REWARD STRATEGY AND PRACTICE

Reward Effectiveness: How Do You Know if Your Reward Programs are Working?

*Tom McMullen, Hay Group**

Many organizations say they do a good job of "benchmarking" their reward programs, but for most this simply means that they compare the compensation of a subset of their jobs to compensation paid in the market for comparable jobs. The majority of organizations do not do a good job at assessing the effectiveness of their reward programs. This paper lays out a balanced approach for evaluating the effectiveness of their reward programs, taking into account both internal and external measurement processes as well as using financial ROI measures as well as perceptions of effectiveness.

Many organizations say they do a good job of externally "benchmarking" their reward programs. However, for most organizations, this simply means that they annually (or bi-annually) compare the compensation of a subset of their jobs to compensation paid in the market for comparable jobs. Benchmarking for most organizations tends to look at the *efficiency* of its reward programs (i.e., am I spending too little, too much or the right amount) versus the *effectiveness* of its reward programs (i.e., do reward programs actually achieve what they should be achieving). Moreover, focusing solely on this type of efficiency benchmarking does not take into account the following:

- **Total remuneration levels:** the dollar value equivalents of benefits and perquisites that the organization offers.
- **The total cost of employment**: the vast majority of benchmarking surveys rely on a sample (i.e., subset) of jobs in the organization and a typical organization reports that it can only match up to 50% of their jobs. We have often found organizations to be less than competitive relative to market compensation on a job-by-basis only to have total employment costs exceeding market because of aggregate staffing levels.
- **ROI/productivity-based assessment:** a comparison of revenue, profit or labor cost per employee.

TOM MCMULLEN is a Vice President and North American Reward Practice Leader for Hay Group based in Chicago.

> This helps organizations assess whether the combination of their staffing levels and total remuneration costs compare to their comparator group.

Given that reward program expenditures are often the largest or second largest controllable expense for an organization, it would seem that HR and senior executives would undertake a formal return on investment (ROI) analysis on its remuneration costs—its annual base salaries, merit budgets, incentive plans, value of health and welfare benefit programs and equity programs. But this is not the case. According to Hay Group research, a majority of reward professionals indicate that their organizations make NO attempt to measure the ROI of their reward programs. In addition, organizations who do measure ROI are split between doing this informally and using more structured, quantitative processes to evaluate the effectiveness of their reward programs. Perhaps more interesting is that the majority of HR professionals believe that their reward programs are either effective or highly effective.

How can HR professionals believe that their reward programs are effective without knowing if these programs provide a reasonable return on investment? Do organizations really know if their reward programs are working? Do they really care to know? As Jack Nicholson's character said in the film "A Few Good Men," can they "handle the truth?" Hmmm.

ROI—NECESSARY, BUT NOT SUFFICIENT

Even if an organization assesses ROI for their reward programs, ROI evaluation, by itself, is not enough since this information provides little insight into *why* reward ROI exceeded, met or did not meet management expectations. Furthermore, since ROI, like many financial tools, is a *lagging* indicator of effectiveness, by the time these results are calculated and assessed, damage may already have been inflicted by misaligned or poorly designed reward programs.

However, *Fortune* magazine's "Most Admired Companies" were much more likely to evaluate reward ROI (64 percent as compared to 38 percent of all companies) and 21 percent (as compared to 9 percent) report using financial or operational data in assessing reward ROI. Although senior executives may not hold HR professionals to the same ROI analysis standards as other organizational areas, a variety of end result measures are reported to be used by organizations who measure reward ROI. These measures include revenues, profits, employee retention, controlled or lowered labor costs, productivity, ability to recruit and employee opinion measures.

REWARD AS A COST VS. INVESTMENT

Perhaps the primary reason why organizations don't do a proper job of assessing the effectiveness of their reward programs is because they actually don't view them as an *investment* at all. Instead, they view their reward programs as a *cost* of doing business.

