Variable Pay and Organizational Performance

Survey Brief – February 2004

Survey of WorldatWork members by WorldatWork, Dow Scott, PhD, and Hay Group, LLC

Introduction

To determine the prevalence and the effectiveness of variable pay programs that are most commonly used in organizations today, WorldatWork partnered with Dow Scott (Professor of Human Resources, Loyola University Chicago) and Hay Group, LLC to conduct a survey of WorldatWork members. Respondents were asked to describe and evaluate their variable pay programs for management and professional employees as they related to:

- Prevalence of design and administrative features of variable pay programs
- Organizational effectiveness; and
- Communication and implementation of variable pay strategies and programs.

This variable pay survey is the second study of pay practices in U.S. companies. The first survey (completed in early 2003) focused on the prevalence of "foundational" or base pay policies and practices, where this study focuses on variable pay programs and how these programs affect organizational performance.[1]

Organizations often operate multiple pay systems for several employee groups who may be eligible for a variety of variable pay programs. For this study, a decision was made to collect detailed information on the most prevalent variable pay program in place for managerial and professional employees. This is based on the following reasons:

- To make the collection and reporting of results practical.
- Management and professional employees have a pronounced influence on organizational performance.
- This group represents a fairly large number of employees where variable pay programs are typically an important part of their compensation package.
- Since compensation and human resource managers would likely be eligible for these variable pay programs, they should have detailed knowledge and informed opinions of how the variable pay programs operate both as a designer, administrator and recipient.

Information about sales and executive incentive plans were excluded from this study.

This report provides aggregated descriptive information concerning the types and characteristics of short-term cash based programs for management and professional employees in participating organizations managerial and professional employees. A more detailed examination of the data, including an analysis of the linkage to company performance, will be presented at the 49th Annual WorldatWork Conference in May 2004 in Boston, MA.

[1] Results from this study can be found at www.worldatwork.org under the Library/Research and Surveys page, and are published in an article by Dow Scott, Richard Sperling, Thomas McMullen and Marc Wallace. (2003) Linking Compensation Policies and Programs to Organizational Effectiveness. WorldatWork Journal. 12(4), 35-44.

Methodology

A representative sample of over 9,000 WorldatWork members was sent a web-link to the electronic survey instrument in late November 2003. Virtually all responses were from compensation professionals or human resource managers who had significant responsibility for compensation decisions. During a two-week period, a total of 958 members responded, a response rate of 11%. Responses from compensation managers from diverse industries and organizational sizes (via employee population) indicate a good cross section of companies. (See *Respondent Demographics* in Appendix).

Compensation managers representing organizations with less than 100 total employees or organizations with less than 30 professional and managerial employees were excluded from the analysis, as compensation practices for these organizations could be atypical and, thus, potentially distort the findings. In addition, responding organizations where neither managers nor professional employees are eligible to receive variable or incentive pay were also excluded from the more detailed analysis of the variable pay practices for this group. A valid or working sample of 793 organizations or 9% of the WorldatWork targeted sample remained for the data analysis. This represents variable pay programs covering approximately 2.8 million management and professional plan participants.

Key descriptive findings are highlighted in the following section. Additional relevant descriptive statistics are provided in this report's appendix.

Note: All percentages are rounded up from 0.5 and therefore may not equal to 100%.

Overall Response to Variable Pay Programs

Seventy percent (70%) of respondents believed that variable pay was important to very important to the success of their organizations' competitive strategy. Furthermore, 36% believed that it is moderately important for most employee groups and 44% believed that variable pay is important for all employee groups.

The following data excludes organizations that do not offer variable pay eligibility to both managers and professionals. However, 14% of this sample grants eligibility to managers only (Not in Senior Executive Team) while less than 1% only to professional employees.

