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CHAPTER TWENTY

Performance Bonus Schemes

OVERVIEW

Performance bonus schemes can be seen as an annual entitlement, be very costly, create endless arguments and not lead to notable improved performance. This chapter explores the foundation stones CFOs and controllers must be aware of if they are involved in designing or fixing a bonus scheme. It was first published in my book *The Leading Edge Manager's Guide to Success.*[1]

Performance bonus schemes have broken down across a wide range of organizations and they can be very costly without improving performance. This chapter is written for the CFO, or controller, who has been asked to design a performance bonus scheme based on better practice or to fix the current broken one. Jeremy Hope[2] summed up the situation in this quote:

> "…But despite hundreds of research studies over 50 years that tell us that extrinsic motivation (carrot and stick financial targets and incentives) doesn't work, most leaders remain convinced that financial incentives are the key to better performance."

THE BILLION-DOLLAR GIVEAWAY

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 the mayhem we currently have?

When one looks at their skill base, one wonders how they acquired the credibility in the first place. Which remuneration expert advised the hedge funds to pay a $1 billion 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. My recommendation to the reader is, do not seek so-called expert advice. Apply the following guidelines and some common sense.

FOUNDATION STONES OF PERFORMANCE BONUS SCHEMES

There are a number of foundation stones that need to be laid down and never undermined in order to build a performance-related pay scheme that makes sense and will move the organization in the right direction. The foundation stones include:

- Use relative measures instead of an annual target.
- Exclude super profits.
- Remove profit enhancing accounting adjustments.
- Apply the full cost of capital.
- Separate at-risk portion of salary from the scheme.
- Avoid any linkage to the share price or share options.
- Make bonuses team-based rather than individual-based.

- Avoid an annual entitlement.
- Link to a balanced performance.
- Exclude unrealized gains.
- Test scheme to minimize manipulation.
- Avoid linking to KPIs.
- Get the management and staff on side

Use Relative Measures Instead of an Annual Target

Most bonuses fail at the first hurdle, because they are based on annual targets. Jeremy Hope and Robin Fraser,[3] 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, their performance was substandard. A good example of this would be in the private sector if rising sales did not keep up with the market growth rate.

Relative performance targets involve comparing performance to the marketplace. Thus, the financial institutions that are making super profits out of this artificially 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 that if you do not know how hard you have to work to get a maximum bonus, you will work as hard as you can.

Exclude Super Profits

Super profits should be excluded from schemes and retained to cover possible losses in the future. In boom times, schemes often 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, but no sharing in any downside. This downside, of course, is borne solely by the shareholder.

There needs to be recognition that the performance in boom times has limited correlation to the efforts of teams and individuals. The organization was always going to achieve this, no matter who was working for the firm. As Exhibit 20.1 shows, if an organization is to survive, super profits need to be retained.

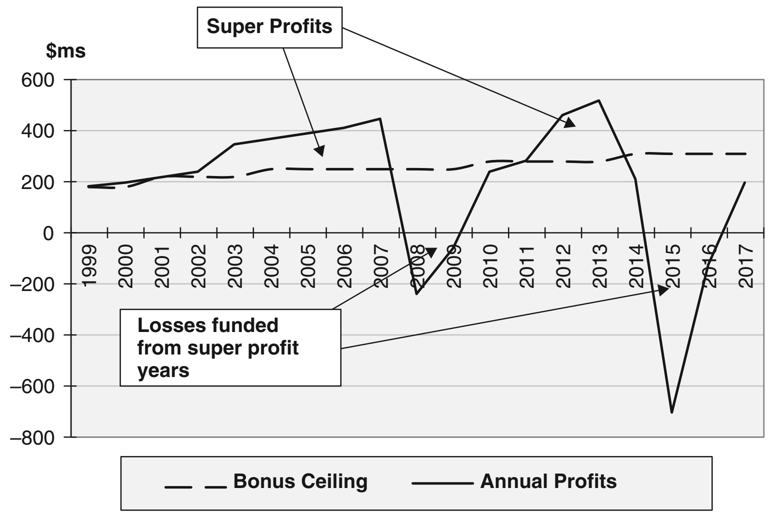

EXHIBIT 20.1 Retention of Super Profits Source: David Parmenter, *The Leading-Edge Manager's Guide to Success: Strategies and Better Practices.* Copyright © 2011 by David Parmenter. Reprinted with permission of John Wiley & Sons, Inc.

This removal of super profits has a number of benefits:

- It is defensible and understandable to employees.
- It can be calculated by reference to the market conditions relevant in the year. When the market has become substantially larger, with all the main players reporting a great year, we can attribute a certain amount of period-end performance as super profits.
- These super profits can fund bonuses in loss-making years when staff are pulling the organization out of the fire.

