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New Ways of Setting Rewards:
The Beyond Budgeting Model

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The issue of incentives has been the subject of fierce debate within both practitioner and academic communities for decades. Some people believe passionately in the power of incentives to improve individual performance. Others believe that in an organization that is well structured and aligned, such additional “bribes” are unnecessary—they are only needed to force people to do what they would not otherwise do naturally. In other words, they are a poor and ineffective substitute for good management practices.

However, many senior executives appear to believe that the performance “holy grail” is finding the right mix of targets and incentives (although there are significant differences across countries). For example, with regard to long-term incentives (including share options), a U.S. executive can expect incentives to represent 97% of basic pay, whereas in the UK, France, and Holland the figure is 38%, and in Sweden and Spain they are almost unknown.¹ A recent global survey reported that incentives are tied to fixed annual targets in 60 percent of cases.²

Another conclusion from various surveys is the level of dissatisfaction with incentive schemes. In a study by consultants William Mercer, 47% of respondents reported that their employees found the systems neither fair nor sensible, and 51% of employees said that the scheme provided little value to the company. No wonder that the study concluded that most individual merit or performance-based pay plans share two attributes: they absorb vast amounts of management time and resources, and they make everybody unhappy.³

Research by the Beyond Budgeting Round Table (BBRT) over the past five years has shown that fixed performance contracts (fixed targets reinforced by incentives) are one of the primary causes of dysfunctional behavior in

organizations today. This article will examine some of the principles that enable leaders to break free from this contract and move to a more lean, adaptive and ethical organization.

The Academic Debate

Most business leaders believe in the power of *individual rewards*. They see the organization as a machine whose parts can be managed by understanding their “cause-and-effect” relationships. People are an important part of this machine and their performance can be “fine-tuned” by changing *extrinsic motivators* such as financial inducements. These beliefs can be encapsulated in the expression “Do this and you’ll get that.” Its management origins stem from the principles of scientific management set out by Frederick W. Taylor in 1911. It was based on piecework. However, relating pay to performance when individual output can be precisely measured is one thing, but applying this approach to complex modern organizations—where success is more dependent on design, innovation, quality, and customer service—is another.

The problem is that knowledge workers now form a majority of the workforce in most organizations today.⁴ Whereas workers used to serve machines, machines now serve workers. While yesterday’s car plants and textile factories employed few managers and thousands of “hands,” today’s financial services firms and software companies employ many managers and hundreds of “brains.” Moreover, whereas industrial organizations were designed around separate functions, today’s knowledge-based organizations (including most modern manufacturing firms) are designed around *interdependent parts*, so setting targets and incentives for each part doesn’t make much sense. Stanford professor Jeffrey Pfeffer makes this perceptive point: “If you could reliably and easily measure and reward individual contributions, you probably would not need an organization at all as everyone would enter markets solely as individuals.”⁵

Like Pfeffer, Harvard professor Robert Simons believes it is impossible to separate the marginal contributions of individuals. He puts the question in this way: “When Ford launches a successful new automobile, how can senior managers calibrate the relative contribution of the design team that created the concept, the engineering team that developed and applied the new technologies, the marketing team that launched the product, and the division president who oversaw the entire effort? How do we measure the contribution of a single violin player in relation to the successful season enjoyed by a symphony orchestra?”⁶

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The theoretical basis for individual incentives lies in experiments with dogs, rats, and pigeons. With enough practice you can teach rats to ring a bell every time they want food. The step up to people is a small one. B.F. Skinner, an American who conducted many of these animal experiments, wrote the bible of

the behaviorist school. He believed that people are nothing more than “repertoires of behaviors” and these can be explained by outside forces he called “environmental contingencies.”⁷

This school of thought is strikingly similar to the “Theory X” view of human resources set out in Douglas McGregor’s classic 1960 book, *The Human Side of Enterprise*.⁸ Theory X stated that people hate work, need to be told what to do, dislike responsibility, and will do no more than the minimum stated in their employment contract unless driven to raise their performance by additional incentives.

