Strategic Rewards®
and Pay Practices:
The Need for Execution

2005/2006 Survey Report

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EXECUTIVE SUMMARY

Over the last few years, a difficult economy and rising benefit costs have prompted companies to look carefully at their approach to aligning rewards with business strategy. As economic and company performance improves, the challenge has moved to effectively implementing those reward strategies.

The 10th annual Strategic Rewards study reveals that companies can improve the execution of their total rewards strategy (both monetary and non-monetary) — in particular, planning reward expenditures on a total rewards basis. However, by increasing collaboration among HR functions and optimizing their reward plans, employers can keep their best workers engaged and motivated while increasing their return on investment.

Key findings

- Despite higher benefit costs, short-term incentive (STI) plan funding and payouts are reflecting improved economic conditions and company financial performance. High-performing firms funded STI programs at an average of 118 percent of target, compared with 93 percent of target for low-performing firms. At the same time, more than half (54 percent) of the organizations increased their company financial performance targets, effectively raising the bar.

- In light of stock option accounting changes, nearly four in ten companies (39 percent) are still adjusting their stock programs — reducing the size of and eligibility for their non-executive stock option programs rather than abandoning them entirely. For executives, changes have focused on shifting the portfolio toward greater use of restricted stock.

- Poor performers receive on average a 2.5 percent annual pay raise, and more than a quarter (27 percent) of companies with STI plans award bonuses to employees who do not meet expectations — money that might be better aimed at the top performers.

- Employers recognize that there is room to improve their performance management systems, particularly in relation to providing periodic performance discussions, helping poor employees improve and offering career development/planning.

- Fifty-eight percent of employers report at least moderate difficulty attracting critical-skill employees in 2005, compared with 40 percent in 2003.
HIGH-PERFORMING FIRMS VERSUS LOW-PERFORMING FIRMS

This report refers to high- and low-performing organizations. The distinction is based on self-reported — but validated — responses to the question “How well did your company perform financially, compared with other firms in your industry over the past year?”

In our analyses, we characterized companies that identified themselves as “substantially above peer group” as high-performing organizations and those that said their performance was below that of their industry peers as low-performing.

When linked to shareholder returns in publicly held companies, independent analyses of these responses show the measure to be valid. Specifically, firms identified as “high-performing” realized a three-year total return to shareholders of 117 percent, compared with 26 percent for those firms identified as “low-performing.”

TOP PERFORMERS VERSUS POOR PERFORMERS

For certain elements of this analysis, employees were divided into groups based on their job performance. The performance measure was a composite of the employee’s self-rating and the rating received from his or her manager during the most recent review period. Those who reported the highest possible rating on both were considered “top performers.” Those whose combined employee/manager ratings were average or below were considered “poor performers.”

ABOUT THIS SURVEY

This year marks the 10th anniversary of Watson Wyatt’s Strategic Rewards research and the first time WorldatWork has collaborated on the report. The survey has evolved over time, and as a special feature, this year’s report revisits certain items from the original survey. While some things have changed in 10 years, others have remained strikingly similar.

In all, 265 organizations with a minimum of 1,000 employees participated in this year’s survey. These organizations, employing more than 2.6 million workers, represent all major industry sectors and geographic regions. This employer survey was complemented by an employee survey of 1,100 workers drawn from a nationally representative sample. Our report highlights the differences in employer and employee perspectives.
TOTAL REWARDS
The survey results show that 70 percent of employers have a total rewards strategy in place and another 17 percent plan to adopt one. Although the majority of companies are moving toward a total rewards focus, many employers — particularly low-performing companies — can improve their execution of this strategy.

Alignment
High-performing companies are more successful at aligning employee behavior with company goals; 71 percent reported that their reward plans are at least moderately effective, compared with only 47 percent of low-performing companies. Additionally, high-performing firms are more likely than their low-performing counterparts to believe that their reward system is linked to business strategy and encourages desired culture and behaviors (Figure 1).

Employee Value
To design effective reward programs, employers should factor in employee preferences. Fewer than four in ten employers (38 percent) currently assess employee reward preferences, although the vast majority of these (90 percent) use this input in designing and modifying their plans.

Employers are also not effectively communicating their total rewards strategy. Half of employers (48 percent) think their employees understand the value of their total rewards package only slightly — or not at all — and less than one-third of the employees surveyed say their company has communicated a total rewards strategy to them.

Not surprisingly, top-performing employees have a better understanding of the value of their rewards package. Nearly two-thirds (63 percent) of top-performing employees indicate at least moderate understanding, versus 36 percent of poor performers.

