Establishing Meaningful and Rigorous Financial Goals

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Introduction

In developing annual incentive plans, the review and approval of meaningful financial performance targets can be a challenging task for the Board of Directors' compensation committee. The frequent source of these financial performance targets is the company's annual budgeting process. These performance targets are also often the basis for providing earnings guidance to the investment community. Absolute financial targets are the most difficult to establish and are the most common type of goal used in annual incentive plans. Many companies use relative financial performance goals such as relative total shareholder return (TSR) in their compensation program, but they are more frequently found in long-term incentive plans.

Absolute financial targets vary among companies and within industries, although the majority of these financial metrics are tied to company earnings. In certain industry sectors, another key performance metric is annual revenues. Annual earnings performance can be measured as either the quantity of earnings or the quality of earnings. A quantity of earnings measurement is tied directly to the company income statement and is typically expressed as net income, net operating income, earnings before interest and taxes, earnings per share (EPS), or another earnings target. In some cases, the quantity of earnings target may be presented in terms of growth over the preceding year's actual results. The quality of earnings metric incorporates the company's balance sheet in the equation by considering if the earnings generate a sufficient return on investment. This metric may take several forms — such as return on assets, return on equity, or return on capital employed.

The budgeting process at many companies often begins several months prior to the beginning of the performance year. In some cases, the budgets are finalized and approved at the beginning of the year based on the best available data and assumptions, which may not include competitors' most recent financial results or their earnings expectations for the

KEY FINDINGS

- The review and approval of meaningful financial performance targets can be a challenging task for the Board's compensation committee.
- Annual incentive plans usually include absolute financial targets as opposed to relative performance targets (more frequently found in long-term incentives), and absolute goals are often difficult to establish.
- The annual budgeting process is a frequent source of absolute financial performance targets as well as the basis for providing earnings guidance to the investment community.
- Compensation committees should take additional steps to ensure that absolute financial targets have sufficient rigor by testing performance targets relative to:
  - past performance
  - peers
  - guidance and market expectations
  - prior year targets
  - long-term incentive plan targets
- The process for establishing annual incentive plan targets that are motivating and aligned with shareholder expectations requires significant input from top management and business unit executives, compensation committee due diligence, and a high degree of good business judgment.

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upcoming year. A company's budget philosophy can also have a significant impact on the suitability of using budgeted revenue, earnings, and returns as the target goals in the annual incentive plan. Companies that establish "aspirational" budgets might conclude that achievement of budget targets should result in higher-than-target payouts. Conversely, companies that establish budgets that are deemed highly achievable and include significant reserves for uncertainties might set incentive plan targets above the budgeted amounts. Thus, there may be a number of reasons why the annual budget and annual incentive plan targets are not the same.

The thesis of this Viewpoint is to answer two questions:

1. Are the company's absolute financial performance goals sufficiently rigorous?
2. What steps should management and the compensation committee take to test the rigor of the financial performance goals to ensure there is a proper degree of due diligence in this important governance process?

Establishing Rigorous Absolute Financial Targets

Annual incentive programs often include hundreds if not thousands of plan participants and can be a key driver of company performance. In the ideal world, incentive metrics are well-understood, plan participants can directly influence the selected metrics, and the goals are both challenging and motivational.

As noted, many companies use the annual budget as the starting point for establishing the performance targets used in the annual incentive plan. The annual budgeting process is typically rigorous and requires significant input from both corporate and business unit leaders and a review of external data, including economic forecasts and industry expectations, before the budget is presented to and approved by the full Board of Directors.

In addition to considering the underlying budget assumptions, there are several steps that can be taken to evaluate if the absolute performance metrics are rigorous, as discussed below.

Performance Targets Relative to Past Performance

Companies often establish future performance targets based on growth over the prior year's actual results. These improvements may include top-line growth, expanded margins, higher returns on capital, increased cash flow, or — in some cases — a combination of higher and lower results such as accelerated revenue growth with flat or slightly lower margins. Some investors and the proxy advisory firms consider prior year financial results an "anchor point" for future performance targets and will react negatively to current year targets below prior year actual financial results, absent a compelling rationale (for example, a business divestiture or loss of a major customer). *Author's Note: In some cases, FY 2020 may not be a good starting point for evaluating improvements in earnings due the adverse impact the global pandemic had upon the Company.*

A useful tool in comparing current year targets to the prior year's actual results is the use of a "financial bridge" that details the key variables and assumptions used to bridge last year's actual results to the current year plan. Projected changes in market growth, market share, product pricing, cost reduction/efficiency, foreign currency, etc. help explain projected improvements in, or challenges to, performance. These allow management to demonstrate to the committee that the current year performance targets are supported by reasonable assumptions, and the resulting goals are sufficiently challenging.

