



Aalto-yliopisto  
Kauppakorkeakoulu

# INCENTIVES & TARGET SETTING

Prof Teemu Malmi

# AGENDA

- Purposes of incentives
  - Different types of rewards
  - Design choices: formula based or not, shape of pay function, size of bonus
  - Criteria for evaluating incentive systems
  - Pros and cons of group rewards
  - Targets: where do they come from?
  - How challenging targets should be?
  - How much influence subordinates should have in setting targets?
  - Objectives & Key Results method by Google etc.
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# WHAT ARE THE PURPOSES OF INCENTIVE AND REWARD SYSTEMS

- Are incentive and reward systems the same thing?
- What are the purposes of incentive systems?

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# DIFFERENT TYPES OF REWARDS

- Monetary rewards -> examples?
- Employee benefits -> examples?
- Dynamics in work, e.g.:
  - Job descriptions
  - Challenging assignments
  - Clarity of roles and responsibilities
  - Meeting practices
  - Participation in developing own processes
  - Feedback
  - Possibility to influence decision making
  - Job rotation

# DIFFERENT TYPES OF REWARDS

- Growth and development, e.g:
  - Performance development discussion
  - Personal growth opportunities
  - Training
  - Growth paths
  - Job rotation

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# FORMULA BASED OR NOT?

- Sometimes fully formula based, sometimes subjectivity plays a role
- In promotions subjectivity typically plays a big role
- In annual bonus assignments
  - All or part of bonus may be based on subjective judgement
  - The weights on some or all of quantitative measures can be determined subjectively
  - Subjective performance threshold or override can be used
- Why companies use subjectivity?
- What positive and negative consequences it may have?



# SHAPE OF THE PAY FUNCTION

- Most often restricted range, i.e. one needs to achieve certain minimum level (e.g. 80% of budget) to receive bonus and there is a cap (e.g. 150 % of budget) restricting the maximum amount to be paid
- Reasons to use upper cutoffs?

# SHAPE OF THE PAY FUNCTION

- What are possible drawbacks of this type of incentive schemes?
- What alternatives exist?
- See e.g. Jensen (2001) “Budgeting is broken, let’s fix it”

# SIZE OF INCENTIVE PAY

- What should be the ratio of fixed vs. performance contingent pay? What factors should play a role here in determining this ratio?
- What guidelines you could suggest regarding the size of incentives?

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# CRITERIA FOR EVALUATING INCENTIVE SYSTEMS

- What criteria you could use to evaluate an incentive system?

# DISCUSSION

- How well monetary incentives satisfy the reward evaluation criteria?
- Are all criteria equally important?

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# PROS AND CONS OF GROUP REWARDS

- Group rewards can mean anything from profit sharing schemes at group level to team level systems
- Pros
- Cons



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# TARGETS – WHERE DO THEY COME FROM?

- Strategic / long-term targets vs. short-term (annual?) targets
- Required growth rate and firm current and future financial status allows you to calculate required profits / cash flow
- Merchant & Van der Stede focus mainly on financial performance targets in a budgeting context
- Strategy, organizational values, various initiatives, etc. may require accountability of non-financial KPI's. This often requires targets to be set to those KPI's

# STRATEGY DRIVEN TARGET SETTING

BSC / Kaplan approach to target setting:

- Establish targets for 3-5 years
- Establish targets that, if achieved, company and its operating processes have been changed
- Part of this gets done when vision is determined
- Break long-term objectives into short-term milestones → connection to yearly planning and budgeting
- This means target setting is done already partly during the strategy process, not during yearly planning process!

# FINANCIAL PERFORMANCE TARGETS

- Model based, historical or negotiated
  - Model based and historical provide often starting point for negotiations
  - Negotiated most common in practice
- Fixed vs. flexible targets
  - Targets may be flexible in relation to volumes, price of inputs, interest rates, exchange rates, etc.
  - Fixed more common in practice, especially at higher levels of hierarchy
  - Relative performance evaluation one way to flex targets
- Internal vs. external targets
  - Internal by far most common, many firms do benchmarking, however

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# HOW CHALLENGING TARGETS SHOULD BE?

