

All Together Now

Group reward strategies

Paul Suff

Peter Reilly

Annette Cox

Published by:

INSTITUTE FOR EMPLOYMENT STUDIES
Mantell Building
University of Sussex Campus
Brighton BN1 9RF
UK

Tel. + 44 (0) 1273 686751

Fax + 44 (0) 1273 690430

www.employment-studies.co.uk

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Overview

Group rewards span everything from team incentives to employee share ownership. Short-term cash-based bonuses and longer-term incentive schemes are relatively common among private sector organisations in the UK. The latest CIPD annual reward survey reveals that 51 per cent of the 603 organisations polled operate a bonus/incentive scheme driven by business results; 27 per cent have a team-based plan; 19 per cent use project-based incentives and 3 per cent operate a gainsharing arrangement (CIPD, 2008). The results also show that a third of employers have a company share option plan; 31 per cent operate a share incentive plan; and 28 per cent offer a Save As You Earn (SAYE) share plan. Group rewards are appealing to employers because such arrangements are linked to improvements in performance, and/or promote a common interest between staff and management.

The rationale for such rewards is the belief that people are motivated to work harder or in a different way in return for financial gain and/or a stake in the business. Financial incentives, for example, work by linking the reward to the achievement of a specific goal, such as improved productivity, so employees' discretionary effort is channelled in that direction. Employees' support for such arrangements will last as long as a positive relationship exists between the expected outcome (the reward) and the performance (effort expended). Employee ownership operates on a slightly different premise: that employees owning equity will be more motivated and committed to the organisation, and this will translate into improved individual and organisational performance. Some businesses take an idealistic view of employee share ownership, seeing it as a way of boosting equality. This is exemplified by the John Lewis Partnership, where all of the firm's equity is held in trust for the benefit of the workforce, and the 'partnership' exists to 'bestow the benefits of ownership on all employees and to ensure the sharing of knowledge, gain and power' (Suff 1998). Others take a more pragmatic view, seeing such measures as a way of strengthening the link between company performance and individual reward.

The evidence only partly supports the theory that group financial incentives, including equity, boost business performance, however. On the one hand, Magnan and St-Onge (2005) report that firms adopting a profit-sharing plan enhanced their

profitability compared with both their own prior performance and with companies that did not introduce profit sharing, while Suff (2008) reports on a Sheffield-based firm where 78 per cent of the 220-strong workforce hold shares and turnover has risen from £2.5 million in 1994 to £21 million in 2006. On the other, Brown and Sessions (2003) found that, though employees participating in productivity-linked bonus schemes, discretionary bonus schemes, share ownership or profit sharing are more optimistic about future employment and pay, and are generally satisfied with their work environment, employees participating in such arrangements are unlikely to work as hard as they can. 'This is an intriguing finding, insinuating as it does that group-sharing schemes are unable to rout the temptation to free ride,' conclude the authors. Sengupta et al (2007) discovered that the presence of employee share ownership did not necessarily produce greater commitment and concluded that managers should not perceive the introduction of a shares scheme as a 'magical cure for poor performance'. And, even though incentives may produce short-term benefits, they may stimulate outcomes that are unsustainable in the long term. Hector Sants, chief executive of the Financial Services Authority, recently said the bonus culture in the London financial markets encouraged too much risk taking: 'There is a risk that the remuneration systems are too short-term and that they incentivise behaviour which is not helpful in terms of maintaining long-term financial stability.'

Whether or not group incentives can produce sustainable improvements in business performance, such arrangements have a number of drawbacks and risk provoking discontent. There is a lack of a real direct link between individual performance and barometers of corporate performance, such as profitability. Such measures are remote from the day-to-day activities of most employees and they do not distinguish between high and low performers. Suff (2001) reports that Oracle Corporation UK declared that its profit-related bonus was 'not a true performance bonus'. Companies and employees also have no real control over rewards linked to profitability or share schemes, and there is a lack of a clear link between employees' effort and corporate performance. External events can cut the level of profit-based payment or reduce the value of an employee's shareholding even though the firm has performed well on other measures of performance. The opposite is also true, with external events contriving to push up profits and the value of shares even though the company has performed less well than in other years. The nature of the financial markets mean that payments from incentives linked to corporate performance can differ wildly from year-to-year, producing a 'feast and famine' effect and an imbalance in employee perceptions. In 2007, employees at the John Lewis Partnership shared a record £155 million bonus pot, equivalent to 18 per cent of salaries, on the back of strong sales and profits. Yet, in 1993 it paid out only 8 per cent. The lack of a clear 'line of sight' between employees' effort and corporate performance is problematic. IRS (2003) quotes a respondent at healthcare manufacturer Wrafton Laboratories, who said that 'unless there is clarity about how an individual can make a difference to business performance and profit, the cost does not have a matching proportional benefit.'

