Performance

Considerations for Setting Incentive Plan Goals

By Tom Ramagnano and Matt Wolfson

It's that time of year when compensation committees begin the process of setting annual incentive goals for the upcoming performance cycle. For most public companies, these goals generally relate to financial metrics such as revenue, earnings, and cash flow that are aligned with the key objectives on which committees want management to focus. Once appropriate metrics are selected, a common annual incentive plan design concept involves the use of a payout curve that incorporates threshold, target, and maximum levels of performance with corresponding payout levels.

This article focuses on three factors that committees should consider when establishing the distance (or range) between the threshold, target, and maximum performance levels required for management to earn corresponding payout levels.

Setting Target Goals

Before threshold and maximum performance levels can be determined, target goals must be set. This process typically begins with the company's operating plan or budget for the coming year. Additional factors are then considered, including historical company and peer performance, investor expectations, long-term business strategy, and the appropriate degree of sharing between plan participants and shareholders.

Once target goals are set, compensation committees should examine the likelihood of such goals being achieved to formulate threshold and maximum performance levels. From a quantitative standpoint, committees should review the degree to which target goals fall in line with the company's operating budget as well as investor expectations. Target goals set above such anticipated results (i.e., aspirational or "stretch" goals) may provide justification for narrower ranges between target and maximum levels.

Committees should also conduct a qualitative assessment based on discussions with management to understand the extent of management's ability to forecast results given current internal and external factors, as well as its perspective regarding the level of difficulty in achieving target results.

Performance Goals
(as a percent of target)

Metric	Maximum	Threshold
EPS/Net Income	110%	90%
Operating Income	115%	85%
Revenue	104%	95%
Return	115%	85%
Cash Flow	118%	80%

Performance curves based on median values[1]

[1]Based on results from Meridian's 2015 Corporate Governance & Incentive Design Survey of 250 large publicly traded companies

Historical Performance

Reviewing a company's historical performance on an absolute basis and peer performance over a five- to ten-year period can also provide guidance in determining performance ranges.

From an absolute perspective, historical performance can be used to gauge expectations for the coming year. For example, an analysis of the average percentage increase in the company's operating income over the past five years may provide insight into potential achievement levels spanning from what can be expected to what could be considered highly improbable. Historical data can also be used to backtest various performance ranges (e.g., +/– 10 percent or –20 percent of target) to assess where results would have fallen.

Relative comparisons to a group of peer companies in related industries with similar capital structures (that are similarly affected by macroeconomic factors) can also be a valuable tool for determining where threshold and maximum goals should be set. We recommend focusing on the 25th and 75th percentiles of historical peer group performance as guideposts for threshold and maximum levels.

Market Data

Finally, the use of market data can help determine performance ranges, specifically with regard to how performance ranges tend to vary by financial metric. For example, tighter threshold and maximum performance ranges (as a percent of target) are typically found with metrics related to revenue versus income (see table at left).

While market data is informative, it should not be universally applied without considering company-specific attributes such as size, industry, market trends, and performance expectations, each of which may have an impact on setting an appropriate range.

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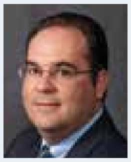

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