

# Design of performance linked reward system business essay



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Performance-related reward system involves rewarding employees according to their performance, or results achieved or contribution to organisations performance as individuals or as a part of a group. It involves a shift of focus from remuneration models based on the worth of jobs and employee skills to their performance.

Designing a performance-linked reward system is conditioned by a variety of factors such as the nature of business, type of technology, the attitude of unions and human resource management strategies of the organisation.

Therefore, no particular model can be recommended; it has to be custom-tailored.

Performance-linked reward systems reduce labour cost, result in increases in real wages and motivate performance. They provide a method of absorbing cost escalation on account of pay increases and thus help in sustaining competitiveness of the organisation.

It has been increasingly realised that performance-related pay, if used in isolation, may have little impact on motivation for performance. Appropriate conditions in the organisation have to be created for performance-linked reward systems to be motivationally effective. These conditions, for instance, will involve proper information, consultation, communication mechanisms, training and development of employees, developing proactive attitude and performance-oriented culture, providing non-monetary incentives and evolving an efficient performance management system and so on.

Reward system cannot be seen in isolation from compensation management.

Compensation management is getting increasingly integrated with business

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and human resource management strategy. Reward system should, therefore, be considered as an aid to better performance in a performance management system which may be integrated with the overall business plan and strategy.

## **FORMS AND CHOICE OF PERFORMANCE LINKED REWARD SYSTEM**

There are several types of performance-linked reward schemes. Generally, these are designed to-share with or distribute to employees as individuals, groups or a collectivity productivity gains, profit improvement or financial results of enterprise performance. Such schemes fall into the following broad categories:

Schemes based on individual or small group performance including piece rates, traditional merit pay, and sales commission.

Incentive schemes which may relate pay to profits on the basis of a pre-determined formula.

Bonus schemes based on contribution to productivity and profitability according to a pre-determined formula with gains sometimes distributed among the individual employees on the basis of merit rating.

Productivity Bargaining.

Employee Stock Options Plan (ESOP).

Competency-based pay.

## 1. Merit Incentive Pay

A common method which has long been in existence is pay increase or bonus payment on the basis of performance rating.

The merit incentive pay scheme provides another method of recognising and rewarding differential performance. This method could particularly be suitable for office staff. The scheme essentially involves the following steps:

- a) The determination of result-oriented merit rating procedures,
- b) The identification of job factors and their relative importance,
- c) The formulation of a scale of reward, and
- d) The communication of the basis of monetary reward.

Illustratively, job factors of salesman can be identified as (a) sales promotion, (b) realisation of outstandings, and (c) good-will calls, (d) after-sales service and, (e) investigation of complaints.

These tasks will differ in their degree of importance. This difference can be recognised by imputing numerical values to different job factors.

Hypothetically, let us assign weight values of 5, 3 and 2 respectively to the above tasks. In practice, weight values can be ascertained through job analysis.

The actual merit rating score will give the percentage of basic wage or basic wage plus D. A. as incentive bonus. Given a result-oriented merit rating procedure and its objective operation in an organization, it should not be

difficult to install a merit incentive pay system. This is not to minimise the difficulties that are usually encountered in operating a -merit rating system. The effectiveness of the performance appraisal system will depend on the soundness of the performance appraisal system.

Sometimes merit increments and merit awards are also given in recognition of superior performance on the part of individuals. These are poor substitutes for a system of merit incentive pay because of several shortcomings.

Under a system of merit increments, there is no prompt relationship between reward and effort. The quantum of reward at a point of time will be considered inadequate. Additional cost in the form of enhanced allowances is built for the company on permanent basis. Employees continue to benefit from their best performance even if it remains below standard in the future.

Employees getting merit awards cannot visualise a proportionate relationship between their performance and reward. The basis of determining the quantum can not be explained to employees who are not given such awards. This may evoke jealousy and friction and may thus jeopardise cooperation and goodwill.

