

How to Design a Good Incentive Plan

by Bob Normand

SUMMARY: Small businesses can utilize incentive plans to reward employees' exceptional performance. Incentive plans should not result in arbitrary distributions of money casually decided upon by senior management. Instead, a good incentive plan must be quantified, must be a predictable result to the employee and must be directly related to measurable performance beyond the norm. This differentiates incentive plans from savings or retirement plans. Incentive plans should be fully integrated with performance objectives of the company and the individual goals of employees.

Incentive Plans Should Be Universal

Get your entire staff to pull in the same direction by designing your incentive plan to include all employees at some level of participation and only after a temporary evaluation period with the company (often 90 days). Many plans include part timers as well as full timers but at a somewhat lesser share of the proceeds.

Incentives Must Be Significant and of Perceived Value to the Recipient

To create a real incentive, the recipient must perceive the potential reward as a significant addition to income. Otherwise, the incentive is looked upon as deserved supplemental income or even a "benefit". To add further to the perceived value, there should be public (company) recognition of the employees' performance.

Incentives Should Relate to Individual Performance

A factor in the determination of how much an individual employee receives should be their performance rating as determined by their last formal job review and appraisal. All other things being equal, a superior job performance should command a higher share of the incentive proceeds.

An Incentive Plan Should Include a Factor for the Employee's Overall Job Responsibility

It is reasonable to relate an employee's rating for incentive purposes to their overall responsibility in the company as determined by the number of employees supervised and/or budget for which they have direct control. General categories can have different ratings in the incentive distribution process (hourly/clerical, supervisor, department head or officer).

A Good Incentive Plan Should Include a Factor for Employee Loyalty

It is reasonable to associate time with the company as "loyalty". An employee that has been with the company for 25 years should have a somewhat higher rating for incentive proposes than someone having only 1 year. A factor can and should be included in the incentive program for employee tenure.

Incentive Plans should be Based On and Pay a Predictable Share of "Excess Profits"

Set a trigger profitability level that must be achieved before incentives are paid and communicate this clearly to all staff. The trigger level should provide a base for company growth and replacement of capital. Many small businesses find that this occurs at the 8-10% net profit level but each company may vary this within reasonable bounds . It is to be understood that a portion of the profits above the trigger level will be shared. The aggregate % share to be distributed to participating employees is determined by company owners but should not be so low as to yield little employee incentive nor so large as to give away the bank. Typically, this share is in the 25-50% range. Disclosing the trigger level and distribution share percentage is at the discretion of the

owner but the more open the system is the more trust, rapport and enthusiasm will be developed with the staff.

Devise a Distribution Method and System to Manage Incentive Disbursements

Devise a rating system that accumulates the value of the criteria mentioned above (responsibility, loyalty, performance). Aggregate the values for all employees. Determine the amount of money to be distributed as a percentage of "excess profits" and divide that amount by the aggregate points for all employees to determine the dollar value per point. Individual incentives can then be determined by multiplying the individual's score by the average value per point. A spreadsheet can be easily set up to automate this task with only a little maintenance required to update employees and employee performance ratings.

Distribute Incentive Distribution Payments Frequently

Pay incentives as frequently as practical but no less than once quarterly, otherwise the incentive is not kept in front of the employee and the incentive weakens. Annual bonus plans, such as a Christmas Bonus are not looked upon as incentives; instead they often are viewed as supplemental income or even an entitlement. Incentive payments should be viewed much like salespeople's commissions, if not, the incentive feeling in the average employee wanes quickly.

When Incentive Plans Are Not Incentive Plans

Avoid devising a system that pays on a percentage of salary as it is difficult to relate to the three criteria stated above (responsibility, loyalty and performance). Even though companies contribute mightily to savings and investment plans such as 401k's, do not look upon these programs as bonuses. They are simply supplemental income, and although they may affect loyalty, they do little to meet the other two criteria.

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