Executive White Paper

Do Incentive Plans Really Work?
VisionLink’s focus is to enable growth-oriented companies to create greater alignment between their business plans and their rewards programs—thereby creating a unified financial vision for growing their companies. We do so by first understanding our clients’ performance framework, then helping them envision, create and sustain compensation solutions that will drive growth.

Our work removes barriers to high performance stemming from an inability to recruit and retain top talent, keep employees focused on and executing key performance initiatives, or achieve an appropriate return on the shareholders’ investment in their key people.

Our firm’s capabilities include comprehensive diagnostic analytics, philosophy and “game plan” development, market pay studies and pay grade development, incentive plan and executive benefit design (including concept, blueprint, financial models, plan specifications, documentation and launch), and rewards administration and management.

VisionLink is a national firm headquartered in Irvine, California. Our work has helped hundreds of companies throughout the continental United States create and sustain transformational rewards strategies.
Do Incentive Plans Really Work?

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Executive Summary

Business leaders who are seeking to grow their companies by improving the performance of their employees (especially key producers), inevitably confront questions such as these:

- Can incentive plans impact employee behavior?
- If so, what kind of incentive plan should I have? Should it be short-term or long-term? What type of long-term plan is best—stock, phantom stock, profit pool or something else?
- If I implement a plan, how will I know it’s been successful?

Ultimately, while there are many factors to consider as business leaders weigh talent and performance issues, one overriding pay question is unavoidable: Do incentive plans really work? If a company pays an employee in a certain way, will it positively influence that person’s performance?

Some authors and other performance experts claim that incentive plans are ineffective. If so, why do so many high-performing companies include both short and long-term value-sharing arrangements as part of their rewards strategies?

Organizations that decide an incentive plan can play a role in promoting the growth they seek must then determine what constitutes an effective plan. They want to engineer plan designs that create alignment between the company vision, its business model and strategy, employee roles and expectations, and financial rewards.

Once a company embarks on the road of plan design, development, and implementation, it has to also be able to determine whether or not the incentive plan is “working.” It must have some means of measuring the impact value-sharing is having on the outcomes it is intended to impact.

This paper addresses all of these issues. It will envision the role well-constructed short, long-term and sales incentives can play in forging an effective financial partnership with employees and creating the value proposition you need to attract and retain premier talent.
Do Incentive Plans Really Work?

There has been a long-running debate about incentive plans and whether or not they “work.” It usually centers on one central question: Do incentive plans measurably and positively influence employee behavior? While many in business assume it’s conventional wisdom that incentive plans have a meaningful impact, some assert otherwise. These opposing voices challenge the assumptions many business leaders hold regarding human motivation in the workplace.

Framing the Argument

One of the most recent challenges to the value of financial incentives is Daniel H. Pink’s 2011 book Drive (Penguin Group). In his book, Pink contends that taking a “carrot-and-stick” approach to motivation is outdated and ineffective. He argues that employees are influenced more by intrinsic factors than by remuneration. Pink backs up his arguments with decades of scientific research on human motivation.

In his book, Pink asserts that by attempting to use financial incentives to drive employee behavior, a company actually narrows their focus, constrains their minds, and impedes their possibilities. He also posits that when a company needs an employee to perform tasks that require creative thinking and innovation, rewards can have the effect of extending the time it takes for that employee to solve the problem. His central thesis is that companies should pay employees adequately and fairly, thereby getting the issue of money off the table, and then give them lots of autonomy so their intrinsic motivations can take over.

Well, guess what? There’s no real disagreement here on any of those points. That said, motivational theory and research are great, but how do business leaders apply this approach in the real world, with real people, and with the growth trajectory of the company at stake? What should businesses conclude from this? Should they pay all employees the same? How do they compensate employees who have higher skill levels and are making greater contributions? Do they simply eliminate incentives all together and encourage employees to enjoy the “intrinsic” rewards associated with their jobs? These are practical questions that need to be addressed in a way that respects the legitimacy both of Pink’s (and others’) arguments and of a company’s need to effectively frame the financial partnership it will have with its workforce.

Clearly, ignoring the role and impact of extrinsic rewards is impractical. Instead, the goal of every business leader should be to develop pay strategies that reward superior performance while supporting and nurturing intrinsic motivators. Such an approach assumes the two are not mutually exclusive. Then can co-exist. This type of culture is built upon a correct understanding
of the role of compensation in general, and incentives specifically, in a total rewards framework.

