Incentive Compensation Principles

by William Mech

What really motivates people? The real answer is: a variety of things. People are not monolithic in the type of rewards they value, nor in what drives them to set and achieve goals. Ideally, incentives should recognize these differences - designed to fit the individual. And maybe if you're a small business owner with a half-dozen employees, you could do so. But how cumbersome would it be for a large business with hundreds of employees to have a vast array of individually customized incentive plans? That's completely unworkable, of course. Still, many companies try to get there by having goals developed for each individual (or team), that relate specifically to what they do all day, and can also be measured objectively. Some weight can then be given to these objectives in an overall incentive formula, and perhaps thereby achieve some level of customization in incentives.

But… what funds the incentive plan? Corporate performance against goals, such as growth, earnings, ROE? Profit, shared according to some agreed percentage? Some other measure of "gain" to be shared? Is the funding always tied to current calendar year results, or should it derive from multiple years' performance? Does funding come from corporate, or from individual business units' results? There is a balance to be struck between a socialization of team results (whether the team be corporate, business unit, project or work group) and individualization. Incentive programs quickly become ***dis***incentive programs if employees put in all the extra effort needed to achieve their specific goals, but… there is no funding available due to factors beyond their control. Similarly, disincentive occurs when there is ample corporate funding, but no payout for them because of the performance of the project team to which they were assigned. There are a few key principles that need to be followed to keep incentives… incentives!

Try really hard to hit target payout, on average

When you tell employees that their target incentive is XX%, they intuitively expect that, on average over time, **that's what they'll get!** Plus, when your HR function does market comparisons, total compensation for a particular job can't be compared to the market's compensation for similar positions using "target" bonus pay, unless both your company and the market are actually paying out at "target". You are distorting such comparisons if bonuses routinely do not average out to target, as well as confusing your employees about what their "target" really is.

Link bonus pay to company fortunes, but vary that link

The higher an employee's target bonus (as a percent of base pay), the more it should be affected by the company's results. Generally speaking, if an employee's bonus percentage is high, that employee has greater influence across the organization. The broader one's responsibilities, the more any bonus should derive from comparably broader results. Highly paid people also have more capacity to absorb risk, and expect variability in their bonus pay. In contrast, lower paid employees, should not only have less of their total pay at risk, but also be affected less by the fortunes of the overall organization, since they influence those fortunes far less directly. Simply put, they need to have less volatility in their bonus pay, and more control over it. Bonus pay should not be a one-size-fits-all system; rather it should recognize the need for

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less volatility and more control when incentive targets are smaller. (note: hold this in tension with #1 & #3)

Be sure that 95% of the time, something gets paid out

Ranges imposed around target payout such as [50%, 150%] are discretionary (some employees might even say arbitrary!) and can be changed. While some constraints around incentive pay are a practical necessity, you can widen the range so that the "cliff" and the "cap" are further out in the tails, thereby minimizing the constraints on rewards (see concluding illustrations). This way, more people participate more fully, and variation in payouts is wider, to recognize variation in performance. High performers get even more, poor performers get much less, but… everybody plays, and plays more often. To the high achiever who is motivated by financial reward, having your incentive pay limited by formula can serve as a disincentive. To the employee who is motivated more by group success than individual achievement, socialization of success is important, and being "cut out" of the process in which your co-workers participate, due to formula constraints, can also serve as a disincentive. To the extent that management discretion can be included in the process of determining payout, while still preserving objective measurement against goals, it could alleviate the concerns noted above.

Summing up, there needs to be a perception of fairness in incentive plan design, in all aspects, from the method of funding, to the consistency and breadth of payout, to the degree of employees' control of results. Recognizing the variation that exists in employees' attitudes toward goals, rewards, socialization, and individual control is critical to finding the needed balance between an incentive plan that is administratively manageable, as well as one that is responsive to the unique needs of employees. Lower wage earners need protection from volatility and more control over outcomes, whereas high wage earners should be expected to have both a broad perspective on company fortunes as well as a higher tolerance for variable pay. Good design sweats these details.

