

Setting Performance Goals in Uncertain Times

There is no single, best approach to goal setting; the right approach depends on each company's situation.

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For many companies, continuing economic uncertainty has reduced visibility to future performance, thereby deepening challenges with goal setting in cyclical industries and raising new challenges for traditionally more stable industries. While visibility generally improved from 2009 to 2010, it remains unclear when and how quickly a sustained economic recovery will take hold. Many companies are struggling to establish meaningful performance expectations, and the integrity of their pay-for-performance relationships is at risk. Responses range broadly, from temporary fixes (e.g., shifting from annual to six-month measurement periods) to more sweeping changes (e.g., replacing absolute with relative performance

measures). While there is no perfect approach to goal setting and structuring incentives, certain principles, including balance, discretion and flexibility, can help mitigate uncertainty for many companies.

Consider the following three companies, each with its own unique context but all sharing a common challenge: how to set meaningful incentive goals when performance expectations are uncertain:

1 | An insurance company with significant exposure to the U.S. housing market sets its budget performance for the coming year based on current market projections. Early into the following year, forecasts for mortgage

originations tumble nearly by half, rendering the company's annual budget and associated incentive goals close to meaningless.

2 | A consumer products company establishes its annual incentive goals just as expectations for consumer spending reach unprecedented lows. In the back half of the fiscal year, consumers unexpectedly open their wallets, and when the holiday season closes, actual results are far greater than the company's initial expectations.

3 | A semiconductor company is subject to intense industry cycles driven by the pace of technological innovation, as well as commercial and consumer spending.

Over time, industry volatility has increased, and the recent downturn marked an unprecedented low.

Goal setting has always been a challenge, but today it is next to impossible to establish meaningful expectations for performance.

Goal setting has always required care, but today the probability of getting it wrong is high, and the costs can be significant — from dealing with discouraged participants to introducing intermediate stopgaps to addressing unwanted turnover — depending on the direction and degree of the pay-for-performance breakdown. Compounding the dilemma, public attention is sharply focused on incentive outcomes, as shareholders look for

Figure 1 | Principles of Balance, Discretion and Flexibility

Balance	Discretion	Flexibility
Brief description		
<ul style="list-style-type: none"> Balance refers to a balanced framework for performance measurement that considers both financial and nonfinancial objectives. Financial metrics capture key value drivers, while nonfinancial measures help qualify financial results and encourage desired behaviors. 	<ul style="list-style-type: none"> Discretion refers to an after-the-fact evaluation of performance that relies on robust information, common sense and sound judgment. Some companies move beyond more common approaches (e.g., discretionary adjustments) and require discretion as an essential determinant of incentive outcomes. 	<ul style="list-style-type: none"> Flexibility refers to performance metrics that adjust for actual market conditions, thereby helping ensure that end-of-year assessments more closely reflect the company's own performance vis-à-vis external market conditions. In an up market, this helps avoid the rising-tide phenomenon; in a down market, it can help keep employees motivated.
Generally, each works best when ...		
<ul style="list-style-type: none"> Key value drivers are readily identifiable and can be measured with a fair degree of objectivity. A formal mechanism is in place to test and ensure the overall affordability of incentive payouts. 	<ul style="list-style-type: none"> Objective information is available to inform the committee's discretion (e.g., relative performance data, customer sensing). Management and the board have consistent dialogue on performance expectations and outcomes. 	<ul style="list-style-type: none"> The industry can be defined somewhat narrowly, and credible market information is available and timely. Participants are knowledgeable of market events and have a fair understanding of performance measurement and incentive mechanics.
A few words of caution ...		
<ul style="list-style-type: none"> Maintain a disciplined approach to the more subjective performance measures and assessments. The nonfinancial component is not intended as a means of simply paying incentives when financial results are lacking. 	<ul style="list-style-type: none"> Each committee is unique — some will be more comfortable than others when exercising discretion. Any breakdown in communication can derail the process; work to avoid surprises. 	<ul style="list-style-type: none"> A sophisticated incentive design can be good — when it engenders credibility by capturing the underlying economics of the business. Sophistication can also be very bad — when it is perceived as complexity, and participants question their own efficacy in driving performance and incentive outcomes.

clear linkages of pay and performance, and regulators weigh in with new requirements for program administration and disclosure.

This article brings forward innovative approaches to goal setting by expanding on the three company experiences summarized previously. Each case study addresses one of three key principles — balance, discretion and flexibility (see Figure 1 on page 56) — and highlights a company that today has a fuller context when assessing performance and determining incentive outcomes.

Case Study 1

Finding the Balance

Two months into a 12-month annual incentive cycle, an insurance company struggled with an earnings target in its annual incentive plan that was close to meaningless. The significant shift in market forecasts begged the question: Should the organization continue with its annual incentive plan and goals as defined, or should

it move to something more sustainable? The company decided to adopt a new, broader performance measurement framework.

