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WHAT ARE KEY PAY ISSUES RIGHT NOW?

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What are some of the most challenging issues and questions facing the pay and rewards field right now? During the last year, we have asked human resource (HR) conference attendees what are the most critical topics on their minds as senior HR leaders and professionals. The most frequently mentioned issues include the following:

1. Should individual or collective performance be the focus for rewarding performance?
2. Should absolute or relative performance be rewarded?
3. Why are team rewards not more frequently used?
4. How do we combine paying for performance with becoming a "best place to work" organization?
5. What should be considered in determining variable pay approaches for executives?
6. Should the focus be on rewarding short-term or long-term performance?
7. With limited time and resources, what should be done first with respect to total rewards?
8. What is the return of differentiating performance and paying for performance—is it worth the time and effort?

These issues do not carry the same weight for all organizations and HR leaders. However, they are worth addressing as we would in face-to-face discussions.

INDIVIDUAL VERSUS COLLECTIVE PERFORMANCE

Where to measure performance is a strategic decision based on cascading organizational goals. To illustrate this, we often use an example of contact centers (handling inbound customer telephone calls or e-mails) as compared with distribution centers. In a distribution center, customers evaluate performance in terms of whether they receive timely delivery of the right products as ordered in good condition. Customers are not interested in the performance between the time the order is placed and when they receive the delivery. Thus, the best business and employee decision is to evaluate performance in terms of total collective or distribution center-wide performance.

In a contact center, the customer evaluates performance based on an interaction with an individual employee who is handling that customer on the phone. As a result, performance is measured in this instance on an individual basis based on measures of individual performance.

High-performance companies cascade business goals from the top of the business throughout the organization. Overall business goals are the foundation for developing closer employee line-of-sight

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measures and goals used to reward performance results. In some instances, performance is measured and defined in terms of groups or teams of employees working on shared goals so rewarding team performance is appropriate. Where goals can best be translated in terms of individual performance and where individuals work relatively independently or autonomously to add value, individual goals and rewards are best utilized.

The decision about where to measure performance is made by studying how the employee influences business goals. Some influence them collaboratively, as in a distribution center, and some individually, as in a contact center. That determines the type of pay for performance that is most likely to work best.

We see a trend with existing incentive plans to add or increase the component that rewards individual performance. We believe this is a result of a company objective to focus on rewarding high performers, given scarce dollars. This next-generation design builds on a company's existing track record of experience with incentive plans. Over time, the company has improved the goal-setting process and the quality of goals and measurement so it is better prepared to tackle individual goals for incentive awards. A recent Hewitt study of incentive plans confirms this trend toward a greater focus on rewarding individual performance in incentive plans.[1]

ABSOLUTE VERSUS RELATIVE PERFORMANCE

Only financially successful organizations can afford to provide competitive compensation and other rewards to employees. Nearly all businesses need to reach a minimum level of performance on certain goals to afford to pay employees, satisfy customers and be economically successful. For example, safety, quality, profit, revenue, delivery time, customer satisfaction and other goals must be achieved at a specific absolute level of performance to define the organization, and the people who work in the organization, as successful.

Most good leaders understand that you cannot have a workforce of all excellent or even satisfactory performing employees if the overall business is not achieving minimally successful levels of performance on key goals that make the business a success. In this instance, absolute performance goals matter, and what constitutes a successful performance level must exceed minimally successful levels.

If a manufacturing facility, for example, misses minimum safety goals, it makes no difference if some workers work more unsafely than others because the absolute goal has been missed. If an entire business misses sales and profit goals at the minimum level, absolute rather than relative goals are paramount.

Relative performance is important when minimally successful performance levels are achieved. For example, where an entire sales force has exceeded minimum acceptable sales performance standards and some employees have far exceeded goals whereas others have performed satisfactorily but not outstandingly, relative levels of excellence should be rewarded. When everyone is performing to meet minimum requirements, relative performance matters.

Many legacy companies got into financial trouble because management, shareholders, employees and unions shared all performance generated without providing some minimum level of value to the customer. For them, relative performance was the focus at the expense of more critical absolute performance.

In measuring and rewarding performance, the solution is not an either/or choice; it is both. Executive incentive plans frequently focus on relative performance compared with peer companies and performance compared with the company's own business plan goals. The objective is improving performance, sustaining high performance and having strong performance results compared to peers.

