

Pay for Performance: The Big Bang Theory

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Big Bang companies use uniquely designed pay delivery vehicles and demonstrate superior execution of their pay programs.

fourteen billion years ago, the cosmological Big Bang occurred. A dense mass of undifferentiated matter broke into unique components, which were thrust out into an expanding universe. Similarly, a Big Bang has occurred with respect to compensation design and execution. With the global economic downturn, existing compensation systems, which were built on principles of sameness and entitlement, were blown apart. Organizations found themselves moving away from sameness into a diverse universe of compensation practices, payout levels and program offerings.

As a result, a small but increasing group of businesses, what the authors' company calls the Big Bang companies, have adopted unique, frequently unconventional plan designs as well

as practical, business-focused pay practices. The pay actions of Big Bang companies reflect what is right to drive their business performance, and not just what everyone else does.

This article describes the strategies these Big Bang companies employ to successfully overcome the strong pull to return to the compensation program sameness that prevailed prior to the global economic downturn. It also examines how Big Bang company success strategies can be adopted by organizations whose imperative it is to align pay to performance and drive company results.

The Forces of Sameness

A number of factors contributed to the pre-Big Bang era of compensation program sameness. These included

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the talent shortages in 1996-1999 and 2004-2007, high turnover and relatively few job applicants. Companies did not want to lose talent just because their compensation program was dissimilar to that of their competitors. Increased regulation and government and shareholder scrutiny led to further similitude and standardization of compensation design and administration. “We want to fly under the radar,” compensation professionals frequently commented. “We just don’t want to stick out by deviating too much from what everyone else does.”

The Big Bang

With the economic Big Bang in 2007-2008, corporate and employee dynamics changed radically. Sameness in compensation was suddenly over. Instead of worrying about what the other guy is doing, companies began to worry about what the business needs. It became OK to be different. Business needs became a prominent common driver for compensation design and decision making. Business-based rewards were the outcome.

Today, organizations have a choice: Go back to sameness in compensation program design and execution, or do what will drive the company’s desired business results. Despite the

strong pull of the former and the appeal of going back to what we used to do, some companies have definitively broken away.

Breaking Away From Sameness

To understand what happens when organizations break away from sameness and move to business-based rewards, the authors’ company late last year studied more than 100 organizations across the country. The “Real Pay-for-Performance Study” (www.sibson.com/publications-and-resources/surveys-studies/?id=1551) findings include:

- The desire to return to sameness is a strong force.
- Breaking away from sameness is difficult, but doable; approximately 20 percent of study participants — the Big Bang companies — succeeded.
- When successfully executed, business-based rewards positively sculpt an outcomes-oriented culture that rewards not only “what” was achieved but also “how” the achievement was accomplished.
- Big Bang companies provide business-based rewards in distinctive ways. However, they all share two overarching characteristics. They use more and uniquely designed pay

delivery vehicles and they demonstrate superior execution of their pay program design and administration.

Pay Delivery Vehicles

A critical strategy Big Bang companies employ is to effectively transform standard pay vehicles and protocols into a portfolio of tools that differentiate and reward performance. Their approach is not simply adopting so-called best practices. (That would be akin to returning to the safety and comfort of sameness.) Instead, Big Bang companies adopt plan designs that will work in their environment to drive individual and company performance. Sometimes, the resultant designs and practices look like best practices; sometimes they look unconventional or even revolutionary. The key is that Big Bang companies rigorously seek opportunities to maximize the business-based rewards potential of each rewards element, including base pay, annual and long-term incentives, and even promotions. As one study participant said, “We use every pay and recognition opportunity available to us to communicate that performance matters. We are not afraid to send hard performance-differentiated pay messages.”

At Big Bang companies, base pay increases are earned based on demonstrated achievement. They are not an entitlement. There is no such thing as across-the-board cost-of-living increases or guaranteed minimums. Rather than such an all-for-one/one-for-all mindset (i.e., “we all get something or we all get nothing”), Big Bang companies set for each individual the business-focused achievement expectations that must be evidenced before even being considered for a base pay increase. Any actual increase is vetted through a cross-calibration process discussed later in this article. Thus, at Big Bang companies, many employees will get no annual increase, while there will be significant increases for the highest achievers.

