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Given that compensation is often the largest controllable expense for an organization, it would seem that HR management and senior executives would calculate return on investment (ROI) for annual merit budgets, incentive pay plans, health and welfare benefit programs and equity programs. This is not the case.

According to a recent study conducted by Hay Group, Loyola University Chicago and WorldatWork, 62 percent of compensation professionals report that their organizations do not attempt to measure the ROI of their compensation programs (Scott, McMullen, Sperling 2005). Moreover, organizations that measure ROI are split between doing this informally and using quantitative data to evaluate their pay programs. What is even more astounding is that the majority of compensation professionals feel that their programs are either effective or highly effective. How can compensation professionals believe their programs are effective without knowing if these pay programs provide a reasonable ROI?

So why don't most organizations measure the ROI for their compensation programs?

There are a number of possible answers. For some organizations, the compensation department may not be involved in this activity-measuring; ROI may be in the purview of finance or operations. For others, measuring

ROI may not be feasible because measurement and monitoring systems are not in place — it may just be too difficult and time consuming. The functional silo orientation in many HR functions may be a contributing factor; the compensation staff focuses on direct compensation, the benefits group focuses on benefits costs, and incentive pay programs may be the purview of specific operational areas. For example, sales departments often design and administer sales incentive programs. Finally, it may not occur to compensation professionals that traditional methods of assessing the value of pay programs have significant limitations. Benchmarking pay programs with other companies, an often-used compensation practice, may indicate if pay program *costs* are aligned with competitors but it does not indicate the economic or perceived value of the pay program, which is by far the more important consideration.

However, even if an organization calculates ROI for its pay programs, ROI evaluation by itself is not enough since this information provides little insight into why ROI exceeded, met or did not meet management expectations. Furthermore, since ROI, like many financial tools, is a *lagging* indicator of effectiveness, by the time these results are calculated, damage may already have been inflicted by misaligned or poorly designed pay programs.

In this first installment of a two-part series, the authors advocate a systematic and comprehensive pay program evaluation process that provides an accurate assessment of the compensation program's contribution to the business and offer insight in how to improve both program quality and effectiveness. In Part Two, which will appear in the next issue of *WorldatWork Journal*, the authors will report the findings from an in-depth survey conducted by Loyola University Chicago, Hay Group and WorldatWork as to the extent to which compensation professionals evaluate their pay programs, the methods utilized and the impact that these evaluation methods have on pay program effectiveness.

For many organizations, it appears that compensation is considered to be *just* a cost of doing business. However, *Fortune* magazine's "Most Admired Companies" were much more likely to assess ROI (64 percent as compared to 38 percent of all companies) and 21 percent (as compared to 9 percent) report using financial or operational data in assessing ROI for their compensation programs (Scott, McMullen, Sperling 2005). Although senior executives may not hold compensation professionals to the same ROI analysis standard as their colleagues in other organizational areas, a variety of end result measures to evaluate their pay programs are used by the organizations that measure ROI. They include revenues, profits, employee retention, controlled or lowered labor costs, productivity, ability to recruit and employee satisfaction measures. Unfortunately, because the use of these measures and evaluation processes across organizations is inconsistent and absent a systematic process for data collection, the value of these evaluation methods is limited insofar as determining trends within the profession.

## Approaches for Evaluating Human Resources Programs

One does not need to look far to find successful approaches for evaluating human resources programs; human resource development (HRD) and performance management (Kaplan and Norton's Balanced Scorecards) are relevant comparators. HRD has taken a lead on the introduction of more rigorous evaluation processes within the HR function because training and development programs are often perceived as valuable but unessential by senior management. As a result, these programs are often cancelled or delayed and HRD staffs decimated when their organizations face financial challenges. In response, HRD professionals have been forced to develop systematic processes of evaluating training programs that better demonstrate their business value. The authors believe that these

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evaluation techniques developed by HRD professionals have direct applicability to the compensation profession and can substantially improve the ability to design and implement effective pay programs. As in HRD and Balanced Scorecard evaluation processes, comprehensive pay program evaluation can:

- Demonstrate the contribution pay programs make to the "bottom line,"
- Provide necessary feedback for improving pay program effectiveness, given the constant changes in the work and business environment,
- Identify problems early in the 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 using the program as designed and
- Better communicate pay values, policies and programs to employees and managers.

