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THE GLOBAL LEADER IN COMPENSATION MANAGEMENT

## The Rule of Threes

# FOOLPROOF PRINCIPLES FOR MASTERING INCENTIVE PLANS

# For Many Organizations, Incentive Planning is Complex and Challenging.

**Designing plans – especially those with many different components – can be tedious and time-consuming, not to mention all of the work that goes into communicating and administering them. Oftentimes, compensation professionals struggle to strike a balance that allows them to maintain control over incentive plans while still ensuring flexibility to meet the evolving needs of the organization.**

The Rule of Threes is a doctrine that allows you to do just that. It's a simplified yet powerful approach to selecting metrics, goal levels, and programs that can truly motivate employees and make an impact on the organization. The rules are easy to remember, and likewise make incentive plans easy for employees to recall and put into action every day.

Throughout this guide, we will discuss the following main ideas for mastering incentive plans:

- The elements of a strong incentive plan
- The common challenges of incentive planning and how to address them
- Why The Rule of Threes exists
- The importance of choosing three metrics and goal levels
- The advantages of having no more than three incentive plans

Let's begin by discussing the foundations of an effective incentive plan.

# The Elements of a Good Incentive Plan

A strong incentive plan bares many similarities to a triangle. Triangles are considered the strongest shape for three reasons: they are easy to balance, easy to understand in mathematical terms, and difficult to manipulate. Likewise, good incentive plans are well-balanced, can be easily understood by employees, and are difficult to game.

Of course, there's another similarity among triangles and effective incentive plans. While triangles have three sides, incentive plans should follow The Rule of Threes, which states that:

- There should be no more than three metrics
- There should be no more than three defined goal levels
- There should be no more than three incentive plans for any one individual

Indeed, trios tend to stick in our minds, as they make a memorable impact and are easy to recall. Yet, you may wonder how it's possible for organizations to fit complex goals into such a simplified approach. This brings us toincentive plan challenges, and ways you can address them with The Rule of Threes.


# Common Incentive Plan Challenges & How to Address Them

When preparing for and designing incentive plans, organizations tend to run into three main challenges. For one, there are some "big" objectives you want or need people to accomplish. These may include large-scale endeavors, such as increasing revenue or safety, or becoming more sustainable.

Then, there are also smaller things that simply cannot be ignored. For this reason, having many people on a committee to help design an incentive plan can leave you with dozens of metrics to consider.

Lastly, there is also the math behind the modeling and payout expectations. While your organization has objectives it must measure and track, you may struggle to identify ways to measure them, or lack the means for measuring them effectively.

Implementing The Rule of Threes can help you meet these challenges, and you probably don't even have to start with an entirely new plan.

## Reuse, Reduce, and Recycle

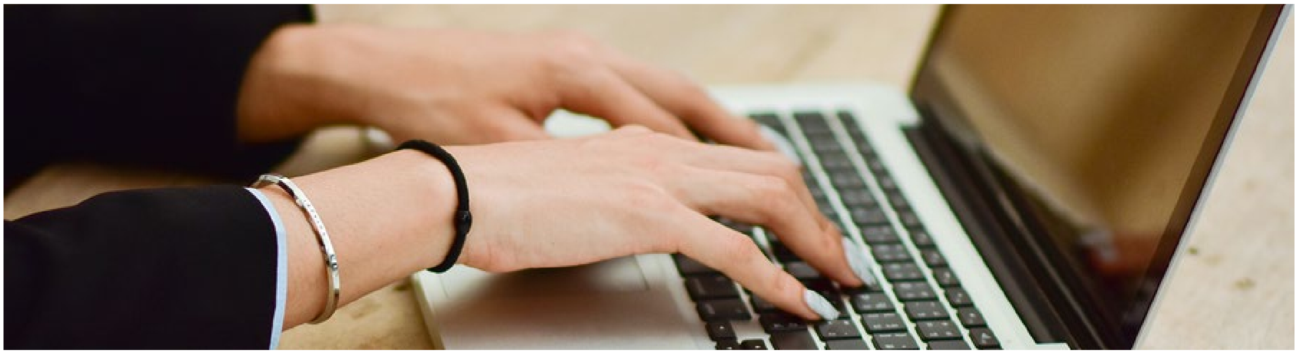
Many compensation teams scrap their entire incentive plan and completely start over every few years. Yet, you don't always need to start with a new plan. In fact, for the most part, the incentive plan you currently have is probably fine in many ways. Thus, before you decide to start all over, consider taking this approach:

- Reuse the plan you already have
- Reduce the plan to a level that makes sense for your current needs
- Recycle this approach to improve on an annual basis

Moving forward, we'll discuss why The Rule of Threes exists and how you can apply it to your existing plan to optimize results.

