Why Most Bonus Plans Fail

And How to Do it Right

THE VISIONLINK ADVISORY GROUP

Generally, there are two categories of companies that have bonus plans for their employees: (a) those that *know* they have bad plans, and (b) those that *think* they have good plans but actually have bad ones.

A harsh assessment? Perhaps. But a true one nonetheless. Certainly, there are some good plans out there. But they are pretty hard to find. This report will reveal why. It will then outline the keys to designing a great plan.

In addition to those whose plans are less than adequate, there are a number of companies that don't have an annual bonus plan at all. The biggest reason they don't is rooted in a fear they will do it "wrong." (And the evidence suggests they're probably right for feeling that way.)

Consider the following survey results from a 2016 WorldatWork report:

> Only 10% of responders indicated they felt their annual incentive plan was effective, while another 25% thought theirs was moderately effective. Thus, 65% were dissatisfied with the results of their plan. And these responders were, generally, representatives of larger, successful companies. If large companies can't get it right (i.e., those with access to high-paid consultants and experienced executive leadership), what chance do smaller companies have?

So the guidance this report offers is for both groups—those with a plan and those who have yet to start one. And fear not. The promise here is that you indeed can have an awesome plan. It is achievable!

Defining a "Good" Bonus Plan

First, let's clarify the meaning of "bonus plan" for purposes of our discussion. Here, we are referring to any type of (non-commission) incentive award paid to an employee that is above and beyond his or her normal salary or wage. It is usually (though not always) tied to the achievement of some specific goals. You may or may not refer to it a *bonus*. Perhaps you call it an incentive plan, or something else. We won't differentiate in this report.

REINFORCE A PARTNERSHIP RELATIONSHIP WITH EMPLOYEES BY SHARING FINANCIAL VALUE WITH THOSE WHO HELP CREATE IT.

How do most business leaders define what qualifies as a "good plan?" Or better yet: a "*successful* plan?" What awesome outcomes are they expecting when they adopt a plan? Over the years, lots of answers have been offered to those questions. Here are just a few we have heard at VisionLink in our work with CEOs:

- I want to encourage certain behaviors
- I want to improve productivity
- I want to reward for the achievement of some specific results
- I want to share part of the company's profits
- I want to be competitive with the market

Some of those reasons are "okay," but most are actually either counter-productive or too obtuse—or both. So instead, let's consider a single success criteria for a bonus that all plans should meet:

> **Reinforce a partnership relationship with employees by sharing financial value with those who help create it.**

A *Partnership relationship* is the crucial mindset a bonus plan should promote. It is the *key* to avoiding a plan that is viewed as manipulative by employees. It is the *key* to eliminating an entitlement mentality. It is the *key* to stimulating innovation, ownership and stewardship. And it is the *key* to establishing succinct and clean alignment between shareholders, managers and employees.

Let's restate those "4 keys."

> First: Avoid manipulation of employee behavior.
> Second: Eliminate a sense of entitlement among employees.
> Third: Stimulate innovation, ownership and stewardship.
> Fourth: Create alignment of purpose and outcomes among all parties.

A strong bonus plan will align with all four of these "Partnership" keys. A bad one will do the opposite—and prevent you from achieving your objectives.

To understand this better let's begin by examining the premise most leaders hold when developing a bonus plan and explore why it's the foundational reason most plans fail.

While we make this examination, keep our goal in mind: Partnership.

Premises, Premises

A premise is defined as "a proposition supporting or helping to support a conclusion." One adopts a premise (believes in a concept or principle) and then acts in accordance with it in the hope of achieving a certain result. However, the desired outcome can only be fulfilled (presumably) if the premise is correct.

> A STRONG BONUS PLAN WILL PRODUCE ALL FOUR "PARTNERSHIP" RESULTS. A BAD ONE WILL DO THE OPPOSITE—AND PREVENT YOU FROM ACHIEVING YOUR OBJECTIVES.

There is a correct premise for constructing a successful bonus plan and there's a wrong premise. Unfortunately, the wrong premise is the one most commonly adopted.

And it almost always leads to organizational frustration and disappointment.

The Wrong Premise

Reward your employees for achieving results that are as close as possible to their job duties. This typically includes the effort to "select the best metrics" for each employee or at least for every department. Then assume that all the collective mini-improvements will roll up into shareholder value creation.

Under this premise, the bonus plan includes detailed metrics (also referred to as Key Performance Indicators, or KPIs) that relate to the specific responsibilities assigned to employees. The idea (which sounds very logical) is that employees will focus on those KPIs and, by achieving them, will contribute to the well-being and profitability of the company.

