Use Employee Ownership to Motivate People and Gain Revenue

How can you give your workers a stake in your organization's success?

BY COREY ROSEN AND SAM SHAH

Are ownership concepts applicable in nonprofit settings? Is there a way for you to share ownership of your organization, in one form or another, with your workers? Does tax law, which says that "no part of a nonprofit's net earnings can inure to the benefit of any private shareholder or individual" mean you can't compensate your employees with incentive pay based on net earnings?

The answers: Yes, yes, and not at all. According to a survey of nonprofit organizations, 53% of respondents provide variable cash compensation to employees; among this group, half make all employees eligible for incentive pay.[1] As a growing number of nonprofits are forced to generate revenue from their own work rather than from donations and grants, it's increasingly important and legitimate to encourage employees to find ways to generate these revenues. In some cases, the organization's survival may be at stake; in others, finding self-generating revenues could help fund other organizational activities. Tying compensation to financial goals, at least in part, thus becomes entirely justifiable.

You can also link pay to organizational achievement, making incentive compensation a key part of attracting, retaining, and motivating good workers. Every nonprofit has objectives that can be quantified with a little imagination.[2] You could set up a point system for several objectives, such as cost savings, new revenues, and goals achieved. Meeting these objectives could then trigger incentive pay for employees.

Who Should Get Incentives?

Traditionally, incentives are focused on "key" people, usually top management. This practice draws from the model in which a few people make decisions while others carry out orders. This model, however, is no longer the norm. Current research shows that organizations with flatter, more participative management perform better than rigidly hierarchical organizations.

If everyone is eligible, however, should incentive pay go to all employees? Or should it be reserved for exceptional performance (and, if so, how would you define "exceptional performance"?) Or should you make all workers eligible but dole out awards based only on the achievement of certain goals?

These concerns can often be clarified by asking teams of workers to set standards or at least help management determine the criteria. If everyone has input in defining goals, there's less likely to be resentment when individual rewards are given. Each culture is different, however, and no one approach is better than another.

How Should Awards Be Allocated?

People's awards can be assigned according to five types of formulas, each of which creates a different type of ownership culture:

1. Awards may be given in proportion to relative pay. Such formulas signal that incentives are simply part of overall compensation. (Example: An employee with 1% of pay will get 1% of the total award.) If employees regard salary, benefit, and bonus formulas as fair, they'll most likely perceive equity award allocation formulas that way, too. (Organizations can also combine the relative pay approach with another formula, such as number of years worked or number of hours worked, or they can cap the eligible pay amount.)

2. Awards may be based on hours worked. Such allocations indicate that "ownership" of the nonprofit is considered a basic right and that everyone's contributions are equally valued. This strategy can help create a culture of common ownership but may also cause resentment—and perhaps recruitment and retention problems—among higher-paid employees.

3. A formula may be based on promotion or a merit assessment. This type of formula rewards meritocracy. It will work well if employees are confident in the judging system; it won't work if they see it as a way to enrich the undeserving. This approach also, indirectly, sends the message that the organization believes not all employees deserve ownership, creating an atmosphere not conducive to building a true ownership culture. To address this issue, some organizations expect all workers to earn ownership at some point or to leave the organization.

4. Formulas may reward seniority. Seniority-based awards encourage employees to stay with the organization, though it's possible that only those with many years of service will realize much of the benefit. Hard-working employees who are younger could be discouraged by this practice, viewing the years required to earn these rewards as daunting.

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5. A reward may be based on positions held. This sort of allotment is the least likely to help create an ownership culture because it reinforces hierarchical notions.

You can combine these five formulas in various ways to produce the desired effect. A point system may allot points for pay, merit, and so on. A multi-system approach may award some shares based on merit, some on tenure, and some on position.

How Much Should People Get?

It's not easy to say how much the award should be. The only study of incentive practices that has examined the size of awards in a variety of nonprofits was conducted in 1990 by Applied Research and Development International. In this study, average award payouts ran from 2% to 5% of pay. (This would be a low percentage in the private sector. The median percentage contributed to profit-sharing plans is around 8% of pay, and the value of stock option awards for non-management employees is on a similar level.)

You must determine the payout needed, at minimum, to encourage employees and not upset boards and supporters. You can seek your employees' input to help calculate these payouts, perhaps even letting them set target levels (subject to board approval). Employees typically set higher goals and lower awards when they pick these variables themselves, yet feel better about what they receive than if management imposes the award levels.

Another approach calls for payout levels based on attainment of escalating targets. For example, you might state that if income exceeds expenses by $50,000 on a project, employees will receive 20% of this amount through incentive compensation. And, if this number is $100,000, employees get 20% of the first $50,000 and 40% of the next $50,000.[3]

Which Approach Should You Use?

You can provide employees with a "stake in the outcome" in five basic ways:

Approach 1: Share Revenues. The simplest approach is to share revenues, a strategy with endless variations:

- Share a percentage of total revenues.
- Share a percentage of total revenues over costs.
- Share a percentage of only certain revenues, such as those from the sale of goods or services (rather than income from grants or contributions).
- Share a percentage of revenues in excess of what's needed to pay for current programs plus a designated addition to reserves.
- Share revenues in excess of pre-set annual or other periodic goals.
- Share revenues only for particular projects or in certain units of the organization.

With this approach, you set the percentage after you determine the pool (the amount of money to be shared.) The percentage might be fixed or graded (15% of the first $50,000 over target, 25% for the next $50,000, and 35% for anything over that, for example). You could cap the amount to protect against unreasonable compensation in the event of a windfall.

