Measuring the effectiveness of pay and reward practices

How do we achieve more evidence-based reward management?

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This article profiles a current IES research project on reward effectiveness and the early findings. Despite the contemporary focus on the effectiveness of certain reward practices such as bankers' bonuses; and despite the spread of evidence-based management techniques and balanced scorecards, it describes how very few UK organisations seem to systematically evaluate and produce robust evidence to justify their reward practices. It considers the reasons for this, including the complexity of rewards and their assessment criteria.

The article makes the case for addressing this situation, for not only are rewards a major cost, but there is research evidence to indicate that pay and reward arrangements can enhance employee engagement and thereby support improved business performance. The aim of the research project is to produce practical guidance and tools to facilitate improvements in the field.

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The context: reward practices under scrutiny

'Agenda for Change Fails to Deliver' (Phillips, 2009). That was how one journalist summarised the recent review carried out by The National Audit Office (2009) of the major pay reform programme undertaken in The National Health Service between 2004 and 2006. According to its head Tim Burr, 'the benefits that should have come with this new simpler system have not been achieved … the programme has further to go before it delivers the intended value for money for the taxpayer'. Perhaps as worrying as the lack of achievement of its goals was the fact that the NAO found no clear assessment criteria or process had been put in place to assess this huge pay restructuring exercise.

Pay arrangements and bonuses have also been under the spotlight in the financial services industry. 'For top executives to award themselves these sorts of compensation packages in the current economic crisis is not just bad taste, its bad strategy and I will not tolerate it' declared new President Barrack Obama. Within a month of taking office, he was initiating pay and bonus caps for senior bankers in the United States.

On this side of the Atlantic too, the Financial Services Authority is investigating bonus practices, given as their chief executive Hector Sants (2008) noted, 'the widespread concern that inappropriate remuneration schemes may have contributed to the current market crisis'. Some would see the current economic crisis as bringing into question the whole market and performance-driven reward orthodoxy of the last 30 years, an approach that five Anglican bishops declared before Christmas to be 'morally corrupt, increasing the gap between rich and poor'.

Sants wrote to bank CEOs demanding that they review their incentive structures last year and he set out the criteria that the FSA will be applying in its risk management assessments, to differentiate between 'good' and 'bad' remuneration policies. These are:

- the performance measures used in bonus plans (too financially driven and not adjusted for risk?)
- the mix of remuneration (too much emphasis on short-term bonus?)
- the level of bonus deferral (not enough?)
- plan governance (also insufficient?).

We know of a number of remuneration committees in other sectors who have since adopted these criteria to review their own reward policies.

Perhaps that's the one good thing about a recession. It does force us to really focus on what is important and ensuring that it's working. The current economic climate has reinforced the move in recent years towards 'competing on analytics', 'fact-based decision-making'(Davenport, 2006) and 'evidence-based management' (Pfeffer and Sutton, 2006). According to one assessment over half of large UK organisations are now using some variant of the balanced performance scorecard to plot and measure their strategic progress.

In HR, we have of course been responding for over 50 years to Drucker's (1954) famous jibe that 'the constant worry' is our 'inability to prove they are making a contribution to the enterprise'. An IES research report last year (Robinson et al., 2008) catalogued a historical weakness of HR measurement, but also described the progress made in a range of contemporary organisations such as Centrica. In the training and development field there is now an expansive literature on evaluation and assessment and a reasonably widespread uptake of the Kirkpatrick model (see Kearns, 2005 for example).

The weaknesses of reward evaluation

You might think that in pay and reward, more than any other area of HR, we should be able to come up with nice 'hard' numbers to demonstrate to even the most interpersonally-challenged CEO that our reward practices really are making a positive difference.

Unfortunately, the UK landscape appears generally bleak in this regard The CIPD's annual reward management surveys (2004 - 2009) do reveal that a growing minority of organisations are attempting to assess systematically the effectiveness of their reward practices. Many now use information drawn from staff surveys, compare with benchmarking data from other companies and draw on the increasing range of human capital data available internally, for example from recruitment questionnaires and exit interviews.