The four quadrants of a total rewards structure are a way of examining the combination of intrinsic and extrinsic factors that influence whether or not premier talent will join an organization, then stay—and how those individuals will perform while there. If any one of these issues doesn’t measure up in the mind of a key person, that employee will leave the organization or not join in the first place. Or they will underperform. Let’s define what each of these factors means.

- **Compelling Future.** Employees certainly want to feel compelled by where the business is headed. More importantly, however, they need to be able to see themselves as an integral part of making that future a reality; that their unique abilities are needed to have the company realize its full potential. This is strongly rooted in intrinsic factors.

- **Positive Work Environment.** Great talent wants to enjoy the nature of the work it is doing and with whom it is engaged in that effort. In addition, high performers in particular want to know that the culture supports achievement and success. Such cultural issues that are largely born of an extrinsic design and effort.

- **Personal and Professional Development.** Growth-oriented companies create an environment where the unique abilities of their key performers can thrive. In such organizations, people with distinctive talent find they are able to accelerate their learning curve and improve more quickly at what they do because of the resources to which they’re exposed. This occurs through a combination of both extrinsic and intrinsic influences.

- **Financial Rewards.** A company’s compensation philosophy, practices and plans frame the financial partnership an organization has with its employees. When done effectively, they reinforce “what’s important” to the present and future success of the business. Further, they give shape to workforce roles, define successful outcomes and align
shareholder and employee interests and vision. Although pay is an extrinsic device, it is most effective when it creates a unified financial vision for growing the business. That appeals to the intrinsic desires high performers have to align themselves with excellence and success.

The ideal environment, then, is one where the Total Rewards Framework is in balance. Otherwise, if the quality of any quadrant is lacking for an employee, he will not perform at his highest level, and probably won’t stay around for long. So while incentives and other forms of financial rewards shouldn’t be viewed as tools of manipulation to influence employee behavior, their absence can likewise communicate a strategically damaging message to key talent. Pay needs to align with vision, strategy, roles and expectations or there is high potential for underperformance.

Consequently, as it relates to an intrinsic/extrinsic balance, the core issue is fairness. Fundamentally, incentives are about fulfilling a commitment to reward people fairly (even generously) for helping to fulfill the mission and business model of the organization. When quality people understand and believe in this commitment, the intrinsic desire of quality talent to deliver on the organization’s business plan is reinforced and unleashed.

Share Value instead of Paying Incentives

Understanding that employees respond best to extrinsic factors that reinforce rather than diminish their intrinsic drive, we need to now examine what incentive plans should reward. The most effective incentive plans “work” only if they compensate employees for actually creating value. This means that an organization must be able to clearly identify and articulate what value creation means in its business and then have a plan for sharing that value with those who produce it.

Incentive plans are viable if they are built on a self-financing premise. This means, simply, that a company pays rewards only out of value that has been created; from what might be termed its productivity profit. This is the value increase that is attributable to the contributions of people rather than other capital assets at work in business. Productivity profit can be used to define a value creation threshold for an organization and become the point at which the company is willing to share value with contributing, results-producing employees.

Productivity profit is calculated by first identifying a capital account for the business. Next, the company will want to determine an appropriate “charge” to the capital account of shareholders for their stake in the business. This represents the amount owners should expect to earn on their invested assets in the enterprise. Anywhere from 8 to 20 percent is commonly used. So if a company’s capital account is $20 million and its capital charge is 12%, then the first $2.4 million of profit is attributed to the assets already at work in the business—before people get
involved. By subtracting the dollar value of the capital charge from the operating income of a business in a given year, you arrive at the “productivity profit.” It’s the amount of profit beyond the capital charge attributable to the contributions of the workforce. (See example below.)

