

Post COVID-19 Outbreak – **Time to Revisit - Incentive Plans**



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Getting incentive pay right is tricky. What might have been right before may not be right any longer - especially after a major change in business climate and/or a shift in company goals, business plans, and strategies.

As companies look to re-focus their businesses after the COVID-19 outbreak, a review and possible change to your incentive plans can have a significant impact on your business in helping support your company's strategy and vision moving forward. Research has shown that organizations that come out of a crisis healthy and stronger typically have leaders that are willing to drive change that engages employees. The COVID-19 crisis is a unique opportunity to revisit those plans.

A key element in the success of any company, large or small, is sound business planning – and that is true now more than ever. One way a company can ensure management provides clear direction for accomplishing goals defined in the business plan, is through a well-crafted incentive compensation program. An incentive plan can align management's performance goals with the organization's goals and offer financial rewards for meeting key targets established in the business plan.

Reasons for Incentive Plans

Companies use incentive plans, sometimes referred to as variable pay plans, for many reasons. **The most common reasons / objectives for incentives are to:**

- **Drive performance results** or achievement of business plan objectives
- **Share success of the company** with the participants
- **Control payroll expenses** by making some compensation costs fixed and some variable

When designing incentive plans or modifying existing plans one should keep “top of mind” these 3 primary objectives. Variable or incentive pay is literally “performance contingent pay” meaning that it’s paid only if key company performance goals are achieved.

Incentive Plan Objectives

For an incentive plan to be an effective business tool, the plan must be aligned to the most critical and measurable objectives in a company's business plan.

That being said, one of the first steps in developing an incentive plan will need to be determining/identifying the appropriate company objectives that the incentive plan would align to. Is increasing profits a key objective? Or maybe it's improving quality/productivity, or fostering teamwork, or developing a new line of business. At the end of the day, you want to make sure the objectives of the incentive plan are consistent with the key goals of the company's business plan.

It is also important that the goals established in an incentive plan are understood by all participants and that they can be reliably and objectively measured. Ultimately, senior management also needs to be in support of both the goal(s) and the incentive plan, not only to help give life to the plan but to help engage their staff in support of implementing it within the workplace.

Types of Incentive Plans

Understanding the purpose of the incentive plan, or what a company intends to achieve through it, helps to determine the type of plan to implement.

There are many different types of incentive vehicles that can be used. For purposes of this article, we will discuss four different types of incentive plans. Each type of plan works very differently, has its own advantages, and works best in certain situations to support and reinforce the implementation of a company's business plan. The plan types we will review here are:

- Annual management incentive plans
- Individual incentive plans
- Gainsharing plans

⋮ **We will not be discussing long-term incentives or sales force incentives in this article.**



Annual Management Incentive Plans

Management incentive plans are usually limited to management roles. These plans relate incentive opportunities to key operating metric(s), 1 - 3 are typical. The performance contributions of specific participants may also be included to determine individual awards; if the company wants to include individual performance as a factor.

Key advantages of a management incentive plan include:

- Sets expectations: Predetermined goals and objectives are established upfront and communicated broadly to all participants
- Emphasizes performance: Incentives actually paid reflect performance at the company and/or division level, and if desired, individual manager/ executive performance
- Reduces fixed costs: Fixed compensation costs are minimized since incentive payment is contingent on performance in key measures
- Motivates participants: Energizes staff to focus on the key objectives of the company
- Puts people in control: People like to feel that they have some control over their compensation. Having the opportunity to earn more if they achieve more gives them that feeling
- Promotes teamwork: Plans that include company, division, or departmental goals improve cooperation and alignment

Individual Incentive Plans

Individual incentive plans differ from management incentive plans in that eligibility is broader including staff / individual contributor roles, and the criteria and payouts are measured against all or mostly individual achievements instead of based on overall company and/or division results. Often these plans are linked to profitability goals to ensure the company has the funds to support the incentive payouts and that participants also stay focused on profits.

