

RELEVANT TO ACCA QUALIFICATION PAPER P5

Reward schemes for employees and management

A major part of performance management involves managing employees and managers, as their performance will have a major effect on the performance of the organisation as a whole. This article looks at how reward schemes can be used to influence the behaviour of employees.

MEANING OF REWARD SCHEMES

A broad definition of reward schemes is provided by Bratton:

‘Reward system refers to all the monetary, non-monetary and psychological payments that an organisation provides for its employees in exchange for the work they perform.’

Rewards schemes may include extrinsic and intrinsic rewards. Extrinsic rewards are items such as financial payments and working conditions that the employee receives as part of the job. Intrinsic rewards relate to satisfaction that is derived from actually performing the job such as personal fulfilment, and a sense of contributing something to society. Many people who work for charities, for example, work for much lower salaries than they might achieve if they worked for commercial organisations. In doing so, they are exchanging extrinsic rewards for the intrinsic reward of doing something that they believe is good for society.

OBJECTIVES OF A REWARD SCHEME

What do organisations hope to achieve from a reward scheme? The following are among the most important objectives:

1. To support the goals of the organisation by aligning the goals of employees with these.
2. To ensure that the organisation is able to recruit and retain sufficient number of employees with the right skills.
3. To motivate employees.
4. To align the risk preferences of managers and employees with those of the organisation.
5. To comply with legal regulations.
6. To be ethical.
7. To be affordable and easy to administer.

ALIGNING THE GOALS OF THE ORGANISATION AND EMPLOYEES

The reward scheme should support the organisation’s goals. At the strategic level, the reward scheme must be consistent with the strategy of the organisation. If a strategy of differentiation is chosen, for example, staff may

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receive more generous benefits, and these may be linked to achieving certain skills or achieving pre determined targets. In an organisation that has a strategy of cost leadership, a simple reward scheme offering fairly low wages may be appropriate as less skilled staff are required, new staff are easy to recruit and need little training, so there is less incentive to offer generous rewards. The US supermarket group Walmart competes on low cost. It recruits employees with low skills, and pays low wages. It discourages staff from working overtime, as it wishes to avoid paying overtime rates.

TO RECRUIT AND RETAIN SUFFICIENT EMPLOYEES WITH THE RIGHT SKILLS

If rewards offered are not competitive, it will be difficult to recruit staff since potential employees can obtain better rewards from competitors. Existing staff may also be tempted to leave the organisation if they are aware that their reward system is uncompetitive.

High staff turnover can lead to higher costs of recruitment and training of new staff. Losing existing employees may also mean that some of the organisation's accumulated knowledge is lost forever. For many knowledge-based organisations, the human capital may be one of the most valuable assets they have. High technology companies such as Microsoft are companies that trade on knowledge, so offer competitive remuneration to key staff.

TO MOTIVATE EMPLOYEES

Motivation of employees is clearly an important factor in the overall performance of an organisation. Organisations would like their employees to work harder, and be flexible. The link between reward schemes and motivation is a complex issue that is hotly debated in both accounting and human resource-related literature.

A well-known theory relating to motivation is Maslow's hierarchy of needs. Maslow stated that people's wants and needs follow a hierarchy. Once the needs of one level of the hierarchy are met, the individual will then focus on achieving the needs of the next level in the hierarchy. The lower levels of the hierarchy are physiological, relating to the need to survive (e.g. eating and being housed); once these have been met, humans then desire safety, followed by love, followed by esteem, and finally at the top of the hierarchy, self actualisation, or self fulfilment.

Applying Maslow's hierarchy of needs to reward schemes suggests that very junior staff, earning very low wages will be motivated by receiving higher monetary rewards, as this will enable them to meet their physiological needs. As employees become progressively more highly paid, however, monetary rewards become relatively less important as other needs in the hierarchy, such

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as job security, ability to achieve one's potential, and feeling of being needed become more important.

Herzberg argued that increasing rewards only motivates employees temporarily. Once they become de-motivated again, it is necessary to 'recharge their batteries' with another increase. A far better way to motivate employees is to 'install a generator in an employee' so they can recharge their own batteries; in other words to find out what really motivates them. According to Herzberg, it is the intrinsic factors in a job that motivate employees, such as 'achievement, recognition for achievement, the work itself, responsibility and growth or advancement.' Giving greater responsibility to employees, for example, can increase motivation.

