Beyond Budgeting
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WHY REWARDS SHOULD BE BASED ON TEAMS RATHER THAN INDIVIDUALS

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About Beyond Budgeting Institute and BBRT

The Beyond Budgeting Institute is at the heart of a movement that is searching for ways to build lean, adaptive and ethical enterprises that can sustain superior competitive performance. We promote a set of principles that lead to more dynamic processes and front-line accountability. Organizations that follow this approach transform their management model in line with these principles.

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Why rewards should be based on teams rather than individuals

Abstract: Self-managed teams are not worthy of the name unless that all share the pain and gain of collective performance. Conversely, if recognition and rewards remain focused on individual performance then teams will never bond together. This paper examines the arguments for moving to a team-based rewards system and how some organizations have made this a key part of their decentralized management models.

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 FW Taylor in 1911. It was based on piece work. 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 that vast majority of the workforce in most organizations today. 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.

Harvard professor of business administration, 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?"[1]

Pfeffer made a similar point when he said that, "individual incentive pay in reality undermines performance of both the individual and the organization. Many studies strongly suggest that this form of reward undermines teamwork, encourages a short-term focus, and leads people to believe that pay is not related to performance at all but to having the "right" relationships and an ingratiating personality."[2]

The evidence on the impact of attracting "star performers" is sobering. When looking at what happens after "star" investment analysts moved from one company to another, Groysberg found that bad things started to happen: "The star's performance plunges, there is a sharp decline in the functioning of the group or team the person works with, and the company's market value falls." In particular, "46% of the research analysts did poorly in the year after they left one company for another…their performance plummeted by an average of about 20% and had not climbed back to the old levels even five years later."[3] Contrast this with the experience at NUMMI (New United Motor Manufacturing) plant in Freemont, California, a joint venture between GM and Toyota (but managed by Toyota). The new management took a bunch of dysfunctional "F" players, retrained them, put them into a great system, and before long the plant was outperforming every other in the U.S. The lesson is that great systems are likely to be more important than great people.

In modern organizations, results are invariably due to the combined efforts of many people and teams. Even taking the example of a sales person 'winning' a major order, can anyone really say that they achieved that on their own? In most companies this is doubtful. There are usually back up support teams involved in managing brands, designing solutions, preparing quotations, providing demonstrations, doing cooperative marketing and so forth.

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."[4]

Thus it should be the team that is the focus of rewards. What constitutes a "team" is this context? The answer is any group that represents an interdependent value delivery network. Anything less than this, to some degree or other, is likely to be divisive. Rewarding the success 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.

Team-based rewards at Nucor Steel

U.S. company Nucor Steel has achieved stunning success over the past five years returning 387 percent to shareholders beating almost every other company in the S&P 500-stock index, including new economy icons such as Amazon.com, Starbucks, and eBay. And the company has become more profitable as it has grown: Sales have almost tripled over the past six years from $4.6bn in 2000 to $12.7bn in 2005 with net profit margins increasing from 7 to 10 percent over the same period. At the root of this performance is a radical compensation system based upon team performance at different levels of the organization. The 11,300 non-union employees don't see themselves as worker bees waiting for instructions from above. Nucor's flattened hierarchy and emphasis on pushing power to the front line lead its employees to adopt the mindset of owner-operators. Legendary leader Ken Iverson's radical insight was that employees, even hourly workers, will make an extraordinary effort if you reward them richly, treat them with respect, and give them real power.

When other traditional manufacturing companies such as General Motors and Ford are struggling to survive, what is it that drives Nucor to greater success? The answer is its devolved management model and a compensation system that rewards everyone for success. While an experienced steelworker at another company can easily earn $16 to $21 an hour, at Nucor the guarantee is closer to $10. But a bonus tied to the production of defect-free steel by an employee's entire shift can triple the average steelworker's take-home pay.