This applies to measuring individual performance as well, although the focus may not be as strong on comparison to peers to maintain teamwork. However, this does not mean companies ignore relative

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individual performance because it is a reality and the high performers want to be acknowledged for their results.

TEAM REWARDS

In many instances, where team members are interdependent and share goals, it is more appropriate and easier to measure small team performance than individual performance. We often use the example of Solectron Corporation in Milpitas, California, a two-time Malcolm Baldrige Quality Award winner, where manufacturing teams were placed on team-based incentives for small teams, and quality and productivity improved as a result, even though performance was outstanding before team-based incentives were used.

The performance advantage came from team problem solving, communications and self-direction; team members gave each other feedback so that overall performance could be achieved. Teams work wherever a group of individuals share accountability for goal achievement and jointly work together to accomplish that goal. Some other examples are selling teams that sell complex products and/or services, product development teams and the distribution centers discussed above.

The reason many businesses have not implemented team-based incentives where they make goal and organizational sense is that most people have been evaluated as individuals throughout their careers and it takes time to transition to team rewards. It is easier to stay with individual rewards because "that is the way it has always been done here."

There is some complexity in team incentive design that must be addressed. For example, how are core team members defined; what is the incentive eligibility, if any, for extended members; how does the team incentive opportunity integrate with an individual's overall incentive and compensation opportunity; what type of teams work best for incentives (e.g., more complexity exists with team incentives based on many small information technology projects than team incentives based on a few major projects or an ongoing work team).

The lesson is that it takes time to get employees used to team-based pay; however, where it has been implemented in a true team situation, it works better than individual pay. Sue Mohrman and Ed Lawler found that in true small teams with shared goals, the goals of the team were more likely to be achieved when pay depended on team rather than individual performance.[2]

BEST PLACE TO WORK

To start many conferences, we commonly ask how many really pay for performance in their organization. Few raise their hands, although most report that they have a strategy or intent to pay for performance. So a knowing/doing gap exists in many organizations. The priority is to really pay for performance from top to bottom in an organization. This is a straightforward strategy; however, few really do it.

Businesses need to form a positive win-win relationship with their workforce. This means employees receive rewards that they value when they themselves add value to the company's business proposition and the organization is successful. "Best place to work" initiatives typically ask employees what they want but do not communicate the key determinants of creating a "best *high-performance* place to work"—that being paying for results and the acquisition and application of key skill and competence to produce results.

We believe that without communicating to employees that they must add value to the business, "best place to work" initiatives create entitlement rather than performance cultures. To provide attractive and competitive pay, benefits and other rewards, businesses must be successful. The award for companies should be changed from "best place to work," which creates entitlement by merely giving employees what they want, to "best high-performance place to work," where employees add sustained value over time, generate positive business results and are rewarded accordingly.

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EXECUTIVE VARIABLE PAY

Different organizational ownership structures may call for different approaches to variable pay for executives. All types of organizations draw their incentive goals from their balanced scorecard of measures—financial, customer, operational, people and future-focused goals. Annual incentive plans for executives in for-profit companies typically have a strong emphasis on financial performance. In contrast, nonprofit organizations may have an incentive gate or goal of the excess of revenues over expenses (income); however, nonprofits in the United States would not share a percentage of income because this jeopardizes their nonprofit status.

Long-term compensation depends on company ownership, although cash long-term incentives may be used by all types of organizations. Publicly traded organizations use equity in the form of performance shares and/or units, restricted stock and/or units and stock options, whereas privately held organizations may use these vehicles but may also use nonstock vehicles such as performance unit or phantom share plans. Nonstock vehicles are frequently used by closely held organizations that do not want to provide stock and dilute ownership to executives. They may use performance units if they do not want to value the company on a regular basis and phantom shares if they want to mimic stock ownership closely.

The mix of long-term compensation vehicles has changed in the past few years to more performance- or time-based restricted stock and performance shares or units and fewer stock options. Performance-based vehicles (performance-based restricted stock and/or units and performance shares and/or units) are the fastest growing form of long-term compensation in large publicly traded companies in the United States because shareholders are demanding performance, not just time in position, for earning long-term rewards.

