage structure
- Examined benchmark data to discern appropriate placement of job classes, as well as adequate representation of all state jobs
- Reviewed the Department's methodological assumptions to ensure their appropriate application
- Evaluated the soundness of survey procedures and methodology in light of the State's total compensation philosophy

INTRODUCTION

The State's primary objective with respect to its total compensation philosophy is to ensure that it remains competitive as an employer in the labor market. To evaluate the State's progress in achieving this objective, the audit analyzed how the Department's annual total compensation survey procedures and its methodology for applying survey data to compensation policies assist the State in implementing its total compensation philosophy. In addition, the audit evaluated some of the State's compensation policies to determine their impact on the State's competitiveness as an employer.

Overall, we found that the State is not using its total compensation dollars as effectively as it could to ensure competitive total pay, to promote and reward performance, and to ensure fiscal efficiency.

With respect to the total compensation survey, our audit found that the Department performs its detailed salary survey procedures, such as job matching, data extraction, and reporting, thoroughly and effectively. However, we found that the State could get more from its limited dollars, meet its statutory requirements, and have a truly market- and performance-driven system if improvements were made to both the State's current compensation policies and the Department's survey practices. In the following sections, we discuss policy and structural changes that can help the State make better use of its total compensation dollars and remain competitive as an employer, as well as procedural changes for improving the efficiency of the survey process.

ISSUES AFFECTING THE COMPETITIVENESS OF STATE COMPENSATION

We found there are a number of weaknesses in the Department's survey practices and in the State's compensation policies that might result in the State's total compensation package being non-competitive. These weaknesses include:

- **Total Cash Compensation -** The Department does not include data on variable compensation, such as bonuses and annual incentives, when evaluating the competitiveness of cash compensation. If variable compensation is included in market data, state cash compensation is 5 percent or more below market.

- **Performance Pay -** The State has not ensured that all dollars available for salary increases were awarded on the basis of performance. Rather, the State has used a portion of salary increase dollars for across-the-board increases for all state employees. In addition, the State has not allocated sufficient resources to its performance pay system to have a meaningful impact on employee performance and has not made good use of bonus or incentive awards to reward performance.

- **Total Compensation (Cash Plus Benefits) -** The Department does not adequately evaluate the value of benefits provided to employees or integrate the value of benefits with cash compensation when assessing the competitiveness of the State's total compensation package.

- **Pay Ranges -** The Department does not use actual pay to assess the appropriateness of pay ranges for individual jobs and the effectiveness of the State's pay administration system in delivering and maintaining competitive levels of pay across all jobs and occupational groups. In addition, the Department's practice of only using market averages to set pay range widths may be too prescriptive and restrictive and is not consistent with best practice in the market. As a result, some salary ranges may be set too low or too high, which may affect the competitiveness of entry-level salaries.

- **Benchmarking -** The Department uses detailed benchmark pay data to adjust salary structures, rather than published compensation planning surveys, an approach which is a best practice in the market. The Department could benefit from using these planning surveys because its current process of conducting detailed analyses of benchmark job data to assess structure movements is unnecessarily time-consuming and the time spent on the process is not proportional to the value added. In addition, the Department does not select a sufficient number of benchmark jobs to ensure compensation levels are competitive.

- **Occupational Groups -** The Department's use of nine different occupational groups is cumbersome and does not reflect prevailing practice for employers using a market-driven pay system. Reducing the number of groups could streamline the annual total compensation survey process and free up resources to evaluate actual pay for more benchmark jobs.

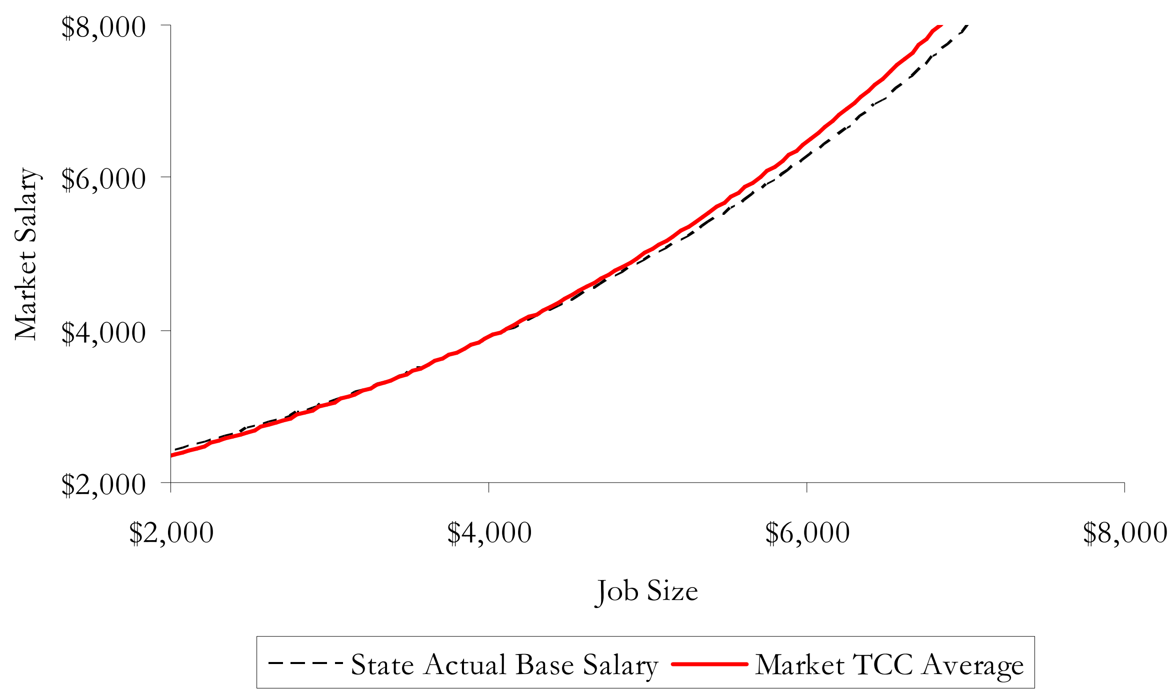
As we discuss in the following sections, each of these issues impacts salaries and the States' ability to remain competitive as an employer. As a result of some of the Department's survey practices and the State's current compensation policies, we found that salaries for some state jobs are lower than salaries for comparable jobs in the market and the value of state benefit plans is significantly below market. These issues may affect the State's ability to recruit and retain qualified employees, which will become even more important in the next few years as the State's workforce experiences significant turnover. Conversely, some practices have resulted in employees earning higher than market salaries, which means higher costs to the State. Although the net effect of these practices is not quantifiable, it is clear that some of the State's current compensation policies may not be the most effective. If the State's total compensation package is to be competitive with the market while making the most of limited dollars, it is critical that policy makers as well as the Department evaluate current strategies for managing the State's compensation system and implement appropriate changes.

