

# DIRECTORS' BRIEFING



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## Incentive pay

● Productivity and high standards are important to you. Recognition and encouragement are important to employees. Incentive pay is a way for you and your employees to achieve results.

A good incentive pay scheme can motivate employees to work better for your business. A badly thought-out scheme, on the other hand, can be divisive and demoralising.

This briefing explains:

- ◆ How to set objectives.
- ◆ The types of scheme to consider.
- ◆ How to ensure your scheme works.

### 1 Setting objectives

Design your incentive pay scheme to achieve specific objectives.

Your targets should be 'SMART' (specific, measurable, achievable, realistic, time-limited).

- A** Decide what **business results** you want to achieve. For example:
- ◆ Hitting a certain sales target during a sales campaign for a new product.
  - ◆ Specific improvements in customer service.

Targets should be challenging — but not impossible — to achieve. Aim for a marked improvement in performance.

You need to be confident that the benefits of the scheme will outweigh its costs.

- B** Decide **which employees** should take part. For example:
- ◆ A specific group of employees, such as the sales team, whose work directly influences the result you are aiming for.

- ◆ The management team, so you can retain the key individuals your business needs.
- ◆ All employees, to raise general productivity and morale in the business.

If you only reward one group of employees, there is a danger of alienating the rest, or being accused of discrimination.

**C** Decide **how long** the scheme should run.

- ◆ If you want to concentrate on one particular result, limit the time. For example, until a backlog of orders is cleared.
- ◆ Consider adopting a scheme as a permanent part of your business's culture.

Incentives will often become less effective as employees get used to them. Change the scheme according to circumstances.

#### FURTHER HELP

There are other Directors' Briefing titles that can help you. These briefings are referred to in the text by name and by the code given to each briefing. For example, the HR briefings have the codes HR 1, HR 2, etc.

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## DIRECTORS' BRIEFING

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## 2 Using cash

Cash is always popular with employees. It is the most widely used form of incentive payment. But it has some disadvantages, too.

- A** Incentives to increase sales almost always take the form of **commission**.
- ◆ Commission is generally set as a flat percentage of sales.  
It is self-limiting. If the goods are not sold, the payment is not made.
  - ◆ The rate of commission depends on the selling price and the degree of effort involved in making the sale.  
It could range from five per cent, where the item sells readily, to 30 per cent or more where the effort required is substantial.
  - ◆ High-performing sales people may be able to earn huge amounts under this system.
  - ◆ Guard against sales people cutting corners to clinch sales.
  - ◆ Time the payments to ensure that sales people can always see another big payout coming. Otherwise, they may leave.
  - ◆ Very high earnings may cause resentment

### Valuing unquoted shares

*Employees who hold shares could make big gains if an unquoted company floats on the stock market, or gets taken over. They are therefore likely to be more committed.*

*But putting a fair value on unquoted shares is difficult.*

*Different methods will be fair for different types of business. You should consider:*

- A** Valuing your business at a **multiple** of after-tax earnings.
- ◆ Select the multiple by reference to the ratio of price to earnings on quoted companies in the same business.
- B** Valuing your business at a **percentage** of gross profits.
- ◆ Particularly in a cyclical business, this could produce big swings in value.
- C** Valuing your business by reference to the **asset value**.
- ◆ This is difficult to apply to a business where the assets are largely intangible.

*Whichever method you choose, you will have to clear it with the Inland Revenue first, if you want to offer your employees one of the tax-favoured schemes (see 3).*

elsewhere in the company, particularly if the sales really depend on a team effort.

- ◆ It is difficult to curb an over-generous commission agreement later, without upsetting and demoralising the sales team.

Start by offering basic pay plus a moderate rate of commission. If business justifies it, you can raise the rate later.

