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Characteristics of Bonus Incentive Plans

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 keep key employees on board? Rather than tie them to the mast, many owners install Employee Incentive Plans that motivate them to stay. In doing so, owners also work to achieve the goal of ensuring their successful exits.

We have identified 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 is communicated clearly by the employer and understood thoroughly by the employee. Therefore, successful plans are in writing and are based on determinable standards. To be successful, employees know that the plan exists and how it works. Plans are 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's bonus is tied to performance standards. Owners often work closely with their advisors to determine which performance standards should be used—perhaps net revenues or taxable income above a certain threshold—for which employees.

The standards of performance that the owner chooses must be ones that the employee's activities can influence and that, when attained, increase the value of the company.

Let's look at how one owner accomplished exactly that.

Duke Manning was struggling to keep his renowned, yet temperamental, chef in line. Henri always wanted more money even though the profits of the restaurant, specifically the kitchen, were uneven. Since Chef Henri controlled both the food costs and the labor costs, Duke and his advisors designed an incentive plan to encourage Henri to keep both items in line, but not too low.

Duke's incentive plan worked as follows: If quarterly food costs were no greater than 26% and no lower than 22% (a range we once believed necessary to keep food quality high) Henri would receive incentive

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compensation equal to 1% of the restaurant revenues. Similarly, if quarterly labor costs stayed between 25% and 21%, Henri would receive another 1% or a possible total of 2% of the gross revenues. Duke determined that if the kitchen could not stay within these ranges, profitability or the reputation and quality of the restaurant would suffer. If the restaurant prospered, revenues could be in excess of $3 million and Henri could earn as much as $60,000.

The result? Henri was motivated to increase revenues, because his bonus would increase while keeping costs and quality in line.

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.

Recall Henri's incentive. Because Duke wanted to keep Henri for the long term, Duke paid half of Henri's bonus to Henri as he earned it and deferred (and subjected it to a vesting schedule) the other half. Of course, if Henri left the restaurant before he was vested he would forfeit half of his bonuses. (Read more about vesting in Issue 19 of **The Exit Planning Review™).**

If you're interested in learning more about this important topic, we have a host of other tools in our incentive plan arsenals to help you design a successful employee bonus plan that contributes directly to the success of your business exit.

Subsequent issues of The Exit Planning Review™ provide balanced and advertising-free information about all aspects of Exit Planning. We have newsletter articles and detailed White Papers related to this and other Exit Planning topics. If you have any questions or want additional Exit Planning information, please contact us.

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