



CEO & LEADERSHIP TEAM

SHORT-TERM INCENTIVE PLANS

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LAWSON **DELANEY**

INTRODUCTION & OVERVIEW

We begin 2023 with inflation rates in Australia at a level not seen since 1990. The skyrocketing cost of living, coupled with the continued scarcity of labour, creates the perfect storm for employees asking for pay rises.

However, for most firms awarding large pay rises is neither sensible nor sustainable.

One way of increasing the money in an employees' pay packet, increasing employee engagement and productivity – all whilst taking lower risk - is through Short Term Incentive plans. The following provides some guidelines into what makes a good Short Term Incentive Plan (STIP) from research led by Lawson Delaney.

Overview of Short-Term Incentive Plans



STIPs are designed to do two things; first, to motivate the behaviour of the individual employee and second, to protect the downside risk of the company.

There are several types of STIP. These plans are often based on a combination of predetermined, measurable business objectives (MBOs) and measurable individual contributions (MICs).

The most common way to measure the MICs is to use the individual employee's key performance indicators (KPIs) that are weighted and given goals / objectives that trigger part (a percentage) of the incentive payment. The MICs are most often combined with MBOs relating to profit, growth, and turnover that also have to be met to recur the remaining part of the incentive payment.

STIPs are distinct from profit share plans where a percentage of profit or profit above a threshold is allocated to a pool which is then shared amongst participants. Crucially, it is also different from discretionary bonuses where the amount of the bonus is determined at the discretion of the Remuneration Committee or Management Team with consideration of performance in relation to business plans and/or individual goals and/or market conditions, or indeed mood of the day.

Good STIPs provide a win-win outcome: the employee is earning more, and the employer is achieving the business results that they are after. Additionally, businesses often see less obvious benefits such as employees have a greater sense of purpose and focus, and engagement scores increase.

SHORT-TERM INCENTIVE PLANS



What do good Short-Term Incentive Plan (STIPS) look like?

Monetary incentive plans do motivate employees. There is considerable evidence that the installation of such plans usually result in greater company profitability and individual total compensation in comparison to the outcomes associated with a non-incentivised total compensation payment system.

It is important to ensure that efforts and rewards are directly related:

1. The incentive plan should reward employees in direct proportion to their performance and increased productivity. The standard set must be attainable, and the employees should have adequate control over the work process in order that they feel empowered to influence the outcome. It is important that employees perceive that the objective is within reach.



2. Clear policies and rules must be developed. Specific policies and rules concerning how employees will be paid and the rules for attaining the standard should be clear to both manager and the employees.

STIPs must be very clear, communicated in writing, and have very few grey areas.



KEY PERFORMANCE INDICATORS

Measuring KPIs with both Quantitative and Qualitative Performance Goals

Performance goals relate to KPIs and are the levels of achievement that warrant STIP awards. For some KPIs, the performance goals will be binary in nature i.e., they will either be achieved or not achieved and have a quantitative measure. Others will have a range of potential outcomes, be more subjective or qualitative, for these qualitative goals it is usual to set three levels of performance:

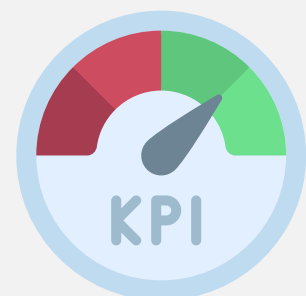
- **Threshold** (a bare minimum, or breakeven point) which is a minimum performance that warrants any STI award.
- **On Target** which is the budgeted outcome when it represents a challenging but achievable outcome.
- **Stretch** which is an outstanding level of performance above and beyond the reasonable target.

Such a range of outcomes and awards has a material impact on behaviour, as the incentive can remain motivating even when the target objective cannot be fully achieved. Also, it is noted that any outperformance of targets already achieved during the year is additionally rewarded.

Weightings

When considering the STIP, it is important to account appropriate weighting to each category of KPI. Each KPI should be allocated a weighting that reflects its relative importance. The total of all weightings should be 100%.

Some roles will favour a heavier weighting to KPIs that are quantitative and may relate to sales figures, growth or production numbers. Other roles by nature may have more qualitative KPIs. All roles, however, should have an STIP that relates to both quantitative and qualitative KPIs.



WHAT CAN BE MEASURED?

