Differentiating and rewarding performance:

Current practice and emerging trends

The current economic climate has caused many organizations to rethink their performance models and the way they assess and reward for performance. Since the global economy bottomed out several years ago, we've seen organizations significantly increasing the pace of change in their performance management processes and how reward programs connect with them, with the goal of creating impactful performance management systems that drive organizational performance.

At the same time, organizations are also struggling to help managers and employees perceive adequate value from their performance management systems. Common challenges include:

- Inconsistent organization performance culture
- Lack of focus from top management to improve performance management processes
- Poor, and often misaligned goal setting and planning processes
- Inadequate and untimely feedback to employees
- Inability or unwillingness to differentiate performance assessments and related rewards
- Bureaucratic processes that are perceived as disconnected from business priorities.

While organizations are traveling different paths, the trend is clear that most are seeking to create better alignment between their business strategy, performance outcomes and how they reward employees for achieving individual, team and enterprise-wide results.

Our research studies confirm this. Hay Group's recent Reward Next Practices Survey (www.haygroup.com) indicates that top reward leaders will be substantially increasing their future focus on performance management processes and improving reward differentiation. In addition, the recent Conference Board CEO Challenges 2014 study (www.conferenceboard.org) reports that improving performance management processes and accountability is a top objective in the CEO's human capital agenda.

The Research Study

To delve more specifically into the types of initiatives organizations are focusing on in the area of differentiating and rewarding performance, Hay Group interviewed senior reward leaders from 15 large organizations in April - May 2014 to gain their views and perspectives around their organization's current and future practices in this area. See the sidebar for a listing for participating organizations. Specifically, we wanted to find out the following from these reward leaders:

- What does rewarding for performance mean in your organization today?
- What is your organization focused on now in terms of rewarding performance using financial and non-financial rewards?
- What are lessons learned in terms of change management and implementation?
- How do you see this evolving in the future?

Participating organizations in the study include Ahold, Carrefour Group, Frito Lay, Gap, GDF Suez, General Cable, HJ Heinz, Ingersoll Rand, Meadwestvaco, Olin Corp, OMV Petrom, PepsiCo, Procter and Gamble Co, QVC, Providence Health System and Starbucks.

Performance and Rewards Culture

For most study participants, there is an increased focus on achieving both better performance differentiation and better differentiation in rewards attributable to performance. The drive for this is coming from the C-Suite and it is largely about getting stronger, sustained performance and productivity from the workforce and, ultimately, a better return on reward investment.

Before an organization can provide differentiated rewards for differentiated performance, however, it must have a shared vision of where it wants to be from a performance culture standpoint. That is, what are the key messages around performance, key metrics and related rewards?

From our research participants:

- "We are taking actions to shift our culture – and performance is at the center of this. Our culture change needs to be a combination of top leadership setting the tone and walking the talk. We are in the process of an organization-wide cultural assessment - i.e., describing our culture today and where we want to be tomorrow. It will be helpful to articulate this to give us a roadmap that can be shared with everyone."

- "Going forward, we plan to take a more individually-focused approach to rewarding performance, adopting an objective means to analyze data around internal promotions and individual execution of objectives. Unit and enterprise wide performance still impacts the total performance assessment, but it will not be weighted as heavily as it was in the past. This change represents a substantive cultural shift in the organization toward a vision of meritocracy."

A number of organizations told us they felt they lost their way in terms of managers and employees becoming overly fixated on final performance ratings and the link to compensation rather than in the constructive feedback and development guidance that should be the primary purpose of this process. Managers are often ill-equipped or unwilling to engage in a robust dialogue of performance and development. Employees often shut down when they hear their rating and tune out other aspects of the feedback.

As a result of this, a number of organizations have taken bold actions and have significantly re-tooled their feedback and assessment process to get "back to the roots" of providing direct and constructive feedback. While wanting to pay for performance, many organizations are at the same time questioning a formulaic tie between performance assessments and rewards. In fact, some organizations have gone so far as to eliminate their formal performance ratings altogether.

From research participants:

- "We just recently overhauled our performance management program. It was built on the premise of why we do performance management in the first place. The key message is about improving performance – not just about how pay relates to this performance. Our key focus centers around limiting the number of priorities (no more than 5), entrusting the manager to assess performance, and focusing attention on employee growth and self-development processes."

- "We are still early on in this journey, but the key element is helping managers understand what 'good actually looks like'. We are building a lot of manager education on this, providing them with some guidelines for what great / good / decent looks like. We've used numeric ratings in the past, but the feedback they got was that people being managed were just focused on 'what's my number?' and not actually focused on their development and performance. Now we are spending more time with managers to help them translate these numbers into words that are meaningful for the employee. This is a key element – not communicating numbers but using words instead."

- "Most people don't want to be placed into a performance category and labelled, particularly the younger generation. My sense is that the younger generation wants to be more of a team. If you are good at what you do in your work and you show up and do this each and every day, why are we putting people into categories?"

