

VARIABLE PAY PLAYBOOK

TABLE OF CONTENTS

Intro	03
Types of Variable Pay	07
Who Gets Variable Pay And Why	10
Frequency of Payout	13
Variable Pay Isn't For Everyone	17
Top 5 Tips for Creating a Variable Pay Plan in Your Organization	19
Bonus Guiding Principle: Keep it Simple	26

INTRO



In a tight talent market where employees have choices about where they commit their time and talent, variable pay is frequently used a retention, recruitment, and motivation tool. [PayScale's 2018 Compensation Best Practices Report \(CBPR\)](#) reveals that nearly three-quarters of organizations give some type of variable pay. At a time when budgets are tight, organizations are starting to shift their rewards towards variable pay over fixed costs (salary). Doing so allows them to really shell out the cash for their highest performers ... but only if they use the right kinds of variable pay.

The prevalence and variety of variable pay has increased over time, and this year's data shows that variable pay continues to be a prominent player in the modern compensation landscape. Approximately 71 percent of all organizations surveyed said that they offer some type of variable pay. That number is even higher among top-performing organizations—where 79 percent offer variable pay (vs. 70 percent of typical).



Often organizations struggle with questions that come up around variable pay plans:

How do I figure out what types of bonuses will work best for my organization?

How do I set goals for performance?

Should I budget for variable pay?

Can I tie my investment in variable pay back to results?

Before you decide whether variable pay is right for your organization, it's helpful to get a deeper understanding of the variable pay options, which kinds of variable pay are typical, and the business and cultural impact of variable pay choices.

The way you design your incentive pay program can make a big difference on multiple pieces of your business, so it shouldn't be an afterthought. Organizations are using variable pay programs to help them compete for talent, to combat turnover, and motivate all employees to higher levels of performance. But when you get it wrong, you might be wasting your compensation dollars and driving your employees towards undesirable behavior that hurts the long-term success of your organization.

WHAT'S YOUR PAY?

In today's competitive landscape, organizations use a rich compensation mix that encompasses much more than just base pay alone. There are bonuses, incentives, benefits, and much more. Together, these pay elements create the total rewards package for employees. Longer term incentives like stocks and equity, as well as various perks and benefits, have their places in the total rewards package.

However, in this white paper we focus on the cash elements of variable pay - everything that comprises and falls under the variable pay umbrella. organizations—where 79 percent offer variable pay (vs. 70 percent of typical).





As an industry, we haven't necessarily come to agreement on the definitions, but we can typically agree on the concepts involved with variable pay.

"Variable" pay is the umbrella. Under the umbrella you can find any number of bonuses, incentives, commissions, and other cash compensation that is contingent upon something happening. Depending on who you talk to, this could be either potential pay ("I can earn this money if I just work hard enough for it") or pay at risk ("this is money I'm not guaranteed, so I don't trust that I'll receive it"). People differ in whether and how much they are amenable to variable pay, depending on job level, job function, geography, life stage and their financial goals and personal risk vs. reward calculus.

"Bonus" falls under the umbrella. Bonuses may or may not be tied to a plan, they may or may not be connected to performance and they are typically backwards in orientation. "Dear employee. You did this thing. This thing worked out well; I liked it. Here's some money to say thank you."

"Incentive" also falls under the umbrella. Incentives are associated with a specific plan, focused on performance and are future-facing.

"Dear employee. I'd like to see you do this thing. If you do, I'll give you some money. And in fact, if you do even better, I'll give you even more money." Because they're tied to a plan, incentives tend to have better return on the compensation investment.

Whether or not an organization is likely to champion variable pay differs by size and industry. For example, 83 percent of large and enterprise organizations use variable pay (vs. 74 percent of mid and 64 percent of small).

In construction, variable pay is highly prevalent: 77 percent have some type of variable pay; while in education it's not (only 33 percent). As you'd expect, tech uses variable pay (83 percent) but government doesn't (only 31 percent).

PREVALENCE OF VARIABLE PAY BY INDUSTRY

Industry	Percent Using Variable Pay
Finance & Insurance	89%
Food, Beverage & Hospitality	86%
Retail & Customer Service	84%
Manufacturing	84%
Real Estate and Rental and Leasing	83%
Technology	83%
Engineering & Science	78%
Construction	77%
Energy & Utilities	76%
Agencies & Consultancies	75%
Art, Entertainment & Recreation	59%
Agencies & Consultancies	58%
Non - Profit	35%
Education	33%
Government	31%

