



July 2006

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Creating Pay-for-Performance Without Breaking the Bank

By Joseph DiMisa



A 2005 Sibson Consulting survey revealed that 90 percent of human resources leaders surveyed believe that the compensation systems in their organizations exhibit a strong pay-for-performance orientation. By contrast, a 2005 study conducted by a noted executive search firm indicated that only 35 percent of employees believe that higher performers earn more than average performers. The gap between these findings presents a serious problem for compensation leaders: *despite its critical importance, the pay-for-performance model is not working at many companies.*

In the cited survey, the human resources leaders were polled about the critical factors impeding a pay-for-performance relationship. Their responses revealed the following organizational barriers:

- **Unclear Performance Priorities:** There is a lack of agreement on determining the most critical measures of performance. Therefore, if performance cannot be defined clearly, it is difficult to develop pay programs that are in alignment with the key measures of success.

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- **Reviewing Rewards in Isolation:** Incentive plans are measured against a flat budget, regardless of underlying performance. As a result, pay outcomes regress to the budget to fit with the budgeting process.
- **Fear of Under-Performer Reaction:** Managers often avoid the "difficult" conversation that supports a low payout. This creates inflation in payouts for the lowest performers, driving up pay plan costs.
- **Aversion to Financial Risk:** Managers are concerned about the possibility of runaway payouts if everyone exceeds expectations. To minimize this risk, pay plans are designed to be too conservative, consequently reducing upside potential for top performers.

How can these barriers be overcome? How does an organization align pay with performance in a way that is financially responsible for the company?

In order to develop a strategy for effectively creating pay-for-performance, one must first understand what the concept represents. Pay-for-performance is characterized by four principles:

- Higher levels of performance lead to higher rewards.
- Lower levels of performance lead to lower rewards.
- Rewards are unequally but fairly distributed across the employee population.
- Employees understand how performance directly impacts rewards.

If a compensation system is not characterized by each of these four principles, then it cannot truly be defined as pay-for-performance.

Through discussions with a number of high-performing companies across a variety of industries, six strategies have emerged that will aid in overcoming these barriers, creating pay-for-performance without generating incremental cost.

Strategy #1: Clearly Define Performance

Rewards programs are intended to drive behavior, so it should be assumed that employees would be driven to do what the compensation program rewards them to do. As such, the plan must clearly focus on the most critical measures of success, and that definition of success must be clearly agreed to by the leaders of the business.

It can be tempting to identify all of the measures and outcomes that characterize performance for a given job role. Clearly, today's business environment requires a flexible approach to job design, creating roles with multi-dimensional performance expectations. As such, compensation programs can succumb to the popular "scorecard" approach to performance measurement, defining success by multiple performance metrics in multiple categories. While this approach may be effective for facilitating performance conversations, it may *detract* from the overall pay-for-performance relationship because there are too many moving pieces. It is more likely that pay will not be aligned with certain performance measures if pay decisions are linked to more than those performance metrics.

Whenever possible, compensation programs should be limited to as few performance measures as possible. The more focused the definition of performance, the more powerful the pay-for-performance relationship. Choosing the "right" performance measure can be accomplished through a variety of techniques. Our experience shows that good selection of performance measures for compensation purposes allows the company to answer the following questions affirmatively:

- If an employee achieves target performance on each measure, will the company be satisfied?
- Would the employee agree that the chosen measures adequately reflect his or her job responsibilities?
- Does an increase in achievement on the chosen measures represent value created for the company?

Strategy #2: Think Differently About the "Bank"

It can be tempting to think about rewards in terms of an absolute dollar budget. It becomes alarming and a source of great debate when any budget line is exceeded, and unfortunately incentive budgets are no exception. However, looking at incentive results through a pure "budget" mindset can be a barrier to effective pay-for-performance.

Recall that one of the principles of pay-for-performance was that pay levels are higher for higher levels of performance. This is true at an individual level (Person A, a high performer, will earn more than Person B, a low performer) as well as at a group/business level (Unit A, collectively performing at a high level, will earn more than Unit B, collectively performing at a lower level than Unit A).

