

The background features a complex, abstract pattern of glowing, translucent lines in shades of blue and green. These lines are layered and intersect to form a central, multi-pointed star or crystalline structure. The overall effect is dynamic and futuristic, with a dark blue background that makes the glowing lines stand out.

Aligning Reward Systems in Organization Design:

How to Activate the Orphan Star Point

By Michael Schuster, Ph.D., Competitive Human Resources Strategies, LLC and Greg Kesler, Kates Kesler

Companies are becoming more sophisticated in using organization design as a critical tool for driving business growth through new structure and capabilities. It is intuitive that aligning the right measures and reward systems with structure and process is important to organization design. But reward systems are often on the sidelines during the design process. The reasons are many, and they need to change with the help of some simple frameworks that provide a basis for diagnosing alignment needs and for making concrete adjustments in incentive programs and metrics to support changes in structure, process and people.

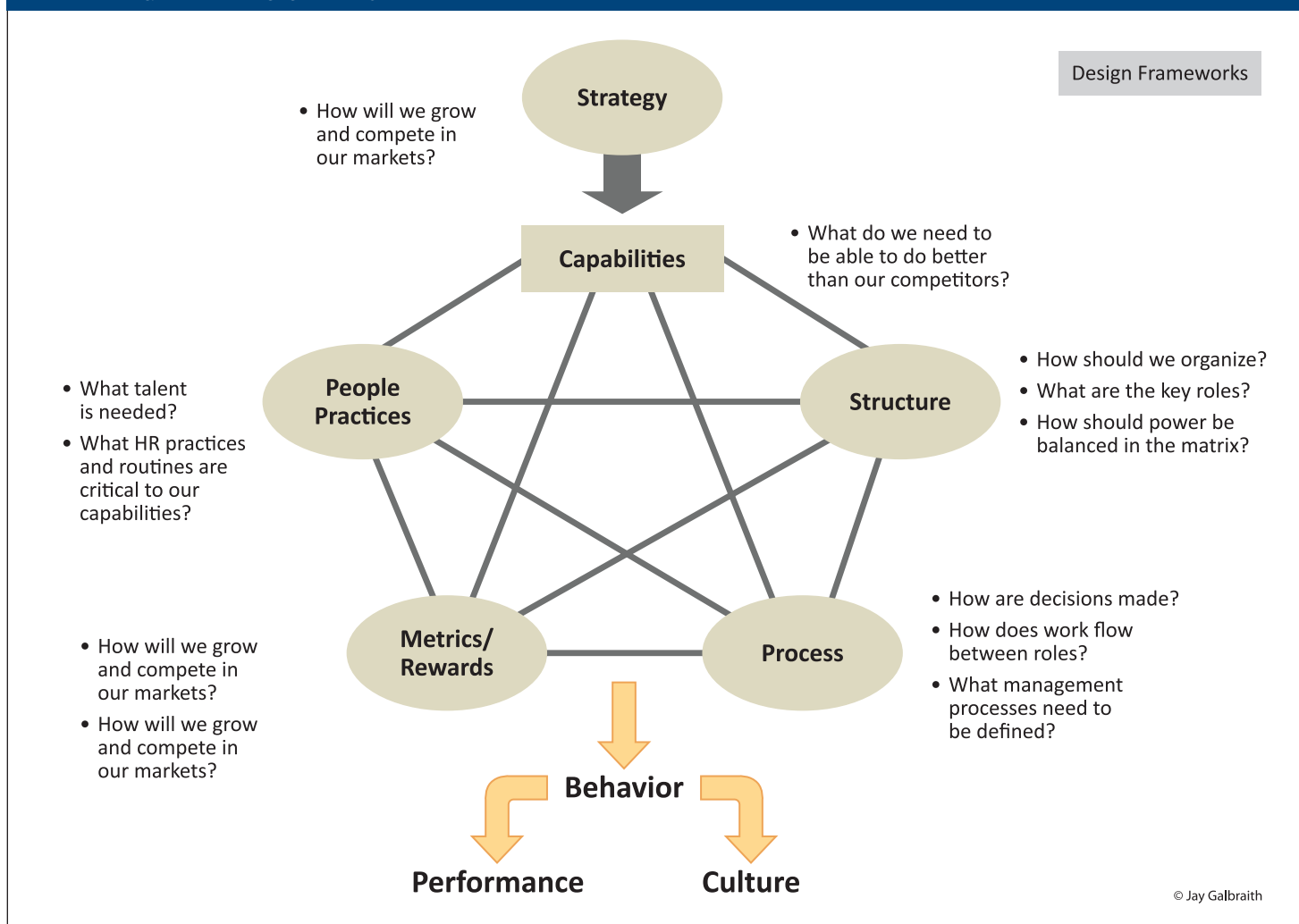
It has been more than 35 years since Jay Galbraith (1975) offered the now widely accepted Star Model (See Exhibit 1) as a lens on organization design that aimed to align structure, process, people and rewards with the business strategy.

