

**Study of Performance Metrics**  
**Among**  
**S&P 500 Large-Cap Stock Companies**  
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## Introduction

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Incentive compensation comprises the bulk of executive pay packages at publicly traded companies. Boards of directors and senior management are continually searching for the right performance measures to balance rewards with financial and operational performance as well as non-financial or individual performance. It's a complex task, and the stakes have been raised.

Last year, the SEC began to require companies to disclose executive pay-performance measures and goals (otherwise known as the "pay for performance" formula). At the same time, many companies have begun shifting the basis for their long-term incentive plans away from stock options and towards performance share plans that are based on performance measures and goals. While stock option grants are still most prevalent, performance share grants and performance unit grants, including performance-based restricted stock, are nearly as prevalent.

<b>Grant Type</b>	<b>Percentage of Companies Using Grant Type - 2007</b>
Stock Options	69%
Performance Units	36%
Restricted Stock	31%
Performance Shares	31%
RSUs (Time Vested)	17%
LTI Cash	10%
SARs	8%

The SEC asserts that if executive compensation performance targets are central to a company's decision-making process, these targets must be disclosed to investors. The new proxy disclosure rules require that all performance measures and goals must be released and compared with actual results. This disclosure requirement includes both short- and long-term incentive performance measures.

New research shows that while companies are disclosing more about their incentive plans – in response to the SEC's new rules – they have a long way to go before reaching full compliance. Short-term incentive plans enhance executive performance, but very little is revealed to investors about these plans.

Earnings are the primary performance measure across all industries, and companies are setting more difficult goals. Thus, the new rules have more closely aligned pay with performance and have informed shareholders of important performance goals.

Although disclosure of executive compensation plans and programs has typically been the responsibility of human resources departments and general counsel offices, senior financial executives should not overlook their crucial role in ensuring compliance with the SEC requirements.

## About This Study

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James F. Reda & Associates, LLC conducted this study of proxy statement disclosures for selected companies from the Standard & Poor's large-cap stock indexes ("S&P large-cap companies") for 2006 and 2007 (as reported in 2007 and 2008). The purpose of this study is to provide a resource of current short- and long-term incentive plan design characteristics and company compliance with SEC disclosure rules.

The data used for this study was collected from SEC filings of *S&P large-cap* companies. The pay for performance formula characteristics examined in this study include:

- ◆ Performance measures (types of measures and weightings)
- ◆ Performance levels (at threshold, target and maximum)
- ◆ Payout levels (at threshold, target and maximum)

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## Study Highlights

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**Lack of Information on Pay for Performance:** While most companies are disclosing the type of performance measures and weightings of each measure (in the case of more than one measure), they are not disclosing the performance levels (numerical value) that need to be achieved in order to receive threshold, target or maximum bonus.

**Long-Term Incentive Plan (“LTIP”) Disclosure:** Our study indicates that among companies with LTIPs, only about one-half included a complete set of metric values in 2006 and 2007 (e.g. threshold, target, maximum) and corresponding payouts.

**Short-Term Incentive Plan (“STIP”) Disclosure:** Our study indicates that among companies with STIPs, only 44% included a complete set of metric values in 2007 (e.g. threshold target, maximum) and corresponding payouts. This amount shows an improvement over the previous year where only 30% of companies reported complete metrics.

### Individual Objectives

More and more companies are expanding their use of Individual performance plans. Over half include non-financial individual performance of Named Executive Officers in determining annual incentive payments (some companies excluded the CEO individual performance). Of the companies that use individual performance, over half assign a separate weighting to this measure ranging from 10% to 50%.

Most of these individual performance plans are not funded using performance metrics.

## Study Summary

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

- TSR, EPS and income or return ratios were the four most commonly used long-term incentive measures, which together make up about 70% of metrics used.
- Income/profit and EPS were the most commonly used short-term incentive measures.
- Most companies with long-term incentive plans had one (65%-67%) or two (21%-25%) performance measures.
- Short-term incentive plans usually included multiple performance measures (60%-65%); approximately 80% had 3 or fewer measures.
- Performance measures relative to a peer group were rarely found in short-term incentive plans (6% in 2006, only 5% in 2007).
- 44% (2006) and 43% (2007) of companies with a long-term incentive plan used a relative measure.
- Just over 70% of long term incentive plans with a relative performance measure used a total shareholder return measure—nearly 90% set target at the 50<sup>th</sup> percentile of their comparator group.
- Maximum payouts were frequently (50% of the time) capped at 200% of target for both short-term and long-term incentives.
- Bonus payouts declined in 2007 as there was nearly a 50% increase in the number of executives receiving less than their target bonus in 2007 (35%), as compared with 2006 (24%).

