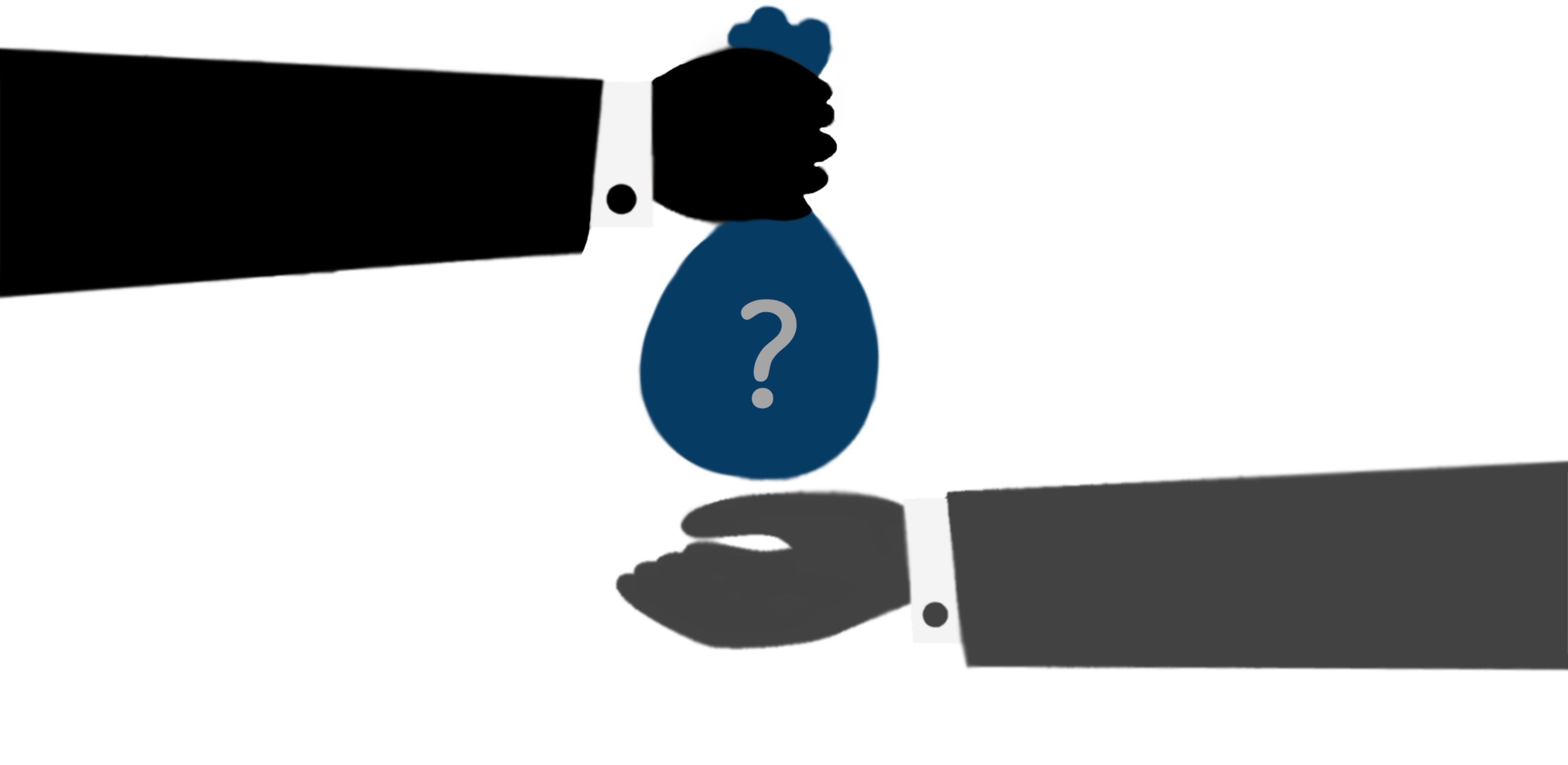
ECONOMIC RESEARCH INSTITUTE

Designing Cash Incentive Plans



Why Develop Cash Incentive Plans?

Cash or short-term incentive plans (STIP) engage employees in the process of achieving business objectives, reward desired behaviors, and help execute the organization's long-term strategy. Organizations will generally invest in technology and training to enable employees to perform their job responsibilities effectively. An often missed opportunity is integrating cash incentive plans to the rewards and performance programs for employees. Incentive plans, when properly aligned to business outcomes and rolled-out effectively, can be a powerful tool that enable organizations to "do more with less" and achieve a greater return on investment (ROI) in cash compensation programs.

