Executing Pay for Performance:

Using Technology to Connect Compensation With Performance Management

by Lynn Summers

©2004 International Foundation of Employee Benefit Plans

The idea of paying employees based on their job performance is both logical and proper, but challenging to execute. The challenges come from determining what performance to reward and how to measure that performance accurately. Advances in technology enable the alignment of performance expectations throughout the organization, as well as the documentation and adjustment of performance goals throughout the year so that compensation dollars can be invested in work effort that truly contributes to organizational success.

The logic of pay for performance is crystal-clear. People are paid contingent upon their performance, thus motivating exemplary effort. Individuals benefit from enhanced rewards and organizations benefit from the cumulative boost in performance.

Doing pay for performance effectively, however, has never been as easy as it sounds. It requires that two processes—compensation management and performance management—not only function well separately, but also operate together in an integrated way. Compensation management cannot fully realize its potential without accurate assessments of individual employee performance. And performance management cannot fully realize its potential without the motivational kick that a well-administered compensation system provides.

What does an integrated pay-for-performance solution look like? The figure provides a conceptual illustration, showing how performance management helps to align individual efforts with corporate strategy and facilitates the ongoing management of these efforts throughout the year. It shows how performance evaluation plays a pivotal role—providing an assessment of individuals' performance that then is used as the principal driver of compensation decisions. And, perhaps most importantly, because it is a fully integrated process, companies can be assured not only that pay decisions are based on well-documented evaluations, but also that the performance their employees are evaluated on has contributed to the execution of corporate strategy.

Over the course of a year, an effective pay-for-performance process involves the following four stages:

1. **Establish performance and compensation plans**—Set the criteria for effective employee performance as well as the rewards to be allocated.
2. **Manage performance**—Assure

Continued on next page

performance stays on track throughout the year.

3. **Evaluate performance**—Assess whether the criteria have been met.
4. **Link performance to reward**—Use the performance assessment to trigger the appropriate financial rewards, as established at the outset.

Planning Performance and Rewards

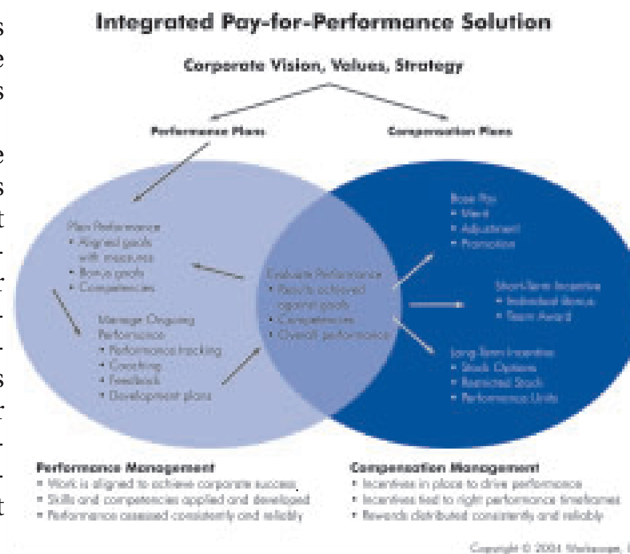
In full-fledged performance management, goals are "cascaded" through the organization. At the top, the CEO sets and "owns" goals that are derived from the corporation's vision, values and strategy. Executives then align their goals to these top-level corporate goals. At each subsequent organizational level, employees set their own business goals to ensure that they support their managers' goals and, ultimately, contribute to the company's achievement of its top-level objectives.

Goal alignment helps to ensure that everyone in the company is working on the right things—that their efforts are relevant. In addition, each goal includes one or more criteria (or measures) for determining if, at the end of the performance period, the goal has been achieved. Defining clear measures up front ensures people's performance will be appropriately and reliably assessed at the back end.

However, the performance plan does not live by goals alone. Performance is, in essence, a two-sided coin. One side consists of the results people achieve against their goals. These are the whats of performance ("what" it is that people achieve). On the other side of the coin are the behaviors employees engaged in, their modus operandi, usually referred to as competencies. Competencies are the hows of performance ("how" employees go about achieving what they achieve).

