How KPIs can help motivate and reward the right behavior

Paper #4 – How to use KPIs to evaluate and reward performance

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Incentive compensation has been in the headlines recently for all the wrong reasons. Some commentators have even gone as far as blaming it for unbounded risk taking, the credit crunch and the subsequent recession. The trouble is that the perfect individual incentive, like the perfect target, doesn't exist. There will always be some collateral damage in the form of distorted and dysfunctional behavior.

These problems are not new. The issue of "incentive compensation" (or "pay-for-performance") and its impact on management behavior has exercised the minds of academics and practitioners for decades. Broadly speaking, it is expected to achieve three aims: to attract, keep and motivate people. One school of thought believes passionately in the power of incentives to improve individual performance. They point to stories about Chinese peasants who, when allowed to keep a proportion of what they produced and sell it at market prices, saw their output rocket. They also point to those jockeys that are on commission and tend to win more races than those on retainers.

Another school of thought believes that in a large complex organization that is well structured and aligned, such additional "bribes" are unnecessary. They believe that they are only needed to force people to do what they would not otherwise do naturally. The troublesome question is this: Why do we need to pay people for doing their job and pay them again for doing it well? Mr van der Veer (until recently, CEO of the giant Shell oil company) provided one answer in a recent interview after he was criticized by shareholders for receiving a $2.6 million bonus even though the company failed to meet its performance targets. "You have to realize," said van der Veer, "that if I had been paid 50 percent more, I would not have done it better. If I had been paid 50 percent less, then I would not have done it any worse."[1] That just about sums up the problem with financial incentives in large corporations. In other words, they are a poor and ineffective substitute for good management practices. This is backed up by dozens of studies over the past 75 years.

The "carrot and stick" approach to motivation is strikingly similar to the "Theory X" view of management set out in Douglas McGregor's classic book published in 1960, *The Human Side of Enterprise*.[2] Theory X stated that people hate work, need to be told what to do, dislike responsibility, and will do no more than the minimum stated in their employment contract unless driven to raise their performance by additional incentives.

When most people start a new job they are highly motivated to perform well. They want to prove to their new employer that they made a good decision in choosing them. That's the *default state of motivation*. But what happens then is that these natural motivators are gradually switched off. The system (and worse, constantly tinkering with it) turns people off. It makes them think about targets and incentives and what they need to do to achieve them. It diverts their attention from their main task (doing quality work for customers) to how to play games with the system to maximize their personal advantage. The challenge, therefore, for most organizations is not so much how to motivate people but how to s*top de-motivating them*.

Enlightened leaders see their organizations as networks of interdependent relationships that require the right leadership qualities to release the pride, passion and creativity of their workers. This approach follows McGregor's "Theory Y" view that people are motivated by self-esteem and personal development, and companies produce better results by encouraging their people to be creative, to improve their skills and to derive satisfaction from their work. The impact of this approach was given a major boost recently following research done by Nathan Washburn who surveyed 520 organizations in 17 countries (including some emerging markets). He found that CEOs who put stakeholder interests ahead of profits generate greater workforce engagement – and thus deliver superior financial results.[3]

While most leaders today would proclaim allegiance to the Theory Y school of management, the reality is that the Theory X philosophy is still alive and well and living comfortably within their management structures—and their target setting and reward systems. It is rather like discovering that one section of your community still uses a language thought to be extinct.

In the wake of the recent economic crisis, strategy guru Henry Mintzberg recommended that firms no longer pay any bonuses. As he acknowledges, "This may sound extreme. But when you look at the way the compensation game is played—and the assumptions that are made by those who want to reform it—you can come to no other conclusion. The system simply can't be fixed. Executive bonuses—especially in the form of stock and option grants—represent the most prominent form of legal corruption that has been undermining our large corporations and bringing down the global economy. Get rid of them and we will all be better off for it."[4]

While Mintzberg makes a strong case for abolishing incentive pay altogether there are ways to align rewards with performance, all of which avoid Theory X type fixed performance contracts and self-interested, greed-induced behavior. The common principles are to base rewards on teams rather than individuals and not to link rewards to fixed targets agreed to in advance.

