How to Make Employee Bonus Plans “Pay Off”!

So you have established a bonus plan for your employees. Congratulations – you’re in good company! A recent study of more than 3,000 employers nationwide shows that 75% of organizations have some type of bonus or incentive plan in place below the officer level. This percentage has continued to rise, even through the recent economic downturn.

Bonus plans are becoming particularly popular with small and mid-sized businesses, as owners seek ways to engage their key employees in helping the company grow and prosper – and then share the rewards of their collective efforts.

There is hesitancy, however, among many business owners to formalize and document these plans. We prefer to keep them flexible and discretionary, to leave our options open until the last minute (typically year-end), and then award based on the degree of largess we feel at that particular moment.

This is fine, if what we wish to accomplish is sharing the results of a good year with our employees. They appreciate the additional money and our willingness to spread the wealth around. But what if we want more? What if we wish to:

- Focus employee attention on the key drivers of the company’s success?
- Propel performance improvements?
- Reinforce the outcomes that are critical for growth?
- Assure an adequate “return” on the additional money paid out in bonus awards?

Research tells us – and my personal experience in the field of compensation confirms – that the way to get the most impact from a bonus plan is to establish a direct causal connection between performance and the reward. In other words, there must be a clear “if this, then that” relationship in place. To the extent that we introduce uncertainty and other noise into this relationship, we reduce the impact that the bonus plan will have on performance.

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>
> — Ann Bares, Altura Consulting

There are essentially two different philosophies regarding bonus plan design and administration:

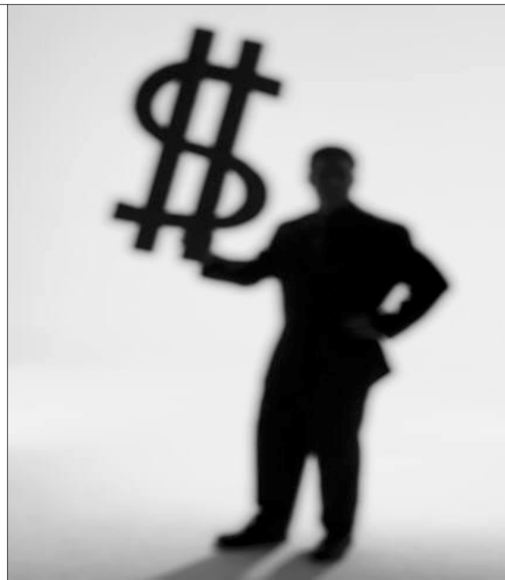
The "Distribution-of-Funds" Philosophy

Profits or some other measure of financial performance creates a pool of available funds, and the bonus is a means of distributing those funds among employees. The biggest advantage of the distribution-of-funds approach is the sense of security and control it creates for owners and management. The biggest downside; these plans have not proven to be particularly effective in driving performance results. These plans may be best characterized as "low risk, low reward".

The "Creation-of-Funds" Philosophy

This approach is also known by the term "self-funded bonus plans". Here, the bonus is seen as an investment which creates its own funds by driving the desired performance results. The plan is designed with a few key measures tied to pre-defined award amounts for different levels of performance. For example, the plan might state that if the company reaches its goal of $1 million in net income, every eligible employee will be awarded a bonus equal to 5% of their base salary. If well designed and executed, this type of bonus plan should generate the gains required to cover (or justify) the costs of bonus awards, plus some.

I happen to be a big proponent of the creation-of-funds approach. I appreciate



the upfront commitment that these plans require from business owners, but I have also seen their power to get employees engaged in making a difference. And any risk associated with this commitment can be significantly mitigated through solid planning and cost modeling.

When considering the move to a more structured bonus plan, there are a number of strategies for increasing your odds of success:

1. **Clarify it.** Be very clear on what you want the bonus plan to do for you and how you will measure whether it gets there or not. Only then will you be in a position to gauge its success later on.

2. **Challenge it.** The most effective bonus plans are almost never developed by one or two individuals working in a vacuum. Get your initial design ideas out in front of a bigger audience for input and reaction. One of the biggest potential pitfalls in bonus plan design is something that compensation professionals call "the law of unintended consequences". The best preventative strategy for this is to involve as many different perspectives as possible during the design process.

3. **Cost it.** Calculate your anticipated "return on payout". Don't wait until year-end to discover how much you will be spending on bonuses; examine this early on as part of your design effort -- *before* you communicate anything to employees. Make sure there is an appropriate balance, under different potential performance scenarios, between the dollars paid to employees and the value received by the company.

4. **Communicate it.** Get the word out, preferably in face-to-face meetings. Employees need to understand not only how the plan works, but also what they can do *every day* to improve the performance measures on which their bonus depends.

5. **Change it**. That's right. Or at least evaluate it every year for its continued fit to your company's reality and strategic objectives. As your business priorities and opportunities change, so, potentially, should your bonus plan.

When you make that key decision to join the growing ranks of bonus paying companies, be sure you take the steps necessary to make your bonus plan pay off for you!

Ann Bares is managing partner with **Altura Consulting Group LLC**. Altura provides management consulting services with a primary focus on compensation and performance management solutions.

[contact]

Ann Bares can be reached at
(763) 745-9425 or
abares@alturaconsultinggroup.com