**ROTRI™ Example:**

<table>
<thead>
<tr>
<th>Capital Account</th>
<th>$20,000,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of Capital</td>
<td>12%</td>
</tr>
<tr>
<td>Capital Charge</td>
<td>$2,400,000</td>
</tr>
<tr>
<td>Operating Income</td>
<td>$10,000,000</td>
</tr>
<tr>
<td>Productivity Profit</td>
<td>$7,600,000</td>
</tr>
<tr>
<td>Total Rewards Invest</td>
<td>$25,000,000</td>
</tr>
<tr>
<td><strong>ROTRI™</strong></td>
<td>30.4%</td>
</tr>
</tbody>
</table>

(ROTRI™ = Productivity Profit/Total Rewards Investment)

To be considered effective and “working,” incentives should only be paid from productivity profit. If there isn’t one, they aren’t “earned” and shouldn’t be paid.

An additional step a company can take is to calculate the return it gets on what it invests in compensation. This means tracking the ratio of its productivity profit to its total rewards investment (salaries, commissions, bonuses, incentives, benefits, retirement contributions, payroll taxes, etc.). For example, as shown in the sample above, if a company’s total investment in compensation is $25 million, and its productivity profit is $7.6 million, its ratio is 30.4%. The first calculation of this type becomes a baseline. A company can then measure year to year whether this ratio improves. It is one way to determine whether the value creation and sharing model is fulfilling its role and if productivity is improving.

If a company has concluded that its incentive plans are not “working,” there’s a high likelihood it is not effectively defining and measuring value creation. As a result, it is probably treating that part of its compensation strategy as a device, a behavior manipulator. The term “incentive,” in effect, implies that one is trying to elicit a certain type of performance through a reward. Value sharing is different. It implies plans are “self-financed” and succeeds in an environment where compensation is used to “reinforce” rather than “force” productive, results-oriented behavior that drives the productivity profit.
Reinforcing vs. Forcing

When business leaders tie their incentive plans to a value creation model, they find such an approach can, in fact, have a powerful impact on employee behavior—just not in the way conventional wisdom assumes. The influence is a result of the outcome focus effective value sharing creates and how that emphasis impacts execution. Clarity invites better performance. Therefore, when someone is clearer about the outcomes for which they are responsible—and a financial partnership has been well defined for their fulfillment—employees are “freer” to perform. In a sense, the value sharing approach gives them permission to apply themselves; it removes a barrier and replaces it with purpose and transparency. Line of sight is improved.

Conversely, organizations that use incentives and other financial rewards in an attempt to force behavior too often end up producing bad profits instead of good ones. Bad profits come at the expense of long-term shareholder value. Even though they show up on the income statement and balance sheet, they come at a price—a negative impact on issues that are crucial to the growth of the business: customer relationships, margins, diminished reputation in the marketplace, etc. Conversely, when companies define clear outcomes tied to growth goals, then reinforce roles and expectations linked to those results, employees are led to a greater level of stewardship. They protect good profits. And their intrinsic instincts are unleashed because there is no conflict between the four components of the Total Rewards Framework.

Below are examples of how a force versus reinforce approach to compensation is manifested.

<table>
<thead>
<tr>
<th>Force</th>
<th>Reinforce</th>
</tr>
</thead>
<tbody>
<tr>
<td>&quot;This is the behavior that’s expected and rewarded.&quot;</td>
<td>&quot;These are the results that are valued and rewarded.&quot;</td>
</tr>
<tr>
<td>&quot;Do these things whether you like them or not.&quot;</td>
<td>&quot;Here are the outcomes we are striving for. Here are our standards, patterns, expectations.&quot;</td>
</tr>
<tr>
<td>&quot;Your bonus reflects our market pay analysis of your job classification.&quot;</td>
<td>&quot;Your bonus reflects the way we share the value that you help create.&quot;</td>
</tr>
<tr>
<td><strong>Bad Profits</strong> that erode the long-term value of the business</td>
<td><strong>Good Profits</strong> that support your overall business growth strategy</td>
</tr>
</tbody>
</table>
Value sharing aligns naturally with a reinforce approach because its premise is that employees are business partners in driving company growth. They have a vested interest in creating value. Such an approach instills confidence in the ability of associates to own results and then codifies their commitment with a financial agreement that appropriately ties compensation to performance. The result is win-win.

Prioritizing Value Sharing

Having established that an effective incentive plan must define how the value that is created will be shared within a “reinforce” framework, we now turn our attention to how that effort should be prioritized. Those priorities will be tied to the performance the company needs to drive the growth the business seeks. Most enterprise leaders have a vision of the future company that is in some way bigger and better than the present. If that is true, then future-focused businesses need mechanisms that enable them to reward people for successfully meeting the performance targets that drive their growth. Typically, this means companies need to consider three different types of incentives that will align compensation with the growth trajectory of the business.

