Aligning Employee Performance to Business Outcomes

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Aligning Employee Performance to Business Outcomes

When performance management programs that emphasize pay-for-performance are effectively designed and managed, they can be a competitive business advantage. The process of creating programs that align employee performance to business outcomes needs to be collaborative with all stakeholders impacted for the solution to be effective. (See ERI Distance Learning Center course #75, Creating a Variable Pay Plan, and #77, Pay for Performance, for more information.)

Business case for performance management program

Effectively designed performance management is intended to be a process that has a number of purposes:

Goal Setting:
- A 12 month period is generally used to set individual goals aligned to team, department, business, and corporates objectives; it may also require "course correction" if goals need to be adjusted based on actual performance or unique circumstances.

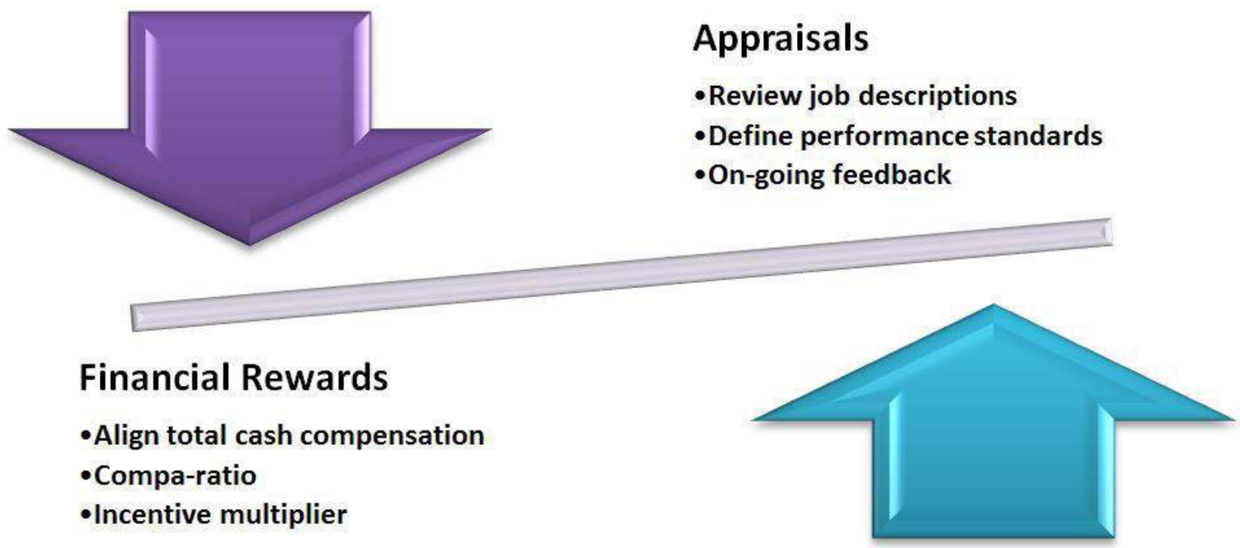
Coaching/ Mentoring/ Development:
- Throughout the year, at key milestones for each goal, observing behaviors and performance can serve as a basis for coaching, mentoring, and development feedback.

Knowledge Sharing /Best Practices:
- While having on-going conversations about progress towards annual goal achievement, best practices are identified and knowledge is shared with peers, other departments, and business units.

Performance Improvement:
- When performance expectations are not met, a well-designed performance management program provides for a fair and supportive process to correct individual performance, identify root causes to performance issues, and lead to employee retention or termination.

