ISSUE 2013-8
OCTOBER 16, 2013

Meridian Client Update

Setting Annual Incentive Targets – Increasing Alignment with Performance

Each year, most companies establish incentive compensation performance expectations for the coming year. While the approach varies from company to company, the intended result is to align annual incentives with expected business results. How companies get there ranges from direct reliance on an annual budget, or use of a straight funding pool, to evaluating a "scorecard" of metrics and performance expectations and tailoring these to the business strategy.

Increasingly, compensation committees want to better understand how metrics align with strategy and the level of stretch in annual incentive programs. Just following last year's practice is often no longer enough. This update will discuss key elements of a robust process for establishing annual incentive targets and payout ranges.

More than Just the Budget

In practice, the annual budget is an important guide in establishing annual incentive targets, assuming it has been based on a thorough and thoughtful development. However, for annual incentive plan purposes, there are several other factors that can and should be considered in translating the budget into appropriate targets and ranges for determining compensation outcomes.

While some companies triangulate between three primary perspectives and find the common intersection between them, prevalent practice has been to rely on the budget or strategic plan alone. The key overlay, though, is the estimated impact of performance on expected levels of shareholder value creation.

The annual incentive plan should be aligned with the strategic plan and ideally reward the performance required to achieve the strategic plan over time. Compensation committees are taking "deeper dives" into how proposed incentive plan goals conform to strategic plan expectations and making an explicit connection between achievement of annual performance targets and the board-approved business plan, then linking the annual incentive targets and projected payouts.

Another way to frame the practice is to consider a "top down" and/or "bottom up" approach to goal setting (and to compensation targets by extension). This intuitive approach allows multiple perspectives to inform the same decision point, and ultimately the final annual incentive goals. It may also assist in identifying gaps between internal and external expectations and allow them to be managed accordingly.

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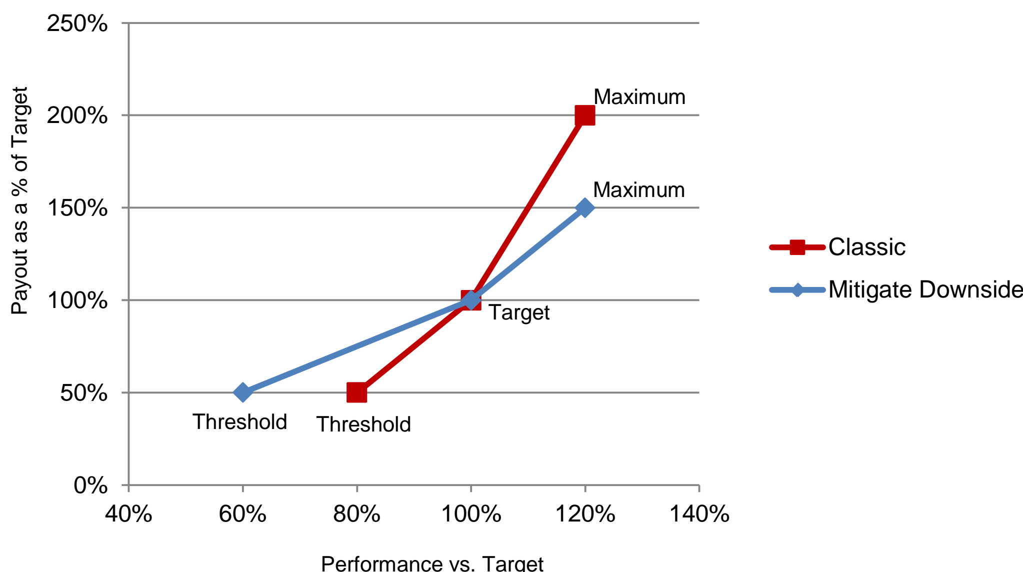
Determining Threshold and Maximum – Aligning the Payout Curve

Once the basic target is set, the range or interval of compensable performance must also be determined, from "threshold" (performance below which no annual incentive is earned) to "maximum" (performance level above which no additional annual incentive is earned).

The mechanics of setting thresholds and maximums can be quite rigorous, or not – there is a wide range of practices in use. The resulting slope of the payout curve can provide insight into the underlying relationship between pay and performance. Target goals should generally align with business and investor expectations, requiring some stretch, but also be achievable. As a general rule, incentives should payout within +/- 50% of target 4 out of 5 years (or about 80% of the time). Analysis of historic achievement may inform the relationship between goal setting and payouts. Performance results that are statistically well above the rule of thumb may indicate targets that are set too low, and vice versa.

The illustration below is fairly simple – the "classic" design assumes that the "threshold" and "maximum" payout levels are met for performance at target +/- 20% (this range varies depending on the type of metric used and the growth/volatility of the business). Actual payout curves are often tailored to reflect different slopes, sometimes including hard steps for key accomplishment levels or steeper slopes to reflect the expected relative difficulty of achieving above or below target performance. Peer or industry data (or even the company's own historical data) can be useful in understanding outlier performance results, which in turn become useful inputs to setting the threshold and maximum boundaries.



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Non-Financial Performance Goals

Some key performance objectives are not measured in dollar terms. These targets can be set as measures of pure accomplishment (with a binary outcome – either you achieved the desired result or not), or in terms of milestones along a line of progress, and/or simply captured as part of the compensation committee's year-end review and use of discretion. Clearly these need to be tailored to the metric and the underlying program or objectives.

Evaluate "Sharing" Ratio

Incentive plans should balance the rewards between participants and shareholders. This would include a reflection on the target incentive level and the incremental cost (or reward) versus the incremental compensation between target and maximum level (and target and threshold on the downside). Testing the alignment of targets and performance ranges can validate the range or raise concerns for further investigation. While there is no "right" answer or best practice in terms of what a typical or acceptable sharing percentage may be, performing this analysis can help inform the decision making process.

Communication is (Increasingly) Very Important

After the analysis is completed, one key element deserves reflection – communication. Annual incentive plans should deliver a message about what is important to the business and what has value. If the targets are properly communicated, plan participants will understand what is important and what it means (to them if they achieve the results). We often hear concerns about "line-of-sight" (or lack thereof) in annual incentive plan metrics or goals. Paying attention to the communication of the plan and ensuring that plan participants understand the connection between their role and the result, make the plan more effective and credible. Furthermore, ensuring a thoughtful and robust process also facilitates required proxy disclosure (external communication) about the incentive plan to help investors understand the pay and performance alignment.

A great plan design or target, poorly communicated will not fully achieve its intended influence on behaviour, reducing the efficiency of the committed dollars (i.e., "bang for the buck"). Effective communication is an investment worth making.

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