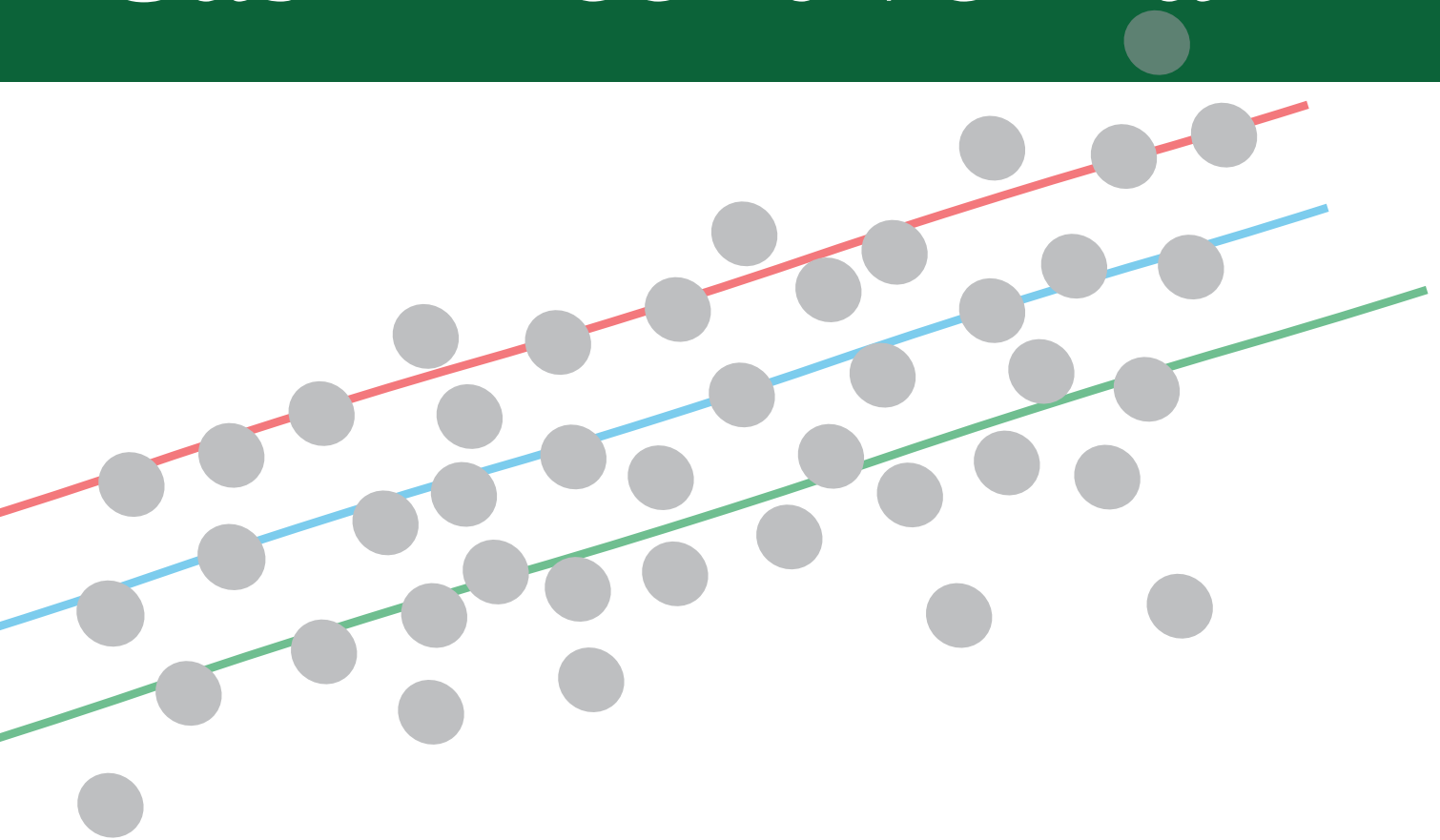


How To Establish A

# Cash Incentive Plan



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**Use this learning aid as a resource for employees to effectively develop, introduce, or update cash incentive plans.**

