

Long-Term Performance Plans:

overcoming design challenges

Buffeted by shareholder demands and regulatory mandates, companies are searching for the “right” long-term compensation vehicle that will balance rewards and performance.

Time-vested restricted stock lacks a sufficiently robust link to performance. While stock options provide a strong tie to performance, they have their limitations. For example, they do not provide direction as to key business results to pursue, and because they are viewed as a lottery by many, they lack muscle as a retention tool (and actually can be demotivating) in down markets. Consequently, stock options are now rarely embraced as the sole long-term incentive vehicle. Filling the void, long-term performance plans increasingly are viewed as a preferred solution, given their many advantages.

When designed right, long-term performance-based plans can build accountability for certain key metrics, or provide a good gauge of performance versus peers. In addition, they provide an opportunity to balance financial and stock market performance. They allow executives to earn shares based on financial goals — if relative total return to shareholders (TRS) is not used — while ultimate value is based on stock price performance. In this way, they

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QUICK LOOK

- ➔ Long-term performance plans increasingly are viewed as a preferred solution, given their many advantages.
- ➔ Companies operating in uncertain markets or industry sectors, particularly cyclical businesses, may not be able to anticipate or forecast market changes.
- ➔ Companies electing fixed goals face the prospect that the plan may or may not pay out during prolonged up or down markets.



reflect the elements of performance that executives can more directly control. Further, these plans can reinforce key financial outcomes or strategic initiatives, enabling a company to direct performance. Long-term performance plans also can preserve tax deductibility under 162(m) and provide an intermediate term incentive to complement annual plans and stock options.

In addition, they address retention in down markets. While not as strong as time-vested restricted stock because they hold more risk, performance-based plans offer more retention power than stock options when they include performance metrics that participants feel they can control.

Yet with all these potential advantages, performance-based plans are not a panacea. They work well for companies that can set clear performance objectives for the short to intermediate term. However, because they demand appropriate measures and suitable goals, they may not be practical for all companies, particularly those in cyclical industries — unless relative measures are used — or those experiencing significant change, such as a major restructuring or acquisition, a complicated turnaround or troubled financial performance.

Companies entertaining the idea of performance plans, as well as those already offering them, need to deter-

mine if a performance-based plan is indeed the right step, given the company's ability to set goals and select the optimal measures. Four ways to approach goal setting include:

- Basing goals on business plans
- Establishing fixed goals that continue for multiple performance cycles
- Comparing relative performance
- Setting shorter performance cycles.

Each approach brings some baggage in the form of issues and limitations, but as explained later in this article, the obstacles are not insurmountable roadblocks, just detours that call for appropriate rerouting. (See Table 1.)

Goals Based on Business Plans

Typically, long-term incentive goals are tied to business plans, but many companies find it difficult to set goals three years in advance. Companies operating in uncertain markets or industry sectors, particularly cyclical businesses, may not be able to anticipate or forecast market changes.

Some companies hold the philosophy that goals represent commitments that must stand, regardless of the impact of external factors. Others allow boards to consider material changes that result from external factors in order to ensure the plan is perceived as fair and maintains its motivational value.

The ability to adjust goals after the

start of the performance period can be a desired feature, particularly where business acquisitions and dispositions occur. However, “non-GAAP” adjustments, even if carefully prescribed and nondiscretionary, have recently come under greater scrutiny by audit firms. Where treated as modifications under SFAS 123R, these adjustments may result in additional compensation charges. Moreover, the ability to make discretionary adjustments may, if too broad, result in liability (i.e., “variable”) treatment.

It is critical to ensure symmetry so that great performance is rewarded and underachievement is penalized. Another factor to address is how unplanned events, such as major acquisitions, will impact assessment or performance and payouts.

The following are ways to moderate for uncertainty:

- **Adjust for market.** Adjusting for the market works well in companies with established peer groups and market indices. At the beginning of the period, the company sets annual and long-term incentive goals based on its best interpretation of forecasted market conditions. At the end of the period, payouts are adjusted automatically in a prescribed manner based on the extent to which actual market conditions differ materially from initial

TABLE 1: GOAL-SETTING APPROACHES FOR PERFORMANCE-BASED PAY

Goal-Setting Approach	Challenges	Ways to Address the Challenges
Goals based on business plans	<ul style="list-style-type: none"> • Uncertain/volatile market or industry; cyclical business 	<ul style="list-style-type: none"> • Predefine allowable adjustments for market conditions or unplanned events. • Allow for board discretion.
Fixed goals	<ul style="list-style-type: none"> • Plan may not pay out in prolonged down markets • Windfalls may result if base year results are too low 	<ul style="list-style-type: none"> • Provide significant rewards opportunity in good years to underscore the plan's potential. • Establish a “high water mark” base for results or the trailing average.
Relative performance	<ul style="list-style-type: none"> • Peer group consolidation/companies going private • Not all financial measures are directly comparable 	<ul style="list-style-type: none"> • Determine how to adjust for market and peer changes. • Measure TRS, which is comparable across companies.
Shorter performance cycles	<ul style="list-style-type: none"> • Doesn't motivate or reward sustained achievement 	<ul style="list-style-type: none"> • Extend the vesting period after earn-out.

If the prospect of adjusting goals is not palatable, companies may consider establishing fixed or relative goals, or keep the line of sight short and go with one-year goals, followed by multi-year vesting.

assumptions. If the market is stronger than expected, then payouts are lower because the degree of actual difficulty was less than forecast. Conversely, if the market becomes tougher during the period, then the plan will pay more because the challenge was greater, and the achievement is more profound. The intention is to recognize the inherent volatility in the market and reward superior performance versus market conditions, without totally insulating participants from absolute profit results. This approach has been used with good success in the semiconductor industry and in the commodity mineral business.

