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THE BLUEPRINT FOR PERFORMANCE-BASED PAY:

STRATEGIES FOR SUCCESSFUL PLAN DESIGN

When executed successfully, performance-based pay can improve retention, drive employee motivation, and ultimately, encourage the behaviors that organizations need to achieve results. Yet, while this approach holds significant potential, employers sometimes find that it doesn't always deliver desired outcomes. In some cases, certain mistakes can even cause performance-based pay to backfire, leading to issues such as demotivation.

While each organization has its own distinct set of needs and unique company culture, there are a few guiding principles most companies can use to achieve success with performance-based pay. Designing a balanced, results-driven pay strategy that rewards employees fairly and motivates strong performance is indeed possible – it just demands a thoughtful approach. In this guide, we'll cover some fundamentals for performance-based compensation, including:

- The critical importance of performance-based compensation
- Various approaches to performance-based pay
- Common plan design mistakes to avoid
- The role of HR in pay-for-performance
- Tips for success and performance discussions do's and don'ts

First, we'll begin by looking at the importance of performance-based pay, and why it has become so widely preferred among modern organizations.

What is Performance-Based Pay?

Performance-related pay, or pay for performance, is a financial rewards system in which all or some of employees' monetary compensation is related to how their performance is assessed relative to stated criteria. The success of this type of compensation depends largely on communication. Participants must know what you're rewarding for, what they need to do to be eligible to rewards, and whether rewards are tied to individual, group, or organizational performance. Thus, your stated criteria should reflect your company values and be consistent with the message you're sending as an organization.

Establishing a Compensation Philosophy

Your compensation philosophy is an integral component of performance-based pay. It is a set of principles organizations use to manage their compensation plans. In publicly traded companies, the compensation philosophy should be part of the company's proxy statement.

A compensation philosophy defines who your competitors are for talent, and encompasses the following additional components:

- Salary
- Merit increases/bonuses
- Company culture
- Learning and development
- Reward and recognition

Why Implement Performance-Based Pay?

At the most basic level, performance-based pay aligns risk (the cost of compensation) with results delivered. For example, companies that are performing well and have a high rate of return can afford higher increases.

Performance-based pay also focuses attention on what's most important to the organization. It drives desired behaviors and is aligned with the needs of a particular business by linking to the company strategy. This approach also allows employees to contribute to their own success, facilitating engagement in the process.

Additionally, performance-based pay is a rational way to differentiate employees. People often become discouraged with pay structure not because of external factors, but when they look around their own department: when employees see peers in similar roles making more than they are for the same level of contribution, they become demotivated. Performance-based pay addresses this issue by recognizing and rewarding the team members who are making the greatest contributions.

At the same time, it can also enhance the communication between supervisors and their employees – given that it's administered correctly. Finally, clear, structured, and well-executed plans can also help companies that fall under pay equity regulations defend their compensation decisions.

What is the Role of HR in Plan Design?

It's important to emphasize that although performance management systems are sometimes perceived as an HR function, that is not the case. Instead, the role of the HR business partner in plan design encompasses:

- Gathering input from stakeholders
- Aligning the performance plan to support the business strategy
- Providing external pay data to support management decisions
- Researching best practices in performance management
- Providing advice and counsel based on data
- Supporting training efforts and implementation of the plan

In short, HR business partners should provide input and expertise, and inform leadership of how the plan could work. Keep in mind that involving stakeholders is very important to successful plan design. The more people you involve, the easier it is to gain acceptance.

With these key principles in mind, let's move forward to explore the different components of a performance-based pay system.

Components of a Performance-Based Pay System

A comprehensive performance-based pay system should include the following key elements.

1 Effective, Understandable Objectives

Employee objectives should be clearly defined and support the behaviors you want to encourage. They should also be measurable. For instance, client retention could be an important metric to your company. Which leading behaviors would you want to see people working towards to support better client retention? Improved service could be an example, but again, make sure you're focusing on metrics for which you can hold people accountable.

2 Performance Process

The performance process should span the entire year and define clear roles for the employee and manager. Both parties should know what's expected of them in terms of tracking performance and meeting to discuss performance. Conversations should take place regularly, so that by the time a formal evaluation approaches, the review is a recap of what's been discussed throughout the year.

3 A Tool to Support Pay-for-Performance

The tool you use to track performance could be custom or off-the-shelf. Most importantly, choose a solution that isn't overly complicated and is user-friendly so your managers will actually take advantage of it. The tool should simplify performance management, but not be used as a substitute for holding performance-related conversations.

Understanding Equity

In addition to the components listed above, it's also important that your performance-based pay plan is equitable. To have equity in your plan, you must:

- Have alignment between results delivered and pay
- Ensure employees have the same opportunity for rewards in the performance plan (though this does not mean that everyone gets paid the same)
- Give employees the opportunity to truly influence the results delivered
- Use comp ratio to determine appropriate pay based on marketplace conditions and employee performance

Comp Ratio

Comp ratio is a process in which an organization uses market data to measure how far off their pay is from market-based pay levels. This information, combined with performance level, can be used to determine salary increases. It is a simple yet effective way to manage compensation relative to performance.

