

# Tips for a long life

*Performance pay systems often fail to last the distance, but Charles Macdonald says they can be effective and durable. He offers some tips for success.*



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Many organisations openly and enthusiastically support the need to pay for performance. The benefits of effective performance pay are frequently promoted, which is no surprise given the potential cost of many performance plans.

However, the effectiveness of performance pay is often not assessed on an ongoing and frequent basis. Systems often seem to be developed and launched with huge energy and enthusiasm, left in peace for two or three years, then reviewed and deemed to have failed, only to be revamped or replaced by a new system. So the cycle starts again.

What are the ground rules for ensuring performance pay is both robust and effective?

## A simple definition

Performance or variable pay is defined as: "Cash remuneration that is determined by reference to actual performance against a set of predetermined performance measures and has to be

re-earned over each performance period."

Performance pay covers profit sharing and gain sharing arrangements and individual and team incentive plans. It doesn't include discretionary bonus plans or equity based plans. Plans typically cover specific groups of employees, though they can also cover a significant proportion of the workforce.

## Why performance pay?

In considering how to make performance pay durable, it can be useful to be clear about why it has been adopted. Amongst other things, this will help assess whether the plan should be stable or will have to change often as objectives are achieved or goal posts move.

Some reasons that companies implement performance pay are shown in the box below. They are all good reasons, but are maybe not always openly acknowledged and are sometimes merely 'corporate speak'.

Reasons to implement...	
Business success	Focusing, and driving, employees to deliver long-term sustainable business success.
Risk management	Helping align remuneration costs with business revenue and profitability, and so reduce business risk.
Market competitive	Providing market competitive remuneration levels and practices.
Corporate culture	Changing to, and maintaining, a desired corporate culture.
Politics of pay increases	Easier to get director approval, and shareholder support, than for large salary increases.
Fashion	Keeping up with the 'Joneses'.

## Is it successful?

Some performance pay plans clearly have worked. These particular plans often have a clarity of purpose combined with a simplicity of design.

For many others, however, the verdict must at best be mixed. The owner of the plan (often HR) may claim success, but this is often not supported by participating employees, by finance or by management.

Many incentive plans are not perceived to have materially driven business success. This can be seen through:

- Frequent design changes in an attempt to get the right plan (though these changes may alternatively reflect changing business needs);
- Excessive use of company discretion, thereby severing the link between the adopted performance metrics and the performance reward; and
- Possibly most importantly, the development of an entitlement culture rather than the desired performance culture.

Significantly, few companies undertake a formal, structured and independent review of their performance pay arrangements and few seem to monitor the level of reward against business success or against the initial objectives used to develop the performance plan.

## Why is it not always effective?

There are, of course, lots of reasons, many of which are specific to organisations.

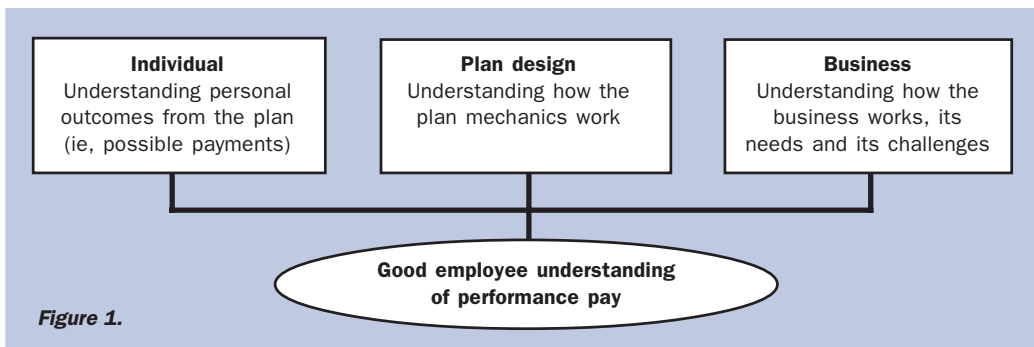
A common situation can see the development of what appears to be a well-defined performance pay structure, including clear employee communication mate-

rial. However, over the next two or three years a combination of changing business objectives, employee turnover and a loss of ownership of the plan can result in the plan being seen as ineffective.

Performance pay needs a champion, and not just when it is being established. Some other causes that appear frequently include:

- Expecting performance pay to achieve several different, and possibly conflicting, objectives;
- Companies not having the measurement systems on which to base the performance plan, nor the culture to constantly be measuring everything. (There is much truth in the saying that you get what you measure);
- Failure to adopt the 'right' performance measures, and not just those that are easiest to measure accurately;
- Poor plan design, including both poor alignment with business requirements and poor combination of performance measures;
- Poor understanding of the plan by participating employees;
- Administration of the plan being too slow and sometimes inaccurate.

Ensuring good employee understanding can be challenging, especially for broad-based or



changes will be necessary, both to improve on the initial design and to accommodate changes in the business. This will see the plan evolve over time, though with much commonality.

There is also a political element to durability—a change in management can mean a new performance metrics, new ideas on handling people issues and, maybe, changes to performance pay. Having well-designed, well-documented and recently reviewed performance pay could avert the need for such change.

Finally, change is inevitable. The performance pay systems in place may have achieved their purpose or the business needs may have altered. Keeping a plan beyond its useful life is in no one's interests.

complicated plans. Achieving good understanding requires attention to each of the three aspects shown in Figure 1.

### How to ensure performance pay is effective

Of course, there is no sure-fire way to ensure complete success. However, the following checklist will help.

**Plan purpose.** Be clear about what the plan is required to achieve and why performance pay is the right way to deliver these goals.

**Plan champion.** Ensure that the plan always has a champion, ideally someone with authority within the company.

**Performance measures.** These must be:

- 'Appropriate', ie, measure the right things and not the easy things;
- Clearly understood by almost all participating employees;
- Robust and durable, ie, unlikely to have to be changed, for either strategic or internal political reasons.

**Few measures.** Keep measures down to as few as possible, and combine them 'intelligently'.

**Material reward.** Reward must be perceived by employees as being reasonable, not only for on-target performance but also for performance above and below target.

**Eligibility.** Establish clear criteria for employees to participate in performance pay, and apply it consistently.

**Flexibility.** Business changes, so make sure the plan can also change and that participating employees expect some changes in the future.

**Participant understanding.** It is absolutely critical that most participating employees have a good understanding of the arrangement. Invite a group of participants to describe the existing plan and discuss its merits over lunch one day.

**Administration.** Often not done well, which will result in damaged credibility and, ultimately, an ineffective arrangement.

**Simplicity.** Must be simple enough so that most participants understand it, but must also match business needs. Over-simplified plans can be as damaging as ones that are too complex.

The above is both obvious and basic. However, the devil is in the detail.

### What about durability?

Making performance pay effective will, of course, help make it durable.

In addition, it is important to assess the plan on a frequent basis, maybe annually. Don't wait till it starts to crack and try not to have the best of intentions, but let other projects take priority. It is likely that minor

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