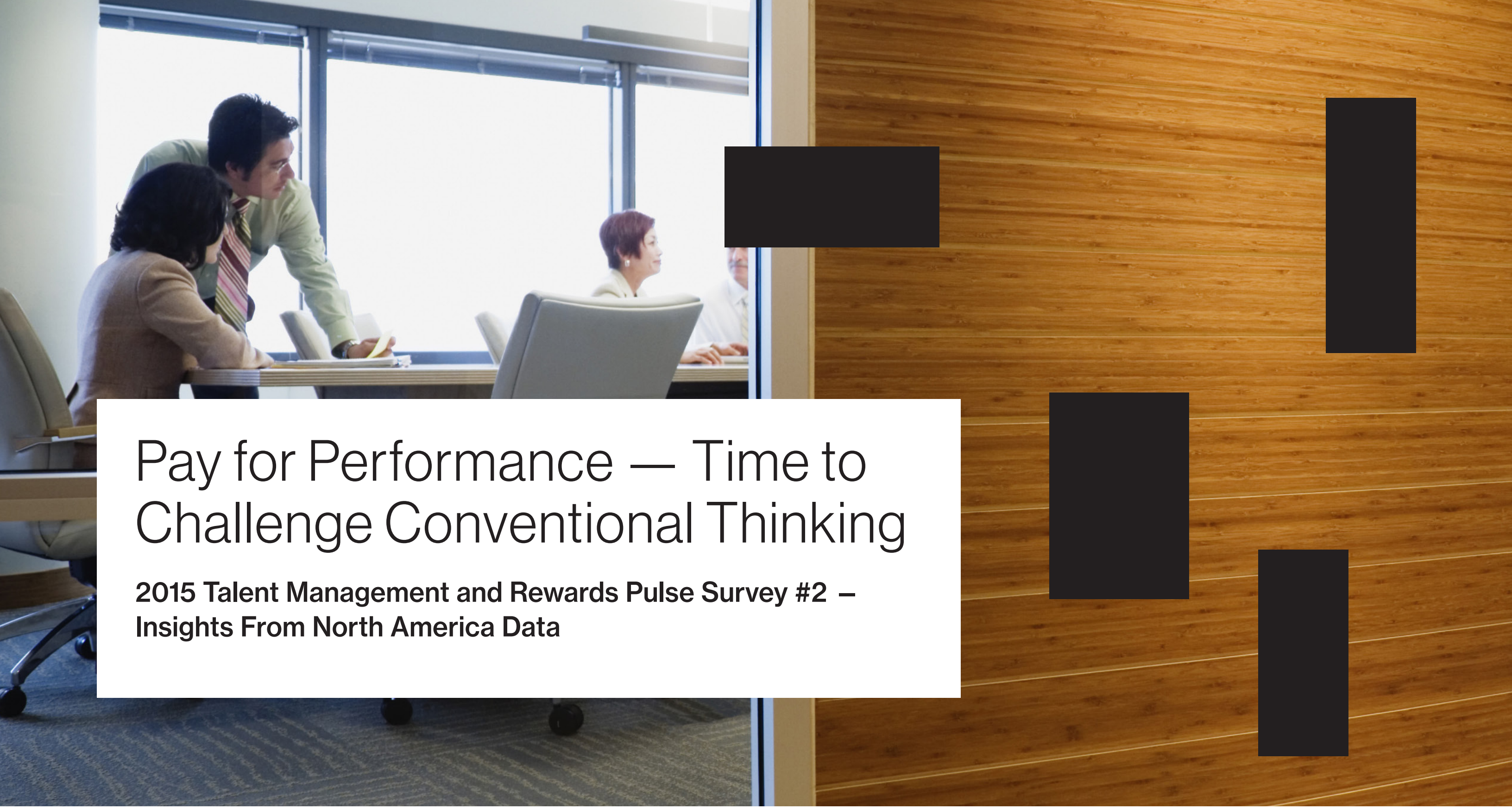

Pay for Performance — Time to Challenge Conventional Thinking

2015 Talent Management and Rewards Pulse Survey #2 – Insights From North America Data

Most companies support the concept of pay for performance (P4P) as part of their total rewards philosophy. And they continue to make a significant financial investment in traditional P4P tools. Annual merit pay cycles for salaried employees are nearly universal in North America, and annual incentives are only slightly less common.

The P4P programs of these companies include some variation of the same elements, but are often based on outdated design and implementation approaches. Our research shows that these P4P tools are not effective at driving improved individual performance, nor at rewarding it.

