Performance bonuses- the foundations stones

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By David Parmenter

Performance bonuses give away billions of dollars each year based on methodologies where little thought has been applied. Who are the performance bonus experts? What qualifications do they possess to work in this important area other than prior experience in creating mayhem we currently have?

When one looks at their skill base one wonders how did they get listened to in the first place. Which bright spark advised the hedge funds to pay a $1bn bonus to one fund manager who created a paper gain that never eventuated into cash? These schemes were flawed from the start; 'super' profits were being paid out, there was no allowance made for the cost of capital and the bonus scheme was only 'high side' focused.

There are a number of foundation stones that need to be laid down and never undermined when building a performance bonus scheme (PBS) that makes sense and will move the organisation in the right direction. These foundation stones are:

- PBSs need to be based on a relative measure rather than a fixed annual performance contract
- super profits should be excluded from a PBS as they need to be retained to cover the loss making years lying ahead
- the profits included in a PBS calculation should be free of all major 'profit enhancing' accounting adjustments
- all PBS, especially those in the finance sector, should take into account the full cost of capital
- any 'at risk portion of salary' should be separate from the PBS
- PBSs should avoid any linkage to share price movements
- PBSs should be linked to a 'balanced' performance
- PBSs should avoid having 'deferral schemes' for unrealised gains
- all PBSs should be tested to minimise risk of being 'gamed' by participants in the scheme
- PBSs should no be linked to KPIs
- PBSs need to be communicated with staff using PR experts
- PBSs should be 'road tested' on the last complete business cycle

Be based on a relative measure rather than a fixed annual performance contract

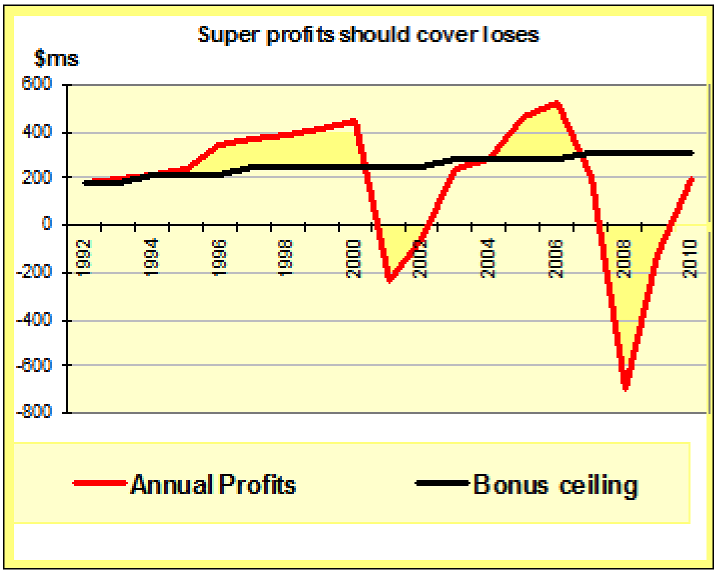
Most bonuses fail at this first hurdle. Jeremy Hope and Robin Fraser, pioneers of the Beyond Budgeting methodology have pointed out the trap of an annual fixed performance contract. If you set a target in the future, you will never know if it was appropriate, given the particular conditions of that time. You often end up paying incentives to management when in fact you have lost market share. In other words, your rising sales did not keep up with the growth rate in the marketplace.

Relative performance targets measures are where we compare performance to the market place. Thus the financial institutions that are making super profits out of this artificial lower interest rate environment would have a higher benchmark set retrospectively, when the actual impact is known. As Jeremy Hope says "Not setting a target beforehand is not a problem as long as staff are given regular updates as to how they are progressing against the market." He argues if you do not know how hard you have to work to get a maximum bonus you will work as hard as you can.

Super profits should be excluded from a PBS and retained to cover the possible losses in the future

In boom times, annual performance targets give away too much. These 'super profit' years come around infrequently and are needed to finance the dark times of a recession. Yet, what do our 'remuneration experts' advise? A package that includes a substantial slice of these super profits; yet no sharing in any downside. This downside, of course, is borne solely by the shareholder.

Exhibit 1: retention of super profits



There needs to be recognition that the boom times have little or no correlation to the impact of the teams. The organisation was always going to achieve this, no matter who was working for the firm. As Exhibit 1 shows, if an organisation is to survive, super profits need to be retained.

If you look at Toyota's great years the percentage paid to the Executive's was a fraction of that paid to the State side Detroit 'fat cats', who had under performed.