And, because awards from corporate-wide incentive schemes, like profit-sharing plans, are generally allocated as a percentage of salary, they tend to favour higher earners, so raise questions about internal equity and fairness, and run the risk of creating tensions in the workplace. Similarly, rewards that are shared equally, regardless of individual contribution, may provoke animosity on the part of those who believe they have worked hard towards colleagues whose efforts have been less obvious. The 'free rider' conundrum has been well documented: sometimes the functioning of a group is less effective than the aggregate of individual efforts, as some members will work less hard when their efforts are masked by those of others than when they are individually accountable (West, 1996). Even incentives for smaller groups may produce problems: it is harder to deal with variable performance within teams, and if left to the group themselves to resolve could easily result in bullying (Reilly, 2007).

There is also the danger that successful schemes – that is, those that pay out regularly – can become demotivating. Kuvaas (2003) notes that 'frequent tangible financial rewards' may switch the recipients' attention away from desirable elements of work, like 'joy, innovation and quality' and towards the reward itself, thus undermining their intrinsic motivation.

Group rewards

Summary

According to Brown (2001), organisations use different reward schemes to reinforce contribution to their strategic business goals at various points in the 'internal value chain'. The schemes can span everything from individually-focused incentives and team-based rewards, which focus effort on clearly defined goals, to company-wide profit-sharing and share schemes that reward the combined contribution and cooperation of everyone across the business. Financial and non-financial rewards can play a significant role in reinforcing teamworking and co-operative behaviour, and in clarifying group objectives and goals (Suff and Reilly 2006). Reward strategies, such as profit sharing and share schemes, can encourage employees to identify more with the business, so they identify with its values and are more willing to make a stronger contribution (Sengupta et al, 2007).

There are problems, however. The most prominent is the 'free-rider' phenomenon (Heneman and Von Hippel, 1995), which sees some individuals receiving an equal portion of the bonus/share pot even though their performance is generally acknowledged to be less than that of the other members of the group. Research indicates that individuals tend to be dissatisfied when they perceive that group rewards have not been distributed to reflect individual contribution, and where they believe work has not been shared out equally among the team. Incentives linked to measures that are remote from the day-to-day activities of employees are also a problem, as reward commentators generally believe that there should be a direct, and clear line of sight between what a group does and what it gets in return.

Understanding group rewards

Bonuses, profit sharing, team rewards and share incentive plans all come under the variable pay banner (Suff and Reilly, 2004). While the rewards from variable pay schemes can be substantial, employees are forced to shoulder more of the business risks – rewarding the 'upside' and penalising the 'downside' of performance. The

relatively large potential rewards make variable pay schemes appealing to many employees, while the theoretical link to performance and their ability to promote a common interest between staff and management make such arrangements increasingly attractive to employers. Group rewards tend to fall into one of two broad categories:

- *performance-based schemes* – such as team-based incentives, where employees are encouraged to meet specific standards or objectives or output targets
- *financial participation schemes* – such as profit sharing and equity-based arrangements, where employees are entitled to a share of the organisation's performance or profits.

The rationale for such rewards is the belief that people are motivated to work harder, or in a different way, in return for financial gain. Incentives play a significant role in helping organisations achieve their goals because they can focus employee attention on what matters and can help to change behaviour. Bonuses and the like channel attention to what needs to be done to receive an additional payment. Such arrangements usually have a short-term focus and tend to be based on specific 'line-of-sight' financial and operational measures, with frequent payouts ranging from one month to one year. IDS (2003) reports that the gainsharing scheme operating at BP Grangemouth, for example, is designed to encourage key measures within the employees' performance contract and to reward them for achievement of those objectives.

A survey of 365 organisations by the Work Foundation (2003) found the following five common reasons and aims for introducing a bonus/incentive plan:

Why did your organisation introduce its bonus scheme(s)?

