

The Case for A Performance Linked Incentive Scheme

Dr J.S Tiwari

“Result based compensation is.... what reengineering is all about. It is about focussing on processes that create results. It is very important that you measure and reward people in ways that are consistent with what your organization is all about”

*-Michael Hammer
ACA Journal, Spring 1996.*

Organizations begin as ideas in the minds of people. The inventor is the garage who decides to build his or her invention by getting together five workers in a shop; the social organizer who starts with a new club or political organization on campus; the young teacher with a vision who decides to start a school of his or her own are all creating new organizations. The organization would survive if it were able to meet the demand for a product or of a service of the society. It might become established over a period because of its products and services. However for it to constantly keep pace with the ever changing scenario and to meet the challenges of the competition it has to have a self sustaining mechanism which thrives on the challenges thrown up by these uncertainties.

The McKinsey 7-S Framework is a good tool to analyze the organizations and find out whether they have it in them to face the uncertainties of the future. Of the seven S's strategy and structure focus on the hardware and the style, systems, staff, skills and shared values focus on the software aspect

of the organization. However, the framework would be much better utilized if it were to give us the policies to be followed. None the less it does identify the important success factors of an organization. Though it identifies People (Staff) as one of the factors it also acknowledges its importance because all other factors have a shared human element. It is this understanding that makes people the most important element in the strategy of organizations. We can no longer think of employees as just another factor in the Cobb Douglas Equation. They have to be properly leveraged to the organization advantage. At the same time the organizations should understand that there is no free lunch. The employees have to be properly compensated if they expect them to be committed to the organization's goals.

Maslow's hierarchy of need identifies the five levels of need. When the first level is satisfied one higher is likely to take over. The organizations have traditionally focused on fulfilling an individual's first three levels of need. However, with the advent of the knowledge worker and greater avenues available

*Dr Jai Shankar Tiwari is Assistant Professor of Management at the Institute of Management Studies, Dehradun

to him the other levels of need gained importance. Even at the worker level, various schemes have come up which target one or a combination of needs. Training programs have been designed to keep the workforce ready to face the challenges of the future. Organizations have gone through processes of establishing the organization vision and mission with the participation of its employees. All these steps are aimed at aligning the organizations and the employee's efforts towards a common goal. However all these efforts will fail if the employees are not properly compensated. As Sam Barlett has said "*All the coaching in the world will fall short if the behaviour you expect is not honoured and recognized*". This leads us to the issue of Employee compensation. More specifically it forces us to think about performance linked compensation.

When the issue of performance linked compensation comes up it brings with it the related issue of performance measurement. Performance appraisal by the Superiors and consent by the appraised has become the norm in most established and progressive companies. This process has also helped in identifying the developmental needs of the individual. It has also helped the company in its man power planning. Moreover, the management has used this for giving increments and promotions. New approaches to appraisal have come up in the form of a 360-degree feedback. This has been put to use for people in the higher levels of management.. However the incidence of a detailed performance appraisal at the worker level is quite less. From my experience in industry I have not seen a full-fledged performance appraisal of the workers. Two factors are responsible for this:

- ◆ The unwillingness of the management to engage in an elaborate appraisal exercise with the perceived fall outs (demand for better pay...)
- ◆ The tendency of ending up with the wrong measurement yardstick. (Ex, no of pieces produced).

We have seen that in companies a special incentive has been traditionally paid which is based on levels of production. This has led to over production and unused inventory. Telco was straddled with high levels of inventory in 1996-97. This may be traced back to the tendency to over produce. Also this has led to incidents where machines have been kept running to meet the production targets even when they had developed leakage and the oil had to be refilled on an hourly basis. This has also led to problems of administering equitable incentives to departments, which are essentially support and non-production departments.

However, we have to overcome this stalemate and come up with strategies that will put the organizations long-term strategies into action. A new concept that can be of help in this is the concept of the Balanced Scorecard. It is organized around four distinct perspectives- financial, customer, internal and innovation and learning. The name reflects a balance between the short term and long-term objectives, between financial and non-financial measures and between internal and external performance perspectives. A performance linked incentive scheme that aims at this balance is what is required for organizations that are willing to strive for the best.

S.K. Engineering Company (SKECO)

SKECO is a mid size engineering firm employing 493 people on a permanent basis. Of these 95 are of the managerial cadre and the remaining are from the associate cadre. The organization has been in existence for the last 20 years and has been a supplier of machined components to the major Automobile companies in India. The company has come a long way since its inception in 1979 at Anand (Gujrat), when it started with only 6 employees. Recently it has started exporting some components to the auto majors in the US. It had got ISO 9002 certification way back in 1990 and has recently been awarded the QS900 certification.

The company has a very good work environment. It has very high standards of housekeeping. Its order books are full at present. However with the liberalization of the Indian economy this is in danger of getting diluted unless the company constantly meets and delights the customers expectations.

