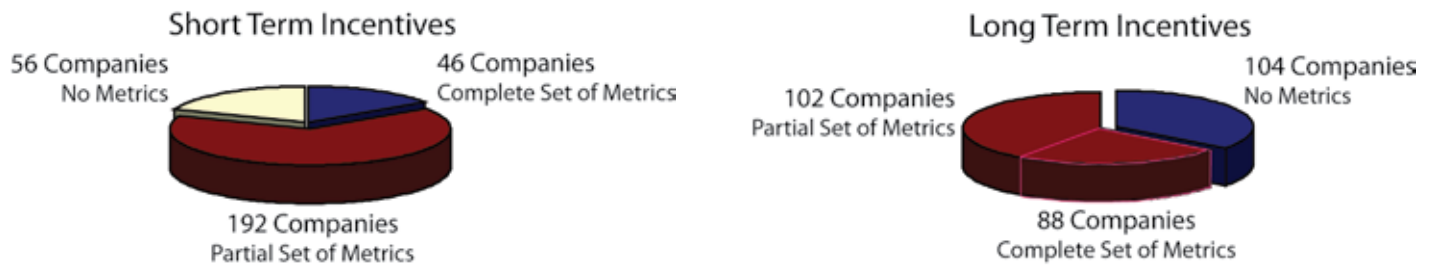


Proxy Disclosure: Incentive Plan Performance Measures and Design Structure

How are companies structuring their incentive plans and what performance measures are they using? With the SEC's new rules on disclosure of executive compensation practices, investors are anxious to find out whether amounts paid correspond with performance. Hopefully the 2008 proxy season will provide them with more conclusive answers than last year.

According to a study by James F. Reda & Associates of *Fortune Magazine's* Top 300 Publicly-traded Companies, while disclosure was improved over last year, a majority of 2007 proxy disclosures on annual and long term incentive plans were inconsistent and incomplete when disclosing incentive performance metrics.

Surprisingly, many top U.S. publicly traded companies failed to disclose or explain their incentive performance metrics. Our study of 2007 proxies of nearly 300¹ companies revealed only 16% (46) of the companies provided complete metric and payout information for short term incentive plans (STIP), while 19% did not provide any metric values for STIP.² The study revealed that 65% (190) had long term incentive plans (LTIP), and of those companies with LTIP, only 46% (88) included a reasonably complete set of metric values and corresponding payout percentages.



Even when we take into account that LTIP often include relative measures which are easier to report than the absolute goals typically used by STIP, it is troubling to see companies providing no metrics at all in situations where non-discretionary plans are in place. It is understandable that companies do not include specific performance targets that reveal competitive information, but it is necessary to disclose the degree of difficulty in achieving the goals and why disclosure of goals could cause competitive harm.

Many have commented on the obscure and often missing disclosures about incentive performance metrics. In Release 2007-214 entitled "Commission Staff Publishes Its Observations in the Review of Executive Compensation Disclosure," the SEC made several key observations and comments, including:

"We issued more comments regarding performance targets than any other disclosure topic in our review of the executive compensation and other related disclosure of the 350 companies. We often found it difficult to understand how companies used these performance targets or considered qualitative individual performance to set compensation policies and make compensation decisions."

In regard to disclosing performance targets, the Commission Staff stated:

"Where it appeared that performance targets were material to a company's policy and decision-making processes and the company did not disclose those targets, we asked it to disclose the targets or demonstrate to us that disclosure of the particular targets could cause it competitive harm. We reminded companies of Instruction 4 to Item 402(b) which requires them to discuss how difficult it will be for the executive or how likely it will be for the company to achieve undisclosed target levels or other factors.

¹ Of the top 300 companies, 6 are private. This study examined the top 294 public companies.

² Of the top 300 companies, a number have stock and discretion bonus plans.

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Summary of Disclosed Measures

Short Term Incentive Plans

Income/profit measures (49%) and EPS (42%) were the two most common measures used by companies in the study. Total shareholder return is not often used for short term incentive bonus plan metrics, with just 5% of companies using them. Other measures used included return ratios other than EPS (28%), sales growth (21%), and cash flow measures (17%). All other measures were 2% or less of those reported.

Long Term Incentive Plans

Total shareholder return (TSR) was the most common performance measure used by companies in our study. 37% of companies with LTIPs use TSR, usually as a relative measure that compares performance to a peer group. Earnings per share (EPS) was the next most frequent measure used by companies at 32%.

35% of the companies used a return ratio such as return on invested capital (11%), return on equity (11%), return on capital (4%), return on net assets (3%), and return on investment (3%) as a performance measure.

