ECONOMIC RESEARCH INSTITUTE

How to Design an Annual Incentive Plan

An annual incentive plan is an important component of the overall total compensation program. It is the most common of all short-term incentive plan practices and includes a performance period of one year or less. An effective annual incentive plan will motivate plan participants to ensure the accomplishment of individual, team, business unit, and/or organization-wide goals and objectives. The alignment of plan participant rewards to organizational goals is important in a high-performing company and an engaged workforce.

Considerations

An annual incentive plan should complement the business strategy and be part of the overall strategy of the total rewards program.

When evaluating the appropriateness of an annual incentive plan, consider the following:

- What are the key goals of the annual incentive plan?
- Will the annual incentive plan complement the organization's business strategy?
- What behavior is the program attempting to influence in the organization?
- Is the program strongly supported by top management?
- Can the organization commit to the program on an ongoing basis?
- How will the organization pay for the program?
- Is the timing right for the organization to implement a plan?
- Who will be eligible for the plan? Is the eligibility criteria fair, equitable, and market competitive?
- Is the amount of pay at risk market competitive?
- Are the financial and non-financial goals attainable at 100% target?
- Are the financial and operational goals stable for financial forecasting?
- Can the results be measured upon completion of the performance period?
- Will the program be legal in all locations with eligible plan participants?
- Are internal resources available to manage the program? (The program should be centrally managed by Total Rewards or Human Resources. Occasionally, Finance may support in program management.)

Define Eligibility and Market Competitive Pay at Risk

An annual incentive plan may be designed for a segment of an employee population or for the entire enterprise. An enterprise-wide annual incentive plan aims to instill a performance-driven culture within an organization. Rewards can be based on achievement of common goals and objectives throughout a business, from the highest eligible job to the lowest eligible job. Eligible employees will typically not be eligible for a second incentive plan, such as sales compensation.

Business Life Cycle

When implementing an annual incentive plan, it is helpful to assess the business life cycle and related objectives of the business:

The life cycle of the business can provide some guidance on the type of goals and performance measures that can best be used to fund the annual incentive plan.

Performance Measures

Performance measures include the financial and non-financial objectives forming the basis of payouts under an annual incentive plan. The objectives should be challenging, yet attainable at 100% of target. An attainable plan encourages the trust, confidence, and support of plan participants. Performance measures may change from year to year depending on the key goals and objectives for the applicable performance period. Other terms used for performance measure include performance metric or trigger.

It is relatively common to see up to three performance measures in an annual incentive plan. Occasionally, there might be more, but proceed cautiously over five. A plan design should be simple and understandable. The following performance measures are commonly used in annual incentive plans:

Financial Performance Measures

- A Measure of Profitability – examples include Operating Income; Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA); Earnings Before Interest and Tax (EBIT); Earnings Per Share (EPS); Net Income; etc.
- A Measure of Revenue – examples include Revenue or Revenue Growth

Operational Performance Measures

- Customer Satisfaction
- Operational Efficiency
- Safety
- Quality

Individual Performance Measures

- Individual Performance
- Management by Objectives (MBO)
- SMART Objectives

Performance measures may also be designed to measure company-wide, business unit, team, or individual results. One measure may be based on company-wide results, another measure may be based on business unit results, and performance may be based on individual results.

It is common to see individual performance measures modifying financial and operational performance measures. This way, the company must attain threshold level for the designated performance measure(s) prior to the funding of the annual incentive plan pool.

Example - with Performance Modifier

Performance Measure	Weight	Results Measured
Operating Income	60%	Corporate
Revenue	20%	Corporate
Customer Satisfaction	20%	Business Unit
Annual incentive plan pool funded based upon above results. Actual payouts of funded pool will be modified based on attainment of MBO results or performance rating from 0 – 150% (*with department average of 100%*).		

In the example below, a plan participant may receive an incentive award based on MBO attainment or an individual performance even when the company does not meet threshold performance for Operating Income, Revenue, or Customer Satisfaction objectives. In a challenging year when the company misses plan, the separate performance payout can be very helpful to recognize important plan participant contributions.

