October 2018

Understanding the Impact of Performance Ratings in Differentiating Pay

With a focus on pay for performance, we examined whether companies with five performance ratings distribute their merit budget differently compared to firms with fewer ratings.

Since 2010, the average merit budget in the United States (US) remained fairly static in the technology sector, ranging between 2.9% and 3.2%, according to our quarterly Radford Workforce Trends Surveys. With a consistent amount of money being set aside for salary increases and a louder drum beat for the need to differentiate pay based on performance, we set out to examine how companies are optimizing their merit budget.

Let's start by looking at the prevalence of salary increases. Since the economic recovery beginning in 2010, salary increases have become widely expected by employees. More than three-quarters of our technology survey participants told us in our Q2 workforce trends survey that they intend to give salary increases to more than 90% of their eligible staff for 2018 performance. That's on par with the 88% of employees who, on average, received an increase in 2018 (for 2017 performance). And with steady merit budgets, significant differentiation in base salary increases across performance levels is undoubtedly hard to deliver. However, it's a worthwhile effort, and arguably, an imperative one in order to motivate and retain top performers in this competitive job market.

Next, we'll turn to the types of performance ratings companies use to determine who gets a salary increase and how much. While many companies are moving away from standard performance rating systems, they are still in place at a majority of technology companies. The percentage of technology companies that say they use performance ratings has declined from 89% in 2014 to 70% in 2018 (that's a data point that will be the subject of a future article). Of those companies with a traditional performance ratings system, five ratings is the most common, increasing from 48% in 2007 to 58% in 2018. Meanwhile, the popularity of four ratings has declined and there has been a slight increase in companies using three ratings over the past decade, as seen in Figure 1.

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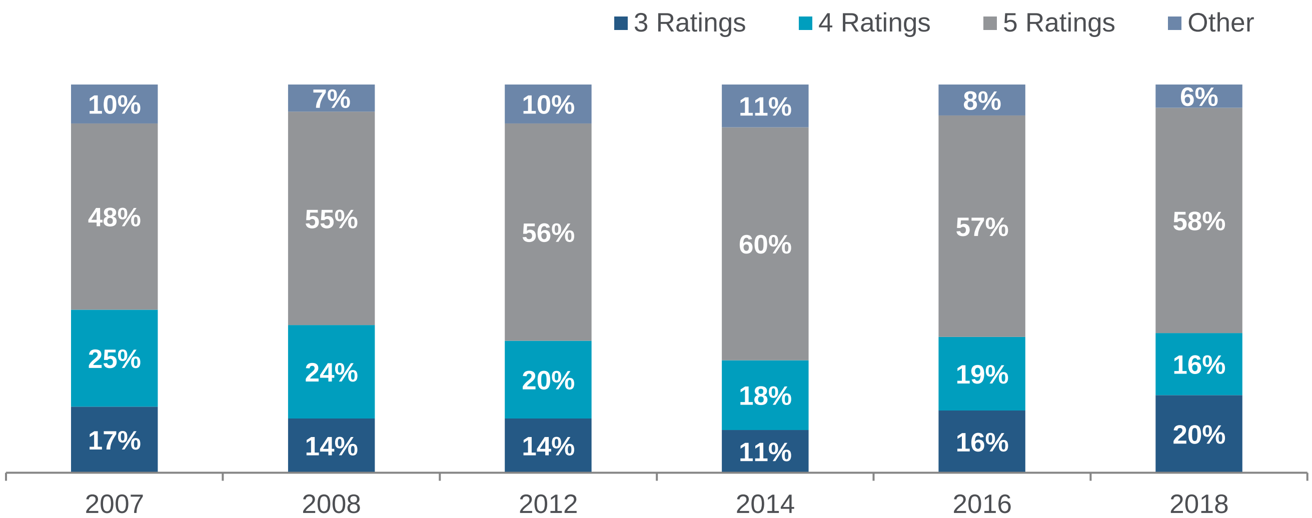
Figure 1

Percentage of Companies Using 3, 4 and 5 Rating Systems



Source: Radford Workforce Trends Surveys of US-Based Technology Companies
Note: Data only includes the years we have surveyed companies on their number of performance ratings.

Based on the principles of pay for performance, we would expect to see two things from companies that have a greater number of performance ratings: the first is a smaller percentage of employee receiving the highest designation of performance, and secondly, that top-performing employees receive a larger merit increase compared to the top-performing employees at companies with fewer ratings. However, our data shows only the first assumption is correct. While we do find that companies with more ratings have a smaller group of employees that meet the highest rating (6.8%), there's a big difference in the percentage of merit increases these top employees receive compared to companies with a three-rating system. We would hope to see a much wider gap in the merit increase between the types of ratings systems, but instead there is only a modest percentage point difference of 0.3%, as shown in Figure 2.

Figure 2

Average Merit Increases to Top Performers in 2018

Number of Performance Ratings	% of Employees Receiving Highest Rating	Average Merit Increase for Highest Performers
Companies with 3 Ratings	23.4%	6.1%
Companies with 4 Ratings	14.3%	6.3%
Companies with 5 Ratings	6.8%	6.4%

Source: Q2 2018 Radford Workforce Trends Survey of US-Based Technology Companies

In other words, the top performers in the five-rating system are not in a significantly better position when it comes to annual salary increases.

In our opinion, this is a missed opportunity for companies with five-rating systems. Pay for performance is a defining characteristic of the rewards programs of the so-called turbocharged technology companies we have studied (a selective group based on high financial performance and impressive levels of innovation). It helps that turbocharged companies have higher salary budgets (4.6% vs. 3.2% for 2018), but they are also putting this additional compensation spend to good use through limiting the number of employees who get an annual increase (72% of the workforce at turbocharged companies receive a merit increase vs. 90% in the broader market). By limiting participation in the merit increase, they can ensure outsized merit or promotional increases to the highest performers.

Next Steps

These data findings should raise several questions for companies as they examine whether their performance rating system is fulfilling its goals, such as:

- Are base salary increases the best rewards vehicle for differentiating pay?
- Is our performance rating system being optimized? Is it an effective system in general?
- What types of rewards decisions are being made based on our performance rating system, and how is this being communicated to employees?

While salary increases are just one component of a total rewards program, companies shouldn't overlook their ability to differentiate merit increases in a way that is meaningful to their top performers. After all, in this competitive job market we encourage organizations to use all the rewards levers available to them.

To learn more about participating in a Radford survey, please contact our team. To speak with a member of our compensation consulting group, please write to consulting@radford.com.

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