



An organization's compensation expense is an investment in talent, which requires a return, just like any other investment. Even though return on compensation (ROC) is harder to measure than the return on traditional capital investments, Sibson Consulting's experience with clients has shown that prioritized investments in talent produce better returns than homogenous or entitlement approaches. Organizations that mismanage their compensation programs will lower their ROC.

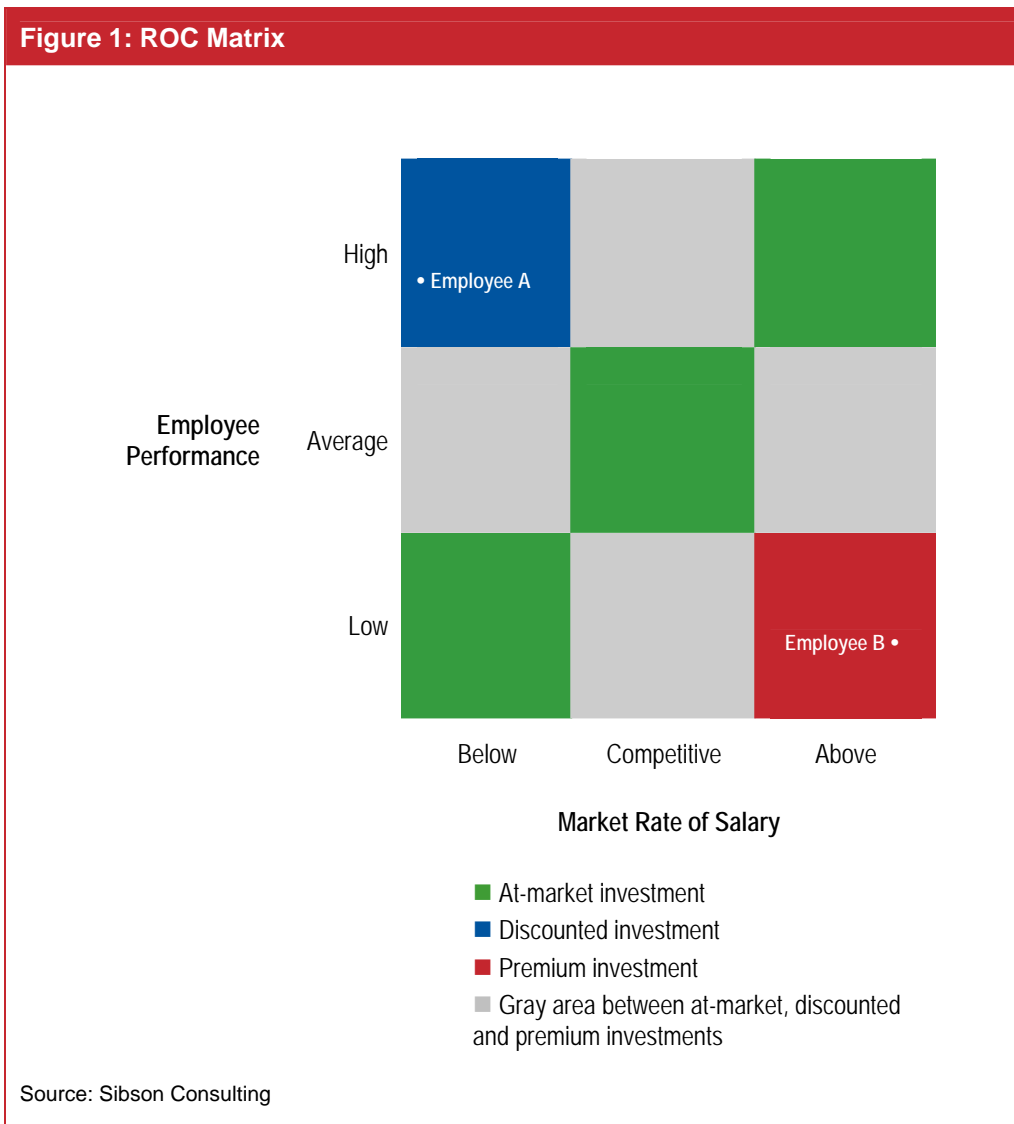
Despite their best intentions, organizations can make mistakes that sabotage their plans to improve their ROC on rewards for top-performing employees. These include the following seven mistakes, each of which is discussed in the article below:

1. Neglecting to benchmark pay practices,
2. Failing to align all the organization's goals,
3. Rewarding employees with limited pay-for-performance differentiation,
4. Accepting performance management data without calibrating it,
5. Avoiding transparency in the organization's pay system,
6. Moving too quickly, and
7. Failing to empower the organization's managers.

Neglecting to Benchmark Pay Practices

Organizations that have been giving only limited-to-modest raises in this difficult economy may not be diligently measuring where their pay stands relative to the market. As a result, they may be overpaying some employees, even though they are not giving large raises, or they may be underpaying some employees, which could cause valuable talent to leave.