Example – with Separate Performance Measure

Performance Measure	Weight	Results Measured
Operating Income	40%	Corporate
Revenue	20%	Business Unit
Customer Satisfaction	20%	Business Unit
Management by Objectives or Individual Performance Rating	20%	Individual

Non-management can then receive their annual incentive payment based on their performance rating. Management may be more appropriately measured based on attainment of their MBOs.

Performance Period

The performance period of an annual incentive plan will typically follow the business plan year whether it is a calendar year or a fiscal year.

Funding the Annual Incentive Plan

A plan's projected payouts can be self-funded or budgeted, or even a combination of the two. Under a self-funded plan, the financial results will fund the payouts under the annual incentive plan. A self-funded plan will typically be highly supported by top management. Under a budgeted plan, the projected payouts under the annual incentive plan will be budgeted. It is common to see both self-funding and budgeting combined to fund a plan.

Implementing a new annual incentive plan can be challenging not only in managing costs but also in attaining consistency in desired targeted incentives. Listed below are several different approaches to implement and fund a new annual incentive plan:

- Tiered implementation by job level (top down approach)
- Gradual implementation (funded using salary increase budget in lieu of base salary increases)
- Self-funded through attainment of financial performance measures
- Budgeted implementation
- Adjust compensation mix of plan participants over a set length of time by moving a percentage of base salaries into incentive compensation. This may be an appropriate methodology for management and highly-paid non-management employees in which the company pays at its desired position to market and is highly supported by top management.
- Combination of the above options

Example

Let’s assume an employee with a current 2018 base salary of $100,000 with no annual incentive plan. A 3.5% salary increase budget is pending consideration. The market supports total compensation of $105,000 for this job with an average incentive of 10%. The company also supports an annual incentive plan at 10% of base pay for this level of job. Consider these options in lieu of a base pay increase:

Option	Timing	Description	New Base Salary	New Annual Incentive Plan (% Target)	New Annual Incentive Plan ($ at Target)	New Total Comp at Target	% Increase over 2018 at Target
1	Immediate	Lower Base / Maintain TC	$90,909	10%	$9,091	$100,000	+0.0%
2	Immediate	Lower Base / Higher TC	$94,091	10%	$9,409	$103,500	+3.5%
3	Immediate	Lower Base / Higher TC	$95,455	10%	$9,545	$105,000	+5.0%
4	Gradual	Maintain Base / Higher TC	$100,000	3.5%	$3,500	$103,500	+3.5%
5	Gradual	Maintain Base / Higher TC	$100,000	5.0%	$5,000	$105,000	+5.0%
6	Immediate	Maintain Base / Higher TC	$100,000	10%	$10,000	$110,000	+10.0%

When evaluating an enterprise-wide annual incentive plan and related costs, it is beneficial to cost out the plan and method of implementation by salary grade or employee level. Does the company support a gradual or immediate implementation? Option 4 above may appear to be the easiest implementation; but, if the plan can be effectively designed to fund a portion of the cost of the annual incentive plan, then Option 3 or 5 above could also be an effective strategy. With strong top management support and market-competitive pay, it is also possible to reduce the base pay and successfully change the compensation mix typically for executives and senior management (Option 2 or 3 above).

Top management support will contribute to a successful message and implementation. Another method for implementation could include a formula based on employee compa-ratio.

Prior to the implementation of a new annual incentive plan, it is important to calculate the costs assuming different performance attainment levels (at threshold, target, and maximum performance) for all eligible participants. Partnering with the Finance Department will help to ensure support of the new plan design and appropriate financial measures, costs, and potential payouts under the plan. Finance will also be responsible for ensuring accurate and timely financial accruals of the plan.

