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Differentiated Compensation: The Corporate Talent Insurance Policy

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Introduction

Today organizations are facing more competitive pressures than ever before. They must evolve and get products and services to market faster because of a never-ending stream of new, smarter competition. Companies are facing these challenges by launching new initiatives to get ahead. These initiatives put pressure on HR because they typically rely on top talent to get the job done. According to a recent Mercer survey 40% of organizations are expanding their overall workforce. Yet, 60% of organizations are anticipating increases in voluntary turnover as the job market and economy continue to improve.[1] At the same time CNN reports that 70% of workers are unhappy at work but will stay with its current employer anyway[2], and Gallup states that over 70% of the workforce is disengaged[3].

These statistics are alarming, and effective talent management is critical for HR to respond to the challenge. Central to an effective talent management strategy is managing talent risk through talent insurance policies that more accurately find and incent the best performers with differentiated compensation. More than 80 percent of companies around the world are offering variable-pay programs or performance-based awards that must be re-earned each year.[4]

This best practice guide explains the genesis of differentiated compensation and outlines how to create strategy, process, and supporting technology infrastructure to move from "good enough" compensation management to a program that aligns employee compensation to a company's key business goals.

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[1] Mercer, "Attraction and Retention Survey", 2012
[2] CNN, "Can't stand your job? Feel better about it", 2012
[3] Gallup Business Journal, "How To Tackle U.S. Employees' Stagnating Engagement", 2013
[4] Hewitt, "Global Compensation Survey," 2010.

The Advantages of Differentiated Compensation

Today's compensation and talent management professionals are looking strategically at the role of performance-driven rewards as a key lever for engaging and retaining top performers. There are numerous strategies for creating a high-performance culture, and today's technology advances have created major opportunities for looking at compensation structures differently than in the past.

Historically, companies had fairly narrow boundaries for compensation plans. The major levers were the merit increase for base pay and bonuses for achievement of goals. While these are still primary, compensation departments are looking more broadly at other variable pay mechanisms that take into account business performance in addition to employee performance.

The most basic example of this type of reward mechanism is to tie a portion of an employee's compensation to the company's financial performance measures, such as sales or revenue at company, division, or even departmental levels. This is an easily available metric that all employees understand. The issue is that the linkage of employee work to this particular measure might not be clear-cut.

Variable reward programs can be part of risk management and thought of as profit insurance. When a company has lower than expected profits, variable compensation budgets are reduced to mitigate any shareholder impact. This is not punitive, as the shareholders have based their investment on the performance of the company and employee actions are directly linked to this performance. On the flip side of the coin, when the company's profits exceed targets, the bonus pool is deepened and employees reap the benefits of the linkage between their performance and the exceptional results.

Other business success metrics being linked to employee compensation include customer satisfaction, customer retention, and customer support. These get a bit trickier to map to individual levels, yet they are critical to a company's success.

Savvy businesses are also looking at other incentives to retain top performers. Grants of stock options and full value shares, education and other development activities, and spot bonuses are also being factored into differentiated compensation plans. Interestingly, top talent rarely leaves a company for compensation reasons alone.

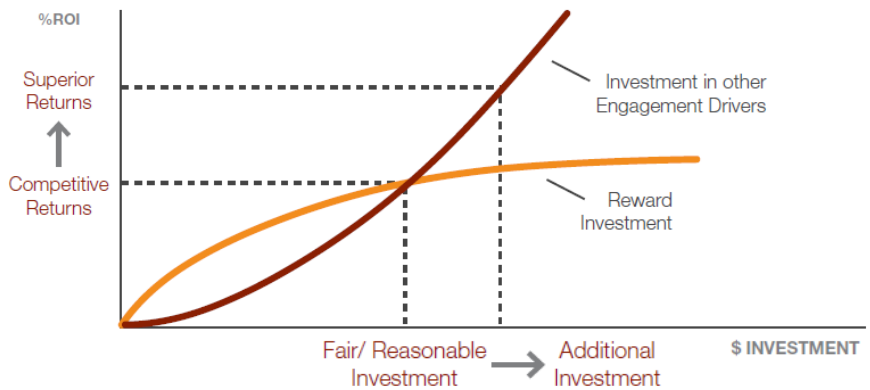

Figure 1. Top talent rarely leaves a company for compensation reasons alone. [5]