The ceiling in Exhibit 20.1 is shown for illustration purposes only.

Remove Profit-Enhancing Accounting Adjustments

All profits included in a performance bonus scheme calculation should be free of all major "profit-enhancing" accounting adjustments. Many banks generated additional profits in 2010–2013 as the massive write-downs from the global financial crisis were written back when loans were recovered.

> I remember a classic case in New Zealand where a CEO was rewarded solely on a successful sale of a publicly owned bank. The loan book was written down to such an extent that the purchasing bank reported a profit in the first year that equated to nearly the full purchase price. Most of the written-down loans had been repaid in full.

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 is in active use around the globe.

Apply the Full Cost of Capital

The full cost of capital should be taken into account when calculating any bonus pool. Traders 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 tolerate, the cost of capital should be set in some higher-risk departments as high as 25 percent. 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 their performance-related pay schemes.

Separate the At Risk Portion of Salary from the Scheme

Any at-risk portion of salary should be separate from the performance related pay scheme. The at-risk portion of the salary should be paid when the expected profits figure has been met (see Exhibit 20.2). Note that, as already mentioned,

	Remuneration		
	Mgr 1	**Mgr 2**	**Mgr 3**
Base salary, paid monthly	48,000	64,000	80,000
At-risk salary (bonus is paid separately)	12,000	16,000	20,000
Salary package	60,000	80,000	100,000
Relative measure, set retrospectively	not met	met	exceeded
Percentage of at-risk salary paid	40%	100%	100%
At-risk salary paid	4,800	16,000	20,000
Share of bonus pool	nil	5p00	10,000
Total period-end payout	4,800	21,000	30,000

EXHIBIT 20.2 At-Risk Component of Salary Source: David Parmenter, *The Leading-Edge Manager's Guide to Success: Strategies and Better Practices.* Copyright © 2011 by David Parmenter. Reprinted with permission of John Wiley & Sons, Inc.

this target will be set as a relative measure, set retrospectively, when actual information is known. When 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.

Avoid Any Linkage to the Share Price or Share Options

Bonus schemes 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 that staff, management, and the CEO have made.

Only a naive person believes that the current share price reflects the long-term value of an organization. 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 an often-disguised way. As strategy guru Henry Mintzberg has clearly stated, "Executive bonuses—especially in the form of stock and option grants—represent the most prominent form of legal corruption that has been undermining our large corporations and bringing down the global economy. Get rid of them and we will all be better off for it."

Jeremy Hope points out in his book *Reinventing the CEO*,[4] these incentives have been behind many corporate failures. Due to the pressure to manipulate the accounts, the share price is too great for the CEO and senior management to resist.

With share options, it is so easy to get it wrong, and in fact give away more wealth in a period than the actual net profits created. In other words, you have given away future profits that may never be generated, and often not by the executives in question.

There is another, more damaging issue in that these measures focus executives on manipulating the short term at the expense of innovation, where the costs are often front-loaded and the rewards back-loaded.

Make Bonuses Team-Based Rather Than Individual-Based

Basing accountability and rewards on teams, rather than individuals, has been talked about for years. It is much more closely linked to Douglas McGregor's *Theory Y* view that people are motivated by self-esteem and personal development, rather than by additional incentives (*Theory X*).[5] In Theory Y, organizations produce better results by encouraging their people to be creative, to work collaboratively, to improve their skills, and to derive satisfaction from their work. Only a simpleton would believe that you can separate out an individual's contribution to the bottom line. As Harvard professor of business administration Robert Simons asks, "How do we measure the contribution of a single violin player in relation to the successful season enjoyed by a symphony orchestra?"[6]

PROFIT SHARING PLAN AT SOUTHWEST AIRLINES

The profit sharing plan at Southwest started in 1973 and is at the heart of its compensation and benefits program. All employees qualify on January 1 following the commencement of their employment. Fifteen percent of pretax profits are paid into the profit-sharing pool, and this is shared across all employees according to base salary. The payments go into a retirement fund for individual employees. While employees are free to increase that amount, 25 percent of the profit-sharing fund is used to purchase Southwest shares. There are no incentive schemes based on achieving annual fixed targets.[7]

As Jeremy Hope points out: The profit-sharing system can only be understood in the context of its purpose. It is not intended to be an incentive for individuals to pursue financial targets; rather, it is intended as a reward for their collective efforts and competitive success.