# Why Does The Rule of Threes Exist?

According to an HRSoft poll, more than one-third of the companies surveyed use four or more metrics in their annual incentive plans. While this approach may work for certain sales plans, having more than three metrics tends to present issues for annual incentive plans.



**The Rule of Threes exists because most people will focus on the two or three metrics that are most likely to benefit them. Additionally, goal levels generally work best with a target in the middle, a floor at the bottom, and exceptionalism at the top. Moreover, the restrictions force stakeholders to put real effort into determining the most important aspects of the program.**

While identifying three key metrics from the beginning makes the design process a bit more difficult, it forces stakeholders to be clear about what the company is trying to accomplish. Likewise, it allows employees to focus strictly on these topmost priorities, instead of going through the process of trying to prioritize objectives for themselves. With too many metrics, employees may lose sight of what really matters. And, employees may also decide that it's simply not worthwhile to pursue a higher number of goals. After all, if you're paying out incentives at 30% of a worker's base pay, and there are eight metrics to consider instead of three, the incentive amount becomes smaller, and thus less likely to win the attention and effort of your most valuable employees.

At the other end of the spectrum, there are also some risks associated with not using enough metrics. Nearly one-third of participants in the HRSoft poll referenced above do not use any metrics in their annual incentive plans at all. In reality, a plan without metrics is really a bonus program, in which employees may be rewarded in the event that something positive happens. This is common in very small companies that may not know what to measure, but larger firms typically need metrics. Otherwise, they're not incentivizing employees to do anything, but are rewarding them in the event that extra money is available.

For the majority of companies, using incentive plans to focus on three key metrics allows them to hit a sweet spot in which employees can dedicate their best efforts while stakeholders have their most important priorities met. We'll dive deeper into the benefits of a three-metric approach in the coming section.

# Why Choose Three Metrics for an Incentive Plan?

**So far, we've discussed some reasons why The Rule of Threes exists. Yet, in practical terms, what makes the number three so powerful when it comes to designing an incentive plan? It turns out there are some key reasons why three metrics work so well for incentive plans.**

For one, having three metrics leaves enough room for differentiation, and enough weight for the metric to have a measurable impact. Think of it this way: If one-third of your employees' total bonus amount depends on them hitting a specific goal, the odds of them focusing on this objective – along with the other two – are likely to be fairly high.

Conversely, with five or more metrics, at least one will be so low in terms of payout that it is essentially designed to be ignored. And if the employee is left to determine the level of importance for each incentive on their own, they may wind up overlooking what matters most.

Finally, focusing on just one or two metrics could work well in theory. Yet, with such a limited number of priorities, leadership may have difficulty coming to an agreement on the right one or two most important objectives.

## How Much of Each Metric?

After thoughtful planning and deliberation have led you to determine the three metrics to feature in your incentive plan, the next question is: How much of each incentive do employees need to achieve? According to behavioral economics principles, incentive pay works best when you give employees three performance levels to strive for:

- **Threshold:** The threshold performance level is "good enough". It is the bare minimum of performance needed to prevent something bad from happening, such as losing a client or getting fired. In other words, employees must achieve this level of effort, or else the company cannot continue operating as it does. Employees should be quite confident that they can hit this level. It should be achievable with 80-90% probability.

- **Target:** Achievable but difficult, the target is the equivalence of doing a good job. Employees should feel pretty sure they could make it, but not positive. There should be a 60-70% chance of achieving the target level.

- **Excellence:** The maximum level of performance will exceed expectations, and employees should feel pretty sure they won't hit it. This level is possible but not always plausible, and there is a 10-15% probability of reaching it.In most cases, this level will only be reached if everything goes right.

Some business leaders might question the threshold level or fault it for being too easy. For some employees, it may translate to underperformance. Yet, it's still enough to keep the company moving forward, and more importantly, it provides a starting point which can be easily communicated to employees for encouragement to do better. Setting the threshold level too high is a mistake many companies make, but it's one that can backfire, causing demotivation. When employees have performed well and the company is doing better but they fail to be rewarded because it wasn't "better enough", they'll be unlikely to contribute the same level of effort again.

