

**Office of Manpower Economics**

Bonus Scheme  
Design and  
Effectiveness

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## OFFICE OF MANPOWER ECONOMICS

### Bonus Scheme Design and Effectiveness

#### INTRODUCTION

1. We have been asked by the Office of Manpower Economics (OME) to prepare a report outlining the operation of typical bonus schemes at organisational levels in the private sector which are equivalent to the Senior Civil Service (SCS). For the purpose of comparison, the salary range in the private sector which is equivalent to SCS jobs has been taken as £60,000 to £150,000 pa. This paper sets out our observations as follows:
  - the prevalence, design and operation of private sector schemes;
  - the similarities and variances from the SCS scheme;
  - how the impact of these schemes is assessed, and
  - how the impact of the SCS scheme could be assessed.
2. In preparing the report we have consulted our own survey of Top Executive Remuneration (2006 Participants are listed in Annex A) and also the most recent (European wide) survey of annual incentive scheme practice (Annex B). The scope of that survey was not confined to but it did include, executives with jobs in the target salary range; in fact, the median salary of the *lowest* paid bonus plan participant was about £50,000. We have supplemented this with data from a more recent small private survey of incentive practice among major UK multinational businesses.
3. Annual bonus design and operation in the private sector changes relatively slowly and, generally, incrementally. Much of that practice is only partially amenable to data driven analysis. Therefore much of what follows is based on observations made in consulting assignments rather than on empirical analysis.
4. In relation to the operation of the SCS scheme we have referred to the 27th and 28th Senior Salaries Review Body's (SSRB) reports on Senior Salaries and we have been supplied with unpublished data which are in preparation for the 29<sup>th</sup> such report. Finally, we have referred to the Cabinet Office document, *Performance Management and Reward Principles in the SCS*.

#### PREVALENCE, DESIGN AND OPERATION

5. There remain two philosophical approaches to the operation of bonuses; one is that they should be payable only for exceeding the requirements of the job (however defined). The other is that bonus is an integral part of total pay. In the private sector the latter approach prevails; it is now generally accepted that bonuses, though variable, are part of a managed pay structure.
6. This can be illustrated by the fact that most private sector bonus schemes depend primarily on the achievement of financial targets. Those targets are most commonly set at budgeted levels (with a range set around budget for performance outcomes which are either side of it).
7. Arguably, the delivery of financial budgets is the essence of meeting (but not exceeding) the requirements of the job but, in the private sector, bonuses are universally paid for hitting target or budget.

8. Notwithstanding their integration into the pay structure, in the normal course of business, private sector bonuses are neither consolidated into base pay nor pensionable.

### Prevalence

9. To establish a basis for describing private sector bonus practice, we examined data from our survey of Top Executive Remuneration for each of the years 2001 to 2006, for which Table 1 shows the numbers of jobs reported in the target salary range and Table 2 shows the corresponding median base salaries.

**Table 1 – Number of Jobs Reported within the Target Salary Range: £60,000 - £150,000**

Reporting Level	2001	2002	2003	2004	2005	2006
2	82	72	184	167	106	85
3	577	827	1075	1005	745	820
4	691	891	517	668	445	788
5			42	134	28	289
<b>Total Sample</b>	1350	1790	1818	1977	1324	1982
<b>No. of Companies</b>	126	141	125	132	115	120

*Source: Towers Perrin Survey of Top Executive Remuneration*

**Table 2 – Median Base Salary for Jobs Reported within the Target Salary Range: £60,000 - £150,000**

Reporting Level	2001	2002	2003	2004	2005	2006
2	£116,500	£118,000	£117,500	£122,500	£121,400	£128,000
3	£107,600	£109,000	£110,000	£110,000	£112,000	£117,620
4	£90,400	£97,200	£100,000	£101,400	£105,000	£111,200
5			£87,500	£95,500	£110,000	£110,000
<b>Total Sample</b>	£107,600	£109,000	£105,000	£105,700	£111,000	£114,410

*Source: Towers Perrin Survey of Top Executive Remuneration*

10. The survey includes companies in both general industry and the financial services sectors. Executives at Reporting Level 2 report directly to the Chief Executive; those at Reporting Level 3 report to level 2 and so on.
11. Among this group, Table 3 shows the eligibility to participate in annual bonus plans by percentages of the sample.

**Table 3 – Eligibility for Participation in a Bonus Plan (as a % of Sample)**

Reporting Level	Eligibility for Participation in a Bonus Plan					
	2001	2002	2003	2004	2005	2006
2	99%	99%	100%	100%	100%	99%
3	100%	100%	98%	98%	98%	98%
4	100%	100%	98%	99%	98%	98%
5			100%	98%	100%	99%
<b>Total Sample</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>99%</b>	<b>100%</b>	<b>99%</b>

*Source: Towers Perrin Survey of Top Executive Remuneration*

12. Data in relation to professional service organisations are harder to come by. Nevertheless, we have worked with several of the major, London based, accounting and legal firms and with some not for profit organisations or service providers and can offer anecdotal observations.
13. Among the professional firms, the target salary range would cover professional jobs to pre-partner level. In these cases, we observe that prevalence and eligibility would be similar to that of the private sector generally and certainly so in the major accounting and consulting firms. In the law firms, bonuses have only been adopted at this organisational level within the last four years or so but now approximately two-thirds of the larger law firms operate bonus plans for their qualified but pre-partner employees.
14. Our general conclusion would be that, while there are certainly differences of design and operation, annual bonuses can be regarded as a normal part of the pay structure for all parts of the UK's organisational spectrum.

## **Design**

15. The conventional private sector bonus structure generally tests the performance of one or more measures, each of which is assessed separately against a target or range of performance and the outcomes aggregated (or, less commonly, multiplied) to determine the total bonus. But there are considerable variations on this theme as follows.

- Most commonly, performance is tested against one or more measures of financial performance; typical practice would involve profitability, efficiency (return on...) or cash management but many other measures are in use (eg revenue or turnover growth or market share). In a professional services firm, 'performance' would almost always manifest itself as personal chargeable time, business development success (sales) or business unit profitability.

Financial measures are sometimes criticised as being backward looking or manipulable. But, in our observation, they are usually derived from or tested against, longer term forward looking plans and, while a certain level of operational budget management is routine, any serious level of financial manipulation is simply not sustainable over time.

- It is common practice for bonus performance measures to reflect an individual's span of authority. For example, the chief executive of a business profit centre might also be a board or executive committee member for a larger business

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unit. In these cases the bonus might be structured on the principle of “one up”, that is to say, partly on the performance of the business unit for which the individual is profit accountable and partly on the performance of the larger business unit to which the individual contributes. The proportions of bonus determined from the different business units’ performances are usually weighted to total 100%; for example, 75% and 25% or 50% and 50%.

