



COMPENSATION: STRATEGIES FOR A BONUS PLAN

I. INTRODUCTION

Compensation should be a strategic tool in a CEO's quest to build a high-performance team. Generally, incoming CEO's inherit an ad hoc system of base pay and bonus that requires a major overhaul. In this white paper, we explore one aspect of the compensation plan: bonuses.

While there are certainly wrong ways to structure a bonus plan, there are multiple correct ways. Some of the concepts and suggestions listed here are universal, and some simply represent my own experience, which may or may not apply to your situation, culture, or board's preference.

II. GIVE YOUR BONUS PURPOSE

Whether intentional or not, some companies use bonuses as a way to create a variable-cost component to compensation—and is most evident in bonus plans tied to year end EBITDA. This is a mistake because the variable cost impact is negligible to the overall bottom line, and it's not the role of your management team to absorb equity risk in their cash compensation.

Instead, consider that a bonus plan is designed to influence behavior, reward outstanding results, and retain your star performers. A companywide metric does little to influence individual behavior because for most individual managers, their direct impact on the total company performance is 10-25% of the total. That means most of their bonus is determined by factors, or departments, outside their control, and companywide metrics are a poor way to reward and retain your star performers. Some may argue that tying bonuses to overall performance creates a team feeling as everyone wins and loses together. My own experience is that stars want to be rewarded for their performance, and

Lecturer David Dodson prepared this note as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation.

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laggards appreciate their lackluster efforts hidden inside other people's success. My bias is to take care of your stars.

Furthermore, you likely have an equity plan to provide rewards for building long-term shareholder value, and in that element of their compensation they are being rewarded for how the team performs.

For these reasons, it's important to tie bonuses to measurements that are in the control of the manager. For example, your CFO's bonus may be tied to collections, meeting her expense budget, and successful transition to a new accounting system; while your VP of Operations' bonus may be tied to a labor ratio and a net promoter score (NPS).

As a "footnote", in computing a bonus, you may consider pulling out of a manager's P&L elements over which that they have little to no control. By way of example, if your CFO has office rent in their section of the financials, you may pull that out of the bonus calculation, since they have no control over rent expense (which will come in no higher or lower than plan). By leaving it in, you will under-reward stellar performance and over-reward mediocre performance; by taking it out you give them greater control of the bonus outcome.

III. KEEP COAL ON THE FIRE

For your managers, consider paying out bonuses quarterly. A quarterly bonus plan has several material advantages over an annual bonus:

- 1) More frequent opportunity to reward and provide feedback. The bonus plan recognizes good results, and forces feedback into your communication with your managers. There is value in putting a bonus check in a manager's hand four times a year instead of once a year. And in doing so, you'll be shining a bright light on performance.
- 2) People discount annual bonuses. During the first quarter, an end of year bonus feels so far away that it ceases to be top of mind.
- 3) It's harder to visualize the impact of one-month's performance in an annual bonus (equal to 1/12th of the overall plan), but on a quarterly basis, not only does every month count, but in some cases every week matters. It's a little like turning those months into weeks, and you see it in the intensity of your team.
- 4) Under a quarterly plan, every three months is a "new game". For the manager that did well in quarter, that does not help them in the subsequent quarter; and for the manager that had a bad quarter, they get to start fresh again.

IV. MAKE IT MEASURABLE

A hallmark of a great bonus plan is when the manager can calculate their own bonus. There's no "black box", no politics, no doubt that performance is rewarded. This means that for both

qualitative and quantitative criteria, you must do a good job of defining success (a bi-product of this standard is it forces you, as the CEO, to carefully define for your team what it is you and the board are looking for).

Imagine the CEO that tells her controller, “You need to fix receivables—they are out of control and we need to get them in line.” You’ve now left it to your controller to define his own standard for success, and it’s unlikely it’s the same as yours. Now consider a bonus plan, where improving receivables is part of their goals, and you’ve defined the specific level of reduction in the +90 day balance—that’s better for you, the controller, and your shareholders because not only is their alignment, but you’ve been forced to do the hard work of figuring out what is and is not reasonable.

