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Evaluating Pay Program Effectiveness: A National Survey of Compensation and Human Resource Professionals

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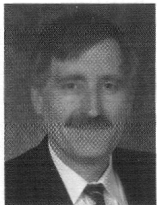
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Evaluating Pay Program Effectiveness: A National Survey of Compensation Professionals



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This paper is the second in a two-part examination of pay program evaluation. The first paper, "Evaluating Pay Program Effectiveness" (published last quarter in the *WorldatWork Journal*), suggested that using return on investment (ROI) to determine the value of pay programs has significant limitations. The authors proposed that comprehensive pay program evaluation should not only assess ROI but should also:

- ▶ Provide necessary feedback for improving pay program effectiveness, given the constant changes in the work and business environment
- ▶ Identify problems early in the pay program's rollout
- ▶ Build employee and management commitment to the pay program by engaging them in the evaluation and improvement process
- ▶ Hold management responsible for implementing the program as designed, and
- ▶ Communicate pay values, policies and programs to employees and managers.

To accomplish these goals, a comprehensive two-dimensional framework for evaluating pay programs was proposed (adapted from the work of Donald Kirkpatrick 1998). The first dimension focuses on four evaluation perspectives that should be considered in the evaluation process:

- ▶ employee perception of the pay program
- ▶ their understanding of the pay program
- ▶ employee behaviors driven by the program and
- ▶ the impact the pay program has on results.

Researchers widely use the second dimension in the process to collect and analyze data:

1. Setting goals or objectives
2. Identifying evaluation criteria
3. Selecting an evaluation methodology
4. Collecting and analyzing data
5. Interpreting findings and
6. Developing and implementing program improvement strategies.

This process ensures the information collected is of sufficient rigor to provide accurate insights on pay program value. This framework is explained in considerable detail in Part 1 of this series, published in the Second Quarter 2006 edition of the *WorldatWork Journal*.

This paper, Part 2 of the series, presents the findings from a national survey of compensation, human resources and finance professionals who identify current practices of how pay programs are evaluated within their organizations. To understand if a systematic and comprehensive evaluation process is used within organizations, the authors structured the survey to address the following questions:

- ▶ To what extent do organizations evaluate pay program effectiveness?
- ▶ How is pay program effectiveness evaluated?
- ▶ Does pay program evaluation tend to be quantitative or qualitative, formal or informal?
- ▶ To what degree does pay program evaluation focus on financial versus human resources measures (e.g., turnover, absenteeism, attracting talent or motivation)?
- ▶ What impact, if any, does pay program evaluation have on organizational effectiveness?

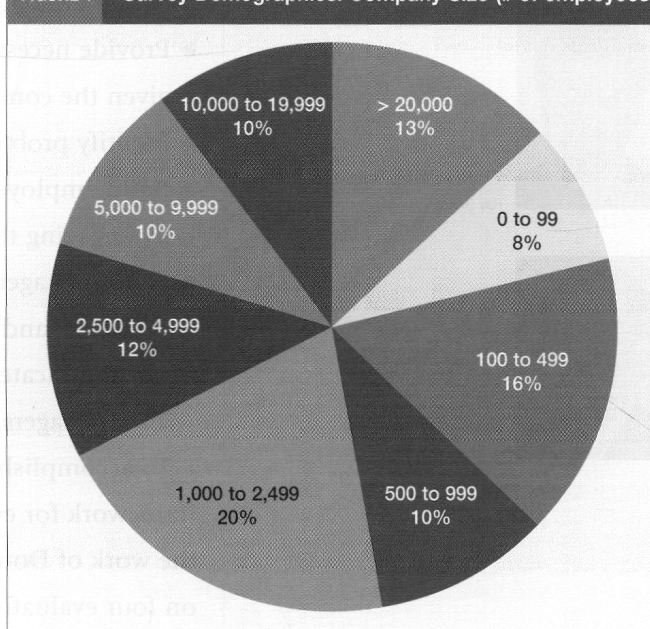
Data Collection Methods and Respondent Characteristics

WorldatWork, Chicago Compensation Association members and registered Hay Group (a management consulting firm) Web site users were invited to participate in the research initiative in January 2006. The survey was open for a 30-day period, and the database was closed in February 2006. The survey required approximately 15 to 20 minutes to complete.

