Taking Variable Pay to a New Level

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QUICK LOOK

- If organizations continue to pursue traditional methods of pay and performance, it likely will not lead to meaningful pay, increased performance or employees who see the link between the two.
- Variable pay should be regarded as an investment, where the return is realized in relation to a fair sharing of the company's successes.
- There are four key steps in developing a new variable pay approach.

Performance-focused pay plans have the potential to link meaningful rewards with measures that are clearly aligned with key business success factors. However, something is wrong in the way organizations link pay and performance.

Only 28 percent of employees surveyed in 2002 by Mercer Human Resource Consulting said that they are personally motivated by their company's incentive compensation plan. Just 29 percent of employees said they believed they were rewarded when they did a good job. These are dramatic and depressing statistics when one considers a survey conducted by management consultants Rath and Strong in the mid-1980s that revealed only 25 percent of employees felt they would be rewarded when they did a good job. If organizations continue to pursue traditional methods of pay and performance, based on the findings of these surveys, it is not likely to lead to meaningful pay, increased performance or employees who see the link.

However, even in light of unimpressive results, organizations are increasing the use of variable pay plans. The WorldatWork *2003-2004 Salary Budget Survey* shows that the number of

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companies using variable pay increased from 66 percent in 2001 to 75 percent in 2003, despite the economic recession hitting U.S. companies. To determine what is necessary to take variable pay to a new level of effectiveness, let's review the key reasons why variable pay is increasing in importance and what can be done to overcome its typical lackluster results.

Why Is Variable Pay Increasing in Importance?

Variable Pay Is Not a Fixed Cost

Unlike salaries that rarely go down, variable pay will decrease during times of poor performance. Variable pay needs to be related directly to the business results and, when they are not achieved, there are no payouts. Along with the contingency factor, variable pay does not compound costs from year to year. The performance gains can accumulate, but variable pay has to be re-earned, thus requiring continuous improvements. In times of low inflation or lackluster economy, variable pay can create a competitive cost advantage by rewarding strategic performance while tightly controlling increases to fixed costs.

Stock Options Will Likely Decline in Prevalence and Value to Most Employees

The Financial Accounting Standards Board (FASB) is developing regulations that require expensing of stock options, which likely will have a dramatic impact on the profit and loss statements of companies that broadly use options. Consequently, Microsoft Corp. has chosen stock grants, and nearly half of the almost 100 life science industry companies surveyed by Buck Consultants said they were shifting to pay strategies to emphasize cash, not equity. Dell Computer announced that it would pay more cash bonuses to offset the cutback in employee stock options.

A comparative analysis between variable pay plans and stock options requires considering total costs with the impact on performance. Which investment will yield the greatest return for the company and employee: stock options or variable pay plans?

Variable Pay Can Reward Line-of-sight Performance

Currently, many profit sharing and stock option programs do not have clear, actionable measures that determine profits or price. When pay plans have little line of sight, the motivational impact is low. If only 29 percent of employees believe they would be rewarded for doing a good job, most employees won't see how their performance drives pay. In contrast, goalsharing variable pay plans use business scorecards to support the line of sight measures with strong alignment between employee actions in business unit results. (See "Key Components of a Business Scorecard" for more information on page 46.)

Variable Pay that Uses an Integrated Set of Measures Can Create Strategic Alignment

Business unit performance is critical for corporate success and competitive advantage. This requires a strategic roadmap with demanding short-term goals that support overall corporate objectives. Financial goals always are vital, but need to be balanced with productivity growth, quality and customer satisfaction. Financial results focus employees on what already has happened and to be conservative on future spending. An integrated scorecard should demonstrate how the financial results are achieved — they are the drivers of strong financial performance. Examples of other measures are process improvement, new products, productivity, new customers and retention. Some drive market shares while others drive unit cost reductions, shorter cycle times and strong customer satisfaction. This enables the company to link critical financial metrics with the factors that achieve them. Selecting and weighting a portfolio of measures is always the most important task.

Variable Pay Has Clear Return on Investment and Cash Flow Advantages

Variable pay is delivered after the performance is achieved, improving cash flow and business effectiveness, with the reward being proportionate to the value of the achievements. The efficacy more than justifies the reward and strengthens competitive market position. Goals are established with targets to improve competitive advantage. Variable pay requires active management, but the efforts are more strategic and connected to the needs of employees and the business. In fact, a key management responsibility is to reduce barriers to high performance so that desired performance results and increased cash flow are achieved.