The company has a flat organizational structure. It has four levels. One for the Associates (the company takes pride in the fact that it considers its workers as associates), the other two levels are the manager and the senior manager level. The highest level is the chief manager level. However at each level there are grades that have been designed to give the employees regular wage hikes. The company also has a policy of giving its employees annual increments. On exemplary performance the individual may get double increments.

The Associates are mostly ITI or Twelfth grade. They have been absorbed in the company after a one-year training period during which they were given on the job training. The managerial cadre has people who are Engineers and Diploma Engineers, Cost Accountants, Chartered Accountants, MBAs and MCAs.

At present the company also has a policy of giving out a Bonus which is substantially higher than the industry average. It is aimed at rewarding the employees by sharing some of the profits with them.

The Performance Linked Incentive Scheme (PLIS)

The Performance Linked Incentive Scheme (PLIS) is a new scheme that has been introduced by the company to recognize and reward good performance of the workers. It has been designed keeping in mind the fact that many people contribute to the achievement of the company's objectives. It also keeps in mind the fact that individuals and teams performance is dependent on a number of factors outside their immediate control. However as an organization we can work cohesively to attain these results. The scheme is also aimed at rewarding such teamwork.

The performance linked incentive scheme of the company is separate from the other schemes, which recognize the workers for their exemplary and consistent contribution to the company's objectives. It is also separate from the policies that relate to the increments that the individual gets on the basis of his persistent efforts and results. It is aimed at creating an atmosphere wherein the greater organizational goals are achieved. It also aims at fostering a team spirit within the organization because the nature of the scheme is such that each individual would have to contribute to make the scheme a success.

Scope and Eligibility.

The PLIS has been designed keeping in mind that the organizational and individual goals are aligned. In this respect the scope of the scheme includes all the employees. This has been done keeping in mind the fact that not all companies are production departments. Moreover mere production and putting in more hours does not yield results to the company. What really brings in money is the organization's ability to constantly meet and exceed the ever exceeding the customer expectations. To that end we have to eliminate all

internal and external bottlenecks and quality issues. And for this the contribution of all the employees is essential. Hence the scope of this scheme includes all the employees.

General Characteristics of PLIS.

- ◆ PLIS is a new scheme of recognizing and rewarding the efforts of the employees of the company.
- ◆ The PLIS will be administered on a quarterly basis.
- ◆ It is different from the normal individual reward schemes.
- ◆ It is not a profit sharing system.
- ◆ It rewards performance of employees on some pre-determined parameters.
- ◆ It will be not be connected in any way with the increments and promotions that individuals receive.
- ◆ It will be linked to the individuals basic and DA. Each individual will get a percentage of his Basic and DA as PLIS for the quarter. However the percentage will be the same for all the employees.
- ◆ All the employees of the organization are eligible for the PLIS.
- ◆ The company recognizes the fact that an individual can contribute only if he is present therefore in cases of absenteeism the PLIS will be administered on a pro rata basis.
- ◆ The parameters to be considered for evaluation would be decided before hand and it will reflect both the short term and long term objectives of the company.

- ◆ The system of calculating the actual performance of a quarter has been dealt with in the succeeding portions of this document.
- ◆ The company reserves the right to withdraw the scheme as and when it deems fit.
- ◆ The number of Non conformances closed (in keeping with the QS9000 efforts the committee may build in the performance of the company at closing down the no of Non Conformance reports that may be highlighted by the Auditors.)

Performance Parameters

The performance parameters will be decided at the beginning of the quarter. The parameters will be decided by a committee, which will comprise of the managing director and the Chief managers of the individual departments. The parameters will be based on the long term and short-term objectives of the company. Other features of the performance parameters are:

- ◆ The individual parameters will be given a weight.
- ◆ The sum total of the individual weights will be equal to one.
- ◆ The weights will be decided based on the importance of a particular factor to the company's objectives.
- ◆ The number of performance parameters will be kept to around 5 to facilitate proper targeting.

Illustration

The PLIS committee may come up with the following parameters on which the next quarters PLIS will depend: (these are indicative)

- ◆ On Time Delivery. (It takes into account the timely delivery to customers. It is calculated as a percentage of on time delivery to the number of opportunities to deliver goods to the customer)
- ◆ Safety incidents. (It takes into account the number of man days lost due to safety incidents)
- ◆ First Time OK. (It takes into account the Percentage of components that were produced OK in the first attempt)
- ◆ Customer Return Percentage. (It measures the percentage of Components rejected by customers in the quarter).

The weights of the individual parameter would be decided on the basis of the organizations long term and short-term objectives. For example the PLIS committee may decide to have equal weights of 0.20 for all the parameters mentioned above in a particular quarter.

Special Clauses.

The following are some of the special clauses of the scheme:

The company recognizes that the individuals are entitled to leave as per the leave rules of the company. However in keeping with the spirit of the scheme the company believes that as far as the PLIS is concerned the employee should be rewarded only for the days he was present and has contributed towards the achievement of the company's goals. Other leave benefits of the employee are not affected by this scheme.