Like goals, competencies also derive from the corporation's vision, values and strategy. Look at any company's values statement. It will invariably have something to say about how employees should act toward customers, toward each other, toward the community. These behavioral "shoulds" are translated into a competency model. Such competencies as teamwork and customer focus thus are usually cascaded down from the corporate vision statement. Competency models also specify the skills, knowledge and behaviors employees need to apply in achieving their goals. They are sometimes based on careful analysis and research to determine the skills that differentiate top performers from average performers, or to delineate the specific skills needed to be successful in a particular position.

For pay for performance to be effective, everyone needs to have a clear understanding of the relationship between their performance and their potential reward. Communicating the compensation plan up front is therefore essential.



So, the performance plan sets expectations for employees: what is to be delivered and how to go about it. And the consequences of meeting and exceeding expectations are spelled out as clearly as possible.

Ongoing Management of Performance

The second necessary element of a sound pay-for-performance process is ongoing performance management. This is a continuous, collaborative communication process between managers and employees. Unfortunately, the ongoing piece is the part of performance management that is most difficult to sustain and that most often drops by the wayside.

Why is ongoing management important to pay for performance? Quite simply, just having put the machinery in place to choreograph the performance of perhaps thousands of employees is not enough. The machinery needs to be constantly looked after and reevaluated as business requirements and accompanying performance goals change. For each employee that veers off course, doesn't make a turn when the company needs to turn and delivers less than he or she could potentially deliver, the company loses.

Ongoing management of performance means that employees track their performance against their goals and report frequently on their status. Tracking progress may include self-monitoring, soliciting feedback from their managers, collecting data from internal or external reporting systems, or any combination of these methods. What gets tracked? The important things to be documented are identified in the measures employees set for their goals. As goals get off track, employees and their managers can work together to problem solve and get them back on track.

Ongoing management also means adapting and adjusting quickly as priorities change. As top-level priorities change, which they inevitably do in most industries, these changes need to cascade down to all employees affected by the change. Ongoing performance management is what enables companies to "turn on a dime" when a change in priorities necessitates a rapid redeployment of resources.

Furthermore, ongoing management of performance means ensuring that the skills needed for organizational success are being applied and developed. Managers, in their role as coach, help their employees solve problems, overcome obstacles, develop needed skills. Individual development plans may be initiated to enable the employee to become more effective at achieving the goals of their current position or to grow into greater responsibilities.

Ongoing management of perfor-

mance is essentially Management 101. It is an integral part of every manager's job, just as self-management is an integral part of every employee's job. It is a classic example of win-win outcomes: If employees can keep their performance on track, adapt to changes in priorities, develop and become more effective in their jobs, and reap financial rewards commensurate with their performance, they win. And, imagine if this happens on a large scale within the company.

Evaluating Performance

Evaluating performance is the third element in the process and entails assessing whether the criteria for effective performance have been met. This is usually done in the context of the focal performance evaluation, although some elements of the compensation plan may be linked to specific metrics that are tracked in internal systems outside the performance management system.

Evaluations need to be reliable—that is, accurate. The usual concern with evaluations, other than those where there are clear quantitative measures, is that they are overly subjective. But consider how different the evaluation process can be if the following conditions hold.

First, imagine that performance has been managed and individuals have kept status notes on their goals and competencies throughout the year. Thus, for each goal and competency, there is documentation covering the entire year.

Second, imagine that the employee and selected others who are familiar with the employee's performance throughout the year, or with his or her performance on a particular goal, have all provided input to the evaluation. Thus, the manager can refer to a wealth of information from a variety of relevant sources, all organized around the employee's goals and competencies, to craft the evaluation.

Third, before evaluations are final, another set of eyes checks them out. The usual approval process involves next-level managers reviewing the evaluations written by their direct reports, checking them for consistency and appropriate language and ensuring that the ratings are supported by appropriate documentation.

With evaluations built on rich and relevant data covering the entire performance period, managers can more confidently make the critical judgments about performance that are demanded by a successful pay-for-performance process.

