Managing Employees Through Incentive Compensation

If You Want Results, Show Them The Money!

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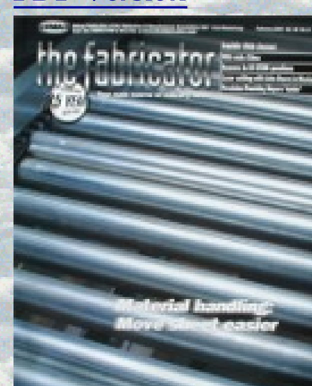

Managing Employees Through Incentive Compensation

If You Want Results, Show Them The Money!

By John M. Collard

Business owners looking to find a way to share the wealth with those required to help create it have an option in incentive compensation (IC). This concept rewards performance and teamwork that produce results.

If you're willing to invest in realistic incentives that reward your managers' and employees' achievements, you'll reap the proceeds. When employees can see dollar signs, and their goals are clearly stated to clarify direction and eliminate confusion, their mindsets change and they become more creative.

The keys to success with IC are to:

1. Set realistic goals and time frames
2. Hold managers accountable for performance
3. Communicate measurement and reward methodology

...and then step back and let them perform.

Incentive Plan

The ultimate goal of the motivational plan is to improve the equity value of the company. Owners accept risk when entrusting operations to the capability, judgment, and decision-making of the people who work for them. Share profits in proportion to the risks being taken.

Include as many employees as possible as part of an incentive-based structure, but realize that each employee will not receive the same amount of compensation. When an employee's income is based purely on performance, as it is in sales, the risk is greater and so should be the possible reward. Employees working under an agreement or union contract governing work behavior and performance will receive a smaller bonus by comparison for achieving their goals. If they want the rewards, they need to share the risk.

Develop an incentive pool based on the amount of gross margin and distribute bonuses based on a weighted average to the team. When the company does well, gross margin improves, thereby increasing the size of the bonus pool, and IC is greater. Tie the incentive at budget to a percentage of salary to help the weighting average calculation.

Pay managers' incentive compensation based 50 percent on what the employees are directly responsible for, 30 percent on how their performance impacts other key departments (for instance, how sales can improve production throughput), and 20 percent on their ability to improve equity value or other elements within their control. The intent is to measure performance and, as important, cooperation among departments and personnel.

Structure a bonus payment scale in accordance with worst, likely, and best scenarios. In the worst case, few bonuses should be paid because goals were not met. In the likely case, pay 40 to 60 percent of the full bonus rate. In the best case, pay maximum bonus rates. The scale is clearly weighted toward higher bonus for greater performance. Communicate progress early and often.

Always be sure to reward positive results when goals are achieved, but never give a full reward when goals have not been accomplished. This type of sliding scale will be looked upon as being fair and will help to motivate people along the way.

Function	Focus On:	50%	30%	20%
General Manager	Company Value	Equity Value Improvement	Earnings Per Share [EPS]	Employee Motivation
Sales	Sales Revenue	Profitable Revenue Generated	Consistent/Flexible Work Flow	EPS/ Net Profit
Estimating	Profitable Work	New Business Win Ratio	Consistent Work Flow	EPS/ Net Profit
Production/ Project Mgt	Throughput, Project Profit	Gross/Margin, Resource Utilization	Billing Rate Overrecovery	EPS/ Net Profit
Human Resources	Employee Relations	Employee Motivation	Employee Satisfaction	Low Rate of Turnover
Finance	Financial Cash Flow	Timely, Accurate Information	Overhead Cost Control	Cash Availability

Incentive Payments

Distributions should be made on a year to date (YTD) calculation, paid quarterly. So the company doesn't take all of the risk, pay about two-thirds of the YTD bonus at the end of the first quarter, 75 percent at the end of the second, 85 percent at the end of the third, and the remainder at the end of the year.

For example, let's say that the gross margin was enough in the first quarter that the bonus percentage would yield a $250 bonus—a quarter of the ultimate $1,000 yearly bonus. The company owner would pay a first quarter bonus of 67 percent, or $167.50. If the financial numbers for the six months warrant a $600.00 bonus, then 75 percent of that — $450.00 — less the $167.50 already paid, which comes to $282.50 would be given out to each employee.

The gross margin at nine months suggests an $850.00 bonus, which at 85 percent comes to $722.50, less the $450.00 already paid, which would result in a third-quarter payment of $272.50. And if the end-of-the-year numbers call for a $1,000 bonus, $277.50 is paid to each employee because $722.50 has already been paid out. The YTD factor becomes self-correcting, yet allows for slowdown in results without putting the company at risk.