At Big Bang companies, the business-based incentive rewards are

not gifted — they are earned as a reward for achieving specified goals or milestones. Targets and metrics are known, and there are a limited amount of discretionary components in award determination. Furthermore, because Big Bang company incentive plans break away from sameness, they disregard — as needed — traditional formulas, performance measurement periods, payout timing and payout form. Instead, the program designs fit the needs and realities of the business.

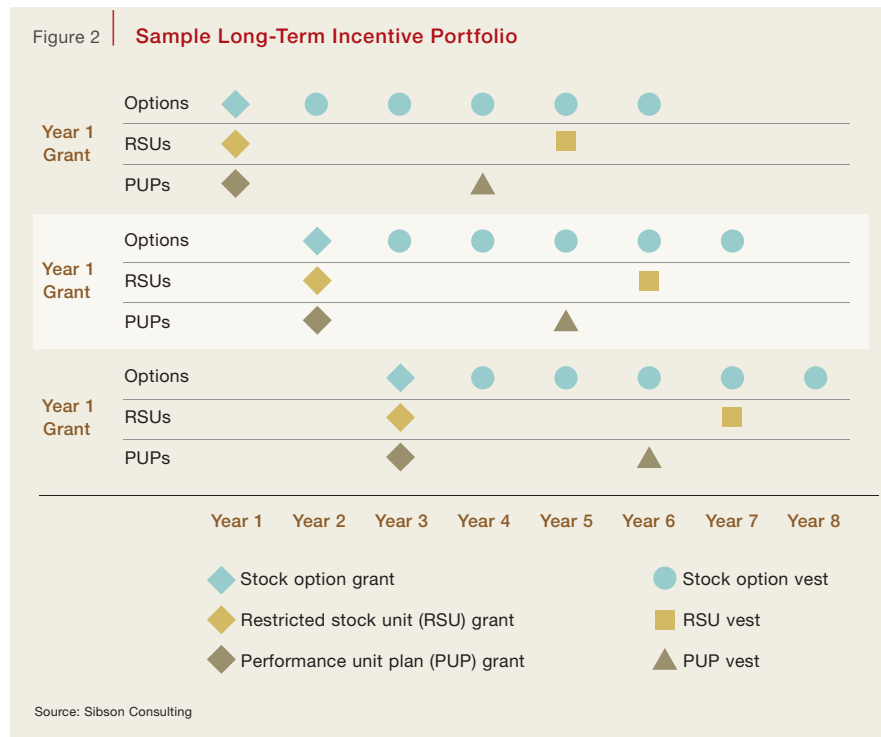
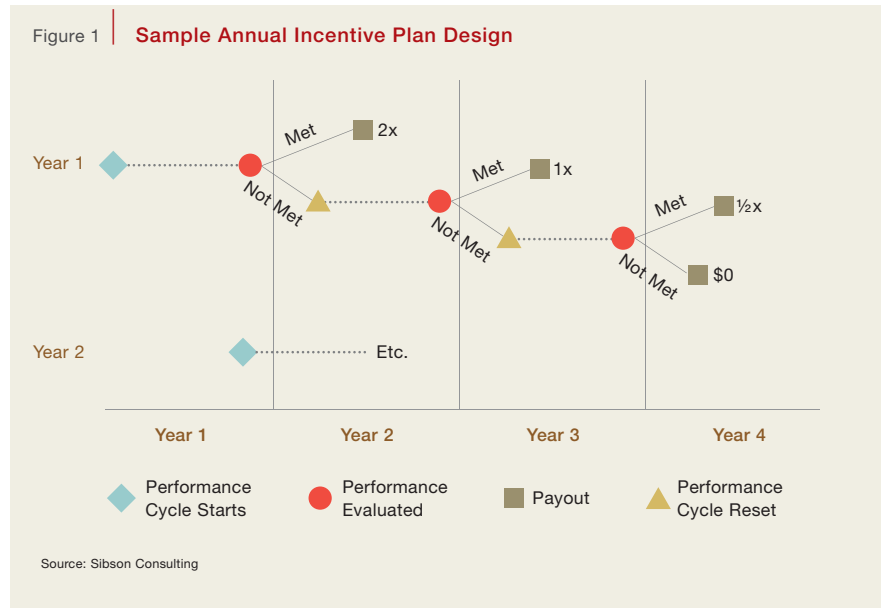
To see Big Bang companies' pay delivery vehicles in action, consider Figure 1, which illustrates an annual incentive plan design at one Big Bang company. The company had not shown shareholders a single profitable quarter in more than three years. New leadership was confident that in a three- to five-year period the company would turn around. In the meantime, however, the board would not approve annual incentive payouts based on improved, but still unprofitable, performance.