- Increasingly, although not universally, some element of bonus is related to the achievement of significant operational or strategic objectives (referred to variously as key tasks or key performance indicators) or to tests of customer or employee satisfaction where these can be measured robustly.

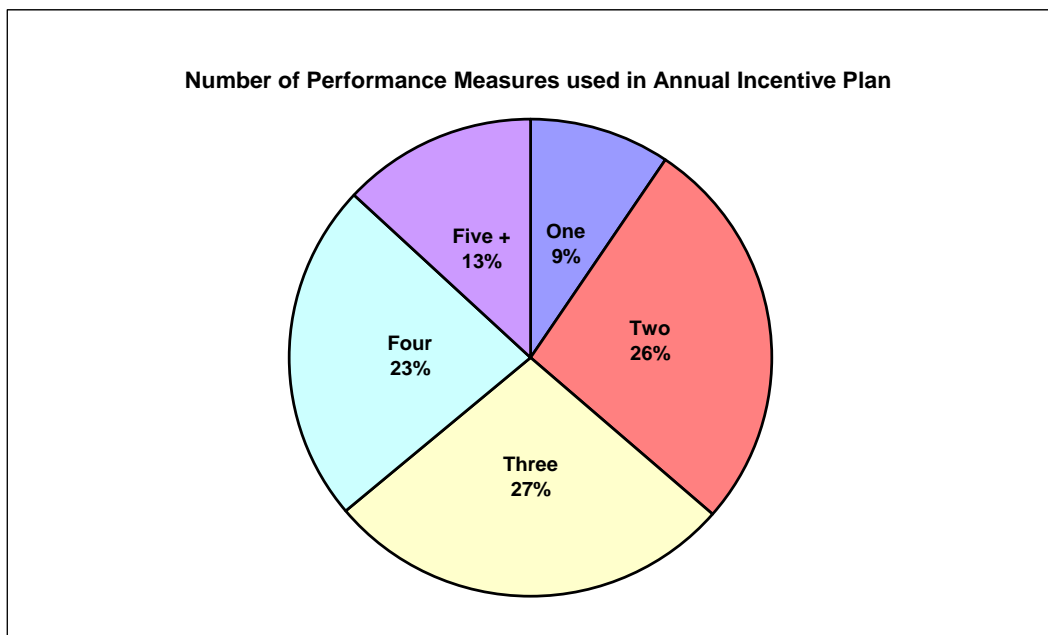
Note that key tasks are almost always about outputs. In our experience, at this organisational level, it is rare (if not unknown) for *bonuses* to be paid only for inputs (*eg* improvement or development of a job-related competency).

The extreme manifestation of this type of bonus would be a completely discretionary bonus award dependent only on a perception of the individual’s performance.

- Finally, bonuses are sometimes derived from a scorecard of business performance. The idea is more often discussed than implemented but typically, under such an approach, there are four quadrants (*eg* financial, operational, customer facing and internal – the precise choice varies by business) and there might be two to four objectives taken from each quadrant with the outcome weighted according to perceived importance. This is an extreme version of the personal objectives structure we have just noted but, while we have observed it in a few major UK companies, it is not common in general industry and is even less common among professional service firms.

16. To give a clearer indication of how practice varies, Chart 1 shows the numbers of performance measures in use among respondents to our survey of annual incentive plan design practice.

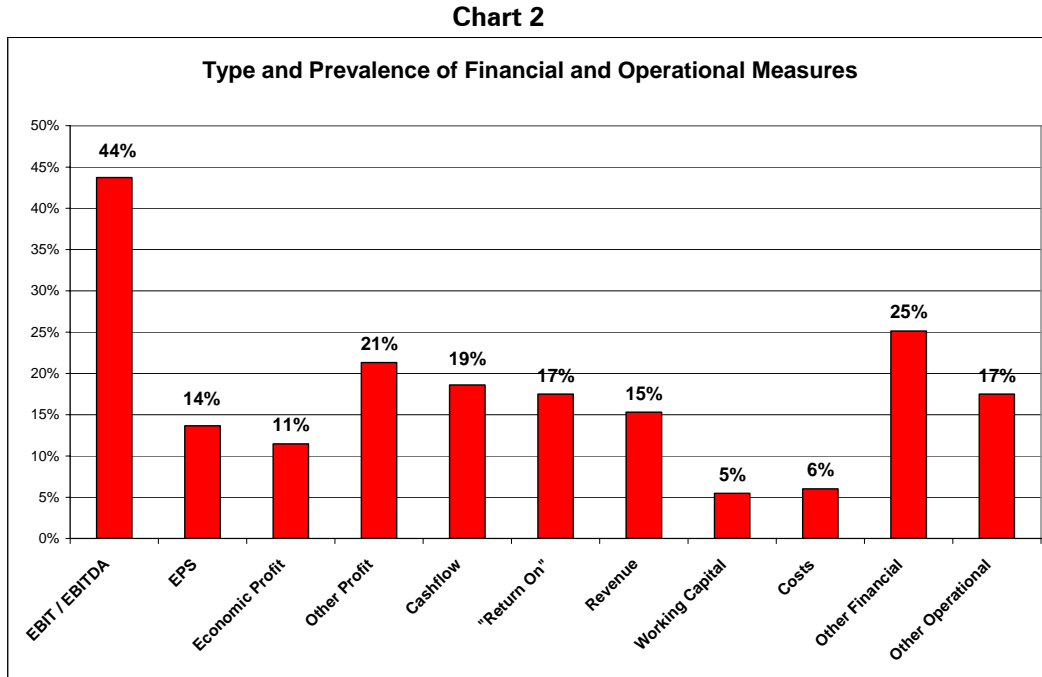
**Chart 1**



Source: Towers Perrin European Annual Incentive Plan Design Survey

17. The results from each of these measures are treated as additive in 75 % of cases and multiplicative in 15% cases. The other 10% would include the kind of scorecard structure or discretionary plan noted above or pool based plans.

18. The nature of the performance measures in use is shown in Chart 2



*Source: Towers Perrin European Annual Incentive Plan Design Survey*

19. Finally, although practice is more variable, we observe that 60 – 70% of survey respondents base an element of their bonuses on individual objectives and, among these respondents, the weighting would be some 30% to 40% of the total bonus opportunity.

