



# Annual Incentive Payouts: Are Target Goals Too Modest?

PART 1 OF 3

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The majority of U.S. CEOs achieved payouts on their annual incentive awards that were at or above target in 2022. While this is generally in line with recent historical trends it begs the question of whether target goals are being set too modestly. Against the backdrop of ongoing recession fears and a challenging operating environment for many S&P 1500 companies, more than 70% of CEOs achieved target or above-target payouts in fiscal 2022. In this three-part series, we examine recent payout levels for annual incentive awards, focus on goal level achievement for earnings metrics, and explore the magnitude of goal changes relative to prior years.

## KEY TAKEAWAYS

- Median payout for annual incentives at S&P 500 companies was \$1.41 million in 2022
- Chief executives are achieving target or above payouts at elevated rates
- Despite significant changes in economic conditions over the last five years, the percentage of CEO payouts at or above target has remained relatively steady
- 54% of companies have achieved payout levels at or above target in two consecutive years
- A near 30-point spread in payouts exists between the highest and lowest performing industry

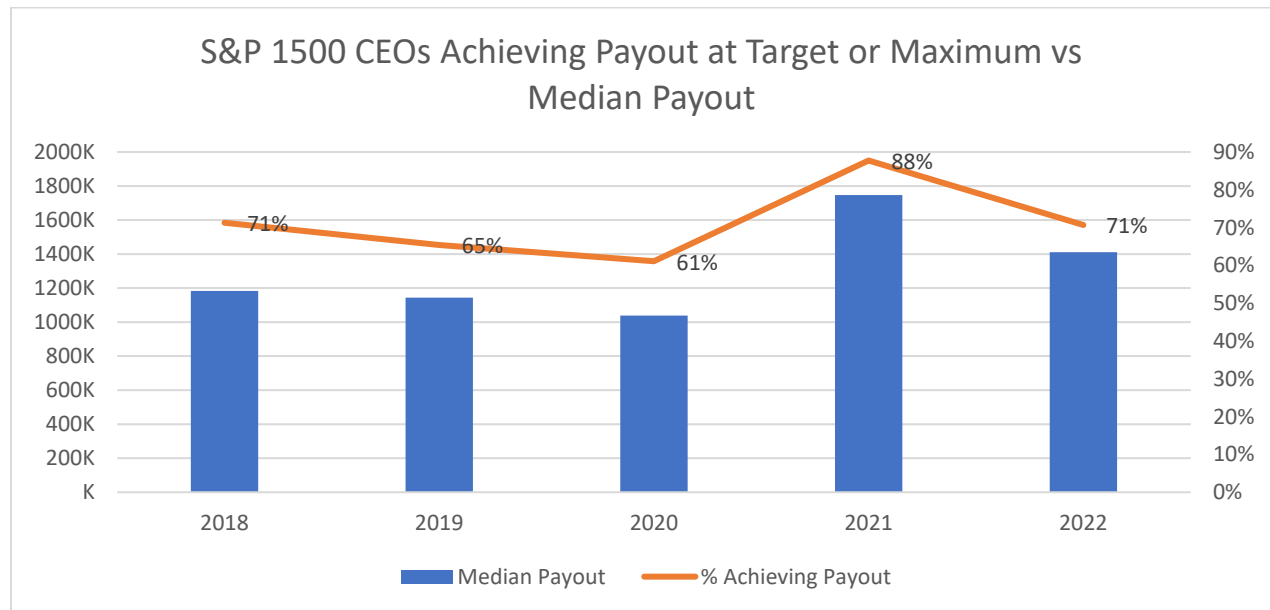
Incentive design requires a delicate balance between the attainable and the desirable, while ensuring value creation for shareholders. Goals should be challenging but achievable. Well-designed performance awards motivate executives to grow their businesses, streamline operations and deliver value to shareholders; but when poorly designed, they serve as cash machines for executives delivering mediocre results.

Our analysis of S&P 1500 companies over the last five years focuses on CEO awards specifically and covers 1,314 companies in the most recent reporting year. The paper is based on data from ISS Corporate Solutions' Incentive Benchmarking module within Governance Analytics as of July 26, 2023. In the first installment of this series, we analyze payout levels for short-term (or annual) incentive awards, observe historical trends, and evaluate payout achievement in consecutive years, noting any industry-specific nuances.