This removal of super profits has a number of benefits:

- it avoids the need to have a deferral scheme for all unrealised gains
- it is defensible and understandable to employees
- can be calculated by reference to the market conditions relevant in the year. Where the market has got substantially larger, with all the main players reporting a great year, we can attribute a certain amount of period end performance as 'super profits'.

When designing a bonus scheme the super profits component should be a deduction from the profits rather than create a ceiling for the bonus scheme. If a bonus pool has 'maxed out' then staff will rather play golf than go hard to win further business. The ceiling in Exhibit 1 is shown for illustration purposes only.

The profits included in a PBS calculation should be free of all major 'profit enhancing' accounting adjustments

Many banks will be making super profits in 2010 -2012 as the massive write downs are written back when loans are recovered to some extent. This will happen as sure as night follows day.

I remember a classic case in New Zealand where a merciless CEO was rewarded solely on a successful sale of a publically owned bank. The loan book was written down to such an extent that the purchasing bank merely had to realise these write downs to report a profit in the first year that equated to nearly the full purchase price.

This activity is no different to many other white collar crimes that occur under the eyes of poorly performing directors.

One simple step you can take is to eliminate all short term accounting adjustments from the bonus scheme profit pool of senior management and the CEO. These eliminations should include:

- Recovery of written off debt
- Profit on sale of assets

The aim is to avoid the situation where management in a bad year will take a massive hit to their loan book so they can feather their nest on the recovery. This type of activity will be alive and well around the globe.

These adjustments do not have to be made for the loan team's bonus calculations. We still want them motivated to turn around non performing loans.

Taking into account the full cost of capital

The full cost of capital should be taken into account when calculating any bonus pool. A trader can only trade in the vast sums involved because they have a bank's balance sheet behind them. If this was not so, then the traders could operate at home and be among the many solo traders who also play in the market. These individuals cannot hope to make as much profit due to the much smaller positions their personal cash resources facilitate.

Each department in a bank should have a cost of capital, which takes into account the full risks involved. In today's unusual environment the cost of capital should be based on a five year average cost of debt and a risk weighting associated with the risks involved. With the losses that bank shareholders have had to stomach the cost of capital should be set in some 'higher risk' departments as high as 25%.

With the current artificially low base rate, a fool could run a bank and make a huge bottom line. All banks should thus be adjusting their cost of capital based on a five year average in thier PBSs.

Any 'at risk portion of salary' should be separate from the PBS

In the finance sector it is traditional for employees to have a substantial share of their salary at risk. The bonus calculation has been a very primitive calculation.

I propose that the at risk portion of the salary should be paid when the expected profits figure has been met, see Exhibit 2. Note that as already mentioned this target will be set as a relative measure, set retrospectively when actual information is known.

Where the relative target has been met or exceeded the 'at risk' portion of the salary will be paid. The surplus over the relative measure will then create a bonus pool for a further payment which will be calculated, taking into account the adjustments already discussed.

Exhibit 2: At risk component of salary

	Remuneration		
	Mgr 1	Mgr 2	Mgr 3
Salary package	60,000	80,000	100,000
At risk portion (bonus is paid separately)	12,000	16,000	20,000
Base salary, paid monthly	48,000	64,000	80,000
Relative measure, set retrospectively	not met	met	exceeded
Percentatge of at risk portion paid	40%	100%	100%
At risk portion paid	4,800	16,000	20,000
Share of bonus pool	nil	5,000	10,000
Total period end payout	4,800	21,000	30,000

PBSs should avoid any linkage to share price movements

No bonus should be pegged to the stock market price as the stock market price does not reflect the contribution staff, management and CEO has made.

Only a fool believes that the current share price reflects the long term value of an organisation. Just because a buyer, often ill informed, wants to pay a certain sum for a 'packet' of shares does not mean the total shareholding is worth that amount.

Providing share options is also giving away too much of shareholder's wealth in a often disguised way.

PBSs should be linked to a balanced performance

The balanced scorecard has offered another avenue to pay performance. PBSs using a balanced scorecard are often flawed on a number of counts:

- The balanced scorecard is often based on only four perspectives ignoring the important 'environment and community' and 'staff satisfaction' perspectives
- the measures chosen are open to debate and manipulation
- there is seldom a linkage to progress in the organisation's critical success factors
- weighting of measures leads to crazy performance agreements such as Exhibit3.

Exhibit 3: performance related pay systems that do not work

Category	Perspective weighting	Measure	Measure weighting
Financial	60%	EVA	25%
		Unit Profit	20%
		Market Growth	15%
Customer	20%	Customer satisfaction survey	10%
		Dealer satisfaction survey	10%
Internal	10%	Above average rank on process industry qu	5%
		Decrease in dealer delivery cycle time	5%
Innovation and learning	10%	Suggestions/employee	5%
		Satisfaction survey	5%

Source:International Institute of Management

An alternative would be to link the PBS to the organisation's critical success factors. See an example of an airline PBS in Exhibit 4.