Objective	Percentage
Improve business performance	67
Create a direct link between employee and corporate performance	60
To recognise and reward achievement	58
To help motivate staff	56
To focus employees on specific objectives	50

Longer-term incentives – such as profit sharing and the allocation of shares – tend to be linked to broader organisational aims, such as improving the firm's bottom line and/or enhancing employee commitment and loyalty. The efficacy of share schemes, at least in theory, is their ability to overcome the perceived conflict between the interests of the owners of the company (the 'principals') and the workers (the 'agents'). Principal/agent theory suggests that as agents build a stake in the business, through the award of shares, their interests become more aligned with those of the firm or principal. Pendleton (2006) notes that the alignment of employee interests with those their organisation is seen to encourage long-term profit-maximising behaviour, such as greater employee effort, workplace innovation and the reduction of wastage.

Performance-based schemes

The most recent CIPD annual reward survey found that 70 per cent of the 603 organisations participating operate a cash-based bonus or incentive plan (CIPD, 2008). Such arrangements are very popular in the private sector, with 86 per cent of manufacturers and 89 per cent of private service sector companies reporting their use. Bonus schemes are widely used in some industries and make up a substantial part of employees' remuneration packages. IRS (2000) found that team-based remuneration is a reasonably common in the call centre industry, for instance. It reported that almost one-third of the 79 call centres it monitored had a team reward mechanism in place. A Danish study of call centres found that, on average, group incentives are worth 23 per cent of gross salaries (Sørensen and El-Salanti, 2004).

Although the latest CIPD survey shows that 60 per cent of cash-based bonuses or incentive plans are linked to individual performance, around half (51 per cent) of respondents say schemes are driven by business results, notably profit. Half of those polled report that their schemes are a mix of individual- and corporate-based measures of performance. Around a quarter (27 per cent) have team-based schemes, 19 per cent operate ad-hoc/project bonus arrangements, and 3 per cent use gainsharing. The proportion of organisations using bonus and incentive plans is broadly similar to both 2006 and 2007, suggesting that such arrangements continue to be a core feature of reward in many organisations (CIPD 2006, 2007a). The results also show that employers regularly monitor the effectiveness of bonuses/incentives, reviewing them, on average, every 1.7 years in private industry.

IDS (2007) says a successful bonus scheme can:

- improve business performance – for example, sales, productivity or profits
- focus employees' efforts on important areas, such as safety, quality and customer service
- motivate staff by establishing a clear link between pay and performance
- allow employees to share success
- assist recruitment and retention
- promote desired behaviour, such as cooperation and good attendance.

Practicalities

There are three main types of performance-based bonus/incentive schemes (Suff and Reilly, 2004):

- *Gainsharing* – a multi-factor system based on a specific formula that allows employees to share in any financial gains and efficiency savings made as a result of

improved performance. The formula determines how the gains are to be distributed between the company and its workforce.

- *Multi-factor schemes* – a system based on two or more factors of performance. Multi-factor schemes can operate at a local level, covering specific jobs, teams or departments with targets over which employees can exert some influence; or they can be company-wide or multi-level arrangements linked to wider business goals. Some firms use the same multi-factor schemes for different employee groups, but tailor the targets to suit specific jobs, functions or units. Multi-factor schemes can also be applied to individual performance (single level), so that the bonus award for each employee is based on their performance against a basket of factors.
- *Team-based schemes* – a system based on the achievement of team targets, and used primarily to reinforce a culture of teamworking and cooperation. Collective targets ensure the link between employees' performance and the bonus is clearly visible. Some employers favour team-based rewards because they believe peer pressure will ensure maximum effort from every group member.

Team or company-wide bonus schemes, such as multi-factor arrangements and gainsharing systems, generally combine both output and input factors and rely on a set formula to calculate awards. IDS (2007) reports that multi-factor schemes are increasingly common as they overcome one of the main problems with incentives linking to just a single factor: the excessive focus on, for example, output, to the detriment of other important factors, such as quality and safety. Some firms retain single factor schemes, however, particularly where an issue requires concentrated short-term attention. More firms are also operating the same bonus arrangements at a number of levels in the organisation (called multi-level), allowing them to implement targets for specific roles, teams or departments within the same system. Personal performance, based on a performance appraisal, is sometimes also used alongside the group bonus. At T-Mobile (UK), for example, individual performance accounts for two-thirds of the bonus pool, with the remainder dependent on company performance (IDS 2007).

The factors or performance measures used to determine bonus/incentive payments largely depend on what is important to the business and the employees covered by the scheme. Productivity measures, such as output, are common in manufacturing, while customer service measures are popular in the service sector and public sector.

