Annual Incentive Plans: The Basics

The primary purpose of an annual incentive plan (AIP), also called an annual bonus plan, is to drive and reward behaviors that have an impact on the operating success of the company. AIPs can be crucial tools in aligning the performance of the company with the pay outcomes of executives. Nearly all AIPs measure company performance over a 12-month period, generally aligned with the company's fiscal year, and provide the opportunity to earn a cash payment based on company performance relative to pre-established objectives. The goals and objectives are typically quantitative in nature often aligned with the financial goals of the company. Although, nonfinancial metrics are also often incorporated into AIPs. This guide provides the basics on how such plans are typically designed, including participation, payout opportunities, performance metrics, payout curve and best practices.

Who is eligible to participate in annual incentive programs?

At most U.S. companies, approximately 50% of the salaried population is eligible for the annual incentive program. Often the "manager" level at most companies and above is eligible for an annual cash bonus. At senior executive levels the AIP is often a significant portion of total cash compensation, rivaling or surpassing the value delivered in salary.

What are the Payout Opportunities for annual incentive programs?

Payout opportunities are set at three levels: Target, Maximum and Threshold, outlined in the table below. Bonus opportunities are generally expressed as a percent of base salary.

Level of Bonus Opportunity	Explanation	Market Practice
Maximum	• Paid for outstanding performance • Generally expected to be met or exceeded 1 to 2 years out of 10	Typically set at 200% of target Companies with more predictable earnings may choose to have less leverage in their payout structures, e.g., having a 150% maximum
Target	• Paid for typical, expected performance, often "budget" or "plan" • On average and over time, companies tend to pay out near target	Target bonuses may range from about 10% of salary at the lowest levels up to 150% of salary or more for the CEO
Threshold	• The lowest non-zero bonus allowable under the plan • Paid for the lowest performance deemed worthy of a bonus • Generally expected to be met or exceeded 9 years out of 10	The most common payout level for threshold performance is 50% of target, although some companies will begin payouts at $1 as soon as threshold goals are exceeded

How do companies select performance metrics for annual incentive programs?

Generally, companies select two to four performance metrics to use in their annual incentive plan. Metrics are often financial, though quantifiable business objectives can also be used. Companies typically use corporate or business unit financial metrics to fund an overall incentive pool, and then may use individual performance as a modifier to determine final individual payouts. Individual performance is generally less of a factor for more senior executives.

Performance measures typically are evaluated against absolute goals. The use of relative performance vs. a peer group is uncommon for three primary reasons:

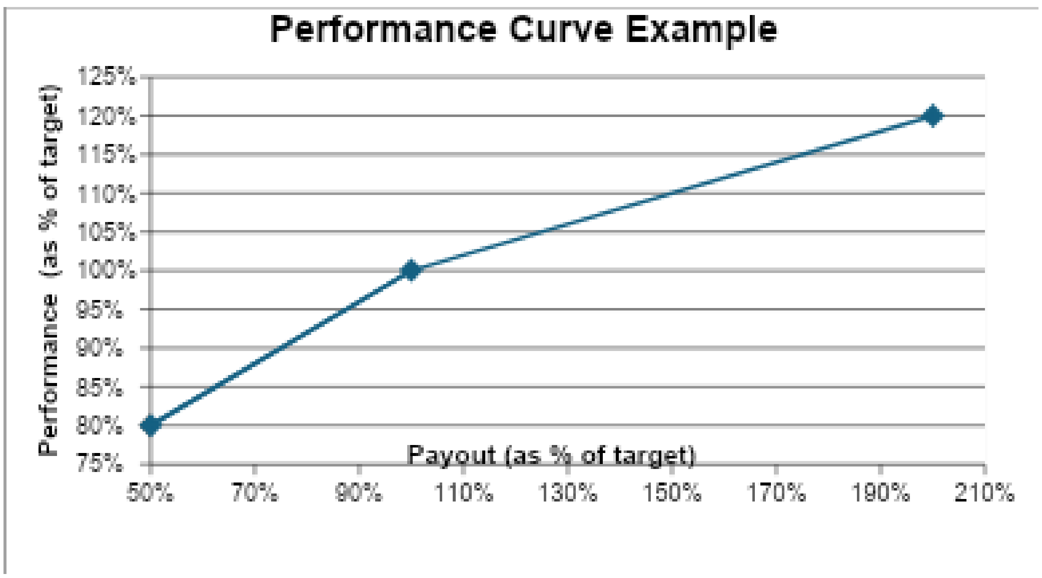
- A consistent measurement of financial performance to a peer group requires the used of standard GAAP financial measures. Many companies struggle to used unadjusted GAAP measures across a broad group.
- The necessary financial information may not be available to pay bonuses in a timely manner.
- Relative performance may be more valid when compared over a multi-year period.