When something is viewed as a cost, the obvious goal is to *minimize* it. If something is seen as an investment, the goal is to *optimize* it and leverage its value. So, organizations, its senior leaders, managers and the HR function are likely to behave quite differently depending on their view of this question. If reward is viewed as a cost, organizations tend to take an ultra-focus on what other organizations do. They benchmark pay levels *a lot*. They ensure that salary ranges, incentive opportunities, merit budgets and the composition of benefits programs are very much aligned with market central tendencies. They don't want to pay too much or pay too little. They follow the herd in terms of how they determine to pay their people. Organizations focus on balancing the competitive positioning of their reward programs with how much they can afford.

There is a fair amount of evidence to support that many (if not a majority of) organizations fall in this camp (see figure 1 below).

Figure 1: Determinants of Base Salary Budgets

	Prevalence
What other firms do, i.e., labor market	H
Organizations ability to pay	M
Desired competitive labor market position	M
Organization performance	M
Increases in the cost of living	L
Employee turnover	L
Employee morale/satisfaction	L

Source: Hay Group's Fiscal Management of Compensation Survey

When reward is viewed as an investment, however, organizations focus on developing a reward strategy that aligns with and supports its business strategy and its human capital strategy. They know how employees provide a sustainable competitive advantage and *how they align employees' interests with the organization's interests*. They also communicate and sustain messaging to their employees about the varied aspects of linkage between performance outcomes and the organization's reward systems (see depiction in Figure 2 below). They do this frequently, in multiple ways and via their leaders (as opposed to the HR function). When reward is viewed as an investment, the view of rewards is much broader, longer term *and* it's usually the case that these organizations are also leveraging their employees and managers in pilot testing the design and communication of reward programs before they are implemented.

