

Selecting the Right Performance Measures for Your Incentive Plan



The Role of Indicators

Building an effective incentive plan requires a company to align interdependent elements within the business in a way that communicates a clear behavior standard to its employees. The plan must have a purpose; it must project the potential that can be realized if the purpose is fulfilled and identify the people that are in a position to impact those outcomes. It must also have a way to standardize the benefit or reward it is going to provide employees and determine how much of increased shareholder value it is going to allocate to employees and how its value will be measured.

This interdependent alignment is held together by forming the right measures and metrics in your reward strategies – especially the company’s incentive plans. Those indicators should be measureable although they may or may not be directly reflected in the financial statements. The measures chosen should help the organization track progress towards strategic objectives and reflect improvement in productivity.

Indicators can be a number or a percentage. They can be tied to the budget (i.e. percent of budgeted target achievement) or stated as an improvement over a prior period. They could have a minimum threshold and these measures could be “tiered,” creating different metrics for different tiers or different weighting of the same metrics.

In all cases, the role of indicators is to accomplish the following:

- Seek to improve performance
- Seek to influence behavior
- Create “focus” through communication and reinforcement
- Engender and encourage an ownership culture

It is important to understand that although indicators are intended to impact behavior and performance, they are not “motivators” per se. Motivation is something internal that employees must assume responsibility for. It is encouraged by aligning employees with roles and tasks that are

consistent with their unique abilities. Motivation is further engendered by a shared vision and values between the company and its workforce.

On the other hand, if indicators are not properly defined, a compensation plan can potentially deflate the motivation of employees. This happens when a member of the workforce doesn't feel as though there is alignment between his or her role and how rewards are earned. This creates frustration and disillusionment, two conditions that are at odds with a positive focus and a culture of confidence.

Two Core Approaches

In establishing appropriate measures and metrics for an incentive plan, it is important that a company begin with an understanding of certain foundational principles. Among them are the following:

- Overall improvement in profits represents the ultimate goal of almost every incentive plan.
- The plan should be self-financing (i.e., it should pay for itself by creating additional value for shareholders).
- Thus, profit-based drivers are the most common targets for incentive arrangements.
- Some plans select other drivers that are more within the reach of employees. These are referred to as KPIs (key performance indicators). It is assumed that improvements in the KPIs will lead, ultimately, to improvements in profits.

These principles lead to two core approaches that a company should consider in its development of incentive plan indicators. One we will call a Profit Based Allocation and the other, Targeted KPIs.

Profit-Based Allocation

Under this approach to building metrics, a company decides that it will allocate a percentage of annual profits to employees. The award amount is divided among employees based on a pre-determined formula. Typically, payouts occur at year end, but some companies prefer to make those payments quarterly.

The focus of a Profit-Based Allocation is solely on annual profits. As a result, the value created can be open ended. This can be good or bad (more on that issue in a minute). The design of this kind of incentive is relatively simple; however it is essential that it be accompanied by a strong performance management system. This is because in a profit based incentive environment, rewards are driven strictly by company performance, not individual or department performance. As a result, a separate management system needs to be in place to reinforce the behaviors necessary to achieve targeted and superior profits.

The Profit-Based Allocation has some inherent dangers or drawbacks. This approach does not always create the complete "line of sight" an organization would want to see fulfilled by virtue of its compensation strategies. Also, because the plan is centered solely on company

performance, employee apathy can set in and morale issues can arise. Consequently, if there is a lack of a strong performance management system in the organization, this approach can be troublesome.

With those dangers in mind, in a "best practices" framework, a Profit Based Allocation should address and/or account for the following issues:

- **Define profits** - whether it will be some version of EBITDA, net income or some other measure. Also, the company must determine if there will be an economic value added component to measuring profits, accounting for a certain return that must be achieved by shareholders before value inures to the benefit of employees.
- **Select either a "Benchmark" or "Growth" Approach** - establishing the baseline upon which contributions to the profit pool will be based. Most companies determine to set a standard upon which (or above which) performance must be achieved for incentive formulas to kick in. Others base incentives on the growth of profit each year - so as not to pay incentives during periods of stagnate growth.
- **Identify Threshold** - this ensures that a certain measure has to be achieved before any payments are made under the incentive plan.
- **Select Percentage to Share (fixed or tiered)** - this will establish the amount of profits (however determined) that will be distributed in the form of awards. This can be a fixed amount for everyone or different for various "tiers" of employees within the organization.
- **Select Allocation Formula** - to determine how the potential value will be communicated to participating employees (percent of salary, pro-rata allocation of pool, etc.)
- **Determine Personal Performance Component** - this is to define whether there will be a certain personal performance threshold that needs to be achieved impacting the degree to which an employee will/can earn benefits.

Targeted KPIs

Some plans select drivers for their incentive plans that are more within the reach or control of employees. These are referred to as KPIs (key performance indicators.) The theory behind the key performance indicator approach is that improvements in the focus and execution of employees on the issues they are best positioned to impact will lead, ultimately, to improvements in profits.

A KPI approach can incorporate company, department or individual metrics. The value of the plan is typically capped and its design can run from quite simple to very complex. What is essential in this approach is selecting the right metrics. This means you are going to identify indicators that will be used to measure performance in each area. For example, company metrics might be a combination of revenue growth and net income. Departmental indicators could be such things as improvement in company retention or an increase in the collection rate on accounts receivable. Individual metrics would be tied to personal performance goals and productivity factors.

