Pearl Meyer

ARTICLE | JUL 2025

A Comprehensive Look at Executive Incentive Plan Design

Steven Hall
PRINCIPAL

This is the third in a series covering Executive Compensation Essentials—a resource for every board, compensation committee, and management team.

Introduction

Executive compensation should first and foremost reflect a company's performance and create alignment with shareholders. While market data, proxy advisor frameworks, and disclosure expectations are relevant inputs, they are secondary. The real value of incentive compensation lies in its ability to reinforce strategy, shape executive behavior, and support long-term value creation.

An incentive plan with deliberately crafted short- and long-term components can be a strategic instrument for focusing leadership attention and reinforcing business priorities. When the structure and mechanics of the plan reflect the company's unique strategy, organizational context, and leadership approach, incentive compensation becomes a meaningful tool for translating business goals into results.

This is the third installment in our Executive Compensation Essentials series. In our first article, we explored how a clearly defined compensation philosophy serves as the foundation for all executive pay decisions. The second article focused on constructing a relevant and defensible compensation peer group to provide appropriate market context. With these cornerstones in place, compensation committees are now positioned to evaluate the design and integration of annual and long-term incentives—the mechanisms by which strategy is executed through pay.

Total Direct Compensation

Executive compensation is typically delivered through three primary components: base salary, short-term incentives (STIs), and long-term incentives (LTIs). Collectively, these elements form what is often referred to as total direct compensation.

Base salary provides income stability and serves as the foundation for calculating incentive opportunities. Short-term incentives reward annual performance, while long-term incentives are designed to align leadership with multi-year strategic and shareholder objectives. The design and calibration of these components must reflect both external competitiveness and internal strategic priorities.

A well-structured total compensation framework balances performance motivation, market relevance, and retention considerations. From this foundation, the incentive components—STI and LTI—can be shaped to drive specific behaviors and reinforce business goals.

Base Salary: The Anchor Point

Base salary is the fixed component of executive compensation, providing financial stability and serving as the baseline for determining incentive targets. While it generally represents a smaller portion of total pay for senior executives, base salary plays an essential role in anchoring the compensation structure. Setting salary levels requires balancing market competitiveness, internal equity, and strategic positioning. Some organizations may intentionally underweight base pay to emphasize a performance-driven culture through greater incentive leverage. Annual adjustments should reflect individual performance, changes in role scope, internal pay relationships, and market movement to ensure fairness and alignment.

Short-Term Incentives: Driving Annual Execution

Short-term incentives (STIs), commonly structured as annual bonus plans, are designed to focus executive attention on achieving the company's near-term financial and operational priorities. These plans typically reward performance over a one-year period and serve as a critical link between business planning and executive pay outcomes.

Most STI programs rely on a combination of quantitative financial metrics—such as revenue, EBITDA, or earnings per share—and strategic or operational goals aligned with enterprise initiatives. Increasingly, companies are incorporating non-financial performance indicators, such as customer satisfaction, safety, or key transformation milestones, to reflect a broader view of success.

Most plans use a threshold-target-maximum payout framework, with carefully calibrated performance curves that provide upside for exceeding expectations and downside risk for underperformance. Ultimately, STI plans should mirror the company's annual operating plan, reward true performance, and be clearly communicated to ensure alignment, transparency, and motivation.

Long-Term Incentives: Enabling Sustainable Value Creation

Long-term incentives (LTIs) are the primary mechanism for aligning executive interests with sustained shareholder value creation. For senior leaders, these programs typically represent the largest component of total compensation and are structured to reward performance over a multi-year period, most commonly three years.

The most prevalent LTI vehicles include:

- Performance Share Units (PSUs): Contingent on meeting defined performance goals such as relative total shareholder return (rTSR), return on invested capital (ROIC), or multi-year revenue or earnings growth. PSUs are the clearest expression of paying for performance.
- Restricted Stock or Restricted Stock Units (RSUs): Time-vested awards generally used to support executive retention and reduce compensation volatility.
- Stock Options: While less common today, options remain relevant in growth-oriented companies where direct linkage to share price appreciation supports long-term value creation.