Schemes based on a number of factors may or may not give each one equal weighting. IDS (2005) reports that whereas automobile manufacturer IBC Vehicles gives each of the four factors in its scheme – attendance, quality, safety and schedule – equal weighting, the three factors covered by the bonus arrangement at ICI Paints – profit, function measures (such as quality) and local/team measures (such as output) – are weighted differently, with local measures accounting for half the potential maximum bonus, 30 per cent for profit and 20 per cent for function measures.

Examples

B&Q: store-team bonus

The store-team bonus was introduced in February 2003, replacing a profit-sharing scheme. Under the new scheme, employees receive a fixed payment of 3 per cent of salary every six months if company profit targets are met (Work Foundation 2003). There is also the potential to earn a further 6.75 per cent linked to store and company performance, plus a lump sum £250 if customer satisfaction levels improve. Each quarter Gallup interviews 3,000 randomly selected customers and a customer service index (CSI) is compiled for each store. A store league, consisting of five divisions, ranks each one, with the top 20 per cent of outlets in the premier league. Rankings are re-calculated each month according to sales and stock-loss performance. If company profitability is 105 per cent of target, staff in the top performing stores (premier league) will receive the full 6.75 per cent in addition to the guaranteed 6 per cent annual profit-sharing payment, while staff in a division four outlet will get 2.25 per cent plus the yearly profit-related payment. The maximum variable bonus, including the CSI payment, is around 15 per cent. Under the old profit-sharing scheme, it was 12 per cent.

IBC Vehicles - manufacturing bonus scheme

A multi-factor bonus scheme covers all of the firm's 1,800 employees, with the exception of the executive team. The level of bonus is determined against four factors - attendance, quality, safety and schedule. To trigger a payment, certain company-wide targets must be met: at least 97.5 per cent attendance across the company; less than a 5 per cent error rate; zero work days lost to accidents; production of a certain number of vehicles per week/month/year. The annual bonus is paid every December and all employees receive the same amount, which, in 2006, was £850 - the maximum possible under the scheme (IDS, 2007).

Pret A Manger: team members' scheme

The sandwich retailer operates three schemes: for head-office staff, team members and shop managers. The team members' scheme covers nearly 3,000 retail staff and is a multi-factor arrangement designed to reward staff for high quality customer service and good attendance. The bonus is mainly determined by the results of a weekly store mystery shopper survey, measured on the following factors: shop appearance (20 per cent weighting), product range available (20 per cent) and customer service (60 per cent). Stores achieving a minimum 90 per cent score in the mystery shopper survey will pay out a bonus, though team members must have 100 per cent attendance to qualify. Eligible employees receive an additional £1 for every hour worked. IDS (2007) reports that in 2005 the bonus was paid 80 per cent of the time, and 76 per cent of the time in 2006.

Success factors

The CIPD (2007b) says that for team rewards to work well:

- all eligible employees must understand and accept the targets
- the reward must be clearly linked to the effort exerted and achievement

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- the reward must be worth striving for
 - performance measures must be fair, consistent and acceptable
 - all eligible employees must be able to track performance in relation to targets and standards
 - the team must be able to influence its performance by changing behaviour or decisions
 - the incentive formula must be easily understood
 - reward must closely follow accomplishment
 - the scheme must be appropriate
 - the scheme needs to be carefully designed, implemented, maintained and adapted to meet changing circumstances.

Clear line-of-sight

IDS (2007) warns that bonus/incentive schemes should not become so complex that the clear line-of-sight is lost between employee performance and reward. Reilly et al (2005) say targets need to be clear and simple, easy to communicate and evaluate, relate to work that employees do, and which they perceive to be both achievable and within their control. As well as not being overly complicated IDS (2007) recommends that targets are 'realistically attainable': set too high and they will quickly demotivate; set too low and they cease to be an effective incentive. Reilly et al point out that organisations need to be clear about what the reward is trying to achieve, and that there should be no hidden agenda. 'Seeking "B" while asking for "A" causes staff to lose trust in the integrity of management,' they warn.

Lawler (1990) said that it is crucial for a clear line-of-sight to exist between what individuals and teams do and what they will get for doing it. His model is as follows: effort → performance → results → measures → payout. Although most performance-based schemes focus on improvements that are substantially within the control of employees involved, such as product quality and customer service, some combine them with broader organisational objectives, such as profitability, over which staff can exercise very little direct influence. Magnan and St-Onge (2005) warn that the impact of a profit-sharing plan is highly dependent upon how employees perceive the line of sight between their work and profits. Such arrangements reduce the clear line of sight between effort and outcome, though some organisations attempt to retain it by including a business unit profit target or sales growth. Some group incentives blur the distinction between short-term output-based performance targets and longer-term measures of corporate performance. IDS (2007) illustrates such an approach with a scheme at Sony UK's Customer Information Centre. This 'multi-level' scheme is based on team performance – assessed through call abandonment rate and customer

satisfaction survey results – and overall company sales. Indeed, Magnan and St-Onge (2005) acknowledge that line-of-sight issues can be minimised if operational measures are under the control of employees.

