

SIX PITFALLS TO AVOID WHEN DESIGNING AN INCENTIVE PAY PLAN

Have you fallen
into these traps
when designing
an incentive
pay plan?

“I am not looking forward to this,” groaned the company president as the company prepared to start designing its new incentive pay plan. Why is that? Because he’d been through this process a number of times in a number of industries ... and early optimism had always turned to disappointment after something unforeseen had gone wrong, leaving leadership scrambling to make midstream changes. Looking back, the problems occurred because the company had fallen prey to an all-too-common pitfall in incentive pay plan design.

By Jason Adwin and Emma Browning, Sibson Consulting

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Incentive pay plans are compelling management tools that have increased in prominence over the past two decades. When implemented correctly, incentives help drive the organization's intended business results and reward and differentiate participants fairly for the value they create.

However, it is easy to make mistakes in designing and implementing an incentive pay plan. Too often variable pay opportunities morph into deferred salary or, at the other end of the spectrum, unrealistic or unclear expectations discourage participants.

PITFALL 1 The Plan Is Too Complex

The mechanics of an incentive pay plan — thresholds, payout curves, links and associated calculations — are moving pieces that must work together. They need to be easy enough to understand so participants can explain how the plan works and what is expected of them. If an intricate Excel model is required to calculate award values, the formulas are overly complicated.

Plans can also be complex because they have too many metrics. The authors recommend having no more than three metrics; and no metric should be weighted less than 20 percent of the target incentive opportunity or less than 5 percent of base salary. These general rules ensure each plan metric has sufficient prominence. While most organizations and employees have well over three goals, it is important to

prioritize a few areas for the greatest impact. No incentive plan can capture every value driver, nor can it be a substitute for sound management.

PITFALL 2 Disjointed Metrics and Goal Alignment

In choosing the metrics, remember the adage “What gets measured gets done.” A critical yet often overlooked component of effective incentive plan design is how organizationwide goals are translated into business-unit, functional and department-level objectives

and, ultimately, into individual employee goals. Organizations that set goals at the top, but fail to cascade them through the hierarchy, sub-optimize the workforce's efforts. Consider a crew team without a coxswain — even the best rowing talent requires coordination to maximize speed.

Goal setting should start at the C-suite and cascade through the various functions and departments. (See Figure 1.) Supervisor and staff goals should be driven by department and division goals, which have to be



driven by the goals of the CEO and the leadership team. Organizations should invest in a strong performance management plan not simply to assess employee performance and development needs but to build a rigorous process to align metrics and goals across the business.

PITFALL 3 Insufficient Modeling or Forecasting

Many organizations fail to take the requisite time to model and test their plans sufficiently. Forecasting all possible results, no matter how improbable, can help avoid nasty surprises. What would happen, for instance, if an organization experienced a windfall that exceeded even its stretch goals? How big would the plan's payout be? Would the increased performance (i.e., revenue, profits) justify these payouts? It is imperative that organizations understand all potential plan liabilities in advance of making any changes.

Prior to making any major changes to a plan (which should not be conducted more than annually), organizations need to consider running the following four analytics to determine what impact the changes may have on the organization and the participants:

- 1 | **Sharing ratio analysis:** How profits are divided between the business's ownership/capital interests and participants under various performance scenarios.
- 2 | **Market competitiveness analysis:** How the range of incentive payouts changes the participants' competitive positioning in the market.
- 3 | **Incumbent displacement analysis:** How pay variability changes the participants' year-over-year earnings and whether the incremental performance is supported through incremental payouts (or vice versa).
- 4 | **Pay mix analysis:** How the portion of total earnings that comes from fixed versus variable pay break down, in aggregate and by individual.

PITFALL 4 Unclear Governance

Organizations need a clear governance process to clarify stakeholder roles in the design, implementation and administration of the incentive plan. Vague governance can lead to different/inconsistent execution of the plan and can cause confusion.

One way to improve clarity is to implement a RACI framework that identifies stakeholders' roles for each plan design task:

- **Recommend:** Develop alternative solutions and recommend direction and associated rationale.
- **Approve:** Have final approval authority over decisions.
- **Consult:** Consult with those responsible for the task; provide expert opinions.
- **Inform:** Kept up to date on progress and decisions.

In a sample organization, the matrix for the task of setting annual employee performance goals and targets may look like the one illustrated in Figure 2.

Thinking through the various activities and stakeholder roles at the start of the process will save time and duplication of any efforts on the back end.