Evaluation is not just an opportunity to collect information, it represents an opportunity to clarify and communicate management priorities, values and willingness to listen to employee concerns.

## Recommended Pay Program Evaluation Framework

Pay program evaluation can be thought of in terms of two dimensions as shown in the matrix in Figure 1 on page 53. Building on what has been learned by HRD (for example, Kirkpatrick 1998 and Phillips 1997) and performance management professionals (Kaplan and Norton 1996), the first dimension focuses on the different evaluation perspectives that should be considered in the evaluation process, that is, employee reaction, understanding, behavior change and impact on end results.

The balanced scorecard emphasizes that it is not enough to judge outcomes, but one must examine *how* those outcomes were obtained to provide a fair evaluation and to provide the information the employee needs to improve.

The second dimension of the proposed framework is the evaluation process, which has been developed by researchers and evaluation experts over many years. We have divided the process into six steps:

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.

To collect accurate information that exposes both the value of the pay program and suggests methods for improvement, the evaluation process steps must be followed and the pay program examined from as many of the four perspectives as possible.

Figure 1 illustrates the evaluation framework by applying it to a monthly bonus program for 110 customer service representatives (CSR). The *monthly incentive pay program* is not fully developed because organizational-specific characteristics such as culture, job duties and technology will have a substantial impact on the overall design of the evaluation process.

## Dimension I: Evaluation Perspective

This paper adapts Kirkpatrick's model to articulate the different perspectives that should be considered in the evaluation process. Kirkpatrick's (1998) framework has four evaluation levels: (1) Reaction, (2) Learning,

**FIGURE 1** Pay Program Evaluation Matrix. Customer Service Representative - Monthly Incentive Pay Program

| | Reaction (Level 1) | Understanding (Level 2) | Behavior (Level 3) | End Results (Level 4) |
|---|---|---|---|---|
| **1. Program Goals** | For CSRs and their managers feel the bonus program: ▶ Is administered equitably ▶ Rewards performance fairly ▶ Measures performance accurately ▶ Pays out if CSRs perform | CSRs and their managers understand: ▶ The goals of the bonus program ▶ How performance is measured ▶ How and when performance will be rewarded | ▶ CSRs resolves the customer problem/ request on the first call. ▶ CSRs follow up with the customer problem or request if not resolved on the initial call. ▶ CSRs handle 15% above the minimum number of calls during peak hours. | ▶ Improved customer satisfaction ▶ Increased sales revenues from new and existing customers ▶ Improved CSR productivity ▶ Increased CSR retention |
| **2. Evaluation Criteria and Measures** | Employee opinion survey measures to assess employee perceptions about bonus program; e.g. equitable administration, fair performance measures, accuracy of performance measures and likelihood of receiving rewards for performance | E-learning program that has multiple-choice questions to test CSRs and their manager's working knowledge of the program | ▶ Track calls that are handled on the initial customer call. ▶ Track unresolved first calls to determine if CSR has followed up with customer. ▶ Track number of calls handled during peak hours. | ▶ Customer satisfaction survey scores (sampled monthly) ▶ Sales revenues by new and existing customers ▶ Number of calls processed monthly ▶ CSR retention rates (monthly) |
| **3. Design Evaluation** | Employee perceptions of bonus program benchmarked with perception of other pay programs and changes in perceptions measured over time | CSRs and their managers must, on average, score 85%; employees receiving less than a 70% will receive additional training. | Behavioral data measured over time to determine if improvements are associated with the bonus program | Measures outcomes over time to determine if improvements are associated with the bonus program |
| **4. Collect and Analyze Data** | Conduct survey and analyze data, for example, t-tests, regression and ANOVA | Averages and total scores | Collect data and use time series analysis | Collect data and use time series analysis CSR retention rates |

The evaluation levels are adapted from Kirkpatrick's evaluation model (for example, 1998). Behaviors and outcomes are defined by management in terms of what is valued (outcomes) and what management believes drives those outcomes (behaviors), so in some cases what one organization defines as a behavior may be defined as an outcome by another organization. Since both behavioral and end results unfold or happen over time, similar evaluation designs and statistical methods may be applied as noted in this example.

