PAYING FOR PERFORMANCE

A Guide to Compensation Management

SECOND EDITION

EDITED BY
PETER T. CHINGOS
AND CONSULTANTS FROM
MERCER HUMAN RESOURCE CONSULTING, INC.

Paying for Performance

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and
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Introduction

Paying for Performance—Best Practices in a Changing Environment

Peter T. Chingos

When we published the first edition of *Paying for Performance* in 1997, the business climate was very different than it is today. At that time, the U.S. financial markets were in the midst of an unprecedented multiyear boom. Many established companies were delivering record profits, but perhaps more important, a myriad of "new economy" marvels were rewriting long-standing rules about the relationship between earnings and market value, the relative importance of growth and profitability, and the definition of what constitutes successful business performance. Since then, the air has escaped from the Internet bubble and both old and new economy companies have been forced to wrestle with more fundamental business issues, including the long-term implications of a possible global economic recession.

This cooler climate impacts every aspect of a company's business and results in some compelling questions about pay programs in general and the pay-for-performance philosophy in particular. What is the proper role of equity in a compensation program, for those in the executive suite as well as the general rank and file? How can companies differentiate between outstanding, average, and below-average performers and ensure that they retain their key employees even when overall company performance is below expectations? And what should our time horizons be for both individual and corporate performance assessments, as well as wealth creation over the course of an employee's career?

While the previous questions are hardly an exhaustive list, they demonstrate that "paying for performance" can be far more complicated than the straightforward term suggests, especially in a rapidly changing economic environment. Even though the "pay-for-performance" concept has become widely accepted in corporate America (few public companies today do not at least pay lip service to the idea in their annual proxy statements), many companies have also discovered that the devil is in the details. Simply doling out stock options at all levels of the organization is hardly an effective long-term approach, even if it does appear (on the surface, at least) to tie pay explicitly to performance. Given this complexity, my colleagues at Mercer Human Resource Consulting and I believe it is an appropriate time to revisit the issues that we raised in the first edition of *Paying for Performance,* to expand on certain key points, and to refine other key messages based on our collective learnings in recent years.

As the title suggests, the emphasis of this book is on reward systems and how those rewards are linked to individual, group, and overall company performance. It is important to note, however, that paying for performance is just one piece of a much larger puzzle—namely, how can an organization best manage all of its human capital in order to build and sustain a long-term competitive advantage.

The notion of human capital as an investment to be cultivated, as opposed to a bottomless resource that can be tapped on demand, represents one of the most significant shifts in business thinking in recent years. In boardrooms around the country, I have seen firsthand how it is has become increasingly accepted that human capital is just as important as the more traditional forms of financial and physical capital to the long-term success of any business. As economic conditions continue to shift, effective human capital management may become the single most important driver of long-term financial success and shareholder value creation.

Of course, paying for performance is just one factor in the human capital equation. While this book touches on other aspects of human capital management, such as performance and talent management, it is first and foremost a book about designing compensation programs in a pay-for-performance environment. As such, one of its primary goals is to provide a broad overview of all of the elements of an effective pay-for-performance system, with each chapter constituting a guide to one specific part of the whole. These chapters can be read sequentially or referenced individually as needed and are designed to provide readers with a thorough understanding of the various pay-for-performance tools at their disposal, the advantages and disadvantages of certain approaches, and the tax and accounting consequences associated with specific compensation vehicles.

While *Paying for Performance* is in one sense a handbook that describes the nuts and bolts of an effective pay-for-performance system, underlying each chapter is Mercer's collective experience regarding "best practices" among high-performing companies in this area. This collective wisdom, obtained through decades of consulting experience with many of the world's most successful companies, as well as specific research projects on the topic, makes *Paying for Performance* more than a mere primer. There is no single "right" or "best" way to institute any of the approaches discussed in this book, but there are certain guiding principles that nearly all high-performing companies follow, either explicitly or implicitly, when designing and implementing their pay programs. These principles represent our understanding of "best practices" in this area and can help ensure that any reward program is properly aligned with a company's overall business objectives, measures the appropriate performance factors, and delivers meaningful rewards that support desired behaviors.

BEST PRACTICES IN PAYING FOR PERFORMANCE

While all of the following chapters reflect the "best practices" of high-performing companies, I'd like to focus on several key themes that Mercer believes should form the foundation of any successful pay program. Most of these principles can be applied to the various topics addressed in the body of this book. While their actual implementation can (and in fact should) vary considerably from organization to organization, the principles themselves should not. In short, they are a roadmap to the design and implementation of an effective pay-for-performance system.

