SUMMARY

MSC ALEXANDRA MÜLLER, PROF. DR. KAI HOBERG

MOTIVATING SUPPLY CHAIN BEHAVIOR - DESIGNING THE RIGHT INCENTIVE SYSTEM

MASTER THESIS INSIGHTS
INCENTIVES TYPICALLY PROMOTE SILO-OPTIMIZATION IN THE FUNCTIONS OF THE INTRA-FIRM SUPPLY CHAIN

Typical Functional Incentives

**Procurement**
- Min. sourcing costs
- Large purchase orders
- Full truck load transportation

**Production**
- Minimize production cost
- Max. lot sizes
- Min. setup times
- Max. yield

**Planning**
- Decreased inventories
- High service levels
- Bulk customer orders

**Sales**
- Max. revenue
- New customers
- Short lead times

Metrics
- Cost per unit purchased
- Supplier performance
- Production unit cost
- Plant utilization
- Set-up and changeover times
- Inventory turns
- Warehouse productivity
- Transportation costs
- Customer satisfaction
- Customer order cycle time
Against this background, a number of research questions concerning incentive systems in supply chain management arise.

Overview Research Questions

1. Which incentive systems are currently applied in SC functions?
   - How high is the variable component of the salary?
   - Which type of non-financial awards exist?
   - Are the goals subjective or measurable?
   - Which dimensions for compensation exist (KPIs)?

2. Which effects do incentive systems have for the company?
   - Do they help drive value of the firm?
   - Do they help supply chain functions?
   - Do they intensify conflicting goals?

3. How does the “right” incentive system in supply chain management look like?
   - What are the correct objectives?
   - How high should the variable salary be?
   - How often does the company measure / pay out?
WE OBTAINED 347 RESPONSES FROM SUPPLY CHAIN EXPERTS ON OUR SURVEY ON INCENTIVES

About the Survey

- Master thesis supervised as part of the joint KLU-McKinsey project “Who is managing our supply chains”.
- Survey was sent to employees working in a supply chain environment of small and medium-sized companies as well as multinational corporations
- We obtained responses from 347 participants and 140 participants completed the survey.
- The responding companies were mainly large corporations in terms of revenue (revenue: more than 1000m. (41.6% of respondents)) with more than 10,000 employees
- Most of the participants work in the chemicals, pharmaceuticals & medicals industry (20.7%) as supply chain managers/analysts (39.3%) on a lower level position (34.3%) with no staff responsibility (54.3%)
- Time frame of the survey: 28th of May 2013, until 22nd of June 2013
- Incentive for survey participation: a 15 Euro Amazon.de voucher or a donation of 25 vaccinations for children against measles
- We donated 1815 vaccinations to SOS Kinderdörfer
OUR SURVEY FOCUSES ON THE GROUPS OF PEOPLE WHO HAVE STAFF RESPONSIBILITY AND THOSE WHO HAVE NOT

By Management Level
- Middle Management: 31%
- Lower Management: 34%
- Top Management: 6%
- Other: 2%
- No Management: 26%

By Staff Responsibility
- more than 50 employees: 9%
- 15-49 employees: 11%
- 5-14 employees: 14%
- 1-4 employees: 11%
- no staff responsibility: 54%

Comments
- Both groups, those with staff responsibility and those without, are of equal size.
- Both groups are of high interest when regarding their satisfaction with their incentive systems.
- Moreover, we equate staff responsibility with management level as there exists a strong significant relationship.
- We expect to see high differences between them, as higher-level managers are often responsible for planning, setting and evaluating objectives, whilst lower-level managers need to execute the instructions of the superior to receive the variable salary.
PERFORMANCE-BASED BONUSES BASED ON INDIVIDUAL, COMPANY AND BUSINESS UNIT PERFORMANCE ARE MOST COMMON

Incentives Applied

<table>
<thead>
<tr>
<th>Incentive</th>
<th>Percentage</th>
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</thead>
<tbody>
<tr>
<td>Bonus based on individual performance</td>
<td>83.6%</td>
</tr>
<tr>
<td>Bonus based on company performance</td>
<td>76.4%</td>
</tr>
<tr>
<td>Bonus based on business unit performance</td>
<td>42.1%</td>
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<tr>
<td>Special further training and development</td>
<td>33.6%</td>
</tr>
<tr>
<td>Bonus based on team performance</td>
<td>32.1%</td>
</tr>
<tr>
<td>Feedback/ praise / public acknowledgement</td>
<td>30.7%</td>
</tr>
<tr>
<td>Special team-events</td>
<td>22.1%</td>
</tr>
<tr>
<td>Performance based stock options</td>
<td>20.7%</td>
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<tr>
<td>Additional working time flexibility</td>
<td>13.6%</td>
</tr>
<tr>
<td>Additional paid vacation</td>
<td>2.9%</td>
</tr>
</tbody>
</table>

Note: Multiple answers were possible

**Comments**

- **Individual performance based schemes** are the **most popular** type of financial incentives in a supply chain setting selected by 83.6% of the participants.

