Variable Pay: How To Effectively Manage It

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Introduction

Variable pay is a significant element of the direct compensation package of a growing number of organizations. The trend is towards more organizations using variable pay and for these organizations to expand eligibility and to increase the prominence of variable pay in the total direct compensation package.

Variable pay is defined as "direct compensation that does not become a permanent part of base pay/salary and which may vary in amount from period to period." Other names for variable pay include: incentive compensation, incentives, bonuses, commissions, cash awards and lump sums.

Variable pay can be in the form of short-term (one year or less) or long-term (two years or more) incentives/bonuses and employee ownership programs. "Incentives" are plans that have predetermined criteria and standards, as well as understood policies for determining and allocating rewards. "Bonuses" are awards delivered at the end of the period, based on a subjective judgment as to the quality of performance and the rewards that are warranted.

Variable Pay Strategy

Effective variable pay programs are the product of an effective variable pay strategy, which guides the design and administration of programs. Effective variable pay strategies have two critical characteristics: they contribute to the organization's success and they are a good fit to the organizational context.

In order for a strategy to contribute to organizational success, it must be aligned with the vision and mission of the organization. Heading the wrong direction at high speed does not bring one closer to the desired destination. An effective strategy should facilitate the attainment of organizational objectives, by ensuring that the right plans are implemented and that they are administered effectively. A sound variable pay plan strategy should contribute to sustaining the viability of the organization's core capabilities and to leveraging its competitive advantages.

The fit of a strategy to the specific context is also critical. It must be feasible given the culture of both the organization and its workforce and it must be realistic, considering the environmental and organizational realities that exist. And the strategy must be well integrated with the organization's strategy and structure, as well as its current human resource strategy. It must also be changed to respond appropriately to changes in the context. Exhibit 1 provides a model for defining and assessing the impact of the context on HR strategy, of which variable pay strategy is a part.

Variable pay differs from other forms of compensation, such as base pay and benefits. It does not fit an entitlement culture, since it is not a career annuity like a base pay increase, and it must be re-earned during each measurement period. From a financial perspective, it is a variable cost, whereas base pay and benefits are fixed in nature. One of the difficulties associated with administering variable pay is that it is much more difficult to measure the competitiveness of plans. Unlike base pay levels, variable pay levels vary dramatically for some occupations, transforming the "prevailing market average" into a broad range, rather than a point. One of the positive characteristics of variable pay is that it can be tied to performance at various organizational levels and it can be based on short-term or long-term performance or a combination of the two.

On of the most significant advantages of variable pay over other forms of compensation is that the costs associated with a plan can be aligned with revenues/performance and thereby vary with revenues in a manner that is economically sound. U.S. organizations have used variable pay much more sparingly than most global competitors and it this places them at a disadvantage when the global economy is subject to large variation. When there is a downturn the need to cut costs to protect profitability can force organizations to cut headcount and alienate the very people who will be needed during the impending upturn. If direct compensation costs are at least partially variable dysfunctional downsizing can be minimized, since costs will flex in synch with revenues if the variable pay plan is well designed.

The motivational potential of variable pay is stronger than other forms of compensation. Although base pay programs that are administered based on performance can be effective motivators the difficulty of tying base pay adjustments to specific objectives is known to all who have tried. Merit pay programs must also reflect increases in the employee's mastery of the job-critical skills/knowledge and since the pay structure is typically moved on an annual basis some of the funds available for base pay increases will be consumed by the need to at least keep the pay rate in the same position in the pay range. What is left over is just not adequate to provide a strong monetary incentive to perform. The fixed nature of base pay also means that a large award for a great year becomes a fixed annuity – U.S. culture pretty much precludes pay reductions for subsequent bad years. Variable pay plans can result in income that is lower than last year's and they can truly provide rewards that are consistent with one's contribution.

Current trends are towards more use of variable pay, which will be discussed further in later modules. Therefore, an organization without a variable pay component will be at a competitive disadvantage, at least for its best performers. Also, variable pay plans are typically "self-funding," which means the results have to be realized before the expense is incurred. This provides an additional source of funding for variable pay, while the base pay adjustment fund must be wrenched out of the budget, while competing with all the alternative ways of spending an organization's available capital.

There are potential disadvantages associated with variable pay. Budgeting is difficult and there is great pressure to make all performance criteria, measures and standards clear and defensible to all parties at interest. As more employees operate in a service capacity, with no physical product that can be counted or weighed forthcoming from their work, the task of getting everyone to agree about what really happened during a performance period is increasingly difficult. When there are significant cash awards at stake, the emotions run even higher.

Notwithstanding these potential disadvantages, there are several strong business reasons for considering variable pay, some of which have already been discussed:

Economics: The conversion of what have been fixed costs to variable costs is an advantage of some significance. Variable pay awards do not compound the way base pay adjustments do, thereby lowering escalation rates over time. Assuming variable pay is tied to performance it both allocates awards more optimally and is contingent on the organization's economic ability to pay. Finally, variable pay plans can be customized to fit different business units, providing a localized customization to the unit's ability to pay and creating a focus on its specific objectives.

Competitive Practice: Variable pay programs can be an effective tool for attracting and retaining critical skills, as well as high performers. Since the existence of a variable pay component in the compensation package offers less of a guarantee but more opportunity relative to income, this type of package will disproportionately attract those confident of their ability to perform well and willing to do so. Leveraging the organization's strengths via variable pay plans is another opportunity… an organization experiencing rapid stock price escalation can include a heavy dose of stock options/grants in it plans, thereby giving it a competitive advantage. The flexibility associated with variable pay plans can enable the organization to emulate the best in its industry in order to say competitive, which is often not possible with base pay or benefits.

Motivation: Already mentioned, this is a major strength of variable pay. Defined objectives/criteria and standards enable the organization to provide a sharp focus on its priorities, and to do so at every level. Variable pay awards act as reinforcement for those succeeding and provide a scorecard to enable people to continuously evaluate results. To the extent that people are provided with a "shared destiny" using group incentives, there can be a strong motivation to support each other and to work cooperatively rather than competing in a dysfunctional manner. The prerequisites to performance are the ability to perform, being allowed to do what it takes, the desire to perform and the knowledge of what constitutes performance. Variable pay plans can function to ensure these prerequisites are in place. HR can use variable pay in their initiatives to promote high levels of performance at individual, group and organization-wide levels.

