Motivating and Rewarding “Value Adding” Performance

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For decades one of the most perplexing challenges for compensation incentive plan designers has been to identify a high impact strategy for motivating and rewarding middle management. To be a “high impact” plan, the incentive plan should motivate middle managers to closely identify with the business, and to enhance its value.

Why focus on middle management? Because we know more appropriate, effective methods for motivating and rewarding the upper and lower levels of employees in organizations than we know for middle management. In other words, the incentive strategies used for upper and lower employee levels not only “fit” better, but the plans are well established and time-tested, and, when well designed, achieve their intended objective a high percentage of the time.

Examples of these well established plans include Executive pay plans for top management, and Skill Based Pay plans and Gainsharing plans for the hourly payroll of organizations. While it is true today that Gainsharing plans do often encompass middle management, as a result of more inclusionary change in Gainsharing philosophy, the goals are broad based, company-wide goals. They do not focus on functional goals with which middle managers are often concerned and identified.

How to Build Business Value Through Managers

If high impact plans motivate managers to more closely identify with the business, what are ways to “build business value”? One commonly suggested means is to impart a “sense of ownership” in the business in the mind of the manager. How can we achieve this for middle managers?

Some people suggest that we should look no further than equity sharingfor the solution. To them, granting ownership in a company by granting stock to many if not all employees not only makes middle managers “think like owners”, but in fact makes them owners.

However, there are nagging questions that are being asked today about whether equity sharing has gone too far in making everyone an owner of the business. Shouldn’t the primary risk takers be the primary beneficiaries of equity based compensation? As a result, companies that believe this are now sharing some less valuable forms of equity with employees below top management.

Another means of building business value is to invest in human capital by building the manager's competencies and capabilities. The thinking goes that, as a manager acquires competencies applicable to the business, and, as meaningful contributions raise the manager's self-esteem and sense of accomplishment, their identification with the business grows. More confident and capable, the manager contributes more to the business because he/she becomes more highly skilled, knowledgeable and motivated.

Also, middle managers are also being asked today to think increasingly in the long term. Not perhaps as long term as owners, who must formulate and instill the company's vision in the minds of employees over a long period of time. In fact, as managers increasingly become a part of the strategic planning process in companies to improve organizational synergy, by design they become increasingly focused on the future.

However, despite the interests of owners and executives in getting everyone in the company to think in the long term, the traditional bonus plans of middle managers are often confined to goals generally or supposedly achievable within a 12 month period. These plans are also often discretionary plans with rewards that are not clearly connected to strategic performance results, and which certainly do not focus upon business value creation. The challenge is to create bonus plans which reward middle managers for adding value to functional operations.

ValuGain® Plans

To overcome the weaknesses of traditional middle management bonus plans, we have created a new incentive plan called ValuGain®. Inspired by the Economic Value Added Plan (EVA) concept (Rappaport, 1986), ValuGain® extends the notion of value creation downward in organizations to encourage functional managers to think, act, and lead functional areas as if they owned them. ValuGain® plans hinge on defining what "adding value" means to a functional area. It is also possible to extend this plan's coverage to the performance of key managers who may not lead a function, but who may be individual contributors capable of significantly impacting the success of the business.

Economic Value Added Plans use the Cost of Capital as the primary measure of success. Since this measure is not applicable to all middle managers (though possibly to some), goals with a variety of more suitable measures are substituted in ValuGain® Plans. These goals focus on adding value to the business through the performance results achieved in functional areas.

What are "value adding" results? A general definition of value adding results is those results which produce a significant, often long lasting impact upon the functional area and/or business. For example, they may transform the function in a significant way, resolve a major problem with long lasting implications, or reduce a major expense and maintain its new level. We have defined some examples of value adding activities below for the Human Resource function (see Figure 2).