The evidence that incentives lead to higher profit performance is tenuous at best. Jensen and Murphy showed that there was virtually no link between how much CEOs were paid and how well their companies performed for shareholders.⁹ In a 1998 survey of 771 U.S. companies, Towers Perrin found that only one-third could see any connection between incentives and financial results.¹⁰

In 1993, social scientist Alfie Kohn’s article in the *Harvard Business Review* entitled “Why Incentive Plans Cannot Work” generated more comment than just about any other article in the history of the journal. “Do rewards work? The answer depends on what we mean by ‘work.’ Research suggests that rewards succeed at securing one thing only: temporary compliance. When it comes to producing lasting change in attitudes and behavior, however, rewards—like punishment—are strikingly ineffective. Once rewards run out, people revert to their old behaviors....They do not create an enduring *commitment* to any value or action. Rather incentives merely—and temporarily—change what we do.”¹¹ When asked, “Do incentives build commitment?” Harvard Professor Chris Argyris answered with a resounding “no.” “In all my years as a change consultant,” he noted, “I have repeatedly witnessed how offering employees the ‘right’ rewards creates dependency rather than empowerment.”¹²

Huge incentives, when linked to fixed targets, can (and often do) lead to a management culture based on fear. Peter Senge, apostle of the learning organization, describes the behavioral consequences in this way: “Once we become

Various devices (including financial incentives) can be used to get people to do something they might not otherwise do, but this is a far cry from making people want to do something.

convinced that we must achieve a certain outcome, our universe collapses and we see everything through the narrow lens of the predetermined outcome. Our awareness diminishes. Our ability to invent totally new ways of responding to new challenges is lost. Fear of failure increases.”¹³ This was the prevailing culture at Enron and WorldCom. The WorldCom culture, say those who worked there, was all about living up to CEO Bernard Ebbers’s demands. “You would have a budget, and he would mandate that you had to be 2 percent under budget. Nothing else was acceptable.”¹⁴

The point that Kohn and others make is that various devices (including financial incentives) can be used to get people to do something they might not

otherwise do, but this is a far cry from making people want to do something. It is the difference between what social scientists call “extrinsic motivation” (where the task is seen as a means to an end, a prerequisite for receiving a reward or avoiding a punishment) and “intrinsic motivation” (where the task itself is appealing). In other words, it is not the *amount* of motivation that matters, but its *type*. Kohn tells us that at least 70 studies have found that rewards tend to undermine interest in the task itself. “This is one of the most thoroughly replicated findings in the field of social psychology,” he says. Psychologists tell us that people have a basic need to feel related and to belong, so the challenge is to create a workplace that is collaborative and feels like a community.¹⁵

It is important to note that Kohn, Argyris, Senge, and Pfeffer were criticizing incentives as applied to individuals. They were less concerned about teams. Indeed, the alternative view is that teams are the right focus for rewards. In this context, rewards are seen as a share of success (like a dividend on intellectual capital) rather than a “do this, get that” type of incentive linked to a target. MIT professor, Edgar Schein, an acknowledged expert in the field of corporate culture, puts the problem of changing the incentive mindset down to the sacred cow of individual accountability. “No matter how much team-work is touted in theory,” he notes, “It does not exist in practice until accountability itself is assigned to the whole team and until group pay and reward systems are instituted.”¹⁶

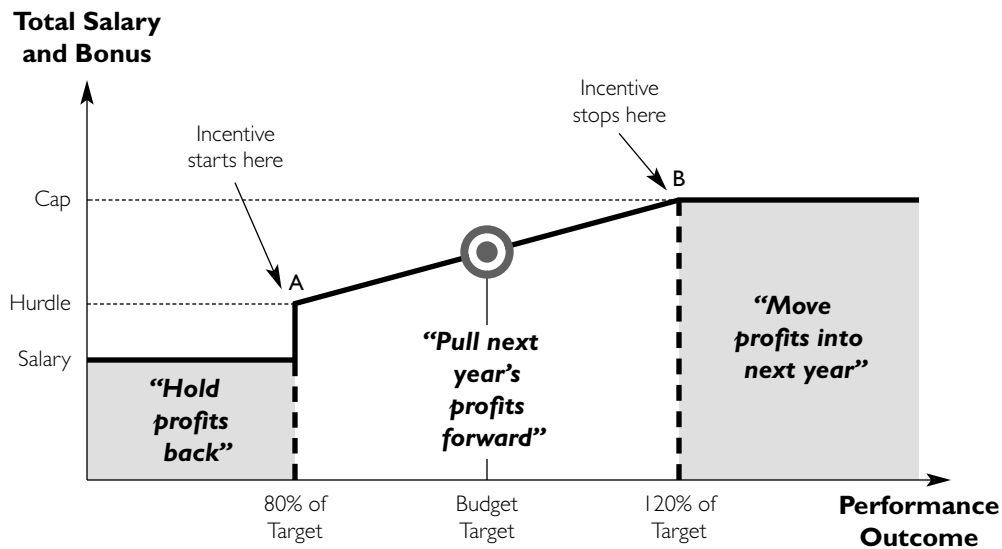
Rewards should be based on the whole team and geared to competitive success, not on a few people meeting some negotiated number. The scope of the “team” should equate with the level of direct dependencies. Anything less than this, to some degree or other, is likely to be divisive. Sharing in the profits of the business unit or firm as a whole is not intended to manipulate behavior, but to demonstrate that everyone is in the same rowing boat, all pulling in the same direction, all dependent on each other.

