

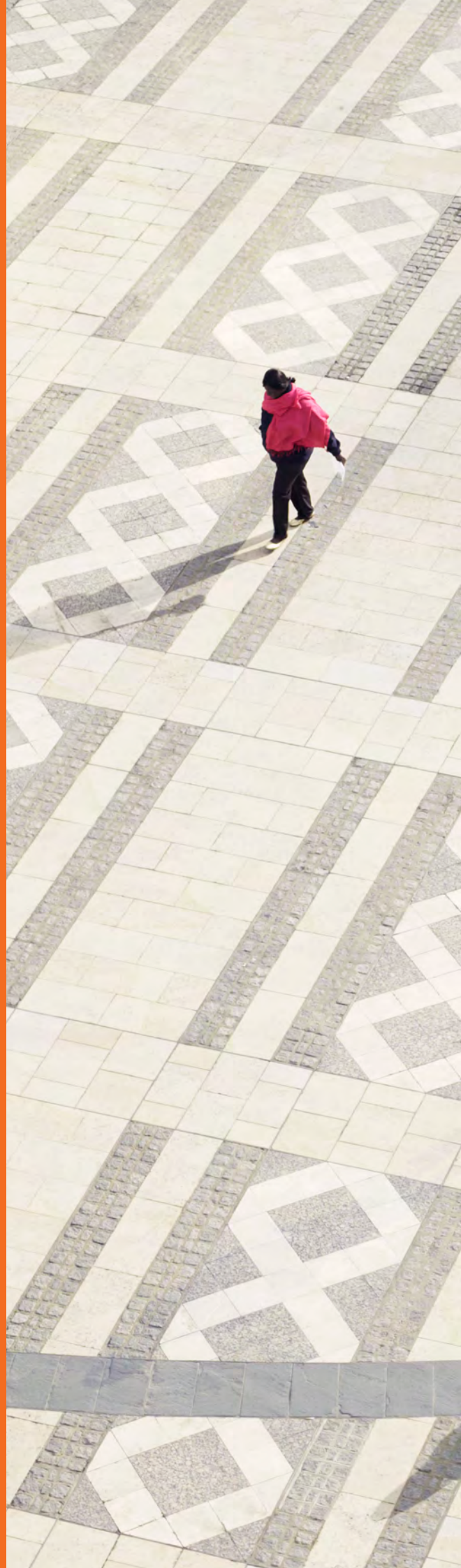
What are you really paying for?

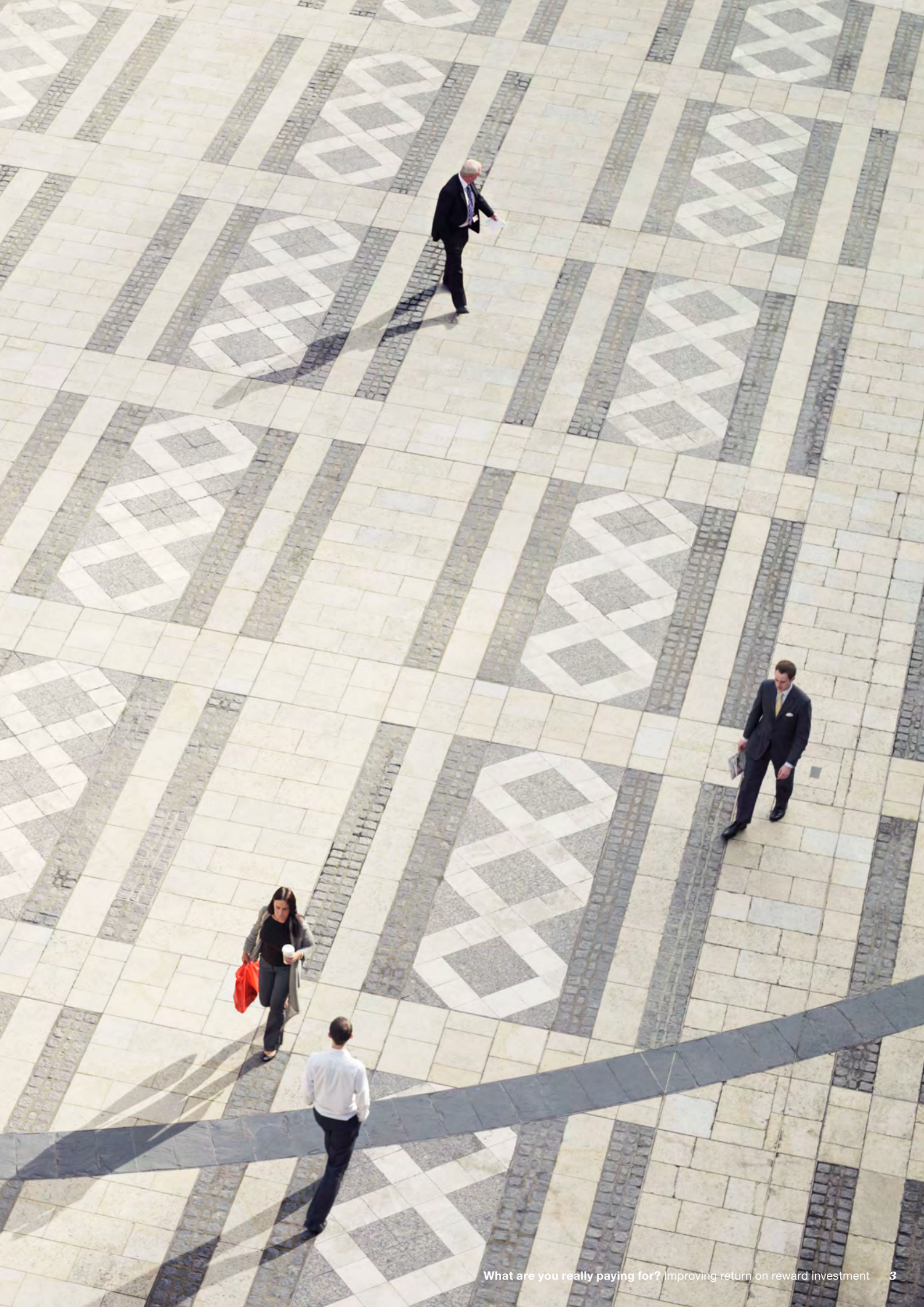
Improving return on reward investment

*A study into how
organisations can improve
return on incentive plans
July 2014*



“Our hope is that this research helps you to design incentives which are smarter, not higher”





About our study

1,009

participants

1,009 participants took part in the study, 57% of who were male and 43% female. Participants were approximately evenly spread over Baby Boomer (born 1940 – 1969), Gen X (born 1970 – 1979) and Gen Y (born 1980 – 1995) generational profiles.

