

Devising a Game Plan for Bonuses

12/11/06

I'm getting ready to do year end bonuses. We've had a good year, and our revenue is way up. I want to recognize the performance of some of my star players, as without their contribution we wouldn't have done as well.

This week's question comes from the owner of a service and manufacturing company operating in Westchester and Connecticut. They have had a good year, revenue wise, and are positioned for growth for 2007. They have some good employees, as the owner indicated, and are starting to worry about how to keep those people around and engaged for another year. Let's take a look at how to help this owner with her question.

Bonuses are great, but can also get you into trouble, so be careful and have a game plan you can live with. First, be sure you can afford it. Be sure you can live with the precedent. Be sure that you can explain and defend what you distributed and how you did it. Finally, use the experience to begin to form a model you can use going forward.

Let's start by looking at what you can afford. Just because the company had a good year, revenue wise, does not necessarily mean you made a lot of profit. And profit is where bonuses should come from, not revenue. Be sure that you check your Profit and Loss Statement,

for net profit and net income. Also check your balance sheet, comparing your debt and accounts payable positions this year vs. last year. Be sure that debt and accounts payable are both down versus last year before you start handing out bonuses. That is the source of your bonuses, and you can only use a portion of that money.

Also, going into next year, you're going to need cash reserves to solve problems and handle things that don't go as planned. Regardless of what you do with bonuses, be sure you keep enough money on hand so that you can cover at least 1-3 months of expenses. Savings are what will protect you, your company, and the employees you're trying to reward, throughout the next year. So, before you distribute money for bonuses, check that you have enough cash on hand to be able to keep up with your savings goal, as well as your bonus goal.

Once you've determined that you have enough money to pay out bonuses, determine how much money you're going to pay out, in total. This is called your bonus pool. This is the total amount of dollars your company will part with, to reward employees and owner, above and beyond salaries paid to date, for a job well done.

Now make a list of employees who are eligible for bonuses.

Don't just reward people who did something wonderful in the last month or two, or people who stand out in your mind because you work closely with them. You may want to start with a list of all employees, and to the right of each name, list accomplishments that would qualify them for a bonus.

Be careful to consider both exempt and non-exempt employees for bonuses. Employees in the administrative and secretarial ranks in the office, and people at the lower rungs of your operations, are often some of your most consistent, reliable, and important performers. While they may not bring in the next big deal, without their steady, thorough approach to doing their jobs well, bringing in the next big account would be much more difficult, if not impossible.

One way to gather data about employees, in preparation for bonus time, is to ask employees to submit a list of above and beyond accomplishments for the year. You can also ask department managers to provide input on the employees they believe deserve special recognition. Going into the year, you can keep a file on each employee, and drop in notes throughout the year, as you and others observe outstanding performance.

Remember, in the hunt for the bonus pool, it is easy to

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recognize the most vocal, the most visible, and the most demanding employees. However, you may find that your best, steadiest, most consistent players are easy to overlook. Be careful to reward consistent performance, recognize steady progress and measure overall contribution. If this were baseball, you'd be looking for the player who can hit base hits all day long, more than you're looking for the player who can hit one or two home runs per year but strikes out the rest of the time.

You may also want to sort employees by the level of the position they hold, or by their salary level. This way, you will be able to proportionally scale any bonus, appropriate to the employment level and income of the person. Think about bonus levels – such as 1, 2, 3, 4. Level one is a small bonus, say 1% of salary; and a level four bonus would be significant, say 10% of salary, for example. Levels two and three would be somewhere in between. Then you can select a level of bonus for that individual employee, based on that employee's level of contribution. High contribution, and the employee gets a level 4 bonus percentage; low, but still recognizable contribution, and the employee gets a level 1 bonus percentage; in between contribution earns a level 2 or 3 bonus percentage. Bonus dollar amount is calculated by multiplying the percentage

assigned to the level, times the employee's annual base salary.

Here's another example, which disregards salary, and focuses on participation in the total bonus pool, based strictly on level of contribution. This example allows you to quickly divide up the bonus pool. First, multiply the level times the number of employees at each level. For example, two employees at level 1 equals $2 \times 1 = 2$. Three employees at level 2 = $3 \times 2 = 6$. Five employees at level 3 = $5 \times 3 = 15$. One employee at level 4 = $4 \times 1 = 4$. Now add up the products of your multiplication: 2 (level 1) + 6 (level 2) + 15 (level 3) + 4 (level 4) = a total of 27 points. Divide the bonus pool into 27 equal pieces, and then distribute the pool as follows: $1/27$ (level 1/27 equal pieces) goes to each of the two employees at level 1, $2/27$ (level 2/27 equal pieces) to each of the three employees at level 2, $3/27$ for each employee at level 3, and $4/27$ to each employee at level 4.

One other approach, which you have to work on ahead of time, is to establish a bonus dollar range with each employee, as part of that employee's total compensation package. Match individual goals to bonus to be earned. Some positions may have larger bonus ranges, based on the critical nature of the position; other positions may be more routine, or less critical, and have smaller ranges. In this case,

the amount of bonus will be defined by both the degree of individual contribution and the availability of bonus dollars, based on the company's total profits for the year.

Whatever method you choose, before you finalize bonuses, you need to go back to your estimate of the money you can afford to hand out in bonuses – your total bonus pool. However you plan to divide up the pool, rationalize how you are relating bonus to relative contribution. And do not allow yourself to exceed the total bonus pool which you established earlier.

Take care that you do not get caught up in the demands some employees may try to place on you; it is common at this time of the year for employees to try to negotiate bonuses. Remember that your job as CEO is to run the company, which is greater than pleasing one or two specific employees. Rewarding employees fairly, based on contribution is different from responding to demands, or even worse, threats. You must build a team of people, who can work together, respect each others' contributions, and who see bonuses as an extra benefit, which has to be earned by consistently excellent performance, and the ability to operate the company profitably throughout the year.

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Once you've worked your way through this model, you can document what you want to do next year. Here are the likely elements of your plan:

- method to gather input on employee performance throughout the year, such as a file folder in which to place notes on contributions
- everyone in the company involved in providing feedback throughout the year
- everyone in the company measured and eligible, from secretary to president
- bonuses are proportional to salary
- bonuses are scaled to four levels
- bonus pool is based on profits
- distributions do not exceed the bonus pool

As you get more comfortable and confident at working with bonuses, you may want to consider twice / year distributions, rather than once per year. The shorter the period, the more likely employees will relate excellent performance to rewards. And the easier it becomes to boost, and recognize, exceptional performance throughout the year.

Now it's time to distribute bonuses. Depending upon how many employees you have, you may want to meet individually with each employee to briefly explain how the bonus was

derived. If you can't meet with everyone, get your managers involved, and tell them what you do, and don't want said. You could also consider a company wide or department wide meeting, to discuss the bonus process. However you approach it, be clear that bonuses were calculated with a great deal of care and with a desire to be fair to everyone.

You may want to ask employees to rate the bonus process, once you are through. Gather data that will help you to refine the process, and make it work better for everyone involved. Ask employees to be constructive in their comments, to take into account the challenge of distributing profits fairly, and to recognize that it is because of everyone's contribution that there are profits to distribute. If an individual has a problem with a bonus, suggest that the two of you spend time in the next month or two, discussing what they can do to change the outcome for next year.

Looking for a good book? Try *The EVA Challenge: Implementing Value Added Change in An Organization*, by Joel M. Stern, John S. Shiely and Irwin Ross.

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