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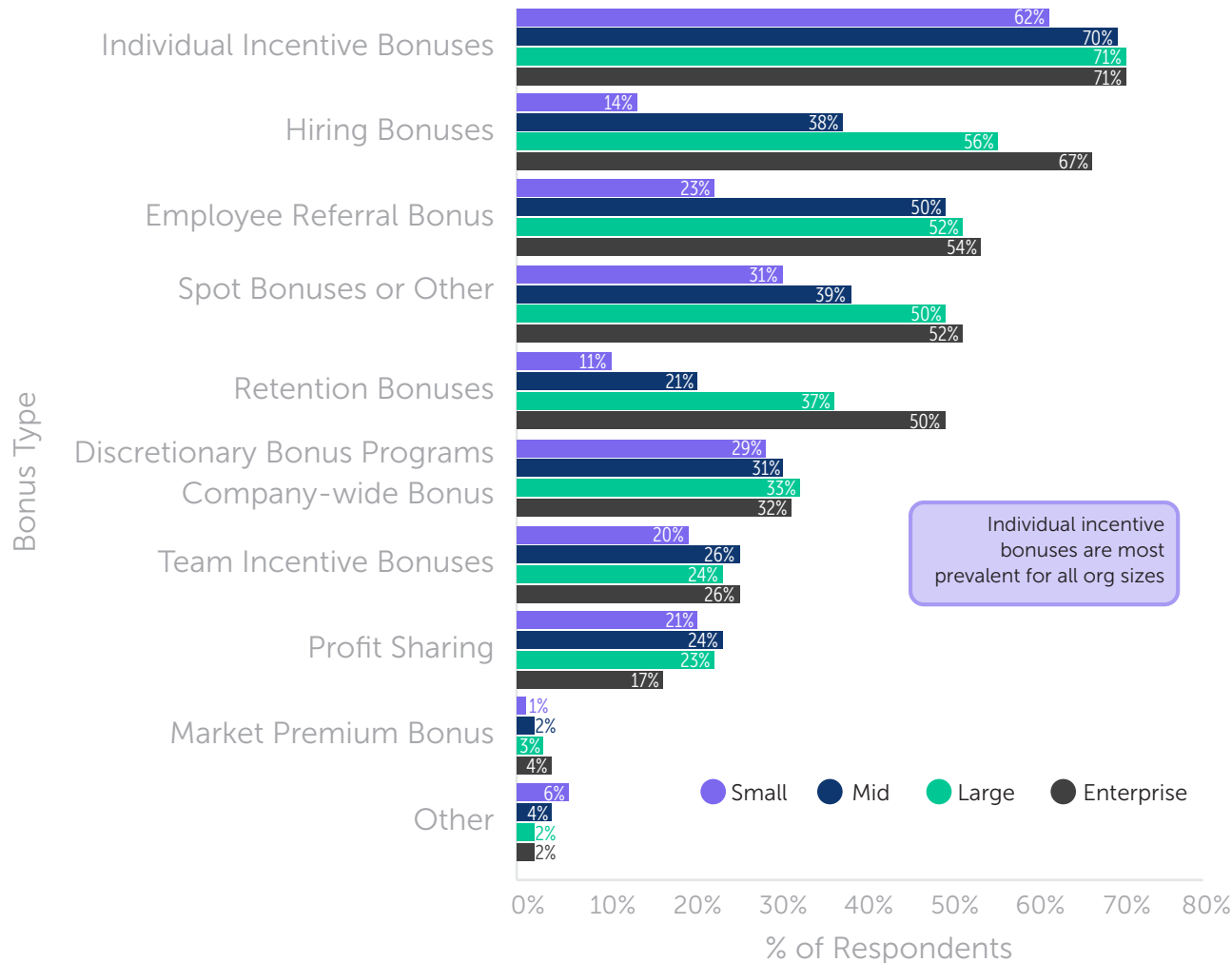
TYPES OF VARIABLE PAY USED

Some organizations will use a mix of bonuses and incentives to complete their total rewards package. Others focus on one or the other. Overall, the most typical type of variable pay awarded is the individual incentive bonus (67 percent), followed by the spot bonus (39 percent) and employee referral bonus (39 percent).

TYPES OF VARIABLE PAY

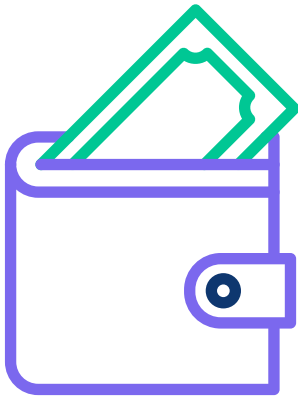
Types of Variable Pay Overall	Percent Using Variable Pay
Individual Incentive Bonuses (Including Performance)	67%
Employee Referral Bonus	39%
Spot Bonuses or Other Discretionary Bonus Programs	39%
Hiring Bonuses	34%
Company-Wide Bonus	30%
Team Incentive Bonus	23%
Retention Bonus	22%
Profit Sharing	22%
Market Premium Bonuses	2%

TYPES OF VARIABLE PAY BY ORGANIZATIONAL SIZE



When digging in further, top-performing organizations are less likely to use spot bonuses (32 percent vs. 40 percent of typical). They are also less likely to use hiring bonuses (29 percent vs. 35 percent of typical), implying that they spend what they have to in order to bring top talent on board, but don't tend to sweeten the deal as much. Both suggest a more controlled and intentional spend of compensation dollars.

Smaller organizations do less of every kind of variable pay, except profit sharing where small and mid-sized organizations beat out their larger counterparts.



The type of variable pay you choose can send a message about what matters most to your organization. For example, variable pay can be a powerful way to reinforce culture. In the [CBPR](#), we asked a question about how organizations plan to retain top talent: over one-third (34 percent) of all surveyed respondents said that their organization has a discretionary bonus plan. These organizations are giving their managers the ability to reward their employees as they see fit.