Vision

Before any organization can hope to develop a successful pay-for-performance program, it must have a vision. While this may sound simplistic, without such direction, it is difficult to even identify the type of performance one should reward, never mind link that performance to various elements of compensation. What would success look like? And how would we know it if we saw it? Before we can begin to answer these questions, we must know what the organization is trying to accomplish. Put another way, a clear corporate vision is the foundation on which all effective pay-for-performance systems are based.

What exactly do we mean by vision? Without getting bogged down in semantic definitions of "vision" versus "mission" versus "strategy," we can perhaps best describe it as a clear sense of purpose. To be an effective part of the pay-for-performance process, a corporate vision does not have to be memorialized in lucite "tombstones" or posted above every water cooler; however, it does have to represent a high-level understanding within the organization of where it would like to be next week, next month, next year, and beyond.

When such a vision exists, the remaining elements of an effective pay-for-performance program can begin to be put in place. Without it, even the best-designed program will drift aimlessly. It may occasionally drive the correct behavior, but it will most likely be by chance rather than by design.

Alignment

If a company's overall vision represents a destination, it still must figure out how to get from Point A (where it is today) to Point B (where it would like to be). Proper alignment of the pay program is critical because it helps ensure that the behaviors the organization is rewarding are the same behaviors that will help achieve the desired results. We often see companies become frustrated when, after spending significant resources rethinking their business strategy, they are not able to make that new vision a reality. Upon closer examination, however, it becomes clear that the behaviors the pay program rewards (either explicitly or implicitly) and the behaviors required to achieve the vision are very different.

Alignment, however, goes beyond simply identifying desired behaviors. It also requires proper *calibration* of compensation programs, to ensure that the levels of pay delivered are in line with the levels of performance that are actually achieved. Mercer's research into the compensation practices of high-performing companies reveals that most use some sort of *external validation* in their pay programs. Such external validation is often both retrospective, to assess how the company actually performed compared to its peers, and prospective, to ensure that performance targets include an appropriate degree of "stretch."

Consider a company that as part of its pay-for-performance philosophy provides highly leveraged annual incentive opportunities with maximum payouts equal to two or three times an employee's "target" award. Theoretically, the company should only be paying out the maximum bonus amount when actual performance is outstanding. But how outstanding is outstanding? By comparing performance targets to both the recent and expected performance of relevant peer companies, we can begin to determine if the plan's definition of superior performance is, in fact, superior. Without such external validation, a company with a stated pay-for-performance philosophy risks overpaying for mediocre performance or perhaps underpaying for exceptional performance. In either case, pay and performance are not properly aligned, making it much more difficult for the pay program to drive the appropriate behavior and for the company to achieve its stated vision.

A Holistic Approach

As mentioned earlier, pay is just one aspect of human capital management. While proper alignment of a company's pay programs is critical, other factors in the human capital equation must not be overlooked. Even more important, however, they cannot be managed discretely. Effective human capital management requires a holistic reward strategy that links pay programs, benefits, and career opportunities and understands the relationships between these various reward components.

Mercer's human capital framework recognizes several elements that go beyond traditional compensation and benefits programs, including people, work processes, management structure, information and knowledge, and decision making. By understanding the role that each of these diverse elements plays in executing the overall business strategy, one can begin to develop an optimal rewards mix that motivates, develops, and drives an organization's talent as efficiently and effectively as possible. Such a holistic approach to reward strategy, in conjunction with a robust pay-for-performance program, can have a significant impact on both human capital decisions and overall business results.

CEO Commitment

Even a properly aligned, holistic rewards program will disappoint if it lacks commitment from the highest levels of the organization. When a CEO demonstrates, in both words and deeds, that he or she is truly committed to a pay-for-performance philosophy, that sense of commitment will cascade throughout the organization. If the CEO is not personally committed to the program, and his or her actions do not support its stated objectives (e.g., by not including senior executives in the same rigorous performance management process used at lower organizational levels), employees will quickly come to believe—and rightly so—that any talk about "paying for performance" is more about style than substance.

How do CEOs at high-performing companies demonstrate commitment to a pay-for-performance compensation philosophy? They begin by identifying and communicating the highest standards of excellence, not just on the basis of historical performance, but also on the basis of achieving breakthrough levels of performance in both financial and nonfinancial terms. When CEOs take the lead in identifying and communicating performance criteria, there is a clear understanding of how the organization will measure success and how specific individuals can contribute to that success.

