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Stroud Quarterly

In this issue of the newsletter, we revisit a lesson that all leaders come to appreciate at some stage of their careers (some sooner than others!): rigorous attention to detail can provide breakthrough results. We hope this material helps your team by providing examples of this concept in various contexts. Please contact us directly with your feedback and ideas, and you can always visit our website at www.stroudconsulting.com to learn more about our practice.

Nathaniel Greene, Managing Partner

Stroud Consulting

In the July issue:

- **Full Article:** The importance of the right incentives
- **Article Synopsis:** Solving problems from first principles, Step 2: Understanding the problem detail
- **Case Study Synopsis:** Reducing Energy Costs and Carbon Emissions - A pulp mill achieves a 150,000 ton reduction in fossil-fuel emissions, and saves $14 million per year

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The Importance of the Right Incentives

by Gaura Gupta - ***follow this link for a PDF of the full article***

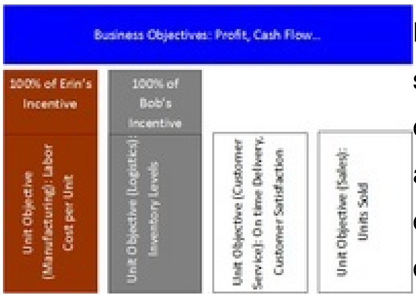
Summary: Businesses use monetary and non-monetary incentives extensively to infuence management's behavior. Measuring the performance that governs the award of these incentives is critical to driving management behavior. Misalignment between divisional and business objectives leads many businesses to establish conflicting measures for their managers. Furthermore, even having the right measures does not ensure that all incentives are aligned with these measures. In this article we will identify reasons for the conflicting incentives and outline a few practical considerations when setting up incentive structures.

Joe Moore sat at his desk reflecting on his latest problem. Joe is the COO of Widget World, a manufacturing company with revenues of $300 Million. In the past few weeks, he has received multiple calls from his VP of sales regarding customers who have not received their shipments on time. At the same time, the inventories had been rising for the last few months – with high debts to pay down, Joe cannot afford to have capital tied up in inventory. When Joe took over as COO at the beginning of the year, he had decided to align the incentive structure more closely with his team's performance measures with the hope of driving the team to attain the performance targets that he had set. Over the last few months, however, he had not seen any improvement in performance, and the conflict within the team had increased to the point where it prevented the the team members from working effectively.

This morning in an attempt to get some alignment amongst his reports, Joe called a meeting with his manufacturing manager, Erin, and his logistics manager, Bob. Through the meeting, it had become obvious that Erin and Bob were not working together on setting the length of each product run. It seemed like a constant battle between Erin wanting longer runs to improve costs by minimizing equipment changeovers and Bob fighting hard to keep them short to minimize the inventories. Joe realized he needed to get Erin and Bob to cooperate, but what could he do?

The purpose of incentive structures is to encourage management to exhibit behaviors and take actions that will help meet the corporate objectives. In the above example Bob, who is in charge of the supply chain inventory, has incentives based on the inventory levels. By minimizing the inventory in the system, Bob can free up valuable cash and contribute to the bottom line. Joe has correctly assessed the measure for Bob's performance to be the inventory level and a 100% of his incentives are paid out against this measure. Now consider Erin, whose incentive program is based on achieving her manufacturing cost targets. Keeping manufacturing costs low requires taking advantage of large runs of the same product. This, of course, builds high inventory levels.

Conflicting objectives between Erin and Bob's business functions are the biggest obstacles in getting them to cooperate. The incentive structure that Joe has implemented is actually working to misalign his functional heads.



How did Joe get it so wrong? And what can he do to change the situation and improve the performance of his business? At the heart of the problem is the misalignment in/of the incentives for managers across different business functions. In a highly cross-functional organization, optimizing local metrics without considering the impact on other functions can lead to conflict and un-optimized business performance.

In one of our recent consulting engagements, we worked with a business that consisted of multiple manufacturing facilities, each of which operated as its own profit center. This setup had its advantages as each facility controlled its P&L and could be held responsible for its margin. In the past, the highly regional marketplace allowed the business to be competitive with other regional shops as a large percentage of sales at each facility came from regionally held relationships. However, with the recent move towards national purchasing, the importance of local relationships has greatly diminished. In this new marketplace, the old business structure leads to competition amongst the individual facilities and prohibits the organization from capitalizing on the competitive advantage within individual facilities. In one particular situation a facility was manufacturing a complex print job by utilizing multiple passes through their single color press when a sister facility with advanced multi-color equipment was located within the same metropolitan area. The multiple passes was costing the business in additional labor but since the facilities operated as separate profit centers there were no incentives to transfer the business to the lower cost producer.

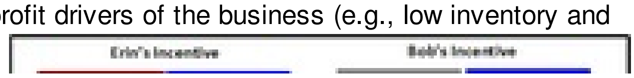
To combat this change in the marketplace, the business underwent a structural realignment along functional lines. Positioning individual facilities as cost centers removed the silos around each facility. These geographic silos, however, were replaced with functional silos around sales and manufacturing. Many of these barriers stem from the nature of the performance incentives. Incentives for the manufacturing managers are based on the labor cost in the facility. The incentives for the sales managers are based on the revenue generated without regard for the operating margins. The many detrimental effects of this system range from eroded margins on existing accounts (when their orders are not produced at the most cost effective facility) to “sister” facilities bidding each other down on price during tenders for new business – thus reducing the total revenue to the “parent” company.

