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2024 Incentive Goal-Setting: Core Principles and Strategies for Uncertain Times

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Many public company boards are finalizing their 2024 budgets, with compensation committees using these budgets to establish performance goals for executive compensation. These efforts have been challenging in recent years and continue to be a challenge. To support this process, here is a quick refresher on core principles and strategies for setting performance goals in times of uncertainty and volatility.

Core Principles

Most companies establish an operating budget within the range of external investor guidance and then set the short-term incentive plan target equal to the budget. Implicit in this approach is the notion that the budget and the target payout are reasonably well calibrated to market (e.g., 50th percentile budget and a 50th percentile payout opportunity). From there, most companies establish the payout slope using a fixed range around target with the threshold and maximum performance levels being the two endpoints under the incentive plan. The payout slope should be calibrated to enable appropriate pay-for-performance sensitivity. For earnings metrics, these ranges are often 85-90% of target at threshold and 110-115% of target at maximum (narrower ranges are often used for top line metrics such as revenue). Generally, the rule of thumb is that the higher up the financial statement, the more predictable the results and thus the narrower the performance range. However, the performance range needs to consider (i) the expected volatility of outcomes for the business and (ii) the payout levels associated with threshold and maximum performance. For example, a backlog-driven business with a recurring revenue model may have a narrower performance range given lower expected volatility of outcomes. Similarly, a company with a wider payout range (e.g., 0-300% of target vs. 50-150% of target) may have a wider performance range to align pay and performance.

When using these traditional approaches to goal-setting, it is always important to check how the resulting performance levels relate to the company's prior year actual results. Does the target performance level reflect a reasonable level of improvement to support a target incentive payout? Does the threshold performance level result in payouts for declining year over year performance? Rigid policies requiring the threshold to be set at or above the prior year result often yield peculiar and potentially ineffective payout curves (e.g., rapid escalation between threshold and target with a flattening out above target), but it is reasonable to be concerned about a material incentive payout (i.e., 50% of target) for a material decline in performance.

Strategies for Addressing Budget Uncertainties

If you're struggling with budget uncertainties given an opaque economic outlook, there are some unique strategies to consider. For example, some companies are adopting a payout curve with a flat area around target. This is sometimes referred to as a “strike zone.” With this approach, there’s a range around budget (e.g., +/- 2%) where performance anywhere in the range yields a target payout. This can be an effective strategy when there’s limited precision around where to set the budget.

Another strategy to address budget uncertainty is to temporarily widen the overall performance range. For example, if you normally have a range of 90-110% of target for threshold to maximum performance, you could consider a range of 80-120% of target. This can be an effective strategy when there’s a wider range of potential outcomes for the business under different economic conditions.

If you’re struggling with either a relatively modest or relatively aggressive budget, it may be appropriate to consider an asymmetric slope (i.e., a “kinked curve”). For example, when the budget is relatively modest, it may be appropriate to steepen the curve below target and flatten the curve above target (e.g., change from 90-100% to 95%-125% of target). Conversely, when the budget is relatively aggressive, it may be appropriate to flatten the curve below target and steepen the curve above target (e.g., change from 90-110% to 85-105% of target). A modified “strike zone” can also be effective in these circumstances, where a constant target payout occurs for performance above target (for a relatively modest budget) or below target (for a relatively aggressive budget). Although these types of changes should only be used in extreme circumstances, they can be necessary to ensure proper alignment between pay and performance.

Where there are material concerns about the overall level of pay for performance, some companies will consider paying a portion of any earned incentive in stock with an additional vesting schedule. For example, 50% of any earned bonus, or 100% of any earned bonus above target, is paid in stock with a one-year vesting period. This continues to provide a performance incentive for achieving company goals, but because the goals are viewed as modest it adds a retention incentive and stronger shareholder alignment. This strategy is generally reserved for the senior-most executives, with all other participants continuing to receive a cash payment on the normal timing.

As you finalize 2024 budgets and incentive plan targets, it’s important to be mindful of core executive compensation principles while also acknowledging that certain circumstances may require you to deviate from traditional approaches to achieve the desired link between pay and performance.

About the Author

Greg Stoeckel is a managing director and consulting team leader at Pearl Meyer. In his management role, he oversees a team of senior compensation consultants in the execution of the firm’s growth strategy and in the development of consultants at various stages in their careers. In his consulting role, Greg is a senior advisor to compensation committees and executives on all aspects of executive and non-employee director compensation.

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