Sales compensation and short-term value-sharing plans are intended to link pay to the achievement of targeted revenue and yearly profitability objectives; they reward people for making the financial engine of the business work effectively. On the other hand, long-term plans compensate employees for driving revenue and profitability growth. Every business has to determine what priority each of these approaches should have. Ultimately, most organizations will want to implement all three. Given that, let’s examine how each of these plans can be successfully addressed.

Sales Incentives

The term incentive is probably most appropriately applied to the sales process because it is focused on driving a very specific kind of performance. Nonetheless, sales incentives must still be aligned with organizational goals relating to growth, profit enhancement and customer retention if they are going to “work.” As a result, before designing a sales compensation plan, we must first get clear on certain business goals:

- What type of growth are we seeking? (Revenue growth? Profit margin improvement? Market share? All of the above?)
- How much growth are we seeking—and over what time period? (Doubling revenue over the next three years? Thirty per cent increase in profits over the next five years?)
Where do we think that growth will come from? (Customer retention? New markets? Acquisitions? Cross selling? All of those?)

Once an organization is clear on its business goals, it must scrutinize its sales process. Securing sales usually involves interdependent categories of activities such as the following:

- Customer Identification and Solicitation—finding the potential buyer
- Demand Creation—introducing and presenting the value proposition
- Point of Persuasion—moving customers to the purchase commitment
- Delivering the Product—ensuring the value proposition is fulfilled
- Servicing the Order—ensuring the value proposition is sustained

Despite what has been said about intrinsic versus extrinsic motivators, people involved in sales believe the fulfillment of each of those components should be rewarded. There is a financial value associated with each phase of the sales cycle. And because each employee involved in that process has a role for which they are responsible within one of more of those categories, incentives must be logically and fairly tied to each of these functions. That is the “art” of sales compensation design.

The ideal sales incentive design will achieve the following:

- It establishes a direct link between organizational goals and sales objectives.
- The top-end rewards are perceived as achievable and are consistently earned.
- Quotas are reached by at least 70% of sales representatives.
- There is a long-term reward component that retains top producers who sustain results over an extended period of time.

**Performance Incentives**

Annual bonus plans and other short-term value-sharing arrangements should reward the year-to-year maintenance of the financial engine of the company, with an eye towards growth. They can either be based on achieving profit goals or tied to the fulfillment of well-defined key performance indicators. Sometimes, they are based on a blend of the two.

**Profit-Based Allocation**

When companies tie annual value-sharing to profits, they have determined that this metric will be the paramount focus with employees. Typically, such plans are set up by allocating a percentage of annual profits to a pool. The award amount each year is divided among participants based on a predetermined apportionment model. Commonly, these plans are set up with thresholds that ensure shareholders receive an
appropriate return on their capital investment before the pool is funded. (See the discussion of productivity profit above.)

The advantage of a profit pool is that it is simple and straight forward. It allows owners to rivet the attention of employees on the production of profits. Employees gain a sensitivity to the issues that impact the income statement of the company and are rewarded for producing the thing most critical to the company’s growth.

The disadvantage of a profit-based allocation is that employees are not paid directly on the achievement of individual metrics that they impact every day. As a result, the company must have an effective performance management system if a profit pool value-sharing approach is adopted.

**Targeted KPIs**

The alternative to a profit pool is a plan that links the incentive to the achievement of specific key performance indicators. In this arrangement, usually there is a targeted benefit that is tied to a percentage of salary. An individual employee can earn the targeted payout or some amount less or more than that, depending on the metrics he achieves. Of course, the employee may also earn no bonus if minimum thresholds are not reached, which are built into the plan.