Why not allow your managers to request spot bonuses for individuals who show strong examples of the organization's core values? If you value collaboration and teamwork, why not set a goal for the team for their next project and reward the team when they meet their goal? If you value boldness and risk-taking, you could even turn some heads by rewarding a failed project, simply because an individual was brave enough to try something new.

WHO GETS VARIABLE PAY AND WHY

There is also a fair amount of variability across and within organizations when it comes to who gets variable pay and why. Some jobs more typically receive variable pay. For example, sales roles and leadership roles usually have explicit payouts tied to specific deliverables. By contrast, engineering and accounting roles are less likely to have high amounts of variable pay.

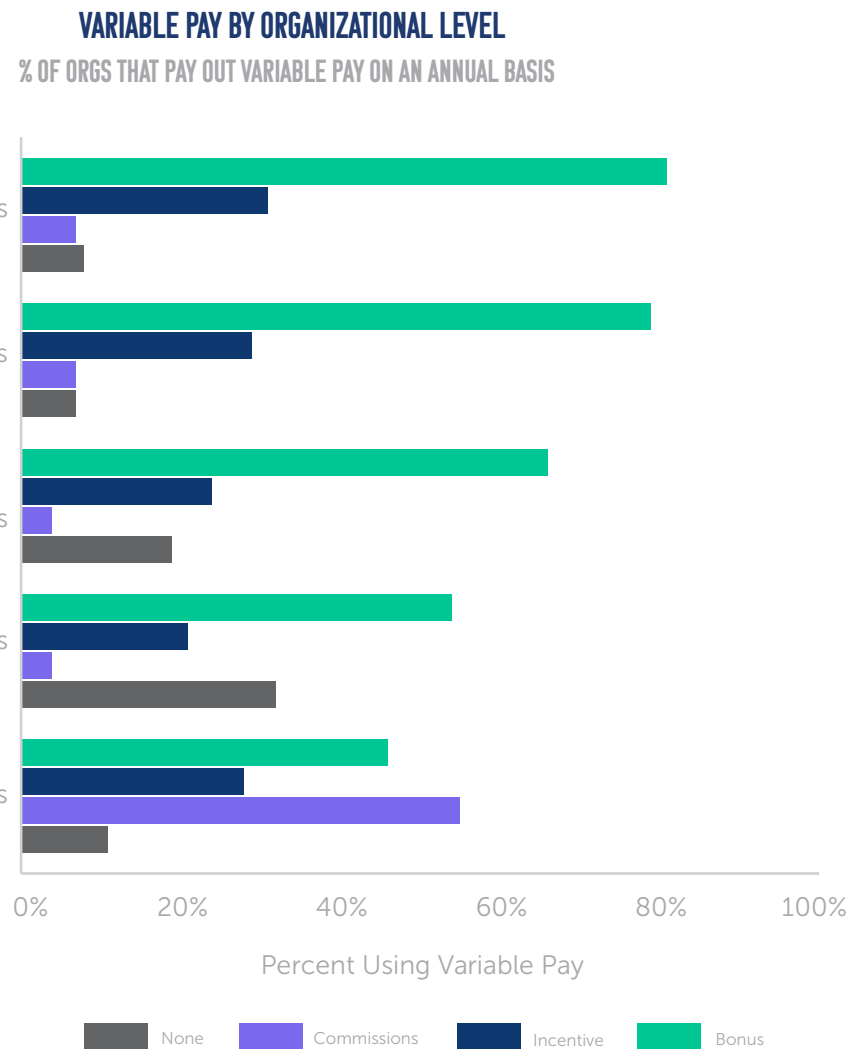
There are both organization-driven and employee-based reasons for this. The types of people drawn to high amounts of variable pay tend to be your risk-takers; risk-takers are often drawn to both sales and leadership roles - roles that chart new territory.

Whether or not sales and leaders perform, or even overperform, can make a significant impact to the organization's bottom line, so often directly linking performance with variable pay can both attract top sales professionals and leaders and positively impact organizations as well.

