Compensation Planning: Opportunity for the Upturn

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For the past several years, compensation professionals have focused on managing into and through a deep recession. Salary freezes and reductions; early retirements, furloughs and layoffs; and benefits reductions have been among the activities that have occupied compensation departments. Now, more than two years since the end of the last recession, compensation professionals need to change their focus to managing beyond the recession and into an upturn.

Clearly, there is need for caution. The economic recovery is progressing modestly and unevenly. There is lingering high unemployment and moderate core inflation, and different industries and companies are recovering at different times and speeds. In such circumstances, compensation professionals — and HR professionals in general — will find both opportunities and challenges. By capitalizing on these opportunities and overcoming these challenges, they can provide strategic value to the businesses and business leaders they serve.

To help with those efforts, this article synthesizes and summarizes collective ideas from conversations the authors had with several business leaders, HR professionals, academics and consultants about what compensation professionals should focus on in the next few years to add the most value.

Take Care of Top Performers

Surveys taken during the past 18 months indicate that a large percentage of employees — perhaps approaching 50 percent — are considering changing employers. (Surveys were conducted by Accenture, The Conference Board, Corporate Executive Board, Deloitte, HR Solutions, Plateau Systems, Zenger Folkman, and others). The danger is that top performers and high potential employees, those most likely to leave because they have a greater ability to find alternative employers, will leave for organizations whose upturns come sooner. This is of great concern considering top-performing and high-potential employees make the biggest contributions to the organization and are the hardest to replace.

It is imperative that top performers and high-potential employees be given larger salary increases and other rewards that clearly demonstrate their contribution and importance to the organization. It is well-established that a salary increase difference between an outstanding and average performer should be at least two times. With salary increase budgets expected to be about 3 percent for the near future, this translates into at least a two-percentage-point difference. The "WorldatWork 2011-2012 Salary Budget Survey" reported that “high performers received merit increases nearly 1.5 times the award size of middle performers.” This represents an average difference of 1.2 percentage points, which is hardly adequate to recognize the extra efforts and contributions made.

There are several ways to create larger differences in merit increases between top and middle performers that have worked in a number of organizations. Some have increased the portion of the population who do not get increases in a given year, either by raising the performance level required to get an increase or by spreading the increases over longer terms for average performers. Other organizations have used a two-pool merit increase approach, in which a separate budget is established for top performers. With an overall budget of 3 percent, this might translate into a budget of 5 percent for the top 20 percent of performers and 2.5 percent for the rest of the population.

While it is critical to reward top performers, it is also important to not forget middle performers - the largest portion of the workforce. After all, these employees are needed to get the total quantity of work done. Merit increases alone may not be the best way to reward middle performers, however, and the authors believe companies should continue the trend to adopt or expand variable pay programs.

Link Incentive Pay to Results

Incentive compensation is an effective way for companies to deal with limited salary increase budgets and also build employee engagement. The advantages are clear: Incentive compensation links employee and employer interests; reduces the company's fixed costs; and shares success with employees by providing additional pay for meeting targets.

Two key elements in effective variable compensation plans are using the appropriate number of measures/goals and making sure employees know how their individual performance contributes to achieving those goals:

- The optimal number of measures is one to three. Using more measures leads to loss of participant focus; more and narrow metrics often also create conflicting subinterests.
- Employees need to understand how their individual performance influences the results being measured. Without that understanding, a variable pay plan will not help direct and drive desired behaviors.

Two examples illustrate how these key elements impact the effectiveness of variable pay plans. The first example, a medium-sized manufacturing company with international operations, and a client of the authors, implemented an all-employee incentive program more than 10 years ago. The plan offers an annual payout for achieving company profit and revenue goals. To create the line of sight for employees, the company communicates monthly measures, including order fulfillment time, hit rate, actual manufacturing cell hours versus standard hours, lost-time accidents, accounts receivable aging and so on, to appropriate departments and shows how these narrower measures influence achievement of the revenue and profit goals. Focusing employees' attention on measures they can directly affect, while keeping the incentive plan metrics fewer and broader, ties employee actions to desired end results and has been key to the incentive program's success.

Another point worth noting about the metrics used in this incentive plan is how they complement each other. The corporate revenue and profit metrics used in the incentive plan are lagging indicators of performance. As such, they are good ways to calculate and explain incentive payments, but they arrive too late to drive or focus employee behaviors. The monthly metrics used were chosen specifically because they are leading indicators of revenue and profit. They provide excellent ways for employees to see what matters in their performance.

A survey recently taken of their attitudes showed this company's employees believe they have a very high to significant impact on profits and only slightly less impact on sales. They also think they understand the incentive program well and believe the program is fair. This incentive compensation program has been very effective, and no changes are planned.

