Advisory Booklet: Appraisal Related Pay

This booklet is intended to assist anyone involved in developing or operating an Appraisal Related Pay scheme. It is one of a series of booklets and handbooks designed to give impartial advice on employment matters to employers, employees and their representatives. Legal information is provided for guidance only and should not be regarded as an authoritative statement of the law, which can only be made by reference to the particular circumstances which apply. It may, therefore, be wise to seek legal advice.

Information in this booklet has been revised up to the date of the last reprint - see date below and is also available on the Acas website at www.acas.org.uk together with the text of all of our publications, a Q&A section and details of the latest developments in employment relations. We also have a Acas Helpline which can answer most of your questions about employment relations matters including your legal rights and duties. Acas is committed to building better relationships in the workplace and offers training to suit you. From a two-hour session on the key points of new legislation or employing people to courses specially designed for people in your organisation. Click here to find out about training sessions in your area. We also offer hands-on practical help and support to tackle issues in your business with you. This might be through one of our well-known problem-solving services or a programme we have worked out together to put your business firmly on track for effective employment relations.

Introduction

In recent years there has been increasing interest in both the public and private sectors in pay arrangements which tie rewards more closely to performance. However, developing an effective appraisal related pay (ARP) scheme is not easy. Consequently, this booklet is designed to: • discuss the benefits and difficulties associated with ARP schemes • give guidance on key factors to consider when introducing ARP • offer general guidance on how to assess performance and relate the outcome to pay • give advice on how to manage certain aspects of ARP schemes. The booklet is concerned solely with payment systems where increases in pay are wholly or partially based on the systematic assessment of performance through individual appraisal, rather than with work-measured or productivity-based systems such as payment by results or piece work, or with profit sharing schemes. The focus is on good practice, and the booklet should be read in conjunction with another Acas Advisory Booklet: Employee Appraisal. A brief outline of some other common methods of rewarding performance is given in Appendix 2. There are no off the peg ARP schemes; they should be designed to suit the individual needs of organisations and introduced only where the existing payment system is sound. Employees must be clear about the aim of the scheme and understand how it will operate. Once introduced, schemes should be regularly evaluated to ensure that they continue to be relevant and meet their objectives.
Introducing appraisal related pay

Key Points: -

Appraisal related pay:

- Emphasises the importance of effective job performance
- Can help to target resources more effectively
- May help to retain and motivate employees
- Should be based on an effective payment system
- Should be appropriate to an organisation and introduced only if the aim is to improve performance
- Should be based on objective and properly measured criteria

What is appraisal related pay?

Appraisal related pay (ARP) is a method of payment where an individual employee receives increases in pay based wholly or partly on the regular and systematic assessment of job performance.

Why introduce ARP?

It is argued that appraisal related pay, in the right context, can be of potential benefit to both employers and employees. It can, for example, help employers improve the efficiency and effectiveness of their workforce by emphasising the need for high standards of job performance. It is further argued that it can offer the flexibility to help motivate and retain valuable employees by targeting higher pay at better performers. Employees in turn may welcome a system which rewards extra effort by extra pay. The introduction or revision of ARP is often linked with other changes in pay administration and personnel policies, including:

- greater decentralisation of the responsibility for pay determination
- the introduction or extension of appraisal schemes
- moves towards harmonised terms and conditions of employment for blue and white collar workers
- the greater use of flexible remuneration arrangements, for example in skills acquisition whereby some organisations award pay increases to employees who undergo and successfully complete training modules.

Despite similarities in the reasons for introducing ARP, there are considerable differences in the way in which employers seek to modify...
payment systems to take account of pay for individual performance. The more common approaches are to:

- replace part or, occasionally, all of general pay increases with ARP awards
- strengthen the link between pay and performance by introducing additional payments above the scale maximum to recognise high performance
- introduce ARP in place of incremental pay increases based on service, age or qualifications.

Who should receive ARP?

Employers of very different sizes have introduced or are actively considering the introduction of ARP. Although more commonly found in larger organisations, smaller firms are also considering its appropriateness. Furthermore, it has been introduced by public bodies and is not confined to the private sector. However, as ARP schemes can be time-consuming to implement and manage and can involve a substantial change to an organisation’s culture, they are often restricted initially to a particular group of employees (usually senior management) before consideration is given to extending them to other parts of the workforce. Such a gradual approach has certain advantages:

- senior managers need to be committed to achieving improved performance from their employees. Experiencing a scheme at first hand will help to foster such commitment
- restricting ARP to specific groups of workers allows an opportunity to test whether the scheme is appropriate, meets its objectives and contains sufficient safeguards to be fair. It is important to establish that such an approach will be acceptable since restricting ARP in this way could lead to the charge that some employees are being treated more favourably than others. However, if the scheme has proved effective with the pilot group, it can then be introduced for other employees, or for the majority, and will be more likely to prove equally effective.

When should ARP be introduced?