The measures most commonly used include attrition rates, levels of staff satisfaction and length of service data (see Figure 1 below).

Yet the surveys show that there has been little growth in recent years in the use of these assessment mechanisms. In the latest 2009 survey, 46 per cent of respondents were unaware of their total spend on rewards, and only 17 per cent could provide figures for its constituent elements, such as benefits. Less than a quarter of organisations use any business data in making their assessment, fewer than a fifth conduct financial cost-benefit analyses of their reward changes, only 32 per cent assess the impact of reward changes on the staff on the receiving end of them, and only 10 per cent can put a financial cost on their labour turnover.

Figure 1: Measures used to evaluate the effectiveness of reward practices (% of respondents)

Measures used	All	Manufacturing & production	Private sector services	Voluntary sector	Public sector
Turnover rate	82	84	80	81	85
Staff satisfaction	53	54	57	35	52
Appraisal & performance management	47	54	47	51	41
Profit	34	41	47	7	6
Length-of-service distribution	33	33	31	30	39
Vacancy rate	32	24	23	44	57
Workforce composition	32	23	23	40	58
Time taken to fill vacancies	31	30	30	40	32
Customer satisfaction	30	26	38	30	19
Reward budget costs	30	35	33	23	21
Competency / skill level of staff	26	28	31	35	13
Job offer refusal rate	23	20	27	26	17
Measures of staff commitment	21	20	21	23	18
Sales growth	19	23	27	5	4
Productivity per employee	19	27	20	14	9
Economic value added	15	16	20	7	5

Source: CIPD. n=534

Our IES research project includes an e-survey of general practice and more detailed case studies, and our early findings very much reinforce this picture of lack of assessment and evidence. Very few organisations seem able to answer basic questions about the effectiveness of their reward policies, such as:

- Is your pay market positioning right? What would happen if you moved up to an upper quartile pay line, would it affect your ability to attract and retain?
- Do you have the right job evaluation system and number of pay grades? What would happen if you had fewer or more?
- What's the return on the cost of your incentive plans? What would happen to performance if you halved or doubled the incentive opportunities?
- Are you getting any measurable return on the cost of your flex and benefits plans?
- How do rewards affect the levels of engagement and performance of your employees?

According to Milsome (2006), 'when implementing new reward practices (such as merit pay), organisations often disregard facts and act on ideology and casual benchmarking'. Martin (2008) is scathing of 'the big idea' of employer branding, which he claims is based on some highly 'questionable assumptions about human capital and woolly thinking'.

Many employers still seem to be pursuing an unmeasured and undifferentiated, low performance/low impact, 'follow-the-herd' reward strategy, engaged in a constant and fruitless search for the nirvana of supposed universal 'best' practice.

The barriers to assessment and effectiveness

Given the contemporary focus on cost effectiveness, quantitative measurement and analytics, why has there been so little progress in the assessment of reward practices?

Faced with the barrage of statistics generated by the typical HR benchmarking study or metrics house, we might sympathise with the hassled HR manager who may have doubts about some of their reward practices, but lacks the will and resource to investigate them.

Beyond lack of time and resource, other reasons raised so far in our research include:

- lack of training and skills in statistics, finance, quantitative and research methods amongst the HR community
- the academic/practitioner divide in HR, which means that many useful studies are hidden away in lengthy, impenetrable academic papers (this one excluded, obviously)
- sheer laziness if we are not being pushed by others to do it (though HR functions are undoubtedly coming under more pressure to justify their existence).

A study for the UK Department of Health (Corby et al., 2003) looked at seven organisations which had introduced new pay structures. The researchers found a complete lack of evidence to indicate whether the stated objectives for the changes had been achieved, but also scepticism amongst the HR managers involved. The researchers believed such was the managers' psychological investment in the changes that they would have had difficulty admitting their goals had not been achieved.

A local authority in our IES research also illustrates the importance of a strong and united political consensus in explaining a long term move to more performance-related and more flexible rewards, although in this case in combination with more attention to the assessment of outcomes, it has resulted in a better evidential base to indicate the beneficial effects for employer and employees of this shift.

