

Key Guidelines for Short Term Incentive Plan Design

Strategic Pay has recently produced the New Zealand Guide to Annual Incentive Plans as a reference source for directors, senior executives and human resources professionals. The Guide is intended to be a practical aid in developing and reviewing short term incentive plans (STIPs) for various levels of employees. STIPs go by many titles including management incentive plans, annual incentive plans, goalsharing plans, bonus plans, performance pay plans, profit sharing plans and “at risk” remuneration.

Over recent years emphasis on STIPs has increased, mostly as they have become a more significant part of executive remuneration. In Australia in particular, they have also been used to calculate the number of shares and options to be granted to executives. Despite this increased emphasis, many STIP designs amount to little more than a means of deferring payment of part of salary until the end of the year. For this reason there is a need for many organisations to critically review the design of their STIPs and their processes for setting performance goals.

It is fair to say that STIPs are far more widely used and understood in Australia than in New Zealand. It is becoming increasingly important for New Zealand employers as:

- + Global competition for talent continues to mount to consider carefully the value of STIPs in providing competitive but affordable remuneration packages for their employees.
- + Alignment of New Zealand pay structures to those being used internationally will enhance the ability of potential employees to come to this country.

It is encouraging that there is recognisable growth in the prevalence of STIPs in New Zealand and evidence of greater competence in their use.

The following guidelines for incentive pay schemes do not cover every contingency but are the critical areas necessary to optimise any development plans. They represent answers to the questions Strategic Pay receives most frequently from clients.

1 Communication

Constant and accurate communication levels designed to fairly inform as to what is being achieved both individually and at a corporate level are a priority in any incentive scheme. The key message is that incentive pay is not further reward for what individuals are already paid to do. It is reward for smarter performance, better levels of organisation performance, greater commitment, and so on. This is an area where schemes often fail as incentive pay is seen as further reward for work already done.

2 Performance Management

The more important part of the communication process is the interaction between the manager and the employee as to what is happening. Issues such as ensuring goals are set, understood and achievable, what level of progress is being made, should goals be altered (relatively rare in the course of an annual cycle), what training is necessary, and all the other issues covered in good performance improvement programmes including incentive pay outcomes are covered here.

3 Line of Sight

Ensuring targets and hence incentive opportunities align with what you can influence is important and is accepted as *being* basic to understanding and channelling behaviour. Line of sight varies depending on the level of the role, the size of the organisation and the complexity of the job. Share options as an incentive have an excellent line of sight in a high tech start-up - probably for all levels of staff but are less relevant for basic support roles in a multinational.

4 Tenacity

It will probably take two years to fully integrate a new incentive based remuneration structure with a three or four month lead in period prior to its initial introduction. Management, HR, everyone, will have to have patience and understand that the system will need fine tuning in the course of the first two cycles. It should not be seen as a big deal, just necessary adjustment to reflect organisation culture and practical experience.

5 Dollars

Make the potential dollars worth having a shot at. One, two or three percent of base salary are very low percentages to put on offer in an incentive scheme and are likely not to be motivating. A base figure should be around 5% for any role. Percentages vary enormously and can be multiples of salary depending on the role. Remember always this money is contingent on performance, ie. It is not a 'gimmee' and many incentive schemes put the money on offer into a range (eg. between 5% and 10%).

6 Time Period

Set the giving out of rewards commensurate with the level of role and the type of duties being undertaken. For many roles a yearly timescale is appropriate. Some support roles would probably benefit from a six monthly or quarterly payout period, as is common in many sales and production roles. Why? It keeps the link between the work done and the reward clear.

7 Understand how Motivation Works

What motivates individuals when it comes to reward and recognition lies within a complex of personal, career, and organisation interaction factors. It is not particularly simple and varies at different stages of the career cycle. The theory is complex and still relatively new and can be best summarised in that our understanding has highlighted a few areas that rarely work in any circumstances and suggested a number of others that are likely to succeed. With incentive pay the motivation link is bound up with personal ownership of it and commitment hence the strong emphasis on communication.

8 When to Introduce

There may never be a wrong time, but certainly some times may be better than others. If other major institutional changes are occurring then it may not be the best time to introduce. Remember that a package of initiatives will make incentive pay succeed with the communication and performance management components being key supports.

9 Who is in the Scheme?

Everyone would be the answer today, although it may be better to phase it in starting with a senior management level. The key to incentive pay is understanding that it is primarily a different way of paying people involving a different perspective which, if it is truly working correctly, links organisation success with personal reward.

10 What happens to the Wage and Salary Bill?

A well designed scheme should be effectively self funding. Alignment of individual, divisional, and corporate accountabilities to financial targets should be seamless. If this link is not there you run the danger of merely increasing your wage and salary bill. Any scheme that ignores this link will have serious questions asked of it at board and/or senior management level.

11 Credibility

This is sort-of 11th commandment for incentive schemes. Don't introduce one if it is unlikely there will be any payouts for the next two years. In that instance, introduce in two years time, especially if the scheme is a new one or substantially revised. Payouts in the initial year will give the scheme credibility. There is of course no reason why a scheme should payout if the results are not there but participants may fairly wonder what all the fuss is about if there is no likelihood of any initial return.

12 Understanding (Kevin's Rule)

An ex-manager (Kevin) made this suggestion which I believe is a good guide to testing the acceptance and understanding of an incentive pay scheme. If you can explain the scheme to a spouse or partner in a few minutes, it is a clear and comprehensible one. If diagrams are being drawn and you're still explaining after half an hour, it's probably too complicated.

13 The Money is only Part of the Issue

Funnily enough it's not the money that is critical in a successful incentive scheme. The process is the key. If the process (all the above) works sure individuals get a payout, and maybe even a substantial one, but it is how they perceive the system that is critical. How you get to the payout will determine the level of acceptance and therefore the success or failure of any scheme.

-- John McGill, Managing Director, Strategic Pay

The full report is available for purchase. For further information, please contact John on 09 303 4045 or john@strategicpay.co.nz