- What kind of targets should be used for strategic purposes, and what kind for short-term purposes?
- How do we define how much stretch there should be? If your answer is “it depends”, it depends on what?
- Research shows targets are largely achievable in practice (80-90% of the time). Why?

# VBM APPROACH TO TARGETS & INCENTIVES: THEORY

Dimension of VBM use	VBM solutions
<b><i>Management control</i></b>	
Objectives and strategies	<p>Maximisation shareholder wealth. EVA™ metrics (or its value drivers) as a single goal throughout the organisation.</p> <p>A value creating strategy is the only possible solution, though silent about the type of strategy <i>per se</i>. Business units are responsible for strategic planning.</p>
Performance measurement	<p>Performance measured using economic profit metrics and their value drivers from top to bottom. Other measures abandoned.</p>
Target setting	<p>Improvement in the current level EVA™. Zero-EVA™ minimum acceptable level. Target setting linked to value drivers.</p>
Compensation	<p>Bonuses paid are based upon changes in EVA™. Bonuses have no caps. Banking to avoid myopia. Stock options only to top management with increasing target level in line with the cost of capital.</p>
<b><i>Influence on decision making</i></b>	
Strategic decisions	<p>Based on EVA™ calculations, no room for decision-making beyond; acquisitions, strategic capital investments and divestments are made accordingly. Strategizing within the business units.</p>
Operational decisions	<p>Both balance sheet and income statements are considered, leading to improved capital investments and more efficient working capital management.</p>

# VBM APPROACH TO TARGETS & INCENTIVES: PRACTICE

Dimension of VBM use	VBM practice
<i>Management control</i>	
Objectives and strategy	Maximisation of shareholder wealth. Both growth and efficiency strategies. Mainly used at the group level.
Performance measurement	EVA™ metrics or its value drivers used at different organisational levels. Such measures are not the only ones throughout the organisation. Old measures are retained.
Target setting	Mainly negotiated, frequently other measures are used. Zero-EVA™ does not have any major relevance.
Compensation	Bonuses paid based upon several financial metrics. EVA™ has a minor role. No banking is present. Stock options mainly for the top management at a fixed price.
<i>Influence on decision making</i>	
Strategic decisions	Still room for strategic judgement beyond VBM. Impact on acquisitions, strategic capital investments and divestments.
Operational decisions	Increased emphasise on balance sheet. Leads to lower hunger for capital investments and more concern about the cost of working capital.



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# HOW MUCH INFLUENCE SUBORDINATES SHOULD HAVE IN SETTING TARGETS?

- Lots of academic research, most suggesting participation is beneficial
  - Creates commitment to achieve targets
  - Information sharing
  - Cognitive - Clarify expectations and encourage managers to think how to best achieve their targets
- Could you suggest situations where participation should not be present? In other words, when target setting should be predominately top down?

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# OBJECTIVES AND KEY RESULTS

- Goal-setting system used by Google, Intel and many others
- Objectives = what we seek to achieve (tangible, objective => i.e. measurable)
- Key Results = how goals will be attained
  - Note: Key results describe outcomes, not activities (also measurable, or at least allow clear evidence of completion)
- In many technology firms, OKR target setting for teams takes place in 3 month cycles

# OBJECTIVES AND KEY RESULTS

- Committed and aspirational OKRs
- For aspirational, the idea is to set targets so that those are 70% achievable
- Teams and individuals set targets for themselves, leaders support and challenge
- Idea is that everyone's OKR (indicators and targets) are transparent to whole organization
- Monetary rewards are not directly linked to the achievement of these three month targets

# SUMMARY / REFLECTION – KEY LEARNINGS REGARDING OUR AGENDA?

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- Targets: where do they come from?
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- How much influence subordinates should have in setting targets?
- What is new in OKR´s?