### Incentive Payments

Lumpsum payments such as sales commission is another traditional method. Generally, the performance and the payment of lumpsum are linked by a formula. Sales commission, however, does not generally consider other

parameters of performance such as realisation of outstandings and selling high profit margin products.

Another traditional method of rewarding performance is piece rates. There are several weaknesses in this system. It is not easy to agree with workers on the standard output required. Frequent changes may be needed in the standard output due to technology changes and this may lead to conflict between unions and management.

Also factors other than individual performance such as change in work method affect output. Conflicts may also arise between different work groups when one group is dependent on another. There is a potential for conflict when norms have to be revised because of such factors as technology changes. Also, modernisation of technology and automation has rendered piece rates somewhat obsolete.

## **2. Incentive Schemes**

Output-based incentive scheme are appropriate where tasks are repetitive and measurable. These involve the following steps:

Selecting the objectives

Determining the parameters of performance in accordance with the objectives

Determining the norms or base values or benchmark values for each parameter

Determining performance-reward relationship

Fixing the relative importance of the selected parameters, that is, their weightages

Designing information and procedure formats

Determining the maximum payable incentive amount (incentive opportunity) and , payment period

Formulating a communication and review scheme

These are, however, not suitable for high technology and service activities, which require information sharing, problem solving and team work.

Productivity gain or profit sharing or employee stock options plan (ESOP) may be suitable types for such activities.

### **3. Group Incentive and Productivity Gain Sharing**

Under the productivity gain sharing schemes, productivity gains are shared in accordance to an agreed pre-determined formula. Profit sharing gives a share of profit. Sometimes, the quantum of bonus is determined on the basis of profit as well as productivity improvements according to a pre-determined benchmark value for each of them.

### **4. Productivity Bargaining**

Productivity bargaining can provide yet another method of improving productivity and linking wage increases- to such improvements. Productivity bargaining, however, does not mean an incentive scheme or wage increases in return for assurances and promises from unions for achieving production targets. This method implies (a) a detailed analysis of the firms operations,

(b) the identification of cost reduction possibilities, (c) estimation of savings in cost, and (d) the development of a system of indexing wage increases with cost reductions actually realised over time. The climate for productivity bargaining has never been more favourable than now. It is for managements to take initiative and build this approach in their collective bargaining relationship with Unions.

## **5. Long-Term Incentive (ESOP)**

Long-term incentive in the form of employee stock options schemes are operated both to improve long-term incentive and to reduce fixed cost. ESOP envisages employee participation in and ownership of a company's equity.

This plan is intended to provide an incentive to the employees to improve the all-round performance and growth of the company and share its prosperity. The plan usually involves allotment of equity shares according to a laid down procedure and subject to governmental regulations, laws and rules. The employees benefit in the form of enhanced market value of his shares and capital gains, which in turn depend on company's and employee performance. Several software and high-tech organisations such as Infosys have conceived and designed such plans.

## **6. Competency-based Pay**

The competency is a critical determinant of performance. Therefore, there is an increasing interest in offering monetary incentive for acquiring competencies required for higher performance on the present job or for the next job. Such competency may for instance include values, attitude and behavioural characteristics which influence performance.



In designing a performance linked reward scheme, choice of an appropriate scheme should be considered as critical. The choice will be determined by a variety of factors such as the nature of the organisation, the nature of technology, the nature of profits, the nature of markets, the human resource strategy and business objectives.

## **STEPS IN DESIGNING**

There is a variety of forms of performance-linked schemes. These must be closely adapted to the particular conditions of individual enterprises and the concerned groups of companies. In designing a custom-tailored performance-linked reward scheme, the following steps are important:

### **1. Custom-Tailored**

There is little scope for relying on model or standardized schemes. Attempts to impose specific performance-linked reward systems through central regulations generally appear to fail. Frequently the appropriateness of what is being required may appear questionable from the perspective of individual enterprises. Therefore, care must be taken in adapting such schemes to the particularities of individual enterprises.