Multiple studies cite that a lack of employee development activities is a key decision point for top performers. Therefore, using development activities—whether they are educational opportunities, formal mentor relationships, or stretch assignments—as rewards for top performance is cost-effective and helps enhance retention. This is potentially powerful insurance for key players in the organization. But for compensation professionals, it is increasingly complex to design, administer, and keep current.

The more tightly aligned the high-performance culture, the more complex the compensation scenarios. Compensation professionals must look at multiple types of measures for various roles in the company. This is further complicated when factoring in commensurate incentives across geographic and regulatory boundaries.

This complexity makes it hard—if not impossible—to keep up with all the potential incentive and regulatory parameters with manual processes and spreadsheets. In large organizations, the process is so complex it is common to find "leakage" in compensation. For example, by the time some businesses get their compensation budgets approved, the compensation pools do not reflect the reality of the staff currently in place.

This can result in:

- Allocating limited compensation budgets to employees who leave shortly after the compensation cycle is complete
- Managers "gaming" the system to keep their compensation budgets the same even after they have lost staff
- Human error in data entry and calculations in spreadsheets
- Unnecessary waste of resources

[5] "Connecting the Dots," *Hewitt Quarterly Asia Pacific,* Volume 7/Issue 1.

Building Differentiated Compensation: Five Steps

Creating a strong differentiated compensation program includes five major steps:

1) Strategy
2) Technology Support
3) Tactics and Programs
4) Measurement
5) Communication

Step 1: Strategy

It might seem to be common sense, but many talent management and compensation initiatives fail to achieve the desired results because implementation starts without a clear sense of the objectives and the success criteria for the project.

A compensation strategy maps the desired company results with the necessary behaviors needed from employees across the company. Once the behaviors are determined, the best combination of rewards is selected to achieve these behaviors. Since the company wants to encourage employees to perform at an extremely high level, the compensation strategy ties to the company's overall talent management and performance assessment strategy.

If the company strategy is to focus a higher proportion of the compensation budget on top performers and high-potential employees, it is critical to be able to identify this category of employee. This is where many companies encounter substantial barriers. When the performance assessment strategy clearly defines the criteria for high performance, managers and employees have a solid foundation for a clear, consistent, and frequent dialogue about the employee's progress.

Best-in-class performance management will usually have the following attributes:

- Goals that are aligned throughout the organization. The goals should be SMART (Specific, Measurable, Attainable, Relevant, and Timely) to ensure that employees know exactly what is expected.
- Continuous feedback and dialogue between manager and employee to assess progress against those goals.
- Regular (typically annual or biannual) focal performance reviews that assess the "what" (what did the employee achieve when measured against goals?) and "how" (how did the employee achieve the goals measured against the organization's values and desired competencies?).
- A talent calibration and talent review process across the entire organization that adjusts for variations in how managers assess performance and brings out potentially hidden high potentials and top performers.

If these pieces are not in place, companies might be managing the performance process by gut feel. This results in a lack of checks and balances and becomes a popularity contest for top talent. This is how “diamonds in the rough” in an otherwise poorly performing team or group might go unnoticed, or underperformers might hide in the glow of superstar colleagues.

The SMART goals portion of the strategy ideally should include the company and employee metrics that are being targeted. Relevant company metrics, for example, might include:

- Revenue
- Sales
- Customer Service
- Quality Statistics

These metrics can apply to the entire company, specific departments or business units, different geographies, or any other relevant segment of employees.

It is obvious that the number of combinations can easily overwhelm the strategy team, so ensuring only the most crucial measurement categories are used goes a long way in making sure that the plans will actually be implemented.

