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Strategic Incentive Scheme: Models, Methods and Case Studies

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Abstract: Thrilled to build a strategy-centered, achievement-oriented development and improvement in an organization, the medium- and long-term strategy assessment & management system is established to standardize the management processes, methods and tactics for strategy clarification, implementation, assessment, reward and feedback.
Keywords: Incentive Scheme; Performance Evaluation; Economic Value Added

1. Introduction

The strategy management system includes strategy composition, strategy implementation, strategy evaluation and strategy incentive, among which strategy incentive, which does not exist alone, nor is managed separately, is an important driving force and reflection of the strategy evaluation system and an indispensable part of the strategy management system.

2. Overview of Strategic Incentive System

2.1 3 key notes on the incentive system are as follows

The strategic incentive system is necessary for corporate development and essential to business goal achievement. A set of new and effective incentive programs have been exploring serving as an important indicator to evaluate the achievement of corporate performance.

Economic value added/EVA" plays as the most important evaluation and assessment method, which reflects that the creation of shareholder value is the basic premise of the incentive system. Without the creation of shareholder value, there is no corresponding incentive.

Normally, some organizations have a strategic incentive system that combines evaluations in short-term and long-term, cash and non-cash, and corporate performance and employee achievements, converting a portion of the existing incentive cash into shares in the business that vest and are valued through medium- to long-term (three-year) performance evaluations[1]. Compared with the simple way of paying cash bonuses in the current period, this "combination" can better prevent managerial myopia from mid-level and senior management favoring short-term profits over long-term growth. By building an incentive system that reflects the joint efforts of employee performance and corporate achievements, as well as shareholder-created values, the goal of developing a harmonious relationship and a win-win situation for enterprises, employees, and shareholders, can be achieved.

2.2 Annual performance and the reward assessment

Under the new strategic incentive system, the bonus table corresponding to the specific organization s annual performance and strategic assessment is as follows. The bonus base will be calculated according to each organization's performance completion score, combined with Figure 1 below.

Annual performance completion score	Annual bonus correspondence factor	Strategic Incentive Correspondence Factor	
		T+1 Annual Incentive Correspondence Factor	T+3 Annual Incentive Correspondence Factor

<table>
<tr><td>Score<85</td><td>0</td><td>0</td><td rowspan="7">The T+3 annual strategic incentive correspondence factor is determined based on the completion of key indicators in the organization’s three-year strategic evaluation system.</td></tr>
<tr><td>95<Score≤85</td><td>0.8</td><td>0.8</td></tr>
<tr><td>100<Score≤95</td><td>0.9</td><td>0.9</td></tr>
<tr><td>110<Score≤100</td><td>1.05</td><td>1.05</td></tr>
<tr><td>120<Score≤110</td><td>1.15</td><td>1.15</td></tr>
<tr><td>130<Score≤120</td><td>1.25</td><td>1.25</td></tr>
<tr><td>Score≥130</td><td>1.35</td><td>1.35</td></tr>
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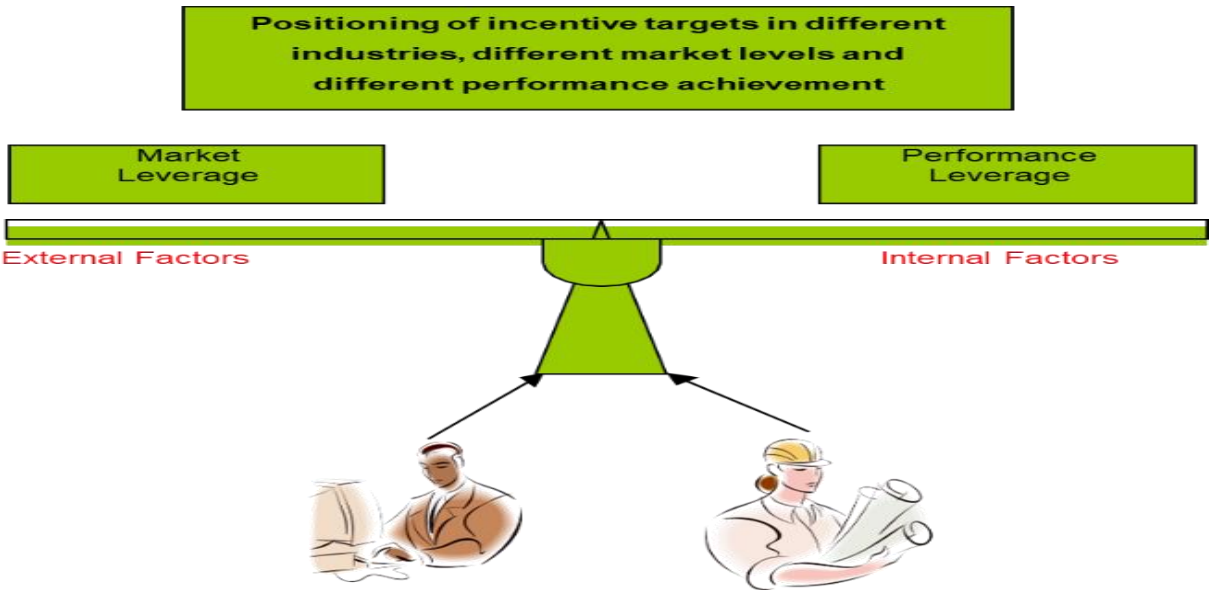
Figure 1: Calculation table of bonus and performance evaluation score