TRYING TO CHANGE BEHAVIOR WILL TYPICALLY BACKFIRE BECAUSE IT IS NOT POSSIBLE TO LINK EVERY METRIC TO TRUE VALUE CREATION.

Beware: This premise can lead to multiple problems. Let's explore a few.

Problem #1: Trying to change behavior almost always backfires. Why? Because, it is not possible to link every metric to true value creation.

Let's look at an example.

Assume you own a boutique hotel in a mountain resort town where there is a lot of lodging competition.

A new employee begins work for you at the front desk. You emphasize that part of her job includes convincing walk-ins to stay at your facility. And you also want her to upsell them to the highest priced room (with the view, amenities, etc.). So you insert two KPIs into her bonus plan: (1) average daily room rate (ADRR)— to get her to upsell; and (2) average daily occupancy rate (ADOR)— to make sure enough guests register with the hotel no matter the rate.

There would seem to be some fairly good logic at play here because these are not complementary metrics. And if we can increase both ADRR and ADOR, profits should climb. Makes sense. The home run would be making sure every walk-in does register to stay *and* signs up for the most expensive suite.

So what's wrong?

Let's consider the behaviors you're encouraging with this approach. In this simple example, is the new desk clerk being encouraged (through the metrics you have set) to live up to the business's core values? Presumably, the hotel has such values as: "Treat the guest with respect" or "Always do what's best for the guest." So if the guest is really the right type of customer for your hotel, and the suite is really appropriate to his or her budget and preferences, then, by all means, help them find the room they want. But if not, is there the possibility that the clerk's efforts will come across as a little pushy, thereby turning a positive experience into a bad one? And is that in the best interest of your business?

In other words, which of these should be the clerk's ultimate goal: (a) get every possible customer into the highest priced room possible, or (b) help each customer have a positive, helpful, and friendly experience? Which one will produce the best long-term (and probably even short-term) results for the hotel? (Consider reputation, brand value, referrals, repeat customers, likelihood of happy guests buying other services within the hotel, and so forth.) In fact, for most people, their personal hotel experience determines whether they're more likely to use a hotel's additional (for-pay) services. That is, if they have a great experience with the first person they meet (in this case, the new front desk clerk), you (the owner) will probably achieve your optimum value from their visit.

Can you see how this example of micro-selecting KPIs can backfire? Does it maybe make you question the premise of overusing metrics and trying to control behavior through an incentive reward? In essence, your bonus plan may have unintentionally communicated the wrong message to the new desk clerk: “The desire to optimize revenue trumps our standard of guest care and concern.”

This example alone should put to rest any notion you have of choosing detailed metrics for your plan. But maybe you’re thinking, “We would never make that mistake.” Ok, let’s consider other problems with the *wrong* premise.

Problem #2: The higher the number of KPIs for individual employees to pay attention to, the greater the likelihood the plan will be confusing and therefore sap instead of fuel motivation.

You might try to mitigate Problem #1 by adding a quality measure such as a customer satisfaction scorecard. Perhaps that would remind your desk clerk to “treat the customer with respect” and overcome her urge to assertively up-sell people. Ok, that could help—perhaps. But now you’ve given her three KPIs (instead of two) to keep track of. It might even encourage the clerk to remind the customer to “please give me a good rating on the scorecard” or make some other inane, self-serving request that prompts an eye roll from the guest as soon as she walks away. That will do the job!

More likely, your new desk clerk will feel foolish for interacting that way with the poor guest. But, hey, her bonus is tied to a scorecard!

You want a high score? She'll schmooze every guest to see that you get one.

By the way, why not add a fourth KPI to the mix—perhaps one that rewards her for promptness or attendance record (to avoid scheduling issues, reduce overtime costs, or other reasons)? And if four is good, five must be better, or even six. Might as well micro-manage a bunch of behaviors while we're at it. The more the merrier!

THE HIGHER THE NUMBER OF KPIS FOR INDIVIDUAL EMPLOYEES TO PAY ATTENTION TO, THE GREATER THE LIKELIHOOD THE PLAN WILL BE CONFUSING AND THEREFORE SAP INSTEAD OF FUEL MOTIVATION.

Don't treat employees like robots or computers ("We just need to write the correct code and we'll get the results we want"). People don't operate that way—at least not the kind you probably want working in your business. "Behavioral metrics" can disillusion your employees, so avoid them.

Obviously not all KPIs trigger behaviors that are counter to your desired result. So far, we are just exploring why it can be tricky to pull off. You can't possibly think of everything that might go through an employee's mind when you roll out a bonus plan chock full of detailed metrics. The odds of "getting it right" through micro-managed KPIs are extremely low.

