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The Top-Down, Bottom-Up Bonus Conundrum

By Priya Kapila

How to create a structured incentive plan that supports your organizational mission.

The debate goes something like this:

1

"We can't do that," says the CFO. "How are we supposed to track to budget if we can't determine incentive costs? I need to calculate the bonus pool amount."

2

"And employees need to know their bonus potential!" the vice president of human resources exclaims. "If we know employee bonus levels, we can calculate costs from the bottom up."

3

The vice president of operations nods in agreement. "Our people are more motivated when they know what they're working toward, what's in it for them...But I see the problem with setting target bonuses at the employee level. As we bring on more employees, our bonus costs could increase a lot. I don't suppose we could consider project profit bonuses again?"

continued ...

4

The vice president of HR interjects, “No! We may as well have a discretionary incentive plan then, given all the adjustments we had to make. Think about all those really strong employees who worked 80 hours per week after that project went south three years ago. It never did fully recover, but we needed to reward their efforts anyway.”

5

“And remember, we’re where we are now because we know—maybe everyone knows—that we’ve been too generous in the past to average performers on really well-negotiated projects,” the CFO adds.

6

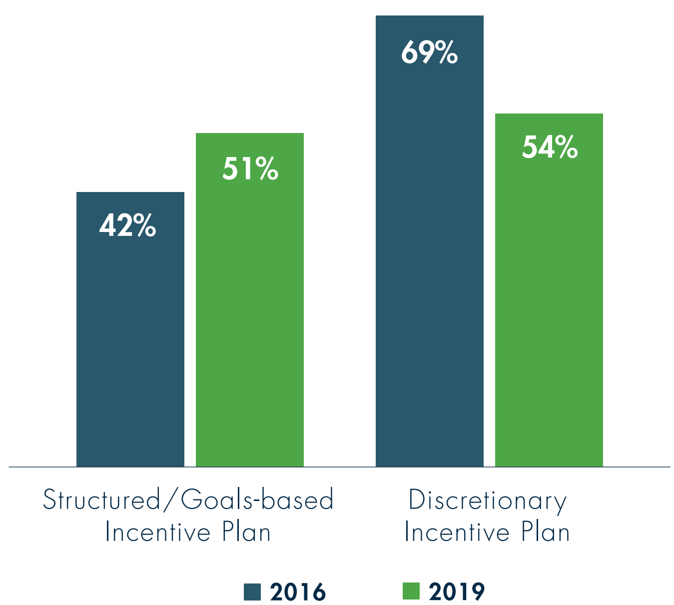
“Yes, I think we’re at consensus on moving away from project profit-based bonuses,” the CEO steps in. “So how are you all going to resolve this top-down, bottom-up bonus funding issue?”

Across the engineering and construction (E&C) industry, companies continue to gradually transition to defined, goals-based incentive programs. FMI’s recent compensation trends survey reveals that just over half of contractors now report having some form of structured incentive plan. By contrast, the prevalence of discretionary incentive plans has fallen from 69% in 2016 to 54% today, as shown in **Exhibit 1**.

The general premise behind a structured incentive plan is to provide clarity on both:

1. How much an employee can earn in incentive pay.
2. What performance goals must be met to earn it.

Exhibit 1. Prevalence of Short-Term Incentive Plan Types



Source: 2019 and 2016 FMI Compensation Surveys

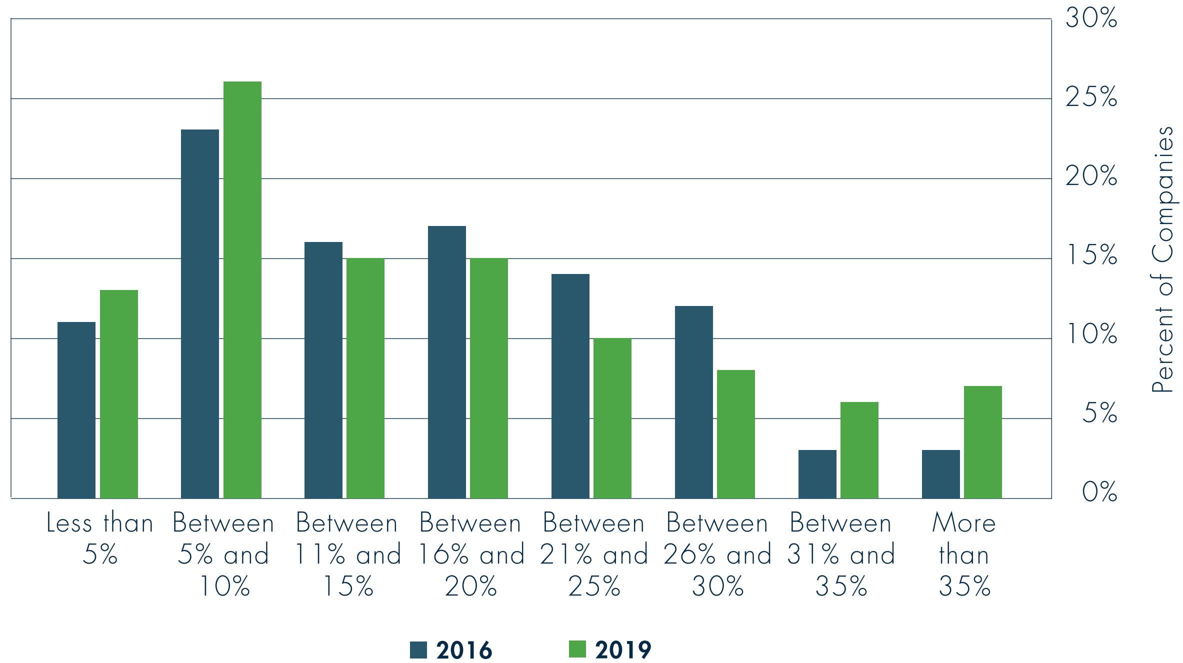
It is the first component that drives the rationale for a bottom-up approach for valuing incentive compensation. At the other end of the spectrum, a top-down approach also values incentive compensation in a formulaic manner, but as a total amount rather than at the employee level.