While the trend is towards increasing a wider range of rewards, a number of companies have moved away from "forced distributions" in favor of "guideline distributions" supported by more robust calibration processes. The thresholds for acceptable performance are also getting tougher. We've found the best organizations have more differentiation in both performance ratings and the rewards that are associated with them.

Financial Rewards

Since the economy bottomed out in 2008, we've seen more organizations placing more emphasis on individual performance assessment processes as well as increased weighting of individual performance in reward decision-making in general. We've seen upward trends since 2008 in the following areas:

- Usage of individual performance triggers in STI and LTI programs

- Usage of individual performance ratings as STI and LTI payout modifiers

- Usage of claw-back provisions in LTI programs

- Funding of recognition program budgets (often at 0.5% to 1% of payroll)

- Shifting of the mix of pay from fixed to variable compensation

- Usage of key talent reward programs, with particular emphasis in off-cycle salary increase treatments and restricted stock grants.

From research participants:

- "We've established a larger base salary increase pool for our highest performers. We've significantly ramped up the portion of the short term incentive that employees receive due to individual performance. Now 40% of our bonus is driven by individual performance."

- "We stress rewarding performance via cash compensation and promotion. Our highest performers are rewarded with a generous amount of stock options and the ability to become a partner in the company. Our approach focuses on promoting and retaining a talented group of individuals to become the future of the company. Our philosophy focuses on giving our highest performers a large stake in the company and a great opportunity for wealth creation."

- Our enterprise financial metrics determine the size of our STI pool each year and how the pool is allocated depends on each individual's performance during the year. We look at two things – "what" you accomplished/results, and "how" you achieved the results – more behavioral. If an employee is rated high on both dimensions, they will get more than 100% of their target payout."

- "Our STI tends towards more differentiation. In the past, only part of variable pay has truly been variable, as not all of it was really at risk. In the future, more variability will be introduced at the individual level, causing more differentiation and reward of performance in a financial form."

- "Base pay isn't currently connected to individual performance, but this is something that will change in the future. Annual incentive / bonus is our primary performance-reward lever currently. Going forward, we will have greater differentiation on base salary increases relative to individual performance."

Non-financial Rewards

Research participants report that non-financial rewards are becoming more of an integral component in their organization's total reward mix. Over the past several years, most organizations have placed increased focus on non-financial rewards as a key employment brand differentiator and retention mechanism. Particular focus is being paid to the following areas:

- Career development: defining job family architectures, requirements for development and activation of assignment planning processes

- Meaningful job design: ensuring that roles are meaty enough with appropriate stretch, autonomy and spans of control

- Work climate: providing managers an understanding of the work climate they create and how to improve it so that employees have higher level of engagement and effectiveness.

Hay Group's employee opinion database underscores this. Table 1 below indicates key retention drivers in our global database of 4MM employee opinion records. The criteria listed in this table are the primary drivers of retention and attrition in organizations today. As seen below, non-financial rewards, such as career development, training opportunities, an energizing work climate and meaningful job design outpace financial rewards in terms of their retention value.

Non-financial rewards are particularly important for key talent retention in an organization. Research participants indicate increased emphasis and frequency on several non-financial reward programs for key talent. These include: career development and assignment planning discussions, more frequent use of visible special project opportunities, access to senior leadership and access to other special/unique training and development opportunities.

Table 1: Key Retention Drivers

	Employees planning to stay for >2 years	Employees planning to leave within 2 years	Gap
Confidence in ability to achieve career objectives	64%	31%	33%
Trust and confidence in company senior management	60%	35%	25%
Opportunities for learning and development	71%	45%	25%
Benefits that meet employee needs	68%	45%	23%
Company demonstrates care and concern for employees	62%	39%	23%
Company is effectively managed and run well	73%	51%	23%
Adequate authority to do the job	73%	51%	23%
Employees paid fairly for the work they do	53%	31%	22%
Supervisory coaching for development	67%	45%	22%
Support for employee creativity and innovation	70%	48%	22%
Cross-work unit collaboration and support	63%	41%	22%
Direction and goals are the right ones for the company	73%	51%	22%

Source: Hay Group Database of Employee Opinions (4MM records)

Organizations report placing more focus on improving how they define "key talent" and the process for defining, managing and rewarding key talent. Per a senior reward leader participating in the research, "we have a formal process to identify key talent – which are our best performers and our high potentials. All managers participate in this annual process so that the organization is accurately identifying these individuals since the designation ties back to our reward and talent management programs. The program includes a '9 box' assessment process on performance and potential. We try to be sensitive to not overworking our top people by not placing them on too many special projects. Overall, we look at development and succession opportunities holistically and do our best to direct them to our key talent."

Several organizations reported more focus and attention on the role of the corporate function to ensure transparency in talent reviews and create a sense of "talent" as more of a corporate (vs. business unit) asset and manage it accordingly, with particular attention paid to calibration processes.