Here are some examples of company and department indicators that we have seen used in the past effectively. Of course, their application will vary depending on industry and other factors.

Company Indicators	Department Indicators
<ul style="list-style-type: none"> • Return in equity • Return on assets • Earnings Per Share • Gross sales • Net Income • Earnings Before Incentives • EBT, EBIT, EBITDA • Economic Profit (Productivity Profit) • Revenue Per Employee • Profit Per Employee • Customer Satisfaction Indicators 	<ul style="list-style-type: none"> • Gross Sales • Gross Margin • Overhead Percentage • Average Daily Room Rate • Average Daily Occupancy Rate • Contribution to Margin • Expenses to Budget • Production Quotas • Employee Retention Percentage • Registrations • Client Referrals • Alpha • Number of MBOs meet • New Loans • Deposits

The dangers with the KPI approach can include the following (among other things):

- Miscalculation (i.e., KPI improvements did not sufficiently offset failure to execute in other areas). This can lead to a company making incentive payments even though profits did not arise. This is sometimes compensated for by having a minimum profit target that must be met before incentives are paid. However, such a standard can be demoralizing if employees hit their targets but are denied payment.
- Gaming (i.e., employees learning how to achieve the KPIs but without respect to the profit goals). This can lead to intentional or unintentional failure to achieve profit objectives.
- Sandbagging (i.e., employees barely reaching KPIs while determining to carry-over performance into the next period). This can lead to failure to achieve full profit potential.
- Misalignment (i.e., forcing employees into behavior that moves them outside their skill sets and abilities). This occurs when extrinsic motivation overrides intrinsic motivation. The KPIs may be achieved while job satisfaction diminishes.

In our experience, KPI approaches work best if they incorporate the following elements.

Range of Incentive

Attractive target incentives should be established for each position. In general, growing companies size their incentives in a range of 25% to 100% of salaries for senior executives. Of course, lower ranges are set for the other tiers.

Sample:

Position	Target Award
Executive	40-60%
Management	20-30%
Other Employees	5-20%

Components of Incentive Calculation

Next, the company should determine how much of an individual's incentive will be based on (a) company performance, (b) department/division performance, and (c) individual performance.

Sample:

Position	Company Goals	Department Goals	Individual Goals
Executive	100%	0%	0%
Management	25%	50%	25%
Other Employees	0%	75%	25%

The determination of this weighting is predicated on the degree of impact each person (position) is deemed to possess relative to the associated result area.

Key Determinants (Drivers)

Company Drivers

Metrics to consider for company performance might include:

- Productivity Profit
- Revenue-to-Budget
- Net Income-to-Budget
- ROTRI™ (Return on Total Rewards Investment)
- Net Free Cash Flow

Department Drivers

Departmental metrics might include:

- New sales (for appropriate departments)
- Division profitability
- Customer satisfaction factors
- Production quotas
- Project criteria (time and budget)

Individual Drivers

Key Performance Indicators (KPIs) designed to measure individual performance fall into

two categories: hard measurements and soft measurements. Hard measurements include specific metrics calculated to reflect on the direct control of the participant. An example of a soft measurement would be the "completion of a specific project by a specific date."

Pre-Determination

The incentive components should be established and communicated in advance of the incentive period (typically annually). The employee should be able to identify and understand the exact requirements associated with achieving his or her target incentive. For example, an incentive structure for a Department Head might be communicated as follows:

Salary	\$150,000		
Target Incentive	30% of salary	\$45,000	
Component:	Company	Weight: 25% Value: \$11,250	Productivity Profit Top line growth
	Department	Weight: 50% Value: \$22,500	Project completion factor Divisional P&L
	Individual	Weight: 25% Value: \$11,250	4 Annual Milestone Goals

Tiered Awards

Incentive targets may be tiered to eliminate an "all or nothing" consequence. Commonly, three to five tiers are recommended. The payout results at each tier should be significantly greater than the preceding tier. Often, the plan grid (see below) can help produce this "tiering" effect.

Executives are often provided with clear measurement grids to help balance non-correlated or complementary goals.

Below is an example that could be used for a company-wide grid.

Revenue to Budget	Factor (percent of target incentive)				
	110%	100	125	150	175
105%	75	100	125	150	175
100%	50	75	100	125	150
95%	25	50	75	100	125
90%	0	25	50	75	100
Income to Budget	94%	97%	100%	103%	106%

In Conclusion

There is no one perfect solution to designing an incentive plan that will be effective for every company. As a result, the way a company approaches the ideal is to understand best practice standards and frameworks and then work within that structure to customize indicators, measures and metrics that are suitable for your business. The selection of the type of incentive plan and its associated metrics should be based a company's culture, business model and goals. Here we have introduced two effective approaches to developing incentive plan indicators. Our recommendation is that you make a decision about which works best for your company and then stay with it - polishing and perfecting it over time. In that context, you will want to measure the plans effectiveness by calculating the company's ROTRI. You will also want to measure and track you employees' commitment, engagement and execution.

VisionLink is a national compensation consulting firm focused on helping companies envision, create and sustain compensation strategies that will be key drivers of results and increase the productivity of employees.



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