Perhaps the conclusion to be gained from this is that monetary rewards alone are insufficient to motivate employees. Other factors such as giving greater recognition and greater responsibility may be equally important, for example giving praise at company meetings, promoting staff, and involving staff more in decision making.

ALIGNING THE RISK PREFERENCES OF MANAGERS AND EMPLOYEES WITH THOSE OF THE ORGANISATION

Managers and senior employees make decisions on behalf of the company, acting as agents of the company. It is desirable that the risk preferences of these employees should match the risk preferences of the organisation and its stakeholders. One problem with many reward schemes is that managers are too risk averse, and will not make investments that may risk their targets not being met.

The events leading up to the financial crisis of 2008 are a good example of the opposite situation, where the risk appetites of employees at investment banks did not match the risk appetites of the owners. During this period, individuals working in the banks were paid large commissions for selling mortgage loans to customers. The problem was that the employees were selling loans to customers that posed a large risk to the banks, due to their low credit worthiness.

The problem was confounded by the fact that in many cases, the employees of the banks were paid commissions on the date that the loan agreements were signed, while the loans lasted for 25 years. In situations where the borrower defaulted, however, there was no claw back, so the employee would not be required to repay the commission.

Many countries have put in place new laws and codes to change this situation. In the UK for example, the financial services authority introduced a code whereby remuneration structures should be based on sound risk management

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practices, incentive payments should be deferred over a number of years, and there should be claw back provisions whereby employees are required to repay bonuses in the event that the longer term results of their actions leads to similar problems experienced in the financial crisis.

Share options may also create a miss-match between the risks faced by the organisation and the risks faced by the holders of the options, since the holders benefit if share prices increase, but do not bear any losses if the share price falls. Share options are discussed in more detail later in this article.

COMPLYING WITH LEGAL REGULATIONS

Rewards should comply with legal regulations. Typically, employment laws include areas such as minimum pay, and equal pay legislation to ensure that no groups are prejudiced against. There have been high profile cases of female investment bankers winning legal cases against their employers because their bonuses were far less than those paid to male colleagues.

ETHICS AND REWARD SCHEMES

In recent decades there has been a move away from fixed remuneration systems towards reward systems where at least part of an employee's rewards are based on performance of the individual and the business as a whole. Some writers claim that this is unethical for two reasons. Firstly such systems tend to place increased business risk onto employees. Secondly, such systems undermine collective bargaining systems, and reduce the power of unions. This leads to a situation where employees as a collective have less bargaining power.

The size of total remunerations paid to directors of large public companies has also become a hot political issue, with a perception that the gap between top earners, and average earners is becoming larger. In the US, the average directors of S&P 500 companies earn 200 times more than the average household income in the US. Defenders of such large differences in pay point out that this difference has actually declined in recent years; in the year 2000, directors of S&P 500 companies earned 350 times the average household income. According to some research, such high packages are justified as they do reflect the performance of those directors.

AFFORDABLE AND EASY TO ADMINISTER

It is an obvious fact that there is an inherent conflict of interest in the relationship between employer and employee. The employee's rewards represent a cost to the employer, which the employer wants to minimise. Clearly whatever reward scheme is in place, it must be affordable to the employer.

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TARGET SETTING

Many reward schemes are based on employees achieving pre-determined targets, so some consideration of target setting is required.

In Fitzgerald and Moon's building block's model, three principles are given when setting standards or targets: equity, ownership and achievability. Equity in this context means fairness; when setting targets for the various managers, those targets should be equally challenging. Ownership means that the targets should be accepted and agreed by those managers for whom they are set. This can usually be achieved by participation. Finally targets must be achievable; otherwise the employees for whom they were set will become demotivated.

The building block's model then goes on to specifically cover reward schemes. It states that there are three principles of a good reward scheme. First, there should be clarity – it should be clear how the reward scheme works. If your boss tells you that you will receive a bonus at the end of the year 'if you do a good job,' that is not very clear, since the boss has not specified what doing a good job means. Rewards should be motivational. Finally there is the important controllability principal. Employees should only be judged and rewarded based on things within their control. This is why profit-related pay might not be relevant to a junior administrative assistant, for example.