F I G U R E 1 : H i g h - P e r f o r m i n g F i r m s B e t t e r A l i g n R e w a r d P r o g r a m s W i t h B i s i n e s s O u t c o m e s

<table>
<thead>
<tr>
<th>Percentage reporting “to a great extent” or “to a very great extent.”</th>
</tr>
</thead>
<tbody>
<tr>
<td>Linked to business strategy</td>
</tr>
<tr>
<td>High-performing firms</td>
</tr>
<tr>
<td>Low-performing firms</td>
</tr>
<tr>
<td>All firms</td>
</tr>
<tr>
<td>Encourages desired culture and behaviors</td>
</tr>
<tr>
<td>High-performing firms</td>
</tr>
<tr>
<td>Low-performing firms</td>
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<tr>
<td>All firms</td>
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</table>

A TOTAL REWARDS STRATEGY — ALIGNMENT, VALUE AND COST
Effectiveness of rewards is defined by alignment, employee value and cost.

Alignment: Rewards that support — and help to produce — outcomes that are important to the employer

Employee Value: Rewards that are meaningful to employees and influence their affiliation with the organization

Cost: The current and projected cost and risk profile of rewards
Cost

In addition to achieving alignment and delivering employee value, successful reward plans strike a balance between effectiveness and cost. However, only 35 percent of employers formally measure the cost effectiveness of their total rewards program to a moderate or great extent. Additionally, nearly six in ten (59 percent) make at most slight modifications to their programs to improve cost effectiveness.

With health care costs continuing to increase, optimizing reward programs may be critical to success. This survey reports an average 11 percent rise in health care costs (excluding employee contributions) for the most recent year. Continuing increases of this magnitude suppress company performance measures and thereby inevitably affect employee pay. For example, 60 percent of employers use operating income growth as a metric in determining funding for short-term incentive plans.

Yet, while nearly 60 percent of respondents report increased collaboration among compensation, benefits and finance functions in developing and managing reward systems, surprisingly few think that cost increases for employee health care coverage (10 percent) and retirement benefits (8 percent) are restricting expenditures for base pay or bonuses. Furthermore, slightly more than 70 percent of organizations say they manage increases in base pay independently of the funding for other reward programs. One possible explanation for these contradictory findings is that HR functions are not planning total rewards expenditures from an integrated point of view.

**BASE PAY AND MERIT BUDGETS**

Merit increase budgets for 2005 rose from 2004 and are projected to increase again for 2006, albeit slightly (Figure 2).

**FIGURE 2:** Merit Increase Budgets Rise Slightly

<table>
<thead>
<tr>
<th>Year</th>
<th>Merit increase budget</th>
</tr>
</thead>
<tbody>
<tr>
<td>2006 (projected)</td>
<td>3.5%</td>
</tr>
<tr>
<td>2005</td>
<td>3.4%</td>
</tr>
<tr>
<td>2004</td>
<td>3.0%</td>
</tr>
</tbody>
</table>

Employees do not think that employers are clearly differentiating salaries based on performance. Twenty-eight percent of top performers believe that their organization pays employees who perform exceptionally well the same as other employees. Less than 10 percent say they are paid far higher. Interestingly, poor performers receive an average increase of 2.5 percent of pay (Figure 3) — money that might be better spent on delivering larger increases to the top performers.

**FIGURE 3:** Employers Can Better Differentiate Raises Based on Employee Performance

<table>
<thead>
<tr>
<th></th>
<th>Average raise last year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Top performers</td>
<td>5.6%</td>
</tr>
<tr>
<td>Average performers</td>
<td>3.5%</td>
</tr>
<tr>
<td>Poor performers</td>
<td>2.5%</td>
</tr>
<tr>
<td>All employees</td>
<td>3.7%</td>
</tr>
</tbody>
</table>
While differentiation is important, employees generally view base pay increases as an entitlement. An overwhelming number of employers say that their employees regard annual pay raises as an entitlement either to a great extent (49 percent) or a moderate extent (46 percent). More top-performing employees (63 percent) view annual pay increases as an entitlement to a great extent, versus 44 percent of poor performers. With poor performers continuing to receive merit dollars, it will be difficult to move away from the entitlement mentality and toward true pay for performance.

Our survey also found that employees — regardless of their performance — value pay over other benefits. When presented with the choice between pay or better health benefits, a better retirement plan, more vacation or a more flexible schedule, the majority of employee participants chose higher pay. Additionally, more than 80 percent preferred a higher salary to a lower salary plus a possible bonus or possible stock or stock options.

