

# Goal Setting: Meeting Stakeholder Expectations in an Increasingly Dynamic and Complex World



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**T**he perennial challenge of setting meaningful, yet realistic, incentive-plan goals has become ever more difficult in an increasingly complex and rapidly changing business world.

Companies now must also accommodate the growing importance of a range of stakeholders. Historically, incentive plan goals have largely focused on meeting the needs of shareholders and driving total shareholder return (TSR). Yet, contemporary thinking has companies taking a more holistic view, one that explicitly recognizes the concerns of employees, customers, suppliers, regulators, and the community at large. (See *The Growing Range of Stakeholders* on page 7.) Although shareholder expectations likely remain primary, meeting the expectations of other stakeholders is fundamental to generating long-term, sustainable shareholder value creation.

The need to get it right by gauging performance in ways that reflect stakeholder concerns has been further heightened by the introduction of annual say on pay, in which goal-setting rigor is subject to regular and increasing scrutiny by institutional investors and

proxy advisers such as Institutional Shareholder Services (ISS) and Glass-Lewis & Co. LLC.

With so much at stake, what is a company to do?

On the following pages, that question is answered in two ways. First, the article describes three sets of criteria to help guide companies in establishing meaningful goals that serve to meet key stakeholder expectations. Next, two cases are provided to illustrate how these criteria can be used in varying situations.

## CRITERIA TO GUIDE INCENTIVE GOAL SETTING

The three criteria for effective goal setting in an increasingly dynamic and complex world are:

- 1 | Adherence to stakeholder expectations
- 2 | Accommodation of organizational capabilities and the business environment — the factors that affect the company's ability to meet expectations
- 3 | Accordance with benchmarks and standards of success.

### 1. Adherence to Stakeholder Expectations

In its simplest form, this first set of criteria asks, "What should we do to compete in this new world where sustainable success requires that we satisfy a broad range of stakeholders?"

The objective is to define what is required to advance key shareholder priorities, enable the company to meet its various talent needs, as well as meet the requirements of customers, suppliers, regulators and the community at large over the short, intermediate and long terms. To simplify the explanation of this element of the framework, the focus has been narrowed to two of the company's primary stakeholders — shareholders and employees.

■ **Shareholders.** Traditionally, shareholder priorities have been narrowly defined in terms of creating shareholder value (i.e., through stock price appreciation and dividends). However,

#### The Growing Range of Stakeholders

Contemporary thinking highlights the need to consider a broad spectrum of stakeholders in a way that extends beyond the traditional view that shareholders are the singularly relevant stakeholder. Several factors have driven this shift in philosophy:

- The war for talent has gone global and innovation-fueled startups increasingly compete against established companies for the best and brightest.
- The pervasiveness of the Internet and mobile devices has made the acquisition and retention of customers more difficult because they are increasingly knowledgeable of a company's products, other customers' level of satisfaction and competitors' offerings.
- Supply chains have also become global and suppliers have become as fundamental to product cost and quality as in-house operations.
- Meeting the ever-broader requirements of regulators has become a necessity, with fines or more onerous penalties a consequence of not doing so.
- The clout of the community at large has grown as interest groups and governments demand more of corporations. Ignoring these outsiders heightens the potential for reputational risk.

issuers are encouraged to go both broader and deeper to focus on the key drivers that influence sustainable TSR. This helps provide greater guidance to the management team, focuses on aspects of performance that are more directly controllable and enhances line of sight. Some of the drivers of TSR that might be addressed are:

- **Financial.** The key financial measures that influence a company's stock price performance.
- **Strategic.** The strategic priorities that enable the company to build sustainable competitive advantage and remain viable over the long term.
- **Operational.** The aspects of operational excellence (e.g., timeliness, reliability, quality) that are fundamental to both financial results and the achievement of strategic priorities.
- **Employees.** An organization's talent goals should be defined comprehensively to address the entire employee value proposition that enables the company to attract, retain and motivate the desired talent (e.g., direct and indirect financial rewards, affiliation, work content, career opportunities). The value proposition should explicitly reflect the company's unique talent needs. For example, a struggling brick-and-mortar retailer making a foray into e-commerce might appeal to expert-upon-hire e-commerce talent through incentive plan designs that are sufficiently insulated from the results of the company's brick-and-mortar operations.

The focus in this article is on direct financial rewards. These need to be sufficiently competitive to enable attraction and retention of key talent and be appropriately structured to motivate and engage this talent to meet the expectations of the other stakeholders.