Summary of reported measures

Measure	STI %	LTI%
Total Shareholder Return	5%	37%
Earnings Per Share	42%	32%
Income/Earnings	49%	17%
Return Ratios	28%	35%
Sales Growth	21%	9%
Cash Flow	17%	6%
Stock Price	1%	6%
Economic Value	2%	2%
Economic Profit	1%	2%
Working Capital	2%	0%
Other	9%	6%
TOTAL	100%	100%

Sample Sizes (number of companies):
 Short-term plans: 238
 Long-term plans: 190

Income measures such as net income and operating income were used by 17% of companies with LTIPs.

Other measures of somewhat lesser significance were sales growth (9%), cash flow, free cash flow (6%), stock price (6%), economic value added (2%) and economic profit (2%).

Multiple Measures

55% of short term incentive plans included more than one financial measure in addition to individual or production objectives, while 40% of LTI plans had at least two performance measures.

Number of Measures	STI	LTI
One measure	45%	60%
Two measures	35%	32%
Three measures	16%	8%
Four or more measures	4%	1%

Sample Sizes (number of companies): 294

Absolute vs. Relative Metrics

Most performance goals and payouts are compared to a financial performance measure, such as earnings per share, return on capital, free cash flow growth, and so forth. Approximately 43% of companies with long-term incentive plans included at least one relative goal, that is, a goal set relative to the performance of a peer group of companies. In half of the companies, relative target performance was achieved by reaching a total shareholder return set at the 50th percentile of the peer group.

For companies using the 50th percentile as target performance and reported thresholds (27 companies), 57% set the 25th percentile as their minimum threshold performance, below which, there is no payout. 11% use the 30th, 35th and 40th (32% in all).

Measure	% of Total
TSR/Stk Prc	67%
Return Ratio	16%
EPS	9%
Income	4%
Sales	3%

Sample Size (number of measures): 98

With 50th percentile targets, the study found more diversity of maximum targets. 30% used the 75th while another 30% used the 100th as their maximum target. Typically

use of the 100th percentile occurred in cases of small peer groups (less than fifteen companies). Another 20% used the 90th and 13% the 80th percentile as maximum targets.

The most frequently used relative performance ranges were 25th/50th/100th (24%) and 25th/50th/75th (20%).

For long term incentive plans, the most common relative measure used was total shareholder return, including stock price (67%).

Level of Reporting

This study found that companies are doing a better job reporting their long term incentive plans (46%), while only 19% of companies with STI Plans provided complete information on performance metrics.

30% of companies failed to report payout information (threshold, target, maximum) for both long term and short term incentive plans.

Payout Percentages

Reports of Performance Metrics (Threshold, Target, Maximum)

	0 Metrics	1 Metric (target)	2 Metrics	All 3 Metrics
Short-term	53%	15%	12%	19%
Long-term	34%	12%	8%	46%

Sample Sizes (number of companies):
 Short-term plans: 238
 Long-term plans: 190

For both short term and long term incentive plans, the minimum threshold an executive needed to achieve in order to receive a payout was often set at 0%, 25% or the 50% percentile.

For both short term and long term incentive plans, the maximum payout an executive could achieve was set at the 150% or 200% percentile, with 200% used more often.

Threshold Payout % of Target	Short-term	Long-term
0%	23%	15%
1% to 24%	11%	11%
25%	11%	18%
26% to 49%	11%	8%
50%	31%	37%
>50%	13%	11%

Sample Sizes:
 Short-term plans: 133
 Long-term plans: 141

Maximum Payout % of Target	Short-term	Long-term
100%	3%	9%
101% to 149%	9%	4%
150%	17%	22%
151% to 199%	3%	3%
200%	51%	50%
201% to 249%	4%	3%
250%	6%	3%
251% to 299%	1%	0%
300%	3%	5%
> 300%	4%	1%

Sample Sizes:
 Short-term plans: 162
 Long-term plans: 151

Summary

Reporting of performance metrics and related payouts was spotty at best among the largest companies in the U.S. However, these numbers are improved over last year and there was sufficient information regarding the types of measures used which could serve as a guide for other companies. This study determined:

- TSR and EPS were the two most commonly used long-term incentive measures
- Income/profit measures and EPS were the most commonly used short term incentive measures
- Most companies with long term incentive plans had either one (60%) or two (32%) performance measures
- Short-term incentive plans usually included multiple performance measures
- Relative performance measures to their peer groups were rarely found in short term incentive plans (8%)
- 43% of companies with a long-term incentive plan used a relative measure
- 50% of long term incentive plans with a relative performance measure used a total shareholder return measure with the target set at the 50th percentile of a peer group
 - In all, two-thirds of companies with relative performance measures used total shareholder return
- For companies using the 50th percentile as target for a relative performance measure, over half (57%) set threshold performance at the 25th percentile
- For short and long term incentive plans, threshold payouts were frequently set at 0%, 25% or 50% percentile of target
- Maximum payouts were usually capped at 150% or 200% of target bonus