Stu's View

By Stuart W. Margolis, CPA MT

Alternative to Raises: Incentive Plans

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As you all are aware, this topsy-turvy economy has created the need for printers to grapple on a daily basis with some very difficult management issues. We hope that you have taken our past articles to heart and have developed some management responses to your specific problem, such as cost-cutting moves, to implement when the need arises. Perhaps you started with assessing and reducing operational costs, then implemented staff cutbacks and terminations. As part of that process, you carefully identified and retained your key staff, and you're doing all you can to communicate with them to let them know on an ongoing basis just how valuable they are to you. But you're not out of the woods yet, and you are worried. How will your "star players" react when you now have to tell them that there can be no raises at this time? How do you continue to reward them, to recognize their efforts, and to encourage their ongoing loyalty?

One way of dealing with all this is to provide creative alternative opportunities for the staff to receive incentives. Since the goal in this economy is to stay efficient, the incentives should be based on operating improvements, efficiencies, etc. This way, by challenging your staff to help contain costs and be more productive, you will be able to recognize and financially reward them for doing so.

Some possible incentive based avenues include:

- Gross Profit
- Spoilage
- Overtime
- Pre-tax income
- EBITDA

In discussing these points, we will be referencing the fictitious Zero Printing Company (Zero):

(Continued)

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Exhibit A: Statement of Income and Expense for the Year Ended December 31, 2008 - ZERO PRINTING COMPANY

Sales	$9,384,000	100.0 %
Materials and Outside Services	2,480,000	26.4
Value Added	6,904,000	73.6
Direct Labor	2,299,000	24.5
Factory Overhead	1,305,000	13.9
Gross Profit	3,300,000	35.2
Administrative Expense	1,306,000	13.9
Selling Expense	1,858,000	19.8
Income Before Interest Expense	136,000	1.5
Interest Expenses	139,000	1.5
Other Income	41,000	0.4
Pre-Tax Income	$ 38,000	0.4 %

Now let's look at some incentive options for Zero (and you).

Gross Profit

Everyone in the manufacturing arena could participate in an incentive program based on gross profit. Alternately, you might want to focus this incentive program on just the shop supervisors and managers, where it will have the most impact. Your goal is to move them from the normal Sales or Value Added based measurement to a Gross Profit incentive based measurement.

Here are the key elements of a Gross Profit incentive program:

- Direct Labor including overtime
- Utilities – turn off the lights
- Supplies – cut out waste
- Repairs and Maintenance – maintain rigid maintenance schedules and take care of the equipment

Let's look at this example from Zero Printing Company:

Example B: Gross Profit vs. Value Added:

	Actual		Target	
Sales	$10,200,000	100%	$10,000,000	100%
Value Added	7,140,000	70%	$7,000,000	70%
Gross Profit	$3,060,000	30%	$3,400,000	30%

With the gross profit increasing $100,000, perhaps you would be able to pay to the manufacturing group as much as $20,000, or 20% of the improvement. That's a nice monetary incentive your staff would appreciate.

Spoilage

Reducing spoilage is a great opportunity. It seems that almost everyone is satisfied if spoilage is 1.5% of Sales. For Zero Printing, spoilage would be $141,000 (1.5% of Zero's Sales of $9,484,000) – certainly not "chump change." Saving just 0.75% of spoilage, or 50% of historical levels, would improve cash flow by $70,500. Imagine how much the cash flow improvement would be if we established a 20% incentive for attaining a spoilage savings! Everyone wins.

Overtime

Now here is a culprit that drains your cash flow, but it may also be the most difficult to improve. This is especially true if, like most printing companies, you have recently downsized. With the cooperation of the salespeople and overall focus to improve efficiencies communicated to supervision and staff, it is possible to improve your overtime.

For example, your salesperson could ask the client for another 12-24 hours to complete a particular job, thereby allowing you to produce the job with regular instead of overtime hours. You could alternatively run only a part of the job now (to give the client what they presently need), then run the rest of the job latter when there is a break in the schedule (without overtime). We have actually seen both these tactics work, and the savings can be very significant.