### **2. Objectives**

The objectives of the schemes need to be carefully formulated. Such objectives are needed to guide the selection of performance measures, the specification of bonus calculation formulae and the reaching of common understanding on the size of bonuses that may be expected through the schemes. The potential for performance improvement may vary greatly from

one enterprise to another, as well as with the passage of time. Both the short and long run objectives for the scheme should be identified.

### **3. Selection of Performance Measures**

The selection of performance measures must be consistent with the scheme objectives; these must encourage those types of behaviour considered important for organizational performance such as increasing output, reducing labour and other costs, improving quality or timeliness of delivery, encouraging co-operation amongst work groups, enhancing adaptability and innovations, etc. In addition, they must not be pursued at the expense of other performance parameters. At the same time, the measures of performance selected should, to a large extent, be under employee control, and not influenced by external influences. Employees will be demotivated if their best efforts are offset by factors they cannot control. The unit, the performance of which is measured, should be small enough to ensure that workers can see some relation between their efforts and rewards. To ensure motivational effectiveness, the measures of performance should also be easily understood by the workers concerned, subject to ready verification if suspicions arise, and be calculable at frequent intervals.

### **4. Basis**

Depending on circumstances, performance awards may be determined on the basis of improvements over the previous year, improvements over a base period performance, or the maintenance of a high level of performance. Bonuses which become exceptionally large should be integrated into basic wages in order to avoid distortions in pay structures. Where necessary, it

may be advisable to resort to procedures for stabilising bonuses of lengthening the period over which performance is calculated.

## **5. External Influences**

To the extent possible, the initial agreement establishing the scheme should specify how target performance levels are to be dealt with when their achievement is affected by external influences such as changes in production methods, product mix and prices of inputs and outputs.

## **6. Distribution**

The rule for the distribution of bonuses amongst workers should be simple and widely supported. It may be based on wage rates or average earnings. Also, to discourage excessive absenteeism, bonus is sometimes varied with the number of hours or days worked. However, distributions in accordance with assessments of individual worker performance by supervisors may be problematic, especially if such assessments lead to significant variation in pay.

## **7. Equity**

There should be equal opportunities to earn bonuses, even though the performance measures may vary. In addition, performance targets should be set after a careful scrutiny of the historical behaviour of the measures selected. The quantum of bonus should be significant enough to evoke extra efforts. At the same time performance awards should not be so large as to put at risk a significant part of employee earnings for reasons beyond their control.

## **8. Safeguards**

Such schemes should not be substituted for wage increases that otherwise would have been granted or replace fixed wages with variable wages.

Performance pay should supplement rather than replace existing wage bargaining arrangements and should not question the need to maintain basic wages at adequate levels. Perhaps of even greater importance in some contexts may be the need to give assurances to existing employees that productivity improvements would not place jobs in jeopardy.

## **9. Involvement and Communication**

Such schemes must be perceived as acting in the interest of employees as well as employers. Accordingly such schemes must be implemented in ways that convince employees that they will receive a fair share of the benefits derived from their extra efforts and their jobs will not be threatened.

Schemes based on collective performance work more effectively when the scheme objectives and operation are explained in detail to all the employees concerned. The success of schemes depends to a large extent on the amount of effort given by management to consultation at various stages – in the planning and design of the scheme, in the process of implementation and monitoring of results. In addition, the schemes have a better chance of success if employees are provided with full opportunities to present their ideas for bringing about improvement. Performance-linked schemes function most effectively when they are accompanied by a formal participative system that facilitates: (a) the transformation of agreed practical suggestions into actual changes in operating methods and procedures; (b)

two-way communications at all levels on operating difficulties and general business trends.

## **10. Union Participation in the Design**

Performance reward schemes may work most effectively when worker representatives are given full opportunity to participate in their design and administration. Such involvement may facilitate comprehension and acceptance of scheme objectives. Moreover, workers may only fully trust the scheme if it has been elaborated in consultation and agreement with worker representatives and they are subsequently given opportunities to verify that awards is being calculated fairly.

