Abstract

This document compares subjective, merit-based bonusing to objective, incentive-based bonusing using real-life situations, motivation research and a professional service firm case study. Architectural, engineering and planning (A/E/P) firms commonly offer merit-based, subjective bonuses. In particular, employees within A/E/P firms have become accustomed to receiving bonuses based on the opinions of supervisors. The question arises as to what affect this method of bonusing has on employee motivation and productivity.

An alternative to the merit-based approach is incentive-based, objective bonusing. What affect might incentive-based bonuses have on motivating employees to improve productivity and profits in A/E/P firms? Which approach to year-end bonusing motivates employees best? These questions are examined in this document. In addition, the document presents the results of a professional service firm that switched from a merit-based to an incentive-based performance bonus program.
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AUDIENCE

This document is primarily intended for leaders, managers and supervisors of professional service firms who are interested in improving employee motivation and productivity.

“Managers must ensure that their reward and measurement systems are equitable. Both high- and low-performing individuals, groups and teams must see the consequences of high performance. The worst reward system is a random one in which no one knows how rewards are allocated! Reward systems can be a powerful driver of organizational effectiveness, just as poorly designed reward systems can be a root cause of today’s performance gaps.” (Tushman and O’Reilly, *Winning Through Innovation: A Practical Guide to Leading Organizational Change and Renewal*, pg 90)
A/E/P BONUSING PRACTICES

The management team of a professional service firm is frustrated by the lack of employee motivation generated from their process of doling out year-end bonuses. Behind closed doors, the firm’s leaders establish the bonus pool, discuss last year’s individual bonus amounts, provide opinions on individual performance, and then determine each employee’s bonus.

The management team believes they are exceedingly generous. However, two responses usually occur after communicating bonus amounts to employees. The first is, “Wow, thanks a lot! I really appreciate this bonus. Come Monday you’re going to see some serious production out of me.” The second response is more like a thud, “Oh, that’s all I’m getting? I expected more. My friend at ABC Architects and Engineers got a lot more. I may or may not be here on Monday.” It seems that about half the employees appreciate their bonuses while the other half expects more. The 50 percent that expect more seem to overshadow the appreciative 50 percent. As a result, bonuses do not seem to achieve an increase in overall employee motivation or the desired “bang for the buck.”

Architectural, engineering and planning (A/E/P) firms commonly offer merit-based, subjective fiscal year end bonuses. In particular, employees within A/E/P companies have become accustomed to receiving bonuses based on the opinions of supervisors. Leaders within these professional service firms realize the need to offer bonuses to retain employees and remain competitive. In addition, A/E/P firm leaders may prefer to distribute bonuses as an alternative to paying corporate taxes. These leaders would rather distribute profits to their greatest assets (people) and “reward” them, as opposed to underwriting Federal or State programs.

Based on the mixed results of merit-based, subjective bonuses, the question arises as to what affect this method of bonusing has on employee motivation and productivity. An alternative to the merit-based approach is incentive-based, objective bonusing. What affect might incentive-based bonuses have on motivating employees to improve productivity and profits in A/E/P firms? Which approach to year-end bonusing motivates employees best? These questions are examined in this article. In addition, the article presents the two year results of an engineering firm that switched from a merit-based to an incentive-based performance bonus program.
MERIT AND INCENTIVE COMPENSATION

The concept of correlating compensation to one’s job performance is almost universally accepted. However, in practice this is easier said than done. For most A/E/P firms, the notion of tying bonuses to job performance usually takes on one of two forms: a merit-based, subjective process; or an objective, goal-setting system with incentives.

Merit-based bonus programs assess employee performance at fiscal year end via subjective evaluations of employees by supervisors. Bonuses based on merit and subjective employee evaluations seem most prevalent in the A/E/P industry. This is probably because distributing bonuses based on subjective evaluations is less complicated and simpler to control (Wagner and Hollenbeck, 2001).

The managers of most professional service firms that use merit-based bonusing determine a bonus pool at the end of a fiscal year. This bonus pool is typically allocated to employees using last year’s bonus as a basis. Managers then subjectively decide what the current year’s bonus should be for each employee. Bonus amounts are compared between employees. Managers add their opinions of an employee’s comparative value and contribution to the firm. Finally, merit-based bonus amounts are adjusted to fit within the bonus pool and bonuses are distributed.

