How to Reward Top Talent With Pay-for-Performance

Lattice

Introduction

You want to inspire your employees to do their best work. And according to many HR leaders, the best way to make that happen is to link performance with compensation. That's the theory, and one of the traditional arguments for incentive-based approaches to performance management.

The argument resonates for most: Performance-based compensation models are extremely popular, particularly for sales-based roles. But they often raise several important questions as well. What are the pros and cons of tying compensation to performance? Who's eligible? And what does "pay-for-performance" even look like in practice?

On the flip side, critics have argued that linking the two distracts employees from more meaningful discussions about growth. In their view, doing so risks turning the performance review into less of an honest exchange of feedback and more of a drumroll for news of a raise or promotion.

When approached thoughtfully, the pay-for-performance model comes with more benefits than risks.

Just as no two organizations or cultures are identical, there is no "right" approach to the pay-for-performance model. Still, most studies have found that it pushes employees to grow and drives business results. For instance, one analysis published by Harvard Business Review finds that performance-based bonuses and raises are closely linked to greater employee satisfaction, trust in leadership, and motivation.

When approached thoughtfully, the pay-for-performance model comes with more benefits than risks. In addition to highlighting those benefits, this ebook will explain the fundamental considerations you need to make when integrating performance management and compensation at your organization.

The Case for Linking Performance and Compensation

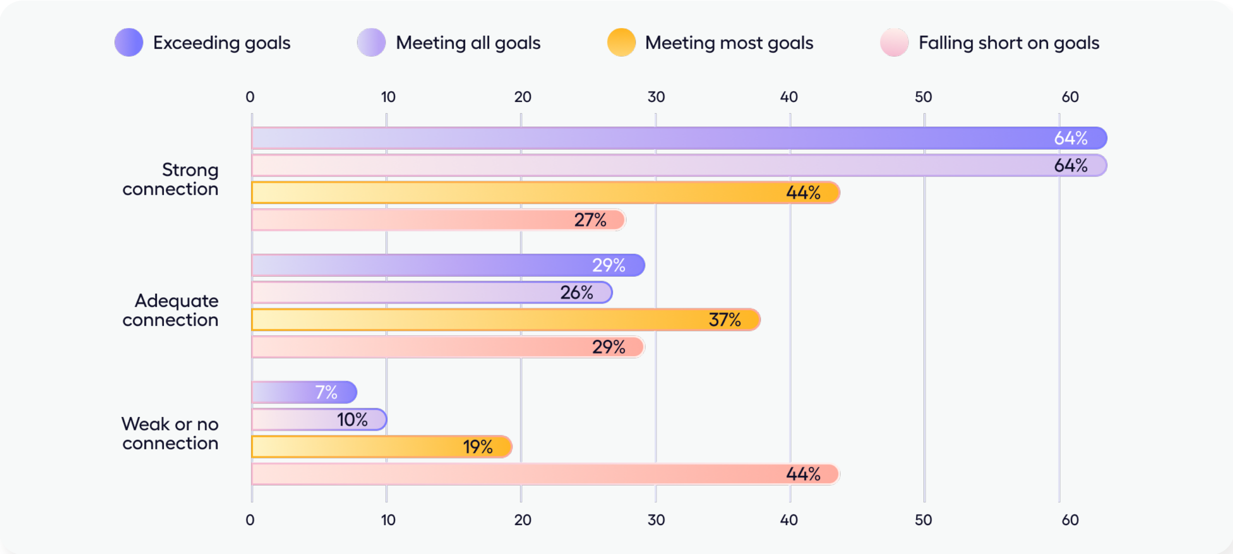
Most employees want their performance tied to their wages. That isn't a hunch: When Lattice surveyed over 2,000 employees about compensation in 2022, performance was rated as the top factor they expected salaries to be tied to. This applied to all generations: "Boomer" and "Gen Z" respondents all believed performance should be the lead influence over pay, ahead of factors like the cost of living, education, and tenure.

HR teams don't need much convincing, either. Lattice's 2023 State of People Strategy Report found that most teams are sold on the idea: 83% of HR leaders shared that they favored the pay-for-performance model. Still, a similar share admitted that they needed to improve how they connected the two.

Data from the Institute for Corporate Productivity paints a similar picture, finding that three-quarters of the highest-performing organizations leverage pay-for-performance. When asked why they valued that model, these organizations cited recognition for high performers (47%) and increasing the likelihood of achieving corporate goals (33%) as top reasons.

Those debating whether to implement pay-for-performance might also take a cue from high-performing HR teams, who not only place more importance on linking performance and compensation, but do a better job at it, too. The 2023 State of People Strategy Report found that nearly two-thirds of HR teams meeting or exceeding their goals have a solid pay-for-performance link. Lower-performing HR teams were likelier to work at organizations with little connection between pay and performance.

HR Goal Performance and the Pay-for-Performance Model



Linking compensation and performance may also help your employees see, in a tangible way, the benefit they bring to your company. Consider an employee who regularly meets or exceeds their goals. While that success might contribute to the growth of the business, under a pay-for-performance model, it also benefits individuals. Without this connection, team and company objectives and key results (OKRs) may seem arbitrary or disconnected from employee needs.

Lastly, Lattice research also suggests that employees are looking for more frequent raises. Delivering on that expectation, responsibly, means having an intentional strategy in place for merit increases, promotions, and other pay-for-performance mechanisms.

While there is no one-size-fits-all approach to pay-for-performance, evidence suggests that the merits outweigh any perceived risks. In the following section, we'll outline some mechanisms (like merit increases) companies leverage to make the pay-for-performance model work.

Pay-for-Performance Mechanisms

Employers have experimented with creating performance-based financial incentives for decades, if not centuries. As a result, today's HR and business leaders have a wide assortment of tools to make the pay-for-performance model work.