Hope and Fraser warn against the use of linking rewards to fixed performance targets, as this leads to gaming. In particular, managers whose rewards depend on fixed targets may be tempted to 'always negotiate lowest targets and highest rewards,' which suggests that management plans will understate the potential that the organisation can make. 'Always make the bonus, whatever it takes,' is another example of gaming suggested by Hope and Fraser, which suggests that managers may indulge in unethical behaviour such as fraudulent accounting in order to ensure that targets are met.

Hope and Fraser suggest divorcing the planning process and the target setting process, and basing rewards on relative targets and benchmarks. A relative target might be market share, for example, where rather than setting an absolute target for a sales manager, a market share (%) target is provided. If the market rises, then more is expected in absolute terms. This adds to controllability, since the sales manager could not be held responsible for a rise (or fall) in the overall market, which is outside of his control, but would be able to control whether or not he achieves the expected share of the market.

TYPES OF REWARD SCHEME

Base pay

Base pay, or basic pay, is the minimum amount that an employee receives for working for an organisation. For example, the employee may be paid \$10 per

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hour for a minimum of 40 hours per week. The employee will therefore earn at least \$400 per week. This will be paid regardless of how many of those 40 hours the employee is actually working. A fixed annual salary is another example of basic pay.

Basic pay may be supplemented by other types of remuneration. A blue collar worker may be paid overtime for example if he works more than 40 hours per week, and a manager may receive some form of performance pay in addition to the base pay. Basic pay is likely to address the lower levels of Maslow's hierarchy of needs mentioned above.

Performance-related pay

Performance-related pay is a generic term for reward systems where payments are made based on the performance, either of the individual (individual performance-related pay) or a team of employees (group performance-related schemes).

In recent decades there has been a move toward performance-related pay schemes in many organisations. This has led to a situation where a higher portion of the employees pay is dependent on performance. This rationale for performance-related pay is that it motivates employees to work harder, and rewards those who make a greater contribution to the organisation's goals. This should lead to efficiency savings. There are many types of performance-related pay, and the most popular ones are described below:

1. Piecework schemes

Under Piecework schemes, a price is paid for each unit of output. Piecework schemes are the oldest form of performance pay, and were used for example in the textile industries in Great Britain during the industrial revolution. Piecework schemes are appropriate where output can be measured easily in units. They are typically used for paying freelance, creative people. Freelance writers for example are often paid based on the number of words.

The benefit of piecework schemes is their inherent fairness. The higher the output, the more the employee (or subcontractor) receives. From the employer's perspective, the employer does not have to pay for idle time or inefficiencies.

From the employee's perspective, such schemes mean that the employee bears commercial risk if demand for their product falls.

A further disadvantage of piecework schemes is that the payment is not based on the quality of output. However, some sort of quality control is likely, and if the quality is not of a required standard, the employee or subcontractor will not be paid.

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2. Individual performance-related pay schemes

Individual performance-related pay schemes are where the employee receives either a bonus, or an increase in base pay on meeting previously agreed objectives or based on assessment by their manager, or both. They are typically used for middle managers in private sector organisations and for professional staff.

The advocates of individual performance-related pay schemes claim that their they are an obvious way to align to objectives of middle managers with the goals of the organisation. If performance targets set are based on the goals of the organisation, then it appears obvious that making part of the rewards of employees' contingent on achieving those targets will mean that employees are motivated to achieve the goals of the organisation.

Individual performance-related schemes also have the advantage over group schemes that the employee has control over her rewards, as they do not depend on the effort (or lack of) of other members of the team.

Critics of such schemes point out that the link between rewards and motivation is far from clear, as discussed above. It is also argued that performance-related schemes lead a situation of tunnel vision whereby if something is not measured, and then rewarded, it won't get done.

Individual reward schemes may lead to a lack of teamwork and may lead to variances in pay among individuals, which can lead to ill feeling.

An example of an individual performance-related pay scheme is one that is operated by a UK bank. Under the scheme, a bonus pool is allocated to each region based on the performance of that region. From this pool, individual awards are made based on assessment of performance, taking into account the rating on a five-point scale. Those with scores of 1 to 3 qualify for a discretionary bonus. The assessment depends on how much new business the individuals have brought in, or how much efficiency savings they have generated. The rewards are usually paid in cash, although for senior employees receive a portion as deferred stock.