- B** For production employees, an element of **piece work** pay is the equivalent.
- ◆ Payment is directly related to production. If nothing is produced, nothing is paid.
  - ◆ Pressure to produce and earn more may lead to a decline in standards. Link quality standards to the production targets.
- C** One-off improvements in non-sales areas — for example, production or support — can be encouraged with **bonuses**.
- ◆ Bonuses can be offered on either a team or an individual basis.
  - ◆ Unless there is a clear-cut benefit to the company, the bonus is just another cost.
  - ◆ Bonuses are often paid out of 'gainsharing' cost savings.  
With gainsharing, any gains made from cost reductions — for example, a cut in hours worked for the same level of production — are shared with employees.
  - ◆ Audit improvements in productivity carefully. Things may not be as they seem.  
For example, one telecoms company instituted a bonus system designed to get enquiries answered more quickly. The number of calls handled increased. But the company eventually discovered that employees were disconnecting one call in three as soon as it came through.
  - ◆ With team bonuses, make sure that all team members are contributing. One freeloading individual can demoralise the whole team.
- D** **Continuous improvement** can be encouraged by instituting a system of performance-related pay.
- ◆ You must set demanding but realistic goals for each employee or team.
  - ◆ Provide feedback on progress towards these goals at intervals during the year.
  - ◆ Determine the pay increases by the progress made.
  - ◆ Use objective measurements, or you risk accusations of favouritism.

Tax and National Insurance contributions have to be paid on any cash payments to employees.

◆ As of 18 April 2005, the Inland Revenue and HM Customs & Excise will merge to become HM Revenue & Customs. Get more information from the website at [www.hmrc.gov.uk](http://www.hmrc.gov.uk).

*"There is an increasing emphasis on team bonuses, as this avoids many of the problems of incentive pay."*

*Helen Morgan,  
Business Link  
for London*

*"For most employees, job satisfaction, clear communication and recognition of effort, are far more important than extra pay."*

*Emma Hall,  
Milton Keynes  
Chamber of Commerce*

*"Pay works best as a motivator if it is transparent and fair."*

*Simon Macaulay,  
Anglo Felt Industries*

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For the incentive to work, the after-tax amount must be significant. Employees are unlikely to respond positively to anything less than an extra ten per cent in their take-home pay.

### 3 Using shares

Offering shares in your business is more complicated than offering cash, particularly if the company does not have a public quotation. But share schemes can be much more effective in linking the interests of the business and the employees, as well as encouraging long-term commitment.

Grants of shares through approved Employee Share Schemes will generally be free of tax and NICs (see below).

Any gains will be subject to capital gains tax (CGT). But all shares held by employees in the quoted or unquoted trading companies for which they work (or in non-trading companies,

#### Share Incentive Plans

*The Share Incentive Plan (SIP) is a tax-advantaged plan which encourages employees to buy shares in their company from pre-tax pay.*

- ◆ The costs of setting up a SIP and any money you pay into it can be set against your company's taxable profits.
- ◆ You can give your employees shares worth up to £3,000 a year. The amount can be linked to performance.
- ◆ Employees can allocate up to ten per cent of pre-tax salary (up to £1,500 a year) to buy shares through the trust tax free.
- ◆ You can provide up to two matching shares for each share bought by the employee, up to a maximum of £3,000 a year.
- ◆ Shares are free of tax and NI as long as they are held for a minimum of five years.
- ◆ You can require your employees to give up free or matching shares, if they leave within three years.
- ◆ SIPs can create a market for the shares in private companies.
- ◆ You may receive capital gains tax relief if you sell shares in your own business through a SIP.

*For a small company setting up a Share Incentive Plan, the Inland Revenue suggests set-up costs of £5,000 to £15,000, as well as compliance costs.*

provided they do not have a 'material interest') count as business assets.

This means that any gains made on selling the shares are taxed at reducing levels after one year.

After two years, the maximum CGT payable (by a higher-rate tax payer) is only ten per cent.

**A** Offer senior executives or key employees an **approved share option** scheme.

- ◆ You give selected employees the right to buy shares at their current price, at a later date.

If the shares increase in value in the meantime, they will make an immediate profit when they exercise their options.

- ◆ Each employee may hold options on shares worth up to £30,000.
- ◆ The option can be exercised after three years, but not later than ten years.
- ◆ Employees who own ten per cent or more of the company's shares cannot participate.

No income tax will have to be paid when the option is granted or exercised.

**B** Small companies (gross assets not exceeding £30m) can offer share options to employees through the **Enterprise Management Incentive** scheme.