The solution to this problem is to recognize that the relationship between pay and performance is the critical measure of plan effectiveness, *not* the absolute value of rewards. Consider the following example (Exhibit 1) for a sales organization with three job roles each exhibiting average payouts that are exceeding expectations:

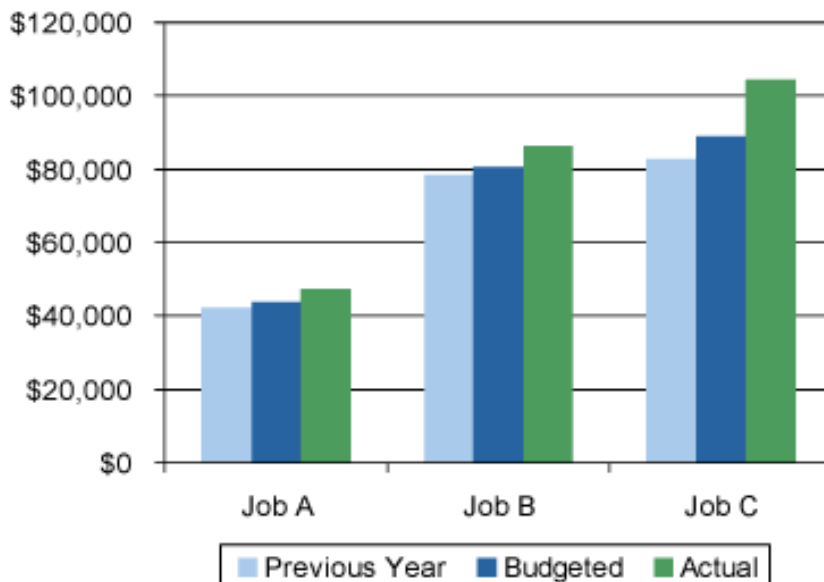
Strategy #1 Tips from Leading Companies

- > "This is the most important step... so make sure you allow the time to get it right"
- > "Make sure 'it' can be measured clearly and consistently... poor measurement undermines the integrity of the pay plan"

Strategy #2 Tips from Leading Companies

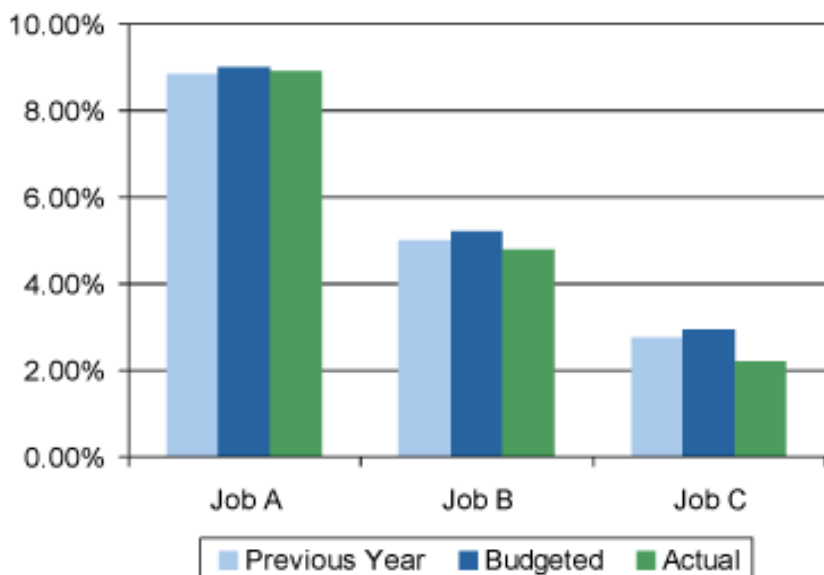
- > "Get all leaders—including Finance—into the room early on to build consensus"
- > "Don't be a budget hound. If you expect to provide more rewards when performance is good, be ready to give up budget when performance is bad"

EXHIBIT 1: ACTUAL PAYOUTS VS. BUDGET (EXAMPLE)



While this may seem alarming - particularly job role C showing actual pay that is over 20 percent higher than the previous year - it fails to take into consideration the performance levels that are generating the high payouts. Additionally, it fails to recognize that higher incentive payouts are generated by performance levels that provide leverage from fixed salary payments, often generating a higher return on the compensation dollar. When the same payout values shown in Exhibit 1 are divided by the total revenue achievement for the job role, compensation cost as a percent of sales (CCOS) is actually *lower* than the previous year in two of the three job roles.