Achieving a New Level of Effectiveness: Four Key Steps

Variable pay should be regarded as an investment, where the return is realized in relation to a fair sharing of the company's successes. When the organization performs better, the rewards should be higher; when performance is worse, the rewards should be lower. This creates an achievement-oriented culture, instead of an entitlement culture. Finally, variable pay (and goalsharing) is a process that supports effective management practices, requires active participation by senior executives, encourages a work force that is eager to achieve and enhances the communication process. While few organizations have these conditions when they begin using variable pay plans, they soon realize the importance of actively managing performance.

Key Components of a Business Scorecard

- Focus on the corporate and business unit strategic measures that create line of sight and line of impact.
- Identify three to six strategic measures, such as financial growth, customer satisfaction, new products/projects, process effectiveness and quality, then weight them based on importance, degree of impact and confidence in the measures.
- Integrate the corporate goals with the key business drivers to assure alignment among organizational, business, team and individual measures.
- Set a range of rewards for each measure based on a continuous improvement methodology — necessary for achieving desired improvement and return on investments.
- Display the scorecard and provide ongoing communications to update progress, creative actions and results achieved to all employees.
- Provide payout opportunities that are consistent with the value of the performance achievements and meaningful to the performers.

For more details on balanced scorecards, go to www.goalsharing.com or www.wilsongroup.com.

To develop a new variable pay approach, consider the following four key steps.

Develop a Variable Pay Philosophy and Commitment to It

Assess your current needs for improving performance, teamwork and employee involvement. Variable pay can be effective with strategic focus and continuous improvement. Use variable pay to create an environment in which employees believe they will be rewarded better when they perform better. Improving performance requires new behaviors that are clearly linked to the measures; this needs to be encouraged and developed. Leadership needs to actively embrace and visibly support the philosophy. It will take time for the new philosophy to gain traction because employees may not trust and understand the new initiatives. But improved results and meaningful rewards can quickly change this perspective.

Build Understanding and Confidence by Piloting New Variable Pay Initiatives

Planners need to provide a process that enables each business unit to identify the blended measures that are well aligned with the corporation's key success factors. The goal-setting process should support fair, stretch improvement targets that build competitive advantage because employees closest to the action need to see them as achievable. While financial measures are always important, the growth, process and customer measures are better drivers of future performance. Use the pilot as an opportunity to understand the dynamic cause-and-effect relationships between measures, build confidence and understanding of the scorecard, and develop ownership behaviors.

It is important for the pilot process to keep the number and complexity of measures simple. This increases understanding and trust. Employee understanding is essential for grassroots leadership. Assess employee understanding of the measures for strategic alignment, adjust accordingly and increase confidence in the management process before proceeding with a broad organizational rollout.

The length of the pilot process will vary based on business needs, but normally is three to 12 months in duration. The pilot payouts usually include recognition awards commensurate with achievements. For those not in the pilot, future program participation can itself be considered an incentive for making the pilot program successful.

Keep Score Continuously and Link Progress to Various Recognition and Celebration Events

In sports it is easy to see the real need for teamwork, personal initiative and scorekeeping. Sometimes in business we lose sight of the importance of behavior, communications and keeping score. The blended scorecard is the framework for how to communicate strategic performance objectives to the employees in the business. It is also a method for measuring improvement and comparing with the competition.

In his book *Leadership*, Rudolph W. Giuliani discusses the concept of everyone being accountable, all the time. Keeping score with updates and creating direct links with rewards (verbal, social, work-related and financial) was a key tool in New York City's turnaround after the Sept. 11, 2001, terrorist attacks. Performance cannot be managed without keeping score. Keeping goals fresh and focused in everyone's mind is the purpose of keeping score.

Annually Review for Effectiveness and Strategic Alignment

The annual review process is very necessary to continue to raise the bar and not allow entitlement to creep in. The business scorecard that was highly successful last year needs to be compared with the current strategic plan to see if new goals need to be added and others dropped. New targets need to be set that are achievable, but have the organization stretch to drive competitive advantage. The review process is key to long-term business success and reward process effectiveness. Fairness and trust will grow when employees see that business performance improvement provides clear rewards to them personally.

Variable Pay Expands Its Reach

The application of variable pay is expanding as organizations seek more effective ways to mobilize the work force. Currently, the majority of variable pay is profit-sharing or other long line-of-sight plans, and survey results clearly demonstrate that they have limited value. Taking variable pay to a new level can happen with the key steps described herein. The most important results will be the majority of employees being confident they will be rewarded when business results are improving and they believe they have contributed to the success of their organization. Thus, motivating and rewarding performance with variable pay will logically lead to organizational, team and individual pride in the accomplishments of goals and competitive advantage. It is no more complicated than that. WS

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FOOTNOTES

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- Leave the "Rewards Category" and "Optional Filter" blank.
- Type in this key word string on the search line: "Incentive compensation" OR "Variable pay" and performance OR goalsharing OR "performance measures" and strategic OR "variable pay" and ROI.