Given employee views, employers are faced with a difficult dilemma especially as the economy improves and attracting and retaining critical-skill employees becomes more difficult. On one hand, they need to provide competitive base pay packages. On the other hand, firms that put more of their pay into incentive programs versus high salaries outperform others (Figure 4). In fact, our results show that high-performing firms generally pay employees the same level salaries as low-performing firms (Figure 5).
SHORT-TERM INCENTIVES

Employers are increasing their reliance on variable pay, raising both funding and payouts for short-term incentive plans. Twelve percent of firms have also increased STI eligibility for non-executives. At the same time, however, companies continue to raise the bar by increasing the targets for both company and individual performance.

Funding

After a dip in 2004, STI funding has rebounded. Average funding as a percentage of target was 99 percent in 2005, up from 81 percent in 2004 and 91 percent in 2003 (Figure 6). High-performing firms continue to fund STI plans at a higher rate (median 9.5 percent of net operating income) than low-performing firms (7 percent).

Funding metrics appear to differ slightly for high- and low-performing firms. The data suggest that high-performing firms are slightly more focused on revenue growth, while low performers focus more on operating income growth and cash flow (Figure 7). High-performing firms are somewhat more likely to include non-financial measures such as customer satisfaction and quality outcomes. The greater use of these measures indicates an understanding of their importance as drivers of enhanced financial performance.

Targets

As STI funding has increased, employers have also raised performance goals for both company and/or individual success (54 percent and 28 percent, respectively). In particular, nearly two-thirds (64 percent) of high-performing firms have increased company financial targets in the last 12 months, compared with 56 percent of low-performing firms.

Employees agree that the bar is being raised. Fifty-five percent think that it has become more difficult to earn a full bonus in the last three years.

Payouts

Given the constraints of small merit budgets and employee attitudes about base pay, short-term incentive plans provide an effective tool to differentiate individual pay based on performance. According to Watson Wyatt’s Human Capital Index research, organizations that make the largest distinctions in top performer pay significantly outperform organizations that make smaller distinctions (Figure 8, opposite).

Although more dollars are currently given to those employees who meet or exceed expectations, employers have the opportunity to
make larger distinctions in employee bonuses. The median payout to employees meeting expectations is 100 percent of the bonus pool, while employees who perform in the top 10 percent receive only 5 percent more. Furthermore, more than a quarter (27 percent) of companies with STI plans indicate they pay bonuses to employees who do not meet expectations.

The attitudes toward annual bonuses differ considerably between top- and poor-performing employees. Nearly three-quarters (74 percent) of top performers say bonuses are very valuable, versus only 30 percent of poor performers. This may be because top performers see the relationship between awards and performance more clearly than poor performers (84 percent versus 61 percent, respectively). In addition, nearly 70 percent of top performers say the amount of their bonus is based on factors within their control, versus roughly half of poor performers.

**LONG-TERM INCENTIVES**

Long-term incentives (LTIs) continue to be an important reward vehicle for executives and non-executives alike as 42 percent of companies offer stock options to non-executives, and 33 percent offer other long-term incentives. However, stock option accounting changes have caused significant plan redesigns over the last two years, and 39 percent of companies continue to make adjustments in 2005 — reducing the opportunity for total direct compensation for non-executives and rebalancing total direct rewards for executives.

Roughly one-third of companies are still adjusting their stock programs for non-executives. Fifty-two percent of them have reduced the number of stock options granted for non-executives, 50 percent reduced eligibility and 27 percent eliminated stock options entirely (Figure 9). Overall, 14 percent of organizations reduced LTI as a percentage of total pay for non-executives, and only 31 percent of these boosted another pay element (e.g., short-term incentives) to compensate.

Thirty-seven percent of participating organizations offer an employee stock purchase plan (ESPP) to non-executives, which allows employees to purchase stock at a discount (often with a look-back feature that provides additional favorable pricing). Despite unfavorable accounting treatment changes, only 9 percent of employers making changes have eliminated their ESPPs in the last year for non-executives (Figure 9).
In light of decreased eligibility among non-executives for other stock-based programs, the maintenance of an ESPP is well advised, given Watson Wyatt’s Human Capital Index research, which found that organizations with broad eligibility for stock-based programs significantly outperform organizations with limited eligibility.

