SCHUSTER-ZINGHEIM
and associates, inc.
E-MAIL sz@schuster-zingheim.com • PHONE 310 471-4865 • WEB SITE www.paypeopleright.com

MOVING ONE NOTCH NORTH: EXECUTING THE TRANSITION TO NEW PAY

Patricia K. Zingheim and Jay R. Schuster

Article published in *Compensation & Benefits Review*, July-August 1995, pages 33-39.

Performance-based initiatives such as total quality, cycle-time improvement, and customer focus do not, in themselves, give a company any unique advantage. Rather, a company builds competitive advantage by combining the right strategy with the effective execution of that strategy.

After all the strategy development sessions are over, success will rest on a basic premise: *People* must execute the strategy. To do so, these people must understand and accept the new strategy and possess the skills, knowledge, and behaviors to execute it effectively. Companies should develop a plan for the communication and execution of strategic direction *through people*. This is easy to say but demanding to accomplish.

The challenge is amplified for companies that do not as yet execute strategy well. Vanguard companies such as Hewlett-Packard, Motorola, Solectron, Monsanto, Nordstrom, Microsoft, 3M, Wal-Mart, and Intel have years of experience in executing strategies that build customer satisfaction. Some provide high-quality products and services. Others are innovative in upgrading their offerings at the same time that they sustain consistency and reliability. Still others have cost-effective production or distribution systems.

Late-starting companies that want to "catch up" by transforming strategies into effective action need help to accelerate the change process. Reward and recognition tools that emphasize these two ingredients will prove helpful:

1. *Development*—acquiring the competencies (behaviors, skills and knowledge) required to support new company directions, and
2. *Results*—converting this development into meaningful outcomes.

Pay transitions can play a significant role in helping companies focus on these two elements.

HOW TO EMPHASIZE DEVELOPMENT AND RESULTS

The first step in carrying out a strategy is for the company:

- to identify and define the core competencies required to execute strategy;
- to establish processes that encourage and help people acquire and grow those competencies;

and

- to implement rewards that link nonhierarchical career growth to acquisition and application of competencies.

Second, the company must focus on how to get results—on encouraging competent people to apply their expertise to get things done differently. It must create processes and rewards that make it attractive for people to transform what they know into needed results.

People want to understand how they are to make a contribution in a workplace that is changing. Unless they can perform in ways that support the change, the company ends up with a "reinvented" company and an "unreinvented" workforce. Companies traditionally prepare for workforce change through processes focused on development, training, and communication. This takes time—a precious commodity when companies are competing with others that already have the advantage of a supportive workforce.

This is where the question of *pay as support for change* vs. *pay as a leader of change* becomes critical. Because pay is a powerful communicator of values and directions, companies have commonly viewed pay as a support system. However, this is changing. An American Compensation Association study showed that more of the companies studied were using pay change to *lead* rather than merely support change efforts.[1] Leading with pay change offers the opportunity to send a more dramatic message, and to do so quickly.

TOOLS OF PAY TRANSFORMATION

Companies most often apply two tactics in attempting the strategic alignment of pay: the development ingredient—paying the person—and the results ingredient—paying for performance. Companies that believe pay can help them institute change often make a transition from *pay based on the job* to *pay based on the individual*. Alternatively or additionally, companies are also moving from time-based pay or individually-based pay to pay based on team/group performance results and individuals' contribution to team performance. Pay for performance often involves variable or lump-sum awards as an alternative to base pay increases. Competency pay and results-variable pay are common tools used in pay transitions.

A number of major companies, including Monsanto, General Electric, Xerox, General Mills, Solectron, Hewlett-Packard, Honeywell, Northern Telecom, and Frito-Lay, use competency pay, variable pay or both as tools to support the communication of new initiatives.

HOW DO WE KNOW PAY WILL HELP?

Companies often initiate pay changes when they realize they are not getting the expected results from techniques that proved successful in the past. The need for change may arise from a number of sources and be addressed in a variety of ways.