3. Group-related performance-related pay schemes

Group-related performance-related schemes are similar to individual, in that rewards are paid based on the achievement of targets. However the targets are set for a group of employees, such as a particular department, or branch of a company, rather than for an individual. Since the rewards apply to a group, they are likely to be based on a pre-determined quantitative formula, rather than on assessment of staff.

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A bonus pool is calculated based on the performance of the team, and this is shared among the members of the team. Bonuses may be paid up at the end of the year, or may be deferred, and paid at a later date, as this may encourage staff and managers to take a longer term view, rather than simply focusing on the current year's bonus.

The advantage claimed for group schemes is that they encourage teamwork. The disadvantage is that the lazier members of the team benefit from the hard work of the more dedicated.

Hope and Fraser give the example of a scheme operated by Svenska Handelsbanken, where each year, a portion of the banks profits are paid to a profit sharing pool for employees, provided that certain conditions are made. The main conditions are that the Handelsbanken Group must have a higher return on shareholder's equity than the average of its peer group. The upper limit of the amount paid into the scheme is 25% of the total dividends paid to shareholders. Employees do not actually receive anything from the pool until they reach the age of 60, at which point they receive a pay out based on the number of years that they have worked for the bank. The CEO of Handelsbanken claimed that employees are not motivated by financial targets, but by the challenge of beating the competition. The reward scheme is designed to be a dividend on their intellectual capital.

4. Knowledge contingent pay

Knowledge contingent pay is where an employee will receive a pay rise or a bonus, or both, for work-related learning. An ACCA candidate, for example, may receive a higher salary once he has passed all the knowledge level papers, and an even higher salary after passing all of his exams.

5. Commissions

Commissions are a form of remuneration normally used for sales staff. The staff may receive a low basic pay, but will then receive commission, based on a percentage of the amount of their sales.

The advantages of commission are that they should motivate sales staff to achieve higher sales, as their rewards depend on it, and they mean that the large part of the salesman's salary becomes variable. If sales are low, the organisation will have to pay less.

The disadvantage of commission is that it may lead to dysfunctional behaviour. Sales staff may indulge in window dressing, for example to meet this years sales target, by selling on a 'sale and return basis' in the final month of the year, with the inherent understanding that the goods will be returned in the following month of next year. They may also lead to short termism, where sales staff 'never put the customer above the sales target' to quote Hope and Fraser.

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6. Profit-related pay

Profit-related pay is a type of group performance-related pay scheme where a part of the employee's remuneration is linked to the profits of the organisation. If the company's profits hit a pre-determined threshold, a bonus will be paid to all members of the scheme. Typically the bonus will be a percentage of the basic pay. The bonus may be paid during the year in question; for example, quarterly, or it may be deferred until some later date, such as the retirement of the staff.

Advocates of profit-related pay argue that it motivates employees to become more interested in the overall profitability and therefore become more motivated to 'do their bit' to improve it. It may also encourage loyalty in cases where staff may lose their bonus if leaving the organisation means that they lose the right to it.

The obvious disadvantage with profit-related pay is that it does not match the primary objective of commercial organisations, which is to maximise the wealth of the shareholders. Managers may be motivated to increase profits by taking short-term actions that will harm the business in the long run, for example, or destroy wealth by investing in projects that increase the profits of the organisation, but produce a return that is below the cost of capital of the organisation.

Profit-related pay might not be a motivator for junior employees, who may fail to see the link between their effort and the overall profits of the organisation.

7. Stock option plans

Stock option plans have become very popular since the 1990s, when greater emphasis started to be given to shareholder value. Under stock option plans, staff receive the right to buy shares in their company at a certain date in the future, at a price agreed today.

For example, Alpha Co is listed on the stock exchange of Homeland. Today, shares in Alpha Co are trading at \$100 each. The company has just awarded the CEO of Alpha Co the option to buy 1 million shares for \$100 each in exactly ten years time. These options have no intrinsic value at the granting date.

If the share price rises to say \$200 in 10 years time, the CEO could exercise his options, buying 1 million shares at a price of \$100 each. Since the shares would be worth \$200 each by then the CEO would make a gain of \$100 per share, or \$100m in total.

Stock option plans are most appropriate for the senior management of organisations as they are the people who have the most influence over its share

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price. The rationale for using stock option plans is that they align the objectives of the directors with the objectives of shareholders. If the share price rises, the senior management benefit because their options increase in value. Thus senior managers will start to think like investors.