(3) Behavior and (4) Results. Ideally, evaluation should take place sequentially on all four levels because each provides a unique perspective for assessing their value and effectiveness. The adaptation of these four perspectives can be described as follows.

### Reaction to the Pay Program (Level 1)

The most fundamental evaluation of a pay program is how it is perceived; not just by program participants (that is, eligible employees) but also by their managers. Pay programs often require employees to change their behavior or accept changes in the way they are compensated. A common reaction, especially if employees do not understand the new pay program, is the belief that the organization may be trying to cheat them by demanding more work for less pay. If employees feel the pay program is unfair either internally (that is, in comparison to other employees) or externally (that is, in comparison to pay programs they might be eligible for in other organizations), regardless of the program's merit or the sophistication of its design, it will meet resistance. Furthermore, employees may be dissatisfied with rewards offered or how the program is administered. By the same token, managers who have a negative view of the pay program will be unenthusiastic supporters and will likely not use the pay program as intended. Arguably, negative perceptions of virtually any pay program are going to undermine its effectiveness.

Some managers are reluctant to ask employees how they feel about pay programs because it may open the door for complaints. Although this may be true, employee expectations can be managed, therefore minimizing these complaints.

Employee and manager perceptions of a pay program or policies can be assessed several different ways, the most common methods include: employee opinion surveys, focus groups and interviews.

### Employee Opinion Surveys

Confidential employee opinion surveys focused on pay program goals, design and administration can provide an accurate and cost-effective assessment of perceptions for large employee groups. However, employee opinion surveys require professional assistance to obtain information that accurately reflects employee perceptions. A recently published *WorldatWork Journal* paper by Scott, Morajda and Bishop (2005) provides more information on the design and administration of employee opinion surveys.

### Focus Groups

Small employee groups are often used to determine how employees will react to an HR program. Focus groups must be carefully structured and use competent and unbiased facilitators to obtain accurate assessments of employee views about pay programs. Because participants may have questions, the facilitator should understand the company's pay package and how it is administered. It is also recommended that employees with different types of pay packages be placed in different focus groups.

### Interviews

Although requiring a substantial investment of time, one-to-one interview feedback may provide the most in-depth understanding of how employees feel about their pay. Interviews must be highly structured and in sufficient numbers to provide comparative information across different employee groups, for example, income levels, gender, age and race. Interviewers, like focus group facilitators, should understand the pay system and be perceived by employees as unbiased and able to keep individual information confidential.

Managers often assert that they can informally determine employee reaction to HR programs or policies by simply keeping their "ear to the ground." Unfortunately, information collected informally can be biased, resulting in inaccurate assessments. First, just because some employees are willing to speak up does not mean they are representative of major employees' opinions on the subject. Second, employees often "pull their punches" when dealing with superiors who can affect their jobs, pay and employment. Third, even the best managers may hear only what they want to hear (especially if they were involved in the pay program's design). As a result, more formal (as opposed to informal) methods to assess employee reactions to pay are encouraged.

### Pay Program Understanding (Level 2)

The second evaluation level focuses on how well employees and their managers understand the pay program. If the pay program is not understood, one cannot expect employees to perform or to behave in the desired way, and the confusion associated with limited program knowledge will create frustration and resentment. Knowledge of the pay program includes understanding the program's goals, how it benefits the organization and employee and what employees must do to receive the rewards.