Linking the Assessment to Financial Rewards

There is more to pay for performance than merely flipping a number over the transom. It is true that determining the appropriate merit increase requires, in most cases, an overall performance rating for each employee. But that number must accurately represent the employee's performance. And there are other elements of the compensation plan that must also be considered. Bonus pay and stock options are typically keyed to particular measures of performance and these measures must be accurately drawn from the appropriate sources. In addition, the measures on which incentives are paid may be individual-level measures or may be at an aggregate level (for example, departmental cost containment or overall corporate profitability). Furthermore, different compensation plans may apply to different job families or different divisions. But the overall process of linking the assessment of performance to financial rewards should be consistent throughout the company.

The overriding needs, from the company's perspective, are to manage the budget dollars allocated for compensation and to ensure that these dollars are distributed in a way that truly rewards people for their performance, and does so in a timely way. The compensation plan, as it applies to each employee, needs to be communicated up front, at the beginning of a performance period—It is always helpful if people know the rules before the game begins. At the end of the performance period, when results are in, compensation managers need to be able to quickly analyze the distribution of results that are tied to compensation and then, with senior management approval, adjust the

Continued on next page

COMPENSATION—ADDITIONAL *Resources*

Article Briefs

Paying for Performance

Pay for performance programs are widely used; however, the true meaning of these programs and their implementation methods differ between organizations. Experts suggest that employers should implement a well-integrated structure of incentive compensation in order to make the pay for performance program as successful as possible. In order to do this, employers should agree on a definition and on processes. It is also important that the plan support business objectives, be effective and operate as a completely integrated reward package.

Aon Consulting: Forum (US).
September 2003, pp. 4-5.
#0141406

For more article briefs, see www.ifebp.org/ManagePay.
To have an information specialist provide customized information for you, call (262) 786-6710, ext. 8350.

Conferences and Seminars

Certificate Series: Basic Compensation Concepts

October 6-7, Phoenix, Arizona

Visit www.certificateseries.org; or call (888) 334-3327, option 2.

Books

Paying for Performance, Second Edition. Peter T. Chingos, Editor. John Wiley & Sons.
■ 389 pages. Item #8384. $70.

To order, call (888) 334-3327, option 4.

guidelines for awarding individual merit increases and bonus payments. Furthermore, the individual reward decisions need to be put into the hands of managers, exercising discretion within the constraints of the guidelines and the company's compensation policies.

Role of Technology

Despite its impeccable logic and inherent benefits, actually doing pay for performance, based on the integrated approach to performance management and compensation planning described here, has been a challenge. Organizations have attempted to implement and maintain this type of system for quite some time with no better than mixed results. The problem has been the tools they have had available to support the processes. Initially, companies used paper—Goals were set on paper and filed away, performance evaluation forms were distributed from HR to be filled out and so on. About 20 years ago, electronic spreadsheets were introduced and supplanted some of the paper forms. Most recently, Internet-based "point solutions" have been introduced to ease the administrative burdens of completing performance evaluations and administering compensation. But still, efforts to introduce and maintain truly integrated processes inevitably reverted to the execution of specific transactions and the idea of performance management as an "ongoing process" was lost.

The advent of Internet-based information technology has changed all that. Technology's ability to pull information from multiple sources and aggregate it, to drive activity by interacting with users and to make information accessible and visible in meaningful ways has brought true pay for performance closer to realization. Consider some of the challenges faced by performance management and compensation planning processes and how technology is now able to address them:

- Aligning the work—Beyond the first levels of management it becomes increasingly difficult for employees to see how their goals contribute to the company's business strategy. In an Internet-based performance management system, employees have "line-of-sight visibility." They can set their goals to align with their managers' and can see how these goals align all the way to the corporate goals. By way of illustrating what a difference line of sight can make: One company, in a survey of 11,000 U.S. workers, found that only 9% of employees believe that their work has a strong link to their organization's top priorities. After another company implemented an Internet-based performance management process, an internal survey found that 91% of employees using the system clearly understood how their jobs supported the corporate objectives. The ability to set goals with an awareness of their ultimate contribution to corporate success makes a difference.
- Ongoing management—Goals that get set on paper and filed away in drawers have scant power to direct and energize employee behavior through the year. In the absence of rigorous, ongoing management of performance, the company loses the advantage that comes with active tracking of performance against goals, adjustment of goals in the face of changing priorities and day-to-day coaching to develop employees' capabilities to deliver results. With an Internet-based system, information about all goals within the organization is accessible through a common database. When priorities change and a top-level goal is modified, the owners of all the goals aligned to it can be quickly notified of the change. Completing periodic status reports within the system enables managers to recognize when assistance is needed to move along goals that are in jeopardy and to coach employees needing help.
- Completing evaluations—When there is little ongoing performance management, completing the focal performance evaluation at the end of the year becomes an exercise in compliance. "HR police" try to round up reluctant managers who procrastinate completing evaluations for months and may never complete them. In contrast, if performance has been managed throughout the year and progress periodically documented, managers find it relatively easy to prepare a fair and accurate focal review. At one company, for example, where an online performance management system was in place, 15,000 employees were scheduled to receive year-end evaluations. Ninety-two percent of those employees completed self-evaluations and 100% of the employees received completed evaluations from their managers, all on schedule.
- Evaluation accuracy—With paper-based reviews or standalone online performance evaluation software, evaluation ratings tend to be overly subjective, poorly documented and often inflated. With documentation updated throughout the year, evaluation accuracy can dramatically improve. Furthermore, input from others regarding an employee's performance can provide additional informative data points. Completing evaluations as part of an online performance management system is therefore not only administratively easier, but the access to documentation from throughout the performance period and to input from multiple sources can result in performance evaluations of unprecedented validity.
- Making compensation decisions—Passing around salary worksheets to determine merit increases and bonus payouts is laborious and fraught with inconsistencies. Online processes can dramatically simplify the task and help to ensure consistency in the application of compensation guidelines across the company. At one company, for example, replacement of a paper-based process reduced the compensation planning cycle time from ten weeks to just four weeks with 100% of managers adopting the tool in the first year with little or no training.
- Pay for performance—In many organizations, senior managers and compensation managers have little confidence in the reliability of performance evaluation ratings that are intended to drive pay for performance. One frequent result is that merit increase guidelines are set conservatively so that there are only moderate differences between the

increases top and mediocre performers receive. This dilutes the impact of a pay-for-performance plan. Furthermore, performance is sometimes subordinated to the requirements of compensation. If there are too many "outstanding" ratings, for example, managers are asked to alter the performance ratings of some employees in order to "stay within budget." This putting of the cart before the horse further erodes confidence in the pay-for-performance process and undermines the performance management process. However, with an integrated online system in which evaluations are based on ongoing performance management data, senior management can have greater confidence in the reliability of evaluation ratings and in setting guidelines with greater differentials between outstanding and average performers. In addition, the ability with online systems to quickly analyze the distribution of ratings and adjust compensation guidelines helps to keep the horse in front of the cart—to allow employees' actual performance to drive their rewards.

Working together, online performance management and compensation planning have the potential to make true pay for performance a reality. A rigorously implemented performance management process helps to ensure everyone is working on what is relevant to corporate success, that the skills needed for organizational success are being applied as well as developed, and that assessments of people's individual contributions are reliable. This assessment feeds the compensation system, enabling it to distribute rewards in an equitable manner, enabling significant reward differential based on performance and giving managers the power to control the distribution of rewards consistent with the organization's compensation plan which is itself linked to corporate strategy. The promise of technology in this case is more than administrative ease and cost reduction. It can help to put the company's compensation dollars to good use while driving individual performance that collectively contributes to organizational success. **B&C**

Lynn Summers, Ph.D., is vice president of research for Workscape, Inc. He is known for his innovative approaches to performance management, 360 feedback and individual development planning. His doctorate, from the University of South Florida, is in industrial and organizational psychology.

Reproduced with permission from *Benefits & Compensation Digest,* Volume 41, Number 9, September 2004, published by the International Foundation of Employee Benefit Plans (**www.ifebp.org**), Brookfield, Wis. All rights reserved. Statements or opinions expressed in this article are those of the author and do not necessarily represent the views or positions of the International Foundation, its officers, directors or staff. No further transmission or electronic distribution of this material is permitted.

PU048014