A Paper of Importance to Organization Leaders by Lanny Goodman

Incentive Compensation

Creating Alignment from the Boardroom to the Broom Closet

The Opportunity

Any discussion of compensation has to start with a disclaimer that all compensation systems are built around the values of the CEO or whoever is responsible for setting compensation. In the most literal sense of the term, when we exchange money for service, we are valuing that service. Everyone has his/her own ideas about how value should be exchanged. The purpose of this paper is ultimately not to debate compensation values but to suggest ways in which incentive compensation can be made to provide real value to the company in exchange for the dollars spent.

Ask any employee who has ever received a bonus what that bonus was based on and how the number was calculated will almost inevitably give you a blank look and a shrug that eloquently says, "Beats me…" I believe the vast majority of bonus dollars are wasted if the intent of management is to incent specific behavior.

Let's go back to basics to understand the problem and solutions will begin to suggest themselves.

All business is about behavior. How the business collectively shows up in the marketplace is the result of the individual behaviors of all the participants in the business. Historically, traditional management which was built on the machine model, strives to define desired individual behavior in terms of goals from which behavioral norms are to be inferred. Management as a discipline is about defining, facilitating and enforcing those goals/norms.

The psychological tools of management, those devices used to basically manipulate employees into the desired behavior a quite crude. They are the carrot and the stick. The carrot is praise, promotion, pay raise, and incentive compensation. The stick is the private admonishment, public evisceration, demotion, the write up in the personnel file, and termination.

Ask any senior manager or CEO who has crafted an incentive compensation program enthusiastically anticipating the desired behavior it was sure to produce. Usually he/she will roll his/her eyes and proceed to tell you all the unexpected, spurious and sometimes bizarre behavior the recipients (victims?) of the incentive program began to manifest.

The underlying problem is that human beings are amazingly complex. Their Pavlovian responses to stimuli are difficult to predict. People are also very clever and if you put a maze in front of them with money at the end, they will rarely follow the path through the maze to the author of the plan thought was the most rational. Of course, the very notion that we are rational creatures is a conceit in which we indulge ourselves that has little basis in fact.

Ultimately, the problem here is a symptom of reductionism, treating individuals as components of a system (the business) rather than looking at the system as a whole. This is the legacy of traditional management practice. It's worth pointing out that the inventors of management as we know it were attempting to minimize employee initiative. This is the cornerstone of traditional management.

If we take a step back and post the question, "What are we really trying to accomplish with this business?" If you are Bill Gates or Warren Buffett, world domination may be the answer, but most of us would settle for making a profit consistent with the risks to which our capital is exposed in the marketplace. This is what business owners want. Profit means growth of working capital to support revenue growth, including the ability to attract debt and/or investment capital. In the final analysis, profit also determines the valuation of the business. Every dollar that flows to the bottom line multiplies itself by some multiple the market assigns to the company's capacity to increase in value.

In the closely held company, who do you suppose lays awake at night worrying about profitability? If you are the owner of such a company, you know the answer to this question: you. This doesn't seem sensible to me. Let's say there are fifty employees (including you) in the company. What are the other 49 employees doing while you lay there at three AM staring at the ceiling. The answer is simple. They are sleeping in the oblivion of ignorance, in spite of the fact that their paychecks are dependent on the company's ability to generate profit.

My theory is this. The object of the business game is to have all your employees lying awake at night sweating profit so you can sleep like a baby. Why should it be any other way? Some would answer, because you're the one getting the value. Why should your employees care about something that doesn't benefit them? The obvious fallacy of this point of view is that without profit companies can't grow. Without profit, ultimately companies can't survive. If the employees don't care about losing their happy home, they shouldn't worry about profit. But in my experience, employees generally resent losing their jobs and when it happens, feel that management has let them down (which they have).

Let's look outside of business for a robust model that we might find useful in figuring out this incentive compensation problem.

When we look outside (literally), what we see is nature in all her glory, profitably self-organizing itself into every nook and cranny of the planet. What might we learn from her? What we have learned from her is that all living things are driven by two imperatives hard wired into their DNA. Those imperatives are survive and propagate. In business, the analogue to survive and propagate is to make a profit. As we've discussed, no profit, no growth, no tomorrow.

So how might we interest everyone in the company's profit? How about give them some of it? That's a start, but there is more to it than that. Lots of companies have profit sharing plans of various sorts. What is critical is to avoid the "manna from heaven" syndrome by which employees get a check of some magnitude with no clue as to how that number was derived or what they did to earn it so they can do more of that and earn more manna.

One more item. If we really want people focused on profit, then we need to ditch the safety bonus, tenure bonus, and individual performance plans. In a self-managing environment, collective reward is the only thing that works. Bear in mind that we are harnessing the power of peer pressure, which is much more powerful than "boss" pressure. Every other reward system dilutes the power of having everyone from the shareholders to the lowest level employee focused on company profitability.

