



Executive Remuneration Perspective

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In this issue, answers to:

What are some of the shortcomings of using earnings per share (EPS) as an incentive plan performance measure?

How can companies incorporate the shareholder experience into their incentive programs without abandoning financial and strategic objectives?

What is the right balance between accuracy of performance and the complexity of the measures?

How might a multiperspective approach to target setting help companies more accurately assess performance?

What are the seven virtues of performance measurement?

The seven deadly sins of performance measurement

One of the greatest challenges faced by both boards and management teams is effectively measuring and rewarding executive performance. Developments over the past decade have further heightened the focus on performance measurement issues, including an increase in the use of performance-based long-term incentive plans and new disclosure rules requiring a more detailed explanation of how compensation decisions are linked to performance results.

Despite the increased usage and attention, many companies continue to struggle with defining and managing their performance measurement system. Much conventional wisdom has developed based on individual experiences, but what works for one company might fail for another. The performance measurement system must reflect each organization's unique industry dynamics, business strategy and management style.

In this Perspective, we'll examine seven deadly sins that can befall organizations when selecting performance measures and setting targets. You'll learn how to avoid these "sins" by following the "virtues" that lead to the right performance measurement system – and obtain the right results.

Deadly sin #1:

Earnings per share (EPS) is the primary driver of shareholder value.

EPS is one of the most common metrics used in discussing corporate performance. Because it is easily understood by executives, widely accepted by investors and always reported by the press as an indicator of whether or not a company is successfully executing its business plans, many companies have adopted this measure for their executive incentive plans. In addition, we suspect more companies are considering broadly used metrics such as EPS in an attempt to avoid potentially disclosing sensitive information about business plans when complying with the SEC disclosure rules (see "Deciding how much detail to disclose" sidebar on page 2).

Deciding how much detail to disclose

Don't fall back on using just EPS and TSR in order to avoid giving competitors insight into your performance targets. The new SEC disclosure rules specify that you don't need to disclose target levels that involve trade secrets or confidential commercial or financial data, if disclosing this information would result in competitive harm to your company.

Not surprisingly, the subject of performance targets received a lot of attention in the comment letters that the SEC staff sent to 350 companies reviewing their 2007 proxy statement disclosure on executive compensation. Here are a few guidelines for companies to consider, based on the SEC report highlighting key findings from the staff's review of these proxy statements:

- If the targets are not disclosed because of competitive harm concerns, the company must discuss in its proxy statement disclosure specifically how difficult or likely it would be for the company or individual to achieve the undisclosed targets.

Sidebar continued on page 3

Despite its ubiquity, EPS has many shortcomings when used as the primary measure of business performance. As a performance measure, EPS:

- Can be affected by changes in accounting policy
- Does not account for the cost of capital and capital structure of the business
- Yields growth percentages that can be misleading or not meaningful when calculating growth from a small base (or from negative earnings)
- Highlights the difficulty in determining the validity of one-time, nonrecurring and extraordinary items

Most important, actual EPS performance (as opposed to performance against expectations) may not always be well-correlated with shareholder value creation. The business community seems to be awakening to the fact that EPS is not the ultimate indicator of performance and some business leaders have even suggested that focusing on short-term EPS results can actually be harmful to long-term shareholder value creation. As a result, some companies are abandoning quarterly, and even annual, guidance.

Executive pay programs should take a cue from these trends and look beyond EPS for alternative or complementary metric(s) that are more closely correlated with long-term value creation and appropriately recognize unique organizational characteristics such as asset intensity, industry and stage of market development. For example, in capital intensive industries such as manufacturing, companies can better reward business results by incorporating measures that capture the cost of capital (for example, economic profit) to ensure that earnings provide a sufficient return on investment.

Deadly sin #2:

Total shareholder return (TSR) is the only performance metric you need.

While EPS may not be well-correlated with shareholder value, no one will deny that TSR closely tracks investor experience. It is the shareholders' experience. In addition, TSR data are readily available and transparent, which allows for the objective benchmarking of performance against peers.