### **Why develop cash incentive plans?**

**Effective human resources programs depend upon achieving business goals (or return on investment). To reach these goals, HR professionals leverage the use of cash incentive plans which generally take the form of pay-for-performance plans.**

### **What is a pay-for-performance plan?**

**In a pay-for-performance plan, employees receive a fixed, competitive base salary and variable pay in the form of short- and long-term incentives (based upon individual, team or organization-wide performance). Employees with poor performance would not receive variable pay.**

# Before implementing a cash incentive plan, you must first consider:



## The Business Impact:

- **Fixed vs. Variable cost:** Labor costs become a flexible cost, higher when the organization is producing more and lower when the organization is less successful.
- **Incent / Motivate:** Encourage employees to work smarter, faster, or longer
- **Employee Engagement:** When cash incentive plans are well aligned to performance and goals, employees have greater job satisfaction which leads to stronger employee engagement.

# How to Design a Cash Incentive Plan

There are several design elements to address when establishing a cash incentive plan:



# Step 1: Define business need and objectives and plan choices

## Three plan levels to consider:

- Individual
- Group: Business unit, branch, team or department
- Corporate, organization-wide

## Plan choices: The most prevalent type of plans are: Gainsharing

Gainsharing plans are effective in continuous improvement and Six-Sigma organizations. This incentive approach rewards outcomes for the success of the work unit or organization, as opposed to the success of the individual employee. Gainsharing aligns employee to the management's performance measures.

A number of different performance measures used in gainsharing require setting a baseline standard to determine where the work unit or organization is "at the present time." Improvements in future measures of performance are then shared with employees. The standards reduce costs or improve productivity, depending upon the plan.

For example, employees are paid a bonus if costs remain below pre-established standards. The standards are based on past cost averages. The ways to reduce costs are developed by a series of committees (which include both employees and leadership) throughout the organization, and by a plant-wide screening committee that reviews and implements changes.

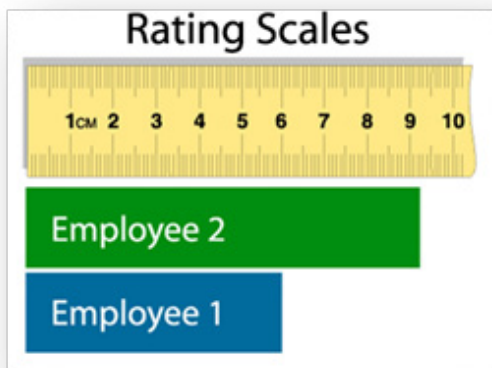
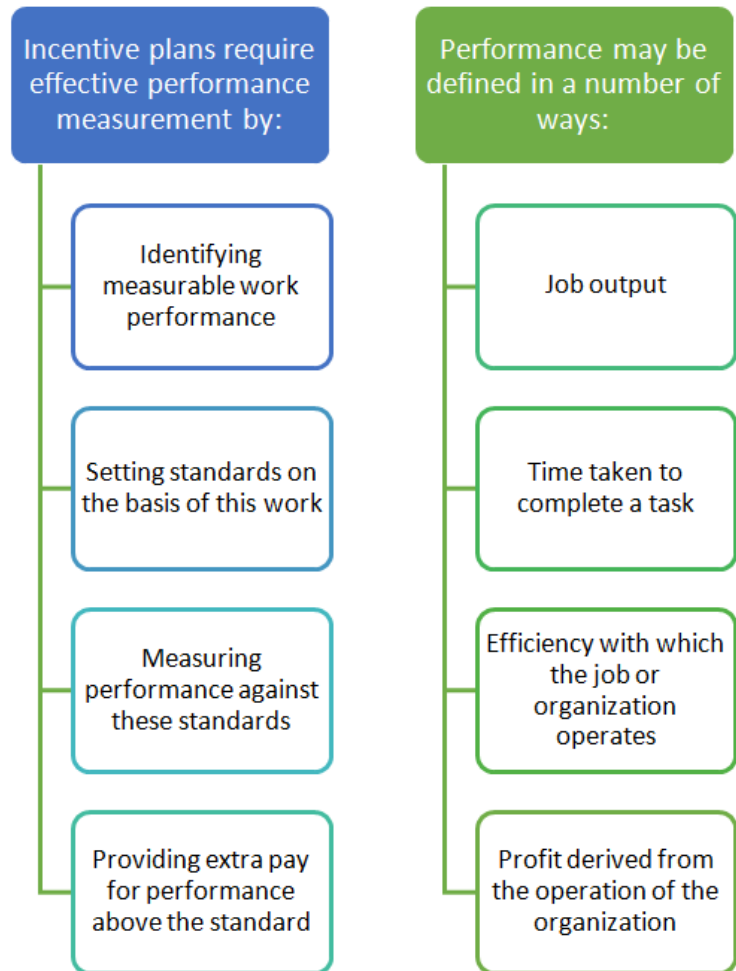
## Profit Sharing