Of the more than 600 respondents participating in the study, 55 percent were compensation professionals, 27 percent were human resources managers and 18 percent held other managerial positions (e.g., primarily business-unit executives and finance professionals). Participating organizations were fairly evenly distributed by size. Approximately one-third of organizations had fewer than 1,000 employees, one-third had between 1,000 and 5,000 employees and one-third had greater than 5,000 employees (See Figure 1 on page 48). Only 8 percent of the sample reported representing organizations with fewer than 100 employees.

Figure 2 on page 49 shows the sample included respondents from a diverse range of industries. The

FIGURE 1 Survey Demographics: Company Size (# of employees)



Because of rounding, this figure totals 99 percent.

FIGURE 2 Survey Demographics: Industry Sector

INDUSTRY SECTOR	%
Manufacturing	16
Finance and Insurance	15
Health Care, Social Assistance	11
Professional, Scientific, Technical Services	8
Public Administration	6
Educational Services	6
Retail Trade	4
Utilities	3
Information (Publishing, Electronic, Print, IT)	3
Transport and Warehousing	3
Wholesale Trade	2
Other Services (Except Public Administration)	2
Real Estate and Construction	2
Other	20

Due to rounding, this figure totals more than 100 percent.

largest representation were from manufacturing (16 percent); finance and insurance (15 percent); health care and social assistance (11 percent); and professional, scientific and technical services (8 percent).

While the Most Admired analysis uses a balanced set of rating attributes covering both financial and nonfinancial criteria, it is important to note that Most Admired Companies outperform the market as a whole.

Respondents were excluded from the analysis if more than one manager responded for a single organization (the highest-ranking manager was retained) or if the organization reported it had fewer than 10 employees.

To examine the impact pay program evaluation may have on organizational effectiveness, companies identified by *Fortune* magazine as a "Most Admired Company" were compared to respondents with the same range in employee size. The *Fortune* "Most Admired Companies" survey is a highly regarded annual analysis of corporate reputations. The Hay Group conducts the survey for *Fortune*. More than 10,000 executives, directors and industry analysts are involved in developing these overall rankings. The survey invites these respondents to rate companies, overall and within industry groupings, on nine criteria ranging from financial soundness and use of corporate assets to quality of management and quality of products and services. While the Most Admired analysis uses a balanced set of rating attributes covering both financial and nonfinancial criteria, it is important to note that Most Admired Companies outperform the market as a whole. In 2006, the top 10 Most Admired Companies delivered a five-year average total shareholder return of 11.1 percent, compared to -2.7 percent for the S&P 500.

Research Findings

In response to the question "Does your company evaluate the effectiveness of its pay program?" 66 percent responded "yes" for base pay programs and 53 percent responded "yes" for variable pay programs. From the total sample, 47 percent of the companies evaluate their base and variable pay programs. However, there was a significant difference in evaluation prevalence for the Most Admired Companies, with 81 percent of these organizations evaluating base and variable pay program effectiveness as compared to 51 percent of comparably sized companies (5,000 employees or more) that did not receive this designation.

The information reported in Figure 3 through Figure 8 (pages 50-52) is only for those organizations that reported they evaluated their pay programs. Figure 3 shows the level at which pay programs are evaluated and the importance associated with that information, collected for evaluation purposes. For base and variable pay programs, overall company or organization level was the most common point where pay program evaluation occurred; 87 percent and 76 percent for base pay and variable pay programs, respectively. Evaluation at either the department, work unit or team level was less prevalent for both base and variable pay. Although individual scores were not significantly different, companies with the "Most Admired" designation indicated that overall, they were more likely to evaluate base and variable pay programs at the organization and business-unit levels.