A company sees others in the industry transforming themselves to improve competitive position. The company's business environment will soon begin to change, is changing, or has changed. It may diagnose this either too late, just-in-time, or well in advance. The sooner the company recognizes and acknowledges the need for change, the more time it will have to institute change through people. Once changes in the company's business environment have begun to negatively impact its competitive position, the "clock begins ticking."

Customers' or competitors' actions cause the company to feel out-of-balance. The discomfort increases when the company's traditional ways of retaining balance and keeping customers satisfied no longer work. When this occurs, management begins to evaluate existing processes, systems, costs, speed, customer-responsiveness, profitability, competency, structure, and programs. When some of these processes prove inadequate because of the more competitive business environment, leadership identifies new directions and begins reshaping the company.

This critical evaluation often includes the pay system. When company leaders judge the system to be sending messages inconsistent with critical strategy, the pay transition process begins. The goal is getting people on board to help both the company and themselves share mutual success.[2]

How long it takes the company to realize that its business environment, competitors, and customers have left it behind determines how fast it must make changes. Companies such as K-Mart and Morrison-Knudsen realized late in the game that they were disadvantaged by business practices that no longer matched changes around them. For these companies, major and rapid change became necessary. Hopefully, most companies will anticipate the need to change and position themselves to move "one notch north" at a more incremental and less dramatic rate.

MOVING "ONE NOTCH NORTH"

The transition from traditional pay to new pay involves more than merely implementing pay tools such as competency pay or results-variable pay. It requires changing many processes, with pay being a lead element of the change. Exhibit 1 outlines the possible stages of pay transition. The exhibit does not imply, however, that all companies need to progress to Stage 5. Two questions will help determine how far north the company should attempt to move.

1. *Where are we; where must we go?* Companies can determine where they are now by looking at the stages. If movement along the continuum would help the company execute its business strategy more effectively, then it should consider evolution or even revolution.

2. *How rapid and how dramatic must pay change be?* The company needs to determine the delta between where it is and where management believes it must be. Based on this, company leaders can decide the extent and speed of change.

Transformations require a company to determine how much responsibility various people will assume for the company's future, and how rapidly they will assume it. The exhibit also suggests that the company should integrate the elements of total compensation with a balance between the emphasis on development and on results. Both responsibility and integration demand special attention.

Assuming Responsibility

Exhibit 1 reflects a continuum of personal responsibility. In Stage 1 pay systems, the company takes a paternal view of people's accountability. In the higher stages, people take more responsibility for developing their own competencies, achieving goals, enabling others to develop, and selecting benefit options.

A writer for a popular magazine recently asked us to comment on the question, “What should people do to get raises?" Our answer: “They should take personal responsibility for learning what the company needs, then develop the competencies to continue to add value to the company." The writer did not want this answer. It wasn't nearly as interesting as tricks on how to manipulate the system or fight for a promotion. But, clearly, such tricks are not the solution either people or companies want.

Exhibit 1

"ONE NOTCH NORTH" STAGES OF TRANSITION TO NEW PAY
Stage #1 Pay is centrally managed to ensure uniformity. Job evaluation emphasizes internal equity. Base pay increases may have moved from time-based increases to "merit" pay increases. Pay communicates "fairness," competitiveness, and reflects historical practice.
Stage #2 Pay is decentralized to business units to recognize situational differences. Job value is based more on the external market than on internal equity. Some variable pay is provided for nonsupervisory and nonselling people, which diminishes the traditional role of "merit" pay. Benefits are cost-contained.
Stage #3 The pay system recognizes the importance of communicating performance initiatives. Team, business unit, and/or company performance measures are introduced. Variable pay in the form of gainsharing or goal sharing is introduced. Competency pay (or skill pay) experiments begin. Benefit choicemaking is introduced. There is some involvement of people in pay design.
Stage #4 The pay system helps communicate business goals and requirements. People are recognized as win-win partners with the company. Variable pay is becoming the primary performance reward at all levels. Competency pay (or skill pay) begins to replace job-based evaluation systems; teams and individuals share importance in the pay process. Benefit choicemaking is extended. People begin to be more deeply involved in pay design.
Stage #5 Pay becomes customer-focused, and the team is the key organizational performance-based unit. Variable pay is the primary performance reward, with team peers judging individual contributions to cross-functional teams. Competency pay dominates the individual pay process. Benefit choicemaking is the rule. People are deeply involved in pay design and day-to-day operation.