Communication: Variable pay, particularly if designed as an incentive, is one of the strongest signals an organization can send to its people as to what is important. By continually measuring results high quality feedback can be provided, enabling people to know how they are doing and how to do better. By making employees eligible for variable pay awards it sends the message that what they do counts and that the organization is willing to show its appreciation tangibly. Finally, the criteria used in variable pay plans can promote the importance of mission attainment and of living the defined values on the way there.

Other: There are other reasons for considering variable pay. The plans can be used to communicate and direct a change from an entitlement culture to a performance culture, as well as promoting employee engagement. Variable pay can also provide a sense of ownership, even for organizations not able or willing to use stock or share equity… emotional ownership can produce results even though financial ownership is not possible. By balancing the definition of performance to include both the short-term and the long-term it is possible to elicit a balanced perspective. Short-term maximization at the expense of long-term optimization is a danger that is fueled by having all rewards tied to performance, which many organizations do. Finally, a reason for using variable pay is that it works. Depending on the soundness of the strategy and the plans, which can be the good news or the bad news. Much damage has been done by variable pay plans that motivated the workforce to do the wrong things. It is therefore necessary that a variable pay plan be respected much the same way an electrician respects a wire carrying high voltage.

Research has demonstrated that some human resource programs and initiatives produce a significant impact on performance in organizations (as measured by factors such as quality, productivity, speed, customer satisfaction and unwanted turnover). The two initiatives that consistently showed statistically significant positive results were linking pay to performance and using variable pay. Research has established the potential of variable pay to produce the desired business results.

Types Of Variable Pay Plans

There are numerous types of variable pay plans. They can be categorized by the level at which performance is defined, measured and rewarded (individual, group or organization-wide). They can also be differentiated by the timeframe associated with measuring and rewarding performance (short-term or long-term). Finally, they can be classified according to the form of award (cash, equity or recognition).

Individual plans: plans that define, measure and reward performance at the individual level. When individual performance is the focus there are several variable pay approaches that motivate and reward at the individual level.

The oldest type of individual incentive plan is the output-based (piece rate) plan that rewards productivity. Another type of output plan is the sales commission, which ties pay to the volume of sales produced by an individual. Anyone who has seen the classic film of Lucy and Ethel on the candy assembly line or Charlie Chaplin in "Modern Times" may view piece rate systems as exploitative, but where output is under the control of the individual and where quality can be controlled this type of plan is highly motivating and produces a direct link between pay and performance. Although most frequently used in production environments output plans are also found in white-collar settings where the work is production like, such as claims processing in insurance or proof operations in banking.

The key to success is being able to measure output accurately and to ensure that the individual is able to control production. If material availability, machine downtime or dependence on others are issues it complicates gaining acceptance that the plan is fair. Most plans call for the payment of a base rate, with incentive pay kicking in above some threshold level of production that is a break-even point (the point at which the employee has earned the base rate).

Basing variable pay on the attainment of specific objectives is a widely used approach. This is often termed the "management by objectives" approach. The objectives can be quantitative, qualitative or time-based and multiple objectives can be used. The most difficult measurement challenges are encountered when setting objectives at equivalent levels of difficulty across units and occupations, as well as identifying objectives that are both under the control of the individual and that can be objectively evaluated. There are challenges associated with assigning relative importance weights to goals, as well as keeping track of progress against expectations on an interim basis, so individuals can keep score and redirect when appropriate.

Merit pay can be objective-based and can result in cash awards rather than exclusively determining base pay adjustments. Exhibit 2 is an example of a system that combines base pay adjustments with cash awards. The cash awards are determined based on the performance appraisal rating, while base pay adjustments are tied to both the performance rating and the relative position of the employee's base pay in the range for the job. This approach can generate relatively large (6% and 3%) performance cash awards with a relatively small fund (e.g., 1 ½% of payroll) for these awards out of the amount budgeted for base pay increases. By reserving these awards for the top performing employees, the potential awards become significant and thereby gain real motivational value.

The use of recognition at the individual level can provide employees with valued rewards, even though they are not financial or are modest in size, and therefore are not technically "variable pay." It is important to recognize that behavioral research has established that being recognized and appreciated can be as powerful as cash in motivating future performance.

Individual plans work best in contexts where individuals work relatively independently of each other and have large amounts of discretion about how they do their work. In some cases, the technology used dictates individual measurement (e.g., inbound or outbound voice center operators who handle discrete transactions with customers alone). Also, in individualistic cultures such as the U.S. the organization is in great peril if it does not recognize the contribution of the individual… "Socialism" is not a popular concept. But individual plans also can be a bad fit in units where employees are highly interdependent and/or when a wide variety of knowledge/skill is required and no one individual has all it takes to produce the desired result. And in countries where the culture is oriented towards collectivistic thinking and behavior (e.g., many Asian countries), individual incentives may be viewed as inappropriate.

Group plans: plans that define, measure and reward performance at the group, unit or team level. There are several types of group plans and the most effective plan will be the one that best fits the specific context.

Productivity/cost-based plans are often called *gainsharing plans*. The name fits the concept; if productivity is increased, the value of the gain will be shared between the employees and the organization. These plans are typically based on formulas that consider cost, resource use or productivity ratios to determine awards. Since they are most often used in stable environments and with non-management employees the payout period is frequently quarterly or even monthly and there is usually an employee suggestion process in place, in order that employees can influence their destiny. When the measures are financial and a "profit center" is the level of measurement, these plans are sometimes made into a profit-sharing plan. When multiple measures are used and they include qualitative criteria they are called, "performance-sharing" (a.k.a., goal-sharing) plans.

Increasingly the work of employees is project-based. This has always been the case with professionals (e.g., Engineers or I.T. personnel). Variable pay plans tied to projects have become more common, encouraged by the development of project management technology, and these plans can be tied to individual incentives as well as group incentives.