Exhibit 4: How the performance related bonus would differ across teams (airline)

	Operational team	Public relations team	Maintenance team	Accountants
Financial performance	30%	30%	30%	30%
Progress in the critical success factors				
Timely departure and arrival of planes	20%	0%	20%	0%
Timely maintenance of planes	10%	0%	30%	0%
Retention of key customers	10%	0%	0%	0%
Positive public perception of organization - being a preferred airline	10%	30%	0%	0%
"Stay, say, strive engagement with staff"	10%	20%	10%	20%
Encouraging innovation that matters	10%	20%	10%	20%
Accurate, timely information which helps decisions	0%	0%	0%	30%

In this example all teams have the same weighting for the financial results. Some readers will feel this is too low. However when you research more on the balanced scorecard philosophy you will understand that the greatest impact to the bottom line, over the medium and long term, will be in the organisation's critical success factors.

The operational team, at one of the airports, has a major focus on timely arrival and departure of planes. You could argue that this should have a higher weighting such as 30%. However, this team does impact in many other CSFs. This team clearly impacts the timely maintenance of planes by making them available on time, impacts the satisfaction of our first class, business class and gold card holders passengers. The public's perception of the airline is reflected in the interaction between staff and the public along with press releases and the timeliness of planes.

Ensuring that staff are listened to, are engaged successfully, are constantly striving to do things better (Toyota's "Kaizen") is reflected in the weighting of "stay say strive" and "Encouraging innovation that matters". There is no weighting for 'accurate timely information which helps decisions' because other teams such as IT and accounting are more responsible for this and I want to avoid using precise percentages such as 7% or 8% which tends to give the impression that a performance pay scheme can be a scientific based instrument.

The public relations team has a major focus of creating positive spin to the public and to the staff. All great leaders focus in this area. You need not look past Richard Branson in this respect. The weights for the PR team will focus them in the key areas that they can contribute. By having innovation success stories and recognition celebrations staff will want to focus in this important area of constant improvement, which has been demonstrated so well in Toyota over the last couple of decades.

The maintenance and accounting teams focus is more narrowed. The accounting team has a higher weighting on "Stay say strive" and "Encouraging innovation that matters" to help focus their attention in these important areas. This will improve performance and benefit all the other teams they impact through their work.

PBSs should avoid having ‘deferral schemes’ for unrealised gains

All unrealised gains are just that. In many cases they are a mirage. Whilst we need to reward those who got in first to a climbing stock we need to recognise that the extent of the gain is largely due to a bounce back.

Already some banks have adopted a deferral mechanism on unrealised gains. Whilst this is understandable we need to consider likely the impacts:

- We do not want all stocks sold and bought back the next day as a window dressing exercise that dealers/brokers could easily arrange with each other.
- The financial sector is driven by individuals who worship the monetary unit, rather than any other more benevolent force. This is a fact of life. A deferral system will be very difficult for them to accept.
- Staff will worry about their share of the pool when they leave, the last thing you want is a team leaving so they can cash up their deferral pool while it is doing well.
- Dead wood may wish to hang around for future pay days out of their deferred bonus scheme

It is my belief that while some sectors may be able to successfully establish a deferral PBS the financial sector is fraught with difficulties. I believe it would be better to focus on the other foundations stones especially the removal of super profits.

All PBSs should be tested to minimise risk of being ‘gamed’ by participants in the scheme

All schemes, where money is at stake, will be gamed. Staff will find out ways to maximise the payment by undertaking actions that will often not be in the general interest of the organisation.

The testing of the new scheme should include the following:

- Rework bonuses paid to about five individuals over the last five years to see what would have been paid under the new scheme and compare against actual payments made.
- Consult with some clever staff and ask them ‘What actions would you undertake if this scheme was running?’
- Discuss with your peers in other companies better practices that work – this will help move the industry standard, at the same time as avoiding implementing a scheme that failed elsewhere.

PBSs should not be linked KPIs

KPIs are a special performance tool, it is imperative that these are not included in any performance related pay discussions. KPIs are too important be gamed by individuals and teams to maximise bonuses.

Whilst KPIs will show; 24/7, daily or weekly how teams are performing it is essential to leave the KPIs uncorrupted by performance related pay.

In my book '*Key Performance Indicators –developing, implementing and using winning* KPIs' I pointed out that not all measures were KPIs. In fact performance measures can neatly be broken into four types.

