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# putting pay for performance into practice

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With merit budgets hovering around 4 percent and inflation in the 3-percent range, it remains common practice to offer a base pay increase to nearly everyone. Survey evidence suggests that companies generally give larger increases to good performers, but is the difference sufficiently meaningful to motivate truly great performance? Providing meaningful distinction for salary increases between better and poorer performers continues to be an ongoing challenge. Using survey data gathered from technology and life-sciences organizations, as detailed in this article, can help uncover current practices and ultimately provide answers for the future of pay for performance.

**QUICK LOOK**

- Overall findings indicate that companies allocated 3.9 percent of payroll to merit increases and an average of 1.1 percent to promotion/adjustment funds.
- In terms of the company size, companies using four- and five-rating systems provided nearly the same increases, regardless of full-time employee headcount.
- Companies using forced ranking performance-evaluation systems appear to have more confidence in their identification of top performers and more aggressively reward those individuals with significantly larger increases.

## Current Practices

With global competition and scarce resources to allocate, compensation practitioners should be directing merit-increase dollars toward those who truly do perform well. What can be learned from current pay-for-performance practices? The *Q1 2007 Radford Quarterly Summary of Industry Trends* (QSIT) survey asked 737 participating U.S. technology and life-sciences organizations to disclose their current and last fiscal year's pay-increase budgets, the number of rating levels used to evaluate employee performance, the use of uncontrolled or forced distribution of ratings and the average salary increase granted to employees in each performance rating category.

By analyzing data from this survey, one can address the following questions:

- Are companies effectively directing larger pay increases toward top performers?
- Does the performance evaluation process and rating scheme contribute to salary-increase differentiation?
- Do companies in specific industries, or of specific size, do a better job recognizing top contributors than other firms?
- Is there a correlation between pay-increase practices and company performance?

The overall findings indicate that companies allocated 3.9 percent of payroll to merit increases and an average of 1.1 percent for promotion/adjustment funds (at a subset of companies) for an overall allocation of 4.6 percent of payroll toward all base salary increases in the current fiscal year.

While most technology-based companies have a performance review process in place, a small number of companies (approaching 5 percent) do not use formal performance ratings, opting to have conversations with employees about performance that do not link results to a specific rating. Some predict that this approach will catch on among companies with an established and tenured workforce, where performance generally doesn't vary significantly from year to year, and the benefits of providing employees with a specific rating do not outweigh the management costs associated with evaluating performance.

Among the companies in the Radford QSIT survey, 84 percent (541 out of 642) reported a performance rating scheme with three, four or five ratings. Companies with six or more ratings, a pass/fail system or no rating are not included in the following analysis because linking pay to performance in those situations is more subjective and not necessarily reflective of industry norms. Of the three most prevalent performance rating systems, 103 companies used three ratings (19 percent), 150 companies used four ratings (28 percent) and 288 companies used five ratings (53 percent).

Analyses of each of these groups reflect a solid bell-curve distribution of ratings and a clear correlation between performance rating and percentage of base salary increase given. The lowest-rated performers averaged increases of less than 1 percent of salary. What is noteworthy is that regardless of the number of ratings, the average increase awarded to those receiving the highest rating was about the same, 5.8 percent. (See Figure 1.)

While one could say that the different rating systems treat top employees similarly, it is interesting to note that companies with more performance

**FIGURE 1: THE CORRELATION BETWEEN PERFORMANCE RATING AND % OF BASE PAY SALARY**

| | Rating system: | 3 ratings | 4 ratings | 5 ratings |
|---|---|---|---|---|
| Percent of companies using | | 19% | 28% | 53% |
| Average salary increase given to highest-rated performers | | 5.7% | 5.9% | 5.8% |
| Percent of employees in each rating | Rating 1 (best) | 20% | 15% | 9% |
| | Rating 2 | 71% | 50% | 33% |
| | Rating 3 | 9% | 31% | 48% |
| | Rating 4 | | 4% | 8% |
| | Rating 5 (worst) | | | 3% |