Specifically, respondents detailed the types of variable pay programs for which managers and professionals are eligible and rated the effectiveness of those programs:

Table 1

Type of Variable Pay Program	% of Managers and Professionals Eligible	% Responded Strongly to Moderately Effective
Individual Performance Bonuses	79%	89%
Team Performance Bonuses	48%	83%
Gain-sharing Incentive	19%	72%
Profit or Revenue Sharing	46%	69%
Equity Programs	59%	68%
Spot / Other Cash-based Recognition Programs	75%	70%

These findings confirm our assumption that variable pay is a prevalent and important element in the competitive strategy of U.S. companies.

Detailed Examination of Short-term Variable Pay Programs

Compensation managers indicated the type of their primary annual (or short term) variable pay program for managerial and professional employees as follows:

Table 2

Annual (or short-term) Variable pay	% of Managers and Professionals That Use as Primary Vehicle
Individual Performance Bonuses	25%
Corporate or Company Measure	31%
Business Unit Measure	13%
Combination of Corporate, Business Unit, and Individual Performance	15%
Combined Individual and Team Performance Bonus	10%
Team Performance Bonuses	2%
Department Measure	1%
Other Types of Bonuses	3%

Although individual short-term cash bonuses are the primary variable pay program for 25% of managerial and professional employees and are rated as the most effective (*Table 1*), 75% of the organizations rely on multiple measurement metrics to motivate this group of employees.

When asked their view regarding leverage (i.e., variable pay as percentage of base pay), 73% of compensation managers believed that their managerial and professional employees were moderately to aggressively leveraged as compared to other companies in the labor market. As might be expected, higher paid professionals and managerial employees are more highly leveraged than those that are paid less, as shown below:

- Paid less than $50,000 are leveraged 0-9%;
- $50,000 to $99,000 are leveraged 10-24%;
- $100,000 to $149,000 are leveraged 10-39%;
- $150,000 to $199,000 are leveraged 10-59%;
- $200,000 to $299,000 are leveraged 40-79%.

Survey participants reported diverse reasons for providing variable pay programs to managerial and professional employees. "Improve organization or team financial performance" is the most frequently mentioned variable pay objective and "creating a more competitive total compensation market position" is the second.

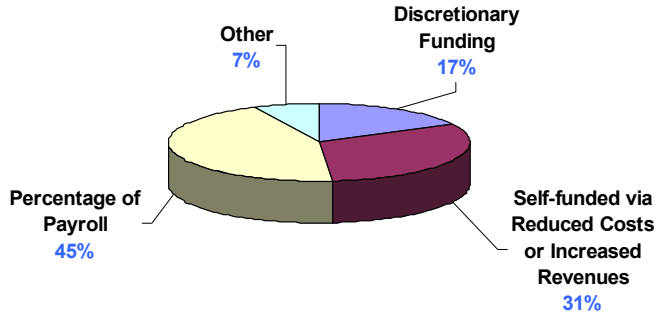
Table 3

Primary Objectives of Variable Pay Program for Managerial and Professional Employees (Respondents asked to **select 3 most important**)	Selection % from 793 Respondents
Improve organization or team financial performance	65%
Create a more competitive total compensation market position	58%
Improve individual performance or productivity	47%
Improve overall productivity	32%
Better recognize employee contributions	32%
Promote a sense of ownership	22%
Use variable pay to better manage compensation costs	17%
Improve employee involvement	12%
Support culture change	8%
Reduce employee turnover	7%

Three primary funding sources for the managerial and professional annual or short-term variable plans were identified, i.e., discretionary, percentage of payroll and self-funded (Figure 1). Most variable pay plans contain a hurdle or trigger feature that can cancel payouts, caps on how much an employee can receive and were paid annually (Tables 4-5).

Figure 1

Funding Sources of Variable Pay Programs
For Managerial and Professional Employees



- Percent of professional variable pay programs that have a hurdle or trigger that can cancel a payout: 82%
- Percent of programs with pre-established performance levels: 87%
- Percent of programs that are capped to how much an employee can receive: 80%

Table 4

If Plan Contains a Cap, the Maximum Percentage of the Variable Pay Target	% of Responses
100 – 124%	24%
125 – 149%	12%
150 – 199%	27%
200 – 249%	25%
250 – 300%	3%
Over 300%	1%
Not applicable	8%

Table 5

Primary Variable Pay Program Designed to Pay Out:	% of Responses
Annually	81%
Semi-annually	5%
Quarterly	7%
Monthly	1%
Achievement of objectives / milestones	2%

The large majority of the variable pay programs have been revised in the last five years (81%) with 47% revised during the last two years.