We can learn much from how visionary leader Jean-Marie Descarpentries used rewards to turn around the fortunes of two French companies (Carnuad Metal Box in the 1980s and Groupe Bull in the mid-1990s). His success was based on a belief in separating target setting from performance evaluation and rewards and measuring performance based on scorecards. The process started with each business unit team proposing its own stretch target. This was a projection of the "best possible outcome" on the basis of everything going right including maximum demand and new products being launched on time. But then—and this was the key to his approach—Descarpentries would promptly forget about the targets. "The purpose," he noted, "is to get managers to dream the impossible dream." He didn't measure managerial performance against the target (thus creating a fixed performance contract), because in that case managers would not enter into the spirit of the stretching process. Instead, he evaluated and rewarded his managers based on a range of indicators including how they performed this year versus last year and how they performed against the competition (see Figure 1). The purpose of the target was to drive imaginative strategies that lifted performance above and beyond incremental change. In other words, managers had to use their judgment and take risks. Table 1 shows the type of scorecard used.

Key Metric	**Weighting**	**Score**	**Weighted Score**
Growth versus previous year	20	50	10
Growth versus competition	20	40	8
Profit versus previous year	20	60	12
Profit versus competition	20	50	10
Debt versus previous year	10	80	8
Quality factors versus previous year	10	60	6
Executive Committee Evaluation			*54%*

Table 1: Performance Evaluation Formula for a Business Unit at Groupe Bull

Each evaluation criterion in the formula was given a waiting according to its importance. The weighted score for each metric was then produced and the aggregate of the weighted scores was the final result. Both the corporate president and his executive committee independently reviewed performance. This assessment was used to set the bonus levels of all managers and employees within a particular business unit.

The amount of subjectivity and judgment involved in this type of assessment process is not to everyone's taste. But as former Unilever change leader Steve Morlidge says, "While the process of calculating rewards is based on judgment, it is done using a rigorous process, one which is transparent and one which is immune to the exercise of prejudice or favoritism. It is, in effect, like the exercise of the law, using laws of evidence." [5]

Some of this evidence is provided by a range of performance metrics but they are then subject to analysis, interpretation and judgment. However, they should not be presented with any judgmental comments. Just presenting the raw numbers is sufficient to drive self-questioning and action for improvement.

The role of KPIs is important. They can be used to supplement the management evaluation scorecard. Figure 1 shows an example of an evaluation scorecard for a Finance team. One approach is to add a column to the evaluation scorecard for "KPI score."

Finance Team Evaluation Scorecard	KPI Score*	Management score*	TOTAL SCORE
Success criteria	(a)	(b)	(a + b)/2
How well are we satisfying our business partners?	86%	80%	83%
How well are we managing our people?	76%	70%	73%
How well are we managing our costs?	91%	80%	85%
How well are we improving our competences?	89%	60%	75%
How well are we improving our systems and processes?	53%	80%	67%
TOTAL	75%	74%	74%**

* Scores are based on judgement with hindsight
**All team members receive 74% of maximum bonus payment

Figure 1: Use KPIs to evaluate and reward the success of teams

While the KPI score comes directly from the KPI reporting system that shows the results of each team in relation to other teams (the different colors represent the four quartiles), the "management score" is based on peer reviews. A simple average of the KPI and management scores could then be used to compute the final evaluation scores. Alternatively, greater weight could be given to either the KPI or the management scores. Who should do the evaluation? This can either be done by a senior executive team or it can be done by involving peers, partners and so forth. Those doing the evaluation will of course have access to the KPI scores and can drill-down to get a better picture. They can also see the rate of improvement or decline and have access to anecdotal evidence of how well the team has performed in the current environment.