Before introducing ARP, employers should consider whether it will be appropriate to their organisation and clarify their objectives. An ARP scheme should be introduced only if the primary reason is to improve performance. Employers should consider whether any change is needed in the existing payment system by measuring it against certain criteria:
• is it fair?
• does it enable the organisation to recruit and retain on equal terms in the labour market?
• does it accommodate change?
• does it measure performance adequately?
• does it motivate employees?
• does it encourage productivity?
• is it controllable? ARP should be based on the foundation of a sound payment system and accepted salary levels. It should not be introduced if what is really required is a general increase in wage rates - ARP is not an effective substitute for adequate basic rates of pay. Another method of improving the payment system is to redesign the payment structure and re-evaluate job gradings. Some employers may find that introducing appraisals and setting systematic and achievable objectives improves the performance of the majority without the additional incentive of an element of pay. ARP ought not be introduced as a 'market supplement' payment to retain certain groups of employees. Any scheme is likely to fail if additional payments are given to some employees but not to others, for example in areas where there are skill shortages. The scheme is unlikely to induce improved effort from the majority as it will not be seen to be rewarding better performance.

**What are the benefits of ARP?**

As employers seek to compete more effectively to meet customer requirements they are increasingly examining methods of improving workforce flexibility and engendering a culture of high performance in their organisations. By making a distinction between individuals' pay on the grounds of properly measured criteria and by linking reward more closely to performance, employees may be encouraged to increase productivity. Resources can be better targeted to recognise effort and achievement, and to reward and retain more effective employees. Properly introduced, ARP can be used as a mechanism for promoting greater employee involvement and commitment to an organisation. Improved quality and customer service can be additional benefits. Employees may welcome the introduction of well designed and implemented ARP schemes as a fairer means of recognising that more effective performers should receive higher pay. There is thus a more direct link between effort and reward which may in turn lead to an improvement in morale.
**What are the difficulties with ARP?**

If not suitably designed and introduced sensibly into an environment where trust is high and there is a readiness to adapt to the change, employee relations may suffer. ARP may not only fail to motivate but may in fact demotivate. Employees may soon become discouraged if they are not aware of the levels of performance they need to attain or where ARP awards are not applied consistently across the eligible participants. There may be doubts about the credibility of the scheme where financial constraints, for example by the use of budgets or 'quotas', unnecessarily restrict the extent or amount of ARP awards. A carefully developed scheme should minimise the scope for complaints about subjectivity in assessment and divisiveness in operation. In particular, the ARP scheme should be designed to avoid any tendency to mark higher each year to retain employees during periods of labour shortage. Any beneficial link between performance and reward may be lost with pay costs rising but without a corresponding rise in corporate or individual performance. Employers are also advised to consider how the scheme will fit with the management style and culture of the organisation.

For example, many employers emphasise the need for teamwork and cooperation. It has been argued that introducing pay based on individual performance runs contrary to that approach. Yet many individuals work in teams and employers will need to make clear how the scheme will continue to encourage and reward individual accountability within the team. An alternative is the piloting of team-based payment systems where performance is linked directly to productivity. Employers may also need to overcome a disinclination among some employees to move around an organisation where learning the skills required by a new job may jeopardise their ARP awards. Employees may prefer to remain in a job where they have already been rewarded. Furthermore, employers who have operated a highly centralised method of pay determination may find a scheme that relies on openness and the judgement of line managers inappropriate. Some trade unions and employee representatives remain hostile to ARP as they see it as an individualised method of payment running counter to the principles of collective bargaining. These objections will best be overcome if, through negotiation and/or consultation, they have an opportunity to influence and agree management’s proposals, develop confidence in the fairness of the scheme and the way it will operate, and if the potential benefits to their members are clearly demonstrated.
Preparing for the introduction of ARP

ARP should not be introduced retrospectively. Employees should be consulted at the earliest opportunity about any proposal to alter the established payment system in favour of ARP. Employers will need to explain the need for such an initiative as well as how both the organisation and individual employees might hope to benefit from its introduction. Necessary research will need to be conducted to select the most suitable and flexible scheme that can accommodate the immediate and continuing needs of the organisation. Extensive communications and training will need to take place as far in advance of the scheme’s implementation date as possible. Employees can only then know what is expected of them and in turn what to expect from the scheme. The next section gives more detailed guidance on these issues.

How to make appraisal related pay effective

Key Points: –

Appraisal related pay:

- There must be commitment to ARP from senior managers
- The role of managers is critical
- Adequate resources and suitable training should be provided
- Employers should consult with managers, employees and their representatives before ARP is introduced
- All employees involved must receive full and clear information about how the scheme will operate
- ARP should be fair and open and based on a formal system of performance assessment
- The scheme should be carefully designed, simple to operate and should encourage consistency and objectivity
- There should be an appeals procedure and the scheme should be regularly evaluated

There is no single model for an effective appraisal related pay scheme. Each organisation is unique and should tailor its approach to meet its needs. Nevertheless, observing the following principles of good practice may help to ensure the implementation of an effective scheme.
An aide memoire of some questions to consider is provided in Appendix 1.

**Commitment**

An ARP scheme is likely to fail if there is a lack of commitment from senior managers. It is they who will need to manage the change to ARP. They must be convinced that such a move is both appropriate and an important mechanism for promoting efficiency by motivating employees to improve performance. Schemes imposed by parent organisations without the agreement of local managers may well fail. Managers will need to monitor and evaluate the scheme to ensure that its subsequent development is meeting objectives and expectations and that it is operating fairly. They should continue to review and implement other important personnel practices such as effective employee involvement, good communications and training for the job. Improved financial incentives by themselves may not lead to greater employee commitment.

