

Money Talks: What Compensation Says about Your Talent



TALENT DEVELOPMENT

HCI White Paper

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EXECUTIVE SUMMARY

Appropriate compensation has always been somewhat of a sticky issue for many organizations, large and small. Talent management that clearly ties pay to performance develops a culture of fairness, and helps avoid employee concerns about performance grading. A quantifiable pay for performance system can address manager and supervisor concerns about telling employees how they are doing and how their performance is linked to compensation. It also answers the compensation ROI for top management through the use benchmarks and defined metrics.

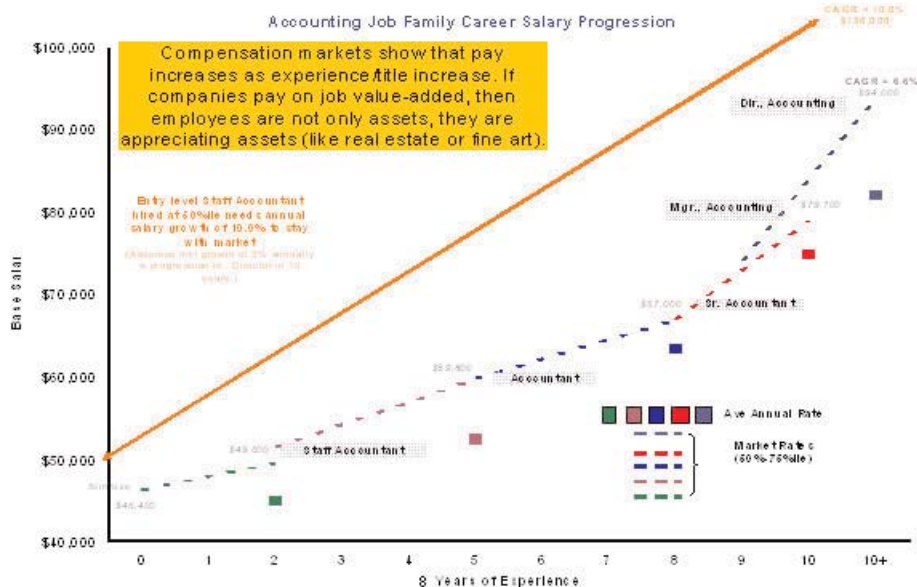
What an organization's performance and pay practices say to its talent may be quite different than what employees hear, according to Jeff Higgins, Executive Vice President of Workforce Planning at Countrywide Financial Corporation. The company or supervisor might say, "You are a performance

review 'star' but company/HR rules limit your bonus." The employee hears this and may think, "The company is ripping me off and someone else is getting my reward." The supervisor may tell an employee, "The annual merit award pool is allocated fairly across the company," while the employee may see average performers receiving a three percent salary increase and above-average performers getting only slightly more.

Some organizations link salaries and bonuses to the market. Their total compensation practices can be described as "competitive" within their industries but many employees take "competitive" to mean, "We're not going to get a single dollar more than the market median." Such disconnects point to fundamental question that still lingers in many organizations, and drives the way they structure compensation: Are employees costs to be minimized or assets to be developed? Figure 1 provides an answer.

Figure 1

Are Employees Costs (to be minimized) or Assets (to be developed)?



The box in Figure 1 argues that employees are assets subject to the principles of Compound Annual Growth Rate [CAGR] just like any other capital investment. Assumed here is that the value of a position increases, depending on supply and demand, at a 3% annual growth rate. The 3% growth rate, coupled with an actual average 7% market growth rate (market compensation data courtesy of Watson Wyatt Worldwide) for accounting positions with increasing levels of experience, equates to an overall 10% CAGR. Employees, especially those who are experienced, engaged, and continue to grow, add value to a company year after year at an increasingly valuable rate. If employees, then, are assets whose value goes up over time, a fairly managed pay for performance strategy will leverage their best efforts and increase their value - and retention - over time.