- Bonuses based on company performance (e.g., EBIT, ROI) are the second most frequent incentives used by 76.4% of companies.

- **Special further training and development** are favored as non-financial incentives by 33.6% of the participants.

- **Personal career plans, innovation awards and talent selection** as non-monetary incentives were also mentioned.

**Top 3 Incentives**

- Bonus based on individual performance (83.6%)
- Bonus based on company performance (76.4%)
- Bonus based on business unit performance (42.1%)
NEARLY HALF OF THE BONUS OF AN EMPLOYEE IS DETERMINED BY INDIVIDUAL MEASURES

- The variable salary is, on average, comprised as follows:
  - 45% by individual performance based measures,
  - 33% by corporate measures,
  - 14% business unit measures and
  - 8% team measures.

- One respondent stated occupational safety as a measure used in his/her company

- Project success and costs were the most frequently mentioned types of metrics

- Customer satisfaction, on the other hand, was selected only by every third participant
VARIABLE PAY LEVELS DEPEND ON THE JOB POSITION

Maximum and Realized Bonus (in percent of base salary)
- Average of Participants -

-32%  22.4%
15.3%  15.4%
9.2%  40%

Managers with staff responsibility
Managers without staff responsibility

Maximum Bonus
Actual Bonus

On average, incentive levels differ significantly between managers with and without staff responsibility.

Managers with staff responsibility receive a higher actual and can also earn a higher possible variable salary.

The maximum possible average percentage of variable salary of all responses is 18.6%. The actual variable pay accounts for 12.3% of gross annual salary resulting in an average payout of 66% of the maximum possible variable salary.

Relative payout is 8% higher for managers with staff responsibility than for those without.

Comments
IN GENERAL THE PARTICIPANTS FEEL THAT INCENTIVE SYSTEMS FOLLOW THE SMART METHODOLOGY

**Specific:** Goals need to be clear, unambiguous and specific

<table>
<thead>
<tr>
<th>Disagree</th>
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<tr>
<td>9%</td>
<td>5%</td>
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<td></td>
<td>86%</td>
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Managers with staff responsibility: Agree 86%, Disagree 5%

<table>
<thead>
<tr>
<th>Disagree</th>
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<tr>
<td>18%</td>
<td>8%</td>
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<tr>
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<td>74%</td>
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Managers without staff responsibility: Agree 74%, Disagree 8%

**Measurable:** Goals need to be measurable

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Managers with staff responsibility: Agree 86%, Disagree 8%

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<td>21%</td>
<td>7%</td>
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<td></td>
<td>72%</td>
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Managers without staff responsibility: Agree 72%, Disagree 7%

**Achievable:** Goals need to be challenging but possible

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<tr>
<td>2%</td>
<td>94%</td>
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Managers with staff responsibility: Agree 94%, Disagree 6%

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<thead>
<tr>
<th>Disagree</th>
<th>Agree</th>
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<tbody>
<tr>
<td>9%</td>
<td>88%</td>
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<td>3%</td>
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Managers without staff responsibility: Agree 88%, Disagree 3%

**Relevant:** Goals need to be relevant and realistic

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<tr>
<th>Disagree</th>
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<td>8%</td>
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<td>86%</td>
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Managers with staff responsibility: Agree 86%, Disagree 6%

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<thead>
<tr>
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<th>Agree</th>
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<tbody>
<tr>
<td>18%</td>
<td>20%</td>
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<tr>
<td></td>
<td>62%</td>
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Managers without staff responsibility: Agree 62%, Disagree 20%

**Time-Bound:** Goals need to be given a target date

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<tr>
<th>Disagree</th>
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<tr>
<td>11%</td>
<td>8%</td>
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<td>81%</td>
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Neutral

