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ENGAGING TALENT WHILE MANAGING PAY COSTS

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A CEO said to her top HR leader, "We are pressed for cost management and return on workforce investment. I want you to adjust the emphasis of our human resource programs over the next 18 months to get more performance advantage from one of our largest expenses, the cost of employee pay." The catalysts for this needed change were most likely increasing healthcare cost, bringing pressure on dollars available for pay adjustment budgets, and the reality of what it costs to deliver a quality workforce in competitive business times.

HR leaders are challenged to engage the best people to not only stay with the organization but also add value to the measures used to evaluate performance at all levels. Regardless of any business slowdown, the best people remain in short supply, and research suggests their commitment to organizations is not as strong as most CEOs would like. Depending on the study, only l5 percent to 25 percent of any workforce is highly engaged and 50 percent are open to changing employers. Organizations are not well positioned to improve the total pay of all employees but must focus on the best performers who are essential during all economic times. This means not just freezing or reducing pay costs but finding a pay and rewards solution that is both attractive to high performers and cost-effective.

VARIABLE PAY: ENGAGING AND COST EFFECTIVE

Presently 80 percent of all U.S. organizations use some form of variable pay for nonmanagement employees. Variable pay is a cash award that does not automatically recur from year to year. Variable pay has become the "performance tool of choice," and research shows it is the best and most proven HR investment an organization can make, most often returning at least two to four times the cost of incentive award payments in the form of improved performance as measured by incentive metrics. It is not only a high-value performance tool but also a powerful pay cost management tool.

Why are most pay costs troublesome to a challenged organization when there is pressure to provide HR solutions offering a high return on investment (ROI)? Nearly every element of pay and benefits represents a fixed cost to the organization except variable pay or incentives. And most of these are really not "fixed" at all — rather they increase annually without regard to organizational or employee performance or the affordability of inflating workforce costs. Annual base pay adjustments for any reason leverage the cost of most employee benefits.

Organizations vary workforce costs typically by reducing headcount, freezing base pay or cutting benefits. These actions create morale problems and may negatively impact the workforce members with high value in terms of skills, competencies and performance results if they are treated the same as employees who are less essential to organizational success. Another solution, improving productivity and efficiency so each employee is accomplishing more work, is important anytime; but as volume typically declines during economic downturns, organizations may not have the excess volume that enables per-person productivity to increase. Still another solution is to ensure that the workforce is managed effectively, for example, by managing overtime or reducing contract workers so per-person productivity improvements can occur with reduced work volumes.

A more workable approach that focuses and rewards employees for achievement of important business goals is variable pay or incentives. Incentives, when properly designed, grant cash awards at the end of performance periods when goals are achieved or exceeded but not when goals are missed. Chart 1 shows key reasons for variable pay.

CHART 1

Reasons for Variable Pay	
Performance leverage	Variable pay provides the best opportunity in terms of HR return on investment of any workforce initiative
Cost management	Variable pay varies cost based on performance where base pay and benefits "keep on giving" during both good and challenging economic times

Variable pay continues to expand, being applied to more employees in more organizations all the time. Variable pay opportunities are increasing. Organizations are developing new variable pay metrics—for example, fast-growth technology companies are now using measures of customer satisfaction, workforce innovation, and management's engagement of the workforce as proven links between organizational bottom-line results and a clear line-of-sight to employees.

KEY VARIABLE PAY GUILDELINES

A few guidelines can enable success from implementing variable pay:

Update performance metrics and goals at least annually to vary award payments based on needed performance results and to avoid entitlement.

Create an understandable employee line-of-sight between close-in metrics the individual can influence and their relationship with the key financial and cost measures that define the organization's ROI.

Engage employees in how they can influence incentive measures and improve results so employees feel they can impact measures used as the incentive funding source that defines affordability to the organization.

ROI funding measures ensure the ratio of incentive dollars paid to organizational results makes economic sense and indeed vary incentive compensation costs based on the organization's ability to pay and business results. The measures for funding variable pay can include one or more performance measures, such as operating income, net margin or other goal performance that positively influences the organization's bottom line.

Chart 2 shows an example of an incentive formula that provides a conclusive ROI on pay costs. The result is that goal achievement and performance improvement pay for incentive awards. This connects employees to organizational success and defines how they add value by closer-in measures and goals.

CHART 2

Example of Incentive Funding Providing the Organization with a Return on Investment		
Funding	**Individual/Team Measures**	**Award**
First, a measure of profit, operating income, net margin, etc., must be achieved to provide funds to be allocated based on achievement of individual/ team measures.	Funds are distributed to individuals and teams once the plan has funded based on closer employee line-of-sight measures that reward individual/team contributions to the funding measure.	Once plan is funded and individual/team measures are achieved, awards are granted. This assures that awards are granted based on dollars available and provide a return on investment.

CONCLUSION

Variable pay or incentives work in challenging cost-management times because they not only reward achieving key performance measures but are also cost effective when they fund based on key measures that make economic sense to the organization. Variable pay provides a rallying cry to the organization's workforce about how they add value and communicates broadly and meaningfully what creates business success.

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