Paying Bonus & Incentives – A worthwhile endeavour?

"Show me the incentive, and I will show you the outcome." Charlie Munger

Let's start by examining the difference between a bonus and an incentive. A bonus is typically paid after the fact and does not require specific criteria to determine the amount to be paid. An incentive, on the other hand, is typically paid for the achievement of specific pre-determined performance criteria, with the amount paid being linked directly to performance against the incentive metrics. The terms bonus and incentives are used interchangeably in most organisations e.g., an organisations short-term incentive plan (STIP) may well be known as the "annual bonus.". In this blog, I am speaking about incentives, i.e., real variable pay that is contingent on organisation/employee performance.

So why all the heat and noise in some organisations about incentives? There are many reasons, all of which have varying degrees of validity. Let's examine the key ones.

1. **Philosophy:** some organisations just do not believe that incentives work and believe there are more effective ways to motivate employees. Personally, I think this is nonsense, and if you disagree, think about how incentives influence sales employee behaviour in your organisation! Other organisations believe that incentives may work but believe that the adverse consequences on employee behaviour outweigh the potential upside. I believe this is the wrong way to think about incentives, but I understand why some organisations take this view, as indeed there can be unintended adverse impacts on employee behaviour. I also believe it is perfectly valid for an organisation to decide not to utilise incentives if they have thought through the consequences and implications for their reward proposition and have taken alternate steps to ensure they have a compelling and competitive reward proposition.
2. **Rewards Strategy:** some organisations have thought through how they want to prioritise their rewards proposition and consciously decide not to utilise incentives and/or decide to use incentives in a very targeted way, e.g., only senior managers and sales employees are eligible for incentives. Organisations that do not use broad-based incentives will focus on differentiating themselves from their competitors via other elements of rewards, e.g., higher base pay, better benefit programmes or market-leading career opportunities.
3. **Organisation culture:** some organisations are just not suited to utilising variable pay because of their culture. They may feel that they are already paying employees enough, or they may feel that incentives do not influence behaviour, or they may not

want to share the wealth with employees, or they are not ready to link pay to performance. These views are all valid, provided that the organisation is prepared to live with the consequences of not utilising variable pay. Organisation culture is about behaviour and organisations tend to get the behaviour they reward. Another aspect of corporate culture that reduces the appetite for variable pay is the need for transparency on how incentives are calculated and transparency on eligibility for incentives by employee category. Some organisations are simply uncomfortable with this level of transparency and thus shy away from utilising incentives. Given the direction of travel on pay transparency, this thinking is a bit like arguing with gravity! It is only a matter of time until all organisations will be dragged kicking and screaming into the limelight over their pay practices.

4. **Incentive pay is too hard to get right**; this view does have some validity. It is relatively easy to design incentives programmes, but it is quite another matter to operationalise them effectively within your organisation. Key challenges include ensuring managers and employees fully understand the incentive program and key performance metrics, and ensuring managers can clearly explain the linkage between employee's jobs and behaviors and their incentives, i.e., how the employee can impact the performance metrics. Organisations that are unwilling to put substantial time and effort into effectively communicating incentives within their organisation would be better served if they abandoned using incentive programmes. Organisations will only leverage the impact of incentives if they put the time and effort into deploying them correctly.

Having dealt with the issues associated with incentives, I will finish by outlining key requisites for effective variable pay (incentives) in organisations including:

1. **Senior management must internalise that the key goal of incentives is to improve organisational performance**. Incentives clarify the most important goals for employees and managers. Incentives provide a framework for goals to be cascaded from the organisation to the business unit and to the employee base. Incentives help to foster employee engagement by providing a framework for feedback and enabling employees to see how they contribute to or make a difference in the organisation. Incentives also acknowledge desired behaviors and results and provide positive reinforcement to employees. Senior management must see the value of deploying incentives to achieve business objectives before it is worth the organisation's time to implement incentives.
2. **Organisation's readiness for incentives**. Even if an organisation has an appetite for incentives, some organisations still need to consider the best timing for the

introduction or revision of incentives to ensure the timing is right and that the approach to incentives is properly integrated with the wider rewards strategy. If an organisation is introducing incentives or changing incentive practices, the incentive should be tied to clearly demonstrable results that the organisation is looking to achieve and to timelines associated with the achievement of these results.

3. **Performance must be measurable**. This seems obvious and common sense, but common sense is not always common! Incentives are paid based on performance against pre-determined metrics. These metrics must be communicated and widely understood. Organisations need to be able to measure performance systematically on a regular basis, be it monthly, quarterly, or annually. It is not uncommon to see organisations struggle to collect data in a timely manner to measure incentive performance.

4. **Costs and resource availability**. The cost of incentives needs to be calculated and modelled so that the organisation is getting a robust return on investment from the incentive programme. The introduction of a new or revised incentive can strain resources in any organisation. The actual design and approval of the incentive programme are generally only approximately 20% of the work. The other 80% of the work and time is spent on effective communication with managers and employees and ensuring the effective administration and governance of the incentive once it is in place.

5. **Employee engagement.** The normal rules of employee engagement apply to incentives as they apply to the other reward elements, i.e., employees must perceive that their incentives are fair relative to internal and external peers doing similar jobs.

6. **Consider external factors.** As well as the internal factors mentioned above, organisation also need to consider a myriad of external factors. These include the need to keep pace with the labour market in terms of offering a compelling reward proposition. Organisations need to keep abreast of what is happening in their industry, including relative labour costs. Organisations also need to ensure they can adhere to legal or regulatory issues, both current and impending.

In conclusion, while incentives are no panacea to the performance management challenges organisations face, they can be a useful tool in an organisations total rewards proposition to ensure optimal organisational performance. The degree of success organisations will achieve using incentives will be determined by how effectively the incentives are designed, communicated, managed, and administered