Should Do, Can Do, Will Do

Setting Incentive Goals That Yield Results

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Today's business environment is placing an ever-higher premium on performance measurement and heightening the scrutiny given to compensation plan design and payouts. When it comes to incentives, boards of directors are in the line of investors' ire if executive payouts do not match company performance results.

Goal setting and measurement are the heart of executive incentive plan design. With good goals and measures in place, incentive plans are poised for success — that is, they are designed to support and drive desired results. Without appropriate goals and measures, business results could be neutral at best and well below a company's potential at worst.

Many companies are wary about setting goals in the current environment because of the uncertainty of business conditions and other environmental factors. Unfortunately, boards too often rely on management to recommend appropriate performance goals and measures, without adequate bases and benchmarks for considering and evaluating management proposals.

What follows is an approach that can help boards — and management — make better decisions about setting goals, establishing measures and determining pay, whether annual, intermediate or long-term.

Be Careful What You Pay For

What happens when measurement and goal setting are not fully thought through? What seems like a good idea may actually work against the intended results. The following four examples illustrate good measurement intentions gone wrong.

Company A wanted to increase its market share, so management introduced a three-year revenue goal as a key component of the long-term incentive plan. Two years into the performance cycle, the company was increasing its revenue and market share, but largely at the expense of price cutting. This, in turn, was leading to unprofitable growth and declining returns. The company also had made a poor acquisition that immediately boosted revenues but did nothing for returns since the acquired company had lower returns than the parent.

In a second example, Company B needed to encourage teamwork among its divisions and decided to measure everything at the corporate level. While measuring teamwork sounded like a good thing, in fact, the performance of the divisions was uneven, with one division performing so poorly that it made it difficult to earn a full incentive payout. The plan actually demotivated the other two business units and reduced their incentive to excel.

In contrast, Company C decided to emphasize individual performance and line of sight, so it established only individual goals. As a result, individuals understood their goals and how to influence them but had no incentive to work together. Instead of sharing goals, they were out for themselves and competing against each other when they should have been focused on their external competition.

Finally, Company D strove to improve customer service by using a customer satisfaction index. When this type of measure was included in its annual incentive plan, many duplicative activities sprang up across the organization to keep customers happy. These activities not only drove up costs, but the company also found that employees were overpromising to delight customers in the short-term. When promises weren't delivered upon, customers expressed disappointment with the service received.

As illustrated in these examples, when choosing goals and measures, it is critical to carefully think through the behaviors the program is designed to motivate, as well as those it might motivate unintentionally. While the examples may seem extreme, they have been repeated in more than one company. The adage that "people will act on what is measured" is true — people will, in fact, focus on what they're paid to do.

Think Through Performance Measure Selection

The following four factors come into play when selecting performance measures:

1. **Nature**: What specific results should be measured?
2. **Level**: At what organizational level should results be measured?
3. **Timing**: Over what timeframe should results be measured?
4. **Standard**: How should performance targets be established?

Each factor has an important impact on incentive plan design as discussed below.

Nature of Measures

While the ultimate measure for all companies is total return to shareholders (TRS), i.e., stock price appreciation plus dividends, TRS typically should not be the sole incentive plan measure. Other financial, strategic and operational measures can help reinforce the short- and intermediate-term results that contribute to TRS performance. These additional measures create line of sight and aid understanding of the plan and the goals. Additionally, they also help foster the collaboration necessary at operational levels.

Determining the specific results to measure starts with identifying the economic drivers of TRS and also the strategic and operational drivers that contribute to financial results. The measures should be as unique as the company's business strategies. The objective is to identify the key measures that contribute to creating value for shareholders. Value trees are useful for teasing out all of the possible drivers and levers that create value. (For an example of a value tree, see Figure 7 in the case study Sidebar on page 33.)

Value trees have several advantages. They provide a comprehensive picture of all the measures that impact TRS, in effect unbundling the economic drivers and identifying the interrelationships among them. They also effectively illustrate which lower-lever drivers can trigger improvement in higher-level results. This connection is invaluable in creating line of sight at lower organizational levels.

When traced to its "roots," a value tree not only addresses financial measures such as revenue, but nonfinancial measures such as capacity and turnover that help determine revenue potential.