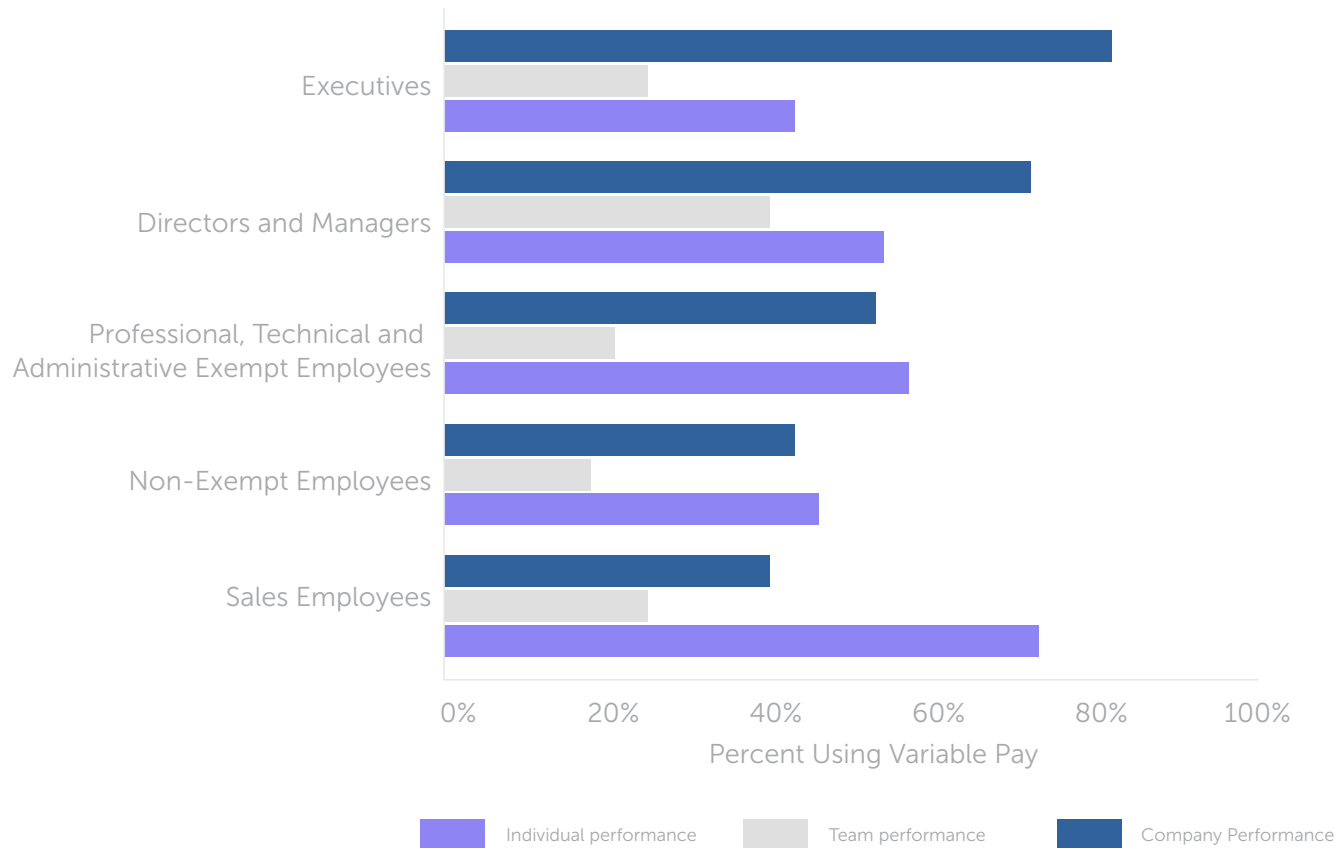
The prevalence and type of variable pay can also depend on organizational level. Often organizations struggle with how far down to extend their variable pay plan. That choice will ultimately depend on culture and budget, but again it's worth noting what other organizations are doing. For those who have variable pay, most extend it all the way to non-exempt employees (only 34 percent do not give non-exempt employees variable pay of some sort).

As expected, the higher the level, the more likely the payout is tied to organizational performance, rather than team or individual performance (82 percent of executive variable pay is based on organizational performance vs. 43 percent of non-exempt variable pay).

While Individual performance is highly utilized at all levels, it's most likely to form the basis of variable pay for sales employees (73 percent). Directors and managers are most likely to have their variable pay tied to team performance (40 percent).



PERFORMANCE-BASED VARIABLE PAY BY ORGANIZATIONAL LEVEL

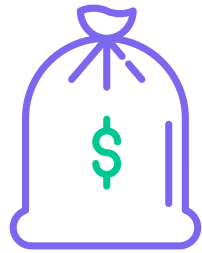


When considering who should receive variable pay in your organization, ask the following questions:

How much does this employee's contributions impact the success of the organization?

Are they likely to perceive variable pay as potential pay or pay at risk?

The answers to these questions should guide who receives variable pay, and what types of variable pay they receive.

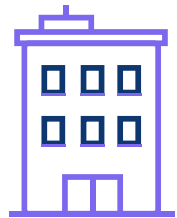


FREQUENCY OF PAYOUT

The next main consideration when it comes to developing a variable pay plan is how often variable pay should be paid out. While a majority of organizations still pay out on an annual basis (56 percent), 28 percent of organizations pay out at least quarterly. Additionally, six percent of organizations have project-based payouts. The larger the organization, the more likely they are to pay out annually.