Integrating Pay Tools

Exhibit 1 also shows the need to integrate the components of total compensation. The company must ensure that each component—base pay, variable pay, and benefits—supports the execution of business strategy. For example, effective competency pay and multisource performance review require the company to identify competencies that it believes will improve the execution of business strategy. This approach also requires the company to see that people understand these competencies and possess the willingness and the trust to give and receive honest feedback. Results-variable pay links goals to business strategy; it is effective only if people believe they can influence the achievement of these goals.

Exhibit 2

<table>
<tr><th colspan="4">MOVING ONE NOTCH NORTH: HOW FAST AND HOW DRAMATIC</th></tr>
<tr><td rowspan="4">Speed of Pay Change</td><td></td><td colspan="2">Magnitude of Pay Change</td></tr>
<tr><td></td><td>More Moderate</td><td>More Dramatic</td></tr>
<tr><td>More Slowly</td><td>Anticipates the need to change</td><td>Realizes in time the need to change</td></tr>
<tr><td>More Quickly</td><td>Realizes in time the need to change; takes incremental change steps</td><td>Realizes too late the need to change</td></tr>
</table>

SPEED AND AMOUNT OF CHANGE

The timing of the pay transition can range from incremental to rapid. The magnitude of change can range from moderate to dramatic, as Exhibit 2 shows. The more urgent the need to communicate new priorities and directions, the more rapid and dramatic the change must be.

There are three possible scenarios:

1. *Anticipating.* The company that realizes the need to change before the pressure is on has the opportunity to institute change more slowly and moderately.

2. *Getting the Message Late.* On the other hand, companies that are late in recognizing challenges and need to catch up must implement both more dramatic and faster pay change to communicate the proper messages to employees. The greater the financial difficulty; the greater the need to change rapidly and dramatically.

3. *Seeing the Need Just-In-Time.* Companies that realize just-in-time their need for change and understand the importance of continuously improving to maintain their competitiveness (because their competitors are not standing still) may want to make incremental pay changes at a quicker pace. They will focus on continual alignment with business strategy.

   Other just-in-time companies going through dramatic restructuring may want to institute dramatic change in pay to reinforce the new messages. Pay may be easier to change while the organization is "unfrozen"—i.e., ready to give up old practices. Companies that implement dramatic change in pay over a longer period will have sufficient time to communicate fully the pay change and increase people’s readiness for it.

ALIGNING PAY WITH STRATEGIC FOCUS

New-pay tools deliver different messages about strategic focus. Exhibit 3 provides examples of various strategic focus messages a company may want to deliver, and how such tools as competency pay and results-variable pay may, in combination, deliver this message most effectively.

In the movie *Amadeus*, Mozart asks the Emperor of Austria for his opinion on a piece Mozart has conducted. The Emperor's response—“Too many notes!"—makes a serious point. The music had a new level of complexity, impossible for some to comprehend at first hearing. The same kind of communication breakdown can confuse the messages the company intends to send during a pay transition. What appears to the company's leaders to be a well-orchestrated transition may have "too many notes."

It is not possible to effectively communicate every possible example of a strategic focus mentioned in Exhibit 3. Rather, by working with combinations of two to four of the highest priorities and linking these to specific pay tools, the company likely will provide the clearest and most powerful message to people about its desired directions.

REQUIREMENTS FOR A SUCCESSFUL PAY TRANSITION

Successful pay transitions involve a few additional elements.

1. *An acceptable level of trust among coworkers and between company and workers.* Trust among co-workers is essential if groups and teams are to accomplish needed results. It is also a necessity if workers are to give and receive accurate and supportive multisource feedback. Leadership builds trust in the company by providing the resources its people need to achieve results, supporting their efforts, and generally living up to its end of the relationship.