## S&P 500 Large Cap Companies

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This study includes a review of stock indices for 2006 and 2007 filed with the Securities and Exchange Commission ("SEC") for companies in the Standard & Poor's 500 large-cap:

ABERCROMBIE & FITCH -CLA	KB HOME
ACE LTD	KIMBERLY CLARK CORP
AGILENT TECHNOLOGIES INC	KING PHARMACEUTICALS INC
AIR PRODUCTS & CHEMICALS INC	KLA-TENCOR CORP
AMAZON.COM INC	L-3 COMMUNICATIONS HLDGS INC
AMGEN INC	LABORATORY CP OF AMER HDLGS
ARCHER-DANIELS-MIDLAND CO	LEHMAN BROTHERS HOLDINGS INC
ASHLAND INC	LENNAR CORP
AUTOMATIC DATA PROCESSING	LIMITED BRANDS INC
AVERY DENNISON CORP	LOEWS CORP
BAXTER INTERNATIONAL INC	MARRIOTT INTL INC
BECTON DICKINSON & CO	MCDONALD'S CORP
BLACK & DECKER CORP	MEADWESTVACO CORP
BOEING CO	MEREDITH CORP
BROADCOM CORP - CLA	MONSANTO CO
BURLINGTON NORTHERN SANTA FE	MONSTER WORLDWIDE INC
CAPITAL ONE FINANCIAL CORP	MURPHY OIL CORP
CARDINAL HEALTH INC	MYLAN INC
CARNIVAL CORP/PLC (USA)	NEW YORK TIMES CO - CLA
CELGENE CORP	NUCOR CORP
CHESAPEAKE ENERGY CORP	NVIDIA CORP
CISCO SYSTEMS INC	PACTIV CORP
CLOROX CO/DE	PEABODY ENERGY CORP
CME GROUP INC	PEPCO HOLDINGS INC
COMERICA INC	PINNACLE WEST CAPITAL CORP
CONVERGYS CORP	PLUM CREEK TIMBER CO INC
CORNING INC	PROGRESSIVE CORP - OHIO
COUNTRYWIDE FINANCIAL CORP	PUBLIC STORAGE
DOVER CORP	ROBER HALF INTL INC
DTE ENERGY CO	ROWAN COS INC
DUKE ENERGY GROUP	RYDER SYSTEM INC
EATON CORP	SARA LEE CORP
ECOLAB INC	SCHLUMBERGER LTD
EOG RESOURCES INC	SCHWAB (CHARLES) CORP
EW SCRIPPS -CLA	SEALED AIR CORP
EXPRESS SCRIPS INC	SIGMA-ALDRICH CORP
FORTUNE BRANDS INC	SIMON PROPERTY GROUP INC
GAMESTOP CORP	ST JUDE MEDICAL INC
GANNETT CO	SUPERVALU INC
GENWORTH FINANCIAL INC	TECO ENERGY INC
GENZYME CORP	TELLABS INC
HESS CORP	TENET HEALTHCARE CORP
HONEYWELL INTERNATIONAL INC	TERADYNE INC
INTEGRYS ENERGY GROUP INC	UNION PACIFIC CORP
INTERPUBLIC GROUP OF COS	UNITED STATES STEEL CORP
INTUIT INC	UNITEDHEALTH GROUP INC
ITT CORP	VF CORP
JACOBS ENGINEERING GROUP INC	WELLS FARGO & CO
JOHNSON CONTROLS INC	WILLIAMS COS INC
	WYETH
	WYNDHAM WORLDWIDE CORP

## Overview of Performance Metrics

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Communicating executive performance targets is challenging and the relationship between pay and performance is often complex. Performance can be measured against a fixed goal (such as an earnings-per-share target) or a relative one (as compared against a peer group of companies). While we take into account that LTIPs metrics use relative measures and are easier to report than STIPs which use fixed goals to maintain a competitive advantage, it is troubling to see companies providing few or 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 would reveal competitive information.

Typically, the peer group used to set compensation levels differs from that used to measure performance. Performance goals influence the type of companies that are selected for the peer group.

Market-based performance measures may be compared with a larger peer group (such as a broad index); whereas earnings growth or return on invested capital will be based on an industry-specific peer group that reflects the inherent economic pressures facing a company and its management.

Performance measures can be segregated into two main categories: market-based (stock price or total return) and financial-based (earnings per share, return on assets, etc.). Some refer to these performance classes as "external" and "internal".

