

## **J.R. Huston Enterprises, Inc.**

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### MS Excel worksheet Figures (attached)

- Figure 48-1 GPM incentive model
- Figure 48-2 NPM incentive model

### MS Word Figures (attached)

- Figure 48-3 The Bonus checklist

### Key Terms

- Bonuses
- Incentives
- Micro bonuses
- Non-monetary incentives

### **PURPOSE**

- To explain the difference between the “traditional” bonus and an incentive
- To explain numerous forms of bonus and incentive methods

### **INTRODUCTION**

What happens in your business when you’re not there? If you left for six months, would you return and still have a financially viable company? Or does everything depend on you?

Not too many years ago, one of the nation’s largest retailers was exposed for its faulty incentive program in its automobile repair department. Managers were rewarded for “up selling” customers. Unfortunately, this practice got out of control, as customers were sold many repairs they simply didn’t need. The national news media got wind of the problem and did an exposé of the retailer, and customer loyalty still suffers.

**\*\*\*\*\* How it works – start \*\*\*\*\***

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One of my clients was very interested in changing the culture within his company. He wanted his managers to “buy into” the company and take ownership for key divisions of the organization. He heard rave reviews about a company that specialized in helping businesses like his accomplish this goal. My client ended up spending over \$50,000 and investing hundreds of man-hours with this company, hoping to change the culture within his organization. Unfortunately, he never did achieve the cultural change he desired and, to this day, he considers the time and money he spent as being wasted.

**\*\*\*\*\* How it works – end\*\*\*\*\***

### **Bonuses and Incentives**

Quite often we use the terms bonuses and incentives interchangeably. However, some confusion exists concerning the two terms that we should address. Let’s start our discussion with some basic definitions.

According to the dictionary, a bonus is “Something given or paid in addition to the usual.” An incentive, on the other hand, is “Something inciting one to action or effort; stimulus.” While the two definitions may not appear to vary much, there is a subtle difference.

**\*\* Main point:** A bonus is “Something given or paid in addition to the usual.” **\*\***

A bonus, the traditional Christmas bonus is a good example, is generally paid with little or no input from the recipient. The person receiving the bonus usually has very little knowledge as to how it’s calculated or determined. It somehow appears from above cloaked in mystery.

**\*\* Main point:** An incentive.... is “Something inciting one to action or effort; stimulus.” **\*\***

The whole purpose of an incentive, on the other hand, is to get the participant involved in the business processes, to help improve those processes, and to share in the monetary rewards of doing so. Owners are encouraged to open up their “books,” and share vital company information with employees. You want them to think like entrepreneurs, who are concerned about the company as an entity. You basically want to create a culture within the organization where everyone desires to build a great company.

The following axioms may seem simplistic but I think they very well communicate two very important principles you want to echo throughout your organization.

We have to take care of the goose that lays the golden eggs.

We don’t get to take cookies out of the cookie jar unless we first put them in.

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It really boils down to just that. If we can create a culture in our company that fosters its long-term financial health and viability, and if everyone participates in the rewards for doing so, we'll have implemented the key components of an effective incentive system.

There are numerous versions of bonuses and incentives being used today. Some are very simple; others are quite elaborate and complex. Whole industries have sprung up whose primary focus is to teach other businesses how to implement an incentive program. I've seen particular methods be extremely effective in one company but not in another. What works for one business doesn't necessarily work for the other. However, there are some principles that prevail.

- Keep it simple, the simpler the better.
- Design the incentive method to fit the culture of the company.
- If the incentive method fails, it isn't the fault of the company using it.
- Employees need to buy into the process, not just the money.
- Incentive methods should be self-funding.
- Entrepreneurial thinking is the goal of an incentive plan.
- Think scoreboards. Remember, what gets measured, gets done!
- Think simple charts and graphs.

We're going to review three basic incentive system methods, plus a number of "micro" or mini-methods. First, let's talk about non-monetary incentives.