A straightforward way for assessing understanding is to administer tests over program policies and descriptive materials. New e-learning technology utilized by human resource development professionals makes this relatively easy and cost effective. In addition to being an evaluative tool, testing also enhances learning by holding employees and managers responsible for understanding the required material. A variety of testing methods can be initiated to evaluate employee understanding based on the level of knowledge required.

In the CSR illustration, if the bonus program is straightforward, a multiple-choice test should suffice. Integrating an e-learning module where employees and managers can learn about the pay program and have their level of understanding tested at the same time is likely the most practical route. Thus, employees are able to learn the materials when they are ready (or by a deadline established by management) and absorb this information at their own pace. Testing is not about grading an individual; it is a tool to encourage learning and to ensure everyone understands the program. The appropriate e-learning materials can be repeated until a passing score is achieved. E-learning also enables management to monitor who has successfully completed the training and identify questions employees are having difficulty answering. Finally, the e-learning module is available on-demand when new employees are hired or when employees require a refresher course.

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### Work Behaviors (Level 3)

For a pay program to impact organizational outcomes or increase ROI, employees must behave differently by putting in more effort, working more efficiently or focusing their actions to be more effective. When pay programs are developed, management frequently pays little attention to what employees will do differently to increase productivity, sales or profits. However, unless the linkage between behavior and end results is established, employees will have little influence on pay program outcomes. With no "line of sight," employees will become frustrated and will not be motivated by the pay program.

For a pay program to be effective or have the desired end results, three things must happen. First, employees must perceive a pay program as fair and worthy of their efforts (Level 1). Second, employees must understand how the pay program works and how to obtain the rewards (Level 2). Third, employees must exhibit the behavior that will generate the desired outcomes (Level 3). Of course, if the behavior change is unrelated to the end result, then the program will not generate value.

Job behaviors can be identified and quantified through a variety of analytical methods including observation, behavioral event interviews or expert panels. These methods provide insight into how critical job behaviors influence desired organizational results. Although compensation professionals are usually familiar with these job analysis techniques as they are used to determine the internal and market value of work, HRD and performance management professionals can help identify critical behaviors linked to positive end results.

As most managers know, desired changes in behavior may not occur due to work climate, peer pressure, work requirements, technology limitations and negative reinforcement by supervisors. As such, behavioral measures can provide important insight into why a pay program may not have a positive impact on desired results. The challenge is in finding behavioral measures that are reliable and valid.

In our CSR example, the three behavioral measures chosen to affect performance are: (a) CSRs resolve the customer problem or request on the initial call; (b) CSRs followup with the customer problem or request if not resolved on initial call; (c) CSRs handle at least 15 percent above the minimum number of calls during peak hours. The major assumption at this level is that these are the behaviors that will drive the desired end results specified in Level 4 (End Results). In fact, there may be a strong rationale for rewarding a CSR for exhibiting these Level 3 behaviors rather than simply expecting these behaviors and rewarding desired results. First, it may be difficult, costly or impossible to measure outcome reliably. Second, the desired results may be impacted by numerous other factors in addition to employee behavior. For example, increased sales may be driven more by the economic health of the United States and company marketing efforts than by the efforts of the CSR.

### End Results (Level 4)

Obviously, it is the end results that management expects to gain from the pay program investment. End results measures include revenues, net profits or cost savings in the production process. End results also can be quantified in terms of reduced employee absenteeism, increased sales of specific products or reduction in waste, which can be attributed to the pay program. However, given senior-management responsibility to owners and the desire to invest scarce company resources where they will have the most impact, examining the results from a cost/benefits perspective or ROI perspective is intuitive.

Sales revenue and the savings associated with improvements in selected outcome measures are usually available. Unfortunately, it is often difficult to isolate the effects of a pay program on desired results. For the example in Figure 1, sales revenue and productivity improvements are easily measured and from this information the payouts for the monthly bonus program can easily be calculated. The estimated costs of designing and administering the bonus program can be made. However, improvement in customer satisfaction survey scores is not easily translated into financial value for the company. Furthermore, it may be difficult to attribute the value of increases in sales revenues, productivity and customer satisfaction to the monthly bonus program. Sales increases could be attributed to other factors such as improvements in the economy (that is, customers simply have more money to spend) or a new company marketing effort.