When designed correctly, performance-share plans will build shareholder wealth and establish a roadmap to financial success for senior management. A balanced incentive plan will include financial goals, stock-appreciation goals, absolute and relative goals. Thus, if the company does well against its business plan but lags others in its industry, the incentive payout will fairly reflect performance.

This review of companies reveals that the income/earnings measure is the most prevalent measure for the annual bonus plan. For example, about two-thirds of companies in the retail industry use net income or earnings. Earnings per share (EPS) is also widely used as a long-term incentive metric. The big debate is whether to include interest, depreciation and taxes when using operating earnings as a performance measure.

The most prevalent LTI metric is relative Total Shareholder Return (TSR), which is often used in the finance, insurance, real estate, transportation, utilities and manufacturing industries. Size does make a difference, as EPS is the predominate LTI metric at smaller companies (those with annual revenues of less than \$5 billion), whereas larger firms use EPS but relative TSR.

Financial-based performance metrics are often combined with individual non-financial performance measures for determining annual bonus payments. These individual objectives typically represent between 10% and 50% of the annual incentive weight. Individual performance generally represents a portion of the target award through the use of weights. Individual performance is occasionally used as a modifier or multiplier of the financial performance.

## The Importance of Disclosure

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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. Where a company omitted a performance target amount but discussed how difficult or likely it would be for the company or individual to achieve that target, we often sought more specific disclosure that would enhance investor understanding of the difficulty or likelihood."

There is evidence that some companies are resisting the SEC. A recent poll by Watson Wyatt of 135 large publicly traded companies found that 42 percent plan to disclose the specific goals used in their executive compensation plans on their 2008 proxies for the 2007 fiscal year, while 31 percent do not plan to release this information.

An Equilar study showed similar results, with larger companies being more compliant than smaller firms. This study shows that reporting has improved but, in most cases, is still far from full compliance and well below the implied survey results.

Even when companies have included discussion of performance goals in their proxy statements, the SEC has not been entirely satisfied with the results. That's because after examining hundreds of proxy statements during last year's proxy season, the SEC determined that the specifics of executive compensation decisions and policies need to be explained in clearer language for investors.

Indeed, most companies are disclosing the performance measures (but not the levels). Others are disclosing the performance measures and the weights on each measure (but not the levels). Make no mistake: the SEC requires the full disclosure of goals and performance measures, including weights and levels in comparison with actual performance and its effect on the executive's compensation.

Many companies refusing to comply with the rules cited potential competitive harm that could result from disclosure. Another concern of these companies is the possible difference between investor guidance and compensation-related performance goals. (In other words, the

compensation-related goals will be below those disclosed to investors.) There are also some firms that prefer keeping their goals flexible and subject to change, which makes disclosure particularly challenging.

One aspect of our study was to focus on which companies provided performance measures or metrics and weights, and to what level of performance would equate to threshold, target, and maximum bonus. We considered a company having adequate disclosure when the company included the below information:

- ◆ Threshold performance levels
- ◆ Target performance levels
- ◆ Maximum performance levels
- ◆ Threshold payout levels
- ◆ Target payout levels
- ◆ Maximum payout levels

Our results with respect to adequate disclosure are as follows:

	<b>STI</b>	<b>LTI</b>
<b>2006</b>	30%	54%
<b>2007</b>	44%	51%

\*It is important to note that the above percentages are based on companies that are required to disclose. If a company does not have an LTI or STI plan, they are not included within the above computation. Furthermore, where a company has a discretionary bonus plan, that company is also excluded from the computation.

## Prevalence of Performance Measures and Targets

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Surprisingly, many top U.S. publicly traded companies failed to disclose or explain their incentive performance payout formula. Our 2008 study of 100 large companies revealed that 69% in 2006 and 66% in 2007 had long-term incentive plans (LTIPs). Of those companies with LTIPs, only 54% in 2006 and 51% in 2007 included a complete set of metric values (threshold, target, maximum) and corresponding payout percentages (as shown below).