20. There is a great deal of variability in practice relating to the design of individual objectives. The issues are:

- definition: ensuring clarity and accuracy in the description and timing of the objective(s) to be completed;
- distinguishing normal course of business objectives (which might be used in salary management or in a more general assessment of performance) and different or more stretching ones for bonus purposes; (note, however, that this is not always in point; for example, in a professional services firm, where it is axiomatic that professional staff must charge their time, a bonus objective of charging, say, 1200 hours is also a normal course of business expectation; this is also a good example of the integral nature of bonuses in relation to some pay structures);
- number: the conventional wisdom is that an individual should be set no more than two to five objectives to retain focus both operationally and in terms of the reward *per* objective; but there are many instances of setting higher numbers of objectives than this; in particular, scorecard based systems are apt to produce 15 to 20 objectives, and

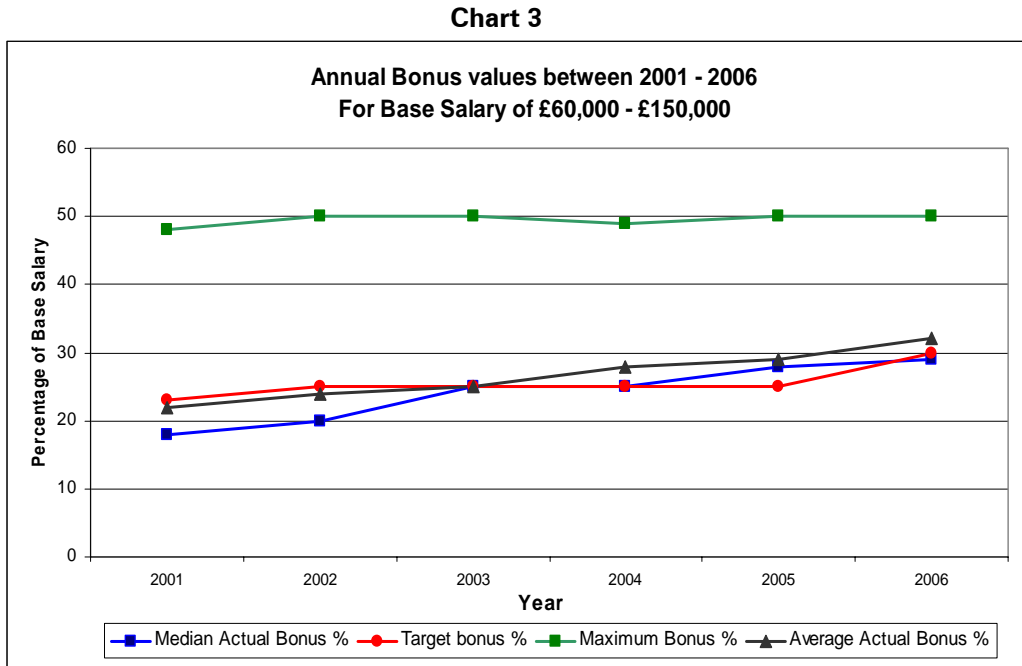
- grading: some objectives are pass/fail but most are (more or less objectively) graded on scales with different levels of achievement.
21. It is also the case that an element of bonus which is either based on individual objectives or discretionary judgement, is sometimes used deliberately as an (upwards) adjustment mechanism to correct perceived inequities in a formulaic outcome. And all private sector bonus schemes (or, at least, we would argue, all well designed ones) incorporate an element of residual discretion which allows for *post facto* adjustments to bonus outcomes (up or down).
22. Such *post facto* adjustments might be made either to take into account unforeseen events (whether opportunities or setbacks) and the individual's response to them or, again, to remedy the undesired outcome of the strict application of a formula. (Almost all – 96% of survey respondents - have the facility to make discretionary adjustments and 49% have done so in practice.)
23. The foregoing describes the design of the great majority of private sector bonus schemes at the SCS equivalent level. Structurally, the committed bonus pool is, in practice, the sum of all the individual bonus entitlements and organisations generally budget at the sum of all the individual target bonuses. But there are minority practice exceptions which we mention here.
- Some schemes operate what is referred to as a “circuit breaker”, that is a corporate condition precedent to any bonus payments being made. Usually this is a minimum level of profitability which, if not met, will preclude the payment of any bonuses even though particular individuals might otherwise have earned bonuses on other criteria.
  - Some parts of the financial services sector (notably fund management and corporate finance) operate bonus pools which are generally a percentage share of the profits. Typically, the pool is 15% to 25% of profit and it is usually distributed among the eligible population by discretion.
  - Finally, in professional service firms, although bonus opportunity might be expressed in terms of individual target bonuses, the reality is governed by the profit which is available for distribution. Therefore, in a poor year, an individual fulfilling all objectives and earning a “target” bonus, would receive less than the target opportunity simply through lack of funds. Such an individual would, of course, do relatively better than those who had not met all their objectives. Note that the reverse is also true. In a good year, actual bonuses for on target performance are likely to be better than the nominal target opportunity simply because there is more money available for distribution. In this way, there can also be an element of profit sharing in professional service firms.

## Operation

24. The primary questions in relation to the operation of bonus schemes are concerned with levels of bonus opportunity and payment. It is axiomatic that, because of the design of private sector schemes, participants will know their bonus opportunity and the level of performance (however defined) required to earn threshold, target and maximum bonus.
25. In this context, we should note that there are no data available about the nature of the performance targets which are set, the outcomes relative to those targets or the consequential bonuses which are paid. In general the information required to

assemble such data would be regarded as confidential by most organisations. It would also be our observation that these matters are rarely examined internally.

26. In Chart 3 we show the median levels of target and maximum bonus opportunity and actual bonuses paid in each of the years 2001 to 2006. There is a slight statistical adjustment in the actual bonus numbers because they are generally amounts earned in a financial year but paid in the following year and expressed as a percentage of the following year's (usually higher) salary. The effect therefore, is that the actual bonus percentages might be marginally (4% to 6%) understated.



27. Chart three shows that, in a representative sample of UK industry:

- practice relating to bonus levels has been relatively flat (trending slightly upwards);
- both median and average actual bonuses have been paid broadly at target amounts, and
- the relationship between target and maximum bonus opportunities has narrowed somewhat from 2:1 in 2001 down to 1.6:1 in 2006; therefore the amount of upside (leverage or gearing) in annual plans has been reducing.

28. At these organisational levels, this reduction in gearing is probably a reflection of decisions which have been taken in respect of higher organisational levels and cascaded down. (In general, over the period 2001-2006, target bonus levels for boards have been increasing at a faster rate than that shown in Chart 3 and also at a faster rate than the corresponding maximum bonus levels. The effect of these changes has been to reduce gearing.)

29. There is sometimes a perception that there is a difference in bonus opportunity between line (*ie* profit accountable general management) and staff (*ie* function, *eg* IT, Finance, HR) jobs but we see no systematic evidence of this. Table 4 shows the data.