The median payout for annual incentive awards in 2022 fell to \$1.41 million from \$1.75 million in 2021. The decline is not entirely surprising because companies generally performed better in 2021 as they rebounded from shutdowns, travel restrictions, supply chain disruptions, and other pandemic-related challenges.

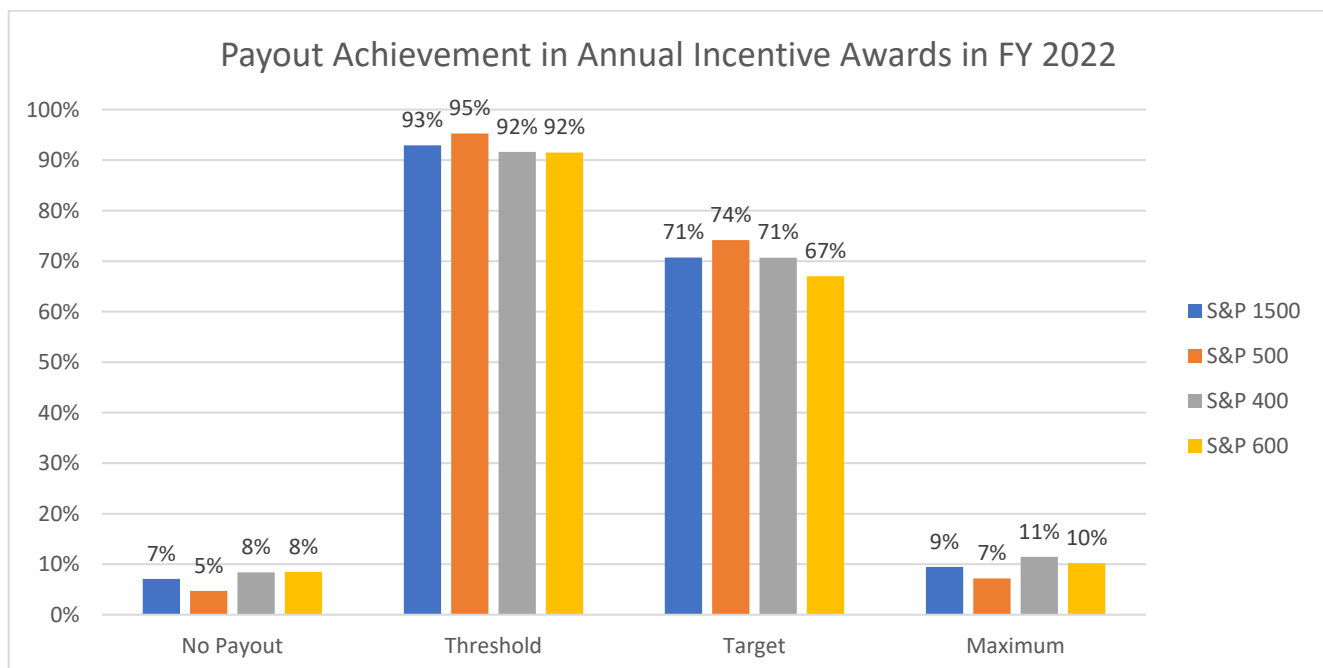
Company size significantly impacts the size of payouts, with S&P 500 companies reporting a median of \$2.3 million in incentive payouts last year, compared with \$925,000 for the S&P 600. Despite the difference in absolute dollars, however, each S&P 1500 market cap grouping has exhibited similar payout growth, with median payouts growing 19% since 2018.

Despite significant variability in economic conditions over the last five years, the percentage of CEOs achieving payouts at or above target has remained relatively unchanged. Whether in 2020 when the business world was upended by the Covid-19 pandemic, in 2021 when companies rebounded aggressively as the economy started opening back up, or in 2022 amidst a stock market swoon, rising interest rates, global conflicts, and other challenges, companies marched along and payout achievement rates were somewhat unaffected by these fresh obstacles. Is this a coincidence, or is there more than meets the eye?