Metrics inform employees and managers of what is important and provide leadership with a dashboard for steering business growth. Rewards influence behavior and are intended to align individual actions with organizational goals. The Star Model

has been widely adopted largely because of its behavioral point of view on organization design.

Metrics and rewards are a substantial part of bringing those behaviors to life, and yet

EXHIBIT 1: GALBRAITH'S STAR MODEL



design practice is not well-defined, and the literature is nearly silent on how to align reward systems to an integrated organization design initiative. Rewards systems are the *orphan star point*.

The wrong incentives may actually make matters worse than no incentives at all. In his famously titled paper, “On the Folly of Rewarding A, while Hoping for B,” Steven Kerr (1975) made the case well. We would extend the argument to suggest a Compensation Hippocratic Oath: first, do no harm.

The Effects of Misalignment

When metrics and pay are not aligned with new organization structures, roles and business processes, the unintended consequences are many. Take the example of a significant reorganization of a large industrial products company intended to drive growth in four vertical markets. The design change shifted the organization from a purely regional model with country-based P&L units to four global industry-aligned units. Despite an intent to realign executive targets and incentives as a part of the initiative, legacy programs prevailed due to a lack of flexibility on the part of corporate compensation programs.

Country managers in the new organization continued to behave as they had in the old. Instead of collaborating across countries and regions to bundle their products with those produced in other country-based businesses, they continued to chase business on their own to keep their local factories filled with orders. Instead of helping key account leaders in a vertical market to offer higher-value solutions that would have meant greater sales for the overall company, they did precisely what they were being incentivized to do.

When metrics and rewards systems are not realigned with changes in structure and business processes, the impacts are predictable:

- Individual performance targets compete with the goals of the strategy.
- Roles and accountabilities are confused or continue to be aligned around the old organization design.
- Decisions are made to optimize performance in one unit contrary to the needs of the larger organization.
- The organization is slow to act and burdened with internal conflicts.

- Leaders resist change (because it is rational to do so when incentives encourage old behaviors).
- Individuals begin to question the impact of the organization design changes on their personal economic well being, distracting them from winning in the new formation.

The Causes of Misalignment

Reward systems are often the missing element in a comprehensive view of organization design for a number of common reasons:

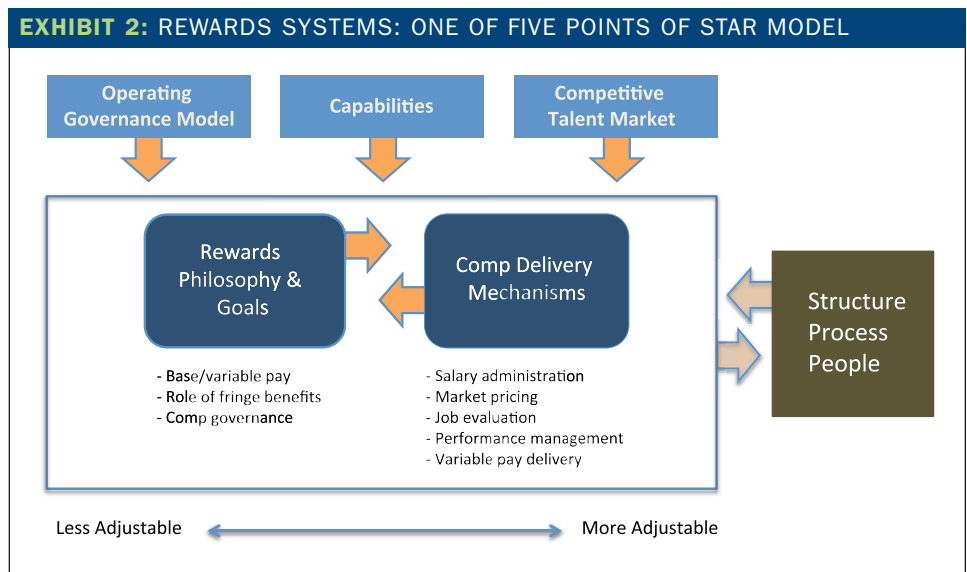
- **Compartmentalized thinking from HR leaders**—Organization design professionals exclude compensation input or include their comp colleagues too late in the process.
- **The special sensitivity of pay programs**—Leadership may be reluctant to make adjustments that could reduce accountability for results or upset internal and external equity dynamics.
- **Lack of flexibility in core policy**—Compensation policy is sometimes over-controlled by pay experts focused more on creating consistency than responding to the differentiated needs of business units.
- **Legacy of pay and metrics complexity**—Programs and measures often try to emphasize too many things and lack focus on profitable and sustainable growth.

Many organization designers lack experience in designing metrics and compensation

systems and so ignore the topic. Perhaps more importantly, when they do engage with their compensation colleagues, both parties approach the topic with very different frameworks.

Organization designers seek to differentiate the organization by creating unique, hard-to-replicate capabilities that can produce lasting and sustainable competitive advantage. Conversely, many compensation strategists seek to match industry patterns to ensure that the company’s policies are not out of line with competitors or with labor market realities. Indeed, corporate governance for executive compensation (through board compensation committees) relies heavily on survey and proxy data, as well as peer company comparisons, to ensure that compensation awards are within acceptable ranges in terms of amount (total compensation value) and delivery mechanisms (base, bonus, equity, etc.).

One HR executive recently articulated a common dynamic: “Our directors, who come from both our industry and other industries, seem to find comfort in focusing on conformity, cost and governance. The compensation consultants are particularly influential. Compensation committees are hiring their own consultants now to balance out perceived conflicts created by the comp consultants hired by HR. These corporate compensation consultants have the last word on interpreting both the market data and the position of the management compensation consultant. Since all the consultants all seem to know each other and have much the same data, there is a lot of conformity.”



An Effective Design Process

Organization designers and comp professionals need a common language and set of frameworks to work together on the orphan star point. And they need a process road map to assure that pay program designs are synched with the design of the other star points.

Our research and consulting experience reveals two frameworks that can guide the redesign of rewards systems in alignment with the other organization design star points:

1. Rewards System Design Logic (The What)
2. Design Milestones Process (The How)

Rewards System Design Logic

Rewards systems alignment should include at least three elements: (See Exhibit 2)

- Strategic drivers (inputs to design thinking)
- Rewards philosophy and objectives (core design decisions)
- Compensation delivery mechanisms (how core policy is carried out)

Strategic drivers

The key inputs to aligned reward systems design are:

- operating governance;
- organizational capabilities; and
- labor market requirements.

The *operating governance* model spells out the extent of central versus distributed decision making for matters of enterprise policy, including rewards systems. The more integrated the governance model, the more linked business units and functions need to be. Harmonized rewards systems and metrics are part of driving integration (see Table 1).

Capabilities represent critical organizational strengths that help the businesses to compete in their markets. These will often vary across a portfolio of business units in a large diversified company (and design choices should accommodate these differences). Capabilities determine what behaviors and actions should be encouraged and rewarded.