**Management role**

The role of managers and supervisors is critical to the effective implementation of any ARP scheme. It is they, in consultation with employee representatives where appropriate, who must define the required standards of performance and behaviour. They must make clear to employees the aim of the scheme and the standards of performance required to attract an ARP award. They must ultimately take responsibility for the decisions about performance. Managers will have to explain performance assessments to employees and may need to defend their judgements if asked. In schemes where pay determination is decentralised they must also decide how to award payment to employees under their control. It would be sensible if a senior manager responsible for personnel is given the responsibility for coordinating the scheme to ensure that it is consistently and fairly applied and that the administration is handled correctly, for example that deadlines are met and paperwork properly completed.

**Allocation of resources**

Initially ARP schemes can be costly both in time and money, particularly where an appraisal scheme has to be introduced first. Adequate resources should be available to conduct any necessary research to select a scheme and to fund the consultation, negotiation and communication which will be required. In addition, the administrative and training costs may be considerable. In order to maintain employees' commitment to the scheme and to meet their expectations of it, employers are advised to ensure that: • sufficient
resources remain available so that performance payments are attainable by most employees • the payment is sufficient to motivate all employees to try to achieve the criteria for receiving the award • those responsible for selecting, introducing and running the scheme are given enough time to approach their task with care • enough time is given to training and to consulting and communicating with those employees who are to be affected by the scheme. As with any other incentive payment system, employers will need to consider carefully the funding of ARP. For example, by linking the source of funds to organisational performance such as sales, it is likely that in a poor sales year extra employee effort may go unrewarded. Similarly, linking available funds to productivity may increase pay costs without necessarily increasing sales and thereby affect profits.

Link with appraisal (1)

A systematic, fair and effective appraisal scheme is the backbone to the introduction of ARP. Appraisals in themselves can motivate and help to improve performance and the benefits of an appraisal scheme such as identifying strengths and weaknesses, highlighting training needs and assessing promotion potential should not be overlooked. There are, therefore, circumstances where it is fully appropriate to introduce an appraisal system for its own sake. This will allow teething problems to be overcome and a proper assessment of the effectiveness of the appraisal scheme to be made, should it subsequently be decided to use it as a basis for assessing ARP awards. While there is clearly a link between appraisal and allocating an ARP award, it will be helpful if both do not take place at the same time as their aims are quite different. The appraisal should provide for constructive discussion about performance and development and also look forward, agreeing additional training and setting objectives for the following year. The pay review is to allocate a monetary reward. However, it is likely that discussion about performance and any challenges by the appraisee of assessments will be largely motivated by the pay links. It will, therefore, be beneficial if the interval between appraisal and the pay review is not excessive so as not to weaken the incentive element and to avoid any accusation that the ARP award does not reflect current performance. Some employers may consider it inappropriate or impracticable to separate the appraisal review from the process of allocating ARP. In such circumstances every effort should be made to ensure that important elements of appraisal such as developmental and training needs are not overlooked.
Consultation and negotiation

Traditionally, trade unions have been critical of any form of individually assessed performance pay on the grounds that it can be unfair. Employees may also regard ARP with suspicion. It is therefore important to involve employees and their representatives in a participative approach to change from the outset. The scheme itself should be jointly developed through the process of involvement with employees and their representatives.

Where employers recognise independent trade unions they are obliged to disclose certain information for collective bargaining purposes. Acas Code of Practice No 2. Disclosure of Information to Trade Unions for collective bargaining purposes contains further information.

A recent European directive giving employees in the UK new rights to information and consultation has been agreed. The directive gives employees the right to be informed about the business's economic situation and to be informed and consulted about employment prospects and about decisions which may lead to substantial changes in work organisation or contractual relations, including redundancies and transfers. The UK has until 23 March 2005 to implement the directive which will be restricted initially to businesses with 150 or more employees. By 2007 the directive will be applied to businesses with 100 or more employees and by 2008 to businesses with 50 or more employees. The directive does not apply to businesses with fewer than 50 employees. Employers may seek to reach agreement through consultation and, where appropriate, negotiation on the following broad areas: • the objectives and design of the ARP scheme and in particular how it is related to the existing payment system • the employees to be included in the scheme • the resources to be made available • the training to be provided • how the scheme will operate, in particular how and when performance will be assessed and by whom • how performance will be related to pay and the nature of any safeguards in the scheme • whether ARP will be consolidated into pay and whether it will be pensionable • the appeals procedure.

Communications

Effective communications and the involvement of those affected are essential in assisting the management of change and in helping to reduce misunderstanding and encourage trust. Employees may be sceptical about the motives for the introduction of ARP and their attitudes will only become more receptive if their fears are eased. When introducing ARP all employees should receive clear information
about how any change in the method of determining pay will affect
them (2). In particular, the provision of information to employees
about the objectives and detailed operation of ARP schemes is a key
factor in their success. New employees will need to be fully informed
about the scheme as part of their induction. A two-tiered approach
whereby managers are first made aware of the proposed programme,
followed by communication to employees, may be the most
appropriate. Managers must be given enough time to discuss with
employees the principles and procedures involved. They can thus
ensure a common understanding about the nature of the scheme and
the proposed criteria to establish the various levels of performance
and, subsequently, pay. At the earliest opportunity, managers should
pass any relevant information to employees. A series of meetings is an
effective approach as it gives employees the chance to ask questions
and clarify details. This can be supported by written material - for
example, question-and-answer briefs - articles in in-house publications,
circulars or by the use of video presentations (3). Whatever approach
is adopted, employers should consider giving the following information
to employees: • the reasons for change • potential benefits to
employees • details of the scheme, for example:
- payment and review dates - calculation of rises in relation to
performance - minimum and maximum increases - appeals procedure
- details of pilot studies, where appropriate • timetable for
implementation. Employee representatives should also be encouraged
to discuss the scheme with their members as well as considering what
information employees might want to know. It will be helpful if
adequate facilities to carry out these tasks are made available. It is
important that communications do not end when the ARP scheme
comes into operation. Employees should receive regular feedback
throughout the scheme’s life. It is also important to ensure that
channels of communications within the organisation, in particular
between the pay and personnel sections, run smoothly so that
potential grievances about late or inaccurate payment can be avoided.