Along with traditional merit increases, other forms of variable pay can be used to reward an individual or team's hard work and goal attainment. Whether in the form of nondiscretionary bonuses or equity refreshes, variable pay offers a versatile tool for organizations looking to connect performance and compensation. Here are just some of the most popular mechanisms.

Merit Increases

Merit increases (or raises) are issued to employees over a set period and may be the most common pay-for-performance mechanism. While they are used to keep employee salaries aligned with the outside market, they can also act as an incentive for higher performers. In the latter case, they're often awarded as a result of an employee's performance on goals established during the most recent performance review cycle. They're also commonly expressed as a percentage of base pay.

For example, a top performer who exceeds every goal might earn a merit increase of 4% or 5%. Lower performers may take home 2%. Note these specific percentages are entirely up to your company's market analysis and budget. For reference, the median U.S. salary increase in 2022 was about 4%, up from 3% in previous years.

Sample Merit Increase Matrix

	Employee Position Within Pay Band				
Calibrated Ratings	Below Minimum	Bottom Third	Middle Third	Top Third	Above Maximum
Truly Outstanding ★★★★★	6%	5%	4%	3%	0%
Exceeds Expectations ★★★★☆	5%	4%	3%	2%	0%
Meets Expectations ★★★☆☆	4%	3%	2%	1%	0%
Needs Improvement ★★☆☆☆	2%	1%	0%	0%	0%
Unsatisfactory ★☆☆☆☆	0%	0%	0%	0%	0%

Along with performance, an employee's position within their existing pay band can be used to determine a merit increase. For example, an employee near the bottom of their band has more room to grow their earnings than someone near their pay ceiling. As shown above, documenting this via a merit increase matrix is one way to clarify this process to HR teams, managers, and employees.

Commission

Some functions, like sales, are deeply familiar with the pay-for-performance model. That's because they operate on a commission model. In other words, a portion of their pay gets determined by the revenue they bring in. For example, a salesperson with a 10% commission would earn $2,000 for selling $20,000 of product. When a commission is an employee's only form of compensation, it's called a straight commission.

But in most cases, a commission is in addition to base pay. That's especially true in industries with longer sales cycles, where it might take months to close a deal. Otherwise, linking performance and compensation might discourage, not motivate, employees. The overall combination of base and commission is often referred to as on-target earnings (OTE) and represents the amount of money an employee can expect to earn if they hit 100% of quota.

Discretionary Bonuses

Discretionary bonuses, as implied by their name, are given at *the* employer's discretion. In other words, recipients did not expect to receive them. These are sometimes called "spot bonuses" or one-time bonuses.

For instance, if a manager wishes to reward an employee for going above and beyond during unexpected circumstances (like working over the weekend to solve an outage), they can use a discretionary bonus. A surprise holiday bonus might count as a discretionary bonus.

While discretionary bonuses can be a lever for pay-for-performance, they aren't the most effective or transparent option. By definition, they aren't promised — so employees won't know what it takes to earn them.

Nondiscretionary Bonuses

Nondiscretionary bonuses are incentive-based bonuses awarded for achieving predefined goals or objectives. These arrangements are sometimes called "bonus plans." The amount earned may depend on several inputs, including individual, department, and company performance. Bonus plans are typically managed separately from commission or quota-based pay.

For example, recruiting teams may be eligible for a bonus plan for filling a specified number of roles. A customer service rep might also receive one for keeping client satisfaction scores high. In both cases, the requirements and calculations behind the bonus are precise and understood. And unlike discretionary bonuses, employees who meet all the criteria may be legally required to receive them under the Fair Labor Standards Act (FLSA).

Note that nondiscretionary bonuses are usually expressed as a percentage of base pay (a 10% bonus calculated based on $100,000 in base pay) or as a flat monetary value ($10,000).

Equity Grants, Profit Sharing, and More

Merit increases, bonuses, and other cash incentives are popular tools for recognizing high performers. Other total rewards offerings, like equity refreshes and profit sharing, can also be used to recognize employees.

One common way (especially at tech companies) to reward top talent is to offer additional stock options or equity "refreshes." In addition to boosting the value of an employee's overall equity, refreshes can be powerful retention tools when coupled with a vesting schedule. "Vesting" refers to the process of earning an asset, like stock options, over a predetermined period. For example, a new employee's option grant may be subject to a four-year vesting period. Refresh grants can be subject to vesting schedules, too.

Profit sharing is another popular way to recognize performance. When a company meets or exceeds its goals, it may offer a portion of those profits to employees — via bonuses or even retirement plan contributions. Retirement plan contributions are tax deductible for businesses, making them a particularly appealing route for profit sharing. Similar to equity grants, profit-sharing programs are often tied to vesting schedules.

Making the Pay-for-Performance Model Work

If you decide that linking performance and compensation is the right approach for your business, there are a few things you'll want to keep in mind to make the arrangement as successful as possible. Here are five tips for successfully implementing the pay-for-performance model.

1 Invest in performance management fundamentals.

The most common mistake companies make when implementing a pay-for-performance model is not having the "performance" part nailed down first. At a minimum, that means having a well-documented and easily understood performance management process. Better yet, it means having a culture of continuous feedback, semi-annual (or more frequent) reviews, quantitative rankings, and goal-setting.

That's because you need criteria or actionable data for making informed pay decisions. Otherwise, employees won't trust the process. Lattice's 2023 State of People Strategy Report found that the teams that most successfully link pay and performance tend to:

- Conduct reviews more frequently (33% quarterly reviews vs. 20% less frequent reviews)
- Include more reviewers (4.5 participants vs. 2.9 participants)
- Feature quantitative ratings in their performance reviews (48% vs. 30%)

Performance ratings, the end product of the performance review process, are critical to the merit increase calculation. But they're not the only factor worth considering: In most cases, objective *and* subjective criteria are used to determine an employee's performance. Goal attainment is often just as important.

