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Pay-for-Performance:

Determining the Right Measures and Goals for Optimum Results

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Today's Speakers



Matt Turner, Managing Director Pearl Meyer & Partners, Chicago

Matt Turner is a Managing Director in the Chicago office of Pearl Meyer & Partners. He has over 20 years of experience advising companies on executive pay and incentive design.

Peter R. Gleason, Managing Director and Chief Financial Officer National Association of Corporate Directors

Peter Gleason serves as Treasurer for the NACD Board of Directors and leads the Center for Board Leadership, the research arm of the NACD.

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Getting pay-for-performance right is a top priority of Compensation Committees



“It is important for financial firms – and firms in general – to reform compensation structures to ensure tighter alignment between executive payoffs and long-term results.”

Lucian Bebchuk, Alma Cohen, and Holger Spamann in their report “The Wages of Failure: Executive Compensation at Bear Stearns and Lehman Brothers 2000-2008”

What do we mean by “pay-for-performance?”



Scenario (3 years):

- Company stock price increase 30%
- Earnings grow 50%
- Revenue grows 10%
- International revenue grows from 10% to 20% of total
- Company weathers a major recall; settles a lawsuit more favorably than anticipated
- Actual 3-year compensation is below median against the market

Do we consider this “pay-for-performance”?

...but what if???



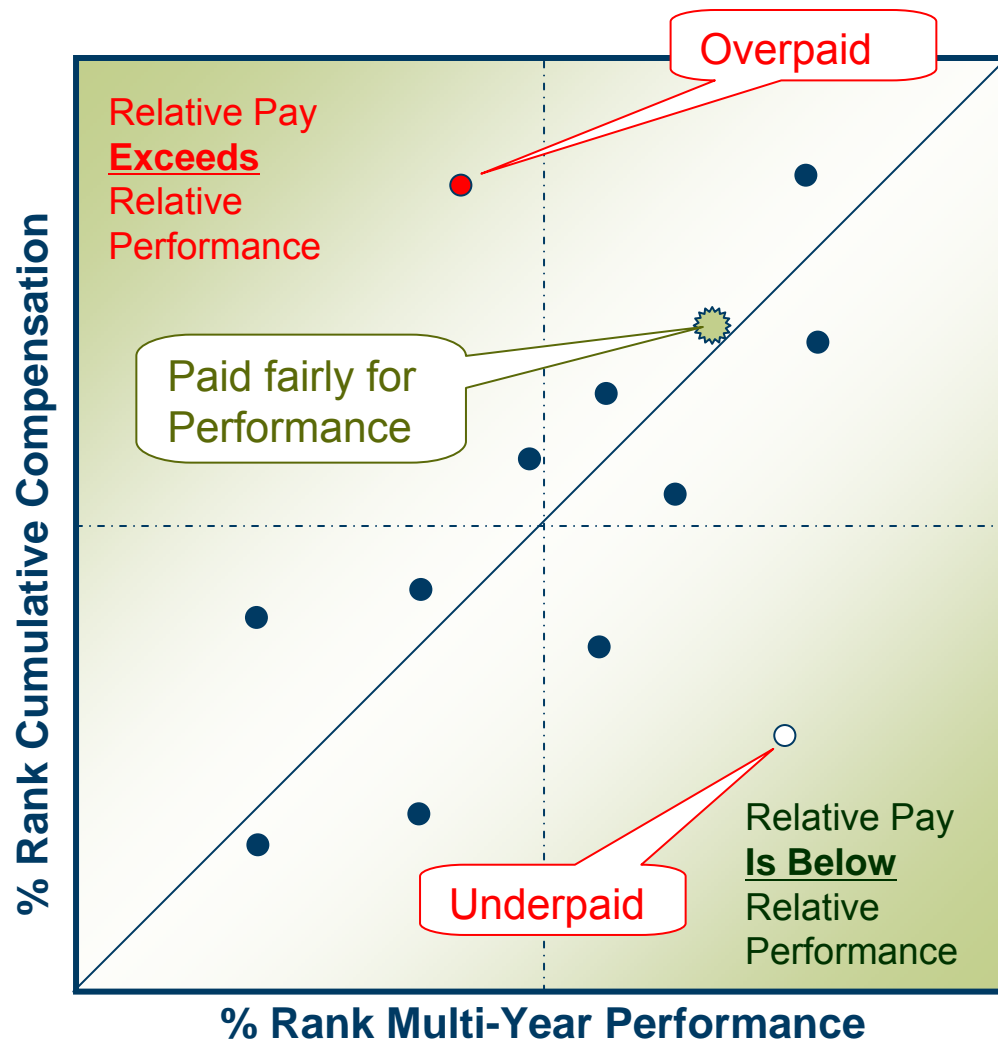
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Other factors:

- ➔ Industry index is up 75%
- ➔ Earnings were near “0” three years ago; ROIC is still below cost of capital
- ➔ Industry revenue up 15%
- ➔ Earnings from international operations declines
- ➔ Brand is damaged
- ➔ Compensation is higher than the prior three-year period for disclosed NEOs

Companies should agree on the pay curve and the definition of “performance”



