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REVISITING EFFECTIVE INCENTIVE DESIGN: STILL THE MAJOR ROI REWARD OPPORTUNITY

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Why revisit basic incentive design anyway? Why use incentives? It's simple: To accelerate the performance of your organization and its people. When people can influence meeting goals and Incentives are used as a part of employee pay, the organization's goals are much more likely to be achieved than when incentives aren't used.

Research in many organizations shows well-designed incentives return about four times what the organization invests in incentive awards paid. For all incentive plans researched (both good and not so good), the return on investment is double what is spent on incentives.[1] Nothing else an organization can spend compensation dollars on can provide a similarly assured return on investment (ROI).[2] So, even if you don't design and implement a "perfect" incentive plan the first time around, the returns are good for what you invest. But clearly it's more effective when it's designed right.

THE SEVEN PRINCIPLES OF INCENTIVE DESIGN

The "secret sauce" of incentive design involves seven suggestions (See Figure 1).

FIGURE 1: SEVEN INCENTIVE DESIGN PRINCIPLES

Principle #	Principle
1	Know why incentives will help.
2	Choose the right performance measures.
3	Choose the right incentive design.
4	Put the right amount of "stretch" in goals and measures.
5	Measure performance where it counts the most.
6	Evaluate outcomes and change as needed.
7	Communicate, champion, and don't give up.

If you follow these principles, you probably will add significant value to your organization. Whenever an incentive plan fails, the failure is commonly attributable to missing one or more of these key design principles.

KNOW WHY INCENTIVES WILL HELP

The only reasons to use incentives are to help improve performance and add value to the business. Using incentives must make it more likely that the organization will perform better. This reasoning is called a business case for an incentive plan. It justifies to CEOs the payoff for using incentives (i.e., ROI). It communicates the need for change to participants.

Some of the possible business reasons to consider incentives include:

- **Poor Performance**. Your organization's performance has become a "burning platform." To survive, the organization needs an immediate, significant change and major performance improvement.
- **Marginally Acceptable Performance**. Performance in your organization has not gone dramatically awry yet a course correction is needed. It is better to call people's attention to the need for change before a severe performance challenge exists.
- **Acceptable Performance**. Performance already may be good or even excellent, but the opportunity for an even better performance future exists.

The more pressing the business need that incentives help address, the easier it will be to justify and implement an incentive plan. Although, clearly, an organization must do much more than just implement an incentive plan to change culture; incentives help move from an entitlement mentality (where employees believe their performance does not affect their rewards) to a culture of rewarding results achieved.

What can you expect an incentive plan to do for your business and your employees? See Figure 2 for the 10 ways that incentives add value.

FIGURE 2: WHAT INCENTIVES CAN DO

Objective #	Incentive Deliverable
1	Communicate — and focus people on — important organizational goals and directions.
2	Link people to measures of organizational performance.
3	Reward people for results achieved.
4	Develop a win-win partnership between people and the organization.
5	Vary pay with performance results.
6	Lead or reinforce other initiatives—customer value, continuous improvement, lean, quality, etc.
7	Extend people's line of sight to key measures and goals.
8	Stop paying an annuity for one year's performance.
9	Contain fixed pay costs.
10	Provide competitive total cash compensation.

So, the first principle is to build a solid business case. Organizations should state, in business terms, how an incentive plan adds value.

CHOOSE THE RIGHT PERFORMANCE MEASURES

Measures and goals are the metal from which the business case and value added from incentives are forged. Incentives that provide a return on investment use measures and goals in one or more categories. (See Figure 3.)

FIGURE 3: PERFORMANCE MEASURES AND CATEGORIES

Category of Measure	Principle
Financial	Income and return ratios
Customer	Customer satisfaction, retention, penetration
Operational	Quality, cost, delivery, safety, efficiency
People	Retention, workforce satisfaction, results of development
Future-focused	New products, new services, breakthrough innovations, new markets

Which measure your organization uses depends on what is most important and can be influenced by employees. Different functional and work groups, and types of employees, may influence different measures and goals. We use the word *influence* rather than *control*. Few employees, for instance, directly impact income or income growth. Many employees may influence these by impacting shorter-range financial goals, such as cost reduction or individual sales. Although people in constant contact with customers can directly impact customer service, many others can influence it.

Incentives can extend the employees' line-of-sight to goals they don't directly impact. This is accomplished by linking incentives to some intermediate goals and communicating to and educating employees on achieving the closer goals that ultimately influence the key but more remote goals.

Although some plans are more complex, a workable, understandable and accepted incentive plan usually has no more than three to five performance measures. This ensures that employees attend to and perform consistently with all the measures. Having too many measures is not only confusing but also permits employees to try to meet only some of the measures — often the easiest ones — because each measure counts less in the overall value of the incentive opportunity.

