



James D. Cotterman

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Staff Compensation Part II — *Incentives*

By James D. Cotterman

In a previous article (*RTL*, June, 2002) we discussed the basic elements of a compensation system, current thinking in compensation philosophy and the basic steps to sort through your compensation structure. This article will focus on one key element of compensation — incentives.

Many employers have adopted a variable pay philosophy in which pay is geared to reflect the employee’s contribution. A recent survey found that 70% of companies have a variable pay program for their non-executive employees and one-out-of-five that do not are considering adding one¹.

Carrot or Stick?

Incentive is defined in the dictionary as “something, as the fear of punishment or the expectation of reward, that incites to action or effort.” Contrast that to one of the principles of a good compensation program — the requirement that the system motivate people to excel and to contribute to the organization’s success. The reality is that compensation makes a lousy stick (the fear or punishment element of the definition), but a moderately successful carrot.

When compensation is used as a stick, increases are less routine, there are no increases, or sometimes compensation is reduced. This might apply to salary, year-end bonuses or total cash compensation for the year. The rationale is that compensation should be aligned with the individual’s performance. The problem is that the individual often responds: “If you pay me less, I will contribute less.” You can quickly see the downward spiral of pay reductions and degrading performance. The problem of poor performance is not solved in this manner.

On the other hand, as a carrot, an incentive may or may not work depending on how it is applied. I am reminded of a consulting assignment where interviews kept coming back to this theme: “I could flip hamburgers for more money than the bonus I receive.” Admittedly, these were lawyers talking and

they were exaggerating to make a point, but the sentiment is universal. In this case an incentive was actually de-motivating.

The incentive needs a “Wow!” factor to successfully build commitment to the organization. Surprisingly, the amount of additional money it takes to go from satisfying a person or to exciting him or her is rather small, even more so when compared to what it buys you in energy and loyalty.

Merit-Based Programs

Let’s examine incentive compensation in the more traditional sense — bonus programs. The concept behind a bonus should be that there is an additional amount of compensation that is available to be earned. Ideally it should be based on both individual and team performance, but it must be merit-based.

In the more traditional notion of “add-on” compensation, an incentive must truly represent a variable — something that is available to be earned. If the extra reward is not earned, there is a very real danger that the additional compensation is perceived merely as an entitlement and not recognition for additional contributions.

An example of an entitlement incentive is the holiday bonus — paid year-in and year-out, typically without regard to merit. Now don’t rush out and kill the holiday bonus program! There is nothing wrong with providing something extra on special occasions, even if it is routine and even if it is given without consideration of merit. But understand that it is not perceived as being at risk.

Variable or incentive pay must share both risks and rewards. That means employees earn more with good performance and in prosperous times and less with poor performance individually and organizationally.

The Individual and the Organization

Notice that I have stressed a reward program that includes individual and organizational or

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team performance. In the boom periods of the 1980s and 1990s, bonus programs stressed individual merit and performance. But when one is focused on oneself, there is a strong likelihood that the performance of others or the group is accorded less importance.

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We have all seen this behavior: an individual is rewarded based on output (billable hours or pages transcribed or time records entered) and, therefore, he or she hoards work, is reluctant to assist others to develop skills, shuns participation in activities or projects that management deems important and even tolerates other's poor performance, as it does not affect his or her earning capacity (or so it is believed). Sometimes even quality can suffer if only raw input is measured.

The individual's performance looks good and a bonus is earned. But has the organization benefited from the results? All too often, it has not benefited sufficiently to warrant the reward conferred upon the individual.

What Works Better?

Consider your best employees. They generally perform well against most if not all of the criteria that you evaluate. Why then, would you select a single metric, particularly a raw input metric, to reward with additional compensation? Would you want their performance to diminish in other areas as they focus on improving the metric that improves pay?

Some firms have successfully implemented a composite scoring system that drives bonus eligibility. The composite represents the measurement of a basket of skills and behaviors (generally the ones on the performance review form). This approach rewards employees who develop and sustain performance across a breadth of areas, rather than focusing on a single measurement.

Finally, consider funding a bonus pool as a way to encourage further organization-centric behavior. One

might tie the size of the bonus pool to revenues, profitability (most likely net distributable cash after all current year obligations are funded), client feedback and the like. The important idea is to focus the individual on results that are meaningful to the long-term competitiveness of the organization as a whole.

Conclusion

Mention a variable pay program in a difficult economy and the employee hears "pay cut." Why? Unfortunately, the specter of variable pay arises almost solely in difficult economic times to reduce compensation costs and to address human resource issues that managers are loath to confront. Those same programs often disappear or are restructured in prosperous times to prevent "over-paying." Take note: It is okay to pay generously in a prosperous and productive environment. Everyone gains — employee, employer and client. ♦

¹ WorldatWork 2001-02 Total Salary Increase Budget Survey, www.worldatwork.org.

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