FREQUENCY OF PAYOUT BY ORGANIZATIONAL SIZE

% OF ORGS THAT PAY OUT VARIABLE PAY ON AN ANNUAL BASIS



54%
Small



55%
Mid



66%
Large

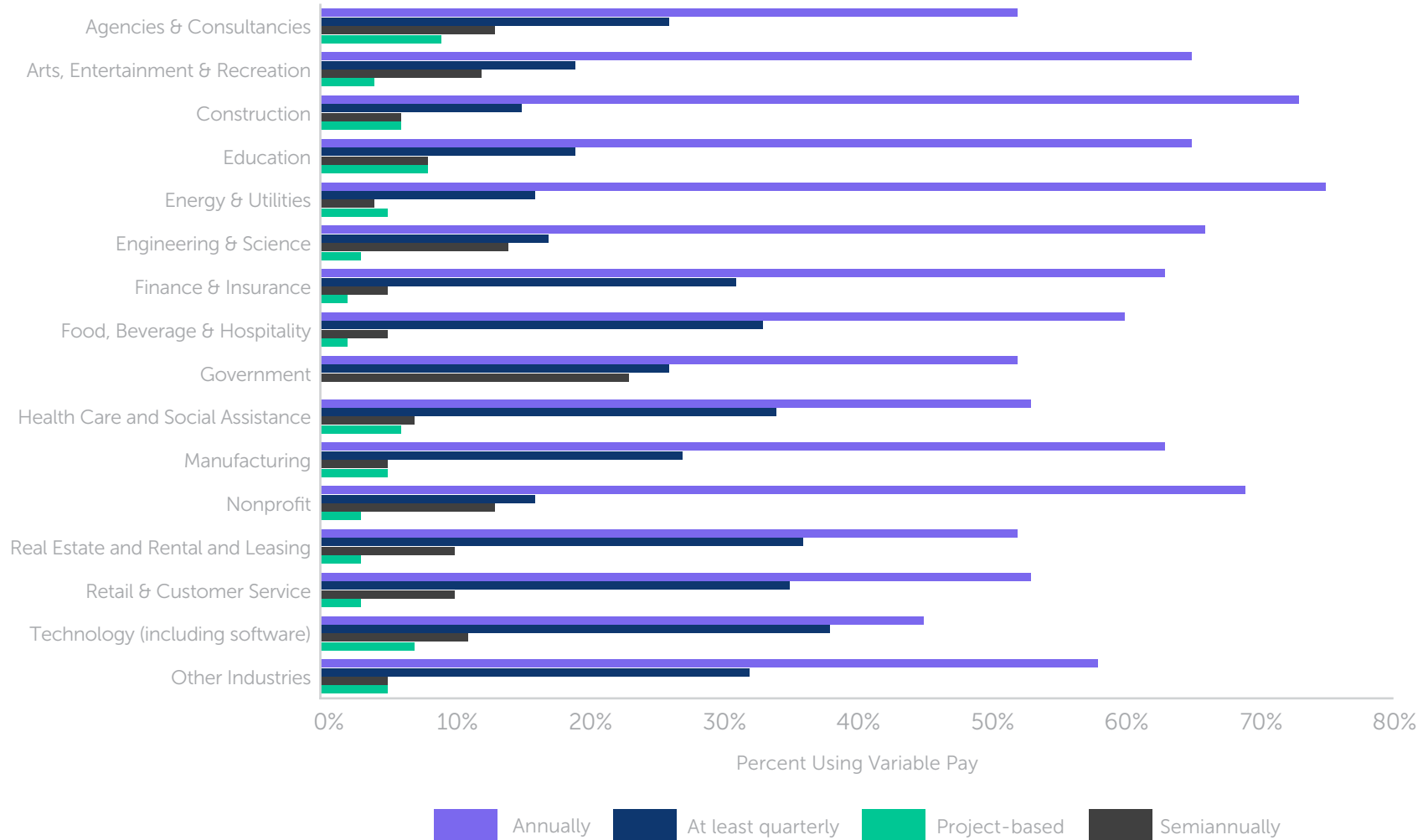


65%
Enterprise

This may be due to the high burden of administration. Additionally, larger organizations are more likely to move at a slower, annual, pace while smaller organizations tend to remain more nimble.

There is also some evidence that suggests that the pace of payout may correlate with a desire to increase tenure in industries where turnover is quick, meaning that average tenure is short.

FREQUENCY OF PAYOUT BY MEDIAN TENURE



In industries that typically have shorter tenures, the likelihood that they pay out bonuses or incentives on a quarterly basis is higher; for example in the food and hospitality or tech industries (both of whom have an average tenure of under three years), nearly a quarter of organizations report paying out bonuses or incentives on a quarterly basis.



INTERLUDE: TO BUDGET OR NOT TO BUDGET

To budget or not to budget for variable pay, that is the question. Having a budget dedicated to it shows a commitment to paying out variable pay. Having no budget for variable pay doesn't necessarily preclude paying out variable pay contingent upon performance, but it does send a different message depending how transparent you are about your budget. Of the organizations who have variable pay plans, 25 percent have no budget for variable pay; that number falls to 18 percent of top-performing organizations (vs. 27 percent of typical).

Whether and how much you budget for variable pay will depend on a number of factors. How literal are you with your budget? Who gets to see the budget? If things aren't in the budget, do you tend to spend money on them anyway? Do you have an established variable pay plan already? All of these questions will help you decide if you should budget your variable pay up front.



VARIABLE PAY ISN'T FOR EVERYONE

There are an increasing [number of articles](#) arguing against the use of a variable pay program. Some studies suggest that business leaders lack confidence in the effectiveness of their variable pay program. It's helpful to understand the common arguments for why variable pay programs don't work so that you can better evaluate how and which variable pay types can reinforce the behaviors you seek to see. Here's why variable pay plans may not work for your organization:



Variable pay can fail when employees don't understand the impact of their performance on business results. In a large organizations, the link between effort and reward isn't always clear. If they can't connect the dots, it won't be as effective because employees feel frustrated by the sense that they cannot influence their bonus outcomes. Variable pay works best when there is clear line of sight between performance and payout.