All incentive measures don't need to work the same way. In some cases, a measure can directly "fund" the incentive payment without concern for other measures. If success is achieved on this one measure, whether or not other goals are achieved makes no difference. The award on this measure is granted. Other incentive measures may serve as a "gate" to earn incentives based on another award. For example, an insurance organization with customer service and quality incentives has a gate of a minimal level of financial performance that must be met to earn the full award achieved for the customer service and quality goals. The financial gate ensures the organization can afford the awards.

Other incentive goals "modify" the outcomes of funding goals. To use the manufacturing incentive example, it could be modified by goals of on-time delivery. When product is delivered as promised, the award for cost performance is modified upward. When commitments are missed, the award is modified downward and less incentive is granted. Measures also can be used to distribute incentive awards among incentive participants. For example if overall company performance goals are met, a certain portion of the award is granted to certain divisions based on division performance. (See Figure 4.)

FIGURE 4: HOW CERTAIN INCENTIVE MEASURES WORK

Use of Incentive Measure	How It Works
Funders	Funds part of an award independent of funding other measures
Gate	Determines if any award based on performance on other measure(s) can be earned
Modifiers	Increases or decreases funding based on another measure
Distributors	Determines if funding based on other measure(s) is earned

Measures and goals are at the core of incentive design. If an organization's measures don't make sense, it's impossible to have a viable incentive plan.

For example, a large retail grocery chain uses storewide incentives with the following four measures:

1. Customer satisfaction survey: Overall satisfaction of customers with the store.
2. Net sales compared to budget for the current period: Selling performance throughout the store.
3. Labor cost as a percentage of net sales compared to budget: Productivity of employees (including overtime) based on sales volume.
4. Supplies cost as a percent of net sales compared to budget: The relative cost of supplies used in the store.

This chain focuses hourly employees in every store on a combination of customer satisfaction, sales, and labor and supplies costs. A "gate" of store sanitation must be met before store employees are eligible to earn an award since store sanitation is so fundamental.

A chemical manufacturing plant focuses only on one measure: improvement in cost management. It shares 50 percent of cost per pound produced below the established budget with all employees in the manufacturing facility. There has been significant improvement in cost reduction because employees understand what impacts cost and are directly involved in managing cost effectively. The cost budget became the source of a win for both the company and employees.

CHOOSE THE RIGHT INCENTIVE DESIGN

Some incentive designs fit certain situations better than others. Organizations differ in structure and culture, as well as how they are organized (for example, some businesses are team-based and others do not use teams). We selected four design alternatives, but in reality, organizations are most likely to take the best from a number of options and customize these to match their specific situation. The basic short-term incentive options are:

- **Business goal plan**. This design provides potential value added whether applied to an organization, unit, department or team basis because it focuses on one or more of the key business metric areas. It is easiest to show value with an incentive plan that focuses on a key indicator of business success such as financial, customer, operational, people, and future-focused goals. The value added to the business at different levels of performance results helps sets the incentive funding and incentive opportunity. When this results/reward relationship shows more value added to the organization than the incentive funding, the plan becomes self-funded (i.e., pays for itself).
- **Gainsharing plan**. This design focuses on cost savings, improvements in efficiency or increased productivity. Gainsharing plans share part of the savings with employees who help achieve the improvements. Eventually these plans can be so successful that it's very difficult to squeeze any more cost out of a specific organizational unit. At that time gainsharing plans may convert to goal plans.
- **Team incentive plan**. A business goal or gainsharing plan can focus on a small team. A team incentive plan shares the incentive earned from achieving goals with team members. The focus is on shared goals — if one team member wins, the others do as well (the concept of shared destiny or "we are all in it together"). Support for the use of team incentives comes from research showing that teams using team-based incentives outperform those using only pay solutions based on individual team-member performance.[3]
- **Individual incentive plans**. When an employee's performance can be judged based on individual performance, organizations often create an individual incentive plan. An individual sales incentive plan based on personal sales is an example. Frequently, individual incentives are based on goal achievement that has a very close line-of-sight for the individual, so tying the individual to the larger organization's goals sometimes is a major challenge. Collaboration and cooperation are important in today's complex organizations. Sometimes care needs to be taken so employees who participate in individual incentives will help co-workers and not compete with others to the detriment of their combined effort.

Many possible incentive design combinations beg for customization. For example, one company decided its needs could be best served by combining an organizationwide incentive plan with a plan that focuses on individual performance. Having had experience with incentives, it was able to use more than the optimal three to five measures. The plan is complex and requires considerable communication. The goal balance is as follows:

- Organizationwide goals: weighted 70 percent
- Individual goals: weighted 30 percent.