EXHIBIT 2: COMPENSATION COST OF SALES (CCOS) (EXAMPLE)



Another example of thinking about the "bank" differently comes from the realm of executive compensation. CEO pay levels are often looked at as absolute figures, identifying the CEOs who are paid above average and those that are paid below average to vilify those with the highest compensation. However, in many cases executives with the highest payouts are earning those rewards based on industry-leading performance. To the extent a company leads its industry in financial performance, it may be sensible to have industry-leading compensation

levels. Similarly, if a company lags its industry in performance, it likely should not have above average payouts.

When thinking about rewards as a proportion of performance results, it should be easy to see how rewards might vary both positively and negatively against target payout levels. By defining "the bank" as the relationship, rather than the budget, organizations can potentially remove the tension surrounding high incentive payments.

Strategy #3: Apply the "Reverse Robin Hood" Principle

One of the great fallacies of pay-for-performance is to put too much energy and effort into ensuring that high performers receive an appropriate amount of "upside." Upside opportunity must be designed in proportion to the downside risk in the plan, or the plan will certainly break the bank.

Sibson Consulting uses a strategy, casually referred to as the "Reverse Robin Hood" principle, to fund the upside opportunity in the compensation plan. While Robin Hood gained praise for stealing from the rich to give to the poor, the Reverse Robin Hood principle means to shift variable pay from the lower performers to the higher performers.

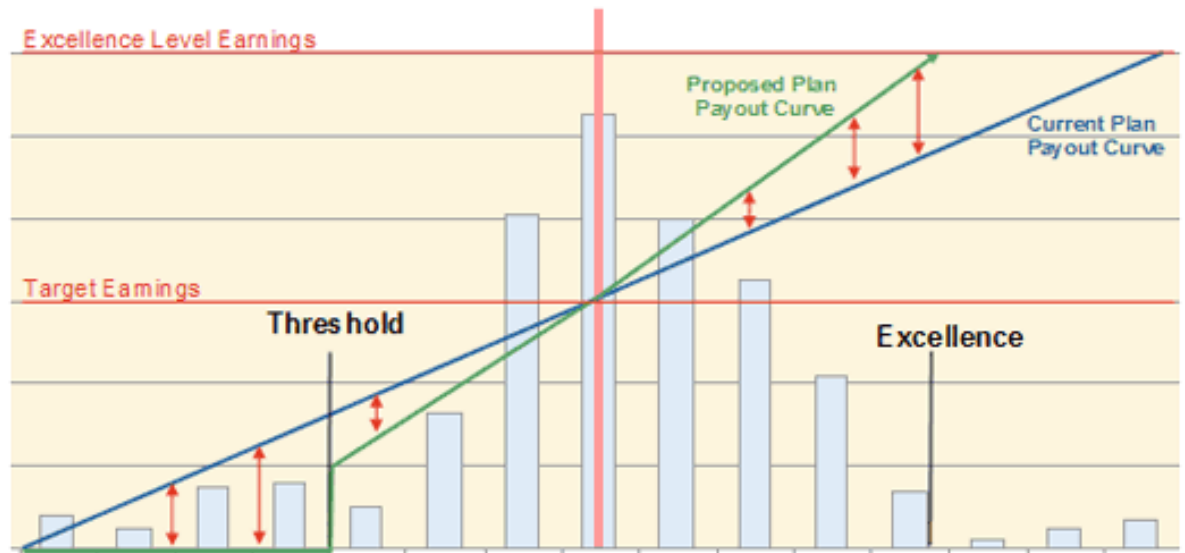
Across industries, it is a best practice to provide "triple leverage" on incentive plan payouts. This means that top performers are able to earn three times their target incentive. This can be quite an expensive proposition if there is not an offsetting reduction in payouts for lower performers. As a result, it becomes critical that there is sufficient differentiation of rewards, both on the upside and on the downside, to create balance between high and low payouts.