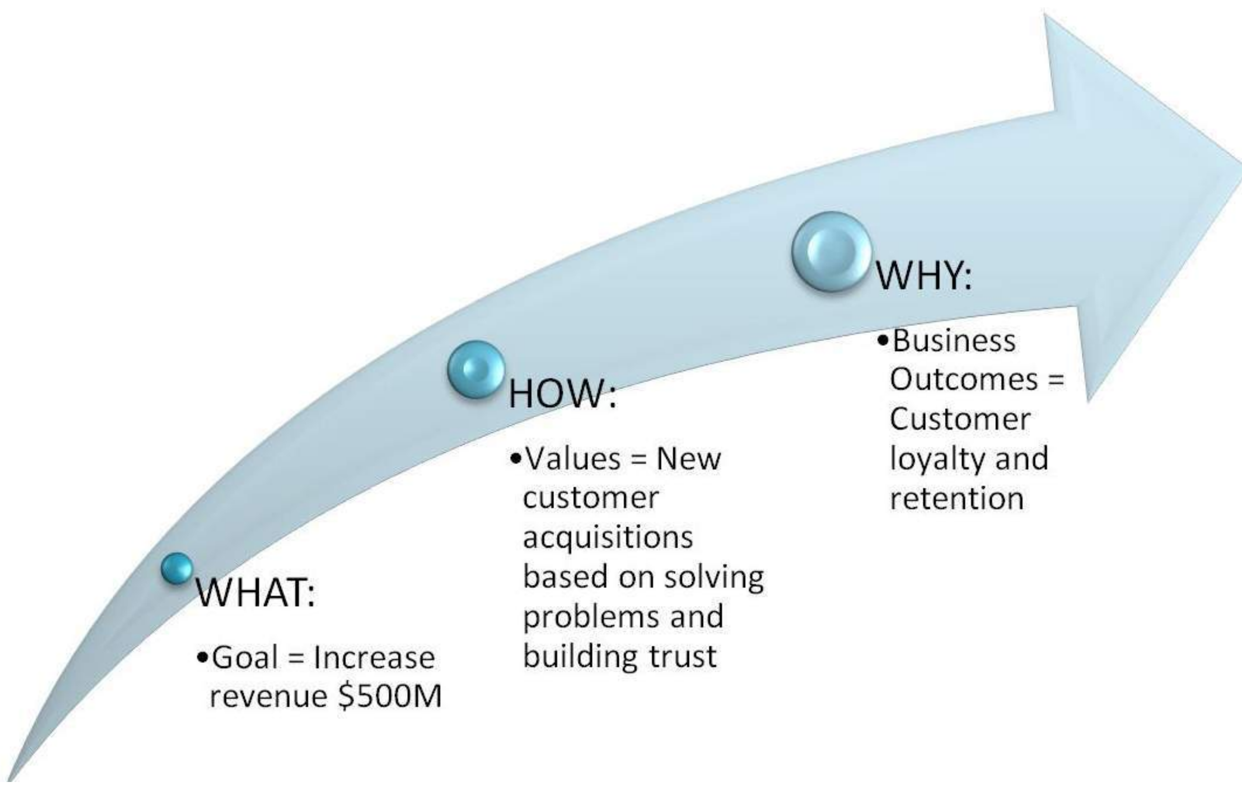
Process overview

There are two essential elements to performance management. First is a fair and objective appraisal system, which is the basis to evaluate performance. Establishing a credible appraisal method requires accurate and insightful job descriptions, identifying performance standards that drive business outcomes, and an engaging process that provides on-going feedback. The second element is effectively aligning rewards decisions to the appraisals, beginning with financial rewards such as total cash compensation, which includes base salaries and short-term incentive plans (STIPs). There are specific analytical tools that enable financial alignment. For base salaries, a compa-ratio, defined as the current incumbent salary over the salary range midpoint, is a useful ratio that measures the degree of market and internal alignment for similarly valued jobs in the organization. For an STIP, an incentive multiplier is a common feature used for adjusting payouts to align with performance.



Appraisals: Define good performance

Organizations that focus on sustainable performance define good performance by integrating company values with expected behaviors for employees to accomplish their goals. Establishing congruence between values and business outcomes can be a strategic advantage in fostering a positive organization culture and rewarding the right behaviors. To define performance standards, follow a simple framework that explains the what, how, and why of good performance standards. Consider the following example:



Start by selecting measures that directly correlate to business outcomes and establishing a baseline for those measures. This requires well-developed measures aligned with a set of benchmark activities that demonstrate performance and allow for appropriate comparisons throughout the organization. Commonly used performance measures focus on quality, quantity, responsiveness, and cost-effectiveness. To create a line of sight for individual employees and embed this into the culture, how a job is defined in the job descriptions is a critical starting point. (See ERI online course #33, Conducting Job Analysis, and a recent blog, Job Descriptions: Start with a Baseline, for more insight.)

