The Executive Handbook on Compensation

Linking Strategic Rewards to Business Performance

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CHAPTER 12

Assessing Variable Pay Readiness

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Many organizations with an interest in variable pay look to external benchmarking practices to determine whether a competitor's or admired company's program may be worth imitating in some fashion. The effectiveness of variable pay in any company will not be related to outside successes, but rather to the company's own culture and work environment. This chapter will help readers assess whether variable pay will improve business success in their current work culture, or, if not, what can be done to begin creating an improvement-oriented environment.

Why Companies Use Variable Pay

A recent survey by Hewitt Associates[1] indicated that 67 percent of companies have at least one broad-based variable pay plan. Spending on such a plan averages 7.8 percent, almost twice the annual merit increase level of 4 percent reported in the same survey. Companies are introducing variable pay programs for four primary reasons:

1. *To thank employees.* Some organizations introduce variable pay as a way to thank employees for their role in the company's success. Linking the individual's success to the company's success can send very positive signals to employees, but it does not generally create a behavioral change. In compensation terms, this is a bonus plan but not a motivational incentive. It may inspire "more of the same," but new attitudes or ideas are unlikely to be spawned by the program.
2. *To address pay equity.* Variable pay is often introduced because competitive market forces demand it. If the competition offers variable pay, a company intent on attracting and retaining the necessary talent must ante up to the market practice.

[1] Hewitt Associates LLC, *Salary Increase Survey Report,* 1997 and 1998.

Well-designed plans can motivate incremental performance improvement, but the genesis of these plans is market pressure, not improvement, and market forces may dictate payouts as much as any employee performance will.

3. *To reduce fixed salary costs.* The most popular reason for introducing variable pay is to take pressure off the base salary increase where it is the only reward mechanism. Base salary increases are expensive, and they are compounded each year. Variable pay, a one-time reward with no compounding effects, represents a wonderful financial solution; it ties fixed costs to expected long-term contributions, and variable costs to one-time accomplishments. The focus under these plans tends to be on individual performance. The plans make strides in reducing entitlement and tying the term of the reward to the term of the accomplishment, but they do little to improve business processes or support empowerment and teamwork.
4. *To create value/share gains.* According to a 1997 Hay Group survey,[2] the compensation programs that give the best return on the payroll invested, and are most accepted by employees, are gainsharing and group incentives. These programs often are developed to support process improvement and to pay out according to the productivity improvements or cost reductions attributed to employees' ideas and efforts. The programs are generally self-funded and have an expected net cost to the organization of $0. There is no entitlement or expectation. All gains and payouts are directly tied to improvements in business processes over which the employees have some control. The greatest variable pay successes have come in the area of gainsharing, which offers: (a) the largest return on invested payroll; (b) employee acceptance; (c) no entitlement; and (d) more positive work practices that provide for greater dignity and respect in the workplace.

In identifying the likelihood of a gainsharing success, it is important to consider management's future-state "behavioral" vision (behaviors and activities that the company would like to reward, encourage, and support), as well as the employees' current perceptions about work practices. When the employees' work practices are aligned with management's behavioral vision, gainsharing can generate enormous gains. To determine whether

[2] Hay Group, Hay Fall Conference Survey, 1997.

"Our Desired or Ideal Culture Would Reward, Encourage and Support the Following Behaviors and Activities..."

			Maximizing customer satisfaction. (#4)			
			Establishing new ventures or new lines of business. (#12)			
		Experimenting with new management techniques. (#5)	Delivering reliably on commitments to customers. (#13)	Demonstrating understanding of the customer's point of view. (#6)		
		Significantly decreasing cycle times. (#9)	Using limited resources effectively. (#15)	Using proven methods to serve existing markets. (#8)		
		Providing employees with resources to satisfy customers. (#10)	Selling successfully. (#16)	Maintaining existing customer accounts. (#11)		
	Encouraging teamwork. (#1)	Establishing clear, well-documented work processes. (#19)	Attracting top talent. (#21)	Maintaining a high sense of urgency. (#25)	Providing secure employment. (#3)	
	Pioneering new ways of doing things. (#24)	Treating employees fairly and consistently. (#22)	Capitalizing on windows of opportunity. (#27)	Using resources outside the company to get things done. (#33)	Being highly organized. (#7)	
Being flexible and adaptive in thinking and approach. (#14)	Tolerating well-meaning mistakes. (#29)	Rewarding superior performance. (#23)	Responding to customer feedback. (#30)	Building strategic alliances with other organizations. (#41)	Establishing clear job descriptions and requirements. (#26)	Supporting the decisions of one's boss. (#2)
Continuously improving operations. (#20)	Participating in training and continuing education. (#31)	Applying innovative technology to new situations. (#28)	Anticipating changes in the business environment. (#35)	Gaining the confidence of customers. (#46)	Limiting the downside of risks. (#32)	Promoting one's point of view strongly. (#17)
Capitalizing on creativity and innovation. (#34)	Encouraging innovation. (#40)	Increasing decision making speed. (#39)	Organizing jobs around capabilities of individuals. (#38)	Minimizing human error. (#52)	Quality checking subordinates' work. (#44)	Maintaining clear lines of authority and accountability. (#18)
Taking initiative. (#36)	Encouraging expression of diverse viewpoints. (#47)	Taking action despite uncertainty. (#43)	Adapting quickly to changes in the business environment. (#42)	Developing new products or services. (#54)	Minimizing unpredictability of business results. (#45)	Respecting the chain of command. (#37)
Pushing decision making to the lowest levels. (#51)	Finding novel ways to capitalize on employees' skills. (#53)	Being loyal and committed to the company. (#55)	Acquiring cross-functional knowledge and skills. (#49)	Achieving budgeted objectives. (#56)	Being precise. (#48)	Supporting top management decisions. (#50)

