WEIGHING IN

Views from Governance and Boardroom Experts

"The key point is that pay-for-performance analytics are about more than compliance and check-the-box satisfaction of external tests."

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PERFORMANCE-BASED PAY

Pay for Performance: Don't Design to Standardized Tests

Over the course of the last 10 years, pay for performance has grown from a boilerplate phrase in almost every company's CD&A to a testable and quantifiable concept, with shareholders now expecting companies to demonstrate their commitment to this philosophy. While a handful of companies dabbled in pay-for-performance tests prior to Institutional Shareholder Services (ISS) introducing its approach, it is really the ISS quantitative tests that filled a vacuum and forced everyone to think more explicitly about what we actually mean by pay for performance.

To criticize the ISS test—or the Glass-Lewis test, and now the SEC's proposed disclosure under the Dodd-Frank Act—is to beg the alternative. Many experts have various and typically valid points of concern about each of these one-size-fits-all assessments of pay for performance. That said, every public company must be mindful of its results vis-à-vis these widely referenced but highly standardized tests. When it comes to developing compensation programs, however, companies should resist the urge to "design to the test." What's better is to define a company-specific pay-for-performance perspective and use it to maintain or improve your executive compensation program.

First, as a public company, you have to acknowledge that for better or worse, TSR, both absolute and relative, is the most common measure of ultimate results across all external tests. It must be factored in to the pay-for-performance assessment to some degree, both because of expectations and coming disclosure mandates. And as an alignment tool—bringing together executive and shareholder interests—TSR is the shareholders' ultimate goal over the long term.

Yet, over a relatively short time period—say three years—it is possible and even likely that TSR doesn't tell the whole story. Your company's strategic decisions may take longer to be fully realized and reflected in absolute market value creation. Likewise, the respective starting points for you and your peers may significantly skew relative TSR comparisons. Consequently, while we all may agree that TSR is a valuable yardstick for measuring results over time, it is less effective over shorter timeframes at conveying the whole story.

The fact that there may be significant timing differences between recognized strategic or financial achievements and market reactions raises the question: what other performance dimensions belong in your pay-for-performance perspective?

It's a worthwhile exercise to define your centerpiece financial performance measures—those that capture profitable growth and returns consistent with your company's specific value proposition. It may also be appropriate to bring in other operational and strategic measures that ultimately drive financial and market performance. This carefully considered combination of market, financial, and operational measures forms a balanced performance measurement framework that can be reflected across annual and long-term incentives. This framework, effectively, becomes the definition of "performance" in the phrase "pay for performance" for your company.

Next, pressure test this framework. In addition to modeling potential outcomes with respect to ISS and other external tests, model outcomes in light of your company-specific perspective. Do the performance scenarios produce realizable pay consistent with your company's view of pay for performance? Are there extreme or unusual—yet possible—outcomes that make you uncomfortable? Better yet, does the incentive system produce desirable pay-for-performance relationships along the entire performance continuum, from very poor to very strong results?

If the outcomes of the modeling aren't satisfactory, there could be a number of potential reasons, any of which can point to program changes that will lead to better pay-for-performance alignment:

- The performance measures may be misaligned. If you believe the measures selected are truly the drivers of long-term value, further analyses may uncover the disconnect with relative TSR (e.g., measurement periods, peer company anomalies, etc.)
- The performance goals may be off—either too difficult or too easy—or the range of performance from threshold to maximum is too narrow or too wide. Additional analytic tools may help to further refine the goal-setting process.
- The balance of the performance focus may be incorrect. Consider shifting the pay mix and looking at all of the incentive plans holistically, not just one at a time.
- The incentive plan design and mechanics may benefit from a fresh look. Think about alternatives such as moving threshold and maximum payouts or the use of modifiers or performance hurdles.

The key point is that pay-for-performance analytics are about more than compliance and check-the-box satisfaction of external tests. Truly valuable analytics offer insights to fine-tune executive compensation programs that can reinforce a company's competitive advantage and ensure shareholders and employees benefit over the long term.