This reserve within the company will prevent early payout for exceptional results without a sufficient catch-up period if these results don't continue. Employees can share in the rewards as they occur rather than waiting until the end of the year — an added incentive.

Plan Specifics

General Management. The general manager must measure the company's real equity value in the same way an investor or potential purchaser would: based on market value of assets, their ability to produce economic value, the ability of the management team to produce cash and profits on a recurring basis, and the ability of the company to produce quality products and maintain customers on a consistent basis.

If all managers make their goals, the general manager will make his or her goals because the equity value will increase. This can encourage general managers to drive volume and throughput well beyond break-even levels and to support their managers to achieve results. For an overview of how the incentive program should be structured for general management and other company departmental areas, see our chart.

Sales. Support the selling process from start to end. If workflow through the plant is level, then overhead as a percentage of sales is reduced, producing greater profits or more competitive rates.

Therefore, it's important to emphasize interdepartmental coordination in your company. Sales can support Production by seeking jobs that fit the plant with flexible delivery schedules if needed. Production can support Sales by over-recovering rates and delivering quality products on time and under budget. Pricing/Estimating can support the whole process by improving the win ratio of jobs bid and by leveling the load to stabilize throughput, thus driving volume.

Put salespeople on a tiered commission structure to reward them for new customers and value-added sales. Pay a higher commission percentage for the first 12 months that a customer is with the company, and then reduce the commission percentage, as the customer becomes a recurring customer. This forces Sales to seek new customers, while allowing customer service to grow the existing customer base; a team effort.

Simultaneously put Customer Service on an incentive schedule on top of salaries to drive revenue growth and retention from existing customers.

Sales must focus on helping the plant's throughput. A focus on flexibility and load leveling will serve to fill part of the valleys in slow periods. They must remember that more sales are likely to be produced during off-peak times, while sales during peak times may not.

Production. The best measure of plant throughput is hours worked versus hours billed, which means comparing the hours for a job on all the timecards to what is invoiced to the customer. The closer these are to a 1-to-1 ratio, the better the productivity, throughput, and profitability. When the production team goes over on one job, they will be compelled to go under on another to balance the over-all ratio for the period.

The whole issue of 1-to-1 accountability will bring to light concerns regarding estimating accuracy, department cost justification, scheduling inequities, flexibility, and the need for volume. It will rebalance the rates and force flexible scheduling to meet throughput demands.

When problems arise, flexibility in delivery time will help avoid just-in-time preparation while driving profitability. The ability to slot another job into production while problems are resolved will maximize yield and eliminate standing around a quiet machine.

When work order hours are out of balance, obtain an adjustment if possible. Customer-approved change orders generate more hours against which to charge time, which can help you get closer to the 1-to-1 ratio. If there is no change order, flag each first occurrence for the Pricing department to factor in — and don't make the same mistake next time.

The End Result

Incentive-based management is a catalyst toward improving direction and creating value.

Tie incentives to your goals to create focus. Motivate the entire work force, allow creative thinking, and gladly pay the bonus when the results improve the equity value of your company.

When the equity value increases, the higher share price improves the value of the investment for shareholders, and you can pay dividends or reinvest in the growth of your company, which often yields even greater returns.

About the Author

John M. Collard, is Chairman of Strategic Management Partners, Inc., 522 Horn Point Drive, Annapolis MD 21403: a nationally recognized turnaround management firm specializing in interim executive leadership and investing equity in underperforming companies. He is Past Chairman of the Turnaround Management Association, and brings 35 years senior operating leadership, $85M asset recovery, 40+ transactions worth $780M, and $80M fund management expertise to advise company boards, institutional and private equity investors. 410-263-9100 www.strategist.ws

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About the Firm

Strategic Management Partners has substantial experience advising corporations and individuals on the strategic and mechanical issues of corporate development and governance, operating management and turnarounds for asset recovery. Our principal has over 30 years experience in P/L Management, Strategic Planning and Repositioning, M&A for Strategic Advantage, Finance, Investing, Raising Funds, Sales/Business Development, Building Selling and Marketing Teams, and Operational Auditing = In Public & Private companies = In healthy and crisis situations.

We work with and support the equity capital community to provide assessment studies to determine the situation, planning and strategy development to direct the company, crisis management to oversee that assets are not squandered away, workout teams that recover assets, and board level oversight to keep the client headed in the right direction.

We seek strategic alliances with private equity funds.

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