It is undoubtedly difficult to assess pay and reward practices in many settings. A wide range of variables and factors, many of them intangible, are generally involved. For example, if you close a Defined Benefit pension scheme you can easily calculate the financial savings. But how do you assess this relative to the demotivation of existing staff and loss of attraction of potential new recruits?

Another problem is that you can rarely carry out controlled research studies and 'experiment' with different approaches to pay and rewards when people's livelihood and standards of living may be at stake. It is also difficult to isolate pay practices to assess their effects. The introduction of performance-related pay for example, is generally accompanied by changes in the performance appraisal and measurement process, so defining positive outcomes and what is bringing them about is very difficult.

Given these barriers, it is important therefore to define just why the effort of measurement and assessment is worthwhile.

Effectiveness: reward and performance

There is an increasing body of evidence that measuring and improving the effectiveness of reward practices has major potential benefits for employers in our ever-more knowledge and service-based economy. Combs et al.'s (2006) meta analysis includes 92 studies showing a link between HR practices and organisation performance. They identify three sets of influential HR practices: those that increase skills, empower employees and improve motivation, and pay and rewards can impact on all three of these areas. For example:

- Thompson (2000) found that practices that build skills, motivation and ability, including share ownership schemes, broad-bands, competence-based pay, and team rewards were associated with higher organisational performance in the aerospace sector.
- In a study of 25 customer service organisations, Brown and West (2005) reported links between employee engagement and customer service performance, with employees influenced by reward practices such as variable pay and recognition awards.

Organisations such as Nationwide, McDonalds, Standard Chartered Bank and Tesco have replicated such results internally and shown powerful linkages between reward practices, employee engagement and their financial performance. Four of the case studies so far have been completed in the research and a précis of two of these is presented here.

Case Study Examples: McDonald’s

One of the IES research case study organisations is McDonald’s, the quick service restaurant chain which employs 72,000 people across 1200 restaurants in the UK. Neal Blackshire the Compensation and Benefits Manager characterises the management approach there as ‘if it moves, we measure it’, and a variety of metrics are used to assess the reward practices he designs.

The investments in staff incentives, training and benefits are perhaps surprisingly extensive in a sector with something of a low skill/low pay reputation, and the Company’s recruitment advertising campaigns, such as ‘Not bad for a McJob’ have been aggressively working to shift that image. The firm commissioned Professor Adrian Furnham to investigate the employment experience and he found that working at the Company had a generally positive impact on young peoples’ skills and employability (Thomas, 2006).

The engagement of McDonald’s employees is measured using the firm’s annual ‘Your Viewpoint’ survey, a long-term tracking study of employee opinions, and it had an 83 per cent response rate in 2008 in the UK. The survey covers views on reward and employment practices and amongst hourly paid staff, 77 per cent agreed that their pay and benefits are competitive, 80 per cent that they are respected and recognised for their work, 84 per cent that leaders behave consistently with the company’s values, and 85 per cent are satisfied with their personal development and growth opportunities.

The proportion of engaged staff has grown from 77 per cent in 2004 to 84 per cent in 2008. The McDonald’s engagement model breaks the contribution of employees into two components: competence and confidence. The confidence index is an amalgam of the responses to questions such as people looking forward to coming to work, feeling motivated in their job, and feeling proud to work in the Company. The aggregate index has increased from 69 per cent in 2004 to 81 per cent four years later. All of their training and skills initiatives have been targeted on building staff competence, picked up in the survey with questions about staff feeling they have received the training they need, are able to satisfy customers and have effective performance reviews. This index has also increased, from 86 per cent to 92 per cent, over the last four years.

But the performance impact is most evident when the variations between outlets are considered. Comparing the outlets with the most positive employee attitudes (where more than 50 per cent of employees are ‘positive’) with those displaying the lowest levels of engagement closely mirrors the sales and guest counts of those stores. Sales are an average 28 per cent higher in the high engagement stores and guest counts are higher by 66 per cent. This is why the need for engaged and committed people in the Company is taken and invested in so seriously: they deliver the quality food, clean environment and speedy service that drives up customer visits that boosts sales and profits.