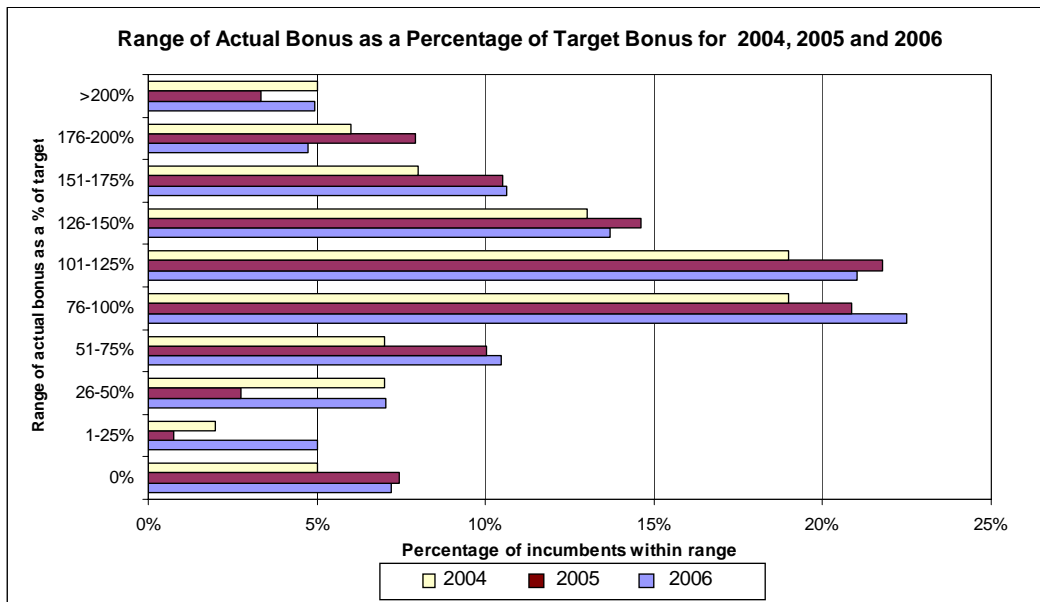
**Table 4 - Staff and Line Bonus Practice**

	Target				Actual			
	Average		Median		Average		Median	
	Staff	Line	Staff	Line	Staff	Line	Staff	Line
<b>2006</b>	33	38	30	34	35	51	30	33
<b>2005</b>	30	32	25	30	27	30	25	26
<b>2004</b>	28	27	25	26	31	28	26	26
<b>2003</b>	29	27	25	26	27	29	25	26
<b>2002</b>	28	30	25	25	26	32	24	25
<b>2001</b>	23	29	22	26	27	26	24	25

*Source: Towers Perrin Survey of Top Executive Remuneration*

- 30. Turning now to payment patterns, year by year there is considerable variance of payments around the median. Chart 4 (below) shows the distribution of actual bonuses paid in 2004, 2005 and 2006 as a percentage of the corresponding target bonus.
- 31. In 2005 and 2006 some 45% of the sample received a bonus of between 75% and 125% of target (2004 36%). For median values, this translates to between about 23% and 38% of salary (2006) or 19% to 31% of salary (2004 and 2005). Note also that, over this period, only some 5% to 7% of the sample received no bonus but that 3% to 5% received more than twice target. At median levels twice target is equivalent to 60% of salary (2006) or 50% salary (2004/05) or more.
- 32. Note that there is a difference in the distribution for the three years, 2006 showing a higher prevalence of below-target bonuses, 2005 the reverse and 2004 perhaps a slightly more even distribution.

**Chart 4**



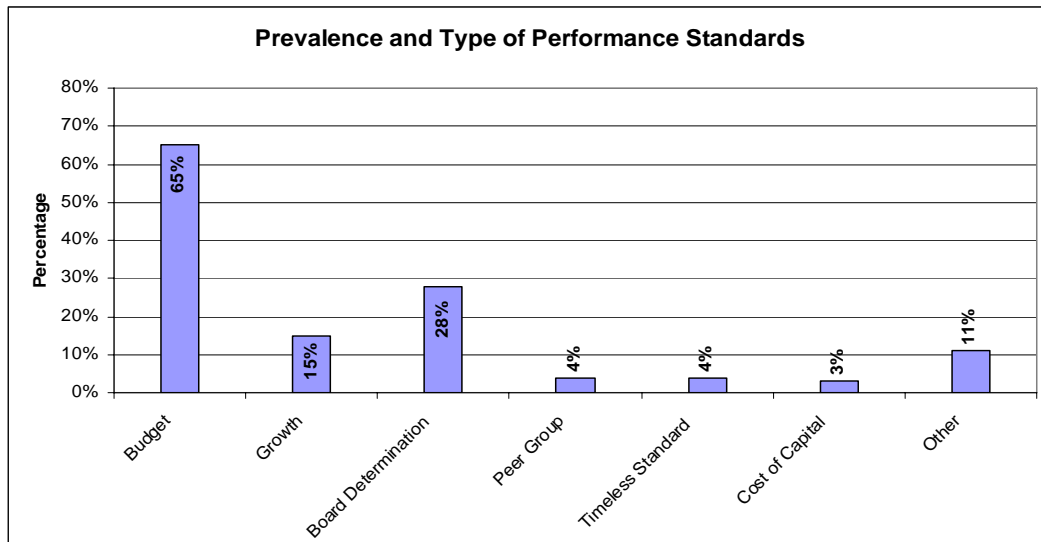
*Source: Towers Perrin Survey of Top Executive Remuneration*

- 33. There is no doubt that the most difficult aspect of operating any annual bonus plan is target setting. The essence of the difficulty is that target setting decisions are made by combining at least two separate judgements in circumstances where the

outcomes are, at best, only partially controllable. In a straightforward case of a financial target (eg profit growth) the first judgement is agreeing the budget for the year and the second judgement is setting the bonus target or range in relation to the budget.

- 34. Although budget is the most commonly used basis for setting financial performance targets, not all schemes are based solely on budget. Chart 5 shows the prevalence and type of the bases for target setting which are in use.