TABLE 1: OPERATING GOVERNANCE MODEL: DEGREES OF INTEGRATION ACROSS BUSINESS UNITS.

| DIMENSION | I. FULLY INTEGRATED (SINGLE BUSINESS) | II. DIVISIONAL (CLOSELY RELATED PORTFOLIO) | III. HYBRID (LOOSELY RELATED PORTFOLIO) | IV. HOLDING COMPANY (CONGLOMERATE) |
|-------------------------------------|--|--|---|--|
| ORGANIZATION DESIGN STRATEGY | Single strategy guides all P&L units with minor variations | Complementary business portfolio and core strategies with synergies | Driving better strategies and more ambitious targets; few synergies | Structuring cheap finance, buying low, selling high |
| GOVERNANCE | <ul style="list-style-type: none"> • Direction comes from organizational center • All process and practices are common • Single culture | <ul style="list-style-type: none"> • Controlling certain key functions to drive scale, common process and policy consistency | <ul style="list-style-type: none"> • Facilitating some scale benefits and some best practices across otherwise Standalone businesses capital, talent and knowledge | <ul style="list-style-type: none"> • Appointing the best people to run the businesses • Business units return financials to parent • No common processes • Multiple cultures |
| TALENT | <ul style="list-style-type: none"> • Single talent pool for leadership jobs • Numerous synergies expected | <ul style="list-style-type: none"> • High degrees of cross-BU movement of key talent with common process and metrics | <ul style="list-style-type: none"> • Limited planned movement of talent across units at senior levels | <ul style="list-style-type: none"> • No movement of talent across units • No synergies expected |
| REWARDS PHILOSOPHY | <ul style="list-style-type: none"> • Single design, limited need for variations • Central administration | <ul style="list-style-type: none"> • Single design, with variations in practices as necessary • Mixed administration | <ul style="list-style-type: none"> • Harmonized variations in design with business unit administration | <ul style="list-style-type: none"> • High variability; no need for harmonization |
| EXAMPLES | Cisco, Coca-Cola, Toyota | P&G, PepsiCo, IBM, Danone, Canon | GE, Unilever, Tyco, Philips | Berkshire Hathaway, Private Equity |

The *competitive talent (labor) market* drivers define the price of acquiring and retaining defined sets of talents, based on market forces globally and locally.

These three drivers provide the guardrails by which a company should set its rewards system philosophy and objectives and influence the design of compensation delivery mechanisms.

Rewards philosophy and objectives

The core elements of rewards systems design are: 1) base pay; 2) variable compensation; 3) fringe benefits; and 4) compensation governance including performance management.

Issues that are often addressed in compensation philosophy and objectives include:

- Should compensation be a driver or a re-enforcer of behavior?
- Where does the firm wish to position itself in the labor market (at what percentile)?

- What portion of total rewards will be distributed in cash, equity and social benefit programs?
- How much leverage should variable rewards have (how much pay should be at risk at different levels of the organization)?
- Where and how will compensation design and delivery be governed?

These rewards strategy decisions tend to be stable over time. As a practical matter, they represent the boundaries that organization designers need to work with as they consider aligning star points. Increasingly, they are influenced by the realities of competing for key talent in fields such as engineering, creative design and general management. Changes in core compensation policy should only be made to change culture to fit new market environments.

Compensation-delivery mechanisms

Compensation-delivery mechanisms include components such as base salary administra- ➤

tion, job evaluation, market pricing, performance management and delivery of variable pay programs. These mechanisms should be adjustable, within controls suited to the operating governance model of the company, and tailored to the needs of major business units.

Variable compensation delivery can include short-term bonuses and long-term incentives such as options and equity and are normally tied to achievement of critically defined metrics. While the design of these programs will be common in integrated companies, the administration of these plans can be adjusted to support a business model or strategy or capabilities to execute the strategy. A business unit that realigns itself from a set of regional profit and loss units to global products or markets must be able to align the metrics for new performance expectations, and then adjust weights in the bonus formula, within limits, to drive new (global) behavior. At a minimum, adjust-

ments must be made to minimize the destructive impact of programs that continue to support the old organization.

The Design Milestones Process

Kates and Kesler have defined an organization design process centered around five key milestones (Kesler & Kates, 2011). The milestones represent a series of design decisions that are made in a logical sequence. In the model, two arrows labeled “operating governance model” and “capabilities” span all five steps in the process. Organization design decisions are anchored to these two foundational elements. These elements should guide design decisions about rewards systems just as they influence structure, process and people decisions.