Approach 2: Share Short-Term Goal Achievements. Another strategy, creating a pool based on short-term goals, also has endless iterations. Your organization could, for example, state that when net assets or total revenues reach a certain level, a pool of X dollars will be shared, and that each time revenues or assets increase another Y%, another X dollars will be shared. This "bucket" approach (the bucket is emptied and refilled) gives employees meaningful targets to shoot for, and reassures board members and stakeholders that incentive compensation is provided only if the organization attains a basic level of financial security.

An alternative is to set achievement benchmarks. For instance, a hospital might base awards on number of beds occupied, number of staff retained, or amount of income received. Such a strategy assures that employees don't overemphasize financial goals or neglect the organization's mission.

Approach 3: Share Long-Term Goal Achievements. This is similar to the approach above, except that the time frame is extended to a number of years. The trick with these structures is to keep employees interested until the rewards pay out. You can do so in several ways. One method is to make annual payments on long-term goal achievements; for instance, you might set a three-year goal every three years, but after the first three-year period goal is met, employees would receive one-third of the total award over the next three years. Or the system could assess goal achievement over the prior three-year period, paying out each year based on previous performance.

Approach 4: Offer Vesting Awards. Another tactic, which can be used with the one above, is to vest people in the award. "Vesting" describes the amount of time someone must work at the organization to earn an equity award. Vesting can occur all at once, called "cliff vesting"; here, an employee earns the right to 100% of the award after five years, for example. Or, vesting can be "graded," meaning an employee could earn a right to, say, 20%

of the award per year over five years. Some organizations might give partial or full credit for years worked prior to plan adoption, while others may elect to start everyone from the date of plan adoption.

Vesting encourages employees to stay with the organization, but the trick is to find a schedule that retains good people without creating the perception that vesting is a remote possibility. Also, if your organization suffers from high (or unavoidable) turnover rates in the average employee's first three years, you might opt to start vesting at the third year. If, however, turnover is low, faster vesting schedules can be an attractive benefit with few negative consequences. If you include service provided before plan adoption, employees will be appreciative. But such a move can increase plan costs and raise the risk that employees will wait to collect their benefit and then promptly leave. However, not giving credit for prior service may cause serious resentment among senior employees. In any event, an analysis of these issues, combined with an assessment of employees whom your organization wants to reward, will make for a fairer incentive compensation system.

Vesting can work if the award is a type of equity equivalent plan designed to give the employee a share of the achievement of a long-term objective or participation in an annual bonus. In the first case, an employee would vest over time before earning a right to the equity equivalent award. In the second, employees' share of the bonus would be multiplied by their percentage vesting; for instance, a worker who is 40% vested would get 40% as much as someone who is 100% vested, all other things being equal.

A nonprofit might set a goal to have 2,000 members and $500,000 in reserve within four years, and set aside a $50,000 pool to cover the award. When these goals are met, each eligible employee might get 25% vesting credit for each of the four years worked. An employee with one year of service, therefore, would get 25% of what a fully vested employee would get.

Approach 5: Provide Unit Awards. Unit awards are the nonprofit equivalent of phantom stock and stock appreciation rights (SARs) in the for-profit world. These instruments give employees the equivalent of share value or the increase in share value. Usually, neither approach gives employees actual stock. With phantom stock, an employee gets the right to the value of X number of shares to be paid out in cash at some time in the future. An SAR is the right to the monetary equivalent of the increase in value of a specified number of shares over a specified time period. As with phantom stock, SARs typically pay out in cash. SARs and phantom stock are usually subject to a vesting schedule based either on seniority or performance.

In a nonprofit organization, employees would receive phantom units or unit appreciation rights. The organization could create a performance measure either with purely financial goals or a mix of financial and other goals. An employee would either get the right to a certain number of units or to the increase in the units' value.

For example, assume an organization created a performance measure that consists of the following:

- increase in reserves (20 points)
- new grants awarded (20 points)
- projects completed on time (10 points)
- number of additional clients served (30 points)
- increase in self-generating revenues from products or services sales (20 points).

The index would be at 100 in the first year. An employee might get 10 units per year in phantom units. If the index grows to 150 after five years, the employee would have 50 units allocated at $150 each. Some of these units might not yet be fully vested, however, so only some could be cashed in. In this plan (and SAR-type plans), the organization must provide the employee with a way to receive cash for the award. In an SAR plan, the employee would have the right only to the increase of $50 per unit, not to the original $100 per unit basis.

When an employee receives a nonforfeitable right to a phantom unit, whether cashed out or not, that unit is taxable to the employee. SARs are not taxed until the cash is actually paid out.

The unit system works best to induce employees to focus on long-term goals. In some cases, this pertains only to certain people in the organization. In some nonprofits, keeping employees for five years is considered an eternity. One of the trickiest aspects of unit plans is to determine the most appropriate measures for performance, and how and when to change them.

Whichever approach you use, equity equivalent plans put a creative arsenal at your disposal. They're a great way to attract workers, accomplish goals, and share ownership with the people who make your organization a success. ■

Footnotes

[1] "Management Compensation Report for Nonprofits," Towers Perrin.

[2] For more on quantifying objectives, see these *Nonprofit World* articles, "Five Steps to Start Measuring Your Outcomes," Vol. 17, No. 5, "Developing Your Outcome Measures," Vol. 17, No. 6, and "Using Your Outcome Measurement System," Vol. 18, No. 1, and the videotape "Outcome Measurement." For more on incentive plans and employee motivation, see "Making Incentive Plans Work for Nonprofits," Vol. 9, No. 4, "Bonus: Not a Dirty Word," Vol. 13, No. 2, and "Building Morale: The Key to Successful Change," Vol. 13, No. 3. These and many other resources for nonprofits are available at www.snpo.org.

[3] If the money comes from grants, you should discuss these incentive pay schemes with funders, because they may prefer that any excess money be returned or used for other projects.

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