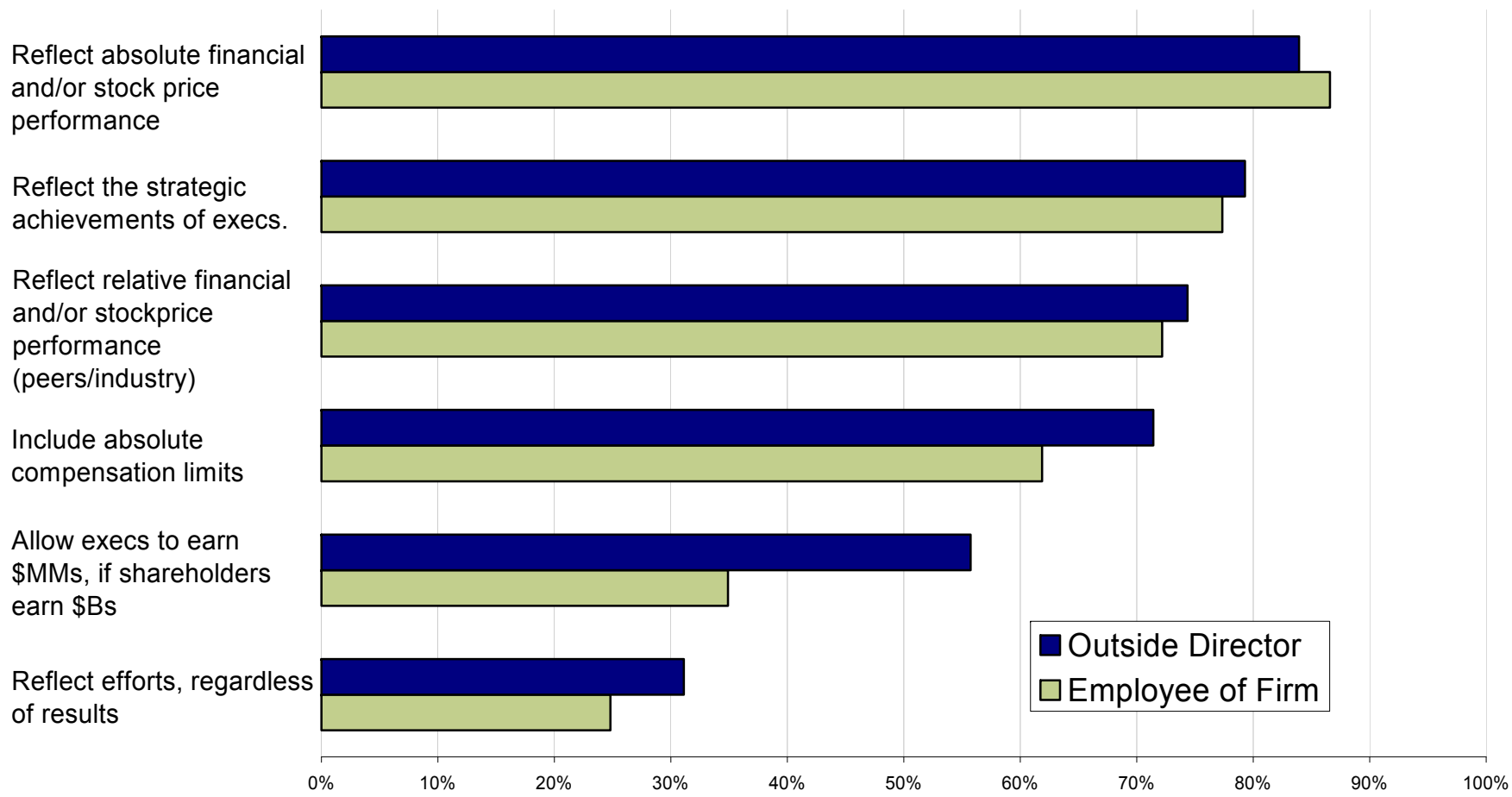
Pay-for-Performance Definition

- **Key measures**
 - Stock and financial?
 - Operational / strategic?
 - Function / unit / individual?
- **Basis of measurement**
 - Absolute standards?
 - Relative to an external benchmark?
- **Timeframe of measurement**
 - Shorter term versus longer term?
 - Balance of focus?
- **Pay curve leverage**
 - Aggressive versus conservative?
 - Balanced?

Good news: management and directors generally agree on “broad strokes”



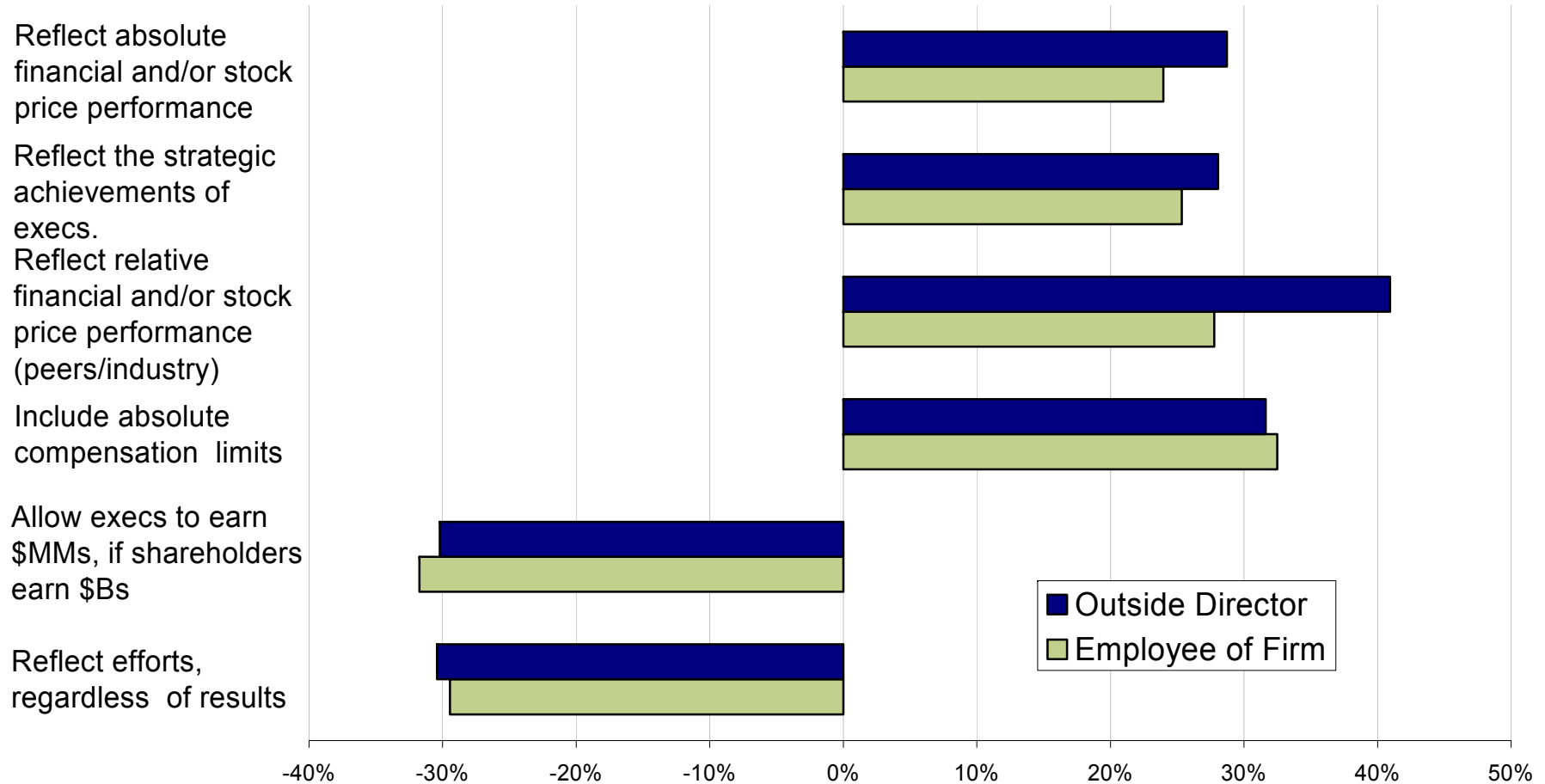
% of Individuals that Strongly Agree or Agree that Executive Pay Should...



Views have changed in recent years, especially those of directors



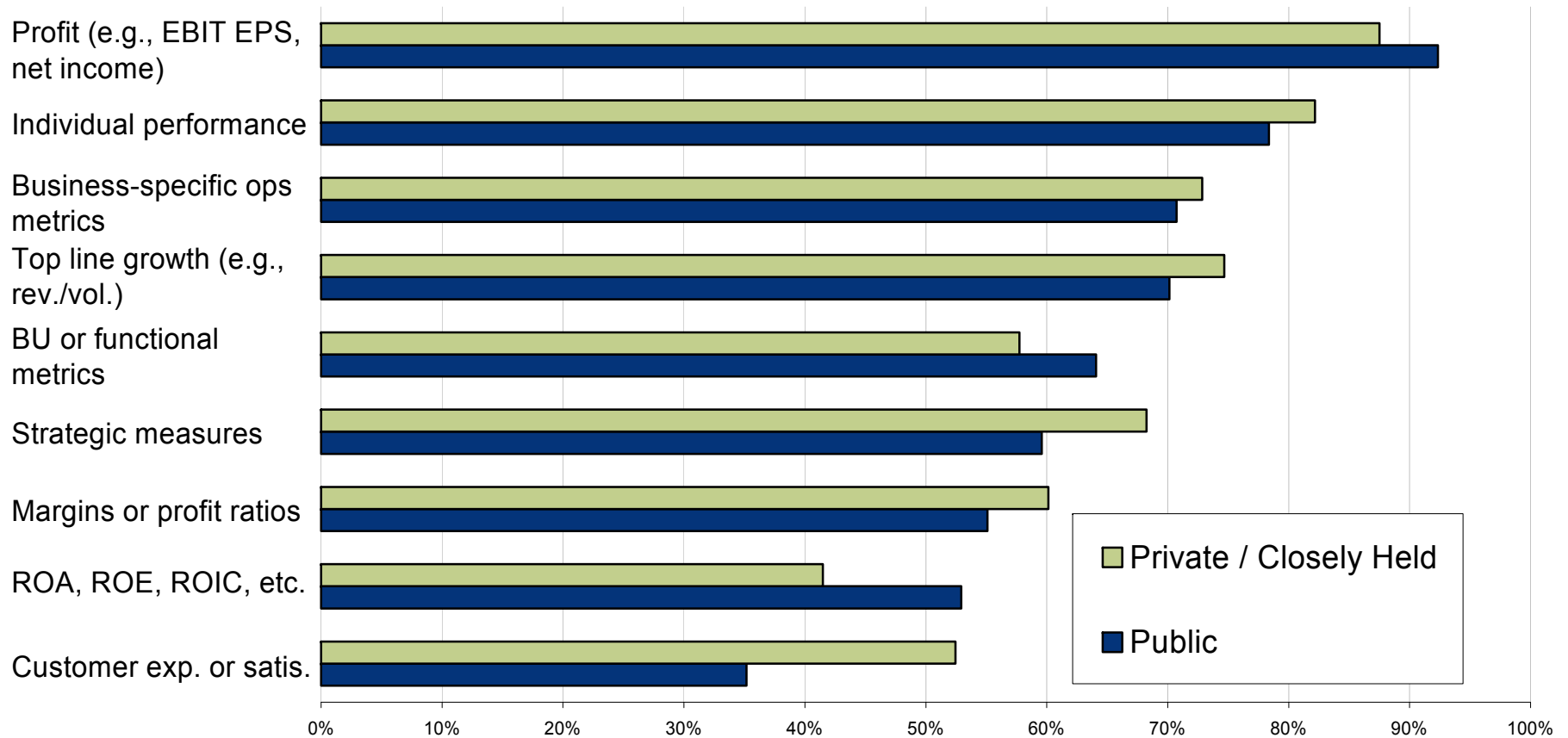
Difference in Perceived Emphasis of Importance Relative to the Past Several Years Executive Pay Should...