Step 1. Review the job description

A well written job description tells you the important performance measures for the job. The job description should include the duties required and the purpose of those duties.

Step 2. Define performance

Define how well the duties must be performed in terms of related accomplishments or outcomes to represent acceptable performance and associated behaviors. Select objective measures that focus on specific accomplishments or outcomes, *not* the actual duties. The measures may be financial or non-financial. Depending upon the type of appraisal or measurement system used, evaluations may be performed in a number of ways:

- employee-supervisor conferences
- analysis of records
- cross-functional or global teams
- work measurement

Here are two examples of performance measures commonly used in organizations:

Customer Centricity – Use a customer satisfaction survey to evaluate this measure and define duties:

- Actively listen to customers concerns to understand their needs.
- Identify appropriate products/services to resolve customer business needs.
- Communicate in a timely manner with appropriate and accurate information.

Teamwork – Use 360-degree feedback to evaluate this measure and define duties:

- Demonstrate a positive, flexible approach while leveraging resources and relationships to complete assigned responsibilities.
- Actively participate in support of team members and overall team outcomes.
- Share knowledge of procedures, resources, and insights with other members of the team.

Differentiate performance

Managers can identify employees who are doing an outstanding job and those doing a poor job. Making distinctions in the middle is difficult. The book Rise of HR by Linda Hill from Harvard business school explains in the Talent Optimization chapter how all employees potentially have a "slice of genius" which is facilitated by effective business leaders who harness talent to achieve breakthrough innovation. Organization cultures are optimizing the contributions of the middle 70% of employees by encouraging more collaboration, while also adapting to the personal styles of employees so that they can be more engaged.

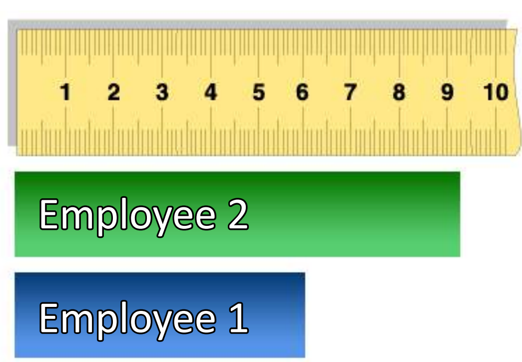
Rating scales

Individuals, teams, business units, departments, and organizations want to know how well they performed. Most organizations use rating scales as a basis for appraisals, which result in distinct performance ratings for each employee. With proper training, translation, and application, the use of more ratings allows for better alignment to individual performance levels given the inherent variability of employee performance.

Below is an example of a five point rating scale:

5 pts *Consistently Exceeds Expectations*	*4 pts* *Often Exceeds Expectations*	*3 pts* *Meets Expectations*	*2 pts* *Some Improvement Needed*	*1 pt* *Major Improvement Needed*
• *Employee displays initiative and self-direction at all times and a consistently high level of skills, abilities, initiative, and productivity. All responsibilities are completed exceeding expectation.*	• *Displays a high level of skills, abilities, initiative, and productivity, exceeding requirements in some areas, while consistently meeting expectations in remaining areas.*	• *Displays and maintains an effective and consistent level of performance. Work output regularly achieves required outcomes. Problems are reported and corrected quickly.*	• *Displays inconsistency in the performance and output frequently falls below acceptable levels. Tasks are incomplete, with serious or potentially serious consequences.*	• *Output is consistently low, regularly fails to meet required outcomes, and error rate is high. The employee may require constant supervision and show an indifference to job responsibilities.*