Balancing the shareholder and employee expectations with organizational capabilities and the business environment requires that, over time, goals should result in performance and payouts that:

- Are sufficient to generate returns above the company's risk-adjusted cost of capital and, in turn, drive shareholder value creation.
- Align relative pay and performance with peer companies.
- Represent a fair sharing of the value created between executives and shareholders.
- Are sufficient to keep executives retained, motivated and engaged.

## 2. Accommodation of organizational capabilities and the business environment that affect the company's ability to meet expectations

At its core, the second set of criteria asks, "What are we able to do?" The objective: setting realistic goals given the organization's strengths and weaknesses, as well as the operating environment's constraints and opportunities.

Organizational capabilities include the company's talent, brand, infrastructure (e.g., systems and core processes, tangible assets, especially those that are

proprietary), and intellectual property. These include what is available in-house and/or through alliances and partnerships.

The assessment of the business environment is meant to identify the various headwinds and tailwinds that exist outside the company. This assessment covers a whole spectrum of factors, including macroeconomic health and trends, competitive influences, technological advancements and regulatory developments.

The more detailed the assessment of the organizational capabilities, the more valuable this set of criteria can be in the goal-setting process. What opportunities exist to improve the company's support of the long-term strategy? Over what timeframe? At what cost and benefit?

The same is true for evaluating the business environment. What is a reasonable or likely range of potential changes to environmental factors over the established timeframes and what is the associated impact on the business? This process may begin as a qualitative exercise, but should ultimately become a quantitative one.

It is helpful to examine a range of possible scenarios to better understand and quantify the impact on results for the different organizational capabilities and external headwinds and tailwinds. (See Figure 1 on page 10.)

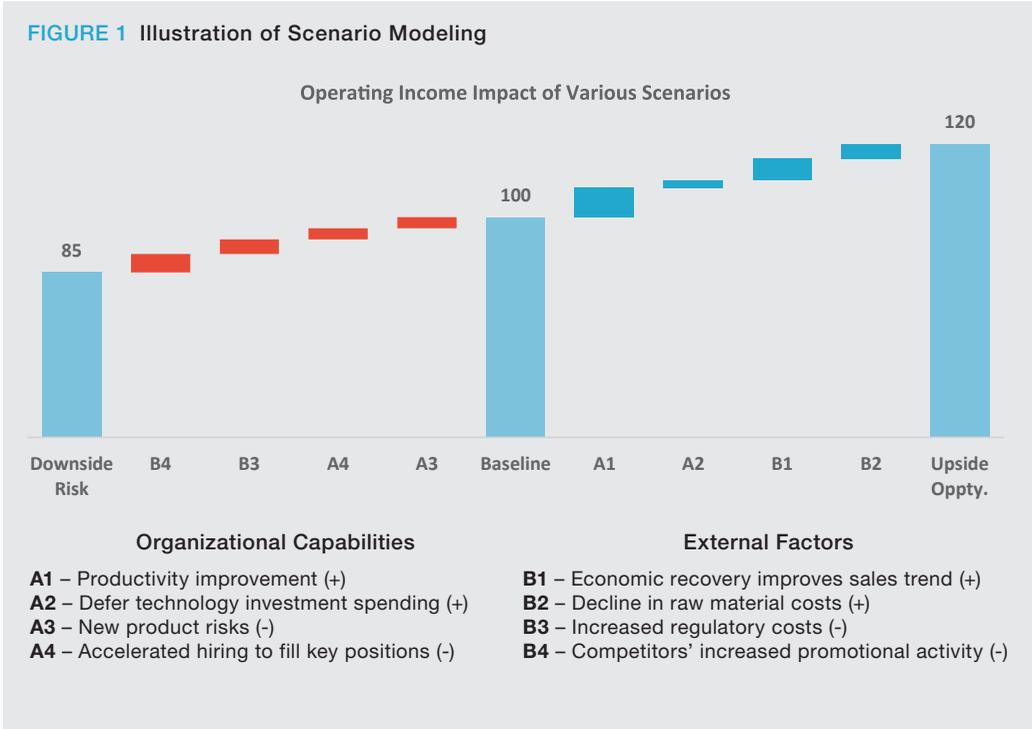
### Proxy Advisers — the Shadow Stakeholder — and Meeting Their Priorities

