Cogent Analytics

Incentive vs. Bonus Payment Structure

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I. ABSTRACT BONUSES VS. INCENTIVES DEFINITION

Bonuses and Incentives are important pieces of your employee's compensation. Most of the best performing companies pay their employees bonuses and incentives based on their work. They do so, to keep their best employees motivated and happy with their career and pay. The biggest question many business owners and management whether to implement a bonus OR incentive plan in their organization. Payscale.com states "Whether you choose to use incentives or bonuses will depend on the needs of your specific organization, taking into account your organizational culture, your business goals, and your workforce". A bonus is an optional pay reward for a specific achievement, whereas an Incentive is part of a strategic plan. Both should not be confused with commissions as this is a variable pay generally tied to a sales matrix." (Payscale, 2017)

Bonuses that are given out by most companies are usually the year-end variety and are either given out to everyone in the organization or are based on subjective data.

As a result, most of the bonuses are just gifts handed out by the company Owners. While there is nothing wrong with gifts, they do not stimulate increases in productivity and teamwork within the organization.

Incentives are designed to provide a stimulus to increase productivity and improve quality within the organization. They are based on objective, measurable guidelines, and specific goals that may be given to individuals or positions within the business.

II. BACKGROUND WHAT, WHY, WHO & HOW MUCH?

As a business management consultant, I often hear from employers as the year-end approaches, which are better bonuses, or incentives and how do they allocate it fairly, equitably, and by how much?

Too often, employers feel compelled to distribute bonuses at the year's end regardless if profits had been made or not. Also, distributions with many are based on factors unrelated to job performance and or increased profits. However, before implementing any bonuses and or incentives, you must start by pre-engineering a profit target.

As a young man growing up and entering the job market, my parents encouraged me always to save 10% of my take-home pay and live off the remaining 90%. With this, they stated that I would then never be broke, with a business, it's not much different. A business should treat profit as an expense to its fixed costs. Place the first 10% of their revenue or whatever profit percent target is they want to achieve into their top line and then operate the business from the remaining income.

III. NEED

Pre-Engineering a Profit -

So how do you pre-engineer profit? First, profit must not be viewed as merely an amount that is left over after all the bills have been paid. Profit levels should be planned, and expenses controlled to achieve that plan. Too many businesses work all year long to merely accept what is left from Sales, Costs, and Expenses.

Profit & Expense Controls Defined -

Profit and Expense Control is defined as a system that provides control over costs and expenses within the business model concerning the fluctuations in sales volume to arrive at a predetermined profit. Said another way, you must control expenses as your sales fluctuate throughout the year. This does happen automatically. As the owner, you must manage your business to succeed and reduce expenses or increase sales when a customer and economic demand dictate.

IV. SOLUTIONS

Pre-Engineered Profit Solutions -

Current Profit formula: Sales – Expenses = Profit.

This is an example of how many companies currently operate. Profit is a result of what is leftover at the end of the month and year. More times than not, you have worked all year long only to find out from your accountant what profit, if any, was generated. While the equation is mathematically correct, the thinking is not!

New Profit formula: Sales – Profit = Expenses.

This formula suggests that your company's plan for annual sales, establishes its profit expectations, and then makes the adjustments necessary to make expenses fit into the equation. If expenses do not work out (planning expenses below the level needed to complete the operations of the business), then you must either raise your sales expectations or lower your profit expectations once established. However, PROFIT becomes a non-negotiable expense item. Once the plan is set, profit should not be compromised. Reduce expenses, manage labor, eliminate unnecessary costs, increase profit margins within the bidding process, or increase sales to ensure the established profit goal is attained throughout the year. Profit should become the most non-negotiable expense item in your business.

The Profit Planned Process

The Profit planning system is not intended as a device for reducing expenses and costs below the levels necessary for accomplishing specific objectives. If utilities expense is $10,000 annually, it is unrealistic to believe you could reduce this expense and plan for $5,000 annually. It is, however, designed to manage those expenses once planned. For example, it is not a wage reduction plan. Still, it is intended to provide the application of sound management in making decisions on labor when sales activity, productivity, and capacity dictate changes be made. When direct labor is not necessary, they must be sent home. If there is nothing to build, we don't need them here. As stated earlier, the plan MUST BE REALISTIC and ATTAINABLE.

1) The primary objective is to provide a realistic predetermined margin of profit through.