Setting Goals

Another crucial component of any successful performance-based pay system is clear goal setting. In order to judge employees' performance, you must be using clear and measurable goals. For this reason, SMART goal setting is recommended. Here is a brief guide on SMART goals:

- Specific: What do you want to do?
- Measurable: How will you know when you've achieved it?
- Achievable: Is it in your power to accomplish it?
- Realistic: Can you realistically achieve it?
- Timely: When exactly do you want to accomplish it?

Here's an example of how SMART goal setting could be applied in a customer service role.

- Specific: How many calls the employee fields
- Measurable: Simple count/number of calls
- Achievable: Typical worker will field 10 calls
- Relevant: Number of calls has a direct impact on the company's bottom line
- Time-based: Calls measured on a daily basis (10 per day)

You might also include some other quality factor, such as the length of calls and the employee's ability to resolve caller issues.

Now that we've discussed some of the essentials for performance-based pay, take a moment to review some common mistakes to avoid in the next section.

Common Plan Design Mistakes to Avoid

As you can see, performance-based pay has the potential to be straightforward and effective. That doesn't mean that it's failproof, however. When organizations find that their performance-based pay plan fails to deliver on the results they'd anticipated, it's usually due to one of these common mistakes:

1 The "Peanut Butter" Approach

This error occurs when managers give the same ratings to their direct reports across the board. They may find it hard to measure their employees' performance, so they fall into the trap of giving everyone an average rating. Unfortunately, when everyone gets the same performance rating regardless of their individual contributions, it fails to improve performance in any area. Top performers have no incentive to continue excelling, and lesser performers aren't motivated to improve.

2 Inability for Employees to Influence Results

Seemingly flawless plans can still fall short if employees aren't empowered to influence results. For instance, let's return to the customer service example from the previous section: if the customer service rep's goal was to increase the number of prospects they speak with in a given day, they wouldn't have the power to change that result. To support credibility and a thorough understanding of the plan, employees must be able to have ownership over their performance outcomes.

3 Lack of Manager Commitment

Sometimes, the performance management process simply isn't important enough to managers. Supervisors may claim that they don't have the time to devote to a performance management system. Yet, their very role is to manage results and develop employees, so performance management should be a priority. To foster commitment among management, make sure the plan is simple enough to administer and that thorough training has been provided.

4 Uneven Application of Standards

Factors such as tenure and manager bias can prevent standards from being applied consistently. For performance-based pay to serve its purpose, standards must be applied in the same way for everyone who is doing similar work.

For our final section, we'll review some additional key tips to help your organization succeed with performance-based pay.

Tips for Success with Performance-Based Pay

It's been mentioned already throughout this guide, but simplicity is such an important aspect of performance-based pay that it bears repeating once more. The simpler and more concise your plan is, the more people will understand it and buy into the process.

Your plan should also clearly communicate eligibility so employees understand what's expected of them, as well as their earning potential. This includes defining performance criteria, expectations, and pay increases for which employees will be eligible going forward. Define your pay-out strategy, and identify the exact performance measurements which will be put in place.

The Dos & Don'ts of Holding Performance Conversations

While performance conversations are the responsibility of your managers, HR can provide the initial guidance needed to help managers navigate these meetings successfully. Here are a few tips to recommend within your organization.

Do:

- ✔ Be prepared and present.
  Both managers and their employees should have the opportunity to prepare, and they should be engaged without any distractions throughout the meeting.
- ✔ Give the discussion enough time.
  If managers are to block off an hour to hold performance-related discussions, they shouldn't spend just ten minutes with their employees. Encourage them to dedicate an appropriate amount of time to address all of the performance areas that need to be discussed.
- ✔ Start with the right assumption and positive intent.
  Approaching performance issues can be challenging, but remind managers to start the conversation off on a positive note. They can approach issues in a helpful way that provides employees with the support needed to get back on track.

- Share examples and specific actions for improvement.
  Oftentimes, performance evaluations lack meaningful examples. Managers should be able to cite specific instances in which employees could have done something differently. Even if an employee consistently exhibits desired behaviors, their manager should still highlight their most noteworthy achievements so top performers know what they can keep doing to drive results.
- Evaluate relative to a standard.
  Remember, evaluations should be based on standards and what's expected of the employee in their role, including the contributions they've made towards their goals. Managers should use these standards as the primary basis for judging performance, not what everyone else does.
- Confirm mutual understanding of both expectations and results delivered.
  Expectations should be revisited regularly to ensure employees know what they're responsible for, and how the results they achieved compare to these expectations.

Don't:

- Delay performance conversations.
  Managers may have the tendency to put off meetings because they're too busy, or because addressing issues can be uncomfortable. It's critically important that corrections are encouraged actively, instead of waiting for issues to fester.
- Stack issues.
  In some cases, managers may also allow issues to build up to the point at which there are multiple problems that need to be discussed. This approach can backfire, leaving both parties feeling overwhelmed.
- Reprimand.
  Instead of reprimanding, encourage managers to use specific behaviors to explain what employees can do differently next time. They should simply review the expectation, where the employee's performance fell short, and what they can do to close the gap.
- Have performance discussions only when something is wrong.