19% of participants were from executive level roles, 45% from senior manager roles, and others from middle management or more junior level positions. A range of industries were represented in the sample with the largest representations in the financial services, EUM (energy, utilities & mining) and telecommunications industries.

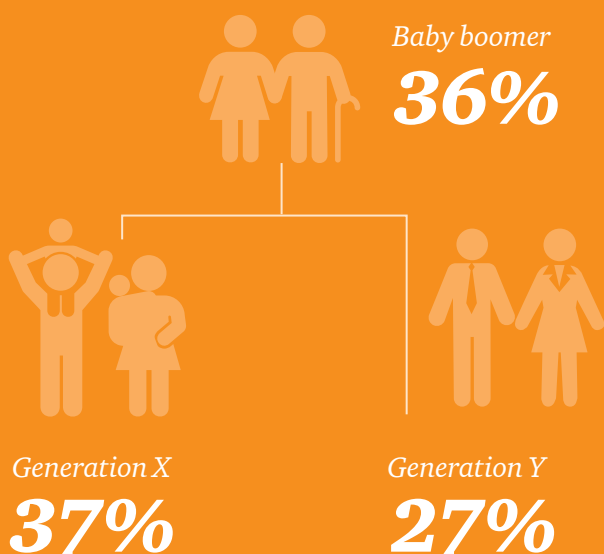
Participants by gender



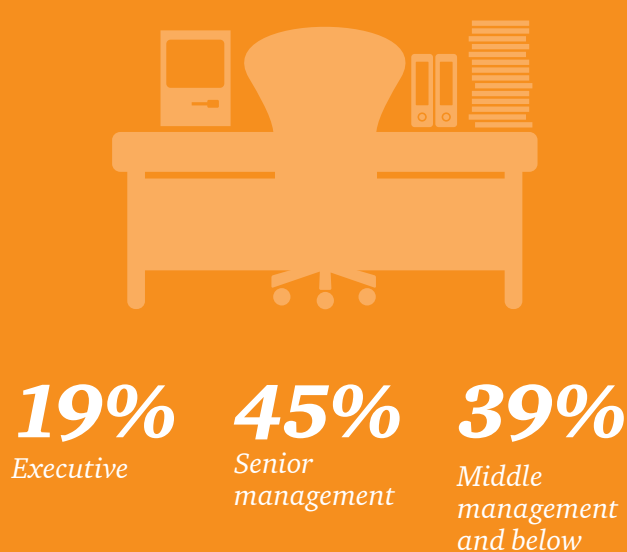
57% Male

Female **43%**

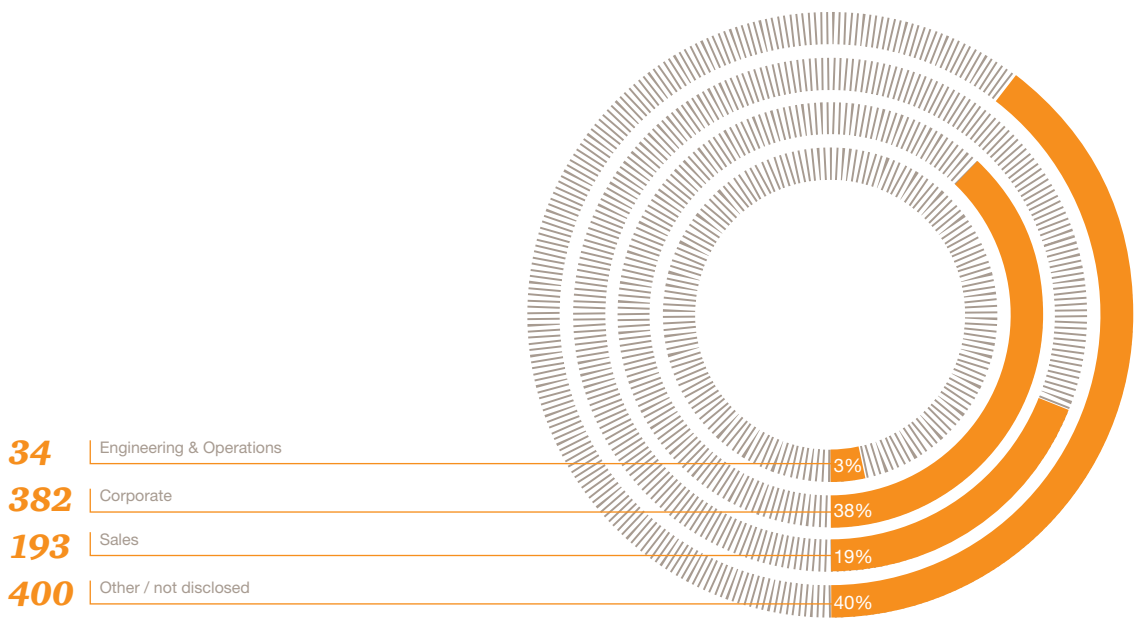
Participants by generation



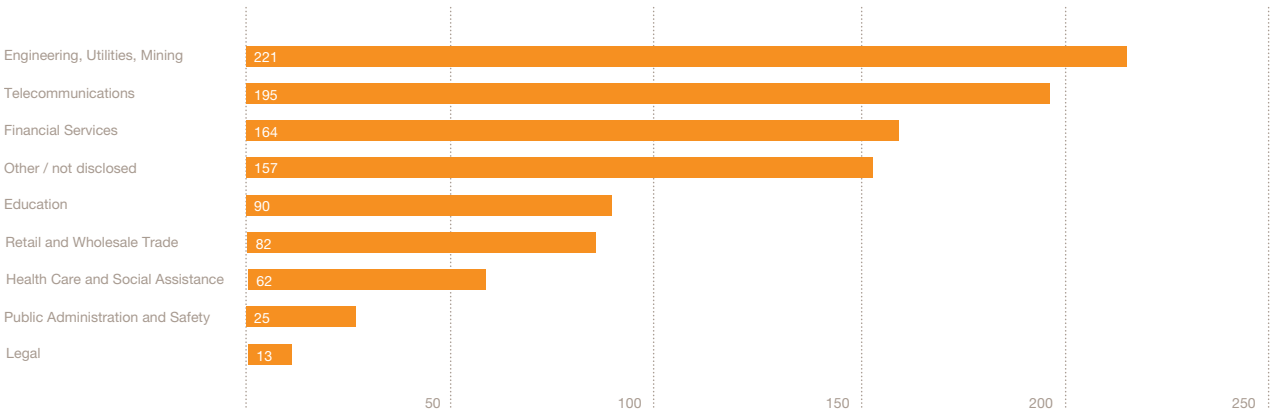
Participants by seniority



Participants by role type

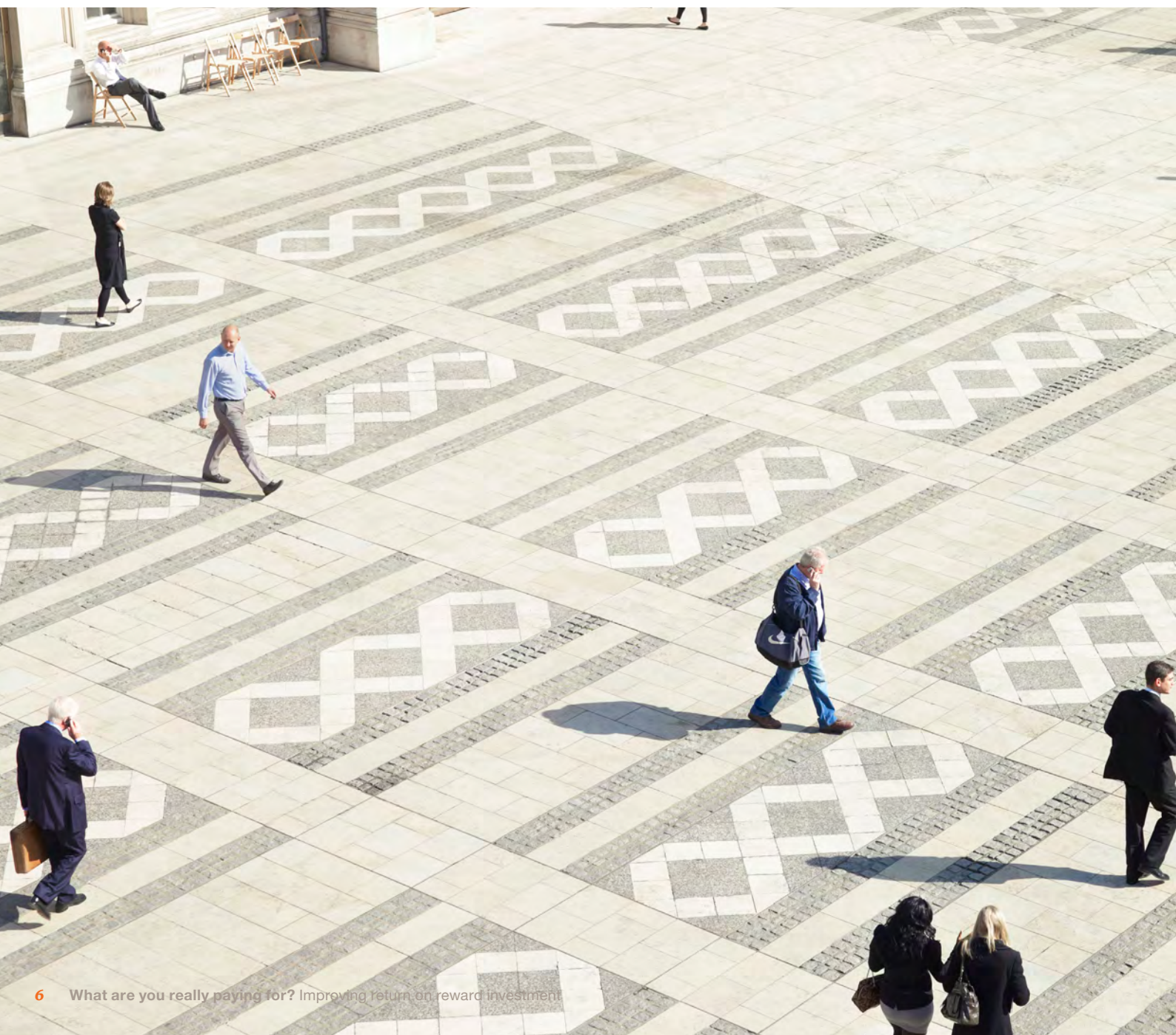


Participants by industry



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Organisations have always been highly focused on the return that they are getting from their reward spend. But over recent years we have heard the tone of the conversation change.

We are hearing a new degree of scepticism, and a concern that an ever increasing reward spend may not be having the motivational impact on our staff we thought it would.

Much of this scepticism is being driven by a small number of highly publicised studies. Most of us have now heard stories, read books or seen headlines telling us that bonuses don't improve performance, or even that they will lead to lower performance.

My concern is that we are in need of some balance in this debate. For example; for much of the evidence we are hearing, there is often equally robust but less popular counter evidence. Also, there are some unanswered questions on how relevant these studies are to the complex real world environments we work in.

