Incentives Reinforce the Business Strategy

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A carefully designed incentive plan can drive your business results and raise employee satisfaction to new heights.

While the competitive pressures of running a successful business continue to mount, the winning formula is deceptively simple. In every economic sector, leading companies demonstrate a common capability: they meet customer needs better and faster than their competitors. In fact, today's competitive environment demands continuous improvement for companies to simply maintain their position in the market.

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A strong awareness of these market pressures has permeated almost all organizations. In the new working environment, most employees are expected to take on new and more challenging responsibilities. As never before, employees at all levels are being asked to innovate, to find new ways to work together, and, ultimately, to do much more with less.

As the competitive organization becomes flatter and leaner, spans of control get broader, with fewer managers directing work and managing results. Decision-making that was once the responsibility of management moves to the people who do the work. The employee who recently received directives and guidance is now expected to think strategically and take every opportunity to help the company meet its key business goals.

While managers may barely be able to contain their enthusiasm for this new paradigm of empowered efficiency, it's no surprise that employees across Canada are asking the same question: "Great – but what's in it for me?" An effective incentive plan that shares the success of the effort can provide a good answer.

The Results/Rewards Link

Incentive plans provide a visible link between business results and individual rewards. A welldesigned incentive plan gives each employee a personal stake in the successful implementation of business strategy, and pays off for all other stakeholders. In a recent survey of Canadian organizations, two thirds of those polled said that their pay-for-performance incentive plans had a positive impact on results.

From the organization's perspective, incentive plans create a common employee focus on key areas of business performance. The plans also contribute to more effective total compensation cost management, since they pay out only when the desired results are achieved. Contrast this with loading all employee reward and recognition into a fixed-base salary, which becomes a permanent, annually compounding fixed cost.

From the employees' viewpoint, incentive plans provide meaningful recognition of their sustained individual efforts and collective achievements. Since they are generally awarded in a lump sum at a specific time, incentive awards carry more "financial clout" than a nominal base salary increase (1.5 to 3 percent spread out over many pay periods). From both the employer and employee vantage point, incentive rewards can offer more bang for the compensation buck.

While incentive plans are undeniably effective

reward tools, recognizing their power only marks the beginning of the design and implementation journey. Specifically, incentive plan designers must invest time and resources in defining their plan's purpose, performance measures, eligibility, and reward payout to ensure its success.

Define Your Plan's Purpose

All effective incentive plans are rooted in business strategy. In fact, an incentive plan cannot be expected to produce results unless its objective is inextricably linked to the company's business strategy. Therefore, at the outset of the design process, the plan "architects" must determine the organization's fundamental business objectives and identify the key results and behaviours critical to successfully meeting those objectives. It is only by answering these questions that the purpose of the incentive plan emerges.

The incentive design team at one manufacturer stumbled over this initial plan design concept. The group disagreed on the primary objective of its largest business unit. Half of the team believed the primary business objective was to maximize the business unit's profitability, while the other half identified the goal as becoming the lowest cost producer of its leading product.

Before proceeding, the plan designers took the time to answer this seemingly obvious question. If they hadn't, any resulting incentive program had at least a 50 percent chance of pushing the wrong levers of organization performance. It was only after the team agreed on their primary business objective that they were able to set performance priorities for the incentive plan.

When an organization does not articulate an incentive plan's purpose, the power of the plan is significantly diluted, or even lost. We have all heard of "discretionary bonus" plans. These are merely incentive plans without a well-defined purpose! These plans deliver rewards after the fact, without ever establishing a link to business strategy and desired results.

Bonuses don't motivate behaviour or drive results. Some managers believe that bonuses reinforce behaviour. But without a clearly stated purpose, employees cannot be expected to discern which of their past behaviour or results are being singled out. Bonus plans also raise employee expectations for future reward delivery and, worse, often create problems of perceived inequities around the eligibility and distribution of bonus funds. With some up-front planning that links rewards to business strategy, an ineffective (and possibly counter-productive) bonus plan can be transformed. The result is a powerful incentive plan that sends clear messages about what is important to your company and what is being rewarded.

Identifying Your Performance Measures

Once the key levers have been identified, the next step is to unbundle those business levers into performance measures that individual employees and teams can influence. The identification of appropriate performance measures is perhaps the most challenging aspect of incentive plan design, and vital to success.

Effective performance measures must meet four key criteria:

They must be measurable.
That is, they must be quantifiable and the organization must be capable of reliably tracking the results over time.