Training

Altering pay determination to a system based in part on individual
performance may mean a substantial change to the culture of an
organisation. This may directly affect managers as individuals through
the make-up of their own pay and also make greater demands on their
ability to manage and assess people. If part of their pay is to be based
on a systematic assessment of performance, employees are more
likely to seek examples from their managers of performance that fails
to reach the required levels to attract ARP. Training and individual development should be at the core of an organisation’s policy to try to ensure that the ARP scheme is effective. The amount of training required will depend on current company practice. Where pay is to be related to an existing appraisal scheme, managers may simply need to understand the link between appraisal and pay and how it will operate. The importance of key principles such as objectivity, consistency and fairness should be reinforced. Where an appraisal scheme has to be introduced first, managers will need considerably more training. In addition to the above, they will need to know how to define performance standards and objectives, how to assess employees' performance fairly and consistently and how to conduct appraisal interviews. It may also be sensible to extend training facilities to certain employee representatives.

Simplicity and openness
The link between appraisal and pay should be kept as simple as possible and easy for all to understand. Employers should consider using standardised forms that are clearly written and easy to complete. It is also important to ensure that employees fully understand the levels of performance to be attained. An ARP scheme whose design and implementation are shrouded in secrecy will lose impact. This is particularly important where an open appraisal scheme has already been in operation. In addition, openness in operating ARP will help to minimise the discretionary powers of managers. While the ARP scheme is in operation, it will be helpful to consider what information might be disclosed to employee representatives and to the employees themselves, for example the total budget distributed, the numbers falling into each performance category, the average increase based on ARP and whether the names of individual recipients should be published. Employers should bear in mind that they may lose an opportunity to use ARP as a motivational tool should they fail to disclose relevant information.

Fairness and consistency
No reward system which calls on managers to differentiate between good and bad performers can ever be totally fair. However, ARP schemes must be designed so that they are seen to be as fair as possible and are felt to be fair by employees. They should focus on performance and not on personality and managers should be reminded that differences in assessments should be reasonable and justifiable. By using criteria that are measurable and as objective as possible, managers can make the ARP award reflect the level of an employee’s
contribution to the organisation and minimise allegations of inconsistency and discrimination. Care should be taken to ensure that the ARP scheme does not infringe equal opportunities legislation. Managers are responsible for defining performance criteria relevant to their particular areas of work and senior managers should monitor those criteria and the assessments made against them in order to maintain consistency. Furthermore, senior managers might well wish to check or countersign any ARP award before the award is made known to the employee. Consistency will be more easily achieved if there is some stability in the turnover of appraisers; ARP may not work successfully in organisations where the management development policy includes a commitment to move managers frequently around the organisation.

Appeals

An appeals procedure will help to ensure consistency of treatment and the maintenance of a credible system. Employers, in consultation with employee representatives, will need to decide how to deal with employees who are dissatisfied because they have not received an award. For example, they might wish to consider: • whether to have a separate mechanism for dealing with appeals relating to ARP awards rather than use an existing grievance procedure • whether employees can appeal only against the performance rating and not against the monetary increase • with whom the appeal should be raised • what the time limits are • whether employee representatives can assist an individual with a claim • whose decision is final. Whatever procedure is agreed, it should be kept simple and made known to all employees.

Monitoring and evaluation

It is important that the ARP scheme is first reviewed no later than one year after its introduction and regularly thereafter. Employees should be asked their views about the scheme so that an evaluation can be made.

Traditionally, pay systems have been subject to change and employers who assess whether a payment system which contains an element of ARP continues to meet its objectives may avoid problems in the future. The scheme should therefore include details of how it might be reasonably re-assessed should it become clear that the scheme has failed in some way to meet those objectives.

Relating performance to pay

Key Points: -

The most usual methods of performance assessment are to:
assess performance against objectives
consider job performance as a whole

Most commonly the overall performance assessment is converted into an ARP award by:
  an extra percentage element added to pay
  movement up an incremental scale

Assessing performance
To be effective, ARP schemes need to use some form of assessment procedure which in turn can be related to the payment structure and determine the ARP award. While there is a variety of systems for performance appraisal, most have at their core an assessment of the employee's performance by his or her manager, usually countersigned by a more senior manager. Two of the most common ways to assess performance are either to assess performance against agreed objectives or to consider performance in the job as a whole. For more detailed guidance on the design of these and other methods, see Acas Advisory Booklet: Employee Appraisal. Employers are advised to involve employees, and in particular supervisors, in determining an appropriate assessment procedure to help to achieve fairness and objectivity. A good approach is to set up a joint working party of managers and employees to determine factors and performance levels to be used.

Performance against objectives
In order to meet a desire for greater objectivity in appraisal techniques, there have been increasing moves to base performance assessments on task achievement. Each year objectives - which may be based on quantity or quality - are set and agreed by the manager and employee and at the end of the year the extent to which the objectives have been met is assessed. The overall performance level is then decided against pre-determined standards and linked to an ARP award.