Exhibit 3 shows how the additional upside created during a plan design change can be funded by a reduction in pay for lower levels of performance. By "robbing" from the low end of the performance distribution (thresholds are very effective for this purpose), additional funds can be directed toward higher performers.

Strategy #3 Tips from Leading Companies

- > "Look at what creates differentiation today and choose the best programs to move rewards"
- > "Be prepared to lose low performers... so have the necessary programs in place to keep the business moving as they leave the company"

EXHIBIT 3: FRAMEWORK FOR USING THE "REVERSE ROBIN HOOD" PRINCIPLE



Strategy #4: Rigorously Test Possible Outcomes

One question nearly always arises when recommending a new plan: "How much will it cost?" This also may be followed by the flip side of that question: "How will it impact the plan participants?" These can be very difficult questions to answer with any certainty. Nobody knows for sure what will happen when a new program is implemented. As the intention of incentive compensation programs is to change behavior, it becomes a difficult task to try to provide any certainty as to what will happen with the new plan. However, three practices can be used to inform the possible cost and impact of the plan.

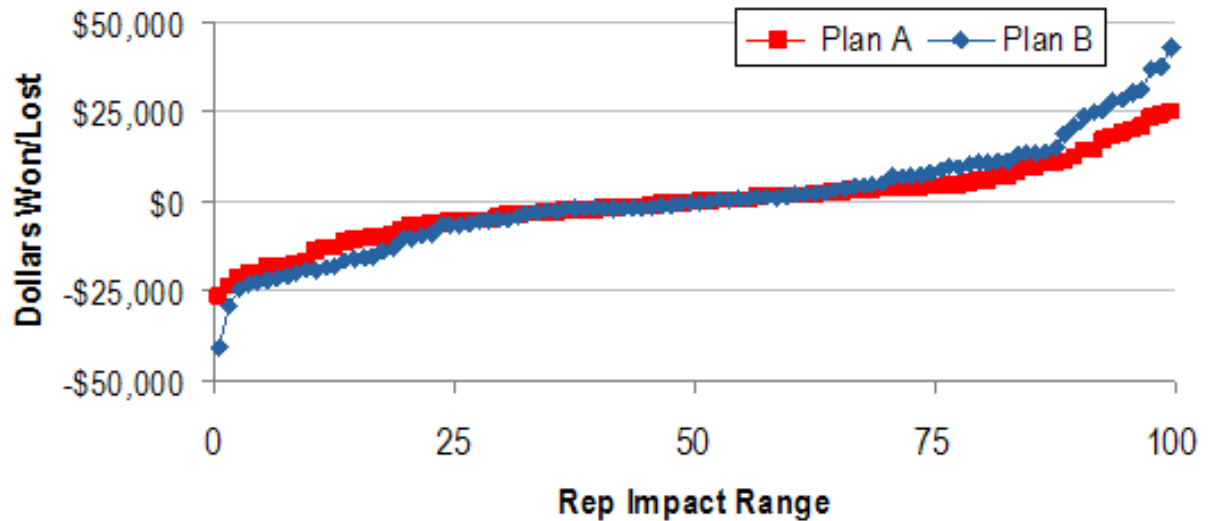
First, use actual historical results to see what the plan would have generated had it been in place in the past. All else being equal, the best predictor of future performance is past results. As a result, a great place to start in terms of understanding the cost and impact of the plan is to recalculate past payments using the new program and to compare the difference.