On a related note, compensation programs that are organization-wide and monolithic (for reasons of administration) tend to feel more like "we're all in this together" than "we appreciate what you as an individual do for us." Different messages work for different organizational cultures and business objectives. If you're working to build your organization or a new product, you may need individual employees who are top performers and can take the reigns. That means giving larger individual rewards to some rather than spreading the pool very thin.



There is a fear that employees just become entitled and come to expect periodic bonuses. The argument says that if you give them cash, they come to expect it. When they expect it, they work it into their budget and use it to pay for day-to-day things like rent or food. Once that happens, the money no longer feels like a reward for great performance.



The folks who champion this fear suggest that one way to overcome it is to provide employees with performance-based rewards that are more tangible in nature (think widescreen TV over \$2000 bonus). The other way to overcome that fear is to have really excellent goal-setting practices, train your managers well, and actually pay out low or no bonus to those who don't hit the mark.



Another reason variable pay programs could fail is if there is too much pay-at risk (for example, setting highly aggressive sales goals) and a culture from the top down that allows unethical behavior to occur. A recent example comes from Wells Fargo, whose employees allegedly opened more than 2 million bank and credit card accounts without customers' permissions. These employees did so to meet sales quota and earn incentives.



Business leaders should think hard about whether they are relying too heavily on incentives to motivate their employees. Many organizations have done so and found out that incentives do the opposite of fostering long-term loyalty. Giving employees Interesting and challenging work, creating a supportive work environment, providing learning and development opportunities and adequate base pay are key elements to building an effective organization.

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Now that you've considered the types of variable pay you want to use, who gets variable pay, and how frequently you want to pay out against your plan, it's time to actually build it. Here are five tips to get you started.



TOP 5 TIPS FOR CREATING A VARIABLE PAY PLAN IN YOUR ORGANIZATION

Often, when building out a new plan, it's tempting to follow the best practices, the next practices, the "bleeding-edge" practices that other organizations are doing. One of the best things about variable pay plans is that they are variable. So how do you know how to build the right variable pay plan?

Consider the needs of your organization, your organizational culture, your business goals and objectives, and the makeup of your workforce. As we go through each of these five tips, think about how your organization's unique circumstances can point to the right way of designing the plan you need.

1. ALIGN PAY TO ORGANIZATIONAL RESULTS

We've done a fair amount of work with organizations on their compensation strategy. One of the first questions we ask is, "what are your organizational goals?" Typically our project partners respond with their talent goals: retention, recruitment, development. Those are definitely good goals, but they're not business goals.



Let's say the business goal is to double revenue in the next five years. A business strategy might be to develop and release a new product every six months. In order to make that strategy work, the talent strategy might be to recruit, retain, and develop innovative product developers. The compensation strategy should clarify organizational priorities and feed into the talent strategy, business strategy and ultimately the business goals.

How? In this example, you might choose to have competitive base pay for your software engineers, research and development, product managers, etc. But beyond that, it's not a bad idea to find some way to incentivize innovation - the actual ideation of the products to be created.

2. SET MEANINGFUL GOALS

In order to create alignment, to create line of sight for employees, you have to set meaningful goals. There are lots of schools of thought on the best way to create clear goals and objectives for employees, including: MBO, SMART, KPIs, [OKRs](#), Cascading goals, etc. If you want to dive deeper into which types of goals make more sense for your organization, take a look at this guide from [Betterworks](#).

Behind all of them is the intention of making clear goals to help employees better understand the expectations of their roles, and how their efforts translate into rewards. Most emphasize the need for goals that are in some way measurable and time-bound. Obviously the goals should help connect the dots between individual and organizational performance. And the goals should be concise - simple. As employees are going about their day-to-day work, it should be clear to them what and how they are working towards accomplishing their goals.

In some organizations, they set organizational objectives which cascade into departmental goals, that then translate into individual goals. Not all organizations have the time available to complete that kind of goal-setting. That said, even in more agile organizations, there is still the notion that employees should link priorities with overall organizational objectives.

We can't understate the importance of setting good goals. It all hinges here. We bring up the cautionary tale of the [Atlanta school district](#) who, in 2009, had the right objective in mind, but through poor planning and poor goal-setting, rewarded the wrong behaviors. Specifically, the district wanted to improve student learning. The measure they picked for that objective was increased scores on standardized tests. Because principals and teachers were incentivized to raise student test scores (not to improve student learning), the wrong behaviors evolved: the teachers cheated on the tests on behalf of the students.

Know the behaviors you seek to see and consider what unintended consequences you may find based on the design of the plan.

3. CONSIDER YOUR WORKFORCE: WHAT'S IN IT FOR THEM?

In most workplaces, there is an exchange of value going on. Employees bring knowledge, skills, passion, dedication, and in some cases blood, sweat, and tears. Employers bring total rewards, training, development, and hopefully a culture where employees want to spend their time. Employees are doing this ongoing calculation to see if this exchange of value feels fair. Top performers, in particular, want to feel like they're getting a good deal for what they have to bring to your organization.