2) The establishment of revenue, cost of goods, gross profit, and overhead expense goals through forecasting.

3) Developing plans to achieve forecasted objectives. Assigning revenue and expense categories to your key employees and or departments, therefore, assigns accountabilities. Your management team and key supervisory employees must understand the impact they have on Gross Profits, which ultimately leads to managing performance productivity and improved revenues.

DEVELOPING THE ANNUAL PRE-ENGINEERED PROFIT FORECASTING

Designated responsible personnel are assigned to forecast sales and to budget each expense item for the fiscal year. This primarily falls into the hands of the owner to initiate and direct the annual forecast but certainly the management team should be involved as you plan all the categories of Revenue and Expenses. The more the senior team members are involved in the planning process, the more buy in and support you will have in executing the plan. Profit Planning is done prior to the end of the fiscal year and should be accomplished within a month or two of year end. The bookkeeper may need to provide more information by category as they have intimate knowledge of the accounting system and categories. Once the plan has been established, the ultimate responsibility for attaining the objectives rests with the OWNER.

After determining the profit plan, it should be distributed and assigned with the authority to manage and the ability to affect the outcome. For example, the direct labor and material budget should be assigned to the Operation Manager. Sales objectives must be assigned to the Sales Manager as well as any expense associated with and affected by the sales team. If all the sales, costs, and expenses categories are not distributed, everything falls back on the OWNER which is many times too overwhelming.

Typically, the normal method used in profit planning development includes reference to at least the last two years of historical operating results along with reasonable, realistic operational expectations for the coming year. When reviewing the historical information, it is wise to look at the results from a monthly perspective rather than simply an annual review. Digging into them on a monthly basis can reveal opportunities not otherwise seen in total. Keep in mind, that departmental profits are more responsible for profits related to variable and or, direct expenses and less on fixed. The exception may be accounting which may or, may not have some influence over fixed costs.

Historical data is to be collected and reviewed and should be used to set overall goals and objectives for the business's upcoming year. All the approved forecasts are put into final form and reviewed with all responsible personnel to make them aware of the final plan. These operating standards become the acceptable means of measuring performance and results.

Once the plan is in play, last year is no longer meaningful. The company only uses last year's numbers to help plan the future. Beating the Plan is the real measuring device for performance management and profit improvements.

Once the plan is established and approved, the profit for the Company is now predetermined. The major consideration of all responsible personnel is to ensure that their planned goals and objectives are achieved so that the predetermined profit will be realized. Since the profit plans coordinate all activities on all levels, this becomes a fully attainable profit improvement to support profit-sharing incentives and or, bonuses

V. BENEFITS

PERFORMANCE BASED INCENTIVES TIED TO PROFIT PLANNING

As the company achieves financial growth and outperforms the previous year's targets, the company can then reward all those who personally contributed to improved productivity and financial growth. With that being said, I will discuss two types of performance-based incentive plans that I have individually implemented to achieve a desired pre-engineered profit.

As mentioned before, the most successful businesses keep their best employees. One way to do that is to incentivize hard-working, dedicated, successful employees. Incentive plans and bonuses keep employees engaged and motivated to further the success of themselves and the company. From Chron, "An organization with motivated employees enjoys high productivity and satisfied workers. Keeping Employees motivated should be a priority in companies." (Johnson, n.d.)

DEPARTMENTAL TEAM INCENTIVES

I have attended national performance management workshops and additional research through Bersin's, Deloitte, The Society of Professional Human Resources, etc. I have uncovered two incentive programs that I have divided into two categories, the first was the departmental team incentive, and the second was the individual incentive. I will first start with the Departmental Incentive.

At the time I discovered this, I was working with a large insurance company that was evaluating employee performance utilizing a five-point rating system that was administered annually. This was not only an annual event to check the boxes to get the reviews done before the year's end. The tasks as designed opened this rating up to too much subjectivity based on canned soft skills and less on performance metrics. As designed, the highest score was (5. Exceeding expectations), and the lowest score was (1. Below Expectations). The overall percent in the study showed that very few exceeded the medium threshold either way. Approximately 70% met expectations, 10% were above expectations, with around 2% below expectations, and the remaining were too new to judge.