### **Non-monetary incentives**

Studies have repeatedly shown that money is not the primary force that motivates people to come to work, buy into the company and do a good job. In the book, ***Built to Last***, the authors construct an excellent case for **non-monetary incentives** and the principles and core values that make a great company endure. Companies with the right culture not only endure, they thrive. They're also the most profitable companies. However, profits and making money are of secondary or tertiary importance at best.

One of the enduring principles of the great companies is that they put their people and the development of their people first. They invest heavily and constantly in the people who make the organization work. Do employees respond to this type of culture? Absolutely!

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The dictionary defines “mercenary” as: “serving merely for pay or sordid advantage; venal; also: greedy.” Companies and employees focusing just on “making money” usually don’t, over the long haul. They may end up “rich” in monetary terms but little else.

Companies, whose primary concern is to create the right culture, and to focus upon core values and enduring principles, create and sustain corporate greatness. They’re also the most profitable companies. However, money and profits are a by-product of the culture, not the primary objective of the organization.

If money and profits are your primary objectives, you’ll create a culture filled with mercenaries. And mercenaries don’t build great companies.

### **Who gets an incentive?**

Preferably everyone will participate in the incentive program. However, this isn’t always possible. Many of my clients like to assign a point value to all the various positions within their companies. Or they might have two separate incentive programs: one for managers and one for field staff. It might look like this.

<u>Position</u>	<u># People</u>	<u>Points</u>	<u>Total points</u>
Division managers	1	5	5
Assistant managers	1	4	4
Office manager	1	4	4
Foremen/crew leaders	3	3	9
Leadmen	3	2	6
Laborers/admin clerks	<u>5</u>	1	<u>5</u>
Totals	14		33

### **How much will each person get?**

Once the values are assigned, the points are calculated and totaled. The total of the incentive to be paid is divided by the point total. This provides us with the per-point value. An individual’s incentive amount is determined by multiplying his or her point total by the value for one point.

### **When should you pay the incentive?**

The timing for paying the incentive is important. Many of my seasonal clients pay their incentives twice a year. One payment is made in early July, and the second at year’s end. Other clients choose to pay field crews twice a year, but key management personnel at either the calendar or fiscal year-end.

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Companies that aren't seasonal in nature often prefer to pay out quarterly incentives. Doing so requires a little more paperwork, but it helps keep the incentive system uppermost in the minds of staff.

### **A penny saved**

The timeless adage, "A penny saved is a penny earned," certainly applies to incentive programs. To put this maxim in perspective, ask yourself a couple of questions.

Question # 1:

If you increase sales by \$1, how much pre-tax net profit goes to the bottom line (assuming a 10 percent net profit)?

Answer:

\$0.10

Question # 2:

If you save \$1 in cost by being more efficient, how much pre-tax net profit goes to the bottom line (assuming a 10 percent net profit)?

Answer:

\$1

Question # 3:

Would you rather have \$1 or \$0.10 in extra net profit?

My point is that an incentive program shouldn't just reward additional sales. It should also focus on operational efficiency. Both are important and necessary.

### **What about Total Quality Management (TQM)?**

TQM and an incentive system should work hand in hand. Remember what Philip Crosby said in his book, *Quality is Free*. "...quality is precisely measurable by the oldest and most respected of measurements—cold hard cash."

Improvements in quality will go to your bottom line. If your incentive method reflects the bottom line, the two will reinforce one another.

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### **Do incentive systems have anything to do with exit strategies?**

Let me answer this question with a resounding, “Yes!!” An incentive system properly designed rewards everyone for taking ownership of the company and for thinking like an entrepreneur. It empowers people throughout the organization and it encourages and allows the person experiencing the problem to solve it.

As people are properly trained, most problems are identified and solved at the lowest levels within the organization. This is not only the most cost-effective solution but it also allows for and promotes absentee ownership. As everyone is allowed to solve problems and implement creative solutions, the company depends on top leadership less and less for tactical or production decision making. Top management is then able to focus its primary attention on strategic issues, rather than daily tactical ones. It's this very process which creates and optimizes exit strategy options.

