Implementing performance based pay for your business

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In a challenging economic environment like ours, the only way to ensure the continued viability of companies is to focus on performance and reward it accordingly. What should be on the minds of executives is how they can effectively measure and manage performance at all levels within their organisations. Organisations need to design performance incentives schemes that drive business success. The best option in rewarding employees is to invest in the development of variable pay schemes that are directly linked to the achievement of the company goals. If your organisation has done well before there is no guarantee that you will continue doing well in the future.

The only way to guarantee future success is to focus on issues of performance and rewards. Embracing an approach such as the balanced scorecard that gives a holistic view of the company's key performance drivers is a good starting point. Within this framework you are assured that the things you are measuring will have a direct impact on the success of the organisation. If you are still measuring performance for the sake of it you are probably wasting your company's resources. Routine performance measurement systems that have no bearing on the business strategy of the organisation should be discarded now. Businesses should strive at all cost to link the measurement of performance to the reward systems. Incentives schemes should reflect the heightened interest and new thinking in measuring performance. The starting point in designing performance incentive schemes is to ensure that you have an effective and objective system of measuring performance. Your schemes should not reward people for achieving financial targets alone. It should be designed in such a way that you also reward performance in those areas that drive financial success like the customer, internal processes and your people initiatives. The underlying model today should be to build incentive schemes as an integral part of your remuneration strategy, reflecting the belief that everyone in the organisation can and should be expected to contribute to the company's success. Besides the base pay strategy which, in actual fact, has little to do with the individual's contribution to the business, organisations need to institute variable pay schemes in order to drive business performance. In variable pay schemes payout is contingent upon the achievement of clear business targets resulting in no added cost to the business.

In other words the schemes should be self-funding. In the design stage of the performance incentive schemes it is important to ensure that there is buy-in from senior management. You can even start by implementing incentives schemes to cover your senior managers and cascade it to the other levels in stages. Incentives schemes that are based on targets that people have no influence over will not lead to the desired business results. For example most profit share schemes are based on measures that are independent of employees and are driven by economic factors that employees have no control over. For incentive schemes to succeed, organisations need to institute a complete culture change in the way rewards are managed. There is need to build a performance culture that will help erase the historical emphasis on base salary that seems to have permeated remuneration practices in the country. The truth is employees are not yet ready to live with the risk of earning a moderate base salary supplemented by performance incentives. For your organisation to achieve that level of understanding there is need for careful planning in the design stages and a well-coordinated communication strategy in the implementation stages. This will enable employees to see the connection between their efforts, the overall business results and their share of the incentive scheme payout. Most of the profit share schemes organisations that are operating at the moment have not been designed properly. As a result employees get payouts based on a target that they have not helped achieve. The end result is that the schemes do not benefit the business at all in terms of improved performance. Schemes of this nature create an entitlement mentality since there is no noticeable link between the achievement of business targets and their effort.