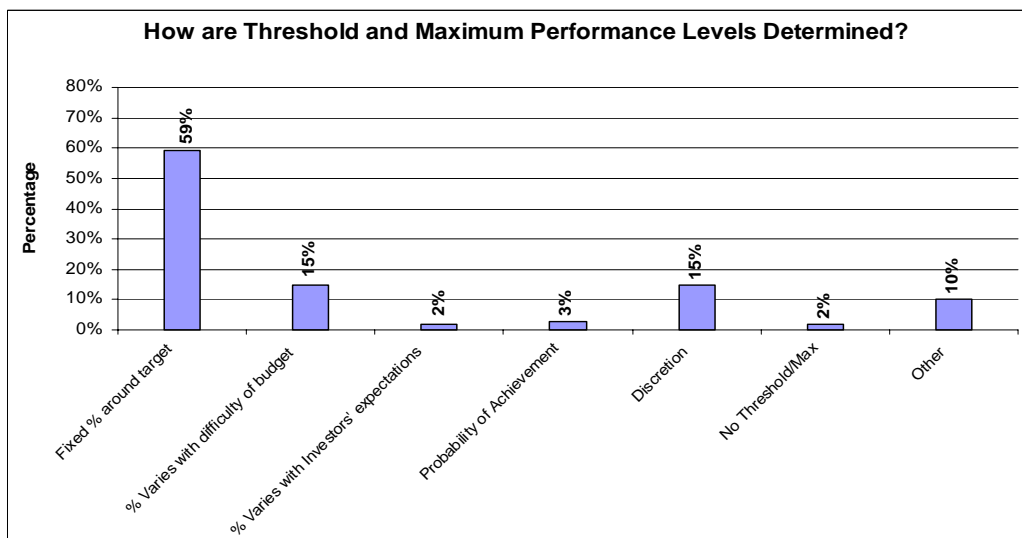
**Chart 5**



Source: Towers Perrin European Annual Incentive Plan Design Survey

- 35. Having decided on the basis or target for the scheme, the next, intimately related decision is the range of performance around target, ie the minimum or threshold level at which bonus will begin to be earned and the maximum level at or above which, maximum bonus will be payable. Again, while one method is dominant, there are several possibilities as shown in Chart 6.

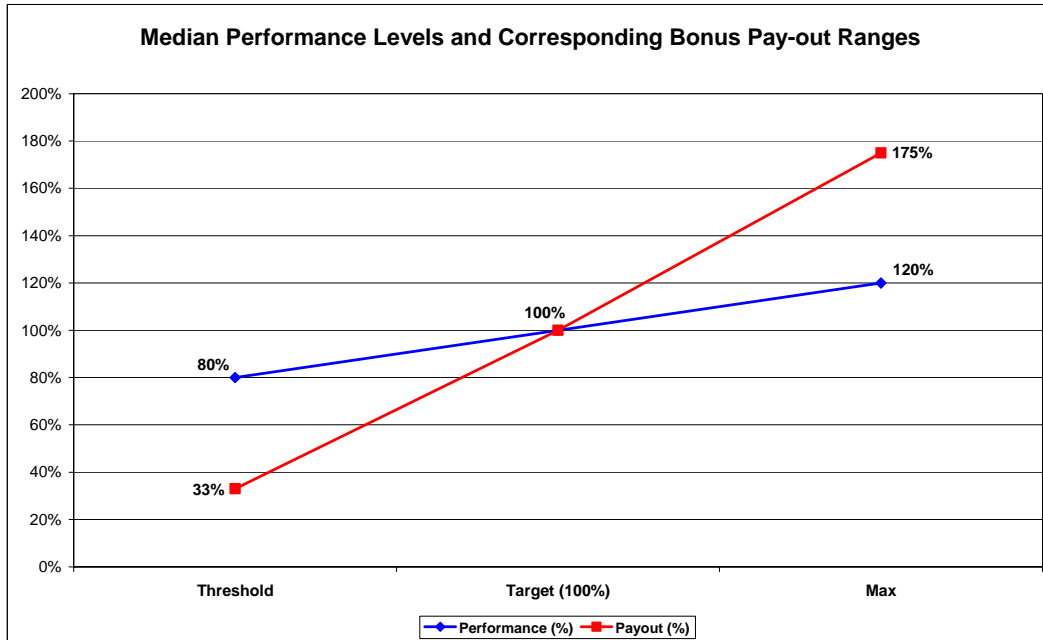
**Chart 6**



Source: Towers Perrin European Annual Incentive Plan Design Survey

36. Finally, the relationship between these decisions, that is to say, what amount of bonus is paid for what level of performance achieved, is illustrated by Chart 7 which shows, for example, that median reported practice is to pay one-third of target bonus for achieving 80% of target performance.

**Chart 7**



Source: Towers Perrin European Annual Incentive Plan Design Survey

37. We believe that this is one matter in which there may be some difference between UK and continental European practice and in which UK practice is evolving. We observe that it would currently be more typical for a UK bonus range to be within 10% either side of target (90% to 110%) and that maximum performance may not exceed target by quite so much.

38. The difficulties of judgement relating to bonuses based on personal objectives are probably greater. Added to the problems of prioritising the choice of possible objectives and the performance standard to be attached to them, are questions of whether the objective bears a range of performance or is pass/fail, the weighting of the available bonus between objectives and the simple difficulty of defining the objective with clarity.

39. Finally, we have no evidence that professional service firms have any less difficulty with these questions. Because of the element of profit sharing which pervades professional service bonus schemes, some of the issues are, perhaps, simplified. But there is one point in particular about which many professional service firms struggle. It is the recognition that there are many commercial activities (professional development, marketing, creation of intellectual capital to name but three) which are critical to the long term prosperity of the firm. But the immediate commercial imperative is to sell and charge time. Giving sufficient importance and recognition to the developmental aspects of performance in bonus scheme design is a perennial difficulty for professional service firms.

## THE SCS SCHEME – VARIANCE ANALYSIS

40. The operation of the SCS scheme is summarised from paragraph 33 of *Performance Management and Reward Principles in the SCS* as follows.

“33. Non-consolidated cash payments, otherwise known as **bonuses, reward in-year performances in relation to agreed objectives, or short term personal contribution to wider organisational objectives**. Bonuses are paid in addition to base pay increases and do not count towards pension.

“34. Bonuses are allocated by departments from a ‘pot’ expressed as a percentage of the SCS salary bill, which is agreed centrally each year following the SSRB recommendations. **The intention is that bonus decisions should be differentiated in order to recognise the most significant deliverers of in-year performance**. There is no specific guidance about how many of the SCS should receive a bonus. The intention is that bonus decisions should more strongly differentiate between the highest and the most disappointing performers which suggest that fewer SCS will receive a bonus than did last year...”

41. The practical application of these principles is described in the SSRB’s 28th Report (at paragraph 2.14) as follows.

“In addition to base pay increases, senior civil servants are eligible for non-consolidated bonus awards. Bonuses are intended to reward delivery of personal business objectives during the reporting year or other short-term personal contributions to wider organisational objectives. In considering SCS staff for bonuses, line managers are asked to take into account:

- performance against agreed priority business or targets;
- total delivery record over the year;
- relative stretch (i.e. challenge of the job compared to that of others); and
- response to unforeseen events which affected the performance agreement.”