An exit strategy is a well-planned process by which you transfer ownership of the company to employees, relatives, another company, etc. The possibilities are numerous. The objective of this process is to transfer ownership in a legal manner that optimizes your return for the business and the continued success of the company. A properly designed incentive system will normally greatly enhance the exit strategy process.

### **The Gross Profit Margin (GPM) Incentive Model**

The gross profit model focuses on achieving a predetermined amount of gross profit dollars. Note that the focus is on *dollars*, not *percentages*. A gross profit percent is not an absolute. If your goal was 35 percent gross profit and you paid incentives on anything above it, you could actually be paying incentives while you're losing money.

I like to identify a dollar amount of gross profit for the company or division to attain during the fiscal year. Once it's achieved, the incentive kicks in. Normally the incentive is a percent of the amount of gross profit above the targeted goal. Many of my clients pay out 25 percent of the dollars above the targeted amount as an incentive. However, first we need to determine who gets paid, and then how much to pay them.

Let's use a specific example. See Figure 48.1.

#### **\*\*\*\*\*Figure 48.1 The GPM Incentive Model\*\*\*\*\***

Key managers and staff from ABC Landscape Company have formulated a budget with a sales revenue goal of \$1,000,000 for the upcoming year. Direct costs are budgeted at \$650,000. General and administrative (G&A) overhead is budgeted at \$250,000 and net profit before tax is

## J.R. Huston Enterprises, Inc.

budgeted to be \$100,000. For the purposes of simplicity, we'll assume we have four quarters of equal revenue and costs. Our breakdown looks as follows:

	<u>Annual Budget</u>		<u>Quarterly Budget</u>	
Sales revenue	\$1,000,000	100%	\$250,000	100%
Direct costs	<u>650,000</u>	65%	<u>162,500</u>	65%
Gross profit target	\$ 350,000	35%	\$ 87,500	35%
G&A overhead	<u>250,000</u>	25%	<u>62,500</u>	25%
Net profit	\$ 100,000	10%	\$ 25,000	10%

We'll pay the incentives on a quarterly basis. However, we'll pay 25 percent, 50 percent, 75 percent and 100 percent of the accumulated incentives after the first, second, third and fourth quarters, respectively. This should compensate for a bad quarter.

At the end of the first quarter, sales were \$225,000 and the gross profit was \$90,000, or 40 percent. The incentive paid works out as follows:

Sales revenue	\$225,000	100%
Gross profit actual	90,000	40.0%
Gross profit target	<u>-87,500</u>	35.0%
Over/under	\$ 2,500	1.1%
Incentive percent (25%)	<u>x .25</u>	
Incentive earned	\$ 625	0.3%
Incentive paid % (1st Qtr. 25%)	<u>x .25</u>	
Incentive paid \$ amount	\$ 156	0.075

At the end of the second quarter, cumulative sales were \$525,000 and the cumulative gross profit was \$194,000, or 37 percent. The incentive paid works out as follows:

Sales revenue	\$525,000	100%
Gross profit actual	194,000	35.0%
Gross profit target	<u>-175,000</u>	37.0%
Over/under	\$ 19,000	3.6%
Incentive percent (25%)	<u>x .25</u>	
Incentive earned	\$ 4,750	0.9%
Incentive paid % (2nd Qtr. 50%)	<u>x .50</u>	
Incentive paid \$ amount	\$ 2,375	0.5%

At the end of the third quarter, cumulative sales were \$725,000 and the cumulative gross profit was \$276,000, or 38 percent. The incentive paid works out as follows:

Sales revenue	\$725,000	100%
Gross profit actual	276,000	38.0%

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Gross profit target	<u>-262,500</u>	36.2%
Over/under	\$ 13,500	1.9%
Incentive percent (25%)	<u>x .25</u>	
Incentive earned	\$ 3,375	0.5%
Incentive paid % (3rd Qtr. 75%)	<u>x .75</u>	
Incentive paid \$ amount	\$ 2,531	0.4%

At the end of the fourth quarter, cumulative sales were \$1,025,000 and the cumulative gross profit was \$379,000, or 37 percent. The incentive paid works out as follows:

Sales revenue	\$1,025,000	100%
Gross profit actual	379,000	37.0%
Gross profit target	<u>-350,000</u>	34.2%
Over/under	\$ 29,000	2.8%
Incentive percent (25%)	<u>x .25</u>	
Incentive earned	\$ 7,250	0.7%
Incentive paid % (4th Qtr. 100%)	<u>x 1.0</u>	
Incentive paid \$ amount	\$ 7,250	0.7%

You'll notice that in the third quarter the cumulative incentive earned of \$3,375 was actually less than the \$4,750 earned in the second quarter. However, the sliding payout percent still allowed us to pay an incentive. Otherwise, the employees would owe the company money, if the full \$4,750 was paid out at the end of the second quarter.

The value for a point in this scenario would be calculated as follows:

Total incentive amount \$7,250 ÷ 33 total points = \$220

Each category of staff member would be paid the following amounts.

<u>Position</u>	<u>Points</u>	<u>\$/point</u>	<u>Incentive amount</u>
Division manager	5 x	\$220 =	\$1,100
Assistant manager	4 x	\$220 =	\$880
Office manager	4 x	\$220 =	\$880
Foremen/crew leader	3 x	\$220 =	\$660 each
Leadmen	2 x	\$220 =	\$440 each
Laborers/admin clerk	1 x	\$220 =	\$220 each

### Benefits

The benefits of such a method are:

- It's objective and quantifiable.

## **J.R. Huston Enterprises, Inc.**

- The incentive is “self-funding,” in that it’s gross profit above what was anticipated.
- Owners can always pay more if they so choose.
- It rewards both increased sales and production efficiency.
- It’s well-thought-out and planned.
- It rewards everyone.
- It focuses on the company or division as a whole.

### **Cautions**

The cautions when using such a method are:

- It’s somewhat complex.
- It requires accurate financial statements.

### **The Net Profit (NPM) Incentive Model**

A mid-size installation company on the East Coast uses a similar approach as the gross profit model for providing an incentive to its four top people. The owner’s objective is to provide these four individuals with an incentive for taking care of the company. However, this company calculates its incentive from net profit, instead of gross profit. Ten percent of pre-tax net profit is split evenly among the four people who basically run the company. The bonus is paid at the end of the fiscal year. If sales are \$4 million and net profit is 13 percent, the total incentive for all four individuals is \$52,000. This amount is then divided evenly among the four. See Figure 48.2.

#### **\*\*\*\*\*Figure 48.2 The Net Profit Margin Incentive Model\*\*\*\*\***

A separate but similar method is used to provide an incentive to all other staff. This approach has been effective for this company. The four top management people really do “run” the company and feel they’re an integral part of the operation. They have the best interest of the company at heart.

### **Benefits**

The benefits of such a method are:

- It’s objective and quantifiable.

## **J.R. Huston Enterprises, Inc.**

- Owners can always pay more if they so choose.
- It rewards both increased sales and production efficiency.
- It's well-thought-out and planned.
- It rewards key individuals who are an integral part of the operation.
- It focuses on the company or division as a whole.
- It's extremely simple to calculate.
- This method can greatly facilitate "absentee" ownership, as it rewards key individuals for effectively running the company.

### **Cautions**

The cautions when using such a method are:

- It's somewhat complex.
- It requires accurate financial statements.
- The incentive is not "self-funding."
- Net profit must be well defined and its calculation agreed to by all, as the owner can "play" with net profit by means of perks and other personal expenses.
- Adjustments must be made to net profit to ensure that it reflects true net profit.
- It works best when key individuals have free access to company financial information.

### **Incentives based on individual jobs and/or field production**

There are a number of methods that attempt to reward field labor for bringing jobs in on or under budget. I tend to disagree with this individual job approach, as it doesn't focus on the entire company, but just on field operations.

Please don't misunderstand. Getting field staff involved in an incentive program is essential, but it must be tied to productivity and efficiency. However, this approach only deals with field efficiency and not managerial effectiveness. It doesn't take into account the larger

## **J.R. Huston Enterprises, Inc.**

strategic issues owners and managers have to deal with, which the gross profit and net profit models address.