Objective goals are straightforward to define for some roles: For instance, a salesperson's key performance indicators, or KPIs, would include hitting specific sales numbers. Subjective goals are valuable but are more challenging to evaluate. For example, the above salesperson may also need to demonstrate that they can communicate effectively internally. Both types of goals are best tracked via a performance management system

2 Be transparent about process and eligibility.

While performance-based compensation models may be increasingly popular, a lack of transparency into how they work can frustrate employees. When adopting a pay-for-performance model, be clear about the calculus behind each decision. “Lack of transparency” consistently ranks as employees’ chief complaint related to compensation.

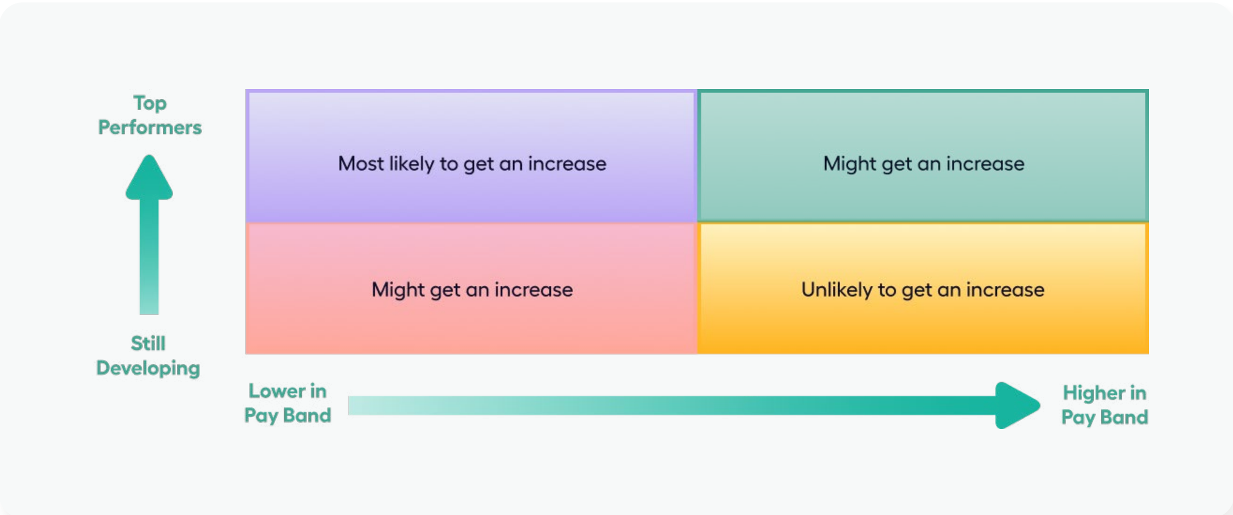
In practice, that means having a senior member of the HR team outline the company’s approach to merit increases at a company-wide meeting. Given the personal nature of compensation, invite anonymous questions before and after the session and follow up via email with clarifying points. Being clear about pay-for-performance also means equipping managers with the talking points and information they need to field questions from their direct reports during one-on-ones and performance discussions.

Things you’ll want to clarify:

- What are the criteria?
- What minimum tenure is required to be eligible?
- What performance review cycle is this referencing?
- Can someone receive more than one raise per year?
- Is everyone guaranteed a cost-of-living increase?
- How can someone find out where they sit within a salary band?

Being clear about this in advance of changes sets employee expectations. It might also be worth visualizing. In the below example, the relationship between performance and position within a pay band is made clear. Top performers who are closer to their pay band’s minimum should expect higher merit increases than those earning closer to the maximum.

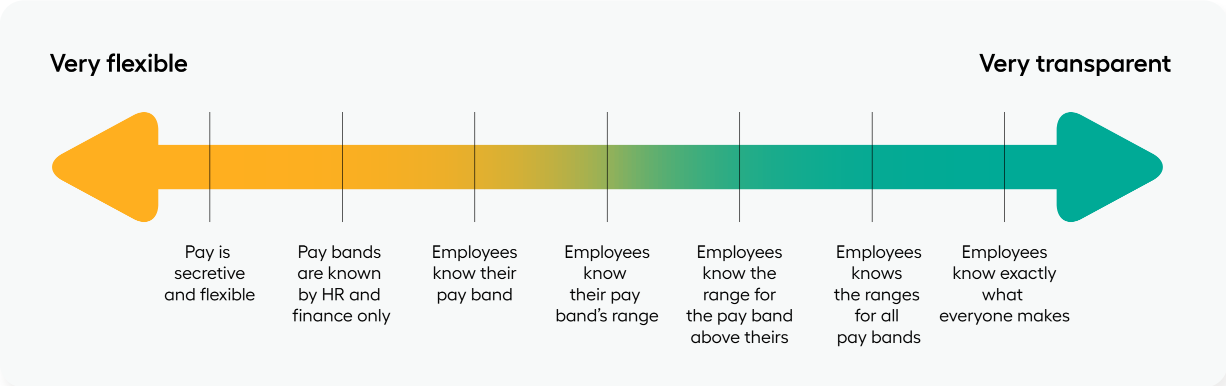
Performance vs. Pay Band Position



This model assumes that employees *know* what their pay bands are. That's where compensation transparency comes in. Compensation transparency refers to the approach companies take in communicating their compensation philosophy.

It isn't necessarily about employees knowing how much peers earn — transparency falls on a spectrum, ranging from that very open model to a closed one, as illustrated below. Wherever you fall on that spectrum, be prepared to explain why you've opted for one approach over another.