It is common to balance a growth measure (Operating Income, EPS) with a return measure (ROE, ROIC), or a top-line measure (revenue growth, market share) with a bottom-line measure (net income growth, cash flow). Most companies use a formulaic approach to their annual bonus plan, but some allow for discretion in determining payout levels.

How Payout Curve's work for Annual Incentive Programs

An AIP must establish a relationship between target, threshold and maximum performance versus payout. While highly dependent upon each individual company's situation and the metrics used, a common threshold performance level for earnings based metrics (i.e. EPS, Op Earnings) would be 70%–90% of target performance and a common maximum performance level would be 110% - 130% of target performance.

The illustration below provides an example. Curves may vary even within industries depending on business volatility, economic uncertainty and the level of perceived "stretch" required to achieve target. For example, in cases when goal setting is particularly difficult due to economic uncertainties or other issues, a Committee may choose to create a relatively flatter slope, with less variability in payout for any given change in performance,



Best Practices in Designing Annual Incentive Plans

Creating an effective AIP requires a blend of business acumen, understanding of human behavior and foresight. Below, we delve into the best practices to consider in AIP design to support achievement of financial and strategic goals.

1. Aligning With Corporate Strategy

The effectiveness of an AIP is significantly diminished if it is developed in a vacuum. These plans need to be aligned with the company's broader corporate strategy. Whether the focus is on expansion, consolidation, innovation, customer satisfaction or operational efficiency, the AIP should reflect these objectives through its performance metrics. This alignment helps ensure that the AIP supports achievement of overarching corporate goals and objectives.

2. Balancing Metrics

A common pitfall in designing AIPs is over-reliance on either financial metrics or non-financial/operational indicators. The most impactful AIPs maintain a healthy balance between the two, often complemented by individual performance measures. Financial metrics, while critical, focus on the ”bottom line” for the plan year. Non-financial and operational metrics, on the other hand, tie payouts to operating the business safely and/or effectively as well as achievement of key objectives that position the company for continued success. Individual performance measures further personalize the AIP, tying a portion of the payout to personal achievements and contributions. This balanced scorecard approach ensures a holistic view, discouraging siloed efforts and encouraging behaviors that contribute to overall success.

3. Setting Clear, Achievable Goals

The objectives outlined in an AIP must be challenging, yet attainable. Impossibly high targets can demoralize employees, while low bars won’t push them beyond their comfort zones. Utilizing the SMART (specific, measurable, achievable, relevant, time-bound) framework can provide clarity and direction. Moreover, goals should be flexible enough to allow for adjustments in response to significant business changes or unforeseen market conditions.

4. Communication and Transparency

An AIP, no matter how well-designed, will falter if it’s not effectively communicated. Employees need to understand the plan’s mechanics, the performance metrics and, most crucially, the ‘why’ behind their goals. This communication must be clear, consistent and ongoing, creating a two-way dialogue that allows for feedback and clarification. Additionally, transparency in the process reassures employees of the fairness of their evaluation, fostering trust in the system.

5. Regular Monitoring and Feedback

AIPs are not ‘set-and-forget’ instruments. Regular monitoring is essential to assess the plan’s effectiveness and the progress individuals are making towards their goals. Leaders should provide regular feedback, both positive and constructive, to guide their teams. This practice not only keeps employees focused and informed but also allows for mid-course corrections if certain aspects of the plan are not working as intended.

6. Discretionary Considerations

While the AIP should predominantly be based on measurable metrics, incorporating a discretionary component gives the board/management the leeway to reward exceptional non-quantifiable achievements. Such considerations must be approached judiciously, with clear guidelines to ensure fairness and avoid perceptions of favoritism.

7. Legal Compliance and Documentation

Compliance with legal standards and proper documentation are paramount. Every aspect of the AIP, including the process of goal setting, evaluation and reward allocation, must adhere to applicable laws and regulations. Thorough documentation helps in maintaining a clear record for audits and demonstrates the organization’s commitment to lawful and ethical practices.

Final Thoughts

This guide highlights AIPs as key drivers of organizational success, crucial for attracting and retaining top talent who propel innovation and growth.

Even well-executed AIPs' effectiveness requires regular review and adjustment in response to changing business landscapes. Aligning an AIP with industry standards and providing the appropriate motivation to employees is a continuous endeavor.

Beyond mere alignment, forward-thinking organizations anticipate changes, ensuring their compensation strategies remain robust and in sync with emerging trends and market shifts, thereby embracing a proactive stance towards AIP optimization.

The Meridian Difference in Annual Incentive Plan Development

Meridian Compensation Partners, LLC is the trusted partner in developing AIPs that aligned to performance and drive organizational success. We work to understand each client's unique business objectives, which informs our AIP designed, crafted for each company's specific needs.

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