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## **The Power and Promise of Incentives**

*By Joanne Sammer*

When it comes to incentive pay, you really do get what you pay for. Therein lies both the power and the promise of incentives. Reward executives for increasing profits and they will focus on increasing profits. Reward employees for manufacturing more widgets and they will do their best to manufacture more widgets.

That is why companies have long relied on incentives to guide and reward the performance of their top executives. Over the past few decades, however, a growing number of companies have begun offering some form of incentive, including business incentives, special recognition awards, and individual performance awards, to the general employee population. According to a 2008 survey of 1,073 large organizations conducted by Hewitt Associates, 90 percent of these companies have at least one type of incentive plan. These companies spent 10.8 percent of payroll on incentives this year and expect to spend 10.6 percent of payroll on incentives in 2009.

Indeed, the power of incentives can play a key role as companies navigate the current economic environment. A well designed incentive plan can help companies drive the type of performance necessary to keep the company moving forward. "It is absolutely essential to have pay at risk in this environment," says Jason Adwin, vice president with Sibson Consulting Group, a compensation consulting firm based in New York.

However, simply having an incentive plan in place is no guarantee that it will help a company achieve its goals. The plan must be tied to the business strategy and goals, clearly understood by participants, and consistent when making payouts. Without these prerequisites, an incentive plan is unlikely to generate the desired results. In fact, a poorly designed and administered incentive plan that, for example, rewards the wrong things or provides arbitrary payouts can do more harm than good.

### **Making incentives work**

The most effective incentive plans are tied to the drivers of value creation within the organization. In many cases, those value drivers are financial but certain milestones and strategic measures, such as customer service, global investments, cost cutting, and acquisitions, also fit in that category. A well designed plan will have goals that are achievable but that employees have to stretch to achieve. "If no one thinks an incentive is achievable, it will not motivate or excite people," says Adwin.

Plan transparency is essential to its success. No incentive plan will succeed unless the participants clearly understand on what they are being measured and how individuals can affect the resulting payouts. There should be no mysteries surrounding how the plan works, how and at what level it is funded, and how payouts are determined.

"How well employees understand the mechanisms of the incentive plan and why they got what they did, determines how satisfied they will be with the eventual payouts," says Adwin. In fact, Adwin notes that where compensation is concerned, employee satisfaction is influenced just as much by, if not more than, their understanding of how pay decisions are made and the perceived fairness of the program as it is by the actual dollar value increases. "If the incentive plan design is transparent and employees understand how the plan works, they will be able to see why their

performance didn't warrant a payout and they are less likely to have a bad reaction," he says.

When offering an incentive, companies should make sure that payouts adhere to the plan formula. If an incentive plan is not paying out, that doesn't necessarily mean it isn't working. In other words, employees should receive high payouts when performance is good and low or no payouts when performance is poor. To do otherwise negates the motivational potential of the plan and, instead, runs the risk of creating an entitlement mentality among employees.

Although these plans tend to payout from a single pool of money that may be tied to overall company performance, there should be opportunities to differentiate awards for the best performers. "Differentiating according to performance is never more critical than when the overall market is down," says Adwin.

Because the overall funding of the plan may be lower because of factors outside of the company's or individual participants' control, companies can take steps to provide special rewards in limited circumstances. For example, if the company is concerned about losing high performers because of low or no incentive payouts, it can offer one-time or spot bonuses to these individuals. "But these should be allocated extremely judiciously," says Adwin.

Although companies with incentive plans may be tempted to change their plans in light of the recent economic turmoil, Adwin suggests that companies sit tight and avoid kneejerk reactions. "If the plan made sense from a strategic standpoint six months ago, making changes to the plan now could be an overreaction," he says. "If you change it now because of the market, you might have to change it again in three months if the market changes again. The key is to make sure there is a good alignment between value creation and payouts."

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