- Further complicating the challenge for issuers has been a heightened focus on the rigor of goal setting by another stakeholder in today's pay-centric world — proxy advisers. ISS is the most influential of the proxy advisers, and in recent years, the frequency of ISS' commentary on the rigor of goal setting has increased significantly.
- To date, ISS has largely taken an overly simplistic approach in its assessments of goal-setting rigor. Its assessments focus primarily on whether the goal (at target) increased year-over-year relative to the prior year target and/or actual results and whether payouts have been consistently above target. This approach often lacks in-depth analysis and consideration of the company's specific circumstances, but frequently carries meaningful weight in ISS' final vote recommendation. This element of ISS' review is particularly troublesome for companies in turnaround situations, which might reasonably be expected to lower goals year-over-year to ensure continued engagement and motivation of employees.
- ISS has signaled that more is likely on its way with this topic. ISS' 2014 policy survey indicated that 43% of investors believe that if performance goals are significantly reduced, target award levels should be modified commensurately (Institutional Shareholder Services 2014). In October 2014, ISS announced its acquisition of Incentive Labs. In its press release, ISS (2014) touted Incentive Labs' proprietary analytical tools for assessing the rigor of performance targets and "measuring the efficacy of the link between pay and performance."
- Given ISS' present (and possibly increasing) focus on goal setting, the ability to describe the rationale and rigor underlying goals in the Compensation Discussion and Analysis (CD&A) is of the utmost importance, particularly for turnaround companies. To this end, the framework can serve as a foundation to structure more nuanced and thoughtful disclosures for shareholder and proxy adviser constituents.

### 3. Accordance with benchmarks and standards of success

In its simplest form, this means "What does good performance look like on a long-term, sustainable basis?" These benchmarks are the references against which

**FIGURE 1** Illustration of Scenario Modeling



the business measures itself and others measure it. They endure over the long term and through economic cycles. Common references include:

- Historical performance of the company (e.g., average, best ever) and peers (e.g., median, top-quartile)
- Best-in-class performance among the company’s own business units (where there are comparables) and other relevant benchmarks for key parts of the value chain, regardless of industry (e.g., firms that are exceptional in marketing and sales, supply chain, manufacturing, managing inventories, serving customers, etc.)
- Analyst expectations for the company and peers/industry
- Theoretical limitations (e.g., outcomes if existing processes are optimized).

These standards should be measured over a time horizon that is sufficient to encompass multiple economic cycles and reflect the underlying timeframes for key stakeholder expectations. When used for goal setting, these standards should be considered with respect to the amount of value that is created by the organization when achieved (i.e., the extent to which returns will exceed the risk-adjusted cost of capital).

The most effective standards are established through rigorous benchmarking in a multi-staged process. This process starts with the high-level financial drivers of value creation (e.g., top-line revenues, bottom-line earnings, returns), but then delves deeper into the second-order operational and strategic factors that drive financial performance. Not only will this process inform goal setting within a given incentive plan, but it will, by establishing a connection between

drivers, also help ensure consistency across the company's various incentive plans. In addition, it will help identify opportunities for performance improvement and the actionable decisions that executives can make to drive value creation.

## **CASE STUDIES**

Using each of these three criteria, individually and in sum, will help provide a structure and discipline to ensure that the goal-setting exercise meets the needs of the company's key constituents.

### **CASE STUDY 1: A CYCLICAL COMMODITY BUSINESS – TRUCKING**

#### **Presenting challenge**

Trucking and freight services are largely commoditized, and as a consequence, business results are highly correlated with the macroeconomic cycle. Because of the cyclical and unpredictable nature of the business, the actual operating environment may vary significantly from the assumptions made during the budgeting and planning process. Incentive payouts may thus vary widely independent of management's contributions to results. If gross domestic product (GDP) growth is unexpectedly robust, achievement of the original goals may warrant a smaller payout; if GDP growth is unexpectedly weak, achievement of the original goals may warrant a larger payout. The trucking company's challenge in this case study was to design an incentive program that reflected the uncertainty of the goals and ensured that payouts, on average, were fair to shareholders.

#### **Criteria 1: Stakeholder expectations**

Given the cyclical nature of the business, key stakeholder expectations in trucking are highly dependent upon the time horizon. Over the short term, shareholders expect management to be flexible and responsive to a cycle-dependent operating environment. Shareholders also expect that executives will manage the asset base and costs at a level that is sustainable throughout the cycle.