Targets also need to be easily measurable (Reilly, 2007). There is a tendency in the public sector to derive targets from either national plans or performance indicators, which, notes Reilly, can produce targets that are not easily measurable. He warns that too often process inputs receive more attention than the outputs in the public sector because the former tend to be easier to specify. In the private sector the opposite is true and it is often easier to specify output targets. Reilly says companies face a different problem when identifying targets, namely trust in the numbers, such as profits, as these in the view of staff can be manipulated. Teams need to have confidence in the figures. Scheme design and data assessment need to take these concerns into account.

Communication

Reilly et al (2005) acknowledge that communication is important in the design, implementation and maintenance of a reward system. This includes conveying both the purpose and importance of the pay system at the outset, being clear about group structures and targets, and informing participants about both progress and the outcome. Similarly, IDS (2007) notes that for a bonus scheme to work effectively, it is important that employees and line managers understand its objectives and the relationship between their own personal performance and the payments they receive, making staff presentations, briefings and guidance vital.

Groups will need to know where they stand in relation to meeting their targets, so performance data needs to be up-to-date, which will require good management information systems. 'This information is important in maintaining the motivational impact of the scheme,' says IDS (2007). IDS offers two examples to illustrate how such information can be regularly relayed: from Sellafeld-based British Nuclear Fuels which operates a red, amber, green traffic-light system to indicate the level of performance against target; and from the BMW Engine Manufacturing site at Ham Hall which publishes performance data monthly on the firm's intranet, to.

Research shows that where communication is effective, performance-based rewards tend to be more successful, and is more important than any other variable (Brown and Armstrong 1999). As the WorldatWork research suggests, knowledge of pay leads to pay satisfaction.

Teams/groups

Today's workplace is teeming with teams (Robbins and Finley, 1997). There are work teams; project teams; customer support teams; design teams; planning teams; problem-solving teams and quality teams; and functional teams, cross-functional and

multidisciplinary teams. For group rewards to be successful, teams/groups need to be clearly defined, and performance measures and appraisal methods must be fair and perceived to be fair by individual employees. Reilly (2007) says bonuses/incentives should only be applied to natural teams, where boundaries and membership are clear.

One of the causes of the relative failure of some sites in the NHS team-based pay experiment was team composition (Reilly et al, 2005). In some sites, managerial, administrative and support staff were excluded from the 'team', which consisted only of front-line staff. At other sites, the 'teams' ignored natural groupings or the boundaries between teams were blurred, which led to tensions between employees. Nonetheless, the authors say that heterogeneous teams, in terms of grade or occupational group, were just as successful as homogeneous teams. This suggests that there is no simple right/wrong model, rather designers need to be sensitive to local circumstances – sensitivities, work interactions, sense of equity, etc.

Size is also important. Most commentators say teams should not be too large for team-based pay to be effective. The bigger the team/group, the less likely it is that individuals will believe their efforts can affect team performance or the overall results measured. 'The team discipline demands that a small number of people collaborate to achieve common purposes and goals. Rarely have we observed more than 10–12 people team up effectively without subdividing in favour of smaller numbers,' write Katzenbach and Smith (2001). Neathey and Suff (1997) agree, recommending the 'right' size for a self-managed team as anything between 5 and 15 people; a smaller number would in most cases be impractical, while many more could undermine group cohesion by creating subgroups, or teams within a team. They found that the average size of a team was 10 members. However, Reilly et al (2005) noted in their pilot of team-based pay in the NHS that bigger teams could work. They can be split into subgroups, with formal/informal division of targets as well. Once teams get above a certain size, pay acts less as an incentive and more as a form of recognition.

Key problems/issues

One of the key problems with group incentives is the 'free-rider' phenomenon (Heneman and Von Hippel, 1995). Individuals tend to be dissatisfied when they perceive that group rewards have not been distributed to reflect individual contribution, and where they believe work has not been shared out equally among the team. High performers are more likely to be dissatisfied with team rewards than average performers (Brown and Armstrong, 1999). IDS (2007) notes that bonus schemes that cover an entire site or company are more susceptible to the free-rider problem. Long (2000) suggests that companies can overcome the free-rider problem by ensuring bonus payouts are made according to a fair measure of individual employee performance. Robinson and Wilson (2006) advocate closer monitoring and supervision of employees to alleviate some of the free-rider problems, though if employees associate incentives with more managerial control their effectiveness is likely to be limited.

