Results from the Real Pay-for-Performance Study

There is widespread recognition among employers and even among many employees that pay for performance (P4P) is desirable conceptually, but there is often uncertainty on how best to execute it and whether it is worth the effort. To gather information about the management, results and success factors of P4P programs, Sibson Consulting conducted in-depth interviews with just under 30 companies, supplemented by a confidential “pulse” survey during the summer of 2010, completed by almost 140 organizations.¹

This report summarizes the key findings on each topic explored in Sibson’s Real Pay-for-Performance Study. Shareholders and other stakeholders increasingly demand evidence that compensation outcomes are connected with performance. The study found that P4P programs can positively contribute to performance in many organizations while others emulate some of the P4P tactics without getting the results. The report notes how the results differed for the organizations that report strong results from their P4P programs, a group Sibson calls the best-results organizations. The best-results organizations had the highest ratings on establishing a P4P culture and creating programs to reward high performers. They represented the top 20 percent of the organizations in the study and have “real” P4P.

(Please note: the accompanying text box highlights the key findings about the best-results organizations.)

P4P Vehicles and Effectiveness

Most participating organizations use one to three pay vehicles to recognize and reward performance. Salary increases, short-term incentives and spot bonuses are the P4P vehicles used most to recognize and reward performance. Equity awards are characterized as having much less differentiation by performance, and are typically granted based on level in the organization. See Graph 1. Among organizations that do not use compensation vehicles to reward P4P, compensation is kept competitive for almost every employee. This strategy helps retain average and low performers, but does little to retain high performers or improve organizational performance.

Many more respondents indicated that their organizations are ineffective

¹ The majority of these organizations are for-profit companies (74 percent), and the other 26 percent represent not-for-profit organizations.

Effective P4P: Key Findings About the Best-Results Organizations

The Real Pay-for-Performance Study found that best-result organizations:

- Use most, if not all, P4P vehicles,
- Fund their bonus pools with a combination of unit and corporate-wide results,
- Provide relatively higher increases to high performers than do other organizations,
- Understand that top performers are most engaged and motivated to perform when operating in an organization that exhibits an effective P4P culture,
- Are more effective at aligning goals by cascading budgets and key priorities through unit and department heads,
- Apply calibration techniques to ensure only true high performers are rated and rewarded as such, and
- Use multiple metrics to track the effectiveness of their P4P culture.

Graph 1: P4P Vehicles Used to Recognize and Reward Performance

- Base Pay Increases: 91%
- Short-term Incentives: 71%
- Spot Bonuses: 49%
- Equity Awards: 33%
- Other Long-term Incentives: 18%
- Profit Sharing: 7%
- Other*: 4%

* Other includes key contributor awards, travel conference awards and special cash bonuses for multiple-role responsibilities.
or only somewhat effective at adequately rewarding high performers (62 percent) than indicated their organizations are effective at rewarding high performers (38 percent). See Graph 2.

As Graph 3 illustrates, the study suggests that the effectiveness of an organization’s ability to link rewards to performance decreases slightly as the time horizon for the reward gets longer.

**Best-Results Organizations**
The best-results organizations use most, if not all, of the P4P vehicles listed in Graph 1. Such broad use of P4P vehicles recognizes high performance in ways outside of more traditional pay vehicles (i.e., base pay increases and short-term incentives). The broader application results in the shifting of compensation dollars and a higher return of investment of compensation dollars towards an organization’s top performers.

**Funding the Short-Term Incentive Pool**
The majority of organizations in the study only use organization-wide results to fund their short-term incentive pool, while approximately one in five organizations fund their bonus pool based on business/unit/department results. See Graph 4.

**Best-Results Organizations**
Best-results organizations use a combination of departmental and corporate-wide results to fund their bonus pools. This provides increased line of sight between individuals or groups and their bonuses, while still placing some weight on overall organization results.

**Differentiation of Pay**
The study looked at differentiation of pay both for merit increases and annual incentive pay for high performers. Just over one-quarter of the organizations in the study give high performers salary increases

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“*The study suggests that the effectiveness of an organization’s ability to link rewards to performance decreases slightly as the time horizon for the reward gets longer.*"
“More than half [of the organizations in the study]... give high performers salary increases that are only 1 to 2 percent higher than average performers.”

that are 3 percent or more higher than average performers. A larger number — more than half — give high performers salary increases that are only 1 to 2 percent higher than average performers, and 12 percent of organizations give the same base salary increase to high performers as they do to average performers. See Graph 5.

For annual incentives, more than one-quarter of respondents are not aware of how much greater payouts are for high performers compared to average performers. Moreover, 17 percent of organizations do not provide any differentiation in short-term incentives for high performers. See Graph 6.

Sibson often hears the following reasons for not differentiating P4P:

> “All of my people are top performers or they wouldn’t be here.”
> “The company met its plan, so everyone should get a bonus at or above target.”

Not differentiating P4P by individual performance can reinforce an entitlement culture unless there is a strong group incentive program such as goal-sharing.

“For annual incentives, almost one-quarter of respondents are not aware of how much greater payouts are for high performers compared to average performers.”

