

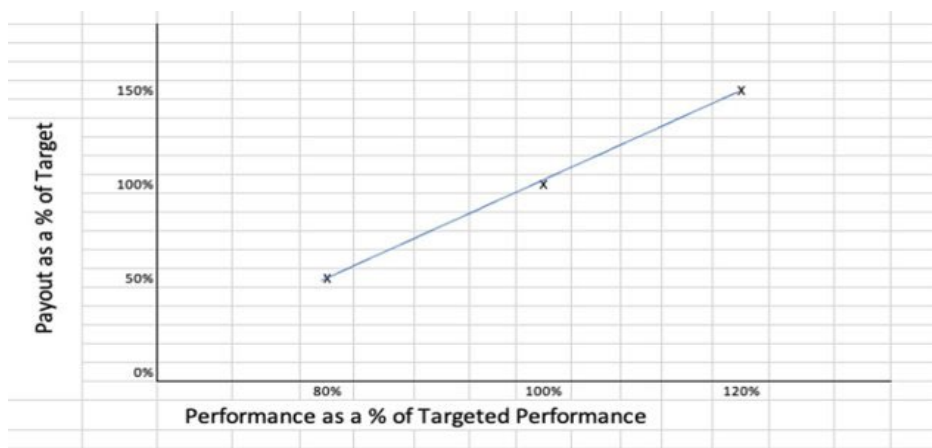
Factors to Consider in the Design of an Incentive Payout Curve

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Incentive payout curves show the relationship between performance against preset incentive targets and the corresponding incentive pay level with the slope of the curve reflecting the percentage change in payout for each percentage change in performance. The actual slope of the curve is a form of communication to incentive participants as to how the company values alternative levels of achievement of the targets.

A **linear payout curve** reflects a constant percentage change in payout for each level of performance.

- For example, the following linear incentive payout curve provides that payouts increase 2.5% for each 1% by which performance exceeds the threshold level of performance (80% of target) capped at a payout of 150% of targeted payout for performance equal to 120% of target.



- A company may select a linear payout curve when there is not a reason to signal that performance at different points along the curve is deemed to be valuable to the company and there is no desire to disproportionately reward performance that exceeds target or to disproportionately punish performance that falls short of target.

A **symmetrically positive payout curve** is one for which the payouts for exceeding targeted performance increase at a steeper rate than the rate by which payouts decrease for performance below targeted performance.

- For example, the following is an asymmetrically positive payout curve where payouts increase by 10% for each 1% by which performance exceeds targeted performance while payouts decrease by 2.5% for each 1% by which performance falls short of target.



- A company may implement an asymmetrically positive payout curve to provide an incentive to overachieve targeted goals to encourage market penetration of a newly introduced product. Another example may be where a company has high fixed costs and capacity under-utilization. In this case above-target performance may have increased gross margins and be highly beneficial to the company.

A symmetrically negative payout curve is one for which the payouts for exceeding targeted performance increase at a lesser rate than the rate by which payouts decrease for performance below targeted performance.

- For example, the following is an asymmetrically negative payout curve where payouts increase by 1% for each 1% by which performance exceeds targeted performance while payouts decrease by 5% for each 1% by which performance falls short of target.



- A company may implement an asymmetrically negative payout curve to reduce the incentive to overachieve targeted goals due to capacity limitations and the increasing cost of meeting additional sales and the corresponding pressure on margins. The steep penalty for falling short of targeted performance may reflect

the importance of meeting performance objectives communicated to investors or risk associated with missing cashflow requirements to satisfy debt covenants. At the extreme, an asymmetrically negative payout curve may cap payouts at targeted performance while having steep reductions in payouts for falling short of targeted performance.

A flat range payout curve. This is a variation on the payout curves outlined above which depicts a flat range of payouts for performance within a range above and below target (e.g., 100% payout for performance between 95% and 105% of targeted performance). For performance outside of the range of the flat payout portion of the payout curve the relationship between performance and payouts may be linear, asymmetrically positive, or asymmetrically negative.

- Having a flat payout curve for performance around targeted performance may reflect uncertainty or lack of confidence in setting a specific performance objective for targeted payouts. The risk of this approach may be to decrease motivation once 95% performance is achieved since payouts will not increase until 105% of target is exceeded.

When designing incentive payout curves, it is important to be clear as to the message the company is attempting to communicate to participants through the design of the relationship of pay and varying levels of performance. Further, the payout curve should be based on the underlying economics of the relationship between performance and returns to the company from such performance and the level of confidence in setting performance targets.