

The Secrets of Performance- Related Pay

Creating direct links between
employees' pay and performance
is what every business wants...
but there are pitfalls

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Table of Contents

- 2. Introduction
- 2. What Are Incentive Plans?
- 2. Who Uses Them?
- 3. How Do They Work?
- 3. What Purpose Do They Serve?
- 3. Are There Any Disadvantages?
- 4. The Importance of Measurement
- 4. A Practical Approach
- 4. Conclusion
- 5. Further Information

Introduction

"Pay for Performance", "Incentive Pay" or "Performance Related Pay" are catch phrases used by organisations aiming to improve individual and team performance through a system of pay that offers rewards for effectiveness. The idea is that higher rewards will lead to better results. Conversely, poor performance will not be rewarded and may lead to dismissal.

Another option is "skills based pay" - where employees are paid a higher salary for possessing certain skills - but it is important to consider your organisation's objectives and be certain that you are rewarding the skills that directly benefit your organisation rather than the individual who possesses those skills.

When considering alternative pay plans, it's important to consider whether or not your organisation has the money that will be necessary to implement such a plan. For example - if your employees regularly work overtime, the increased cost could be significant.

The primary argument in favour of any form of incentive or performance related pay scheme is that it acts as a motivator, through both providing incentives in the form of monetary rewards and by recognising achievements. Further benefits cited include the fact that individuals can identify closely with their employers' goals and that this can increase productivity and encourage quality, flexibility and teamwork.

Today it is becoming more common to link pay to an employee's over all 'contribution' perhaps considering skills acquisition, peer support, mentorship and other contributions rather than just looking at an employee's performance in terms of their individual output.

What is performance-related pay?

The CIPD defines Performance-related pay (PRP) as "a method of remuneration that links pay progression to an assessment of individual performance, usually measured against pre-agreed objectives ('classic' PRP also known as individual PRP or merit pay). Pay increases awarded through PRP are normally consolidated into basic pay although sometimes they involve the payment of non-consolidated cash lump sums."

What Are Incentive Plans?

In an incentive pay plan, employees get a base salary and can earn more, depending on meeting specific measurable objectives.

Companies have been using such plans in various forms for a large part of this century and the plans include such formats as management by objective, profit sharing, commissions and bonuses.

Who Uses Them?

The Chartered Institute of Personnel and Development has published the following usage information:

- Across the whole UK economy in 2006/07, 35.5% of pay reviews were based either wholly or partly on an assessment of individual merit¹.
- This represented the first significant increase in the incidence of merit pay in recent years – up from levels hovering around the 30% to 31% mark in each of the previous four years.
- Individual PRP is far more prevalent in the private than in other sectors – and indeed is virtually 'the norm' in some parts of the sector such as financial services.
- In the public sector, by contrast, the vast majority (60 out of 67 pay awards monitored during 2006/07) provided for a basic percentage increase, with just seven including a performance-based element².
- The use of PRP also remains relatively rare in the voluntary sector.
- Merit pay most commonly covers managerial and other white-collar staff – and despite a growing interest in the idea of extending coverage to manual workers, few schemes do so.
- There are of course major differences in coverage of PRP internationally – for example, employers in France make greater use of merit pay than occurs in Great Britain³. Ironically, this is partly attributable to the much more highly regulated employment background in France that leaves individual managers keen to exert some control over the improvement of performance via pay.

Factsheet on Performance Related Pay

The Chartered Institute of Personnel and Development provides a factsheet on performance related pay that offers introductory guidance to performance related pay. It

- explains what is meant by performance-related pay (PRP)
- looks at how performance is measured and linked to pay
- examines the coverage of PRP and current trends in awards
- assesses key issues in the implementation of PRP schemes
- includes the CIPD viewpoint.

The factsheet is available at:

www.cipd.co.uk/subjects/perfmangmt/perfrelpay/prefrelpay.htm

How Do They Work?

The incentive must be large enough to motivate people to change their behaviour. Targets can be set on items of tangibility such as billable hours, number of units sold and some with subjectivity - for example, based on how customers rate the performance of the organisation. Incentives can be paid quarterly, half-yearly or yearly.

Every incentive plan must be based on measuring individual and team performance against key performance indicators in the organisation.

What Purpose Do They Serve?

When employees benefit financially from organisational profitability and effectiveness, they are more motivated to operate as a team to reach company objectives. Usually, as a result, employees are happier and stay longer.

Research has shown that, in addition to help with recruiting and retaining skilled workers, incentive pay plans improve communication, company financial results, morale and teamwork.

Are There Any Disadvantages?

Incentive plans can have disadvantages - particularly in administering them and, in the event of objectives not being met, managing the disappointment of people who thought they had achieved enough to be rewarded.

Incentive pay is paid out in arrears - it's important therefore to recognise that by the time the incentive is paid out, the organisation's fortunes might have deteriorated and a cash flow problem may exist. You have to set aside money for it. And you have to be committed to sharing information about how the organisation is performing.

Other factors are:

- Some job applicants don't want to work for companies where part of their pay is uncertain.

