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How to share profits with your staff without running into problems

Brad Cherniak | 15/10/13 9:40 AM ET

Fotolia Profit sharing is only one of a menu of options to explore for rewarding and retaining employees that should be considered.

Successful companies — and those seeking success — commonly do some form of profit sharing with their employees. For a big company this is relatively uncomplicated and safe, but for a small to medium-sized company, profits can be a wildly moving target. And employee expectations and behaviours can have a material impact on current and future profits.

So how should these companies sensibly and safely establish a profit-sharing program?

The first thing to remember is profit sharing is only one of a menu of options to explore for rewarding and retaining employees that should be considered. Those include: base salary, usually cash, but timing of payment can vary; performance-based bonuses in cash or shares; share grants — real or derivative — also called phantom shares; and share options, which can have many different features.

Also, remember that profit sharing affects the bottom line of your company, and therefore its value. It also affects the cash the company has available for capital expenditures, unexpected events, and contractual returns to key stakeholders such as banks and suppliers.

It is critical to realize that profits for SMBs can be volatile — both upward and downward — so unintended consequences can be significant.

"It's a tough subject due to the uniqueness of each situation. There really isn't a "one size fits all" approach to designing and executing employee incentive plans, whether they are short- or long-term plans" says Kevin O'Neil, partner at Sapient Capital Partners.

"Sound methodology and always testing against corporate goals is the key to success, and as corporate goals change, so should the incentive plans."

If you decide to go ahead, you will need to feel your way through, making a series of tweaks based on your experiences, and perhaps unexpected developments. Be careful what you agree to ahead of time, start small and simple, and build in flexibility for the unexpected.

Here are some basic steps to begin:

— Model out your expected profit for the year, including base salaries and expected performance-based cash bonuses you have promised your employees. Also, carefully consider your expected operating and capital expenditures needed to achieve your forecast sales and margins. Remember, everything you do from here is built on this analytical foundation.

— Always compare the total cash compensation of key employees to current market rates. Shortfalls can be made up with profit sharing and with shares in the company or share options. The size of the current bonus pool will affect the amount of profit sharing you can do — they are interrelated and must be modelled out together.

— Determine the right proportion of your expected profits to share with employees — the common range to start is 5% to 10%. Be careful to consider future hiring requirements and realize it is very expensive to bring in senior star performers from other companies.

— Create triggers to determine whether the profit pool will be paid out each year. It can be based on key corporate objectives, such as winning specific new customers or pieces of business, or achieving a target level of sales or profit. The key is to protect the business from unforeseen challenges and avoid exacerbating a liquidity crunch.

— Once the total pool is established, develop a methodology for making individual awards that is clear, logical and fair. If you don't, you risk creating rivalries and even sabotaging your team's cohesion and eroding trust. Remember you want to motivate, but also keep your best employees. Think carefully about the stars on your team, but don't forget the pawns. Base individual allocations on roles and expectations based on your key performance indicators, or KPIs, — the metrics used to run your business and increase its value. Individual profit sharing can be based on percentages of base salary, or a percentage of the overall pool. The latter makes the employee think more like an owner.

— Look regularly at the combined cash and non-cash compensation of your employees to make sure things aren't getting off kilter as the company and its profits increase over time. Don't be complacent. Overpaying employees risks throwing your entire compensation structure off and complicating your ability to expand your team. It can even demotivate come employees. And remember it is far harder to claw back excessive compensation than to expand it slowly.

— Get legal and tax advice in structuring and documenting your profit-sharing plan. The Canada Revenue Agency is increasingly taking a closer look at these plans to ferret out abuse. This way, you can better test how profit sharing works for your situation, and hopefully avoid making mistakes that are difficult to reverse.

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