Performance Targets Relative to Peers

Several companies have a well-defined peer group that is used for performance comparisons by company management, investors, and analysts. Unlike the compensation peer group, these companies may be larger or smaller than the company. We recommend that a 10-year history (if available) be created to track the

Company's performance relative to peers in order to establish if it is more profitable and/or growing faster than its peers.

This data is an important step in evaluating the degree of rigor in performance targets: a company that has historically grown faster than its peers, or achieved higher margins or returns on capital, would be expected to maintain its superior position even if the peers are closing the performance gap. Conversely, companies that have historically lagged their peers would be expected to implement changes in the business to accelerate performance improvements and begin to close the gap with its peers.

In some cases, a company may only have two to three direct competitors for performance comparison purposes; while not as reliable as a broader data set, the data and analysis may still provide valuable insights on goal rigor.

Performance Targets Relative to Guidance and Market Expectations

Prior to the global pandemic, most large companies provided earnings guidance and prepared detailed investor presentations to set expectations for the coming year. In most cases, investor guidance is provided as a range — for example, revenue growth of 3%-5% and operating margin of 12%-14%. Earnings guidance is often set at a level that management and the Board have a high degree of confidence of achieving. While guidance may be somewhat conservative, there may be an adverse reaction from investors that creates downward pressure on the stock price if guidance is set too low. Thus, it is incumbent on management to set realistic expectations.

The rigor of a company's incentive targets can often be evaluated based on its position relative to guidance. For example, incentive targets at the midpoint or higher end of the guidance range would suggest a fair amount of rigor; targets above the high end of guidance might indicate the incentive targets are potentially aspirational and might warrant an above-target payout if achieved; and targets set below the midpoint or the lower end of the guidance range may require further explanation, as paying target incentives when actual performance is below shareholder expectations could be problematic.

Performance Results Compared to Prior Year Targets

Another effective technique to evaluate the rigor of performance targets, albeit with the benefit of 20-20 hindsight, is to compare actual performance to target over the past 5 to 10 years. If the company has generally achieved 80% to 120% of target payouts over multiple years, it may suggest the goal-setting process has been effective and the resulting outcomes have been fair to shareholders and plan participants.

On the other hand, if payouts are highly volatile or payouts are consistently well above or below target, it may indicate the goal-setting process should be reviewed to determine if the outcomes were warranted.

For example, one company may be falling consistently below target because the CEO or Board is establishing stretch targets that cannot be achieved. In another situation, the company's business may be so volatile that setting annual performance goals has been a significant challenge, resulting in wide swings in incentive payouts over time. A third company may have consistently paid above target and can support the outcome with outsized shareholder returns and industry-leading growth and profitability.

Performance Relative to Total Shareholder Return

Another test for evaluating the suitability of the performance metrics and goal rigor is a comparison of annual incentive plan payouts as a percentage of target as well as absolute and relative TSR. Over long periods of time (7 to 10 years) the trend line for annual incentive plan payouts with a company's absolute and relative TSR would indicate the market is rewarding shareholders at a similar rate as the company is rewarding incentive plan participants for achieving annual performance results.

Correlation analyses can also be performed to assess how closely annual performance results link to shareholder value creation. In some cases, the correlation may be quite high, but the payout history may not align with absolute or relative TSR due to potential issues with the goal-setting process. For example, revenue growth and return on invested capital may have a high correlation with stock price changes; however, past incentive payouts may not align with TSR, as revenue growth targets may have been set artificially high in several of the prior years.

Annual and Long-Term Incentive Plan Comparisons

Another test of goal rigor is to compare payout levels under the annual incentive plan to those of the long-term incentive plan (e.g., performance shares and stock options). For example, are the rolling 3-year average annual incentives similar to the 3-year performance share plan payouts covering the same period? If not, can the differences be explained?

It is also a good practice to compare the annual incentive plan's underlying performance targets against the performance share plan metrics' underlying performance targets.