However, while executives can generally understand how their decisions impact EPS, the relationship between executive behaviors and TSR results is less direct. Issues with TSR or share-appreciation-based plans include:

- TSR is impacted by factors outside of management control or influence, including macroeconomic factors, broad market trends and specific sector competitive issues
- TSR represents actual performance and expectations for future performance; rewarding for TSR means rewarding for results that have not been delivered
- Little understanding by participants as to how they can meaningfully impact the measure, given the variety of drivers, particularly at levels below the senior executive level
- Market movement typically lags financial, strategic and operational outcomes, and may not appropriately reflect current actions that position the business for long-term success
- Difficulty communicating the plan and its potential value to participants

While companies can control for general market or industry movements by measuring TSR performance on a relative basis against peers, relative performance evaluation leads to further practical challenges. For example, it can be difficult to identify and maintain an adequate number of peers to provide apples-to-apples comparison given the extent of consolidations in many industries. (See “Perspective 59: Incentive plan goal setting: new challenges, new approaches” for more considerations when using relative performance evaluation.)

Given these realities, although TSR or share-price appreciation can play a role in the performance measurement system, it should not be relied upon as the sole determinant of executive performance. The most effective incentive programs will also include metrics that are directly linked to the business strategy, provide clearer line of sight to executive behaviors and measure outcomes (not expectations).

A common design approach is to utilize a short-term incentive plan with specific financial, operational and strategic goals to complement a long-term plan based on TSR or share-price appreciation. Even better, some organizations have adopted a long-term incentive plan that rewards both TSR and the achievement of long-term financial goals, such as a targeted level of return on invested capital. Performance share plans, which deliver a specified number of common shares to executives at the end of a performance period depending on performance against established criteria, can be particularly effective vehicles for rewarding both financial and market results.

Deadly sin #3:

A balanced scorecard is the best framework for measuring performance.

Scorecards, which measure results against a range of factors, are often used to paint a more holistic picture of performance outcomes than can be captured by one or two metrics.

They recognize the trade-offs in decision-making, such as maximizing returns today versus investing for future growth. When designed well, scorecards will capture both lag metrics used by investors to judge performance (that is, financial and market measures) and lead metrics that reflect current decisions that will position the company for future success that are typically operational and strategic in nature (for example, customer satisfaction and new market penetration).

Yet “balanced” scorecards, which typically place equal weight on financial objectives and a host of other operational and strategic objectives, may not appropriately reflect your business priorities. Undoubtedly, some business goals are more important than others and using too many measures dilutes executive focus.

Scorecards are often more effective if they are “unbalanced.” Concentrating on few metrics, especially for incentive systems, sends a clear message to executives regarding business priorities and holds them accountable for most important dimensions of performance. Unbalanced scorecards also provide greater flexibility to reflect the business strategy as it evolves.

Sidebar continued from page 2

- SEC comment letters indicate that companies could describe the degree of difficulty of achieving the targets by addressing the relationship between historical goal achievement and future expectations, such as whether the company or executive achieved, or came close to achieving, similar targets in prior years.
- If a company does not disclose the specific targets, it must be prepared to provide a detailed explanation of specifically how a competitor could use the target numbers to harm the company to the SEC staff upon request.

Companies will need to balance the need for transparency with the objective of motivating specific behaviors that drive business results – cookie-cutter incentive plans do nothing to set you apart from the competition, and are unlikely to encourage the behaviors that will truly power your business.

“Undoubtedly, some business goals are more important than others and using too many measures dilutes executive focus.”

One variation of the “unbalanced” scorecard is to utilize a common framework of growth, operational, profitability and market measures, but to vary the metric weightings based on current business priorities. For example, a company that has recently weathered an industry slump by focusing intensely on profit margins could change its metric weightings as the market rebounds to affect a desired shift in focus from cost containment to growth.

Another variation is to use a scorecard for allocating the bonus to business units or individuals, while funding the incentive pool based on only those metrics that are deemed to be the most critical. This approach ensures that the primary value drivers fund the incentive program, and that managers focus on the breadth of performance required to execute the strategy.

Regardless of the plan design, performance metrics should consider your company’s specific strategy for achieving competitive advantage, as well as what factors executives truly have the ability to influence. Carefully contemplating these issues will lead to a more effective performance measurement program than simply adopting a generic balanced scorecard developed without this critical insight.