Merit Increases

Only 20% of employers in North America say merit pay is effective at driving higher levels of individual performance at their organization. And a mere 32% say their merit pay program is effective at differentiating pay based on individual performance. In fact, roughly a third (30%) report that annual base-salary increases are not at all effective in this regard.

Why Is Merit Pay Not Effective?

Organizations are trapped in an outdated paradigm.

In setting budgets for merit increases, employers are for the most part tracking the market in "business as usual" mode *(Figure 1)*. Consequently, in many cases, "merit" pay is largely a conventional annual entitlement. All too often, managers are compelled to give some type of increase to everyone instead of differentiating performance and rewarding employees accordingly.

Figure 1: **Basis for determining budgets for merit increases**

71%	**Wage increases** in local markets
54%	Organizational **financial performance** in **most recent** year
32%	**Budgets** in previous cycles
19%	Other
8%	**Long-term** organizational performance

Moreover, 99% of employers feel obliged to give these increases on an annual cycle. Is this the best way to reward employees? Or would a more timely reward (e.g., a spot bonus following the achievement of a major performance objective) be more meaningful and effective? Depending on an organization's business model, 12 months may seem like an overly lengthy time to wait for performance measurement and accompanying reward (if applicable).

The opportunity: It may well be time to break out of this paradigm and rethink merit pay. Improving individual performance differentiation, rethinking the role of merit pay, and reconsidering the timeliness of these rewards will help deliver a better return on employers' significant merit pay investment.

Short-Term Incentives

Employers similarly give short-term incentives low marks. Only half say short-term incentives are effective at driving higher levels of individual performance, and even fewer (47%) say that these incentives are effective at differentiating pay based on individual performance.

Why are employers falling short?

Underfunding bonus pools. Since 2005, North American companies have fully funded their bonus pools only twice. Average projected bonus funding levels for 2015 were only 87% of target. Moreover, these funding levels do not appear to accurately reflect the productivity of workforces given that 85% of employees are meeting or exceeding expectations.

Not delivering on the promise of differentiation. Twenty-six percent pay bonuses to employees who fail to meet expectations. Even top performers receive a lower bonus than called for in the plan design. Employers want to pay top performers bonuses 39% above target, but end up paying about 23% above target.

Following conventional approaches to incentive plan design. "Me too" incentive plans fall flat with workers and deliver a poor ROI. Overwhelmingly, incentive plan designs are very similar across organizations and seem to be caught in a business-as-usual cycle.

Key plan-design parameters are focused on defining company performance, and to a lesser extent on defining individual and team performance for broad-based plans well below executive levels *(Figure 2).*

The opportunity: Many employers are ready to move beyond conventional approaches to the design and delivery of short-term incentive plans. Improved funding of these programs, along with well-defined team and individual design parameters and rigorous objective setting, will help employers realize increased differentiation and a greater performance lift.

Figure 2: **Prevalent plan design parameters**

51% of employers report funding and performance measure(s) are **organization-wide,** individual payouts are determined by **individual performance**

38% use tiered incentives whereby several **performance tiers** are used to measure corporate/division, business unit/team and individual performance (e.g., additive plans or bottom up plans)

73% say **job level** is the primary basis for setting individual targets

The world of work and performance time horizons are shifting.

There is a growing need to go beyond simply rewarding individual performance in the recent past.

Organizations say their managers are adopting a broader, more forward-looking view of performance. Consider, for example, the performance indicators that employer respondents say their managers use to make decisions about merit pay and its intended impact *(Figure 3).*

This suggests that managers are moving beyond simply rewarding short-term individual performance. They regard performance measurement not just as a look back in time but also as a holistic assessment for today and the future. In addition, managers give substantial weight to team performance.

Going **ratingless** raises the bar for **manager effectiveness** in **performance** and **pay differentiation.**

Figure 3: **Factors affecting merit increase decisions**

In making decisions about merit increases, employer respondents say their managers give more weight to the following performance indicators than was called for in the program design:

	Program design	Manager considerations
Criticality of roles	19%	42%
Possession of **skills critical** to the success of the future business model	25%	45%
Demonstration of **knowledge** and **skills** required in current role	46%	64%
Achievement of **team goals**	25%	41%

The manager's role is becoming more critical in organizations that are eliminating performance ratings and taking the opportunity to rethink their definition of performance. These companies typically put greater responsibility for pay decisions in the hands of line managers. This shift leads to a greater reliance on manager discretion in making pay decisions, making manager effectiveness even more critical (*Figure 4,* page 4).