Companies can seek 'advance assurance' from the Inland Revenue that they meet the scheme's requirements.

- ◆ All employees can take part in this scheme, if the employer so chooses. The total value of shares under option must not exceed £3m.
- ◆ The employees must spend substantial time working for the company. This means at least 25 hours a week or 75 per cent of working time.
- ◆ Provided the options are exercised within ten years, and at the market price when they were granted, employees do not pay income tax or NICs.
- ◆ The value of the shares under option must be agreed with the Inland Revenue when the grant is made.

**C** Consider setting up a **sharesave scheme**.

- ◆ All employees must be able to take part on similar terms.
- ◆ All members get the right — but not the obligation — to buy a number of shares, normally at a discount to their current price, after three, five or seven years.
- ◆ They save a regular amount with a bank

"I have seen incentive schemes which make two departments fight each other over cost allocation. Not only does it ruin teamwork, it is a major waste of effort."

*Lucinda Neall,  
Neill Scott Partnership  
training consultants*

"It is a well-established fact that getting a pay-for-performance scheme right is one of the most difficult tasks any management can undertake. People often get it wrong."

*Michael Armstrong,  
management  
consultant*

"Employee contributions to the Government's new Share Incentive Plan are taken from gross pay and therefore free of income tax and NICs. So this plan may become more popular over time than the traditional SAYE-Sharesave plan."

*Fred Hackworth,  
Employee Share  
Ownership Centre*

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or building society in the meantime, to pay for the shares.

They can save £5 to £250 per month.

- ◆ If the shares rise in value, employees have a profit when they buy shares.

If the shares fall in value, they ignore the option and take the savings instead.

No income tax is payable on the grant or exercise of the option, or on the interest.

#### D Many companies set up **non-approved share schemes**.

- ◆ There are no limits on the amounts that can be granted under such schemes.
- ◆ The shares count as business assets and qualify for CGT taper relief.  
But employees who receive benefits have to pay income tax on the full amount.
- ◆ Conditions are normally imposed. The idea is to ensure that the rest of the shareholders benefit as well.

In the longer term, shares have been a much better investment than cash. But they can fall as well as rise, for reasons outside your control.

## 4 Other incentives

Incentives other than cash and shares can give your employees more fun and cause less hassle.

- A** A **company car** may be necessary to the job, and a top-of-the-range model is certainly an incentive to some employees.
- ◆ Company cars can be a big overhead.
- B** An all-expenses-paid **foreign trip** can be an effective incentive.
- ◆ Set minimum performance requirements that will comfortably pay for it.
  - ◆ It can bring some fun into the workplace.  
It will be discussed by other employees, but is unlikely to be resented — as an equivalent grant of money might be.
- C** **Incentive award vouchers** are becoming increasingly popular.
- ◆ Whereas cash payments tend to be spent on an employee's monthly outgoings, vouchers are spent on something specific.  
This visible reward usually acts as a more effective incentive than cash.
- National Insurance contributions are payable on non-cash vouchers.

## 5 Implementing a scheme

In order for an incentive pay scheme to work, your employees must be fully committed to it.

- A** **Explain** the reasoning. A written explanation will answer most questions.
- ◆ Agree a strategy and list of objectives.
  - ◆ Agree the way to measure improvements and calculate incentive pay.
  - ◆ Discuss specific responsibilities and goals with each employee. Employees should feel that they own the scheme.
- Act quickly to defuse any conflicts between different objectives or between employees.
- B** Continue to **manage** your employees.
- ◆ Provide regular feedback to help employees achieve their goals.
  - ◆ Listen to their suggestions.
  - ◆ Agree targets at a regular review.
- C** Analyse the **success** of your incentive pay scheme regularly.
- ◆ Amend the scheme if it does not work.

## 6 Finding help

- A** The **Institute of Actuaries** and the **Faculty of Actuaries** list members in your area, many of them specialising in employee benefit consultation (01865 268205).
- B** The **Employee Share Ownership Centre** advises on incentives (020 7436 9936).
- C** Some **accountants** and management consultants specialise in pay.

### EXPERT CONTRIBUTORS

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