3. Methodology of strategic incentive system

3.1 Balancing considerations in medium and long-term incentive goal setting

According to the new strategic evaluation system, in the new medium- and long-term incentive target setting, we must consider the expectations of the company and employees, but the company and employees are expected to achieve different degrees of results in different strategic objectives, the two levers of market and performance, so the thinking and focus in these two areas will be different[1]. We must position the incentive targets differently according to different industries, different market levels and different performance conditions, as showed in Figure 2:

Figure 2: 2 leverage Model



3.1.1 The core of enterprise human resource management

The core of enterprise human resource management can be summarized as 3P management model of human resources, namely, three basic points "position (Position), performance assessment (Performance) and talent (People)".

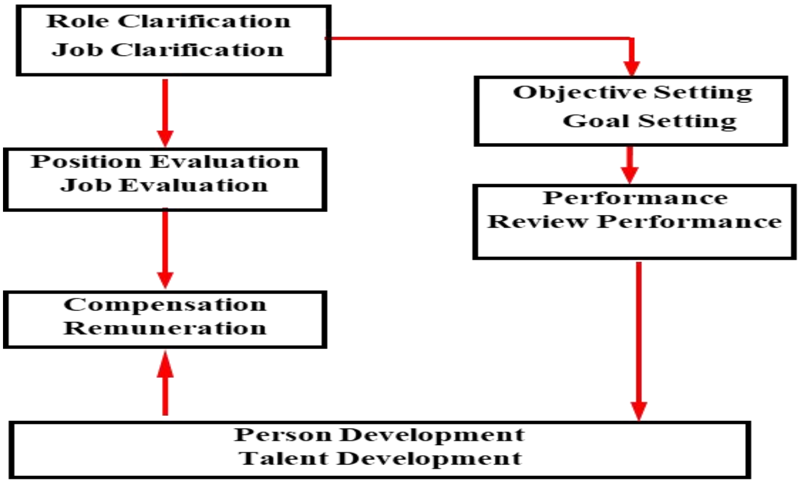
Therefore, the three steps before and after the core chain of the 3P management model are:

Job analysis as a basic tool to clarify the job responsibilities of employees, determine the relative value of jobs through job evaluation, and determine fixed salaries based on job values [2].

Designing indicators, programs and tools for performance appraisal according to employees' job responsibilities, and designing tools for salary, benefits and even bonus allocation according to the results of performance appraisal.

Determine the salary of incumbent employees according to the market, according to the scarcity of talents and the suitability of talents in the market, as shown in Figure 3

Figure 3: 3P Management Model



3.1.2 Management levelsof HR 3P management model

The essence of HR 3P management model is to take job analysis as the starting point, combine with performance management and talent development, take salary allocation as the result, and use this as the main line to develop and implement the human resource management activities of the enterprise. At the same time, it also contains three management levels, namely, the management of individuals, the management of organizations and the management of strategies.