Managers with staff responsibility: Agree 81%, Disagree 8%

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<thead>
<tr>
<th>Disagree</th>
<th>Agree</th>
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<tbody>
<tr>
<td>12%</td>
<td>14%</td>
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<tr>
<td></td>
<td>74%</td>
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</table>

Neutral

Managers without staff responsibility: Agree 74%, Disagree 14%
FROM A SUPPLY CHAIN PERSPECTIVE MANAGERS WITH STAFF RESPONSIBILITY ARE MORE SATISFIED WITH THEIR INCENTIVE SYSTEMS

**Hypotheses**

**H1**: Incentives promote conflicts between the different functions in a supply chain

**H2**: The higher the incentives the higher the performance / motivation of the employee

**H3**: Incentives encourage people to not act in companies’ interest & to manipulate the underlying KPIs

**H4**: KPIs determining the bonus are not the right ones.

**H5**: KPIs are rather short-term than long-term oriented

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**Overview Hypotheses**

### Managers with staff responsibility

<table>
<thead>
<tr>
<th>Disagree</th>
<th>Neutral</th>
<th>Agree</th>
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<tr>
<td>50%</td>
<td>25%</td>
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### Managers without staff responsibility

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<thead>
<tr>
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<tr>
<td>36%</td>
<td>29%</td>
<td>35%</td>
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**Disagree**

**Neutral**

**Agree**

- 50% 25% 25%
- 36% 29% 35%

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<tr>
<td>30%</td>
<td>22%</td>
<td>48%</td>
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<tr>
<td>32%</td>
<td>22%</td>
<td>46%</td>
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**Disagree**

**Neutral**

**Agree**

- 30% 22% 48%
- 32% 22% 46%

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<tr>
<td>61%</td>
<td>18%</td>
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**Disagree**

**Neutral**

**Agree**

- 71% 12% 17%
- 61% 18% 21%

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**Agree**

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<td>13%</td>
<td>17%</td>
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### Managers without staff responsibility

<table>
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<th>Neutral</th>
<th>Agree</th>
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<tbody>
<tr>
<td>54%</td>
<td>21%</td>
<td>25%</td>
</tr>
</tbody>
</table>

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**Disagree**

**Neutral**

**Agree**

- 70% 13% 17%
- 54% 21% 25%
H1: Incentives promote conflicts
MANAGERS WITHOUT STAFF RESPONSIBILITY SEE MORE CONFLICTS BETWEEN DEPARTMENTS

Conflicts between departments

Metrics

Procurement
- Supplier performance
- Cost per unit purchased

Production
- Plant utilization
- Set-up and change-over times
- Waste and scrap

Planning
- Inventory turns
- Warehouse productivity
- Transportation costs

Sales
- Customer satisfaction
- Customer order cycle time

Conflicts

- Purchasing price vs. waste and scrap
- Purchasing price vs. inventory levels
- Purchasing price vs. transportation costs
- Max. lot-size vs. inventory levels
- Supply chain costs vs. process quality
- Inventory levels vs. service level
- Inventory levels vs. forecast accuracy
- Supply chain costs vs. customer satisfaction

Comments
- 43% of lower level managers cannot observe that superiors of different departments meet regularly to discuss incentives holistically.
- 47% of top managers agreed that the incentive system promotes communication between departments compared to only 27.6% of the managers with no staff responsibility.
- Most respondents equate conflicts with conflicting goals resulting in win-lose situations for all departments.
- Insufficient information sharing was also mentioned as a hindrance to good collaboration.
H2: Incentives promote motivation

The current incentive system motivates top-level managers more than lower level managers

Motivation of employee (in percent of agreement)
- Average of Participants -

- Comments -

- Managers with and without personnel responsibility agree on the fact that they would perform worse without an incentive system (51.6% and 44.7%)

- Both groups would not see an increase in their performance if the variable salary doubles (46.9% and 39.4%)

- Results show that 42.2% of all participants take their bonus payment for granted which actually indicates that the incentive system does not contribute to their motivation as they presume that they will receive their bonus either way
**H3: Incentives promote unethical behavior**

In particular procurement and sales seem to optimize their own objectives without considering the company goal.