- Many small companies struggle to implement incentive plans because they are poor at setting goals.

It's sad to say, but "pay for performance" initiatives have enjoyed only limited success, especially as they relate to the way companies administer their pay or salaries:

- The measurement of individual performance is often the greatest difficulty with a performance pay scheme.
- The second greatest drawback is the short-term focus on objectives that may result in lack of attention to longer-term issues.
- Often, the amount of pay involved is not enough to substantiate a change in performance.

There's a problem with many performance evaluation systems - performance factors and management by objectives or results (MBO or MBR) are often subjective and lack a credible process for ensuring accuracy and fairness. Setting performance factors and MBO/MBR's that are meaningful to both the employee and the organisation, realistic, measurable, achievable, properly aligned with organisational goals, and credible is difficult.

And it's harder to do the lower you go into the organisation. Although by no means perfect, some companies use a 360-degree feedback system to ensure more complete, accurate, and fair assessment. But the downside is that a 360-degree feedback system requires considerable staff time to administer it fairly and thoroughly.

Tying a salary increase to degrees of performance often encourages managers to rate everyone high enough to receive a pay increase. Since managers fear losing staff, especially in today's labour market shortage, they would rather have everyone get something than nothing. This results in very little differentiation in pay increases based on performance and puts into doubt any effectiveness gained through a scheme that promises something but delivers very little.

It's an acknowledged fact that highly motivated people tend to be that way in all things they do, both work and personal. Successful people in one situation tend to be successful again in another. Conversely, people who fail tend to have a history of failures.

PRP trends

Key developments in the most recent pay round as monitored by IRS include:

- One quarter of pay awards in 2006/07 were based entirely on merit, with the pay bill budget increase set at 3.5% at the median (or mid-point) - up from 3.3% in the previous year's analysis.
- Individual merit pay increases ranged from nil to 36.36%.
- The maximum merit payment was 8% at the median - up from 7.4% the previous year.
- A further one in eight pay reviews combined a basic pay rise with a supplementary payment linked to performance - with a median basic increase of 3% and merit pay bill budget of 2%.

Source: CIPD

The Importance of Measurement

For any performance pay system to work, it's important that the performance measurement systems are effective, easy to understand and easily communicable. This is a lot more difficult to achieve than first appears. For example, the thing to be measured may be intangible - for instance, "what is the level of morale?" It begs the question as to whether in this instance morale can be measured at all.

Because measurement is so important, it is crucial that every organisation has what is known as key performance indicators. These will differ from organisation to organisation since some indicators will rank as more important to some rather than others.

A Practical Approach

The following is a practical approach to establishing a performance pay system through addressing the key questions that need to be asked against a background objective to encourage and reward both individual and team performance:

- What are the team outcomes, in general terms that you want to reward?
- How will the total funds available for pay-out to the employees be determined?
- How frequent should the rewards be given - quarterly, half-yearly, yearly or more frequently?
- Should payments be made on account on the basis of small rewards given more frequently motivate more, or will larger rewards paid less frequently provide greater incentive?
- Are the rewards to be paid in cash or would a share option scheme (or perhaps a shadow share option scheme) provide greater advantage?
- Performance measures - What are the measures of performance?
- Is the business able to measure performance now or would it need to establish key performance indicators?
- Is the target of performance to be absolute or will there be a minimum and maximum performance level for each measure in respect of which rewards will be given?
- How is each measure to be weighted in terms of importance?

- Performance pay opportunity - what is the target pay-out opportunity that each individual can aim for?
- What is the pay-out for minimum rewarded achievement of each measure and the pay-out for maximum rewarded achievement of each measure?
- Is there any overall corporate objective that has to be met before any payout is given - such as the organisation as a whole being profitable or meeting its overall performance objectives?

Conclusion

If a company's focus on rewarding employees is based on their organisation's achievements of key goals, perhaps measured in the sense of true "economic value added", they will find that all parties are more motivated, from employees to management to outside shareholders. The trick is to establish a programme that is both fair and equitable, yet provides challenging but achievable and measurable targets.

At a practical level, you will need to decide who is to approve the performance related pay plan, how it is presented to the employees and how it will be administered.

The rise of share incentives

Mercer's UK executive pay survey published in March 2006 revealed that performance share plans have replaced share options as the main form of long-term incentive.

Further Information

This guide is for general interest - it is always essential to take advice on specific issues.

We believe that the facts are correct as at the date of publication, but there may be certain errors and omissions for which we cannot be responsible.

If you would like to receive further information about this subject or other publications, please call us – see our contact details on the next page.

References:

¹ CARTY, M. (2007) Merit-based budgets increase to 3.5% over 2006/07 pay round. IRS Employment Review. No 882, 19 October.

² SUFF, R. (2007) Public sector pay 2007/08. IRS Employment Review. No 887, 14 December

³ BELFIELD, R., BENHAMOU, S. and MARSDEN, D. (2007) Incentive pay systems and the management of human resources in France and Great Britain. CEP Discussion paper 0796. London: London School of Economics, Centre for Economic Performance. Available at: <http://cep.lse.ac.uk>

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