The big weakness of stock option plans is that share prices may depend on external factors as much as on the performance of the directors. During the bull markets of the 1990s and 2000s, many companies share prices rose simply because the market rose.

Another weakness is risk misalignment. Share options reward managers if the share price goes up. If the share price falls, however, there is no difference in reward between the share price remaining the same (\$100) and falling to (\$1) – so managers may be motivated to take extreme risks where the exercise price may not be met.

What shareholders really want is the performance of their company to be better than the market. One solution to this is to use an indexed exercise price, where the price at which the director can buy the shares is equal to the current market price, plus the increase in the stock market index between the date that the options are issued, and the exercise date. This means that the share option reflects the controllability principle more closely, as directors would not be rewarded for rises in the stock market in general.

PENSION SCHEMES

Defined benefit pension schemes used to be a popular form of reward. Under such schemes, the employer pays a pension to former employees based on their final salary, and the number of years that the employee worked for the organisation. A typical example is that the former employee receives 1/60ths of their final salary for every year of service. An employee who works for 40 years for the same organisation would therefore receive a pension equal to 40/60ths of their final salary from the date of retirement to the date of death.

Defined benefit schemes leave organisations with an uncertain, often large liability, and for this reason, many organisations have now discontinued such schemes.

Defined contribution schemes are another form of pension scheme where the employer pays a certain percentage of the employee's salary into an account for the employee in a pension 'pot.' The employee may also have the option of making additional voluntary contributions into this pension pot. The pension pot is then invested, and the employee receives whatever is in their account on retirement. In some countries, employees may be required to use what is in the pot to buy an annuity, which pays them a fixed income for the rest of their lives.

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Many countries offer tax incentives for such pension schemes, such as allowing employees to reduce their taxable income by the value of contributions made to the schemes.

BENEFITS IN KIND

Benefits in kind (or indirect pay) are paid to employees in addition to their base salary and performance-related pay. Benefits in kind include items such as health insurance and meal vouchers. They are usually provided to more junior staff in order to provide additional incentives at a lower cost. They are often used as a form of recognition, so the employee of the month for example will be given a benefit rather than a cash payment.

The advantage of benefits in kind is that greater flexibility can be given in designing a reward scheme for an individual.

'Cafeteria' schemes have also become popular, whereby employees are told that they may select benefits from a menu up to a certain value. The advantage of this is that employees will select the benefits that they value most. Benefits from which the employees can choose typically include such items as health insurance, holiday vouchers, company cars or sports vouchers.

Cafeteria schemes may be difficult to administer. Staff may also find them complex to understand, as they will have to select a number of benefits that have a value that is within the agreed limit.

ESTABLISHING THE LEVEL OF BENEFITS

How much should employees be paid? Two factors need to be taken into account here. First, competitiveness, and second internal equity.

As already mentioned above, unless the level of pay is competitive, it will be difficult to recruit and retain the right number of skilled employees. If it is too much, the cost to the organisation will be too high. Here the organisation will compare its pay levels with competitors. Such information may be available from job adverts in newspapers or on the Internet, or from recruitment consultants.

Internal equity relates to the pay differentials within the organisation itself. Staff will become demotivated if they feel that the remuneration system is 'unfair' and that other people are being paid more generously. Job evaluation techniques are used that try to determine the value of a specific job to the organisation. Based on this, the level of rewards for that particular position will be determined.

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THE ROLE OF APPRAISAL IN REWARD SYSTEMS

Many of the performance-related reward schemes depend on the performance of the employees. As such, the employees' performance has to be assessed. This usually takes place during the appraisal process. Staff will be assessed on a regular basis, for example twice a year. During the appraisal, targets will be set for the next period, and rewards agreed if the targets are met.

CONCLUSION

A good reward system aims to motivate employees to work harder, and align their goals with those of the organisation they work for. The current trend towards performance-related reward systems is designed to lead to greater rewards and motivation for those who contribute the most. However, designing such reward systems is complex, as they aim to influence human behaviour. As the human resources director of Flowpack Engineering said (quoted in Bratton) 'There is no such thing as a good pay system; there is only a series of bad ones. The trick is to choose the least bad one.'

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