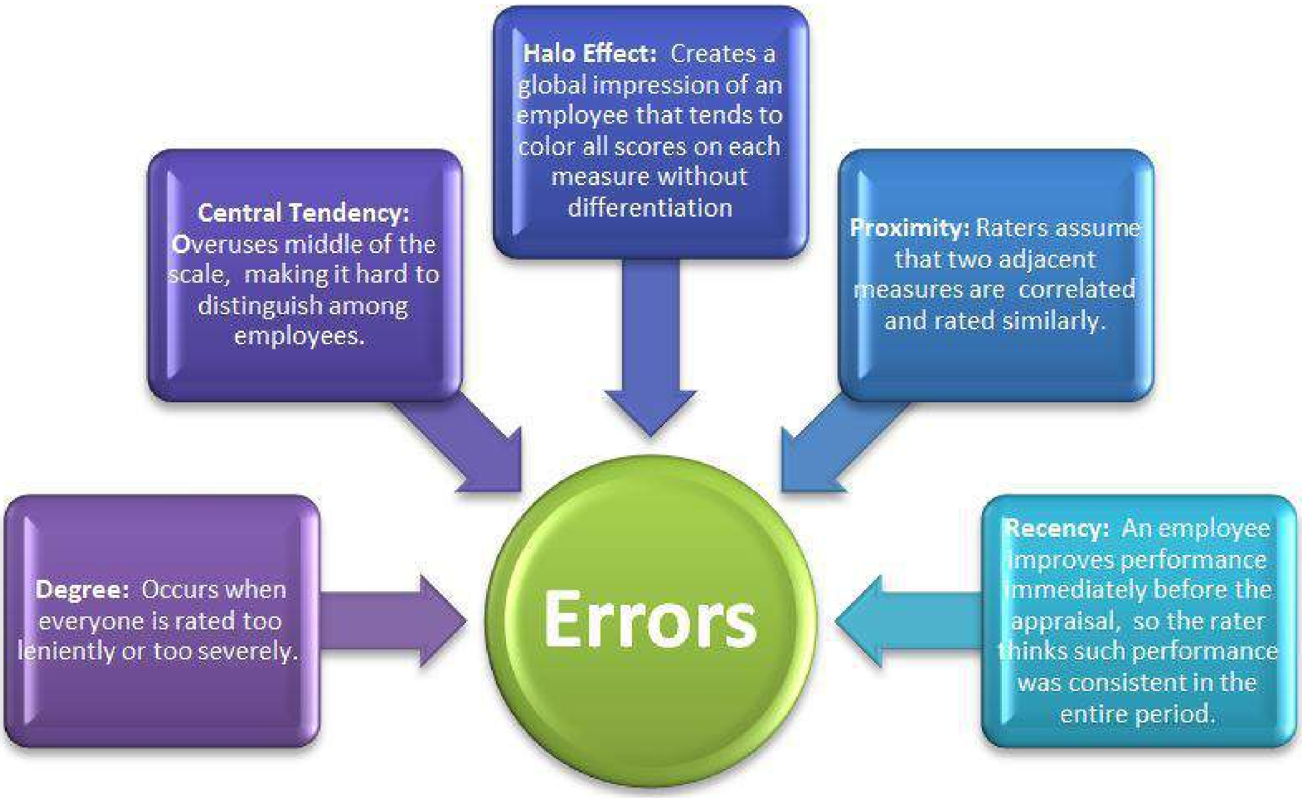
Rating scales are useful for quantifying non-financial, qualitative performance measures. Effectively defined rating scales allow for consistent rating across measures, as well as between raters. For each measure, the rater appraises the degree that best describes the employee's performance. The point values are arranged in either increasing or decreasing order. From these, a total score can be calculated for the employee.



When setting the rating scale, keep the following principles in mind:

- ***Commonality:*** Rating scales require managers and employees to agree about the meaning of measures and their point values. Facilitate these discussions before finalizing the scale.
- ***Performance Measures:*** Different jobs require that different measures be used. Avoid using a one-size-fits-all measure.
- ***Weighting:*** Assign weights to each measure, aligning the relative importance, impact on business results, and sphere of control on the measure. Avoid using a one-size-fits-all weight.