An equally important element of CEO commitment is the CEO's willingness to drive change throughout the organization. As organizations continue to reposition themselves in light of changing economic realities, CEOs are spending more and more time on the performance management process, personally setting goals and evaluating performance for those who will carry out the new strategy. Importantly, this personal involvement is not limited to the CEO's half-dozen direct reports but extends to a broader group of executives and delivers a clear message to those executives that a rigorous performance management process is critical to the company's success. Those executives, in turn, can then drive that message even deeper into the organization.

Accountability

Personal accountability is in many ways the hallmark of an effective pay-for-performance program. A well-aligned program with a rigorous performance evaluation process means nothing if, at the end of the year, individuals are not held accountable for meeting agreed-upon goals.

Traditionally, a strong sense of accountability has meant that "the numbers tell the story." At the beginning of each performance period, companies set specific financial targets that support their overall business objectives. At the end of each period, actual performance is evaluated against the original target and individuals are held accountable for their performance through compensation and future career opportunities. While this notion of "black and white" results is common (numeric targets are either met or they are not), we increasingly see high-performing companies recognizing that shades of gray can also exist without sacrificing accountability.

One approach that is becoming more common is the use of nonfinancial measures in incentive plans. This can take the shape of a formal "balanced scorecard" in which performance is evaluated in specific areas such as financial results, people management, customer satisfaction, and intellectual capital development, or it can simply involve basing a portion of an annual incentive award on nonfinancial criteria such as quality or diversity. In either case, the measures remain quantitative, but they give a more appropriate picture of overall performance than rigidly adhering to a single financial metric such as earnings per share.

A second way some leading companies are moderating their approach to accountability is to continue to set specific, measurable targets in a variety of areas, but to refrain from attaching specific payout formulas and weightings to the various goals. Instead, they assess the various factors retrospectively, in light of the actual market conditions that existed over the course of the performance period. One company we have worked with describes it quite succinctly as a "qualitative assessment of quantitative performance."

To be effective, accountability does not have to mean rigid inflexibility, in which missing a target by one unit or 0.1% results in zero reward, regardless of any extenuating circumstances; however, there does have to be a clear cause-and-effect relationship between results and rewards. Strong performance should be rewarded; poor performance should not.

Balance

One of the most challenging aspects of any pay-for-performance program is striking the right balance among various compensation elements and performance measures. As organizations grow and become increasingly complex, their multiple objectives are not always compatible. In the short term, many companies believe that meeting or exceeding Wall Street's earnings per share (EPS) expectations each quarter is critical. But how can they balance that short-term focus with a long-term need for sustainable growth, some of which may require investments that will actually reduce short-term earnings? A clearly defined vision can help settle some of these differences, but tension inevitably exists.

When a company says it pays for performance, what type of performance is it talking about? Absolute performance? Or relative? If our share price rises 20% in a year in which our leading competitors all rise 30%, are we doing well or not? If our share price falls by less than the market average, is that cause for celebration? And more important, should our employees be rewarded for "beating" the market, even though our company as a whole is worth less than it was at the beginning of the year?

Similar issues exist in other areas as well. Over what time periods should we evaluate performance? While annual incentive plans are commonplace, many high-performing companies also have multiyear plans to ensure that key executives do not lose sight of their longer-term objectives. And what about the balance between cash compensation and equity? An over-reliance on equity can produce unintended consequences, such as retention difficulties in a declining market.

No single approach is properly "balanced" for every company or business situation, but the rationale behind the development of a holistic rewards program applies here as well. When evaluating any pay program, you must understand how the various pieces fit together and the types of behavior they will reward. If the pay program seems to support conflicting objectives, the correct balance has likely not been achieved.

Rewarding Top Performers

Another delicate balancing act involves rewarding top individual performers when the company as a whole is not doing well. While it may be tempting to argue that no single person should receive a substantial reward if some baseline level of organizational performance is not achieved, such an approach can be painfully shortsighted. When an organization is not performing well, the top performers of today are the ones who will drive overall performance improvements in the future. Failure to deliver rewards to top performers in difficult times can result in retention problems that exacerbate the problem even further, because those top performers are most likely to be coveted by the company's competitors as well.

In recent interviews with approximately two dozen Fortune 100 executives, all of them said that their companies have the ability to recognize top performers when company or business unit performance is below expectations. The actual approaches vary considerably from company to company (e.g., special grants of stock options, restricted stock awards, cash payments), but they universally recognize the need to reward top performers, regardless of overall business conditions.

In the chapters that follow, we discuss the various aspects of an effective pay-for-performance program in more detail. Many of these chapters will also expand on one or more of the aforementioned "best practices," and discuss how they can be applied to specific case studies or other real-world situations. Each chapter can be read as a self-contained overview of a specific topic, with the overall intent being to provide useful information on a broad range of issues related to people, performance, and rewards.