Best-Results Organizations
In contrast, the best-results organizations provide relatively higher increases to high performers. These organizations reduce gaming by giving managers access to rating and compensation data, and teaching them that if everyone receives a high performance rating, there will be less money for those who truly are high performers.

In addition, these organizations have a greater understanding of how much differentiation they achieve. Management at top performing companies are provided with compensation scorecards in order to compare pay recommendations before they are approved, to see if any managers or departments are deviating from expected guidelines.

PERFORMANCE MANAGEMENT AND CULTURE
The study found that slightly over one-third of organizations perceive their performance management programs as being effective, and a similar percentage believe their company cultures support pay for performance. See Graph 7.
In Sibson’s experience, both effective program design and company culture are needed to support a strong P4P environment.

Respondents who indicated that their organization’s P4P culture is effective were asked whether the three factors listed in Graph 8 contribute to the effectiveness. A large majority selected each factor.

The study asked respondents who indicated that their organization’s P4P culture is ineffective whether the three factors listed in Graph 9 contribute to the ineffectiveness. The factors most cited are limited compensation budget and the inability of leaders and managers to deliver feedback are more often the causes of perceived P4P culture effectiveness. In Sibson’s experience, a limited compensation budget is often only a perceived limiting factor that can be overcome through program design, and that managers often struggle to deliver feedback because of a lack of proper skill-based training.

**Best-Results Organizations**

Best-results organizations understand that top performers are most engaged and motivated to perform when operating in an organization that exhibits an effective P4P culture. Though they may also have limited budgets due to budget constraints or market trends, they often carve out money to earmark extra rewards for high performers and tend to see fewer people as high performers, thus enabling them to reward even with limited budget.

These organizations exhibit strong leadership support for P4P. They understand that the likelihood of P4P cascading down an organization results from leadership driving P4P in their own groups; P4P support rarely bubbles up from the lower or middle management layers of an organization.

**Goal Alignment and Ratings Calibration**

The study found a wide variation in the perceived effectiveness of goal alignment. See Graph 10. Sibson defines goal alignment as the extent to which individual, department, division and organizational goals are linked around a common set of priorities and objectives.

Similarly, the study found a wide variation in the effectiveness of ratings calibration. See Graph 11.
The rating-calibration process attempts to ensure that ratings are checked and adjusted against a common organization-wide standard.

**Best-Results Organizations**
The best-results organizations are more effective at aligning goals by communicating budgets and key priorities with department heads, ensuring that their managers and supervisors disseminate the information through the organization.

Best-results organizations use multiple rating-calibration techniques. Approaches can include the following:

- Determining individual ratings at cross-organizational, formal, performance-review process meetings;
- Publicizing rating distributions of all departments for senior leaders; and
- Creating organizational-wide target distributions, then auditing and reporting on actual distributions.

**Target and Actual Performance Distribution**
While a majority of organizations in the study target between 5 percent and 20 percent of their workforce as being top performers, actual ratings suggest a much higher percentage of employees are classified as top performers. (defined as top rating in three- or four-point scale, or top two ratings in five-point scale). Compare Graphs 12 and 13. This breakdown typically results from either organizations not adhering to their distribution guidelines when it comes to execution or managers’ failure to turn in evaluations on time. (The latter is a common excuse Sibson hears for making cross-calibration “impossible.”)

“While a majority of organizations in the study target between 5 percent and 20 percent of their workforce as being top performers, actual ratings suggest a much higher percentage of employees are classified as top performers.”

**Metrics for Tracking P4P Effectiveness**
Almost one-third of organizations do not currently use metrics to track the effectiveness of paying for performance; base pay increase distribution by performance rating is used most frequently by organizations using metrics. See Graph 14 on the last page. Of organizations using metrics, the majority only use one or two metrics to track pay for performance effectiveness.

**Best-Results Organizations**
Best-results organizations consistently use multiple metrics to track the effectiveness of their P4P culture and are continuously identifying opportunities for improvement. They understand that what gets measured gets done and that making managers

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Survey

Sibson’s Real Pay-for-Performance Study confirms that P4P is not a one-size-fits-all endeavor. There is a wide variation in the relative success of organizations’ ability to establish and execute P4P programs effectively. The way in which pay for performance is incorporated depends on the organization’s culture.

The key lessons about P4P from the best-results organizations are:

- It can be done. Some organizations make P4P real while others struggle.
- Leadership support is the critical catalyst for P4P.
- Metrics are critical to track the effectiveness of P4P because what gets measured, gets done.
- Many challenges can get in the way, but they can be overcome.
- Transitioning to effective P4P is a multi-year process.

While some company leaders wish that compensation management would “return to normal,” Sibson believes that compensation management needs to shift to a “new normal.” The “new normal” is based on creating a pay-for-performance mindset that will exist in both “up” and “down” economies. In today’s continued economic environment of limited compensation budgets, now is a perfect time for business leaders and their partners in human resources to unite in replacing cultures of entitlement with cultures of accountability that create a clear connection between performance and rewards.

For more information about the results of this study, including more analysis of the best-results organizations and case studies, or to discuss how to develop an effective P4P culture, please contact one of the following consultants from Sibson Consulting’s Performance and Rewards Practice:

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Graph 14: P4P Effectiveness Metrics

* Compa-ratio is the relationship between individual salaries and the midpoint of each salary band.