TOTAL CASH COMPENSATION

Cash compensation is typically made up of two elements: (1) base salary and (2) variable, or incentive, compensation. Base salaries are the standard salary amounts that an individual receives annually. In organizations where pay is linked with performance, salaries are adjusted through **merit programs** and increases can be either "base-building" or "non base-building." If the increase is base-building, the employee's salary will permanently reflect the increase. If the increase is non base-building, the employee will receive a one-time, lump sum payment. The State's current performance pay system is a merit program that uses base-building performance awards for increases that are within an employee's pay range. Awards above the pay range are non base-building and are limited to those employees who are at the top of their pay range and who performed at the highest level. Variable, or incentive, compensation, on the other hand, is paid as a one-time, lump sum payment, often referred to as a "bonus." Variable or incentive compensation is compensation delivered apart from merit pay increases. It is typically tied to specific performance goals and administered separately from merit pay programs.

We reviewed the Department's survey procedures and found that data on variable compensation, such as bonuses and incentives, are not included when evaluating the competitiveness of cash compensation. Currently the Department only compares state base salaries with market base salaries. We have found, however, that variable compensation such as cash incentives and bonuses are a prominent component of total compensation. A 2004 survey by Watson Wyatt Data Services of non-executive level positions indicates that approximately 77 percent of all organizations and 52 percent of public sector and not-for-profit organizations offer at least one bonus plan. The survey also found that the average amount of bonus paid among these public sector and not-for-profit organizations was 5.3 percent of annual salary. These bonuses are in addition to forms of performance pay typically categorized as merit increases to annual salary. In addition, we reviewed 35 jobs using a national salary survey to determine what percent of their total cash compensation included variable, or incentive pay. These included positions such as accountants, social workers, and equipment operators. For these jobs, we found that the market provides an average of approximately 5 percent of base salary in a cash bonus. This bonus is not reflected in the Department's analysis of cash compensation. The difference between state salaries and market cash compensation is greater for positions with higher salaries, as shown in the following chart.

State Actual Base Salary
vs.
Market Total Cash Compensation (Base Salary + Bonus)



As mentioned previously, statute requires the Department to survey other public and private employers to determine if the State's cash compensation and performance awards are comparable with other public and private employers. The Department cannot fulfill this statutory requirement if it does not consider total cash compensation paid in the market when assessing the competitiveness of state compensation. Omitting total cash compensation will result in state compensation being lower than comparable market cash compensation. We included a similar finding and recommendation in our 2003 Annual Total Compensation Survey audit report. This recommendation has not been implemented.

RECOMMENDATION 1:

The Department of Personnel & Administration should purchase salary surveys that include total cash compensation (base salary plus bonuses/incentives) and use this information when assessing the competitiveness of cash compensation.

DEPARTMENT OF PERSONNEL & ADMINISTRATION RESPONSE:

Agree. Implementation Date: July 1, 2007. The Department recognizes bonus and incentive pay as part of a total compensation package. In fact third-party surveys are already purchased that include bonus and incentive pay along with compensation data; however, it has not been reported separately in these surveys nor did our direct survey collect sufficient data. Although not separately analyzed, the data on incentives and bonus has been part of the salary planning budget data used in the analysis to derive and verify overall average market movement. The Department is working with the survey organizations it uses (e.g., Mountain State Employers' Council, Colorado Municipal League, and Central States Compensation Association) to design survey tools to better collect this information. In fact, Mountain States Employers' Council will be reporting this data separately in time for the Fiscal Year 2006-07 Annual Compensation Report due August 1, 2005. The Department will take additional steps to collect this information from all possible sources, including purchasing more surveys, but acknowledges that they may not be readily available and it may require additional operating funds to purchase more surveys.

While it may be true that the average bonus – for those employees that get a bonus – is 5 percent, since not all employees get a bonus the actual budget increase would be significantly less. For example, if 15 percent of the workforce receives a 5 percent increase, the budget amount may be around 1.3 percent.

PERFORMANCE PAY

Colorado implemented performance pay as part of its total compensation system in July 2002. The purpose of a performance pay system is to link pay and performance so that higher performing employees are rewarded for their contributions with the goal of improving employee motivation and results. Many organizations are moving to systems that increase the link between pay and performance, especially in the public sector where accountability and stewardship are gaining prominence. Colorado's performance pay system consists of three components – performance management, performance-based pay, and dispute resolution. State agencies are responsible for developing their own performance pay programs that are consistent with the parameters established by the Department. Under these programs, employee performance is rated at one of four levels – unsatisfactory, satisfactory, above standard, or outstanding. Agencies are appropriated funds for salary increases, a portion of which is for changes in the pay structure and a portion of which is for performance-based pay awards. The Department's guidelines support the use of both base-building and non base-building awards; however, the performance pay system allows non base-building awards only for employees receiving an "outstanding" rating and where the award amount would exceed the top of the employee's pay range. Statute requires all other performance awards to be base-building. [Section 24-50-104(1)(c), C.R.S.]

We reviewed the State's performance pay system and identified several problems with the way the system is currently being administered. These problems directly affect salaries and the State's ability to remain competitive as an employer with the market. Specifically, we found:

- ***Base salaries are not managed around market levels.*** Market practice is to recognize the midpoint (i.e., competitive market level) as the top amount a fully competent, high performing employee can receive as his/her base pay. Once an employee's salary reaches midpoint, typical practice is to reduce the pay increase amounts for satisfactory performance to levels that maintain the employee's pay near the midpoint. This practice recognizes that an employee whose base salary is at the midpoint and who is performing "satisfactorily" is already being compensated at the market rate. Awarding an increase that would move base pay above the midpoint is not appropriate for "satisfactory" performance. An emerging practice is for organizations to award non base-building awards that recognize strong performance for that year, but do not obligate the organization to pay above market rates in the future, a concern particularly if performance drops. This practice ensures that an organization does not have large numbers of employees making salaries above the market average without ensuring that performance is also at a high level. The State's current practice is to allow employees who receive a "satisfactory," "above standard," or "outstanding" rating to receive base-building performance awards unless they are at the top of the pay range. This includes employees whose salaries are above the range midpoint and are already paid well relative to the market. Allowing base-building awards in these situations results in employee salaries becoming higher than the average market salary for a similar position, even when performance does not justify the increase.

- ***Employees received an across-the-board increase, regardless of performance.*** Best practice in a performance pay system is to allocate all appropriated funds to performance pay increases. Across-the-board increases are not consistent with the intent of a performance pay system because all employees receive the same increase, regardless of performance. We found that in Fiscal Year 2005, the policy decision was made to grant an across-the-board increase of 2 percent and allowed a performance pay increase of 1.1 percent. As a result, all state employees who received a "satisfactory," "above standard," or "outstanding" rating were given an across-the-board increase of 2 percent. Only 1.1 percent of the appropriated funds remained for performance pay increases. As we discuss below, 1.1 percent is too small an amount to provide meaningful performance awards.

- ***Current performance awards are too small to have any effect on employee behavior or motivation.*** Best practice in effective performance pay systems is to offer total performance awards for exceptional performance that range from 8 to 15 percent. Effective performance pay systems typically maintain two distinct programs: a merit pay program to award base salary increases and an annual incentive/variable pay program that provides lump sum awards (non base-building) tied to the achievement of specific annual goals. For example, Watson Wyatt's Professional & Managerial Compensation Survey reports that the surveyed job Accountant received a merit increase to base salary (for highest performers) of 5.9 percent. The same Accountant also received an average annual cash incentive (non base-building) award of 5.0 percent. According to this survey, the total performance award for the Accountant amounted to 10.9 percent of base salary. We found that in Fiscal Year 2005 the average award for a state employee receiving an "outstanding" rating was just 2.18 percent. While this amount is nearly double that awarded to employees receiving an "above standard" rating, it is too small to have any effect on employee behavior or motivation.

