

Reward – in an unfamiliar world

Points of view by Mary O'Hara

Partner, HR & Reward Services,
PricewaterhouseCoopers



Mary O'Hara, Partner
mary.ohara@ie.pwc.com
Tel: + 353 (1) 792 6215

In today's turbulent economic environment, many organisations are examining their business strategy and making significant changes to the way in which they operate. It has become common practice to see wage cuts and reductions in staff / redundancies as 'necessary' steps in an organisation's business survival strategy.

Yet at the same time, there remains a need to prepare for the future and organisations need to be well placed to prosper. Throughout history, employers have been challenged with attracting, motivating and retaining the best employees. Yet the premise has been consistent: provide productivity and results to our enterprise and we will provide you with something of value.

Given the heightened focus on remuneration systems, is it imperative that organisations give due care and attention to their reward philosophy. This means developing and implementing remuneration strategies based on a number of core tenets, including – creating a clear link between performance & reward, adjusting for risk and communicating a model based on simplicity and transparency. But how do organisations reflect these principles in the design of their reward programmes?

All organisations should be aware of their total annual remuneration cost and how this cost is changing year on year. This should not be limited to basic salary, but should take into account incentive payouts, as well as fringe benefits like pensions, healthcare and training. Examining the value of the total remuneration costs as a percentage of total costs will then indicate how important it is to manage it effectively.

PricewaterhouseCoopers' European Human Capital Effectiveness Report 2009 states that companies will typically have remuneration costs ranging from 10%-55% of total costs. Obviously in any downturn, organisations look at a variety of cost saving initiatives, and given the potential size of the remuneration costs – it is inevitable that such costs come under the spotlight.

However, there is a trade off to be achieved in 'right-sizing' versus the impact reducing employee costs has on the organisation. The challenge is to contain costs and also to improve business results. With business confidence still fragile and more job cuts coming through the pipeline, it might appear premature to begin looking above the parapet towards the recovery. Smart companies, however, recognise that now is the

time to examine how their business model needs to adjust and are looking at what capabilities are required to compete in what will be a less familiar business environment.

Really understand the full elements of reward and how this can be linked to business performance

In the earliest years, reward was based largely on formulas that served the entire employee population in an organisation. Salary structures were just that -- rigid and highly controlled -- and benefits programs were designed as a one-size-fits-all answer to a homogenous work force. Fast forward to today where the current reward model is often seen as complex, poorly aligned, even more formulaic and importantly, often not motivating.

A reward package will typically include the following elements: basic salary and fringe benefits (fixed pay), short term incentives and long term incentives. Each element will vary in line with the seniority of the position involved and the industry / company size. Fixed pay is in place for attending to basic duties; short term (annual) incentives for meeting short term targets; and long term incentives for achieving strategic targets in line with sustainable business growth.

Long term incentives will typically deliver equity, over a 3/5 year period; and the short term incentives will reward in cash on an annual basis. For an employee to successfully qualify for incentive payouts means he/she must achieve pre-set targets / objectives – but formulation and calibration of these targets can be a complex process.

Use reward to successfully attract, retain and motivate the right employees

Over the past decade, successful organisations have spent a great amount of time and effort on identifying and managing key talent. Such organisations are strategic and deliberate in how they source, attract, select, train, develop, retain, promote, and move employees through the business. Research undertaken on

the value of such systems consistently uncovers benefits in a number of critical economic areas including: revenue, customer satisfaction, quality, productivity, cost and market capitalisation.

While high performers are essential to a company and warrant attention, an emerging focus is also being placed on another group - pivotal employees. Pivotal employees are members of the workforce that are expected to create value and determine the success of the organisation; they vary by industry and are not necessarily managers or high performers. For example, pharmaceutical companies depend on the research and development of new drugs – research chemists are likely to be pivotal employees.