Profit sharing plans provide an opportunity for employees to share in the organization's profits. The organization puts a portion of pre-tax profits into a pool that is split among eligible employees. Employees with higher base salaries receive a larger percentage of the profits. The money is usually paid on an annual basis.

Profit sharing plans assist in gaining employee focus on the bottom line and become more aware of the profit margin since they receive a piece of the pie. Management often feels that having the employee focus on profits is useful and will lead to organizational success. This type of plan provides for higher labor costs when the organization performs well and lower labor costs when the organization faces an economic downturn. Make sure profitability is achieved without compromising quality.

# Step 2: Performance Measurement

Performance measurement is probably the most important step in establishing any incentive plan.



Many cash incentive plans employ multiple performance measures by using a composite score (if possible). The values of the performance measures are added together.

## Step 3: Assign weights to each measure

**The relative importance of a measure can be set by assigning weights. There are 3 main methods.**

1. Use a number of compensable factors based on the job evaluation results.
2. Use the multiple-hurdle approach, in which a minimum threshold level must be reached on each performance dimension before any incentive is paid.
3. Utilize a series of mini cash incentive plans, one for each performance measure.

## Step 4: Define costs

Cash incentive plans that focus on efficiency involve defining a standard or normal cost and then rewarding employees on a schedule that is achieved at less than this standard cost. Ensure the financial metric is reliably measured and available to be reported to plan participants.

## Step 5: Relate performance to reward

The central imperative in a cash incentive plan is that the person being paid understands that a particular outcome or behavior, when compared successfully with the performance standard, will lead to a specified reward. In order to develop this relationship, the following must be present:

- The performance standard must be clearly stated.
- The ratio between the performance standard and the reward must be delineated by modeling a payout curve in which the slope represents the ratio.

## Step 6: Payout Timing and Frequency

The closer the reward is received to the desired performance, the stronger the motivational value. The employee can more easily attribute the reward to a particular performance outcome.

## Step 7: Determine the Incentive Amount

The degree to which the amount or percentage that can be earned will be perceived as significant varies with each person. In general, rewards of less than 5% of base salary are not considered highly motivating.

Variable pay is pay at risk. It may be based on organizational, team/group, or individual performance. Often, the criteria may be organization-based, such as return on equity (ROE), return on investment (ROI), profit target, division, or individual performance.

The incentive amount may be determined as a percentage of profits or net income that exceeds a percentage of capital, as in a **formula-driven plan**. In this type of plan, the formula generates a fund and individuals share on a pro-rata basis.

The incentive amount may also be an individual award and/or organizational goal which is established and awards are based on achievement against these established goals. This type of plan is referred to as a **performance target plan**.



# Step 8: Implementation

**Communicate, educate and train all the stakeholders. Ensure that there are no shortcuts at this step**

## Conclusion

Once the cash incentive plan is implemented, the plans need to be evaluated for on-going alignment to changes in the business. More cash incentive plans fail because of inadequate auditing and maintenance than for any other reason. Organizations with successful cash incentive plans audit all phases of the incentive operation at regular intervals of one year or less.

Standards may be audited by analyzing an operation selected at random. Failure to meet or exceed standards should be carefully investigated, and the reasons should be found and corrected. Remember, paying workers “average earnings” if they fail to reach standards (rather than finding and correcting the reason for the failure) weakens cash incentive plans. The periodic audit assures that high earnings are not used as a signal to revise standards, but that every standard is periodically audited and revised up or down as prevailing circumstances dictate.



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