How Do the Approaches Work?

The Top-Down Method

Just as it sounds, a top-down funding process begins, and usually ends, with the determination of the total incentive pool. The most common method is to carve out a portion of profits to allocate for incentives awards. One of the most popular compensation questions asked by owners and senior leadership is, "What is the industry average for the percent of profits devoted to incentives?" The "2019 FMI Compensation Survey" results suggest that not much has changed since 2016; the average percentage of pretax net profits allocated to short-term incentives is approximately 16%. However, as shown in **Exhibit 2**, there is wide variation in allocation amounts.

Exhibit 2. Short-Term Incentive Compensation as a Percent of Pretax Net Income



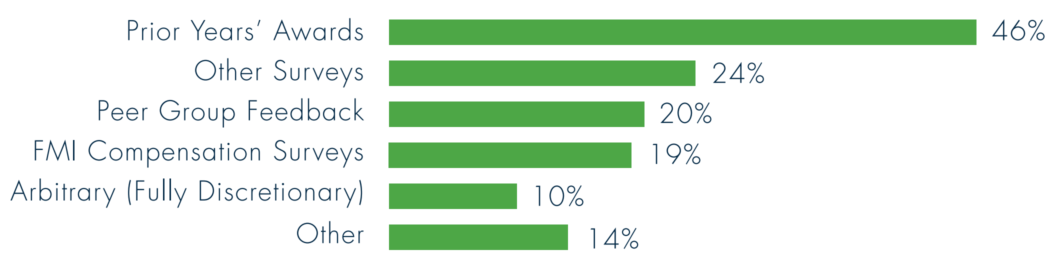
Source: 2019 and 2016 FMI Compensation Surveys

While knowledge of total incentive costs is essential for budgeting, challenges ensue when leaders begin to try to effectively distribute the pool. There is often no clear alignment between the pool amount and the number and level of eligible employees. In this situation, a company is bound to encounter difficulties with a shrinking fund as more staff is added to the incentive program.

Consider a company with a pool of $1 million—per an unstated policy of allocating 15% of profits to incentives—and 100 eligible employees; on average, each employee receives $10,000. One year later, let's assume volume and staff have grown significantly but margins have not kept pace. As a result, the pool is $1.05 million and there are 135 eligible employees. Now the average incentive award is only $7,777, or about 22% less than the prior year. If employees performed at approximately the same level during both years, does the discounted incentive seem fair?

What's more, leadership should be aware of incentive awards and employee expectations in relevant competitive markets. In the illustration above, it is fair to assume that $10,000 is not the market-competitive incentive level for all eligible employees. But without the knowledge of what competitors are offering workers in similar roles, companies tend to be overreliant on their past history of incentive payouts, as indicated in **Exhibit 3**.

Exhibit 3. Prevalence of Methods for Determining Short-Term Incentive Awards



Source: 2019 FMI Compensation Survey

The Bottom-Up Method

As the name implies, the bottom-up approach begins with establishing incentive amount expectations at the employee level; the sum of these individual amounts produces the overall value of incentive compensation. This approach provides clarity to employees: If the incentive potential is communicated to them, they have a better understanding of how they will be rewarded for their efforts. There is also a critical related advantage in that employees who have defined goals and transparent expectations are generally more engaged and motivated, according to Gallup. Therefore, the bottom-up approach can have a direct positive impact on company performance.