And the reporting is worse for short-term incentive plans (STIP) with only 44% of the companies providing complete metric and payout information in 2007. This is an improvement over the previous reporting year, the first year under the new SEC disclosure requirements when only 30% completed reported the pay for performance formula. This prevalence exclude discretionary bonus plans, which is a substantial factor in short-term incentive plans

Reporting for long-term incentive pay for performance formula has been consistently better than reporting of short-term pay, but this was largely due to the use of relative measures comparing performance with other similar companies on a percentile basis. Relative measures are much less sensitive to a company than the disclosure of specific values and targets. The following table provides more detail regarding the reporting of threshold, target, and maximum values where three performance levels are required by the SEC to be reported:

# of Performance Levels Reported (Threshold, Target, Maximum)	2006		2007	
	STI	LTI	STI	LTI
<i>No levels reported</i>	39%	36%	22%	26%
<i>One level reported (typically target)</i>	24%	4%	22%	14%
<i>Two levels reported</i>	7%	6%	13%	9%
<i>Three levels reported (full disclosure as required by SEC)</i>	30%	54%	44%	51%

An examination of payouts relative to target shows that more companies are exceeding targets than not. Among companies that reported short-term incentive payouts last year, more than half (about 65 percent) met or exceeded their performance goals, and more than one-third (about 35 percent) fell short of their targets.

This is a big drop from 2006, when 76 percent of companies reported that performance goals were met or exceeded. This data suggests that the economy has slowed from 2006 to 2007, or that performance goals are being set more fairly — or a combination of the two.

Long-term incentive payout versus target data is harder to find but suggests that goal setting was less rigorous as the percentage of companies that met or exceeded goals increased last year.

Most companies do not disclose long-term incentive performance and payout information. But of those that do, the percentage of companies that met or exceeded goals was 63% in 2006 and 57% in 2007.

## Performance Measures for Incentive Plans

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### Short-Term Incentive Plans/Bonus Plans

Total shareholder return is not often used for short-term incentive bonus plan metrics. In this study there was no direct use.

- EPS (29% in 2006 and 27% in 2007) and Income/Earnings (22% in 2006 and 24% in 2007) were the two most common measures used of all measures disclosed in the study.
  - 48% of companies with STIPs used EPS in 2007 as compared to 51% in 2006
  - 40% of companies with STIPs used Income/Earnings in 2007 as compared to 38% in 2006
- Other measures used included return ratios (17% in 2006 and 16% in 2007), sales growth (14% in 2006 and 16% in 2007), and cash flow measures (9% in 2006 and 11% in 2007).

### Long-Term Incentive Plans

Profit ratios, earnings per share, and total shareholder return (TSR) were the most common performance measures used by companies in our study.

- 25% of the companies used a return ratio as a performance measure in 2007 (24% in 2006), such as return on invested capital, return on equity, return on capital, and return on net assets.
- EPS was the next most frequent measure used by companies at 23%.
- 22% of companies with LTIPs use TSR, usually as a relative measure that compares performance to a peer group.
- Basic income measures such as EBITDA, net income and operating income were used by 8% of companies with LTIPs (11% in 2006).
- Other measures of somewhat lesser significance in 2007 were cash flow, including free cash flow (3%), stock price (2%), economic value added (1%) and economic profit (1%).

## Summary of Reported Measures

<b>Measure</b>	<b>2006</b>		<b>2007</b>	
	<b>STI</b>	<b>LTI</b>	<b>STI</b>	<b>LTI</b>
<b>Profit:</b> Earnings per share, net income, EBIT/EBITDA, operating income, pretax profit	52%	34%	52%	34%
<b>Total Shareholder Return:</b> Stock price appreciation plus dividends (relative and absolute), stock price	1%	23%	0%	24%
<b>Capital Efficiency:</b> Return on equity, return on assets, return on operating income, return on capital, economic value added	18%	24%	17%	26%
<b>Revenue:</b> Revenue, revenue growth	14%	11%	16%	13%
<b>Cash Flow:</b> Cash flow, cash flow growth	10%	3%	11%	1%
<b>Other:</b> Quality assurance, new business, market share, customer satisfaction*	5%	5%	4%	2%
<b>TOTAL</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>

Sample Sizes (number of companies): 100(2006), 90 (2007)

Short-term plans: 91 in 2006/85 in 2007

Long-term plans: 72 in 2006/65 in 2007

\*Important Point to Note: In the case of STI, this chart does not include individual performance plans of which over 50% of companies use in their short-term incentive plans.

## Absolute v. Relative Metrics

Virtually all short-term incentive plans use absolute metrics to determine performance and most TSR-based LTI plans use relative measures.

## Payout Percentages

For short-term incentive plans, the most common payout range (threshold to maximum) was 0% to 200% (21% in 2007). The next most common were 50% to 200% (16% in 2007) and 50% to 150% (9%). There was an increase in max payouts in 2007 to 200%.