Private companies are more likely to use strategic and/or customer measures in annual incentive plans



% of Organizations Using Measure in Annual Incentives



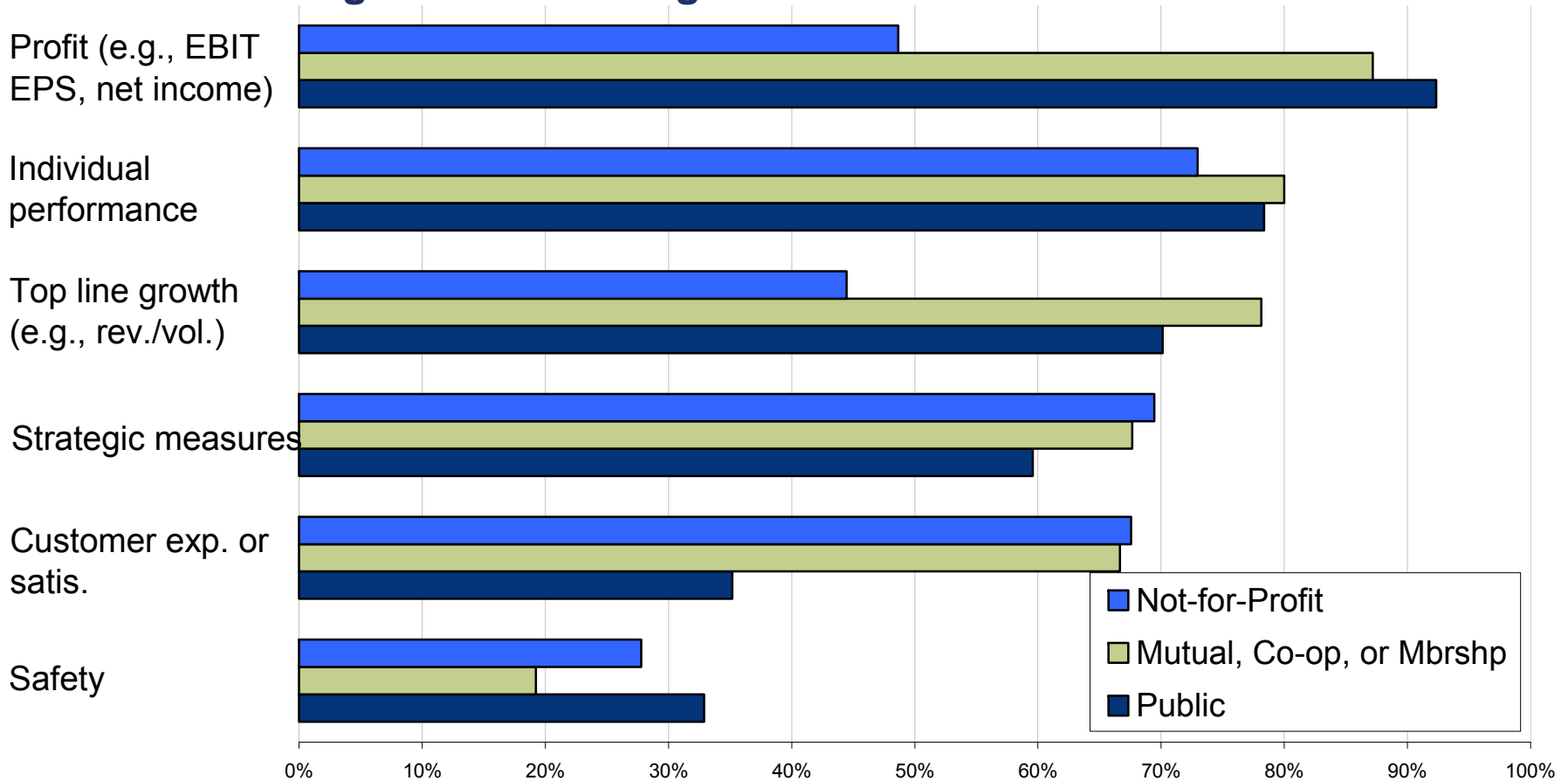
Note: All other measures cited by less than 35% of respondents; numbers sum to greater than 100% because many companies use more than one measure

Mutuals and Not-for-Profits also measure performance differently from public companies



- Mutuals and NFPs incorporate strategic measures and customer experience/satisfaction to a larger degree than public companies