The advantages of this type of incentive plan include:

- Helps to recognize each participant on an individual basis
- Ensures payments are performance-based rather than discretionary
- Motivates and helps attract and retain talent as it gives them some control over their compensation and career and rewards them for their contributions to overall company results
- Focuses individuals on what they can do to support achievement of company goals
- Is a variable expense that is only paid when desired results are achieved; takes pressure off base pay which is a fixed expense

Gainsharing Plans

Gainsharing plans are group employee incentive plans designed to share the value of any resulting productivity gains, cost savings, and/or quality improvements among participating employees. These plans differ from individual incentive plans in that performance criteria is established for a group rather than individuals. The gains are generally based on a predetermined formula and are shared equally among all covered employees.

The advantages of a gainsharing plan include:

- Coordination and teamwork are encouraged
- Employees learn more about the business and key metrics that drive success at the company
- It reinforces a participative work environment fostering a culture of continuous improvement
- Employees focus on specific objectives that are important to the operations
- Incentive pay is self-funded by productivity improvement
- Promotes increased employee accountability, commitment, pride, and goodwill toward the company
- Participants are typically non-management staff

• **All variable pay plans can energize the workforce and support the implementation of a company's business plan. It is important to note that while each of the incentive plans mentioned in this article can offer great advantages to a company, the most appropriate plan is highly dependent on the specifics in place at each company.**

Linking Incentives to Total Pay

The development of an incentive plan must be integrated with the company's total rewards strategy and programs. Questions to be asked are:

- How important will incentives be to the total pay package?
- How will the availability of incentive pay affect the base salary structure and merit-pay adjustments?
- What is market practice for total pay mix – base versus incentives?

Below is an example of how pay mix may be distributed between base pay and incentives. Keep in mind that this will vary based on competitive practice for the industry, location, company size, life stage of company, and a company's rewards strategy.

	Base Pay	Variable/Incentive Portion of Total Direct Pay*
CEO	20 - 40%	60 - 80%**
Executives	50 - 70%	30 - 50% **
Management	70 - 85%	15 - 30%
Individual Contributors	80 - 95%	5 - 20%

**Total Direct Pay includes base pay plus annual and long-term incentives.*

***Often includes annual and long-term incentives; varies based on competitive practices and rewards strategy.*

Eligibility

The key factor in determining eligibility to participate in an incentive plan is based on the philosophy of upper management, the control and influence of participants in meeting goals and objectives, the industry and competitor practices. Typically eligibility is defined based on salary band, organizational level, base salary level, line versus staff, key positions, or decision-making authority.



Other Factors

Other issues that need to be addressed when developing an incentive plan include:

- Size and importance of incentives to be offered
- Availability of individual, department, or company performance criteria that can be reliably measured
- Establishment of meaningful performance goals
- Compatibility of company culture with the proposed incentive plan

What Type of Incentive Plan?

Addressing the above-mentioned issues will provide the framework for determining the most appropriate plan for a company. The incentive plans described here are all cash reward plans. They can be supplemented with intrinsic rewards such as employee recognition programs, employee coaching and development programs, assignment of special projects, promotions, and service awards. Intrinsic awards also have an important role and should be considered when developing a comprehensive rewards strategy.

Why Some Incentive Plans Fail

A sound incentive plan can be very influential and an effective management tool to support the business plan. However, if not properly designed, an incentive plan can fail or even sabotage a business plan and demoralize instead of engage employees. Incentive plans fail for various reasons, including:

- Incentives are not consistent with the organization's business strategies, culture and/or management style
- The goals of the business plan and the performance standards are not measurable
- The earnings potential of the incentive is not meaningful to participants or the goals are not realistic
- Proper "line of sight" to the incentive goals is not established
- The incentive plan and achievement towards annual goals are not communicated well to participants throughout the year
- The incentive plan is a substitute for solving other organizational problems
- Plan is too complicated causing it to not be well understood and/or not focusing participants on the most important priorities

A business plan can be an effective management tool to improve company performance. However, if not properly implemented, a business plan loses its effectiveness. Linking the implementation of the business plan to a variable pay incentive plan can help ensure that the business plan will not wind up in the circular file.



In Summary

People don't work for money alone, but they do respond to incentives. Incentives can motivate employees to challenge themselves to meet a goal that they understand, or even better, helped to establish. This is when "true" engagement takes place, behavior starts to change and business results improve. Winning and achievement is fun and rewarding, and when incentives are done well, it's a pay-off for all involved – employees, the company, and shareholders.



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