The State must make several changes to its current compensation practices, including restructuring how it moves employees through the salary ranges, if it wants to have a true performance pay system. First, the Department should ensure that pay range midpoints are set at competitive levels and continue to educate employees about how compensation is determined. Employees whose salaries are below midpoint can continue to receive base-building increases as performance awards until their base salary reaches the midpoint. However, the State should adopt the use of non base-building increases (bonuses or incentives) to reward performance for employees whose salaries are already at or above the midpoint. Second, the State should ensure that all salary increases are awarded on the basis of performance.

Third, the State must restructure the dollars currently available for salary increases to provide for larger increases to reward performance. For example, under the State's current system, if an employee receives a 6 percent increase each year until he or she reaches the top of the pay range, the employee's salary would increase from $75,600 to $117,262 over 10 years and the State would have paid out a total of almost $1 million. In contrast, if the State adopted market practice and provided base-building salary increases only until an employee's salary reaches midpoint and non base-building increases above midpoint based on performance, the same employee's salary would increase from $75,600 to $94,414 over 10 years and the State would have paid out about $850,000. This leaves a difference of more than $100,000, which could have been available for performance bonuses of up to $10,000 per year – only if the employee's performance merited the award. It is important to note in this example that under the market approach, the employee who is making $94,414 at the end of 10 years is making the market level of pay for a comparable position if the midpoint has been set at the market average actual rate. However, in the example, the employee who is making $117,262 under the State's current system is making more than $22,000 per year above the market average actual rate and will continue to receive above the market rate in the future even if he/she does not perform strongly. It is important to note, however, that this approach may affect PERA benefit calculations that are based on the average of an employee's three years of highest annual base salaries.

These steps are key to improving the competitiveness of the State's compensation system and would further the State's goal of rewarding employees based on performance within current funding levels.

RECOMMENDATION 2:

The Department of Personnel & Administration should restructure the way employees move through the pay ranges and improve the State's performance pay system by:

a. Setting pay range midpoints consistent with market average actual rates and continuing to educate employees about how compensation is determined. In addition, base-building increases should be used to reward performance when salaries are below the midpoint and non base-building increases (bonuses and incentives) should be used to reward performance when salaries are at or above the midpoint.

b. Working with the General Assembly and recommending any necessary statutory changes to set a single budget amount for pay increases and then allocating that entire amount to performance-based increases, rather than a portion of the amount going to "across-the-board" employee pay or structure increases.

DEPARTMENT OF PERSONNEL & ADMINISTRATION RESPONSE:

Implementation Date: July 1, 2008.

a. **Partially Agree.** The Department believes it sets range midpoints consistent with the market albeit using a different methodology. We agree that a practice needs to be developed to move employees through the ranges, especially in light of inadequate funding for performance pay, and the Department is in the process of researching and designing such a practice, which includes examining setting pay range midpoints that remain comparable to the market. We also agree that state pay ranges may be too wide.

We agree with the concept of using base-building and non base-building increases to reward performance. In fact, several years ago, the Department actually set a structure in place which utilized the concept of employing base building increases to a specified point in the range and then non-base building increases based on performance (former "job rate" concept). This structure was not fully implemented because performance pay was not funded. The change from the former step system to this type of range movement met with such a high degree of resistance that the General Assembly passed legislation requiring revision to the performance pay system, which removed the "job rate" concept along with other changes. Therefore, any contemplation of returning to that type of range movement must consider the State's organizational culture and political factors along with an assessment of potential fiscal impact due to raising midpoints based on actual salaries.

The Department believes in transparency when it comes to setting compensation and agrees to continue educating employees as to how their compensation is determined, from formal rules and informational publications to meeting with groups of employees. We recently held seven different employee forums around the state on total compensation education. We also are currently piloting an online total compensation calculator to show individual employees the State's investment in their total compensation, including salary, employer contribution to group benefits, leave, pay premiums, retirement contributions and others.

b. **Agree.** The Department agrees that a single budget amount for salary adjustments can work, provided that a portion of this budget amount is available to recognize the performance of competent but not excelling performers. The Department will work with policy-makers on changing to a single line item for pay increases. This will allow the State to provide competent, but not excelling performers with a reasonable pay increase while compensating high performing employees with a larger pay increase in order to remain competitive with the market, as well as allocating a small portion to bring employees up to the minimum of their pay ranges.

TOTAL COMPENSATION (CASH PLUS BENEFITS)

Total compensation includes cash and benefits such as health and dental insurance, retirement plans, short- and long-term disability, and leave. As part of the annual total compensation survey process, the Department must assess the State's non-cash compensation package to determine how it compares with the market. To make this assessment, the Department uses the Colorado Municipal League and the Mountain States Employers' Council surveys to compare the State's benefit expenses and practices with other employers. Specifically, the Department compares the State's contribution to the costs of group insurance with contributions made by other employers in the market.

We reviewed the Department's current approach to assessing benefits and found that it does not ensure that the State's total compensation package will be competitive with the market. Specifically, we identified the following issues:

- **The Department's approach focuses more on the employer contribution to the cost of benefits without adequate attention to the value of benefits.** Competitive total compensation fundamentally means the "value" delivered to employees, not just the cost or proportion of cost paid by the employer. Providing competitive benefits requires asking, "How can we provide a better/more competitive benefit?" To make this determination, organizations must look at the level of services provided (e.g., types of services, deductibles, co-pays, out-of-pocket maximums) as well as the types of benefits employees value most. In addition, organizations should review employee usage of benefits to determine which services are used more frequently. Organizations can then structure their benefit plans to ensure that the more highly valued and frequently used services are provided at the lowest possible cost, while services that are not valued as highly or used as frequently are allocated the higher costs. Although the Department looks at the cost and level of benefits provided by the State as part of its survey process, we found that it does not sufficiently evaluate the competitiveness of its plan design or the types of services employees' value and use the most. The Department's overall conclusion in the 2005 Total Compensation Report with respect to benefits was that the State's contribution to health insurance premiums is below the market. We strongly agree with this conclusion, but without an evaluation of the total *value* of benefits, the State cannot be certain that increasing contribution levels alone will address this competitive weakness.

  We compared the State's major benefit plan features (i.e. the value received by employees) to Mountain States Employers' Council's 2004 Health and Welfare Plans Survey and identified numerous critical areas where the State's benefits are significantly below the market average. For example, we found that in addition to lower-than-market premium contributions, the State health plans' prescription and office visit co-pays, deductibles, out-of-pocket maximums, and lifetime maximums are all higher than the market average. For the State's dental plans, we found that the State's contribution to premiums is also below market and the absence of orthodontia coverage in the Basic Plan significantly diminishes the value of the plan as this benefit is common in the market. For life insurance, we found that the maximum benefit in the market is typically $100,000, compared to $33,000 for the State. These findings indicate that even if the State increases its premium contributions to market levels, the value of State benefits may still be below market levels. Therefore, the Department needs to change how it evaluates benefits to ensure that it assesses the true "value" of benefits to state employees to determine what changes are needed to best meet employee needs and remain competitive with the market. Using this information, the Department should modify benefit plans or recommend higher levels of cash compensation to close the gap created by benefit plans that may be below market.

