

## Bonus, Anyone?

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"Bonus" is the Latin word for "good", though you would hardly get that impression from reading the financial press recently. Everyone is feeling the pain, cynicism abounds. It is likely that your company's current bonus programme is now hopelessly unachievable, indeed irrelevant in the present circumstances. So what do you do about bonuses for this year? And what do you do when the economy starts to pick up again?

### Salvaging your Current Bonus Plan

Every incentive pay programme should be tailored specifically to the needs of the company, and never more so than now, where this year's results are likely to be significantly different from the business plan, and next year's are impossible to forecast. The immediate problem is managing shareholders' and employees' expectations. Normally changes in the business environment can be forecast some months ahead, but the suddenness of the current downturn is unprecedented. In some industries (agribusiness for instance), variation in year-on-year profits is relatively common, and their incentive pay programmes are set up to take account of that volatility. But for companies which have experienced steady growth over the last few years, recent drastic revisions of otherwise reasonable profit forecasts are affecting employee morale.

There are some questions which need to be addressed immediately:

- With profits down or non-existent, is it right to pay bonuses at all this year? Are they affordable for the company?
- If you do pay bonuses, should you be selective about who receives them, and on what basis do you decide?
- Are you prepared to revise performance measures and targets to allow at least some bonus payments? How do you calculate and communicate the changes?
- What about next year? Is it likely that there will be no bonus pool? If so, how and when do you communicate this to staff?

In deciding whether to pay bonuses this year, a lot depends on the way your current scheme has been set up. What was the underlying purpose of your plan?

- Was it effectively a profit-share – widely distributed, everyone getting more-or-less the same "value" in the payout (probably a percentage of Base Salary)? If so, bear in mind that there will be a point where the potential "bonus" payment may be so low in dollar terms – especially compared with previous years – that it is best not to distribute it at all.

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- Was your scheme focused on rewarding outstanding performance, giving relatively high payments to a restricted number of top-performing employees? If so, then there may well be at least some money to distribute this year, but with very much more rigorous, and defensible, performance criteria. You need to start working on defining and communicating those criteria now. The danger is that some people who considered themselves “high-flyers” will miss out this time, and they must be actively managed if you want to retain them.

## Reassessing Future Policy

While other more immediate concerns take precedence over your reward policies, it is nevertheless important to start weighing up the pros and cons of re-establishing an incentive scheme, as you will need to act decisively when the economy does recover:

- First, and most fundamentally, should you have an incentive plan at all?
- If you do decide to reinstate one, how can some of the pitfalls be avoided?

## Bonus, Anyone?

It is tempting to consider abandoning the whole idea of incentives and bonuses, and revert to the not-for-profit approach of paying salaries only. Indeed, your company may be pressured by shareholders and unions to make such a commitment now. There is a school of thought – admittedly, driven mainly by academics – which suggests that people *do not* give their best effort when incentive pay is part of their rewards.

But in spite of the bad press, bonus plans have a long history on their side. The Romans had “self-funding” bonuses for their soldiers - paid for by their defeated enemies. In 1408, John Thornton received a bonus for completing the Great East Window of York Minster on schedule in three years. It’s all about goals and objectives, and the fundamental need in the human psyche to be rewarded for reaching them. It’s unlikely that we have seen the last of incentive pay plans.

## Identifying the Risks

So how have we arrived at a point where the concept of “bonuses” has become so immoral, corrupt, damaging? Quite simply by ignoring the risks. There are two major ones, both quite simple and obvious, but which seem to have been overlooked by the some of the companies that are now being so heavily criticised:

- Encouraging behaviour you don’t want
- Paying bonuses when you can’t afford them

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## Behaviour versus Real Results

Every discussion on incentive pay, be it within Human Resources or a formal presentation to the Board's Remuneration Committee, should start with this slogan writ large:

"YOU GET WHAT YOU PAY FOR"

In other words, the problem with bonuses is that they *do what they are supposed to do*. At AIG, brokers were encouraged to achieve ever-higher revenue without evaluating the quality of the business and the threat to shareholders' investments. In the same way, every Sales Manager knows that if you pay bonuses on the basis of revenue, you will sell the products which are easiest to sell, not necessarily those which are the most profitable or strategically important. Every incentive plan has a downside. The bonus plan rules must take account of those negative effects – for instance by implementing impartial quality review systems or stipulating what balance of products must be sold within a portfolio.

## Affordability

The second imperative to evaluate is *affordability*. No company should ever be forced into the situation of paying bonuses when it is not profitable. Payment thresholds should be set to ensure that the company meets all its financial targets, including dividends, before any bonus payments are triggered. Problems arise when a division is profitable, but the company overall is not. Plan rules should take account of that eventuality in advance, rather than trying to deal with it after the event.

Another very important aspect of affordability is the shareholder's perception of what is reasonable. Shareholders' wealth has suffered massively over the last few months. When the economy does recover, as eventually it will, shareholders will not be willing to pay large bonuses for achieving results which are merely in line with the overall market, however spectacular the percentage gains may appear to be. They may even want to suspend bonus pay plans until share prices get back towards pre-2008 levels. In any case, payment thresholds for both annual bonuses and long-term incentive plans will need to be set using comparative data over specific market indices, industries and competitors. "Average" results will not be good enough.

## It Must Not Happen Again ...

Finally there is going to be an increased focus on governance. Too often, in my experience, Boards have concentrated on the cost in dollar terms of an incentive programme without necessarily querying its substance and the alignment with strategic objectives. It is the job of the Remuneration Committee to scrutinize all these aspects, as well as potential downsides, and pass them as acceptable before any plan can be implemented.

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So what part will bonuses play in remuneration policies of the future? They will continue to be an important element in reward packages offered in the private sector, as well as some not-for-profit organisations. The difference will be more focused governance, greater scrutiny, frequent challenges from shareholders, better alignment to strategic objectives. If an incentive programme is robust enough to withstand such hurdles, then surely it is all the more rewarding when targets are achieved and the bonus is paid out. Is that a bad thing?

*To have a confidential discussion on the issues raised in this Article, how they affect your organisation and how I might help you, please contact me on +64 9 478 4684 or via email: [janet@rewardmanagement.co.nz](mailto:janet@rewardmanagement.co.nz).*

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