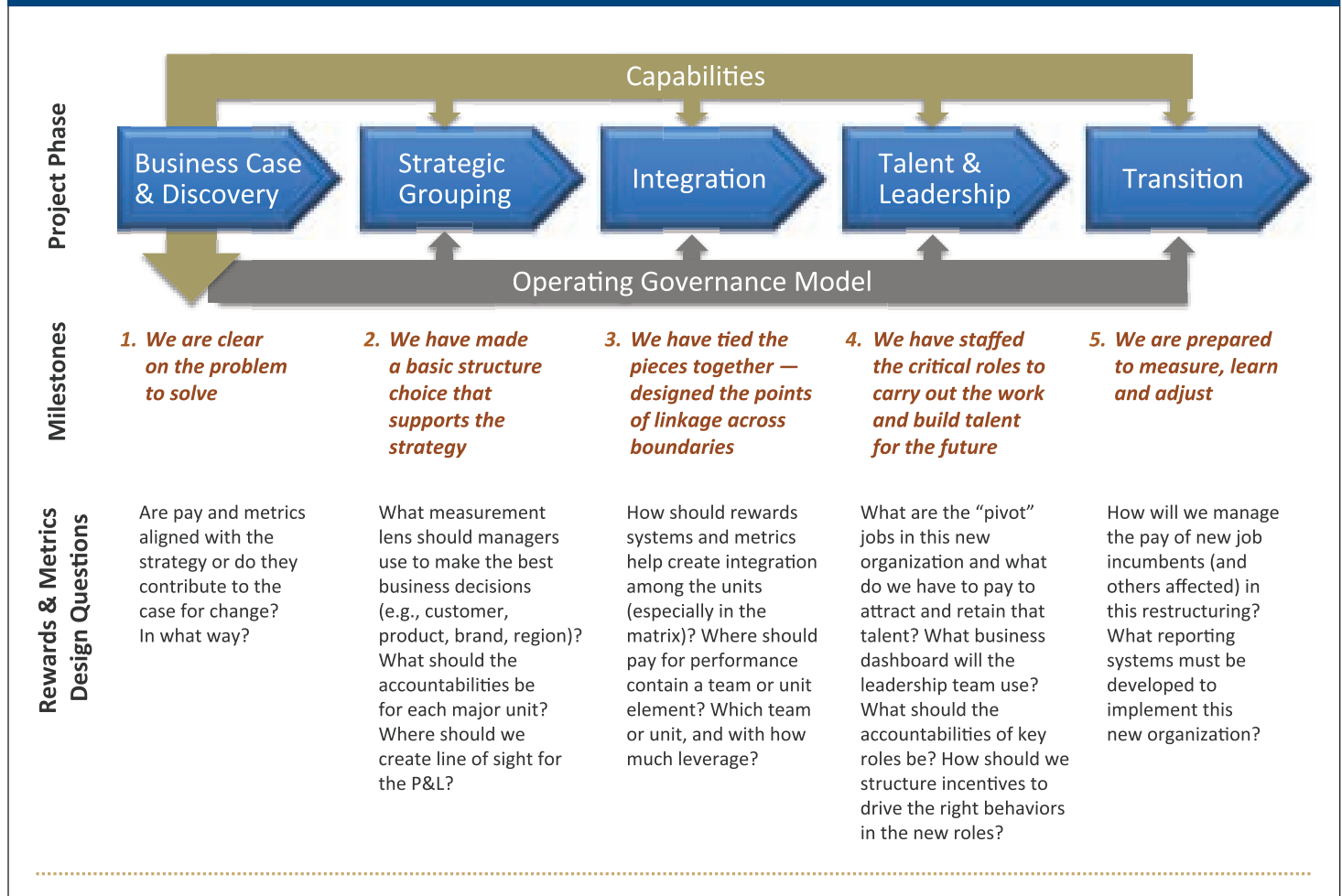
The design questions related to metrics and rewards at each milestone are highlighted in

Exhibit 3. The design work related to metrics and rewards at phase in the process is discussed below.

