

2021.09.03

Unit 11 – Motivation

[Can Profit Sharing Motivate Your Employees? | What Is Profit Sharing? \(thehartford.com\)](https://thehartford.com)

Financial motivation method – Profit Sharing scheme



Published: December 6, 2017

Updated: September 25, 2020

Can Profit Sharing Motivate Your Employees?

Stephen Robert Morse

In 2015, Apple, the hardware giant, made a major change that affected thousands of its employees: For the first time, in addition to the company’s engineers and corporate employees being eligible for stock grants, all employees, including the thousands of people who work at Apple retail stores, became eligible for these benefits, too. This is a form of profit sharing, which the dictionary defines as “a system in which the people who work for a company receive a direct share of the profits.”

Although your small business will likely be unable to grant stock options to employees, there are other ways to incentivize your employees.

What Is Profit Sharing?

What is profit sharing anyway? While many small businesses are profitable, their employees often don’t share the upside. Yet some small businesses reward — and incentivize — their employees with profit sharing plans. [Investopedia](https://www.investopedia.com) defines a profit-sharing plan as “a plan that gives employees a share in the profits of a company. Under this type of plan, an employee receives a percentage of a company’s profits based on its quarterly or annual earnings.”

This article will explore the benefits (and drawbacks) of profit sharing as they relate to small and growing businesses. It will discuss the rationale for sharing profits and discuss how profit sharing is one way to hire and [retain better quality people](#) and motivate them to work harder in your small business.

Profit Sharing Plan as a Motivational Tool

If your small business decides to set up a profit sharing plan as a way to motivate and reward your employees, it's helpful to know that there are two primary forms of profit sharing programs you can implement: a program that rewards employees with bonus compensation — whether on a monthly, quarterly, or annual vesting schedule — or a program that is in the form of employee retirement savings.

1. Bonus Compensation

Let's say you own a consulting firm and you have five employees working for you, including three consultants, one finance manager, and one administrative assistant. Last year, your small business made \$500,000 in net profit and is expected to make a similar amount of profit this year.

You wonder what would happen if you created a profit sharing pool for your employees. In this case, the pool could be 10% of the profit. Thus, if you made \$500,000 in profit, your five employees would split \$50,000 as bonus compensation.



Whether they will split these profits evenly, or whether you award performance-based bonuses among them, is up to you. Alternatively, the profit sharing percentage could be tied to the employee's base salary, reflecting their different levels of responsibility in your business.

For example, you could split your \$50,000 bonus pool evenly, giving \$10,000 to each employee. Or, you could generate a plan that more accurately reflects skill levels: You could split the \$50,000 by giving \$2,000 to your office manager, \$3,000 to your finance manager, and then distributing \$25,000, \$12,000, and \$8,000 to each of your consultants based on their job performance.

Imagine that your employees are now more motivated than before to come to work every day. They will take greater initiative in sourcing new business and doing spectacular work and, as a result, your existing

clients retain your services for a longer time. Now, it looks like your small business may make \$800,000 in annual profit.

Thus, your five employees will split a larger bonus pool of \$80,000, and you will take home \$720,000, a substantial increase from the \$500,000 you took home last year before you implemented the profit sharing initiative.

The thinking behind this kind of profit sharing is that an individual employee who has more skin in the game will likely be more willing to put in the extra work to make a good project great or to go above and beyond to impress a client.

2. Retirement Plan

As the [National Federation of Independent Businesses](#) writes, there is a second type of profit sharing option that your small business may wish to explore. This involves creating an employee retirement plan (in either the form of a 401(k) plan or a traditional pension plan) that can be set up through a bank, into which employer contributions are made.

Here's how this would work:

First, you as the small business owner would decide how much money you would contribute to your employees' retirement accounts. For example, based on your anticipated profit for the year 2017 you may decide to contribute 20% of your employees' salaries, but determine that the maximum contribution limit should not exceed \$50,000.

When profits are higher, you can contribute a greater amount of rewards to this program, which will likely lead to even greater employee loyalty and satisfaction. An advantage of this type of profit sharing program for your employees is that participants aren't taxed on retirement account money until they withdraw it.

Drawbacks to Implementing a Profit Sharing Plan and Program



While profit sharing done right can help motivate employees, there are also some drawbacks. For example, if your small business is a startup that isn't yet profitable, your employees may never see any benefits from the system you have created. Thus, they may feel profit sharing is meaningless as a benefit.

Whether or not profit sharing will work for your small business also depends on the kind of work that you do, and how directly your employees are motivated by financial gain. Professor Michael Jacobs of UNC Kenan-Flagler Business School gave an example to the QuickBooks Resource Center of an automotive repair service whose incentives were based on the shop's revenues, causing some mechanics to aggressively upsell unneeded services to customers.

As he noted, "They damaged their brand and their reputation."

Another drawback is that you must determine how much profit to share with your employees. Although this process can be eased by creating profit sharing plan requirements for each employee — for example, sales goals for a sales employee vs. getting the numbers right for an accountant — some employees will still inevitably complain about what they receive relative to others.

Specific to the retirement plan form of profit sharing, if the profit sharing retirement plan takes the place of a traditional 401(k) plan, your employees may find that they don't want to bear the risk involved, as profit may vary from year to year. They may prefer the relative stability of a traditional retirement plan that rewards them for the time spent working in your small business, regardless of how profitable your business is (or isn't).

Is Profit Sharing Right for You?



Profit sharing can be a great boon to your small business. To help determine whether instituting a profit-sharing plan will provide the right incentives in your workplace and reward the behaviors you want to encourage, speak with your accountant, bank representative, or lawyer.

In addition to deciding whether or not profit sharing makes sense for you and your small business, you'll want professional input to the program's design — to create a written profit sharing plan document, set up a trust for holding the plan assets, and determine eligibility and record-keeping requirements.

And there's another incentive for you as the business owner: Because the contributions your small business makes to a profit sharing program are tax-deductible, you may also be able to reduce your tax liability and save quite a bit of money for your small business, and thus yourself.

Profit sharing is not a one-size-fits-all solution. Weigh the benefits and drawbacks specific to your business culture and employees before determining if a profit-sharing program will enhance your business.

As a small business owner, you're making important decisions every day. For more tips and advice to help you learn and grow as a small business owner, subscribe to the [Small Biz Ahead weekly e-newsletter](#).