Group recognition is also a form of reward that can have positive motivational impact. Pitting groups against other groups may create a positive competition, assuming their work is not interdependent, and celebrating the results of a group can increase its cohesiveness. Team-based incentives have been talked about a great deal in the last decade, but it is important to determine what type of team a plan is being developed for and what kind of plan will motivate the team to produce the desired results. Work teams are units that perform the work of the organization and are staffed by people who work in the team full-time and who are permanently assigned. This type of team can be rewarded using the typical group plans. A project team is usually made up of members who work either full-time or part-time in the team and who are assigned only for the duration of the project. This argues for a project-based variable pay plan, particularly for those who are assigned full-time during their involvement. "Parallel" teams are usually made up of employees who participate in addition to performing their full-time job and who may be assigned for a short time. This type of team is often called a "task force." It is common to reward task force members with recognition or modest financial rewards, given that their compensation is tied to their performance of their permanent assignment.

Organization-wide plans: plans that define, measure and reward performance at the organization-wide level. There are two major types of plans – one that provides rewards in cash and a second that uses stock or other forms of equity/ownership.

Profit-sharing plans typically share a portion of profits over a threshold level that provides a fair return to shareholders. Distribution of a profit-sharing pool is almost always egalitarian, with employees sharing an equal percentage of their base pay, or even receiving the same dollar amounts. Profit-sharing plans have been used in the U.S. since before 1900 and their primary purpose has been to create a "shared destiny" among employees, thereby motivating them to align their efforts and to focus on organizational profitability. Organizations such as Sears became preferred employers because of these plans, but many were qualified deferred plans and served to provide retirement income and estate building. Performance-sharing plans are a variation of the profit-sharing model; they differ in that they use multiple measures, many of which may not be financial (e.g., customer measures, quality measures and the like). The recent rise in popularity of the "balanced scorecard" concept has made these plans more popular, since their criteria are a scorecard for measuring organizational performance.

Stock or equity based plans differ from cash based plans in several ways. First, they inherently have a longer-term timeframe for realizing value. Also, they vary in value at least partially based on external factors rather than organizational performance. The equity markets create the wealth produced by stock, through price appreciation, so organizational performance may only determine how much stock is distributed and not what it is eventually worth to the holder. Stock purchase plans give employees an opportunity to buy stock, often at a preferred price. Although popular in the past organizations came to realize that it was difficult for low-paid employees, who had little discretionary income, to participate extensively and that the volatility in stock prices often produced a level of risk they could or would not take. For this reason, most broad eligibility stock plans are either stock bonuses/grants or stock options. Some profit sharing and performance-sharing plans pay out partially in cash and partially in stock, with the ownership of the stock being transmitted to the employee. This avoids the affordability problem for lower-paid employees and makes them immediate owners, able to vote the stock and to enjoy dividends and price appreciation. Stock options are tools for providing privileged access to stock ownership, by granting the right to purchase a specified amount of stock at today's price for some time into the future (most commonly ten years). If the stock does not perform well employees can walk away from the exercise option without losing money; if it does well they can often exercise and sell immediately or after a relatively short time. Unless the employee makes a bad early exercise decision, this is a risk free program.

A final type of organization-wide variable pay plan is a deferred compensation plan, most often a "401K" plan that enables participants to delay receipt of income and to enjoy a matching contribution from the organization. Although the conventional forms of 401K plan matching is a set formula (e.g., the first 6% of employee contribution will be matched 50% by the company). What makes these plans an incentive plan is when the matching percentage becomes variable, based on company performance. For example, the company might match 50% on a guaranteed basis, but if the company meets its targets it would increase the match to 75%, and if performs at a very high level the match would go to 100%. This could be an attractive way to encourage more retirement plan augmentation, as well as make the company contributions contingent on its performance.

To summarize, the type of plan used should fit the context and facilitate the attainment of the organization's objectives. Plans intended to align people would tend to be group or organization-wide, while plans attempting to maximize individual performance would be designed to measure and reward performance at the individual level. As more organizations operate in multiple countries, (cultures) they find that it may be necessary to use different types of plans in different regions or in different business units, due to the differences in the contexts within which the plans will operate.

Plan Design Issues

There are seven key design issues that guide the creation of an effective variable pay plan.

Plan Objectives: The first step in the design of a variable pay plan is the establishment of those objectives the plan is to achieve. By first establishing the objectives the search for the appropriate type of plan is made easier and the selection is focused on the needs and priorities of the organization.

One of the most common objectives is to align reward costs with performance, whether it is at the organization-wide, group or individual level. As mentioned earlier when discussing the advantages of variable pay each year's cost is a one-time expenditure that is not compounded in future years and the costs can be controlled through a budgeting process. By tying variable pay funds to the firms ability to pay under multiple scenarios there can be close alignment between revenue/operating budget and costs.

Another prevalent objective is to motivate performance at the individual, group and/or organizational level. Because variable pay plans can be tied to predetermined objectives employees know what is at stake and what it takes to realize rewards, as well as being able to keep 'score' during the year and do determine how well they are doing. By developing multiple plans or plans with performance measured at multiple levels, the business plan can be integrated across levels to be sure individual and unit performance delivers the desired results at the organizational level.

Sharing success with employees goes beyond motivation and can act as a way of expressing the importance of everyone's contribution and displaying willingness to reward effort and results. Closely aligned with this objective is that of attracting and retaining critical skills. Individual variable pay plans can send the signal that the organization provides large compensation potential for high performers, as well as brand the organization as one who recognizes and values good employees. It has often been said that "what you reward you get more of," and this concept extends to "what you offer will determine what you get – in the way of employee quality."

One of the most overlooked characteristics of variable pay is its ability to act as a powerful signaling device. Effective communication of what the organization needs and wants is best done in a free market culture like that prevailing in the U.S. by providing inducements. This is not to suggest that cash is the only inducement that will encourage people to help the organization succeed, but it is a tangible yardstick of accomplishment and it fits the type of employment arrangement typical in the U.S.

Type of Plan: When the objectives for the plan are established the next step is to determine what type of plan will best fit the context and that will have the best chance of meeting the objectives. In the previous section the various types of plans were discussed. The decisions about the type of plan will hinge on:

1) Whether performance will defined, measured and rewarded at the individual, group or organizational level,
2) The timeframe for measurement,

3) The role variable pay will play in the total compensation package,
4) The performance measures that will drive the plan, and
5) What the performance standards will be based on and the level at which they will be set.