Value trees lend themselves to all types of industries and businesses from call centers to restaurant chains to manufacturers and financial services. Creating value trees is an exercise that can spark excitement and foster ownership and new understanding of business linkages among the cross-functional teams that create them. Further, using value trees to explain individuals' connection to and impact on company results can aid understanding, ownership and community at all organizational levels.

In identifying various measures, it can be helpful to consider common industry measures, competitor measures, and measures favored and tracked by analysts. Ultimately, however, the measures chosen will be unique to the business strategy. The process of identifying drivers will yield more measures than could be included in incentive plans or performance management, so prioritization is critical.

Thus, once measures have been identified, the next step is to prioritize those that have the greatest impact on TRS. This involves isolating the leverage points — that is, determining which measures represent the highest priority areas for improving success with customers, and most importantly, represent an opportunity to improve versus competitors. Finance and HR can effectively team up for this analysis. Approaches such as sensitivity analyses (i.e., percent change in economic value, profits, returns associated with a 1 percent change in the measure) and review of key analyst metrics, business strategies and customer feedback can provide intelligence as to which drivers have the greatest potential to impact TRS.

Level of Measurement

The next step in the process is determining the appropriate measurement level. Typically, these decisions involve consideration of the following:

- **Decision autonomy**. How much autonomy do business unit leaders possess versus needing corporate blessing? If units are more autonomous, then more weight generally should be placed on business unit versus corporate results.
- **Shared accountability and resources, and coordination across units**. If businesses share accountabilities, resources and/or customers, then consider putting more weight on higher-level goals. Alternately, companies can use shared objectives to make individuals and/or functions jointly accountable for shared results. Such an approach promotes collaboration while providing clearer direction and greater line of sight. For example, say the sales function is making delivery promises to customers, but manufacturing can't deliver on them. Making both sales and manufacturing equally accountable for quality and timing can contribute to better coordination.
- **Affordability.** Many companies include company-wide or business unitwide financial measures to ensure

the affordability of bonus payouts. Sometimes these measures are structured as thresholds, or triggers, which require minimum performance before payments of any kind can be made. In other cases, they reduce but do not eliminate the payments that can be made.

Companies often mix measurement levels, for example, using half corporate measures and half divisional or individual measures, or a 70/30 mix with the greater weight on corporate or division measures, depending on the factors listed.

While, as a general rule, having measures at a level closer to a participant's line of sight yields more incentive value, sometimes maximizing the line of sight can impede teamwork. For example, a health care company rewarded executives in different regions on company performance since the regions shared resources and people, and the company did not want one region to optimize its performance at the expense of the other.

Conversely, a diversified manufacturer used its intermediate-term incentive plan to reward its different divisions based on their own growth and returns. However, the company balanced the highly entrepreneurial nature of the intermediate plan by also granting stock options to all executives. This approach reinforced the need for a company perspective, despite the divisions' relative autonomy.

Measurement Timeframe

The next consideration is timing. Timing is influenced by a company's business cycles and the time span for realizing the results and consequences of decisions and actions. It helps to consider the following three aspects:

1. **Lead time**: Once plan participants know the measure and goal, how quickly can they take actions in response?
2. **Lag time**: After actions are taken, when will the results be known?
3. **Residual impact**: How far into the future will consequences extend?

Companies need to be aware of situations where short-term results are rewarded while longer-term results turn negative. For example, one company cut back on both marketing and research to bolster short-term earnings, but seriously damaged longer-term profits. This kind of issue can be avoided by introducing measurements based on rolling multiyear versus one-year periods, adjustments to annual performance based on sustained performance, and/or measures with different performance periods (e.g., one-year measures as well as three-year measures).

Standards or Goals

The final aspect of measurement is setting standards or goals. Performance targets can be set in one of four ways: 1) against budget; 2) as a percentage above historical performance; 3) versus a fixed standard; or 4) by peer comparison. The most common goal-setting approach involves linking incentive goals to annual budgets or three-year business plans. Unfortunately, this approach is only as good as the budgeting and planning process that underlies it. Companies often make one of two mistakes. Often goals are set top-down, imposed from the top of the organization with little input from the broader group of plan participants. This mandated approach often results in limited ownership and commitment by participants because goals are too often unrealistic, unattainable and lack the power to motivate desired behavior.