Example - Including Threshold / Target / Maximum Payouts

Management Level	Professional Level	Administrative / Operative Level	Grade	Annual Incentive Plan Award (% of Base Salary) Below Threshold (0%)	Threshold (25%)	Target (100%)	Exceeds Target (125%)	Far Exceeds Target (175%)	Maximum (200%)
CEO			14	0.0%	12.5%	50.0%	62.5%	87.5%	100.0%
President			13	0.0%	12.5%	50.0%	62.5%	87.5%	100.0%
Executive VP			12	0.0%	10.0%	40.0%	50.0%	70.0%	80.0%
Senior VP			11	0.0%	8.8%	35.0%	43.8%	61.3%	70.0%
VP	Senior Fellow		10	0.0%	7.5%	30.0%	37.5%	52.5%	60.0%
Senior Director	Fellow		9	0.0%	6.3%	25.0%	31.3%	43.8%	50.0%
Director	Expert		8	0.0%	5.0%	20.0%	25.0%	35.0%	40.0%
Senior Manager	Senior Specialist		7	0.0%	3.8%	15.0%	18.8%	26.3%	30.0%
Manager	Specialist		6	0.0%	3.8%	15.0%	18.8%	26.3%	30.0%
Supervisor	Senior		5	0.0%	2.5%	10.0%	12.5%	17.5%	20.0%
	Intermediate	Specialist	4	0.0%	2.5%	10.0%	12.5%	17.5%	20.0%
	Entry	Senior	3	0.0%	1.3%	5.0%	6.3%	8.8%	10.0%
		Intermediate	2	0.0%	1.3%	5.0%	6.3%	8.8%	10.0%
		Entry	1	0.0%	1.3%	5.0%	6.3%	8.8%	10.0%

The plan may also be designed so that overachievement may pay out at a steeper formula than at threshold-to-target performance.

When an annual incentive plan is designed without a "ceiling" or "cap/maximum payout," earned payouts can be excessive and occasionally unrelated to employee performance or contribution. Revenue and profitability objectives may be understated to provide for overpayment of incentive plans. It is often best to ensure a ceiling is in place in the design of an appropriate plan that avoids these issues. In general, most companies designate a ceiling on the plan participants' payouts—frequently at 200% of target.

Establishing Threshold, Target, and Maximum Goals for Performance Measures

The annual performance measures should be a stretch but attainable at 100% target. The "threshold" or "gate/hurdle/qualifier" is the minimum level of performance required (financial or non-financial) before an incentive can be funded or earned. Top management should "own" one set of numbers for the organization each plan year to ensure the entire organization is working to a common goal. The maximum under the performance measures will fund the plan at maximum payouts.

The following example shows how a sample annual incentive plan pool is funded at different performance levels:

Example

Performance Measure	Scope	Target Amount	Weight	Below Threshold	Threshold	Target	Exceeds Target	Far Exceeds Target	Maximum
Revenue	Business Unit	$100,000,000	25%	<90%	90%	100%	110%	115%	120%
EBITDA	Corporate	$20,000,000	50%	<94%	94%	100%	108%	112%	118%
MBO /Individual Performance	Individual	100%	25%	<75%	75%	100%	125%	140%	150%

Financial results for multi-national companies should be measured on an "as reported" basis with no adjustment for currency gains and losses.

Eligibility

The plan document should state the eligibility criteria for the annual incentive plan.

Example 1 – All regular employees hired on or before October 1 and employed continuously through the last working day of the end of the plan year will be eligible to participant in the annual incentive plan. Awards will be prorated for new hires and employees on an unpaid leave of absence.

Example 2 – All regular employees are eligible to participate in the annual incentive plan provided they fulfill these criteria:

- An active employee with at least 90 days of continuous service during the Plan Year; and
- Not eligible for another short-term incentive or sales compensation plan; and
- Not involuntarily terminated for unsatisfactory performance or misconduct; and
- In active status on the last date of the performance period, December 31, unless employed within a country which legally mandates an alternative date.