If labor costs are a significant expense in your company financials, consider introducing a cash incentive plan. The positive business impact of this type of plan includes incentivizing and motivating employees, engaging them in their jobs and business outcomes, and better financial management of fixed versus variable costs. Cash incentive plans are intended to be self-funded and trigger payout when achievement of business outcomes exceeds current baseline performance.

Impact

Fixed vs. Variable Cost: flexible costs that increase when the profits increase

Motivation: encourage employees to work smarter, faster, or longer

Employee Engagement: greater job satisfaction with line of sight to impact on business and customers

Is your organization ready?

For incentive plans to work, your organization has to be ready in terms of culture and environment. Before implementing a cash incentive plan, evaluate the prevalence of the following:

- **Teamwork with individual accountability:** Employees generally need to cooperate rather than compete with one another. An effective incentive plan requires employee collaboration and productive working relationships.
- **Leadership sponsorship:** Business leaders must be committed to a pay-for-performance culture and relationships with employees based on trust and empowerment.
- **Employee participation:** Effective incentive plans must be credible and accepted by the eligible employees. This is accomplished by having a cross-section of different employees participate in the design and testing of the STIP plan drafts.
- **Keep it simple:** Employee trust requires that they understand how the plan works, how it affects their pay, and how they can influence the measures assigned to them in the STIP. Complicated payout calculations or formulas coupled with many policies or procedural rules, as well as too many performance measures, will confound the plan.
- **Transformation:** New incentive plans should be not be introduced while an organization is going through technological or other transformation, as it will be difficult to determine baseline standards for current performance. Other project milestone bonus programs can be introduced during periods of transformation.

Depending on the outcome of your evaluation, there may be "pockets" in the organization conducive to incentive plans, while others may need additional effort, like one-on-one conversations with leadership, team building exercises, and/or employee focus groups. Put in the extra effort up front to ensure that stakeholders buy into the plan.

How do I design a plan?

The key decision points in plan design are determining the plan level, performance measures, incentive amount, and timing or frequency.

Plan Level

A large organization can typically make the resources commitment required to support individual-level plans. Small organizations with limited resources will have department-wide or organization-wide plans to minimize the administrative burden associated with more individualized plans.

Consider these three plan levels:

For individual plans to work, several requirements must be met.

- **Independence:** These plans assume that the employee is an independent operator that can carry out all of the activities required to achieve the performance measure without assistance from another worker. In this way, performance is a function of the employee's effort. Many call center or telemarketing environments will have individual level plans.
- **Measurability:** The performance standard must be clearly defined and measurable if such a plan is to be useful.
- **Stability:** The job must be relatively stable. The output required from the job should be consistent, and the input to the job should arrive in such a way that the employee can work continuously.

Performance Measures

Performance measurement is probably the most important step in establishing any incentive plan. Organizations must be certain that incentive pay plans are based on meaningful measures of required output, rather than merely activities that can be easily measured yet do not have a discernible business impact. If the selected measure is related only peripherally to organization goals, the incentive plan impedes attainment of organization goals. Ensure that the metric is reliably measured and available to be reported to plan participants. The process of selecting meaningful measures should include the following steps:

1. Define the output of the job by identifying measurable work performance.
2. Set standards on the basis of output results, such as cost reduction, efficiency, productivity, or customer satisfaction.
3. Select two to five performance measures and assign weights to their relative importance.

To a customer service representative, revenue goals may establish line of sight, yet customer retention or satisfaction may be a better measure.

The other component to measures is establishing line of sight to broader levels of performance. For example, a recruiter has a goal to improve the time to hire, the overall HR department has a goal to improve quality hires, and the company's goal is to improve retention. The recruiter's cash incentive plan can be linked to one or all three levels depending on the business requirements and work processes, as shown in the below table:

Plan Level	**Plan Variations** 1	2	3	4
Basis of Measures	**Time to Hire**	**Time to Hire and Quality Hires**	**Time to Hire, Quality Hires, and Retention**	**Quality Hires and Retention**
Individual	100%	50%	25%	0%
Division, site, team, or department	0%	50%	25%	50%
Corporate or organization-wide	0%	0%	50%	50%

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. You want to provide extra pay for performance above the baseline standard while ensuring that the organization's business objectives are achieved. As you are evaluating the incentive amount, you also want to review internal pay relationships such that lower-skilled workers participating in an incentive plan do not earn more than their supervisors or higher-skilled workers who are not participating in the plan.