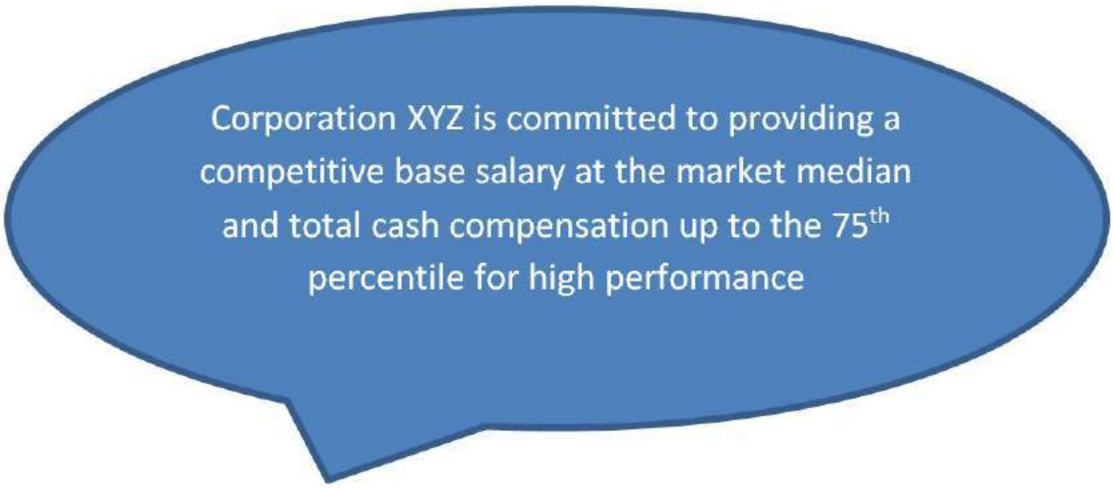
Consider these common errors when rating employees:



Wrapping up an appraisal requires engaging the employee in a positive discussion to finalize a rating (or score) and provide feedback for the overall performance. At this juncture, there should be no surprises, but rather a sense of mutual appreciation supporting each other in the business outcomes. Focusing on the intended purposes of performance management introduced earlier will optimize the employee's contributions and accomplishments for his or her own benefit, as well as that of the team, business unit, and organization.

Aligning rewards decisions to employee performance

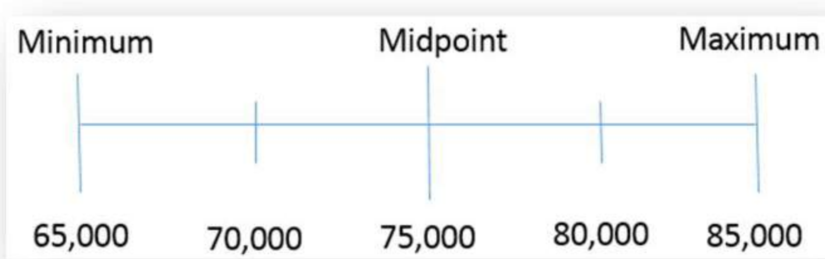
The second element to performance management is aligning financial rewards to employee accomplishments based on an overall total rewards philosophy. To effectively align total cash compensation, companies need to communicate a specific philosophy. Consider this example:



Salary range and fixed costs

Beginning with base salaries, the goal is to match employee performance with pay range progression, while controlling fixed costs and paying fair, competitive salaries. For example, depending on the culture and philosophy, managers may give meaningful increases to high performers and average increases to average performers. Those individuals who have reached the maximum pay range for their jobs may receive lump sum payments, which will keep fixed costs flat year over the year and not over pay for a skill set; these individuals should also be encouraged to retool or gain skills in order to advance their careers and increase their pay opportunities. Poor performers are generally not eligible for increase consideration until performance improves.

To align base salary decisions to individual performance, a salary range with a spread between 20% and over 50% is set in the salary structure design. (See ERI's Distance Learning Center course #82, Creating a Competitive Salary Structure for additional insight on this topic.) The salary range defines the minimum, midpoint, and maximum. An example of a salary grade for a Market Research Analyst is shown below:



Base salary guideline matrix

An organization may create a base salary guideline matrix as a tool to align with the organization's total rewards philosophy, while also taking into account the salary increase budget for the organization, salary ranges, current salaries, segmentation by departments, budget allocation rules (e.g., for merit, promotions, market adjustments, etc.), and adherence to pay range standards. The relationship of the incumbent's pay relative to the assigned pay range is commonly referred to as a compa-ratio (e.g., if the range midpoint is $75,000, and the actual salary is $74,000, then the compa-ratio equals 0.987). Companies align the design of the base salary pay-for-performance to this ratio. In the example below, the compa-ratio and performance ratings determine the break points for the base salary guideline matrix.