While the concept of focusing on employee behavior and recognition to drive a pay-for-performance culture is generally appealing, the blatant challenge to the bottom-up approach is: *How does the company manage costs under this structure?*

Think about the company described above. Now, instead of a pool to define incentive award opportunity, each employee receives an incentive award target amount. In the first year, 100 eligible employees have target incentives ranging from 5% to 30% of base salary, and the sum of these values is equal to $900,000. One year later, the 35 new employees have similar target award values, and existing employees' salaries have increased, so that the sum of target incentives is now $1.2 million. This time, if employees performed at approximately the same level in both years, does the higher total incentive amount seem appropriate?

For the bottom-up approach to work, the incentive targets must be market-competitive and fair. Furthermore, they must be aligned with employee expectations relative to performance targets. If a company establishes very aggressive goals, and if employees only earn the target incentive when they achieve those goals, then the incentive levels should also be aggressive. Conversely, if the performance goals are basic or broadly defined, target incentive levels may be lower.

Incentive target amounts must also be financially reasonable. This is the critical link between a bottom-up and top-down approach. If the sum of the individual incentive targets is not financially sustainable under projected business conditions—based on the performance goals and leadership expectations—then establishing and communicating them is a wasted effort.

Why Bother With Bonuses?

The best approach for evaluating incentive compensation funding—incorporating both top-down and bottom-up calculations—can be complicated. As a result, some companies are inclined to consider eliminating variable pay altogether. Under the premise that employees would rather have additional guaranteed income versus the uncertainty of an annual incentive award, this option seems reasonable, at least initially. Unfortunately, doing away with incentives is not that simple for several reasons:

1. **(Almost) everyone is doing it**
   Eliminating incentive pay within an organization contradicts today's industry norms. More than 80% of companies offer incentives to employees, and as the company size increases, they become increasingly common, as shown in **Exhibit 4**.

Exhibit 4. Companies Offering Short-Term Incentives by Revenue Size

Source: 2019 FMI Compensation Survey

2. **Complacency is a risk**
   According to FMI's latest compensation trends survey, incentives are most often put in place to reward, engage and motivate employees. While there are other means to establish employee interest and involvement in the performance of the business, incentives are a clear, tangible tool. In absence of a sufficient replacement, employees will not necessarily have the same drive to perform.

3. **The recency effect**
   Generally, if a company terminates its incentive programs, a suitable increase in salaries is applied. The amount is often 50% to 100% of incentive payouts averaged over the last several years. The immediate impact can be relatively positive since most employees appreciate the premium on their regular take-home pay. However, the positive residual is usually short-lived. Within a year or two, there tends to be significant pressure to bring back incentives. The salary increase provided to make up for eliminating incentives has been forgotten, and employees are well aware that most other companies still offer incentives. This combination results in strong employee outcry for a new incentive plan.

What's the "Right" Process?

Combining top-down and bottom-up approaches is always optimal. That way, employees have clear knowledge of how much they can earn as an incentive award, and the company knows the total cost of incentive awards. In practical application, these questions must be considered:

1. **Is staffing appropriate?**
   Inadequate staffing has direct influence on payroll costs, including incentive compensation. If headcount is too high, or if employees are not well-classified in their job roles, then incentive costs may be higher than reasonable. There is a tendency to overreward employees when a company runs "lean;" but when the incentive plan is overly focused on pool funding—or there is a perception that incentives are driven primarily by the top-down approach—it results in slow and ineffective hiring practices (due to the concern that new people will deplete the pool). Companies must have the right people to achieve current and future success—both in their own jobs and for the company at large.

2. **Are incentives fair, competitive and performance-aligned?**
   Once the workforce is confirmed, the next step is to identify the structure of incentive awards. The actual amounts are frequently top of mind for employees. Therefore, leaders must know the going rate of incentives in the market across positions. For some jobs, it can be key to know whether there is prevalence for incentive pay at all.

   The conditions under which the amounts are earned can be just as important, if not more so, than the amounts themselves. In fact, among the top challenges of incentive plans identified in FMI's compensation trends survey, "setting the appropriate target goals" outranks "setting appropriate incentive amounts to motivate participants." It's best to align incentive expectations with performance expectations such that employees feel sufficiently rewarded based on the effort exerted to earn the incentive.

3. **What are the potential incentive award outcomes?**
   Finally, review the outlook for the business and economic conditions. Assess the potential incentive payouts under various workforce and performance scenarios. This process of examining incentive awards resulting from different outcomes is essential to maintaining a sustainable incentive plan. For example, if one mediocre year puts the company in a poor financial position, action should be taken to adjust performance or award expectations to reduce the likelihood of this happening again.

FMI's compensation trends survey reveals that owners want to share the benefits of the company's performance with employees. To do this effectively requires syncing results with rewards and ensuring employee communications reinforce the same. This way, employees understand better how they should perform to best position themselves for optimal compensation.

Priya Kapila is a compensation discipline leader with FMI Corporation. Priya is responsible for leading the compensation consulting practice of FMI Compensation. Services provided to clients are primarily focused on the areas of executive compensation, organizationwide salary structure development, and short-term and long-term incentive plan design. She can be reached at *pkapila@fminet.com.*

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