When using this approach, it is helpful to go beyond total and average costs and look at the impact at an individual level. Looking at the extremes offers a feel for how difficult the change process might be. Exhibit 4 shows an analysis of the impact of two possible plan changes with the same overall cost impact. Representatives are ranked from left to right according to the change in earnings under each of the plan scenarios. As seen below, Plan A creates less change at an individual level.

Strategy #4 Tips from Leading Companies

- > "Avoid the temptation to save time and manage to the average. Look at the impact person by person, particularly the top 10%"
- > "Be mindful of the impact on informal leaders... and the more vocal critics"

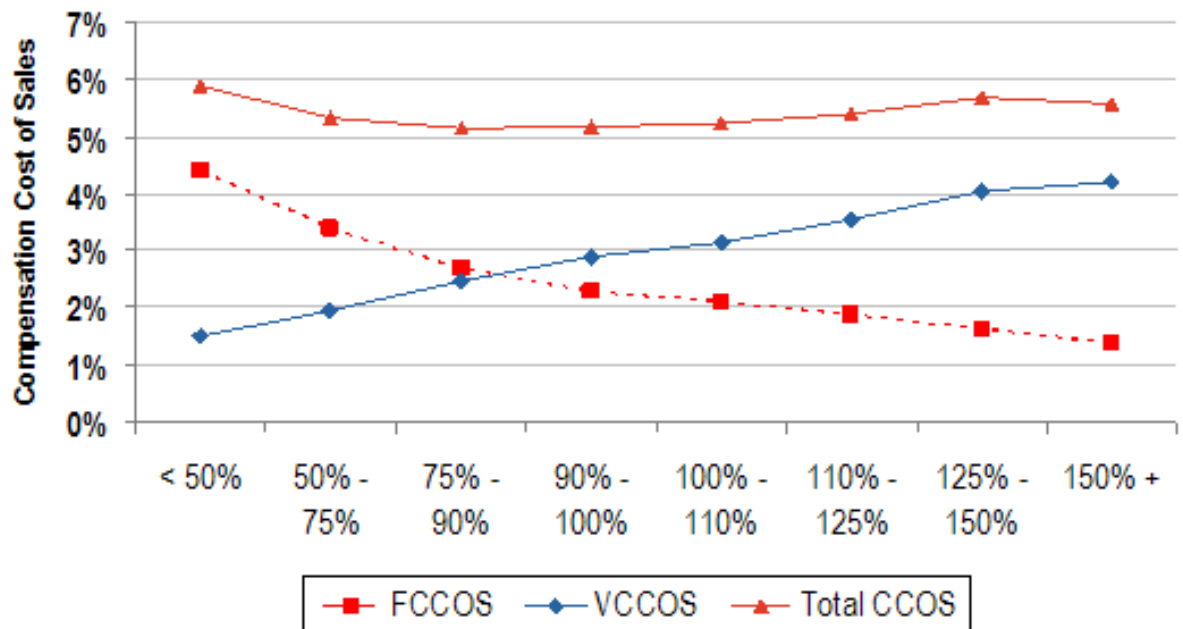
EXHIBIT 4: "WINNERS VS. LOSERS" CHART



A second approach is to use historical data, but "liberalize" actual results to model some change in behavior. This is done by applying a modifier to individual performance values to shift or alter the performance distribution. Multiple scenarios can be run to move the performance distribution so that average attainment moves up or down by 10 percent, or to assume that average attainment does not change but the standard deviation decreases or increases (narrowing or widening the distribution, respectively). While it is hard to say whether any one of these scenarios is a possible outcome of the new plan, they will offer greater insight to the drivers of cost in the new plan.

The third approach is to look at the cost of sale along the performance distribution to identify how the cost of the plan will vary assuming different levels of performance. Because payouts increase as performance increases, the absolute variable cost of the plan will surely increase for higher levels of performance. However, as a percent of revenue (or whatever performance metric is used), the variable cost may increase less. In addition, higher performance levels help offset fixed compensation amounts (base salary), so the total cost of sales may *decrease* as performance increases.