### **1. Beating the budget**

Many contractors provide an incentive or bonus based on “beating the budget,” which usually means bringing the job in below budget for field-labor hours. A pre-determined amount per labor hour saved is identified, for instance \$25. For every labor hour below budget, the crew gets \$25 to divide among its members.

While this approach has its merits, managers must monitor quality control and safety issues very closely. Corners can be cut in order to shave extra hours. Field crews can also work against one another, as they’re focused on “their” individual jobs and not the company as a whole.

If the crews consistently beat the labor hour budget, shouldn’t the estimators adjust their methods to accurately reflect these improved production rates? What happens if management invests in a new piece of equipment, a mini-skid steer for instance, that saves crews many labor hours? How do you reflect this change in both your estimated production rates and your incentive system?

### **2. Commissions for field crews**

This approach doesn’t work in all situations, but can be effective in some. An arborist in the Northwest pays his crews a percent of what’s billed for a job. He calculated crew labor at approximately 30 percent of the price he charged. Crews were paid 30 percent of whatever they billed. If a \$2,000 job was performed in one day, the crew would get \$600, or 30 percent. If it took them two days, they’d still get the \$600. All callbacks had to be handled by the crew without any remuneration.

This method worked well for the field crew. However, it was very narrow in its focus, and didn’t take into account overall company managerial effectiveness. Accurate estimating was essential, using this model. Management had to ensure that crew safety, as well as quality control, didn’t suffer, as crews might rush to get jobs done.

### **3. The foreman’s bonus checklist**

While it doesn’t just focus on one particular job, the bonus checklist, outlined in Figure 48.3, can be effective. It’s very straightforward and self-explanatory. Management reviews and identifies the items on the checklist on a month-to-month basis. Changes are made to these items as management deems necessary. Management also determines the amount each item is worth. Regular pay before the bonus for foremen is at fair market value. The bonus provides an excellent incentive for foremen to ensure that jobs are run efficiently.

## J.R. Huston Enterprises, Inc.

### \*\*\*\*\*Figure 48.3 The Bonus Checklist Model\*\*\*\*\*

The downside of the bonus checklist method is that it only addresses field efficiency, and at only the foreman or crew leader level. It doesn't address strategic company effectiveness, or incentives for field labor. The bonus checklist also is somewhat subjective and time-consuming in that someone, usually the field supervisor or owner, has to monitor all the items on the list for every crew leader. Disagreements can ensue if all items aren't documented properly and thoroughly.

#### 4. Unit or "piece" work

As a young boy in Pennsylvania, I'd often pick apples in the fall. We were all paid by the bushel basket. I believe the going rate was \$.35 per bushel. If you picked 20 bushels of apples, you were paid \$7 by the field supervisor at the end of the day. Remember, this was back in the 1950s and early 1960s. The supervisor would mark you down for a bushel of apples in his book every time you brought a bushel to the field truck. Everything was pretty clear and objective. If you didn't like the rate or the conditions, you'd simply go to another orchard to work. Fortunately, I quickly found other forms of work.

The piecework approach may be fine for factories and situations where there are well defined and controlled working conditions. However, it breaks down for the construction and service industry. It also tends to get crews too focused on themselves and individual productivity, as compared to promoting a team atmosphere within the whole company. While the piecework approach may work in some limited areas of the green industry, it's normally not practical as an incentive approach on a large-scale basis.

### Micro bonuses

The following are a number of approaches for providing an incentive to your employees that you might find insightful and helpful. Quite often management will provide these "micro" or "mini" **bonuses** as a supplement to a more all-inclusive approach.

#### 1. Funny money

One contractor makes copies of 20-dollar bills. If he "catches" a field or office staff person doing something worthy of a reward, he signs and gives the individual one of them. At the end of the month, the employee can exchange the copy for cash.