The objective setting approach must be tempered with common sense by appraisers. Some of the objectives may be met, others not and circumstances may have made it difficult for an employee to complete certain tasks. Managers need to conduct regular reviews with employees to consider whether objectives need revision, for example in the light of the economic environment, and at year end need to consider, in broad terms, how effective an employee has been. The following is an example of objectives for an office based supervisor: •
to ensure that the error rate on manual customer records is reduced to 1 per cent • to produce a report on how best to reorganise the recording procedure by the second quarter of the year • to ensure that 50 per cent of customer records are converted and input to the computer • to ensure that customer enquiries are dealt with promptly and courteously and answered within 48 hours, wherever practicable • to continue to hold regular team briefing meetings with staff, at least bi-monthly • to reduce expenditure on photocopying, telephone and postage by 10 per cent. The manager assesses the employee’s performance and the extent to which the objectives have been met and rates the employee against one of the agreed overall standards of performance. For example: • Very good - A very high level of performance; agreed objectives consistently achieved • Satisfactory - A fully satisfactory performance meeting all or nearly all objectives • Less than satisfactory - Insufficient objectives have been met and the individual needs to improve skills or effort, or both • Wholly unsatisfactory - The basic requirements of the job have not been met and little or no progress has been made towards agreed objectives.

Considering job performance as a whole

Working from a job description, the main features of the job are broken down and examined against an agreed and pre-determined set of performance factors and standards. Some of the factors commonly found in whole job appraisal schemes include timekeeping and attendance, volume and quality of work, job knowledge, forward planning, relationships with others, communications, reliability and problem solving. The features laid down may vary with the nature of the job but some such as timekeeping may remain common to all. An employee’s performance under the agreed headings may then be considered against a number of performance standards, which can be as low as three or as high as six. The methods used to guide appraisers will vary between organisations, but definitions are often provided both for the factors and for the standards.

the narrative with the points scoring system; points are awarded in a range from 0 to 10 and guidelines are provided to help appraisers determine performance in order to minimise subjectivity. It is simple to operate but has the disadvantage of not including weightings against the factors. The two methods of assessment - performance against objectives and whole job performance - need not be seen as mutually exclusive. Some organisations supplement objective setting with the whole job method to arrive at an approach which seeks to make use of the advantages of both schemes. Whichever appraisal scheme is finally agreed upon, it is relating the overall performance
For example, when assessing quality of work the following aspects may be examined: • consistency and effectiveness in meeting standards and/or accuracy required for each task undertaken, taking into account the degree of assistance required • errors and/or rejects causing unnecessary extra work • completeness and presentation of all associated documentation and/or products • maintaining a tidy work area. The following guidance may be used in assessing performance standards: • Exceptional - The individual maintains a level of quality well in excess of the requirements of the job • Highly effective - The individual consistently achieves all the requirements of job quality • Effective - The individual achieves the requirements of job quality but sometimes needs guidance to reach this level • Less than effective - The individual fails to meet the requirements of the job and weaknesses need to be identified and addressed • Unacceptable - The individual's quality of work is unacceptable. Some schemes use the same principle as that above but add a rating matrix to the procedure which involves point scoring for each factor against set performance standards. The factors can be 'weighted' to reflect the varying degrees of importance attached to the different factors. Narrative definitions for each performance standard for each factor are not given but appraisers rely on a standard list of definitions relating to all jobs. Appraisers award points against each employee under their control with the final points tally being converted into whatever percentage of ARP is appropriate. This method is relatively easy to design and implement, whether or not some method of weighting is included, but has the disadvantage of having to rely on the subjective judgements of the appraisers. A further variation in assessing performance in the job as a whole is to combine assessment to a reward payment that is the next step.

Paying for performance
In order to take account of existing pay and appraisal systems and the need to meet differing objectives, organisations have adopted a number of approaches to introducing ARP. Although most schemes are unique to an organisation, employers normally reward overall performance, as assessed during an earlier appraisal, by one of the following two mechanisms: • an extra set percentage element added to pay depending on certain performance standards being reached, or • pay tied to an incremental scale with movement up the scale dependent on above average performance. Information on methods of paying awards.

Additional percentage element added to pay
Under this method and subject to their level of performance, employees receive an extra percentage element added to their pay in a range from, for example, zero up to 10 per cent - the amount being dependent on the individual’s level of performance.

For example:

<table>
<thead>
<tr>
<th>Rating</th>
<th>ARP % element</th>
</tr>
</thead>
<tbody>
<tr>
<td>Excellent</td>
<td>10</td>
</tr>
<tr>
<td>Good</td>
<td>7.5</td>
</tr>
<tr>
<td>Satisfactory</td>
<td>5</td>
</tr>
<tr>
<td>Fair</td>
<td>2.5</td>
</tr>
<tr>
<td>Poor</td>
<td>0</td>
</tr>
</tbody>
</table>

Either of the columns above could be extended or reduced as appropriate, but it is unusual for ARP awards to exceed 10 per cent of salary. For those new to a job or under training, the appraisal and ARP schemes may be designed to give the manager the opportunity to mark an employee under a special category, for example 'needs further experience'. The assessment may be treated as the equivalent of a 'fair' assessment and the employee receive an appropriate increase.