IDS (2007) notes that team or departmental bonuses can generate inter-team rivalries. This can result in the best individual performers in the poorer performing groups wanting to migrate the teams receiving the highest payments. Profit-sharing plans, are generally allocated as a percentage of salary, so they tend to favour higher earners, which raises questions about internal equity and fairness, and runs the risk of creating tensions in the workplace. 'Profit sharing is unlikely to be taken seriously if the amount of the pie to be shared is insignificant,' note Morris et al (2006). Robinson and Wilson (2006) found that profit sharing is generally ineffective in raising productivity where it operates in a low-skilled and uncertain business environment.

The more remote the target, the less control employees will have over the outcome. Expectancy theory suggests that employees become demotivated if factors outside of their control adversely influence the size of the bonus payment. Measures such as profitability are remote from the day-to-day activities of most employees and external factors can affect profit levels irrespective of how well or badly employees perform. Brown and Armstrong (1999) report how a bonus scheme operated by Nuclear Electric suffered from a number of external events, including a rail strike and a major crane breakdown, over which staff had no control.

Research suggests that bonus schemes tend to have a limited shelf life, with performance peaking after the initial 2–3 years of operation, after which performance tails off (Bullock and Lawler 1984). 'We believe team-based pay will only operate successfully for a limited period,' conclude Reilly et al (2005) when reporting on the NHS pilot. For example, gainsharing schemes, which are often based on employees identifying improvements to boost performance, will provide employees with a new challenge initially in order to secure a bonus payment, but this effect tends to diminish over time. Ideas for improvements will be reasonably easy to identify when the scheme is in its infancy, so payouts will be fairly high. Over time, ideas will be harder to identify, so payments will begin to fall and employee expectations, which will be based on the early payouts, will not be met. Moreover, employees may worry that management will continually raise the performance bar. This has led in certain circumstances to employees trying to operate 'rate-busting', where higher performing individuals are pressured by the rest of the team to 'slow down'.

Financial participation schemes

In the latest CIPD reward survey just under half (47 per cent) of the participating private sector companies operate a share scheme or other long-term incentives for employees. Specifically, a third operates a company share option plan (CSOP), while 31 per cent offer a share incentive plan (SIP). SIPs are more popular among manufacturers (39 per cent) than service sector firms (26 per cent), whereas CSOPs are slightly more popular among service sector companies (33 per cent) than manufacturers (30 per cent). The figures also reveal that incentive plans, such as SIPs, are now more common than traditional share scheme arrangements, such as Save As You Earn plans, which enable employees to save in special accounts and purchase

equity. This point is amplified by IDS (2007). It reported in 2007 that the number of SIPs approved by HM Revenue & Customs (HMRC) had risen by almost half in the previous two years, and were increasing at a much higher rate than SAYE schemes. Official figures from HMRC for 2005 reveal that 46 per cent of FTSE 100 companies have a SIP, as do 24 per cent of FTSE 250 firms. Overall, 653 companies operated a SIP in 2005. As a SIP can allocate free shares, take-up rates are usually very high – usually above 90 per cent, according to IDS (2007).

Share incentive plans (SIPs)

Share incentive plans are all-employee schemes designed to encourage share ownership among the workforce. There are four types of award: free shares; partnership shares bought by the employer; matching shares awarded by the employer; and dividend shares. Employers can mix and match these to tailor the reward and can link the allocation of free shares to performance criteria (individual, team and company-wide). SIPs are tax efficient for both the employee and employer, with no income tax or national insurance payable on shares held in plan for at least five years. And, unlike Save As You Earn plans, any contributions to a SIP are from pre-tax salary, and employees have greater scope to vary the amount of money they invest on a monthly basis.

Company share option plans

Staff have the option to purchase, at some date in the future, a set number of shares in the business (there is a ceiling on the number of shares an individual can hold at any one time). Schemes can apply performance conditions to the option before it can be exercised. Employees participating in a CSOP pay no income tax on their share option when it is granted or when they exercise their right to buy shares.