Case examples: A major accountancy firm

Another of the case studies in the IES research is one of the major accounting firms. Perhaps not surprisingly, here again there is a very clear set of reward metrics which are regularly reviewed at Executive and business unit level. The firm's current reward strategy is based on six explicit principles which strongly emphasise rewarding performance They are:

- market-leading bonus for market-leading performance
- performance-driven reward that is fair and equitable
- a variable proportion of reward that increases with grade
- market competitive salaries
- competitive benefits, with choice and flexibility
- people management leaders empowered to make and communicate reward decisions.

The firm monitors a set of 13 Key Performance Indicators based on each of their reward strategy principles, using a traffic light system of assessment against them. These principles and measures are organised as follows:

Market-leading performance for market-leading reward

- Total cash median above external market median and upper quartile above market upper quartile in all grades.
- Improvement in employee survey scores on statement 'our compensation is as good as or better than our competitors'.

Performance-driven reward

- Actual salary increases and bonuses for exceptional performers compared to strong performers.
- Performance ratings distribution by grade and function.
- Improvement in employee survey score on 'does your compensation match your performance?'.
- Improvement in survey score on 'the firm makes adequate use of recognition and rewards other than money to encourage good performance'.

Reward that is fair and equitable

- Same average pay level for males and females in each grade.
- Same promotion rates for males and females and part-time and full time staff.

Market competitive salaries

- Median actual salaries for each grade within 5 per cent of market median.

Competitive benefits with choice and flexibility

- Proportion of employees making flexible benefits choices.
- Survey results for 'our benefits fit my needs', 'are you happy with the range of benefits?' and 'I am aware of the benefits the firm offers me'.

Performance managers empowered to make and communicate reward decisions

- Reward not a reason stated by employees for leaving in exit interviews.
- Improvement in survey results on 'how satisfied are you with the recognition you receive for your performance?' and proportion of managers surveyed who feel that they are 'very involved in making/communicating reward decisions for their team.

Targets are set and results compared with prior year performance on each of these measures.

In common with the rest of our case studies so far, the firm's head of reward is quick to point out the weaknesses in this framework and the need to extend it and improve the integration of the various measures used. A new HR information system will make extracting the data easier, and she really wants to see the information have more visibility and make a real impact down in each business.

But also consistent with our other case sources, she stresses the need for an evolutionary approach both to rewards and the evaluation of their effectiveness, making improvements when and where possible, but also adapting to changes in circumstances inside and outside the firm.

A general process for improvement

The national surveys shows that our two case study organisations are very much in the minority. So how can the IES research contribute to improving this situation? What is obvious from our case studies so far is that there are no universal set of reward data and metrics that all organisations should use. As our research on human capital measurement more broadly also concluded, the measures have to be tailored to each sector and organisation.

But the case organisations do all share a common prioritisation of the importance of evidence-based reward management, and all operate some type of process to effect it. Though not always specified or defined in an orderly sequence, this process seems to have four components:

- setting reward strategy goals, which define what effectiveness is and how you measure it
- conducting a reward review: assessing current reward policies practices against these criteria, using both general research and situation-specific evidence in the organisation; identifying key issues and agreeing changes
- piloting and making improvements
- continuing to measure, monitor, review and adapt the rewards package.

Step 1. Set strategic reward goals and success criteria

Cynics might argue that strategic reward goals are simply variations on the traditional 'holy trinity' of compensation: recruit, retain and motivate. Yet the whole point of being strategic is to set out how you believe rewards can best support the success of your organisation, establish the criteria to assess their success in doing so, and make changes to close the gaps.