The four types of performance measures	Frequency of measurement
key result indicators (KRIs) - give an overview on the organisation's past performance and are ideal for the Board as they communicate how management have done in a critical success factor or balanced scorecard perspective	Monthly/quarterly
result indicators (RIs) give a summary on a specific area and they tell staff what they have done e.g., yesterday sales	All time frames
performance indicators (PIs) are targeted measures that tell staff and management what to do e.g., # of sales visits organised with key customers next week/fortnight	All time frames
key performance indicators (KPIs) tell staff and management what to do to increase performance dramatically e.g., planes that are currently over two hours late	24/7, daily, weekly

Certainly most teams will have some useful monthly summary measures which I call result indicators which will help teams track performance and be the basis any performance bonus scheme.

Communicating with staff using PR experts

All changes to such a fundamental issue as performance related pay needs to be sold through the emotional drivers of the audience. With a PBS this will require different presentations when selling the change to the Board, CEO, senior management team (SMT) and the management and staff. They all have different emotional drivers. We need to note nothing is ever sold by logic e.g., remember that your last car purchase.

> Selling by Emotional Drivers: How a Car Sale is Made
>
> Let us look how a second hand car salesperson sells cars using emotional drivers. Three customers over the same day arrive to look at the 'car of the week' that has been featured in the local paper. The first person is a young information technology guru, Y generation, with latest designer gear, baggy trousers part way down exposing a designer label on his shorts. The salesperson slowly walks up, all the time assessing the emotional drivers of this potential buyer, looking for clues, such as clothing, the car they arrived in, and so on. The opening line could be "I hope you have a clean licence, as I will not let you out in this beast if

you have not. This car has 180 BHP, a twin turbo, and corners like it is on railway tracks.” SOLD.

The second person could be me, with my gray hair visible. The salesperson would say, “This car is five-star rated for safety, eight air bags, enough power to get you out of trouble, unbelievable braking when you have to avoid the idiots on the road, and tyres that will never fail you.” SOLD.

The third person, with designer clothing and bag, is addressed with “This car has won many awards for its design. Sit in the driver’s seat and see the quality of the finish. Everything is in the right place. I assure you that every time you drive this car you will feel a million dollars!” SOLD.

Thus, we need to radically alter the way we pitch the sale of the new performance related pay rules to the CEO, SMT, the board, and to the affected staff. We have to focus on the emotional drivers that matter to all these parties. The emotional drivers will all be different.

Many change initiatives fail at this hurdle because we attempt to change the culture through selling logic, writing reports, and issuing commands via e-mail. It does not work. The new performance related pay scheme needs a public relations (PR) machine behind it. No presentation, e-mail, memo, or paper should go out unless it has been vetted by your PR expert. In addition I would also ‘road-test’ the delivery of all your presentations in front of the PR expert before going live.

PBSs should be ‘road tested’ on the last complete business cycle

When you think you have a good scheme test it on the results of the last full business cycle, the period between the last two recessions. View the extent of the bonus on the net profit.

You need to appraise the PBS as you would a major investment in a fixed asset where you have committed a future stream of income to pay for an asset. See Exhibit 5 for an example of this road test.

Exhibit 5 for an example of this road test

		1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Annual Profits (excluding all cost of capital charges)		180	180	200	220	240	350	370	390	410	450	-240	-60	290	310	460	520	210	-700	-125	200
Removal of accounting entries				-30										-20		-40	-40				
Super profits clawback							-10	-20	-30	-30	-40					-20	-30				
Full cost of capital		-30	-30	-30	-32	-35	-60	-62	-62	-75	-75	0	0	-40	-42	-65	-70	-30	0	0	-30
Adjusted profit		150	150	140	188	205	280	288	298	305	335	-240	-60	230	268	335	380	180	-700	-125	170
Expected profit based on market share		140	140	140	160	180	260	260	265	280	290			190	220	300	350	170			160
Profits subject to bonus pool		10	10	0	28	25	20	28	33	25	45			40	48	35	30	10			10
Percentage of pool	33%	3.3	3.3	0.0	9.2	8.3	6.6	9.2	10.9	8.3	14.9	0.0	0.0	13.2	15.8	11.6	9.9	3.3	0.0	0.0	3.3