Eligibility: One of the critical plan design issues is who to include. The objectives established for the plan and the type of plan provide considerable guidance as to who it makes sense to include. A commission plan to increase individual sales would be unlikely to include clerical personnel… a plan intended to provide a shared destiny throughout the organization may not leave out any employee.

The criteria that potentially can be used to determine eligibility for plans are varied. Deciding to include all employees sends that message that the plan objectives need the contributions of everyone. Basing eligibility on title/status (e.g., officer; vice president) was more prevalent in the past than today… organizations use titles for many purposes and these designations may not fit sensible criteria for plan eligibility. It is more common to base eligibility on job grade or pay level, since there tends to be a correlation between grade and the potential impact the job has on organizational results. Unfortunately there never seems to be a cutoff point that does not start "border disputes" and everyone who is one level below begins a lobbying campaign to have their job raised one grade… this has been the undoing of many job evaluation plans because those guarding the borders always seem to be overwhelmed by the aspirants.

One of the most common cutoff tests is whether or not someone has a *direct* and *significant* impact on organization/business unit results… but it is easy to see how these words can mean different things to different people. The same is true of using a criticality of skills test… many refrains of "if we are not critical let's see how you do without us" have been heard in response to this test. The discretion of management is sometimes used, and the quality of the selection will depend on the quality of the criteria used and of the people applying the test. Finally, the longevity of the individual may be used. If longevity is valued, however, it is usually better to establish a separate service award program, in order to avoid disconnecting rewards from performance.

One option to using a binary classification is to have tiers of participants, with the target award levels varying by grade/pay level. This avoids an "us-them" message and most employees will accept that those at higher levels are appropriately put more at risk and that they have a more direct impact on performance. But, create a border and you create a border dispute. So even the tiered approach does not avoid debates, but it does tend to lessen their intensity, since less is at stake.

Formula For Determining Award Funds: There should be a set of criteria that will be used to determine how much is available for variable pay awards. This determination is critical, since it will govern the relationship between performance and reward costs.

Below some level of performance, it will probably not be possible to afford and/or justify the payment of any additional awards on top of base pay. Many a shareholder rebellion has been caused by variable pay plans with very low performance thresholds… a California utility paid out millions in "incentives" the day before it sought bankruptcy protection, justifying this by saying it was part of the employee pay package. It seems to some that people were rewarded for destroying the organization, and this is bad public relations.

Discretionary determinations are not always inappropriate, since many organizations find it difficult to forecast with any certainty. If there is an unstable and unpredictable environment, it may be more appropriate to evaluate what results were at the end of the period and how good they were considering what happened. On the other hand, discretionary plans with no predetermined criteria provide little motivation or focus and can be viewed as "Santa Claus" plans by shareholders. One way to improve on discretionary plans is to identify the criteria that will be used to measure performance in advance and to keep score during the period, communicating interim evaluations. This can provide focus without the certainty of having standards tied to the performance criteria.

When setting performance standards one can "look back" (compare to historical results), "look around" (compare to peers) or "look ahead" (set future goals). Stable organizations in settled environments often use compounded improvement formulas to drive their standards. Rapidly changing organizations that are in volatile and highly competitive environments may compare to others, thinking that their relative standing in this comparator group reflects performance, and does so better than a forecast that was not much more than a guess. Organizations that have to meet certain thresholds in order to survive or to be viewed as successful will tend to use a future-oriented perspective when setting standards. Whichever perspectives is used there is the issue of a threshold, below which even base pay has not been earned and above which it is reasonable to reserve a portion of the bounty for those who made it happen.

An issue related to determining the award fund is the mix of base and variable. Variable pay can vary from nothing (an all base pay package) to everything (an all variable pay package), with most plans coming down somewhere in between. This decision impacts the budgeting for both base pay and variable pay, as well as determining the makeup of the cost structure. The current organizational context should drive the overall mix decision, while the nature of different units and different occupational groups/jobs should establish the mix at the unit and individual level.

Formula For Allocating Funds: The second part of the allocation issue is how to allocate the funds generated to groups and/or individuals in the form of awards. This decision is similar to managing a water distribution system: based on what is available in the reservoir (due to rainfall), how the water will be parceled out to businesses, farms and homes. Some plans, such as cash profit-sharing plans, use an egalitarian distribution and award everyone the same % of base pay or the same $. Others will allocate the total fund to units, based on their relative performance, and then let the units allocate their funds to individuals (or prescribe that the allocation be on an equal % or $ basis). Finally, an individual performance metric (e.g., performance appraisal rating) may be used to differentiate award size across individuals. One further variation of this approach is the "World Series Team Share" method, which gives everyone their share assuming they showed up and did what was asked, whether they batted .400 or .100. This type of binary differentiation avoids people whose performance was not at least at a "fully meets expectations" level from receiving an additional award attributable to the efforts of others.

It is helpful to formulate a model that addresses what variable pay awards are based on (organizational, unit and/or individual performance) and what the award potential is for all categories of employees. The most common practice is to base senior executive awards on organization-wide performance criteria, middle management on a combination of organization and unit performance and the remainder of eligible employees on a combination of organization, unit and individual performance. Exhibit 3 shows an example of an allocation model; it should be noted that employees who do not fall into the managerial/professional category have the largest portion based on individual performance, although there can still be a "World Series Team Share" binary approach, resulting in the same relative award for those performing satisfactorily.

The award targets are often tiered, with senior management having the highest variable pay award potential (expressed as a % of salary), reflecting their greater impact on performance and their ability to absorb more contingency in their direct compensation package. Exhibit 4 illustrates the typical relationship between levels, with threshold, target and maximum awards specified as a % of base pay. The actual percentages vary widely by type of industry, organizational maturity and culture, but the relationship across levels is fairly typical.

One way to base awards on multiple criteria is to create a matrix as shown in Exhibit 5. This approach can be used to accommodate two goals or it can be used to combine organizational and unit performance determinants. For example, the vertical axis (labeled Goal 1) could be organizational performance and the horizontal axis (labeled Goal 2) could be unit performance; the same approach could be used to measure both unit and individual performance. A final modification would be to use all three levels, making individual performance a modifier that further revises the award indicated in the two dimensional matrix, which would be based on both organizational and unit performance.