**Frequency of Agreement with Statement**

<table>
<thead>
<tr>
<th>Department</th>
<th>Disagree</th>
<th>Agree</th>
</tr>
</thead>
<tbody>
<tr>
<td>SCM</td>
<td>47%</td>
<td>27%</td>
</tr>
<tr>
<td>R&amp;D</td>
<td>37%</td>
<td>27%</td>
</tr>
<tr>
<td>Procurement</td>
<td>34%</td>
<td>44%</td>
</tr>
<tr>
<td>Production</td>
<td>33%</td>
<td>34%</td>
</tr>
<tr>
<td>Sales</td>
<td>30%</td>
<td>49%</td>
</tr>
</tbody>
</table>

Comments:

- 8.0% of lower-level managers would window dress the KPIs if this increases the bonus compared to only 6.3% of top level managers.
- Managers with staff responsibility assume that the focus on KPIs does not increase willingness to manipulate metrics (48.4%) but 46.0% of lower-level managers believe that it does.
- Nevertheless, all state that it is difficult to manipulate the KPIs in their companies (82.8% and 71.0%).
- Participants further stated that KPIs are usually not so clearly defined that no room for certain interpretation exists that can be exploited to one’s own advantage.
H4: KPIs are not the right ones
LOWER-LEVEL MANAGERS ARE NOT SATISFIED WITH THEIR METRICS USED TO DETERMINE THE VARIABLE PAY LEVELS

Satisfaction of employees concerning performance measures (in percent of agreement)
- Average of Participants -

- Results show that 73.5% of managers with staff responsibility are satisfied with the metrics that are used to measure the achievement of their personal objectives compared to only 38.1% of lower-level managers.

- One third of lower level managers consider their incentives to be the wrong ones.

- The measures underlying the incentive systems are not objective for 30.3% of managers without staff responsibility.

- Top-level managers' objectives are based on objective KPIs (70.3%).
**H5: KPIs are short-term oriented**

**INCENTIVES ENCOURAGE EMPLOYEES TO FOCUS ON SHORT–TERM OBJECTIVES WHILE NEGLECTING LONG–TERM ISSUES**

**Perception of short-term objectives (in percent of agreement)**
- Average of Participants -

<table>
<thead>
<tr>
<th>Perception of short-term objectives</th>
<th>Average of Participants</th>
</tr>
</thead>
<tbody>
<tr>
<td>Incentives encourage employees to focus on short-term objectives while neglecting long-term issues</td>
<td>55% (Managers with staff responsibility)</td>
</tr>
<tr>
<td>KPIs used to measure the achievement of personal objectives reflect strategic company goals</td>
<td>81%</td>
</tr>
</tbody>
</table>

**Comments**

- Incentives encourage employees to focus on short-term objectives while neglecting long-term issues

- KPIs enable the company to increase the business success sustainably was agreed on by 49% of lower level managers compared to nearly 80% of top-level managers

- An incentive formula needs to include both short-term performance criteria (e.g. average return on assets), and long-term performance criteria (e.g. average growth rate) in determining executive bonuses
DESPITE THE HIGH SATISFACTION LEVELS OF MANAGERS FIELDS OF CONFLICT DO STILL EXIST IN SUPPLY CHAIN MANAGEMENT

Challenges of incentive systems

“No real measurable and objective KPIs exist; performance evaluation depends mostly on subjective interpretation and justification”

“No real measurable and objective KPIs exist; performance evaluation depends mostly on subjective interpretation and justification”

“conflicting goals are present every day”

“individual objectives are counterproductive for the cooperation with very target-oriented colleagues”

“individual objectives are counterproductive for the cooperation with very target-oriented colleagues”

“Well-coordinated objectives across functions are essential”

“The company success needs to be the first priority for all departments”

“There are consultation, communication and constructive collaboration problems between our departments”

“conflicting goals are present every day”

“individual objectives are counterproductive for the cooperation with very target-oriented colleagues”

“No real measurable and objective KPIs exist; performance evaluation depends mostly on subjective interpretation and justification”

“The company success needs to be the first priority for all departments”
### Effects of Incentive Systems (Agreement in %)

<table>
<thead>
<tr>
<th>Statement</th>
<th>Managers with staff responsibility</th>
<th>Managers without staff responsibility</th>
</tr>
</thead>
<tbody>
<tr>
<td>The metrics that are used to determine my bonus are the right ones for me</td>
<td>73%</td>
<td>39%</td>
</tr>
<tr>
<td>Overall, my incentive system supports the corporate objectives a lot</td>
<td>72%</td>
<td>50%</td>
</tr>
<tr>
<td>Conflicting objectives exist between departments because of incentives</td>
<td>62%</td>
<td>43%</td>
</tr>
<tr>
<td>My incentive system promotes constructive collaboration &amp; communication btw. functions</td>
<td>54%</td>
<td>25%</td>
</tr>
<tr>
<td>Overall, the incentive systems are well coordinated between the functions</td>
<td>49%</td>
<td>19%</td>
</tr>
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</table>

**Comments**

- Both groups are satisfied with the incentive system *(SMART goals, higher motivation, KPIs are not easy to manipulate, objectives reflect strategic goals)*, but managers with staff responsibility always to a greater extent.