This can be done for qualitative goals as well—and the fact that it’s hard to do is *precisely* why it’s important to do. Failing to do so is a bit like drawing the bullseye after you’ve shot the arrow. For example, if your product quality is lacking, and you want to improve product quality, you’ll improve your chances of success if you also define how you’re going to measure product quality—whether it be NPS, renewal rates, a decrease in service tickets, or number of product returns.

V. THE 90-DAY PLAN

Much of what you ask your managers to do is project based, episodic, or not immediately apparent in the financials. An example might be the creation of a new commission plan. While providing medium term value, in the quarter created it generates no profit for the company. Likewise, a smooth conversion of an MIS system is critical to the success of your company, just as an on-budget/on-time relocation of your warehouse—but neither will show up in that quarter’s financial results. They are, nonetheless, critical to your company’s success.

Therefore, some CEOs have had success with allocating a portion of a manager’s bonus to a 90-Day Plan. The key components of a 90-day plan may include:

- 1) Two to four key goals or projects. A byproduct of coming to a small handful of “priorities”, is it forces you to define true priorities for your manager, and then articulate those in an unambiguous way.

Many early CEOs (certainly was the case with me) bounce from “priority” to “priority” never fully committing to a single path and as such getting nothing done. By limiting the 90-Day Plan to a few items, it will press you to think hard about what really you need done that quarter.

- 2) As earlier indicated, while elements of a manager’s specific 90-Day Plan may be qualitative, you’ll want to do your very best job at defining success. For objectives that are especially difficult to create a measurable quantifiable standard, check in frequently with the manager and let them know how they are tracking. The best managers will come to you well in advance of the end of the quarter and ask if they have achieved 100% of that component, and if not what would constitute 100%.

By the way, the 90-Day Plan component should be completed for most quarters. These are targets largely within the manager's complete control.

VI. BALANCING OUT THE COMPONENTS

It's easy to find yourself overloading a bonus plan with too many components, such that any one achievement does not really move the compensation needle for the manager. For example, if your plan has eight components – and let's assume they are all weighted equally – any single target is only worth 12.5% of a quarterly bonus. If the manager's full annual bonus potential is \$20,000, a single quarterly component only has a value of \$625.00.

Instead consider finding targets that capture most of a manager's work, and don't have overlapping targets. For example, for your operations manager there's no reason to have a bonus for revenue, one for labor management, and another for material expense. Instead consider using a single gross margin target which will capture all three of those components. For the same reason, you'd not want to have a gross margin target and a sales target, because they are so intertwined you don't need both.

In the end, it would not be unreasonable to have only three components in the bonus plan. For example: 90-Day Plan, Gross Margin, and NPS.

The weighting between the components are important, but less than you may think. It's unlikely whether you weight the NPS target as 35% of the bonus, or 25% of the bonus, the decision will materially impact the manager's behavior. Instead it's likely to be more about signaling the culture of your company. For example, if Gross Margin is 50% and NPS is 10%, you've more or less said 'hit your numbers, and customer experience is just an added plus.' But if you were to rank NPS at 50%, you're sending a clear signal the company is to be built on providing outstanding customer results. As well, I would not have any one component less than 20% of the total, as the dollars at stake become too small to impact behavior.

VII. SLIDING SCALE AND SINGLE BULLSEYE

While some CEOs like to have multiple targets (e.g. a bank plan, a board plan, a manager plan...and then the CEO's top-secret plan of what they really think will happen), we recommend having a single bullseye that is the same for managers and the board. That plan represents not what you wish might happen, but the planning tool you and your team will use for what represents difficult, yet achievable targets. In this way, everyone (you, your team, and the board) are pulling for the same goals as a single team.

As an aside, some people mistakenly think by putting a very high target in front of someone, you increase the likelihood of hitting that number. My own experience is to give your team high-performing, yet realistic, goals...and then work to achieve them.

Consider a sliding scale, as you'll want to reward those that exceed the goal and you don't want to be in a position where someone missed a target by a non-material amount and loses their entire

bonus. The simple solution is a sliding scale, where 50% of the bonus is achieved by hitting plan, and 100% by beating plan by a predetermined amount. What this means, of course, is that a person’s bonus potential may be much higher than under a situation where the bonus is fully earned by just hitting plan—but that’s all good. You won’t mind paying out a few extra dollars to someone that just clobbered the plan.