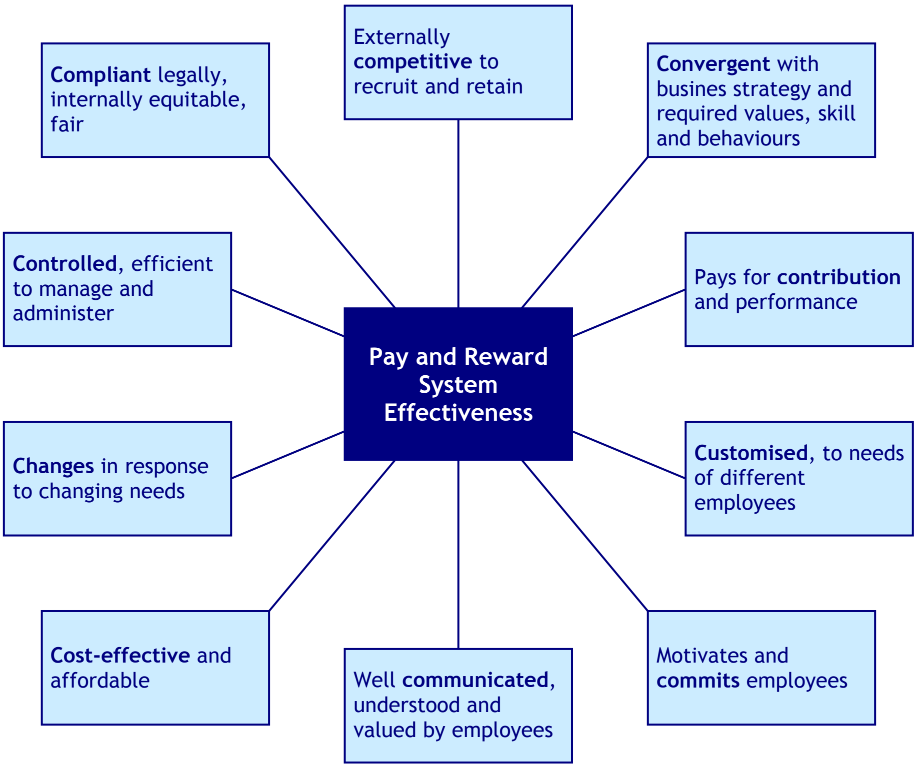
When BT implemented a series of major changes between 2003 and 2006, it did so on the basis of a very clear set of reward goals:

- clarity and transparency
- business linkage and reinforcement
- external market focus
- performance-related and differentiated pay
- fair and equal rewards
- personal choice and flexibility.

This agenda drove the changes to pay structures, pay reviews and total rewards, and was used to assess their effectiveness (Armstrong and Brown, (2006). Subsequent employee surveys revealed that the vast majority of staff 'understand and support' the changes.

Figure 2 illustrates what our research has found to be some of the most important criteria which are used to assess the effectiveness of reward arrangements. While a potential conflict of criteria is evident, of more concern is how few of the criteria most organisations use, beyond the ubiquitous one of market competitiveness.

Figure 2: A framework for reward strategy and effectiveness work: the ten 'C's



Step 2: A reward review

Around a fifth of UK companies have a specific review group to audit their reward arrangements, and far more carry out periodic reviews of their reward arrangements. This might involve an in-depth exercise, or a regular assessment of existing rewards and changes. At a UK drinks company, a line management committee meets quarterly and reviews any proposed changes to reward arrangements.

An effectiveness review generally involves:

- gathering information on existing practices
- making assessments of the effectiveness of the various reward practices
- agreeing key reward issues to address
- considering possible options to improve the delivery of the reward goals
- agreeing the optimum improvements and planning their implementation.

In respect of external information, as well as benchmarking remuneration levels, organisations such as McDonalds are also reviewing evidence from external research studies. There is a wealth of academic research material on rewards which could be valuably used to help to assess and improve in-house practices if they were made more accessible and available. Two examples are in respect of pay competitiveness and on the topical issue of bonus and incentive plans.

The competitiveness of pay levels. A number of research studies (eg Pfeffer, 1998) point to the detrimental effects of paying below market median rates. But we have found no studies so far which conclusively demonstrate that adopting a market pay position above the median actually achieves improvements in business and HR metrics to justify the extra costs involved.