<table>
<thead>
<tr>
<th>Performance Incentive Approaches</th>
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<tbody>
<tr>
<td><strong>Profit Based Allocation (PBA)</strong></td>
</tr>
<tr>
<td>• A percentage of annual profits awarded to a pool</td>
</tr>
<tr>
<td>• The award amount is divided among employees based on a pre-determined formula</td>
</tr>
<tr>
<td>• Awards paid at year end</td>
</tr>
<tr>
<td><strong>Targeted KPI’s (TKPI)</strong></td>
</tr>
<tr>
<td>• Employees assigned a “targeted” incentive value, often based on a percentage of salary</td>
</tr>
<tr>
<td>• Achievement of award is tied to multiple metrics that can vary by person</td>
</tr>
<tr>
<td>• Awards paid at year end or quarterly</td>
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**Growth Incentives (long-term value sharing)**

Growth incentives probably best represent what value-sharing really means. These plans define a method by which employees can participate in the success they help the organization achieve. When employee compensation is tied to results that are generated over an extended period of time, incentive participants are rewarded similar to owners. As a result, they become better stewards of those long-term outcomes. They begin thinking more like owners.

Incentives tied to company growth serve a comprehensive function. They turn businesses into wealth multiplier organizations by allowing all key stakeholders to have a vested interest in the company’s success. They protect good profits and prevent bad ones by ensuring that key producers remain focused on long-term value creation and not just short-term cash
maximization. In an ideal structure, the combination of short and long-term plans keep people focused on the current performance engine of the company while also encouraging the building of the future business at the same time. Finally, they instill a sense of trust and build a culture of confidence because value-sharing is an inherently “fair” approach.

If engineered correctly, long-term value-sharing plans are “self-financed.” As indicated earlier, this means they are funded by the future value that is generated and only paid out if that threshold has been achieved. They come out of the productivity profit of the company. This protects both the interests of shareholders and of key talent—and represents a more unified approach to growing the company.

Ultimately, there are about nine different types of long-term value-sharing arrangements. To choose the right plan, business leaders must examine each option in the context of the outcomes they are trying to achieve. While all of the plans are intended to reward the building of company value over time, each has a different way of creating that outcome. The choice of which plan is best is determined by the company’s pay philosophy and its comprehensive vision of what the future company will look like. For example, some owners want to share stock with those to whom they want to transition the business one day, or because they need to extend equity to certain key people they’re trying to attract or retain. Another might not want to dilute his equity by sharing stock but still wants to tie a long-term benefit to the value increase in the business. In making a determination about which approach is best, a business needs to examine which plan will create the alignment it seeks between pay and long-term results:

1. Stock Options
2. Performance Shares
3. Restricted Stock
4. Phantom Stock Options
5. Performance Phantom Stock
6. Phantom Stock
7. Strategic Deferred Compensation
8. Performance Unit Plan
9. Profit Pool

Each option has its own advantages and disadvantages—depending on the objectives the organization wants to achieve. So, company leaders need to understand what each plan helps the business accomplish and under what circumstances it would be an appropriate approach. The ideal way to sort through the options is to employ a decision tree process. Often, it takes the assistance of an experienced advisor to help with that analysis to ensure the right approach and structure are chosen and the desired results are achieved. Below is a sample of how such a decision tree process might be organized.
This kind of process is designed to lead an organization through a sequence of questions that either reveals or eliminates certain strategies from consideration. For example, the first query asks whether or not the company wants to consider sharing stock. If the answer is no, then at least three potential value sharing approaches are eliminated. The question that follows asks whether the company still wants to tie the benefit to the value of company, even if it doesn’t want to actually give equity away. If the answer is yes, several plans are revealed as options. Further questioning across the page makes clearer which incentive is most appropriate.

Incentive plans will only “work” if they support both shareholder and employee interests. The decision tree process helps determine how the company’s compensation philosophy will best be represented in the long-term value sharing approach that’s adopted.
Selecting the Right Value Sharing Plan

As indicated earlier, most businesses will ultimately need to offer all three categories of incentives—sales, performance and growth. Effectively blending these pay plans helps build a comprehensive value proposition that will give a company a competitive advantage in attracting and retaining the best talent.

If all of these plans are important, the issue becomes how one prioritizes the development of their incentives. In our white paper entitled “The Most Important Compensation Plan a Company Can Have” (see http://www.vladvisors.com/compensation-knowledge-center/whitepapers/), the issue of prioritization is addressed comprehensively. Part of what is said there is the following:

Before trying to determine which specific plans might be most important, an organization would be better served by identifying planning phases in which rewards strategies can be considered and given context. Below is an illustration of how these phases might be sequenced.