The organizationwide goal is to increase revenue, net profit, customer retention and customer penetration. Individual goals cascade from the organization's goals and relate to the employee's individual impact on organizational performance. The company believes that if individual employees have a combination of close line-of-sight individual incentive goals and longer line-of-sight organizational goals, they balance both cooperative and individual performance. (Another organization may have considered a team-based portion for the incentive design.)

Telephone customer service organizational units need to balance quality and productivity. A large service center uses a strong individual performance management and coaching system to focus on service quality and improve productivity. It implemented a team incentive based on the department team meeting or exceeding performance on four monthly team goals. This encouraged people to help each other and work together to reach common goals:

1. Abandoned call rate for a month
2. Decreased telephone on-hold time
3. Improved quality audits
4. Increased call volume.

To qualify for an award, the participant must achieve individual quality and productivity goals. This solution creates a balance between quality and productivity and team and individual performance. The customer service organization is able to handle more calls at a high level of customer service and thus deliver great quality to more customers.

Many not-for-profit organizations use incentives below the executive level. For example, a medical group focuses on two goals that the board established: increased customer satisfaction and improved access to care. These two goals can be used throughout the organization for a wide range of people and units. The business case for these goals is that the organization has two things to sell: 1) customer satisfaction, including high levels of clinical quality and a reputation for delivering outstanding care, and 2) patient access to this high-quality service in a timely manner and a productive delivery system that can keep its channels as a healthcare provider filled.

PUT THE RIGHT AMOUNT OF "STRETCH" IN GOALS AND MEASURES

How is "excellent," "satisfactory" and "unsatisfactory" performance defined for incentive purposes? Typically, 80 percent of employees view their performance as "better than satisfactory," and the word "excellent" often has come to mean the minimum acceptable level of performance.

This raises the issue of setting goals that have enough "stretch" so they can be achieved and also provide a win for both the organization and its employees. What is excellent performance as judged against a specific goal? What is the minimum level of goal achievement that justifies any incentive award at all? How do you make sure employees focus on performance goals throughout the entire performance period?

Figure 5 shows a number of ways to address the goal-setting process and suggests how to build stretch into goals.

FIGURE 5: SETTING STRETCH PERFORMANCE EXPECTATIONS

Basis for Setting Stretch Goals	Description
Business plan	If the business plan is reasonable and has stretch in it, then the incentive goals based on this plan also should be achievable but represent solid business performance.
Participation	People are more committed to achieving goals they help develop than goals that are developed for them. Getting input from participants in setting goals is valuable. But this does not mean the leadership team doesn't actually set the final performance goals and expectations.
Continuous improvement	Many organizations believe that if they set really tough goals, the workforce will figure out how to achieve them. But too-tough goals sometimes cause people to give up when they begin to miss them early in the performance period. One antidote is to set realistic goals that have some improvement and increase the stretch in future performance periods. It is important to communicate upfront to employees that performance improvement will continue to be built into the goals.
World-class sustained	This means achieving a constant high-performance level that would be recognized as world-class performance. The organization is satisfied with consistent performance at this high level. This goal strategy often avoids needing to improve every year once great performance is achieved but requires consistency.
Compare to prior results	Many organizations set goal performance levels by exceeding the previous year's performance (ratcheting baselines).This ensures stretch goals but needs to be evaluated as a strategy because it may ignore the realities of the marketplace, customer needs or general economic conditions. Others may compare to the last couple of years to smooth out the performance expectations (rolling baselines).
Industry standards	How an organization compares to the performance of other organizations can provide an index of how it's doing from a comparative standpoint. Frequently outperforming competitors is a viable goal and takes into account factors that impact an industry uniformly.
Prevailing practice or "best" practice	What others do provides some organizations with clues about what they should do. There is considerable comfort in doing what others do and this helps many organizations set goals and goal performance standards. However, what others do constitutes prevailing practice and not necessarily "best practice." What is "best" for one organization may not be best for another and creates average performance. Comparing to best practice provides more of a stretch, depending on your organization's performance.

MEASURE PERFORMANCE WHERE IT COUNTS THE MOST

Measure where the organization hopes to get optimum performance. Most organizations are interested in impacting organizationwide goals that represent a long line-of-sight to employees. However, to use these goals, organizations must make them "real" to incentive participants. Considerable education and engaging employees in understanding how they impact these measures are necessary for organizationwide plans to be successful.

Organizational unit, team and department goals are medium line-of-sight. The challenge here is to link the individual to the organizational unit and the unit goals to the organization's goals. Team performance should also not be optimized at the expense of the organization.