The alternatives for allocating awards to individuals are numerous and each approach sends a different message:

- equal percentage of base pay rate
- equal percentage of range midpoint
- equal percentage of base pay rate up to a maximum
- varied based on organizational level or grade level
- equal dollars to each participant
- equal dollars per hours worked in period
- varied based on individual performance

The objectives for the plan will help guide allocation. If the plan is intended to convey a shared destiny it will award the same amount or same percentage of pay to each participant. If the plan is intended to differentially award based on contribution the performance rating will be used to vary awards across individuals.

Form And Timing Of Awards: Two maxims apply here: "cash is not everything but it buys most things" and "sooner is better than later." The majority of variable pay plans deliver awards in the form of cash, although as mentioned earlier, stock or other real property may be used, and in some cases, non-financial recognition is more appropriate. Perquisites (special advantages, such as cars, club memberships and the like) may also be used when they have status value or tax efficiencies associated with them. Unfortunately, the actions of greedy executives have given perquisites a bad image, although it might be more palatable to see advantages given to people who perform at high levels, rather than those who happen to have high pay rates.

The timing of awards becomes an issue when a plan covers a wide variety of occupations or the gamut from executives to operatives. For a production worker covered by a formula-based gainsharing plan an entire year may not be an appropriate timeframe... more frequent measurement and reward (quarterly or monthly) may better fit the work cycle. The same may be true for direct sales personnel. On the other hand, for executives who may be responsible for planning, building and making operational a billion dollar facilitiy, it may be unnatural to try to measure and reward performance in a time period as short as one year. For this type of employee, a multi-year plan may make more sense and measuring performance may be more accurate.

A final dimension of the timing issue is the option of either allowing an award recipient to defer the amount to some time in the future or requiring them so to do. Some stock plans have a multi-year vesting period and some cash plans a multi-year measurement period. And some employees may value the option of voluntarily deferring awards to a time when they will no longer be working or at a time when triplets will all start college simultaneously. Finally, some organizations allow deferrals of annual incentives to a time when the participants will require cash to exercise stock options, which enables the short and long-term variable pay plans to be integrated.

Plan Administration

The best-designed plan will fail if it is not administered effectively. The objectives for the plan and the type of plan will impact how a plan should be administered, and the design will largely prescribe the administrative policies. However, much can go wrong. Failure to continuously evaluate a plans continued appropriateness and to make the necessary modifications required by changes in the context will render a plan ineffective.

The Plan Management Cycle: A variable pay plan is a part of a compensation strategy, which in itself is a part of a human resource strategy. As noted in the course on human resource strategy, these strategies must be consistent with the organizational strategy and its context. Therefore, a change in organizational context or strategy may signal to need to revise the human resource strategy, and perhaps the compensation strategy. Variable pay is but one element of compensation and it must be kept in alignment with the other elements and remain consistent with the role the compensation strategy assigns it. This means that any variable pay plan must be a part of organizational decision-making and strategic management and therefore those making these decisions must be part of variable pay plan design, communication, implementation, administration and evaluation. Ownership of variable pay plans by the Compensation function is not desirable, unless it is shared with executive management.

The compensation strategy should provide direction to those charged with designing variable pay plans. It should answer the key question: what role variable pay will play in the total compensation package and what criteria will be used for evaluating its appropriateness and effectiveness on an ongoing basis. The variable pay plan design decisions should be guided by the compensation strategy and the organizational culture should guide the communication and training necessary in order for a plan to succeed. The evaluation of plan effectiveness should be largely prescribed by the compensation strategy and the plan objectives.

Plan Implementation: An effective plan must "take" in the organization; that is, it must be accepted, viewed as adequate, appropriate, fair and competitive. The manner in which it is implemented will largely determine how well it will guide and motivate effort. The implementation plan starts with the initial design of the plan. If those who develop the plan (outsiders or insiders) do not have both the knowledge and credibility required the plan will not launch. Japanese organizations take a great deal of time to achieve consensus about issues like variable pay plan design – it is then a simple matter to gain acceptance, since all the right people were involved and had their say. U.S. organizations are criticized for moving quickly through design and then taking forever to force the plan into place, as they prevail over the detractors. This is clearly a stereotype, but the culture is one that tends to reward moving quickly and bravely and often seeking broad-based participation is viewed as weakness or indecision. The parties who must accept the plan include participants, but this does not mandate a democratic election, which could drag out indefinitely and be the camel that started out to be a horse, until a committee got involved.

Piloting a plan can give developers an opportunity to discover what they forgot. It is also a lower risk way to launch a plan. However, there is always a danger of trying the plan out in one niche and then making the assumption that it will operate similarly in other parts of the organization, however different they may be. One of the techniques used to test the measures being used is to do a "dry run" behind the scenes to see how well the criteria can be measured and the resources required to do it well.

Communicating a plan and training those who will either play roles in its administrations or be "consumers" (participants) is critical to implementing a plan. Too often designers assume everyone will figure it out, which they do…each their own way. And communication cannot be accomplished in 45-minute group meetings. One of the most effective ways to build understanding is to use scenarios that show how the plan will operate and how it will respond to changes. A simple four page fold-over booklet can do much to explain the plan – the pages should answer the critical questions:

1) Why is the organization doing this – what does it want to accomplish,
2) How does it work,
3) How much can people get and
4) What specifically will happen and when?

Policies and procedures can also help enhance understanding, as can plan documents written for those who did not complete law school. Training people who play roles is also critical; particularly managers who are expected to make decisions about how well individuals and units did and to what they are entitled. If there are deferrals or stock involved there will be a greater requirement for documenting the specifics and it should be remembered that even if the plan is not fully committed to writing it is a verbal contract relative to those things that were said or even those hinted at. Finally, there should be a "sunset provision" that says the plan is good for a specific period (e.g., one year) and that at the end it will be evaluated and modified, left as is or terminated. Too many plans went into old age strictly because of inertia, not because they worked.
The final step in plan implementation is to develop and communicate the "instrument panel" that will monitor the plan and evaluate its effectiveness. If this is not during at the start, the plan can be taking the organization in the wrong direction at high speed.