Some companies have plans with as many as twelve or even fifteen KPIs for employees to track. It can make their incentive plan participants feel like they're in the second grade. Not sure what results you'll get but you won't get an increased sense of Partnership.

Problem #3: Motivation is intrinsic and is easily diminished by external enticements.

Consider this true story about a day-care facility. The business had a problem with parents picking up their children late. So they introduced a fine for tardy pick-ups. Guess what happened? The number of late pick-ups doubled! Whaaaat? It seems that parents no longer felt an ethical obligation to avoid inconveniencing the teachers. Being late became a commodity for which they could simply pay extra. This is a "reverse financial incentive" principle that has broad applications. People will do what they feel motivated to do for their own reasons. Money is not and should not be seen as a way to get people to do a good job.

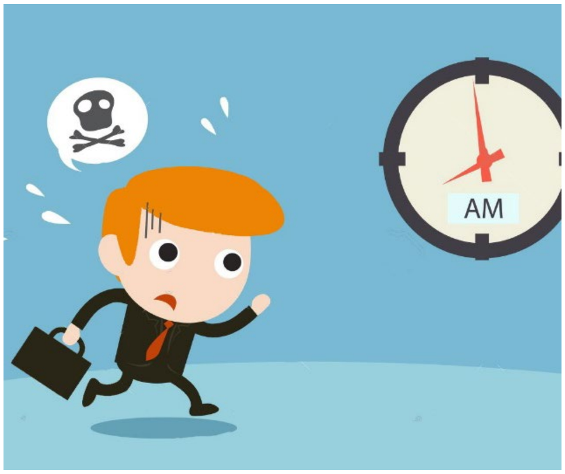
Problem #4: You simply won't be able to identify metrics for every position.

Ever try to create a production KPI for a file clerk? How about a combination of lowering the paper cut ratio and reducing the average decibel level of the file drawers slamming shut? Believe it or not, there have been crazier ones (well, maybe not much crazier).

What KPIs do you select for a HR team member? Controller? Receptionist? Pretty challenging isn't it? You can trust that whatever KPI you come up with will have virtually no impact on their job performance. If it does have any impact, it will likely be a negative one (see problems 1, 2 and 3 above).

Why waste the time? Why search for the undiscoverable? You won't find it. And you don't need to. There *is* a simpler solution (which we will get to further on).

Problem #5: Some employees might manipulate results in order to achieve the appearance of the intended targets while others could simply take advantage of loopholes in the metrics, leading to negative consequences.



One company, for example, introduced a financial incentive program to improve punctuality. After operating the plan for a while they discovered that instead of arriving to work late, employees were simply calling in sick—thus missing the entire day. As a result, the company experienced a 6-8% drop in productivity per month. This reinforces the point that you simply can't predict the behaviors your incentive plan may produce.

Remember the Veterans Affairs scandal a few years ago? In at least one hospital, staff bonuses were tied to patient wait times. And doctors were rewarded for minimizing the number of patient follow-up visits. Brilliant! Forget patient care and fudge a few numbers and, *voila*, $400 million of bonuses were paid in 2011.

And do we even need to mention Wells Fargo? Hopefully not. Who wants to build a culture of fudging, hedging, and pretending when you can create one built on Partnership?

Problem #6: It is impossible to equalize metrics across individuals and departments.

One company VisionLink helped had two employees working side-by-side in the same job with comparable productivity (according to their manager). One (Heather) earned a $12,000 bonus while the other (Kevin) earned $3,000. Why?

Heather was assigned to support the XYZ account. Kevin was assigned to service the ABC account. Remember: Kevin and Heather were considered "equal" employees. But their bonuses were tied to the performance of their respective servicing accounts. You guessed it. The XYZ account placed very nice orders the year before (something Kevin had nothing to do with—at least directly). And the ABC account had an off-year. No one felt right about the result. So the team members who worked the ABC account were awarded a make-up bonus. The lesson to employees: The metrics really don't matter!

IT IS IMPOSSIBLE TO EQUALIZE METRICS ACROSS INDIVIDUALS AND DEPARTMENTS.

It is tough to deal with these types of differences, subtleties and unexpected outcomes. So it's best to not even try.

Problem #7: You will likely produce unintended consequences that no one anticipated. They are more often bad than good.

Consider a manufacturing company's production line that was challenged (and incentivized) to increase output based on research conducted by the boss. The thought process seemed sound—and the team members were excited about the incentive. So they all dug in. For a while, production improved. But no one had considered the safety or maintenance consequences—at least not sufficiently. By the end of the first quarter, quality issues surfaced that proved the relatively low productivity gains were minimal compared to the cost of the incentives—resulting in a negative return on investment.