Having said that, we shouldn't dismiss these messages too quickly. The emerging messages may very well be important. But we need to find the signal in the noise. We need practical solutions which are relevant in the business world. We need incentives that work in a world where jobs are increasingly complex.

We are excited and proud to present a unique contribution to this debate. We have recognised the need for additional research that explores and tests the more popular emerging messages in a way that better balances research rigour and industry relevance.

Our results show that incentive pay is likely to boost effort/motivation but only under certain conditions, and to varying degrees depending on industry, demographics and seniority.

We believe a more nuanced view of reward that is better aligned to employee behaviour, can result in a greater return on incentive spend.

My hope is that this research helps you to move the discussion forward in a way that is relevant to your organisation, and helps you to design incentives which are smarter, not higher.

Emma Grogan

Executive summary



Keep it simple through fewer metrics and less ambiguity

Focus team-based incentives on small, familiar teams

Caps and decelerating bonus payments should be used sparingly

Money is only one part of the deal – but an important one. Get it right

Reward personalisation may not be worth the added cost or complexity

Same perceived value

Higher rewards spend

- Employees required up to 18% higher pay when pay was subject to more uncertainty, ambiguity or complexity.
- Most employees were not motivated by team bonuses when the team size exceeded 5.
- Employees required 19% higher bonuses when their team mates were unfamiliar to them.
- About half would pick up the slack for free riding team mates if there were incremental bonuses available.

- 41% of employees would stop working around bonus caps.
- 29% continue to work beyond the cap for better results.
- Employees can view caps as a signal of acceptable or maximum performance.

- Employees were willing to take an 11% pay cut for their ideal job, 9% to have the ultimate work/life balance, and 6% for the ideal manager.
- Surprisingly, the value that employees placed on non-financial aspects was not overly significant. Pay is still a critical lever.

- Differences in incentive preference by industry, employee profile and role type were not as pronounced as we might think.

Lower rewards spend

- Use at-risk rewards and discretion only where absolutely necessary. Wherever possible, clearly define performance expectations to minimise ambiguity. When considering more than a few metrics, be sure the gains from specificity will offset any costs caused by the added complexity.

- Measure performance at the individual or small team level where possible, and allow familiar colleagues to form teams to increase motivational value. Team bonus structures can counteract the effects of free-riding, but free-riding should still be addressed quickly to avoid longer term negative team response.

- When using caps and differential bonus rates to be fiscally responsible, organisations need to be aware of the opportunity cost of lost incremental performance. Caps should be used sparingly and only where there is a real threat of overpayment.

- Employees will trade off financial rewards for more intrinsically motivating roles, better leaders and more flexible working arrangements. However, stated amounts are typically less than 10% of total remuneration. Ensure that financial incentives are appropriately designed for equal, if not bigger, impact.

- Any efforts to tailor incentive plans should carefully weigh the benefits against associated incremental costs. Tailoring should be based on evidence rather than intuition, as the perceived value of tailoring is often overplayed. Prioritise tailoring efforts rather than trying to achieve ideal conditions for all groups.

A new approach to researching reward

A richer debate

In recent years the debate over the effectiveness of incentive design has become increasingly sophisticated, incorporating much scepticism about the connection between traditional designs and employee performance¹.

A key catalyst for the debate has been a relatively small number of prominent and topical studies that have attracted strong interest from our business leaders and remuneration practitioners.

For example, we are increasingly being told of “the surprising truth about what motivates us”², that our employees are “predictably irrational”³ or are yearning for a “4 hour work week”⁴ rather than more pay.

Other academic research shows evidence of people sacrificing their own payoffs to punish free-riding team members⁵, decision-makers struggling with complex payoff structures⁶, situations where less pay leads to better outcomes⁷, employees who stop working at arbitrary wage thresholds⁸, and even backfiring bonuses⁹.

With incentives being such a significant proportion of the cost base for many organisations, it is no wonder leaders are paying attention.

More talk, but where is the action?

While the discussion is encouraging, action has not kept pace with the rhetoric. Many simply continue to look to popular industry templates, or just keep tinkering with last year’s model. Or worse, when things aren’t working, companies respond with more (or less) dollars, and more complex variations of old approaches. We put this down to four factors:

- Fear of losing key talent when operating outside industry norms
- Difficulty converting new insights into practice
- Confusion regarding the evidence given equally compelling counter-evidence
- A concern that the insights might not translate to our specific operating environments.

As a result, there has been limited innovation in performance-based pay frameworks and, arguably, more complexity.

1 PwC The Psychology of Incentives (2012)

2 Dan Pink – Drive (2011)

3 Dan Ariely – Predictably Irrational (2008)

4 Timothy Ferriss – The 4-Hour Work Week (2007)

5 Fehr & Gächter (2000) – Cooperation and Punishment in Public Goods Experiments

6 Camerer & Hogarth (1999) – The Effects of Financial Incentives in Experiments

7 Gneezy and Rustichini (2000) – Pay Enough or Don’t Pay at All

8 Camerer et al. (1997) – Labor Supply of New York City Cab Drivers: One Day at a Time

9 Ariely et al. (2005) – Large stakes and big mistakes

“Design remuneration that is more closely aligned to the behaviours of our modern workforce without sacrificing performance”



Taking action

This report takes a close look at the more popular and important challenges to traditional performance-based pay approaches, and offers ideas for putting insights into action. Our findings are presented within five overarching themes:

- 1** *Simple and certain is valued most*
- 2** *Team-based incentives only work under certain circumstances*
- 3** *Incentive mechanics provide a strong signal – be careful what you pay for*
- 4** *People don't only work for money—but money is important*
- 5** *The evidence to justify reward personalisation is not strong*

A unique research approach

We developed a unique scenario-based survey design that borrowed elements from robust research methods, but which were framed in real-world industry situations.