Talent needs are equally cycle-dependent. Management needs to be retained and engaged in a down-cycle when incentive plans are typically underwater. Management also needs to be motivated to stretch for incremental opportunities in an up cycle when incentive plans are likely to be a layup. Thus, it is critical to ensure that goals have an appropriate level of stretch and executives have sufficient line of sight to the levers that can be pulled to drive results in various market environments.

Over the long term, shareholders want management to optimize the asset base and maximize operational efficiencies to ensure shareholder value is created over the entire cycle, and multiple cycles, by generating returns that exceed the company's cost of capital.

### **Criteria 2: Organizational capabilities and external factors**

The cyclical nature of the external operating environment is an important determinant of top-line performance over both the near and longer term. Because it is difficult to predict when the cycle might turn, the actual operating environment may not reasonably be understood at the time the goals are set.

In addition to top-line growth, the ability to build value for shareholders is largely a function of asset efficiency (e.g., fleet and supporting infrastructure) and the development of effective systems (e.g., manpower planning, fleet management and logistics) that enable the company to operate at the lowest possible cost while meeting the needs of customers.

### **Criteria 3: Benchmarks and standards of success**

Because top-line and bottom-line growth are both highly correlated with GDP growth, the company focused on operating leverage as the basis for developing a benchmark. Analysis of company and peer historical results and extensive financial modeling indicated that, over the cycle, the operating leverage could and should achieve a 3% premium in operating profit growth above GDP growth.

### **The Solution**

Given the uncertainty associated with forecasting GDP growth, the appropriateness of annual goals is more accurately judged at the end of the year when actual GDP growth is known. Therefore, the company introduced a formulaic approach for the annual plan whereby goals were adjusted after the fact to reflect how the actual operating environment varied from the assumptions underlying the budgeting process. (See Figure 2 on page 13.) Adjustment criteria were established based on the sensitivity of results to assumed GDP growth.

This approach to goal setting recognized that exogenous factors are a key driver of results and that management's response to any given market environment is an element that can be measured and rewarded. It also provided a mechanism to provide relief (and improve retention) in a down cycle and require additional stretch in an up cycle. Further, it avoided the need for blanket discretion and reduced the incentive for management to sandbag the budget.

To complement the goal-setting solution, the company incorporated a number of operational and non-financial goals in the annual incentive plan to encourage the behaviors and decision making that would allow the company to generate returns in excess of the cost of capital. Cost per ton shipped and equipment downtime were included to determine improvements in fleet efficiency and management. Measures of capacity utilization were used to assess whether managers were taking the actions necessary to "right size" the business to the market environment. These measures were seen as being controllable in the short term and across a variety of market environments and were also required to achieve the desired long-term 3% premium in operating profit growth relative to GDP.

**FIGURE 2** After-the-Fact Adjustment Schedule for Case Study 1

Illustrative Adjustment Schedule  
*Plan Payout as a Percentage of Target*

Actual Profit v. Budgeted Target	GDP Growth				
	+0.6% to +1.5%	+1.6% to +2.4%	Expected: +2.5% to +3.5%	+3.6% to +4.5%	+4.6% to +5.5%
170%	200%	200%	200%	200%	200%
160%	200%	200%	200%	200%	167%
150%	200%	200%	200%	200%	133%
140%	200%	200%	200%	167%	100%
130%	200%	200%	200%	133%	67%
120%	200%	200%	167%	100%	33%
110%	200%	200%	133%	67%	0%
100%	200%	167%	100%	33%	0%
90%	200%	133%	67%	0%	0%
80%	167%	100%	33%	0%	0%
70%	133%	67%	0%	0%	0%
60%	100%	33%	0%	0%	0%
50%	67%	0%	0%	0%	0%
40%	33%	0%	0%	0%	0%
30%	0%	0%	0%	0%	0%

For the long-term incentive plan, the company used the 3%-premium-to-GDP standard as the basis for setting long-term operating profit goals (e.g., the multi-year goal was set at 3% above forecasted GDP growth irrespective of positioning in the cycle). For example, if GDP growth was forecast at 2.5% over the next three years, the operating profit goal would be set at 5.5%. This approach to long-term incentives rewarded and encouraged strategic investments and behaviors that provided the foundation for long-term, sustainable value creation.