## Why Three Goals?

The reason for using three levels of achievement to gauge performance on your metrics is simple. Too many levels can become complex and difficult to remember. Plus, this approach aids in your ability to clearly communicate the purpose of the program, which is to hit the target and aim for the maximum. Two-thirds of HRSoft poll takers say that their organizations set the target level for their incentive plan based on mathematical projections of what may be possible. This is a best practice and is more appropriate than setting a target aligned with max payout, which 17% of companies polled do. Aligning target levels with the max payout is the most common reason for people to cheat on incentive plans. For instance, employees may over-project revenue at the end of the year, or move some of next year's revenue into the current year just to reach a target. If you set a target at max, you probably won't have much else for employees to reach for below it. While this may be appropriate for one-and-done projects with strict deadlines, the instances in which these types of plans work successfully are rare.

Ultimately, three goals identify for your employees what has to be done, what should be done, and what can be done (or, what they have the potential of doing). At the threshold or "good enough" level, 50-75% of the target should have been reached, while 100% is met at the target level. To exceed expectations, employees should deliver 150-200% of the target value.

Of course, not all incentives are relevant to all employees. In the final section, we'll discuss how having three programs can fulfill the performance needs of most organizations.


# Why Have Three Incentive Plans at a Maximum?

With the right approach, it can take months to define the metrics and proper goal levels for an incentive plan. After all, it's critical to ensure you're using incentive plans to provide the greatest value for both the organization and its employees.

Yet, if during the planning stages your company determines that three metrics simply aren't enough to accomplish everything needed to get done, you can still break more than three goals down into multiple plans.

Maybe you'll need two or three plans, but be cautious not to exceed this number. Each plan must have enough to direct decisions and actions, and this value becomes more dispersed the more plans you add. Plus, most people find it hard to remember more than three things for an extended period of time. Limiting the number of your incentive plans allows them to stay focused on what matters most, keeping these factors in mind every time they make a decision.

Three plans or fewer are also easier to communicate. And, with great communications, you're more likely to get most of the participants to remember the purpose, the metrics, and the potential value of each plan.

Sometimes, we may strive to simplify incentive plan administration and management by using the same incentives for the entire organization. Yet, in our attempt to keep things simple for ourselves, we may make it impossible for someone else to understand or care about the plan. If employees can't find the purpose, metrics, or potential value in a plan, it's unlikely that they'll care. On the other hand, when they have a clear line of sight into these factors, they're much more likely to care, and your incentive plans thus become more effective.

# Conclusion

**For many companies, incentive planning is inherently complex, but as we've seen throughout this guide, it doesn't have to be.** Taking a principled approach to each core component of incentive planning, including the number of metrics, performance levels, and plans themselves, gives both your employees and the company as a whole a clear path towards goal accomplishment.

To recap some of the main points discussed herein, take a moment to review some key takeaways from our guide:

- Ideally, incentive plans should have no more than three metrics, there should be no more than three defined goal levels, and no employee should have more than three incentive plans.
- The challenges of incentive plans include the need to meet both big objectives and smaller priorities, along with the lack of knowledge or ability for measuring what matters. The Rule of Threes provides guidance for navigating these challenges.
- While many organizations tend to rebuild their incentive plan every few years for the bottom up, you can instead reuse and reduce your existing plan on an annual basis to reflect the company's current needs.
- The Rule of Threes forces stakeholders to decide what's most important, provides three clear goal levels for employees, and is easy to remember.
- Three is the best number for metrics because it allows room for differentiation while still providing enough weight for the metric to have a measurable impact. Too many metrics may go ignored by employees, while using too few may make it difficult to agree on what's most important.
- There should also be three levels of performance: threshold, target, and excellence. These levels communicate to employees what has to be done, what should be done, and what can be done.
- Enforcing a limit on incentive plans ensures that each will have enough value to direct decisions and actions, while also making it easy for employees to remember their priorities. Three plans are also simpler to communicate, and with great communications you may get most employees to remember the purpose, metrics, and potential value of each plan.

As we've discussed, enforcing The Rule of Threes demands more thought and strategic planning upfront. Yet, the hardest part is getting started, and once you've begun, you'll be on your way to designing an incentive plan that truly resonates with your employees and has the potential to make a measurable impact on your organization as a whole.

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Dan has coauthored several books on compensation and is a popular blogger on the topic. He also does dozens of presentations every year.

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