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Leah Carlson Shepherd

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Tying bonuses and other rewards to employee performance isn't a new idea, but more employers are relying on this strategy and finding innovative ways to tailor these programs to company needs, experts say.

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Ravin Jesuthasan, managing principal at Towers Perrin, says variable pay "is accelerating in a big way," and more new hires are "buying into the idea."

Jason Kovac, compensation practice leader at WorldatWork, an association for HR pros, expects this trend to continue, filtering down to middle managers, partly because it gives firms more leverage to influence employee behavior.

Performance-based pay, or variable pay, is taking unique twists, too. Jesuthasan has seen more companies with programs to award equity grants or noncash rewards based on performance, sometimes handing out their own products or a partner's products. Other companies use extra time off as the reward for top-notch performance, perhaps closing a manufacturing plant or an office if a team meets its targets.

At least 80% of organizations offered a variable pay program last year, according to Hewitt Associates. Company spending on variable pay as a percentage of payroll was 11.2% in 2006. It is projected to remain steady at 11% this year.

"The majority of companies have realized that only through performance-based awards can an organization effectively motivate and reward employees for helping achieve their goals. Variable pay plans, as opposed to holiday bonuses, clearly connect employees to company performance," says Ken Abosch, a consulting business leader for Hewitt Associates. About 45% of employers use spot bonuses, while 20% use group incentives and 18% offer a bonus at a milestone, such as a project completion, according to WorldatWork.

Variable pay programs are helping productivity, retention and morale, Kovac notes. The reward could be linked to sales, customer service ratings, Web traffic or any quantifiable factor that's important to the company.

"Companies are trying to customize what's going to work in their culture and their employee population," says Linda Amuso, senior vice president at Radford Surveys & Consulting, a San Jose-based business unit of Aon Consulting. "These programs are most effective within a strong performance-management culture. It's very contingent on very strong line managers and the ability to set goals and measure goals objectively."

Unions used to oppose variable pay, favoring a more egalitarian system, Jesuthasan says, but their mindset is gradually changing. Unions are starting to help manage performance, define success and measure it, he notes.

Downsides

Variable pay programs do have drawbacks. "The biggest challenge is if the company doesn't meet its goals, and employees have worked hard and put their all in," Amuso comments.

The variable pay program could cost more than anticipated, especially if the performance bar is too low, Kovac warns. Employers could face discrimination lawsuits if the program favors certain groups. Kovac recommends having documentation to show that any differentiation in pay or rewards is based solely on performance.

First-hand experience

American Express has a long history of using performance-based rewards, including management bonuses, sales incentives, spot bonuses and other informal rewards. Jose Irizarry, vice president of compensation for American Express, notes, "The difference [in pay] between our highest performers and our meet-expectations performers is sometimes three times or greater."

This has been an effective tool for the company. "We have an exceptionally high rate of retention for our top performers," Irizarry comments. "We like what we see organizationally from a financial perspective." He feels it works well within the company's results-oriented culture. Sometimes goals must be adjusted midstream to account for unexpected external events that affect the company, and flexibility is needed.

Employees generally like performance-based bonuses, and the level of employee satisfaction registered in employee surveys continues to rise, he observes.

Advice for employers

If workers feel the rewards depend on managers' subjective preferences, a variable pay program could kill morale. Amuso advises companies to train managers on setting proper goals and having objective measures.

Kovac recommends making the reward meaningful enough to spark behavior change. If it's too low, employers won't see results. If it's too high, employers will be wasting money. The amount needed for motivation could be different for various groups, depending on income, age, job responsibilities or other factors.

Irizarry recommends being clear about the top two priorities or goals because "if everything's important, nothing's important." The impetus must come from senior managers to be effective. "HR can facilitate it, can't lead it," he says. - L.C.S.