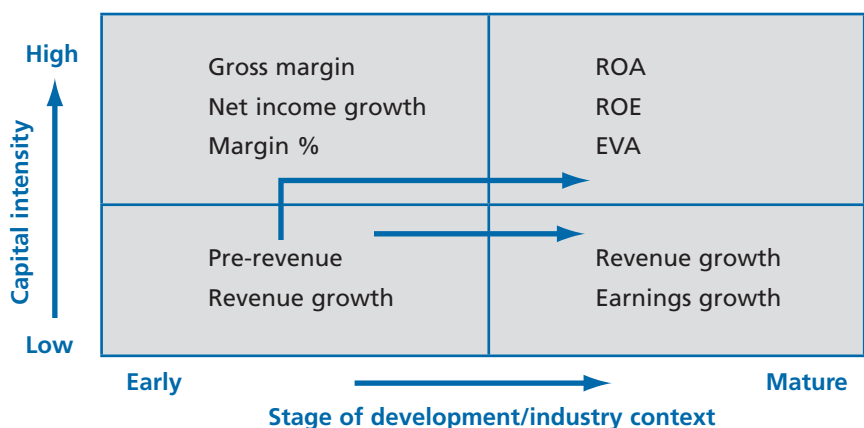
Deadly sin #4:

If a competitor or peer uses this measure, you need to use it too.

Performance metrics should be selected based on a variety of internal and external organizational factors. By simply using a “prevalence test” of metrics used by peers, companies can fail to account for the differences inherent in their business (for example, stage of development and organizational strategy) or objectives (such as growth and cost management).

Each stage in a company’s lifecycle has its own measurement priorities. Start-ups or organizations pushing for growth in new areas have different strategic and financial goals than established firms. As a result, growth-related metrics usually play a more prominent role in performance measurement in younger companies, whereas profitability or return-based metrics tend to become more important as a company matures (see Exhibit 1).

Exhibit 1: Measurement matrix



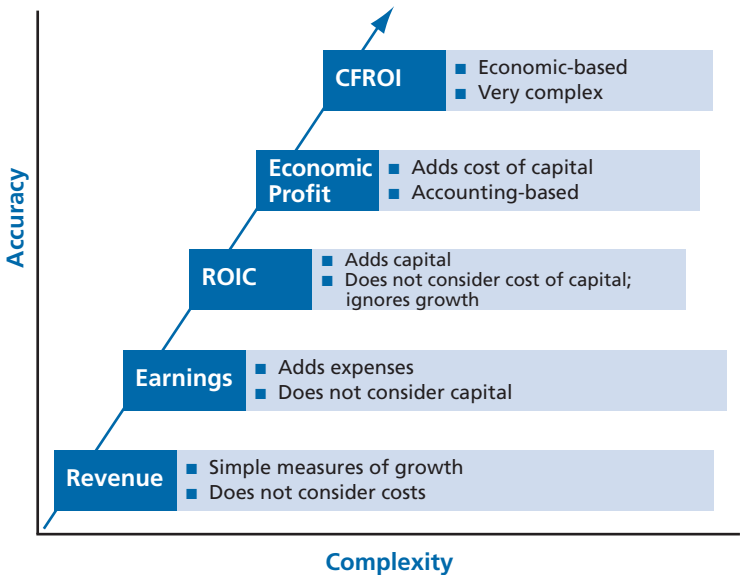
Performance metrics should also support the organization’s unique business strategy. For example, a discount retailer might focus on gross margin as a measure of performance, while the same metric would not be appropriate for a high-end retailer whose competitive advantage lies in delivering superior products and customer service for a premium price.

While organizations can learn from what others do (emerging or leading practices) and from what analysts observe (historical assessments and performance forecasts), ultimately the right performance metrics and incentive targets will depend on company-specific factors, rather than industry trends.

Deadly sin #5:
To be effective, the performance measures you use must be commonly accepted and well understood by everyone – immediately.

Companies often fall back on the simplest performance measurement systems – including subjective evaluation of performance after the fact – because they fear complexity will make the plan too difficult to communicate and administer. But, there is a clear trade-off between accuracy and complexity; more complex metrics include additional information that more accurately captures performance results (see Exhibit 2).

Exhibit 2: Choosing the right performance measures; accuracy and complexity trade-offs



“Performance metrics should also support the organization’s unique business strategy.”

“Having simple performance measures may make plan administrators happy, but an overly simple plan is unlikely to deliver the results shareholders expect.”

In addition, some amount of complexity may be necessary to effectively deal with specific business measurement challenges such as measuring performance in a cyclical industry, dealing with merger or acquisition activity, or ensuring the profitable use of capital. For example, you may need to measure outcomes on a relative rather than absolute basis to objectively capture performance during a market downturn, or you may need to incorporate adjustments to traditional accounting definitions to avoid penalizing strategic investments, such as amortizing significant capital expenditures over an extended time period.

Having simple performance measures may make plan administrators happy, but an overly simple plan is unlikely to deliver the results shareholders expect. Start by designing your ideal performance program first; then look for ways to simplify how the plan is administered and communicated. Also remember that while the measures may be complex, the messaging need not be. By focusing on the specific executive behaviors that will drive the metrics, you can more clearly convey how performance will be measured and rewarded.