A bottom-up approach, where goals are negotiated with senior management, also has drawbacks. Sandbagging can occur, creating goals with inadequate stretch. As a result, the plan may pay out even though company performance falls short of potential.

Avoid the Goal-Setting Traps

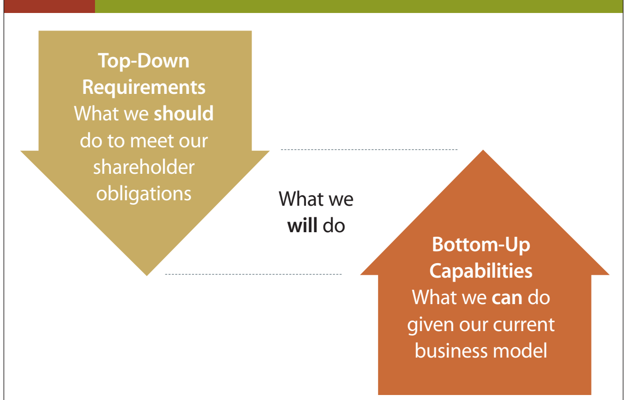
When it comes to setting goals, companies need to be cognizant of four common traps that can derail an incentive design.

1. Negotiating prowess can count more than great performance when it comes to payouts.
2. Managers lack the action plans to achieve the goals. This is common when goals are driven down from the top.
3. Goals are set arbitrarily — that is, without rigor or benchmarking against peers, market expectations or historical performance.
4. Goals are unrealistic and consequently, demotivating or worse yet, ignored. This also is typical of top-down driven processes.

One way to circumvent these traps is to ensure that goals represent sustainable performance that will beat competitors' results and market expectations, and that the goal-setting process is neither dysfunctional nor open to gaming the system. Companies should employ a balanced approach to goal setting using both top-down and bottom-up perspectives. (See Figure 1.)

It may sound easier said than done, but a balanced approach to goal setting can position a company for success. The balanced approach helps a company avoid the traps.

FIGURE 1 A Balanced Approach to Goal Setting



Top-down: focuses on what companies should do to meet their obligations to shareholders; bottom-up: focuses on what they can do based on their current business model. These two perspectives then must be reconciled to determine what they will do. It is only in this way that an organization can establish sustainable goals that are achievable and also have adequate stretch. Fundamental to the approach is that goal setting is driven by facts, not by negotiating prowess. While this approach may seem intuitive, surprisingly few companies address goal setting in this way.

Should Do

The top-down perspective reflects the company's obligations to shareholders: what a company should do to justify its continued independence and management's continued stewardship. When establishing top-down goals, companies should consider three relevant benchmarks: historical performance, future expectations and continuous year-over-year performance improvement. Figure 2 on page 29 defines these benchmarks and the issues to address for each.

Boards should insist on this fact base when reviewing management's plans. Unfortunately, companies often focus on only one of these benchmarks. For example, one regional bank was quite diligent about looking at its own historical results, but paid little attention to market expectations or historical results for its peers. When the bank adopted a goal-setting template incorporating each of the three elements, all of its business units recalibrated their goals, in all cases driving more stretch.

The last step in the top-down analysis is to look at what story the three benchmarks reveal and then to use the data to develop consensus goals. This is illustrated in Figure 3 on page 29.

In this case, future market expectations received the greater weight because they complement the company's view of its own sustainable performance. This goal sets a bar that is attainable and also will meet shareholders expectations.