Base Salary				
Compa-Ratio				
Rating	**Under 0.90**	**0.90 to 1.0**	**1.0 to 1.25**	**1.25+**
Outstanding (A)	4.25% to 5%	3.5% to 4%	2.75% to 3%	1.75% to 2%
Exceeds (B)	3.5% to 4%	2.75% to 3%	1.75% to 2%	no increase
Meets (C)	2.75% to 3	1.75% to 2%	no increase	no increase
Too New To Rate (X)	delay increase	no increase	no increase	no increase
Not Meet (D)	no increase	no increase	no increase	no increase

The matrix is a tool to be used as a guideline. Note, ranges are used both in the breakpoint and the percent increases to provide flexibility and reasonable discretion for allocating the financial rewards so that they align with individual performance, while also supporting the total rewards philosophy and company culture.

Short-term incentive plans and variable costs

The financial reward with the most impact for performance alignment is a short-term incentive plan. Effectively designed STIPs enable the execution of strategic goals spanning typically one year or less and are "at risk" compensation, thereby a variable cost. STIPs are financially engineered to be self-funded, and accruals happen at regular intervals for year-end (YE) estimated outcomes based on actual year-to-date (YTD) progress. The company goals are defined with three tiers:

- ***Threshold:*** A minimum acceptable outcome must be achieved before any STIP funding; this level of attainment will generally fund the STIP at 50% to 75%.
- ***Target:*** This entails a "stretch" goal that drives business growth; this level of attainment will fund the STIP at 100%.
- ***Maximum:*** A maximum which controls for windfall gains and excessive risk taking; this level of attainment may fund the plan at 125% to 150%.

The funding of STIP is determined as soon as the business outcomes are finalized and will generally have a weighted design structure which supports the line of sight for business impact. Below is an example with an earnings-before-interest-and-taxes (EBIT) objective as the metric to trigger STIP funding since the organization is investing and growing fast (the prior year actual EBIT was $175M):

	Threshold	Target	Maximum
EBIT Objective	$175M	$200M	$215M
Funding Multiplier	50%	100%	125%
Weighting			
Corporate	50%	50%	50%
Individual	50%	50%	50%

Employees receive a payout for achieving a target goal over a specified period, typically one year or less, depending on the industry (e.g., retail or hospitality). The goal is to match employee performance relative to his or her contribution to business outcomes. As an individual advances in his or her career, the STIP target award increases relative to the pay mix of total cash compensation. Below is a sample payout grid when the STIP is funded at target:

Cash Incentive Payout Grid

STIP								
	Incentive Multiplier			Target Payout				
Rating	Min	Target	Max	Admin	Early Career Professional	Management & Specialists	Executive
Outstanding (A)	150%	150%	175%	7%	12%	25%	50%
Exceeds (B)	110%	120%	130%	6%	10%	20%	40%
Meets (C)	95%	100%	105%	5%	8%	15%	30%
Too New To Rate (X)	25%	50%	75%	n/a	n/a	n/a	n/a
Not Met (D)	n/a	n/a	n/a	n/a	n/a	n/a	n/a

Bring it all together

Once you have business outcomes reported and employee's appraisals for the performance period completed, you can begin the total cash compensation planning for the employees. Let's use the market research analyst salary grade example from earlier, along with the below parameters:

Parameter	Employee #1	Employee #2
Employee	Eileen	Sam
Current Salary	$78,000	$70,000
Rating	B = Exceeds Requirements	C = Meets Requirements
Compa-ratio	1.04	0.933
Payout Eligibility	10%	8%

Combining the base salary guidelines with the STIP payout grid, we have the full total cash compensation summary matrix. Based on the individual performance and business outcomes, we have some meaningful guidelines to allocate financial rewards per the below highlighted in red.