From this perspective the organization is seen as a complex network of interdependent relationships that requires the right leadership to release the untapped potential of human capital. It is recognized that leaders cannot predict, coordinate, and control local actions from the center. It is the power of intrinsic motivation that needs to be harnessed.

This approach is similar to McGregor’s “Theory Y” view that people are motivated by self-esteem and personal development, and companies produce better results by encouraging their people to be creative, to improve their skills, and to derive satisfaction from their work. While most leaders today would proclaim allegiance to the Theory Y school of management, they would be surprised to find that the Theory X philosophy is still alive and well and living comfortably within their management structures, and within their budgeting and reward systems. It is

Most incentive schemes lead to a distortion of management behavior that, in turn, has a negative impact on business performance.

FIGURE 1. Why Traditional Approaches Fail



Adapted from HBR article "Corporate Budgeting is Broken—Let's Fix It" by Prof. Michael Jensen, Emeritus, Harvard Business School. © BBRT 2003. All rights reserved.

rather like discovering that one section of your community still uses a language thought to be extinct.

Despite hundreds of research studies over fifty years that tell us that extrinsic motivation doesn't work, most leaders remain convinced that financial incentives are the key to better performance. It remains one of the greatest barriers to transforming organizations, from centrally controlled machines to devolved human networks.

Why Traditional Approaches Fail

Even if you believe that there is a direct correlation between incentives and results, it is not hard to conclude that most incentive schemes lead to a distortion of management behavior that, in turn, has a negative impact on business performance.

Most incentives schemes are based on achieving a fixed target agreed in advance. These schemes typically set fixed targets at "100 percent" but management bonuses typically begin at 80 percent of target and end at 120 percent of target (see Figure 1). This can produce perverse effects. For example, if a manager thinks he can't make the minimum target (at point A) then there is no incentive to maximize profits beyond that point. Nor does it matter if he misses it by a small or a large amount. He might as well ensure that next year is as good as possible (for example, by bringing spending plans forward) causing the cur-

rent year to miss the target by a wide margin. Likewise, if the year has been exceptionally good and the maximum bonus is reached with something to spare (at point B), then again it is in his interest not to increase profits beyond that point, but instead to move that extra profit potential into the following year.

Only between points A and B does the incentive scheme encourage managers to maximize profits. However, in this case, the pressure is to hit the maximum bonus by fair means or foul. Booking next year's revenues in the current year and deferring current expenses into next year are just a few of the games that are commonly played. However, while all these games might be rational to managers, they are not so for shareholders who would prefer to maximize performance in every year.

These behavioral distortions can affect customers. Anyone who has been visited by an overly aggressive pensions salesperson will know the problem. These people are on commission to sell specific products and set out to prove why they are the best. Pfeffer provides a good example from Sears where officials found widespread evidence of customer fraud. Employees, anxious to meet quotas and earn commissions on repair sales within its automobile repair shops in California, were selling unneeded services to unsuspecting customers. Sears was eventually forced to abandon the system.¹⁷

The answer, according to Harvard professor Michael Jensen, is to provide an open linear relationship between results and rewards. He believes that leaders should, "adopt a purely linear pay-for-performance system that rewards actual performance, independent of budget targets. A manager receives the same bonus for a given level of performance whether the budget goal happens to be set beneath that level [point A in Figure 1] or above it [point B]. Removing the kinks eliminates the incentives to game the process."¹⁸

While this is undoubtedly a step in the right direction (and overcomes many of the "gaming" problems), the approaches that we have seen work well have different characteristics. Moving from absolute to relative targets and from individual to team-based rewards are perhaps the key differences.