Respondents were ‘real employees’ rather than university or focus group subjects, and were sourced from a range of industries, demographic profiles and role types. Rather than using basic survey style questions, most questions asked for dollar trade-offs, to enable us to assess both the direction and materiality of employee preferences.

Generally speaking, the results tell us that incentives do matter, but in complex ways. We provide evidence of the potential costs associated with alternative incentive designs, and evidence of how demographic, industry and role types might make these lessons relevant (or not) for your organisation.

More from less?

It is our hope that this study will help remuneration practitioners and business leaders to apply the most important emerging insights in ways that are relevant to their specific industry and employee populations.

By doing this, we can design remuneration that is more closely aligned to the behaviours of our modern workforces, without sacrificing performance.

Simple and certain is valued most by participants

Many organisations use ‘at-risk’ rewards, designed with management discretion, multiple metrics and complex mechanics. Yet all of these features seemingly destroy value in the eyes of the employee. Could we better align rewards to employee preferences to deliver more motivational value at less cost?

Many employees have a component of their pay that is variable.

The outcome of this component for the employee is usually based on some mix of market risk, role-related metrics and manager discretion.

We posed three different scenario based questions to understand the potential costs of using these common determinants.

The value of certainty

Your fixed pay is reduced by 10% (equivalent to \$10,000 in this scenario) and is replaced by a bonus. There is a 99% chance that you will get the bonus in full, and a 1% chance that you will get no bonus at all.

To be equally motivated, I would need this bonus to be approximately \$_____.

Our results showed just how sensitive employees are to the introduction of risk in their pay, and the value they place on certainty, validating similar results from earlier studies.

We found that employees require a bonus of about \$15,000 to compensate for a loss of \$10,000 in fixed pay—even when the bonus has a 99% chance of being paid in full. This is significant if we consider that the risk-neutral employee should only require \$10,100 to be equally motivated.

Males required more (\$15,600) than females (\$14,000)—implying males are more risk averse.

Risk preference was not overly sensitive to role seniority or employee generation.

Aversion to discretion

You are offered a bonus to replace the loss of \$10,000 in fixed pay (10%). How much would you need to be equally motivated if the bonus was:

- *based completely on your input over the year (measured objectively, eg number of calls you have made to customers); or*
 - *based on your manager’s perception of how you have performed over the year.*
-

Our results also showed that employees generally required more in bonuses when management discretion was used to determine bonus outcomes, rather than input or effort based measures.

The compensating amount required for the input based bonus was \$16,800, while the compensating amount under the discretionary bonus was \$19,900 – representing an 18% premium when discretion is used.

Gen Y employees were most sensitive to the use of management discretion in bonus determination, requiring bonuses 21% higher, compared with Gen X (19%), and Baby Boomer (16%) counterparts.

Male employees were also more sensitive to the difference, requiring bonuses 20% higher, compared with females who required bonuses that were 16% higher.

Sensitivity to complexity

Your fixed pay is reduced by \$10,000 (10%). It is to be replaced by one of three bonuses. Either, a bonus determined by:

- *the result of 1 metric; or*
- *the combined result of 4 metrics; or*
- *the combined result of 10 metrics.*

Each metric is equally weighted towards your bonus outcome and you have the same ability to influence the outcome of each metric (ie 80% controllable).

How much would you require under each bonus to be as equally motivated as you were before the reduction in fixed pay?

With regards to number of metrics used to determine bonus outcomes, respondents across all levels showed a disproportionate sensitivity to plans that included 10 metrics.

Compared with the single metric bonus, respondents only required a 5% premium for a 4-metric plan, but a substantial 18% premium for the 10 metric plan.

This was particularly pronounced for Gen X employees, who required a 21% premium to maintain the same levels of motivation under a bonus based on 10 metrics.



Employees require a bonus equivalent to 15% of fixed pay to compensate for a loss of 10% in fixed pay—even when the bonus has a 99% chance of being paid in full.



Employees require bonuses that are 18% higher when the bonus outcome is based on management discretion rather than an objective effort based metric.



Employees require bonuses that are 18% higher when the bonus outcome is based on 10 metrics rather than 1 metric.

“Employees require significantly higher bonuses when management direction is used”



Insights to action

- *Employees are generally risk-averse. Where the inclusion of at-risk components are less necessary, offer more certainty in pay.*
- *Use discretion sparingly within an incentive plan, and if possible, be clear on how discretion may be used.*
- *Invest the time upfront in determining the metrics of an incentive plan and only include those which have strategic value and are critically important.*

Team-based incentives only work under certain circumstances

Team based bonuses are used in many organisations to align employee efforts and encourage collaboration. But what does an effective team-based bonus look like? Does it matter how many employees are in the team and who makes up the team? How will incentives affect efforts when team members are seen to free-ride at their colleagues' expense?

“Participants are sensitive to the familiarity of their team members”

Team, business unit, office and even company level shared bonus arrangements are commonly used to align behaviours and encourage collaboration in organisations.

We investigated two important design considerations that could impact on the motivational effectiveness of team-based rewards: team size; and team composition.

We were also interested to know how employees would respond to the presence of free-riding behaviours in their team when team-based bonuses were at stake, which is often an argument put forward against team metrics.

Maximum team size

Imagine your bonus is determined by the outcome of a team, and fill in the blank:

“If my bonus was determined by the outcome of a team, I would be somewhat motivated by the bonus up to a team size of about _____, but would not be motivated by the bonus if the team was any larger than this”.

We found that most (60%) employees would stop being motivated by team-based bonuses once team size surpassed 5. Almost 90% of respondents said they would lose motivation when their team size surpassed 10 employees.

These thresholds are significantly smaller than the team sizes currently being rewarded in the majority of incentive arrangements, presenting an important challenge to these plans.

Defining teams to be most motivating

Imagine that your fixed remuneration is reduced by 10%. It is replaced by a bonus. The bonus is to be based on one of two collective performance outcomes of:

- *you and 5 colleagues you have not met*
- *you and 5 colleagues you know well*

How much would you require under each bonus to be as equally motivated as you were before the reduction in fixed pay

Across all groups, participants were sensitive to the familiarity of their team members, requiring a 19% premium to their bonuses on average for equal motivational value. This varied little regardless of gender or generation.

