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Executive Compensation

Peer Comparisons Faulty Measure Of Exec Performance, Experts Say

Companies looking to revitalize their executive compensation structures in the new economy should incorporate a diverse set of performance metrics that extend beyond peer group comparisons and purely financial measures, executive compensation specialists said in separate interviews with BNA.

''Compensation committees can start the incentive program revision process by assessing peer group data and using it as a general frame of reference. Then they must apply the assessment to their own company's unique situation to ensure their plan is competitive yet self-oriented,'' Laura Hanf, vice president at Pearl Meyer & Partners LLC in Charlotte, N.C., said March 16 in a BNA interview.

''There are some circumstances where the use of peer group comparisons as performance targets is appropriate. However, it is important that companies avoid using only peer comparisons or defaulting to the metrics of peers when facing challenges,'' William H. Ferguson, a worldwide partner for Mercer Human Resource Consulting in Los Angeles, Calif., told BNA March 18.

The poor practices of using of limited and oversimplified performance metrics, neglecting objectivity, and having inflexible and completely uniform scorecards were among the other common problems for corporate incentive compensation programs that were identified in a March 12 news release by Mercer Human Resource Consulting.

Common Mistakes Include Overusing Financial Metrics. In defining executive performance metrics in light of the failing economy and heightened public scrutiny of executive benefits, companies must be sure to motivate and reward their executives only for good performance, the Mercer release said.

Many companies continue to struggle with defining and managing their performance metrics, and ultimately decide to apply a standard peer group approach that might work for one company, but fail for another, the release said.

The release identified seven specific common corporate practices that can negatively affect a company's incentive program, including:

- Use of earnings per share as a main driver of shareholder value where EPS can yield growth percentages that can be misleading or meaningless when calculating growth from a small base or negative earnings;
- Identification of total shareholder return as the only performance metric where returns are affected by market trends and other factors outside management's control;
- Use of balanced performance scorecards that place equal weight on financial, operational, and strategic objectives where some business goals are more important than others;
- Adoption of metrics used by peer companies where performance measures should also support an organization's own unique business strategy;
- Use of oversimplified metrics that are unlikely to deliver good results where complexity may be necessary to deal with challenges such as mergers and acquisitions;
- Use of the company's planned budget and strategic plan as the sole performance metrics where concrete budgets and plans are too difficult to set in the current economy; and
- Use of the same performance metrics for all senior executives where differences in talent needs may present unique challenges for executives in different business units.

''I have seen these problems across all different sectors of business, including the financial, retail, real estate, and technology industries. Each of these sectors have unique performance measures. However, all of them share the same overarching potential pitfalls as well,'' Ferguson said.

Good Metrics Must Be Varied and Customized. Instead of focusing on rigid and unvaried metrics, boards should first identify the specific tasks needed to generate sustainable profits, and then design their performance metrics around those factors, the Mercer release said. Other best practices for compensation committees mentioned in the release include:

- Select both internal and external metrics that accurately reflect desired behaviors and outcomes, and revisit these metrics as the company's priorities change;
- Use multiple performance measures and avoid relying on one or two metrics;
- Create a balance between collaboration and accountability with targets that are clearly defined and applied across business units; and

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- Ensure that short term and long term incentive plans are created to avoid double payments for the same performance or continuous payments of high annual incentives despite never reaching long term goals.

Companies need to incorporate sustainable measures into their executive performance metrics, and follow through with consistent communication to help executives comprehend targets, the release said.

That boards and compensation committees must implement diverse and customized executive performance measures is not a new concept. ''These are aspects that do not change with up or down cycles in the economy. Committees and boards cannot simply ponder benchmarks or the amount of pay an executive should receive, but must now define how compensation is decided with clear, comprehensive performance metrics,'' Ferguson said.

Complicated Measures Must Be Explainable. Oftentimes, executive performance measures are too complex to explain to shareholders, and even to some executives and other employees of a company, Jack Dolmat-Connell, president and CEO for the independent executive compensation consulting firm Dolmat-Connell & Partners in Massachusetts, told BNA March 17.

''In the end, all metrics need to be aligned to provide shareholders with a positive return, so investor comprehension of the facts is important,'' he said.

Companies often resort to adopting metrics that are too simple to encompass the more complex aspects of executive performance, Ferguson said. ''While more complicated metrics are difficult to understand, especially for shareholders, companies can and must find clear and easily understandable ways to explain metrics to interested parties,'' he said.

''I encourage boards, executives, and shareholders to avoid shying away from communicating about more complex measures. There is a simpler way to talk about every performance metric, no matter how complicated the structure of it is,'' he said.

If a particular metric is so complex that a board member or executive cannot clearly articulate its structure or function, then the metric is likely to render portions of a company's incentive plan ineffective, Pearl Meyer's Hanf said.

''The goal of having comprehensive performance measures is not necessarily to have every shareholder understand all the intricate details of a metric, but to have those involved in designing the incentive plan understand the details themselves, and be able to explain the metric in simpler terms,'' she said.

Boards Should Exercise Risk Assessment. When compensation committees are contemplating whether a performance metric or target is appropriate, they should consciously and repeatedly examine the risks involved, Mercer's Ferguson said. ''Companies need to step back and look at whether they are stretching themselves too far,'' he said.

''One area that many companies seeking assistance under the Troubled Assets Relief Program are having to address now, and that all companies will soon have to consider, is looking at ways to reduce excessively risky behavior of executives,'' Pearl Meyer's Hanf said.

Boards of all companies need to be especially keen on creating incentives that reward only healthy executive performances, she said. ''This is where the importance of strong internal controls becomes very apparent,'' according to Hanf.

Risk management is an important aspect to consider with performance metrics, however, it is not the usual focus with companies in the technology industry because such companies tend to have more product and timing-based metrics, Dolmat-Connell said.

By Tina Chi

Mercer's news release on the seven common flaws in executive performance measurement is available on their Web site under ''Featured press releases'' at http://www.mercer.us/mediacenterlisting.htm?siteLanguage=100 .

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