One approach to bonus payments (adopted by Descarpentries at Bull) is to pay every team member the same percentage but of different maximum amounts. For example, the team leader might receive (as per the example in figure 2) 74% of six months salary. Other senior managers might receive 74% of 3 months salary and other employees 74% of 2 months salary.

The performance criteria for these scorecards will vary by type of team. For example, a support services team will want to emphasize partner satisfaction and costs, along with cycle times, quality, cost and customer satisfaction. Underpinning each chosen evaluation criterion will be a number of points that judges will need to consider thus providing a consistent framework for all those involved in the peer review assessment process.

Six implementation guidelines

1. **Abandon incentives linked to fixed targets and move to a relative performance contract.** The relative improvement contract focuses managers on maximizing value at all times rather than playing games with the numbers because there are no fixed targets that lead to irrational behavior. Performance is judged after the event rather than based on a fixed target. The logic is that it is only after the event that you can judge whether performance is good in the context of actual market conditions. 'What was the inflation rate? What impact did the floods have? What was the impact of our biggest customer going bankrupt? It is only after the event that you can determine whether your performance is acceptable or not. However, it is also important to understand that, even though managers are evaluated and rewarded "with hindsight", there is still a "performance contract" (but based on some form of *relative result*). The benefits are that the process is fast and, because the performance bar is always being raised, it is more likely to maximize profit potential.

2. **Base accountability and rewards on teams rather than individuals.** Most leaders believe in the power of individual accountability and rewards. These beliefs can be encapsulated in the expression "Do this and you'll get that." Its management origins stem from piece work. However, relating pay to performance when individual output can be precisely measured is one thing, but applying this approach to complex modern organizations where success is more dependent on design, innovation, quality and customer service, is another. Harvard professor of business administration, Robert Simons, believes it is impossible to separate the marginal contributions of individuals. He puts the question in this way: "When Ford launches a successful new automobile, how can senior managers calibrate the relative contribution of the design team that created the concept, the engineering team that developed and applied the new technologies, the marketing team that launched the product, and the division president who oversaw the entire effort? How do we measure the contribution of a single violin player in relation to the successful season enjoyed by a symphony orchestra?" [6]

3. **Don't worry about free-riders.** Some people might argue that moving incentives away from individual performance is a charter for producing free riders—those managers who keep out of the limelight yet produce little by way of results. The experience at Southwest and Handelsbanken, however, suggests that this is not as big a problem as feared. In a team-based organization driven by peer pressure, free riders are exposed very quickly and replaced by people more willing to commit themselves to the common goals of the team.

4. **Make rewards fair, consistent and inclusive.** The number one factor on most employees' list of pay related issues is *fairness*. Fairness in this context is about differentials between one level and another and between employees in the same team. However, achieving fairness is a difficult task as each person may have a different view. One hallmark of fairness is inclusiveness. Having different schemes for different levels with significant differences in the size and opportunity of payout can spell disaster for any rewards scheme. All permanent employees should share in one way or another. How should the value center team leader distribute rewards? One approach (as we noted in the Groupe Bull example) is to give every member of the team the same percentage award. So, in the above example, every member of the team might receive 74 percent of some multiple of monthly salary.

5. **Take employee recognition seriously.** Recognition (as opposed to rewards) is one of the most potent tools in the managers' toolbox, but it is rarely used to maximum effect. Going out of your way to praise someone's effort or performance can make their day. A birthday card, some flowers, or a book voucher says that your work has been recognized. These are all simple expressions that say thank you. And it's inexpensive! Southwest Airlines takes employee recognition seriously. If you walk around Southwest's head office in Dallas you will see thousands of photographs and certificates on the walls concerned with employees and what they have done for the organization.