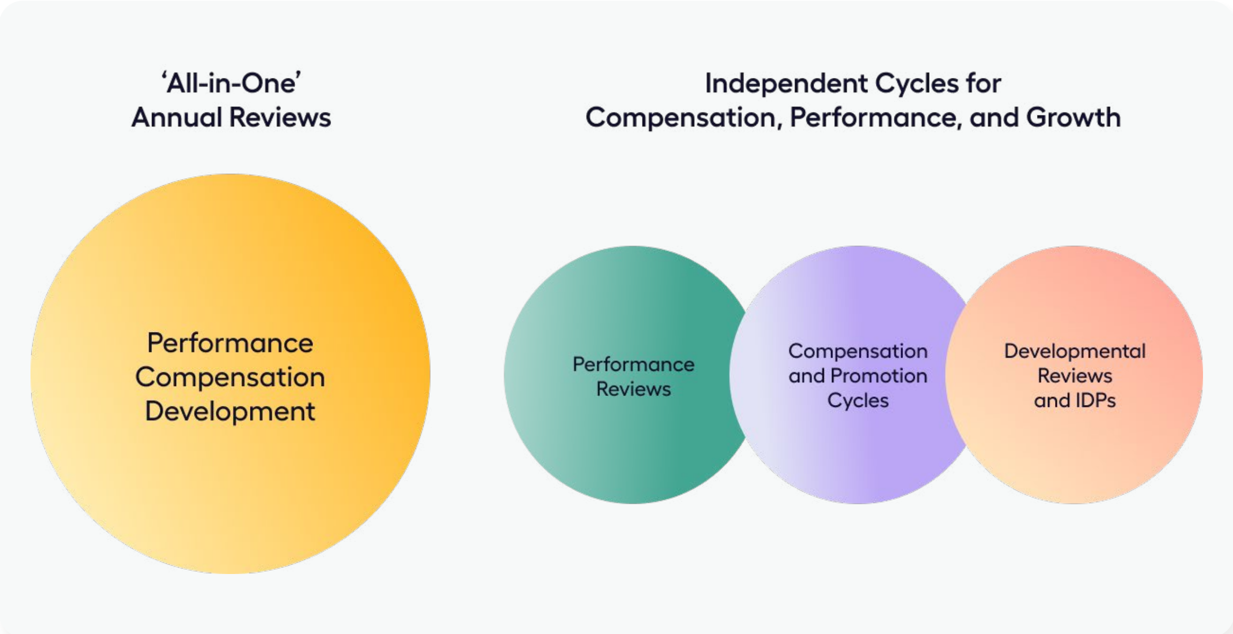
Comp Transparency Spectrum



According to the 2023 State of People Strategy Report, over half of companies limit pay band access to only HR and finance. Still, the status quo might not necessarily be the best way forward for most organizations. Growing employee expectations and new regulations have cranked up the pressure on organizations to lift that veil. Another survey found that 67% of US employees want more pay transparency from their organizations.

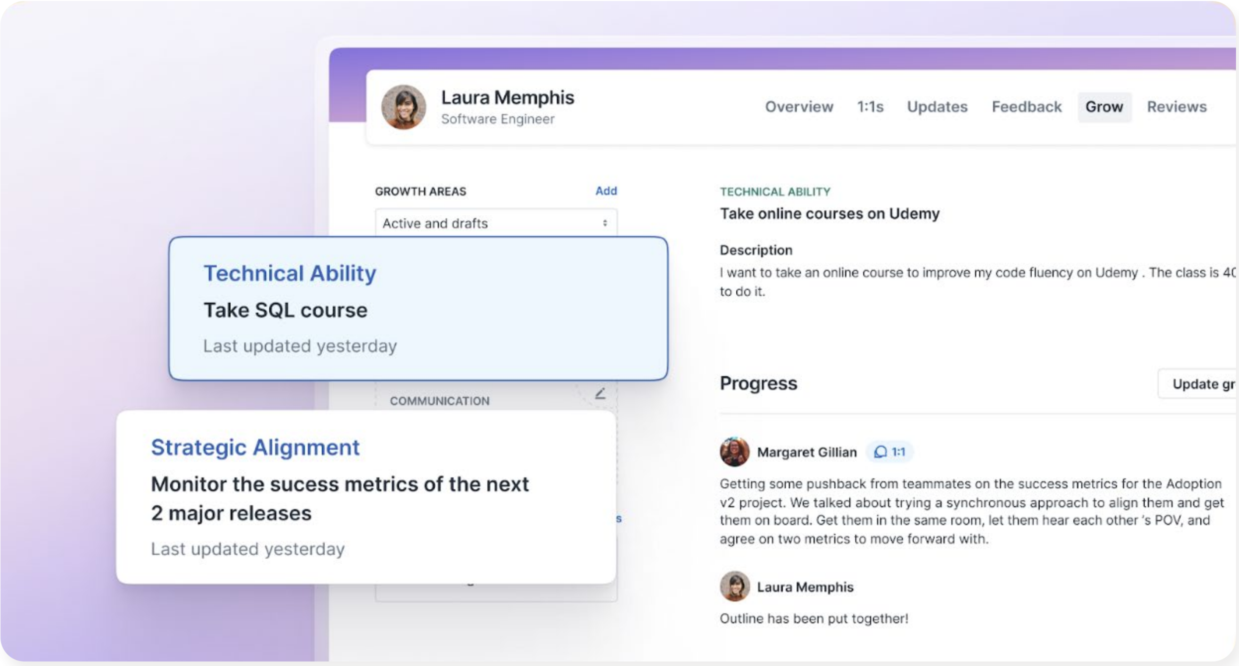
3 Decouple development and compensation conversations.