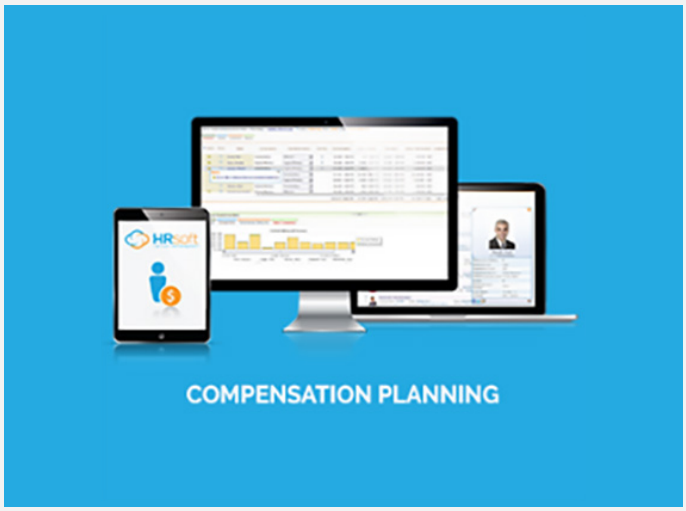
  Make sure performance meetings are also being held when things are going well so positive behaviors can be reinforced, too.

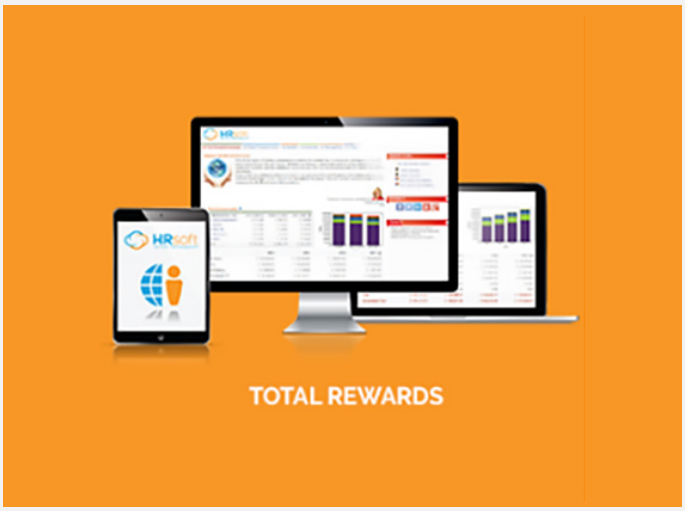
Summary

Well-designed performance-based compensation plans should align with a company's business strategy, and they should drive behaviors in a direction that supports business results. Because each organization is different, the precise ways in which plans are designed and administered will vary from one company to the next. With that said, here's a recap of some of the general guiding principles discussed within this guide, which can be applied successfully in most companies:

- Incorporate input from various stakeholders.
  Getting more people involved in the designed process will support buy-in, and it will also streamline the roll-out process.
- Develop an effective communication plan to all levels of the organization.
  Your communication plan is incredibly important, and demands thoughtful consideration from the very beginning. Determine how it's going to be rolled out to every level of the company, at what time, and which communication channels you'll use.
- Consider technology platforms to support your process.
  These solutions can support performance tracking and the administration of performance-based pay plans, but they shouldn't substitute conversations between managers and employees.

A final but important concept to consider is communicating the "why" behind performance-based pay. Some organizations make the shift towards this compensation approach without sharing its value with managers and other important parties. Performance-based pay isn't just a system for managing costs and salary increases. When used most effectively, it should also drive the success of the organization at all levels.





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Phone: 866.953.8800 | Email: info@hrsoft.com | Web: hrsoft.com

About the Contributors

Alison DiFlorio | Managing Partner, Exude, Inc.

Alison DiFlorio, PHR, is a Managing Partner at Exude, Inc. for the Human Capital Consulting Division. She co-founded the division in 2006 after more than 20 years in HR and training/development roles in the corporate sector. Her group provides expertise in the areas of training and development/management consulting, HR compliance and process and onsite HR consulting/placement. Alison's work is based on the belief that an organization's greatest resource is its human resource. Alison is a graduate of The George Washington University where she earned a BA in International Studies.

Phone: 215-875-8733 | Email: adiflorio@exudeinc.com

Jeffery Bacher | Consultant, Exude Inc.

Jeffery Bacher is a consultant for the Exude, Inc. Human Capital Consulting Division. Before joining Exude, he was most recently a principal and executive compensation consultant at Conduent Human Resource Services. He has practiced development and project leadership responsibilities for clients throughout the Mid-Atlantic and Northeastern United States. He is a seasoned executive with over 30 years in both corporate and consulting roles with a proven track record of problem solving and creative thinking. Experience includes service as the Compensation Committee Chair for a $100 million NASDAQ company, numerous not-for-profit Boards, and advisor to both public and privately held Boards as trusted advisor to the Compensation Committee.

Phone: (610) 256-4804 | Email: jbacher@exudeinc.com