A checklist to ensure you lay down these foundations stones carefully

Checklist	Is it covered?
1. be based on a relative measure rather than a fixed annual performance contract	
All fixed in advance, annual targets for bonuses are removed	❑ Yes ❑ No
Relative measures are introduced to take account of:	
▪ Comparison against market share	❑ Yes ❑ No
▪ Comparison against other peers	❑ Yes ❑ No
▪ Changes in input costs (e.g. where base rate is zero banks	❑ Yes ❑ No
Progress against the relative measures are reported 3 or 4 times a year	❑ Yes ❑ No
2. super profits should be retained for the loss making years lying ahead	
Super profit scenarios have been analysed	❑ Yes ❑ No
Historic trends analysed to estimate when super profits are being made	❑ Yes ❑ No
Drivers of super profits identified e.g., the interest margin banks had in 2009 meant that even a fool would have made super profits	❑ Yes ❑ No
Super profits removed from net profit as a % of each $m made rather than have a ceiling	❑ Yes ❑ No
Model tested against last ten, twenty years retained profit/losses to ensure formula is right	❑ Yes ❑ No
3. The profits in a bonus calculation should be free of all major 'profit enhancing' accounting adjustments	
Eliminate all short term accounting adjustments including: ▪ Recovery of written off debt ▪ Profit on sale of assets ▪ Recovery of goodwill	 ❑ Yes ❑ No ❑ Yes ❑ No ❑ Yes ❑ No
4. taking into account the full cost of capital	
All departments which has a specific profit sharing scheme should have a 'cost of capital', which takes into account the full risks involved.	❑ Yes ❑ No
5. separate out 'at risk portion of salary' from bonus element	
Test the new system on previous years	❑ Yes ❑ No
HR to discuss the change on a one to one basis with all managers affected	❑ Yes ❑ No
Prepare an example of the new scheme and publish in a secure	❑ Yes ❑ No

area of the HR team's intranet section	
6. avoiding linkage to share price movements	
Removed all bonuses that are linked to share prices	❑ Yes ❑ No
Removed all share options from remuneration	❑ Yes ❑ No
7. linked to a balanced performance	
Remove all KPIs from bonus schemes	❑ Yes ❑ No
Evaluate progress against the success in the critical success factors	❑ Yes ❑ No
8. Avoid having a deferral scheme for all unrealised gains	❑ Yes ❑ No
9. all bonus schemes must be 'game' tested	❑ Yes ❑ No
Rework bonuses paid to about five individuals over the last five years to see what would have been paid under the new scheme and compare against actual payments made	❑ Yes ❑ No
Consult with some clever staff and ask them 'what actions would you undertake if this scheme was running'	❑ Yes ❑ No
Discuss with your peers in other companies better practices that work – this will help move the industry standard at the same time as avoiding implementing a scheme that failed elsewhere.	❑ Yes ❑ No
10. don't link KPIs with performance related pay	❑ Yes ❑ No
Removed all KPIs from performance related pay	❑ Yes ❑ No
Removed all KPIs from Job descriptions	❑ Yes ❑ No
Removed all KPIs from annual performance agreements	❑ Yes ❑ No
11. communicating with staff using PR experts	❑ Yes ❑ No
Sold changes via the emotional drivers	❑ Yes ❑ No
Have prepared presentations that are targeted specifically at:	❑ Yes ❑ No
▪ the board	❑ Yes ❑ No
▪ CEO	❑ Yes ❑ No
▪ Senior management team	❑ Yes ❑ No
▪ the staff on performance related pay schemes	❑ Yes ❑ No
12. road test the bonus scheme on last complete business cycle	❑ Yes ❑ No

Writer's biography

David Parmenter is an international presenter who is known for his thought provoking and lively sessions, which have led to substantial change in many organisations. David is a leading expert in the development of winning KPIs.

David's work on KPIs is recognized internationally as a breakthrough in understanding how to make performance measures work. His book, 'Key Performance Indicators: Developing, Implementing, and Using Winning KPIs' is one of the best selling performance management books on Amazon.com. John Wiley & Sons Inc have also published his second book "Pareto's 80/20 rule for Corporate accountants".

David has delivered workshops to thousands of attendees in many cities around the world including Sydney, Melbourne, Kuala Lumpur, Singapore, Tehran, Johannesburg, Dublin, London, Manchester, Edinburgh and Prague.

David has worked for Ernst & Young, BP Oil Ltd, Arthur Andersen, and Price Waterhouse, and he is a fellow of the Institute of Chartered Accountants in England and Wales.

He has written over 30 articles for the accounting and management Journals including *"quarterly rolling planning - removing the barriers to success"*, *"Throw away the annual budget", "Beware corporate mergers", "Implementing a Balanced Scorecard in 16 weeks not 16 months", "Convert your monthly reporting to a management tool", "Smash through the performance barrier", "Is your board reporting process out of control?" "Implementing winning Key Performance Indicators", "Quick month end reporting" etc.*

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