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ARTICLE | JUL 2025

# The Basics of a Short-Term Incentive Plan

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

## Introduction: Connecting Day-to-Day Execution with Year-End Results

Well-designed executive compensation programs do more than reward outcomes, they also encourage the right behaviors that support the company's long-term objectives. At the heart of this alignment lies the short-term incentive (STI) plan. While base salary provides income stability, and long-term incentives support retention and future value creation, it is the annual bonus program that connects day-to-day execution with year-end results. When constructed thoughtfully, the STI plan becomes a powerful tool for focusing leadership attention, reinforcing strategic priorities, and translating operational performance into pay outcomes.

In this fourth installment of our Executive Compensation Essentials series, we turn our attention to the design fundamentals of short-term incentives. Building on our previous discussions on pay philosophy, peer group development, and the total compensation framework, this article addresses how to select short-term performance metrics, calibrate goals, and structure payout mechanics that are practical and aligned with business strategy.

## Plan Funding: Ensuring Affordability and Alignment

Effective STI plans are affordable and aligned with shareholder/owner outcomes. To help ensure financial stability, companies often include formal funding or budget mechanisms in the STI plan, which can include:

- *Fixed Poo*l: A target dollar amount budgeted at the start of the year (e.g., percentage of payroll, flat amount, or summation of participant target opportunities). Actual individual payouts will depend on performance, but the funding level is pre-set.
- *Pool Funding Tied to Company Performance*: An alternative to the fixed pool is a variable one where the amount depends on company financial performance, typically as a formula. For example, based on the achievement of a company-wide financial target (e.g., profitability measure) the STI will be funded as a percentage of that target (e.g., 80–120%) and function as a modifier to amounts earned based on the achievement of STI performance metrics.
- *Corporate Performance Triggers*: These ensure that payouts are only made when the company achieves a minimum acceptable level of performance. Performance triggers often include financial metrics, such as profitability or income-based measures. Unlike pool funding tied to company performance, which acts as an award modifier, performance triggers function as an on/off switch to the STI payout.

- *Discretionary Reserves for Adjustments in Extraordinary Circumstances*: While less common, companies may pre-fund or set aside a pool of funds for discretionary adjustments.

A well-constructed funding approach ensures incentive payouts do not undermine financial stability or shareholder/owner expectations.

## Performance Metrics: What to Measure and Why

The primary role of an STI plan is to reward the successful execution of near-term business priorities. In most organizations, this means a one-year performance window with a strong focus on financial results and operational delivery. Metric selection is one of the most consequential decisions in STI plan design and should reflect the lifecycle and priorities of the business. Effective metrics:

- Reflect critical drivers of annual business success,
- Are objective and measurable,
- Provide line-of-sight to participants,
- Are resistant to manipulation, and
- Are easily understood by stakeholders.

Financial metrics typically serve as the backbone of STI plans. Common measures include revenue, EBITDA, earnings per share, or operating income. Strategic or operational metrics, such as customer satisfaction, product launch milestones, or safety performance, may be layered in to reinforce cross-functional initiatives. Increasingly, companies are incorporating ESG or human capital objectives, but these should be approached with care to avoid undermining clarity or focus. Individual performance modifiers or scorecards can be used to reflect role-specific contributions, but their application should be consistent and transparent.

Lastly, the weighting of performance categories should reflect organizational priorities. Too many metrics or overly complex weighting systems can obscure the plan's intent. Simplicity strengthens both communication and credibility.

## Payout Mechanics: Linking Pay and Performance

Effective STI plans use a threshold-target-maximum framework with associated payout curves. This structure allows companies to scale payouts based on actual performance, offering upside for strong results and downside protection when goals are missed but performance still warrants a partial STI payout. For example:

| | **Threshold** | **Target** | **Maximum** |
|---|---|---|---|
| **Performance Achievement** | 80% | 100% | 120% |
| **Award Payout** | 50% | 100% | 200% |

Payout leverage should be carefully managed. Excessive upside can encourage excessive risk-taking, while low differentiation between performance levels weakens motivation.

## Target Setting and Calibration: The Discipline Behind the Design

Establishing credible, motivating performance targets is the cornerstone of STI success. Effective targets are:

- Anchored in the company's annual financial plan or strategic roadmap,
- Informed by historical performance and external expectations, and
- Calibrated to reflect a range of outcomes.

The target goal should represent a challenging but achievable performance level. Threshold and maximum levels should be clearly defined, with corresponding payout opportunities that reflect true stretch or acceptable underperformance. Plans that consistently pay out at or above target may signal poor calibration or lack of rigor.

Compensation committees should be cautious with subjective or discretionary adjustments. While flexibility is necessary, overreliance on discretion can erode the perceived fairness and discipline of the program.

## Communication: Clarity Drives Commitment

Even the most well-designed STI plan will fall short if executives do not understand how the plan works. Effective plan communication:

- Clearly articulates metrics, goals, and payout mechanics,
- Reinforces through regular performance updates, and
- Emphasizes the link between business strategy and incentive design.

In short, transparency builds trust. Executives are more likely to engage with the plan when they can see how their actions affect outcomes.

## Conclusion: Aligned STI Plans Drive Performance and Results

Short-term incentive plans are the most immediate and visible expression of pay-for-performance. When designed with discipline and purpose, they can focus executive energy, drive operational results, and reinforce accountability. But simplicity, clarity, and strategic alignment remain the hallmarks of effective plan design. As companies refine their approach to incentive compensation, getting the basics right on STI plans is essential.

In our next installment, we will turn to long-term incentives (LTI), exploring how LTI design can support sustainable value creation and strategic execution over multi-year time horizons.

## About the Author

Eric Myszka is a Managing Director with Pearl Meyer. With over 20 years of experience in executive compensation, Eric works with Boards of Directors and management teams of public and private organizations, ranging from early-stage start-ups to Fortune 500 organizations, designing compensation programs that are both market competitive and align with strategy, all while ensuring compliance with regulatory standards and stakeholder expectations. Eric is a frequent speaker on pay for performance, corporate governance, and tax implications of executive compensation pay programs.

## 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.