As for the incentive program that links to this, if we save $50,000 a year in overtime by such tactics, why not share some of that with the staff? See how this can mount up.

Pre-Tax Income

As you can see in the following example, Zero did not have a very good year.

Example C: Pre-Tax Income (Zero Printing Company)

	Actual	Target
Pre-Tax Income	$38,000	$238,000

We recognize that sharing this kind of sensitive information is not commonly done at privately held companies. Obviously, each company is different, and you will need to carefully decide those given access to this information within your company. It just depends on your culture. What if, though, you decided to create a pre-tax income incentive program with a 20% incentive rate? It might look like this:

Example C: Pre-Tax Incentive Program:

> Target Pre-Tax Income of $238,000 – Actual Pre-tax Income of $38,000 = (200,000 x 20% incentive rate) = Incentive payment of $40,000

This hefty incentive could be divided among the staff you identified to participate in this program, and would go a long way in replacing the annual salary increases they may have been hoping for. The fact that the group as a whole must work together to achieve this goal also provides valuable teamwork and learning opportunities for your staff. Moreover, let us not forget your ultimate goal in promoting a pre-tax income incentive program: increasing your bottom line.

EBITDA (Earnings Before Interest and Taxes, Depreciation and Amortization)

EBITDA incentives are yet another alternative concept, and may be the better measure of performance rather than just using pre-tax income. EBITDA incentive works best when those being motivated are not involved in equipment purchases and financing. Let's analyze Zero's situation again.

Exhibit D: EBIDTA Improvement for Zero Printing Company

	Actual	Target
Pre-Tax Income	$ 38,000	$ 238,000
Depreciation	310,000	312,000
Interest Expense	139,000	130,000
EBITDA	$ 487,000	680,000

Notice there is an EBITDA improvement of $193,000 between the Actual and Target, which would manifest itself in reducing debt or increasing cash. Either way, it results in a very welcome increased cash flow.

For Zero, with a 20% incentive program in place, management would receive almost $38,600 in incentive bonuses.

Coupling EBIDTA with an incentive program will both help improve your bottom line and allow the staff to contribute toward your EBITDA goal in their particular areas.

Summary:

As we noted, different types of incentive programs may be appropriate for different personnel or departments in your organization. Be careful, though, that your incentive program gives everyone a stake in the endeavor. Your goal is to build teamwork and a commonality of purpose, not create "walls" or friction between departments.

So, maybe you can't give salary increases this year -- but these incentives can still be a very effective management tool for you, as well as a good incentive for your employees. By holding your salary levels, your company maintains a healthier cash flow. And since you only pay the incentive bonus if the improvement goal is actually attained, your immediate cash flow needs should also be more stable. Remember our mantra: CASH IS KING. The better your cash flow, the healthier your company will be and the more readily you will be able to respond to both economic variances and opportunities.

As for your staff, these incentive programs provide a much-needed boost to employee morale. There is nothing more devastating to morale than feeling helpless and unable to do anything. By implementing an incentive program, you rally your people around an action plan, giving them back a sense of hope, of control back and the ability to act. Your incentive plan tells them, "Here is our common goal, and here is what you can contribute to get us there." In doing so, you've created a positive, energized, forward-thinking work environment – and one in which your "star players" will continue to be motivated because of that big incentive "carrot" possibly waiting for them at the end of the day.

So pick your incentive program and get it in play with your staff. They are looking to you for leadership, hope, and purpose. Challenge them with an incentive. You – and they – will be happily surprised by the outcome.

(*) "A Cup O' Joe is a complimentary teleconference series for printers offered by MargolisBecker on timely topics for the graphic communications industry. Details and registration forms for upcoming sessions are available at www.margolisbecker.com under the "Events" tab. Questions may be directed to Bonnie Pfaff at 888.577.1717 or bpfaff@margolsbecker.com

Stu's View is contributed by Stuart Margolis, CPA and Partner of MargolisBecker LLC to provide information that helps firms operate profitably. More information can be found at www.margolisbecker.com.