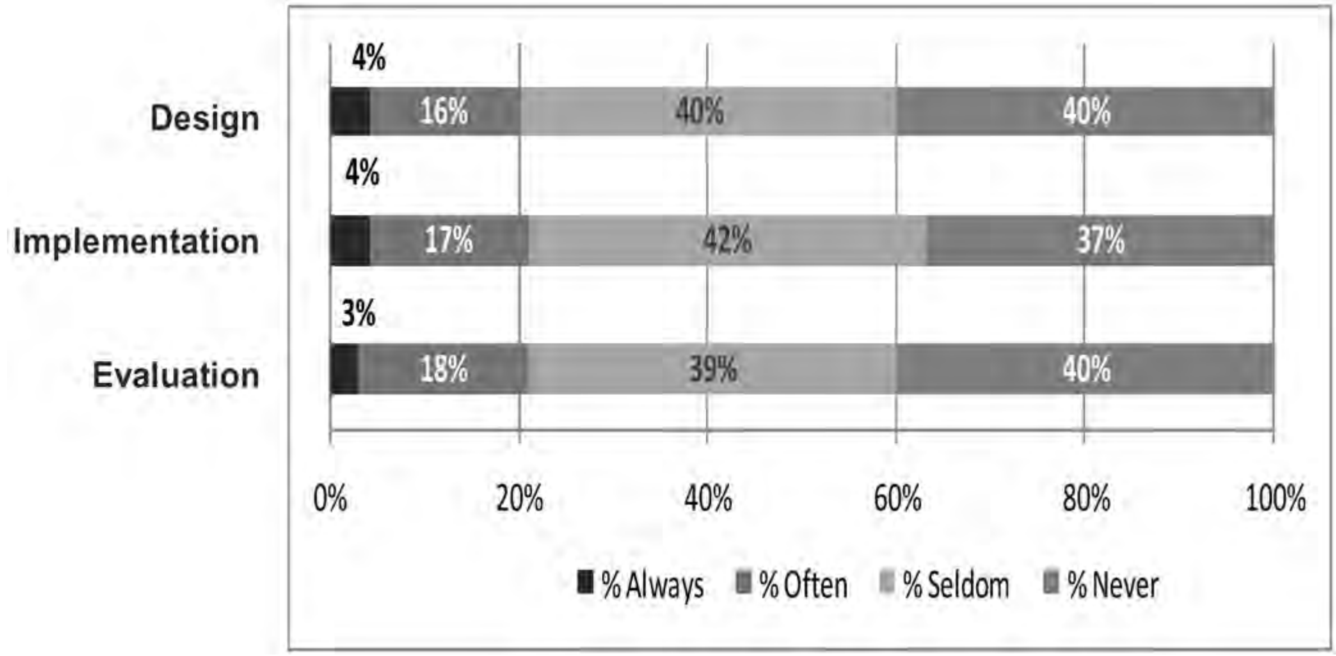
Figure 2: Total Reward Framework

Source: Hay Group

UNDERSTANDING THE EMPLOYEE'S PERSPECTIVE

We have found that most organizations do not do an adequate job of understanding their employee's perceptions around their reward programs. In addition, our research indicates that only about 1 in 5 organizations utilize employees directly when designing or modifying reward programs. It's about the same ratio in terms of the number of organizations saying they use their employee's direct feedback in assessing the effectiveness of reward programs (see Figure 3 below).

Figure 3: Organizations Utilizing Employee Input in Reward Programs



Source: Hay Group's Role of Rewards in Engagement Survey

While involvement is slightly better for managers; it appears that a majority of reward programs are still designed, implemented and evaluated in the "ivory tower" by corporate HR, finance, and operations staff. This is ironic when considering that most organizations can tell you, via their market research function, incredible levels of detail regarding the product and service preferences of the organization's various customer demographics, but has virtually no data on the reward needs and wants of their internal customer (i.e., employee) base.

Most organizations today have workforces that span multiple generations in different stages of their careers. What engages and motivates generation Y workers is very different than baby boomers, yet many organizations' reward systems are often seen as one size fits all programs that don't seem to be meaningful for any particular employee population. In an era when workforces are becoming more diverse and more flexible, the leading organizations are the ones that are adapting and tailoring their reward programs—especially their non-financial rewards programs—around the needs and wants of their different employee segments. But, an organization can't make an informed decision on how to adapt these programs if they have no reference posts on which programs provide the most impact on engagement.

An effectively designed employee engagement and total remuneration perception survey process provides a critical management tool. It is as relevant and powerful as other operational, customer and fiscal feedback systems and it can provide real insight into the health of a company's most important intangible asset—its people and their views on their reward systems.

AN APPROACH FOR EVALUATING THE EFFECTIVENESS OF REWARD PROGRAMS

Reward program evaluation is not just an opportunity to collect information, it represents an opportunity to clarify and communicate reward management priorities, values and willingness to listen to employee concerns. Building on the work by Kaplan and Norton in the Balanced Scorecard and Kirkpatrick on HR Training and Development program evaluation, an assessment of overall reward program effectiveness can be made considering four important assessment criteria—perception, understanding, behavior change and end results.

1. **Perception:** The most fundamental evaluation of a reward program is how it is perceived—both by program participants as well as their managers. Reward programs often require employees to change their views or accept changes in terms of how they are rewarded. A common reaction, especially if employees do not understand a new program, is the belief that the organization may be trying to cheat them by demanding more work for less rewards. If employees feel the reward program is unfair it will meet resistance. Managers who have a negative view of the reward program will be unenthusiastic supporters and will likely not use the reward as intended. Arguably, negative perceptions of a reward program will likely undermine its effectiveness. Perceptions of reward programs are most typically assessed via employee opinion surveys, focus groups and interviews.

2. **Understanding:** The second evaluation level focuses on how well employees and their managers understand the reward program. If the program is not understood, one cannot expect employees to perform or to behave in the desired

way, and the confusion associated with limited program knowledge likely creates frustration and resentment. Adequate knowledge of reward programs typically include an understanding the program goals, how it benefits the employee and the organization and the relationship between performance contribution and rewards received. In addition to testing tools, which are more often seen in training and development versus reward applications, a way to assess understanding of program intent or design provisions is to evaluate this via 1-1 conversations or small team meetings with employees.