Beyond Budgeting Model

The "Beyond Budgeting" Model has twelve principles that have been derived from the experiences of over twenty-five organizations that have, in one way or another, replaced traditional budgeting with more flexible steering mechanisms. Their aims have been not only to reduce the costs of budgeting and implement more adaptive planning processes, but also to devolve the responsibility for strategy and the accountability for results to teams closer to the customer. How these organizations have dealt with rewards is a key determinant of a successful transformation. The more successful cases have based evaluation and rewards *on relative improvement contracts with hindsight rather than on fixed performance contracts agreed upon in advance*. This principle rejects the "cause-and-effect" assumption that most incentives are based upon.

Leaders in most Beyond Budgeting companies have renounced the idea that the organization is a machine with levers that can be pulled to change efficiency, speed, and performance. Nowhere is this rejection more obvious than at the Swedish bank, Svenska Handelsbanken. Since 1970, when the fortunes of the bank were transformed by visionary leader, Dr. Jan Wallander, motivation has had nothing to do with “incentives,” but everything to do with “involvement.” In other words, if any target or plan (reinforced by incentives) is imposed on a person or team, then little or no ownership of it—or commitment to it—will result. No one can be persuaded of someone else’s view of the future. They must engage in the planning process with others and thus share the commitment of the team. People are involved in setting their own improvement plans. This view is at the core of the Handelsbanken philosophy.

There are a number of sub-principles that provide a framework for formulating a rewards policy that supports the Beyond Budgeting Model. These are:

- *Do not base rewards on a fixed performance contract.* Breaking the direct connection between fixed targets and financial rewards is crucial if firms really expect business unit managers to strive for exceptional performance. Beyond budgeting leaders build trust and self-confidence rather than relying on performance contracts and the fear of failure.

Breaking the direct connection between fixed targets and financial rewards is crucial if firms really expect exceptional performance.

Their approach is to offer people a “relative improvement contract.” The implicit agreement is that, “You give us your complete commitment to achieve exceptional results and we will provide the leadership, challenge, and opportunity you require for self-improvement.” They set expectations based on medium-term goals, transfer

power to front-line people, and let the results do their talking. They eschew detailed maps in favor of compasses that provide direction but don’t dictate decisions. Their aim is to consistently beat the competition rather than some negotiated number. However, perhaps most important of all, they know that (especially in the information economy) it is the creativity of their people that determines success. Human capital begets financial capital—this order is important.

- *Evaluate and reward performance relative to peers, benchmarks, and prior periods.* One way to break the connection between fixed targets and incentives is to base performance evaluation on some agreed formula tied to a range of relative targets. Jack Welch was a great believer in this approach. In one of his annual letters to shareholders, he said: “GE business leaders do not walk around all year regretting the albatross of an impossible number they hung around their own necks. At the end of the year, the business is measured, not on whether it hit the stretch target, but on how well it did against the prior year, given the circumstances. Performance is measured against the world as it turned out to be: how well a business

anticipated change and dealt with it, rather than against some 'plan' or internal number negotiated a year earlier."¹⁹

