How to design an effective bonus scheme

Despite the variety of employee perks available today, for the vast majority of companies the most popular part of the reward package for employees remains the bonus scheme.

WHAT IS A BONUS SCHEME?

A bonus scheme is a reward tool that provides a lump sum payment in return for meeting agreed objectives. The way schemes are designed often means that the value of the bonus is included in the targets that are set, which makes the scheme self-financing.

Performance targets can be single issues such as increasing sales, or more commonly a mixture of business goals. In either case, goals are usually objective, for example a profit target. Performance below and above the stated goal may be recognised as well.

The reward strategy usually classes bonus schemes as variable, because the value can change from one performance period to the next. However, bonus pay can have an effect on calculating a "week's pay" for some statutory benefits. It is also part of pay under UK equal pay legislation, and will need to be included in pay calculations for meeting annual gender pay reporting requirements.

WHY INTRODUCE A BONUS SCHEME?

The key design feature of a bonus schemes is to motivate employees to achieve key business objectives. The goals may be set at individual, team or business unit level. Reasons for introducing a bonus scheme include:

- To improve business performance, e.g. sales or profits;
- To provide focus on key objectives, e.g. customer service or quality;
- To increase employee motivation by establishing link between contribution (input) and pay (output);
- To improve alignment with shareholders because employees share in business success;
- To support organisational change; and
- To reward staff when the business is doing well, without permanently increasing the annual pay bill.

WHAT TYPE OF BONUS SCHEMES EXIST?

Broadly speaking there are four types of bonus scheme:

- Individual;
- Team;
- Business Unit; and
- Hybrid, e.g. individual plus business unit.

Schemes can be either single-factor or multi-factor. A single factor scheme provides focus on a specific goal, for example sales. The management of a multi-factor scheme provides broader focus and may involve using a balanced scorecard approach.

Providing consistency in setting bonus targets can be one of the hardest things to achieve. This is particularly the case for individual or team-based arrangements. A fair scheme tries to ensure that people receive the same reward for the same performance. Scheme design therefore needs to take account of how easy or difficult it is to achieve the targets. This can be a particular problem with individual schemes, for example those applying to a sales force.

The choice of approach is down to deciding what will be most effective. This includes taking into account the impact that one individual's performance can have on other people. As an example, in a sales scheme it might be best to set individual targets for each salesperson. In contrast, in a scheme based around profitability, a business unit approach might be more effective.

HOW TO FUND THE BONUS SCHEME?

It is common for bonus schemes to create a bonus pool. The funds for the pool come from either the increased performance or reduced costs that form the scheme goals. A well-designed bonus scheme can therefore be self-financing.

Performance above and below the preferred level may result in different levels of bonus funding. The shape of the line that relates bonus to performance is a key design decision. The choices are between a straight line, a curve or an s-curve. These all create different performance messages for employees and different funding needs for the scheme.

Sometimes performance is measured in one business year but payments are made in a different year. In such cases, it is common to accrue for the cost of the bonus scheme in the company's accounts.

HOW TO MAKE THE BONUS PAYMENTS?

The most common form of bonus payment is cash. Some schemes defer part of the payment for a period of time. In these cases, the deferred bonus might be in cash or shares. This arrangement is most common for executive level schemes.

The most common ways of deciding individual bonus payments are:

- A flat rate payment;
- A percentage of salary payment;
- Varying payment by seniority or role; and
- Varying payment based on individual or team contribution.

Some schemes might use a combination of these approaches.

HOW OFTEN SHOULD BONUS PAYMENTS BE MADE?

This largely depends on the choice of goals. Schemes based on business goals, such as profit, often feature annual payments. For schemes that have goals more directly related to the role, such as service delivery, then more frequent payments might be more appropriate.

There is usually a trade-off between frequency of payment and the value of the bonus paid. More frequent payment intervals may be more motivating because they improve linkage between performance and reward. However, the short period may also mean that the bonus pool is smaller because of the limited time available to generate it. The opposite may be true of annual schemes.

HOW TO AVOID EQUALITY ISSUES?

Equality issues can develop based on gender, race, disability and age. This is because pay discrimination is illegal under the equal pay legislation and under the Race Relations Act and the Disability Discrimination Act. Scheme design also needs to comply with legislation covering pay for part-time employees. The starting point is to make sure that the targets set are fair. Actual bonus payments then need monitoring to ensure that they are fair.

CEO PAY RATIO REPORTING

Executive bonuses have come under increased scrutiny with greater corporate governance being introduced to ensure they are fair, transparent and appropriate. The CEO pay ratio regulations will be in effect from 2020 and the ratio is calculated based on the relative sums of pay and bonus levels for the CEO in relation to the rest of the workforce. Companies will have to factor in what this pay picture says about their wider commitment to fairness and good corporate governance when explaining the figures.

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+44(0)1733 391 377
info@paydata.co.uk

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