% of Organizations Using Measure in Annual Incentives

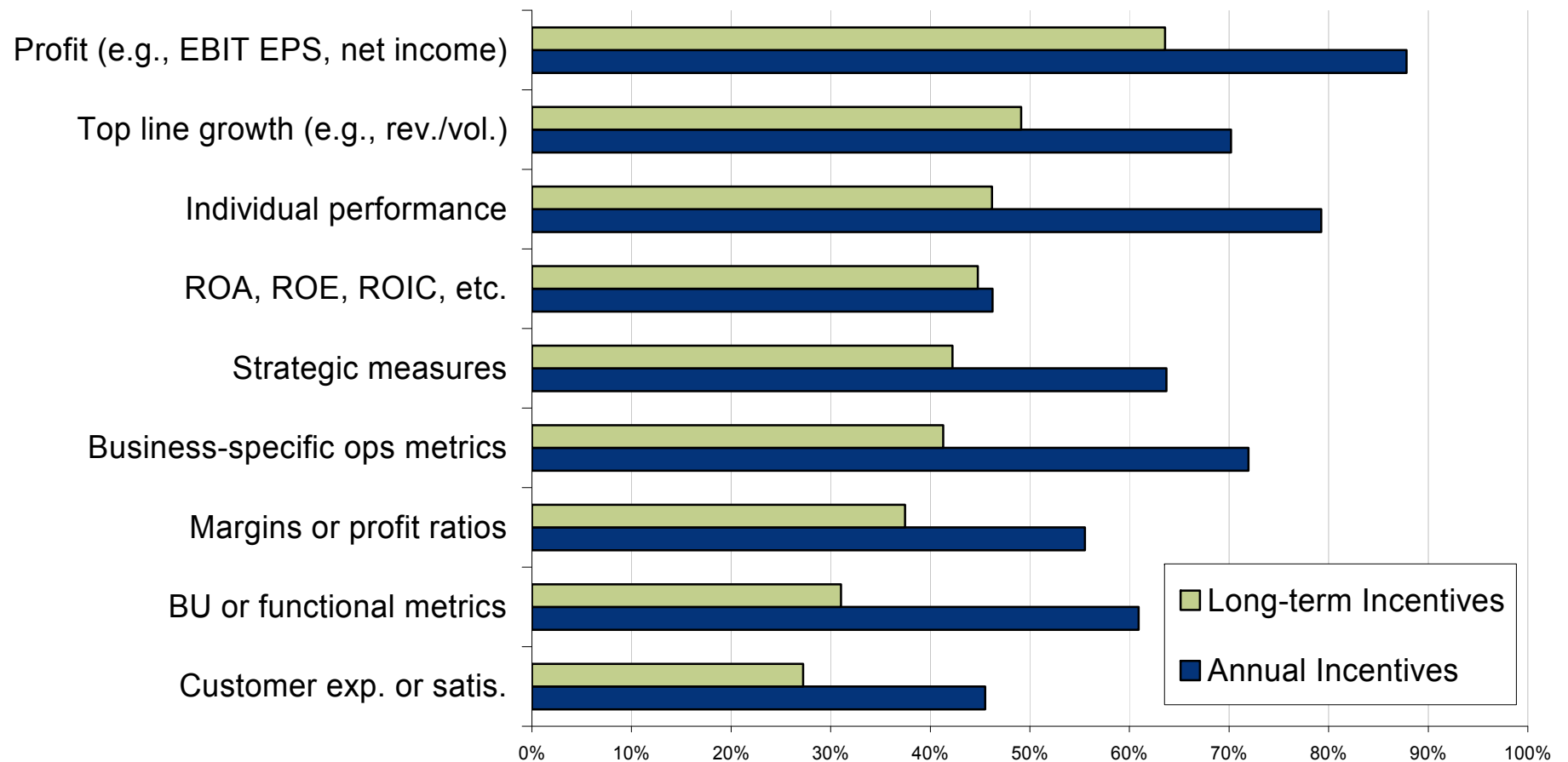


Note: All other measures cited by less than 30% of respondents; numbers sum to greater than 100% because many companies use more than one measure

LTIPs incorporate fewer measures and focus on profits, growth and returns



% of Organizations Using Measure in Long-term Incentives



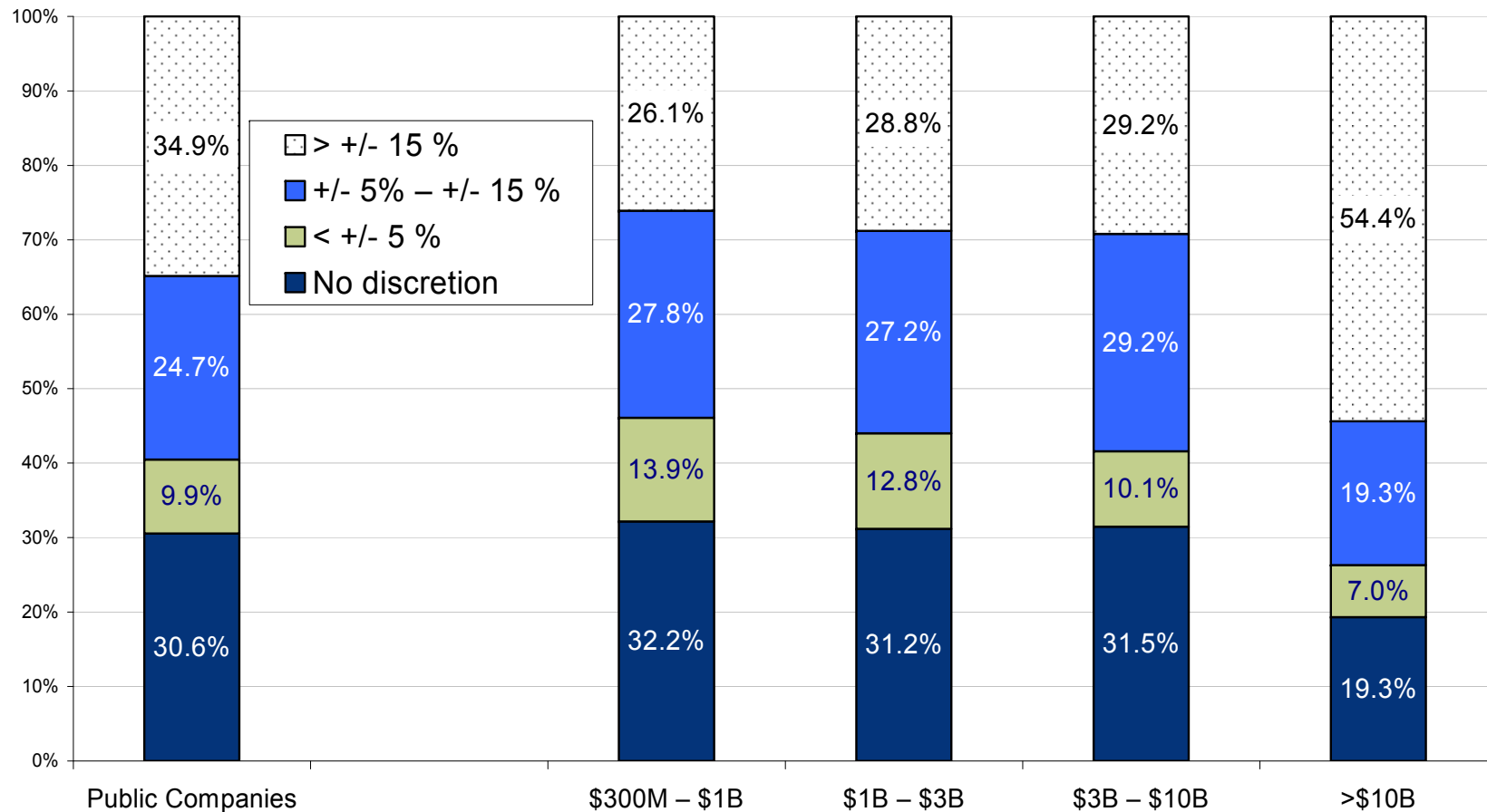
Note: All other measures cited by less than 30% of respondents; numbers sum to greater than 100% because many companies use more than one measure

Discretion remains as an available tool, and even more so for larger companies



- Directors say discretion usage today is similar to usage in past years
- It is most often applied to achieve a level of fairness in incentives

Amount of Discretion in Annual Incentive Determination



Some analytics may help to clarify a definition of “pay-for-performance”



- **Pay mix relative to peers**
 - Fixed vs. variable; short-term vs long-term; cash vs equity?
- **Helps determine the “leverage” in pay-for-performance**

- **Performance sensitivity**
 - How much pay is tied to each performance measure?
 - How does an incremental change in performance for a given measure affect compensation?
 - How does a change in stock price affect executives’ personal wealth?
- **Helps to understand how incremental performance - of different types - may impact actual compensation under various circumstances**