In this case study: We utilized departmental goals due to the many shared activities needing to be done within the departments. Besides, the Managers provide monthly 15-minute coaching and feedback sessions on objectives within their department with all their direct reports so that 6 and 12-month evaluations were more realistic and less subjective. Departmental Goals budgeted pre-engineered profits within the span and control of each department. If that department contributed to 25% of the profits, their share of the overall profit pool would equate to a 25% share. The rating system was now reduced to four measures 1) Exceeds Expectations 2) Meets Expectations 3) Below Expectations 4) Owners Discretion.

How was the incentive pool divided among team members? If the allocated pool for this department was $10,000.00, and the medium score provided was 70% meets expectations, then $ 7,000.00 would be distributed evenly to those who met expectations and above. Those within the 10% group who exceeded expectations would divide an additional 10%. For those who fell below expectations, they would be capped at a 2% cost of living adjustment. The owner then, at their discretion, could distribute the remaining amount to employees that had gone above and beyond to create an exceptional experience and service.

PERSONAL CONTRIBUTIONS

This example is based upon an individual's job performance and quantitative measurements, as well as Company Profits.

How is this pool divided? (as exampled in "worksheet A")

Incentive Pool: This represents the amount of money that is set aside for distribution to those eligible employees. It is based on the company exceeding its profitability goals. Funds that generate the incentive pool consist of a predetermined percentage share of the dollar amount the company exceeded their predetermined profit. The goal is that all these dollars be distributed. The actual individual payout, however, is affected by other factors such as the Employee Appraisal, Longevity with the company, and position. The Incentive Pool, therefore, is a potential figure.

Weighted Shares: This represents the method for determining the amounts that each position or individual associated with the company is eligible to receive under the Incentive Compensation Program.

Evaluations: The periodic employee performance appraisal will be used to determine eligibility for any incentive payout. This is the one real factor in which the employee can control and directly related to their performance contribution.

Minimum Expected Profit: This represents the amount of profit the company is expected to yield during the quarter and or annually.

VI. EVALUATION

GOAL SETTING – (to achieve Incentives that work and lead to Pre-Engineered Profits.) When selecting a system by which to motivate people, we must determine the method of setting the measures of achievement by which these incentives are to be awarded. An incentive system to be effective must have predetermined or known goals. Without predetermined targets, the employee has no control over his performance.

What is a good goal:

1) It contains known and achievable objectives.

2) It must be under the control of the participants.

3) It must be of known value.

4) It must be fair.

5) It must have measurable elements or qualities.

6) It should avoid subjective influences (This may be difficult in many circumstances).

Ideally, the payout interval should be paid out when it equals a minimum of an employee's one week's pay or, more to inspire performance. A payout of less than a week's salary will be less motivational.

VII. COSTS

METHOD FOR CALCULATING THE ACTUAL INCENTIVE CONTRIBUTION

Example: WORKSHEET “A”

Company Incentive Plan
Employee Incentive Plan Worksheet

Incentive Plan Parameters			Profit Shares		
% of Excess Profits to the Plan:	25.00%		>$500,000.00+	we will give	25%
			$$451,000.00-$499,000.00	we will give	20%
# of Months in Incentive Period:	12	OVERRIDE	$400,000.00-$450,000.00	we will give	15%
			<$375,000.00- $399,000.00	we will give	10%
Evaluation % Allocations:					
Between:	90	and	100	we will give	100%
	80	and	89	we will give	75%
	70	and	79	we will give	50%
	69	and	0	we will give	0%

Calculation of Bonus Pool						
Month/Day/Year	Budgeted Profit	Actual Profit	Excess Profits	%		Bonus Amount
June 30, 2019	$2,209,302.00	$ 2,300,000.00	90,698.00	25.00%	$	22,674.50
Sept 30th 2019	$2,175,922.00	$ 2,200,000.00	24,078.00	25.00%	$	6,019.50
December 31,2019	$1,806,083.00	$ 2,000,000.00	193,917.00	25.00%	$	48,479.25
March 31st., 2019	$1,442,772.00	$ 1,500,000.00	57,228.00	25.00%	$	14,307.00
Totals	7,634,079.00	8,000,000.00	365,921.00		$	91,480.25
(+/-) Carryover from Prior Period	(including losses)		0.00		$	-
Total Amount Available					$	91,480.25

