SAP SuccessFactors

SAP White Paper
Compensation

Can You Pay People Without Rating Them?

Reconciling Performance Management Trends and Compensation Realities

THE BEST RUN SAP

Table of Contents

Lauren Bidwell, Ph.D. and Steven T. Hunt, Ph.D.

The field of performance management is experiencing a transformation. This transformation is focused on creating new methods that emphasize coaching dialogue instead of performance ratings, rewarding employees more informally and frequently, and being transparent about how staffing and pay decisions are made. These new methods are helping foster better relationships between employees and managers and enabling more fair and accurate decisions about talent. But for compensation professionals, these changes can be concerning as they can directly impact processes used to allocate pay and rewards.

Managing compensation in a changing performance management climate

To learn how companies are managing compensation in this changing performance management climate, the Human Capital Management (HCM) research team for SAP® SuccessFactors® solutions spoke with compensation professionals from a variety of customer organizations. Our conversations focused on four specific changes that can create significant challenges for compensation departments: eliminating formal performance ratings, adopting a more continuous approach to performance management, using informal and frequent methods of rewarding employees, and managing greater employee expectations for transparency.

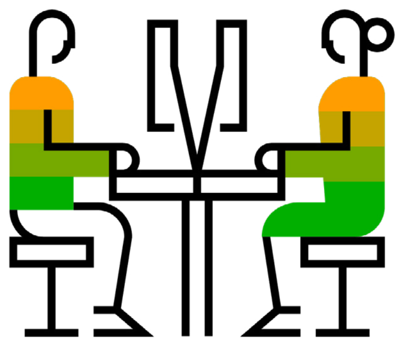
Our findings suggest there are right and wrong ways to navigate these changes. Failing to think through the consequences that changes to performance management have on compensation practices can pose a serious threat to pay equity and effectiveness. But when managed the right way, many of the changes present opportunities for compensation professionals to positively transform the use of pay and rewards.

The primary focus of compensation is ensuring that investment decisions related to pay are made in an effective manner. In many cases, these decisions require comparing employees against one

The Performance Management Change	The Compensation Challenge
Eliminating formal performance ratings	Maintaining a "pay for performance" philosophy so the company invests more in employees who contribute more to the company
Adopting a continuous, conversational approach to performance management	Making compensation decisions using qualitative performance information captured throughout the year
Using informal, frequent methods of rewarding employees such as "spot awards" and nonmonetary recognition	Ensuring informal, unstructured awards are distributed effectively and equitably
Greater employee expectations for transparency around compensation fueled in part by access to third-party open sources of compensation data	Ensuring information about pay is effectively communicated to employees and addressing inequity concerns based on potentially misleading third-party data

another based on the value they provide to the organization. In contrast, a major goal of performance management is to provide employees with coaching feedback that emphasizes a person's relative strengths and weaknesses. This feedback tends to be most effective when it intentionally avoids comparing employees against each other. While compensation and performance management share common goals around maximizing employee engagement and motivation, they emphasize different techniques to achieve these goals. In the past, performance management and compensation processes were often so tightly linked, despite this difference, that neither one was very effective. As these two processes start to separate, compensation professionals have an opportunity to reimagine how pay decisions are made without being constrained by performance management methods that may not have been designed with compensation in mind. Today, compensation professionals can build processes that focus on the primary objective of compensation: to generate a return on investment and maximize the productivity of employees through effective use of pay and other forms of monetary rewards.

Today, compensation professionals can build processes that focus on the primary objective of compensation: **to generate a return on investment and maximize the productivity of employees** through effective use of pay and other forms of monetary rewards.



Your company eliminated annual performance ratings

THE CHALLENGE: HOW DO YOU ENSURE COMPENSATION DECISIONS ARE EFFECTIVE AND EQUITABLE WITHOUT RATINGS TO TIE THEM TO?

A critical component of a compensation professional's job is to ensure that compensation dollars are being spent wisely. In other words, they must ensure the company invests more in those employees who contribute more to the organization. Companies do not have to use annual performance ratings to achieve this. But allowing managers to make compensation decisions without any form of rating to guide them can pose a threat to effective and equitable decisions. As compensation professionals at two technology companies described:

"We've seen greater differentiation, but can't say whether the differentiation is dependent on performance because we don't have ratings. Our belief is that nobody needs rankings or ratings to know who his or her highest performers are. But the risk is how you know you are creating equity across the company?"