1. **Envision the Future**
   - Establish a Pay Philosophy

2. **Perform a Market Pay Assessment**
   - Set Pay Grades
   - Establish a Total Compensation Structure

3. **Establish Sales & Performance Incentives**
   - Establish a Growth Incentive

4. **Envision a Rewards Reinforcement Strategy**
   - Implement a Rewards Management & Communication Plan
Note how these phases have a logic and order to them.

- Before any pay program can be considered, the company must have a clear picture of where it’s headed and what it believes, philosophically, about how people should be paid and value should be shared.
- Before constructing sales and performance incentives, pay grades need to be established and a compensation structure framed. Without those, the company runs the risk of creating new programs in a vacuum, without consideration for their impact on a comprehensive pay strategy.
- Once the total rewards picture is complete, the organization is in a position to envision how it needs to reinforce the financial partnership it wants to have with its workforce and implement a strategy for managing and communicating each specific plan over the long term.

So what determines which phase of planning a company should be addressing “right now?” And does an organization ever reach a point when it’s “done” with this process? Well, the answer to the latter question is “not really.” That is because businesses go through cycles, and where they are in that evolution largely determines which phase needs attention again (which also answers the first question). In general terms there are two dynamic progressions, as illustrated below, that impact compensation planning: the business evolution cycle and the business economic cycle.

These cycles are dynamic, not static. As a result, the phase of compensation planning that is required for each is likewise going to be fluid. For example, as a business moves through the startup and into the rapid growth stage, it might need to pause and rethink how it has organized its salary structure. It will want to determine whether the pay levels it originally established for given positions are still relevant and market competitive. As this same company enters a period of economic distress—due to either internal or external factors—it may need to focus on how its incentive plans are structured. For example, during such periods, the
organization may want to place more emphasis on long-term value-sharing arrangements (which don’t have a cash flow impact on the business right now) that offer significant upside potential for key producers “down the road.”

In short, the pay factors to be considered at any point in time are numerous and they change regularly. A company needs a system such as the total compensation structure mentioned earlier to ensure it is able to meet the demands these changing cycles impose without having to “recreate the wheel” every time.

**Aligning Incentives with Business Objectives**

All compensation, and especially incentive plans, should help focus employees on the company’s priorities and strategies. In other words, the company’s growth objectives, and individual roles in the same, should become clearer as a result of how employees are paid. Of course, these issues are different for every business. However, they typically include priorities and objectives such as the following:

- Define and remove barriers to the company’s growth goals.
- Expand the business’s core value proposition.
- Accelerate the execution of the organization’s business model, processes and strategies.
- Identify and execute new growth drivers.
- Maintain the company’s revenue engine.
- Expand the company’s market reach and audience.
- Stay ahead of market trends.
- Be responsive to customers.
- Codify expectations and accountability and build a sense of partnership with key employees.
- Manage change effectively and encourage innovation.
- Become a magnet for the best talent.
- Be a great company.

Business leaders need a workforce that understands these priorities and will assume an appropriate level of stewardship for their fulfillment. How incentives are constructed can tie priorities to pay and thereby reinforce in the minds of employees “what’s important.” They help clarify priorities.

*The CEO Worry List*

Chief executives of businesses translate “what’s important” into a kind of worry list they carry around with them all the time. They all have one. It’s what keeps them from going to sleep at
night or awakens them at three in the morning. Pretty much every business issue is placed in a group on that list. Those categories represent the five lenses through which the CEO sees the organization. From this perspective, the company leader makes decisions based on the current state of the business and where he or she wants it to be in the future. Generally, these categories are as follows:

- **Sales**—How do we grow sales while maintaining the current revenue engine of our business model?
- **Productivity**—How do we maximize revenue per employee and ensure we are achieving a superior return on investment for shareholders?
- **Competitive Advantage**—How do we continue to grow our return on equity and sustain our growth trajectory in a competitive market?
- **Execution**—How do we perpetuate our success and maintain a committed, engaged workforce?
- **Talent**—How do we attract and retain premier talent?