Human resources or the compensation department were the primary designers of the variable pay plan (66%) often with input from senior management. Compensation managers seldom involved employees who would be eligible for the program (77%).

Sixty-seven percent (67%) of compensation managers believe that most to all eligible employees understand the variable pay program.

Findings report in Table 6 indicates that variable pay plans are communicated in diverse ways and not communicated at all according to 7% of the respondents.

Table 6

Details and Updates of the Variable Pay Program are Communicated Through:	% of Responses
One-on-one discussions with their supervisor	55%
Written materials outlining plan	52%
Information posted in a public place or the intranet	31%
Employee meetings	34%
Variable pay information in NOT communicated	7%

Compensation managers were asked to rate their variable pay program for managers and professional employees on several dimensions. Listed below in Table 7 is the percentage of managers that said that the variable pay plan was effective or very effective for the stated dimension.

Table 7

Variable Pay Program Dimension	% Responded Effective to Very Effective
Overall effectiveness	64%
Motivational value of the program	55%
Funding mechanism	77%
Appropriateness of the variable pay plan measures	68%
Frequency of payouts	79%
Relationship between variable pay program payouts to organizational performance	72%
Relationship between variable pay program payouts to group or team performance	43%
Relationship between variable pay program payouts to individual performance	53%
Employee understanding the program	61%
Responsiveness to change	50%
Administrative ease	64%
Appropriate return on investment	62%

Overall, approximately two thirds of compensation managers seem to be satisfied with the outcomes of their variable pay programs.

However, this still indicates that a significant minority (one out of every three) are not satisfied.

The criteria used to judge the effectiveness of managerial and professional annual or short-term variable pay programs are shown in Table 8.

Table 8

Criteria Management Uses to Judge Effectiveness of Their Programs (Respondents asked to select **All That Apply**)	Selection % from 793 Respondents
Business operating results	73%
Informal opinion gathering from senior leadership	35%
Employee satisfaction survey measures	30%
Employee productivity metrics	28%
Employee turnover or retention	27%
Informal opinion gathering from employees	23%
Management does not evaluate variable pay plan success	16%
Labor costs are controlled or lowered	9%

Compensation managers indicate that "line of sight", improving the linkages between payouts and performance and improving the communication of plan objectives are the most important ways to improve the variable pay programs (Table 9).

Table 9

How Variable Pay Programs Can Be Improved (Respondents asked to **select 3 most important**)	Selection % from 793 Respondents
Improve plan "line of sight" to individual or team efforts	**60%**
Improve linkage between payout and performance	**57%**
Improve communication of plan objectives	**48%**
Increase understanding of the variable pay plan	**33%**
Improve ease of administration	**23%**
Increase payout opportunities	**23%**
Ensure goals are viewed as more attainable	**22%**
Reduce conflicting goals	**9%**

Conclusions

This study indicates that variable compensation for most managerial and professional employees is still administered under fairly traditional – time tested – methodologies and processes such as individual bonus, profit sharing, gainsharing and equity programs. Compensation professionals believe that these processes are generally effective, as is evident by their widespread use and positive responses.

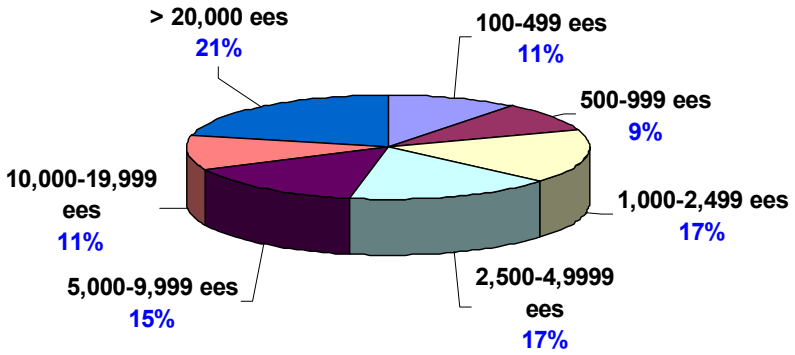
Program designs for short-term or annual cash variable pay programs are generally given high ratings for effectiveness by the survey respondents, but program implementation is not viewed as favorably. Relatively low marks are given for the effectiveness of the compensation programs' motivational value and communication to employees. Although individual variable pay plans are rated highly, most plans have a shared variable pay component.

