

Executive Bonus Plans: Attracting and Rewarding Key Employees

Introduction to Executive Bonus Plans

In today's competitive business landscape, attracting and retaining top talent is essential for organizational success. Executive Bonus Plans serve as powerful tools for incentivizing and rewarding key executives, aligning their efforts with the company's strategic objectives. This article delves into the intricacies of Executive Bonus Plans, exploring their types, benefits, best practices in design, and considerations regarding life insurance and regulatory compliance.

What is an Executive Bonus Plan?

An Executive Bonus Plan is a short-term incentive employers offer to their top executives. These plans reward executives based on their performance over a specific period, typically a year, with cash payments at year-end. There are two main types of executive bonus plans: discretionary and non-discretionary.

Discretionary Executive Bonus Plan

Discretionary executive bonus plans typically communicate a potential bonus depending on how the company and/or executive performs during a short-term period, typically a year. The evaluation is generally wholly discretionary and, as a result, there is no clear communication to executives concerning what they need to do to have the executive bonus payout at all or at different levels. Consequently, since there is no pre-established plan, discretionary executive bonus plan payments get disclosed in the Bonus column of the Summary Compensation Table in the proxy by U.S. public companies. While they provide flexibility, they lack transparency and clarity, often resulting in unfavorable perceptions by proxy advisors and shareholders.

Non-Discretionary Executive Bonus Plans

A discretionary executive bonus plan is not very good if a company wants its short-term compensation to provide an incentive for specific behaviors and goals to be achieved. Consequently, most companies structure their executive bonus plans as non-discretionary bonus plans. These plans are structured so that performance goals are communicated to executives at the beginning of the short-term period covered by the bonus (again, typically a year), as well as the various performance measures achievements that will lead to multiple payout levels if at all. Because non-discretionary plans generally communicate the goals up-front and the bonus opportunities are governed by a plan document, these executive bonus plans get treated as non-equity incentive compensation plans for purposes of disclosure in the proxy statement for U.S. public companies.

Here's how a non-discretionary executive bonus plan could operate:

- The Company determines its budget for the year, including the short-term incentive target value to be offered to key executives.
- The Company determines what performance achievement levels will result in threshold, target and maximum payouts.
- The Company communicates each key executive's short-term incentive performance goals and target value.
- Typically, the Company then provides key executives with at least quarterly updates on how it is faring under the established performance measures throughout the year.

- After fiscal year-end, the Compensation Committee typically agrees on the performance levels achieved under the various performance measures used for the Executive Bonus Plan and the payouts for the key executives.
- This is typically communicated to the key executives before any earned executive bonus payout.

For additional details on non-discretionary bonus plans, please see Meridian's Annual Incentive Plans: The Basics, available at [Annual Incentive Plans: The Basics - Meridian Compensation Partners \(meridiancp.com\)](https://meridiancp.com).

Why Consider an Executive Bonus Plan?

Executive Bonus Plans offer several advantages, including retaining top talent and motivating key employees to achieve strategic goals. By providing unique benefits and tying incentives to performance, these plans contribute to a robust compensation strategy aligned with business objectives.

Best Practices in Designing Executive Bonus Plans

As stated above, most public companies utilize non-discretionary executive bonus plans, as they tie short-term incentives to achieving short-term performance goals. Designing effective Executive Bonus Plans requires careful consideration of performance measures, goal alignment, goal transparency, and legal compliance.

The best practices in designing executive bonus plans are:

- Align the performance measures and goals selected with corporate strategy.
- Balanced performance metrics, often a mix of return metrics and growth metrics, are used.
- Set clear, achievable goals.
- Communicate the key plan provisions to executives and ensure transparency in the process.
- Monitor performance under the various performance measures regularly and seek executive feedback on progress towards the established goals.
- While non-discretionary executive bonus plans are predominantly based on pre-established goals, incorporating a discretionary component can provide leeway in administering the plan due to unforeseen circumstances or allow for rewarding performance that leads to non-quantifiable achievements.
- The executive bonus plan should be legally compliant and have the proper documentation.

Do Executive Bonus Plans Use Life Insurance?

Typically, public companies do not use life insurance for executive bonus plans. The executive bonuses are funded out of the budget established for the year. Some insurance companies have developed life insurance products to fund executive bonus plans, but we rarely see these used by our U.S. public company clients.

Does Section 162(m) Apply to Executive Bonus Plans?

Section 162(m) of the Internal Revenue Code limits the deductibility of compensation exceeding one million dollars annually for certain employees. The Tax Cuts and Jobs Act of 2017 eliminated the performance-based pay exception, subjecting all forms of compensation, including executive bonuses, to the deduction limit.

Conclusion

Executive Bonus Plans play a crucial role in attracting, retaining, and motivating key executives, driving organizational performance and success. By adopting best practices in design, ensuring transparency, and adhering to regulatory requirements, companies can leverage these plans effectively to achieve their strategic objectives and gain a competitive edge in today's dynamic business environment.