Avoid the Annual Entitlement

The finance sector has a belief that the bonus is a right, and in many cases, it has already been spent. We need to move bonuses out of the annual cycle. Southwest does this very cleverly.

NO ANNUAL CASH PAYOUTS AT SOUTHWEST AIRLINES

Southwest doesn't make an annual cash payment; instead, they pay the bonus into an employee pension plan. This has the effect of minimizing any fallout from a poor year. In other words, employees are not planning to spend their bonus on "something special" and then become disappointed when it doesn't happen. The pension payment approach cushions poor years but also has the effect of relating performance to the share price (both pension schemes own a substantial element of company stock).[8]

Link to a Balanced Performance

Performance-related pay schemes should be linked to a "balanced" performance. The balanced scorecard has been used, I would argue, largely unsuccessfully, as a vehicle to pay performance. Schemes 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 link to progress in the organization's critical success factors.
- Weighting of measures leads to crazy performance agreements such as those shown in Exhibit 20.3.

Scorecard Perspective	Perspective Weighting	Performance Measure	Measure Weighting
Financial	60%	Economic value added	25%
Results		Unit's profitability	20%
		Market share growth	15%
Customer	20%	Customer satisfaction survey	10%
Focus		Dealer satisfaction survey	10%
Internal Process	10%	Ranking in external quality survey	5%
		Decrease in dealer delivery cycle time	5%
Innovation and Learning	10%	Employee suggestions implemented	5%
		Employee satisfaction survey	5%

EXHIBIT 20.3 Performance-Related Pay System That Will Never Work Source: David Parmenter, *The Leading-Edge Manager's Guide to Success: Strategies and Better Practices*. Copyright © 2011 by David Parmenter. Reprinted with permission of John Wiley & Sons, Inc.

An alternative would be to link the scheme to the organization's critical success factors. See an example of an airline scheme in Exhibit 20.4.

In this exhibit, all teams have the same weighting for the financial results. Some readers will feel that this is too low. However, when you do more research 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 organization'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 percent. However, this team does impact in many other critical success factors. This team clearly impacts the timely maintenance of planes by making them available on time; and impacts the satisfaction of our first class, business class, and gold-card-holder 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 members are listened to, are engaged successfully, and are constantly striving to do things better (Toyota's Kaizen) is reflected in the weighting of "stay, say, strive" as well as the catchphrase "encouraging innovation that matters." There is no weighting for "accurate timely information

	Operational Team	Public Relations Team	Maintenance Team	Finance	Team
Financial performance of team	30%	30%	30%	30%	—
Progress in the critical success factors (CSFs)					
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%	—
	100%	100%	100%	100%	

EXHIBIT 20.4 How the Performance-Related Bonus Would Differ Across Teams (Airline) Source: David Parmenter, *The Leading-Edge Manager's Guide to Success: Strategies and Better Practices*. Copyright © 2011 by David Parmenter. Reprinted with permission of John Wiley & Sons, Inc.

that 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 percent or 8 percent, which tend to give the impression that a performance pay scheme can be a science-based instrument.

The public relations team has a major focus of creating positive spin for the public and for the staff. All great leaders focus in this area (a superb example is Sir Richard Branson). The weights for the public relations team will direct them in the key areas where 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 at Toyota over the past couple of decades.

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

Exclude Unrealized Gains

The treatment of unrealized gains is a sensitive issue. Some performance-related pay schemes include deferral provisions in an attempt to avoid paying out bonuses on unrealized gains that may never materialize. The question is whether the cure is worse than the ailment. The issue comes back to the impact on human behavior. Already, some financial institutions have adopted a deferral mechanism on unrealized gains to avoid situations like the $1 billion bonus to one fund manager who created a paper gain that never eventuated into cash as the global financial crisis wiped it all way.

Use history to work out the amount of deferral required and apply consistent rules. Where stocks have been volatile, history has shown the quicker they rise, the faster they fall. Use a table to establish how much of unrealized gain is held back (i.e., 20%, 40%, 60%). It is not recommended to hold back all unrealized profit, as there are some downsides that need to be mitigated:

- 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.
- Underperforming staff may wish to hang around for future paydays out of their deferred bonus scheme.

It is my belief that while some sectors may be able to successfully establish deferral provisions, they will be fraught with difficulties in the financial sector. In some cases, it would be better to focus on the other foundation stones, especially the removal of super profits, and take into account the full cost of capital.