When it comes to designing an effective incentive plan, start by thinking about what motivates your workforce. Ask yourself, what will enable them to feel like they're getting a good deal? Part of your design challenge is to figure out who finds value in incentive pay, and how will you generate value from their efforts.



It's not about catering to the needs and preferences of your workforce; it's about understanding your workforce enough to know what types of pay are most motivating. What is the value your organization has to offer to current and prospective employees? What is the value you expect in return? Does it seem like a good deal to you? To them? Keep in mind that the value your employees find in working for your organization typically goes far beyond pay. Consider your total rewards package, developmental opportunities, the ability to do meaningful work, or whatever your specific workforce finds most motivating.

4. NOW, THINK ABOUT DIFFERENCES ACROSS YOUR WORKFORCE

Your workforce is probably not monolithic. There are ways to consider various different personas within your workforce in order to identify the types of things that are likely to motivate your workforce. One of the simplest ways to differentiate your workforce is by generation.

Generational Differences

It may or may not be the best way to segment your workforce, as generational stereotypes are often just that, stereotypes. That said, they do provide a great example for how groups of people may feel differently about variable pay. For example:

- Baby boomers tend to be more private about pay, so public displays or discussion of pay may not feel motivating to this group: think goal charts and contests. This group tends to be focused on retirement and benefits, has longer tenures, and is less likely to be motivated by variable pay.
- Generation X is the sandwiched generation. Smaller than both Boomer and Millennial generations, this somewhat pessimistic generation saw the end of pensions. Gen X is semi-private about pay, focused on cash and benefits, and fairly distrustful of organizations, having gone through more than one economic bust. For them, variable pay is “pay at risk.”
- Millennials are a different group. They are notoriously public about pay. A highly mobile workforce, Millennials are focused on cash and variable pay. They see variable pay as potential pay: it’s mine if I work for it.
- We don’t yet know much about Generation Z, although they’ve already begun to enter the workforce. So far, they seem to be a bit of a pendulum swing back from the Millennial mindset in some ways. They are realistic and very eyes open. They’re not as public in communication as we can see from their online social media preferences for temporary apps like Snapchat vs. Facebook.

Job Function and Job Level

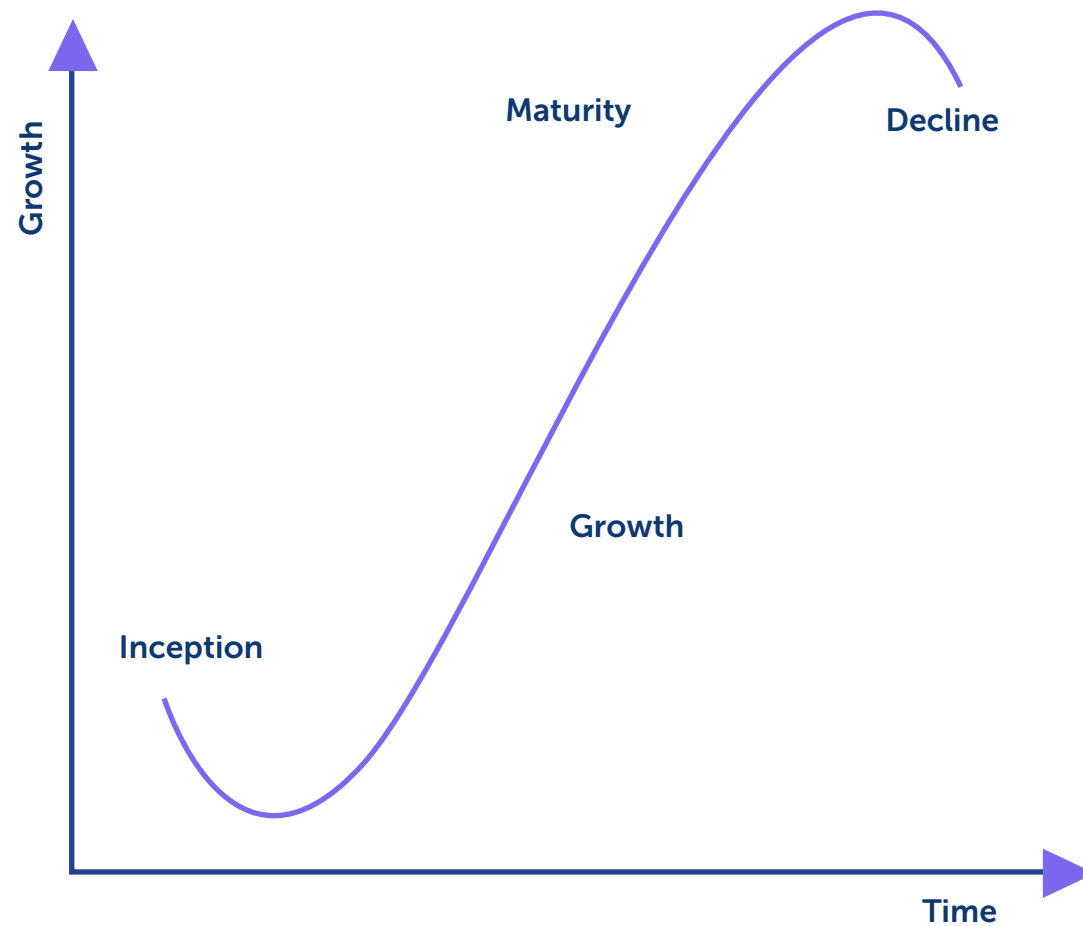
Segmenting your workforce into generations is one way, but perhaps not the best way, to divide your workforce to gain a better understanding of what motivates them.