They must be within the "line-of-sight" of plan participants.
Employees must believe they can impact the measure.

They must directly reinforce the achievement of key business objectives.

There must be a connection between hitting the incentive plan's performance target and the achievement of some core element of the company's business strategy.

There must be a manageable number of performance measures.
Too many performance measures will create confusion. On the other hand, a single performance measure may not capture the key drivers of business success. In most cases, the optimal number of measures is two or three.

A Successful Plan Fails

An incentive plan only achieves its purpose when performance measures meet each of these criteria. Consider, for example, the packaged goods company that identified "growth of business" as the key to its success in the increasingly competitive North American market.

In order to reinforce this key business strategy, the company developed a states incentive plan to grow the business. Although its purpose was spot-on, the plan broke down in establishing performance measures. Its primary performance measure was market share, where sales representatives would receive substantial cash incentives if they grew the company's market share in their territory. At year-end, virtually every representative had increased their market share, and each earned a sizable reward.

So why did the plan fail? Market share is certainly measurable; and it is clearly within the line-of-sight of sales representatives. But market share alone was not a complete measure of the plan's objective: business growth. In the big picture, the total market for the company's key products actually shrunk significantly.

Even though their market share increased, the volume of that market had dropped off so much that the company actually recorded lower total sales than the previous year. And so, as a result of a poorly-selected performance measure, the company had to pay performance incentives for results that didn't meet its own definition of business success.

Who Will be Covered by the Plan?

The decision of who to include and exclude from an incentive plan participation is critical. To begin answering the eligibility question, plan designers should turn to the plan's purpose. If the primary objective is to improve employee satisfaction, then equity is the key consideration in eligibility. If the plan purpose is to improve business results, then the impact of each job on the key result areas is the key eligibility factor.

In incentive plans designed to improve results, employees with discernible, direct influence on the selected performance measure should clearly be "in". Where these employees could impact the performance measures but for some reason don't, incentives will provide focus and motivation to get on board.

Organizations can take a fresh look at just who is in a position to influence performance measures by mapping accountability for the results. This process assigns ownership of outcomes to employees or groups of employees and can prevent plan designers from unknowingly excluding key influencers from the plan participation.

To create a process map, plan designers should begin by fully understanding the performance measure and then move on to laying out the sequence of organization processes and activities that contribute to it. Once the map is complete, line-of-sight (or influence) to each stage of the process is assigned. The list of employees with direct line-of-sight becomes the proposed plan participant list.

A Vancouver-based company developed an incentive plan with the objective of reducing its total cost per manufactured unit. Cycle time to market was identified as the key performance

measure and the plan eligibility was extended to each manufacturing work team. The plan participants focused their efforts on meeting the new cycle time standards; however, distribution employees (who were not participants in the plan) did not. Manufacturing significantly reduced its cycle time, but the product flow bottle-necked in the warehouse. As a result, inventory carrying costs escalated, customers saw no improvement in cycle-time, and overall financial results fell.

The breakdown of this design was the exclusion of employees who had impact on cycle time to market. Had the process been carefully mapped out, the plan designers would not have overlooked the distribution team's influence on the plan's central performance measure.

Once a process map has allowed plan designers to identify employees who impact the performance measures, the eligibility question is still not completely answered. The issue of equity remains unaddressed until the list of employees not included in the plan is reviewed. A "scan for equity" allows eligibility to be extended to employees who may not directly impact the plan's desired outcomes but do contribute to creating the conditions in which they are achieved.

Staff/support employees are often the most difficult eligibility call. They may be included in a plan to foster a greater sense of teamwork and equity, even though their line-of-sight and ability to influence the performance measures is not as clear as line/operations employees.

Some organizations resolve this dilemma by including staff employees in the plan, but offer them a lower target award. North American studies of incentive plan design indicate that when an organization unit – a plant, office, division – extends plan participation to staff/support, the plan effectiveness increases and employee satisfaction is enhanced.

The "scan for equity" ensures that incentive plan eligibility will build teamwork and shared accountability rather than send a negative message about whose contributions are more highly valued by the organization.

Setting Reward Size

Many organizations are tempted to start designing incentive plans by determining the size, form and frequency of potential payouts. In reality, this is the place to end the design process. Critical design decisions about other plan elements (e.g. plan purpose, eligibility, and performance measures) will heavily influence the structure of awards.