Adjustments to Financial Results

One of the reasons a company may under- or out-perform its budget/incentive plan targets is the occurrence of unplanned events or significant deviations from the assumptions used to prepare the budget (e.g., a spike in commodity prices, a material change in foreign currency exchange rates, changes in tax rates, new accounting pronouncements, major acquisitions or divestitures, or a restructuring of the business).

Compensation committees often adjust for the effects of these items, both positive and negative, in order to properly measure operating results. These adjustments also have the benefit of allowing the committee to hold management accountable for achieving the agreed-upon budget/incentive plan targets, and they can reduce the need to build large contingencies into either the budget or financial targets.

Stress Testing

The impact of a 1% change in key variables on estimated financial results can be enlightening when evaluating if performance targets are solidly built or susceptible to modest changes in the company's operating environment. Stress testing provides management and the compensation committee with an understanding of how volatile the incentive plan metrics may be and how achievable the approved targets are if the economic environment changes.

Stress testing can also help establish the width of the performance curve (i.e., the performance and payout levels at threshold, target, and maximum performance).

Other Performance Considerations

There are other considerations in the measurement of absolute financial performance that can have a direct bearing upon an annual incentive plan's motivational impact. One design feature that we occasionally find in annual incentive plans is a performance modifier based upon the company's relative financial performance or TSR. If the company exceeds its financial targets, and relative performance is below market, the modifier would serve to reduce the annual incentive payout; if the company falls short of its financial targets, and relative performance is above market, the modifier could be used to increase the annual incentive. As shareholders continue to evaluate the alignment of incentive compensation and shareholder returns, it is possible we may see an increase in the use of a TSR modifier or payout cap added to annual incentive plans.

Another design feature is the establishment of a "performance target range" in lieu of setting a single absolute financial performance target. For example, a company may establish a goal of $5.85 EPS for a performance period based upon the budgeting process. However, the company may elect to prescribe a 100% target payout for performance within the range of $5.75 to $5.95. The use of a performance target range acknowledges the lack of absolute precision used in the goal-setting process, provides the same reward to plan participants for achieving performance within an acceptable margin of error and is consistent with the earnings guidance provided to shareholders and market analysts.

Our Conclusions

As discussed in this Viewpoint, most companies use absolute (as opposed to relative) financial goals in the annual incentive plan that are derived in part or directly from the company's budget. Management and the Board strive to establish budgets that are reasonably challenging to meet shareholders' expectations as to both the quantum and quality of earnings.

The reliance on absolute performance goals in annual incentive plans requires that management and the compensation committee evaluate the approved budget for the degree of rigor built into the performance goals. A company's budget philosophy can have a significant impact on the suitability of using budgeted revenue, earnings, and returns as the target goals in the annual incentive plan.

Management and the compensation committee should also review goal rigor using the techniques described in this Viewpoint to the extent that such analyses were not performed as part of the budgeting process. These analyses can be used to refine incentive plan goals to ensure they reflect the company's pay for performance objectives and provide a high degree of motivation to plan participants.

Importantly, properly established performance targets may also reinforce the company's credibility with shareholders and plan participants. Companies that consistently pay above-target incentives when stock prices are falling are likely to be criticized for a misalignment of pay and performance. On the other hand, companies that consistently pay below-target annual incentives are likely to experience a high degree of employee dissatisfaction and a loss of employee motivation. In both situations, investors and analysts are likely to question the reliability of a company's earnings guidance.

Despite the best efforts of the management team and compensation committee, annual incentive plan targets that are established at the beginning of the performance year are bound to be affected by unplanned events. Most one-time, unusual items can be addressed with an agreed-upon list of adjustments to GAAP results when calculating annual incentives. Companies may also want to consider carving out a portion of the annual incentive for non-financial/strategic goals that position the company for long-term success (e.g., environmental, social, and governance metrics). It may also be appropriate to use a relative performance modifier in determining actual incentive plan payouts, such as relative TSR or earnings growth, to adjust for targets that, in hindsight, were either too aggressive or not aggressive enough.

At its core, the process for establishing annual incentive plan targets that are motivating and aligned with shareholder expectations requires significant input from top management and business unit executives, compensation committee due diligence, and a high degree of judgment that can and should be constantly refined in order to fully support the business needs of the company.

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