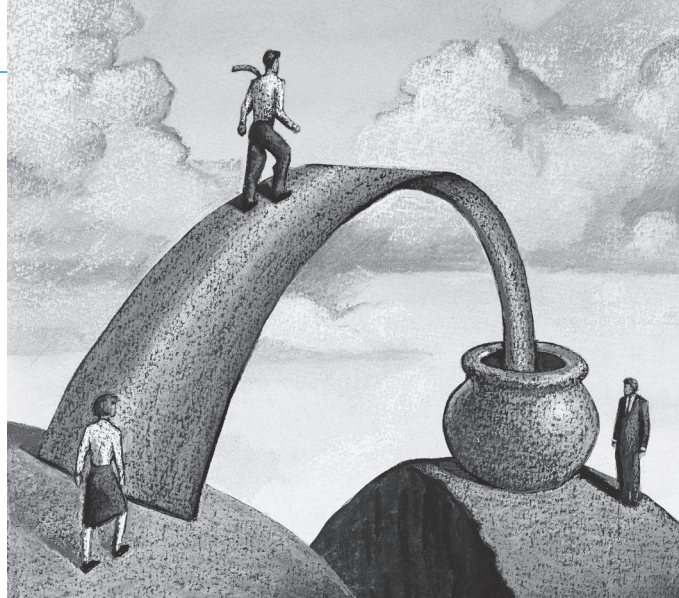


Build success with effective bonus plan

By Bill Fotsch
and Steve Wilson



A business owner passed out bonus checks at his holiday party. They'd had a great year, and everyone had worked hard. The owner spent a lot of time determining each individual bonus amount in a way that he believed was a fair reward for the contribution of every employee. Within days of passing out the bonus checks, however, the business was in an uproar about who got what amount. One manager and two employees quit. The owner was angry that people didn't appreciate the bonus checks that he felt he was so generously giving to his employees.

Perception is reality. When the owner arbitrarily imposed his perception of each employee's contribution, he ran into the employee's perception of that contribution. Because the company did not have a well-designed bonus plan, employees had their own ideas of how big a bonus they felt entitled to.

To keep perception in line with reality, you need a bonus plan that allows every employee to know in advance what measurable goals are expected of them, and what they will receive when they and the team meet or exceed those goals. A bonus plan consists of a series of one or more payments during a one-year period to reward groups for consistently meeting and exceeding expectations.

It's important to understand the relationships between the various forms of compensation in your company. If your wage and salary system is not properly structured, a bonus plan won't fix it. If your work groups rely heavily on individual tips or commissions, a group bonus plan is unlikely to foster better teamwork.

Effective bonus plans share several basic characteristics. When designing your plan, remember the following:

► **Use a basic formula, so that every employee understands the expectations.** Create a simple "scoreboard" to post on the wall, and update it regularly. Most employees can't relate their daily performance to a complex computer spreadsheet produced once a month.

► **Offer a meaningful reward, perhaps somewhere between 10 and 15 percent of an employee's pay.** Early bonus payments start small and get larger toward the end of the year. Once all annual goals are met, the payments increase substantially to reward exceptional performance. To keep your employees motivated, they need prompt feedback at least once per quarter.

► **Plans should be "self-funded" by increasing current or future profit beyond levels that could be expected without a bonus plan.** If your industry average is 3 percent profit, why reward average performance? Employees need to understand that profit is essential to growth and success, so average performance is neither encouraged nor rewarded. Only by producing profit levels that exceed the averages will there be extra money available to reward performance.

Two of the most common types of effective bonus plans are "calendar plans" and "cycle plans." A calendar plan measures performance during a period of time, say a month or a quarter, and pays a reward based on the level of performance achieved by the end of the time period. Employees know when a bonus will be paid, but they may not know the exact amount of the bonus until the final calculation. For example, the 10-20-30-40 Plan is a calendar bonus plan.

A cycle plan, such as the Bucket Bonus Plan, is just the opposite. Performance goals for a year are set in advance and broken into increments. Each time an increment of performance is achieved, a predetermined

amount of bonus is paid, and a new cycle of performance begins. Employees know the amount of the bonus in advance and determine how quickly they will earn the bonus. Both the 10-20-30-40 Plan and the Bucket Plan are effective because they incorporate all of the fundamentals of a good bonus plan.

10-20-30-40 PLAN

Any incentive plan should fit in the context of an overall strategy to improve business results by more effectively engaging employees in understanding and driving those results. So, the first step is to define what "winning" means for the business; not for all time, but typically for the next year. To find the critical number (or numbers) for your business, try a "high involvement" process, getting input from the employees and the management, as well as using company financials and general market information and trends.

Once you have determined your critical number, the next step is to make results visible to all employees, so they can see how the company is doing and how they can affect the results. A good scoreboard enables each department or group in the company to see the impact of its actions. Having employees forecast expected monthly results in their area of responsibility gets them thinking about what they can do to achieve those results.

With your critical number defined and scoreboard in place, you are now in a great position to define your incentive plan. Start by looking at what your critical number performance has been. This becomes a baseline.

If the critical number is not improved above this baseline, no incremental wealth has been created, and therefore there is no ability to fund a bonus. Next, estimate how much the critical number could improve

over the next year. Be aggressive! Frequently, the amount of improvement estimated by the management is exceeded by the employees. A 30 percent improvement can often be achieved in the first year!