Total Cash Compensation												
Base Salary					STIP							
Compa-Ratio					Incentive Multiplier			Target Payout				
Rating	Under 0.90	0.90 to 1.0	1.0 to 1.25	1.25+	Min	Target	Max	Admin	Early Career Professional	Management & Specialists	Executive
A	4.25% to 5%	3.5% to 4%	2.75% to 3%	1.75% to 2%	150%	150%	175%	7%	12%	25%	50%
B	3.5% to 4%	2.75% to 3%	1.75% to 2%	no increase	110%	120%	130%	6%	10%	20%	40%
C	2.75% to 3	1.75% to 2%	no increase	no increase	95%	100%	105%	5%	8%	15%	30%
X	delay increase	no increase	no increase	no increase	25%	50%	75%	n/a	n/a	n/a	n/a
D	no increase	no increase	no increase	no increase	n/a	n/a	n/a	n/a	n/a	n/a	n/a

An example of the final total cash compensation plan that is submitted for review, approval, and payroll processing is shown below:

ERI's Salary Assessor ® ERI's Salary Assessor ®
Today's Date: 2/22/2016

Total Cash Compensation Planning List

Incumbent Data						Survey Benchmark		Planning					Final	
Name	Title	Pay Grade	Midpoint	Compa Ratio	Rating	Salary Median	Total Cash 75th	Current Salary	$ Increase	% Increase	$ Payout	% Payout	Salary	Total Cash
Eileen	Market Research Analyst	2	$ 75,000	104	2	$ 78,557	$ 85,610	$ 78,000	$ 2,200	1.75%	$ 8,970	11.50%	$ 80,200	$ 89,170.00
Sam	Market Research Analyst	2	$ 75,000	97	3	$ 78,557	$ 85,610	$ 73,000	$ 1,460	2.00%	$ 5,840	8.00%	$ 74,460	$ 80,300.00

ORGANIZATION DATA:
Area: United States Average
Industry: All Industries - Diversified
Codes: eSIC: 0000, NAICS: 000000, usSEC: 0000
Size: (Data reported by years of experience)
Planning Date: 2/22/2016

Data as of: 1/1/2016

The final base salary recommendation resulted in base salary increases of 1.75% for Eileen and 2% for Sam, who has a lower compa-ratio. The organization wants to retain Sam and make sure his base salary compensation is competitive. The performance differentiation is more pronounced with STIP. Eileen received the maximum STIP award of 13% for her level and rating, whereas, Sam received an 8% STIP award at target, as determined by the below calculations:

STIP	Eileen	Sam
Pay Band	Early Career Professional	Early Career Professional
Performance Rating	B / Exceeds Expectations	C / Meets Expectations
Funding Multiplier	100%	100%
Incentive Multiplier	110% / 120% / 130%	95% / 100% / 105%
Corporate & Individual Weight	50% / 50%	50% / 50%
Award Target	10%	8%
Corporate Payout	50% * 10% * 100% * 78,000 = $3,900	50% * 8% * 100% * 73,000 = $2,920
Individual Payout	50% * 10% * 130% * 78,000 = $5,070	50% * 8% * 100% * 73,000 = $2,920
Total Payout $	$3,900 + $5,070= $8,970	$2,920 + $2,920= $5,840
Total Payout %	5% + 6.5% = 11.5%	4% + 4% = 8%

Conclusion

Performance management requires thoughtful, well designed appraisals with on-going feedback, coupled with financials rewards aligned to individual contributions and business outcomes. The tools, analysis, and overall design differ depending on the employer's total rewards philosophy and business strategy.

Managing talent and retaining high performers, while keeping average performers engaged, is a challenge for organizations. Involve the stakeholders in the process to foster an engaged, collaborative, high-performance organization culture. Employees must perceive that their efforts are reflected in the performance management process, such that they can directly impact the performance measures within the purview of their job responsibilities. (See ERI's recent blog, Performance Management & Goal Alignment, for additional insight.)

For more information regarding total cash compensation planning, related technology, and data solutions, call our "best in class" service team at 800-627-3697 or visit www.erieri.com.

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