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 we suggest that these motives are not nearly self-serving enough? The real purpose of installing a bonus plan for your employees is to motivate them to help you reach your financial and transition goals. Your employee incentive plan should be designed to support your fundamental goals by motivating your key employees to stay with your company and build its value.

Consider the following realities:

- Few owners will take an extended vacation much less cut back on their involvement without leaving capable management in place to run the business.
- Most sophisticated buyers will not seriously consider a company that lacks a good management team.
- Many, if not most, companies are sold to key employees.
- 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 or to transfer the business to children or to employees, the success of your strategy depends on the presence of motivated 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.

Linking Company Financial Success to Employee Rewards

Usually, this means that owners (and their advisors) must develop an incentive formula that links increases in the income or cash flow of the business to the employees' rewards. In its simplest form the incentive plan gives the key employee a cash bonus. Part of the bonus is paid currently and part is subject to vesting thus handcuffing the employee to the business.

Here's an example of how one fictional owner set up his company's incentive plan:

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

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

Austin'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.

Keep in mind that the formula you and your advisors create for your company can and should reflect the specific characteristics of your business. For example, the head of the sales department might be rewarded for increasing the adjusted gross profit margin. 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'd like to explore how an employee bonus plan might work for your business, we can help. We can help you identify the objectives for your plan and determine the best way to structure and install a plan to meet those objectives.

For more information or to learn how L. Harris Partners can help you grow your business:

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