



**Pay-for-Performance:
*A Practical Guide to
Merit-Based
Compensation
Planning***

A slowing economy accelerates the need to tie employee performance to highest-priority business goals. By following the steps outlined in this white paper, organizations can use even static salary budgets to drive greater shareholder value *and* employee satisfaction.

Compensation is one of the HR Department's most effective tools for attracting strategic talent and retaining and motivating top performers. But on average, employee salaries already account for *at least* 70% of expenses, often topping 80% in the academic and public-sector communities. With CEOs looking for ways to raise shareholder value and corporate dividends without also raising expenses, it's unlikely the HR team can count on major salary-budget growth to help them meet their organizations' ever-growing needs. In fact, the *WorldatWork* Salary Budget Survey, the largest of its kind, forecasts salary increases to plateau for the coming year at just 3.9%.

If organizations can't make large, across-the-board salary increases, how can they continue to compete for — and keep — the strategic talent critical for meeting both short- and long-term business objectives? The answer lies in finding a new way to carve up a basically static budget so that top performers can continue experience competitive salary growth. In other words, pay-for-performance.

The concept of awarding higher pay for higher performance isn't new. Neither is the strategy of using pay incentives to align individual-employee performance with business objectives. There are plenty of metrics that show pay-for-performance programs deliver results. For example, the Watson Wyatt Human Capital Index documents that in organizations that make substantial pay distinctions based on performance, *the total return to shareholders is 49 percentage points higher* than in organizations that don't. With ROI like that, it's easy to see why pay-for-performance is increasing — with approximately 80% of U.S. organizations now reporting the use of some form of performance-based compensation.

Unfortunately, simply implementing a pay-for-performance program doesn't assure ROI like this. In fact, all too many organizations implement these programs only to find that performance, morale, and retention all take a nosedive.

This happens because there is often a basic disconnect between what the program intends, and how it is administered. Performance reviews, for example, can be notoriously subjective, with factors such as the "halo effect" or managers' latest interactions with employees skewing the way employees are rated. This generates a sense of uncertainty about the rules and what it takes to succeed. Employees wind up feeling they are accountable for things largely outside their control. The result is that good performers feel undervalued, while the pay advantage goes to not-so-good performers who know how to manipulate the rules of the game. Clearly, this defeats the pay-for-performance program's ability to drive strategic business goals.

Aligning performance with strategic goals is especially critical as the economy potentially enters a recessionary period and organizations must get more from every employee. A flawed pay-for-performance program will only amplify the negative environment created as employees perceive that job security and opportunities are

diminishing. On the other hand, a strong program can minimize external economic trends by keeping the organization's sites clearly focused on driving customer satisfaction, competitive advantage and shareholder value.

Creating a Strong Pay-for-Performance Program

What does it take to create a successful merit-based compensation program? According to Anne C. Ruddy, CCP, president of *WorldatWork*, HR professionals “will have to think more holistically and learn the art and science of ‘total rewards’ to attract, motivate and retain talent.”

The first step is to understand compensation planning function in the context of talent management. From this more strategic view, it's clear that compensation planning is about far more than just salary. It's about aligning rewards with performance to drive and *sustain* measurable contributions to organizational success: think back to the Watson Wyatt HCI research mentioned earlier showing a 49-point advantage in shareholder value.



The next step, then, is to understand the organization's strategic business objectives. What kinds of competitive challenges does the organization face?

What are the immediate goals? What are the mid-range and long-term-goals? To answer these questions, the HR team must open a conversation with executive management, the sales force, and stakeholders from throughout the talent management lifecycle. Work closely with the learning, career and succession-planning teams to understand the specific knowledge, jobs and skill sets that play vital roles in the organization's future. Also work closely with the performance management team to align employee goals to the organization's and to integrate the review process — including performance and evaluation criteria — with the compensation planning process. For example, planning should include discussion of goal evaluation for so-called overachievers who meet stretch objectives.

Don't stop at simply defining objectives: *prioritize* them so appropriate weight can later be given to employee contributions toward meeting strategic objectives.

This careful analysis of how compensation planning fits into the total talent management lifecycle creates the foundation for a pay-for-performance program that enables employees to see exactly what's expected, how to meet expectations, and what they will receive when they do. This also allows the HR team to create a predictable “performance calendar,” with early-warning checkpoints to keep employees from falling behind and showing them exactly how much time they have to bring their performance up to speed to earn their desired reward.