A CASE STUDY

In this example, a mid-sized financial services company wanted to design a new process or tool to

achieve the following goals:

- Achieve "balanced ratings" to spot true high performers - without forced rankings
- Simplify the performance review and bonus process
- Cost effective pay for performance (same \$\$ bonus pool)
- Incent high performance culture for attraction and retention
- 100% completion and compliance

The existing system used by the company had a number of drawbacks, says Higgins. First, it used Excel-based evaluation forms and system. The rating scale was A to F - "Like being back in school!" - that relied on unrealistic self-assessments. One result was ratings "gaming" by supervisors. The bonus programs were not tied to performance. For employees the amount of the bonus was based on the letter rating without regard to position, grade, or salary. For managers the bonus program had no standards, no link between pay and performance,

Figure 2



and was subject to a supervisor's whim.

Furthermore, the system collected no consistent data and didn't have the ability to analyze what data it had. It also took three months to complete the process and the compliance rate hovered around 50% to 60%.

A deeper look at what this company wanted to achieve reveals the details behind their goals.

EMPLOYEE BONUS PROGRAM

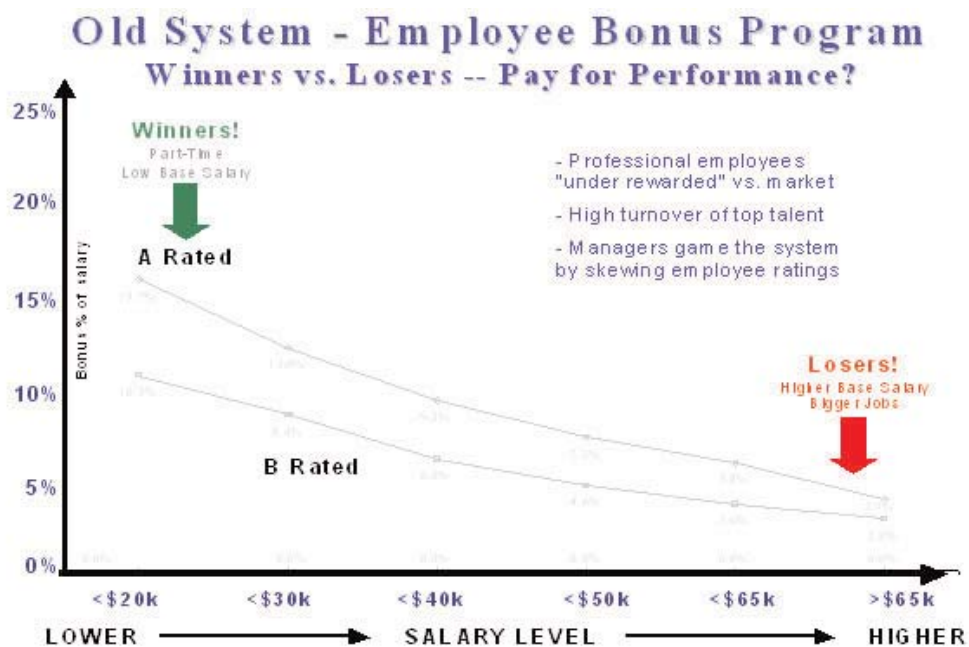
The company first concentrated on the employee (non-Manager) performance ratings and bonus program. Under the old system "winners" and "losers" were unfairly distributed. The "winners" were part-time employees or those with low base salaries. Their bonuses could be as much as 15.7% of their salaries for an A rating. The "losers" were those with higher base salaries. Their bonuses were 3.9 to 5.8% of their salaries; and these employees

had bigger jobs and were often top performers. "The real professional employees were under-rewarded versus the market." One result was high turnover of top talent. Figure 3 illustrates the bonus pattern and also shows the relative advantage lower-paid B rated employees had over A rated, but higher paid, employees.

Add the influence of managers to favor or disfavor certain employees and the inequities of the system in use before become apparent. "This is hardly a pay for performance system." Under it, C rated and lower employees - designated as poor performers - received no bonus at all. Yet B rated employees just one point above a C rating did. And 33% of A rated employees ranked just one point above B - do these B and A rated employees really deserve their ratings? This was one of the inequities the company wanted to fix.