3.1.2.1 Levels of management - Level 1 - Personal management

From the perspective of personal management, we must clarify the responsibilities and performance objectives of individual positions, and manage them in conjunction with personal development, and finally give remuneration according to their position value, performance and personal ability[2].

3.1.2.2 3 management levels - Level 2 - Organizational management

From the management perspective of the organization, we need to clarify the allocation of responsibilities of each department in the organization, the results of the job grade allocation and the distribution of performance goals, to make the overall distribution of compensation resources in conjunction with the relative value of the jobs in each department, the performance results and the ability the people in the organization.

3.1.2.3 3 levels of management - Level 3 - Strategic management

From the perspective of strategic management, we must analyse each organization, clarify the objectives, regularly review the performance achievement of each organization, analyse each organization's future development capabilities, and finally apply them to the allocation of each organization's compensation resources[3].

The above 3P system of human resource management tells us that when considering the organization's salary allocation, we need to consider the organization's performance accomplishment and the future development of the organization's capability.

3.2 Compensation Management Panorama

Scientific salary management generally includes two modules: compensation scheme design and salary scheme implementation. In the salary scheme design module, it is mainly based on the company's business strategy, clarifying the concept of salary payment, determining the basic scheme of salary distribution by combining the job value, personnel suitability and performance requirements, adjusting the company's compensation budget on this basis, and dividing the fixed base and floating base[2]. In the implementation phase of the compensation plan, corresponding performance consultation shall be conducted from time to time based on the implementation of the performance plan, and organizational performance assessment, individual performance assessment and individual ability (development) assessment shall be conducted at the end of the performance cycle, and the performance pay of the organization shall be finally accounted for based on the results of organizational performance assessment, and the performance pay of the employees shall be finally accounted for based on their individual performance assessment and individual ability (development) assessment. A panoramic view of compensation management is as shown in Figure 4 below.

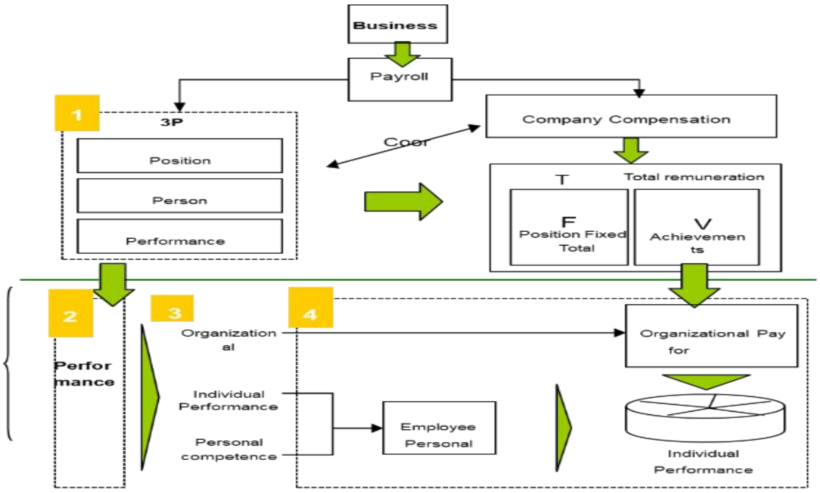


Figure 4: Panoramic view of compensation management

3.2.1 The core of the strategic incentive system is the creation of shareholder value EVA

At present, the strategic incentive system is based on the corresponding strategic evaluation system, with "economic value added/EVA" as the most important evaluation and evaluation method, which reflects that the creation of shareholder value is the basic premise of the incentive system, without the creation of shareholder value, there is no corresponding incentive. The core of the new strategic incentive system is also the compensation allocation based on the creation of shareholder value EVA.

3.2.1.1 Economic Value Added (EVA)

Economic Value Added (EVA) is a financial management system, decision-making mechanism and incentive compensation system based on the concept of economic value added. It is a financial assessment of a company's performance based on net operating profit after taxes and the total cost of capital investment required to generate these profits. The economic value added created by the company each year is equal to the difference between the net operating profit after taxes and the total cost of capital[3].. The cost of capital includes the cost of debt capital and the cost of equity capital. From an arithmetic point of view, EVA is equal to operating profit after taxes minus the cost of debt and equity, which is the residual income after deducting all costs, EVA is an assessment of the true "economic" profit, i.e. the amount by which the net operating profit exceeds or is less than the minimum return that an investor could obtain by investing the same capital in other similar risky securities[3].