In 2005, Nucor handed out more than $220 million in profit sharing and bonuses to the workforce. The average Nucor steelworker took home nearly $79,000 last year. Add to that a $2,000 one-time bonus to mark the company's record earnings and almost $18,000, on average, in profit sharing. Not only is good work rewarded, but bad work is also penalized. Bonuses are calculated on every order and paid out every week. If workers make a bad batch of steel and catch it before it has moved on, they lose the bonus they otherwise would have made on that shipment. But if it gets to the customer, they lose three times that.

Managers' pay is also at risk. Department managers typically get a base pay that's 75% to 90% of the market average. But in a great year that same manager might get a bonus of 75% or even 90%, based on the return on assets of the whole plant. Executive pay is geared toward team building. The bonus of a plant manager depends on the entire corporation's return on equity. So there's no glory in winning at your own plant if the others are failing. There's a healthy competition among plants and even among shifts, balanced with a long history of cooperation and idea-sharing. The pay of CEO Daniel Di Micco is also based on performance. In 2005, he collected a salary and bonus precisely 23 times that of his average steelworker (the average ratio in America is around 350 to 1). He gets few stock options, and most of his restricted stock and other longer-term bonuses don't materialize if the company doesn't beat the competition and outpace a sample group of other high-performing companies.[5]

Create positive peer pressure to perform

Some firms are relying more on 'peer pressure' than on direct incentives. No self-respecting manager would want to go to a meeting of his or her peers knowing that they have under performed and let down the whole team and possibly drained the bonus pool. Internal and external league tables enable a framework for performance evaluation that provides a powerful force for continuous improvement as one business unit strives to improve its position against its rivals.

Peer pressure can be either 'positive' or 'negative'. Negative peer pressure leads to a 'fortress' mentality. Local vested interests are paramount as managers seek to gain the maximum advantage (e.g., the most resources) from the corporate center. Other similar business units are seen as the 'enemy'. Positive peer pressure is about improving faster than rivals but within a climate of cooperation and sharing. Achieving a balance between competition and cooperation needs to be carefully managed. The defining difference is the rewards system. If rewards are at the whole business level then individual units have little need to act with a fortress mentality.

Handelsbanken uses peer pressure to drive continuous improvement. The most intense competition is at the regional bank level where a "cup" is awarded each year for the winner. There is also a system of "handicapping." Each year the cost of capital employed is charged to regions according to the BIS rules (i.e. the Bank of International Settlements operates standard lending to capital ratios according to the risk profile of the investment portfolio). The cost of the excess capital in the bank, over and above the BIS amounts, is charged each year to regions in proportion to their profitability over the previous three years. This means that the most successful region receives the highest capital charge thus making it harder to make a return. Similarly, the poorest performer receives the lowest capital charge thus making it easier for them to catch up.

Don't be too concerned about the 'free rider' problem

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 Toyota, Handelsbanken and Southwest, however, suggests that this is not as big a problem as feared. In a team-based system driven by continuous improvement, free-riders are exposed very quickly and replaced by people more willing to commit themselves to real performance challenges. Rewards should be focused on the whole team and based on a range of performance measures, not on a few people meeting some negotiated number. And they should be based on an agreed definition of success. This is supported by empirical evidence that shows that the problem of free riding is quite modest. As one comprehensive review reported, "Under conditions described by the theory as leading to free riding, people often cooperated instead."[6]

Teams sort out problems with their own members at WL Gore & Associates a $1.8 billion company with nearly 7,000 employees and 45 locations around the world. Known for its "wearable weather protection" GORE-TEX® fabrics, Gore attributes its astounding product diversity and rate of innovation to not only its polymers and patents but to a unique corporate culture that eschews hierarchy and encourages teamwork and hands-on innovation. For example, there are no chains of command or predetermined channels of communication. Associates (not "employees") are hired for general work areas, are assigned no titles, and work under the guidance of sponsors (not "bosses") on projects that match their skills and career objectives. The result is an egalitarian work atmosphere that minimizes bureaucratic delays and fosters rapid decision-making and product development.[7]

The performance appraisal system is based on team reviews. "You've got to be a team player at Gore," says lab engineer Dave Thompson. "Your team rates your contribution on a scale of one to six, and that's one of the things salaries are based on. Everyone chooses a sponsor who helps them develop, and they also have a leader who would traditionally be titled manager. Plant production leader John Housego explains: "I was voted into this job. That was a really special moment."