- *Use a few simple, clear, and transparent measures.* If performance is to be evaluated on the basis of a number of measures, then they must be simple, clear, and transparent—and not subject to embellishment. Accountability and performance should be judged against a range of parameters appropriate to a business unit, profit center, or cost center. This is where many companies weave a web of such complexity that many managers often become bemused, bewitched, and bewildered by the arcane workings of the accounting system. Unfathomable allocations and complex transfer pricing calculations (often driven by tax reasons) are just two of the causes. The problem is that accountants are desperately trying to make financial sense of responsibility centers (spread costs and minimize tax), whereas it is behavioral sense that organizations now need. Each company must agree a set of rules governing the management of and accounting for responsibility centers.
- *Align rewards with strategic goals.* Companies with a strong link between strategy and rewards reported total shareholder returns almost 40% higher than those with a weak linkage, according to a Watson Wyatt study of group incentive plans.²⁰ Handelsbanken is a good example. Its strategy is clearly set out in the annual report: "Handelsbanken aims to make a better contribution to society than other banks. This should be done by offering a better service while using fewer of society's resources, i.e., by having lower costs. If we succeed in this we will also achieve higher profitability. This is why our goal is to have higher profitability than comparable banks."²¹ Thus its profit-sharing scheme is based on a formula related to how well the bank performs against its rivals. The same principle can be applied at lower organization levels. If this is not done properly teams can find that the incentive scheme is at variance with strategy. This happened at General Motors when the strategic emphasis was on quality but the incentive emphasis was on volume. As one ex-manager recounts, "So repeatedly we leave it to the dealer to rebuild our vehicles, or we do it in our own yard after they come off the assembly line. Our plant is only working two shifts, five days a week, but our repair operation works three shifts, seven days a week, trying to repair the cars that have been poorly put together on the line."²² Finding a few key value drivers and the key performance indicators (KPIs) that support medium-term strategic goals should provide the correct framework for setting team-based rewards. The balanced scorecard is a useful tool in this regard.
- *Reward the performance of teams.* The philosophy of Beyond Budgeting is that results are produced by teams. It is difficult, if not impossible, to compute the incremental contribution made by a designer, an engineer, an accountant, or a salesperson to the final result. Thus it should be the team that is the focus of rewards. What constitutes a "team" in this con-

text? The answer is any group that represents an interdependent value delivery network. Some people will say that moving incentives to the level of the “work unit” is a charter for “free riders”—those managers that keep out of the limelight yet produce little by way of results. The experience at Handelsbanken, however, suggests that this is not as big a problem as feared. In a system driven by peer pressure, free-riders are exposed very quickly, and replaced by people more willing to commit themselves to real performance challenges.

- *Align rewards with interdependent groups.* Sharing insights and best practices across the organization is a key objective for many leaders, but this is difficult to achieve if performance is evaluated and rewarded based on departmental budgets. Breaking the “defend your own turf” attitude is the real objective. One of the key features of Dr. Wallander’s philosophy at Handelsbanken was to involve everyone in the success of the organization. This supported the “one team” approach that focuses on satisfying the paying customer rather than the needs of the hierarchy.
- *Do not use rewards to “motivate people.”* Using the language of “gainsharing” or “group rewards” (as opposed to “incentives”) was an important change in the approach adopted by Handelsbanken. Indeed, Wallander is quick to point out that there is an important difference between providing attractive incentives that are designed to motivate people and providing some extra financial reward for team or group performance. As Wallander is quick to explain: “The profit-sharing scheme is there not as an incentive to work harder but as recognition of the efforts of the workforce.” How-

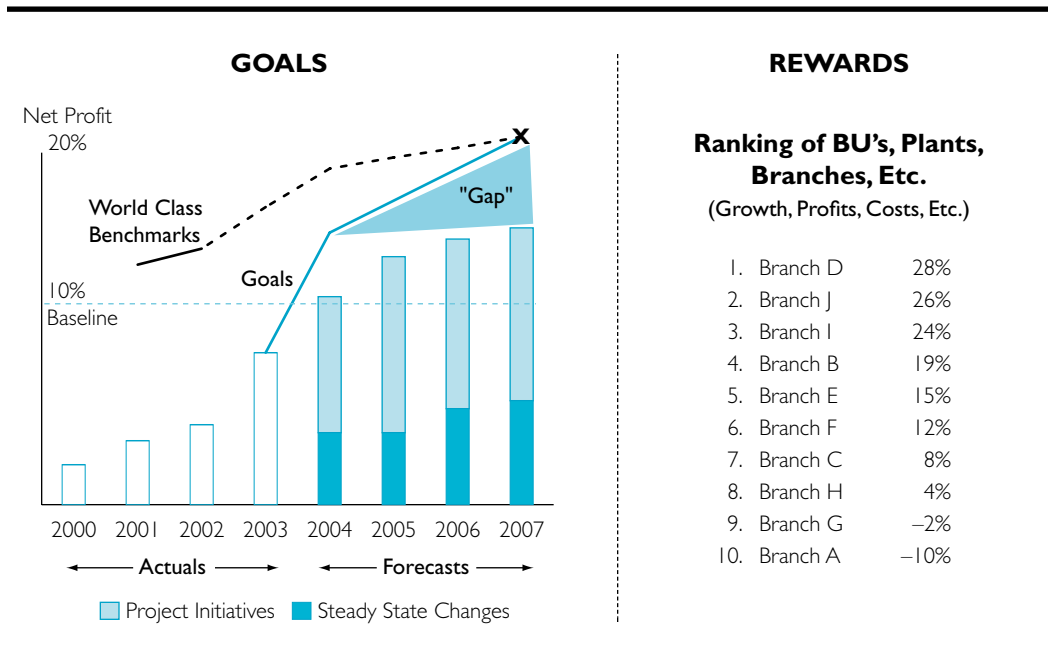
Motivation is not about achieving the “right financial incentives.” It is about achieving the right level of involvement and commitment.