Some schemes are underpinned by general increases; for example, an agreement might state: The fund for the performance review has been the subject of negotiation with union A and has been agreed at x per cent representing a general increase + y per cent of the total paybill costs, the latter being distributed as an appraisal related element. Pay increases will be distributed as follows:
Other schemes might include salary bands which have a spread of 80 to 120 per cent of midpoint salary for each grade (perhaps assessed from annual surveys of pay rates within the locality). In these grades there are no incremental steps and progression through the band is based on performance, for example: And broken down into the following bands: 80 - 88% Unacceptable 89 - 96% Less than effective 97 - 104% Effective/new starter 105 - 112% Highly effective 113 - 120% Exceptional Some employers may prefer to rank their employees to determine ARP increases, typically in a scale from 1 to 100. The performance of employees is rated taking into account achievements of targets and general performance in the job. The employees are then ranked against each other within each operating unit to assess who will be eligible for whatever portion of the ARP budget agreed.

Performance pay linked to an incremental scale
The other most common type of ARP scheme, used more usually for white collar employees, is one where some progress up the pay scale, formerly triggered by age, service or qualification criteria, has been replaced by the need to satisfy certain performance criteria. Generally this takes three forms: • incremental pay scales which include a 'progression bar' • accelerated progress up the pay scale, or • additional discretionary points tacked on to an existing incremental pay scale.

Progression bars
Increasingly, incremental pay scales include a 'progression bar', movement beyond which is restricted to those employees who satisfy certain performance criteria. Following internal consultation, organisations agree where to place the bar, be it at the mid-point of the scale or at some point either side of the mid-point. Thus as an example employees may receive a general increase and progress to
the mid-point of the scale by service related increments, with progress beyond the mid-point by performance only.

Accelerated increments
The award of increments after a certain point can be limited to those performing better than average. Rather than receive an added percentage element to pay, employees’ movement up the incremental pay scale can be accelerated, depending on performance. For example:

<table>
<thead>
<tr>
<th>Performance</th>
<th>Increments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Excellent</td>
<td>2 increments</td>
</tr>
<tr>
<td>Good</td>
<td>1 1/2 increments</td>
</tr>
<tr>
<td>Satisfactory</td>
<td>1 increment</td>
</tr>
<tr>
<td>Fair</td>
<td>1/2 increment</td>
</tr>
<tr>
<td>Poor</td>
<td>No increment</td>
</tr>
</tbody>
</table>

Additional increments
The disadvantage of the inclusion of progression bars in an existing incremental pay scale is that those employees with long service and merely average performance levels may be excluded from the higher reaches of the scale. The most satisfactory schemes are those where the incremental scale remains available to the majority, with progress beyond via additional increments based on continued good performance. Some ARP schemes, therefore, are designed to include a number of discretionary points above the scale maximum, movement into which is based on high performance. However, it is advisable that the scheme includes some ceiling on discretionary points. This should help to avoid the development of anomalous overlaps in pay between grades which erode legitimate differentials.

Managing appraisal related pay awards
Key Points: -
Employers, in consultation with employees and their representatives where appropriate, should consider:
- The best method of making the ARP award
- Whether ARP should be consolidated into pay
- The best time to make the award
- The distribution of the award
How ARP will be applied to certain groups of employees

While the operation of ARP differs widely between organisations, prior to introducing a scheme, employers need to consider certain specific points, common to all, about managing the awards to be made. This section gives guidance on: • the methods of payment and timing of the award • how to control the distribution and the amount of the award, and • how ARP might be applied to certain groups of employees. Employers should be willing to involve employees and their representatives in the resolution of these issues since this may lead to a fairer, better designed scheme and one that helps to meet the aspirations of employees.

Methods of payment and timing of ARP

The significance of ARP as a proportion of total pay differs widely but there are few organisations where the only form of wage increase is one linked purely to individual performance. Selling such schemes to employees may be difficult and such a shift to rewarding individual effort may alter collective representation and be resisted by trade unions. Organisations may find that a less radical approach, where elements of ARP are introduced whilst a general pay increase is retained, is more acceptable and successful. Whichever method is finally decided, employers may need to check local market pay rates at regular intervals to ensure that the basic pay structure remains competitive. Employers will need to decide whether to pay the award as a lump sum with reversion to the base salary at the end of the year or whether to consolidate the award, as an annual increment, into an individual's pay packet. Cumulative ARP awards may result in two individuals receiving significantly different rates of pay for performing the same task. Employers may therefore prefer to treat ARP as a supplementary payment, applicable on a year to year basis, or simply to award ARP as a lump sum. They will also need to decide whether ARP should be treated as pensionable pay. The lump sum method has three advantages. Firstly, keeping ARP separate from salary can have a greater motivational impact by giving the performance element a separate identity. Secondly, the awards can be more easily withheld if performance deteriorates; where ARP is consolidated into pay any option of future downgrading may be difficult to implement. Thirdly, it enables good performance to be rewarded without distorting salary comparisons. However, the award of lump sum payments can be unpredictable and those employees who continue to perform highly might prefer
recognition in the form of a more regular increase. Where lump sums are paid, employers can enhance their impact by deciding when to make the payments. Allocating awards at popular times, for example at Christmas, may be appreciated by employees. However employers who use other means of rewarding performance, for example profit-related pay or the use of group bonus payments, are advised to pay these at different times of the year. Otherwise employees may become confused between payments for individual effort and those recognising corporate success. The increased use of computerised personnel records means that employers can choose to award ARP at different times of the year. But, bearing in mind that the operation of a successful ARP scheme depends on an appraisal system, employers should be alert to the need to keep such a dual system simple.