Charting each employee on an ROC Matrix that compares employee performance to the market rate or benchmark for the employee's salary (see Figure 1 on the next page) will help determine how the organization is compensating its employees relative to the market. It will show whether each employee's compensation could be considered a discounted investment, an at-market investment or a premium investment. The organization can then use this information to make individual investment decisions regarding employee compensation.



Although most employees should fall in the green squares of the matrix, where their performance roughly equals the market rate of their salary, this is not always the case. For example, although Employee A in Figure 1 would be considered a discounted investment and Employee B would be considered a premium investment, neither position is necessarily wrong. The organization needs to take into account factors such as the employee’s compensation history, rate of advancement, leadership potential and other factors to determine if the person’s compensation investment is acceptable.

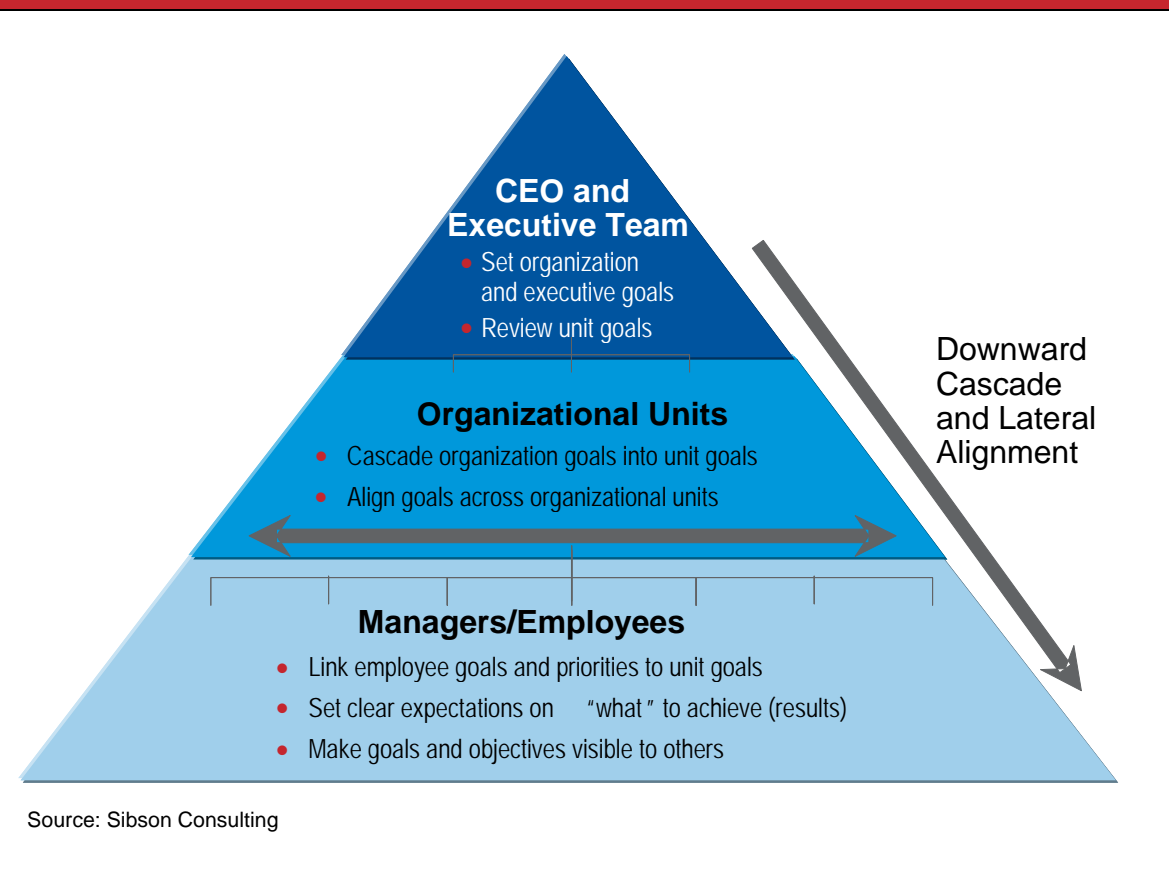
Also helpful is a compensation scorecard that tracks key metrics. It provides intelligence the organization can use to assess both pay program effectiveness and improvement over time. A business that creates a compensation scorecard is making a commitment to continually improve its pay programs. (See “The Compensation Scorecard: What Gets Measured Gets Done” (http://www.sibson.com/publications/perspectives/Volume_18_Issue_2/comp-scorecard.html) in the June 2010 issue of *Perspectives*.)

Failing to Align All the Organization's Goals

An organization's goals must be aligned so all its units, managers and employees are working individually and together to achieve results that have been established by the CEO and the executive team. If an organization's goals are not aligned, its various units, managers and employees will work to achieve goals that are probably not optimally focused on achieving the organization's objectives.

As shown in Figure 2, the CEO and the executive team set goals for the organization and its executives. It is up to each unit to determine what it must do to achieve those goals. The organization's various units then need to coordinate their goals to determine what must be done collectively. For example, if one of the organization's goals is to improve its talent management initiatives, HR, finance and other departments that would be affected need to determine what role each must play in achieving that goal. After unit goals have been aligned, the next step is to set the goals for the organization's managers and, finally, each individual employee.