Understand how future performance scenarios will impact incentive payouts



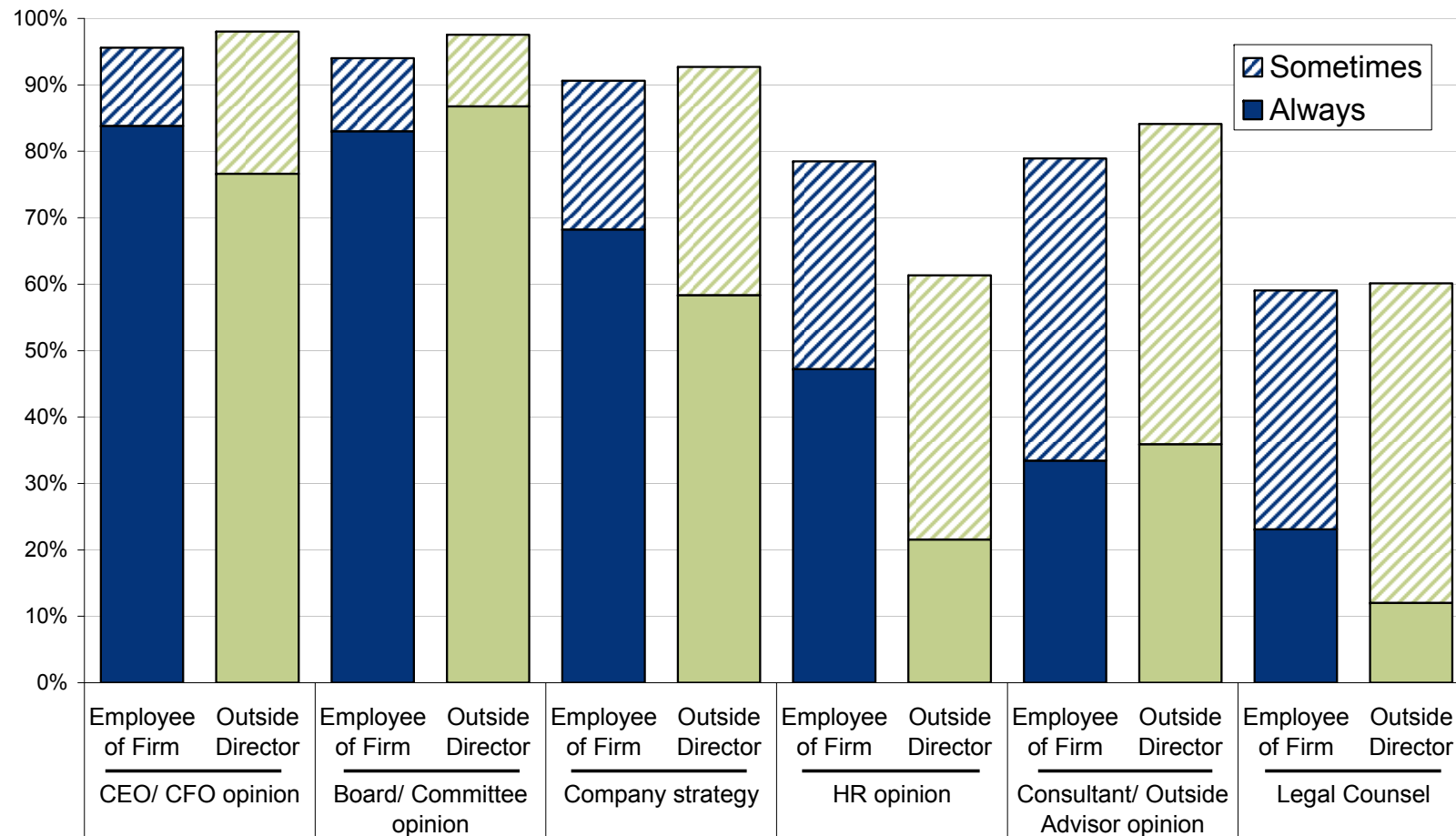
- Model multiple performance scenarios
 - Understand payouts, including how those payouts might compare relative to market
 - Review unusual and mixed-performance scenarios
 - Consider the circumstances under which discretion might be exercised and discuss openly with management

A thorough mutual understanding of your company's definition of pay-for-performance will make "first quarter" conversations much more productive and much less frustrating!

Performance measure review typically takes into account multiple perspectives



% of Companies Reporting Factors Used to Select Performance Measures

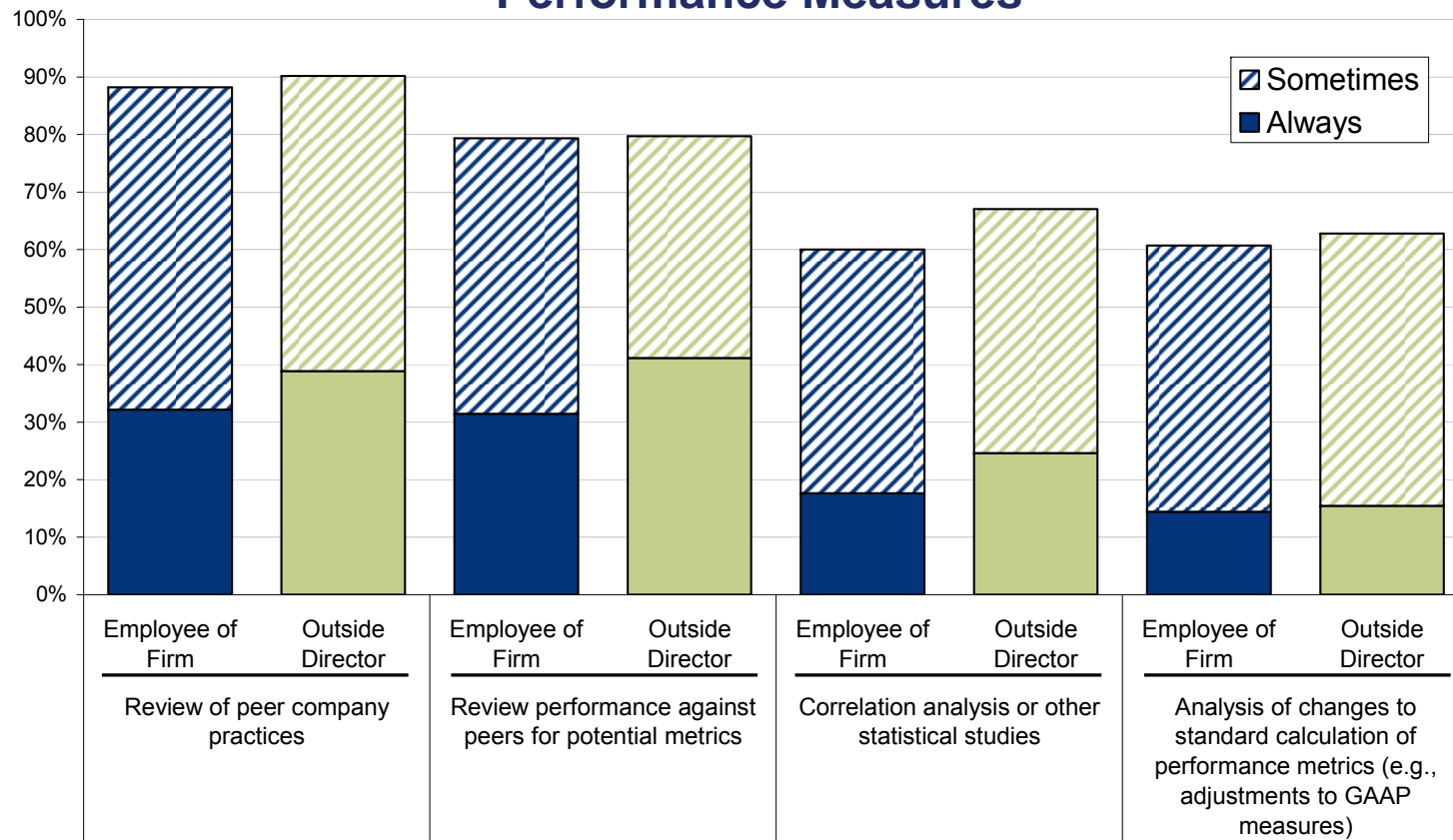


Companies sometimes look externally for guidance in selecting measures



- Simple prevalence surveys and performance comparisons are more common than statistical analysis or exploration of tailored measure definitions