The earned incentive, if any, will be prorated based upon the number of months of participation during the performance period in the event of any of the following:

- New Hire
- Transfer
- Promotion
- Demotion
- Death
- Retirement
- Layoff
- Disability
- Unpaid Leave of Absence

Eligible Earnings

There are typically a few different approaches for defining eligible earnings. For example, they can use Human Resources records, such as base pay as of December 1, or use a payroll-generated report, as in the example below:

Example

Eligible earnings for the annual performance period include actual earned wages over the applicable performance period, including overtime pay, shift premiums, lead pay, bereavement leave pay, jury duty pay, paid time off, sick leave, vacation pay, and holiday pay. It excludes all other compensation including but not limited to incentive/bonus compensation, tuition reimbursement, uniform allowance, relocation expenses, and unpaid leaves of absence.

A payroll report will typically provide ease of annual incentive plan calculations since the pay has already been adjusted based on new hire dates and other events, so additional prorations may not be necessary.

Payouts under the Plan

When the company attains one or more of the following performance measures (in this design), the plan funds. So, in this case, if EBITDA (weighted 50%) and MBO/Individual Performance (weighted 25%) fund the pool, but revenue (weighted 25%) was missed, then only 75% of the annual incentive would be paid based on the attainment achieved. It is common to see results prorated between performance levels in an annual incentive plan.

Example

Performance Measures - Year-End Attainment									
Performance Measure	Scope	Goal at Target	Weight	Below Threshold	Threshold	Target	Exceeds Target	Far Exceeds Target	Maximum
Revenue	Corporate	$100,000,000	25%	<90%	90%	100%	110%	115%	120%
EBITDA	Corporate	$20,000,000	50%	<94%	94%	100%	108%	112%	118%
MBO / Individual Performance	Individual	100%	25%	<75%	75%	100%	125%	140%	150%
Generates Awards (% of Eligible Pay)									
Management Level	Professional Level	Administrative / Operative Level	Grade	Below Threshold (0%)	Threshold (25%)	Target (100%)	Exceeds Target (125%)	Far Exceeds Target (175%)	Ceiling (200%)
CEO			14	0.0%	12.5%	50.0%	62.5%	87.5%	100.0%
President			13	0.0%	12.5%	50.0%	62.5%	87.5%	100.0%
Executive VP			12	0.0%	10.0%	40.0%	50.0%	70.0%	80.0%
Senior VP			11	0.0%	8.8%	35.0%	43.8%	61.3%	70.0%
VP	Senior Fellow		10	0.0%	7.5%	30.0%	37.5%	52.5%	60.0%
Senior Director	Fellow		9	0.0%	6.3%	25.0%	31.3%	43.8%	50.0%
Director	Expert		8	0.0%	5.0%	20.0%	25.0%	35.0%	40.0%
Senior Manager	Senior Specialist		7	0.0%	3.8%	15.0%	18.8%	26.3%	30.0%
Manager	Specialist		6	0.0%	3.8%	15.0%	18.8%	26.3%	30.0%
Supervisor	Senior		5	0.0%	2.5%	10.0%	12.5%	17.5%	20.0%
	Intermediate	Specialist	4	0.0%	2.5%	10.0%	12.5%	17.5%	20.0%
	Entry	Senior	3	0.0%	1.3%	5.0%	6.3%	8.8%	10.0%
		Intermediate	2	0.0%	1.3%	5.0%	6.3%	8.8%	10.0%
		Entry	1	0.0%	1.3%	5.0%	6.3%	8.8%	10.0%

Let's assume a Director has a 20% annual incentive plan target with eligible earnings of $100,000. The annual incentive plan targeted payout is then $20,000. In this case, revenue attainment was missed. If EBITDA was attained at 108% and weighted at 50%, and the MBO was attained at 100% and weighted at 25%, then the following calculation would be used for the earned payout:

Example - Sample Payout

Description	Weighted	Target	Calculation
Eligible Earnings of Employee		$100,000	$100,000
Annual Incentive Plan Target % (Director)		20%	20%
Annual Incentive Plan Target $	**100%**	**$20,000**	**$20,000**
PAYOUT CALCULATION			
Revenue (weighted at 25%) below threshold 89% and does not pay out	25%	$5,000	$0
EBITDA (weighted at 50%) attains at 108% and pays out at 125%	50%	$10,000	$12,500
MBO (weighted at 25%) attains at 100% and pays out at 100%	25%	$5,000	$5,000
Earned Annual Incentive Plan Payout (Before Taxes)	**100%**	**$20,000**	**$17,500**