Problem #8: Attempting to come up with the "perfect" metrics is a time waster.

Consider the amount of time and effort it takes to produce a plan with granular KPIs—only to then discover it produces an undesirable outcome (double whammy: wasted time *and* a bad plan). Maybe you can pull it off in in a very small organization that has a narrow business focus (assuming it was a good idea in the first place). But it is just too hard to make work in an organization with more than a few employees. Perhaps you could pull it off if you employ 25 people or less. But imagine choosing KPIs for 250 or 2,500 employees. Unfortunately, many have tried but to a frustrating and disappointing end.

Here is a revealing example. Several years ago VisionLink reviewed a plan developed by a company with a little over 200 employees. It was full of spectacular metrics, precise targets, carefully constructed allocations, and challenging employee goals. It was truly quite impressive. However, we asked the CFO a simple question: "How much time (off the top of your head) did the CEO, CFO, HR VP and staff, and department heads take to design, review, and finalize this plan? Just take a wild guess." Performing a "back of a napkin" calculation, they estimated total internal staff time of 253 hours. That is a crazy amount of time to spend designing a bonus plan. "How well did the employees understand the plan," we asked. "Uh, not very well," they responded, eyebrows raising. "So…have you seen a change in performance?" "Not really."

ATTEMPTING TO COME UP WITH THE "PERFECT" METRICS IS A TIME WASTER.

How confident are you that you can identify the perfect KPIs for all employees? The margin for error is huge and at the cost of valuable management time to create them. Undoubtedly, a significant portion will backfire. It is inevitable.

Final Thoughts about the Wrong Bonus Plan Premise

The point of our analysis so far is *not* to suggest that a bonus plan should or can exist without any metrics. Certainly, such measures are important; even necessary. Instead, the point here is that micro-selecting KPIs on a granular level just isn't productive. At best it will have no real impact. At worst it can lower productivity.

As a result, don't allow yourself to think that when a plan isn't "working" the solution is to expand or keep digging for the "right" KPIs. When someone suggests the need for more metrics, your instinct should be to reject the idea. Offer a polite smile but don't surrender. Do not conclude you just haven't found the right combination of specific measures yet—that with a little more effort you'll root them out. You won't. You'll just get more frustrated.

Here's a quick review of the eight problems associated with the wrong premise:

1. Trying to change behavior will typically backfire because it is not possible to link every metric to true value creation.
2. The higher the number of KPIs for individual employees to pay attention to, the greater the likelihood the plan will be confusing and therefore sap instead of fuel motivation.
3. Motivation is intrinsic and is easily diminished by external enticements.

4. You won't be able to identify metrics for every position.
5. Some employees might manipulate results in order to achieve the appearance of the intended results while others could simply take advantage of loopholes in the metrics, resulting in negative consequences.
6. It is impossible to equalize metrics across individuals and departments.
7. You will likely produce unintended consequences that no one anticipated. They are more often bad than good.
8. Attempting to come up with the "perfect" metrics is a time waster—and thus an unnecessary cost to the organization.

The Right Premise

Reward your employees for understanding and striving to achieve the shareholders' most important financial results. And treat every employee as an important part of your team.

To start, let's change some terminology. From here on let's discontinue using the term "bonus plan" and instead use "value-sharing plan" (VSP). Let's see how the implications of this wording offer a better premise.

What is the most important result desired by shareholders? It can vary, of course. But it usually centers on a key financial measurement such as enterprise value, profits, or cash flow. A common one is "sustainable and growing profitability." Owners are happy when profits are growing—especially when they're growing for the right reasons.

So if ever-growing profitability is a desirable goal for shareholders, why wouldn't we want our employees to focus on that same goal? Shouldn't the key, if not sole, KPI for the VSP metric be profits (however they're defined or measured)? If so, then why not build the plan around profits instead of trying to thread the KPI needle for every employee?

> REWARD YOUR EMPLOYEES FOR UNDERSTANDING AND STRIVING TO ACHIEVE THE SHAREHOLDERS' MOST IMPORTANT FINANCIAL RESULTS. AND TREAT EVERY EMPLOYEE AS AN IMPORTANT PART OF YOUR TEAM.

But wait (you're thinking), profits are too far removed from the mindset of employees. Some employees might even think that profit is a dirty word.

Profit simply means that *value* has been created. Your business model worked! You did something good for your customers. As a result, shareholder capital is being rewarded. Therefore, employees should be too, right? If employees are taught the importance of profits and how they influence their "partnership compensation" (the VSP), they'll want to ask the logical question: "How can we help grow profits?" This idea is so powerful we can even use the term "value" interchangeably with "profits."

