First Principles of Executive Pay: Setting Effective Performance Goals

BY JOHN BORNEMAN

Nearly all companies have the same philosophy for their executive compensation plans. The goal is to create incentives that drive the creation of value for shareholders and then align the pay for the executives with their performance against goals that will achieve this objective.

While this ideal of "pay for performance" sounds simple in principle, creating the right calibration can be very challenging in practice, as many members of board compensation committees are painfully aware.

Over much of the last decade, most companies have relied on a common formula to strike the right balance in incentive plan design and goal setting:

- Create business plans that represent year-over-year improvements in performance.
- Assume that the level of improvement is consistent with the pay philosophy (e.g., median pay for median performance).
- Incorporate an element of relative total shareholder returns into the long-term incentive plans to directly align pay and performance results.

In a growing economy, this approach has generally worked pretty well, and only the outliers needed a more robust assessment of the pay for performance linkage (e.g., companies with above market pay positioning or in declining industries or markets).

However, as uncertainty increases and markets begin to look weaker, setting effective performance goals is likely to become much more difficult. How should a board respond if performance results start declining year over year? When is just maintaining prior-year results good performance, or could be considered even excellent performance? How should management be rewarded when the 'stretch' in their business plans becomes ever more difficult to achieve?

The answer is a return to first principles: Be clear on the objective of your incentive plan design and setting performance goals that meet those objectives.

Establishing performance goals to support pay for performance

If the objective of the incentive plan design is aligning pay with performance for shareholders, then the board should answer three key questions in order to establish effective performance goals:

1) What performance drives shareholder value? If the goal is to drive shareholder value, then clearly it is important to understand what performance is most important to achieve that result. Growth? Margins? Return on invested capital? The drivers of value creation are not always the same for every business or industry, and being clear on these drivers is essential to setting appropriate goals.

2) What does "good" performance look like? What is exceptional performance? How do the proposed goals compare to recent peer performance? How do they compare to analyst expectations for the company and industry? Do we think we are aligning 50th percentile pay with 50th percentile performance?

3) How will the goals be perceived by our shareholders? Shareholders are becoming more sophisticated in evaluating performance goals and assessing year-over-year performance and results. Where goals do not represent continuous improvement, they will receive additional scrutiny, and boards should be prepared to explain and disclose the rationale for falling performance in particular, especially if payouts continue to be at or above targets.

Making it work — testing and verification

Answering these questions often requires a rigorous assessment of company performance, which may go beyond annual and long-term business planning. Boards need more comprehensive context to help in making decisions when setting incentive plan goals to ensure effective pay-for-performance alignment.

The following inputs are often considered when setting incentive goals, in addition to any internal business plans:

- historical company performance;
- historical performance vs. goals;
- historical performance vs. guidance;
- historical performance vs. peers;
- relevant economic forecasts (e.g., gdp, inflation);
- analyst expectations; and
- analyst expectations for peers.

Such benchmarking of performance provides additional context for the board, allowing directors to either challenge management's goal setting relative to plan (where warranted), or providing a stronger rationale for the board to pay at or above "target" in an environment of flat to declining performance if the data continues to support such payouts as "exceptional" performance in a weak market.

As setting goals becomes more challenging, and the "story" for shareholders becomes more complicated, it is incumbent on boards to more rigorously assess the performance goals in their incentive plans to ensure effective pay for performance alignment. ■

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