Can Do

Developing a bottom-up perspective — or what the organization believes it can deliver — involves four

FIGURE 2 Benchmarks for Top-Down Goals

Benchmarks	Issues to Address
Historical Performance of Peers with respect to the key drivers of shareholder value, e.g., top-line growth, bottom-line growth and returns	If performance is *below peers*, determine: 1. What is the gap between actual results and competitive performance? 2. What are the reasons for underperforming and can these reasons be acted upon? 3. How long will it take to achieve results on par with the industry? If performance is *above peers*, determine what is required to sustain and/or further improve performance.
Future Expectations of the Market, which includes analyst expectations for the company and the industry as a whole. Ideally the company should be striving to beat both.	**Consider four issues:** 1. Is the company positioned to meet or exceed market expectations for its own performance? 2. Are analysts' expectations for the industry higher than for the company? If so, why? 3. How much stretch is required to meet expectations for the industry? 4. How long might it take to achieve industry expectations, and what is a reasonable ramp-up plan? Even though a company has done well versus peers historically with respect to earnings growth, analysts may expect it to slide backwards. Therefore, it is not sufficient to simply beat its performance expectations. The company also needs to restore its industry positioning.
Continuous Year-Over-Year Performance Improvement of the company's own results — performance needs to at least match past achievement.	**Consider:** 1. What *internal factors* will affect future performance (e.g., new product launches, technological breakthroughs, projects under way to improve the company's cost structure)? 2. What *market factors* will affect future performance (e.g., potential market growth, as well as economic or sector-specific factors (e.g., mortgage rates)) that could have a differentiating impact on performance? Can the company expect to capture or lose market share based on changes in its relative competitive advantage?

FIGURE 3 Using Benchmark Data to Develop Consensus Goals

Benchmark	Earnings	ROI
#1: Historical Peer Performance 50th/75th Percentile	12% – 16%	12% – 15%
#2: Future Market Expectations 50th/75th Percentile	11 – 13	14 – 17
#3: Sustainable Performance	13	13
Consensus Goals	**13%**	**14%**

steps (Note: Steps 1 and 2 were discussed under the Nature of Measures section on page 25.):

1. Understand the drivers of the value of the company's stock — both financial and nonfinancial.
2. Identify which of these drivers require strong focus in order to improve company results.
3. Determine the potential opportunities for improving performance for these key drivers.
4. Roll up these improvement opportunities to see what the implications are for overall company results.

This type of analysis ensures that goals are grounded in facts to the maximum extent possible and not influenced by negotiating skill.

Identifying the potential for improvement relative to the key drivers also should be guided by relevant benchmarks. Three types of benchmarks can be considered:

1. **Internal comparison** to best-performing units and locations. Internal benchmarks are appropriate if the company has multiple locations or similar units and can determine how much improvement would result if lower-performing units matched the benchmark. For example, a residential services provider with hundreds of locations focused on bringing all units below median to median, and all median performers to the 75th percentile. Comparisons can also be made over time by benchmarking against best month's or best year's performance.
2. **Technical limits** take an engineering approach by identifying the optimal level of performance. Technical limits examine key processes and see how close results can get to optimal performance (e.g., reducing downtime). For example, when a gold mining company set its goals in a rigorous way, the line employees were amazed to discover

the potential for improvement. Line management worked with finance to understand the drivers and leverage points; they used multiple benchmarks to understand where the improvement opportunities were given technical limits.

3. **External comparison** — how peers have done. Industry benchmarks can be used to assess competitor performance. For example, the call center industry has a wealth of data on various productivity metrics. One call center benchmarked each of its work processes against peer data to identify improvement opportunities.

Will Do

The final step is to reconcile what the company **should do** with what it **can do** to determine what it **will do**. In most cases, some tweaking of goals may be necessary to reach consensus. However, there may be situations in which the two perspectives cannot be reconciled.

Generally, results are close and only require minor tweaking. If there are major disconnects, the assumptions for top down and bottom up should be revisited to make sure they still hold. If the goals set from the top are truly imperative for the shareholders to realize adequate returns, then it may be necessary to fundamentally rethink the business strategy and/or the business model to deliver the needed results. Failing that, it may be necessary to explore different end games, such as selling off underperforming parts of the business or, as a last resort, the entire business.

If the bottom-up goals are better than the top-down set, go for it and set more aggressive goals; just be sure that pay and performance are aligned, so truly exceptional results will yield commensurate levels of pay.