Thus Watson Wyatt's research (2002) found that reward policies had more impact on a company's growth in value than other aspects of HR management. Yet competitiveness of base pay explained just 0.2 per cent of that growth, with pensions, group and individual incentives, total reward designs and stock ownership having a much more significant impact.

Bonus and incentive plans are perhaps the aspect of reward where there has been most academic research, but also the most controversy, as the current financial services debate illustrates.

Studies demonstrate that high performing companies tend to make greater use of cash incentive plans and also employee share plans (see Cully, 1999 for example). Professor Simon Burgess's (1999) comprehensive meta-analysis of research on incentives draws two main conclusions. First, 'employees do respond to cash incentives'. But second, 'often in sophisticated ways, that may or may not benefit the organisation', (as has also been illustrated in the City).

This is why, while external research can help to inform reward effectiveness review, looking for evidence inside each organisation appears to be critical. For the academic research generally appears to support a contingency, 'best fit' model of reward effectiveness, rather than the universal 'best practice' approach.

Step 3: Piloting and implementing changes

92 per cent of the participants in the CIPD's reward management survey reported that implementing their strategic reward changes was either difficult, very difficult or near impossible. The external research in this area is unambiguous: managerial involvement and employee communications are absolutely critical.

Armstrong and Brown (2001) found that organisations which had rated their pay changes as less-than-effective were far more likely to also report that they had devoted too little time to communications, training managers, and to programme testing. More resource, this would suggest, needs to be devoted to improving reward communications and management processes if we are to improve the standards of reward management and the impact of rewards on performance in UK organisations.

In a Scottish financial services company, a 2 day pilot exercise was carried out in the marketing department prior to the introduction of a new base pay system. On some aspects, such as external market data, we found that managers did not want as much information as we had provided. But in other areas, such as how to conduct an appraisal with a low performing employee, we found they wanted much more support from HR than we had planned. The new system was implemented far more effectively as a result of the learning drawn from this pilot.

Step 4: Measure, review and adapt

Evaluating and improving reward arrangements is a continuous process, not a 'quick win'. It is vital after changes have been made to set assessment processes up, put clear performance measures in place and to monitor progress against them.

The best organisations at reward evaluation are not differentiated by having more information, data and metrics. They rather seem to focus on a relatively small number of key human capital measures and integrate these into their management and reporting processes. The information is really well used, by HR to improve plan designs and by line managers to improve the rewarding experience of their staff.

Law firm Cameron McKenna (2005) successfully addressed the problems of high turnover amongst legal secretaries, though a series of changes in their rewards and working conditions. Their 'people report' also describes that more that 50 per cent of partners in the firm were recruited in as trainees, an attractive statistic for ambitious law graduates.

Organisations such as Nationwide, McDonalds and Standard Chartered are carrying out regular monitoring and review of a wide range of employee, HR and business statistics to assess and improve the effectiveness of their HR and reward arrangements. Standard Chartered has also found powerful linkages between employee engagement and business results in its branch network. Dr Tim Miller, Director of People, Property and Assurance, emphasises the role of reward as one of the levers helping to create this high-performance, high-engagement culture:

'Our commitment to our employees is to develop them, recognise their contribution and reward their success. Through our reward practices, our employees should be motivated to focus on business and personal objectives, deliver outstanding performance and encouraged to act in line with the Bank's values.'

Conclusion: Moving from bad to good

Oscar Wilde' in *The Importance of Being Earnest* advised us to beware of people like us, 'who know the price of everything and the value of nothing'. It might be argued that in too many UK organisations we know neither and to improve the effectiveness of our reward practices, we need to make progress on both fronts.

Angela Wright (2006) writes persuasively that reward effectiveness research 'may seem like a lot of work, but if people are the organisation's greatest asset then surely more solid evidence of what reward practices add value and what do not is vital management information'.

In this article, we have described a process to help overcome the barriers and make progress in this field. As we continue our research, we would be pleased to hear from you if you have ideas or examples to share.

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