

*As published in WorldatWork's June 2010 edition of Compensation Focus*

## 10 Steps to Paying for Real Performance

*By Aria Glasgow & Kristine Oliver*

Few companies would ever say that they *don't* pay for performance, but the term is often overused. How can organizations ensure their incentive programs are built around the goals most important to the company's long-term success and that any payouts will be proportionate to participants' efforts? The following 10 objectives offer a framework for designing and administering appropriate and effective performance-based programs.

### 1) Focus on performance metrics that are directly tied to key priorities

It may seem obvious, but a surprising number of organizations fail to sufficiently link incentives to the achievement of their most critical strategic and business goals. Other times, plan designs don't appropriately target the level of performance needed to drive success in these areas.

Profitability is not always most important. It may be more important to the company to focus incentive programs on driving growth, shareholder alignment, expense reduction or operations. All performance metrics should be reviewed annually and updated as needed to reflect changes in the organization's strategic focus.

### 2) Balance performance metrics

Effective incentive plans include a combination of company and team/individual goals and incorporate both relative and absolute performance. Most plans provide a balance of company and division/individual performance that reflect the influence of the participant. Incentives for senior management positions and non-revenue generating support roles may be tied more to organizational performance, while team/individual goals may be best reserved for revenue-generating positions for which they are easier to measure.

Balance is also important when using a formulaic approach to determine incentives, or when a degree of discretion is permitted in the calculation of final payouts. For example, if a participant fell short of a performance goal but achieved a significant portion of the goal, the plan might allow managers to consider a partial payment if funds are available.

### **3) Set annual performance targets that are realistic – but raise the bar**

Faced with annual goal-setting, most organizations rely on a combination of historical performance, annual budget, the strategic plan and external factors (i.e. peer or industry performance). Typically, plans define threshold, target and stretch levels of performance for different payout ranges. This helps to define the relationship between performance and award.

Setting goals too high can be de-motivating, and creating insufficiently challenging goals will create an inappropriate pay-for-performance relationship. Target goals should be attainable but require effort and focus. A rule of thumb is that participants should meet target goals 50%-60% of the time. More challenging stretch goals should have a 10%-20% probability of payout, reflecting exceptional performance that warrants above-market rewards.

### **4) Keep plan designs simple and focused**

Performance plans drive desired behaviors and actions only when they are clearly understood by participants. As a general rule, a plan with more than five performance goals is probably too complex. Having a summary document that clearly explains the plan will help employees understand what they need to do to earn a reward.

### **5) Vary the level of actual payouts**

Pay-for-performance is called “variable” compensation for a reason. The most high-performing companies tend to build the most variability into their pay programs. It seems obvious, but high performance (company or team/individual) should result in high payouts and low performance should result in low or no payouts. It’s surprising how many plans call themselves pay-for-performance plans, but clearly are not!

### **6) Reward incremental improvements**

It’s often appropriate and important to recognize and reward participants for genuine effort. A plan in which participants either reach the stated goal or forfeit any payout can be de-motivating. In extreme cases, it may even drive employees to overly risky behaviors. If plan goals are specific and measurable, providing participants with partial payouts for performance that falls between threshold, target or stretch goals can keep them focused and motivated.

### **7) Model plan payouts to ensure sufficient funding is available**

Before communicating a plan, companies should be aware upfront of the total plan cost, as well as prepared to fund all possible levels of organizational and individual performance. Modeling out costs for the achievement of threshold, target and stretch performance also can reveal the need for a plan “trigger” (e.g. 80% of budgeted net income) that will identify the minimum level of financial performance needed to start funding the plan.

## **8) Avoid entitlements**

It should be clear to every incentive plan participant that performance incentives must be earned anew each year — employees should never assume they will receive payouts at target levels. This point should be reinforced by management during bonus discussions. Compensation professionals can also play a role by comparing bonus recommendations against actual goal achievement and identifying circumstances in which goal achievement doesn't correlate with recommended payouts.

## **9) Maintain good business judgment**

Even the best-designed incentive programs are not perfect, nor are the formulas devised to calculate incentive awards. Ensure that high performers are rewarded for their results, even in difficult times. It may be appropriate at times to consider the “big picture” when calculating final awards to acknowledge that some factors influencing performance were genuinely outside employees' control.

## **10) Ensure good plan communication**

Providing ongoing updates to employees about the company's performance, their team's performance and their own performance relative to goals will help keep employees engaged. Additionally, there should be effective systems in place to measure/track performance progress and results.

Incentive plans should be reviewed annually to assess whether they are working effectively. A well-designed incentive plan will align pay and performance by encouraging employees to make the right decisions and put in the effort needed to help make your company successful.

## **About the Authors**

Aria Glasgow is a Vice President with Pearl Meyer & Partners, where her areas of expertise include broad-based compensation design and administration for employees at all levels, variable pay design, total compensation competitive analysis, performance management and total rewards program design. She consults for a variety of industries including financial services, not-for-profit, technology, healthcare, retail, and professional services.

Kristine Oliver, a Vice President with Pearl Meyer & Partners, has worked for more than a decade in compensation, including seven years in the consulting industry specializing in community banking. Her areas of expertise include executive and broad-based compensation, short- and long-term incentive compensation design, total compensation competitive analysis, and performance management. She also works closely with the firm's survey practice and is a frequent speaker at regional banking conferences.

Read the June 2010 edition of [Compensation Focus](#).

Contents © 2010 WorldatWork. No part of this article may be reproduced, excerpted or redistributed in any form without express written permission from WorldatWork.

## About Pearl Meyer & Partners

*For over 20 years, PM&P has served as a trusted independent advisor to Boards and their senior management in the areas of compensation governance, strategy and program design. The firm provides comprehensive solutions to complex compensation challenges through the development of programs that align rewards with business goals to create long-term value for all stakeholders: shareholders, executives and employees. The firm maintains offices in New York, Atlanta, Boston, Charlotte, Chicago, Houston, Los Angeles and San Jose.*



**NEW YORK**

570 Lexington Avenue  
New York, NY 10022  
(212) 644-2300  
newyork@pearlmeyer.com

**ATLANTA**

One Alliance Center  
3500 Lenox Road, Suite 1708  
Atlanta, GA 30326  
(770) 261-4080  
atlanta@pearlmeyer.com

**BOSTON**

132 Turnpike Road, Suite 300  
Southborough, MA 01772  
(508) 460-9600  
boston@pearlmeyer.com

**CHARLOTTE**

3326 Siskey Parkway, Suite 330  
Matthews, NC 28105  
(704) 844-6626  
charlotte@pearlmeyer.com

**CHICAGO**

123 N. Wacker Drive, Suite 1225  
Chicago, IL 60606  
(312) 242-3050  
chicago@pearlmeyer.com

**HOUSTON**

Three Riverway, Suite 1575  
Houston, TX 77056  
(713) 568-2200  
houston@pearlmeyer.com

**LOS ANGELES**

550 S. Hope Street, Suite 1600  
Los Angeles, CA 90071  
(213) 438-6500  
losangeles@pearlmeyer.com

**SAN JOSE**

2880 Zanker Road, Suite 203  
San Jose, CA 95134  
(408) 954-7399  
sanjose@pearlmeyer.com



[www.pearlmeyer.com](http://www.pearlmeyer.com)