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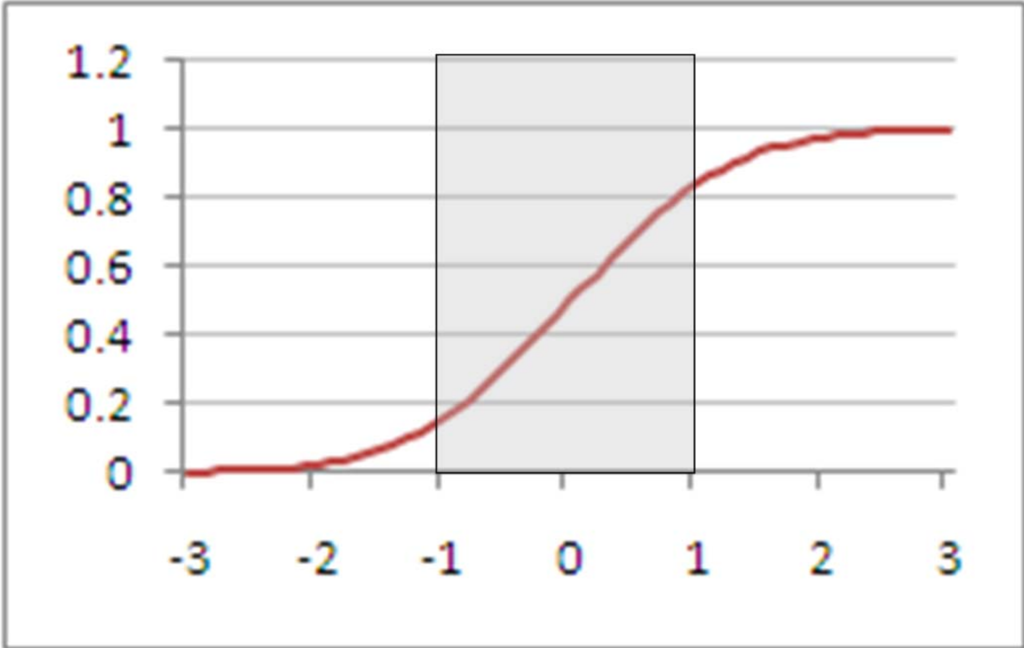
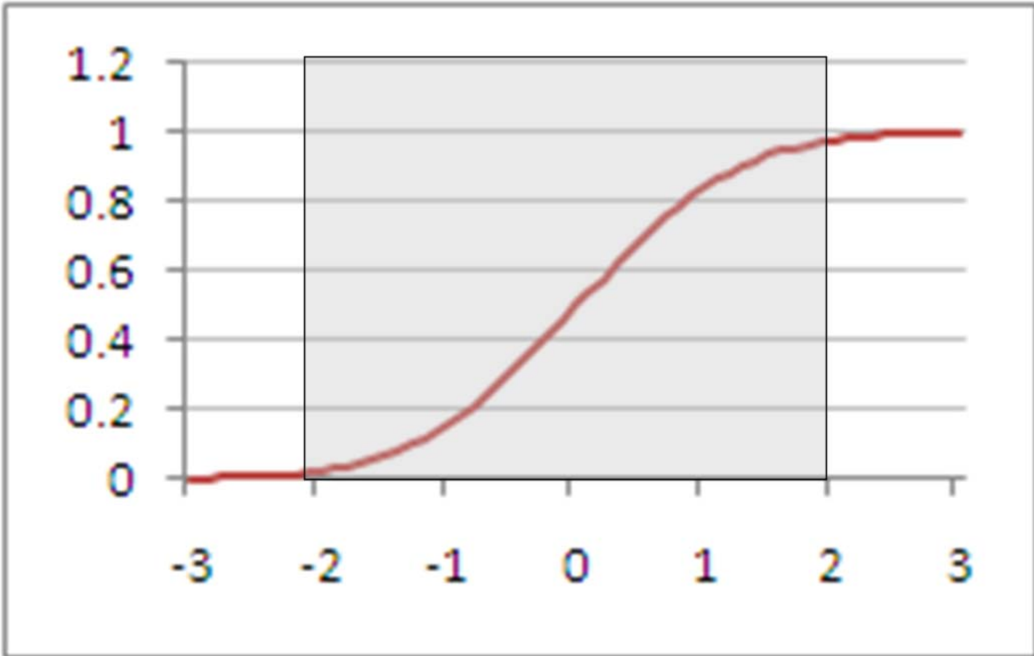
Examples for #3

Pay bonuses not like this:



But like this:



Set any “cliff” and any “cap” so as to minimize constraints.

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