While the above example is obvious and well-understood, there are numerous more subtle examples of this misalignment in different types of organizations. Physicians and hospital administration are often at odds with each other due to their very different incentives. In an engagement with a hospital, we were asked to help improve patient satisfaction by reducing the wait time for patients. Popular sentiment identified the availability of examination rooms as the critical lever to reducing wait times. On further investigation, the facts revealed that the physicians were directing the patients to be escorted into examination rooms well before they would be available to examine the patient, and hence reducing the utilization of the rooms. From the physician’s perspective, this helped eliminate any lost time because their patient was always ready; however, this behavior led to patients waiting longer and being less satisfied with the hospital. longer wait times for patients and reduced level of satisfaction with the hospital.

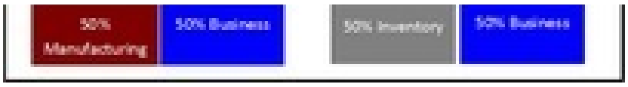
This problem of contradictory incentive measures makes it very difficult to design a pay-for-performance system that works for the whole organization and optimizes overall business metrics. Add to these problems the difficulty in agreeing upon the correct individual metrics for business units, and it is not hard to imagine why so many organizations get it wrong. Two methods of structuring incentive programs can help alleviate this problem: (1) balance the incentive program with a blend of individual and group performance, and (2) utilize multiple metrics to ensure the right “enterprise” thinking.

The problem with the incentive structure discussed at the beginning of this article is that the individual metrics are the only input to the payout. At the other end of the spectrum of incentive structures is payout using company performance as the only input. This method has been documented to be ineffective largely due to the “free rider” problem. As in democratic elections where voters do not see the value of their “one” vote, people do not believe that their extra effort will make a real difference and hence are not motivated to perform any differently. So how can an organization design a pay-for-performance system that works and does not create functional silos?

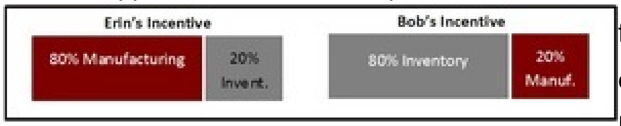
Any incentive program must start with identifying the key behaviors that the business chooses to reward. These behaviors must link directly to the profit drivers of the business (e.g., low inventory and short setup times in the above example). The



metrics for the program must be designed to accurately reflect this behavior and be easily and transparently measurable. After agreeing upon the metrics for individual business units, an incentive program with a tiered structure where the payouts are based on these individual's metric and the overall business performance would help foster collaboration while still encouraging improved overall performance. In the past, many companies have set up bonus schemes with a percentage reserved for overall business objectives. In the above example, Joe could engineer an incentive program where 50% of Erin and Bob's payout would be dependent on the overall business performance.



Another approach is to use multiple metrics that cover all the direct and indirect responsibilities of each function. For the examples in this article, Joe could establish an incentive program where both Erin and Bob would have incentives dependent on the manufacturing performance as well as the inventory levels.



Conclusion: As we have seen in the examples presented in this article, designing incentive systems that motivate the right behavior is difficult and imprecise. Businesses use monetary and non-monetary incentives extensively to influence the behaviors of management staff. Without aligning these incentives within the organization, resulting behaviors can be unproductive and uncooperative. Organizations can greatly increase the productivity and reduce conflict among their management teams by clearly understanding the behaviors that their existing incentive programs drive, and by ensuring an adequate balance between individual and business incentives.

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About the Author
Gaurav has experience working with clients in a variety of industries from food and beverage to healthcare to oil and energy. In addition to his work with clients, Gaurav is also a part of the North American office leadership team where he has responsibilities in business development, recruiting, and intellectual property development.
Gaurav received a bachelor's degree from Middlebury College and a master's degree from Cornell University.

Solving problems from first principles

Step 2: Understanding the proble detail

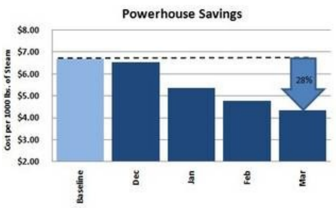
By Taylor Milner

In part two of our ongoing series, we'll examine the importance of understanding the problem detail, offer best practices and tips for completing this step, and showcase real-life case studies where we've applied this important step successfully.

[Read the rest of the article](#)

Reducing Energy Costs and Carbon Emissions: A pulp mill achieves a 150,000 ton reduction in carbon dioxide emissions, saves $14 million per year

Case Study Spotlight



The company believed that their current boilers were at maximum capacity and therefore could not burn more bark, a waste by-product that also dramatically reduces carbon emissions. A multi-million dollar capital request was in the works to help increase the capability, but this project would take several years before it would start to generate savings. The pressure was on now.

[Read the rest of the case study](#)

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