Then, estimate how much incremental cash or profit will be generated by the improvement in critical number performance. Let's say your critical number is revenue per employee. You have been at \$100,000 per employee in the last year. You estimate that the team could achieve \$130,000 per employee next year. What would that be worth, given the number of employees you have and the average margin you get on sales? For example, perhaps getting to \$130,000 per employee would generate an additional \$1,000,000 dollars in profit. Great! You now know how much money you have to work with.

And say you decide that 30 percent of each incremental dollar of profit generated will go into a bonus pool. So, if you achieve the \$130,000 level, the bonus pool will be \$300,000. Another way to look at this is to say that for every incremental \$1,000 of revenue per employee above the baseline of \$100,000, the bonus pool will go up by \$3,000. This defines the overall parameters.

Now, you have to determine how to pay out the bonus pool, both in terms of how much each employee receives and when they get paid. You could decide that each employee gets an equal share, so if you have 100 employees, each employee gets 1 percent of the bonus pool.

Many companies choose to distribute the bonus pool based on wages paid. This is a highly objective measure, and it tends to reward employees who have been with the company longer or who have higher levels of responsibility as reflected in their wage level.

Determining when to pay the bonus is the next challenge. You can pay at the end of the year, but that is a long time to wait. It's hard to get employees fired up in January about a bonus that they won't see for 12 months.

The 10-20-30-40 Plan uses quarterly payments. You might want to make "progress payments" that are scaled: 10 percent, 20 percent, 30 percent and 40 percent.

Say the company is on track to pay a particular employee a bonus of \$3,000. Pay \$300 at the end of the first quarter, \$600 at the end of the second quarter and so forth. And

because the bonus is based on cumulative results, even if goals were missed in the first couple of quarters, and no bonus was paid, there is still the possibility to earn the entire bonus for the year. So, if we have a lousy start of the year and no bonus is paid in the first three quarters, but we have a fantastic fourth quarter and we get all the way back to plan, the bonus paid would be the full \$3,000.

A great way to make the bonus visible and demonstrate that it is being funded by the staff's efforts is to tie the updated forecasts for the critical number to their effect on the anticipated bonus. As forecasts for the critical number move up or down, so does the forecasted bonus. These weekly forecasts are the key to improving results.

BUCKET BONUS PLAN

The Bucket Bonus Plan also works best when financial information is updated weekly. Each cycle of the plan is an increment of profit. Visualize it like an irrigation system. Water is pumped from the well (sales) into a pipe.

Along the way, water is drawn from the pipe to nurture crops (expenses), and what reaches the end of the pipe fills a bucket (profit). Every time a bucket is filled, part of the water is given to the employees as a bonus.

The first few buckets pay smaller amounts, and the amount of the bonus increases with each bucket. Fill the bucket four times and get four bonus payments. Fill it eight times and get eight payments.

Operating the Bucket Plan is just as simple. Put the outline of a bucket on the wall. At the end of each week, estimate sales, expenses and profit. Use a highlighter to fill the bucket corresponding to the profit for the week. When your accountant completes a monthly financial statement, adjust the next weekly estimate to bring the level in the bucket in line with actual profit. When the bucket is filled, give everyone a bonus! You'll be surprised how quickly people understand that more sales or fewer expenses will fill the bucket faster and they'll get more bonus checks.

Encourage your staff to fill lots of buckets by starting the bonus small and increasing the amount with each

bucket. For filling the first bucket, each employee gets \$300. The second bucket pays \$360, and so on.

To make the bucket plan even more effective, incorporate critical numbers into the amount of the bonus paid for each bucket. Let's say you decide to pay a \$150 bonus to every employee for filling the first bucket. Add \$75 to the bonus if sales are 30 percent ahead of last year at the point the bucket is full. Add another \$75 to the bonus if defective work is less than 1 percent.

The potential bonus is still \$300, but employees must meet all three goals — profit, sales growth and quality — in order to get the full amount. For the second bucket, allocate the \$360 bonus to \$180, \$90, and \$90 respectively. Increase all three amounts proportionately for each bucket filled. For each cycle of the bucket, employees must learn how to balance profit, sales and quality to earn the maximum bonus.

NO BONUS WITHOUT PROFIT

Many profitable companies go out of business because they run out of cash or provide poor products and services. The best bonus plans often include rewards for improvements in two or three other critical numbers that must be balanced with short-term profit. Increasing sales or improving quality can require spending money now in return for future profit and growth. The goal of the bonus plan is to involve every employee in finding ways to maximize the return on investment needed to move the critical numbers in the right direction.

Remember, when selecting critical numbers, focus on areas where every employee has some influence over the outcome. Sales growth is an example of broad involvement. It is possible to get every employee involved in producing sales. On the other hand, employees have much less influence over raw material prices. Basing your bonus plan on a few critical numbers doesn't mean you ignore other important measurements. Make your bonus plan effective, and watch your profits soar! 💰

Since profit is essential to growth, average performance is not encouraged nor rewarded.



(L-R) **Bill Fotsch** is head coach for *The Great Game of Business, Inc.*, a subsidiary of SRC Holdings Corp. For further information, call 800.386.2752 or visit www.ggob.com.

Steve Wilson is president of Willow Creek Consultants and founder of Mid-States Technical, an INC 500 engineering services firm in the Midwest. You may reach him at 208.762.8638 or visit www.willowcc.com.