This approach accomplishes two objectives. Management evaluates employee performance in a collaborative manner through the bonus adjustment discussion. This helps provide information to company leaders about how other managers view each employee’s contribution to the success of the firm, thereby enabling the manager to coach employees toward improvement based on “management opinion.” Second, profits are distributed to the people in the organization instead of paying high corporate income taxes. Management believes that this distribution of profit to employees is effective in motivating employees, thereby maintaining retention and competitive advantage.

Some of the reported pitfalls of the subjective, merit-based approach are:

1. Employees may not be satisfied with the bonus amount, thereby reducing employee motivation and causing management to feel that employees are unappreciative;

2. No direct correlation exists between bonus amounts and an employee’s performance, which can limit potential improvement in motivation (Applebaum and Mackenzie, 1996);
3. Employees become accustomed to receiving additional compensation in the form of increased bonus amounts without an objective basis. When an objective event occurs, such as a market niche downturn or a large client is lost, bonuses may be limited or unavailable. This may cause employees to become disenchanted and seek employment at a competing firm; and,

4. Staff may question and become frustrated over the manner in which their bonus was determined. As a result, motivation levels are impacted.

Incentive-based bonusing is an alternative for A/E/P firms to consider (See Figure 1 for a comparison between merit-based and incentive-based bonusing). An effective incentive pay program sets goals and commensurate bonus rewards before the timeframe used to evaluate and measure performance commences. Discussion, collaboration, and buy-in occur between managers and employees before individual goals are set. Goals are perceived as being reasonable, achievable and challenging or they fail to inspire people to invest the needed effort (Kanungo and Mendonca, 1992). Reward potential is established upfront and blended with company and team performance factors.

**Figure 1 – A/E/P Bonus Systems**

<table>
<thead>
<tr>
<th>Merit-Based Bonusing</th>
<th>Incentive-Based Bonusing</th>
</tr>
</thead>
<tbody>
<tr>
<td>Subjective</td>
<td>Objective</td>
</tr>
<tr>
<td>Dependent on management opinions</td>
<td>Tied to actual performance/results</td>
</tr>
<tr>
<td>$’s loosely related to last year’s amount</td>
<td>$’s directly related to current year results</td>
</tr>
<tr>
<td>Unclear expectations/how $’s calculated</td>
<td>Clear expectations/how $’s calculated</td>
</tr>
<tr>
<td>Emphasizes individual performance</td>
<td>Based on firm, team and individual performance</td>
</tr>
<tr>
<td>Easier to implement</td>
<td>More challenging to implement</td>
</tr>
<tr>
<td>Management holds power/control</td>
<td>Employee holds power to influence outcomes</td>
</tr>
<tr>
<td>No/low accountability</td>
<td>High accountability</td>
</tr>
<tr>
<td>Bonus pool</td>
<td>Bonus pool range</td>
</tr>
<tr>
<td>Avoids corporate taxes</td>
<td>Avoids corporate taxes</td>
</tr>
<tr>
<td>Lack of research support</td>
<td>Significant research support</td>
</tr>
</tbody>
</table>
Reasons for implementing an incentive-based bonus program include: increasing accountability, mitigating subjectivity, establishing clear expectations, aligning actions to achieve goals or strategic objectives, and linking bonus rewards to performance. However, firms sometimes rush into incentives as a non-confrontational, painless way to attempt to get people to “do their jobs” (Wahby, 2000). Incentive systems can be difficult to set-up and administer. In addition, incentive bonus programs may cause unhealthy behavior if goals are too individualized and do not consider company and team performance.
CASE STUDY: Small Engineering Firm Incentive Bonus Initiative

In 2000, a 30-person engineering firm (ENG) implemented an incentive-based bonus system. For over 25 years ENG had used a merit-based, subjective bonus process. Management believed that the merit-based system was not effective in motivating employees to improve job performance, and speculated that the subjective year-end bonus process may have been demotivating and counter-productive. Productivity and profitability had remained at or below industry averages for several years. In response, a new management team at ENG developed a program called the Performance Bonus System (PBS). The stated goal of PBS was to “get people focused on what’s important to the firm’s success, as well as theirs.”

In addition to evaluating an employee’s performance relative to their job description and the firm’s mission and values, employees developed two financial-related targets with their supervisors. One target type related to revenue; the other was based on profit. Target types were set by management for each position within the firm, and were established based on each position’s ability to have a reasonable amount of control over outcomes.