Finally, don't hesitate to take on the change management aspect inherent in performance measurement. As many companies have discovered, educating executives about the performance measurement system provides an excellent opportunity to communicate directly and regularly about the future direction of the business.

Deadly sin #6:

Your budget and strategic plan is your performance target.

While many companies consider their annual budget and strategic plan to be common-sense standards for assessing performance, using only internal measures often leads to under- or over-calibration of performance and then a misaligned payment of incentives. If you have a stretch budget and budget is your primary performance measure, then you may be underpaying employees' achievements if they achieve target results. On the other hand, if your company sets its goals based purely against its own historical performance, then it's likely you've built incentive payments into the budget – even in poor years.

Informing targets using a number of different perspectives – rather than relying solely on the strategic plan and budget – can help you more accurately assess performance. There are a wide variety of external factors, such as industry peers' historical performance, industry analysts' future estimates, shareholder expectations, or macroeconomic indicators that may influence growth or profitability, that could be considered in addition to internal inputs such as historical performance or management forecasts. You can also incorporate relative measurement directly into the incentive plan by ranking performance results against results of a group of comparable peers.

In addition to providing a more objective basis for evaluation performance, unlinking the budget from incentive plans takes the pressure off of the budget-setting process and helps prevent executives from sandbagging their estimates of the company's future potential.

Deadly sin #7:

All senior executives should be rewarded using the same performance measurement program.

Most companies reward executives using largely the same performance vehicles and plan metrics in order to tie executives to common goals and encourage collaboration and team work. While this approach works well for small, homogenized businesses, larger, more diversified organizations may require more differentiation.

Business units can have significantly different strategic priorities or may be in very different stages of the business development. There may also be varying degrees of synergies across business units – some may act as stand-alone companies, while others have integrated products or customer bases. Differences in talent needs – driven by either business characteristics or geographical factors – may also present unique performance measurement challenges.

By analyzing the similarities and differences across business groups, you can better determine to what extent the performance measurement approach should be consistent across the company or customized to specific business units, executive groups or other segments.

If your analysis suggests that a tailored approach is needed, begin by reviewing the performance metrics (or metrics weightings) for alignment with each business units' priorities. It is easier to vary the weightings of the same measures, then to create totally new measures by business. Varying the incentive plan leverage or offering a choice of alternative long-term incentive vehicles may help a diversified company attract the right talent to execute on different business strategies. Performance benchmarks should also be tested to ensure they represent a similar degree of difficulty (for example, a performance standard of 10 percent ROIC may need to be lowered for a new business in an emerging market).

Of course, companies must balance the need for customization with the objective of fostering collaboration and team work across business. The ultimate goal is that plans are fair and consistent and, for senior executives, at least a portion of incentives should be tied to overall corporate performance to ensure proper alignment with shareholder interests.

The seven virtues of performance measurement

By keeping the following “virtues” in mind, companies avoid the deadly sins outlined in this Perspective and develop an effective performance measurement system that serves as a solid foundation for rewarding executives:

1. Identify what you need to accomplish to beat the competition and generate sustainable economic profits; design your performance measurement system around those factors.
2. Pick internal and external performance measures that accurately reflect the behaviors and outcomes you want to achieve given your company's current strategy and stage of development; revisit them as your priorities change.

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3. Consider using standard performance measures such as EPS and TSR, if helpful – but don't rely on just one or two metrics to assess performance.
4. Create a robust target-setting process. If your industry offers a viable number of comparable peers to allow for relative goal setting, consider setting incentive targets around how your company performs on specific measures versus that of your competitors. In addition, establish a clear performance standard and competitive cost structure.
5. Make sure your goals and incentives are fairly defined and applied across business units and that they encourage the appropriate balance between collaboration and accountability.
6. Be sure your short- and long-term incentive plans are aligned to avoid paying twice for the same performance – or paying high annual incentives year after year without ever reaching your long-term goals.
7. Be clear about what specific behaviors you want to encourage and what measurable outcomes you want to achieve – and follow through with clear, consistent communication to help participants understand exactly what's expected of them in order to achieve their incentive targets.

Additional resources

For more information about performance measurement systems, we invite you to visit our online anthology of performance measurement articles at www.mercer.com/payforresults.

In addition, to learn more about goal setting (Perspective #59), peer group selection (Perspective #61) and implementing global performance systems (Perspective #66), please visit our library of articles at www.mercer.com/perspective.

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