Source: ISS Corporate Solutions, data as of July 26<sup>th</sup>, 2023

Zooming in on 2022 and slicing the data by index, we observe that more S&P 500 CEOs achieved threshold and target payouts than their counterparts at mid- and small-cap companies in the S&P 400 and S&P 600. Only 5% of S&P 500 CEOs received no payout, compared with 8% at the remaining S&P 1500 companies. Are S&P 500 constituents outperforming their smaller counterparts, or are they setting more easily attainable goals? It's not an easy question to answer, and one that we will not attempt to address in this paper, but it is a notable observation throughout our analysis.



Source: ISS Corporate Solutions, data as of July 26<sup>th</sup>, 2023



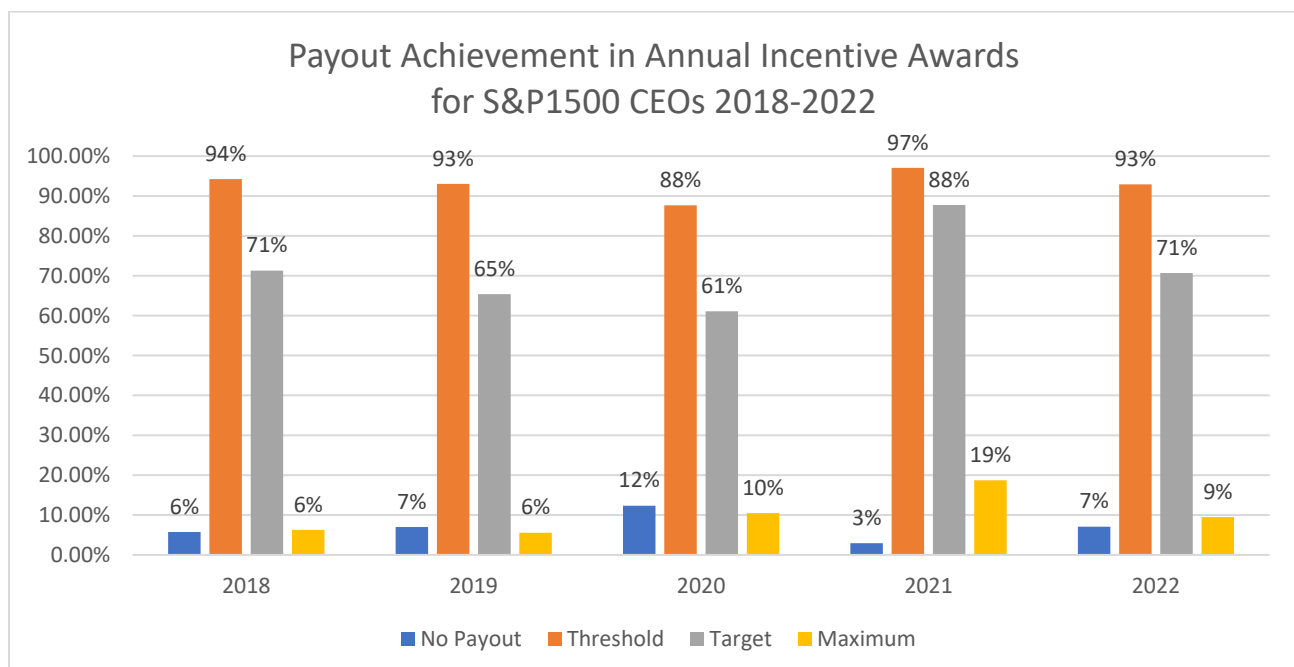
As we consider payout achievement in the broader context of incentive award design, and specifically the tradeoff between challenging yet attainable goals, we should remind ourselves of the best practices for determining payout rates:

- Threshold payouts should be achieved eight to nine times out of every 10 years, or an 80-90% achievement rate
- Target payouts should be achieved five to six times out of every 10 years, or 50% to 60%
- Maximum payouts should be achieved once or twice every decade, a 10% to 20% rate

While this is often observed at a company level, it can be extrapolated to a macro level in assessing overall achievement rates for companies in an index, an industry, or the overall market. When payout rates consistently stray beyond these ranges, it often indicates an underlying issue with the design of the performance plan. This could include the wrong metric selection, the formulation of the payout curve or goals that are either too easy or too hard to achieve.