Incentive plans play a crucial role in helping a CEO address each one of these categories. In fact, unless the value-sharing approach that’s adopted has an impact on one or more of those issues, its appropriateness should be questioned. The reason many organizations assume incentive plans don’t “work” is because they have not effectively linked those programs to the worry list of the chief executive officer. Again, compensation is a strategic issue and tool. It needs to align pay with business purposes and objectives. Since CEOs have primary responsibility for their achievement, he or she needs to have an active role in determining the strategic direction compensation should take.

**Connecting the Dots**

When a company’s compensation plans are designed, executed and managed properly, they should create something called line of sight. This is achieved when individual employees understand and can articulate the link between the vision of the company, its business model and strategy, their role in that strategy and what’s expected of them in that role, and, how they will be rewarded for fulfilling those expectations. When an employee sees the relationship between these interdependent factors, they become more focused and better stewards. They become business partners instead of just employees.

To determine the extent to which your organization has achieved line of sight with its workforce, consider inviting four or five or your key people to answer questions that reveal the links just described:
1. What is the vision of this company—what is it trying to become?
2. What is the company’s business model and its strategy for competing in the marketplace?
3. What is your role in that model and strategy, and what’s expected of you in that role?
4. How are you rewarded for the fulfillment of those expectations?

Most company leaders that perform this experiment are surprised by what they find. They learn that each employee’s response is different and is disconnected from what they would like it to be. It is often through an exercise such as this that they realize their compensation plans (especially incentives) have been created in a vacuum and are not linked to the broader purposes they need to serve. It’s this kind of outcome that leads them to consider value-sharing in a new context—one that addresses these line of sight issues.

![Line of Sight Diagram](image)

When a company establishes a reward system in the context of personal responsibilities, employees knows exactly what they need to focus on. Once properly focused, their execution level changes and they begin performing at a higher level. When that performance consistently improves, sustained success results. As this cycle continues over time, the organization develops a culture of confidence that becomes self-perpetuating. This level of culture-based sustained success is the real source of its competitive advantage.
The Employee Hierarchy of Needs

In creating line of sight, it’s also important that the rewards component addresses what employees consider to be their financial “hierarchy of needs.”

The starting point is cash flow and standard of living issues. Key employees in particular have an intuitive sense about what they should receive in this regard. They will typically evaluate their salary and bonus in this context.

The next level of concern is risk protection. Employees want to be sure that their financial environment is protected from risks such as those associated with illness or injury. Risk protection is taken care of by a comprehensive and flexible benefit plan.

Once cash flow needs are met and risks are managed, employees next turn their attention to retirement planning. Most individuals look to their employers as a primary source for providing this mechanism. For highly compensated, premier employees, meeting this financial objective usually requires a combination of qualified and executive retirement plans. In addition, sometimes an incentive component will be added to the latter to combine the reinforcement of performance standards with the desire to provide high-level talent with a quality retirement planning opportunity.

Assuming retirement has been effectively addressed, employees turn their focus to wealth creation. This is where value-sharing comes in. Key performers want to know there is a mechanism in place to participate in the value they help create. They view it as a “fair” way to compensate them for the contribution they make to growth. This is where the right balance between short and long-term incentive plans is particularly important. Top-level producers in particular view their place in the business as a means of creating a kind of entrepreneurial experience for themselves. If they can’t share in the value they help create, they are likely to start their own enterprise where they have control over that element. Within the framework of the organization that employs them, they want to feel like real business partners in the company's success.

Ultimately, all of this adds up to the needs individuals feel (and therefore seek) for wealth multiplier opportunities in their relationship with the business to which they’re going to commit their unique abilities. They look to the business as a channel for leveraging their
prospects for driving wealth. For top producers, if they aren’t given this chance with their employer, they will seek it through other channels such as a different organization or by starting their own company. To the extent owners recognize this, they will gravitate towards compensation arrangements that increase value participation for all stakeholders—not just shareholders. They will adopt a wealth multiplier philosophy in the belief that allowing opportunities for employees to share in the growth they help fuel only magnifies ownerships’ ability to multiply their own value. And approaching compensation planning in this way ensures that incentive plans are more likely to “work.”

Acknowledging and addressing the employee’s hierarchy of needs engenders a more unified financial vision for growing the business. When business associates see the relationship between the fulfillment of ownership’s wealth building objectives and their own, there is a greater sense of partnership, fairness and purpose that emerges. That unifying effect sinks deep into the culture and has a sustained impact.