The Role of Judgment

An important consideration is the level of judgment that should be employed in assessing results, particularly in addressing the degree of difficulty associated with the goals and the uncertainty presented by the financial markets, business environment and competitors. Both boards and management want the opportunity to apply judgment when major unanticipated and uncontrollable setbacks — or windfalls — significantly affect performance. Establishing frameworks for modifying incentive goals and/or making after-the-fact adjustments will help structure discussions about the impact of unplanned events. (Discussions that deteriorate into prolonged negotiations will mar the integrity of the plan design and demoralize participants.)

Judgment and after-the-fact adjustments should not provide carte blanche to forgive subpar performance. Rather, they should form the basis for reasoned discussions about management actions to anticipate or respond to unplanned events (even if they were unable to mitigate despite best efforts). In 80 percent or more cases, adjustments will not be warranted. For example, employees at a mining company appealed for relief from rising energy and raw materials prices. However, no adjustments were made because management failed to take precautionary actions; it failed to buy contracts to hedge against escalating prices and also moved too slowly to consider alternative energy sources.

Key questions to consider when deciding whether goal adjustment might be appropriate include:

- Is the circumstance or event a business risk for which management should be held accountable?
- Will adjusted goals result in unacceptable disconnects from the consequences to shareholders, i.e., where the company loses money, but the executives get paid.
- How prominent is pay in driving behavior and/or reinforcing accountability? (The more the adjustment, the weaker the accountability.)

To structure such decisions, three parameters should be established:

1. **At the start of the performance cycle**, establish the factors that will be considered for possible adjustments. These can either address items which management cannot control and therefore, should not be held accountable for, and/or circumstances that materially affect the difficulty of achieving goals. As shown in Figure 4, it is helpful to define three sets of factors: 1) those that would merit an adjustment, e.g., accounting rule changes; 2) those that could warrant an adjustment, depending on the nature of the event, e.g., unanticipated regulatory changes or natural disasters; and 3) those that will not result in an adjustment, e.g., competitor actions or poor publicity.
2. Make sure discretion is informed by facts. Further, agree ahead of time on the facts that will be considered, e.g., competitor performance, market growth.
3. Specify the boundaries of adjustment. Although adjustments can provide some relief, they should not totally absolve management of its responsibility. Therefore, the size of the adjustments should be bounded, typically not to exceed +/-20 percent. Adjustments need to go both ways; that is, consider windfalls that benefit the company and escalate performance, but also consider misfortune or harsh conditions that have the potential to dampen results.

Appropriately Linking Pay and Performance

Once goals are established, they need to be linked to compensation. This involves two considerations.

First, make sure pay reflects the toughness of goals. If goals are tougher than those of peer companies, then pay opportunities should be commensurately higher. So if performance targets correspond to the 65th percentile, pay targets should, too. In Figure 5 on page 32, the pay and performance targets were set independently and therefore are not aligned. The payout for 65th percentile performance is at median; this is guaranteed to create ill will among plan participants.

Second, reflect the volatility of results when setting payout ranges. One company had a very narrow range from threshold to maximum: a threshold of 90 percent and the maximum at 110 percent of target. Evaluating its historical volatility revealed that in three-quarters of the cases, results were either above maximum or below minimum. As a result, the company widened the range to 80 percent to 120 percent. (See Figure 6 on page 32.)

FIGURE 4 Factors to Consider for Possible Goal-Setting Adjustments

Event	Will Adjust	Consider Adjustment	Will Not Adjust
Accounting rule change (e.g., FASB 106)	☑	☐	☐
Unanticipated regulatory change	☐	☑	☐
Capital or business restructuring	☐	☑	☐
Strategic decision to increase research, advertising, etc. beyond planned levels	☐	☑	☐
Legal action against the company affecting operating income by >5%	☐	☑	☐
Natural disasters	☐	☑	☐
Recession	☐	☐	☑
Interest rate shifts	☐	☐	☑
Planning errors	☐	☐	☑
Competitor actions	☐	☐	☑
Poor publicity	☐	☐	☑
Strikes	☐	☐	☑
Legal action against the company affecting operating income by <5%	☐	☐	☑