Over the last five years, over 90% of S&P 1500 CEOs with an annual incentive award have issued a payout of at least threshold – the minimum payout that can be achieved. The exception is 2020, when the unexpected pandemic wreaked havoc on many companies' incentive plans. Even then, only 12% of companies reported no payout on their STI plans. At the time, many companies resorted to award modifications, goal changes, and discretionary adjustments to account for external circumstances. That led to lower, but not drastically different, payout levels compared to other recent years.

Analyzing historical data in the context of the payout ranges discussed above reveals that threshold and target payouts have generally fallen outside the optimal range, indicating that threshold and target payouts have become easier to achieve over the last few years. Payouts have been consistently above the target range of 50-60%, raising potential questions as to whether boards and compensation committees are setting rigorous enough goals for the CEO and the executive team.



Source: ISS Corporate Solutions, data as of July 26<sup>th</sup>, 2023

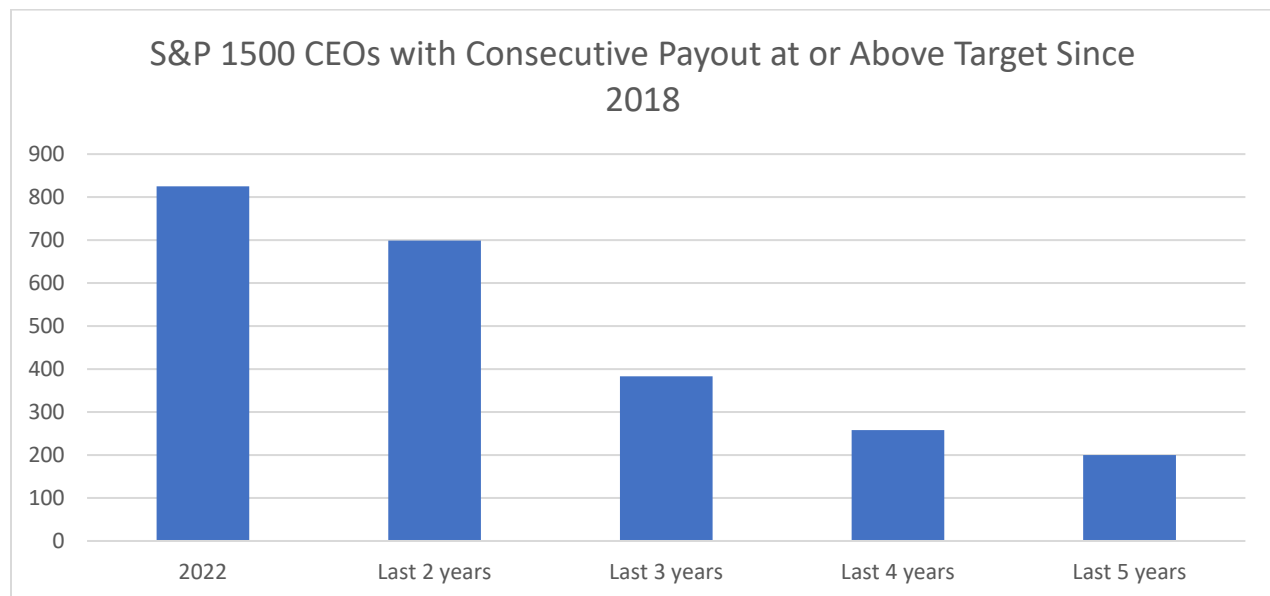




To evaluate the goal-setting process, we looked at how many companies achieved target payout levels in consecutive years. The thinking goes that if an executive achieves a target payout in one year, one should expect more rigorous goals to be set in the following year, making it less likely to achieve target payouts consecutively.