Another client, a medium-sized financial services organization that operates entirely in the United States, also has an all-employee incentive program, but it is considerably less effective. The organization has historically measured performance using between eight and 10 measures. The company communicates progress toward goal accomplishment at least quarterly through employee meetings. However, employees see their individual performance as influencing only one or two of the measures. Employees try to optimize those few measures, which has led to fragmented, rather than focused, efforts and less than desired overall results for the company. A survey of employee understanding and perception about this program has led management to conclude that major plan changes are needed and the program is currently under review.

Manage New Job Structures

Job structures will continue to change. There will be more hybrid jobs, combining work previously done in separate positions. Some of these hybrid jobs will be broader because of the combination of work, but some will be diluted as lower-skilled jobs are eliminated and their work is combined into previously higher-skilled jobs. The combinations will vary based on the needs and circumstances of each organization. This will result in more unique jobs and combinations of job skills and requirements.

Changes in technology, streamlined processes and different organization structures also will change the skill requirements of many jobs, and new skill sets will be developed. To the extent that apprenticeships and on-the-job training are part of the mix, different jobs (or performance expectations) will be created at the entry end of job families to accommodate employees on the learning curve. New jobs may also need to be developed at the top end of job families.

With little or no growth in many companies for the past several years, more people have spent more time in their current jobs and face reduced promotional opportunities for at least the near term. It is likely that these people can contribute more than has been expected of them, but not by working harder or more hours. Rather, job designs need to be modified to keep up with and fully use the skills and capabilities employees have developed. All of these changes will continue to put pressure on job evaluation methodologies and market pricing. Companies that use job evaluation need to ensure their methodologies and processes are able to recognize and reflect the value of new combinations of skills, new skills related to new technologies, and the different job requirements caused by streamlined processes and organization structures. Companies that use market pricing will be challenged to create market survey matches based on skills and responsibilities rather than on specific work activities; they will be able to match fewer jobs based on duties as they create more new and hybrid jobs that survey models do not describe. In many cases, neither job evaluation nor market pricing alone will be sufficient; organizations will need to use and balance the two methods.

Communicate Clearly and Openly

It will not be enough for compensation professionals to change their focus and their organizations' compensation programs as recommended earlier. Employees — and business leaders — need to understand the programs for the organization to get the maximum benefit. Communication is a major tool, and compensation professionals should be proactive in making sure it is done well.

There will be continued and increased pressure for companies to communicate their compensation programs clearly and openly. Employees cannot have been happy about many of the compensation actions companies have taken in recent years, but they appear to have accepted the necessity of those actions. As the economic recovery continues, however, employee retention and engagement will likely be influenced by how well they understand what is expected of them and what they can expect in return.

It is well-known that pay is not near the top of employees' list as an engagement driver. That conventional wisdom, however, does not tell the whole story. Employees care about having their efforts and results acknowledged, being treated fairly and knowing what matters to the organization; they care about the organization recognizing and rewarding their value. Pay demonstrates the organization's perceptions about the employee's value, which in turn influences the employee's perceptions about the organization.

Companies that develop and communicate a clear compensation philosophy — and deliver rewards consistent with that philosophy — can significantly improve employee perceptions of the compensation program and of the company overall. That compensation philosophy needs to convey the criteria that establish employees' salary and bonus potential together with the factors that drive decisions about actual salaries, raises and bonuses. Communicating the factors that are the foundation of the organization's compensation programs tells employees what the organization values and imparts a sense of organization fairness. Transparency goes a long way to increase employee engagement and support the goals of the organization moving forward.

Conclusions and Recommendations

It is likely that the economic recovery will continue to be modest and uneven. It will take quite a while and/or stronger growth to offset the financial and job losses of the recent recession. During this time, compensation and other HR professionals can provide substantial strategic value to their organization's businesses, business leaders and employees by taking the following actions:

- Take care of top performers with both salary increases and variable pay, but don't forget the middle performers. Design compensation programs that differentiate rewards based on performance. Work with managers, who execute those programs, to make that differentiation happen.
- Link incentive pay to organization performance. Design programs that directly link incentive payouts to results, use one to three high-level measures, and work with operating management to create a line of sight to ensure employees know how their individual efforts and results impact those measures.
- Manage new job structures with jobs and job families that fit new work and new ways of doing business. Work with operating managers to design jobs and job families effectively. Make sure job evaluation and market pricing methodologies and processes stay relevant and effective in valuing new and changed jobs.
- Communicate clearly and openly to get the most out of your compensation programs, improving organization performance and increasing employee engagement.

This article discusses a number of areas that compensation professionals do not control, but compensation professionals add value beyond what they control. The focus they provide, the programs they design, and the education and advice they give to managers and business leaders are key ways compensation professionals have added and can add substantial value to the businesses and business leaders they serve.

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