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**FIGURE 2: CRITERIA USED TO DETERMINE EMPLOYEE PERFORMANCE-RATING DISTRIBUTION**

| Criteria for Performance Rating Distribution (Number of Companies) | % of Companies Using Each Approach | % of Employees Receiving Highest of Three Ratings | % of Employees Receiving Highest of Four Ratings | % of Employees Receiving Highest of Five Ratings |
|---|---|---|---|---|
| No target or guideline used | 46% (303) | 22% (40) | 17% (48) | 9% (99) |
| Recommended/loose target | 35% (233) | 19% (33) | 15% (59) | 8% (120) |
| Specific distribution ratings or limited use of top rating | 11% (71) | 19% (12) | 13% (21) | 9% (32) |
| Forced ranking process (used for some or all jobs) | 10% (58) | 19% (13) | 14% (14) | 11% (27) |

It appears that the notion of pay for performance—as evidenced by larger salary increases to those with better performance ratings—is in fact being widely used among technology and life-sciences companies.

ratings in their scale limit the top rating to a smaller percentage of employees. Therefore, while the top-rated performers are compensated equally with increases averaging 5.8 percent, the percentage of employees receiving this figure widely varies.

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The first question for individual companies to ask is, "Do we give larger pay increases to our better-performing employees?" However, the follow-up question is even more important: "If we want to strengthen our commitment to pay for performance in base salary administration, is there a benefit to using a particular approach to performance rating management?"

To answer this second question, it is necessary to explore the findings from a few different perspectives. It is apparent that companies with more performance rating levels give the highest rating to a smaller percentage of employees than do companies with evaluation systems containing fewer rating choices.

However, if truly differentiated pay-for-performance policies were actively followed, one would expect larger percentage increases for the highest-rated performers in companies with more rating choices since such increases are given to a smaller percentage of employees. Instead, 9 percent of employees average 5.8-percent increases at companies with five ratings, while 20 percent of employees average 5.7-percent increases at companies with three ratings. While the top-tier performers (the top 9 percent) at companies with three ratings (where 20 percent received the highest rating) may be getting larger increases than the same percentage of employees at companies with five ratings, this would mean the other 11 percent are receiving a smaller raise to allow the average for the whole 20 percent to be 5.7 percent.

Companies with the five-tier system—who should be in a better position to identify the top performers—apparently are not rewarding top performers any better (and potentially not as well) than companies whose performance rating system only identifies the top 20 percent of employees. If the granularity of the rating system doesn't significantly impact the pay of identified top performers, is it worth the effort to classify employees using five ratings instead of only three?

The analysis sought differences in pay-increase practices according to demographic differences among participating companies. Surprisingly, there is little to distinguish the findings across ownership or company size. The 395 public companies in the survey who provided an average 4-percent

merit budget this year reported average merit increases of 5.7 percent to top performers measured using three ratings, an average 5.9 percent at the companies with four ratings and an average 6.1 percent at companies with five ratings. These figures are not significantly different from the findings for the 182 private companies who also had an average 4-percent merit budget. The private companies using three ratings provided an average increase of 6.1 percent to top performers, with a 6-percent increase when a four-level rating scheme is used and an increase of 5.6 percent when five ratings were used. The distribution of ratings was also similar in these groups.

In terms of the company size, companies using four- and five-rating systems provided nearly the same increases, regardless of full-time employee headcount. Another analysis was completed, looking at public company financial performance. It also failed to show significant differences. Companies with Total Shareholder Return (TSR) of at least 30 percent during the last three years reported an average merit budget for the current fiscal year at 3.9 percent, compared to 4 percent for those with negative TSR. Top ratings were distributed to approximately the same percentages of the population reported above and with the same general pattern—large pay increases given to smaller populations, where more ratings are used to rate performance.