Plan Administration: Things happen… even things no one thought of. Variable pay plans are subject to challenge and litigation because they offer the promise of reward. Sales compensation suits are often found to be the most common type of civil suit and though these plans tend to be much more specifically formula-driven, other types of variable pay plans may create the same kind of legal liability. The best way to make administrative decisions is to do so based on policies that were developed before the plan went into effect. Snap decisions can often fill the gap when rules are unclear but

they then often become precedents that guide future action, even though they have not been thoroughly reviewed and adopted through consensus.
New hires and terminations during the year raise the question of eligibility for plan rewards and is probably the most common event requiring administrative action. There is no right answer to the questions that arise – only the best one for the organization at that time. For example, is someone hired six months into an annual plan eligible to get anything? Does someone who is fired on December 15 get left out of the annual plan that ends two weeks later? Death, disability and retirement decisions are usually clear, assuming the appropriate action is determined in advance, but what about leaves of absence? One critical issue for annual plans with quarterly or monthly interim payouts is whether everything earned that period is paid or if there should be some holdback for negative periods. Asking for refunds due to a bad February after large payouts for a great January will hardly win over the hearts of participants, so this issue should be decided in advance, based at least partly on discussions with participants. For example, most gainsharing plans with monthly payouts hold back 25% and the books are closed at the end of the year – with no refunds demanded if the holdback balance is not enough to cover a very bad year end.

A key design decision with a major impact on how fair participants think the administration is – when, if ever, are criteria and/or standards changed? There some that believe once the plan is set that no changes should occur. However, many incentive plans went dead part of the way through the year when unanticipated external events made making the plan automatic or impossible. Even though it seems reasonable to modify a plan to fit realities as they evolve it is very hard to make this a two-way street. If something happens to make goal achievement harder, there will be a long line outside the plan administrator's office full of heart-rending stories. However, if something makes the plan easier, the lack of a line may alert that administrator to an unbalanced situation. That notwithstanding, a process for modifying a plan based on unanticipated external events should be established at the time of plan inception.

A legal issue arises when non-exempt employees are included in variable pay plans, particularly incentive plans with established criteria. The US Fair Labor Standards Act (FLSA) prescribes that the base rate computation for the overtime pay rate is raised by incentive awards. This often necessitates the difficult re-computation of overtime earnings retrospectively. To avoid such an administrative disaster it is advisable to anticipate the requirement and perhaps tie incentive awards to taxable earnings or at least base pay plus overtime earnings. This should avoid the need for back computation, although it does present an additional expense for which you should anticipate and plan.

Evaluating Plan Effectiveness: As suggested earlier, if the evaluation criteria and processes are left until the end of the plan period it is much like saving the cost of ship radar and then trying to decide why it hit the rocks after it has sunk. The questions seem simple: Did the plan ask for the right results? Produce them? Did it ask for the right behaviors? Produce them? Did everyone understand the plan? Accept it? By developing a list of effectiveness criteria, measures and standards and by beginning to evaluate plan operation when it is launched a lot of salvaging wrecks can be avoided. Interim results vs. budget, trends in productivity and other analysis can diagnose difficulties and make it possible to do course corrections or to change standards before difficulties compound. Particularly in the first year of operation, it is critical to identify the refinements needed and to make them, before a payout is resentfully made. By continuously evaluating the plan, the organization can often limit changes to refinements and save a plan that otherwise would be cancelled at the end of its maiden year.

Prerequisites For Variable Pay Plan Success: If a plan in successful in facilitating the fulfillment of the organization's mission and meeting its objectives it will be viewed as a valuable tool for long-term viability and success. If it fits the culture and context, it is going to be consistent with the values and priorities of those who participate, making it acceptable to them. If the plan is consistent with the organizational structure and supports its strategy, it will become an integral part of the business plan. And if it is well integrated with the other elements of human resource strategy (staffing, development and performance management) it will assist in attracting and retaining the human capital the organization needs.

When Is A Plan Likely To Fail? If the culture is one of entitlement, the pay for performance philosophy underlying variable pay will conflict with what employees expect and can be the source of dissension. If the economic environment is such that performance is largely dictated by outside factors (e.g., governmental regulation) it may be difficult to convince employees that they control their financial destiny. If good measures are hard to identify or get agreement about and/or if the organization does not have the required measurement mechanisms in place it will be difficult to convince employees that their performance can be fairly and consistently measured.

Certainly if the organization does not have the resources to afford variable pay the prospect of large rewards should not be made. Affordability of a plan is a critical part of a feasibility study and multiple scenarios must be modeled in advance to ensure that the organization is happy to pay given alternative outcomes.

If communication is poor or trust is lacking there is little chance for variable pay plan success. And finally, if the people who are the participants in a plan are not viewed as critical assets, who must contribute in order for the organization to succeed, there is no reason to consider adopting a plan.

In summary, what works is what fits a specific organization, or part of an organization, at a specific point in time. A well-designed plan also requires good implementation and administration and it must be evaluated continuously to ensure it remains effective.

Trends and Current Issues In Variable Pay

There are pronounced trends relative to the use of variable pay, as well as a number of emerging issues. Trends do not dictate the direction an organization should take in their variable pay strategy or programs, but there is peril in not monitoring what others are doing and determining why they are doing what they are doing.

Trends: More organizations are using variable pay as a significant element in their total rewards package. This trend is particularly pronounced in the U.S., since usage of broad-based programs has been much less prevalent than in many other parts of the world. As mentioned earlier, variable pay plans have a number of strengths when an organization must compete for critical skills and when it must cope with a turbulent environment that makes revenues much more variable. Alongside this trend is the expansion of eligibility for variable pay programs. For decades, significant variable pay potential was reserved for executives and sales personnel… this is changing dramatically, to the point that organizations will ask why any employee group is not included, rather than skeptically asking why they should be. This will have a profound effect on the people cost structure and may provide some insulation from the dramatic downsizing many organizations are using to align costs with revenues. It will also better equip organizations to use contractors and project personnel to do much of the work traditionally done by permanent employees, a requirement for success in many industries today. It may also change the nature of the employment relationship substantially, to one in which the expectation of longevity becomes "however long the relationship is mutually beneficial."