Given the fact that other factors besides the behaviors of the employee may substantially influence outcomes in some situations, behavioral measures may provide the most accurate measures for assessing the value of a pay program.

Despite these inherent weaknesses, attempting to evaluate pay programs in terms of their effect on end results and their ROI is a worthy goal. This information allows management to make comparisons with other investment needs and to determine the true value of the pay program to the company. The evaluation processes described in dimension II can help clarify the value added by the pay program.

## Dimension II: Evaluation Process

This paper's model, as shown in Figure 1, focuses on four evaluation perspectives and to a lesser extent, how to measure or assess the achievement of these different perspectives. In addition, utilizing a systematic evaluation process obtains accurate information for each of these perspectives. These following six steps in this evaluation process are briefly summarized in the following. A more detailed treatment of the evaluation process and statistical methods can be obtained from numerous research studies and HRD textbooks (for example, Werner and DeSimone 2006).

### Setting Goals or Objectives (Step 1) and Identifying Evaluation Criteria (Step 2)

Effective evaluation requires setting specific program goals with measurable evaluation criteria to determine if these objectives are met. For example, CSR bonus program goals could include:

1. Increase CSR productivity and
2. Improve customer satisfaction

The measures associated with Goal 1, increase productivity, require number of calls handled by CSR for designated periods of time (for example, shift, hour or week) to be counted. Management must decide if certain types of customer problems are more difficult and deserve more weight in the calculation. If two CSRs are involved in handling a customer problem, how is the call credited? Even with inherent issues surrounding results measures, quantifiable data is often available and utilized to evaluate CSRs.

Even if CSR productivity represents a sound measure and translates into cost savings, increased productivity may not capture how the customer feels about this experience or whether this experience will influence future purchasing decisions. If management believes customer satisfaction drives future sales, then this measure gains importance. As managers of call centers know, productivity can increase at the same time customer satisfaction plummets. However, in both cases, if productivity or customer satisfaction decreases, no one may know why.

Although seldom explicitly considered when establishing pay program goals, one should consider employee reactions to the program and their program knowledge. First, if CSRs do not think the program is fair or motivational, their reactions will seriously impact their response to the program. Second, if CSRs do not understand the workings of the program, how can they focus their efforts on what management believes will drive their success? As a result, clearly articulated pay program goals and evaluation criteria and measures are essential for each of the three evaluation perspectives described in Dimension I.

### Selecting an Evaluation Methodology (Step 3) and Collecting and Analyzing Data (Step 4)

The evaluation methodology is important in determining the impact that a pay program has on the outcomes (Level 4) desired by management. For example, customer satisfaction may be heavily influenced by the promises of the salesforce or quality of phone-answering technology, neither of which the CSR controls. Evaluation methodology can determine what influenced increased customer satisfaction, the pay program or the new technology.

A fairly common approach is to compare the performance of employees who are participating in the pay program with those who are not. In this case, the use of new technology would be available to both groups. Statistical tests can then determine if participating employees reacted more positively, were more likely to behave as desired or were more likely to obtain the expected program results. Collecting before and after measures for each of the comparison groups enhances the accuracy of these comparisons. The most sophisticated of the comparison designs is called a Solomon Four, which is described in evaluation and HRD textbooks (for example, Werner and DeSimone, 2006). T-test, ANOVA and regression are statistical tests often used to determine if significant differences in attitudes, knowledge, behavior or results occur across these groups.

In the CSR example, a comparison would be made between a group of CSRs who are eligible for the monthly bonus and a control group of CSRs who have similar demographics and terms of how they are managed but do not receive the monthly bonus. Again, measuring the criteria from each perspective before and after the implementation of the bonus program is ideal to control factors that may bias the results. However, this evaluation method can be problematic given

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potential management reluctance to implement a two-tier pay system for employees doing similar work.