"We did away with performance rating scores which helped us move away from our old compensation merit matrix to processes that are more fluid. HR gives managers general guidelines for decision-making, but it's tough to monitor whether managers are using these guidelines effectively since there are no ratings."

If you eliminate performance ratings, it is important is that you replace the rating process with a well-defined, consistent method of accurately assessing employee contributions that will support compensation decisions. SAP customers described several ways to of doing this, including:

1. Replacing individual manager evaluations with manager calibration sessions

Traditional performance reviews often involved having a manager and employee sit down on an annual or quarterly basis to review past accomplishments, discuss future plans, and agree on an overall rating of the employee's performance. Many companies are eliminating the rating portion of this meeting. Instead, information related to employee accomplishments is used during subsequent talent review meetings where the manager meets with other managers to discuss which employees are contributing the most to the organization. This approach removes the anxiety and distraction created by including an overall rating in the performance review conversation. It also creates incentive for employees to accurately document their accomplishments throughout the year, as they know this information may be used in talent review meetings that could impact decisions affecting their compensation.

2. Replacing ratings of performance with ratings of employee value

Rather than rating what employees have done in the past, some companies are focusing on what they believe employees will contribute in the future and using this to guide decisions about pay. For example, managers may be asked to rate the relative criticality of an employee's skills and capabilities for future business operations. This information is then used to determine compensation adjustments. As one SAP customer described:

"Rather than creating a performance rating, managers are expected to translate the information [the perceived value of an employee] into an appropriate pay decision. There should be no surprises at the end of the year".

Generating accurate predictions about an employee's future contributions requires managers to know each employee at a deep level and have insight into the full range of that employee's unique skills and capabilities. For this reason, it can be valuable to host calibration sessions where stakeholders from across the organization are invited to share feedback and points for comparison. At the very least, managers should be given clear criteria for evaluating an employee's future value. Remember, employees are still going to ask why they did or did not receive the pay they expected, regardless of whether decisions were based on ratings of past performance or evaluations of future value.

3. Evaluating employees entirely based on goal accomplishment

This process starts with managers working with employees to establish and maintain clear job goals. Employees meet with their manager on a regular basis to discuss, clarify, and if needed modify goals throughout the year. These ongoing discussions focus on improving goal clarity, supporting goal accomplishment, and evaluating whether individual goals, tasks, and projects are on track. Managers then reference specific goal accomplishments when making subsequent decisions about pay. As an executive at one company put it:

"We focus on what people have done for the company and not who they are as individuals".

Companies that use this approach often include safeguards to ensure employee behaviors support company values. This is to avoid rewarding people for accomplishing the right things the wrong way. Some companies also calibrate goals based on difficulty and importance so that certain goals are considered more valuable than others when it comes to compensation increases.

You still have ratings, but have adopted a continuous approach to performance management

THE CHALLENGE: HOW CAN MANAGERS GENERATE MEANINGFUL RATINGS THAT REFLECT THE BENEFITS OF MORE FREQUENT MANAGER-EMPLOYEE CONVERSATIONS?

The reason many companies eliminated formal performance ratings was not because ratings cannot work, but because the rating processes they were using generated data that was not considered accurate or useful. For example, some companies' performance rating processes were so tightly coupled with compensation that they were basically a compensation justification exercise (for example, if an employee is rated as a "solid performer," an automatic 3% increase is given, but if they are rated as an "outstanding contributor", a 4% increase is given). Adopting a more continuous approach to performance management can provide opportunities to improve how companies guide compensation decisions. Encouraging more ongoing dialogue between managers and employees can help managers gain a deeper understanding of the true contributions and capabilities of each one. This knowledge can in turn lead to more effective, accurate ratings used for compensation decisions. As one compensation professional described:

"Six or seven years ago, we dabbled with eliminating ratings. Today, we're rethinking the purpose and putting our focus on results instead. Ratings are back ... We feel we need to modernize the way we view compensation decisions and think about it more from a business point of view. Are we spending our resources in the most effective way?"

Companies are 'modernizing' ratings by basing them on more ongoing information about how well an employee's actions directly support company values and objectives, as opposed to evaluating general personal competencies and skills. As one compensation professional described:

"We used to have only mid- and end-year evaluations. Now we have more informal check-ins and a year-end rating component that mirrors what is being discussed during those check-ins. Ratings used to be based on competencies and skills, but now managers base ratings on employee goal accomplishment and how employees reflect the company culture. It's a whole different methodology for which Continuous Performance Management is very conducive."