For example, if the targeted customer attrition rate is 2.0% per quarter, then this bonus component may look like this:

	Percent Achieved				
	0%	25%	50%	75%	100%
Attrition Target	3.0%	2.5%	2.0%	1.5%	1.0%
Bonus Amount	\$ -	\$ 1,250.00	\$ 2,500.00	\$ 3,750.00	\$ 5,000.00

In this example, anything lower than 3.0% attrition will not earn a bonus, 50% of the bonus (which is also the company plan) is achieved at 2.0% attrition, and 100% bonus is achieved at a 1.0% attrition. Any midpoints are determined by linear interpolation.

By eliminating any cliffs, and avoiding binary outcomes where possible, managers are always pressed to perform. Even if they are not going to hit the full plan, and they know it, there is still money on the table for every inch they move toward achieving plan. Likewise, after the “budget” is in the bag, the manager has all the incentives to perform well beyond.

VIII. TRANSITIONING FROM LEGACY PLANS

You’ve no doubt inherited a compensation system that you’ll have to transition from. First, remember that compensation is highly sensitive to nearly every employee. Handle any changes to someone’s compensation with care and compassion.

If there is no bonus in place, or the level of bonus is lower than you would like, you might consider loading all future increases in compensation into the bonus component rather than lowering their base salary and replacing it with a bonus. For example, if the manager is making \$75,000 per year with no bonus, rather than give them a 5% increase for the following year (\$3,750), consider giving them a \$10,000 bonus potential, of which half of that is earned by hitting plan.

You might also want to roll this out slowly, first installing the bonus plan for some or all of your direct reports, getting the organization confident in the integrity of the plan and the associated norms, and only after that including the next level of managers in the plan.

IX. THUNDER PAY

I called it “Thunder Pay”, and you’ll no doubt have a better name, but I always included in the structure of the bonus plan a Thunder Pay component that was occasional and totally discretionary. For example, if your manager exceeded targets well beyond the 100% level, you can add some

Thunder Pay to the calculation. If an employee did an exceptional job solving a customer complaint, consider \$50.00 in Thunder Pay.

By the way, especially with employees who are not part of the bonus pool, gross up the Thunder Pay on an after FICA basis to a nice round number—you don't want to award them with \$50.00 in Thunder Pay but their paycheck reads \$41.37.

X. A FEW MISCELLANEOUS THOUGHTS

- 1) Make it clear to your managers you want them to succeed. Pay them with enthusiasm and show as much excitement for handing out the bonus check as they should feel receiving it.
- 2) Don't forget the theater! Make it an event and never add the bonus into the person's base salary so that the amount is buried in their regular paycheck. You want to physically hand them the check, thank them, and make a big deal over their achievement. If they are on auto deposit, make the bonus check a physical check that you can hand to them. In some cases, include some sizzle like a paid dinner reservation:

"Lenny, I could not be happier to give you this check. And I want you and your wife to celebrate your great quarter, so I made a reservation for you at Del Frisco's, the bill is coming to me, and don't hold back on desert or drinks. I want you two to really live it up on me."

- 3) The component weighting does not need to be the same for all managers (e.g. the CFO may have a higher percent attributed to the 90-Day Plan than the Sales VP), but within a given manager's plan, I would not change the weighting often. Best to keep one weighting in place for the entire year.
- 4) If you screwed up on the budget, and the bonuses are largely unachievable, partner in your board and discuss changing the targets. The purpose of a bonus plan is to reward, retain, and impact behavior. If the budget is unrealistic, then you're potentially wasting an important part of your compensation plan if you don't re-adjust.
- 5) Pay it out quickly. Calculate the bonus amounts, and then get the checks printed and in their hands.

Finally, a thoughtful bonus plan forces you to focus your organization around true priorities and also presses you to create measurable metrics for success. While the stated goal of a bonus plan is to reward and incent your team, a good plan forces you to better define where you want to take your company. It's more work for you, but it's a high-leverage opportunity you don't want to miss.