Extent to which company should reward, encourage, and support each attribute above

Very Frequently/To a Great Extent/ In Most Parts of the Organization — *Sometimes/To Some Extent/ In Some Parts of the Organization* — *Very Infrequently/To a Small Extent/ In Few Parts of the Organization*

Figure 12.1 Gainsharing target culture.

management's behavioral vision is consistent with a gainsharing culture, and whether the current work practices are aligned with that culture, a diagnostic chart modeled after Figure 12.1 on page 129 is recommended.

Defining the Gainsharing Target Culture

Hay Group research has identified 56 attributes (behaviors or activities) that define a work culture. Around these attributes, Hay built a cultural diagnostic called Target Culture Modeling℠, or the C-Sort. Each culture varies, depending on which attributes are encouraged and which are discouraged by the organization. The tool is generally used to better understand the current culture, articulate the future culture, and identify gaps between the current state and the future state. The C-Sort exercise involves senior management's working through a forced distribution of the 56 attributes (each on a small Post-it™ note) over seven columns, to reflect the frequency and extent to which the behavior/activity is demonstrated in the organization.

Figure 12.1 shows a representative target culture that would be supported with gainsharing. Note that there are no negative behaviors/activities. All of the attributes can be positive or negative, depending on how they support a company's business goals and environment. The key behaviors/activities supporting a gainsharing success are:

1. Being flexible and adaptive in thinking and approach.
2. Continuously improving operations.
3. Capitalizing on creativity and innovation.
4. Taking initiative.
5. Pushing decision making to the lowest levels.

These behaviors describe an empowered, adaptive, process-based work culture.

If an organization were to stress the following behaviors/activities, it would inhibit the success of gainsharing:

1. Supporting the decisions of one's boss.
2. Promoting one's point of view strongly.
3. Maintaining clear lines of authority and accountability.
4. Respecting the chain of command.
5. Supporting top management decisions.

These behaviors describe an authoritarian, functional work culture.

The behaviors/activities that senior management wants to reward, encourage, and support are key to predicting a gainsharing success. Not all companies will want to encourage the target cultural attributes identified in Figure 12.1; those in disagreement should explore alternative variable pay options. For companies that do target the gainsharing cultural attributes, the next step is for employees to complete an assessment of the company's current work practices, highlighting where the company should focus any specific change efforts.

Identifying Supportive Employee Work Practices

To determine whether current work practices are aligned with the behaviors of the gainsharing target culture, the following five questions should be answered:

1. *Is the organization focused?* The extent to which the organization has a clear business focus and consistent goals and direction will influence the success of a gainsharing program. Focused companies will often develop cascading goals, providing all employees with a "line of sight" to the key business drivers.
2. *Does the culture support team performance?* The degree to which the accomplishment of objectives is dependent on the integrated efforts among employees and departments will influence the success of the program. Companies do not need to place all employees on a team, but they can encourage all employees to direct their efforts toward improving business processes that transcend their individual area of accountability.
3. *Is the workforce empowered to initiate positive change?* The extent to which employees are encouraged to use their initiative to take actions, to take risks, and to suggest improvements will influence the success of the program.
4. *Is there a willingness and an ability to change?* Successful improvement efforts are dependent on trust and achievement motivation. The extent to which employees (a) trust the company and its management and supervision and (b) are more motivated by the desire to get the job done than by fear of making mistakes, will impact the success of the program.
5. *Do human resources programs support performance planning/measurement?* The effectiveness of measuring job performance and employees' view of the compensation arrangement as equitable and motivational will impact the success of the program.