- **The Department does not integrate the value of benefits with cash compensation when assessing the competitiveness of the State's total compensation package.** An integrated analysis of salaries and benefits is essential to ensure the State is offering a "prevailing" total compensation package. In a total compensation environment, the gap created by weaker than average health, life, and dental benefits can only be made up by above average cash compensation, either through performance or variable pay programs that provide incentive compensation. As discussed above, the State's premium contributions to health benefits and benefit levels are significantly below market levels. We have also identified several concerns about total cash compensation that affect the State's competitiveness. It is therefore essential that the Department integrate its analysis of both cash and non-cash compensation practices when assessing the State's competitiveness as an employer and making recommendations for adjustments to salaries and benefit levels. This analysis could focus on a limited number of jobs for which the Department estimates the value of the major benefit items for the State as well as the market and combines those to compare total compensation. The conclusions from these jobs can be extrapolated to the rest of the State's positions in making recommendations for pay strategy changes and funding levels.

RECOMMENDATION 3:

The Department of Personnel & Administration should improve its approach to evaluating benefits by:

a. Assessing the true value of benefits delivered to employees and modifying benefit plans or recommending higher levels of cash compensation to close the gap created by benefit plans that may be below market average. The result will be a total pay package with a value comparable to the market

b. Integrating its analysis of cash and health, life, and dental benefits to the degree possible within existing survey sources.

DEPARTMENT OF PERSONNEL & ADMINISTRATION RESPONSE:

Implementation Date: July 1, 2008.

Partially Agree. While the Department agrees with the auditor's recommendation regarding assessment of the total value of employee compensation and continues to research this issue, the determination of "value" is a time-consuming and costly project, which is frequently subjective. We have not found a clear definition of "value" and a methodology to measure and compare this "value" to the market. Previous efforts to accomplish this objective have proved to be difficult, not cost effective, and too subjective to be useful at this point. We actively participated in a project sponsored by the National Association of State Personnel Executives; however, the national effort was abandoned because of the difficulties encountered. Employers using a valuation process are often dependent on annual consulting contracts.

If "value" is defined as a comparison of certain plan design features such as co-pays, co-insurance, deductibles, and out-of-pocket maximums, the Department already monitors trends in this area. However, changes in plan designs drive costs. In fact, common health care cost control mechanisms currently being applied in the market are to increase co-pays, deductibles, etc. These mechanisms were applied several years ago in an effort to mitigate the State's rate increases and keep benefits affordable for employees who had to bear the entire increase. Because of the legislative support to increase the State's contribution over the past two years, the State was able to provide a modest decrease in the co-pays and deductibles on some benefit plans in an effort to recognize the value of these portions of the benefit offerings. We thank the Legislature for the support in increasing the State's contribution and will continue to work to reduce the significant gap between the State's contribution rate and the market contribution rate. This gap must be closed before adding the costs associated with richer plan designs so affordability is not adversely impacted. The Department needs to take a long-term approach by first continuing to develop a definition of "value" that is then applied to cost, followed by the value of services themselves. We will contact the consultant's client employers to assess the costs and their satisfaction with the valuation model for their total compensation programs. If a useful method can be identified, it may be necessary to appropriate additional resources, especially for the valuation of services, including the potential need to commit consulting dollars for future years.

The Department also agrees with the total compensation tenet of balancing benefit plans and levels of compensation and it is part of our long-term strategic direction. However, it will take a number of years to accomplish this flexibility because other issues must be addressed first, e.g., funding for performance pay, closing the gap in employer contributions to group benefits.

The Department agrees to integrate its analysis of salary and benefits and will evaluate the best method to accomplish this analysis, while recognizing that the Department needs to thoroughly evaluate the validity of any data collected and how representative it is of the workforce before extrapolating the conclusions to the diversity of state jobs.

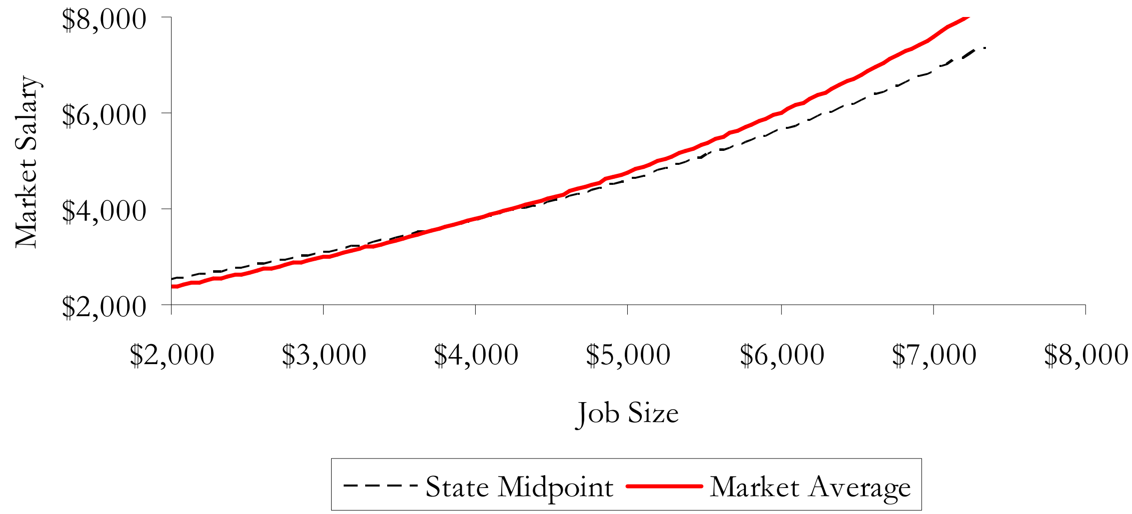
ACTUAL PAY

The State's pay program includes multiple salary ranges that have been established for various jobs within each of the State's nine occupational groups. Salary ranges establish the range of pay, from minimum to maximum, that can be paid for a particular job. For example, the salary range for an Office Manager II within the administrative support occupational group has a minimum salary of $3,245 per month and a maximum salary of $4,799 per month. The salary for an individual in this position could be anywhere within this range. The Department defines the salary range midpoint as the competitive level of pay for each job in the State and sets state midpoints in line with market pay range midpoints. To set pay range midpoints, the Department gathers data on the salary ranges used by other organizations and calculates the difference between the prior year's midpoint rate and the current year's midpoint rate for every job surveyed. The Department then adjusts the salary ranges within each occupational group to match the salary range data obtained from the market.

We found that state midpoints, which should reflect the pay for a fully competent employee, are generally not aligned with the market. The Department's practice of using market midpoints to set compensation levels does not accurately reflect competitive practice and is not prevailing in the market. Most practitioners use **actual pay data**, not salary range data, to assess the effectiveness of the organizations' pay administration system in delivering and maintaining competitive levels of pay across all jobs and occupational groups. This is an important distinction. Collecting salary range data falsely assumes that organizations are actually paying their employees in accordance with the ranges. In contrast, actual pay data captures the actual salaries other organizations in the market are paying for similar jobs. Once an organization knows how its actual pay levels compare to market pay, it can establish budgets for salary increases that will align the organization's actual pay with its desired competitive level.