The size of an incentive award can be based on two key factors: competitive practice and target levels of performance. Competitive practice can serve as a bellwether for setting target incentive rewards – particularly if the ability to attract and retain employees is critical to the achievement of business objectives.

In addition to the external relativity of market practices, reward size must also be set in the context of the value created inside the organization. Specifically, the cost of paying incentives must be within the incremental value created by achieving the target performance level.

A Canadian auto parts manufacturer ran up against a reward size dilemma in an incentive plan designed to increase productivity in one of its smaller divisions. The plan's productivity performance measures were achieved and resulted in a total of $100,000 in cost savings. Following the plan design to the letter, the company then paid a $1,500 incentive to each of its 112 front line employees. Result: a net loss to the company of $68,000!

While a payout of this size was consistent with the incentive plans of some of the company's direct competitors, it was wholly inappropriate, because the cost of paying the incentives outweighed the organization's return on meeting

the plan objectives. Under such a scenario, an effective plan design must either raise the target level of performance or lower the target award.

Does Your Plan Motivate?

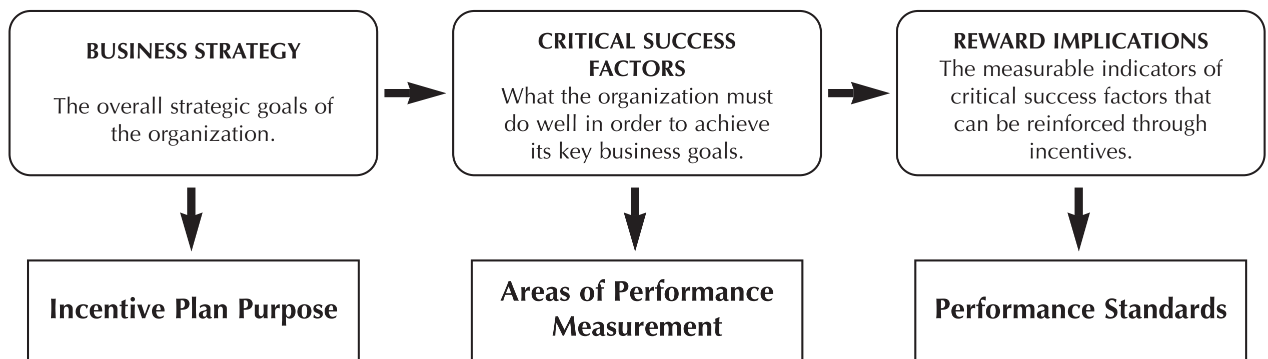
Once you have assessed your organization's competitive practices and the affordability of plan payouts, the third and final aspect of reward size must be considered: its impact on participants. Plan designers must ask themselves: "Is this reward significant enough to get the attention of plan participants and motivate the behaviours needed to meet the plan's purpose".

Although answering this question will require some interpretation, the target level of performance should always bear a direct relationship with the target incentive reward. In other words, if the performance target demands a great deal of change and extra effort, the payout to employees should be "worth" the time and energy they've invested. As a general rule, rewards of less than 5 percent of base salary are not considered by incentive design professionals to be highly motivating – particularly if the plan is highly complex and the performance standards are high.

Once award size has been determined, the core plan design components are finalized. Designers can then concentrate on the subtleties of plan design, begin communication and implementation efforts, and watch their incentive plan do its work.

Incentive plans are powerful tools that can improve your company's results. Poorly implemented, they can also have negative effects on corporate performance and morale, as some of our examples demonstrate. However, the benefits to be reaped from a soundly-designed and implemented plan are well worth the time and effort required to get it right. Eighty-eight percent of North America's leading companies sure think so!

The Strategic Foundation of Incentive Design



	Incentive Plan Purpose	Areas of Performance Measurement	Performance Standards
Example One: Retail Banking	To reinforce the expansion of the range of products/services used by retail branch customers.	**Customer Service** • retention • penetration • acquisition • process cycle time of customer requests/applications	• Performance **vs** business plan • Performance **vs** industry standard • Historical performance (e.g. year over year)
Example Two: Non-durable Manufacturing	To reinforce becoming the low cost provider of a commodity product.	**Manufacturing Cost** • throughput cost • down-time • scrap rate • defect rate • productivity	• Performance **vs** business plan • Performance **vs** industry standard • Historical performance (e.g. year over year) • Cost **vs** break-even