The new employee bonus program was based on position and job grade within that position. The

Figure 3



tiers were paid on a sliding scale as a percentage of base salary tied to supervisor evaluation rating. The system used a 100% pay for performance correlation that assumed balanced ratings

Instead of the one-size-fits-all system formerly in place, where no differentiation of contribution was made between lower paid employees and the higher paid professionals, six grades under three categories of employees were established. Not only that, the old A to F school-type grading nomenclature was dropped. A and B ratings were used for "standard" employees, professionals fell into C1 and C2 grades, and senior professionals and leaders were placed in C3 and C4 grades. This eliminated the stigma of being rated C, D, or F.

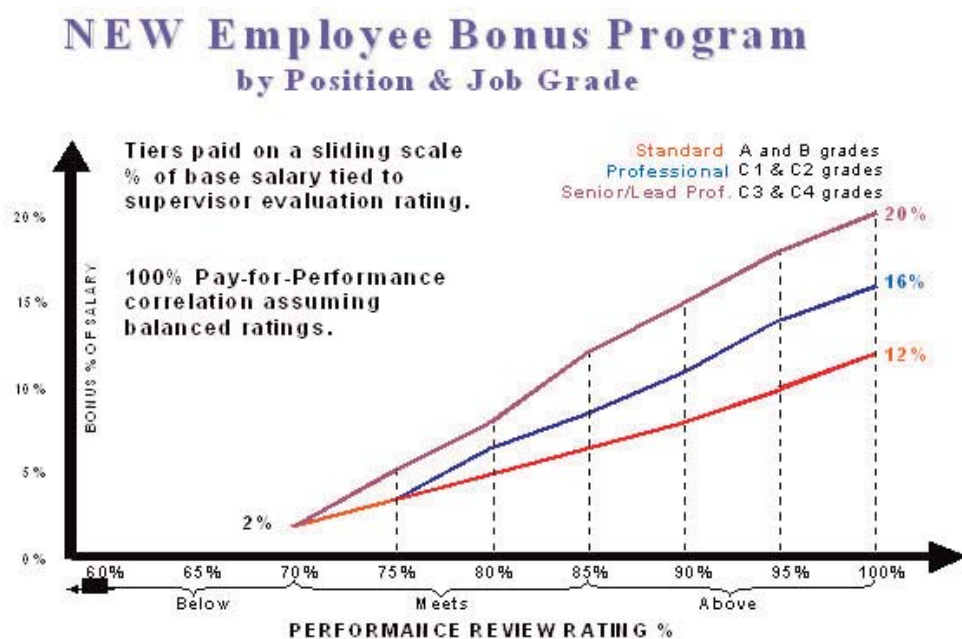
MANAGER BONUS PROGRAM

The manager bonus program was structured similarly to the employee program, and was subject to the same inequities. The difference between a high C and a low B were small, and 37% of those rated A

were just one point above B. Under the old system, there was a low correlation of pay to performance, no differentiation among experienced and less experienced managers, and no real standards upon which to measure performance. As a result, most bonuses were clustered in the 5% to 12% of salary range, regardless of whether one was rated B or A.

The new system operated on a two-year pay for performance cycle, with standards and benchmarks to back it up. Under performers, performers, and high performers were identified based the standards set and what percentage of their bonus targets were met. In the first year, most managers who received bonuses (mostly performers and high performers) achieved 60% to 80% of their targets, with a large cluster around 80%. In the second year of the system, the majority of those who received bonuses exceeded their bonus targets, and a greater percentage of them were high performers. In both years, fewer low performers were over-rewarded and fewer high performers were under-rewarded, especially in year two.

Figure 4



AUTOMATED PERFORMANCE MANAGEMENT

The financial services company in this case study accomplished the transformation from the old system to the new with an automated performance management system. The system evolved over the course of four years to encompass ever-greater functionality and eventually included strategic components. Figure 5 illustrates how the system grew.