EXHIBIT 5: CCOS ALONG THE PERFORMANCE DISTRIBUTION



If there is a way for the plan to be "broken," someone will find it. To the extent specific behaviors or sales tactics can be used to manipulate plan results, those should be clearly articulated and strategies should be developed for monitoring and managing reps if these situations arise. Knowing how the cost of sales will evolve under different performance scenarios will eliminate surprises and build comfort that pay-for-performance can exist without creating a financial burden for the company.

Strategy #5: Actively Manage the Relationship

Creating pay-for-performance is not a one-time decision. Organizations with the strongest pay-for-performance recognize that pay-for-performance decision-making is an ongoing business process that must be met head-on. While it is impossible to describe and discuss the universe of possible situations that may arise, the following two principles characterize pay-for-performance decision making:

- *Do not let the plan design break the plan:* Too many companies allow a distortion in the pay-for-performance relationship for the sake of not making mid-year changes to a communicated compensation plan. However, remember that compensation programs are designed as a means to an end—they are a mechanism through which individual rewards are aligned with performance. As such, no plan is sacred for the sake of consistency. If pay and performance are not aligned based on the design of the plan, a change must be made.
- *Do not let management break the plan:* If a rule is in place to reinforce the pay-for-performance relationship, it should be enforced. Only under the most business-critical circumstances should exceptions be made that allow for a breakdown of pay-for-performance. This means having hard conversations about low payouts for low performers, or potentially having to reduce payouts if unethical behaviors lead to abnormal attainment.

Strategy #5 Tips from Leading Companies

- > "Resist the pressure to water down a tough program. Have the courage to create change"
- > "Automate the basic analytics of pay-for-performance so you have easy access to the latest data showing the relationship"

The scary thing about pay-for-performance decisions is that once they are made they become precedent. If an exception is made once, it will inevitably be made again-and if the exception is favorable to the employee, odds are more of that type of exception will follow. The two principles mentioned above describe how business leaders must have the courage to act firmly to maintain the integrity of the pay-for-performance relationship. This creates a solid foundation upon which a performance-oriented culture can be built.

Strategy #6: Communicate, Communicate, Communicate

Recall that one of the four principles of true pay-for-performance is that employees actually understand how performance and pay are related. Often, employees will not necessarily believe management when a plan is said to align pay and performance. People need to see how and why their paycheck may vary for one reason or another. Similarly, managers across all functions want to have certainty that the plan is compensating people fairly given the actual level of performance, and they too require visibility for pay and performance results. As such, there are a number of best practices to effectively communicate the pay-for-performance relationship across the enterprise:

Strategy #6 Tips from Leading Companies

- > "Make sure communication comes from all directions. It does not and should not be the head of HR doing all the talking"
- > "Be able to explain why the plan change is a good thing on an elevator ride- someone is bound to catch you coming into the office one day"

- When launching a new program, give plan participants a tool to calculate payouts that has "what if" functionality. This way they know what performance outcome is required to reach a desired level of income.
- Use existing reporting technologies to show pay and performance results to management team members so they can see the relationship over a period of time.
- Provide "commission statements" or "bonus results summary statements" when paying out incentives. These statements should clearly show the actual level of performance and how that performance level drives the incentive amount.

Invest the time in effectively communicating a new program and reinforcing the pay-for-performance philosophy over time. The cost of additional communication is very small compared to the amount of money being paid as part of the plan, and it serves as a great insurance policy for making certain that an appropriate return on an organization's investment in compensation is realized.

Conclusion

The six strategies described in this article can help create a more effective pay-for-performance relationship in a compensation program. It is important not to rely heavily on any single strategy. All of the modeling in the world could not overcome an unclear definition of performance and ineffective plan management practices. By incorporating these strategies into any pay-for-performance program, organizations will find themselves with substantially more motivating programs that drive business results without fear of breaking the bank.

Authors Note: The "Six Strategies" and "Tips from Leading Companies" represented in this article were developed from conversations with a number of Sibson Consulting clients.

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