Building the Right Pay-for-Performance Program for your Organization

Once the foundation has been laid, the next step is examining the components of the system itself. While all good compensation management programs are different — because the organizations they serve are different — these components should be built into every program:

- **Company information:** approved budgets, both overall and broken down by teams, departments, or geographic units
- **Employee information:** current and historical data on salary, performance ratings, bonus/stock options, etc.
- **Job market information:** current salary survey data (industry/function specific)
- **Organization-specific strategic information:** business goals and priorities -- both long-term (retention) and short-term (MBO) objectives

Successful Pay-for-Performance: Putting the Pieces Together

Clearly good compensation management takes a good system. It's also clear that a good system means an automated one. A manual and paper-based system simply cannot provide the robust data, real-time budget control, and what-if modeling capabilities required for success. But beyond automation, what makes a great compensation planning program? Look for these five hallmarks:

#1. INTEGRATION. Pay-for-performance is a powerful strategic asset because it motivates *individual* performance, and aligns *all employees'* top performance with the *organization's* performance goals. A good system not only integrates with the total talent management strategy – and those systems – it also integrates seamlessly with business processes and systems such as accounting. For example, this type of integration is essential for accessing real-time views of where total and departmental salary budgets stand. Integration also gives the HR team greater ability to handle the complexity of compensation planning, such as being able to capture bonuses along with base salary increases. Finally, it reduces data entry errors and improves the overall accuracy and effectiveness of the process.

#2. INFORMATION. It's not enough simply to have access to company, employee, and job market information. A good compensation planning program must support good decision-making by providing a 360° view of this information — allowing the HR team to weigh every factor with a bearing on pay and performance. For example, if the CEO requests a list of candidates to take a particular job, a

good system will enable the HR team to reach across the talent management lifecycle to view succession planning information *and* learning information in order to respond with the names of employees who are ready to take on a specific challenge today, *and* the names of additional employees who could take on the challenge down the road, and what learning experiences they would need in order to be ready.

- #3. CONSISTENCY.** For pay-for-performance to be perceived positively, employees must understand both the rules and rewards and experience the system as fair and transparent. This sustains morale and is also the key to compliance with EEO and pay equity requirements. Thus, look for a compensation program that replaces personal subjectivity and any “halo effect” decisions with: a **clear rating scale, consistent standards for applying the scale, and a solid audit trail** documenting how decisions were made.
- #4. EDUCATION.** Do more than make the pay-for-performance process transparent. Invest in educating employees about **how merit decisions are determined and applied** equitably without bias; **the organization’s commitment to rewarding performance**; how the program **advances employees’ immediate and long-term success** by keeping their performance high -- and focused on goals that matter most to the organization.
- #5. FLEXIBILITY.** Look for a program that supports **modeling and what-if scenarios**. This enables the HR team to assess the impact of a certain bonus or salary *before* the organization commits to it. Plus, it’s important that the system offer the flexibility to handle both **annual and non-annual incentives (off-cycle)** and to tie compensation not just to financial performance, but to team plans, geographic location, functional levels or other criteria.

When and How to Implement the Pay-for-Performance Program

The best time to implement pay-for-performance is immediately following the annual review. This way, the entire organization starts “fresh” from the review process with every employee knowing ahead of time the exact performance requirements and rewards that will be at stake in the *next* review.

The process of implementation itself, of course, varies depending on your system vendor. The HR team can considerably cut the evaluation-selection-implementation timeline by seeking executive sponsors of the process. In other words, shrink the decision-making pool and empower this smaller team to clearly define requirements and accelerate the process. The ultimate key, however, is in finding a partner who can take you through a “technology onboarding” process that’s much like your own employee onboarding process. This process would ideally include:

- **“Recruit”** the system and vendor that most closely fit your needs.

- **Evaluate** using a scorecard approach to develop a balanced perspective on overall capabilities.
- **Conduct a gap analysis** to find any areas where configuration is needed to make that “good fit” a “perfect fit” not just for compensation planning, but for integration with your total talent management initiative.
- **Apply learning** (any customization, training, etc.) to implement the system.
- **Set goals** including implementation timeline, performance expectations presented as SMART goals (specific, measurable, achievable, relevant, time-bound).
- **Measure performance** against goals and evaluate success.

Finally, remember that your technology partner can be one of your most valuable assets in creating an effective pay-for-performance program. Leading vendors have experience that reaches across many organizations. They can be excellent sources not only for technology, but in real-world best practices for everything from integrating compensation planning into the total talent management framework, to securing buy-in from managers and employees alike.

PLATEAU™

4401 Wilson Blvd.
Suite 400
Arlington, Virginia 22203
703-678-0000
www.plateau.com

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