Milestone One: Business Case

The first step in the milestone model is to create a clear case for organizational change to either support a new business strategy or to close a performance gap. In this diagnostic step, leaders and designers should ask: “How are current metrics and rewards contributing to the current problem?” Examine the current measures used to hold key players accountable. It is often revealing to line up the score cards of regional managers with those of the global unit heads and functional leaders. Individual performance targets and quarterly business review metrics should be examined for alignment against the strategic goals of the business. A gap may exist in the way behaviors are incented relative to new capabilities the business needs to create. These data points should be factored into the diag-

EXHIBIT 3: THE FIVE-MILESTONE DESIGN PROCESS (WITH REWARDS SYSTEM DESIGN QUESTIONS)



nostic “problem statements” that emerge from interviews, focus groups and other qualitative analysis.

The business case milestone is complete once a set of design criteria has been articulated. Later, in most cases, adjustments to rewards and metrics will play a role in achieving these design criteria.

Milestone Two: Strategic Grouping

Once the business case is spelled out, the next set of decisions in the design process is to define the basic structure of the organization. Put another way, what basic grouping of work do we believe will best create the capabilities necessary to deliver the strategy? Metrics can play an important role in helping the leadership team choose the best primary grouping logic (function, product, geography or customer). Robert Simons has argued the power of measures as a force for strategy alignment and renewal (Simons, 2005). A creative way to puzzle through the pros and cons of each option is to ask the question: “What lens do you want your leaders looking through as they make decisions? What data should inform their work and how they track progress?” In Gillette’s razor business, the focus is brand not product. Brand metrics drive brand leaders to embrace cannibalization and planned obsolescence of older models to continue innovation into newer shaving systems with a higher value proposition and price points for blades. Roles and metrics aligned by product would likely drive very different behaviors.

Once a basic structural choice is identified, metrics should be listed for each of the proposed organizational units or groups. Without a basic summary of the accountabilities of each unit, it is difficult to know what is being proposed. For example, a unit called “marketing” may take many different forms ranging from media and communications to product management to profit and loss management.

Metrics also play a useful role in testing whether the strategic grouping concept makes sense. Who owns the P&L in this new organization is often an early point of discussion as alternative design choices are debated. Engaging the CFO and the CIO in discussions at this point always makes sense to gain their input and to give each an opportunity to begin to form new thinking about how to support a realignment of P&L reporting.

| TABLE 2: HOW REWARDS AND METRICS CAN HELP SUPPORT INTEGRATION DESIGN NEEDS. | |
|---|--|
| Typical Integration Needs | Potential Ways to Use Rewards & Metrics |
| <ul style="list-style-type: none"> Communities of practice in things such as talent development to grow general managers across its worldwide operating units | <ul style="list-style-type: none"> HR professionals in business units have an objective related to companywide talent development |
| <ul style="list-style-type: none"> Functions are aligned into cross-functional product category teams to speed consumer-centric innovation | <ul style="list-style-type: none"> All members have category team objectives Incentive formula includes category as well as division and enterprise performance |
| <ul style="list-style-type: none"> Product units are placed under one market executive in order to bundle products and services sold into a vertical market | <ul style="list-style-type: none"> Complementary P&Ls set for product and vertical market units Managers are measured on total value of key customer order |
| <ul style="list-style-type: none"> Key account organization works across business units to bring one face to large customers | <ul style="list-style-type: none"> Division and enterprise account reps share credit in scorecard for sales Incentives reinforce higher value bundled sales |
| <ul style="list-style-type: none"> Divisions share common infrastructure under an enterprise executive for China to maximize presence and influence (cost effectively) | <ul style="list-style-type: none"> Set some shared objectives for country and divisional leaders and give both a substantial stake in enterprise performance in the country |

Milestone Three: Integration of the Design

In this design stage, the work shifts to linking together the separate organizational units that have been planned. A clear, common rewards philosophy and set of goals will act as an integrating force in the culture of a company, often demonstrating a lot about what leadership values. In itself, this can be a positive force. But it is not enough.

