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SHORT-TERM INCENTIVES CHAPTER 10 ABSTRACT

SHORT-TERM INCENTIVES

Short-term incentives can have a tremendous impact on a total executive reward strategy—that is, if they are if they are designed correctly by someone who truly understands their function in the overall plan. Correctly used short-term incentives can create focus on short-term priorities, align rewards with business and individual performance, provide a competitive or differentiated pay package, align people costs with business results, and increase employee commitment.

Perhaps one of the most appealing aspects of short-term incentives is the variety of ways in which you can use them. They can be a function of the individual's performance, the team's performance, the business unit's performance, or an organization's overall performance or the accomplishment of a specific goal or milestone.

Short-term incentives allow the executive twin opportunities: they create a potentially clean slate to reward an executive, and a sharp scalpel to hone in on performance and reward surgically. There are no particular tax or accounting ramifications that need to be considered, there are no eligibility or maximum amount issues that are potentially bothersome, and as long as the factors meet the regulations of section 162m of the Internal Revenue Code, then the amounts associated with short-term incentives are fully deductible.

We can divide short-term incentives into three major components:

- 1. Discretionary:** Discretionary bonuses are unexpected rewards for past behavior.
- 2. Pool:** A pool percentage is premeditated and involves some type of percentage compensation based on the performance of a certain project.
- 3. Target:** Target incentives are very specifically measured, often using key performance indicators to indicate the challenges to be met.

The right kind of short-term incentive can be just the ticket when it comes to effectively motivating management by linking the incentive to real-world performance of the executive achieving the goal.

As with all types of incentive plans, there are three major approaches to developing the type of targeting systems used in short-term incentive plans. They are:

1. Historical – sometimes called a “look back approach.”
2. Business plan – sometimes called a “look forward approach.”
3. Peer comparison – sometimes called a “look around approach.”

All three approaches are valid and can sometimes be used in combination very effectively. If used properly, they will help push forward appropriate goals and payouts that are consistent with creating shareholder value.

All decisions regarding the final target amount of the annual or short-term incentive plan need to be made in conjunction with the balance of the various reward components. The mix must be right, as well as the individual components.

Most organizations pay short-term incentive plans out annually, and we think that in most cases that makes the most sense. But if an organization is facing bankruptcy, coming out of a turnaround situation, or facing significant but dangerous competitive pressures on a narrow timetable, then it should consider how frequently it pays out its short-term incentives.

The simplicity of an incentive should not eliminate the need to communicate to executives. Management needs to be sure that executives understand how the short-term incentive plan operates by itself and, more particularly, how the short-term incentive plan operates within the framework of the overall reward program. Incentives don't work unless they are understood.