One criticism of the pay-for-performance model is that it distracts from meaningful conversations about growth; during reviews, employees will tune out everything besides compensation. After all, Maslow's hierarchy of needs tells us that when performance, compensation, and development compete for attention in an "all-in-one" review, compensation (or safety) will always win.



But here's where the criticism stumbles: These topics don't *have* to be coupled in one conversation. For most organizations, eschewing annual reviews for more frequent performance reviews offer an alternative space to discuss growth. Better yet, carving out time dedicated exclusively to employee development makes it possible for pay-for-performance fans to have their cake and eat it, too.

Developmental reviews offer a way to do just that. Unlike traditional performance reviews, these conversations are employee-led and focus exclusively on growth and development. For an employee, questions in a developmental review might include, "Which strengths would you like to build on in the next six months?" or "What would you like to try or do differently in the coming months?"



People success platforms like Lattice enable employees to set career goals and check in with their manager on progress.

Other mechanisms, like individual development plans (IDPs), give companies yet another lever to keep growth top of mind. IDPs are documents created collaboratively between employees and their managers that define short and long-term career goals. These might also be the end product of the developmental review.

4 Understand how compensation fits in with the rest of your people programs.

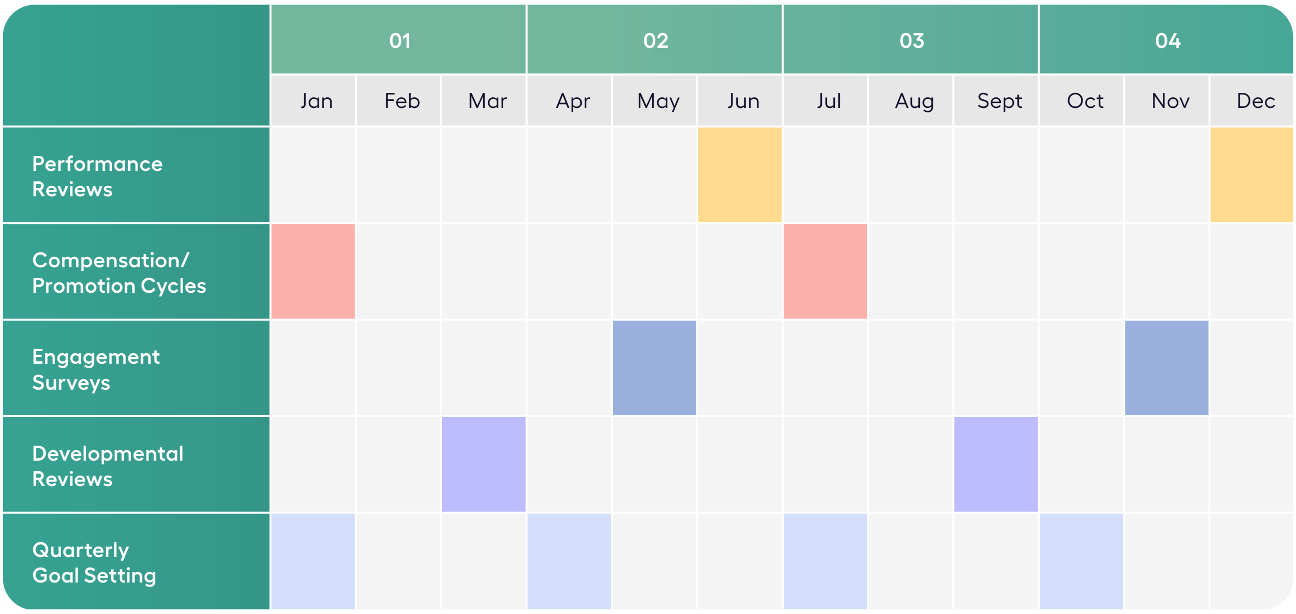
Compensation nor performance are your HR team's sole priorities throughout the year. You might have at least one people program in effect in any given month. **People programs represent the ways companies exchange information with employees to enable their best work** — including aligning on goals, providing feedback, and taking and responding to employee input. In practical terms, they are the big rocks on your HR team's planning calendar, including:

- **Quarterly goal setting** between employees and managers
- **Performance review cycles** that pull together feedback and achievement over time and allow for forward-looking conversations
- **Engagement surveys** that enable leadership and management to gauge and respond to employee sentiment
- **Compensation and promotion cycles** to reevaluate employee pay on an ongoing basis and reward top talent for meeting goals

People programs aren't limited to just the above. Depending on your team's bandwidth and organizational needs, developmental reviews might have a place alongside these programs. Similarly, there's no universal answer to how often to conduct performance reviews, engagement surveys, or any other people program. Lattice's Advisory Services distill some of the most popular approaches in *People Program Models: Six Approaches to Bringing Your People Strategy to Life*.

Some general best practices will still apply in most cases. For starters, scheduling compensation cycles *after* reviews empowers your team to close out the performance cycle and complete calibration. Performance calibration refers to the post-review adjustment of employee ratings to adhere to a company-wide standard. It's intended to account for discrepancies between managers who might interpret rating scales differently. These calibrated scores can then figure into merit increase calculations.

Sample People Programs Calendar



Be mindful of HR bandwidth and *especially* wary of overwhelming employees with to-dos. In addition to staggering your people programs (as pictured above), one factor to consider is scope. For example, not every team will have the resources to conduct a comprehensive 360-degree evaluation more than once a year. In that case, perhaps your mid-year reviews might only include a self and manager evaluation.