For example, project managers were held accountable for utilization (billed hours divided by total hours worked) and a project budget management ratio (what was billed to a client divided by what was charged to a project – the goal was for the ratio to be close to one or greater). The actual numerical values for the two targets were tailored to individuals and established between the supervisor and the employee at the beginning of a fiscal year.

The PBS was simple and tied an employee’s bonus to how well a person performed relative to the two financial targets, as well as the firm’s mission and values and one’s job description. The system was designed to give every employee goals to shoot for, create accountability, provide a framework for healthy supervisor and employee reviews, and impart rewards for doing jobs well and applying company values in day to day work.

Each employee’s performance, from the receptionist to the President, was evaluated and rewarded. Administrative, non-billable staff were rated and rewarded based on how well they executed their work consistent with their job description and the company’s values. Company and team results were communicated via email to employees on a quarterly basis. This communication was well received by employees and replaced monthly, company-wide, non-billable, two-hour meetings where management presented and discussed company status and financial information.
ENG management was pleased with the results after the first year of implementing PBS. Utilization increased 10 percent. However, the most significant outcome was a 120 percent increase in profits. After two years of implementing their objective, incentive-based system, ENG experienced a doubling of profits and a 12 percent increase in utilization. Although ENG’s results were based on a two year period, the outcomes seem consistent with independent research. In a comprehensive review and study comparing the effectiveness of several motivation alternatives, incentive compensation created the most significant improvement in productivity (Locke et al., 1980 and Wagner et al., 1988).
WHAT DO THE EXPERTS SAY?

Hardly any literature exists that analyzes the effect merit-based pay and its subjective evaluations have on motivation and job performance. The lack of information may indicate that professionals in human resources and organizational development do not believe merit pay is an effective motivator. Initiatives to improve employee motivation and work efforts will not likely be successful if a weak link exists between pay and job performance (Wiley, 1997). In addition, Tushman and O’Reilly (2002) assert that if rewards are perceived as being allocated without a clear reference to performance, they provide no incentive for high performance. They maintain that the only reward system worse than a random, subjective system is one in which employees do not know how rewards are allocated.

However, because subjective, merit-based fiscal year-end bonusing is common practice in A/E/P firms, employee bonuses may be viewed as a part of normal wages. As a result, employees may consider wages to be solid feedback concerning their work as well as a reward for their ability or competence. Rewards, such as wages, that reflect ability may lead to greater intrinsic motivation (Wiley, 1997). This indicates that the reward or bonus itself may not influence motivation, but the type of feedback implied by the bonus may. If bonuses provide information about competence, extrinsic rewards such as bonuses may be received as intrinsically motivating (Wiersma, 1992).

A large amount of research literature addresses the effect incentive compensation has on generating motivation and improving productivity. Dating back to the early 1900’s, Scientific Management Theory has advocated using financial compensation to impel motivation and job performance. Henry Gantt, an early 1900 scientific management contributor, developed a task-and-bonus wage plan that paid workers a bonus if they completed their work within a specified timeframe (Wagner and Hollenbeck, 2001).

Incentive compensation plans set goals and associated rewards in advance. This gives a worker the opportunity to know how much money will be earned if they pursue and achieve certain levels of performance. More than 100 studies support the assertion that performance is enhanced by goals that are both specific and difficult (Locke, 1968). Goal setting also works most effectively when combined with incentives so that goal accomplishment takes on meaning (Sawyer et al, 1999). The primary virtue of goal setting is that attention is directed to specific desired results, clarifying what is important and what level of performance is needed (Vancouver and Putka, 2000).
SUMMARY

Getting A/E/P professionals focused on the “business of the firm” while producing technical work is a challenge. It has also been asserted that motivation is the number one problem in business (Watson, 1994). Given that architects, engineers and planners tend to prefer objectivity over subjectivity, it appears that incentive-based bonusing in A/E/P companies can be more effective than merit-based bonuses.

The substantial increases in productivity and profitability at ENG over a two-year period indicate that professionals respond well to goal setting and closely related financial rewards, as well as clear communication regarding job and values expectations. This outcome seems to fit with motivation research that has studied and documented the effects of tying financial rewards to targets associated with job performance. In the case of ENG, the fact that significant productivity increases occurred over a two-year period indicates that pay-for-performance as an extrinsic motivator positively influenced employee intrinsic motivation.
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REFERENCES