For executives, changes have focused on shifting the portfolio toward greater use of restricted stock. While 14 percent of companies making changes this year eliminated stock options for executives and 14 percent reduced eligibility, nearly two-thirds of employers (63 percent) offset these changes by replacing stock options with restricted stock, and another 20 percent moved to cash-based LTIs.

### THE 10-YEAR VIEW — COMPARISON TO 1996

The first Strategic Rewards survey was conducted 10 years ago, and the similarities — and differences — in economic conditions are striking. Both periods are marked by a post-recession expansion and comparable levels of unemployment, but today’s globalization has created a dramatically different situation for American business. In particular, the current expansion differs from that of 1995–96 in terms of limited job creation due to outsourcing and offshoring of job opportunities as well as ongoing increases in productivity.

On the positive side, a comparison of the 1996 and 2005 results (Figure 10) suggests that organizations are making modest strides in balancing all three total rewards elements (alignment, value and cost). Employers are improving alignment by linking the reward system to business strategy and encouraging desired culture and behavior. The modest improvement in alignment is also due to a stronger connection between organizational performance and merit pool determination.

However, employers have made little progress in articulating their compensation strategy and involving employees in the design and modification of reward plans. The resulting lack of communication contributes to the persistent view among employees that they are entitled to merit increases. Watson Wyatt’s Communication ROI Study indicates that direct conversations with line managers during ongoing performance management discussions provide the best vehicle for communicating reward systems.

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**Areas of Improvement**

<table>
<thead>
<tr>
<th>Area</th>
<th>1996</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reward system is linked to business strategy*</td>
<td>23%</td>
<td>35%</td>
</tr>
<tr>
<td>Reward system encourages desired culture and behaviors*</td>
<td>25%</td>
<td>34%</td>
</tr>
<tr>
<td>Reward systems are valued by employees*</td>
<td>27%</td>
<td>30%</td>
</tr>
<tr>
<td>Organization’s merit pool reflects good performance</td>
<td>30%</td>
<td>39%</td>
</tr>
<tr>
<td>Organization’s merit pool reflects poor performance</td>
<td></td>
<td>53%</td>
</tr>
</tbody>
</table>

**Opportunities**

<table>
<thead>
<tr>
<th>Area</th>
<th>1996</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Compensation strategy is clearly articulated*</td>
<td>30%</td>
<td>30%</td>
</tr>
<tr>
<td>Employees understand reward plans*</td>
<td>25%</td>
<td>23%</td>
</tr>
<tr>
<td>Effectiveness of reward plans is measured on an ongoing basis*</td>
<td>20%</td>
<td>21%</td>
</tr>
<tr>
<td>Employees are involved in the design and modification of reward plans*</td>
<td>6%</td>
<td>2%</td>
</tr>
<tr>
<td>Merit increases are regarded as an entitlement**</td>
<td>52%</td>
<td>49%</td>
</tr>
</tbody>
</table>

* Percentage reporting “to a great extent” or “to a very great extent.”
** Percentage reporting “to a great degree.”
Companies with strong performance management systems post significantly better financial results, according to WorkUSA, Watson Wyatt’s ongoing study of U.S. employee attitudes. Unfortunately, while most employers report that their organizations have incorporated best practices in designing their performance management programs, they have been less successful in executing the performance management processes. Ninety-one percent say they provide formal goal-setting linked to business objectives, and 74 percent say managers are at least moderately effective at linking the goals. But only 58 percent of top-performing employees indicate that their managers provide a formal linkage to business goals. Moreover, only 31 percent of poor-performing employees say this is the case (Figure 11).

Despite difficulties in recruiting and retaining employees, employers appear to struggle with ways to improve and strengthen the performance of their existing workforce — particularly their poor-performing employees. Nearly half of employers think that managers at their organization are at most slightly effective at carrying out periodic performance discussions or helping poor performers improve. Employees tend to agree: 53 percent of top performers and only 30 percent of poor performers say that managers help poor performers improve.
One step toward improving managerial effectiveness may be to provide managers with the appropriate training. Only 36 percent of organizations have a formal training program for managers to enhance their ability to effectively manage rewards. However, those that provide them are better able to manage employee performance (Figure 12).

**GLOBAL COMPENSATION**

The majority (61 percent) of organizations in the survey have operations outside of their home country, and 30 percent have operations in more than 10 countries — yet only 29 percent have implemented a global total rewards strategy. These companies have done so in order to create a common culture (46 percent), encourage internal equity (40 percent), and provide a consistent link between rewards and results (40 percent).