Core to this change is using rating and compensation methods where managers actively discuss and review information about employee accomplishments gathered throughout the year. The rating process should not be a two-week exercise done at the end of the year. Ratings and compensation decisions should be a continuation and summary of information managers have been discussing with employees on an ongoing basis. As one SAP customer told us:

"If managers and employees are having effective and transparent conversations about performance through the year, the actual rating becomes a "non-event."

You're using informal methods of rewarding employees such as spot awards

THE CHALLENGE: HOW DO YOU ENSURE THESE MANAGER-DRIVEN AWARDS ARE DISTRIBUTED EFFECTIVELY AND EQUITABLY?

Many companies are making greater use of spot awards and non-monetary awards. These awards have the potential to be very motivating to employees, but their informality and relatively small size often deems them unnecessary to monitor for equity issues. As a compensation professional described:

"A manager can't award the same employee more than $7,500 in a given year, but anything $1,000 or less is under total manager discretion. Our HR business partner does not review or monitor these decisions."

The reality is that even small awards will frustrate and demotivate employees if they are distributed inequitably. As the same individual went on to say:

"We think managers having more autonomy is a good thing. But there is a trade-off in being able to monitor decision accuracy. As gender pay equity becomes more critical, we recognize this tradeoff could be an issue."

To ensure managers are making the most effective compensation decisions possible, companies should provide them with the necessary training and resources including:

- An overview of the company's compensation philosophy related to on-the-spot and non-monetary awards
- Clear definitions of award-worthy behavior based on organizational values and goals
- Guidance for determining appropriate award type and value

Giving managers more decision-making autonomy around compensation does not mean managers should not have to justify their decisions. In fact, giving managers more freedom to make pay decisions should increase expectations that managers can explain how they make these decisions. By asking managers to justify their on-the-spot and non-monetary award decisions, companies can mitigate the risk of rewards being given in an inappropriate or inequitable manner. Managers should also ensure that employees understand why they are receiving the award. As one compensation professional described:

"Managers can allocate budget [for awards] at their will, but need to explain how they allocated it and why. This is for both the employee and the manager's benefit. They need to be able to say what specific behavioral and/or cultural values the award is aligned to."

Employees expect more transparency around compensation than ever before

THE CHALLENGE: HOW DO YOU ENSURE THAT INFORMATION ABOUT PAY IS EFFECTIVELY AND SENSITIVELY COMMUNICATED TO EMPLOYEES?
Employees have more means of accessing pay information today than ever before (for example through job search sites). With this accessibility comes a new level of expected transparency around pay decisions. As part of a broader research study on changing compensation practices, we spoke with 50 front-line employees from a variety of organizations and industries. These employees described a clear expectation of managers being willing to have detailed conversations related to decisions that affect their pay. But we know from our conversations with managers that talking to employees about pay decisions can be difficult and uncomfortable.

Compensation professionals told us that managers struggle to have productive conversations with employees about compensation because they:
- Don't understand how components of the compensation package are determined themselves
- Don't grasp the importance of communication
- Weren't directly involved in the compensation decision and thus do not feel accountable for it
- Don't want to have potentially uncomfortable conversations

As one compensation professional described:

"We provide training videos to talent acquisition and HR to ground them in the basics of our compensation philosophy. We provide training directly to managers related to compensation, FAQs, and so on. But we did focus group interviews this year and the reality is that neither employees nor managers understand the compensation program. They don't understand how decisions are made. It's not resonating. It's just too overwhelming alongside all of the other information managers and employees have to regularly take in."

Managers are much more likely to have high quality, critical conversations related to pay decisions if they are provided training on how to do so. In addition to managers being trained on how compensation decisions are made across the organization, communication training for managers should focus on:
- The importance of communication in influencing employee receptivity to decisions
- Improving interpersonal skills needed to navigate difficult conversations – several companies stressed the value of in-person, live, and interactive training with a role play component where managers can practice delivering uncomfortable pay decisions
- Tips for what to say and what to be careful about saying

All changes can be seen as threats or opportunities, and the performance management transformation is no exception. The changing world of performance management presents an opportunity for compensation professionals to rethink the processes used to make and communicate compensation decisions. But to achieve this, companies must think through the downstream consequences of changes in performance management on compensation and be proactive in implementing strategies to overcome these challenges ahead of time.

SAP SuccessFactors

Follow all of SAP

www.sap.com/contactsap

THE BEST RUN SAP®