- **Adjust for unplanned events.**

Anticipating opportunistic events, such as acquisitions and divestitures, is difficult. Yet provisions can be included that allow goals to be adjusted for these events. One approach is to adjust goals based on the board-approved proforma for the acquisition. This has the advantage of providing a set of checks and balances — if management is too optimistic about the expected results, then it faces stretch goals with a high degree of difficulty. Conversely, if management is too pessimistic regarding future performance, the acquisition likely will not be approved. For divestitures, goals can be adjusted based on the expected contribution of the divested business to the planned targets.

- **Allow for discretion.** Some com-

panies provide discretion to their compensation committee, allowing it to weigh market factors and adjust payouts as appropriate. Rather than use a formulaic approach based on relative performance as described in this article, the committee looks at performance versus peers on a more judgmental basis. If a company has few peers, this may be the only practical course of action for addressing relative performance. However, the accounting for such discretionary adjustments may make such approaches problematic going forward. If the committee retains significant discretion, the awards may have to be accounted for as liabilities accounting, and there may also be 162(m) compliance issues.

If the prospect of adjusting goals is not palatable, companies may consider establishing fixed or relative goals, or keep the line of sight short and go with one-year goals, followed by multiyear vesting. Each has challenges, but with careful management such designs can be workable.

Fixed Goals

This approach defines aspirational performance on a sustained basis (e.g., 12-percent earnings growth during a three-year period) as separate from the business plan, and accordingly establishes long-term incentive goals. These goals remain fixed during multiple performance cycles. The plan pays out based on goal attainment

regardless of business plan achievement. Companies electing fixed goals face the prospect that the plan may or may not pay out during prolonged up or down markets. The performance during the initial cycles strongly influences participants' perceptions of the plan. If the plan pays out in the early years, participants can experience the upside and be more willing to accept the downside in years where performance may not be as strong. Conversely, if the early years bring marginal or no payouts, then participants may quickly adopt the attitude that the plan "does not work."

Fixed goals can work well when a company can agree on long-term expectations for good performance, regardless of what it believes it can achieve during any single three-year period. It also allows a company to avoid negotiation or maintain a multi-year focus, even though establishing three-year business plans is deemed infeasible for purposes of compensation. A leading food company that sets sustained performance expectations finds executives willing to live with periods of no payout because they know rewards can be significant in good years.

One potential shortcoming of such plans is that a really bad year provides a base that can result in windfalls for subsequent cycles. One fix is to establish a "high water mark" whereby the base can never fall below a prior high or some trailing average.

Relative Performance

Measuring performance relative to peers is another option for companies that face goal-setting challenges.

Relative measurement works well when the peer group is well-defined and of sufficient size and comparability. Utilities, retail and consumer products are three industries that meet these standards, and relative performance measurement is frequently used in their performance-based plans. Provided the prior standards are met, relative measurement can be particularly useful in these industries, especially if they are cyclical, as is the case with retail.

Relative performance measurement, although conceptually appealing does have some drawbacks:

- Industry consolidation can swallow up peers, so companies must determine how the metric will be adjusted to reflect changes in the peer group due to acquisitions.
- Volatile players can sometimes do better than steady performers since big improvements for a poor performer in past years can move them to the top of the relative rankings in later years.
- Companies also need to determine whether “good” relative performance will be rewarded even if the performance declines, but the decline is less than the competition.
- Relative measurement is an after-the-fact calculation, so incentive value can be limited because it is hard to communicate how a company is doing on an ongoing basis.

Relative TRS is the most effective metric because it is known on a daily basis and is directly comparable across companies. Some companies also use relative earnings per share (EPS) or relative return on capital employed (ROCE). However, using financial metrics requires significant work to ensure an “apples-to-apples” comparison.

A major department store uses a mix of vehicles but feels that a portion of awards, at all times, should be based on relative performance. Relative TRS is used to balance the measurement of absolute performance, which is considered in the annual plan through financial and operational measures. The retailer also offers stock options to reward for absolute stock price performance. The company believes that measuring TRS versus peers contributes to a focus on being an outperformer.

Shorter Performance Cycles

Some companies get around the goal-setting challenge by including one-year goals in a long-term plan. Although it makes goal setting easier, one-year goals do not provide the short-term/long-term balance that many companies seek when using a multiyear performance plan, nor do they help sustain longer-term performance.

To achieve some long-term/short-term balance, companies address the longer term by having the award vest over a period of years once earned (e.g., two years), with the idea that performance must be sustained for the award to ultimately have value. Companies need to ensure there are solid reasons for emphasizing one-year performance. It works best when a lot is riding on near-term performance; e.g., a company in turnaround needs to prove to analysts that it can meet its one-year commitments. It also may be the appropriate solution in cyclical industries where relative performance measurement is not an option, perhaps because too few peers exist.

Final Thoughts

Performance-based long-term incentives can be used to ensure executive pay swings with shareholder fortunes, yet for every advantage, there’s a slippery downward slope, particularly for

companies that face difficulties setting goals because of market uncertainties or major changes. Companies that make the effort to understand the challenges and adopt viable measures for addressing them may find performance-based long-term equity plans to be an answer that serves all stakeholders.

Those that decide performance-based plans aren’t viable have two alternatives: They can stay with stock options or adopt an enhanced annual plan that provides enhancement above target.

As with any compensation approach, the best solution is the plan rooted in a company’s unique business and talent characteristics and designed to drive shareholder value. ^{WS}

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