Exhibit 3

ALIGNING PAY TO COMPANY'S STRATEGIC FOCUS		
STRATEGIC FOCUS	**COMPETENCY PAY**	**RESULTS-VARIABLE PAY**
COST REDUCTION	Is managed within pay budget or by requiring people to learn new competencies as expectation for continued employment, not for pay.	Uses gainsharing.
CUSTOMER FOCUS	Competencies focus on communication, understanding and partnering with customers, customer responsiveness, and long-term relationship development.	Measures include customer satisfaction, customer retention, repeat business, and volume/revenue.
FINANCIAL PERFORMANCE	Individual's value-added determines base pay.	Uses companywide or business unit variable pay based on financial measures.
INNOVATION	Competencies focus on innovation/ creativity/invention, breakthrough thinking, integrating work/thinking of others, catalyst for change.	Uses product development variable pay (includes cross-functional members from R&D, marketing, manufacturing, and finance); variable pay is measured as percent of revenue from new products or new product profit.
SPEED	Competencies focus on enabling process improvement, decisionmaking; competency development involves rigorous schedule.	Uses variable pay measures that include production or product development cycle time, delivery, and response time.
QUALITY	Competencies focus on enabling process improvement, customer understanding and responsiveness, problemsolving and decisionmaking, TQM/CQI skills.	Uses measures of reliability and consistency, warranty expense and adjustments, accuracy, timeliness, recovery from failure, rework, and rejects.
GROWTH	Competencies involve those listed above—customer, innovation, speed, quality. Company may need new technical expertise to enter new businesses or markets or expand business.	Uses variable pay measures based on revenue, market share, and profitable growth.

2. *Honesty on the part of both the company and its people.* The company needs to be honest about its business challenges, strategy, and people's role in helping it succeed. People need to be honest in putting forth effort, giving feedback for multisource review, and self-reporting results accurately on measures for variable pay.

3. *Urgency about change and demonstration that it is in people's best interest to change.* The company needs to make it worthwhile for people to change through enlightened self-interest, which ranges from people wanting to share in the company's success to not wanting to be laid off.

4. *The courage to move forward.* Leaders must have the courage to diagnose the situation and move on it. Too often leaders dilute the potency of a pay transition under the belief that more incremental and slower change will make people better ready for change. Experience suggests that unless leaders move forward and address pay system entitlements, they will send their people unclear messages about values, directions, and urgency. Going backward is seldom an alternative, and moving forward boldly is credible and essential.

Educating people on the business is a first step. Honest communication and role modeling also facilitate people's ability to accept change. Companies can take these steps at any time before or during any pay transition.

INITIATING PAY TRANSITIONS

Leaders concerned about the role of pay in leading or supporting the company's ability to execute strategy would do well to begin by evaluating the company's competitive situation, the need to execute strategy, and the commitment to lead or support change through pay.

Steps to take: First, determine the role pay will play in the company's future. Subsequently, evaluate where the company is now compared to where leaders want it to be. Then pick a goal and aim to execute it effectively and consistently.

It's becoming common practice to move pay processes "one notch north." If timed and planned effectively, pay transitions can help companies turn struggling strategies into realities. Changing the foundations on which pay is determined is not an easy process. People expect the arrangements they had at the time of hire to continue. This is why it is easier to implement new pay with new people in a “greenfield" company. However, most companies will need to undertake change in the context of existing employment relationships. Many companies are taking up the challenge; they are delivering messages that will help their people and their companies thrive.

ENDNOTES

[1] McAdams, Jerry L., and Elizabeth J. Hawk. *Capitalizing on Human Assets.* Scottsdale, AZ: American Compensation Association, 1992.

[2] Schuster, Jay R. and Patricia K. Zingheim. *The New Pay: Linking Employee and Organizational Performance*. New York: Lexington/Macmillan, 1992.

Patricia K. Zingheim and Jay R. Schuster are partners in Schuster-Zingheim and Associates, Inc., a pay and rewards consulting firm in Los Angeles (310-471-4865). They are recipients of WorldatWork’s 2006 Keystone Award, the highest honor in the total rewards profession. They are the authors of three books, *High-Performance Pay* (WorldatWork, 2007), *Pay People Right!* (Jossey-Bass Publishers) and *The New Pay*. Their Website is www.paypeopleright.com.