The new annual incentive plan would continue to capture earnings as the critical financial result (i.e., did we meet our earnings number?). And, it would go further to address the quality of earnings by capturing margin achievement (i.e., did we meet our earnings number in the right way?). And further still, the new plan would evaluate progress against key strategic objectives, thereby recognizing important efforts to protect and improve earnings and margin over time (i.e., are we better positioned going forward?). Note that the three components of the resulting performance measurement framework — the earnings, margin and strategic components — are more or less equally weighted (see Figure 2).

Importantly, the company incorporates an overarching “governor,” whereby aggregate incentive dollars in any year are capped as a

percentage of the company’s earnings; this cap is held constant year over year. This helps ensure affordability and is essential where incentives can be paid for nonfinancial performance.

Over time, this new plan implemented for 2011 is expected to generate more balanced incentive outcomes, marking a significant departure from the company’s prior system with budget-based performance goals that were, more often than not, less than meaningful at year-end.

Case Study 2

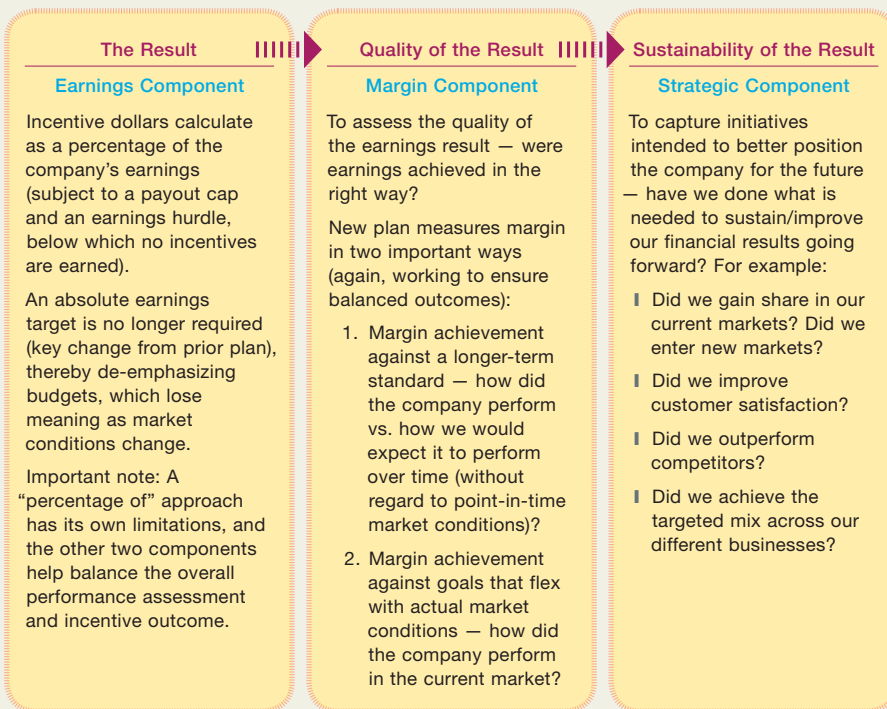
Requiring Discretion

In consumer-driven businesses, significant revenues are generated in the back half of the year. This seasonality makes goal setting difficult in a steady economy, let alone in today’s uncertain environment. When back-half consumer spending in 2010 picked up much more than expected, a consumer products company reached revenue far beyond its initial expectations. The resulting above-target annual incentive payout was, in hindsight, more a reflection of conservative goals than strong company performance.

Going forward, the company decided to establish performance ranges, rather than single-point performance goals. These performance ranges correspond with ranges of incentive payouts (see Figure 3 on page 60), and at year-end, the company (in practice, the compensation committee) will look back to the facts and circumstances for the year and then determine the appropriate incentive payout for a given performance result.

The committee now has the opportunity to interpret performance outcomes in a broader context, with consideration to prevailing economic conditions and other factors: Did the company gain customers? Did the company beat the competition? Was quality maintained? Did shareholders benefit? This after-the-fact assessment works to ensure that pay and performance are more appropriately aligned. Of course, the committee

Figure 2 | A Balanced Performance Framework



also had discretion to adjust incentive payouts under the prior, more formulaic incentive plan. However, the plan itself did not articulate under what circumstances or to what degree this discretion should be applied.

The new plan is innovative in that it not only allows for discretion, but it requires discretion. This approach works well for both employees and compensation committee members. Employees still know the score to some degree, since performance and payout ranges are established up front. Employees also have a strong sense for the performance criteria that will inform the committee's discretion at year-end. Committee members are more comfortable now that key performance criteria are known up front, and they have a structured approach to calibrating pay and performance with the benefit of hindsight. That said, this approach requires a strong committee that is comfortable with interpreting performance in a broader context and secure with its central role in determining incentive outcomes.

Beyond right sizing pay and performance outcomes, the new plan has

improved the dialogue between management and the committee around past performance, future expectations and how those expectations are to be achieved.

Case Study 3

Building in Flexibility

Weary of the whipsaw impact of broader economic and industry conditions on its performance against expectations, a semiconductor company endeavored to develop a different approach to setting incentive goals for 2009 and going forward. Looking back, the company's incentive payouts had been more often than not driven by external conditions rather than the company's own intrinsic performance. Like the insurance company in the first case study, the company's incentive payouts had exhibited a classic feast-or-famine pattern, with large payouts in up cycles and low or no payouts in down cycles.