Timing of Payouts

Companies will commonly pay out their annual incentive plan one time each year, upon confirmation and approval of results at the completion of the annual performance period. Payouts are typically paid in cash, after taxes, through an employee's normal payroll channel, within 60 to 75 days after the close of the annual performance period. Always ensure the legal requirements have been met.

Proceed cautiously on more frequent payouts (e.g., quarterly or semi-annually). Quarterly or semi-annual results may be achieved and fund a quarterly or semi-annual pool, but the company may still miss the annual goals. When annual incentive plan % targets are too high, occasionally there will be pressure to have more frequent payout cycles. Quarterly and semi-annual payouts will also require additional company resources to manage the plan.

Plan Document

An annual incentive plan is typically a non-discretionary plan as it is commonly supported by a plan document and communicated to plan participants in advance of the performance period. The plan document should be simple to understand but well documented to capture the key components of the annual incentive plan. The annual plan document will contain the company's key goals and objectives for the performance period, eligibility, performance period, targeted % incentive, plan rules, performance measures, how the plan is funded, eligible earnings, individual award calculation, method of payment, approvals, managing exceptions and change in business ownership (e.g., acquisitions, divestitures, sale, bankruptcy, etc.), and other legal requirements of the plan.

A general, up-to-date “legal” statement is important including but not limited to who has authority to approve and define company performance, as well as individual performance and the ability to review, alter, amend, or terminate the annual incentive plan at any time.

Ensuring a Successful Plan

A successful plan will be not only owned by its top management and the Board of Directors, but will also have succinct objectives motivating eligible plan participants. It should be clear that the established goals are challenging yet attainable. Payouts will have been modeled at various funding levels, and the relationship of the plan expenses to the attained performance measures are appropriate, as well as market competitive. The plan will include an up-to-date legal review. The plan design will have appropriate thresholds and maximums, and payout opportunities will be cost effective while rewarding a motivated workforce. Management will provide regular attention to the plan to ensure the goals and objectives are well communicated, progress towards objectives are assessed, and issues are resolved on an ongoing basis. Approvals will provide for timely and legal payouts. The plan will provide for regular feedback to ensure ongoing improvements in plan design and administration.

Communicating the Plan

A well-documented and well-communicated annual incentive plan will support in delivering the best results. Ideally, top management announces the key goals and objectives under the plan, as well as regular updates. Management training provides the knowledge and understanding of the plan in order to successfully explain the plan and motivate team members to attain a successful payout under the plan. Some employees may need coaching on how they can contribute to an annual incentive plan, whether is it through cost savings, influencing revenue, increasing operational efficiency, or individual or group performance. Quarterly goals and progress towards objectives should be communicated regularly with plan participants—ideally by the CEO or President of the company. When communicating business goals and results, transparency is best. Payouts under the plan should be documented in writing for each employee, preferably accompanied by an email from the CEO or President.

Summary

The most effective plans will be well designed and contribute to the attainment of challenging yet attainable goals. Top management will highly support the plan and communicate the plan openly and regularly to plan participants with gratitude and appreciation. When the CEO or President communicates quarterly goals and progress towards objectives under the plan directly to participants, as well as the year-end attainment, employees become motivated and trust is created. Transparency wins! This contributes to a high performing, engaged workforce and the successful execution of challenging goals and objectives under an annual incentive plan.

Any information presented in this document is provided for instructional purposes only. Outside legal counsel and professional support should be obtained as needed prior to the implementation of an annual incentive plan.

Please email Linda L. Cox at linda.cox@erieri.com with questions or comments

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ERI Economic Research Institute
111 Academy Drive, Suite 270
Irvine, CA 92617

800.627.3697 I erieri.com