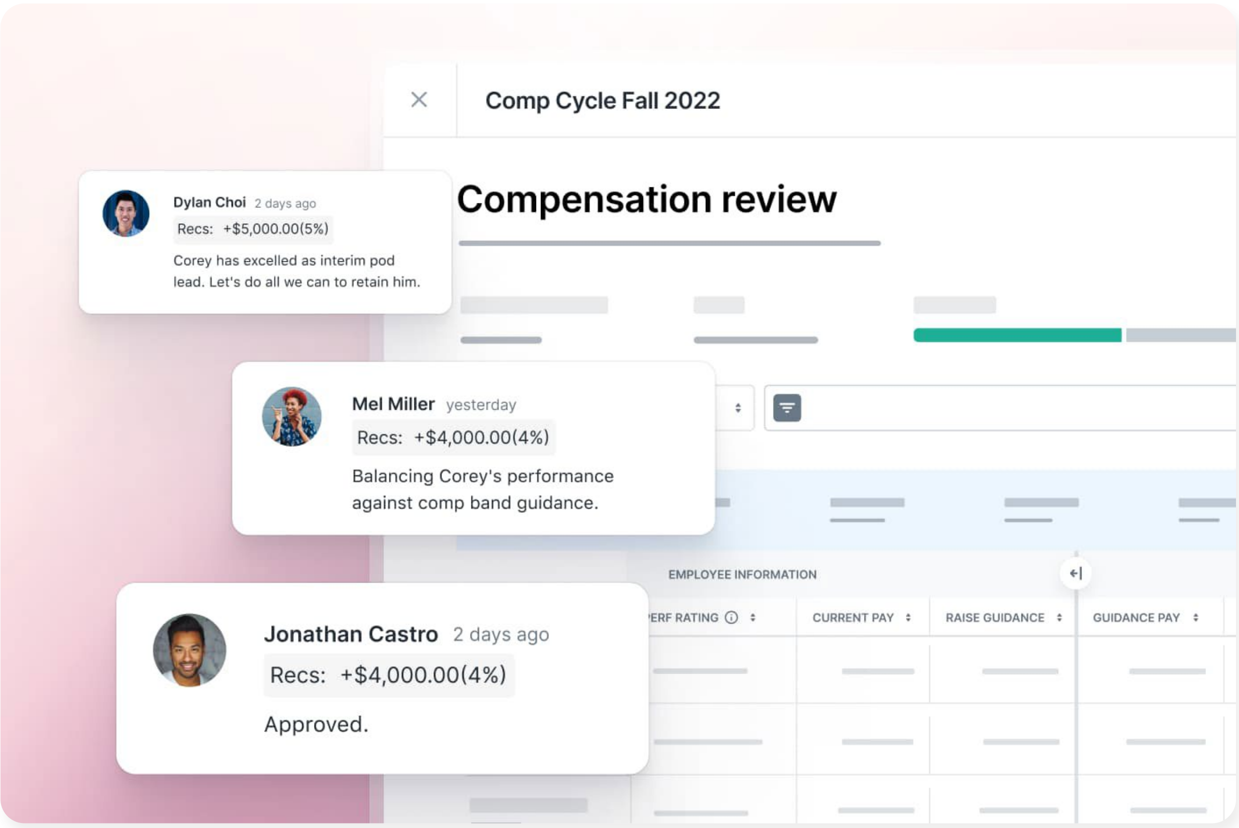
Similarly, you may not be able to commit to a total compensation review more than once a year. In this case, running a primary and secondary cycle is an option. In the **primary cycle**, you'd proactively review compensation for the whole company. Most of your promotions and raises would happen within that cycle. On the other hand, your **secondary cycle** would catch anyone left behind — those who may not have received a promotion or raise in the primary cycle but have since earned it. This method also provides a means of rewarding (and retaining) talent without waiting 12 months.

5 Set yourself up for success with the right tech.

Compensation is complex, and a lot can go wrong in any given merit cycle. Software doesn't just make it easier for HR teams and managers to navigate the process — it empowers better recordkeeping, collaboration, and a more secure overall process. Perhaps most importantly, it can help you stay competitive and reward top talent appropriately.

Document the decision-making process.

Simple as it seems, documentation is one of the most critical challenges of pay-for-performance. Pay decisions typically involve multiple stakeholders, and it's not uncommon for managers, directors, executives, and others to all weigh in on a raise or adjustment. HR should preserve this dialogue, whether it's written down or automatically logged and timestamped using compensation management software. In this respect, documentation isn't just a compliance checkbox — it also pressures stakeholders to back up and explain their recommendations.