42. It is interesting (and, perhaps, instructive) to compare this paragraph with paragraph 2.11 of the same Report which deals with the separation of the SCS into performance tranches.

“The allocation of individual SCS members to tranche depends on the assessment of their performance relative to others operating at broadly the same level, rather than on any absolute standard. According to the Cabinet Office’s guidance to departments, the assessment should reflect:

- how the job has been performed;
- overall track record and growth in competence; and
- what has been achieved against the individual’s performance agreement”

43. There are subtle differences of emphasis between the two paragraphs but also a great deal of similarity; it is arguable that the bonus judgements, rather than being different in *kind* from the salary judgements, are the same criteria broken down to the next level of specificity. The exception to this observation would be the bonus criterion about response to unforeseen events.

44. This then, is a good example of the difficulty that exists in separating work that is part of the “day job” and performance which justifies a bonus.

45. This is particularly true in the SCS bonus structure which is wholly dependent on what the private sector would describe as personal objectives or key tasks. And this is the primary difference between the SCS system and those which operate in the private sector; there is no element of purely financial performance. Far from being a surprise, given the nature, scale and sheer complexity of the home civil service, we do not see how the system could operate in any other way.
46. But there are three other dissimilarities between the SCS scheme and private sector schemes:
- the lower levels of bonus payments,
  - the lower prevalence of payments among the eligible population, and
  - the emphasis, in the SCS scheme, on *relative* performance.
47. Table 5 compares the average bonuses paid to the SCS in the period 2004-06 with the average private sector bonus over the same period.

**Table 5 - Average Bonus Payments in the SCS and the Private Sector**

	Year					
	2004		2005		2006	
	£	%	£	%	£	%
<b>SCS</b>	4,960	7.0% <sup>1</sup>	5,011	6.9% <sup>1</sup>	6,942	9.3% <sup>1</sup>
<b>Private Sector</b>	31,100	27.8% <sup>2</sup>	30,800	28.5% <sup>2</sup>	35,400	29.1% <sup>2</sup>

Sources: Towers Perrin Survey of Top Executive Remuneration; Cabinet Office statistics

Notes: <sup>1</sup> Percentage of median salary <sup>2</sup> Average percentage of salary

48. Note also that the SCS bonus pools of 4% of paybill in 2004 and 5% in 2005 (with a 2008 target of 10%) might be compared with the private sector's median target bonuses of 25%- 30% of salary or maximum of 50%-60% of salary.
49. However, it is also true that the average SCS salaries for the period, implied by the Table 5 numbers, are in the approximate range £70 – 75,000 (compared with private sector median salaries in the range £105 – 115,000; see Table 2). We therefore checked the database to see how bonuses change if we set the median salary at £70-75,000 and they range from about £13,800 to £15,000. Broadly, therefore, we can say that at directly equivalent salary levels, private sector bonuses are two or three times the size of SCS bonus payments.
50. Not only are payments much higher in the private sector, they are also more widely spread. We show in Table 6 the comparison between the percentages of the eligible populations to whom bonuses were paid in the period 2004-06.

**Table 6 - Percentage of Eligible Population Receiving Bonuses in the SCS and the Private Sector**

	Year		
	2004	2005	2006
<b>SCS (%)</b>	58.6	75.6	67.3
<b>Private Sector (%)</b>	95.1	92.5	92.7

Sources: Towers Perrin Survey of Top Executive Remuneration; Cabinet Office statistics

51. In some respects there are structural differences which might account for the far higher prevalence of payments in the private sector. For example, a member of a subsidiary board will often receive a bonus on the profitability of the subsidiary. The individual will (except in extreme cases) receive that element of the bonus even though the individual's contribution for the year might have been below par.
52. Similarly, the "one-up" principle noted above (¶15) can operate so that some bonus is received from the "one-up" element even though no bonus is earned from the performance of the individual's own part of the organisation.
53. The other differentiating factor is the SCS scheme's emphasis on *relative* performance. This would be unusual, though not unknown, in the private sector, where it is sometimes referred to as forced distribution. The extreme application of this principle would be a scheme in which the personal performance of the individuals is ranked and the bottom, say, 25% to 40% on the list simply do not receive any bonus even though, on other criteria, they might have earned one.
54. Interestingly, relative performance can become relevant in professional services firms in times both of feast and of famine, since each circumstance can involve judgements about who is to benefit most from the plenty or who is to receive a share of what little money there is. Note though that, in both circumstances, difficult judgements can be avoided by apportioning the available money *pro rata* to target values. As we understand it, this is not possible in the SCS scheme.
55. We can therefore observe that:
- the SCS scheme is, *per se*, more difficult to manage than private sector schemes because it depends entirely on judgements around personal performance which are only partially made in the private sector and it contains the element of relative performance which is also rare in the private sector, and
  - it is generally tougher in its operation, again because of the presence of relative performance and also because of the (possibly consequential) lower percentages of the eligible population who receive bonuses.
56. It would be interesting to reflect on these differences in the context of the SCS scheme's bonus levels, which are so much lower than those obtaining in the private sector.

## THE IMPACT ON PERFORMANCE

57. As far as we are aware, the private sector makes no explicit attempt to evaluate the impact of these schemes on performance. We believe that there are two reasons for this:

- bonuses based on purely financial performance normally operate on a principle which is referred to as “self-funding” or “self-financing”; these are simply labels which describe the fact that financial results are calculated *after* deducting the cost of the corresponding bonus payment; therefore the argument is that, by definition, if, for example, profits have grown by 10% after bonus costs, then performance must have improved to that extent, but
  - the substantial difficulty is that any comparison needs a *datum* line or control; in this context, the control question is, “how would the individual or organisation have performed *without* the intervention of the bonus plan?” and, as a practical matter, it is impossible to create that control; this is the fundamental problem underpinning all research into the general question of whether or not, performance related pay is effective.
58. So there seems to be an element of self-fulfilling prophecy (or self-evidence) at work here. In relation to financial performance this is manifested in the self-financing principle outlined above and for personal objectives it stems from the nature of the objectives. For example:
- if an IT Director is charged with the implementation of a new software platform which will have prescribed operational benefits, a two-year lead time and a cost of £200m and the new platform is delivered on time, to budget and to specification, there must, by definition, be a positive impact on performance; similarly
  - if a member of a management team which is tasked to improve its leadership behaviours improves the average score of a 360° feedback process from 4 to 4.25 then, clearly, behaviour must have improved.
59. Even if the general proposition of self-evidence is true, the proposition is only as strong as the operational data underlying it; a robust, tried and tested 360° feedback process, customer or employee satisfaction surveys are examples.
60. But the central imponderables in assessing the impact of annual bonus schemes on performance remain:
- the lack of a control for comparison purposes, and
  - the difficulty of judging performance relative to circumstances.
61. If we take the example of the business which grows profits by 10% (157) and accept that this constitutes a real performance improvement but suppose that the market grew by 15%, how, then, is the performance to be assessed? Or perhaps, in the following year, profits grow by only 5%; still an improvement but less good than the prior year. But now suppose that, in that second year, the market *declined* by 2%.
62. Which of the two years’ performances is better seems self evident but the open question would be whether the corresponding bonus scheme succeeds in providing rewards which reflect that reality and, by extension, whether the bonus scheme had any impact at all on the superior year two outcome.
63. In general then, we are left with the observation that, in the private sector, the impact of annual bonus plans on performance is taken to be self-evident or is accepted as an act of faith. In view of the central position of annual bonuses in private sector pay structures, this observation too seems unsurprising.

