Word to the Wise

How to Build an Incentive Compensation Plan

It's well known that the manufacturing industry is facing a talent shortage. In fact, according to the 2015 Skills Gap Study conducted by Deloitte Consulting & The Manufacturing Institute, it now takes more than 70 days to recruit skilled production workers and 90 days to recruit highly skilled engineers, researchers and scientists.

One of the keys to keeping skilled employees on board is compensating them appropriately. Many manufacturers and distributors have implemented incentive compensation plans to keep key personnel motivated and happy at work.

According to compensation consultant Andy Klemm, incentive compensation plans are intended to produce "differential performance in people and jobs." Incentive payments — which are earned in addition to an employee's base salary as a reward for meeting certain goals — typically start at 15 percent of an employee's base salary.

Tie to Overall Goals

To do their job of driving desired change, incentives must encourage behaviors and activities that further the company's overall mission, values, culture and compensation philosophy.

When launching a plan, you may want to start with just a small group of executives. Meet with them to define which goals should be incentive eligible. Goals should be "SMART" — Specific, Measurable, Attainable, Results-oriented and Time-based. A well-designed plan will include goals that relate to all areas of the company including finance, operations, customer service and employee development and training.

For example, a goal for a purchasing executive might be to reduce purchasing costs by a certain percentage over the next year. A safety officer might be incented to meet specific goals for lost-time accidents. And, an operations executive might have a goal of installing a new production line by a certain date or redesigning a process to reduce costs.

Some goals will be shared among several employees, while others will fall to individuals. Klemm says that each employee should ideally have three or four goals for the year, and they don't all have to be equally weighted.

Funding the Plan

This is where many owners get nervous — and many plans fail. But if designed correctly, the incentive compensation plan will fund itself. The plan will either create enough savings or produce enough revenue to fund a pool from which incentive compensation payments are made to participants.

This self-funding concept is integral to the effectiveness of the plan because it gets all participants pulling together to create the funding pool. Payouts are typically made annually.

Communication with participants should be extremely clear and straightforward, outlining exactly what they need to do to earn their incentive payments. Avoid complicated formulas — a one-page description of all goals and performance targets should be sufficient.

Most companies start with one-year goals, but as the incentive plan matures, it's common to add long-term incentives that cover two to four years.

Think It Through

Before committing to a payout schedule or amount, be sure to discuss your plan with your financial advisors. Your CPA can help you think through logistics, help vet your goals against your strategic plan, and alert you to any tax consequences.

We are committed to your success and we hope you find this information valuable. If you're considering offering your employees an incentive comp plan, we can help. Contact us today to discuss your options.

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