You'll get your best results if you (a) teach and (b) trust. *Teach* your team members what it means to create value for the organization (by doing what is meaningful for your customers). Then *trust* them to do the right things. Engage them in a conversation:

> "Here are the results we want to achieve for our customers. Here's how that translates to value creation for our shareholders. What do you think you can do, in your job, to help achieve those outcomes?"

> YOU'LL GET YOUR BEST RESULTS IF YOU TEACH YOUR TEAM MEMBERS WHAT IT MEANS TO CREATE VALUE FOR THE ORGANIZATION. THEN TRUST THEM TO DO THE RIGHT THINGS.

Under this approach, the bonus payment becomes a celebration of company success.

"Hey everyone. We did a great job for our customers this year! As a result, the company had a good year. We are thrilled to share some of the value with you!"

Does this not sound like a better idea than, "Figure out how to make this metric go up and I'll pay you a bonus?" It should. And it works. Through this approach, you're approaching a partnership culture.

Value Creation (profits) must be the critical determinant of the size of the VSP pool.[1] Here's how to relate profits to your plan. Each of these is important.

- <u>Don't make any payments unless you achieve a minimum profit level.</u> We'll call this value threshold "Base" (or Baseline). Some clients insist that they must pay bonuses every year—people expect it and count on it. Hello!? That is called a salary! If you're guaranteeing something why would you call it an incentive? That's the worst possible thing you

[1] *There may be circumstances when you use revenue or something else instead of profits. You get to determine the single, clear metric that your plan is tied to.*

could do. Why? Because you're creating an entitlement program but pretending it's a reward for special performance.

What if you're in a down period or not expecting profits this year but you are willing to invest in value-sharing payments because of the commitment needed to achieve your tough goals? No problem. You can make Base $0 if you want. Or it can even be a negative number. But there has to be a value-creation focus or you're doing an injustice to the shareholders. Employees must understand that payments are not guaranteed. The Base goal should not be so low that it is automatically achieved every year. Conceptually, it might be missed once every five years or so (a rule-of-thumb). Don't make it too easy.

- Create a meaningful VSP pool that's tied to your actual annual budget. This is "Target." This represents the profit level that shareholders are expecting for the year. It is in the annual plan. All of the company leaders, board members and/or primary shareholders have signed off on it. Once you have set an aggregate VSP pool opportunity you have determined your pool *budget*. On average, you should expect to hit your budget and pay at or near the Target pool in three out of five years.

- Create a stretch goal that is challenging but achievable. You would anticipate hitting this kind of target once every five years. We'll call it a "Superior" goal. Obviously, employees would earn higher payments if you reach this threshold.
- Don't cap the plan payouts for results beyond Superior. Caps aren't needed. Neither are they a positive message in the spirit of partnership. Keep going. If the value is created beyond even your Superior expectations, share some of it. Don't be stingy.

> You don't have to go overboard but it is not a sound philosophy to set arbitrary caps. If you want your employees to continue to perform on a superior level, then for heaven's sake reward them when they do! It reinforces the outcomes you seek.

Teach your employees that profits are good, essential, important, and the central tenet of their compensation growth. Show how value-sharing is linked between three connected constituencies—customers, shareholders, and employees.

> HAPPY EMPLOYEES ENSURE HAPPY CUSTOMERS. AND HAPPY CUSTOMERS ENSURE HAPPY SHAREHOLDERS—IN THAT ORDER.
>
> ~SIMON SINEK

True value creation occurs when all three stakeholders participate in successful financial results: (1) Satisfied customers are generating profitable (growth-driving) product sales; (2) Capital (the shareholder's stake) is receiving a positive and appropriate return; (3) Employees are participating in the value they help create. The VSP becomes the rewards mechanism that reflects that three-part achievement.

The right premise is rooted in the belief that once you have achieved an appropriate and satisfactory return for shareholders, any excess return must be attributable, at least in part, to the innovation, hard work, and efforts of your employees. Therefore, they deserve some of that value. *The VSP is the organized and structured system for allocating that value.* A VSP payment to employees should be viewed by company leadership as both deserved and earned. And it's simply the moral thing to do because it reflects a commitment to the principal of partnership: "The company couldn't have produced these profits without you. So, of course you deserve some."

The right premise results in a number of advantages and positive characteristics. Let's take a look at just three:

Advantage #1: Simplicity and Clarity

A single, important, and clear performance indicator creates greater focus.

Employee: "Profits? How do we maximize and sustain profitable growth?"