One possible exception is sales commissions. I say possible because some companies have gotten away from straight commissions in particular because it is very difficult to integrate straight commission salespeople into a corporate culture. They are basically independent contractors. The argument that salespeople prefer the "eat what you kill" world of straight commission is a generalization. There are some who undoubtedly do. There are many highly productive salespeople who would be just as happy on a straight salary and profit sharing.

Steps

There are three distinct design problems in creating an effective profit sharing plan. They are:

- Forming the pool
- Dividing up the pool
- Paying out the pool

Let's look at each of these individually.

There are lots of ways of forming the profit sharing pool. The key is to make the process formulaic and transparent. In other words, make it something that all employees understand and can calculate on a paper napkin in a couple of minutes. Does this limit executive discretion in deciding how much to distribute to employees? Yes. If done right, however, it will handsomely compensate shareholders for that loss of control. Bear in mind that any and every compensation system is subject to reassessment and revision, although this should not be done more than once a year.

There are basically three ways of doing this: some hidden, arbitrary decision, a straight split, or a sliding scale. The first option is the least effective and leads to manna from heaven syndrome. A straight split is a reasonable strategy. My preference though is a sliding scale where the more profit the company makes, the bigger the slice the employees get. This is one compelling way to get your employees focused on profit, lots of profit.

The first decision needs to be what is the profit floor below which there is no profit sharing. The number should never be zero. There are many ways to calculate this. My suggestion is as follows. If you estimate the value of your company if you put it on the market today and if you got that cash and put it into T-bills and took your annual return in interest dollars and divided that by your current revenue, you will get a percentage of sales that you should be getting if your company was subject to zero risk. That should be the absolute floor. If your company can't generate it's equivalent ROI from an investment backed by the full faith and credit of the US government, then you really should sell it and find a place for your capital where the risk/reward ratio is in better balance.

You may actually want to set the bar a bit higher. For the sake of example, let's call the floor 6%. If the company generates 6% or less, there is no profit sharing. Our message to the employees is, "If you collectively can figure out how to beat this number, we're going to share the surplus with you. The sliding scale might look something like this. Anything over 6% up to 8%, 70% of that goes to the shareholders and 30% goes to the employees. Over 8% up to

10%, we split 50-50. Anything over 10%, 70% goes to the employees and 30% to the shareholders.

So the shareholders continue to get benefit from higher levels of profitability but the employees get a real lift.

The second design problem is how to divide up the pool. The classical way is to divide a profit sharing pool up *pro rata* by current base salary levels. There is a problem intrinsic to this approach. It sends an unequivocal message to your employees: if you make a lot of money already, you're important. If you don't, you're not important. This is not the way to get your employees laying awake at night worrying about how to maximize the value of your company.

How about the following? Why not divide the pool up equally among all employees? I'm no socialist. There is a very practical rationale behind this approach. I would make the case that all your employees are equally important. But some are more interchangeable than others. If you question this, just ask all your lowest paid employees to stay home for a week and see how much work you get done. What what determines our compensation in this life is how interchangeable we are. Dishwasher? Highly interchangeable, low pay. Neurosurgeon? Not very interchangeable, high pay.

If you want your employees to be as passionate about profit as you are, you have to give them a taste and send a clear message to them that you acknowledge their importance. You may have to make some adjustments in base pay for more senior employees, but this (with the possible exception of sales commissions) should be your only incentive compensation company-wide.

The reason is simple. You want everyone from top to bottom in the organization focused on the same thing: profit.

This is a difficult thing for most CEOs to wrap their brains around because individual incentive comp is so deeply embedded in American business culture. Many times I've had clients squirming uncomfortably as we discussed this approach and coming back with the proposal, "How about 25% individual performance and 75% profit?" My experience has been that perversely, people will devote 75% of their efforts to win the 25% incentive comp and 25% making sure the company as a whole is healthy. As CEO, what you care about is profitability and a healthy company. So should everyone else.

The last design problem is how to pay out the profit sharing pool. To answer this question we can look for guidance to your behavior. Do you look at your income statement only once a year? Of course not. You study it every month. Wouldn't you want your employees to do the same? So what is the justification for paying profit sharing once a year instead of every month? "Easy," you say. "Cash flow, and what if profits vary from month to month? What if we post a loss?"

All those are legitimate issues and are all easily addressed. First, cash flow. This one's easy. We pay profit sharing on the accounts receivable period. Let's say your accounts receivable is the equivalent of 60 days worth of sales. That means at the end of sixty days, you should have collected all the money owed to you at the end of the month in question. So we pay profit sharing on the 61st day. One ancillary benefit of this is that it doesn't take an MBA to realize that a check in the hand today is worth more than a check in the hand two weeks from now. What winds up happening is that all your employees are now breathing down the necks of your collections and sales people to get the money in that the company is owed. Most employees would be astonished that your company loans money, interest free, to your customers for 30, 60, 90 days or more. (You should be too.)