Effective LTI design requires careful calibration. Performance metrics should be clearly defined, achievable yet rigorous, and aligned with the company's strategic objectives. Vesting schedules must strike a balance between retention and performance motivation. Many companies also consider a mix and weighting of LTI vehicles to ensure the program reflects both business realities and talent objectives.

Beyond financial alignment, LTIs play a strategic role in talent continuity, succession planning, and reinforcing shareholder alignment. When structured thoughtfully, they provide meaningful differentiation in the executive value proposition and support the long-term stability of the leadership team.

Integrating Incentive Components: A Holistic Approach

While base salary, short-term incentives, and long-term incentives each serve distinct purposes, they should not be designed in isolation. A truly effective executive compensation program functions as an integrated system, one that is aligned with business strategy, tailored to leadership philosophy, and responsive to organizational context.

Strategic alignment is the starting point. A company pursuing steady, mature growth may emphasize profitability and operational efficiency in its incentive metrics, whereas a high-growth organization might weight revenue acceleration or market share gains more heavily. Incentive structures should clearly reinforce the strategic imperatives of the business.

Leadership philosophy matters. Some executive teams thrive on aggressive stretch targets and high variable pay; others may require more stability to maintain focus through volatile cycles. Incentive design should reflect the leadership team's appetite for risk and their capacity to manage long-term performance execution.

Finally, simplicity and transparency are critical. Complex plan designs may be difficult for directors, executives, and shareholders to understand and evaluate. The goal should be to create a clear links between performance, payouts, and long-term value creation.

Ultimately, integration means more than fitting components together. It means designing a pay framework that communicates strategy, drives execution, and supports long-term leadership effectiveness.

Governance Considerations

Effective incentive plan design must be supported by sound governance practices. Compensation committees should ensure that incentive programs are well-documented, consistently applied, and aligned with evolving shareholder and regulatory expectations.

Key governance tools include:

- Share ownership guidelines that reinforce long-term alignment and encourage executives to build meaningful equity stakes.
- Clawback policies that provide the ability to recoup incentive compensation in the event of financial restatements or misconduct.
- Clear disclosure of plan structure, performance goals, and payout rationale, which is particularly important for public companies navigating proxy advisor scrutiny.

Periodic reviews of incentive design and outcomes—relative to both internal objectives and external norms—help maintain alignment, relevance, and credibility.

Conclusion

Executive compensation plans should do more than deliver pay. They should serve as deliberate extensions of corporate strategy. Well-designed incentive programs attract the right leadership talent, motivate them with meaningful performance-based opportunities, and retain them through long-term value creation. When the structure, metrics, and goals of an incentive plan align with business priorities and shareholder expectations, compensation becomes a tool for driving strategic execution, not just governance. The most effective programs are grounded in a clear philosophy, informed by market context, and calibrated to the company's unique stage, strategy, and leadership model.

In our next article, "The Basics of a Short-Term Incentive Plan," we'll take a deeper look at the core design elements of annual incentive programs, including metric selection, goal calibration, and payout mechanics. That will be followed by "Structuring a Long-Term Incentive Plan," which will explore LTI vehicle mix, performance metrics, and emerging practices in multi-year incentive design.

About the Author

Steven brings 20+ years advising on executive and director compensation for domestic and international clients, focusing on designing programs aligned with long-term performance and talent attraction and retention.

About Pearl Meyer

Pearl Meyer is the leading advisor to boards and senior management helping organizations build, develop, and reward great leadership teams that drive long-term success. Our strategy-driven compensation and leadership consulting services act as powerful catalysts for value creation and competitive advantage by addressing the critical links between people and outcomes. Our clients stand at the forefront of their industries and range from emerging high-growth, not-for-profit, and private organizations to the Fortune 500.