Define the current baseline standard and then reward employees for achievements that exceed that baseline.

In determining the incentive amount, the following analysis and benchmarking are necessary:

- Determine the competitive base salary and total cash compensation benchmark for the job(s) and associated plan participants. Refer to images #1 and #2.

  The example benchmarks assume a total rewards philosophy that pays competitive base salaries at market mean and total cash compensation for high performance at 65th percentile.

- Determine the appropriate pay mix at the threshold, target, and maximum. Refer to image #3.

  The example analysis models 3%, 5%, and 8% payouts for the threshold, target, and maximum, respectively.

Image #1. Source: ERI's Salary Assessor – Base Salary Benchmark List

Benchmark List

-- Select Saved List --

Compensation Type: Base Salaries | Pay Period: Annual | Percentiles: Customize | Experience: Default

#	Position	10th Percentile	35th Percentile	Survey Mean	65th Percentile	90th Percentile	Actual Salary	Market Index
1	Customer Service Clerk	27,098	29,713	31,475	32,462	36,061	30,400	97
2	Customer Service Representat	31,825	35,686	37,997	39,484	44,200	36,800	97
3	Assembler Metal Fabricator	30,664	34,368	36,658	38,118	42,771	36,000	98
4	Extruder Operator Plastic	29,799	33,370	35,607	37,035	41,610	35,000	98

Image #2. Source: ERI's Salary Assessor – Total Cash Compensation Benchmark List

Compensation Type: Total Compensation | Pay Period: Annual | Percentiles: Customize | Experience: Default

#	Position	10th Percentile	35th Percentile	Survey Mean	65th Percentile	90th Percentile	Actual Total Compensation
1	Customer Service Clerk	27,520	30,176	31,961	32,967	36,623	30,000
2	Customer Service Representat	32,863	36,851	39,229	40,773	45,643	40,000
3	Assembler Metal Fabricator	31,187	34,955	37,279	38,769	43,502	37,000
4	Extruder Operator Plastic	30,236	33,860	36,126	37,578	42,221	36,000

Image #3. Source: ERI's Salary Assessor– Benchmark List Exported to Excel (Supplemented with User Analysis)

ERI's Salary Assessor ®
Today's Date: 4/5/2016

Benchmark Listing of Positions

	ERI Survey														
	Salary		Total Compensation		Actual / Present		Pay Mix (salary/incentive)			Incentive			Total		
Position	Mean	65th Percentile	Mean	65th Percentile	Salary	Incentive	Threshold	Target	Max	Threshold	Target	Max	Threshold	Target	Max
Customer Service Clerk	$ 31,475	$ 32,462	$ 31,961	$ 32,967	$31,000	$ -	97/3	95/5	92/8	$ 930	$ 1,550	$ 2,480	$ 31,930	$ 32,550	$ 33,480
Customer Service Representative (General Calls)	$ 37,997	$ 39,484	$ 39,229	$ 40,773	$38,000	$ -	97/3	95/5	92/8	$ 1,140	$ 1,900	$ 3,040	$ 39,140	$ 39,900	$ 41,040
Assembler Metal Fabricator	$ 36,658	$ 38,118	$ 37,279	$ 38,769	$36,000	$ -	97/3	95/5	92/8	$ 1,080	$ 1,800	$ 2,880	$ 37,080	$ 37,800	$ 38,880
Extruder Operator Plastic	$ 35,607	$ 37,035	$ 36,126	$ 37,578	$35,000	$ -	97/3	95/5	92/8	$ 1,050	$ 1,750	$ 2,800	$ 36,050	$ 36,750	$ 37,800

ORGANIZATION DATA:
Area: West Chester, Ohio
Industry: All Industries - Diversified
Codes: eSIC: 0000, NAICS: 000000, usSEC: 0000
Size: (Data reported by years of experience)
Planning Date: 4/5/2016
Years of Experience: Default
Annualized Salary Trend: 2.5% (Adjustment: 0%)

Data as of: 4/1/2016

Payout Timing and Frequency

The payout of the financial rewards should be soon after the goal is achieved. Most incentive plans are paid out on a quarterly, semi-annual, or annual basis—especially organization-wide plans. For lower-skilled employee or service industry employees, results are measured on a more frequent basis, and payouts will generally be on a monthly or quarterly basis, allowing for reporting, calculations, and payroll processing. The closer the reward is to the desired performance, the stronger the motivational value.