Figure 2. Examples of “Value Adding” Goals and Measures in the HR Function:

> *Improving the quality of human resources (i.e. people you employ), moving from “average” to “above average.”*
>
> *Aligning training programs with the business strategy, such as programs aimed at overcoming skill deficiencies.*
>
> *Achieving key organizational objectives through well designed incentives.*
>
> *Improving benefit programs at no increase in cost.*
>
> *Reducing Worker’s Compensation expenses which are draining profitability.*
>
> *“Turning around” a negative culture through Organizational Development interventions.*
>
> *Reducing high turnover rates.*

ValuGain Time Frame

ValuGain goals may or may not be achievable within one year. Unlike traditional bonus plans, their results are monitored over a period of time. This is important for true value adding results. They are fundamentally important to the management of the function and to the success of the business. There cannot be “slippage” for that value to be maintained.

Economic Value Added Plans achieve results by funding a multi-year bonus plan. This encourages eligible executives to make investments today which will pay off in the future when rewards are paid. Thus, more may be “spent than gained” in the early plan years. But, if the manager makes the right choices, the strategy should produce results in subsequent plan years. By that time, the accrued bonus pool is more than sufficient to reward the accomplishment.

How To Create a Value Added Incentive Plan

Companies can create value adding incentive plans easily if they understand what value means to their operations. The key steps in creating Value Added incentive plans are as follows:

1) Fund the bonus pool over a 2 – 5 year period. A 1-5 year goal interval is acceptable if value can be added by the end of one year.

2) Identify value adding activities in functional areas. This is done via a group process, which is facilitated by an impartial leader. Typically only one process is needed unless the nature of the functional area of responsibility is somehow changing significantly enough to warrant a new determination as to how a manager can add value.

3) Establish measures for the goals. This will permit the performance manager to determine to what extent a goal has been met. Quantitative measures are always preferred over qualitative measures.

4) Assess performance over time. Use all possible means for reviewing the results achieved. This includes the immediate manager, peers, customers, 360° feedback, and others. Which goals were achieved, maintained or regressed?

5) Translate value added into financial rewards. When goals are established, weight their importance. Multiply the budget weight times the level of achievement to calculate the bonus payout. Bonuses not earned are returned to the bonus pool.

6) Allocate rewards to bonus eligible plan participants.

7) Monitor progress or regression of goals attained beyond one year.

The Importance of Continuity

Accomplishments of the past have an easy way of becoming tomorrow’s failures. Ensuring the continuity of past achievements into the future is of critical importance. W. Edwards Deming once said that quality programs should have “constancy of purpose”. So should functional incentive plans. Companies cannot pay managers for adding value while experiencing “slippage” in other areas of prior goal accomplishment.

As a result, ValuGain® Plans monitor the progress or regression of value adding goals beyond a one year period. We suggest keeping a running record of prior years’ goals and accomplishments on a ValuGain® goals form, which should be kept in the employee’s file. The importance of continuity should be discussed each year with participants.

A loss of previous progress affects the overall evaluation of progress in ValuGain

Plans because it represents a loss in value to the organization. And, if slippage does occur, a percentage of bonuses earned in the current year is withheld and returned to the bonus pool.

It may be re-earned if a previously attained goal is successfully re-attained. Again, this is similar to calculation made in EVA Plans based upon the fluctuating measure of the Cost of Capital.

Summary

The notion of “adding value” sounds like a worthwhile goal to strive for ,in companies today. But it is neither easy to define nor reward. ValuGain® Plans force organizations to closely examine what adding value means to their functional areas. Once identified, ValuGain® plans reward managers for adding that value. Continuity of these gains is preserved by accruing accomplishments and by examining the status of prior gains. Slippage in the status of prior accomplishments detracts from added value. Rewards should be similarly affected. ValuGain Plans enable organizations to impart a sense of business ownership to middle managers, drive improvement and fairly reward managers for growing the business’ value.

References:

Deming, W. E. Rappaport, A. 1986. Creating Shareholder Value. The Free Press.