Fewer variable pay plans celebrate aging and thus performance has become the dominant driver of rewards. Multiple plans are becoming more widespread, principally because measuring performance at multiple levels is more common. One of the best ways to ensure performance at the individual level results in performance at the group level and that the benefits also accrue at the organizational level is to design variable pay plans that emphasize the need to manage performance across all levels. Stock-based plans are increasing in frequency, notwithstanding the skepticism prompted by market performance from 2000 to today. The belief that being an owner can motivate one to behave like an owner is one reason for the increased popularity of broad-based stock plans. Another is the fact that the equity markets fund employee rewards through price appreciation and that the organization does not have to write a check, thereby impacting earnings. As employee ownership becomes more extensive the governance of organizations may well change as well, a possibility not lost on governmental regulators or investors.

Issues: Global strategies for variable pay are being formulated as organizations do business, or at least compete globally. The key issue is whether plans are universal or whether localized adaptation consistent with global principles becomes the preferred approach. The first shock to the compensation planner who has not dealt with issues relating to the design of plans that reach across cultures and borders is the number of new issues that present themselves and how complex they are. Laws, regulations and tax codes differ dramatically across borders, even within regions many consider to be homogeneous (e.g., Asia). Economic conditions also vary – across countries and within countries across time. Cost of living and inflation rates are two byproducts of economic variations and these can materially impact the ability to move key personnel around the globe and how the organization delivers the paycheck. There are logistical and communication challenges as well. European data privacy laws are far different than those in the U.S. and may prevent administrators from being able to obtain employee information necessary for plan operation. Language barriers can frustrate the most basic communications relative to plan design and administration. And cultural differences can cause meanings to change as information goes through the value-based filters of the sender and the receiver.

There are strong arguments for global consistency when designing plans and when making administrative decisions. It enables the organization to maintain internal equity, particularly for units like global teams that require close relationships and interdependent work. If the mobility of personnel across borders is important, consistency in the rewards package can ease the movement. One of the most important characteristics of having one plan for all is that it can provide alignment with the organization's objectives and can also communicate corporate values. The fact that consistency can promote cultural homogeneity could begin a debate about whether this was in fact a good thing, particularly as many organizations want to be diverse mosaics, full of different perspectives and different ways of approaching things. The "one plan for all" promotes alignment but may also rob the organization of any true dialogue – the "group think" trap.

Certainly one of the strongest arguments for consistency is the cost of administration. Having separate sets of variable pay plans for each country can overload administrative resources, and many may argue there may even need to be different plans for different regions/states within the same country. But having one plan should be more efficient of resources and certainly is a consideration when developing a global strategy. By using a strategy to drive decisions about plans, it may be found that similar countries can have the same plan and that the final result is a catalog of a manageable number of models that can serve a larger number of countries. The efficiency gained by combining plans runs the risk of ignoring or minimizing local differences, however, and having a plan found to be illegal or that it is subject to a local tax that was missed can be both embarrassing and expensive.

The arguments for local customization are significant. Cultural differences may mean that an effective plan in the home country would have disastrous effects in some locales. If an incentive plan that recognizes individuals causes them to resign in disgrace because they were separated from their group it could hardly be considered a success. Some of the same issues are faced with base pay plans and the eligibility for perquisites, of course. But variable pay plans are highly visible because the rewards show up at one time and because the plan provisions are widely communicated, so they are subject to widespread scrutiny.

It may also be that the same business varies substantially in its characteristics across regions. A widely respected brand in the U.S. may be unknown elsewhere, necessitating different marketing strategies in the other countries and this would inevitably impact the definition of performance and which criteria were used in the variable pay plan. Many other differences bring into question the feasibility of defining performance using the same criteria and setting the same standards. The conceptual framework of the plan may be the same, however, and the customization may be limited to the goals. The workforce may differ as well across borders and this may impact the decision about plan eligibility, particularly if there are strong local mores that dictate only senior managers receive variable pay… or that whatever one person gets everyone should get. And the plan may even undermine local management, which may operate in a formal hierarchical structure and use discretion to parcel out rewards. Finally, data privacy laws or conventions mentioned earlier may impede administration, even in two contiguous countries.

National/ethnic cultures are an important consideration relative to variable pay strategies, but so are organizational cultures. Some organizations treat business units as if they were completely separate, while others ensure that there is considerable consistency. Some are paternalistic or egalitarian while others are hard-edged and competitive. Some believe it takes all employees to achieve goals, while others think it would be preferable if a large percentage of employees would just do what they were told – the "people as costs rather than people as assets" mindset. There is great value in defining and assessing the organization's culture before attempting to design good fit variable pay programs. Honesty about the culture is a prerequisite for success, but a search for the universally good culture should be eschewed. For years Pepsi and Coke have had very different cultures but yet have been successful in the same industry and have done so by aligning their human resource strategies and programs to fit their respective cultures. The culture will have a major impact on eligibility for variable pay plan participation, as well as the rules for allocating award funds.

The workforce culture is defined not only by national/ethnic origin. Generational differences should be considered when designing variable pay plans, since the reactions of a group early in their careers seeking adventure may differ dramatically from those of a group with relatively long service. The stereotyping of a cohort (e.g., Boomers, GenXers) should be avoided, since perspectives will vary widely within any group. But the value differences and views of work should not be ignored either. Occupational differences should also be examined when deciding on the type of variable pay plans which will cover the workforce. Engineers, Accountants, Sales personnel and Skilled Trades personnel will all have systemic variations in what they view as being an appropriate pay package and the pay relationships that should exist.

The final issue to be discussed is the use of stock-based variable pay plans. These plans are rapidly becoming more prevalent and they tend to cover a broader spectrum of employees today when they are adopted. An insightful quote is "people don't wash rental cars." If employees view themselves as hired hands, only there for this years harvest and who knows where next year, they are apt to vary in commitment and motivation from those who view an organization as their career-long home… or even the company whose destiny significantly impacts their financial destiny. However, with the adoption of broad-based stock plans goes an added responsibility… preparing employees for stock ownership. The tax and legal implications are significant, but the increasing price volatility in equity markets is even more impactful. Those who are at or near the subsistence level tend to have little discretionary income and they can afford little risk. Mortgage lending officers still have very narrow views as to what constitutes "income," even relative to cash plans with a consistent history of payouts. Stock plans raise another issue about what the employee will be able to portray as a part of income or even personal worth. It is therefore critical for the organization considering the use of stock plans to do the economic education necessary to prepare participants and to ensure they have adequate resources to make ownership and positive experience rather than a personal disaster.