ever, dismantling individual incentives for sales people can be difficult, especially when they represent a high proportion of earnings (using relative measures in the form of “league tables” is one way to overcome the problem). Motivation is not about achieving the “right financial incentives.” It is about achieving the right level of involvement and

commitment. This requires the use of “good management practice” and includes building ownership of goals and plans through the involvement of people at every level in those processes.

- *Make rewards fair and inclusive.* One hallmark of fairness is inclusiveness. Having different schemes for different levels with significant differences in the size and opportunity of payout can spell disaster for any rewards plan. All permanent employees should share in one way or another. Most profit-sharing schemes, for example, are “proportionate” to position/salary (although Handelsbanken has adopted an extreme position of providing all qualifying employees with exactly the same “dollar” bonus). Consistency is another factor. Handelsbanken’s bonus scheme has remained unchanged for thirty years.

FIGURE 2. How Goals are Disconnected from Rewards



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Beyond Budgeting Best Practices

The evidence from our cases suggests that there are different ways to align rewards with performance, all of which avoid forming fixed performance contracts. One focuses on the relative success of teams based on a range of KPIs, another is based on an individual receiving a bonus package with elements related to the performance of different units (e.g., business unit and corporate), and yet another involves disregarding all lower-level reward systems and opting for a group-wide profit-sharing scheme. Each organization has handled rewards in a different way. However, the common principle is that they do not link rewards to fixed targets agreed to in advance.

Figure 2 shows how a few best practice organizations have divorced targets from rewards. First, a business unit team would consider whether its goals (these will include a range of KPI's) need re-setting (if, after considering the latest rolling forecasts, it is on a trajectory that does not need changing, then the team may take no action). Assuming that action is necessary, the team will evaluate the gap between its current trajectory (after factoring in "steady state" changes and the impact of project initiatives currently in progress) and its medium-term goals (estimates of where best practice will be in, say, three years from now) and re-set its goals on the basis of the maximum performance potential over that period. Plans are then put together on the basis of these assumptions. The aim is to be at or near the top of the peer group rankings list *and stay*

there. The team will also be conscious of baseline expectations. These represent the minimum acceptable levels of performance.

While plans and assumptions might be challenged by more senior managers, goals are not “negotiated” nor are they fixed or attached to incentives. The outcome is that the team has the confidence to stretch its performance knowing that the chosen goals will not be used as the basis of either performance evaluation or rewards.

Although managers know in advance which KPIs they will be assessed on and what constitutes “acceptable performance” (or the “benchmark expectation”), they generally don’t know until the end of the year how well they have performed and thus how much of a bonus they will receive. Because performance is evaluated against a range of factors relative to competitors, the market, and maybe the previous period, managers also know that they can achieve good bonuses in a low-profit year (though “affordability” may be a factor) and poor bonuses in a high-profit year, depending on their relative performance. The relevant question that the peer review panel must ask is: “Did they do as well as they could have done given what we now know about the profit-making opportunities during the period and what the competition has achieved?”

It is the uncertainty that drives success. It is like a car race in which each driver has to beat the competition while at the same time dealing with many unknown factors that will determine the outcome, such as the performance and behavior of other drivers, the reliability of the car, and the weather conditions. Each driver roughly knows what has to be done prior to the race to improve his or her usual performance and (preferably) to win. However, only with hindsight will the drivers know how well they have performed. This “relative performance” approach focuses business unit managers on maximizing profits at all times rather than playing games with the numbers, because there are no fixed targets that lead to irrational behavior.

The following two case examples show how the principles can be translated into operating practice.