One governance area where organizations often struggle is midyear goal adjustments. Organizations need to make advance provisions to define those situations where goals may be adjusted and those where they will remain the same.

Extraordinary events — such as activity surrounding mergers and acquisitions, accounting rule changes and geopolitical events — are typical candidates for goal adjustments, while economic circumstances — such as a recession or a change in commodity pricing — are less likely to result in any changes. (See Figure 3 on page 44.)

PITFALL 5 Poor Communication

Communications that facilitate employee understanding are critical to the success of any incentive pay plan. Some organizations simply send

participants an email describing a new plan and are surprised when some participants do not understand it or do not even read it. Although an email will work for some participants, it will not work for everyone. Organizations need to explore all of the many communications options that are available and tailor the media to each audience (e.g., employees versus managers). Effective communications mechanisms include:

- Face-to-face communications from the participant's manager.
- Videos or webinars on the company's intranet to help participants understand the new incentive pay plan.
- Plan brochures or desktop summaries that outline how the plan works in a few pages.
- Personalized statements and plan calculators that are tailored to the participant's role and earnings opportunity.

Communications from the participants' managers have more impact and create better engagement than communications from human resources. Managers must be trained not only to understand the plan but to communicate and answer questions. An organization never wants a manager to tell a participant, "I don't understand it, either."

PITFALL 6 Failure to Calibrate

Plan administration must be consistent in the various departments across an organization. Many issues that exist in incentive plans occur because the actions are not transparent or are not compared across units. Calibration, which is the sharing of results or planned actions among peer leaders, can help. Calibration can take place in a meeting, by publishing a scorecard or by requiring two or three tiers of approval in batches.



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There are three incentive plan components that require organizational calibration, and they occur at the beginning and the end of the plan cycle:

1 | **Goal setting:** Performance objectives need to be calibrated to ensure that goals across the business have a similar degree of stretch from department to department. Inconsistency will lead to problems where

participants in various functions have different earnings opportunities based on similar results.

2 | **Performance ratings:** While typically not an incentive plan design component, performance ratings are often used as a mechanism to allocate incentive pools. If ratings are not calibrated across departments, incentive payouts will be disproportionate.

3 | **Payout levels:** Actual payouts should be reviewed to ensure incentive dollars are allocated to the most deserving employees in an equitable fashion.

A basic scorecard (see Figure 4) makes it easy to track inter-departmental consistency and ensure that the plan's payouts are coordinated with a department's performance rating.

Figure 3 | Guidelines for Changes in Goal Setting (Illustrative Example)

Circumstance	Adjust	Do Not Adjust	Consider Adjustment
Accounting rule change	✓		
Board-directed strategic change	✓		
Acquisition or divestiture	✓		
Recession			✓
Material change in ability to measure stated goal			✓
Extraordinary competitor actions			✓
Legal action affecting operating income by > X percent			✓
Significant operational restructuring (e.g., major IT conversion)			✓
Change in currency exchange rates		✓	
Interest rate shifts		✓	
Planning errors		✓	
Poor publicity		✓	

Source: Sibson Consulting

Conclusion

Avoiding the six pitfalls will help an organization design and implement an incentive pay plan that rewards all participants fairly. A well-crafted plan should be simple enough to be easily understood. It has goals that are set at the top and are cascaded through the organization. All possible results are tested and modeled to avoid unanticipated problems. An effective governance process clarifies who is responsible for what in designing, implementing and administering the plan. The plan is thoroughly communicated through a variety of media. And goal setting, performance ratings and payout levels are calibrated throughout the organization to ensure consistency. Once all these steps have been taken, the participants and the organization will come out ahead. **W5**

Jason Adwin is a vice president and consultant with Sibson Consulting in New York. He can be reached at jadwin@sibson.com.

Emma Browning is a consultant with Sibson Consulting in Raleigh, N.C. She can be reached at ebrowning@sibson.com.

Figure 4 | Sample Scorecard

Department	Average Performance Rating (1-5)	Annual Incentive (% of Target)	Department Performance Against Goals (1-5)*	Turnover	Promotions (% of Department)
A	3.4	100%	4.2	4%	6%
B	3.2	102%	3.8	8%	5%
C	4.0	105%	5.0	1%	3%
D	4.1	109%	2.8	3%	8%
E	3.6	94%	3.0	10%	12%
F	3.1	91%	4.5	6%	6%
G	3.2	100%	4.1	5%	7%
H	4.2	110%	3.2	4%	5%

*Goals can be measured against costs, revenue, productivity and customer satisfaction.

Source: Sibson Consulting

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