That settles the cash flow issue. As far a variable profitability is concerned, we share the gain, we share the pain. If people want to share in the rewards, they have to share in the risks. Here's how we do that. Let's say you have a break even month. According to our formula, from six percent down to four percent, the shareholders absorb 70% and the employees profit sharing account goes upside down for 30%. From 4% to 2%, the employees absorb half that amount, and anything below 2%, the employees absorb 70%. We don't expect them to give the money back, but they do have generate more profits to make up the deficit before any further profit sharing is paid.

There is an interesting phenomenon this creates. Many businesses are cyclical. They make money say nine months out of the year and have a slow period where they lose money for three months. Under this plan your employees will quickly realize that during those three months they will be way upside down in their profit sharing accounts and they will have to spend the following three months just to close the deficit. There will be some serious conversation about how to eliminate the three months of losses. Interestingly, if you have a hundred employees working on the problem, the odds are excellent that they will find a way.

Vesting into the plan is important. Generally a year on the job will be necessary to make sure the employee is likely to stick and that he/she is delivering enough value to justify the dilution in the plan that all employees will experience when a new employee is added to the plan.

At the end of the vesting period, an internal customer feedback session should be held where the employee's internal customers determine whether or not he/she will be invited to join the profit sharing plan. For more information on this process, see my white paper *Performance Reviews That Actually Improve Performance*.

Be Aware of Some Issues

The primary inhibitor to implementing the profit sharing plan I've described is that unless you run your company with open books, your employees don't know enough to understand the value of the profit sharing plan. To learn more about open books, read my white paper, *Open Books, Get Your Employees Excited About Increasing Profit.* You will have to train your employees to understand the economic realities of your business. They need to understand the basics of risk and reward.

The other system that will be important to look at is how you do performance reviews. What makes this system work is peer pressure, not boss pressure. In order for this to work, teams must be able to hire and fire their own members. This requires training and a well defined set of protocols that are fair, equitable and will meet the legal litmus tests necessary to avoid litigation.

Sadly, after years of working in traditional organizational environments, employees are cynical. Their bias is to assume that any change in compensation is going to cost them somehow.

Overcoming their understandable negativity will take time, education and trust building. To get the most benefit from the program, you will also have to train employees to understand how they can impact profitability. The logical place to start to accomplish this is continuous improvement.

Action

1. Educate yourself. Learn about open books and what it takes to familiarize your employees with reading and understanding your financial statements.
2. Calculate your minimum acceptable return.
3. Design how the pool will be formed, how it will be divided up, and how it will be paid out.
4. When rolling out the program, communicate, communicate, communicate. Do not assume that just because you explained everything once, that your employees understood it or believed it.
5. Make a big deal out of passing out the first round to checks.
6. Realize that it is the people at the bottom of the salary scale whose lives will be most powerfully impacted by this plan. Make sure you have a program in place by which you can begin to harness the growing level of interest and commitment to company profitability the plan will begin to generate.

Conclusions

Most incentive compensation plans are Pavlovian and manipulative. If we want our employees to act like adults we need to treat them like adults: give them access to information, involve them in the process of creating profit and share the profit with them.

You have a lot of brains in your organization you are paying to attend to your business eight, ten, twelve hours a day. What we know about traditional management practice is that it grossly under-utilizes that brain power. This is the legacy of traditional management and it's useful to know that this was by design. Conditions have changed in the past hundred years since management as we know it was invented. What we need now is just the opposite. We need organizations, systems and processes that draw out the full value of what our employees are capable of bringing to the party.

The profit sharing plan described here is just one of a number of systems and processes I have developed to create self-managing companies, built on the principles of complexity theory, the emerging scientific discipline that has shown us that the universe is self-organizing and that this attribute can be applied to leadership, management and organization design. For more information, visit www.lannygoodman.com.

About Lanny Goodman

Since 1980, CEOs of companies large and small have consulted with Lanny around their strategic planning processes. Primarily focused on entrepreneurial organizations, Lanny's planning methodologies help companies focus their efforts, improve profitability, rationalize their operations and leverage their people.

In the late 1980's Lanny began exploring how changes in our understanding how the universe works might apply to how we lead and manage companies. Building on the principles of the new science of complexity theory, Lanny began working with his clients, researching and experimenting to create the first comprehensive system for creating companies that run themselves. Lanny's book, **The End of Management** lays out the logic of self-managing systems.

His company, Management Technologies Inc. provides comprehensive support services to organizations interested in creating companies built from the ground up to fully leverage their people. For more information visit www.lannygoodman.com.

Lanny's work has been the subject of a feature article in Inc. Magazine. He has been quoted there extensively as well as in Fortune Small Business and the New York Times. A compelling speaker, he has spoken at sixteen Inc. Magazine national conferences including five Inc. 500 conferences, celebrating the 500 fastest growing private companies in the country.

Lanny holds a BA in Fine Arts and an MBA in Financial Management and lives in Albuquerque, NM. He can be reached at lanny@lannygoodman.com or by phone at 505-884-7300.