**CASE STUDY 2: AN INDUSTRY-LEADING PERFORMER – RETAIL**

The study company, a retailer, had delivered industry-leading growth in profitability and shareholder returns on a regular basis. Its strategy focused on constantly improving its customers’ experience and making disciplined, long-term investments in a seamlessly integrated omnichannel presence (i.e., brick and mortar and e-commerce) to yield sustained growth and top-quartile TSR. This strategy was supported by a results-oriented culture that sought constant improvement without shying away from aggressive stretch goals.

The challenge for this company was twofold: to drive sustained improvement in long-term returns and to ensure the alignment of pay with both absolute and relative performance. That challenge was complicated by the company's successful track record, which created a high bar from which to grow. Coupled with continuing pressure to set ever more difficult goals, the company could easily find itself paying executives at the market median for performance materially above competitive levels or paying little or nothing for average performance. In either case, the outcome would likely be demotivating to executives and potentially heighten retention risk.

### **Criteria 1: Stakeholder expectations**

Shareholders were expecting the company to sustain its history of industry-leading performance and continue to deliver long-term shareholder value creation. To do this, the company needed to: 1) focus on a disciplined approach to investment in its omnichannel strategy; 2) continue to deliver an outstanding customer experience; and 3) seek to retain and motivate the existing leadership team, which the board and shareholders valued greatly.

From an employee perspective, pay and performance needed to be aligned so that pay was commensurate with the results produced on both an absolute and relative basis. To achieve this, goal setting and incentive plan design (e.g., target pay opportunities, payout leverage) needed to be calibrated to ensure that industry-leading performance was rewarded with industry-leading actual/realized pay, while industry-matching performance needed to be rewarded with industry-competitive actual/realized pay. Further, goals needed to be set to support the high-performance culture.

### **Criteria 2: Organizational capabilities and business environment**

Thanks to an established and revered brand, outstanding talent, great store locations and a well-integrated e-commerce platform, the company maintained a position of strength. The company's ability to continually raise the bar, however, was becoming increasingly constrained because the low-hanging fruit for operational improvements had already been harvested and the pool of desirable store locations had been shrinking. The company needed to identify new opportunities for growth and profitability and preserve its high-performance talent and culture.

Although forecasts indicated that the challenging market environment would make significant year-over-year improvements difficult in the subsequent year, over the three-year planning horizon, the market environment was likely to brighten considerably.

### **Criteria 3: Benchmarking**

The company had a history of performing at or above the 75th percentile on all high-level financial metrics, such as revenue, earnings growth and return on

invested capital (ROIC). Also, it had consistently improved performance over prior years and beaten analyst expectations, leading to top-quartile TSR growth. Setting an “on-average, over-time” standard for revenue or earnings growth did not seem appropriate since the continuous compounding of high-growth would, over time, require unrealistic increases on a dollar value basis. Instead, the company focused on ensuring continued discipline in its long-term investments and improvements to operational efficiency by establishing a targeted ROIC of 5% to 7.5% above the company’s weighted average cost of capital (WACC).

The company’s benchmarking exercise had showed that it consistently underperformed peers on inventory turns and payroll as a percent of sales, both of which were attributable to its long-standing focus on delivering a superior customer experience. Executives realized that new technologies offered solutions that could reduce costs and inventory levels without sacrificing the customer experience. In addition, the company could reap additional benefits from the continued rollout and expansion of its omnichannel platform. Improvements in these areas would allow the company to deliver returns in the targeted range.

## THE SOLUTION

Both the new annual and long-term incentives were designed to maintain the company’s best-in-class performance while ensuring that pay was aligned with performance. The annual plan also focused on key strategic changes that would be needed to support this performance.

The key financial metric in the annual incentive plan was operating income and goal setting was deliberately divorced from the budgeting process. The target goal was set at what was considered to be median performance, and yielded a target (i.e., 100%) payout. However, internally, all budgeting and planning were focused on providing the progress needed to meet the on-average, over-time ROIC goal, which was also generally consistent with 75th percentile earnings growth (determined to be about 15% above median levels). Based on historical analysis of peers, this level of earnings performance was consistent with a payout at 150% of median. Thus, the payout curve was structured so it paid target for median performance and 150% of target for stretch performance. (See Figure 3 on page 16.) Knowing that the macroeconomic environment presented headwinds for the coming year, planned first-year growth was relatively modest. Subsequent growth goals were set more aggressively to ensure that the annual goals delivered the targeted multiyear performance levels.