   Kelleher has never believed that compensation was the primary motivator. "If somebody was working just to be compensated," he says, "we probably didn't want them at Southwest Airlines. We wanted them working in order to do something in an excellent way. And to serve people. So we said to [employees]: This is a cause, this is a crusade. This isn't just an ordinary corporation, and you're doing a lot of good for everybody. We're proud of you, and we want you to have psychic satisfaction when you come to work. We get people who take a 25% cut in pay because they say: We just want to enjoy what we're doing. They've done pretty well with their 401(k) and stock options. But those are variable. People are willing to take that risk and take lower pay because they want to feel fulfilled in the workplace."

6. **Use a group-wide profit sharing scheme.** One way to ensure fairness and inclusivity is to use a group-wide profit sharing scheme. Some organizations use these schemes either wholly or as part of the rewards package. But how they are designed matters greatly.

   In 1990, DuPont pulled the plug on one of the most ambitious and closely watched incentive pay programs in American history. A plan in which the company's 20,000 fiber-division employees had a portion of their pay increases at risk. Employees received bigger increases if DuPont exceeded its profit goals, but smaller payouts or none at all if goals weren't met. Two years into a three-year trial, DuPont cancelled the plan partly in response to plummeting employee morale: the 1990 recession had made it almost certain that for the first time, the company wouldn't reach its goals. The problem is that when employees get rewards they feel good but the moment they stop they feel resentful. This phenomenon, often known as entitlement creep, is a common problem with pay-for–performance schemes. "In a recent quarter I got 96 percent of the maximum bonus. Why was I docked the 4 percent is the response?" is the typical thought process.

   Southwest Airlines and Handelsbanken use only one group-wide profit sharing scheme for all employees. Thus, there are no set incentives for any team or salesperson to achieve a specific target. Both use the language of gain sharing (sharing in the fruits of collective success) as opposed to individual incentives (you must achieve x result to earn y bonus) to provide people with a stake in the success of the organization. The profit sharing plan at Southwest started in 1973 and is at the heart of its compensation and benefits program. All employees qualify on the 1 January following the commencement of their employment. Fifteen percent of pre-tax profits are paid into the profit sharing pool and this is shared across all employees according to base salary. The payments go into a retirement fund for individual employees. While employees are free to increase that amount, 25 percent of the profit sharing fund is used to purchase Southwest shares. Pilots and flight attendants have other stock option plans. There are no incentive schemes based on achieving annual fixed targets.

   Handelsbanken executives believe that its group-wide profit sharing scheme is an important element in removing the cellular or "defend your own turf" mentality that pervades many organizations. It avoids the problem of rewards becoming entitlements that, if not received, lead to a disaffected and, in some cases, a demoralized workforce. Another feature of the Handelsbanken/Southwest schemes is that they don't make an annual cash payment; instead, they pay the bonus into an employee pension plan. This has the effect of minimizing any fall-out from a poor year. In other words, employees are not planning to spend their bonus on 'something special' and then become disappointed when it doesn't happen. The pension payment approach cushions poor years but also has the effect of relating performance to the share price (both pension schemes own a substantial element of company stock).

The profit-sharing system can only be understood in the context of its purpose. It is not intended to be an incentive for individuals to pursue financial targets; rather, it is intended as a reward for their collective efforts and competitive success. It might be called a "dividend" on their intellectual capital. Many people find it hard to understand the lack of financial incentives. Wallander's answer? "Beating the competition or one's peers is a far more powerful weapon than financial incentives. Why do people need cash incentives to fulfil their work obligations to colleagues and customers? It is recognition of effort that is important. Managers will only strive to achieve ambitious goals if they know that their 'best efforts' will be recognized and not punished if they fail to get all the way."

Moving from individual incentives to team-based rewards can have a transformational impact on an organization. It sends a message that we are all in this together fighting for the common good. But despite hundreds of research studies over 50 years that tell us that extrinsic motivation (carrot and stick financial targets and incentives) doesn't work, most leaders remain convinced that financial incentives are the key to better performance. It remains one of the greatest barriers to transforming organizations from inflexible and expensive centrally controlled machines to adaptive and lean devolved human networks.

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Endnotes

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