Also, the commonality of interests of workers and employers in improved productivity, performance, earnings and equity is likely to be much more apparent where pay systems are developed and elaborated in accordance with rules established through collective bargaining.

## **11. Review**

There should be a clear provision for modifications owing to changes in production methods or in prices or inputs or outputs.

The effectiveness of all pay systems decays with time and the duration of schemes based on collective measures of performance are particularly short. Accordingly it should be foreseen that the basic parameters of such schemes would undergo regular periodic revisions. Indeed it should be expected from the outset that the collective performance measures and targets would undergo continuing change every few years in the light of the experience.

## **ISSUES AND TRENDS**

There are many issues and trends occur in linking performance with reward system which are as follows:-

### **1. Level of Education**

The level of education of the employees, among other factors, will determine what type of scheme is likely to be easily understood by them and will motivate them. The nature of the business and the operations will also influence. Organisations in low cost manufacturing or which promote innovation, skills and higher performance or which are in service industries may need to consider different forms of performance pay. Their business and human resource management strategy will differ; the form and content as well as objectives of performance pay should be consistent with them.

### **2. Trade Union**

The chance of success of performance-linked pay will depend on the tradition of collective bargaining and attitudes of unions. While the negative attitudes hinder its introduction, the positive attitude considerably facilitates it

### **3. Organisational Culture**

Performance pay gives better results in organisations characterised by employee involvement and team spirit. A pro-active culture in the organisation is found to be valuable to performance and productivity.

#### **4. Package of Monetary and Non-Monetary Incentives**

Performance pay is at best an element in the reward management and motivational system. Besides performance pay, it is essential to pay attention simultaneously to such aspects as re-organisation of work process, training, employee involvement and participative decision-making, opportunities to contribute ideas and knowledge, non-monetary recognition, career development and goal setting.

#### **5. Rewarding Good Performance**

Rewarding good performance may include, among others, such mechanisms as cash awards, appreciation letter and certificates, training in reputed institutions, foreign travel, job enlargement and enriched roles, publicity in newsletters and membership of professional societies, etc. For higher effectiveness of performance-linked pays system, such reward mechanisms should also be used.

#### **6. Performance Pay and Performance Management**

It is increasingly realised that performance is affected by a variety of factors. These factors, for instance, will include knowledge and skills which are developed through training, work attitudes and intrinsic rewards. These and other factors which affect performance are considered in the wider context of performance management and human resource management with performance pay constituting an element of it.

#### **7. Caveats**

It is being increasingly realised that

The performance pay systems should be designed to promote the kind of performance an organisation needs. It should, therefore, be integrated with human resource management strategy for better performance and growth of the organisation.

The performance pay should underpin the organisation's main values such as team work, creativity, flexibility and quality.

The system should provide an impetus to and support the behaviour expected of the employees. Therefore, it must communicate to employees the type of behaviour to be rewarded and the way in which it will be rewarded.

The reward system should be strengthened through re-organisation of work process and enlarged job responsibilities, training, consultation, communication and participatory system. Employees should also be consulted in the formulation of the plan.

The criteria for determining performance should be objective, measurable, easily understood and related to what employees can control.

The quantum of performance pay should be significant enough to be motivationally effective and its distribution should be equitable.

The payment of performance pay should follow the performance as soon as possible and as frequently as possible.

The performance level should be achievable; otherwise it will have a demoralising effect.



The quantum of pay should be sufficiently flexible to absorb downturn and adequately reward when performance is good; it should also safeguard the minimum remuneration for the value of the job.

## **QUESTIONS**

Q1. Explain what is performance-linked reward system?

Q2. What are the various ways in which performance can be linked to reward system?

Q3. In designing a performance-linked reward system, what considerations will you take into account?

Q4. List out the various steps involved in designing a performance-linked reward system. Give an example.

Q5. Examine the current issues and trends in linking performance with reward system.