- ◆ The company also values the contribution of the employees who decide to leave it for the period in which they were in employment with the organization. Therefore at the end of the quarter in which an employee leaves his PLIS will be calculated on a pro rata basis for the number of days in the quarter he has worked for the company. The amount will be adjusted against his/her dues if any and the balance posted to him as a cheque at the forwarding address mentioned by him.

Calculation of PLIS

The individual performance parameters have certain weights. These have been done to indicate the management's thrust areas for the quarter. However in keeping with the thought that honest efforts have to be rewarded the company

feels that in the event of the organization not achieving a particular objective the actual performance will be measured against the target. The employees will get due rewards for their efforts but the reward would be a fraction of what they would have got if they had met the target. On the other hand if the organization exceeds the PLIS targets that it had set for itself the employees will get due rewards for that too. This entails that a stepwise payment be made for each level of performance.

- If the organization meets all the targets that it had set for itself in a quarter then the PAYOUT FACTOR would be taken as one.

- ♦ PAYOUT FACTOR is the factor, which determines the level of reward that each individual will get.
- ♦ The PLIS for each employee will be calculated by the formula:
(PAYOUT FACTOR *20%*(Basic+DA)).
- ♦ The PAYOUT FACTOR will be calculated on the basis of a table, which indicates the weights of the individual parameters, the targets for each parameter and the PAYOUT FACTOR for individual parameters at different levels of performance.

(For example the organization may have targeted 95% on time delivery for the quarter. Its individual weight may be .20 however at different levels of on time delivery the PAYOUT FACTOR may be as follows:

%on time delivery	<90	90-95	95-96	96-97	>97
PAYOUT FACTOR	0.2	.6	1	1.5	2

In this case if the organization meets the targets in all other parameters and achieves an On time delivery of 97 % the composite PAYOUT FACTOR will be $0.80*1+0.20*2=1.2$.

The detailed PAYOUT Table would look like this:

Sample Payout Table.

	Weight					
Safety Incidents	0.2	>15	10-15	7-10	4-7	<4
PAYOUT FACTOR		0.2	0.75	1	1.25	1.5
First Time OK	0.3	<80	80-88	88-90	90-95	>95
PAYOUT FACTOR		0.2	0.6	1	1.25	2.0
Customer Return Percentage	0.2	>5%	3-5%	2-3%	1-2%	<.5%
PAYOUT FACTOR		0.2	0.5	1	1.5	2.0
No of Non Conformances closed	0.1	<8	8-15	15-22	20-30	>30
PAYOUT FACTOR		0.2	0.6	1	1.5	2.00
%on time delivery	0.2	<90	90-95	95-96	96-97	>97
PAYOUT FACTOR		0.2	.6	1	1.5	2.0

- ◆ The payout factors of the individual parameters should lie between a minimum of 0.2 and a maximum of 2. This will ensure that the payout to the individuals under the PLIS will vary between 4-40% of his/her Basic+DA.
- ◆ The PLIS committee before the start of the quarter will decide the payout factors for each level of performance in a particular parameter.

Sample calculation of PLIS.

The PLIS will be calculated in the way as explained below:

- ◆ The actual results at the end of the quarter will be calculated.
- ◆ These will be matched against the ranges of performances for each parameter to find out the individual payout factor.

For example if the actual performance for each parameter is as follows:

Sample Payout Calculation Table.

PARAMETERS	WEIGHT	RANGE AND PAYOUT FACTORS.				
		>15	10-15	7-10	4-7	<4
Safety Incidents	0.2	>15	10-15	7-10	4-7	<4
PAYOUT FACTOR		0.2	0.75	1	1.25	1.5
Actual Safety incidents			12			
First Time OK	0.3	<80	80-88	88-90	90-95	>95
PAYOUT FACTOR		0.2	0.6	1	1.25	2.0
Actual First Time OK					93	
Customer Return Percentage	0.2	>5%	3-5%	2-3%	1-2%	<.5%
PAYOUT FACTOR		0.2	0.5	1	1.5	2.0
Actual Customer Returns %					1.57%	
No of Non Conformances closed	0.1	<8	8-15	15-22	20-30	>30
PAYOUT FACTOR		0.2	0.6	1	1.5	2.00
Actual no of Nan Conf. closed			12			
%on time delivery	0.2	<90	90-95	95-96	96-97	>97
PAYOUT FACTOR		0.2	.6	1	1.5	2.0
Actual %on time delivery				95.5		

Based on the weights and the actual payout factors got for actual performance the aggregate PAYOUT FACTOR will be:

$$0.2*0.75+0.3*1.25+0.2*1.5+0.1*0.6+0.2*1=1.085$$

Therefore if a person is present on all working days in the quarter he will get 1.085*20% of his total Basic+DA for the quarter.

Calculation of PLIS on Pro rata basis

Suppose that the aggregate PAYOUT FACTOR as calculated in the previous section comes out to be 1.085.

An employee has availed of 15 days of leave in a quarter of 91 days.

Therefore on a pro rata basis his PLIS will be = (91-15)*1.085*(Basic+DA for the quarter)/91.