## ASSESSING THE SCS SCHEME

64. What is the purpose of a bonus scheme? Is it:

- a communications activity designed to change or reinforce behaviour and/or improve performance?
- a variable part of the pay structure which is managed to link costs to performance and/or affordability?
- or perhaps, in the SCS's case, simply the provision of an element of pay which is widespread in the competitive market (but which does not seem to flow naturally from the culture of the SCS or the work that it does)?

65. As we have already noted (¶157), any structured attempt to assess the impact of a bonus scheme on performance must fail because it is impossible to know how the individual or the organisation would have performed without the bonus scheme.

66. We conclude therefore, that the impact of a bonus scheme can only be assessed on its own terms and that this assessment will involve more judgement than empirical analysis. This is our conclusion as to how, *de facto*, the private sector assesses its schemes.

67. In our experience, schemes which might properly be called *incentive* schemes involve very sharp focus on a very few (often only one) objectives, a high degree of risk of failure and correspondingly high potential rewards. They are also often confined to small, tightly knit teams. They are, arguably, most often found in companies which have been the subject of management or private equity buyouts when a few individuals have invested their own assets and may sacrifice some immediate pay in the hope (or expectation) of substantial capital gain over a defined period (*ie* to the point where the business is sold or listed).

68. In these terms, all of the practice we have described in this paper and the SCS scheme itself, relates to schemes which form a managed and variable part of the pay structure.

69. If this analysis is correct, then the impact of the SCS scheme will be assessed against the criteria which are set for it. We do not have any detail about the operation of the SCS scheme or, rather, how the principles outlined above are operationalised and so cannot make specific observations but the following general points seem to follow from our remarks:

- the bases or data on or against which SCS performance (however defined) is assessed must be sufficiently robust to inspire confidence that the corresponding judgements are sound;
- the process for establishing priority business objectives must produce clear and, ideally, quantifiable objectives which might be capable of valid amendment in case of change of circumstances;
- simple matters, such as the numbers of objectives set, ought to allow clear focus by the individual, and
- taken together, the preceding points ought to allow a robust assessment of the individual's record over the year and a corresponding degree of confidence that there has been an impact on performance.

70. However, we think that the two other standards set for the SCS scheme (relative stretch and response to unforeseen events) are very difficult to manage.
71. It seems to us that assessing relative stretch and ensuring consistency of application across departments can only be done by the exercise of the nicest judgement and we can only observe that the supporting process would need to be correspondingly high quality if participants are to be confident in its outcomes.
72. Similarly, we think that responsiveness is a wholly subjective characteristic which is further dependent on the circumstances in which it is assessed and the standards applied by the assessors. We do not know how the SCS assesses responsiveness but anticipate that some form of consistently applied peer review would help. This is another example where confidence in the underlying data or process seems critical to acceptance. As we noted earlier (¶22), in the private sector, an individual's response to changed circumstances generally forms part of a discretionary assessment.
73. It seems to us that, in the context of the SCS scheme, the impact on performance also comprehends the impact on behaviour. There are two aspects to this both of which are functions of the impact of relative performance.
- It would be easy (not to say trite) to dismiss the bonus levels in the SCS as uncompetitive or irrelevant but we do not think that this is the whole story. In the context of average bonuses of 7% of salary, a percentage point or two of variation (either way) from expectation could be highly motivating or demotivating. Similarly, comparisons with colleagues might have a disproportionate effect on individuals' perceptions of the respective values to the organisation. So we do not think that the amounts necessarily affect participants' perceptions of value.
  - The apparently simple requirement to assess performance relative to others is, as we have already noted, a tough requirement by private sector norms, the more so because a relatively high proportion of the SCS do not receive a bonus (it is simpler, we think, to communicate that an individual is one of the top 5% (with a bonus) or bottom 5% (without one) because the distinctions are so clear). Therefore we do wonder about the motivational impact on individuals of being told that they are not to receive a bonus so that, by necessary implication (see Table 6) they are in the bottom performing 25% to 33% of the SCS.
74. The final observation we can make, therefore, is that the impact (on performance and /or behaviour) of the SCS bonus scheme may depend on a clear view about its purpose.
- If the idea is to provide, as far as is practical within the constraints of the Service, a simulacrum of private sector competitive practice, then it would be easy to criticise the scheme for providing too little reward for far too much effort and with some risk that the outcome is motivationally dysfunctional.
  - But we think there is another way of looking at this issue. The SCS reward system operates within tightly regulated salary scales, even though there is a system of merit awards. It seems to us that, while 10% of paybill (the treasury's long term target) may not be a large bonus pool, it is a perfectly adequate merit pool.

(For the avoidance of doubt, by bonus pool we mean a relatively large amount available for distribution against the achievement of short term operational objectives. A merit pool is a relatively smaller amount available for distribution to those who have increased their long term value to the organisation. Generally, merit pools are applied to salaries (or to salary increases) but there is no reason why, as we suggest here, the idea should not be applied to non-consolidated, non-pensionable bonus payments.)

75. We have already observed (¶143) the subtle distinctions in the SCS system between bonus criteria and salary increase criteria but perhaps these distinctions are not of great importance. We wonder if the better view of the SCS bonus scheme is that its real purpose is, or ought to be, to provide bonuses to those individuals who simply perform better in their jobs.
76. This would reduce the emphasis on the concepts either of exceeding the requirements of the job or of improving the performance of the organisation. The practical manifestation of both of these concepts is hard enough to assess in the relatively clear cut environment of the private sector and it seems quite impractical in the context of the Service. (To apply the *reductio ad absurdum*, consider the idea that one individual or team could change the overall performance of a single Department of State, let alone the Service as a whole.)
77. In the light of some of the subtle differences and difficult ideas the SCS bonus scheme tries to incorporate, we wonder if it has been established with sufficient clarity about its purpose or objectives. We think that, perhaps, reframing the objective for the SCS scheme in the way we have suggested (¶175) might take pressure off the assessment of outcomes which, in the context of the Service, may be incapable of assessment, while retaining the justification for variable payments.