Asymmetric payout curves were used to help emphasize the top-tier focus. Thresholds were set at 90% of goal (median performance) and maximums were set at 125% of goal, well above the stretch target of 115% of goal. Payouts were 67% of target at threshold and 225% of target at maximum, providing significant upside.

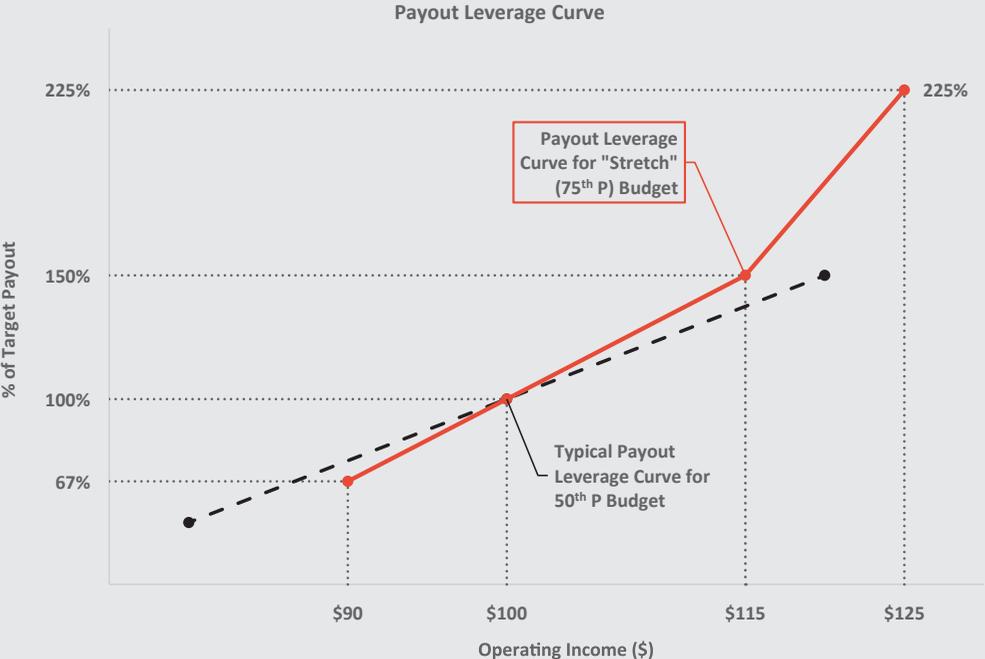
To emphasize the changes needed to support both near-term and longer-term performance, nonfinancial objectives were used to reinforce improvements in

inventory turns, employee productivity and the omnichannel rollout. Goals for the first two metrics were initially targeted at peer levels and later exceeded them. To ensure that the goals were met without diminishing the company’s very positive customer experience, a modifier was added to reduce payouts if those scores dropped.

The long-term incentive plan focused on ROIC. The ROIC goal was also set at median, but again, internal planning was organized around delivering stretch 75th percentile performance (consistent with the targeted return of 5%–7.5% above WACC). Although high threshold and maximum levels were used in the long-term incentives (LTI), payouts were not as leveraged, reflecting that stock price movements would provide the desired levels of realized pay. The trajectory of annual operating income and inventory turn goals was established to ensure that executives would achieve the long-term ROIC goal. To further reinforce strong relative performance, a relative TSR modifier was also included.

**FIGURE 3 Annual Incentive Leverage Curve**

- Step 1** — Company establishes a “stretch” budget that is representative of 75th percentile performance
- Step 2** — A review of competitive pay data suggests that a 150% of target payout would typically deliver 75th percentile pay
- Step 3** — Payout leverage curve is shifted to deliver a 150% of target payout for achieving the stretch budget
- Step 4** — Company reaffirms that the sharing rates are appropriate above/below target and that the 100% payout is representative of what is typically considered to be 50th percentile performance



## CONCLUSION

The complicated exercise of goal setting can be both simplified and made more effective through the use of the three-part goal-setting framework. The overarching goals of incentive compensation design — to advance key shareholder priorities and meet the company's talent needs — can be supported by an approach that focuses on the expectations of key stakeholders and the company's ability to meet those expectations. It can also be supported by consideration of the benchmarks that will be used to assess results. Not only can this framework be applied across a spectrum of company circumstances, including companies in cyclical industries and companies with track records of sustained high performance, but can also help companies faced with compensation challenges operate effectively in today's increasingly uncertain and complex environment.

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## AUTHORS

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