Time-series analysis is a second common method for evaluating pay programs that offers an alternative to making comparison among employee groups. This evaluation method collects a series of before and after measures of employee attitudes, knowledge, behaviors or results over time. If a significant change was made at the time the pay program was implemented, the change is attributed to the pay program (that is, assuming another event did not supersede the effect of the program). For example, customer satisfaction is measured each week by asking a random sample of customers who have called in to complete a short satisfaction survey. Once this data has been collected for 10, 20 or more weeks, the bonus program is implemented. The data continues to be collected for the next 10 or more weeks. If the level of customer satisfaction increases significantly after the bonus program was implemented and absent external events affecting customer satisfaction, then we can likely attribute the bonus program. Time-series analysis can determine if a significant change in sales occurred post program implementation. Of course, the same evaluation method can be used to determine if the new technology also affected customer satisfaction.

There are numerous statistical techniques to analyze pay program evaluation data. This paper is not intended to offer a detailed treatment of methodological or statistical issues associated with program evaluation because specific situations will determine the appropriate analytic methods. Statisticians, books and articles can provide detailed information on research and statistical methods. Although computer application software has made running these statistics easy, it is important that correct evaluation design and statistical tests are chosen.

### Interpreting Findings (Step 5) and Developing and Implementing Program Improvement Strategies (Step 6)

The key to interpreting findings generated from Step 4 is to clearly articulate the evaluation goals to be answered at the beginning of the process for each level of evaluation and then develop appropriate measures, collect data from employee groups specified by the evaluation design and use appropriate statistical techniques. If these steps have been carefully followed, interpreting findings involves packaging the information in readable form for the stakeholders to consider. We have found that graphic displays of data focused on specific issues are most effective.

In the CSR example, presenting the findings to CSRs and their supervisors and managers participating in the program is important. First, because this data were collected from them, often with their knowledge, employees will want to know what was found. Second, discussing the findings with employees and their supervisor can provide important insights as to why employees perceived the pay program as they did or how the pay program influenced their behavior. For example, employees may know why customer satisfaction decreases toward month end.

Finally, if we are to improve the effectiveness of pay programs, program participant and manager involvement in the evaluation process will foster considerable commitment to improving the pay program. Previous research initiatives found that approximately four of five organizations do not involve employees in the design of compensation programs and compensation professionals report that building better line of sight and effective program communications are viewed as two of the top challenges in pay program design (Scott, McMullen, Wallace 2004).

Pay programs must change because of the constantly changing competitive environment. Effectively changing programs involves numerous people and it is essential to have a strategy for implementing change. Building commitment for change is absolutely essential. It is important to build into the design of a new pay program the elements required for effective evaluation and a plan for implementing changes as they are suggested. Implementation of important program changes is most often the "weak link" in the evaluation process.

## Conclusion

Pay program evaluation requires careful thought and a commitment to using the feedback to improve these programs. However, given the substantial investment made in pay programs and the impact they have on organizational effectiveness, comprehensive pay program evaluation makes good business sense. Unlike other HR programs, management cannot just cancel pay programs when the economy "softens." Even so, systematic evaluation can add significant value to pay programs when one goes beyond measuring a financial-oriented ROI. The authors' recommended approach, similar to the Balanced Score Card, reduces the dangers of overdependence on "lagging" financial indicators and considers employee perceptions, knowledge and behaviors associated with pay programs, which form the basis for getting desired results. When management wants to know why the pay program did not meet expectations, compensation professionals will be better prepared with answers and, more importantly, suggestions as to how these pay programs can be improved.

In the next issue of *WorldatWork Journal*, the second paper in this two-part series will examine actual pay program evaluation practices of organizations. This information is from a national survey of compensation professionals who are WorldatWork members, Chicago Compensation Association members and contacts of the authors. WJ

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