The effectiveness of compensation programs is ultimately based on how those programs contribute to the effectiveness of the organization. Implementation, therefore, seems to be where organizations report an area of focus to improve overall compensation program effectiveness.

Respondents' Report - Appendix

Respondent Demographics

Responding Firms by Employee Size *



** Respondents with less than 100 employees are not included in this descriptive analysis.*

Responses by Industry

Table A-1

Industry Sector (Top 12)	**# of Respondents**	**% of Valid (Non-missing) Responses**
Manufacturing	175	26%
Finance & Insurance	146	22%
Information	56	8%
Healthcare & Social Assistance	46	7%
Utilities	48	7%
Professional, Scientific, & Technical Services	34	5%
Retail Trade	25	4%
Other Services (Except Public Administration)	15	2%
Real Estate & Rental & Leasing	14	2%
Transportation & Warehousing	12	2%
Accommodation & Food Services	9	1%
Wholesale Trade	9	1%

Descriptive Statistics of Variable Pay Study

All percentages are rounded up from .5 and therefore may not equal to 100%.

Table A - 2

Importance of Variable Pay to the Success of Organization's Competitive Strategy	% of Responses
Not important	1%
Minimally Important	8%
Moderately Important	21%
Important	38%
Very Important	32%

Table A - 3

Statement That Best Describes Management's Philosophy About the Use of Variable Pay	% of Responses
Not important or minimally important	2%
Unimportant for all but a few specific employee groups	19%
Moderately important for most employee groups	36%
Important for all employee groups	44%

Table A - 4

	Sample Size		# of Managers and Professional Employees				
	Valid	Missing	Min	Max	Mean	Median	Std. Dev.
Number of mangers & professional employees within your organization	758	35	30	250,000	3,688	800	13,105

Table A - 5

Annual (or short-term) Variable pay for Managerial and Professional Employees	% of Managers and Professionals That Use as Primary Vehicle
Corporate or Company Measure	31%
Individual Performance Bonuses	25%
Combination of Corporate, Business Unit, and Individual Performance	15%
Business Unit Measure	13%
Combined Individual and Team Performance Bonus	10%
Team Performance Bonuses	2%
Department Measure	1%
Other Types of Bonuses	3%

Table A - 6

Percentage of Managerial & Professional Employees That Are Eligible for Variable Pay in Table A - #	% of Responses
1 to 24%	13%
25 to 49%	8%
50 to 69%	5%
70 to 79%	3%
80 to 89%	5%
90 to 99%	9%
100%	55%
Not Sure	1%
Not Applicable	1%

Table A - 7

Manager's View Regarding Leverage (i.e. Variable Pay as a Percentage of Base Pay)	% of Responses
MINIMAL: Variable Pay as a percentage of base pay is LESS than the labor market	12%
MODERATE: Variable Pay as a percentage of base pay is COMPARABLE than the labor market	54%
AGGRESSIVE: Variable Pay as a percentage of base pay is HIGHER than the labor market	19%
No philosophy or view	8%
Not sure	5%
Not applicable	3%