WORKSHEET “B

INCENTIVE PAYOUT

PERFORMANCE POOL	112,000

Participation Factors

Length of Service		Position			Performance Evaluation	
A : Over 9 years	100	100	A : Executive	100	A : Rating 75% to 100%	100
B : 5 to 8 years	75	75	B : PM or Supv	75	B : Rating 60 to 74%	75
C : 2 to 4 year	50	50	B : Internal Support	75	C : Rating 50 to 59%	50
D : 1 year or less	25	25	C : External Support	50	D : Rating below 49%	0

Pool Distribution

Employe		Se	Factor	Posit	tor	valuatio	ac	Pool Poin	Share %	Paymen
Acord	Jim	C	50	B	75	A	100	3,750	0.49%	$549.02
Aldrich	Terry	C	50	C	50	A	100	2,500	0.33%	$366.01
Anspaugh	Bill	C	50	C	50	A	100	2,500	0.33%	$366.01
Autph	Jack	C	50	A	100	A	100	5,000	0.65%	$732.03

COMMUNICATING ANNUAL INCENTIVE POOL INFORMATION

Hold Semi-Annual Company employee meetings after the financial close of the previous quarter, target ten working days after the quarter close. Graphically communicate the Company semi-annual revenue goal for the full 12-month period. Verbally review the last half year's performance, address both positive and negative points. If the semi-annual financial performance was positive, announce the percentage above the base amount that was achieved and will be added to the Incentive pool. If the semi-annual financial performance was negative, announce the percentage below the base amount that must be regained before any contribution to the Incentive pool.

Show the difference in the sales and expense dollars as a percentage based on the goal of X % base profit. Each quarter is looked at separately and then a cumulative value of the Incentive Pool percentage as noted.

QUALIFICATIONS FOR PARTICIPATING IN THE INCENTIVE POOL

USING WORKSHEET “B”

The most recent performance evaluation rating will be a factor in determining each employee’s share of the pool. Employees who rate less than 1.70 are not eligible to share in the pool.

For example:

Evaluation Rating:	Evaluation Factor:
A-1	2.00
A-2	1.90
A-3	1.70
B-1	1.90
B-2	1.70
B-3	1.50
C-1	1.70
C-2	1.50
C-3	1.30

Length of Continuous Service will also have an impact on determining the employee’s share of the pool as follows: (Example)

Length of Service:	Service Factor:
Past 2010	100
2011-2015	75
2016-2018	50
Less Than One	25

Position Factor will be determined as listed: With more responsibility comes more weight

Executive Team – 100

Project Manager / Supervisor – 75

Internal Support – 50

External Employees – 25

All employees should know of the intention to utilize this Incentive Compensation program, informing them of the current performance levels and how it will impact their potential incentive payouts.

Employees should be further instructed to understand that changes might be made to this incentive program, without prior notice, at the discretion of the Owner. Factors that would necessitate a change in the program would be a change in the business or economic conditions. Otherwise, the payout would become a gift resulting from increased profitability caused by an external influence.

Also, any previous quarter losses are subjected to an incentive reduction in the following quarters. This is sometimes caused by chargebacks and or change orders following the close of a previous quarter.

VIII. SUMMARY

The incentive systems addressed were designed to reward PERFORMANCE based on contribution to bottom-line results – In other words, to achieve Pre-Engineering Profits. It is necessary that the individuals who are eligible to participate in either Incentive Compensation Programs are aware of the system and how it operates. This means that they must know their Incentive is strongly influenced by their score on the Performance Appraisal System. Besides, they must understand how this system works and how the dollars for the Incentive Pool are determined.

As mentioned in the above definitions, an incentive program should be implemented to reward employees for performing excellent work beyond acceptable work standards and for acting in a capacity (high productivity and quality), which directly impacts profit and revenue enhancement Incentive programs should not be viewed as an integral component of the primary competitive compensation program. A competitive compensation program is developed to attract and maintain qualified employees. Incentive programs are implemented to reward an individual for achieving high performance and recognition for direct, positive contributions to Company profits. When the company understands where it wants to be with established Pre-Engineered Profits, the Performance Standards can also be set to direct employees toward set performance incentives over occasional bonuses.

Johnson, R. (n.d.). What Business System Should Be Used To Motivate

Personnel? Retrieved December 19, 2019, from Small Business: https://smallbusiness.chron.com/business-system-should-usedmotivatepersonnel-30805.html Payscale. (2017, June 30). Payscale. Retrieved December 19, 2019, from https://www.payscale.com/compensation-today/2017/06/difference-bonus-incentive