For those organizations where pay programs are evaluated, this paper's findings showed considerable variations in the depth and rigor of the analysis (See Figure 4). Few organizations report that they seldom, if ever, evaluate their pay programs after the programs are implemented for base and variable pay (10 percent and 7 percent, respectively). Whereas at the other extreme, 27 percent of respondents indicated that their organizations evaluate base pay and 38 percent said they evaluate their variable pay programs by

calculating both the cost and their bottom-line impacts. The most common practice for organizations is to calculate the costs associated with the compensation program and to informally discuss the impacts on bottom-line performance.

Companies were more likely to calculate the cost and at least discuss the bottom-line impact on variable pay programs than for base pay programs. This finding is consistent with the authors' beliefs that variable pay programs, by their very nature, are easier to evaluate.

Figure 5 on page 51 summarizes the criteria used to evaluate both base and variable pay programs. The most often used criteria for base pay programs are "attracting new employees or time to fill open positions" and "impact on employee retention or turnover." Whereas, the most widely used criteria for variable pay are "impact on revenues, profits and net worth" and "impact on productivity or cost savings." Given the significantly different nature and objectives of the base and variable pay programs, it is not surprising that different criteria are used to evaluate these programs.

Figure 6 reports the perspective used to evaluate base and variable pay programs. For all participants, informal feedback from both employees and managers are heavily used information sources. Formal employee feedback is relied upon for more than one-half of the

FIGURE 3 Pay Program Evaluation Levels

	Prevalence		Importance	
	Base Pay	Variable Pay	Base Pay	Variable Pay
Company or Organization Level	87%	76%	60%	56%
Business Unit or Division Level	45%	50%	23%	31%
Department Level	33%	27%	11%	9%
Work Unit or Team Level	16%	14%	6%	4%

FIGURE 4 Depth of Pay Program Evaluation

	Base Pay	Variable Pay
Seldom, if ever, evaluate after implementation	10%	7%
Calculate costs, but do not try to determine value/contribution	24%	12%
Calculate costs and discuss their impact on bottom line	39%	43%
Calculate costs and bottom-line impacts	27%	38%

respondents for both base and variable pay. More than two-thirds of the respondents indicated that results or outcomes attributed to base pay, were used to evaluate base pay and 88 percent said the same was used for variable pay programs. These data indicated that 80 percent calculated the ROI for variable pay programs, whereas a lower percentage of organizations (34 percent) calculate the ROI for base pay programs. Companies designated as "Most Admired" were more likely to engage in a comprehensive evaluation approach that included employee understanding, behavior change and results to evaluate pay programs, especially for base pay programs.

Figure 7 shows that the evaluation processes

(i.e., research methodology) used by most organizations are weak and largely informal. The most-powerful evaluation methods are seldom used. Less than one-third of the organizations even attempt to evaluate pay programs, and less than one-sixth compare pay program effectiveness with a nonparticipating employee group. However, as one might expect, "Most Admired" companies are more likely to use rigorous methods for evaluating pay programs.

Figure 8 on page 52 indicates that respondents strongly agree that more needs to be done to develop methods that accurately assess the contribution pay makes to the bottom line and to calculate ROI. Ninety

FIGURE 5 Criteria Used to Evaluate Pay Programs

	Base Pay	Variable Pay
Impact on revenues, profits, net worth	80%	90%
Impact on productivity or cost savings	72%	83%
Impact on quality waste or rework time	53%	61%
Impact on employee retention or turnover	84%	79%
Impact on employee satisfaction/engagement	78%	82%
Attracting new employees or time to fill open positions	86%	66%
Impact on overtime or other labor expenses	54%	41%
Qualification of recruits or applicant pool	74%	40%
Other qualitative measures (e.g., capability, competency)	67%	68%

FIGURE 6 Pay Program Evaluation Perspective

	All Participants		Most Admireds	
	Base Pay	Variable Pay	Base Pay	Variable Pay
Informal feedback from participating employees	39%	55%	60%	53%
Informal feedback from supervisors or managers	64%	71%	70%	50%
Formal feedback from participating employees	55%	79%	73%	79%
Level of employee understanding of program	47%	79%	69%	80%
Behavior change of participating employees	55%	N/A	84%	N/A
Results or outcomes attributed to pay program	67%	88%	93%	100%
ROI	34%	80%	70%	80%