Exhibit1

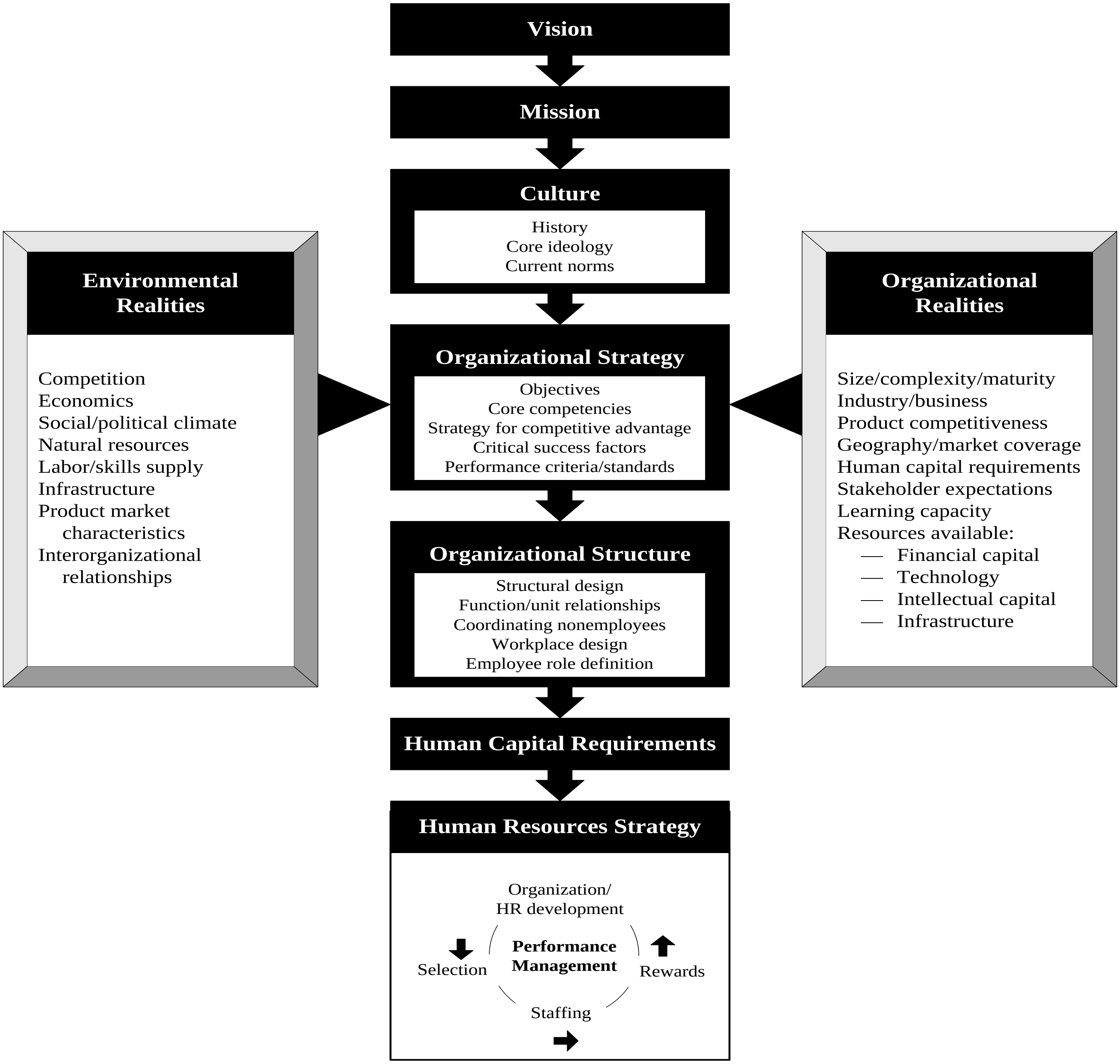
Vision
Mission
Culture
History
Core ideology
Current norms
Environmental Realities
Competition
Economics
Social/political climate
Natural resources
Labor/skills supply
Infrastructure
Product market characteristics
Interorganizational relationships
Organizational Strategy
Objectives
Core competencies
Strategy for competitive advantage
Critical success factors
Performance criteria/standards
Organizational Realities
Size/complexity/maturity
Industry/business
Product competitiveness
Geography/market coverage
Human capital requirements
Stakeholder expectations
Learning capacity
Resources available:
— Financial capital
— Technology
— Intellectual capital
— Infrastructure
Organizational Structure
Structural design
Function/unit relationships
Coordinating nonemployees
Workplace design
Employee role definition
Human Capital Requirements
Human Resources Strategy
Organization/
HR development
Selection
Performance Management
Rewards
Staffing

Exhibit 2

Basis For Determining Variable Pay Awards

Performance-→	*Organizational*	*Group*	*Individual*
Top Management	**100 %**	**0 %**	**0 %**
Middle Management	**50 %**	**50 %**	**0 %**
Professional/ Supervisory	**25 %**	**50 %**	**25 %**
Other Employees	**25 %**	**25 %**	**50 %**

Exhibit 3

Variable Pay Award Targets (% of Base)

	Threshold	*Target*	*Maximum*
Top Management	**25 %**	**50 %**	**100 %**
Middle Management	**15 %**	**30 %**	**60 %**
Professional/ Supervisory	**10 %**	**20 %**	**30 %**
Other Employees	**5 %**	**10 %**	**15 %**

Exhibit 5

Variable Pay Awards: Two Objectives Of Equal Weight
Goal # 2 (e.g., Market Share)

Goal # 1 (e.g., Profit)	*Threshold*	*Target*	*Maximum*
Maximum	**100 %**	**150 %**	**200 %**
Target	**50 %**	**100 %**	**150 %**
Threshold	**25 %**	**50 %**	**100%**