% of Companies Reporting Factors Used to Select Performance Measures

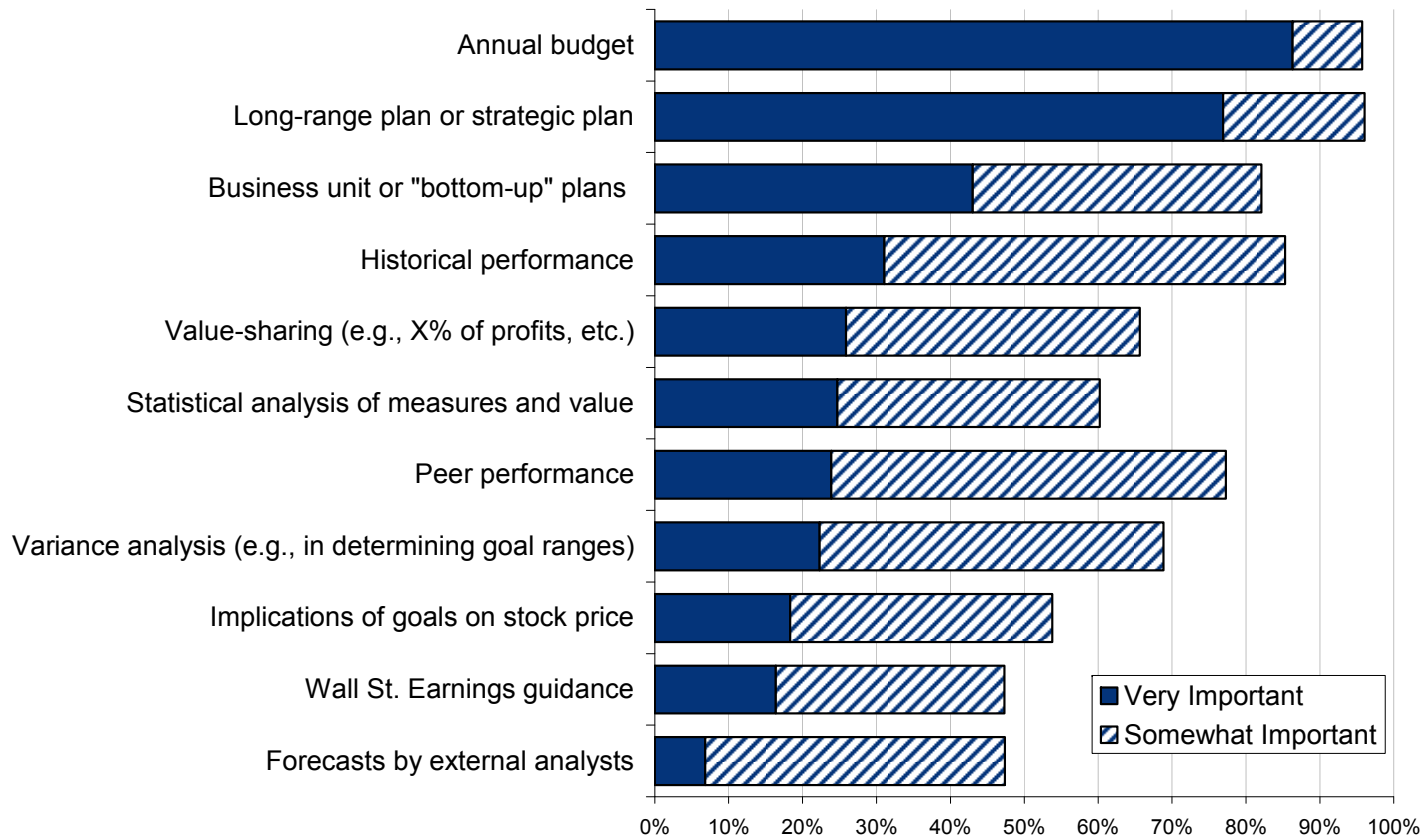


Goal-setting also takes into account multiple perspectives



- A minority of companies make use of the advanced analytics but many seem to be using multiple perspectives

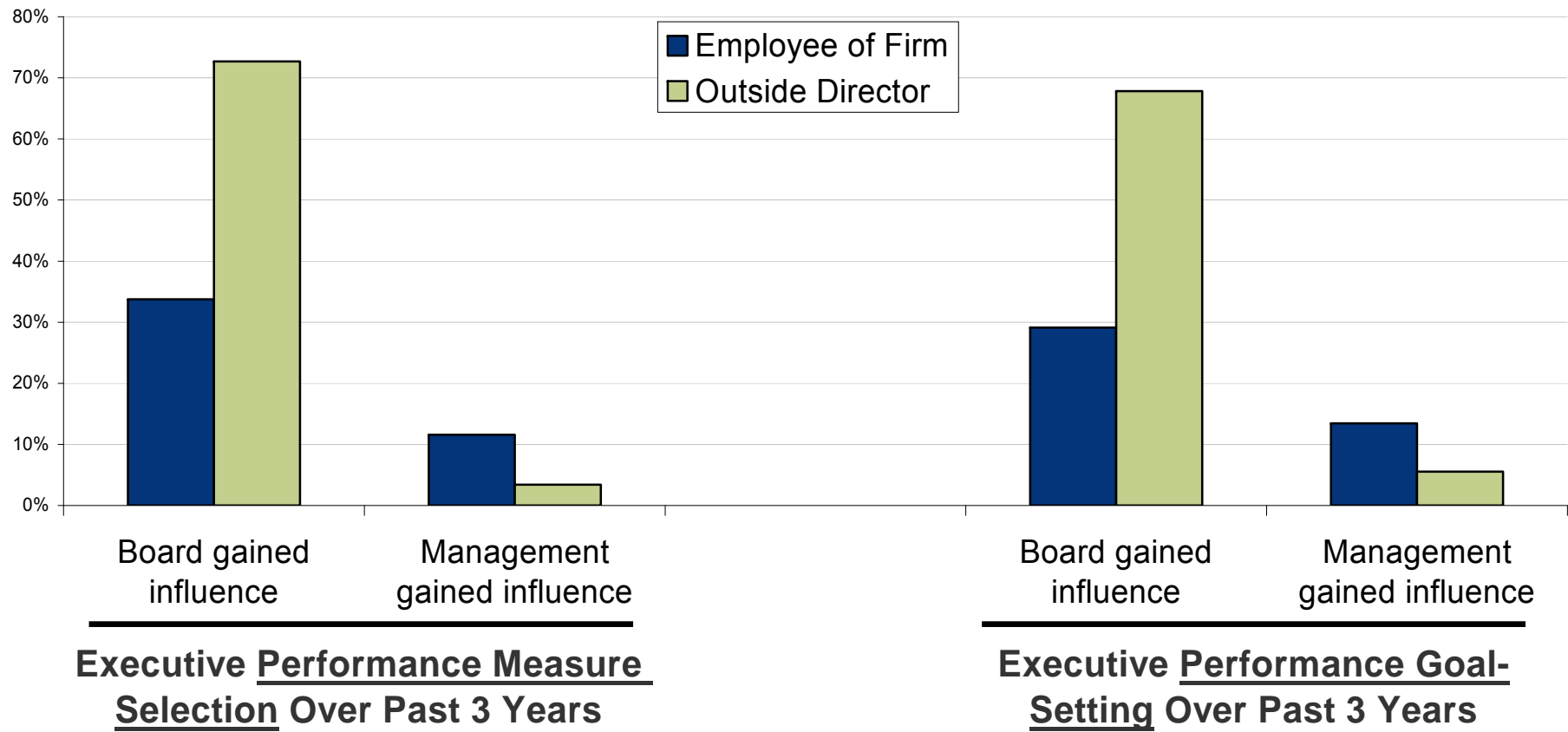
% of Companies Reporting Factors Used to Set Performance Goals