3.2.1.2 Inside EVA

(1) EVA is a measure of shareholders' profit

The cost of capital is one of the most prominent and important aspects of EVA. Under traditional accounting profit conditions, most companies are making a profit. However, many companies are actually undermining shareholder wealth because the profits earned are less than the full cost of capital. EVA corrects this error and makes it clear that managers must pay capital when they use it, just as they pay wages. Taking into account the cost of all capital, including net assets, EVA shows the value of wealth created or damaged by the business in each reporting period. In other words, EVA is profit as defined by shareholders. Assuming shareholders want a 10% return on their investment, they believe they will only "make money" if their share of after-tax operating profit exceeds 10% of capital. Anything before that is just to achieve the minimum acceptable compensation for business risk.[3]

(2) EVA aligns decisions with shareholder wealth

EVA metrics help managers apply two basic financial principles in their decision-making process. The first principle is that any company's financial metrics must maximize shareholder wealth. The second principle is that the value of a company depends on the extent to which investors expect profits to exceed or fall below the cost of capital. By definition, a sustainable increase in EVA will result in an increase in the market value of the company. The current absolute level of EVA is not decisive; what matters is the growth of EVA, and a sustained growth in EVA leads to a sustained growth in shareholder wealth.

3.2.1.3 4M EVA system

(1) Evaluation metrics (Measurement)

EVA is the most accurate performance measure that provides the most accurate and appropriate assessment of a company's performance regardless of the time period.

(2) Management System (Management)

EVA is a single indicator that measures all corporate decisions. Companies can use EVA as the basis for a comprehensive financial management system that includes all policies and guidelines, methodological processes and metrics that guide operations and set strategy.

(3) Incentive System (Motivation)

EVA allows managers to focus on the owners of the business so that they can see things from the shareholders' perspective and be rewarded as if they were owners of the business.

(4) Philosophy System (Mind-set)

Under the EVA system, all financial and operations functions work on the same basis, providing a channel for employees in all departments to communicate with each other. EVA provides favourable conditions for communication and cooperation among all departments, creating a channel of contact between decision-making and operations departments and eliminating stereotypes and mistrust between departments, which can exist especially between operations and financial departments.

3.2.1.4 Calculation of economic value added

Return on Invested Capital (ROIC) = Net operating profit after tax ÷ Invested capital

Weighted average cost of capital (WACC) = cost of debt + Cost of equity

Weighted average cost of capital (WACC)

Economic Value Added (EVA) = (ROIC - WACC) X Investment cost

$$v\ WACC = \frac{E}{V} * Re + \frac{D}{V} * Rd * (1 - Tc)$$

3.3 Essentials of EVA Incentive Plan Operation

Linking EVA to compensation gives management the same focus on the company's success or failure as shareholders: by linking EVA to management compensation, that is, by rewarding management with a percentage of EVA, an environment is created in which management is brought closer to shareholders. As a result, company managers and even general employees begin to think like shareholders of the company. The idea of calculating management bonuses according to a fixed percentage of EVA is the idea of a compensation management system with EVA at its core.

Establishing an effective cooperation mechanism between shareholders and management: The introduction of EVA incentive plan establishes a mechanism for shareholders to control management's behaviour and ensures that management maximizes shareholders' wealth while pursuing its own interests. This operating mechanism enables management and shareholders to maintain the same status, enhances the trust relationship between principal and agent, and truly coordinates the relationship between management and shareholders. the EVA incentive plan establishes a bond of interest between management and shareholders, further rationalizes and coordinates the relationship between management and shareholders and motivates management to operate and manage with the same mind-set as shareholders.

3.4 Combine medium- and long-term incentives with EVA

The leverage incentive program is closely related to the company's EVA bonus program, where the amount of the bonus is determined and the level of operations owns equity in the company in addition to the cash bonus. Combining stock/option awards with EVA bonuses makes the stock/option itself a variable pay-out, thus making the entire incentive system more leveraged.