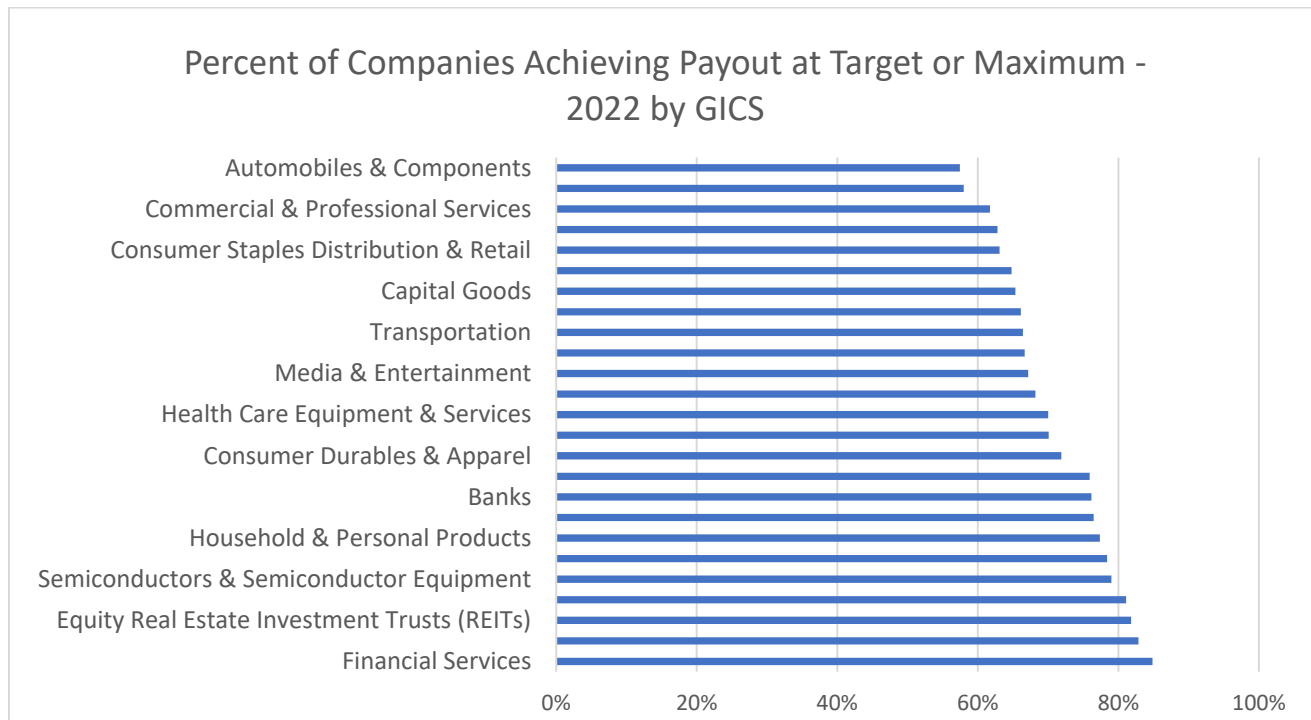
Our hypothesis is reflected in the data, which shows that half of the CEOs (54%) achieved payouts at or above target in the last two consecutive years. Those percentages decline consistently for each additional consecutive year, to as low as 15% of CEOs achieving or exceeding targets for five consecutive years. And while that figure may seem low, it means that approximately 200 companies achieved that milestone for five consecutive years.

Statistically speaking, if the odds of achieving target or better are 50-60% in any given year according to award design best practices, then the odds of having five straight years of target achievement are at most 8%. Yet we see about twice that level in practice, raising questions about the goal setting process at these companies, including the board and management's view on target payouts. Is it the new norm that target payouts are to be expected each year, similar to how threshold payouts are practically considered a given?



*Source: ISS Corporate Solutions, data as of July 26<sup>th</sup>, 2023*

As is typically the case, the results vary by industry. In 2022, only 57% of CEOs in the Automobiles & Components industry achieved at or above target payouts, while 85% of chief executives in the Financial Services industry achieved that feat. Macroeconomic conditions clearly play a critical role in these determinations, but one cannot help but wonder to what extent goal setting is a factor. Are companies setting equally challenging goals across different industries, what quantitative techniques are companies and their advisors leveraging to set goals during uncertain times, and are shareholders paying attention to the gritty details of incentive award design to pick up on these nuances?



Source: ISS Corporate Solutions, data as of July 26<sup>th</sup>, 2023

We report the facts and reserve judgement for others, but these are questions that compensation professionals should be thinking about as we head into the next cycle of award design and goal setting, particularly amidst lingering questions of a looming recession, the rise of AI and its disruptive potential to business, and a number of ongoing global crises.

In the second installment of this 3-part series, we examine goal achievement at the individual metric level and take a closer look at earnings metrics.



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