Bonus Incentive Plans: Making the Grass Greener

Too often, owners only discover that the compensation plans they've put in place for key employees are sadly inadequate when those key employees leave their companies for greener pastures. The departure of one or more of these key employees not only complicates your daily business life, but it can slam shut the door on your exit plans. Without experienced management in place, you may find it very difficult (if not impossible) to leave your business in style.

Key employees are aptly named not only because they are key to the efficient and profitable operation of your business; they are also key to your departure. No one will want, or be able, to run your business without you unless key management remains after your departure.

How then does an owner manage to make his grass greener and keep key employees in his pasture? Rather than tie them to the fence post, smart owners implement employee incentive plans that motivate those employees to stay. In doing so, owners also make strides toward the goal of a successful exit.

There are four characteristics common to successful bonus plans. They:

- Are specific, not arbitrary, and are in writing;
- Are tied to performance standards;
- Make substantial bonuses; and
- Handcuff the key employee to the business.
- Let's look at each briefly.

Clear Communication.
The most basic characteristic of a successful plan is that it's communicated clearly such that it's understood thoroughly by the employee. Communicating clearly typically means that the plan is in writing and based on determinable standards. Plans are also explained to employees in face-to-face meetings, often with the owner's advisors present to answer any questions.

Performance Standards.
The second characteristic is that the incentive plan bonus is tied to performance standards. Owners often work closely with their advisors to determine which performance standards should be used; e.g. net revenues or taxable income above a certain threshold-for which employees. The standards of performance that the owner chooses must be ones the employee can influence and that, when attained, increase the value of the company.

Let's look at how one owner created a successful employee bonus structure.

Bert Miller's manufacturing business was growing at an impressive rate, but his bottom line was not. His highly effective sale manager was driving growth, but an analysis of the growth disclosed it was coming from Bert's lowest margin product lines, which carried highly commoditized prices. Bert's new and most promising products, which generated higher margins, had been flat for three years.

Bert had approved the commission structure in place for the sales force, based on gross revenue, with an over-ride on revenue growth for the sales manager. The plan had certainly driven revenue higher, but the unintended consequence was growth from low margin products and that growth was beginning to stretch the Company's manufacturing capacity.

Bert redesigned and implemented a new incentive compensation plan for his sales force and sales manager. The plan drastically reduced the sales commission on low margin products, with a much greater commission rate on high margin products. The plan also eliminated the sales manager's over ride and in its place was an annual bonus based on the gross margin of the revenue generated by the sales manager's team.

The result? Bert's sales grew at a slower rate, nearly all of it from higher margin products, and the bottom line was growing at 2.5 times the rate of sales growth. The new incentive compensation plan motivated the sales manager and his team to sell the right products, not the "easy to sell" low margin products.

Substantial.
Third, the size of the bonus must be substantial enough to motivate employees to reach their performance standards. As a rule of thumb, a plan should create a potential bonus of at least 30 percent of a key employee's compensation. Anything less may not be sufficiently attractive to motivate employees to modify their behavior to make the company more valuable.

Handcuffs.
Finally, a successful plan handcuffs the key employees to the business. The goal here is to keep the employee with the company the day after, and even years after, the bonus is awarded. Owners typically use several techniques to create "golden handcuffs" for their employees.

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L.Harris Partners

952.944.3303
tom.siders@lharrispartners.com
www.lharrispartners.com