This redirects managers' efforts from lowering shareholder expectations to striving to improve performance, thus giving management and shareholders a common bond of interest. At the same time, it achieves the effect of a positive strategy driving a positive budget rather than a moderate budget driving a moderate strategy.

EVA takes into account all factors related to a company's value creation and balance of interests, not only as a measure of company performance, but also as a framework for overall financial management and as an incentive mechanism for management compensation. As a highly integrated approach, EVA can be applied in a variety of areas such as goal setting, performance evaluation, communication with investors, strategic assessment, capital allocation, M&A valuation, and the determination of incentive bonuses, all of which cause managers to think like owners.

4. Case presentation of listed and non-listed companies

4.1 Case Study I - Strategic Incentive Plan for Public listed Companies

4.1.1 Balanced consideration of two leverage effects

a. Consideration of Market Leverage: 2008 Executive Compensation Study Report (Summary)

b. Consideration of performance leverage: Two main perspectives are considered.

ROE Benchmarking: Return on net assets (ROE) is an important indicator of a company's profitability and one of the most important profitability indicators for the company's shareholders. We plan to analyse the absolute level and relative position of China Resources Power's ROE in comparable industry markets to serve as one of the reference indicators for determining the relative compensation levels of China Resources Power's general managers.

PE Benchmarking: The price-to-earnings ratio or P/E ratio is an important indicator of external investors' expectations of a company's future profitability. We plan to analyse the absolute level and relative position of China Resources Power's P/E ratio in comparable industry markets to serve as one of the reference indicators for determining the relative compensation levels of China Resources Power's general managers.

The above two indicators were selected as the basis for determining the "external competitiveness" of CR Power's General Manager, based primarily on an "internal" (ROE benchmark strength) and "external" (PE benchmark strength) perspective. The PE benchmark) to measure the overall performance of China Resources Power in a relatively comprehensive and objective manner. We propose to take 50% of the weight of each of these two indicators for comprehensive analysis and measurement, in order to achieve a balance between internal and external performance of the company and to achieve a relatively comprehensive and integrated consideration.

4.1.2 Consideration of performance leverage

a) The following Figure 5 shows the ROE data for different comparable companies in the power industry market from 2005 to 2007.

b) Weighted ROE = 2007 ROE*60% + 2006 ROE*30% + 2005 ROE*10%

c) China Resources Power ROE Benchmark Advantage Ratio = China Resources Power Weighted

ROE / (average of the weighted ROE of the other four companies)

Note: ROE = recurring net income / average of net assets at the beginning of the year and net assets at the end of the year, recurring net income and net assets data from the 2005-2006 annual reports and data from the 2007 earnings announcement.

Table 2: PE Benchmarking Table

Hong Kong listed power companies	2005 PE	2006 PE	2007 PE	PE Weighted value
Huaneng Power	12.75	10.62	16.12	14.13
Datang International	12.50	10.71	28.45	21.53
China Power	11.90	13.50	25.19	20.35
Huadian International	11.56	11.36	19.25	16.11
China Resources Power	5.68	11.83	23.88	18.44
China Resources Power PE Benchmarking Advantage Rate				1.02

d) The following Figure 5 shows the PE data of different comparable companies in the power industry market from 2005 to 2007.

Note: PE = annual average share price / earnings per share

e) Weighted P/E ratio = 2007 P/E ratio * 60% + 2006 P/E ratio * 30% + 2005 P/E ratio * 10%

f) China Resources Power PE Benchmark Dominance Ratio = PE Weighted Value of China Resources Power / (average of the PE-weighted values of the other four companies)

g) From the above analysis, it can be seen that the basic conclusion of the comprehensive and balanced consideration is that the return on net assets and the price-to-earnings ratio of China Resources Power are both 1.27 times of the comparable market. Based on the basic principle of fair and reasonable incentives, we suggest that the compensation level of CR Power's general manager is 1.27 times the benchmark value of the comparable market, which is acceptable from the perspective of both the company and the market.

h) Based on the above analysis, we measured the total amount of strategic incentive funds for the management team of CR Power. The incentive program uses EVA sharing plan. The value of ROIC above WACC is considered as creating shareholder value and the incentive fund is extracted according to the following formula.