While the system itself can be considered strategic, especially because it links pay to performance and provides accountability, the ability to communicate company strategy to the company's talent demonstrates the link between them and enhances the strategic process of alignment. The system uses a dashboard approach that is the portal for access to all the system's features, including compliance reporting, the ability to navigate the organizational chart through to individual reports on managers

and other employees, performance rating criteria, and qualitative feedback. It utilizes a central database with in-depth reporting capability across the workforce. For example, the system can produce a report that shows if employees are satisfied with their compensation by position

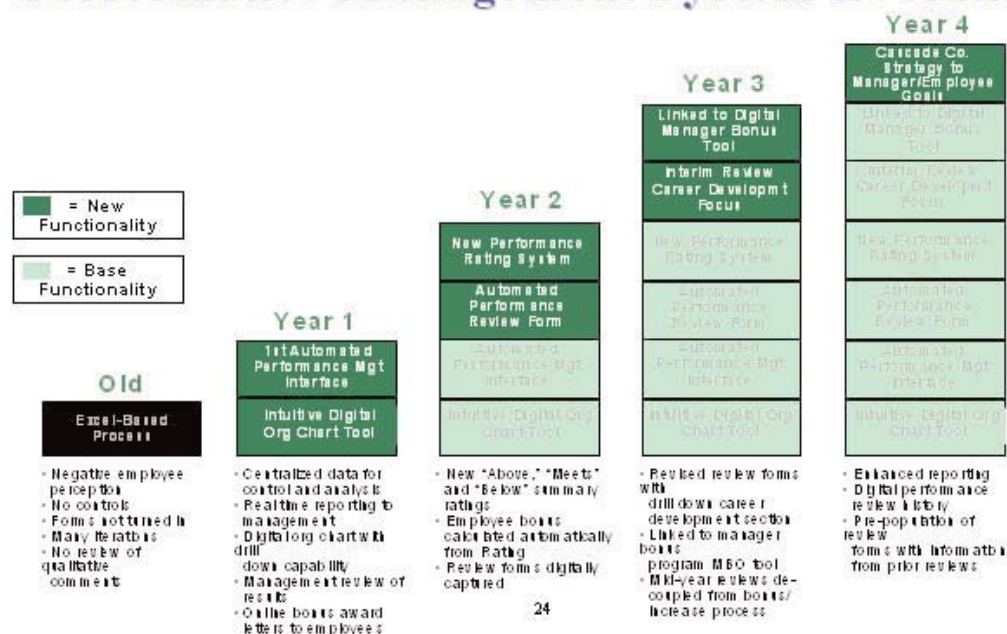
This data can be parsed into more detail. For example, it can be compared year-to-year or just after performance review periods. It can be compared between managers and non-managers, sales and non-sales staff, etc. The system also allows the company to look internally and determine what it does well and what needs improvement.

GOALS ACHIEVED

The new automated process has achieved the goals desired at the outset of implementation. There is now an upward transparency of performance rating, bonus, and merit criteria. This starts a whole new line of discussion and limits skewing of rat-

Figure 5

Performance Management System Evolution



ings. Managers are giving employees honest feedback, often for the first time. Balanced ratings spotlight the true high performers. As a result, employees' perceptions of fairness generated bonus rewards. The pay for performance model can be used without incremental costs, so there's more "bang for the buck." There's been an increase of up to 500% in bonuses to high performers, driving an increased rate of retention and the pay for performance culture. The on-line evaluation history component of the system ensures continuity. Remarkably, the time to complete the process dropped from 90 to 30 days and compliance went from a high of 60% to 99%.

Progress on balanced performance ratings has been solid. The company's target median performance level is 80%, i.e. 80% equals "meeting expectations." In year one, under the old system of A to F ratings, 87.2 of those people in the program met (70.1%) or exceeded (17.4%) the threshold. Under the new balanced system the percentage of people who met or exceeded that 80% threshold ranged from 81.5%