Basing Rewards on the Relative Success of Operating Teams at Groupe Bull

The formula in Figure 3 was used by Jean-Marie Descarpentries at Groupe Bull in the mid-1990s. He turned around this French government owned computer company from making heavy losses in 1993 to making profits in 1997 and paved the way for a successful privatization. His success was based on a belief in separating target setting from performance evaluation and rewards. Each business unit team had to propose its own stretch target. This was a projection of the “best possible outcome” on the basis of everything going right, including maximum demand and new products being launched on time. However, and this was the key to his approach, Descarpentries would then promptly forget about the targets. “The purpose,” he noted, “is to get managers

FIGURE 3. Performance Appraisal Formula for a Business Unit Using a Relative Improvement Contract at Groupe Bull

Key Performance Indicator	Weighting	Total Score	Weighted Score
Growth versus Previous Year	20	50	10
Growth versus Competition	20	40	8
Profit versus Previous Year	20	60	12
Profit versus Competition	20	50	10
Debt versus Previous Year	10	80	8
Quality Factors versus Previous Year	10	60	6
Executive Committee Evaluation			54%

to dream the impossible dream.” He didn’t measure managerial performance against the target (thus creating a fixed performance contract), because in that case managers would not enter into the spirit of the stretching process. Instead, he evaluated and rewarded his managers on a range of indicators including how they performed this year versus last year and how they performed against the competition. The purpose of the target was to drive imaginative strategies that lifted performance above and beyond incremental change. In other words, managers had to use their judgment and take risks.

Each KPI in the bonus formula was given a “weighting” according to the degree of difficulty (rather like a diving competition). At the end of the year, an executive committee would evaluate performance and mark each KPI out of one hundred. The weighted score for each KPI was then produced and the aggregate of the weighted KPI scores was the final result.

How the final scores were applied to individual bonuses is interesting. Here is how it worked: Maximum performance bonuses were set at 30 to 50 percent of salary at the executive level, 20 to 30 percent at the operating level, and less (although not zero) in other areas. However, what was interesting was how the actual payout was calculated. For example, if a business unit employee had a base salary of \$50,000 and the maximum bonus was set at 30 percent (or \$15,000) and the formula set the payout at 60 percent, then the final payout would be \$9,000. Both the corporate president and his executive committee independently review performance. First they examine growth versus last year and against the competition, bearing in mind all the competitive factors that pertained during the period. Second, they examine profitability. Third, they look at debt. Finally, they look at certain qualitative factors such as employee turnover. The choice of balance sheet and strategic measures might be different for each business unit. This assessment sets the bonus levels of all managers and employees within that particular business unit. If a business unit team underperforms, it is given a second chance. However, if it underperforms again the following year, the team members are likely to be moved elsewhere or even receive dismissal notices.

Camille de Montalivet, ex-finance director of Groupe Bull, explains the system's goals as follows:

"The whole point about the evaluation process is that it is seen to be fair and is detached from both target setting and forecasting. Also, the components and weightings of the formula are cleverly thought out. With a strong bias towards growth, managers cannot simply 'make their target' by cutting discretionary expenditures such as training, marketing, and satisfaction programs. And with the inclusion of qualitative factors (that can be any measures closely related to the needs of the business unit), there is a built-in assurance that managers will spend considerable effort on continuously improving the business. At senior levels of the organization, managers might have only part of their bonus linked to a business unit's performance and part linked to the group result. I cannot emphasize enough how important these reward systems were in the performance transformation at Groupe Bull."

Basing Rewards on the Relative Success of the Group at Handelsbanken

Handelsbanken uses only one group-wide profit-sharing scheme for all employees. Thus, there are no set incentives for any team or salesperson to achieve a specific target. Nor are branches rewarded for their placement in the performance-league table (although they are *recognized* in different ways, thus increasing the importance of league tables). The bank uses the language of gain sharing (sharing in the fruits of collective success) as opposed to individual incentives (you must achieve *x* result to earn *y* bonus) to provide people with a stake in the success of the organization. This is how it works.

Every year since 1973, the bank has allocated part of its profit to a profit-sharing system for employees. The funds are managed by the Oktogonen Foundation. The main condition for an allocation to be made is that the Handelsbanken Group must have a higher return on shareholders' equity after stan-

Beating the competition is a far more powerful weapon than financial incentives. Why do people need cash incentives to fulfill their work obligations to colleagues and customers?

dard tax than the average for other banks. Of the profit after tax, half is paid to shareholders by way of dividend and half is paid into the employee profit sharing pool. All employees receive the same allocated amount. Disbursements can be made when the employee reaches the age of sixty. Anyone

who entered the scheme at its inception would have accumulated a fund value of around 3 million Swedish krona (\$430,000) by 2000. Today, the Oktogonen Foundation is the bank's largest shareholder, with 10.2 percent of the voting power.