Table A - 8

Approximate Variable Pay Target (or Typical Payout if the Plan Has No Target) As a Percentage of Salary						
% of Salary	Over $300,000	$200,000 - $299,999	$150,000 - $199,999	$100,000 - $149,000	$50,000 – $99,999	Less Than $50,000
	% of Responses					
0-9%	2%	3%	5%	9%	30%	60%
10 to 24%	3%	5%	19%	50%	57%	23%
25 to 39%	7%	19%	40%	29%	8%	2%
40 to 59%	21%	29%	15%	6%	1%	0%
60 to 79%	15%	7%	4%	1%	0%	0%
80 to 99%	5%	4%	1%	1%	0%	0%
100 to124%	6%	3%	2%	1%	0%	0%
125 to 149%	1%	1%	0%	0%	0%	0%
150 to 200%	2%	0%	0%	0%	0%	0%
Over 200%	1%	0%	0%	0%	0%	0%
Not applicable	38%	30%	15%	4%	4%	15%
Total	100%	100%	100%	100%	100%	100%

Table A - 9

Hurdle or Trigger That Can Cancel or Prevent a Payout	% of Responses
At the Corporate Level	49%
At the Business Unit Level	14%
At the Team Level	0%
At the Individual Level	3%
At Multiple Levels	16%
No	15%
Not Applicable	3%

Table A - 10

Timeframe When Current Primary Pay Program Was Last Substantially Revised (Or, if never substantially revised, instituted)	% of Responses
Over 10 years ago	7%
5 to 10 years ago	12%
3 to 5 years ago	18%
2 to 3 years ago	16%
1 to 2 years ago	22%
In the last year	25%

Table A - 11

Individuals / Function Responsible for Designing the Current Primary Variable Pay Plan (Assuming Senior Management Approval)	% of Responses
Solely Human Resources	18%
Human Resources with line management input	48%
Line management with Human Resources input	13%
Sole line management	2%
Other	19%

Table A - 12

Involvement of Plan Participants in the Variable Pay Program Design	% of Responses
Plan participants were NOT INVOLVED in the design	77%
Plan participants provided input via focus groups, suggestion boxes, etc.	12%
Plan participants provided recommendations for management approval	4%
Plan participants were involved in design of the plan	4%
Plan participants were involved in the design of the plan and heavily influenced the decision to implement the plan	1%
Other	2%

Table A - 13

Extent Do Eligible Employees Understand the Variable Pay Program	% of Responses
Virtually NO eligible employees understand the variable pay program	3%
MOST eligible employees DO NOT understand the variable pay program	12%
About HALF of the eligible employees understand the variable pay program	18%
MOST eligible employees understand the variable pay program	48%
Virtually ALL eligible employees understand the variable pay program	20%

About WorldatWork®

WorldatWork is the world's leading not-for-profit professional association dedicated to knowledge leadership in compensation, benefits and total rewards. Founded in 1955, WorldatWork focuses on human resources disciplines associated with attracting, retaining and motivating employees. Besides serving as the membership association of the professions, the WorldatWork family of organizations provides education, certification (Certified Compensation Professional - CCP®, Certified Benefits Professional - CBP™ and Global Remuneration Professional - GRP®), publications, knowledge resources, surveys, conferences, research and networking. WorldatWork Society of Certified Professionals and Alliance for Work-Life Progress (AWLP) are part of the WorldatWork family.

About Dow Scott

Dr. Dow Scott is both a Professor of Human Resources and the President of Performance Development International, Inc. (PDII). His teaching, research and consulting have focused on creating effective teams, performance improvement strategies, equitable pay and performance enhancing variable pay systems, and high performance organizations both in the U.S. and abroad. He often gets involved in evaluating variable pay programs that are currently in use or designing new programs that will enhance employee commitment and productivity. He has received national recognition both among academic and professional audiences for his research.

About Hay Group, LLC

Hay Group is a global Human Resources consulting firm that helps organizations get the most from their people by creating clarity, capability, and commitment. Founded in 1943 in Philadelphia, Hay works from 72 offices in 37 countries. Hay's areas of expertise include:

- Organizational effectiveness, role clarity, work design, and assessment;
- Selection and development;
- Compensation, benefits, and performance management;
- Executive remuneration and corporate governance; and,
- Employee and customer attitude research.

Based on 60 years of specific, documented evidence that people, not strategies, drive long-term success, Hay Group has built a worldwide presence in assisting organizations to achieve their goals.

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