In our experience, setting compensation on the basis of pay range data (midpoints) rather than actual pay causes salaries to deviate from actual practice in the market over time. Our analysis shows that this may already be happening in Colorado. Using data for 40 state benchmark jobs, we compared the State's *midpoint* with the market *actual average salary*. As the following chart shows, state midpoints tend to lag the actual salaries in the market. When this occurs, state salaries may tend to be less competitive with the market. For example, according to data gathered by the Department, the actual salary in the marketplace for the Police Administrator I position is nearly $590/month higher than the State's midpoint for the job. This means that the State's entry-level salaries for this position are lower than the market's. This gap may result in significant recruitment and retention issues for the State.

State Range Midpoints
vs.
Market Actual Salary



We believe that the Department should use actual data to assess the effectiveness of the State's salary structure and the competitiveness of state cash compensation. If the Department continues to rely on pay range data to set compensation levels, cash compensation will continue to be out of alignment with the market. We made the same recommendation in our 2003 audit of the Department's survey process. Since that time, the Department has begun to collect some actual market data, but it does not use these data to develop recommendations for annual salary adjustments. The Department does use actual pay data to identify jobs that may need to be re-classified to a new pay range, but this limited use will not ensure that the State's actual pay levels are in line with competitive practice.

RECOMMENDATION 4:

The Department of Personnel & Administration should ensure the State's pay range midpoints are aligned with actual market pay rates by analyzing actual pay data to assess the competitiveness of state compensation levels each year and to recommend salary increase budgets.

DEPARTMENT OF PERSONNEL & ADMINISTRATION RESPONSE:

Partially Agree. **Implementation Date: July 1, 2007, for including actual salary data in the annual survey report**. The Department agrees that actual pay plays a significant role in determining market competitiveness but does not agree that it is necessarily the only or best way to set pay ranges consistent with the State's organizational needs. We analyze and apply actual pay data in assessing competitiveness by using it to verify annual salary recommendations, and as one component when reviewing individual class salary levels compared with the market (separate processes from the annual survey). We do not believe average actual market pay data should be the sole basis for setting salary budgets. Prior to 1987, the Department used actual pay data to make recommendations but found this historical practice to be unstable for the State's pay structure. Due to uncontrollable factors in the market that caused fluctuations, the Department found actual pay analysis resulted in erratic survey recommendations. The General Assembly changed the statute in 1987 to require occupational group recommendations in order to provide more stability to survey recommendations. Thus, the Department has consistently used pay structure movement from one year to the next as the more reliable and stable method of adjusting its pay ranges. Equitable pay ranges provide earning opportunity for employees. In addition, the Department provides a number of compensation policies that allow appointing authorities flexibility in making pay decisions to address their unique business needs in order to stay competitive while remaining within the pay ranges.

Auditor's Addendum: The Department indicates partial agreement with the recommendation, but Milliman does not see any agreement in the response. While the Department states that using actual pay is not "the best or only way to set pay ranges consistent with the State's organizational needs," Milliman believes that using actual pay is consistent with the statute and with best practice. The statute seeks to ensure that pay (we read "actual pay") for state employees is competitive in the market. Current State pay ranges are not aligned with market pay levels simply because the ranges are tied, not to actual pay, but to range midpoint data collected by the Department. This practice results in pay ranges for some jobs that are above or below what the position could expect to be paid in the market. Secondly, the overwhelming majority of organizations set their pay ranges based upon actual pay in the market for a position, NOT based on reported range midpoints.

Our recommendation here does not suggest that actual pay should be used to set budgets; that role we believe is best performed by salary planning surveys. Rather, actual pay can be used to evaluate the need to make special pay adjustments to jobs or classifications that have fallen behind the market (this "system maintenance" is outside the annual survey report) and as needed to combine with data from salary planning surveys to develop total budget requests.

PAY RANGE WIDTHS

A pay range is typically composed of a minimum salary level and a maximum level. Best practice in the market is to set pay range widths (percentage difference between the maximum and the minimum) based on an organization's compensation philosophy. For example, the minimum can have a number of functions such as defining the starting level of salary for all positions in the range. It can also function as an indicator of the lowest amount to be paid for an employee with no experience or serve a strategic role ensuring that the organization starts its employees at aggressive levels compared to the market. Maximums can serve an equal number of different roles, depending on an organization's pay strategy.

We reviewed the Department's methodology for setting pay ranges and found that it may be too prescriptive and restrictive and is not aligned with best practices in the market. The Department recommends pay range adjustments each year based solely on its analysis of reported market range data for each occupational group. This analysis is essentially an "average of averages" in which the Department averages data on range minimums and maximums for jobs in each occupational group to set ranges for that group. According to the Department, its statutory requirement to provide "prevailing total compensation" to state employees forces the Department to establish ranges using this approach because it is based on prevailing market range data. We believe the intent of the statute, however, is that the State provide competitive pay and a range is a means to that end. Therefore, the Department does not need to establish pay ranges that are averages of market practice, particularly since a pay range is an element of both pay strategy and pay administration. Pay ranges are not intended to reflect competitive actual pay practice for a given job.

The inconsistency between the Department's approach and market practice lies in the fact that the Department is essentially aggregating and then averaging the unique compensation strategy of each individual organization that participates in published surveys. This practice is not recommended because it can result in actual salaries being inconsistent with the market. We found an example of where this has occurred in the case of the Accounting Technician II. According to the Department's published market surveys, the average range width for this particular job is 36 percent, yet the job is placed within a classification at the State whose range width is 52 percent. This wide range results because other jobs within this occupational group report a wider range width that brings the average up. The effect of managing pay under the Department's approach is that the real difference in terms of dollars may be significant. In the case of the Accounting Technician II, the difference between the market range width and the State's range width greatly affects the minimum of the salary range. The State's salary range minimum for the job is $428/month less than the average minimum in the marketplace. This could have an adverse effect on recruiting and retention because State entry-level salaries for this position may be lower than the rest of the market. Conversely, in the case of an Accountant IV, the State's range has a maximum that is $1,552 above the average maximum in the marketplace, a fact that could result in the State paying more for the position than other organizations in the market.

Most organizations set their pay ranges in a manner that supports their own unique compensation strategy. Essentially, there is no "prevailing practice" for setting pay ranges. Rather, there are "best practices" that are dependent on organizational compensation philosophy. A typical best practice is to use ranges that are 35 percent wide for hourly or lower paying positions. For the State, this could mean setting a 35 percent range width for all jobs earning less than $35,000/year. The range is smaller for these types of positions because:

- Lower paying positions have short learning curves; and
- There are fewer opportunities for these jobs to become more complex and thus narrower ranges of pay are appropriate.

For professional and managerial positions, best practice has been to use ranges that are 50 percent wide or more. For the State, this could mean setting ranges that are 50 percent wide for positions paying more than $35,000/year. The range is wider for these types of positions because:

- Higher paying positions take longer to master because of their complexity; and
- There are more opportunities for these jobs to grow by taking on greater responsibilities while still performing the basic job functions (thus requiring a wider range of pay opportunity).