The opportunity: As organizations refine and adopt new definitions of performance to align with changing business requirements, it's key to empower managers to make pay decisions based on clear criteria that encompasses past achievements as well as current and future potential.

Figure 4: **Predominant practices in “rating-less” organizations for:**

Determining Merit Increases

55% Provide guidelines to managers on how to make **pay decisions** and stay within budget, but allow full autonomy over **final decisions**

31% Make adjustments as needed to maintain **market competitiveness**

21% Make adjustments to reflect **promotion** or **career development**

Determining Individual Incentive Awards

53% Provide guidelines to managers on how to make **pay decisions** and stay within budget, but allow full autonomy over **final decisions**

27% Rely on **relative ranking** for determining awards – not a performance rating, but a ranking used only for the purposes of pay, and not communicated to employees

23% Base awards on an **assessment** against defined performance criteria

Pay for performance – Moving beyond conventional thinking

To determine what pay for performance means for your organization and secure a better return on program investments, take the following steps:

1. **Define what performance means for your organization.** Are your managers defining performance differently from what you have been traditionally measuring and rewarding? Many managers and business leaders are updating their definition of performance to better support changing business models. They are often placing a greater emphasis on an individual’s contribution to team/network performance, possession of skills critical to an evolving business model and demonstration of high potential for future achievement. If your organization’s business model is changing or has changed, check that your programs are aligned with this shift.

2. **Drive the right performance.** It’s critical to ensure that individual performance objectives are aligned with corporate strategy, and that performance management involves a continuous dialogue between managers and employees designed to drive the right behaviors and outcomes. Managers should establish common levels of stretch objectives up front and chart employees’ progress on an ongoing basis.

3. **Revisit how to reward (not just pay) for this performance on a per-program basis.** Reevaluate the objectives of each reward program to ensure they are aligned with that definition.

   - **Merit increases.** What is the objective of merit pay in your organization and are you seeing the intended uptick in performance? Instead of spreading out the typical budget calling for 2.5% to 3% annual increases among the overall employee population, would you get a better return by investing scarce merit dollars in employee segments where increases are more likely to result in a performance lift – for example, top-performing early career employees? Or, could you also achieve better results by focusing on key business criteria such as possession of critical skills, willingness to be agile and expected future contribution? Merit-pay increases are changes in future compensation and should take into account the future value an employee is expected to deliver.
   - **Incentives.** Annual incentives are intended as a tool for rewarding the prior-year’s performance. These programs should reflect a balance between team and individual contributions consistent with your organization’s performance definition.

Are your managers **defining performance differently** from what you have been **traditionally** measuring and rewarding?

You may want to consider whether individual performance differentiation should be the same across all segments. Some companies are embracing the "power law" or "power curve" approach to differentiation, which is based on the notion that top performers disproportionately drive business value. Consequently, employers using this approach can create radically different opportunities for some roles and employee profiles, and less differentiation for others.

- **Nonfinancial incentives.** In determining how to align rewards with an organization's updated definition of performance, it's important to broaden the scope of reward programs to include nonfinancial elements such as career management and PTO based on employee preferences.

4. Remember that one size does not fit all. How an organization defines performance and how it aligns its reward programs with that definition may not be the same for all employee groups. In fact, the current system may work well for some employees. While organizations do not want to tailor programs on a per-person basis, meaningful segmentation for key groups that propel your company forward in different ways may help address pay-for-performance issues.

5. Cultivate a high-performance mindset. To embed the desired performance mindset in a company's culture, pay for performance must be viewed as more than a one-time event. To achieve this goal, managers must become champions of high performance by continually coaching employees to achieve their full potential. It is critical for managers to have ongoing performance dialogues with employees in which performance is assessed and goals updated. This approach also requires that distinguished performance be recognized and rewarded on a timely basis throughout the year. These actions will enable you to transform your pay-for-performance program from a clichéd one-off event to a continuous effort to cultivate and improve a high-performance mindset.

It's time to **challenge** conventional thinking on **pay** for **performance.**

It's time to challenge conventional thinking on pay for performance. These steps will help you make connections between rewards and performance in a way that best supports your company's goals and objectives.

About the Survey

This 2015 Talent Management and Rewards Pulse Survey #2 includes insights from 150 participating organizations in North America. It fielded September through November 2015.

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