What is the best incentive plan?

The incentive plan should reflect the intended business impact and the assessment of the organization readiness. There are several types of plans.

Gainsharing

Gainsharing plans are effective in continuous improvement, as in Six-Sigma organizations which require employee participation by providing feedback and suggestions for improvement. Gainsharing aligns the employee to management's performance measures. These plans are generally part of an overall cultural shift to encourage team work, collaboration, and increased engagement.

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. Determine the quality or quantity requirements then evaluate the amount of improvement that can positively affect the standards to reduce costs, improve productivity, or increase customer loyalty or satisfaction, 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 throughout the organization and by a plant-wide screening committee that reviews and implements changes.

As with any initiative that affects the organization culture, there needs to be commitment to monitor, audit, and keep the program aligned with business realities. Gainsharing plans require the commitment of resources to coordinate suggestions, improvements, measurements, and broader communication efforts. Critical to success is understanding there is no silver bullet approach to introducing a gainsharing plan; rather, it is important to follow a process of open, transparent, and collaborative communication so that all stakeholders trust the program.

Profit Sharing

Another plan type is profit sharing. These 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 distributed 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 employees in gaining focus on the bottom line and becoming 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 results in higher labor costs when the organization performs well and lower labor costs when the organization faces an economic downturn.

There are several types of profit sharing plans, which are differentiated based on when profit shares are distributed:

- **Cash plans:** pay out profit shares at regular intervals; also known as current-distribution plans
- **Deferred plans:** is frequently tied to a retirement plan
- **Combination plans:** profits to be distributed are managed by a trustee, and distribution is delayed until some event occurs; this type of plan is frequently tied to a retirement plan

Unfortunately, there are disadvantages to using profit sharing plans:

- **Employee perception:** Employees do not receive rewards based on their individual efforts and so may feel that their individual performance does not matter.
- **Quality control:** Profitability may be achieved at the expense of quality.
- **Taxes:** The Fair Labor Standards Act (FLSA) requires employers to recalculate each non-exempt employee's regular rate of pay, based upon his or her total compensation. Some profit sharing programs may have components that will require a recalculation of "regular pay."

Guiding Principals

Incentive plans assume that performance varies among employees and that this difference is observable. In many jobs, variation is impossible or is so indiscernible that it is unrealistic to try to measure it for pay purposes. Even if there are differences, measuring them or attributing them to the effort of the employee may be difficult. Frontline employee incentive plans in the manufacturing and related industries that produce physical goods will generally have team or gainsharing type plans, as explained earlier. Services industries may use individualized incentive plans, as the direct line of site to employee efforts is more observable.   Both types of plans are self-funded, with payouts occurring only after a baseline standard is met.

For a compensation plan to motivate performance, employees must…

- believe that good performance will lead to more pay,
- want the reward that the organization is offering,
- understand that good performance will not lead to negative consequences,
- realize that other desired rewards (besides pay) result from good performance, and
- believe that their efforts lead to improved performance.

Employees may feel that their performance is not being truly rewarded if…

- the performance measured is affected by things beyond their control so that their efforts have little effect,
- the performance measure does not adequately reflect contributions made within a reasonable line-of-sight, or
- the incentive plan is based on a limited number of employee contributions that may be perceived as reflecting neither the contributions they make nor those that the organization really requires.

Summary

Designing incentive pay plans requires alignment with business objectives and the organization culture. The manner in which performance and rewards are connected will require a clear definition of performance and identification of funding for the incentive pay plan. Once the cash incentive plan is implemented, the plan needs to be evaluated for on-going alignment to changes in the business. Part of the plan maintenance and auditing is evaluating those who do and do not receive a payout to determine if the measures are appropriate for the business relative to employee skills and capabilities. The periodic audit assures that high earnings are not used as a signal to revise standards, but that every standard is periodically reviewed and revised up or down as prevailing circumstances dictate.

If you have any questions or want additional information regarding the content of this research and related compensation analytics, give us a call today at **1-800-627-3697** and one of our Subscriber Services team members will be happy to assist you.