



# 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

{14}
  {2}
 
 {0}

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

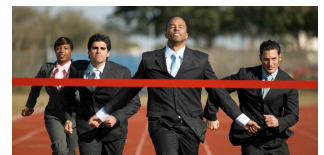
## Archives

### Archives

## Editor's Picks



**Why are commodity markets behaving like stock markets?**



**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).

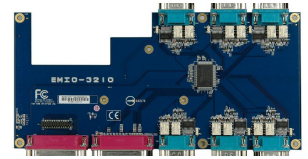
When targets are tough to achieve, avoiding missing them is essential, not only for the firm to improve profitability, but also for the manager, well, to keep the job. There is typically no bonus in years when results are below expectations, and anecdotal evidence suggests that managers only 'enjoy'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



## Nine likely scenarios arising from the growing use of robots



## The top ten ways in which firms and universities interact

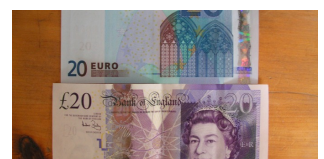
## Recent Posts



## We need to address the role private debt and real estate play in our economies



## Why Are We Waiting? – Book Review



An important element of firms' management control systems is the practice of establishing targets for future performance. Such procedures 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 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 metrics in their annual bonus plans and assess the implications of such expectations for managerial incentives.

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.



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

Featured Image Credit: [meridican CC-BY-2.0](#)



**Wim A Van der Stede**, is the CIMA Professor of Accounting and Financial Management, and Head of the LSE's Department of Accounting. His research interests pertain broadly to the study of management control systems, i.e., the study of performance targets and the

budgeting processes used to set them; performance measurement and evaluation; and incentive systems that relate performance evaluations to the provision of rewards. He tweets at [@stede\\_w](#)

Tweet { 14

Share { 2

Share

G+ Share { 0

**Britain needs Europe  
a lot more than  
Europe needs Britain**



**Multinational firms  
still have a lot to learn  
about doing business  
in Africa**



**Good corporate  
social performance  
may lead to higher  
credit ratings**

## Archives

› November 2015

› October 2015

› September 2015

› August 2015

› July 2015

## Categories

Categories

Select Category

submit

1

Email

Print

Meta

October 14th, 2015 | [Featured](#), [Performance Measurement](#), [Wim A](#)

[Van der Stede](#) | [0 Comments](#)

[< Previous post](#)

[Next post >](#)

[Log in](#)

[Entries RSS](#)

[Comments RSS](#)

[WordPress.org](#)

[See all of our blog posts](#)


## Leave A Comment

Name (required)	Email (required)	Website
-----------------	------------------	---------

Comment...

POST COMMENT

- Notify me of follow-up comments by email.
- Notify me of new posts by email.

 **LSE USAPP**

Book Review: Why Are We Waiting?: The Logic, Urgency and Promise of Tackling Climate Change

 **LSE IMPACT BLOG**

Book Review: The 'Postmodern Turn' in the Social Sciences by Simon Susen

 **LSE EUROPP BLOG**

Book Review: The Eagle in Splendour: Inside the Court of Napoleon by Philip Mansel

by Nicholas Stern

---

Book Review: Mission Accomplished?: The Crisis of International Intervention by Simon Jenkins

---

Brutal election for Maine liberals, North Carolina's aggrieved Governor, and Houston's equal rights ordinance fails: US state blog round up for 31 October – 6 November

---

 **LSE BRITISH POLITICS AND POLICY BLOG**

Book Review: Mission Accomplished?: The Crisis of International Intervention by Simon Jenkins

---

“As cold as charity”? Or a cold, hard look at charity? The next debate, after Kids Company

---

There is real cause for concern when the persuasiveness of a story depends more on public attitudes than the facts

---

Reading List: Teaching excellence and the proposed changes to the higher education landscape #HEgreenpaper

---

When are journal metrics useful? A balanced call for the contextualized and transparent use of all publication metrics

---

 **LSE MEDIA POLICY PROJECT**

Ofcom's Plurality Framework: Protecting the Status Quo?

---

Surveillance and civil liberties: Interview with David Davis MP

---

Free speech in the chiller as police pounce on journalists and academics

---

 **LSE PODCASTS**

Social Media and Social Change: analyzing debates over valuation [Audio]

---

Russian Foreign Policy as an Exercise in NationBuilding [Audio]

---

Social Class in the 21st Century [Audio]


---

Croatian elections: a final look at the parties and the campaign

---

Having won back his majority, Erdoğan must now focus on reuniting Turkish society

---

 **LSE REVIEW OF BOOKS**

Book Review: The Eagle in Splendour: Inside the Court of Napoleon by Philip Mansel

---

Book Review: The Sociologist and the Historian by Pierre Bourdieu and Roger Chartier

---

Book Review: The Reject: Community, Politics and Religion after the Subject by Irving Goh

---

 **LSE EVENTS**

EVENT RESCHEDULED: Pension Poor and Housing Rich: a generational perspective of the Greek crisis, its aftermath and possible ways out

---

The Imperial Frontier: state construction and frontier governmentality along the global periphery

---

Sociology and the Digital Revolution - the Transformation of Everything

---

**ARCHIVES**

Archives

Select Month ▼

---

Copyright © 2015 London School of Economics