Incentive fund amount = EVA ((company equity + interest-bearing liabilities)*(ROIC-WACC))*BSC%*d*r

According to the strategic requirement of designing the balanced scorecard index system and using it for annual appraisal, the appraisal score BSC% is used as the adjustment factor of the incentive fund.

The basic allocation factor d is determined based on the target level of the number of incentive recipients.

The performance adjustment rate r is based on a specific value of CR Power's benchmark ROE advantage ratio, which is based on its performance in comparable industry markets, provided that the start-up conditions are met in order to achieve effective and positive incentives for CR Power's management team.

4.1.3 Calculation of several points

a) The calculation of economic value added is "justified".

b)The connection between the economic value added and the incentive system to reflect the strategic direction and intentions of the company.

c) The design of the incentive system needs to take into account the concept of "time and space".

A combination of long-term, medium-term and short-term indicators.

Internal and external milestones/ Internal and external phase indicators/ Internal and External Phases.

4.2 Case Presentation II - Strategic Incentive Plan for Unlisted Companies

4.2.1 Motivation Main Line: Strategy - Organization - Work　People

The steps for developing a strategic incentive plan for an unlisted company are as follows

First define the company strategy and business model

Next, organize the organizational structure and business processes

And implement to job responsibilities and performance target breakdown, as shown in Figure 6

4.2.2 Restructured organization - Matrix operation

Development Goals	2011 Cement Holding Targets	
○ Regional Market Leader ○ Cement Industry Leader	Cement	• Annual production capacity of more than 50 million tons • Ranked in the top five in China and first in South China • 20-30% regional market share
	Concrete	• Annual production capacity of more than 30 million square meters • Ranked first in the country
	Net Profit	• Over 1.3 billion
	ROE	• >10%

Figure 6: Matrix of corporate s performance indicators

Second, combined with the strategic needs, adjust the organizational structure, adopt the matrix mode of operation, strengthen the construction of functional departments at headquarters, provide strong support for regional companies, and give full play to the market flexibility of regional companies.

4.2.3 Perform job optimization and job matching

The idea of job optimization and people-job matching is as shown in Figure 7.

a) First clarify departmental responsibilities

b) Restructuring of job postings, Restructuring of job postings

c) Then improve job responsibilities

d) On the basis of clear job responsibilities, job value assessment, personal performance target setting and job matching assessment are conducted to ensure the reasonableness, fairness and effectiveness of the incentive through the above work.

Among them, job evaluation is the basis for establishing a fair and reasonable incentive mechanism. After sorting out the responsibilities of each position, the International Job Evaluation System (IPE V3.1), which was mainly used, analysed the following four influencing factors: communication, innovation and knowledge, and comprehensively and comprehensively assessed the contribution of the position to the company in terms of 10 dimensions, i.e. job value.

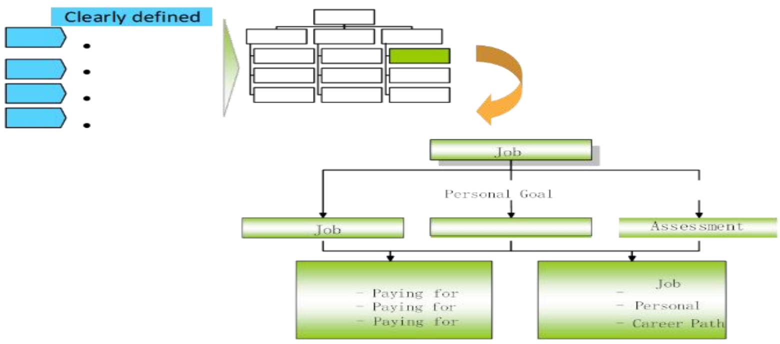


Figure 7: Cascading from business strategy to job responsibilities

The internal equity of key positions is achieved through job evaluation, which downplays administrative levels and focuses on job values.

With job responsibilities and values clearly defined, there is a solid foundation to consider the effectiveness of matching people to jobs.

5. Conclusion

There are 4 key points of the strategic incentive plan: Motivational issues are not just motivational, they need to be closely related to strategic, organizational and people issues, the management of incentives should be "value" oriented, the process of improving the incentive system itself is a process of mutual communication and consensus building and both incentive levels and the company's own capabilities need to be considered in the improvement process.

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