

Setting performance targets that drive performance

By Karen Vandenberg

Best Practice Principles

The ASX Corporate Governance Principles and Best Practice Recommendations note that senior executive remuneration should be structured in such a way as to demonstrate a clear relationship between senior executives' performance and remuneration.

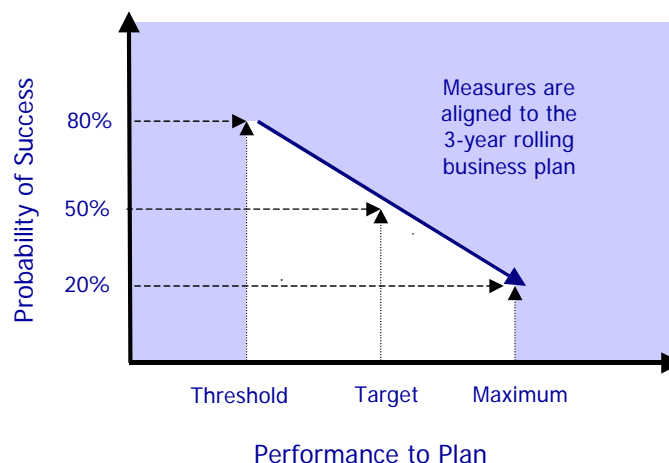
Performance-based remuneration (linked to clearly specified performance targets) can be an effective tool in promoting the interests of the company and its shareholders. Guidelines contained within the Best Practice Recommendations suggest that incentive schemes should be designed around appropriate performance benchmarks that measure *relative performance* and provide rewards for *materially improved company performance*.

Establishing Performance Targets

Performance targets should be set at a level that supports the organisation's strategy and rewards executives for material improvements in company performance. At a minimum, a **year-on-year performance improvement** should be the objective, where performance targets are linked to the achievement of the annual business plan, while also having reference to the long term strategic plan.

For example, 'target' should be initially set at the achievement of the annual business plan (including the cost of the incentive), and 'maximum' set beyond the 'stretch performance' level. For each performance measure, a 'threshold' represents the minimum acceptable level of performance before incentives commence and is initially set at a level that is equivalent to the actual performance of the business in the prior year.

These performance levels are then tested against the expected probability of success to ensure the incentive structure continues to motivate and drive the performance of participants, as shown in the illustration below.



In general, performance at target should have a 50% probability of success. Performance levels should also be aligned to the annual business plan as described in the following table.

Performance level	Description

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Performance level	Description
Hurdles	<p>Hurdles are pre-conditions that must be met before <u>any</u> incentives will be paid and represent the minimum acceptable level of overall corporate performance.</p> <p>Where a hurdle is applied, it is usually a single measure of company wide financial performance and is designed to ensure the incentive plan is affordable. Incentives over and above the fixed remuneration package should not be paid for performance below the hurdle.</p>
Threshold	<p>The threshold represents the performance point at which incentive payments may commence for each performance measure and may be set at a level that is equal to the actual performance of the business last year on that measure.</p> <p>Thresholds should be set at a level where there is a reasonable probability of achieving the result (around 70-80%). For financial measures, they may be expressed as a dollar amount or as a percentage of the company's budget performance for the performance period (85% to 100% is typical).</p>
Target	<p>The target is usually equivalent to the budget performance levels outlined in the business plan for the incentive year plus the cost of the incentive.</p> <p>Target should therefore be seen as a realistic stretch measure and set at a level where there is a 50% probability of achieving the result.</p>
Maximum	<p>The maximum incentive will only be paid if business performance meets or exceeds the targets set for the following year or at least 10% improvement on the current year. It could be considered to be an aspirational target for the business.</p> <p>The maximum should be set at a level where there is a 10-20% probability of achieving the result.</p>

Major abnormal items that are expected to have a significant impact on the results of the business should be factored in when setting performance targets for the coming year. In some circumstances (such as start-up businesses, R&D investment or business transformations), the Board may set performance levels that do not deliver year-on-year performance improvement and may in fact have the business in a loss making position.

In approving the annual business plan and the budget, the Board should ensure that the plan aligns with long-term results for shareholders even if they do present a short-term financial loss for the business. Where this occurs, the performance measures selected by the business should focus on minimising the impact of the loss and/or on measurable objectives that ensure the delivery of a long-term positive result for the business and its shareholders.

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Responsibility of the Board

The Board has a fiduciary responsibility on behalf of shareholders to approve the business plan and the budget that align with building shareholder value. In principle, if the incentive targets are linked to a budget that has been approved by the Board, the company is obliged to follow through by the payment of incentives if the performance conditions are achieved. Therefore, the Board should think carefully about approving a business plan that represents a financial loss; in these circumstances both the senior executives and the Board should take action to carefully manage any expected loss and to tie incentives to measures that reduce the targeted loss.

Where performance targets are not achieved because of circumstances that were unforeseen at the time the targets were established and are clearly outside the control of the executive (such as an acquisition, an investment in the business, a new property investment etc), the Board might use discretion in deciding whether or not to award incentives.

Summary

The central issue in setting performance levels is ensuring the target is realistically achievable and motivational. Setting performance levels is not an exact science; the aim is to balance the return on investment for the organisation with the individual's reward opportunity, and the need to retain key talent required for business sustainability. Key considerations include:

1. Do the performance levels in the plan justify the proposed spend? Would we be willing to pay the proposed incentive amounts for the stated levels of performance particularly where a loss is anticipated?
2. Is there enough differentiation between the Threshold, Target and Maximum performance levels? Is the hurdle (if applicable) set at a level that sufficiently protects the organisation and ensures the plan is affordable?
3. What is the probability of achieving the Threshold, Target and Maximum performance levels and the potential impact on motivation and retention?

In any case, both the performance measures and the performance levels should be reviewed annually to ensure they align with not only the annual business plan, but also the company's longer-term strategic plan.

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