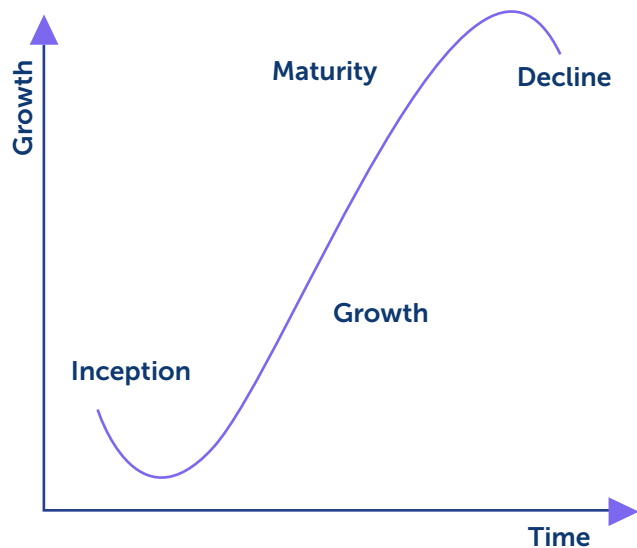
- Your accounting and finance group wants you to use variable costs, but not for their own personal pay.
- Sales is high risk / high reward job, and they want those rewards in cash.
- Jobs at entry levels or closer to minimum wage tend to be more focused on base pay. There are very real costs involved in paying rent and buying groceries and it’s tough when those are paid out on a variable basis.

Consider the various different personas in your workforce, their characteristics, and what types of compensation might motivate them. If you don’t know, ask.

5. SPEED OF BUSINESS & ORG LIFESTAGE

One consideration that guides many decisions, if subtly, is the speed of your business. This will depend on both your industry and the lifestage of your organization.





Some considerations on the length of your payout cycle: make sure your variable pay plan fits within your budget. Think about the timing of your pay out with respect to cash flow. And finally, done right, a variable pay plan should reward the types of things that benefit the organization; they should be self-funding.

Inception – aka startup: at this stage, cash is light and few organizational structures and systems are in place.

- Mix of pay: Typically in this stage, there is high equity, low base pay, medium variable pay, and high individualized rewards and recognition. Inception is typically a high risk high reward environment for employees.
- Payout cycle: employees will need to feel progress, so build incentives based on milestones and pay out when you reach them; don't wait until the end of the year.

Growth phase: at this stage, cash is tied up in growth; often the infrastructure becomes critical during this stage.

- Mix of pay: Organizations in this stage start pulling back on equity. They remain low base but high in variable and individualized rewards. Growth is still fairly high risk/high reward, but there is more potential for cash.
- Payout cycle: the organization is usually fast-moving during the growth stage. Waiting to pay incentives annually is too long. This is a good time to consider paying at the speed of your business, whether it's agile, quarterly-based, or on another cycle altogether.

Maturity phase: usually mature organizations have cash and organizational systems well in place.

- Mix of pay: Mature organizations are most likely to have and pay in cold hard cash. They are low in equity, high in base, moderate in variable, and moderate in individualized rewards. Mature organizations are usually the safest bet for employees.
- Payout cycle: both now and future: quarterly & annual goals

Decline (or hopefully renewal): at this point, pretty much everything is a question mark.

- Mix of pay: Organizations in decline don't have a lot to offer in terms of long-term security. As a result, they aim for low to no equity. They usually offer medium base, but low variable that may not be motivating without confidence in the employer. These organizations have moderate individualized rewards and use culture or even "tradition" to bridge the gap.
- Payout cycle: Because confidence is low, if they do variable pay at all, shorter payout cycles might yield more effort.



BONUS GUIDING PRINCIPLE: KEEP IT SIMPLE

While you're designing your plan, keep in mind that someone somewhere will be explaining this plan to someone else... without you there to clarify the fine points. A very basic plan can work for many organizations a starting point.

IN THIS PLAN, THERE ARE FOUR ORGANIZATIONAL LEVELS. THE PAYOUT IS LINKED TO TWO DESIGN ELEMENTS, MIX OF PAY AND GOAL RATIO:

- Mix of pay defines how much of their total compensation will be variable. This number increases as you go up in levels, as higher levels typically have a greater ability to impact organizational performance.
- Goal ratio refers to how much of the variable payout is based on individual goals vs. team or org level goals. Here again as you go up in levels, the ratio shifts from individual performance drivers towards organizational drivers.

Ultimately, every conversation about pay is an opportunity to talk with employees about what motivates them, so make the pay part easy for managers to talk about so they can focus their conversations on performance expectations.

When you design your plan, start with your organizational objectives, consider your culture and your workforce, and use the right combination of bonuses and incentives to motivate and engage your employees. Whether you choose to use incentives or bonuses will depend upon the needs of your specific organization, taking into account your organizational culture, your business goals, and your workforce.



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