We also explored the impact of team-based bonuses when team members witness free-riding behaviours from their team members.

Free-rider response

You are part of a two person team. There is a bonus available based on the overall result of the team, and you both will share equally in the result. Last year you both worked equally hard and achieved the maximum bonus available. This year your colleague has significantly reduced efforts, requiring a decision from you to either:

- increase efforts beyond what you did last year to compensate for your colleague's decision, and maximise your bonus; or
- reduce efforts towards that of your team mate, resulting in a lower bonus

Remember you will share equally in the bonus result which is based on overall team effort.

Encouragingly, more than half (53%) of employees would increase their effort despite the fact that the free-riding colleague would equally benefit from this decision.

While some participants recognised that colleagues may have a legitimate reason to reduce efforts, a significant proportion stated that the bonus was the driving factor in their decision to work harder.

Females and older generation employees were more likely to decrease efforts in response to free-riding team mates. It was clear that fairness concerns were overriding any focus on incremental bonus for many of these employees.



More than half (53%) of employees would increase their effort regardless of the fact that a 'free-riding' colleague would also benefit from their additional efforts.



To be equally motivating, bonuses based on teams comprising unfamiliar colleagues need to be 19% higher than those based on teams comprising familiar colleagues.

“While the weighting is unfair, why would you not go for maximum benefit to your bank account?”

“The project needs to be completed no matter how many weeks are worked each. It may happen that one year the tables will be turned”

Response from participants who increased effort

Insights to action

- Where possible, reduce the number of employees in shared bonus arrangements by carefully considering for which employees collaboration is most critical.
- Allow familiar colleagues to work together where possible, or foster opportunities for colleagues to become more familiar with each other.
- Free-riding is inevitable. Structure bonuses to promote strong team performance and collaboration when contributions are mixed and confront lower performers early and frequently.

Incentive mechanics provide a strong signal – be careful what you pay for

While recent research has implied that bonuses don't work, in our study a significant proportion of employees responded to signals in a hypothetical incentive structures, such as were caps on incentive payments and bonus rates.

Incentive 'mechanics' such as changing bonus rates, thresholds and caps are common to many incentive plans. The rationale driving such design decisions is complex and multi-level.

To enable organisations to better inform such design decisions, we explored two questions:

- How would employees respond to a bonus cap when additional performance outcomes were still available (but would not be financially rewarded)?
- What impact would diminishing incremental rewards have on effort?

In a scenario based approach, we asked respondents to consider how much additional effort they would apply when their bonus rate was diminishing and capped, and when incremental company outcomes (ie customer satisfaction in this example) were directly related to effort.

A hypothetical bonus structure

You have been asked to contribute between 0 and 150 minutes of additional work each week over the year.

A bonus is available which will increase at a diminishing rate, and which will cap out at 90 minutes per week extra effort.

Outcomes which are important to the organisation (ie customer satisfaction) will increase with your efforts at a constant rate.

Outcomes available will reach a maximum at 150 minutes of additional work each week.

How much extra effort per week would you contribute over the year given this bonus structure?

In the results we saw two prominent spikes in behaviour. The larger spike was at the maximum levels of effort (and company outcome), indicating a large proportion (29%) of employees were willing to apply maximum effort despite the absence of incremental bonus payments.

The second spike representing 24% of respondents was at the point of the bonus cap, suggesting that this group of respondents were more focused on financial rules which had been communicated to them.

A third smaller group (17%) said that they would stop working at 60 minutes. Qualitative responses suggested that this was often related to the trivial incremental pay available beyond this point, and that 60 minutes per week was simply 'enough' of an additional contribution.

It is worth noting that the pattern of effort did not neatly map to the pattern of (diminishing) bonus. Instead effort was organised around the two salient 'signal points': maximum remuneration and maximum outcome.

“Respondents’ effort patterns did not follow the bonus payment schedule but fell predominantly around these two salient ‘signal’ points”



29% of respondents would work beyond bonus caps in pursuit of maximum performance outcomes

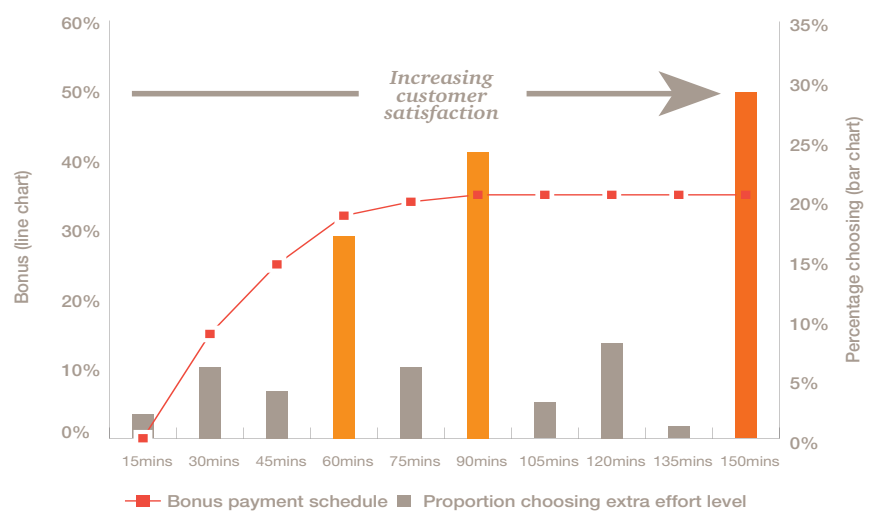


24% would stop working when they reach the bonus cap

Figure 1 – Hypothetical outcome based bonus (capped and decelerating)

Extra hard work per week	Outcome ie Customer satisfaction score	Bonus paid to you % of fixed pay
15mins	10%	0%
30mins	20%	15%
45mins	30%	25%
60mins	40%	32%
75mins	50%	34%
90mins	60%	35% (cap)
105mins	70%	35%
120mins	80%	35%
135mins	90%	35%
150mins	100% (max)	35%

Figure 2 – Stopping decision (effort) vs bonus available



Insights to action

- Be careful where you set bonus caps. Employees may view these as signals regarding the maximum effort the organisation expects. Carefully weigh the benefit achieved from fiscal responsibility against these effects.
- Be careful of maximum outcome / effort levels communicated as employees may anchor on salient messages when deciding what constitutes a normal performance level.