The strategy phase will cover the timing of the performance assessment and compensation management cycles during the year as well as the mix of cash versus noncash incentives. These are typically decisions made very infrequently and represent the company’s general talent management and fiscal philosophies.

Another critical decision is how the compensation philosophy reflects the company values. If a company values a performance-driven culture, the retention of top performers is critical. As a result, the compensation philosophy might be to compensate the role at a higher position compared to the market. This will drive the downstream programs and tactics employed by the compensation team.

Step 2: Technology Support

The entire performance and compensation process should have a strong technology underpinning. Without a strong talent technology platform, companies end up with static goals and performance documents that are not modified based on changing business conditions and are not reviewed until the next performance cycle.

In addition, the talent calibration process relies on a single view of organization talent. Without a technology enabler, talent reviews become a lengthy and costly manual process. The technology is also critical to move the calibrated performance assessment data into the compensation technology process.

Given the extraordinary complexity of global compensation plans, flexible and highly configurable technology is essential to manage the process in a way that enables focus on top performers. The technology should take the “heavy lifting” off of the compensation team with regards to compensation rule definition and editing, employee eligibility, and transparency into process and practice in any organization across the globe.

Considerations for the technology platform should include a review of how compensation rules and calculations are created, edited, and implemented. This will be absolutely critical in order to administer a complex compensation landscape. Additionally, the system should be capable of dynamically calculating employee eligibility. Since employees might be eligible for multiple plans—and it is certain that employees will transfer between departments and geographies—eligibility can change along with these transitions.

To use metrics from the finance and customer support systems, consideration should be given to whether the compensation system can use the input system to calculate variable pay. For example, if employees are compensated based on financial results for their division, the compensation engine must calculate the proper compensation based on the data passed from the finance system.

Finally, the company might consider whether the system can accommodate a single consolidated view of compensation budgets. This is a radical departure from the manual spreadsheet-driven process that requires the compensation team to compile multiple disparate spreadsheets. As employees transfer within the organization, leave the company, or get hired, manual processes make it difficult to react and change the budgets accordingly. Because the budgets are a challenge to keep updated, there is a high likelihood of budget leakage, where monies are not controlled tightly and are then not available to use on the top talent.

Many existing systems are limited in that they require companies to standardize their compensation plans, which forces the plans to conform to existing rules. An effective compensation management technology should be designed to handle the increasing level of complexity of all the different existing and emerging compensation plans (variable pay and pay for performance) and tools (such as options, restricted stock units, phantom stock, and short- and long-term incentive plans).

Key Features of Compensation Planning Systems

- Global compensation rules library
- Configurable total compensation platform
- Global total compensation budget dashboard
- Integration with performance, goals, and other systems
- Base salary and merit planning
- Incentives and bonus planning
- Equity, stock, and long-term incentive (LTI) planning
- Total rewards statements

Step 3: Tactics and Programs

The next phase of implementing highly differentiated compensation is setting the tactics and programs essential to execute on the strategy. These tactics include making the following decisions:

- Who should be eligible for a bonus or other variable compensation program?
- How are the pivotal roles that influence the company metrics identified and at what percentage of the market pay range are they paid?

- How does the company ensure that an employee's total compensation including variable plans and equity stays within the market ranges for the role?
- What are actual quantitative targets for the performance metrics?
- What percentage of the compensation plans is based on company versus business unit versus individual performance?
- What percentage of the company's compensation budget will be set aside for top performers?
- What is the framework for the employee communications strategy?
- What percentage of available equity pool is allocated to top performers and high-potential employees?

The tactics and programs step is essential for performance and compensation conversations to occur. Objective performance discussions between managers and employees are only possible if specific criteria are set. The other outcome of this step is that macrolevel communication can occur to alert the organization as to the incentive targets possible if high performance is achieved.

Step 4: Measurement

The next step for developing a differentiated compensation program is to measure progress for the business and for the individual. As discussed above, a high-performance culture is created by establishing an environment where consistent and frequent discussions about employee performance are held between manager and employee. These discussions help employees correct any performance gaps early enough in the cycle to make sure they can attain the targets for high performance.