Controlling the amount and distribution of the awards

The key factor in determining eligibility and the amount of ARP is the pay philosophy of the organisation. It is unlikely that any motivational effect can be achieved if only a small percentage of eligible employees can receive ARP - the remainder may be discouraged. If becoming eligible is seen as a success, ineligibility will certainly be seen as failure. The demotivational effect of receiving nothing requires serious consideration by employers when designing a scheme. The procedure organisations adopt for allocating the ARP budget varies, as it depends on the existing payment system and the proposed design of the scheme. Employers may wish to assure employees and their representatives, however, that the overall value of the ARP budget would be greater than if the existing pay structure was uplifted purely by a general increase. Some employers choose to make unconsolidated one-off lump sum payments to employees to ensure the smooth introduction of ARP. Some organisations prefer to allocate a limited amount of money to managers who in turn award ARP among their employees following a pre-determined formula. It is said that this approach has a number of advantages: • it reflects the reality of cash limits • it provides a useful means of cross-checking managers' opinions of employees • it encourages managerial consensus of employees' performance. It is equally argued that such a formula contradicts the ideal of a method of payment designed to encourage each employee unreservedly to raise performance to a level that attracts an additional award. The assessment procedure may also be seen as subordinate to financial considerations. In a forced distribution, the proportion of employees to be allocated to each overall assessment category might be:
Managers are expected to produce assessments mirroring these percentages. This approach has the benefit of keeping costs within known limits and is a safeguard against both extreme assessments at each end of the scale and the inclination of managers to bunch ratings around the average point. However, it assumes that the actual distribution of performance standards naturally follows these percentages. In effect it might force managers to downgrade assessments and in particular it is likely to be inappropriate for small groups of employees. Employers are therefore advised to temper the use of such systems with common sense and perhaps be prepared to set more flexible guidelines for the distribution of ARP.

Application of ARP to certain groups of employees
During the preparatory stage of an ARP scheme employers should consider how to apply payments to particular groups of employees. Some appraisal schemes may already include certain guidelines which can be extended to the ARP scheme. Others may need to be reviewed. There will be a need for clear understanding about the following groups so that the scheme is seen to be fair and credible. These decisions should be made following consultation and, where appropriate, negotiation with employee representatives. New starters and trainees It may be that from time to time assessors will feel unable to rate performance either in individual tasks or in overall job performance because there has been insufficient time to make a valid assessment. Employers will need to decide what period of time these employees must serve before being assessed and included in the ARP scheme. Temporary employees and contract workers Employers will need to decide whether to include temporary employees in the scheme and if so, after what period of employment. However, the Fixed-term Employees (Prevention of Less Favourable Treatment) Regulations 2002 which came into force on 1 October 2002, provide that employees on fixed-term contracts should not be treated less favourably than comparable permanent employees, on the grounds that they are fixed-term employees, unless this treatment can be objectively justified. Fixed-term contracts are contracts where it has
been agreed at the outset that the contract will end when a specified date is reached or on the completion of a specified task or when a specified event does or does not occur.

Towards the end of 2002, the Government began consulting on the potential impact in the UK of a European Commission proposal for a Directive on working conditions for agency workers. The new directive would require equal treatment for agency workers after their first six weeks. Progress on the consultation and any subsequent legal requirements will be reported on the Department of Trade and Industry website www.dti.gov.uk.

Promotees  Promotions usually mean higher pay but as ARP is reward for past performance, employers will need to determine whether any additional payment should be made for past effort or whether the promotion itself is sufficient reward. Transfers and leavers  Employers will need to judge whether to pay ARP to those employees who leave or who transfer to other parts of the organisation. It may simply be decided to pay ARP on a pro rata basis for the time served. Maternity/Paternity/Adoption//Parental and authorised sick leave Employees on leave for part of the year should have any increase based on performance during their period of attendance. Their increase may then be calculated on a pro rata basis, reflecting the proportion of the year spent at work. Part-time workers  The Part-time Workers (Prevention of Less Favourable Treatment) Regulations 2000 provide that part-time workers must not be treated less favourably in their terms and conditions of employment than comparable full-time workers. Any ARP formula applied to part-time workers should, therefore, be no less favourable than the full-time formula. A pro rata calculation is likely to be the simplest way to achieve this. Trade union officials and members  The ARP scheme should make clear that there will be no adverse repercussions because of trade union duties or activities (with the same principle applying to public duties). Neither should employees be penalised for participating as officials in formal disputes between the union and the employer except where they exceed the scope of their official duties. Non-achievers  It is important that the scheme is not designed to be used as part of an organisation’s disciplinary procedure. However, although there may be no direct link, the reason for any disciplinary warning is likely to be taken into account when arriving at the overall performance assessment. Managers should consider whether, in the normal way, additional training, counselling or development might help an employee to improve, particularly where personal problems are found to have affected performance (4).
Appendix 1
Introducing ARP - an aide memoire
What are the objectives of the ARP scheme? Will ARP be appropriate to the organisation and its culture? Will ARP be linked to other changes in working practices? Is there an effective and systematic performance appraisal scheme in place? How will it be linked to ARP? Are there other ways in which the organisation recognises good performance? How will ARP fit with those? Will ARP be the only form of wage increase? What resources will be made available? What programme of negotiation and consultation with employee representatives is anticipated? How will employees be told about the proposals? What reaction is expected? What training will be provided? Which ARP scheme will be used? Will ARP be introduced gradually? Who will eventually receive ARP? How achievable will eligibility for ARP be? What percentage of employees can expect to receive ARP? What aspects of the scheme will be negotiable with employee representatives? How open will the scheme be? Who will monitor consistency and objectivity? How will ARP be paid? Will ARP be consolidated into pay? Will ARP awards be considered as pensionable pay? When will it be paid? What appeals procedure will there be?

