

Taking Aim At Performance Targets

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Short-term incentive plans enhance executive performance, but very little is revealed to investors about them, according to new research by James Reda and Associates LLC. And while companies are disclosing more about their plans, they have a long way to go before reaching full compliance with new U.S. Securities and Exchange Commission rules.

Earnings are the No. 1 performance measure across all industries, and companies are setting more difficult goals. Thus, the new rules have more closely aligned pay and performance and have informed shareholders of important performance goals.

Last year, the SEC started requiring companies to disclose executive pay-performance measures and goals. At the same time, many companies have been shifting the basis for their long-term incentive plans away from stock options to performance-share plans that are based on performance measures and goals.

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 both financial and operational performance. It's a complex task, and the stakes have been raised.


The SEC asserts that if executive compensation performance targets are central to a company's decision-making process, they 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.

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's requirements.

There is evidence that some companies are resisting the SEC. A recent poll

BY JAMES F. REDA AND DAVID M. SCHMIDT





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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. Reda's results show 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 refusing to comply with the rules cited potential competitive harm that could result from disclosure. Another concern 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.

Setting Performance Goals

In the Reda study, associates examined proxy statement disclosures for selected companies from the Standard & Poor's large-cap and mid-cap stock indexes for 2006 and 2007 (as reported in 2007 and 2008) with regard to short- and long-term incentive plan design characteristics as well as compliance with the associated SEC disclosure rules.

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 involve-

ment is critical, but who are already burdened by Sarbanes-Oxley compliance and other finance issues that arise on a daily basis.

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).

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.

For example, 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 establish a roadmap for senior management to financial success and will build shareholder wealth. 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.

Reda's review of companies reveals that 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 is also widely used. The big debate is whether to include interest, depreciation and taxes when using operating earnings as a performance measure.

EPS is also an often used long-term incentive metric. The other 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) and larger firms use EPS but relative TSR.

The 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 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.

Little Revealed

Reda's study, based on 2007 and 2008 proxy statements, highlighted the limited reporting even at the some of the largest companies.

Only 16 percent provided complete disclosure of performance metrics and payout information for short-term incentive plans. Reporting for long-term incentive performance metrics was much higher, at 46 percent, but this was largely due to the use of relative measures comparing performance with other similar compa-

nies on a percentile basis.

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 70 percent of companies reported that performance goals were met or exceeded. This data suggests: the economy has slowed from 2006 to 2007; and 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, a high percentage are exceeding goals — which is quite the opposite of the results of annual bonus payouts. For 2006, 60 percent reported that goals were met or fully achieved, while in 2007 that number rose to 70 percent.

Keeping Investors in the Loop

Investors are increasingly aware of executive compensation issues and anxious to see whether 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 report. 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.

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TAKEAWAYS

>> The SEC issued new proxy disclosure rules last year requiring that all performance measures and goals be released and compared with actual results. This requirement includes both short- and long-term incentive performance measures.

>> Some companies are resisting disclosure. A recent poll of large publicly traded companies found that less than a third plan to disclose the specific goals used in their executive compensation plans on their 2008 proxies for the 2007 fiscal year, citing potential competitive harm that could result.

>> New research by James Reda and Associates found that while incentive plans enhance executive performance, very little is revealed to investors about them. And while SEC requests seem straightforward, implementation is hard, especially for financial executives.

>> Most investors don't mind high incentives for outstanding executive performance. Despite the fears some companies have regarding disclosure, most firms have a positive story to tell and should not hesitate to reveal their performance strategy.