In 2006 W.L. Gore was voted the "best place to work in Britain" in a Sunday Times poll. The survey showed in nine in every ten employees think their manager trusts their judgment, just a fraction fewer feel he or she talks openly with them, a similar proportion feel their manager cares about them, and 84 percent say the principles of the firm would not alter if the leader changed – all are the highest scores for these questions among the 100 best companies. Further accelerating Gore to its No 1 position are the exceptionally high "my company" scores: 92 percent believe they make a valuable contribution to the firm's success, and 93 percent would miss it if they left.[8]

Use the language of teams and rewards rather than individuals and incentives

It may sound like a semantic point but the language used in the organization to talk about rewards sets the tone for how people understand and internalize them. Most incentives schemes are based on a "carrot and stick" approach. Take the case of UK truck maker, Leyland Trucks. Its history was steeped in the language of pay differentials, 'payment-by-results' schemes (such as piecework) and pay disputes. CEO, John Oliver, explains the background. "If people are paid by results, that's exactly what will dominate their daily thinking. They will focus exclusively on getting as many widgets out of the door as possible to maximize their earnings. Once the requisite number has been achieved you can forget about everything else. Quality, customer satisfaction, on-time delivery and so on do not figure in their personal vocabularies. Job-and-finish mentalities can often free up huge tranches of spare time but, in their minds, that's theirs. They've earned it, so you can't have it. Managers may tear their hair out with frustration, seeing this huge window of opportunity for addressing all the other ills of working life. But we shouldn't blame the workers. Management created the system, management created the values, and management have to accept total responsibility for the situation."[9]

Leyland Trucks was implementing lean manufacturing. But the old system was based on the 'push' system of driving production to maximize volume and at odds with its lean manufacturing principles that is based on the 'pull' system of building to customer order. Leaders realized that here was a collision waiting to happen. So they scrapped decades of piecework-type incentives (despite resistance from the trades unions) and introduced team-based rewards. The change in the language was crucial. Instead of talking about meeting volume targets suddenly the conversation was about output quality, productivity, safety and customer delight.

The new language also touched another hot-spot. Leaders knew that the primary concern of employees was not so much about pay and conditions but more about job security. So they told the workforce that the proposed changes were about meeting customer needs and that this was the best strategy to maintain their jobs. And the way to achieve this was to regulate production through the plant, focusing on high quality and reducing waste. Making thousands of trucks that they struggled to sell was no longer the way forward. A number of years later, Leyland Trucks won the 'factory of the year' award and its employees have had a more secure future than in recent memory.

But the benefits didn't stop there. There is now a remarkable degree of cooperation between management and the shop floor. This even extends to smoothing production. For example, the company has introduced a scheme known as "Additional Vacation Days." This means that if there is a requirement to increase production, then teams (i.e. all employees) accept the need to work longer hours at no extra cost and then receive those hours back in quieter times (usually tacked on to a Bank Holiday or weekend). They receive around 2-3 weeks notice. Workers don't like this arrangement, but they understand that it is all part of improving profitability and thus their own security of employment (the number one objective of all managers and employees at the company). However, this agreement needs constant communication to remind employees of the benefits. This change alone contributed to a reduction in costs of 7.6 percent. Other seasonal fluctuations are managed through temporary workers.

Using the language of 'group rewards' as opposed to individual incentives was also an important change in the approach adopted by Handelsbanken. Indeed, Dr 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 he 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. Essentially, motivation is based on the self-satisfaction on 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."

Conclusion

Underestimating the challenge of dealing with rewards can be disastrous for the devolved organization. Nothing can undermine the best intentions of an alternative performance management process 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. A combination of groupwide and team-based rewards based on relative performance seems to be the way forward.

Endnotes

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