Measurable Business Objectives (MBOs) and Measurable Individual Contributions (MICs)

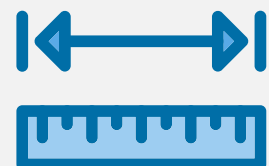
As well as all employees having both quantitative and qualitative KPIs, all STIPs should have both MICs and MBOs components. While the STIP will have most of the incentive triggered by individual performance and contribution (MICs) there should be a percentage of a STIP that relates to overall business performance (MBOs).

What is important is to consider the individual's role and what influence they can have on the outcome, remembering that STIPs where the employee feels that they have no influence on the outcome are ineffective.

As an example, if the individual is responsible for revenue generation, then the incentives should directly relate to this. It would be reasonable to expect a high weighting of quantitative MICs relating to sales activity but less weighting on MBOs relating to productivity or turnover.

The “**Combined Matrix**” is designed to give importance to both the team-based (company) and individual performance goals in rewarding and engaging employees. **In a Combined Matrix, companies can use a payout matrix with individual objectives and company objectives.** Under these types of programs, the actual payment can range anywhere from 100% to 0%. Of course, this gives maximum flexibility, thus allowing for adjustments to be made if the individual performs well but the company does not and vice versa.

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Important:

Always remember to make an STIP relate to the specific role and to have the majority of the weighting towards KPIs that are achievable and controllable for the individual.

MEASURABLE BUSINESS OBJECTIVES

MBOs

There are five broad metric categories that are often used as measures:

- Balance sheet
- Profit measures
- Cashflow
- Stock price
- Miscellaneous measures

AON Global has provided data looking at the number of metrics used across various industries. The average number of metrics used by S&P 1500 companies is 3.6, with companies in the Energy (4.7) and Utility (4.9) industries using the most, and Retail (2.7) using the fewest.

Profit measures are the most common and Balance sheets the least common.

When comparing industries, there are some clear differences. Banks and Insurance companies are significantly more likely to use return measures than other industries. Conversely, they are less likely to use cash flow measures. Utilities are the most frequent users of profitability measures.

In addition to these company level measures, individual performance is used by 43% of S&P 1500 companies.



MBOS CONTINUED

For listed companies:

- A majority (56%) report to use a stock price-based measure in their long-term incentive plan.



- Among Utility (96%)



- Energy (88%) companies, the use is almost universal.



- Conversely, use among Retail companies is much lower than average (23%).



However, despite its popularity, stock price is not always the most common measure in every industry.

Both Retailers and Fast-Moving Consumer Goods (FMCG) companies use a profit measure most often.



MEASURABLE INDIVIDUAL CONTRIBUTIONS

Remember that MICs should be SMART

► **SPECIFIC**
It is clear and specific?

► **MEASURABLE**
How it will be measured?

► **ATTAINABLE**
Does the individual have the capability, time and resources needed?

► **RELEVANT**
Is the goal or objective relevant to the individual?

► **TIME BOUND**
There should be a specific time frame for the objectives.



Timing:

Short-term incentive plans have a performance period of one year or less. The most common performance periods are annual and quarterly.

The vast majority of Australian companies with STIPs use their company's financial year as the measurement period. The financial year is the obvious choice as it aligns with budget processes and planning periods.



IN CONCLUSION

Inflation rates in Australia will continue to rise in 2023, however, businesses cannot justify large pay rises for their employees as they are neither sensible nor sustainable.

Through the use of Short Term Incentive Plans, employee engagement and productivity can be increased, all whilst taking lower risk.

Lawson Delaney's research, using multiple global data sources, clearly shows that now is the time to implement your business' Short Term Incentive Plans.

For more insights and information, please visit our website at www.lawsondelaney.com.au or contact us at 03 9946 7300 or support@lawsondelaney.com.au.

ABOUT LAWSON DELANEY

Lawson Delaney has two distinct teams that specialise in recruiting CEOs and leadership teams for private businesses, and recruiting accountants both commercially and for Accounting firms – from merging Partners to graduate intakes.

What ties us together is the unwavering commitment to our vision: to be the most caring, capable, and considerate recruitment company in Melbourne.



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David May has 20+ years' recruitment and executive experience.

When David isn't completing executive search processes for business leaders, he adds value to his clients through market mapping services, advising on internal leadership development, consulting on remuneration and benefit reviews, and delivering workshops on gender diversity.

David enjoys the HR conversation and is passionate about helping clients create thriving workplaces. He has published multiple papers on Practical Flexible Work Policy, Diversity in the Workplace, Mental Health and Leadership, The CEO and Mental Health, Leadership Development and Unconscious Bias.

David is on the board of The Male Hug, a not for profit organisation that is committed to raising awareness, early stage prevention, research and education for men's mental health for professional males.

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