Employer: "We innovate, treat customers well, provide value to them, respect capital and cash, discover how to improve, and assume accountability for our roles."

Employee: "Ok, I get it. Let's make that happen."

Advantage #2: Consistency and Alignment

Employees see the VSP as affirmation of their partnership relationship with company owners. What do actual partners receive? A share of profits. Why shouldn't employee-partners be treated the same way? If the shareholders' goal is sustainable, growing value, shouldn't that be the goal for the employees too. With a VSP, it is.

Advantage #3: Enhances Communication

Once you have launched a VSP, the most important thing you can do next is to consistently communicate with your employee-partners about how the company (and therefore the plan) is doing. Periodically update your profit forecast for the year. Do a quick calculation and let your employees know how the business is performing and what that means for them. Some private companies don't detail the exact profit goals for the year. That's ok. Just tell them you're at 104% of budgeted value. Or 95%. "If we finish the year there, here's what your VSP payout will look like." Let the information galvanize your team.

THE RIGHT PREMISE IS ROOTED IN THE BELIEF THAT ONCE YOU HAVE ACHIEVED AN APPROPRIATE AND SATISFACTORY RETURN FOR SHAREHOLDERS, ANY EXCESS RETURN MUST BE ATTRIBUTABLE, AT LEAST IN PART, TO THE INNOVATION, HARD WORK, AND EFFORTS OF YOUR EMPLOYEES. THEREFORE, THEY DESERVE SOME OF THAT VALUE.

The right premise is simple, fair, and motivating. Here is your basic message to employees (modify as you wish):

- Profits are crucial to the success of our organization. We can't survive without them.
- End-of-year value is a reflection of a job well-done. The better we do at acquiring new customers, satisfying them, and managing expenses, the higher profits will be.

- Shareholders have invested capital in the business—at substantial risk. They deserve a significant part of the value the business creates. But they want to share a meaningful portion with you.
- The shareholders recognize that they need great employees to innovate, sacrifice, create, sell, service, and so on.
- As a result, we have developed a value-sharing plan. It's based on these principles. It is a way of determining how to share profits between shareholders and employees. It translates to a specific opportunity for you, at the end of the year, to receive a meaningful payment as a reflection of your contribution to our successful year.
- It is not guaranteed. There may be years where there is no payment. There may be years (hopefully!) where the payments are quite significant. But you will be aligned directly with shareholders. If your payment is lower one year, shareholder value will be too. As you can see, we're treating you like a partner in our success.
- Now, please determine how you can contribute to the generation of profitable growth for the company. This doesn't mean: Make money at all costs! It means we grant you the autonomy to discover with us how, together, we can create value for our customers in ways that are profitable for the company. We look forward to your contributions, ideas, and efforts. Help us learn how we can assist you in your important role.

Should Profits Always be the Only Metric in a Value-Sharing Plan?

No.

Let's be clear. Adopting the right premise does not mean you shouldn't appropriately consider and select KPIs that actually drive bonus payments. Those metrics may not be limited to profits. The point is that no bonuses should be paid *unless minimal profit thresholds are reached*. We must produce a minimum return on capital for shareholders to justify meaningful variable pay commitments to employees. Capital gets paid first, then employees. You can modify this theory if you must, but it is a sound and tested principle. Employees should appreciate the importance of supporting a return on shareholder capital and then reap the rewards for helping achieve that threshold.[2]

> NO BONUSES SHOULD BE PAID UNLESS MINIMAL PROFIT THRESHOLDS ARE REACHED. YOU MUST PRODUCE A MINIMUM RETURN ON CAPITAL FOR SHAREHOLDERS IN ORDER TO JUSTIFY MEANINGFUL VARIABLE PAY COMMITMENTS TO EMPLOYEES.

Hopefully, you understand that we're not talking about a profit-sharing plan, *per se*. Profit-sharing plans simply allocate a percentage of the profits back to the employees. These can become entitlement plans. "Oh, I got $5,000 last year. How come I only got $4,000 this year?" "Well we hired more employees so the value is being shared with more people." "Huh? Doesn't make sense to me!" There's more involved here than allocating 0.17% of profits to Joe and 0.18% to Sally. This report can't cover *all* of the differences between the concepts. This is simply a warning not to fall for the apparent allure of a "profit-sharing" bonus plan. That may be fine for your qualified plan contribution, but not for a true value-sharing program.