To dampen the volatility of incentive payouts over time, the company now allows incentive goals to flex with market conditions. At the beginning of each year, the company establishes an earnings target based on its

then-current expectation for market conditions — in this case, overall market size. As the year progresses, actual market size will vary from the company's initial expectation, and so too will the company's earnings target:

- If the overall market shrinks relative to the company's initial expectation, the company's earnings target also decreases.
- If the market grows beyond the initial expectation, the company's earnings target increases.

In effect, the company's earnings target dynamically adjusts with overall market size (similar to the insurance company discussed previously, which flexes margin goals). At year-end, the company's actual earnings result is tested against the adjusted earnings target to determine the incentive payout. A given earnings result will generate a higher incentive payout in a smaller market, and a lower incentive payout in a larger market. The notion is simple: \$1 of earnings is a better result in a \$10 market than in a \$100 market.

Furthermore, the company's total target incentive opportunity scales with the earnings target: A higher earnings target translates to a larger incentive opportunity, and a lower earnings target to a smaller incentive opportunity (see Figure 4).

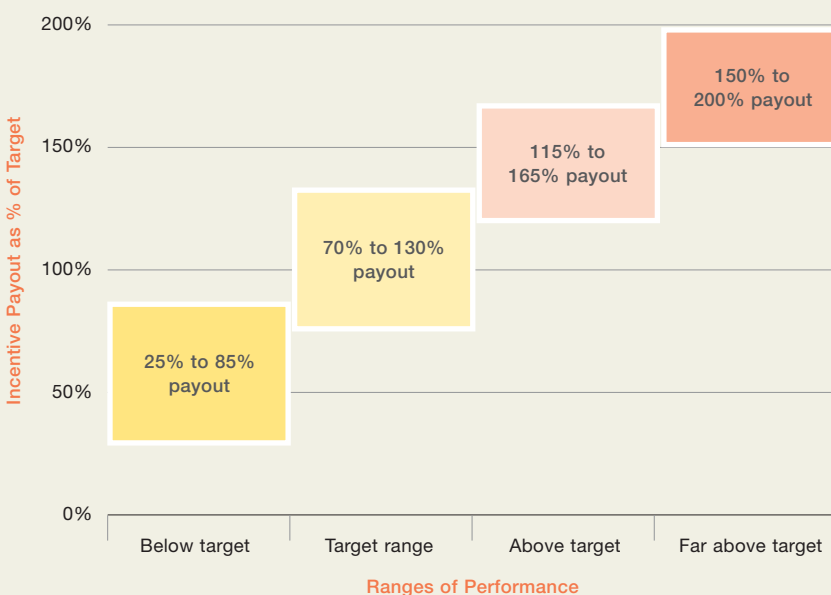
This scaling is important so as not to insulate incentives entirely from the company's absolute profitability (which works to ensure overall affordability).

In any given period and over time, this plan should better reflect the company's true performance, with lesser regard to industry conditions.

Conclusion

Goal setting will continue to be challenging for many companies. Expectations established at the start of a performance period may not be meaningful at the end. Achievement against predefined goals may not reflect true performance, and corresponding incentive payouts may be disconnected — strong performance in a down market might generate

Figure 3 | A Framework for Discretion



relatively low incentive payouts, and weak performance in an up market might deliver relatively high rewards.

Whether implementing short-term fixes or making broader changes, many companies today are facing

fresh decision points. Again, there is no single, best approach to setting goals and structuring incentives, and no incentive program is perfect. Each of the client experiences presented is heavily context-driven, and so


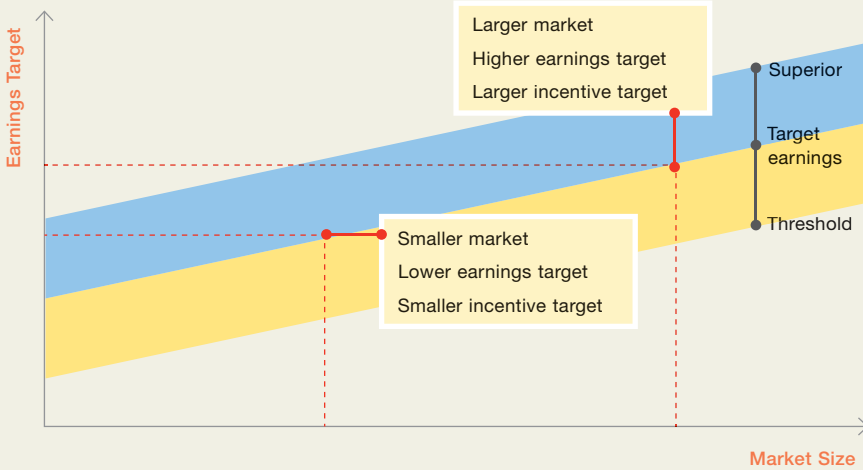
too should be your company's approach. That said, the principles of balance, discretion and flexibility can help mitigate uncertainty and are important hallmarks of sustainable pay-for-performance frameworks. 

Figure 4 | A Framework for Flexible Expectations



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