When will the scheme be evaluated, and by whom? How will the operation of the scheme be monitored?

Appendix 2
Some other methods of reward
The emphasis which organisations may wish to place on performance can be enhanced by the introduction of profit linked bonuses or profit sharing based on the organisation’s overall performance. Employers are advised to ensure that they make clear to employees the distinction between individual and corporate performance and the link with their pay packets; ARP is designed to reward individual performance whereas profit sharing or profit-related pay are designed to reflect collective performance and enhance corporate identity.

Share incentive schemes
Share incentive schemes involve the provision of shares to employees – either by giving them direct or allowing them to be bought. The aim is to encourage staff involvement in the company’s performance and therefore improve motivation and commitment.

The Share Incentive Plan (previously the All-employee share ownership plan (AESOP)) The share incentive plan ("SIP") was
introduced by the government as part of the 2000 Finance Act. SIPs can include four types of shares:

Free share – companies can give up to £3,000 worth of shares a year to each employee.

Partnership shares – employees can buy up to £1,500 worth of shares a year.

Matching shares – companies can reward this commitment by giving up to 2 matching shares for each partnership share an employee buys.

Dividend shares – companies can provide for dividends paid on free shares, partnership shares and matching shares to be reinvested in further shares.

Companies can award some or all of their free shares on the basis of performance – so long as they satisfy certain criteria laid down by the Inland Revenue (for more information visit www.inlandrevenue.gov.uk share schemes or telephone 020 7438 6718).

Other schemes Examples of other share incentive schemes include:

Savings Related Share Option Schemes (SAYE) – tax advantaged share option scheme for all employees and directors. Participants save up to £250 per month and use the savings and tax-free bonus to exercise their options and acquire shares at the end of a 3, 5 or 7 year period.

Enterprise Management Incentives (EMI) – companies with gross assets not exceeding £30 million can grant tax and NIC advantaged share options worth up to £100,000 each to any number of employees, subject to total share value of £3 million under EMI.

Company Share Option Plans (CSOP) – up to £30,000 worth of share options each can be granted to any number of employees with tax and NIC advantages provided the options are not exercised within three years of grant.

Profit-related pay

Profit-related pay is where part of an employee's pay is formally linked in value to the profits of the organisation for which he or she works.

Payment by results (PBR)
This is one of the most common payment systems in use. It takes many forms, some quite complex, but common to all is that the individual's earnings are based directly on his or her personal performance but without the need for a detailed assessment based on objective criteria. Performance is usually measured by quantity of output but may also be appropriate to quality. PBR may also be applied to groups, pay being divided between group members, either equally or in an agreed ratio.

Commission

PBR is usually more suitable for production work but it can be applied to other jobs. For example, the commission paid to sales staff is a form of individual PBR. Because results are relatively easy to measure, most sales employees have a significant element of performance pay in their overall packages. Often basic salaries are lower for sales employees than other employees with similar responsibilities in recognition of the commission potential they have in addition to basic pay.

Bonuses

For senior managers, bonuses are often paid as recognition of the performance of the organisation as a whole. They are also often used as a means to retain employees whose promotion opportunities might be slim, particularly those at the top of a pay scale. Lastly, they can be used to reward employees for particularly meritorious work.

Notes

1. For further information see Acas Advisory Booklet: Employee Appraisal. 2. Employers should bear in mind that the introduction of ARP will affect a serving employee's contractual rights by altering the terms and conditions of employment. They should therefore seek to ensure that such a change is agreed in advance. 3. Guidance on communications can be found in Acas Advisory Booklet: Employee Communications and Consultation. 4. For further guidance see Acas Advisory Handbook: Discipline and Grievances at Work. 5. For further information see Acas Advisory Booklet: Pay systems.

Sources of advice and further information

Small Business Service  Impartial advice about starting and running a business Tel: 0845 600 9006 www.businesslink.gov.uk

Department of Trade and Industry  Wide range of information on workplace issues www.dti.gov.uk
Equality Direct  A confidential helpline service on all aspects of equality in the workplace Tel 0845 600 3444

Acas Advisory Service  Advice and consultancy services on diversity in employment Tel 08457 47 47 47 Suggested further reading

Armstrong, Michael  Employee reward CIPD, 2002 Armstrong, Michael and Brown, Duncan  Paying for contribution: real performance-related pay strategies Kogan Page, 1999


Incomes Data Services  Performance-related pay IDS,1998 (IDS Study 650)

Incomes Data Services  Performance management IDS,1997 (IDS Study 626)

Industrial Society, 1998  (Managing Best Practice 43)

Naisby, Alison  Appraisal and performance management Spiro Press, 2002

Incomes Data Services  Bonus schemes IDS, 2001 (IDS Study 705)

Industrial Society  Competence-based pay Industrial Society, 1998 (Managing Best Practice 43)

Naisby, Alison  Appraisal and performance management Spiro Press, 2002

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