You'll use profits as a guide in setting the funding levels for the plan. But you may go more granular in recognizing variations in results. For

[2] Sometimes the Base VSP threshold is computed by subtracting a calculated shareholder minimum expected return from profits.

example, suppose your budget for the year is $20 million in revenue and $3 million in profits. Would you be equally happy with $23 million in revenue and $2.9 million in profits? If so, then the VSP pool should be the same. You'll need creativity and flexibility in setting the budget and respecting possible variations in results.

Plus, you *may* need to reflect department or division results in your payouts. Should the general manager of a division be recognized for his excellent results within his profit center? Or should he be tied solely to company-wide results? An argument can be made for either approach. In many cases a blend of the two will be right. Distinct metrics (other than profits) may be extremely helpful in the design of the plan for those granted autonomy, budget control, sales responsibility and more. This is an important consideration and the "right" solution varies from company to company. Watch for another report on this subject.

DISTINCT METRICS (OTHER THAN PROFITS) MAY BE EXTREMELY HELPFUL IN THE DESIGN OF THE PLAN FOR THOSE GRANTED AUTONOMY, BUDGET CONTROL, SALES RESPONSIBILITY AND MORE.

Employee Goal-Setting

At this point, you are likely asking: "What about employee performance? Should it be considered when determining payouts under the VSP?" Believe it or not, you should avoid it in *most* cases.

Naturally, it is important for employees to set goals. And it is also important to help them achieve those goals and monitor their progress. Just don't try to tie their VSP payment too directly to the achievement of individual objectives. Why? See bad premise items 1, 2, 3, 4, 5, 6, 7, and 8 (hint: that's *all* of them).

If employees know their bonus will be tied (whole or in part) to their personal goal achievement, ask yourself these questions:

- Will they set challenging and even transformative goals—or ones more easily achieved?
- Will they create original, innovative, and imaginative goals—or standard, typical, bureaucratic ones?
- Will they find the goal-setting process to be stimulating and engaging—or dry, routine and boring?

You get the idea.

Don't stifle innovation and creativity by telling your employees they won't get their full bonus unless they can check the boxes on a list of perfunctory achievements. Separate goal-setting from payment celebration. All performance management trends support this kind of approach.

Caution: In spite of this general advice, there is no reason to exclude subjective adjustments to an employee's VSP payment based on outstanding performance or to eliminate or reduce payments in exceptional situations. We're not suggesting you have to be overly rigid in this regard. Many times, the situation is the boss. So be flexible but be wise. There are times where it may be the right technique.

Think of the right premise as being a "bottom up" approach. It encourages employers to involve employees in the generation of ideas and practices that will create value and drive profitability. The wrong premise is "top down." It assumes managers and leaders will know best how to identify the specific "key performance indicators" for employees—thereby allowing those employees to manipulate them to maximize their bonus.

The right premise treats employees like partners. The wrong premise treats them like cogs in a wheel.

Is the Right Premise Always…Right?

As with any general rule, there are exceptions. The core principle behind the right premise is to avoid trying to micromanage behavior through an incentive program ("do this and you get that"). But sometimes you have to become more granular. Here are a few examples:

THE CORE PRINCIPLE BEHIND THE RIGHT PREMISE IS TO AVOID TRYING TO MICROMANAGE BEHAVIOR THROUGH AN INCENTIVE PROGRAM.

Sales Compensation

There is really no way around needing to feed sales people a steady diet of raw meat. The more they are responsible for "finding" and "closing" business the more sense it makes to align their pay with direct revenue conversions. And that's the difference. If you have someone whose sole (or at least primary) job is to sell something, then by all means develop a commission plan and build around it. Of course, that arrangement carries its own baggage (sandbagging, cutting corners, customer satisfaction management, and much more). These are outside the scope of the right premise we have been discussing.

Project Specific Incentives

It is more challenging to build a "company-unifying" bonus plan when leaders are managing projects with varying scopes and time periods. There is no central profit indicator—though there may be project-based profits. That said, the same principles apply (don't over-manage the details) even though the design approach is more challenging.

Time Periods or Projects with no Projected Profits

Sometimes you invest in a project, customer, or long-term opportunity that is not expected to result in immediate profits. There are two ways to approach this. First ask if you can measure the profitability even if it is a negative number. You can still bake a bonus value into the negative number as part of the reward for meeting the objective. In other words, suppose you expect to lose $100,000 on a project. Is it worth it to pay me a $50,000 bonus to manage the project to make sure you don't lose $200,000? It may be.

A second situation is when you are developing a new product and need to isolate a team of people to achieve a quality expectation and time deadline. You may not even be sure the product will drive revenue, let alone profits. This may be a situation where another type of bonus structure may fit better.