The company adopted a “multiple bites at the apple” approach to avoid having an annual plan that would not pay out year after year. As illustrated in Figure 1, each year a profitability goal is set. (Under normal circumstances the goal would be reasonably achievable. However, because the company has been unprofitable for many years, it is a stretch goal.) If the goal is achieved by the end of the first performance cycle, two times target is paid out. If not, and the goal is achieved in the second year, one times target is paid out. If the goal is not achieved in the second year, but rather in the third year, 50 percent of the target award is paid out.

Big Bang companies are particularly adept at breaking away from sameness in long-term incentive portfolio design. Figure 2 illustrates the long-term incentive portfolio at a Big Bang company. This company moved from a single long-term incentive vehicle (stock options) to a breakaway design

with multiple delivery vehicles, each rewarding a different performance achievement. The vesting schedules result in a continuous release of value to the participant. In addition, the payout forms (full-value shares, stock options and cash) are designed to share performance risk and improve retention.

Big Bang companies also view promotions as a business-based rewards vehicle. Instead of treating promotions as an entitlement, Big Bang companies use them to reward individual sustained achievement that is consistent with the needs of the business. By design, Big Bang company promotions are infrequent.



Big Bang companies use cross-manager calibration to increase visibility of ratings and pay actions among peer managers and to ensure that they identify and reward top performers.

They are not precipitated by long tenure in a role, because the individual maxed-out in the salary range or because the individual's manager is a skilled negotiator. Promotions are tied to business growth and turnover (not historic precedent) People are promoted only when there are real jobs that the business needs to fill. The rate of promotion is budgeted, promotions are tracked and reported and the approval process is clear.

Execution

Big Bang companies tend to execute better than other companies. As a result, their compensation programs are more likely to work as they were intended to, fit the organization's current business needs, support goal difficulty and alignment and differentiate for performance. Pay plans and protocols are easy to understand and hard to mismanage. Plan administration is automated, and

there are formal consequences for poor execution. Moreover, the plan's real intentions are supported by leadership, and pay decision transparency creates the possibility of public embarrassment. The process fits with the business need and cycle, and the parameters are updated annually for business and market conditions.

Unlike at other companies, where a lack of clarity about the employer's business-based expectations leads to rewards becoming an entitlement, at Big Bang companies, an employer's expectations and employee rewards for the employee value exchange are explicit. (See Figure 3.)

Some Big Bang companies differentiate with carve-outs from merit and incentive pools. For example, if the company has budgeted 3 percent for merit increases, it could carve out 0.5 percent of that amount for high performers. Then, if 75 percent of the population is rated as average

performers, it would get raises that average 2.5 percent, while 25 percent of the population — the high performers — would get raises that average 4.5 percent. As the number of high performers increases, the amount each can get is reduced in order to stay within budget. If the number of high performers decreases, each can get a greater amount.

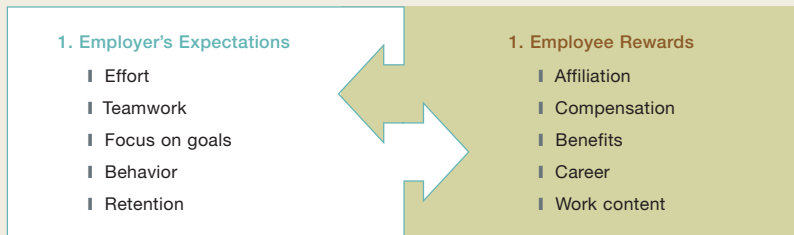
The carve-out approach is not only effective in calculating raises or annual incentive payouts, it is sometimes used to clarify expectations about the level of differentiation in performance ratings and rewards, and thus what employees can expect relative to their performance. This is important given satisfaction and the sense of fairness about rewards is largely about how the actual reward matches up with expectations. To align expectations with reality, the carve-out parameters need to be updated annually according to business and market conditions.