FIGURE 7 Pay Program Evaluation Method

	All Participants		Most Admireds	
	Base Pay	Variable Pay	Base Pay	Variable Pay
Informally evaluate the pay program (no quantitative information is used)	52%	49%	70%	70%
Compare pay program criteria before and after program implementation	35%	47%	45%	75%
Compare pay program effectiveness with a nonparticipating employee group	16%	14%	15%	15%
Examine pay effectiveness measures over time	29%	30%	40%	50%

FIGURE 8 Pay Program Evaluation Improvement

	Base Pay	Variable Pay
Nothing needs to be done	20%	21%
Develop systems to provide capability to evaluate pay effectiveness	92%	93%
Develop better qualitative measures (e.g., capability, competency)	80%	73%
More accurately assess the cost of pay	73%	77%
Develop methods to accurately assess contribution pay makes to bottom line	80%	93%
Develop methods to accurately assess cost and contribution of pay effectiveness	93%	91%
Calculate ROI of pay programs	88%	92%
Engage management to realize importance of base pay evaluation	91%	90%

percent of respondents said that they need to help management realize the importance of pay program evaluation.

Conclusions and Recommendations

Most organizations evaluate their pay program using a variety of methodologies, however, informal processes are still the most common approach. “Most Admired” companies are more likely to evaluate pay programs and to use more objective and formal methods for doing so. Much remains to be done if the reader accepts the thesis that information from comprehensively designed pay program evaluation can substantially improve the quality and effectiveness of pay programs. The majority of organizations do not evaluate their base and variable pay programs, and only about one-third of organizations calculate the cost and bottom line impact of their pay programs. Less than one-half of the companies attempt to evaluate their pay programs pre- and post-implementation. Even fewer attempt more rigorous comparative or time-series analysis.

One important “qualitative” insight is the divide in thinking of human resources and compensation professionals about pay program evaluation. On one side of the divide are those who tend to view pay programs as a cost of doing business. Professionals holding this belief tend to have an orientation on focusing their evaluation efforts on cost control and benchmarking. On the other side are compensation and human resources professionals who view pay programs

as an *investment* and are concerned about optimizing the return on this investment. As a result, they are more likely to be proactive in determining how employees, especially high performers, perceive their pay program. Furthermore, those that see pay programs as an investment want to ensure their employees understand the pay program’s purpose and design, and they are interested in how the pay program shapes employee behavior.

To obtain senior management legitimacy and to enhance the impact of the pay program, the authors recommend that an organization follow a systematic and comprehensive process for evaluating pay programs, as suggested in “Evaluating Pay Program Effectiveness.” Given the substantial investment made in pay programs and the program’s impact on organizational effectiveness, comprehensive pay program evaluation only makes good business sense. When management desires to know why the pay program did not meet expectations, compensation professionals must be prepared with answers and, more importantly, must be able to make suggestions as to how these pay programs can be improved. More specifically, pay program evaluation must use multiple perspectives and rigorous analytical methods including the following:

- ▶ Use formal employee opinion surveys or focus groups to determine how eligible employees and the managers to whom they report feel about the pay program (e.g., fair, equitable and competently administered).
- ▶ Test eligible employees’ and manager understanding of the pay program.

- ▶ Monitor the influence of the pay program on employee behavior since changes in behavior drive expected performance and pay.
- ▶ Assess the results that the pay program is expected to impact (e.g., retention and performance).
- ▶ Calculate the ROI; program costs and value added.
- ▶ Use rigorous research methods to analyze data from each perspective.

Although evaluation methods and use of multiple perspectives may be new for many compensation professionals, human resources development and training professionals have considerable expertise in this area. Furthermore, most HR development professionals routinely develop e-learning programs that can be used to effectively communicate the intent and substance of pay programs. Thus, pay program evaluation provides an excellent opportunity to begin working with human resources development to educate employees about compensation and evaluate the impact of these programs. The earlier paper in this series provides specific strategies as to how to comprehensively evaluate pay programs. **WJ**

Resources Plus

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