Employers believe all employee share schemes, such as SIPs, help link the interests of workers and those of the firm; improve motivation; help build a new corporate culture; enhance performance; and aid recruitment and retention (Suff, 2001). There are three perspectives of the psychological effects of employee share ownership (Bakan et al, 2004). The 'intrinsic' model suggests that employee ownership alone increases commitment to, and satisfaction with, the company. The second perspective – the 'instrumental' model – argues that employee ownership increases employees' influence in the decision-making process and, hence, their level of control which, in turn, boosts commitment, satisfaction and performance. The third model, the 'intrinsic' approach, proposes that commitment and satisfaction will improve if the financial rewards of employee ownership are sufficient.

IDS (2007) says the practical benefits of SIPs include boosting employee engagement by giving participants a stake in the business and an opportunity to share in its success; rewarding staff who purchase equity from their own money by granting additional 'matching' shares; and enabling low earners to build a stake in the business by offering free shares. Unpublished, internal research by RBS has found a connection between employee engagement and share ownership. The more engaged employees are those that are more likely participate in such schemes.

Examples

AstraZeneca

The pharmaceutical company made its first award of free shares in April 2002 and partnership shares were introduced in 2002/03, with the first purchases in July 2003. Employees become eligible for free shares as soon as they start working for the company. These are awarded each April as a percentage of each employee's salary. Originally the level of award was linked to the firm's overall performance, particularly earnings per share, but in 2004 AstraZeneca revised this to create a closer link with individual performance. Now the award is based entirely on individual performance, up to a maximum of 20 per cent of salary. IDS (2007) reports a 99 per cent take-up rate. Partnership shares are mainly acquired through the firm's flexible benefits scheme.

BT

The telecom company's Employee Share Investment Plan provides staff with the opportunity to acquire a stake in the firm (BT 2007). Under the scheme, BT can provide free shares to employees, and staff can also purchase equity out of their pre-tax salaries. The company says that in the 2007 financial year, it allocated £25 million of profits to provide free shares to UK staff. Its non-UK workforce also receive shares or, where shares are not practical, a cash equivalent. The amount provided for the free share allocation is based corporate performance measures determined by the board of directors. BT says 93 per cent of UK staff participate.

Scottish & Newcastle

The brewer introduced a SIP in 2002 has operated a plan every year since. It is open to all UK-based employees who are UK taxpayers. Free shares are offered to staff completing at least six months' continuous service. Eligible staff can apply for the next allocation either on paper or online. The award of free shares normally coincides with the firm's year-end results. To date, the value of the free shares has been linked to a percentage of each employee's 'eligible earnings' - that is, their taxable earnings for the previous year. The percentage varies each year. IDS (2007) reports that in 2006 the company awarded free shares worth £700 or 5 per cent of earnings, whichever was lower. From 2007, the firm has linked the award to company profits.

Key problems/issues

There are a number of potential drawbacks to share-based incentives, however. Many of these replicate the problems with performance-based group incentives (above), such as the remoteness of the share allocation from employees' day-to-day activities and the problems of free-riders. Suff (2001) reports that share schemes are generally poor motivators because of the lack of direct link between individual performance and share allocation, while Brown and Sessions (2003) found that group-share schemes fail to overcome the free-rider problem associated with most group-based incentives. The CIPD (2007c) reports that the evidence that all employee share schemes improves organisational performance is patchy.

It lists the main problems as:

- if the share price falls, this may lower morale and cause recruitment and turnover problems
- there is a high administration overhead, both short-term in getting the plan approved and communicating it to employees, and long-term in managing the relevant records for performance-related schemes
- risk of arousing unrealistic expectations.

IDS also says that the complexity of a SIP can make it difficult to communicate to staff, and that administration is complex and may be costly as it is usually outsourced to a specialist third party. It also says as there is no cash alternative to a SIP, the employee is exposed to the full risk of a fall in the share price, which may be demotivating (IDS, 2007). Suff (2001) reports the example of Somerfield to illustrate this point. Retention and recruitment problems at the food retailer all mounted after the company's share value fell considerably, well below the share option price offered to staff participating in its share schemes. IDS (2007) also reports that some employers have also questioned the length of time – five-year holding period – shares have to be kept in a plan before the full tax benefits can be realised, as it is too long to be an effective retention tool.

Morris et al (2006), who looked at share arrangements in a major UK retailer, found that the lowest paid employees are often reluctant to participate in such schemes. The study also reports no statistical difference between managers and non-managerial staff in participating in profit-sharing and SAYE schemes, though the support of the latter is mainly dependent on whether they believe the scheme is intrinsically fair. Likewise, Kuvaas (2003) found that the ability of employee share plans to motivate depend on employees' assessments of their fairness. The author found that older workers and those with longer tenure are less likely to view such arrangements as fair. Kuvaas suggests that financial participation schemes should be designed to maximise perceptions of fairness and to encourage support among those involved.