The Department needs to reevaluate its strategy for managing the State's salary structure to ensure that it supports the State's compensation philosophy. Specifically, the Department needs to consider factors in addition to market averages when setting pay ranges to better meet the State's objective of providing prevailing total compensation to state employees. We made a similar recommendation in our 2003 audit of the Department's survey practices that has not been implemented.

RECOMMENDATION 5:

The Department of Personnel & Administration should reevaluate its strategy for managing the State's salary structure and consider factors in addition to market averages when setting pay ranges to better meet the State's objective of providing prevailing total compensation to state employees.

DEPARTMENT OF PERSONNEL & ADMINISTRATION RESPONSE:

Agree. **Implementation Date: July 1, 2008.** The Department agrees that the pay range structure should reflect the State's compensation strategy. We also agree with the auditors in setting fixed pay ranges for individual occupational groups based upon the State's compensation philosophy. We also concur with the auditor's statements that there is no prevailing market practice in this area and employers set range width to support their unique strategies. The Department believes that pay range width is established for purposes of pay opportunity and it is appropriate to determine pay range width based on the unique requirements of each occupational group and the needs of the organization. For example, jobs with shorter learning curves, such as Administrative Support and Related jobs, have a narrower range width than those requiring broader competencies, such as Professional Services jobs. Our long-term total compensation strategy is enumerated in *Total Compensation Strategy: Moving Toward a Flexible, Integrated Total Compensation Program*, which the Department believes best serves the interests of all stakeholders in keeping our total compensation competitive. We also agree to examine other methods for setting pay ranges as part of our ongoing research of professional trends in order to remain competitive.

BENCHMARKING

Benchmarking is the process of matching jobs with similar jobs in the market to compare salary and pay range data. As part of the annual total compensation survey process, the Department identifies a sample of state jobs as benchmarks to compare with positions in other organizations. The Department then uses pay range midpoints and salary data for the benchmark jobs to calculate the overall salary structure adjustment for each occupational group and the specific pay range adjustments for each individual job. For example, survey data may indicate that on average, the midpoints for jobs within the professional services occupational group have increased 3.2 percent. The Department would then recommend a 3.2 percent salary structure increase for this group.

We reviewed the Department's benchmarking process and found that overall, the Department spends too much time on detailed data analysis to determine salary structure adjustments, but not enough time on analyzing actual pay data for an appropriate number of benchmark jobs. As discussed in the following sections, the Department needs to make changes to streamline the benchmarking process and to make better use of limited resources.

- ***The Department's practice of using detailed benchmark data to adjust salary structures does not accurately reflect competitive practice and is not prevailing in the market.*** Most practitioners use published compensation planning surveys to adjust salary structures. These surveys include data showing the average percent increases or decreases in salaries for various industries, market sectors, and occupational groups. This process is simple and typically results in salary structure movements between 2 percent and 3 percent annually. The Department could benefit from using these planning surveys because its current process of conducting detailed analyses of benchmark job data to assess structure movements is unnecessarily time-consuming and not proportional to the value added. The Department could reach similar conclusions regarding structure adjustments and spend significantly less time on the process by using planning survey data. We have found that data obtained from these surveys is just as robust and reliable as the information obtained through the Department's extensive analysis of benchmark data. Although we have recommended in previous audits that the Department use compensation planning surveys to adjust salary ranges, these recommendations have not been implemented. Currently the Department only uses these surveys to validate its own analysis and to develop general budget recommendations. Using these surveys to adjust salary structures would allow the Department to focus its resources on analyzing actual pay data and current compensation levels for more jobs, as discussed below.

- ***The Department does not select a sufficient number of benchmark jobs to ensure compensation levels are competitive with the market.*** Best practice for organizations that have a market-driven pay philosophy (like that of the State's) is to measure at least 75 percent of its total jobs as benchmarks. A market-driven pay system should seek to collect market data on as many positions as possible because these systems rely on market data. Directly linking as many jobs as possible to actual market data validates the "market orientation" of the system. We found that for the 2005 Total Compensation Survey, the Department matched only 210 of the 528 (40 percent) total state jobs with jobs in the market. This is approximately the same percentage of jobs selected in prior surveys and includes the same jobs reviewed by the Department each year. This means that about 60 percent of all state jobs are never benchmarked by the Department and evaluated against the market. By benchmarking such a limited number of jobs, the Department cannot ensure that compensation levels for non-benchmark positions are consistent with competitive market levels. (Note: We did not evaluate the number of positions that are "linked" directly to these benchmarks and which, through that "link" could be said to be included as benchmarks. It is likely that these jobs would increase the percentage of jobs that could be considered as benchmarked by five to ten percent.)

  We have recommended in previous audits that the Department increase the number of jobs that it benchmarks. The Department has argued, however, that it is costly and impractical to expand the number of benchmark jobs evaluated each year. Currently the Department only uses data from Colorado surveys to benchmark its jobs. According to the Department, it already matches as many jobs as possible using Colorado surveys and increasing the number of benchmarks would require the Department to conduct its own direct surveys which can be costly and time-consuming. Conducting its own direct surveys would not be necessary, however, if the Department used national surveys to benchmark additional positions. Compensation professionals routinely use national surveys and adjust the data for their state by using geographic differentials, which are commonly used and easy to apply. The Department could use these national surveys and easily adjust the data to reflect the Colorado market. This would enable the Department to increase the number of benchmark jobs to around 400, or about 75 percent of the total state jobs.

  The Department has also expressed concerns about the resources required to review additional jobs each year. This can be addressed by spreading the benchmark analysis over multiple years which is a common practice among other organizations. For example, many organizations collect information for one-third of their benchmark jobs each year so that after a three-year cycle, all jobs have been thoroughly evaluated. We have found that salaries for most jobs do not change significantly from year to year and thus do not need to be evaluated annually. We recognize though that there may be certain positions that do experience significant annual changes. When identified, the Department could be sure to include those positions in its annual benchmark analysis. By using this approach, the State could benchmark about 400 of its 528 jobs and annually collect information on 135 of those 400 jobs. This is a stronger approach to pay administration than the one currently used by the Department because more jobs are compared with the market, which helps ensures competitive pay levels for the State. In addition, this approach is more cost-effective and efficient because reducing the number of jobs reviewed each year reduces the amount of staff time needed for the analysis.

RECOMMENDATION 6:

The Department of Personnel & Administration should improve its annual total compensation survey process and make better use of limited resources by:

a. Using published compensation planning surveys to develop recommendations regarding structure adjustments to state pay ranges.

b. Identifying at least 75 percent of the total state jobs as benchmarks for regular analysis using both Colorado and national survey data. The Department should then analyze approximately one-third of those benchmark jobs each year as part of the annual survey. Over a three-year cycle, roughly 75 percent of state jobs will have been reviewed for market competitiveness.

DEPARTMENT OF PERSONNEL & ADMINISTRATION RESPONSE:

Partially Agree. Implementation Date: Ongoing.

The Department agrees to continue to use published compensation planning surveys to develop recommendations regarding structure adjustments to state pay ranges. While the Department does not agree that planning surveys should be the primary source or used as the sole basis to determine the pay range adjustments, these are valuable tools to verify survey recommendations based upon detailed market data.

