Target Ratcheting

Here is one diehard maxim of business: don't overshoot your budget target because next thing you know your target for next year will be tougher yet. Target ratcheting at work; that is, when you do better than target, your next target is even higher, but when you do worse, your target won't be reduced. So why shoot yourself in the foot? Add to this the common belief in budgeting settings that either you spend it or lose it, and thus arises the motivation to not only "not overshoot" but "spend more" to boot. A double whammy: leave money unearned and spend more than is necessary.

Clearly, such budgeting practices like target ratcheting create counterproductive incentives because they motivate managers to withhold effort to avoid difficult targets in the future. This may be a truism, but it is only half true at best, literally, as suggested by our research[1] because there is an implicit inter-temporal dimension to budgeting consisting of credible manager performance and firm commitment.

Specifically, we find that firms do not lightly increase targets and, against what the maxim above would suggest, actually commonly reduce earnings targets when their managers fail to meet prior-year targets – *but that is for their well-performing managers only*. Conversely, however, we find that, *for the not-so-well-performing managers*, the standard ratcheting axiom appears to apply (which makes it half true); that is, firms increase earnings targets when these managers meet or exceed prior-year targets but rarely decrease their targets.

This suggests that 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.

Thus we find no evidence that good performance in one period renders future targets more difficult to achieve. To the contrary, we show that earnings targets for managers in high-profitability entities are relatively easy-to-achieve and more likely to be revised downwards than earnings targets for managers in low-profitability entities. This shows, importantly, that the target-revision process is not invariant to managerial type. Instead, well-performing managers appear to receive informational rents that persist through time while their counterpart managers do not.

Are these rents potentially problematic? If firms can reasonably credibly distinguish their managerial types, then either type's incentives 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. Hence, there is a degree of serial correlation of target difficulty over time, which suggests that firms at least implicitly consider longer-term performance in budgeting (which, by the way, debunks another myth).

The study in brief[1]

An important element of firms' management control systems is the practice of establishing targets for future performance. Such practices serve to organize and coordinate firms' decisions and form the basis for performance evaluation and compensation. We provide novel empirical evidence about firms' target-setting practices based on a survey of compensation practices at 666 entities. We examine the extent to which firms use past performance as a basis for setting earnings targets in their annual bonus plans and assess the implications of such targets for managerial incentives. Perhaps the key finding is about "target ratcheting" where prior studies find that firms revise performance targets upwards when their managers exceed prior-year targets, yet do not revise targets (or revise targets less) downwards when managers fail to meet prior-year targets. These target ratcheting practices are interpreted as evidence of counterproductive incentives because they presumably motivate managers to withhold effort in order to avoid difficult targets in the future. We argue that this interpretation is incomplete and makes inconsistent assumptions about how information about prior-year performance is used when setting future targets.

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). In the poor-performing businesses where targets are tough to achieve, avoiding missing target is essential, not only for the firm to improve profitability, but also for the manager, well, to keep the job. Not only is there typically no bonus in years where target is being missed, anecdotal evidence suggests that managers only "enjoy" a few chances to not meet target. And how about the managers who have been meeting or exceeding target 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 so even if there is less internal pressure for a while, there is no basis for any manager to rest on their laurels lest they will find themselves amongst the not-so-well-performing sort in no time.

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[1]Indjejikian, Raffi J, Matějka, Michal, Merchant, Kenneth A, and Van der Stede, Wim A (2014), Earnings targets and annual bonus incentives, *The Accounting Review*, 89(4), 1227-1258 (ISSN 0001-4826).