## Does Process Matter?

What can a company do if it wants to improve the relationship between size of base pay increase and performance rating? Does the degree of freedom given to managers in assigning the ratings make a difference? This is the question of structured versus unstructured distribution guidelines. More formality may limit the percentage of employees receiving a certain rating and may even require a discussion among management to identify top performers.

Survey respondents were asked to identify the criteria used to determine the employee performance-rating distribution. Responses in the left column of Figure 2 on page 41 reveal that nearly half (46 percent) of companies do not target any specific rating distribution, a third (35 percent) offer a guideline or target distribution and the remaining firms require some level of increased scrutiny in the process.

Does the use of a particular rating distribution approach alter the percentage of employees deemed top performers? While one might expect a forced-ranking system to result in fewer employees receiving the highest rating, it does not. Figure 3 shows that the percentage of employees in each rating bucket is about the same, regardless of the rigor applied to determining who gets each rating.

Figure 3 shows that companies using a forced-ranking process—a minority of just 10 percent of companies in the study—awarded larger increases to top-rated employees than did companies with less stringent performance rating distribution guidelines. This was more significant among companies with four or five ratings.

It appears that the companies that go through the process of a forced ranking to identify top performers do a better job differentiating the awards

**FIGURE 3: AVERAGE MERIT INCREASE AWARDED, SEGMENTED BY NUMBER OF RATINGS (%)**

| Criteria for Performance Rating Distribution (Number of Companies) | Employees Receiving Highest of Three Ratings | Employees Receiving Highest of Four Ratings | Employees Receiving Highest of Five Ratings |
|---|---|---|---|
| No target or guideline used | 5.8% (40) | 5.7% (48) | 5.1% (99) |
| Recommended/loose target | 5.9% (33) | 5.7% (59) | 5.9% (120) |
| Specific distribution ratings Limited use of top rating | 5.5% (12) | 5.9% (21) | 6.3% (32) |
| Forced-ranking process (used for some or all jobs) | 4.9% (13) | 7.3% (14) | 7% (27) |

It appears that the companies that go through the process of a forced ranking to identify top performers do a better job differentiating the awards given to those employees than the companies using a less formal process to identify top performers.

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given to those employees than the companies using a less formal process to identify top performers. Regardless of the process used, the percentage of employees rated highest remained about the same.

Perhaps because the process is more thoughtful and time consuming, forced-ranking companies appear to have more confidence in their identification of top performers and more aggressively reward those individuals with significantly larger increases. Perhaps these companies simply embrace the concept of pay for performance to a higher degree than those which apply fewer rigors to their rating process.

Whatever the reason, it is clear that even though the process of forced ranking did not single out a smaller percentage of employees for a top rating nor significantly alter the percentages of employees receiving other ratings, it did result in more meaningful pay increases to top employees than those received by their high-performing peers under different evaluation procedures.

## Conclusion

This analysis of survey findings makes it evident that companies do give larger salary increases to better-performing employees. The survey found similar practices regardless of the number of performance levels used, and results did not significantly vary based on company size or financial performance. However, as the number of performance ratings increase, companies limit the top rating to a smaller percentage of employees.

With the exception of the small percentage of companies using a forced-ranking process, companies using a like number of ratings generally gave similar sized salary increases to the same percentage of employees regardless of the method used to determine which employees fall into each rating category. Although not controlled as a variable in this study, the average merit-increase budget was essentially the same for companies in each of the groups analyzed in this pay-for-performance correlation analysis.

If companies are serious about improving the relationship between pay increases and top performance rating, implementing a forced-ranking system may provide the discipline to do so. For those less inclined to actually implement forced ranking, or for those who have tried and failed to persuade managers to shift money to better performers in more subtle ways, perhaps a layered budget approach is an alternative to consider. WS

### RESOURCES PLUS

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### EDITOR'S NOTE

**For a detailed explanation of the layered budget, go to www.worldatwork.org/workspan to find out if this approach can help your company improve your pay-for-performance process.**