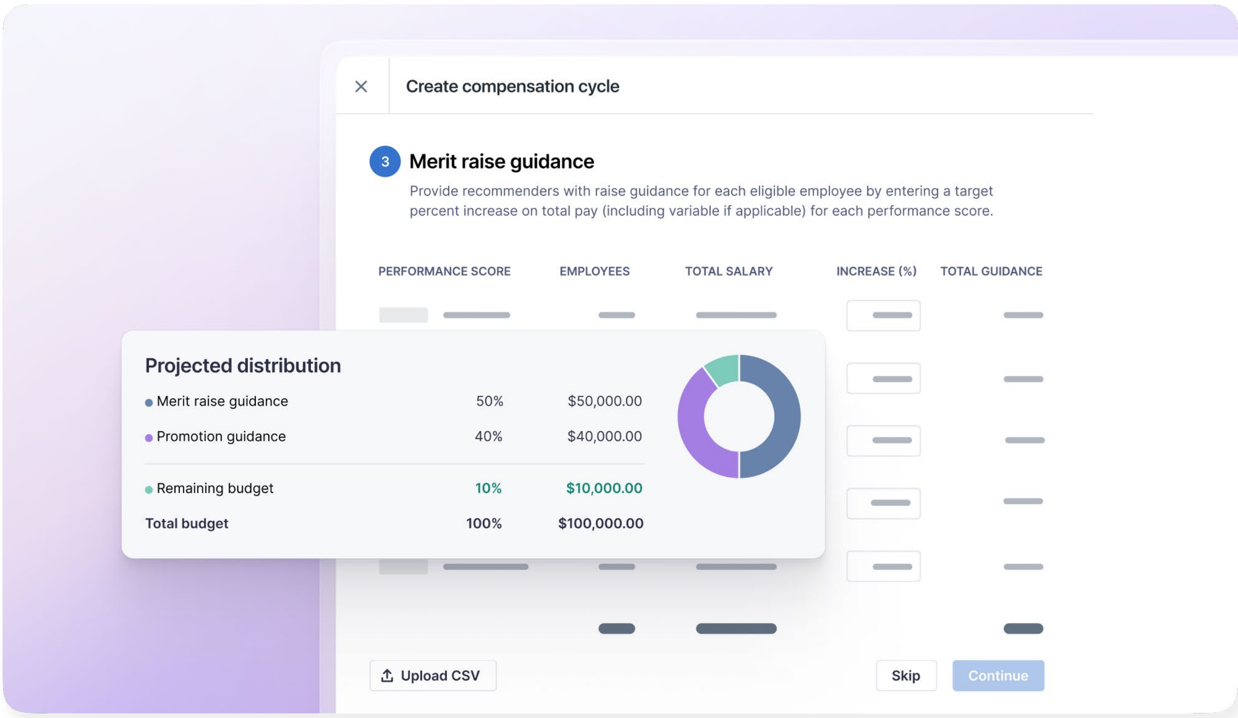
Using a compensation management tool like Lattice,
you can clearly document how merit-increase decisions get made.

Naturally, not all manager recommendations are guaranteed approval. When it's time for HR and compensation teams to have these hard conversations with managers, they have a paper trail to point to. If the data yields pay equity concerns, software like Lattice allows them to discuss and note those discrepancies in context. Having this documentation in an integrated tool (and not in spreadsheets) gives businesses a means to protect themselves and their employees from the stubborn challenge of inequity.

Give managers clear compensation guidelines.

Running *any* compensation cycle is a demanding, high-stakes job. Operating on a pay-for-performance model is even more complex. You'll need to bring performance ratings, current salaries, pay bands, and budget into one view. In the past, that meant exporting these data points from disparate sources and consolidating them into spreadsheets. Besides being unwieldy and insecure, keeping compensation data in a spreadsheet is not a scalable practice.

When you manage performance and compensation in the same platform, this consolidation happens under the hood — making it much easier to provide managers with compensation guidelines. **Compensation guidelines** give managers recommendations on merit increases, bonuses, and other pay decisions by considering factors like performance, pay bands, and budget. Traditionally, HR teams might provide this context in an email or spreadsheet — or simply not at all.



Lattice's Compensation tool integrates ratings, pay bands, and existing compensation, allowing HR teams to manage the entire compensation cycle from an easy-to-navigate hub.

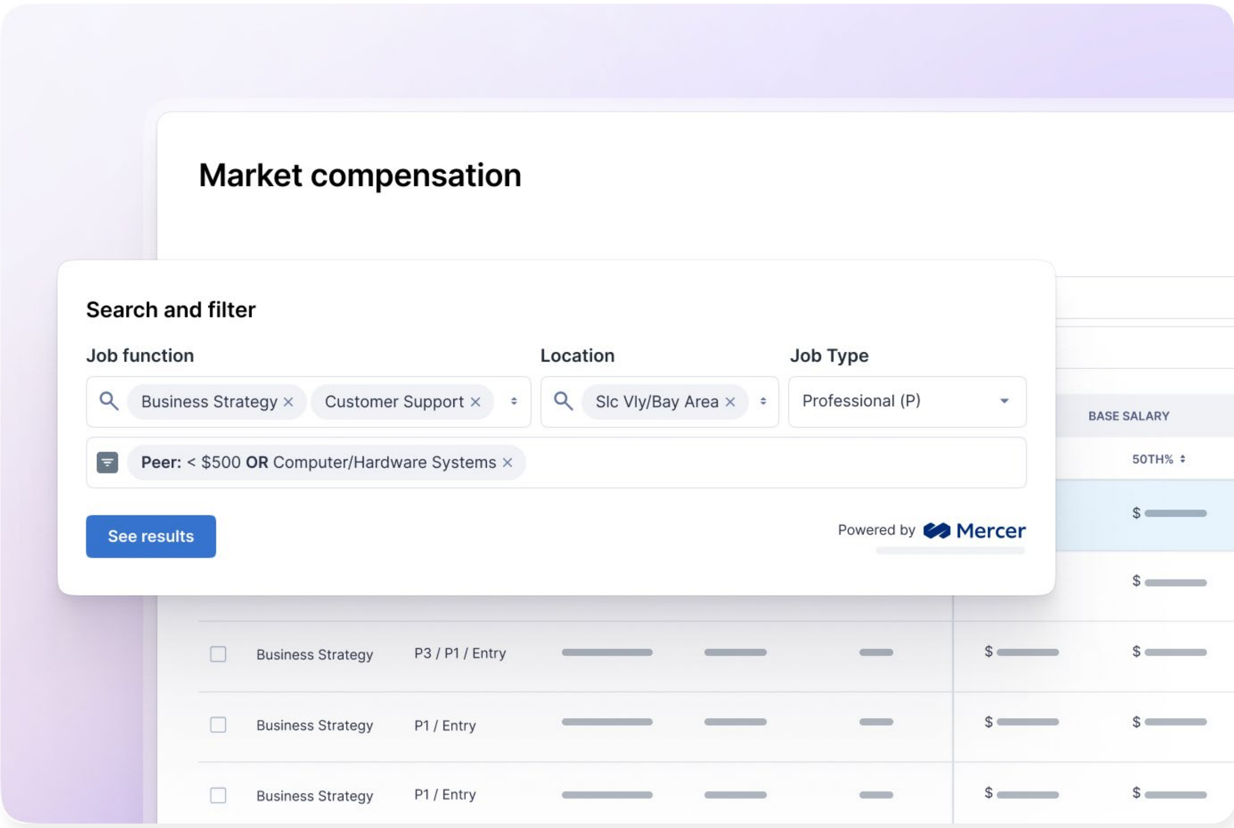
Technology makes it easier to give managers the compensation guidance they need. Still, ahead of a merit cycle, consider organizing training sessions to reacquaint leaders with your compensation philosophy and what factors should (and shouldn't) influence pay. If your company conducts quarterly performance reviews, for example, should managers consider performance for the whole year or the last quarter? What are the risks of raising employees to the top of their pay band?