People don't just work for money – but money is important

We often hear that there is more to work than pay, but to what extent would employees really swap their pay for other (non-financial) benefits? Do employee groups systematically differ in this regard, or are the lessons general?

We chose three key non-financial benefits, and asked our respondents to quantify the trade-off they would accept to have access to each.

First we looked at role fit, asking employees how much fixed pay they would trade off to work in their ideal job. Secondly, we asked them what they would forgo to have the ultimate work/life balance. Finally, we asked what they would sacrifice to work under their ideal manager.

The acceptable discounts were not overly substantial, ranging between 6.0% and 10.5% – suggesting pay remains a critical aspect of the equation.

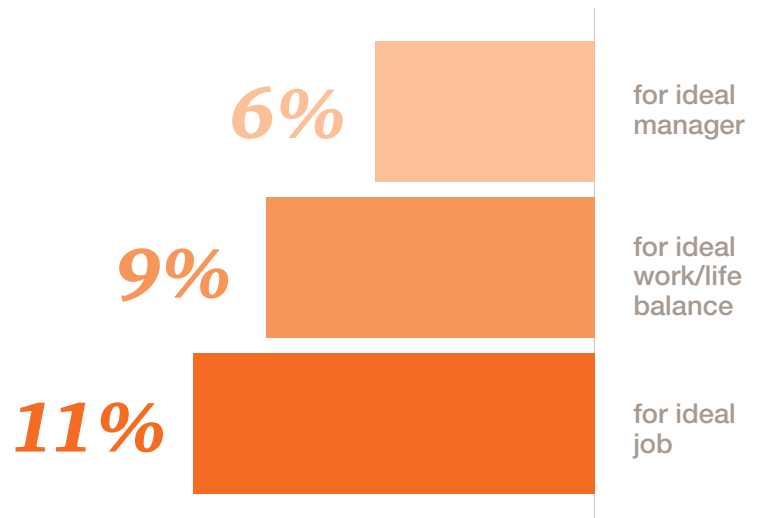
The highest levels of trade-off were for the first question, with staff willing to take an average 10.5% cut in pay to move to their ideal role. This appetite to trade pay for role increased with seniority, with executives recording a 12.0% trade-off, senior managers 10.8%, and middle managers 9.6%. Results were generally consistent across industries and gender.

Employees were also willing to accept an average reduction of 9.2% for the opportunity to have the ultimate work/life balance. Males would trade off more in this respect (9.5%) than females (8.9%). Executives were also particularly interested in swapping pay for improved worklife balance (11.2%).

The discount that employees were willing to accept for an ideal manager was smaller, but not trivial at around 6%. In this respect females were willing to accept a larger discount (6.7%) than males (5.4%). Gen Y workers were willing to trade more than their older colleagues at almost 7%, compared with Baby Boomers (5.5%) and Gen X (5.7%).

While the results confirm that employees would accept some reduction in their current remuneration to have access to better role fit, better management and more work/life balance, those reductions were not large, and did not differ substantially across employee demographics.

Figure 3 – Percentage of fixed pay participants are willing to sacrifice



Employees told us they would accept an 11% reduction in pay to move to their ideal job, a 9% cut for ideal work/life balance and a 6% reduction to work under an ideal manager.



Insights to action

- Allow for better role-matching, preferred leaders and more flexible working arrangements.
- Rather than trying to achieve ideal conditions, focus on the one or two initiatives that would provide the greatest return on employee motivation.
- Don't forget about the financial – it is still important and getting it right could return at least as much to the organisation, if not more for some employees.

The evidence to justify reward personalisation is not strong

Do employee groups have materially different preferences when it comes to incentive design? Should we tailor incentive plans to suit these groups, or at least offer choice? Given the obvious incremental costs and complexities associated with tailoring incentive programs, would the return be worth the cost?

“We found that overall, the difference between groups was not overly pronounced”

There has been some discussion over recent years about the need for tailored incentives and personalisation of rewards. Given that such initiatives come with inherent costs and risks, it is important to investigate whether any differences in preferences by employee groups are material enough to warrant attention.

Further, if there are important differences, which elements are practical and realistic to customise? We looked at preferences in fixed and variable pay, work/life balance and management discretion in pay outcomes.

Fixed or variable?

As presented in Section 1, we found that employees are generally very sensitive to a loss of certainty in pay. The results showed higher levels of risk aversion from male respondents, but patterns across industries, generations and seniority levels were similar, shining doubt on the need to tailor incentive plans for different attitudes towards fixed and variable pay.

Work/life balance

Over recent years many organisations have been investing in flexible working arrangements, often designed with specific employee groups in mind.

To investigate preferences for such programs, we asked respondents how much of their current pay they would sacrifice for the ideal work/life balance.

Executive were willing to offer the highest levels of trade-off, perhaps given more time-poor and high income work environments. Those in sales roles also offered higher sacrifice in current pay for these conditions, compared with their counterparts in corporate and Engineering & Operations roles.

But again we found that overall, the difference between groups was not overly pronounced, providing a challenge to some commonly held opinions about what our employees are truly seeking.

Management discretion

As presented in Section 1, employees will generally require more in bonus opportunities when management discretion rather than employee effort is used to determine bonus outcomes.

Unlike results related to employee risk and work/life balance preferences, this investigation yielded some important differences between respondent groups.

The results show that those in Engineering & Operations roles, Gen Y employees, male employees and executives were relatively more averse to the use of discretion in pay outcomes than other groups.