**Measuring Success**

Now that we’ve provided proper context for evaluating whether or not incentive plans “work,” we should consider some final ideas about how to measure the success of these plans. The proper question to ask in making this evaluation is whether or not the plan under consideration is fulfilling its role. As we have discussed, the real purpose of incentive plans is to frame the organization’s financial partnership with its employees in the context of a value creation and value sharing philosophy. That being the case, here is how you might consider evaluating the success of your plans.

*Review Your Compensation Philosophy*

Does your company have a clear compensation philosophy statement? Have you effectively communicated that philosophy to your employees? Are your company’s compensation strategies consistent with your pay philosophy? If you can answer each of those questions affirmatively, then you are being clear about what your company is willing to “pay for” and you are implementing plans that follow your philosophy. That’s a successful approach.

*Review Your Commitment to Rewarding Value Creation*

Before designing your plan, did you clearly define what value creation means to your organization? Does the plan you implemented include metrics consistent with that definition? Does value sharing occur out of the productivity profit of the company? If you can answer yes to each of those questions, then the plan is self-financing – it is only paying out value when that value has been created. Your affirmative answers also suggest that during periods of economic decline or stagnation, the plan is self-restricting in its payouts. That should be considered a successful approach.
**Review Your Use of Market Pay Data**

Do you compare your pay strategies with market pay standards? Does your philosophy statement define where you want to be relative to market pay? Do you perform an internal equity analysis with the market pay data you receive (determining the relative “positional value” of certain roles within your organization)? If you can answer these questions with a yes then you are combining outside metrics with organizational priorities to determine if you are over or underpaying for certain functions. If your approach offers significant upside potential relative to the market, within defined value creation and sharing parameters, then you have a competitive advantage in attracting key producers. That is also a successful compensation strategy.

**Review Your Total Rewards Framework**

Does your company market a future to its employees? Have you created a compelling vision in their minds? Have you clearly defined the financial partnership? Are you maintaining a positive work environment? Are there opportunities for personal and professional development? If your organization has adopted this framework then you are not using financial rewards as the sole means of attracting, retaining and motivating key producers. You are relying on a blend of intrinsic and extrinsic factors to engender engagement. By continuing to pay attention to each issue in the total rewards framework, and working hard to ensure evaluation and implementation, your company will have increasing success at becoming a magnet for the “right talent.” Ultimately, the total rewards approach is a successful one.

**Conclusion**

Do incentive plans really work? On the basis of the issues addressed in this paper, the answer is yes, if you:

- **Define value creation** – Effective plans reflect the company’s philosophy about what it means to create value and that incentives should be “self-financed”; they should be paid out of the company’s productivity profit.

- **Define value sharing** – Effective plans present the opportunity for employees to share in the value that they help create, through a reliable mechanism.

- **Reinforce instead of force behavior**– Effective plans don’t try to change the behavior of an employee through compensation manipulation. They are designed to reward the achievement of well-defined outcomes within the framework of a clearly defined financial partnership.
**Prioritize value-sharing** – Based upon identified business goals, effective compensation strategies prioritize value-sharing through sales, performance, and growth incentives that align pay with the strategic direction of the company.

**Create alignment** – Effective plans are those that align owner and employee financial goals and that link rewards to the achievement of the key results upon which the business and personal targets rely.

**Connect the dots** – Incentive plans are most effective when they create clear line of sight through which employees see the relationship between their roles, key business outcomes and their compensation.

**Properly measure success** – You can measure the success of your incentive plan by analyzing whether it is in line with your growth strategy, your compensation philosophy, your definition of value creation, your pay strategy, and the total rewards framework you offer to your employees.

When a company approaches incentive planning on the basis of the principles outlined in this paper, it creates a way to reward employees that is consistent with the level of business growth and profits the company seeks. That business ensures the incentive plans it implements will indeed “work.”

**About the Author**

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Ken has been consulting with middle-market private and public companies on executive compensation and benefits issues for over 30 years. In addition, he has authored numerous articles and white papers addressing compensation and rewards topics that modern businesses face. Ken also conducts monthly webinars for business leaders on compensation best practices. His client work centers on the development of overall compensation strategies designed to enhance and improve shareholder value and workplace productivity. He is one of VisionLink’s six principals.