	2006	2007
0%-200%	23%	21%
50%-200%	11%	16%
50%-150%	12%	9%

For long-term incentive plans there was a distinct shift from 0% to 200% payouts to 50% to 200% payouts. This increase in threshold, or more importantly, the establishing of a threshold greater than zero, is a trend that is expected to continue.

	2006	2007
0%-200%	16%	11%
50%-200%	19%	28%
50%-150%	9%	9%

## Investor Awareness

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### Effects on Investors

The study found that while incentive plans enhance executive performance, very little is revealed to investors about them.

Though the SEC's requests seem straightforward, implementation is proving to be difficult, especially for financial executives whose involvement is critical, but who are already burdened by Sarbanes-Oxley compliance and other finance issues that arise on a daily basis.

The performance goals need to be reasonable and aligned with the business plan and investor communications. In addition, the minimum threshold payout for an incentive plan should be adjusted to be fair to both executives and shareholders. Typically, STI plans have higher thresholds than LTI plans. In other words, the actual performance must be 90 percent of goal before the plan begins to pay out (typically, the plan will pay out 50 percent at this performance level). LTI plans typically have a lower performance threshold since they are more difficult to forecast over multiple years. This is key factor because some plans set their threshold level too low (or too high) and their maximum payout levels too high.

Performance-based compensation can be used to balance executive pay with corporate performance. A fair balance can be struck between shareholders and senior management under the oversight of the board of directors. However, the selection of performance goals can be difficult and the performance measures and goals must be disclosed to investors.

### Keeping Investors in the Loop

Investors are increasingly aware of executive compensation issues and are anxious to see if pay corresponds with performance. As a result, companies will be focusing on making shareholders more comfortable with their strategies by more clearly communicating goals.

To justify their executive pay policy to shareholders, companies in the United Kingdom are required to disclose certain information to shareholders regarding executive pay and hold an annual shareholder vote on a company's remuneration committee study. Though the vote is not legally binding, a "no" vote typically results in a public outcry and significant time and money spent in rebuilding the company's reputation.

In the U.S. there has been some interest in instituting a similar scheme. The U.S. House of

Representatives passed a “say on pay” measure this year, which could take effect in the near future.

Generally, shareholders do not mind if executives are paid high incentives, but only for outstanding performance. Executive compensation disclosure rules attempt to share the pay versus performance story with investors. Despite the anxieties some executives may feel toward disclosure, most companies have a positive story to tell and should showcase their performance strategy to shareholders.

## **About James F. Reda & Associates, LLC**

James F. Reda & Associates is a nationally recognized independent compensation and corporate governance consulting firm. Located in New York, New York (headquarters) with a satellite office in Atlanta, Georgia, our principal consultants have over 50 years of combined experience in compensation consulting. Our consultants are quoted frequently in leading media publications such as BusinessWeek, Forbes, Fortune, The New York Times, and The Wall Street Journal.

Our firm has extensive experience in the areas of equity awards, compensation committee advisory services, incentive programs of all kinds, and the performance evaluation and goal-setting process. We work with clients from the following industries: financial services, health-care, life-science, technology, retail and manufacturing. We have substantial experience working with private companies.

James Reda has authored two books on the subject of executive compensation and the role of the compensation committee, entitled *Pay to Win: How America's Successful Companies Pay Their Executives* (Harcourt: 2000), and *The Compensation Committee Handbook* (John Wiley: 2007), which is in its third edition. Mr. Reda served as a commissioner on the national panel "Executive Compensation and the Role of the Compensation Committee", assembled by the National Association of Corporate Directors. Mr. Reda is also a member of a task force created by pre-eminent trade group the National Association of Stock Plan Professionals in order to rationalize executive compensation.

### **Our Services Include:**

- Advising compensation committees on all executive compensation matters
- Providing corporate governance advice with respect to executive and board compensation
- Benchmarking total compensation, including: base salary, short-term incentives, long-term incentives, executive benefits and perquisites
- Assisting with all aspects of short- and long-term incentive plan design, including: tax, accounting, and SEC implications of such arrangements
- Working with companies to determine competitive employment agreement plan designs
- Providing expert witness testimony, opinion, and litigation support
- Evaluating CEO, other senior executives and board
- Providing assumption analysis and expense calculation for FAS 123R purposes
- Designing executive ownership guidelines and capital accumulation programs
- Reviewing special situation incentives associated with IPOs, business units, partnerships, distressed companies, and mergers & acquisitions
- Designing deferred compensation, supplemental executive retirement programs (SERPs) and other executive perquisite and benefit programs
- Designing change-in-control and severance programs