That said, here's a warning. It may be tempting to look at all teams or departments in this fashion. But resist the urge. It's likely to lead you back to that dark place you've been before. As a general rule, don't try to bend or break the good premise rule. Instead, make it your friend.

Conclusions

At VisionLink, we want to change the way the business world thinks about bonus plans. Let's stop trying to change behaviors. Let's celebrate success. Release yourself from the self-torture and agony associated with metric-laded, detailed plans that hinder instead of enable higher levels of employee performance.

> RELEASE YOURSELF FROM THE SELF-TORTURE AND AGONY ASSOCIATED WITH METRIC-LADED, DETAILED PLANS THAT HINDER INSTEAD OF ENABLE HIGHER LEVELS OF EMPLOYEE PERFORMANCE.

A great VSP comes down to three simple steps: Identify clear goals; Set specific standards; Operate an effective system.

1. *Clear Goals*
   Remember the universal goal: Reinforce a partnership relationship with employees by sharing financial value with those who help create it.

Identify the positive financial results desired by owners and link all metrics to them. A key profit indicator should always be at the center of the plan funding.

Judge every plan design decision by a simple question: Will this strengthen our partnership relationship with our team members?

2. *Specific Standards*
   Every VSP (bonus plan) should meticulously adhere to three standards:

   It should be *Clear*.

   "I can understand how the plan works. I understand what results we're expected to achieve. I understand what it will mean to me if we achieve those results."

   It should be *Believable*.

   "I believe we can achieve the company goals. We can definitely achieve the Target results and I also see how we can reach Superior."

   It should be *Meaningful.*

   "It is important to me that we achieve those results. I understand and am excited about what it will mean both to the company and to me if we do."

3. *Effective System*
   You need a process for designing, operating, and communicating your plan.

   Design

   Develop a successful process (including the ones discussed in this report) to build out your annual plan. No shortcuts. No unnecessary complications. A straightforward, step-by-step method for plan creation.

(Visit www.BonusRight.com if you're interested in learning about VisionLink's proven process.)

Operate

Prepare to handle plan administration smoothly and efficiently. You will need to determine how you will handle employee status changes, exceptions, unique situations, and special circumstances. You'll need accountability, deadlines, and commitments. This can be done with some practical planning and without burdening your Human Resources team.

COMMUNICATION IS ARGUABLY THE MOST CRITICAL PART OF YOUR SYSTEM.

Communicate

This is arguably the most critical part of your system. It is impossible to over-communicate your plan to your team members. Educate them. Inform them. Reinforce plan values. Share the future, not just the past. Help them gain clarity. Show them how the results can be achieved. Help them understand how meaningful the values can be. Remind them of your trust and commitment to them. Treat them like partners.

You can discover simple but effective ways (statements, explanatory summaries, mid-year updates) to regularly communicate to your plan participants. What good is it to have a great plan with poor or no communication? Developing an effective communication strategy does not have to be hard. Challenge the creativity of your HR team to excel at rewards reinforcement. And give them the resources to do it.

A bonus plan should never be built to try and change or manipulate behavior. It will not get people to do things they weren't doing before you started paying them an incentive.

A BONUS PLAN SHOULD NEVER BE BUILT TO TRY AND CHANGE OR MANIPULATE BEHAVIOR.

Partnership.

Every element of your VSP should reinforce this core objective. You'll get there. Be patient. Actually, no, don't be patient. Start today. Eliminate the wrong premise from your thinking. Eliminate it from the minds of people around you. Embrace the right premise. May it lead you greater prosperity for you and your employee-partners.

BonusRight

If you could benefit from a tool that will help you design, communicate and manage a bonus plan that is built on the "right" premise, check out VisionLink's revolutionary new online tool—BonusRight—at www.bonusright.com.

Ready to Speak to a Compensation Specialist?

If you would like to speak with a pay expert about your business goals and pay strategy, call us at 1-888-703-0080.

About the Author

Tom Miller
President
The VisionLink Advisory Group

Tom has advised organizations on executive compensation and benefit plans for 39 years. An inveterate entrepreneur, he has founded and operated two compensation consulting businesses as well as a benefits administration company and a registered investment advisory firm. His current company, The VisionLink Advisory Group, has served more than 500 companies across North America and Great Britain. In 2016, Tom established another company, BonusRight.com, a cutting-edge “software-as-a-service” incentive plan design platform. BonusRight is the first tool supporting Tom’s mission to transform the way businesses share wealth with their employees.

THE VISIONLINK ADVISORY GROUP

7700 Irvine Center Drive, Suite 930 • Irvine, CA 92618 • 888-703-0080
www.vladvisors.com
www.phantomstockonline.com
www.bonusright.com