#### 2. Safety and attendance reward

A number of my clients provide employees with a \$25 per month incentive to show up on time and to work safely. If they're on time all month, they get an extra \$25 at the end of the

## **J.R. Huston Enterprises, Inc.**

month. The same goes for safety. If they're safe all month and have no accidents, they get an extra \$25 at the end of the month.

### 3. The \$.25 per man-hour bank

A contractor in the Northeast banks \$.25 per labor hour for all his field staff. Staff members who stay to the end of the season receive an extra \$.25 for every hour worked throughout the season. Someone working 1,600 hours would receive an extra \$400 at season's end.

### 4. The gross profit margin hurdle method

An arborist in the Northeast provided his field crew with a monthly gross profit incentive. Gross profit was calculated at the end of each month. Ten percent of the dollar amount over \$10,000 GPM was paid out as an incentive. Individuals received a percent of the total bonus pool.

This percent was calculated by dividing the individual's pay for the month by the total eligible payroll for all staff. For instance, if the total eligible monthly payroll was \$20,000 and an individual's pay was \$2,000, that person would get 10 percent of the bonus pool ( $\$2,000 \div \$20,000 = .1$ , or 10 percent). If the pool was \$2,500, the individual would be paid \$250 at the end of the month.

### 5. The split hourly pay method

An irrigation contractor decided to pay his irrigation service technician two different pay rates. He paid him \$25 per hour for every billable hour he produced. However, non-billable hours were paid at \$12 per hour. Billable hours for the technician went from five or six per day to eight or nine per day.

### 6. Percent of materials sold

Another irrigation service contractor paid his service technicians a bonus based on the marked-up price charged to customers for materials. Technicians were paid five percent of the retail price for all materials sold. However, replacement of large ticket items such as controllers had to be approved by the office prior to installation.

## **SUMMARY**

Businesses are primarily comprised of two types of issues. One set of issues has to do with line production or service. I like to refer to these issues as being tactical in nature. They're readily visible and easily quantifiable. The other set of issues deals with strategic concerns in the

## **J.R. Huston Enterprises, Inc.**

form of managerial effectiveness. You can set them apart as tactical versus strategic, production versus management, or efficiency versus effectiveness.

As mentioned previously, Peter Drucker, in his book, *The Effective Executive*, summarized it well by stating that managers make sure that things get done right and leaders make sure that the right things get done.

An incentive program that rewards company personnel for simply increasing sales can be disastrous. Operational efficiency needs to be addressed in the incentive formula as well.

An effective bonus or incentive system has to address both ends of the management spectrum. Top management has to have a vested interest in steering the ship in the right direction, while production people must have a vested interest in pulling the oars, without which the ship would be dead in the water.

To effectively address both areas, a two-fold incentive method approach is normally best. Incentive programs tend to be dynamic. There's no "one size fits all" approach, or a method that works best all the time. Owners and managers need to study their corporate culture and determine what will work best for their particular company. Often you just have to experiment to see what works best.

Quite often the terms "bonus" and/or "incentive system" are used interchangeably. This is understandable because the term "bonus" is so ingrained in today's business jargon. However, there's an important difference. The recipient of a bonus usually has little input into the process that creates the bonus. It somehow mysteriously appears. Incentives, on the other hand, are designed to involve the recipient in the very processes and methods of the organization. The incentive is a by-product of the processes and methods in which the individual participates.

Non-monetary incentives are more powerful motivators than mere monetary ones. Great companies primarily focus upon creating a corporate culture based upon core values and enduring principles, the by-product of which is money and profits. Companies and individuals whose primary motivation is making money are called mercenaries. You don't build a great company with mercenaries.

### **Action point:**

Evaluate the culture within your company. Ask yourself what would happen if you were out of the picture for six or 12 months. Review the incentive and bonus benchmarks discussed in Chapter 46 and Appendix E.

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This article was adapted from James Huston's new book and audio book, *How to Price Landscape & Irrigation Projects*, released in July 2003. The author is president of J.R. Huston Enterprises, Inc., which specializes in construction and services management consulting to the Green Industry. Mr. Huston is a member of the American Society of Professional Estimators and

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