The Department agrees that it would be ideal to benchmark at least 75 percent of state jobs through the survey process. The Department continues efforts to increase the number of benchmarks to the extent possible. With the unusual nature of many state jobs found only in the public sector and specifically state government, third-party survey data is not available for many state jobs. The Department uses Colorado survey data because that is our labor market. The Department purchased regional and national data but determined that these surveys were not cost effective due to the small number of additional benchmark jobs from the national data sources, the duplication of firms providing data to both Colorado and national survey sources, and the time and effort for more complex methodologies, e.g., geographic adjustments for regional or national data. We concluded that adequate data from Colorado survey publications exists to provide a representative market sample for making survey recommendations. For example, "Expert Tips on When to Use Salary Surveys to Your Best Advantage" (*Salary Survey Strategy*, Institute of Management and Administration (IOMA), January 2005) reports that the appropriate survey sources include jobs from the labor market in which an employer competes. The Department has identified the Mountain States Employers Council (MSEC), the Colorado Municipal League (CML), and the Colorado Health Association (CHA) as adequately covering the benchmark positions representing our competitive labor market. The article further suggests that frequency is based on when data are needed for making informed decisions, which is typically on an annual basis for a market-competitive system. The Department believes its practice of annually reviewing all available benchmark jobs in Colorado surveys is sound professional practice. The data is also used as part of studies of individual classes through the separate processes under a separate statute so it is an effective use of our limited resources. The Department will continue this practice.

Auditor's Addendum: The prevailing practice among organizations that are "market driven" in their pay strategy (as is the State) is to collect data on significantly more than 40 percent of their positions. That practice is driven by the organization's commitment to ensuring that pay levels are linked to market data and NOT to internal job relationships. Milliman disagrees about the utility of national surveys in terms of the data, the complexity of using that data, and in terms of the number of benchmark jobs available from a few key sources. The Department's current benchmark group (40 percent of state jobs) is too small to ensure that pay levels for the vast majority of jobs are set at competitive levels and without additional data, we do not believe that the Department can assert with a high degree of confidence that pay levels across the State are aligned with the market.

OCCUPATIONAL GROUPS

The State's salary program is designed around nine occupational groups – enforcement and protective services, health care services, medical, labor/trades/crafts, financial services, administrative support and related, professional services, teachers, and physical sciences and engineering. All state jobs are categorized within one of the occupational groups and the Department establishes separate pay ranges for each job within a group. The Department analyzes market data specific to each occupational group to determine the average pay range widths (minimum to maximum salaries) and pay range adjustments (increases or decreases in dollars) for jobs within each group. The Department uses this information to make adjustments to the pay ranges within each occupational group.

We reviewed the State's salary structure with its nine occupational groups and found that it is more cumbersome than it needs to be and does not reflect the prevailing practice for employers using a market-driven pay system like the State's. The majority of employer's using a market-driven pay system use one to three occupational groups because it is more flexible, easier to maintain, and easier to communicate to employees. We have recommended in previous audits that the Department simplify the State's salary program. According to the Department, however, different occupational categories or classifications of work (e.g., health care, law enforcement) may display discrete market behavior. For example, health care jobs in general may be under greater labor market pressure due to labor shortages than jobs in the financial services area. As a result, the health care jobs may have higher salary increases from year-to-year or may adopt additional compensation elements, such as incentives. By having separate occupational groups, the Department believes it can make adjustments for specific industries more easily than it could with fewer occupational groups.

While we agree that having separate occupational groups can help align the State's pay practices with the market, the distinction between some of the State's groups is artificial because the differences among the groups are not significant. We believe there are actually substantial similarities between classifications in several of the State's current occupational groups. For example an Accountant II is currently in the financial services occupational group and has a minimum salary of $3,283 and a maximum salary of $4,990. A Legal Assistant II, on the other hand, is in the professional services occupational group and has a minimum salary of $3,257 and a maximum salary of $4,982. Further, an Office Manager II is in the administrative support occupational group and has a minimum salary of $3,245 and a maximum salary of $4,799; while a Statistical Analyst I is in the physical sciences and engineering occupational group and has a minimum salary of $3,263 and a maximum salary of $4,991. We found that none of these jobs have experienced significant market changes over the past few years and their pay is similar, yet they are all in different occupational groups. The best practice among most compensation practitioners would be to include them in one occupational group with a pay range from $3,250 to $4,875 instead of using four different groups and ranges.

While multiple occupational groups provide the appearance of stronger linkage with the market, the variability in market practice and in the data itself means that the implied differences may not be real or material. In addition, practically speaking, using multiple occupational groups is unnecessarily complex and inefficient because excessive time and resources are needed to analyze pay data and make adjustments for nine different groups. It also makes it more difficult for the Department to explain to employees why some occupational groups receive a much smaller pay adjustment than others, when the positions within those groups appear to be very similar. Therefore, we would recommend reducing the current occupational group system as the following table illustrates.

Current Occupational Group		Proposed Occupational Group
Enforcement and Protective Services	⇨	Enforcement and Protective Services
Health Care Services	⇨	Health Care
Medical	⇨	
Labor/Trades/Crafts	⇨	Labor/Trades/Crafts
Financial Services	⬂	
Administrative Support and Related	⬂	
Professional Services	⇨	Professional and Administrative Services
Teachers	⬀	
Physical Sciences and Engineering	⬀	

In this example, the Department would only have to analyze market data for four occupational groups, instead of nine, to determine the average pay range widths and pay range adjustments necessary for these groups and positions. This would significantly reduce the amount of resources needed to conduct this analysis, yet would still provide robust and reliable data.

RECOMMENDATION 7:

The Department of Personnel & Administration should align the State's compensation program more closely with the market by reducing the number of occupational groups.

DEPARTMENT OF PERSONNEL & ADMINISTRATION RESPONSE:

Partially Agree. **Implementation Date: July 1, 2007.** The Department agrees to continually evaluate the number of occupational groups to ensure that the compensation program is properly structured. Reducing the number of occupational groups too far could result in recruitment issues and would not reflect the statutory intent of providing prevailing compensation for the breadth of state occupations. For example, the recommended adjustment for Engineering and Physical Sciences group reflects the higher market demand or salaries for engineers in the workforce as opposed to Professional Services jobs. Reducing the number of groups too far given the diversity of state jobs could actually increase the number of individual classes that are above or below the market, which in turn would generate greater workload on limited staff resources to perform more labor-intensive system maintenance studies. Thus, merely reducing the number of occupational groups will not significantly reduce the amount of resources needed to conduct the annual survey analysis. With the present state of automation, the number of occupational groups is somewhat irrelevant to having robust and reliable data. The Department needs to perform a thorough analysis to determine the appropriate number and composition of occupational groups for the state personnel system.

Auditor's Addendum: Occupational groups tend to mask market movement for individual jobs and result in a "rising tide lifting all boats" in a particular group. Reducing the number of groups and focusing on data for greater numbers of benchmarks will allow the State to ensure individual jobs are paid competitively and that limited resources are directed appropriately to specific market conditions.

STATEWIDE PAY EQUITY

An additional issue affecting the State's competitiveness as an employer relates to the State's definition of salary equity. The Colorado Constitution defines "equity" to mean that pay must be the same for similar work, regardless of a job's geographic location within the State. This definition is in direct conflict with Section 24-50-104, C.R.S., which requires the State to offer "prevailing" (or competitive) compensation. We have found, and compensation surveys show, that salaries vary, depending on where a job is geographically located within the State. The current approach results in the following:

- Jobs in markets where the cost of labor is lower than the Front Range are paid more than their local peers, resulting in above market compensation. These include markets such as Pueblo and Mesa counties.