While your HR team knows these answers, it's likely many managers don't. When you pair technology with communication and enablement, your entire team can make better pay decisions.

Use benchmarking to stay competitive and retain top performers.

Compensation benchmarking is the process of comparing your company's pay data against market pay data. In other words, benchmarking ensures that your salaries and bonuses remain competitive and equitable. That makes it a powerful tool for retention, hiring, and engagement. Over two-thirds of younger workers say they'd leave a job if they felt underpaid.

The implications of over or undershooting pay decisions are hard to overstate. By underpaying employees, companies can lose their ability to attract and retain qualified talent. Overpaying employees is just as counterproductive as it can negatively affect payroll budgeting efforts. Salary benchmarking allows companies to offer attractive compensation packages to employees while promoting long-term business success.



Unfortunately, accurate benchmarks aren't easy to come by for companies under 1,000 employees. That's because benchmarking relies mainly on data from third-party firms, most of which don't cater to small or midsized businesses. And if they *do*, the benchmarks might not be in an immediately usable format or integrated with the software you use. When you have access to these benchmarks within the same tool you already use to manage compensation, you aren't just empowered to report market data but act on it faster. Lattice's integrated compensation benchmarks also make it possible to evaluate employee pay on an ongoing basis, not just within a merit cycle. That also makes it easier to catch and rectify troubling pay disparities using an off-cycle compensation change.

Conclusion

Pay-for-performance isn't a niche idea. Today, most employees and HR teams believe in the concept, even if the latter admits they could do a better job implementing it.

On its face, it's easy to understand why: Acknowledging high performers with merit increases, bonuses, and other incentives only increases the chances they'll continue to deliver results. After all, it's a cardinal rule in psychology: reward what you want to be repeated. If the "why" behind the pay-for-performance connection is intuitive, it's the "how" that keeps most HR and total rewards professionals up at night.

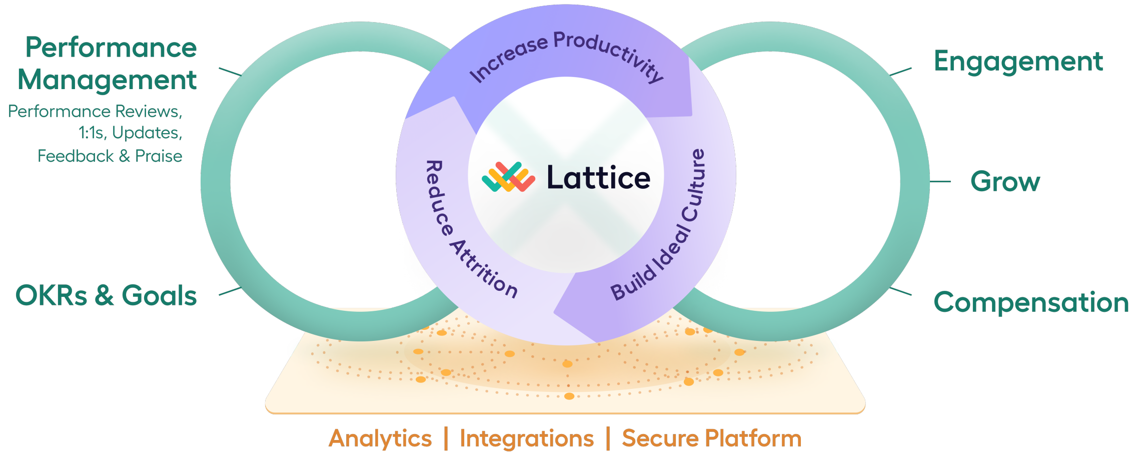
The journey may be difficult, but the destination is worth it. Employees want acknowledgment, and for companies that don't recognize and reward their workforce, there could be a high price to pay: Workers who say they haven't been "adequately recognized" for all that they do are twice as likely to quit within a year, according to one Gallup survey. Even in times of economic uncertainty, few things matter more to businesses than employee retention.

> *A pay-for-performance system is one way to acknowledge your top performers and keep your workforce satisfied and retained.*

Lattice believes it takes a holistic investment in engagement, development, and performance management to build an award-winning "best place to work" where employees thrive. Compensation is just as critical to the employee experience, which is why it's a core part of our suite of people management tools. Watch this Lattice product video or schedule a demo today to see our solution in action.

About Lattice

Lattice is the people success platform that enables HR leaders to develop engaged, high-performing teams. By combining continuous performance management, employee engagement, development, compensation, and growth in one solution, organizations get powerful, real-time analytics that leads to actionable insights turning managers into leaders, employees into high performers, and companies into the best places to work.



The Lattice People Success Platform

Lattice works with companies that aspire to put people first. Whether redefining the beauty industry or building self-driving cars, all of our customers have one thing in common: They value their employees and want to invest in the development and success of their people. To see Lattice's platform in action, schedule a product tour.

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Discover how Lattice empowers thousands of companies to build award-winning cultures.

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