Board involvement in measure selection and goal-setting has markedly increased



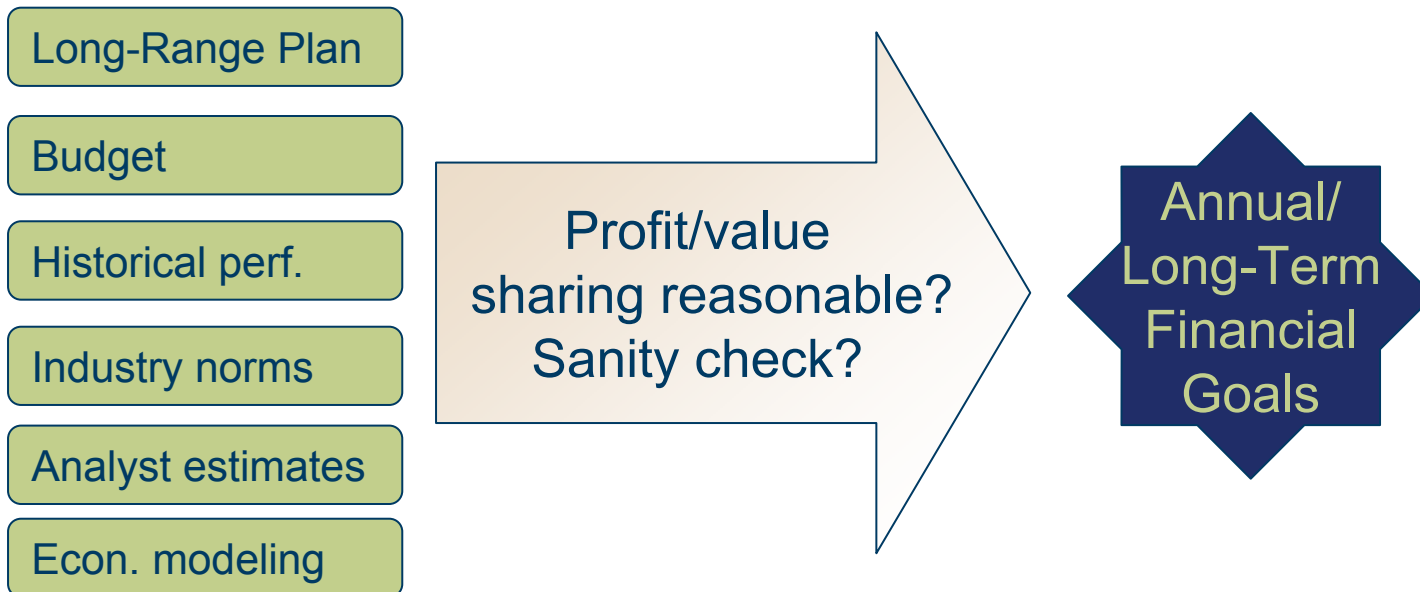
Relative Influence of Management and Board in Performance Measure Selection and Goal-setting for Executives



Compensation Committees should...



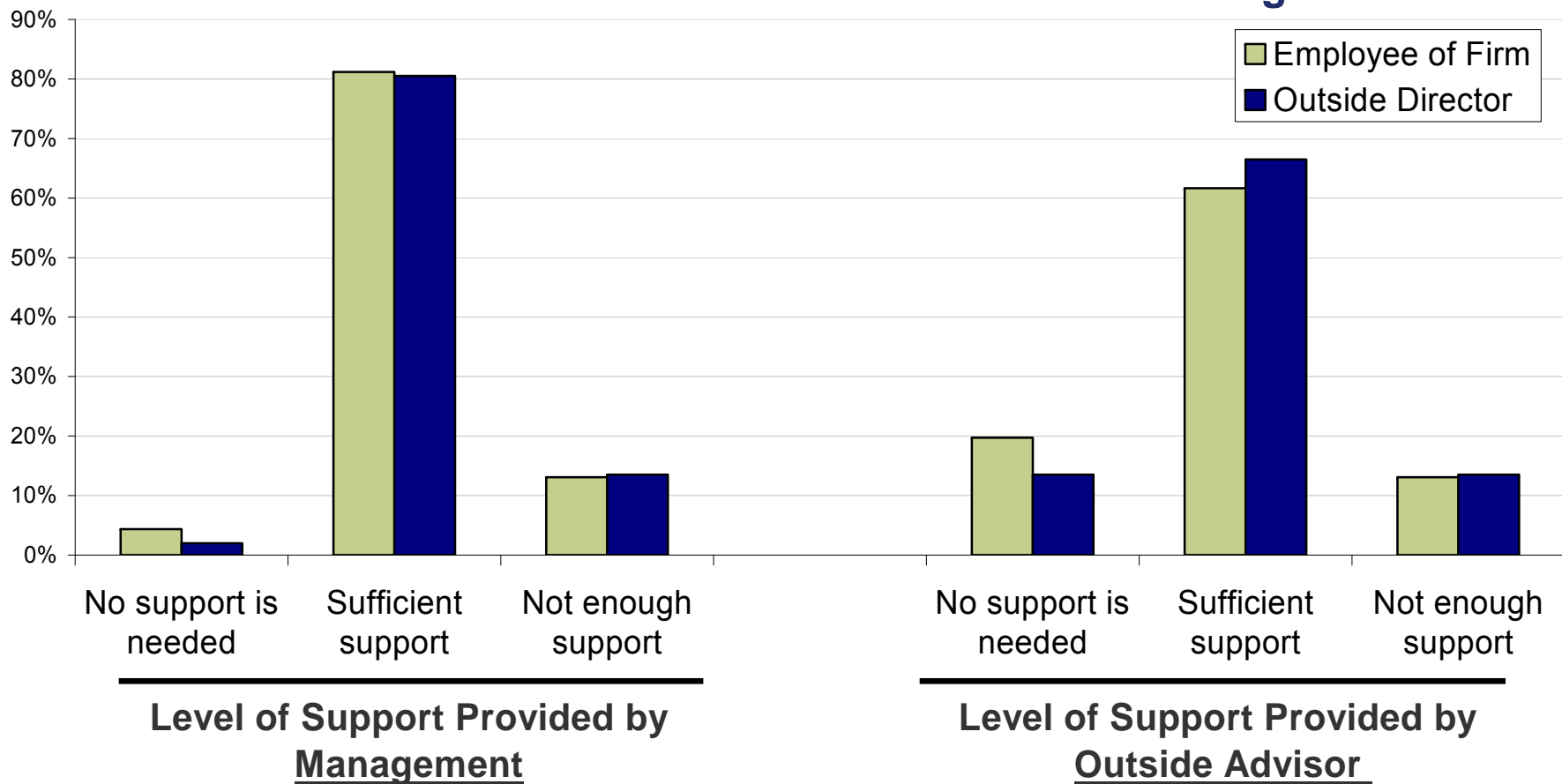
- Spend more time on measure selection and goal-setting
- Seek multiple perspectives; make use of various analyses
 - Bottom-up – company long-range plan, annual budgets
 - Recent experience – historical performance (company and industry)
 - Expectations – analysts, valuation multiples, economic modeling (DCF, EVA, etc.)
 - Affordability – profit- and value-sharing relationships
 - Reality – sanity check on the answers



Do Compensation Committees have the support they need?