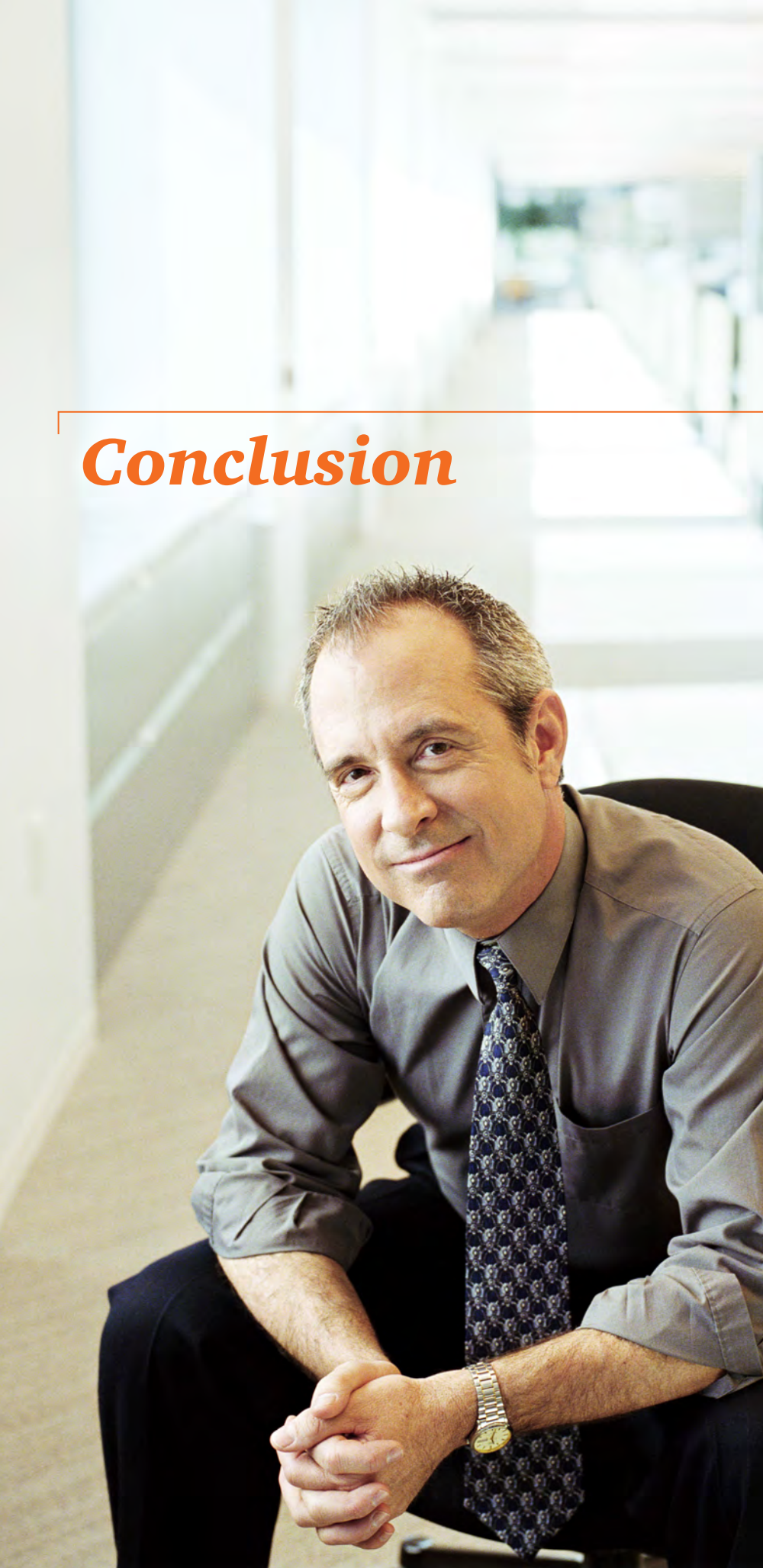
These results suggest that particular care should be taken when designing this element of incentives, and the level of management discretion applied may need to be tailored, depending on the employee groups in question.

Figure 4 – Average bonus premium required if management discretion used to determine outcome (rather than effort)

Overall	18.4%
Female	16.3%
Male	19.9%
Baby Boomer	15.9%
Gen X	19.4%
Gen Y	20.5%
Middle management and below	17.4%
Senior management	18.9%
Executive	19.9%
Engineering, utilities, mining	20.4%
Financial services	20.9%
Telecommunications	21.9%
Sales	15.5%
Corporate	21.3%
Engineering & Operations	30.4%

Insights to action

- Any efforts to tailor reward arrangements should carefully weigh the benefits against associated incremental costs and risks.
- Tailoring efforts should be based on evidence rather than intuition, and this evidence suggests that the importance of tailoring should not be overplayed.
- Prioritise any efforts on the preference differentials that matter most rather than trying to achieve ideal conditions for all groups.



Conclusion

Most remuneration practitioners and business leaders are painfully aware that there are problems with incentive pay, having read much of the topical academic, industry and pop science literature – literature that challenges what we thought we knew about incentives and employee behaviour.

But this evidence is not always helpful. Much has equally compelling but less popular counter-evidence; much of it is derived from highly simplistic industry survey methods or anecdotal evidence; much is overly generic in its findings.

Sadly, these concerns lead many to dismiss the evidence-based approaches and label insights as interesting but too difficult for practical application. As a result, many organisations either revert to familiar approaches to incentive design or just follow industry norms. Even worse, some simply increase the amount being paid under existing sub-optimal incentive structures in the hope they will come good.

But too much is at stake, both for our employees' workplace well-being and motivation, and for our organisations' return on investment.

PwC's research method was developed to take the discussion forward, to explore the interesting and important evidence in more relevant ways, and to create actionable insights.

For those that apply these insights, the ultimate result is either lower overall remuneration spend for comparable levels of staff motivation, or higher levels of staff motivation and performance from our current wage bill.

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