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Bonus Incentive Plans for Employees: What's the Point?

When we ask business owners about the possibility of installing an employee incentive plan, we often hear one of two responses:

- “I would like to do something to reward my key employees for their performance.”
OR
- “You know, one of my best employees left last week for a company for more money. I think I'd better do something to stay competitive in the marketplace.”

May I suggest that these two motives are not nearly self-serving enough? The purpose of installing a bonus plan for your employees is to motivate them to help you pursue your goals.

While owners differ about when they want to leave or how they wish to leave, or even whether they want to leave their companies, the underlying goal is consistent: whatever the ultimate departure – be sure to leave in style. No matter what type of employee incentive plan you create, it should be designed to support your fundamental goals by motivating your key employees to stay with your company and help build its value.

Consider the following realities:

- Some owners may rarely take an extended vacation much less cut back on their ongoing involvement without leaving capable management in place to run the

business.

- A sophisticated buyer may not seriously consider your company if it lacks a good management team;
- You may, at some point, entertain the idea of selling the company to key employees; and
- Transferring a business to children can be especially risky in the absence of key employees who will remain with the new owners.

Whether your goal is to sell to a third party, transfer the business to children or to employees, or to retain ownership long-term, the success of your strategy may depend on the presence of motivated, high-performing key employees.

We measure the effectiveness of an employee incentive plan in part by how well it motivates key employees to increase the value of a business. Effective plans necessarily reward employees as they increase the value of the business.

Usually, this means that owners must develop an incentive formula that links increases in the key performance indicators of the business to the employees' rewards. In its simplest form the incentive plan gives the key employee a bonus. In designing a strong incentive plan, consider the timing of the bonus that creates the best incentive. You may want to consider designing a bonus program with an additional incentive for key people to stay with your company – a “handcuff” of sorts.

Let's look at how one owner set up his company's incentive plan.

After meeting with his advisors, Mel Houston decided to give two of his key employees 30 percent of the company's pre-tax income above \$100,000 (the company's historic performance level). After Mel installed this plan, the company's pre-tax income increased to \$300,000 so his key employees shared 30 percent of the excess income (\$200,000) or \$60,000.

Because Mel wanted to retain his key employees over a long period of time, he decided to pay half of this bonus after the company's year end, and subject the other half to a non-qualified deferred compensation plan with vesting over several years.

Mel's plan (like yours should) provides that as the cash flow of his business increases (and thus the value of the business increases), he rewards his key employees accordingly. In doing so, both he and his key employees attain their goals.

Notice that Mel does not have to reach into his own pocket to pay the bonus. Instead, he is merely sharing a portion of the growth that they create. You may also notice that Mel benefits in two ways from the increase in income. First, he shares in the increased income and cash flow. Second, the value of his ownership interest most likely increases by some multiple of increased cash flow.

Keep in mind that the formula you create for your company can and should reflect the

specific characteristics of your business. The head of the sales department might be rewarded for increasing the adjusted gross profit margin. A chef in a restaurant might be rewarded for reducing food costs (without affecting the quality of the meals served). Whatever factor you identify as a key to increasing the value of your company can be incorporated into your key employee incentive planning.

If you would like to discuss your options for installing employee incentive plans to support your goals, please contact us. We can collaborate with you and your other advisors to develop a customized incentive plan tailored to your business and your future.

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The example provided is hypothetical and for illustrative purposes only. It includes fictitious names and does not represent any particular person or entity.

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