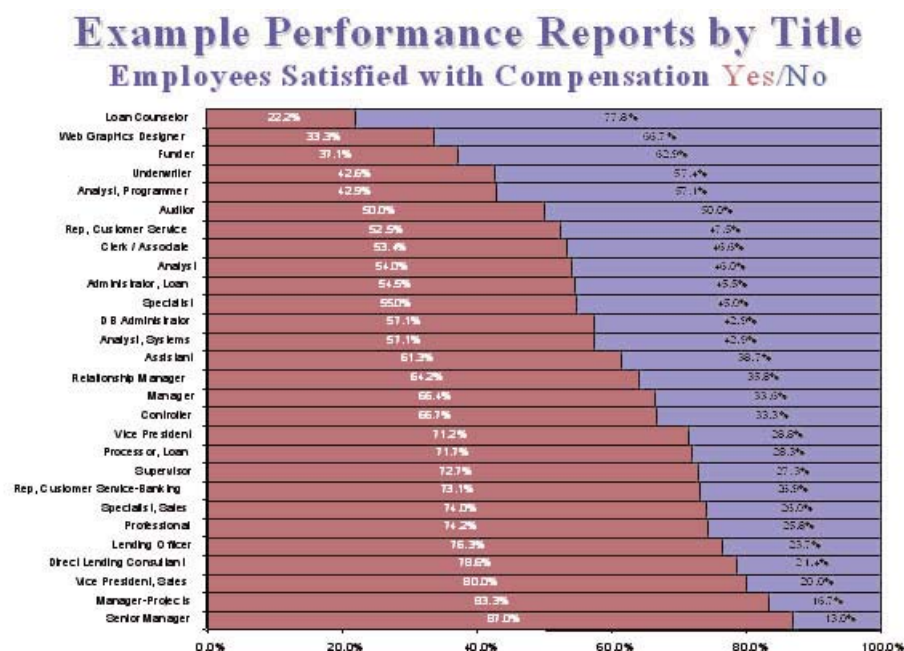
to 83.7%. However, the percentage of employees who rated above 80% went from 17.4% in year one to a high of 40.6% in year two (37.4% in year three, 39.4% in year four). While years two through four are not an apples-to-apples comparison, it is revealing to note that with opportunities to game the system almost eliminated, significantly more people reached high performer status.

CONCLUSION

Work remains to be done. A significantly higher percentage of VPs and managers to employees (32.9% vs. 19.9%) are rated in the 85% to 90% performance range. This suggests that these ratings are still skewed. However, the ability of the system to collect data on employee satisfaction with their compensation and its capacity for evaluating what works well and what needs improvement suggests that any remaining inequities can be corrected.

The key conclusions that are evident from the experience of the company in this case study include:

Figure 6



- Desktop-based programs such as Excel, while useful for individual productivity, are inadequate to manage a company-wide reward system.
- Inadequate management leads to the possibility of manipulation, a loss of confidence in the system by employees, poor compliance (participation) and the possibility of rewarding under-performers and failing to reward high performers.
- In fact, such a system can discourage high performers and lead to increased turnover
- Employees are assets, and low engagement and retention cost a company money
- A technology-based solution that emphasizes pay for performance, has standards, accountability, metrics, and transparency can drive high performance culture and increase retention

The competition for talent is too intense to leave compensation issues to be managed with out-of-date methods. By the same token, organizations must leverage the highest levels of performance from their talent. Today's sophisticated technology solutions help make pay for performance the new norm.

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PRESENTER

Jeff A. Higgins

**Executive Vice President, Workforce Planning
Countrywide Financial Corporation**

Mr. Higgins has led numerous HR initiatives to quantify human capital metrics that successfully turned HR data into predictive analytics to drive ROI and company strategy. In his roles at The Irvine Company and IndyMac Bank notable proj-

ects include turnover/retention drivers, high performer profiling, ROI of recruiting and sales force profiling, with ongoing work on cost-of-turnover and manager-effectiveness scorecard. Mr. Higgins is a former CFO with over 15 years in finance and accounting roles of increasing responsibility for companies such as, Johnson & Johnson, Baxter International and Colgate Palmolive. Jeff has presented his work at national HR metrics conferences and has been a member of the PricewaterhouseCoopers Saratoga Institute advisory council. Mr. Higgins graduated from Utah State University with majors in accounting, finance, and management information systems, and received his MBA from the University of Southern California.

MODERATOR

Joy Kosta

As Director of Talent Development and Leadership Communities at The Human Capital Institute, Joy brings twenty-five years of experience in multiple facets of organizational development, human resources and business management with an emphasis in customer satisfaction, service quality, process improvement, and applying the Malcolm Baldrige Criteria for Performance Excellence. As founder and President of Performance Partners in Health Care, a company dedicated to building better patient experiences, she has authored several curriculums in leadership and staff development, and co-authored with Harold Bursztajn, MD Senior Clinical Faculty member, Harvard Medical School, Building a Treatment Alliance with Patients and Families.

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