From another study participant, "one of the key reward tools we use are temporary rotational assignments which provide an opportunity to move to a different market for a period of time. We are doing more and more of these. They are essentially an opportunity for people to pick up and go to Mexico or Europe and lead an important assignment for a few weeks to a few years. Most last a month or two. People generally love it and it has served as well as a recognition vehicle. We tend to only offer our best employees these type of opportunities."

Some study participants also see organization redesign opportunities as a way to improve career development opportunities in the company and to accelerate change in terms of identifying organization blockers and pushing them out of the organization. Per one research participant, "we typically re-organize every two years or so and we offer poorer performing, longer-tenured individuals early retirement or exit them in other ways. We need to get these blockers out of the way to free up opportunities to our high potentials. This is an effective way to show them love in low salary increase years."

Many organizations in the study are increasing their focus and utilization of non-financial recognition programs as a way of reinforcing the organization's culture and performance orientation. We've seen a clear trend in organizations moving away from predominately tenure-based or purely discretionary recognition programs to those that are aligned with key business priorities. From one research participant, "we are placing a lot of focus on our non-financial as well as spot recognition programs. These programs are important for us because it provides a timely way to recognize performance as it happens. They are being repurposed and rebranded around our new focus on accountability and performance. Our spot bonus programs are being reshaped as well so as to provide meaningful financial rewards for more collaborative team-based performance."

Change Management

Research participants spent as much time telling us about their focus on change management and implementation process as they did their strategy and design around performance management and linkage to rewards. The critical role of the line manager, key enabling processes and effective communications all rose to the top of the list in terms of key criteria that drives success in the implementation of these programs.

From research participants:

- "While it's not sexy, sustained and repetitive communications is absolutely critical for success in differentiating performance. You need repetitive, engaging communication and education to keep these areas top of mind for people."

- "When a change occurs in almost any organization there will be three groups of employees – those who support the change, those who reject the change, and those who are indecisive (wait-and-see). We've learned that the key to acceptance of new ideas is to define and articulate the value of the change in the eyes of the employee and then to actively educate and engage employees about the benefits of the change, spending more time with the non-committed employees to get them to "buy-in" and to leverage the supporter to become even more energized and take the rest of the organization with them."

- "Communications should not focus on how these systems work, but rather on what is the purpose of the systems. Effective change management is 20% design and 80% communication and alignment. A phased-in or gradual implementation also has a positive impact, as does leading with implementation with senior leaders and then cascading the program down after this. "

- "We have historically not had great success in implementing our reward and performance programs. Primary lessons learned include the need to be direct and honest in our communications, to be transparent in our program design and to provide time and processes to allow our managers and employees to fully understand and ask questions about these programs. For example, we tend to have a lot of discretion in our variable pay programs, but often line managers and executive leaders don't tell participants why and how they used discretion to modify incentive payouts, resulting in a lot of confusion among employees. Employees need to understand how the enterprise and the divisions are performing - as well as their individual performance - quite often they don't have this information. As a result it weakens the performance-reward linkage."

Effective performance and reward programs not only need to be designed well, they need to be accepted and supported by key groups in the organization. Effective communications are a threshold, but ensuring the right groups are engaged and aligned in the change process is critical.

From research participants:

- "We've learned that the key role in making any change stick in the organization is the mid-level manager. They are the ones who have to deliver the message so they need real training, support and involvement in the process. In retrospect, I wish we engaged these people more frequently in the implementation process. While we provided some OK training to people managers, we found that they wanted and needed more around the real reasons why we were making changes to our performance and reward programs and what the essence of the change really is. In the end, we regretted taking such a top-down command and control approach and instead feel we needed to do more bottom-up orientation and alignment of managers."

- "It is important to bring the finance function in sooner than later in any change to the performance management and reward program so they are clear on how the program change will work. This can be a derailer if they are brought in too late."

- "You must have support from your top leaders. You won't go anywhere in terms of changing your reward and performance management program without executive alignment and support. Solutions must be customized to your particular situation. 'Best practices' are interesting, but not the end-all. At the end of the day, what you do needs to be bought in by the top of the house, managed effectively and constantly assessed. Communication, training and manager support is critical."

Conclusion

Given a challenging economy and a focus on sustained performance results, organizations are asking more from their employees. Many organizations are taking a fresh look at their performance management processes and reward linkages. Performance management can be a powerful tool to help businesses implement their strategy and reinforce their desired work culture if organizations invest the time and resources to clarify these linkages. However, many haven't. Managers and employees generally want to do the right things, but they need help in knowing what the right thing is, and understand their impact on delivering business objectives.

"Pay for performance" is not just about base salary increases and incentive pay. It's about reflecting pay–for-performance in multiple and differentiated rewards. It is also about differentiated opportunities for promotions, career development, financial and non-financial recognition and meaningful work opportunities.

Differentiating and rewarding performance is difficult for managers doing the work and faced with a broad range of talent and capabilities. They need tools and capability building to do this work. A great program on paper will fail if the organization hasn't done the ground work to build the toolkit and socialize managers to, most importantly, understand the purpose of the programs, but also grasp how to make the system work through goal setting, feedback, calibration and communication processes.

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