Whether share schemes have a long-term positive impact on staff behaviour is also questionable. A large number of employees, particularly the lowest earners, are likely to turn their shares into cash at the first opportunity, undermining the belief employee share ownership will have a long-lasting effect on their attitudes and commitment.

Key messages

In this section we distil the earlier research evidence to guide readers towards good practice in their operation of group reward systems. As before, we distinguish between those schemes that offer an incentive to raise performance and those that aim to encourage staff to participate in the success of the organisation in financial terms.

General principles

- Clear picture of what the aims are (eg to reward performance, share the spoils of success, develop sense of shared responsibility, raise productivity, improve quality, deal with process logjams).
- Work out the budget for the scheme and model the payout on a best-case scenario (ie assume scheme will be successful).
- Up front leadership by the management team to demonstrate its importance and benefits to both the organisation and staff.
- Creating a climate where staff trust in the integrity and competence of management, such that they are prepared to accept the scheme design, despite whatever doubts they might have.
- Continual communication that addresses staffs' interests and concerns.
- Good quality project management. This means communicating the purpose, mobilising effort, keeping participants up to date with progress, and dealing with the inevitable problems that arise.
- A process that engages staff and develops their trust (or if this is not possible, a process staff accept). Staff involvement that is sufficient to gain engagement or acceptance.
- A line of sight between effort and reward in incentive schemes. This means relating the size of the reward to the difficulty of achieving it. But be mindful of the effect

the reward will have on non-participants, as well as how it is viewed by those taking part.

- Good information management that allows precise monitoring, both to pick up the early signs of problems and to communicate with confidence to the organisation.

Team-based pay

- The right team size to meet the scheme's focus (ie incentive schemes work better with small teams; only recognition is possible with large teams).
- Team selection that makes sense in terms of the scheme purpose (eg a whole unit emphasises oneness; a sub-unit specific objectives; a process team inter-connectedness).
- If not existing teams, then natural teams that are clearly defined in that boundaries can be easily specified and defended. If this is not possible, consult staff on membership/participation, but be certain before starting who is included in which team.
- Wide discretion/autonomy for the team to be able to work independently. Ideally, a fair allocation of work among team members.
- Decide upfront on any exclusions from team-based pay participation (eg on performance, service, pay grade).
- A reward mechanism (eg bonus, non-pay reward) that fits the scheme objectives and is acceptable to staff.
- Clear and simple targets, easy to communicate and evaluate.
- Aim for outcome rather than process targets that, wherever possible, deliver real value (and are seen as such by staff and management).
- Targets that are seen by staff as:
 - achievable
 - within their control
 - legitimate
 - relevant to their normal work
 - consistent between teams
 - measurable.
- Be prepared to remove/adjust any of the targets if they are shown to be irrelevant or unattainable during the course of the scheme, due to factors beyond the control of the team.

Financial participation schemes

- What is the natural cycle of the business – are short-term or deferred rewards more appropriate?
- Be clear about the purpose of the scheme – delivering a bonus tax efficiently is different from using a share scheme to increase commitment and participation from employees.
- Choose advisers carefully – large, complex schemes with tax implications are likely to need external advice. Advisers need a broad understanding of pay and reward processes, not simply the tax dimensions.
- Be clear about the extent to which financial and non-financial participation mechanisms are intended to complement each other.
- Consider adjusting and/or implementing non-financial participation techniques to meet the needs of the pay scheme prior to installing it – this may be needed to meet employee expectations of opportunities to influence decision-making.
- Assess the current level of financial literacy among the workforce and use it to determine the amount of communication likely to be needed to ensure full comprehension of how the scheme works.
- Transparency is important, especially in terms of the connections between employee effort and the performance measure being used – be prepared to do lots of communication around the process of profit generation.
- Choice of communication methods – the more complex the scheme, the more likely that multiple methods will be needed. Managers of successful financial participation schemes often state that there is no such thing as too much communication and it needs to be ongoing.
- Prepare managers for the possibility of either heightened expectations of employee involvement in decision-making or reluctance to participate further, and how they might tackle either position
- Think about how to deal with shirking and how peer pressure or performance management might be used to overcome this.
- Model the likely maximum and minimum payouts that could be generated by the scheme, how the payouts compare with those generated from executive compensation schemes and how staff reactions might be handled in either case.

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