More Bang for your Bonus

A practical White Paper by Chris Lang, DBA Expert

Everyone loves a bonus, whether it's an unexpected one off or a reward for a job well done. Some companies hand out bonuses on an arbitrary basis depending on their opinion on how particular employees have performed, others pay them on the basis of how much profits the company has made over a period of time. Although not all, a lot of companies create a bonus scheme and do a great job of communicating it to their employees. But why can a bonus scheme be important and how does a company go about setting one up in the first place?

Why a Bonus Scheme?

The first point is to see a bonus scheme as a tool that can be used to drive a company's strategy, not merely as a means of rewarding employees. Most companies have a three to five year strategy involving driving revenue whilst controlling costs in order to raise net profits to a desired level. This net profit level is likely to depend on the owners' wants and desires for the company. Having a focus on these targets allows a bonus scheme to be designed to fit in with the company's overall strategy and drives the company towards attaining its goals.

However, it's not all about the numbers. Another key element in a company being able to achieve its target is having good, talented employees who are able to drive the company towards attaining its maximum potential. It is usually the case that spending on retaining good employees is more cost effective than recruiting and training new ones. Having a well-designed bonus scheme, that's targeted, communicated and achievable, can be one of the factors employees take in to account when considering their worth to a company and their desirability to work hard for it. Again taking a strategic approach to the structure of the bonus scheme is important in order to have the most impact. An element of a bonus scheme dedicated to Continuing Professional Development, along with regular employment reviews, is a good way to demonstrate a company's commitment to its employees which in turn should lead to higher loyalty and employee retention.

One element that can put companies off having a structured bonus scheme is the perception that this ties them into a scheme that might have a detrimental effect should the finances of their company take a downward turn. By linking the bonus scheme to the financial performance of the company bonuses would only be paid out if there's the money to fund it. In all cases any bonus payments should always be at the discretion of the directors of the company. Even if a bonus scheme forms part of an employment contract this caveat should always be made clear. This gives the directors the right to amend or cancel any bonus payment which, whilst not being ideal from an employee relations point of view, can be necessary in extreme situations.

What should a Bonus Scheme look like?

One way of designing a bonus structure so that it drives both the company towards its target and its employees towards their individual development is to set a method of creating a bonus pool and then splitting this in to two elements; a financial element and a non-financial element. Careful consideration should be given to the basis on which the pool is created.

A bonus scheme that pays out 'X to an employee if net profits for the year are 'Y' is simple to calculate and easy to explain, however it's difficult for employees to see how their efforts can affect the outcome of company's financial performance, especially if they don't control the levers that lead to the net profit amount.

For example, a company may be doing a great job of winning business and delivering projects on time and under budget but if the directors of the company decide that they need to increase their spending on marketing in order to continue to drive the company this could have a big impact on the company's net profits. So we have the employees working really hard to deliver the company's strategy on revenue but not seeing any reward in terms of bonuses. The risk in this is that employees become demoralised, their performance begins to dip, revenues decrease therefore net profits decrease and by default so do bonuses. A vicious cycle!

It is therefore important that employees feel they have their bonus destiny in their own hands.

One way around this situation is to base this element of the bonus scheme on the Gross Profit (or Revenue) of the company. In order for a company to cover its costs and make the required Net Profit, a definitive amount of Gross Profit is necessary.

Creating a Bonus Pool

This should be based on the company reaching specific financial targets. A bonus pool is created once the financial targets have been reached with the pool increasing when the targets are exceeded. The first target is almost certainly going to be a desired amount of Gross Profit. However it is often necessary to have a secondary target to ensure the Gross Profit generated translates in to higher Net Profits. This secondary target should, in most cases, be linked to average employee efficiencies i.e. staff cost to fee ratio, average hours billed to clients, utilisation percentage etc.

The bonus pool can be based on a set amount for reaching the targets plus a percentage of the difference between the monetary target and what was actually achieved.

For example:

Gross Profit target = £1,000,000
Billed Hours target = 1,600 per employee
Bonus for reaching targets = £20,000
Actual Gross Profit achieved = £1,200,000
Billed Hours achieved = 1,610
Gross Profit above target = £200,000
20% of this goes in to the bonus pool = £40,000
Total bonus pool = £60,000

Financial – 50% Company Wide

Half of this bonus pool would then be split out between all the employees of the company. There are various ways this can be then distributed between them:

- Pro rata based on an employee's salary in relation to total salaries
- Pro rata based on an employee's grade i.e. all Designers receive the same amount
- All employees receive the same amount

The aim of this element of the bonus is to drive behaviour to help the company attain its financial strategy. By linking it to Gross Profit it means the employees have the levers and ownership that can directly impact the amount they're likely to receive in bonuses.

Non-Financial – 50% Individual

The remaining balance of the bonus pool can be distributed on an individual basis. It's ideal if there is a formal annual employee review process in which an individual is set personal targets to achieve. The money remaining in the bonus poll can then be distributed to those employees that are deemed to have exceeded their personal targets and would form one part of their reward package.

One method of determining the amount an individual employee would receive from this pool would be to mark them on a score of 1 to 5 on a set number of personal targets. When this has been done for all employees all the marks can be added up and the total of this element of the pool divided by the total marks. This would give an amount per mark that can then be multiplied by the number of marks each individual has achieved.

Using the previous example:

Half of the total bonus pool = £30,000
Total marks achieved by all employees = 300
Bonus amount per mark = £100
Marks for employee 'A' = 12
Individual bonus amount for 'A' = £1,200

The aim of this part is to incentivise employees to improve their knowledge and ability thus helping them to achieve goals relevant to them but also in line with the company's strategy, creating a workforce that is highly incentivised and very loyal to the company.

Overall bonuses can be a powerful tool when used strategically to drive a company to attaining its goals. By linked it directly to the company's financial performance it should always be affordable and accountable. So long as it is clearly communicated to employees it is also a great way of increasing loyalty and giving employees a feeling of control and ownership over their own destiny.

Chris Lang has been working in the Marketing Communications industry for over 20 years. In 2007 he formed Flash Accounts Ltd with the aim of providing small and medium sized companies with a full internal finance function without the cost of full time employees. He calls this service "in-sourcing."

Chris and his team have worked with many companies over the years to help improve their financial performance, not only by processing day-to-day data but also improving processes and commercial awareness throughout the company. This approach ensures high quality information and therefore better decision making at the top level.

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