The call for “boundaryless organization” at GE, IBM and elsewhere has become an urgent matter of working across geographies, functions and business units to go faster and to gain the benefits of scale. Some common examples of integration needs include the following:

- Divisions in GE share common infrastructure under a single enterprise executive for China to maximize presence and influence with regulators and customers.
- Coca-Cola uses communities of practice in talent development to grow general managers across its worldwide operating units.
- Covidien uses a key account organization to work across business units to bring one face to large health care customers.
- Functions are aligned into cross-functional product category teams at Green Mountain Coffee Roasters to speed consumer-centric innovation.

- Tyco’s valve and control product units are placed under a single vertical market executive to bundle products and services sold into the oil and gas market.

There are many ways to create integration, ranging from establishing networks and councils to creating robust planning processes and linking units together with smart pay programs and measures. It is in Milestone 3 that the bulk of the compensation alignment effort needs to occur. The compensation-delivery mechanisms have the potential to be powerful integrative forces in integration challenges like those listed above. Capabilities and operating governance (two of the strategic drivers in rewards design) should influence which integrating tools to apply (including rewards and metrics) and how to apply them. Let’s look at the logic stream for rewards and metrics as integrators in organization design (see Table 2).

Variable Compensation

The importance of aligning management incentives with desired organizational capabilities should not be underestimated. Variable pay is the “so-what” — the payoff — of well-crafted metrics. A senior HR executive at a well-known logistics company characterized the power of management bonus programs in getting people’s attention around a critical capability:

“Compensation here is focused on operational excellence. It tracks to our advertising message. A huge portion of compensation is tied to performance metrics, to a lesser extent

financial metrics. Your pay is tied to 99.998 percent successful delivery metrics. You can hit your numbers from an operating profit standpoint, but if you miss your operational performance metrics, your total pay will be dramatically reduced. This focuses managers on their operational results, which is how the company differentiates itself in the marketplace. In short, hit your operational goal and your pay is doubled. Meet your P&L numbers but not your operational metrics and you could lose your job.”

One important consideration is the relative weighting of financial goals and other operating objectives with other priorities. Integration at the enterprise level is reinforced by a single balanced scorecard approach that dictates broad categories of measurement that are adaptable to divisional needs.

Another key challenge is the need to balance the inherent tension between a) establishing clear line-of-sight between a manager’s variable pay and her own outputs versus; and b) encouraging more collaboration based more on unit or companywide results and payouts (integration). Leaders and compensation people often err on the side of narrow line-of-sight for its supposed motivating effects. This argument is often exaggerated, and, in any case, integration and collaboration become more difficult when there are smaller units of measurement for variable pay.

Performance Management

Larry Bossidy and Ram Charan (2002) made the case that performance management in high-performing companies is a business process, not a human resources process. PepsiCo, P&G, Honeywell and others are known for their goal-deployment rigor through core business processes that cascade objectives down and sideways across the businesses. New business teams and other organizational startups should be launched with deliberate efforts to create linkage among the targets of those who depend on each other in the new structure to achieve business results.

Milestone Four: Leadership and Talent

In this milestone, the new organization design is staffed. This is a window of opportunity to upgrade leadership and other talent in the new organization. The temptation to fill new roles with legacy players should be avoided (CLC, 2010). Companies continue to battle for critical skill sets that remain in short supply and

now on a global scale. In the fourth phase of organization design, the human resources executive must be thinking about how to use pay to attract and retain needed talent.

The combination of base pay, variable compensation and benefits (i.e., total compensation) needs to be market-driven, with each component weighted by the organization’s compensation philosophy. Rarely will the organization design influence the design of base pay programs. It may, however, influence matters such as job evaluation and merit guidelines. Some newly created

completely right the first time. It is critical to begin using the new metrics to track results and be willing to make adjustments in the design over time.

The redesign of an organization can fundamentally change roles and responsibilities in a manner that creates perceived winners and losers. It is easy to give people more money when they are promoted. It is often less clear how to treat pay and perks of those with diminished roles. Human resources should have a clear practice to guide pay decisions as organization implementation takes place.