- Managers without staff responsibility think that there are consultation, communication and constructive collaboration problems between departments.

- They also see that incentive systems are *not well coordinated* between the departments.

- Overall, only 48% of lower level managers are satisfied with their incentive system compared to *80% of top level managers*. 
Both groups see room for improvement but managers with staff responsibility to a greater extent.

Suggestions for Incentive System Improvements (Agreement in %)

- Objectives should increase the company’s success sustainably: 95% (managers with staff responsibility) vs 94% (managers without staff responsibility).
- Common objectives for the different functions: 91% (managers with staff responsibility) vs 81% (managers without staff responsibility).
- Better coordination of objectives between functions: 79% (managers with staff responsibility) vs 79% (managers without staff responsibility).
- Objectives should be based on cost consciousness and on a holistic approach to thinking and acting: 40% (managers with staff responsibility) vs 64% (managers without staff responsibility).

Comments:

- Managers without staff responsibility would like to have objectives that are based on cost consciousness as 43% think that bonus is based on subjective evaluation of the superior.
- Managers with staff responsibility instead are neutral as their bonus is already based on objective KPIs (70%).
- 89.1% of managers with staff responsibility, as well as 81.6% of lower-level managers, prefer monetary incentives.
- Training, working time flexibility or acknowledgment is favored by 10.9% or by 18.4% respectively.
 Managerial Implications for the Optimal Incentive System Design

1. **Incentive systems pay off**: they do not promote conflicts, increase the motivation of the employee and thus his performance, encourage people to act in companies’ interests, KPIs are long-term oriented and the right ones for individual functions.

2. Top-level managers need to acknowledge that incentive misalignment exists across different functions leading to different satisfaction levels along the hierarchy.

3. **Global supply chain metrics** need to be implemented and included in the bonus schemes to focus on the overall company performance, for instance total SCM costs, inventory turn, and on-time delivery.

4. **Aligning the responsibility for achieving specific objectives with the responsibility for the related operational tasks**

   The marketing and sales department is given ownership of finished goods inventories and stock levels are included into their objectives. On the other hand, customer satisfaction metrics need to be included in the planning and production department’s objectives.

5. The sales department should not only be incentivized on total sales, but also on forecast accuracy and working capital. On the other hand, the production and planning department should be incentivized on the service level to end customers to align them with sales.

6. Objectives of the procurement department should not only include the average purchasing price, but also the on time availability of the right-quality materials at the start of production.
CROSS-FUNCTIONAL OBJECTIVES NEED TO BE INCLUDED FOR EACH FUNCTION IN ORDER TO SATISFY THE FOLLOWING FUNCTION

Suggestions for the Optimal Incentive System Design

**Procurement**
- On-time availability of materials
- Right quality
- Inventory level

**Production**
- Inventory level
- Service level/customer satisfaction

**Planning**
- Service level/customer satisfaction

**Sales**
- Inventory level
- Forecast accuracy

Company Goals
- Min. sourcing costs
- Max. lot sizes
- Long runs
- Decreased finished goods inventories
- Max. revenue

Each function should receive an incentive that is aligned with its internal customer
HOW DOES THE “RIGHT” INCENTIVE SYSTEM IN SUPPLY CHAIN MANAGEMENT LOOK LIKE?

Goals do not need to be bonus relevant – company’s success can also be achieved by a common vision.

Functional objectives based on company objectives that can be further drilled down to individually controllable objectives.

Omit individual objectives as they are counterproductive for the cooperation with very target-oriented colleagues.

The company’s success must have the highest priority for all departments!

Interdepartmental objectives with focus on single function’s KPIs to avoid silo mentality!

The incentive system must be well coordinated between the different functions. All functions must confirm that the objectives are SMART!
FOR FURTHER QUESTIONS PLEASE FEEL FREE TO CONTACT US

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