It is also important to note that incentives schemes are not a substitute for bad management practices. The incentive scheme will only add value in a business that has a well-coordinated business strategy. Copying what other organisations are doing will not help either. You need to have a system that addresses your own needs, hence the need to design a system specifically for your organisation. If you are one of the CEOs who have not considered the option of paying employees part of their remuneration as a variable component to support better business performance, it is high time you got over that hurdle. Successful companies are those that are seeking and designing creative compensation systems that reinforce business results. Compensation models that are dependent on the base salary served our country well in the past. Now is the time for industry to design performance incentives that drive business results. The truth is employees want to work for successful organisations. What they need is guidance from the executive on how to achieve success, hence the need for the latter to take a leading role in ensuring that the company achieves business results and people are rewarded accordingly. There has been a drastic increase in the number of companies operating employee profit share schemes. While the use of incentive schemes such as profit sharing is prevalent in a number of organisations, the impact of such schemes on employee behaviour and company performance remains unclear. This in some cases has resulted in some companies withdrawing such schemes because they could not sustain them in the face of dwindling profit margins. A number of organisations have introduced incentive schemes in a bid to shift a portion of their payroll costs to variable pay. In most profit share schemes, payout is determined by one or two financial measures and the distribution of proceeds is tied to each employee’s pay as a percentage of the total payroll. Group schemes like profit share fail to specifically direct or reward individual employee behaviour. As a result, such schemes have produced somewhat limited effects with respect to improvements in employee performance or company profitability. These schemes do not differentially reward individuals who perform well compared to the poor performers. This fact alone can increase perceptions of inequity in the whole remuneration structure. Another problem with ordinary profit share schemes is that there is very little effect on employee behaviours, so there is little or no impact on company profitability. In most cases profitability of the company is so remote from the average effort of employees on the job. Profits are generally impacted on heavily by a number of other factors such as company strategy, interest rates etc, that are totally outside the control of ordinary employees. When it comes to designing performance based pay systems, companies normally face the dilemma of whether to reward individual or team performance. The downside of rewarding individuals is that, cooperation between them may become a problem. On the other hand, if you reward the team, it might promote free rider behaviour and demoralize the high performers. The best option out of this dilemma is to come up with a profit share scheme that takes into consideration both team and individual performance. Key measures to be used for the scheme should cover the key drivers of the business i.e., financial, customer, people and internal business processes. This allows employees to focus on a set of balanced performance measures that drive overall company business goals. One such scheme is called the Financially Funded Goal Sharing Scheme. In this scheme payout potential is determined by a measure of profitability, just as in profit share. However the payout is conditional i.e. tied to the achievement of additional goals that are more meaningful to and controllable by employees. The latter will have to earn their profits by achieving various performance goals. How does such a scheme work? If you achieved your profit targets as a company, you will have a gross profit share allocation that will be distributed only on condition that you have achieved other goals such as operating income, operating costs, value of new business, customer satisfaction index (e.g. 95%) and level of skills growth in the organisation. Without passing the above hurdles no profit payouts will be made.

In such schemes companies normally share 5% or so of their target net profit and maybe 8% of any profit above target. Whatever figure comes out of this process forms the company’s gross profit share allocation. The gross profit share allocation is then deposited into a pool called the net profit share allocation on the basis of achievement of a number of other goals. Each goal is allocated a priority weight that determines how much will be shared as a result of the company having achieved that goal. How much does each individual get then? What each employee will get depends on their individual performance. Depending on the rating scale you are using in your performance appraisal system you can allocate the percentage points per rating that each individual employee will get. These percentage points will be used in a formula that includes net profit share allocation and total salary bill. For this system to be effective you need to have a performance measurement system that is linked to key performance drivers of your business and it should be credible in the eyes of employees. The major advantage of such a scheme besides fostering teamwork is that it ensures that the company will not share the profit (the gross profit share allocation) when other measures on the company’s scorecard are below the targeted performance. This setup ensures that at no time will the company share profits when its survival is in danger even though they have made profits.

Profit sharing schemes are normally established to encourage greater financial performance and the need to lower relative labour costs. They also create a sense of common fate that normally help in erasing the entitlement mentality to performance. For profit share schemes to succeed there must be management credibility and trust otherwise the system will not work. Participation of employees in the design stage is also critical, and this must be supported by open communication system. Above all, scheme rules need to be very clear outlining the conditions covered under the scheme. Organisations need to realise that profitability years are rare hence there is a need to manage employee perceptions and expectations. In most cases employees end up viewing the plan as a guaranteed benefit irrespective of the profitability of the company. If the link between organisational profitability and payouts is not clearly articulated it can create resentment. Employees may also view it as a ploy by management to use the plan as a low pay supplement. The existence of uncontrollable factors that impact on profitability also affects the credibility of profit share schemes. If all the necessary conditions for success are adhered to in the design stages, profit share schemes can help the company motivate staff to achieve organisational goals.

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