- Jobs in markets where the cost of labor is higher than the Front Range are paid less than their local peers, resulting in below market compensation. These include markets such as Vail, Steamboat Springs, and Aspen.

By paying the same salary for a position regardless of its geographic location, the State cannot meet its statutory obligation to provide prevailing compensation, at least not "prevailing" in the location where the job performs its services. To remedy this conflict, however, constitutional changes are needed. We have identified similar findings and recommendations in previous audits. Efforts to change the constitutional definition of "equity" have been unsuccessful. The Department of Personnel & Administration should continue to support these changes in the future should the opportunity arise.

Follow Up on Prior Audit Recommendations

We conducted a follow up on recommendations made in the 2003 Performance Audit of the Colorado Department of Personnel & Administration's Annual Total Compensation Survey. Throughout this report we have commented on recommendations that were made in the last audit, but have not been fully implemented. Recommendations from the last report, which are not discussed in the body of this report, are listed below along with their implementation status.

Recommendation 1:

Assess and report to the General Assembly on the impact the total compensation package has had on the State's ability to recruit and retain employees.

Partially Implemented. The Department completed part of the assessment of relative importance/priority of compensation components in a survey of managers, supervisors, and human resource administrators and submitted the results as a supplement in the Fiscal Year 2005-06 Annual Compensation Survey Report on August 1, 2004. The Department has also designed an employee survey. The Department expects survey results to be available and included in the Fiscal Year 2006-07 report. Additionally, the Department's workforce data specialist has designed an online exit survey to be used on an ongoing basis as part of assessing the impact of the State's total compensation components on recruiting and retention. Exit surveys can provide strong clues as to the strength of the State's recruitment and retention strategies.

Recommendation 8:

Consider alternatives to the State's leave policies.

a) Implement a consolidated leave program.

b) Eliminate injury leave for a make whole policy.

Partially Implemented. During the 2004 Legislative Session, Senate Bill 04-10 attempted to amend the sick leave statute and allow the State Personnel Director to develop and implement leave policies. This Bill, which was a necessary first step to a consolidated leave program, was defeated. The Department continues to seek statutory change. The injury leave policy was not changed in anticipation of implementing consolidated leave.

Recommendation 10:

Assess succession plans, career development initiatives, and internal skill sets as they relate to the Department's ability to conduct the Total Compensation Survey. In the event that current staff are unavailable to conduct the survey, a formal plan to ensure the ability of the Department to maintain this service is essential.

Partially Implemented. The Department is training two additional staff to assume annual survey duties, one of whom has sufficient analytic and statistical expertise to take primary responsibility for completing the survey. In addition, the Department has created a new position that will assist with the benefit portion of the survey process. Finally, the Department has begun documenting the steps and procedures necessary to complete each survey task.

Class	Title	Milliman Market Avg	State Market Avg	% Diff*	Comments
A3C1	Community Parole Officer	$4,074	$3,941	-3%	Matches are consistent
A4B2	Police Officer I	$4,558	$3,947	-13%	Milliman matched this at a slightly higher level than DPA
A4B5	Police Administrator I	$7,062	$6,780	-4%	Matches are consistent
B1A2	Accountant II	$4,456	$4,074	-9%	Matches are consistent
B1A4	Accountant IV	$5,662	$5,845	3%	Matches are consistent
B1C2	Accounting Technician II	$2,877	$2,679	-7%	Matches are consistent
B1C4	Accounting Technician IV	$4,362	$4,621	6%	Matches are consistent
B2A3	Auditor II	$4,416	$3,997	-9%	Matches are consistent
B2F4	Budget & Policy Analyst IV	$6,612	$6,629	0%	Matches are consistent
C5K2	Therapist II	$4,516	N/A		
C5L2	Therapy Assistant II	$2,939	$2,662	-9%	Matches are consistent
C6R2	Health Care Technician II	$2,354	$2,584	10%	Matches are consistent
C6S3	Nurse III	$4,624	$4,134	-11%	Milliman matched this at a slightly higher level than DPA
C6S4	Mid-level Provider	$6,129	$5,452	-11%	Milliman matched this at a slightly higher level than DPA
C8A2	Diagnostic Procedures Technology II	$3,805	$4,243	12%	DPA matched this at a slightly higher level than Milliman
C8D1	Laboratory Technology I	$3,079	$3,314	8%	Matches are consistent
D6A1	Electrical Trades I	$3,836	$3,709	-3%	Matches are consistent
D6D2	Structural Trades II	$3,450	$3,449	0%	Matches are consistent
D7A2	Equipment Mechanic II	$3,778	$3,467	-8%	Matches are consistent
D7A4	Equipment Mechanic IV	$4,578	$4,941	8%	Matches are consistent
D7B2	Equipment Operator II	$2,480	$2,567	4%	Matches are consistent
D7B3	Equipment Operator III	$2,893	$3,021	4%	Matches are consistent
D8C1	Dining Services I	$1,845	$1,633	-11%	Milliman matched this at a slightly higher level than DPA
D9C2	Inspector II	$4,406	$4,094	-7%	Matches are consistent
G1A3	Police Communications Supervisor	$4,366	$4,293	-2%	Matches are consistent
G2D4	Data Specialist	$3,215	$3,155	-2%	Matches are consistent
G3A3	Administrative Assistant II	$2,786	$2,807	1%	Matches are consistent

Class	Title	Milliman Market Avg	State Market Avg	% Diff	Comments
G3A4	Administrative Assitant III	$3,256	$3,432	5%	Matches are consistent
G3A5	Office Manager I	$3,723	$4,180	12%	DPA matched this at a slightly higher level than Milliman
G4A2	Collections Representative II	$2,565	$2,275	-11%	Milliman matched this at a slightly higher level than DPA
H2I4	IT Professional II	$5,476	$5,240	-4%	Matches are consistent
H2I6	IT Professional IV	$6,376	$5,599	-12%	Milliman matched this at a slightly higher level than DPA
H6G1	General Professional I	$3,238	$3,563	10%	Matches are consistent
H6G3	General Professional III	$4,093	$4,398	7%	Matches are consistent
H6G8	Management	$7,339	$7,139	-3%	Matches are consistent
H6M1	Food Service Manager I	$3,203	$4,124	29%	DPA matched this at a higher level than Milliman
I2C4	Professional Engineer I	$6,931	$6,133	-12%	Milliman matched this at a slightly higher level than DPA
I3A4	Environment Protection Specialist III	$5,162	$4,742	-8%	Matches are consistent
I3B3	Phy Sci Research/Scientist II	$5,695	$4,842	-15%	Milliman matched this at a higher level than DPA
I5D3	Engr/Phy Sci Tech III	$4,688	N/A		

* We expect some variability here even if the matches are consistent. Normal variation caused by survey participation and other influences ranges from +/- 5% to +/-10%, depending on the "commonness" of the benchmark job.

Data for this activity were drawn from the identical surveys as those used in the DPA's Total Compensation Survey. The Milliman Market Average and the State Market Average are displayed in simple average reporting format.

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