FIGURE 5 Linking Goals Met to Appropriate Compensation

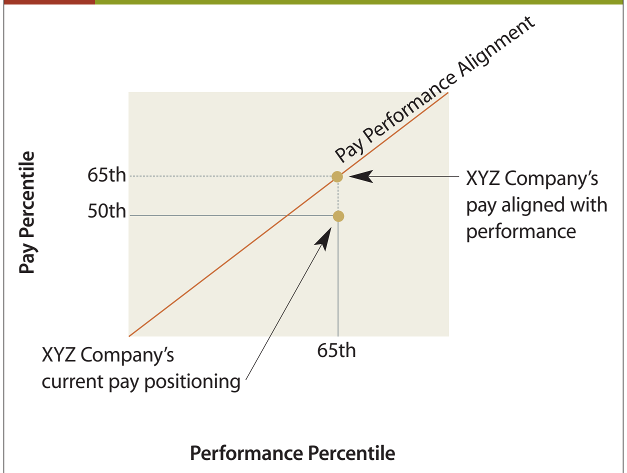
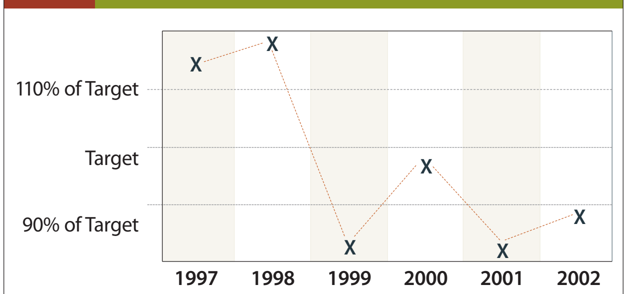


FIGURE 6 Setting Payout Ranges



Final Thoughts

The primary objective of goal setting and measurement is to select measures that align with business strategy. Focus on the goals that are truly critical; three to five measures typically are the maximum. Evaluate both the intended and possible unintended consequences of the measures. Make sure plan participants understand the measures and how they can influence the outcomes. Finally, make sure payouts reflect the toughness of the goals and the volatility of results. WJ

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How a Call Center Applied the Goal-Setting Framework

A major call center had been performing just above the industry median in earnings growth, but its returns lagged the industry. With returns below its weighted average cost of capital, value likely was being destroyed. The call center examined why its ROI was below its competitors and found three possible culprits: failure to control working capital, significant underperforming assets, and/or overpaying for acquisitions and not realizing synergies among the businesses.

Although the company had done well versus peers historically with respect to earnings growth, analysts expected it to slide backward. In such a situation, it was not sufficient for the company to beat its own market expectations; it also had to figure out how it would restore its industry positioning.

Even though analysts saw the call center slipping versus peers, management believed it could improve its competitive performance. When management consolidated its historical peer performance, future market expectations and sustained performance to consider the whole story, it decided to place the greatest emphasis on future market expectations. The future view was only slightly above what the call center considered to be its own sustainable performance. This bar appeared attainable and would also meet shareholders expectations.

Thus, the call center established its top-down "should do" goal at 11 percent earnings growth. The next step was to develop the bottom-up perspective and determine its "can do" goal. The call center traced its value tree to two key drivers of value: turnover and the number of calls handled per customer service rep. (See Figure 7.) The criticality of these value drivers was confirmed by analyses that showed reducing turnover could result in a 25 percent improvement in EBITA over three years.

To focus on appropriate goals, management compared each call center unit's current average calls per shift and turnover rates to two internal benchmarks: each unit's best month and the results of the best performing units. It found it would realize substantial improvement if half of the units performing below median could rise to the median of all units and if one-quarter of the median performers could reach the average of the top quartile performing units. Unit performance was also compared to industry benchmarks, but those benchmarks were so much higher than current performance that the stretch would be too great. The internal benchmarks also required stretch, but offered more realistic and reachable goals.

Total improvement opportunities presented a "can do" target of 10.5 percent compared to a "should do" goal of 11 percent. Management had to bridge the gap between the two targets. Given that external benchmarks exceeded internal performance, management knew it was important to strive for the higher, 11 percent goal. It decided to target certain underperforming units that had the potential to exceed median results. If those units could rise to the occasion, the higher earnings growth goal would be within reach. So the "will do" earnings growth goal was set at 11 percent.

FIGURE 7 The Value Tree