KPMG

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How do you know your employee incentive scheme is working?

Article

Introduction

So your organisation is one of those with an incentive scheme, which is designed to drive high performance and align the interest of employees with those of shareholders! Well, what makes you so sure that your incentive scheme is generating significant value for the regular payouts that your employees receive from it? Have you carried out an assessment of the effectiveness of the scheme in terms of its ability to drive performance, the desired behaviour and achievement of corporate objectives?

In a recent survey KPMG conducted on reward practices involving 120 companies in Nigeria, about 80% are operating incentive schemes. However, the question is whether they carry out a periodic assessment of the effectiveness of such schemes. In the 2015 edition of the KPMG Consumer Market Remuneration Survey, we noted about 17% increase in payouts from incentive schemes even when there was significant contraction in profits. This suggests that there is no alignment between the payout from the incentive schemes and corporate results. This may be due to the use of the wrong performance measures or a fundamental defect in the design of the scheme.

In an economic crisis, employers should focus on enhancing efficiency and optimal use of resources. They, therefore, need to review their reward systems, particularly incentive schemes, to ensure that they are effective in driving achievement of agreed objectives in the most cost-efficient manner. In a WorldatWork[1] survey amongst compensation professionals, 70% of the respondents were of the opinion that incentive pay is "important or very important" to the success of their organization. Therefore, the need for an effective incentive scheme to curb guaranteed entitlement culture has become more critical in the current tough operating environment.

Why incentive schemes do not deliver the desired results

Beyond implementing an incentive scheme, every organisation must ensure that the scheme is properly designed to drive optimal results. Generally, as part of the life cycle of every reward model, a critical evaluation is required periodically to measure effectiveness and value-add in achieving the objectives of setting up the model. The business needs to know how the incentive scheme is impacting results, if at all it is. If an organization has never evaluated its scheme, it can never be too sure what impact the scheme is having on its people and performance. Every company should therefore review its incentive scheme and make necessary adjustments to enhance effectiveness in achieving the defined objectives.

With over 20 years' experience in advising clients on reward systems in Nigeria, KPMG has witnessed numerous schemes with one form of defect or the other. These defects undermine the ability of such schemes to drive performance and optimal results. The common aspects of incentives that employers typically get wrong include the following:

i ***Selecting the "right" performance measures:*** A scheme can only be said to measure the "right" key performance indicators (KPIs), if such KPIs are derived from the company's strategic objectives. For an incentive scheme to be effective, it must focus on results that are key to the business. This way, it will help align and channel employees' efforts towards achieving those strategic objectives.

Unfortunately, most schemes are primarily focused on achieving the hard numbers only: profitability, productivity and / or turnover/sales. Though quantitative KPIs are important, other non-quantitative KPIs such as succession planning, customer satisfaction, risk

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[1] The WorldatWork is a global human resources association and certifying body for compensation, benefits and total rewards professionals based in the United States of America.

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management, regulatory compliance, corporate governance and innovation, which impact long term sustainability, are critical and should be embedded as part of a robust KPI framework. Also, companies should ensure continued relevance and effectiveness of the selected performance measures. As the strategic focus of the business changes, the scheme KPIs should also change accordingly. In determining the "right" measures to adopt, companies need to consider line of sight i.e. ability of employees to influence the results being measured.

ii ***Poor design mechanics – no threshold and maximum performance levels:*** A specified minimum level of performance results should trigger payout from any scheme. Incentive schemes should therefore be introduced to reward any "extra" results / efforts achieved above what is the norm. Many companies struggle in determining the appropriate minimum level of performance (threshold) that should trigger payout. Some schemes set the threshold so low that employees do not need to exert themselves to qualify for payout. These sort of schemes unfortunately encourage an entitlement mentality that undermines their effectiveness in driving a high performance culture. The threshold should not also be set too high as to discourage employees from aiming to achieve it. The possibility that the result achieved is reflective of the general operating environment, notwithstanding the efforts of the executives/employees should be taken into consideration. Many profit sharing schemes violate the threshold principle, as they always pay out as long as there is profit. In addition, a cap should be introduced to forestall unintended windfalls and discourage excessive risk taking. Usually, the cap operates by limiting additional payout beyond a particular performance level.

Overall, taking an informed decision on performance levels requires a good understanding of the business.