Companies with global total rewards strategies also report more progress in monitoring the design and delivery of reward programs across global operations — particularly in terms of alignment and cost (Figure 13). While these companies are more likely to make sure that their program appropriately reflects the market, only 11 percent of those with a global total rewards strategy report checking on the value of rewards to employees to a great extent.

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**FIGURE 12: Firms With Formal Manager Training Programs More Effectively Manage Employee Performance**

<table>
<thead>
<tr>
<th>Percentage reporting “to a moderate extent” or “to a great extent.”</th>
</tr>
</thead>
<tbody>
<tr>
<td>Provide coaching and feedback to employees throughout the year</td>
</tr>
<tr>
<td>Provide formal midyear (or other periodic) performance discussion</td>
</tr>
<tr>
<td>Help poor performers improve</td>
</tr>
</tbody>
</table>

- Have formal training program
- No formal training program

**FIGURE 13: Firms With a Global Total Rewards Strategy More Likely to Monitor Programs**

<table>
<thead>
<tr>
<th>Monitor Design and Delivery of Global Reward Programs for:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alignment with organizational goals</td>
</tr>
<tr>
<td>Alignment with global total rewards strategy</td>
</tr>
<tr>
<td>Total cost</td>
</tr>
<tr>
<td>Appropriate relationship to market</td>
</tr>
</tbody>
</table>

- Have global total rewards strategy
- No global total rewards strategy
ATTRACTION AND RETENTION

In a competitive job market, low-performing firms have an uphill battle in recruiting and retaining top employees. Only 58 percent of employees at low-performing firms say their firm offers promotion/advancement opportunities, compared with 81 percent of employees at high-performing companies. Similarly, more employees at high-performing firms say they have an opportunity to influence and earn a bonus (Figure 14).

With a strengthening economy, attracting critical-skill employees has become increasingly difficult in the last two years. Nearly six in 10 employers (58 percent) report at least moderate difficulty, compared with 40 percent in 2003. Employers are having more success retaining critical-skill and top-performing employees, which may be contributing to the problem. While the overall voluntary turnover rate of 10.6 percent has remained relatively stable since 2003 (Figure 15), voluntary turnover is substantially lower for critical-skill and top-performing employees (5 percent and 4 percent, respectively) regardless of company performance.

Many employers (58 percent) formally track the reasons that top performers leave their organizations. Consistent with past years’ results, the top three reasons (cited by both high- and low-performing companies) are promotion opportunities (54 percent), inadequate pay (33 percent) and inadequate career development (30 percent).

Looking deeper, differences in culture and management style in high-performing versus low-performing firms may also affect why employees leave. Twenty-seven percent of high-performing companies versus 15 percent of low-performing companies cite work/life balance as a reason that top performers leave, possibly because of the company’s focus on results coupled with resource constraints. Problems with management are more of an issue at low-performing firms than high-performing firms (32 percent and 20 percent, respectively), perhaps indicating a lack of management training or constantly evolving messages and tactics to address financial performance.
CONCLUSION

Organizations have a significant opportunity to improve their return on human capital investments by aligning reward plans with business strategies and by enhancing the value delivered to critical workforce segments. As a first step, employers can review their total rewards packages and evaluate their strategy from an integrated point of view, with increased collaboration among the compensation, benefits and finance functions.

While companies have made modest improvements in balancing alignment, value and cost as critical elements of a total rewards program in the last 10 years, they still have opportunities to improve in key areas: understanding employees’ needs and preferences, linking rewards and organizational performance, and communicating clearly and directly about these programs. By making reward plans meaningful to employees — and then communicating the programs — organizations can improve the perceived value of their compensation packages.

Differentiating base and variable pay by employee performance is also critical. Organizations that make the largest distinctions in how they allocate rewards significantly outperform organizations that make smaller distinctions. The most successful organizations also continually raise the bar on both company and individual performance. This in turn helps them increase the funding for performance-based variable pay plans and attract top-performing employees.

As attracting and retaining top performers and critical-skill employees becomes increasingly difficult, performance management takes on additional significance — especially in linking goal-setting to business objectives and pay decisions to review results. Those employers who effectively use performance management systems to create alignment and help their workers improve will be better positioned for success.

The bottom line is that a well-designed, well-executed and well-communicated total rewards program will motivate employees, improve competitive position and strengthen shareholder returns.
ABOUT WATSON WYATT

Watson Wyatt Worldwide (NYSE: WW) is a global human capital and financial management consulting firm. We specialize in employee benefits, human capital strategies, technology solutions, and insurance and financial services. Watson Wyatt has more than 6,000 associates in 32 countries.

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