## Annex A

### Towers Perrin survey of Top Executive Remuneration

#### 2006 PARTICIPANT LIST

Abbey	Experian	Old Mutual	Unilever
AEGON UK	FKI	Orange	United Business Media
Aggreko	Friends Provident	O2	Viridian
Alliance & Leicester	Fujitsu Services	Pearl Group	Visa International
Allianz Cornhill	Gallaher	Pearson	Vodafone
Amec	GE Healthcare	Pilkington	Whitbread
American Express	George Wimpey	Premier Farnell	William Hill
Anglo American	GKN	Prudential	Willis Group Holdings
Arla Foods	GlaxoSmithKline	Rank	Wilson Bowden
Asda	Group 4 Securicor	Reckitt Benckiser	Winterthur Life UK
Associated British Foods	GUS	Reed Elsevier	Wolseley
AstraZeneca	HBOS	Rentokil Initial	Woolworths
Aviva	Hendersons	Reuters	WPP Group
AXA	HMV	Rexam	Xansa plc
BAA	HSBC Holdings	RHM	Xstrata
BAe Systems	ICI	Rio Tinto	Yell Group
Bank of Ireland	Imperial Tobacco	Rolls-Royce	ZZ Top Exec Financial Services
Barclays Plc	Inchcape	Royal Bank of Scotland Group	
BG	ING Direct	Royal Mail	
BHP Billiton	Inmarsat	Royal & Sun Alliance	
BNFL	Intercontinental Hotels	RWE npower	
BOC Group	International Power	RWE Thames Water	
Boots	Invensys	SAB Miller	
BP	ITV	Sage Group	
British Airways	John Lewis Partnership	Scottish & Newcastle	
British American Tobacco	J Sainsbury	Scottish Power	
British Energy	Kesa	Scottish & Southern Energy	
British Sky Broadcasting	Kingfisher	Serco Group	
Britvic	Land Securities	Shell	
BT	Legal & General Group	Shire	
BUPA	Lend Lease	Signet	
Burberry	Littlewoods	Skandia International	
Cable & Wireless	Lloyds TSB	Smith & Nephew	
Cadbury Schweppes	London Stock Exchange	Smiths Group	
Cambridge Silicon Radio	Lonmin	Standard Chartered Bank	
Capital One UK	Marks & Spencer	Standard Life	
Centrica	Meggitt	Stora Enso	
Chubb Insurance	MFI	Tate & Lyle	
Colt Telecommunications	Misys Banking Systems	Taylor Woodrow	
Computacenter	Mitchells and Butlers	Tesco	
Co-operative Group	National Air Traffic Services	Three	
Corus	National Grid	3i	
Diageo	Nationwide Building Society	Thus	
DSG	Network Rail	Tomkins	
EasyJet	Next		
Easynet			
Euronext			

**Annex B****European Annual Incentive Plan Design Survey (2004)****PARTICIPANT LIST**

3i	British American Tobacco	Etex
ABN Amro	British Energy	Euroclear
Actis	Buhrmann	Exel
ACTS	BUPA	F. Hoffmann-La Roche
Agfa Gevaert	Centrica	Faurecia
Aggreko	CEPSA	Ferrovie dello Stato
AHOLD	Ciba Specialty Chemicals	FöreningsSparbanken
AIR LIQUIDE	Cognis Deutschland	Gambro
AKZO Nobel	Colruyt	GAS NATURAL
Allianz	Comdirect Bank	GETRAG FORD Transmissions
ALTANA	Commerzbank	Getronics
AMEC	Credit Suisse Group	Gruppo Banca Nazionale del Lavoro
AstraZeneca	DaimlerChrysler	GSK
Autogrill	DDOHG/DDI und Dow	Gus/Wehkamp
Autostrade per l'Italia	Olefinverbund	Hagemeyer
Aventis Pharma Deutschland	De La Rue	Heidelberger Druckmaschinen
Aviva	Dell Germany	HEINEKEN
AWD Holding	Deutsche Bahn	Henkel KgaA
Banque Cantonale Vaudoise	Deutsche Lufthansa	HHG
Barclays Bank	Deutsche Post	HMV Group
Baxter	Deutsche Telekom	Hochtief
Bayer	Diageo	HSBC
Bayerische Hypo- und Vereinsbank	Draka Holding	IBERDROLA
BBVA	Dresdner Bank	ICI
Bekaert	DSM	IKB
Belgacom	DVB Bank	Infineum International
Benetton Group	Dyckerhoff	ING Groep
Berentzen-Gruppe	DZ Bank	Interbrew
BG Group	E.ON	Intercontinental Hotels Group
BMC Software	EDS	ITV
Bombardier Transportations	Electrolux	IVG Immobilien
Bradford & Bingley	ENDESA	J Sainsbury
	Enel	
	Ericsson	KBC

Cont'd..

## **Annex B**

### **European Annual Incentive Plan Design Survey (2004)**

#### **PARTICIPANT LIST**

Koninklijke Wegener	Reckitt Benckiser	Talkline
LA CAIXA	Reed Elsevier	Tate & Lyle
LAFARGE	REPSOL	Taylor Woodrow
Laurus	Reuters	Tchibo Holding
Leaseplan Corporation	Rolls Royce	TELEFÓNICA
Legal & General Group	RWE	Telekom Austria (wireline)
Leoni	Saab	Telewest
Linde	SABMiller	TeliaSonera
Lonza	Sandvik	The Big Food Group
Lycos Europe	SAS	The BOC Group
M J Gleeson Group	SCH	Thiel Logistik
Manor	Schering	Thus Group
Marconi	Scottish & Newcastle	TNS
Marks & Spencer	Scottish Power	TOTAL
Metro Cash & Carry	SEB	TOWER Automotive
Mitchells & Butlers	Serono	Trelleborg
mmO2	SGL Carbon	UBS
Mobilcom	Shell	UCB
National Grid Transco	Skandia	Umicore
NCR Corporation	SKF	Unilever
Nestlé	Software	Unisys
Network Rail	Sol Meliá	Visteon
Nortel Networks Germany	Solvay	Viterra
Novartis International	Somerfield Stores	Vodafone
Numico	Spirent	Volvo Car
Nutreco	Standard Chartered	Vopak
Pearson	Stefanel	Wind Telecomunicazioni
Philips	StoraEnso	Wolseley
PINAULT PRINTEMPS-	Suez	WPP
REDOUTE	Swedish Match	Zapf Creation
Pirelli&C	Swift	Zurich Financial Services
PON Holdings	Swisscom	
RAG	Syngenta	
RAG Coal International		