Figure 2: Goal Alignment



Rewarding Employees with Limited Pay-for-Performance Differentiation

When it comes to rewarding performance, many organizations fall into a trap that Sibson consultants call the "peanut butter spread," where the rewards are spread thinly but evenly among everyone in the organization. If the organization's annual increase budget is 3 percent, everybody gets 3 percent. Although it is easy to administer and defend, the peanut butter spread does nothing to improve the organization's ROC. In order to make an investment, the organization has to prioritize who should get what and make difficult choices rather than taking the path of least resistance.

Although it may be difficult to differentiate when the salary increase budget is small, it is not impossible. One effective strategy, carving out dollars from salary increase budgets and incentive pools explicitly to reward high performers, leads to more effective investments in talent. (See “How to Use “Carve-Outs” to Truly Pay for Performance” (http://www.sibson.com/publications/perspectives/volume_19_issue_1/Carve-Outs.html) in the June 2011 issue of *Perspectives*.) Even with a modest salary budget, say 2.5 percent, if 0.5 percent is carved out for high performers, average performers get 2 percent, and if 25 percent of the population are high performers, they can get as much as 4.5 percent increases. The same concept holds true for funded bonus pools. When communicating reward decisions, allocations from the high-performer pools can be used as a tool to recognize top talent while managing the expectations of the broader workforce.

Accepting Performance Management Data Without Calibrating It

Calibration¹ guarantees the integrity of the data used to make reward decisions based on employees’ contributions (*i.e.*, pay for performance). In an organization without calibrated performance data, managers’ individual standards of performance may lead to inequitable ratings and pay investments, which lowers motivation.

In some organizations, calibration is handled by HR. What is more effective, however, is to have the organization’s leaders meet and calibrate the data themselves. The prospect of a leader trying to justify the position that there are “no poor performers” in his or her group is often enough to encourage employee differentiation. Formal performance management calibration sessions, within and between functions, will ensure that performance standards and ratings are applied consistently. (See “Harnessing the Power of the Group: The Case for Talent Calibration” (http://www.sibson.com/publications/perspectives/volume_16_issue_3/group.html) in the June 2008 issue of *Perspectives*.)

Avoiding Transparency in the Organization’s Pay System

Organizations that communicate a pay philosophy and the rationale for pay decisions and place appropriate context on how they arrive at individual decisions are more likely to have employees motivated by compensation than those that manage compensation in a “black box.” Sibson Consulting’s *Rewards of Work Study* (<http://www.sibson.com/publications-and-resources/surveys-studies/?id=1507>) shows that employees who are satisfied with their understanding of the compensation process, and believe decisions are fair, are substantially more satisfied with their compensation outcomes.

Employees are more accepting of pay decisions when they understand how they are made and believe that everyone in the organization is subject to the same system. Without transparency, employees tend to feel that their compensation is being controlled by their manager rather than by an organization-wide system. Employees are much more likely to accept an unfavorable outcome if they understand the process that determined that outcome, even if they disagree with it.

Moving Too Quickly

Organizations that want to enhance their ROC by improving how compensation drives employee motivation should recognize that change does not occur overnight. For best results, businesses need to slowly transition from legacy approaches to focus on execution. It is better to execute a few changes well than to implement broad changes poorly. Implementing a series of prioritized changes over several compensation cycles will give the business time to properly absorb change into the culture and produce the desired impact. It will also improve employee buy-in

¹ Calibration is the sharing and adjusting of decisions across a group, rather than allowing each manager to make decisions on his or her own.

for the compensation system. Moreover, any mistakes will be easier to correct before they become entrenched.

Too often, organizations with a vision for the future have an aggressive desire to implement change swiftly and with a heavy hand. When this occurs, program results often fail to match the rhetoric, further demotivating employees and challenging the organization's credibility.

Failing to Empower the Organization's Managers

Organizations that hold managers accountable for pay decisions also need to give them the training and tools they need to do the job effectively. In many cases, managers have only a pool of dollars and loose allocation guidelines, which can be confusing. The best compensation investments are made when managers can leverage all of the appropriate pay, performance and business planning data available throughout the organization. Giving them more sophisticated information will help them effectively allocate salary and incentive pools. This includes external market competitive benchmarks, internal average salary benchmarks, time in role/role history, performance rating history (*i.e.*, longer-term performance data), compensation history, depth of responsibility and role criticality, and talent scarcity assessments.²

Managers also need interpersonal and relationship skills training on how to have meaningful compensation conversations with employees and not just read a script. The goal is to be able to blend a business conversation with a performance management conversation to create a developmental conversation that clearly demonstrates what the employee needs to do to improve his or her compensation.

Conclusion

Organizations that want to improve their ROC by leveraging compensation to foster employee engagement and motivation can benefit from regularly reviewing their compensation practices. Even though ROC can be difficult to measure, organizations need to be aware of the many possible mistakes that can sabotage their ROC so they can take steps to avoid them.

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² Role criticality and talent scarcity assessments are workforce planning analytics that identify (1) those key roles that most influence organizational success and (2) those roles where talent is both difficult and costly to replace.