SHORT VERSUS LONG TERM

Some employees have a stronger influence on the long-term performance of a business than do others. For example, the senior executive team has more influence over long-term business goals and metrics than do nonmanagement employees. Increasingly; company stakeholders such as shareholders and boards want executive compensation based on the ability to sustain key measures of performance for periods of at least 3 to 5 years. And this most often means measuring long-term performance based on earnings, customer growth, profitability; customer service, new products and/or services and other measures and not merely providing long-term compensation that is principally time based, such as restricted stock plans.

Good executive compensation governance suggests that a substantial portion of the total compensation of members of the senior executive team should be based more on long-term incentives based on key overall company measures of performance and less on short-term or annual incentives, base salaries and executive benefits and/or perquisites. When the company wins long term, those employees who influence long-term performance win as well.

Many employees influence key measures of individual, team, functional or organizational measures in the short term—typically annually. Sales professionals influence annual sales performance, manufacturing workers influence annual or even daily product quality and delivery and so on. This is the business case for short-term variable pay for everyone in the organization because every employee should influence some key measure of short-term performance.

Where employees influence long-term performance, longer term measures and incentives should be used. In most instances this includes all members of the executive team and probably key operational and staff leadership. Long-term incentives may also apply to product development people whose development efforts for a product and/or service do not match an annual cycle and when customer and/or market acceptance of the product and/or service is the key end result. Other employees influence measures for a year or less, and this should be the basis for putting all nonmanagement employees on annual or more frequent incentives with straightforward measures and goals.

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FIRST STEP

With limited time and resources, what should be done first relative to total rewards? The first step is to educate the leadership team on the importance of focusing total rewards and then to develop or update the total rewards strategy based on company goals and objectives. Second, consider variable pay for all employees because no other HR tactic or strategy has close to the proven record of success as implementing a performance-based variable pay plan throughout the organization based on a few key prospective goals.

A WorldatWork study (*Capitalizing on Human Assets*) and our research for *The New Pay* in 1992 confirmed this.[3,4] WorldatWork's study showed a well-designed variable pay plan returns 4 times the cost of incentive payments in terms of return on investment to the organization. Even the typical plan not ideally designed returns twice what it costs the organization in terms of payments to employees.

The winning solution for implementing a HR program that adds proven value to the bottom line is a variable pay plan for everyone in the company. No HR program compares with variable pay in terms of generating a high-performance place to work, creating a culture of performance and getting value to the business (return on investment) as variable pay.

PAY-FOR-PERFORMANCE RETURN

What is the return from differentiating performance and paying for performance? Is it worth the time and effort? Common sense suggests that if you don't pay for performance, you are likely to create an entitlement mentality, which has proven to be a problem to organizations that must generate more income than costs to survive over time. If you ask yourself the question, "If you don't pay for performance, what do you pay for?" you reach your own conclusions about the value of paying for performance.

Everything else you can pay for creates entitlement and does not reward high performers for their results. Because most of the best people are employed, you must take them from another organization. And because high performers want their performance rewarded, they will be attracted to workplaces where performance, skill and competence matters and is rewarded.

Is true differentiation of individual performance worth the energy? Most leaders can easily identify the high performers at all levels in the organization and could gain concurrence among other leaders if discussed. The energy required involves emotional energy—being able to communicate performance differentiation to employees. Differentiating performance may seem less worthwhile given the small salary increase budgets currently in place and forecasted for the foreseeable future; however, this in turn leads to using variable pay. Leaders are responsible for leading and guiding the development of culture and sometimes this can be heavy lifting.

Because few HR leaders report their organizations really do pay for performance, this should be the single most important HR priority undertaken and done so as soon as practical. Anyone can pay competitively or offer liberal benefits and perquisites; however, the best companies and the best HR leaders will pay for performance. If only a few reading this article joined the ranks of champions for paying for performance, it would move HR leadership closer to a seat of significance at the strategy table.

CONCLUSIONS

There are many issues organizations need to address about managing pay effectively. The overriding challenge is how to pay for performance to make sure the organization utilizes a major resource—pay—to reward performance excellence and provide a talent proposition that makes sense. The truth is that organizations that perform better are able to pay and reward talent more effectively. And starting with these eight issues may be one way to begin to meet the key challenge of truly paying for performance.

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ENDNOTES

[1]Hewitt Associates. (2006.) "Base Pay Takes a Backseat." *HEWITT Magazine Online*, (3). Available at http://www.hewittassociates.com/Intl/NA/en-US/KnowledgeCenter/Magazine/2006_ iss3/features-hewitt-04.html

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