Test Scheme to Minimize Manipulation

All performance-related pay schemes should be tested to minimize the risk of being manipulated by participants in the scheme. All schemes in which money is at stake will be gamed. Staff will find ways to maximize the payment by undertaking actions that may well be not in the general interest of the organization. The testing of the new scheme should include:

- Reworking 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.
- Consulting with a cross section of staff and asking them, "What actions would you undertake if this scheme was in place?"
- Discussing effective best practices with your peers in other companies: this will help move the industry standard while avoiding the implementation of a scheme that failed elsewhere.

Performance-related pay schemes 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 scheme with the same care and attention you would apply to making a major fixed asset investment.

In Exhibit 20.5, I have gone back 10 years, removed the impact of profit enhancing accounting adjustments (in this case, recovery of debt previously written off), deducted off the super profits (on the operations of last 10 years

		20	20	20	20	20	20	20	20	20	Last year
Annual profits (excluding all cost of capital charges)		(240)	(60)	290	310	460	520	210	(700)	(125)	200
Removal of profit enhancing adjustments				(20)		(30)	(20)				
Super profits clawback						(60)	(120)				
Adjusted profit		(240)	(60)	270	310	370	380	210	(700)	(125)	170
Expected profit using agreed benchmark ROCE				190	220	240	240	170			160
Adjusted profits for bonus pool calculation				80	90	130	140	40			10
Size of bonus pool if share is	**25%**	**0**	**0**	**20**	**23**	**33**	**35**	**10**	**0**	**0**	**3**
Size of bonus pool if share is	**33%**	**0**	**0**	**26**	**30**	**43**	**46**	**13**	**0**	**0**	**3**

EXHIBIT 20.5 Testing the Performance Scheme on Past Results

anything over $400 million deemed to be super profits) and removed the expected profit shareholders would see as a given using an agreed "return on equity" benchmark.

Avoid Linking to KPIs

Performance-related pay schemes should not be linked to KPIs. KPIs are a special performance tool, and it is imperative that these are not included in any performance-related pay discussions. KPIs, as defined in Chapter 18, are too important to be gamed by individuals and teams to maximize bonuses. Performance with KPIs should be considered a "ticket to the game."

Although KPIs will show how teams are performing 24/7, daily, or weekly, it is essential to leave the KPIs uncorrupted by performance-related pay. As mentioned in Chapter 18, it is a myth that by tying KPIs to pay, you will increase performance. You will merely increase the manipulation of these important measures, undermining them so much that they will become *key political indicators*.

Certainly most teams will have some useful monthly summary measures, which I call *results indicators*. These result indicators help teams track performance and are the basis of any performance-related pay scheme.

Get the Management and Staff On Side

Schemes need to be communicated to staff using public relations experts. All changes to such a fundamental issue as performance-related pay need to be sold through the emotional drivers of the audience. With a performance-related pay scheme, this will require different presentations when selling the change to the board, chief executive officer (CEO), senior management team, and management and staff. They all have different emotional drivers.

It is important to sell to management and staff why the existing scheme needs to change. As mentioned in Chapter 2 Leading and Selling Change it is important to start the process off by getting management to see that the default future is not what they want. We need to sell the change using emotional drivers rather than selling by logic, as already discussed.

Many change initiatives fail at this hurdle because we attempt to change the culture by using logic, writing reports, and issuing commands via e-mail. It does not work. The new performance-related pay scheme needs a public relations machine behind it. In addition, you should road test the delivery of all of your presentations in front of the public relations expert before going live.

PDF DOWNLOAD

To assist the finance team on the journey, templates and checklists have been provided. The reader can access, free of charge, a PDF of the suggested templates, and a checklist from www.davidparmenter.com/TheFinancialControllersandCFOsToolkit.

The PDF download for this chapter includes:

- A checklist to ensure that you lay down these foundation stones carefully
- A printable version of the templates used in this chapter

NOTES

1. This chapter is adapted from David Parmenter, The Leading-Edge Manager's Guide to Success: Strategies and Better Practices (Hoboken, NJ: John Wiley & Sons, 2011).
2. Jeremy Hope, "How KPIs Can Help Motivate and Reward the Right Behavior," IBM white paper, 2010.
3. Jeremy Hope and Robin Fraser, Beyond Budgeting: How Managers Can Break Free from the Annual Performance Trap (New York: Harvard Business Review Press 2003).
4. Jeremy Hope, Reinventing the CFO: How Financial Managers Can Transform Their Roles and Add Greater Value (Boston: Harvard Business School Press, 2006).
5. Douglas McGregor, The Human Side of Enterprise (New York: McGraw-Hill, 1960).
6. Robert Simons, "Control in an Age of Empowerment," Harvard Business Review (March–April 1995): 80.
7. Hope, "How KPIs Can Help Motivate and Reward the Right Behavior."
8. Ibid.