Strong positive responses in these five areas should encourage the company to design an effective gainsharing program, regardless of any external benchmark findings. Nucor Steel provides a powerful example of a culture with work practices that support these five enablers. Gainsharing has been a key part of Nucor's culture; employees often see productivity-based payouts of up to 200 percent of base pay.

Supportive Work Practices Survey

To determine whether gainsharing is likely to result in a positive behavioral change for employees, the Hay Group has developed a Work Practices Survey comprised of 64 questions that relate to the five enablers described above. Companies choose a couple of questions from each of the enabler categories—a total of no more than 15 (to limit completion time to 10 minutes)—and distribute the survey to all employees who will potentially participate in the gainsharing program. Following are some excerpts from the survey. The numbers in parentheses indicate the percentages of respondents in the normative database who agree with the survey statement.

Business Focus Statements

- I know how my job can impact the company's financial results. (84%)
- I am adequately informed about how well the company is performing. (71%)

Companies that fall significantly below the survey norms should consider developing a system of cascading measures, or communicating how every employee in every department contributes to the success of the business. Companies above the norms should probably focus their efforts on one of the other enablers.

Team Dependence Statements

- Teamwork is very important to the company's success. (92%)
- This organization encourages cooperative efforts. (49%)

Companies that fall below the team dependence norms should de-emphasize organization charts and job descriptions and begin focusing on business processes and supporting-employees' roles. The creation of

superordinate goals may help to encourage cooperation and effect some immediate behavioral changes.

Empowerment Statements

- Management listens to my ideas for improving productivity/reducing costs. (37%)
- Decisions often made at a higher level could be better made at a lower level. (61%)

Companies struggling with empowerment must think through the roles of executives, supervisors, and associates in an empowered environment. Often, that means increased training levels with regard to coaching and feedback, presentation skills, meeting skills, and process improvement techniques. The empowerment experts at Ritz-Carlton have established 20 Ritz-Carlton Basics (rules for performance), but individuals are allowed great flexibility in interpreting and applying the basics to solve customer problems.

Willingness and Ability to Change Statements

- If I work harder, I will earn more at the company in the long run. (37%)

Not many companies have the level of trust and commitment they desire. Unlike the other areas surveyed, there are no clear tools to alleviate distrust. Rebuilding employee trust may take years. It is not accomplished with promises and edicts; it requires consistent fair dealings with employees, and an environment that respects the dignity and contributions of all employees. To foster this commitment, employees must be connected to a higher goal than accomplishing their job's objectives.

- I have a lot of ideas on how to improve productivity in my area. (62%)

Gainsharing is intended to motivate a behavioral change, and employees cannot be afraid of making that change. Ken Iverson, founder of Nucor Steel, taught his associates that more is learned by making a mistake than by getting it right, so "go out and make a mistake." Nucor employees are motivated to get the job done.

Human Resources Support Statements

- Supervisors/management lets me know if I'm doing a good job. (51%)
- I have a good understanding of how my performance is measured. (57%)
- The end results of my job are being effectively measured. (37%)

Individual performance management does not imply individual rewards. In a team environment, individual recognition will probably make three people unhappy for every person it makes happy. Although gainsharing is focused on group improvement, it must be built on an individual performance management system that encourages development of the skills and competencies necessary for long-term success and survival at the company. Gainsharing will reward business results, but the means to achieving those results will be associates' attaining more skills, asking for more responsibilities, and striving to develop the competencies that will drive long-term business success.

- Current pay practices strongly influence my activities on the job. (33%)

The enemy of effective pay programs is entitlement. Gainsharing programs typically have no target payout level. Only if employee efforts create a quantifiable performance gain will there be any sharing. Despite this stern warning and a target payout of $0, these programs pay out over $254/quarter, on average, and generate a 115 percent return on invested payroll for the company. Comparing a company's survey results to a normative database like the one above is an excellent way to obtain defensible, quantitative data on the areas the company needs to improve. But it is also important to understand the "hows" and "whys" behind the numbers. A successful assessment should therefore also include management and employee focus groups built around the findings of the C-Sort and Work Practices Survey. Management interviews should attempt to build consensus around the target culture and identify barriers to consensus. Employee focus groups should flesh out the reasons behind significant variations from the normative database.

Translating Readiness into Success

Effective gainsharing programs are not pay plans; they are tools for successfully integrating business focus, process improvement, continuous

communications, and rewards. Following are some guidelines for ensuring the success of a gainsharing program.