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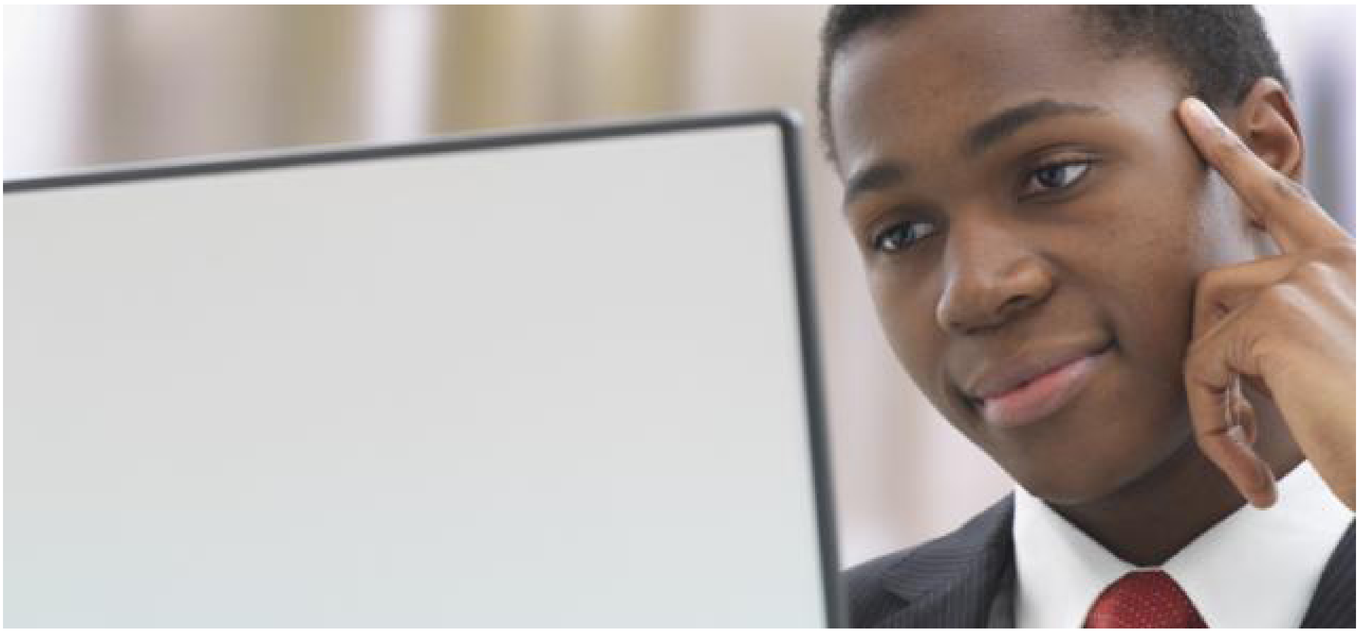
Where available, the trend in business performance and shareholder's expectations should be reviewed in setting the "right" trigger points. Industry / external benchmarks could also be considered.

iii ***Performance measurement – getting it right:*** Many companies have issues with the fairness and effectiveness of their Performance Management System (PMS). This may result in making undeserved incentive payouts that are not commensurate to value-add. Our review of a good number of PMSs often shows a skewed distribution, whereby majority of employees are placed in the higher end of the performance rating scale. Interestingly, the reverse situation, where most employees are rated in the lower end of the scale, is very rare. This is not surprising as most supervisors / managers do not want to be seen as the ones denying their team members their bonus entitlement. Unfortunately, the effectiveness of an incentive scheme is largely a function of the effectiveness of the underlying PMS. Unknown to these companies, their schemes are actually promoting an entitlement culture, rather than driving high performance. The implementation of a bell curve distribution / calibration may address such negative trend.

iv ***Differentiating performance:*** Given the performance focus of incentive schemes, only employees that add value should qualify for payout; low performing employees should receive minimal or no payout. Many



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schemes do not have a reasonable level of differentiation between the various performance levels. The level of differentiation should be such that a low performer would aspire for improved performance so as to earn similar payout as high performers, while the high performer is motivated to continue to do better.

A healthy parity ratio should be established to deliver sufficient differentiation between grade levels and performance levels. To get this right, the company should determine the value-add associated with the different grade levels and performance ratings in use. Many schemes do not realize or factor in this principle in their design mechanics. As such, any resulting premium for higher grade levels / performers happens by chance and may not necessarily be appropriate. In addressing this issue, care must be taken to avoid situations where high performers on lower grade levels are earning much higher than their senior peers with low/average performance levels.

v ***Quantum of the potential payout:*** The potential payout must be significant enough to motivate action from employees. A test of materiality is whether the payout would make a difference for employees, if they missed out on it. Numerous guidelines exist for consideration in setting the size of payout. Typically, the greater the influence on business results, the higher should be the potential payout. Hence, at executive and other more senior staff levels incentive payout should be materially sizable.

vi ***Clawback provision:*** For an incentive scheme to be effective in driving performance, it must have a mechanism for recouping underserved bonus or payment. A clawback provision is important to ensure that senior management/executives do not game the system, by collecting bonus for material misstatements or errors in the financial statements. With clawback, a company can recoup any excess / undeserved payment.

Conclusion

In conclusion, it is not sufficient for companies to operate incentive schemes. They also need to carry out periodic assessment of their effectiveness in achieving the desired objectives. With a proper review, an organization could save significant cost, by ensuring that only deserving performance results are recognised and rewarded. Businesses must ensure that the right measures and performance levels are being set. The scheme structure must be flexible such that it changes as the business focus changes, for it to remain relevant and aligned. Given the heightened focus on ensuring optimal deployment of resources, organisations should move away from guaranteed payments, and shift to incentive schemes that align with shareholders' interest.

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