3. **Behavior change**: For a reward program to impact organization outcomes or increase ROI, employees must behave differently by putting in more effort, working more efficiently, creatively or focusing their actions to be more effective. When reward programs are developed, management may pay little attention to what employees will do differently to achieve certain end results. However, unless the linkage between behavior and end results is established and understood, employees will have little influence on reward program outcomes. With no "line of sight," employees will become frustrated and will not be motivated by the reward program. Of course, if the behavior change is unrelated to the end result, then the program will not generate value. Job behaviors are most often identified and assessed via a range of analytical methods including observation, behavioral event interviews or expert panels.

4. **End results**: Obviously, it is the end results that management expects to gain from the reward program investment. End results measures often include top line and bottom line financial measures such as revenues, profit, total labor costs or cost savings. They can also include return ratios such as revenues/employee and profit/employee. End results can also be given as operational measures or ratios, such as reduced voluntary turnover, absenteeism, increased sales of product units, accident free days, reduction in waste, etc. which can be attributed to the reward program. While many of the top line and bottom line end result measures are often available, it can be challenging to isolate the impact of a reward program on end results.

Despite some inherent challenges, evaluating reward programs in terms of their effect on end results and their ultimate ROI is a worthy goal. This information allows management to make more informed comparisons and decisions relative to other investment needs and to get a better perspective on the value of reward programs to their organization. Again, it is not sufficient to only judge outcomes. The assessor must examine *how* those outcomes were achieved to provide a more robust evaluation and to provide the information needed to improve the reward program.

TAKING A BALANCED APPROACH

If we are to improve the effectiveness of reward programs, gaining a deeper understanding of employee and management perspectives as well as employee and manager involvement in the reward program evaluation process will foster considerable commitment to improving the reward program. Reward programs must change due to changes in the organization's business priorities and external competitive environments. Effectively changing reward programs involves multiple and balanced perspectives and viewpoints and it is essential to have a strategy for engaging these stakeholders and implementing change.