The profit-sharing system can only be understood in the context of its purpose. It is not intended to be an incentive for individuals to pursue financial targets; rather, it is intended as a reward for their collective efforts and competi-

tive success. It might be called a “dividend” on their intellectual capital. Many people find it hard to understand the lack of financial incentives. Wallander’s answer is that “beating the competition or one’s peers is a far more powerful weapon than financial incentives. Why do people need cash incentives to fulfill their work obligations to colleagues and customers? It is recognition of effort that is important. Managers will only strive to achieve ambitious goals if they know that their ‘best efforts’ will be recognized and not punished if they fail to get all the way.”

Handelsbanken executives believe that its group-wide profit-sharing scheme is an important element in removing the cellular or “defend your own turf” mentality that pervades many organizations. It avoids the problem of rewards becoming entitlements that, if not received, lead to a disaffected and (in some cases) demoralized workforce.

The important issue is not so much the financial payout but the *recognition* of the contribution that employees make to the organization’s success. This case debunks the idea that direct financial incentives are necessary to reinforce performance improvement. Wallander believes that as far as motivation is concerned:

“We find that our people are driven by their urge to show a better result than their competitors—to be above average. The Oktogonen profit-sharing scheme in which every employee has an interest is also important. Essentially, motivation is based on the self-satisfaction of doing a good job for the company and the praise they will get. We have no specific proof of this, but it’s what we believe and we think the evidence shows up in the results.”

Since abandoning the budgeting model in the 1970s Handelsbanken has produced outstanding returns for shareholders, consistently beating all its rivals in Europe on the key ratios of cost-to-income and costs-to-total-assets.

The Roles of Balanced Scorecards and Shareholder Value Models

Balanced scorecards are increasingly used to evaluate performance and rewards. Most firms allocate a percentage of the bonus pool to a range of KPIs, some of which are weighted to reflect the degree of stretch in the target or other degree of difficulty. However, the problem of the fixed performance contract invariably remains. Even the case examples described in Kaplan and Norton’s book, *The Strategy Focused Organization*, use annual targets as a basis for evaluating rewards.

Shareholder value models are also increasingly used by firms to set rewards. Like the balanced scorecard, most are based on annual targets. However, using one-year changes in value presents many problems. One concerns the position when a major investment produces negative short-term returns before larger returns in the medium-term. Another is the use of proxies (such as

economic value-added) that invariably rely on inaccurate estimates of annual changes in economic value.

Share options are another component of the rewards package frequently used. These are predominantly based on a cost price that is fixed for the entire option period. Thus, any increase is rewarded. Alfred Rappaport, one of the founding fathers of value-based management, believes this is wrong: “Fixed priced options reward executives for any increase in the share price—even if the increase is well below that realized by competitors or by the market as a whole.” He believes in the power of shareholder value measures to evaluate and reward executive performance *provided that such measures are based on returns equal to or better than those earned by the company’s peer group or by broader market indexes.*²² This approach supports the general relativity principle of the Beyond Budgeting Model.

Conclusions

The best practice cases show how some companies have applied the principles of the Beyond Budgeting Model. There are, however, other approaches that can be adopted depending on the company, strategy, organization level, and prevailing culture. Perhaps the ultimate best practices model, particularly in Anglo-Saxon countries with a strong tradition of incentives, should have a percentage of rewards based on the relative success of the company (the Wallander approach), a percentage based on the relative success of the local team (the Descarpentries approach), and an element based on personal merit (unrelated to specific targets). Applying these principles requires the combined efforts of a multi-functional team. Underestimating this challenge can be disastrous. Nothing can undermine the best intentions of an alternative performance management process such as beyond budgeting like an unaligned or ill-thought-out package of management rewards. Rewards should be disconnected from fixed targets and based on a fair, open, and agreed formula underpinned by relative performance measures. Many reward systems carry a great deal of “excess baggage” from a company’s history. They are notoriously difficult to change, but change they must if the new model is to be implemented successfully. The best approach is for a senior team to thrash out a set of common principles to which everyone can agree.

Notes

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