The motivation and engagement of employees can have a significant impact on influencing behaviour and therefore on the long-term sustainability of business. Good reward programmes are intended to positively influence the behaviour of employees; if they are not doing so, questions must be asked as to why this is the case. The most successful companies have realised that they must take a much broader look at the factors involved in attraction, motivation and retention. And they must deploy all of the factors -- including compensation, benefits, work-life, performance and recognition development and career opportunities -- to their strategic advantage.

It is important not to lose sight of the non-financial reward elements and organisations should monitor and manage any demographic changes that will impact their ability to compete effectively, and reward in line with employee (and generational) requirements. The PricewaterhouseCoopers' global report "Millennials at work: Perspectives from a new generation" shows that younger employees place more focus on flexible working hours, leave allowances and mobility than they do on cash-based reward.

One of the key methods to successfully motivating and engaging employees remains through incentive schemes, with objectives aligned to overall business strategy, while managing the inherent risk associated with these incentives. In order to successfully attract and retain key talent and pivotal employees, the remuneration offered should be in line with market rates, subject to where the overall reward philosophy has been pitched.

The value of any reward package should be easy to understand

In designing a reward package, simplification is critical, with a trend towards fewer complex incentives and a greater focus on long-term arrangements and higher degrees of deferral. The more complex a reward scheme, the more difficult it is to manage and, just as importantly, to communicate to employees. What compounds this further is the fact that a long term incentive scheme, which will not pay out for three years, is sometimes ignored by the employee until due, and increases the pressure to "fill the gap" and ensure the employee is rewarded by way of short term incentive. Studies have shown that employees who clearly understand the potential value of their total reward package are more engaged, and therefore more likely to go that "extra yard".

Incentives should be driven not by an annual measure of performance, but rather by performance measured over a period that is closer to the life of the activity in question. For example, if an over-riding objective is to grow company profits by 5% over the coming year, this also needs to be aligned with future growth (there is little merit in achieving the objective in year 1, only to see this eroded with a loss in year 2 of a 5 year plan). Deferred incentive plans can play a very important part in cost and risk management, as they can reduce remuneration costs in the short term; reduce risk and maintain an appropriate return on investment on remuneration costs and employees can achieve returns aligned with long-term business growth.

The reward package needs to be clearly communicated

In order for the total reward programme to be effective, it needs to be successfully communicated to all employees. It is now crucially important that reward systems are more transparent to employees, particularly those employees that have been impacted by a reduction in total reward over the past 18 months. There needs to be a clear understanding of the challenges facing the organisation, and why this has led to changes in reward – including the basis for determining bonus targets and objectives, the total reward mix between fixed pay, short term and long term incentives and the peer group used for remuneration benchmarking.

Furthermore, there is a need for direct consultation between human resource professionals and the executive management of the

organisation, in order to ensure that such transparency and understanding is on the agenda at the highest level. Changes to reward structures will only succeed if HR professionals understand what their management are trying to achieve in the long term, and in turn use their expertise to help achieve this. An increase in clarity around reward philosophy ought to have a positive effect on employees and further influence their behaviour in line with overall business strategy.

Conclusion : Link reward to long term business performance

There is a need for the fundamentals of reward to be reviewed and re-applied in many organisations. The three core principles of reward management – attraction, retention and motivation – must now be combined with the simplification, communication and transparency of reward. This will allow for the retention and further engagement of

key talent and pivotal employees.

Clearly, any restructuring of rewards represents a significant challenge and cannot be achieved overnight. Key steps include developing relevant and transparent performance indicators as well as explaining to staff what is required of them and how they will be assessed. Organisations need to convince staff that the new approach can enhance long-term rewards for them and the business, at the same time ensuring that there is a clear line of sight between performance, reward and career progression.

For companies to succeed in an unfamiliar world, where economic challenges continue to dominate, adapting to a more balanced remuneration model, which links long-term performance and reward, will be key to a sustainable future.

¹Report is part of the “Managing Tomorrow’s People” series.