Incentive Comp Principles

By William Mech

1) Try really hard to hit target payout, on average

When you tell employees that their target incentive is XX%, they intuitively expect that, on average over time, that's what they'll get! Plus, when you do market salary comparisons, and are comparing to similar positions including "target" bonus pay, you are distorting the comparisons if bonuses routinely do not average out to target.

2) Link bonus pay to company fortunes, but vary that link

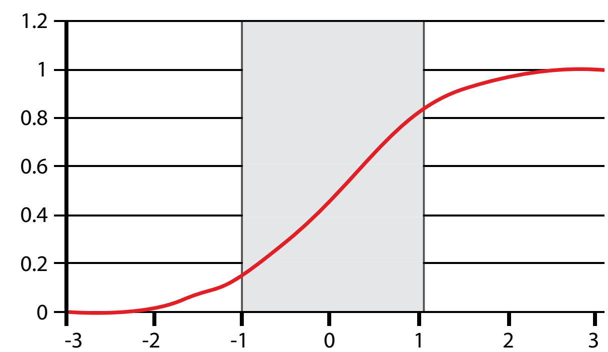
The higher an employee's target bonus, the more it should be affected by the company's results. Highly paid people have more capacity to absorb risk, and variability in bonus pay is expected. But, the broader one's responsibilities, the more bonuses should derive from comparably broader results. Lower paid employees should not only have less of their pay at risk (in %), but also be affected less by the overall organization. They need less volatility in their bonus pay, and more control over it. Bonus pay should not be a one-size-fits-all system, rather it should recognize the need for less volatility and more control when incentive targets are smaller. (note: hold in tension with #1 and #3)

3) Be sure that 95% of the time, something gets paid out

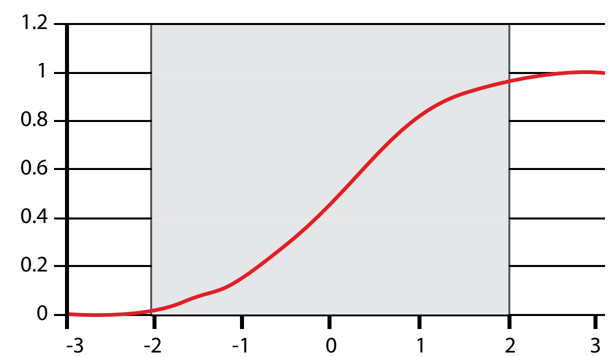
Ranges around target such as [50%, 150%] are purely discretionary (arbitrary?) and can be changed. Widen the range so that any "cliff" or "cap" are further out in the tails; minimize constraints on rewards. Then, more people participate more fully, and variation in payouts is wider, to recognize variation in performance. High performers get even more, poor performers get much less, but… everybody plays, and plays more often.

Examples for #3

Pay bonuses not like this:



But like this:



Set the "cliff" and the "cap" to minimize constraints

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