Big Bang companies use cross-manager calibration to increase visibility of ratings and pay actions among peer managers and to ensure that they identify and reward top performers. In companies where there is little or no calibration, the rating and pay action is between the manager and the employee. In companies with cross-manager calibration, a group of peer managers and the leader (the person directly above each peer manager) review all ratings and pay decisions before they are finalized. Cross-manager calibration works because it gives leaders a chance to express their intentions and provides transparency. Managers seek to avoid being embarrassed in front of their peers, which could happen if they recommend pay actions that are not supported by individual or group performance.

In Big Bang companies, the calendar for performance management and compensation decisions is aligned with the company's business cycle (see Figure 4).

Note that in most organizations, the main business cycle is the budget/

Figure 3 | The Employee Value Exchange



Source: Sibson Consulting

fiscal year. Companies can use a one-time “stub year” with less than 12 months, if needed, to sync the pay process with the budget/fiscal year.

Call to Action

Becoming a Big Bang company requires patience, persistence and a strong belief that business needs and business realities should drive pay design and execution decisions. Most Big Bang companies have top leadership support for aligning pay with business performance and for the transparency required to execute business-based rewards.

The first steps toward breaking away from sameness include the following:

- Become well informed about the business’s performance imperatives, from an external and internal perspective. Seek the answers to the questions in Figure 5 to provide context for the business’s

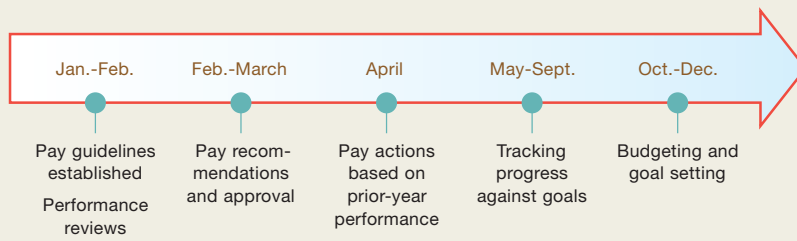
performance imperatives. Needed insights can be found with analysts’ reports, the business press, the company’s financial filings, investor reports and quarterly earnings calls.

- Assemble an affinity group of like-minded colleagues (especially those in leadership positions) who recognize that individual rewards at the company should reflect evidenced contribution to the achievement of the business’s imperatives.
- In concert with the affinity group, develop and implement a two-year roadmap of design, execution and leadership actions that will result in pay delivery that is right for the business. The roadmap typically includes:
 - The business’s performance imperatives
 - Current and potential pay-for-performance champions in the leadership group, as well as a plan to engage them to

more effectively use pay to reward performance that drives desired business outcomes

- The identification of business units that truly need or want significant performance improvement supported by rewards — plan to establish business-focused pay designs and practices in these units. (Many Big Bang companies piloted the business-focused designs and practices at the business unit level in order to build momentum for companywide changes.)
- An audit and assessment of the existing pay plan designs and pay decision-making processes. The audit and assessment will determine the extent to which the company’s pay designs and processes reflect the business’s realities and support the achievement of the business’s imperatives rather than just mimic what everyone does.

Figure 4 | **Sample Calendar for Performance Management and Compensation Decisions**



Source: Sibson Consulting

Figure 5 | **Performance Imperative Review**

Who We Are	How do outsiders succinctly describe our company’s business, strategy and differentiating factors?
Peers	Who are our company’s (real and perceived) competitors? What differentiates our company from its competitors?
Threats and Risks	What are the primary threats to our company’s sustainable, profitable growth in the current economy?
Revenue/Expense	What are the main drivers of revenue and expense for our company?
Actual Performance	How has the company performed against the key financial and operational measures of success for our company?
Comparative Performance	What is industry analysts’ assessment of our company’s performance relative to peers? Our future investor guidance?
Pay-for-Performance	What is industry analysts’ and investor advisors/activists’ assessment of our pay-for-performance relationship? Who said what?

Source: Sibson Consulting

Conclusion

Given the ongoing slow economic recovery, companies have a choice: return to sameness or do what will drive their business results. While breaking away from sameness is difficult, it is doable. Those organizations that successfully break away are well positioned to achieve the business results that will make them winners for years to come. **WR**

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