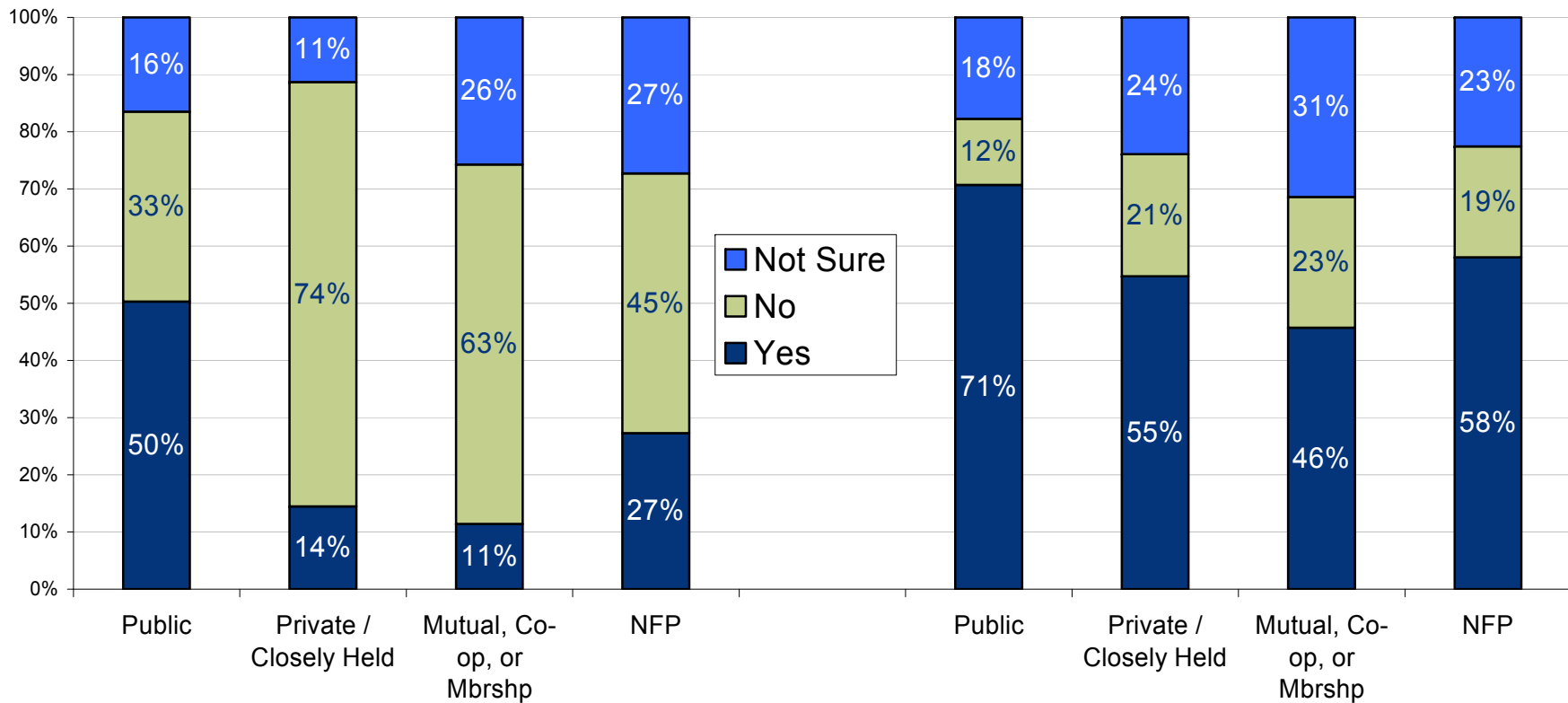
Level of Support Provided to Compensation Committee in Performance Measure Selection and Goal-setting



Risk assessment of executive compensation is relatively new



- Public companies, more so than other types of companies, are conducting explicit risk reviews; They are also more confident that they understand the risks inherent in the pay systems



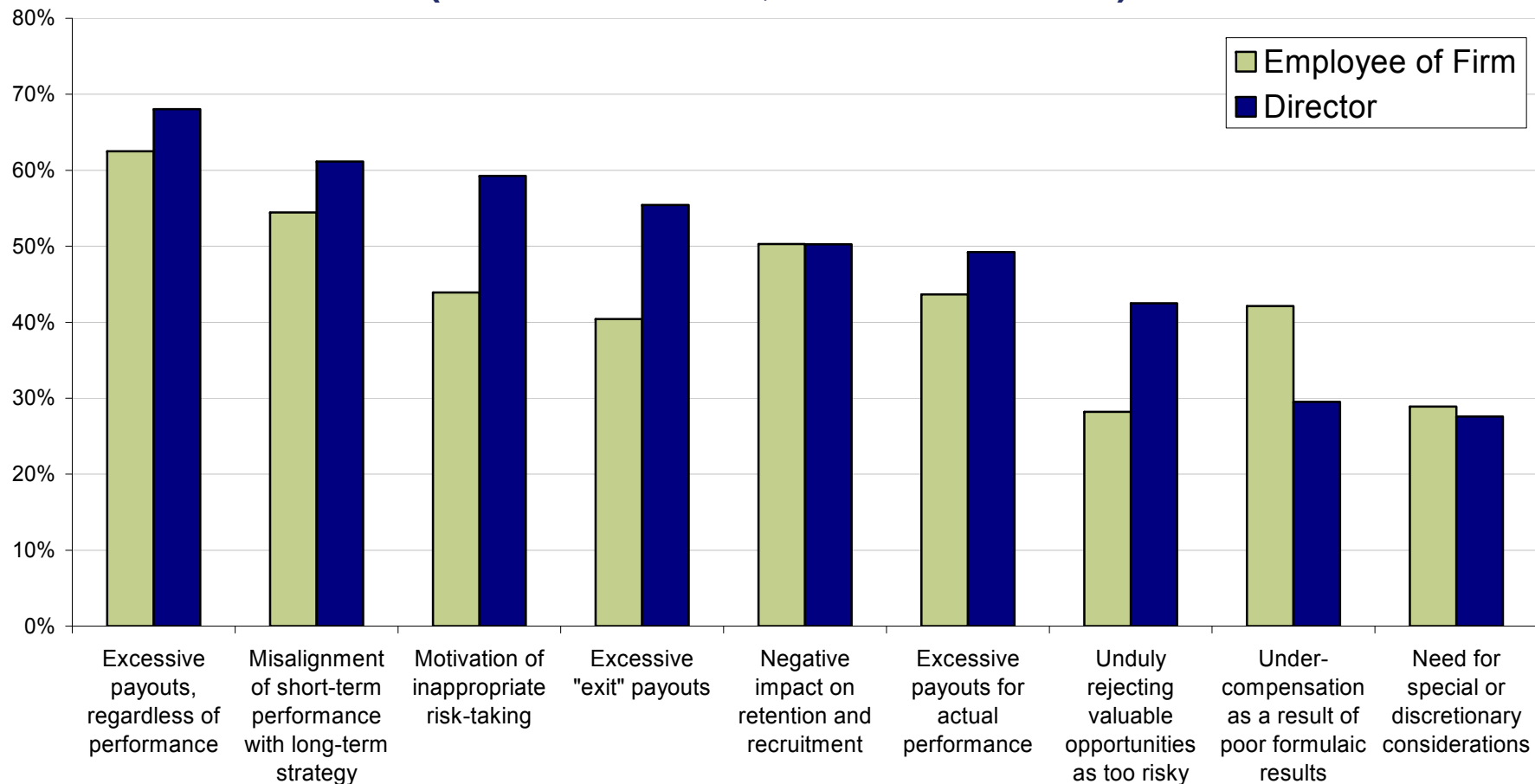
Conduct a Risk Assessment of Exec Comp Programs

Confident that Committee Fully Understands Compensation Plan Risk

Directors are generally more sensitive to risk concerns, except retention risk



Importance of Compensation-Related Risks % of Responses that were a "4" or "5" (5 = Most Critical; 1 = Least Critical)



Getting pay-for-performance right for your company takes time and effort



- Gain consensus on a definition of “pay-for-performance” on the Committee and with management
 - Understand which performance measures are critical and indicative of underlying performance
 - Determine the level of discretion to be available to the Committee and scope out the specific conditions under which discretion might be used
- Set meaningful and well-grounded performance goals
 - Utilize a sufficient number of resources
 - Ensure you are getting the right level of support
- Conduct a risk assessment and understand the differences between management and director perceptions

Although these activities can be time-consuming and resource-intensive, they are well worth the investment!



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May 5 – The Board's Role in Corporate Strategy

June 2 – Tone at the Top

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Questions?

Thank You!



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