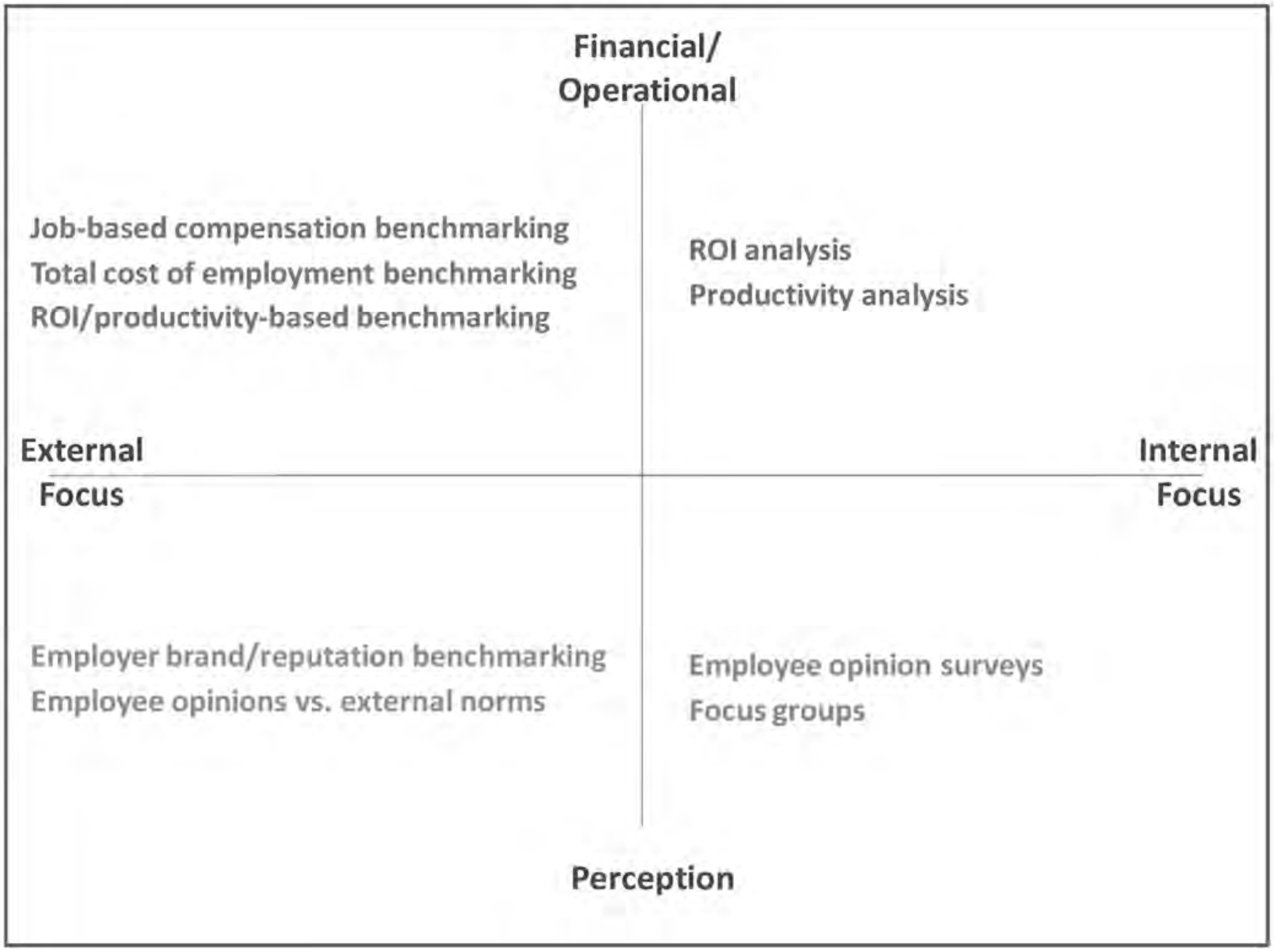


Figure 4: Balanced Framework in Assessing Reward Effectiveness

Source: Hay Group

Evaluation of reward program effectiveness requires careful thought and a commitment to using feedback to improve these programs. However, given the substantial investment organizations make in reward programs and the impact they have on organizational effectiveness, comprehensive reward program evaluation makes good business sense.

A systematic and balanced evaluation process can add significant value to reward programs when one goes beyond relying solely on financially oriented ROI measures. As Figure 4 (above) indicates, a robust evaluation process making use of financial, operational and perception measures of success as well as internal and external based analyses will provide the organization with a well rounded assessment of reward program effectiveness.

This approach reduces the dangers of over-dependence on "lagging" financial indicators and considers employee perceptions, knowledge and behaviors associated with pay programs, which form the basis for getting desired results. An effective evaluation approach collects information on how employee opinions relate to external comparators as well. There are information sources who can provide external norms on employer branding and corporate reputation assessments (e.g., Hay Group conducts Fortune magazine's Most Admired Company analysis) and who can provide external employee opinion survey norms.

By undertaking this type of reward effectiveness review, reward professionals will be better prepared with answers, and more importantly suggestions, as to how reward programs can be made more effective.

References

1. Finding the Right Combination: How the Most Admired Companies Unlock Reward Effectiveness, Journal of Compensation and Benefits, Tom McMullen, Mel Stark and Mark Royal, November/December 2011, 10-14.
2. The Role of Rewards in Building Employee Engagement, WorldatWork Journal, Dow Scott, Ph.D., Loyola University Chicago; Tom McMullen, Hay Group; Mark Royal, Ph.D., Hay Group, Fourth Quarter 2010, 29-40.
3. Reward Next Practices, Tom McMullen, Hay Group White Paper, www.haygroup.com, August 2009, 1-20.
4. Evaluating Pay Program Effectiveness, a National Survey of Compensation Professionals, WorldatWork Journal, Dow Scott Ph.D., Thomas D. McMullen, Richard S. Sperling, Third Quarter 2006, volume 15, number 3, 47-53.
5. Evaluating Pay Program Effectiveness, WorldatWork Journal, Dow Scott Ph.D., Thomas D. McMullen, Dennis Morjada, Second Quarter 2006, volume 15, number 2, 50-59.
6. The Fiscal Management of Compensation Programs, WorldatWork Journal. K. Dow Scott, Thomas D. McMullen and Richard S. Sperling. 2005, Volume 14, Number 3, 13-25.