Individual goals provide the closest employee line-of-sight but are more difficult to develop in a consistent quality manner across the organization. SMART (Specific, Measurable, Achievable, Realistic, Time) objectives or cascading goal methodology helps, but the challenge is to ensure all the individual goals add up to business value added to the organization and performance optimization across the organization.

EVALUATE OUTCOMES AND CHANGE AS NEEDED

When should or might you change incentive goals and for what reasons? A software development company set incentive goals based on expected improved performance over the prior year. The general economy turned down, making it impossible for the company to achieve its aggressive sales and profit goals and unlikely incentives would be paid. The CEO was concerned, feeling employees would give up since the goals he had believed were a reasonable stretch were actually not within reach. The conclusion was to adjust goals mid-year to more reasonable expectations and strongly communicate the need to help the organization get through the year. In this instance, it worked. In other companies, adjusting goals may not have been affordable.

Typically, organizations consider changing goals or performance requirements relative to measures at the start of the next performance period, it is important at this time to match measures and goals to the organization's business plan and the realities of the marketplace. This also gives the organization a significant communications opportunity to let the incentive participants know what is expected and how they fit in.

The real question is about changing goals and goal requirements midstream. Some of the business reasons organizations may find compelling enough to warrant changing performance expectations and incentive goals during the middle of a performance period could include the following:

- Changes in business strategy/plan objectives that can't wait for the start of a new performance period
- Capital or technology changes that happen during a performance period
- Product mix changes
- Competitive necessity or improvements
- Accounting changes.

The key issue is the immediate nature of the need to change. It makes no sense to stay the course when the situation changes significantly and dramatically, and incentive goals will serve only to undermine new directions and priorities.

COMMUNICATE AND CHAMPION

Implementing incentives where none exist is a "hot" change. Changing from a base pay-only program to incentives gets everyone's attention and gets it quickly. And it is "noisy" change that may create concern.

It's essential to tell why you are changing rewards and adding incentives. What is the present situation relative to the organization and workforce? Why must the situation change? What desired future state is the organization seeking as a result of adding incentives? Where do people fit in the formula for change? How will their pay be influenced, and what must they do to receive an incentive award?

One new CEO decided the reason for incentives was to change the workforce's strong focus on an entitlement mentality. The CEO implemented incentives to send a message that adding value to the organization is critical to organizational success. It put some "skin in the game" so employees became interested in how the organization performed on key incentive goals.

The principal cause of incentive failure is lack of championing and sponsorship from the top of the organization. Senior leadership must educate on the importance of goal achievement. Championing must be continuous, not just at the start of the incentive plan. Incentives are the responsibility of the managers from top to bottom — helping to set goals, coaching employees on how to reach the goals, problem solving with employees, removing barriers to performance, communicating and helping ensure everyone knows what is required of them. The reason for the incentive is improved results, and the incentive plan serves as a communications vehicle to accomplish this.

We like to get employees involved in helping to design the incentive plan. Whether they are part of a focus group or on an actual design team depends on the organization and the situation. But involving people who will actually be incentive participants in the design of the plan is invaluable. They are able to provide inputs and improvements. Their most important and powerful role, however, is in their communication and support of the plan. They can begin the communications process at the start of the design and be involved throughout the life of the plan. And they play an important role when the plan is evaluated — at least annually.

DON'T GIVE UP!

Implementing an incentive plan represents a major change. Most employees are used to getting a fixed paycheck, and many have never had any of their compensation depend directly on their performance. A "merit" increase is most often diluted with issues of internal equity, competitiveness, cost of living, promotions and the like, meaning little of it is really for merit at all. Incentives for performance are a big change, and the organization's leaders must be ready to stick with the change process for several years at least. If your CEO asks, "What's the biggest bang-for-the-buck change we can make in compensation in the next year?", incentives may be the answer. It may be time to look at the seven incentive design principles outlined in Figure 1.

Incentives work, and most organizations need them somewhere right now. Incentives provide a great opportunity for pay and reward professionals to "put some performance bread on the company's table" this year and next. Many organizations are working through the challenges and opportunities that incentives present and are getting added value.

ENDNOTES

[1] McAdams, Jerry L., and Elizabeth J. Hawk. (1992.) *Capitalizing on Human Assets: The Benchmark Study*. Scottsdale, AZ: American Compensation Association.

[2] Lawler, Edward E., III. (1990.) *Strategic Pay: Aligning Organizational Strategies and Pay Systems*. San Francisco: Jossey-Bass Publishers.

[3] Mohrman, S.A., S.G. Cohen, and A.M. Mohrman, Jr. (1995.) *Designing Team-Based Organizations: New Forms for Knowledge Work*. San Francisco: Jossey-Bass Publishers.

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