Business Focus

Translate return on investment. Employees need to be aware of what return on investment (ROI) means for the business, what factors drive ROI, and which of these factors they can impact. The gainsharing payout formula should include factors that drive ROI and are under employees' control, and should exclude any factors outside of the employees' control, regardless of their impact on the company's profitability. If employees do not see the link between their efforts and the payout, they will not change their behavior and the plan will not be successful.

Create more superordinate goals. All employees need to focus on what they can do to help the overall system excel. Companies should create more superordinate goals that challenge employees to work as a team and to improve larger, more integrated work processes. Companies must not give in to pressures for individual rewards that may suboptimize overall performance. Inevitably, there will be some "hard working" employees who may complain about "carrying the underperformers." In the gainsharing culture, this may mean that the "hard working" employees place some pressure on their underperforming peers, create a new process to improve performance, encourage additional training for the underperformer, or explore alternative areas where the underperformer may have a greater chance of success. The underperformers become everyone's problem.

Process Improvement

Develop improvement accountability. Not only must each employee have a line of sight to business success, but he or she must have accountability for improving the processes that are involved, and a mechanism for ensuring that improvement ideas are examined. As Jack Welch, CEO at General Electric, says, "The idea flow of the human spirit is absolutely unlimited. All you have to do is tap into that well."[3] Companies must establish involvement programs that capture and review every improvement idea.

[3] "How Jack Welch Runs GE," *Business Week,* June 8, 1998, p. 98.

Develop improvement know-how. Accountability for improvement does little good without knowledge of how to critically examine a problem, generate ideas, and evaluate and prioritize those ideas. Improvement training is often focused exclusively on the associates, but effective programs provide tools for all levels of the organization. Supervisors must learn more facilitative skills; coaching skills; and feedback, effective communications, and listening skills. Leaders must learn how to build a more informal and inclusive environment.

Continuous Communications

Communicate frequently. Employees must receive frequent communications on financial/operational successes, the status of their ideas, and the link between their ideas and business success. If the link between employee improvement ideas and business success is unclear, employee behavior will not change.

Create an integrated message. Gainsharing programs must seamlessly communicate the "what," "how," and "why" behind the expected changes and the program's success. Factors such as performance management dimensions (skills, competencies, behaviors), business measures (quality, productivity, schedule fulfillment, cost reduction), and process improvement techniques (Kaizen, Juran, quality circles, or Deming) must be developed in unison and presented to employees as an integrated program. Following is an illustration of this message:

- What are we trying to accomplish? Improved performance in key business drivers, and an understanding of what every employee can do to impact these drivers.
- How are we going to get there? By utilizing the improvement tools of the Kaizen program and training employees in the competencies that will result in increased contributions.
- Why will the company and its employees invest in these efforts? The results of these efforts will mean more profit for the company and more compensation to its employees.

Communicate the reasons behind the payout. Establish closer ties between employee improvement and the program's payout. More important than the payout is the reason for the payout—not "Productivity went up" or "Costs went down," but what employees did to help the business succeed.

Rewards

Gainsharing payouts must be self-funded and tied to (1) process improvements resulting from employee efforts, and (2) the positive behavioral change that motivated these efforts.

Gainsharing is not a pay plan. It should be viewed as "an employee involvement program that ties pay to improvements in total employee performance." The success of the program is based fundamentally on the ideas that employees have for improving processes, and the gains that these improvements generate. The pay element is a reinforcement tool; employees are fairly compensated for their incremental thoughts and energies.

Several years ago, a unionized division of a Fortune 100 company voted in favor of a one-year, quarterly gainsharing pilot plan by the narrowest of margins. The pilot plan went four quarters without a payout. At year-end, the union voted on whether to renew the gainsharing plan. The outcome? Surprisingly, the employees, by a wide margin, voted in favor of renewing the plan. Why? After the introduction of the gainsharing program, supervisors and managers seemed to pay more attention to the efforts and ideas of the employees. Despite the program's compensation shortfall, the work environment had significantly improved.

Conclusion

The role of variable pay will never be less significant than it is today. Variable pay plans may be effectively used to thank employees, address pay equity, reduce fixed cost, or create value/share gains. Each of these uses is defensible and can improve morale, but only one—create value/share gains—can affect and support a cultural change. To determine whether gainsharing will support the culture or the desired cultural shift, companies should identify management's future-state "behavioral" vision, as well as the employees' current perceptions about the work practices that support that vision. If gainsharing supports the desired changes, companies should dedicate themselves to developing a gainsharing program that successfully integrates business focus, process improvement, continuous communications, and rewards.