Talent analytics and reporting that provide enterprisewide, reliable data is the key to program success and continuous improvement, yet too often lacking.

The other critical measurement is business performance. Frequent updates from the business units regarding progress against the stated goals help employees understand whether their performance is "moving the needle" on the right metrics.

Step 5: Communication

Communicating to employees the results of the year's progress against goals—both individual and business—is the final step in creating the differentiated compensation program. Total rewards statements are a useful tool in this process. Top performers will clearly see the results of their work and can compare their compensation with the targets established at the beginning of the process.

This is a critical step because top performers need to see concrete evidence that their differentiated performance resulted in differentiated compensation. And less-impactful performers, likewise, need to clearly understand where they did not measure up.

Pay for Potential

Pay for performance is one approach to retain high-potential employees. However, companies need a strategy to recognize the future contributions that these employees will bring to the organization. Pay for potential ties to an overall talent management strategy in a slightly different way. Where pay for performance requires a tight linkage between performance assessment and compensation management, pay for potential also adds succession planning and employee development.

Calibration is a key component of pay for potential, but is used in a different way in pay for performance:

- Performance calibration is used in the pay-for-performance process to ensure that performance is assessed uniformly across a company.
- Pay for potential requires a more broad calibration process that weaves in competency assessment as well as development activities associated with high potential.

Once the broader talent calibration process is established and implemented, the company should consider what types of rewards might be established for high-potential resources. This could be a prime opportunity to leverage noncash rewards or long-term incentives like equity. Examples of noncash rewards could be advanced education opportunities or other types of development activities.

Equity and other longer-term incentives are an attractive option due to the typical vesting timeframes. Employees remain engaged and are incented to perform at a high level to reap these longer-term rewards. These types of rewards—in conjunction with the opportunities for advancement—are significant differentiators compared with employees assessed as average.

Differentiated Compensation in Action: A Case Study

A large global financial services organization based in Canada with approximately 45,000 employees created an overarching talent management strategy that included a heavy focus on performance-driven rewards. Goals were clearly stated and goal attainment was directly connected to rewards. This company had a single, end-of-year performance and compensation cycle.

The requirements for the implementation system started with a focus on differentiating compensation for top performers, with a secondary focus on streamlining the overall compensation process. The company selected an MBO-based bonus structure accompanied by variable pay and equity plans based on company and business unit targets. The added complexity in this structure was that the differentiated rewards had to be applied across multiple geographies and multiple currencies.

A key part of the successful implementation was the change management associated with getting line managers to engage in the conversations necessary to objectively assess performance, and then calibrate the assessments across the globe. The technology solution selected allowed the company to easily apply the rules that were created around the multiple plans.

The results exceeded the company's expectations. Employees saw an immediate shift in the company toward a high-performance culture. Rewards were differentiated to focus a higher share of the compensation budgets toward the identified top performers and high-potential employees. As a result, the company saw a significant increase in retention of these employees. Additionally, the company confirmed a 20,000-hour savings in resources when they eliminated their manual processes.

Conclusion

In a world where traditional compensation, layoffs, and bonuses make headlines and are becoming increasingly scrutinized and transparent, companies cannot afford to increase their risks in this area. Smart performance-linked differentiated compensation can make the difference between keeping star players and driving powerful company performance or diluting your company's talent pool and its ultimate impact on the market.

Companies can ensure they take advantage of the best talent insurance available by focusing executive-level time and attention on compensation philosophy and strategy, acquiring reliable market pay data, hiring a top-notch compensation team, training managers to execute on the compensation rules, and putting the right technologies in place.

Blending creative cash and noncash incentives and disproportionately distributing them to your highest performers and highest-potential employees is not only good talent insurance, it is good business.

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Oracle Corporation
World Headquarters
500 Oracle Parkway
Redwood Shores, CA 94065
U.S.A.

Worldwide Inquiries:
Phone: +1.650.506.7000
Fax: +1.650.506.7200

oracle.com