Managers with a history of good results get more flexible performance targets

Wim A. Van der Stede finds evidence that, contrary to common belief, firms don't always ratchet up targets

Here is one diehard maxim of business: don't overshoot your performance target this year, because before you know it the one for next year will be tougher yet. This is target ratcheting at work: when you do better than the established goal, your next objective will be even higher; but the converse is not true. If you do worse, the company will not reduce expected results next time around.

Clearly, such budgeting practices create counterproductive incentives because they motivate managers to withhold effort in order to avoid difficult performance metrics in the future. Why shoot yourself in the foot? Add to this the common belief in budgeting that either you spend it or lose it, and the motivation arises to not only 'not overshoot' your earnings target, but to 'spend more' to boot. A double whammy: leave money unearned and spend more than is necessary.

Target ratcheting may be a truism, but our research *Earnings targets and annual bonus incentives* suggests it is only half true at best, literally, because there is an implicit inter-temporal dimension at play in budgeting, meaning these decisions are not made only on a year-over-year basis. They involve longer cycles that take into consideration credible manager performance and firm commitment.

We find that firms do not increase earnings targets lightly and, against

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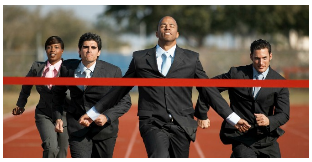


Managers with a history of good results get more

what the maxim above would suggest, even commonly reduce them when their managers fail to meet prior-year goals – *but that is for their well-performing executives only*. Conversely, *for the not-so-well-performing managers,* the standard ratcheting axiom appears to apply. Firms increase earnings objectives when these executives meet or exceed expectations, but rarely decrease targets if they miss the goal mark.

In short: good managers are not punished for either their one-off misses or overshoots. Managers with less credit, however, face less forgiveness: target overshoots are seen as overdue whereas shortfalls suggest that pressure needs to be kept on.

Well-performing managers appear to receive rents due to their past results that persist through time. Are these rents potentially problematic? If firms can reasonably, credibly distinguish their managerial types, then the incentives to both types are improved: the well-performing ones are not prompted to leave money on the table while the others are kept focused on meeting tough targets.

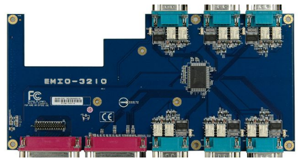
Target difficulty tends to stay at the same level over time, which suggests that firms at least implicitly consider longer-term performance in budgeting. Of course, I suspect this can't go on for too long for either type of manager (although our research could not explicitly answer this question).

When targets are tough to achieve, avoiding missing them is essential, not only for the firm to improve profitability, but also for the manager, well, to keep the job. There is typically no bonus in years when results are below expectations, and anecdotal evidence suggests that managers only 'enjoy' a few chances to not meet target.

How about the managers who have been meeting or exceeding their company's objectives and enjoy some rents? This, too, will only last so long, as their targets are merely comparatively *easier*, not necessarily plain *easy*. Businesses change, and even if there is less internal pressure for a while, there is no basis for any manager to rest on their laurels lest they find themselves amongst the not-so-well-performing sort in no time.

The study in brief

flexible performance targets



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Perhaps the key finding is about 'target ratcheting'. Prior studies find that firms revise performance targets upwards when their managers exceed prior-year goals, yet do not revise their expected results downwards (or reduce them less) when managers fail to meet objectives. These practices are commonly interpreted as counterproductive incentives because they presumably motivate managers to withhold effort in order to avoid difficult targets in the future.

We argue that there are inconsistent assumptions about how information about prior-year performance is used when setting future targets.

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Note: This article gives the views of the author, and not the position of LSE Business Review or the London School of Economics.

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