Companies continue to battle for critical skill sets.

positions may be considered “pivot” jobs (Boudreau and Ramstad, 2007) due to their disproportionate impact on the building strategic capabilities. Creative designers at Apple and Nike are paid based on market pricing of jobs. Software engineers at Google are paid at levels necessary to compete with Facebook and others in the same talent market. GE and other companies continue to market price division general management roles, especially for executives that have global experience, because these pivot roles have an outsized impact on results.

From the point of view of compensation strategy, benefits represent a substantial cost of total compensation and therefore must be considered as a strategic cost. Organizations derive little if any behavioral change from this portion of compensation, but benefit programs can be an important factor in attracting and retaining the right talent, and their design can help or hinder the portability of talent around the world or across lines of business. If the operating governance model of the enterprise is a “holding company,” this is not important; but if the intent is a more integrated model, where leadership talent can be moved across boundaries, a common platform of benefits may be quite important.

Milestone Five: Implementation

The development of the business dashboard and agreement on management routines for quarterly and annual business reviews are critical elements transition planning. Implementation of complex organization realignments often takes many months or more. Rarely do leaders and designers get it

Our research indicates practices vary widely in this regard. In some companies, immediate downward adjustments are made. In others, a “red circle” treatment may last for a transition period of one or two years. Still others, in order to avoid adverse cultural reactions, may protect people indefinitely. Clearly those organizations with broad banding approaches to job evaluation have greater flexibility in this regard.

Implications for Human Resources

Organization design has become a core competency for the human resources organization throughout the past five years. But this capability should not be the sole domain of organization effectiveness professionals.

Human resources executives should bring compensation professionals into the organization design process early. The core compensation philosophy and goals should be considered with more attention to the operating governance model of the company. Pay systems can be separated into those elements that remain relatively fixed and common over time versus those delivery mechanisms that can be adjusted to fit the needs of different business units trying to build unique competitive capabilities, linked to their strategies.

The silos within the human resources function need to be bridged, and compensation, organization effectiveness and staffing people need to be partners in the organization design and implementation process. HR generalists

should become skilled activists in developing metrics and helping to cascade business objectives up and down and across the organization in the launch of new teams.

Rewards and metrics should cease to be the orphan in Galbraith's famous Star Model. This box of tools is much too important to be ignored in our efforts to build more agile, capable organizations to compete in today's markets. **P&S**

References

Bossidy, L., Charan, R., and Burck, C. *Execution: The Discipline of Getting Things Done*. New York: Crown Business, 2002.

Boudreau, John W. and Ramstad, Peter M. (2007). *Beyond HR: The new science of human capital*. Cambridge, MA: Harvard Business School Press.

"Managing Leadership Performance Risks." Corporate Leadership Council, Corporate Executive Board Company, February 2010.

Galbraith, Jay R. (1975). *Designing complex organizations: An executive briefing on strategy, structure, and process*. SF, CA: Jossey-Bass.

Galbraith, J.R. *Designing Matrix Organizations that Actually Work*. San Francisco, Calif.: Jossey-Bass, 2009.

Galbraith, Jay R. and Kates, Amy (2007). *Designing your Organization: Using the Star Model to solve 5 critical design challenges*. SF, CA: Jossey-Bass.

Kerr, Steven (1975). On the folly of rewarding A, while hoping for B. *Academy of Management Journal*, 18, 769-83.

Kesler, G. and Kates, A. (2011). *Leading organization design: How to make organization design decisions to drive the results you want*. SF, CA: Jossey-Bass.

Simons, R. *Levers Of Organization Design: How Managers Use Accountability Systems For Greater Performance And Commitment*. Cambridge, Mass.: Harvard Business School Press, 2005.

Michael H. Schuster, J.D., Ph.D., is a professor of management strategy and chair of the U. S. Coast Guard Academy's Management Department. He is also managing partner at Competitive Human Resources Strategies, LLC (CHRS), a consulting firm based in Narragansett, R.I. He can be reached at mschrs@cox.net.

Gregory Kesler is a managing partner in the consulting firm Kates Kesler, based in Wilton, Conn. He writes and lectures extensively on the subject of organization design. He can be reached at greg@kateskesler.com.