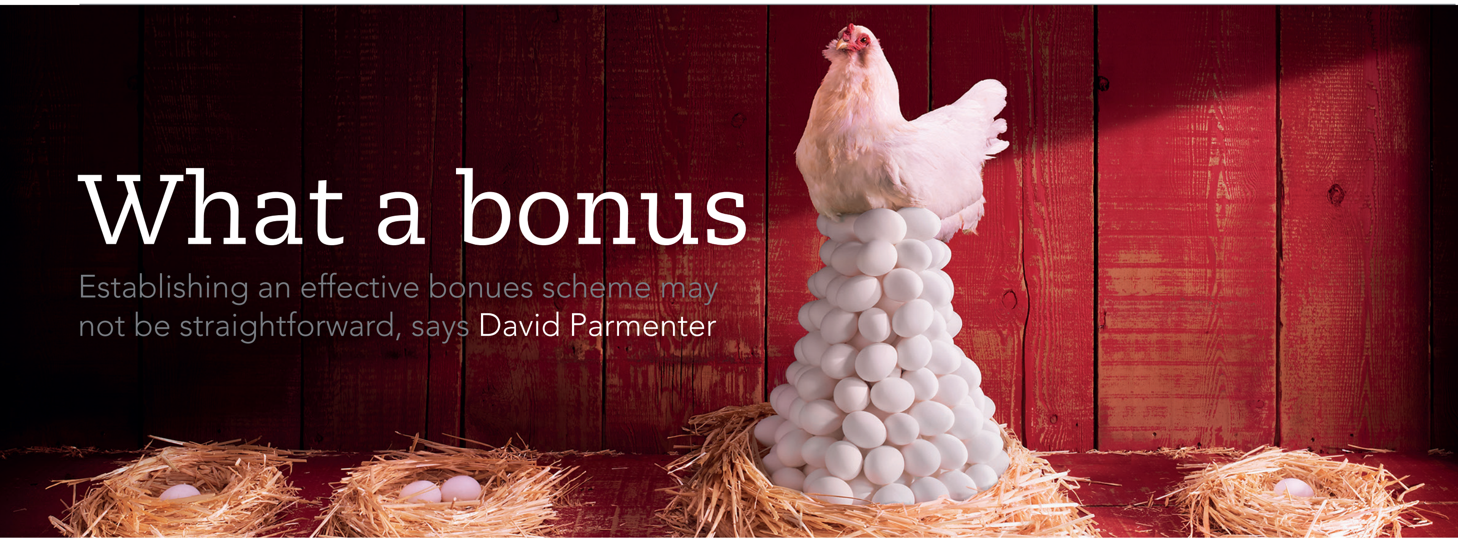

What a bonus

Establishing an effective bonues scheme may not be straightforward, says David Parmenter

Bonus schemes can be seen as an annual entitlement, be very costly, create endless arguments and might not lead to notable improved performance. So what foundations should CFOs and financial controllers lay down if they are designing a bonus scheme?

Most bonuses fail at the first hurdle. If you set a target for employees that depends on market performance, you can't really know if the measure will be appropriate until the target date comes. You often end up paying incentives to management when their performance was in fact substandard. Instead, performance should be compared internally (one team against another) and externally (against the competition) rather than against a future – likely or unlikely – eventuality.

Not setting a target beforehand is not a problem as long as staff are given regular updates on their progress against other teams in-house and competitors. As Jeremy Hope, co-founder of the Beyond Budgeting Round Table, wrote in the IBM white paper *How KPIs Can Help Motivate and Reward the Right Behavior*, '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 incentive schemes and instead retained to cover possible losses in the future. In boom times, bonus schemes often give away too much. 'Super-profit years' come around infrequently and are needed to finance the dark times of a recession. They can fund bonuses in loss-making years when staff are pulling the organisation out of the fire. Management needs to recognise that performance in a boom year has limited correlation to the efforts of teams and individuals.

No unearned adjustments

All profits that are included in a performance bonus scheme calculation should be free of all major unearned '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.

One simple step you can take is to eliminate from the bonus scheme all unearned accounting adjustments such as recovery of written-off debt and profit on sale of assets. Basing rewards on teams, rather than individuals, is much more closely linked to social psychologist Douglas McGregor's 'Theory-Y' view that people are motivated by self-esteem and personal development, rather than by additional incentives (Theory X). Theory Y organisations produce better results by encouraging their people to be creative, work collaboratively, improve their skills and derive satisfaction from their work. As Robert Simons, professor of business administration at Harvard Business School, asks, 'How do we measure the contribution of a single violin player in relation to the successful season enjoyed by a symphony orchestra?'

Share price pitfalls

In addition, bonus schemes should avoid any linkage to share price movements. Only a fool believes that the current share price reflects the long-term value of an organisation. Any closing share price is based on the last trade; just because a buyer, often ill informed, wants to pay a certain sum for a portion of shares does not mean all shares are worth that amount. With share options it is so easy to get it wrong and in fact give away more shareholder's funds in a period than the actual net profits created. In other words, by issuing share options you have given away future profits that may never be generated.

Key performance indicators (KPIs) – the 10 or fewer measures that are measured frequently, are linked to the organisation's critical success factors and can be owned by individual teams – are too important to be gamed to maximise bonuses. Performance with KPIs should be considered a 'ticket to the game' and excluded from bonuses. If you pay by KPIs, you undermine them so much that they will become 'key political indicators'. ■

David Parmenter is a writer and presenter on measuring, monitoring and managing performance

Next steps

1. Read Jeremy Hope's *How KPIs Can Help Motivate and Reward the Right Behavior*, IBM white paper, 2010.
2. Look at clever schemes used elsewhere and perform a wide consultation within your organisation before you put in a bonus scheme.
3. Email me (**parmenter@waymark.co.nz**) and I will send you a chapter from my CFO book covering all the foundation stones you need to understand and adopt.