Harvard Law School Forum on Corporate Governance and Financial Regulation

Thoughts for Directors

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Tags: Board evaluation, Board performance, Boards of Directors, Compensation disclosure, Executive Compensation, Executive performance, Firm performance, GAAP, Pay for performance
More from: Catherine Keller, Joel Trotter, Steven Stokdyk, Latham

Editor's Note: Steven B. Stokdyk and Joel H. Trotter are global Co-Chairs of the Public Company Representation Practice Group at Latham & Watkins LLP. This post is based on an article by Mr. Stokdyk, Mr. Trotter, and Catherine Bellah Keller.

Boards and management regularly use key performance indicators or metrics to oversee their businesses. These metrics typically cover financial and operating matters and are specific to each company and within industries. Metrics may be financial or operational, qualitative or quantitative, absolute or relative, or focused on short- or long-term performance.

Metrics are critical to understanding and managing trends in the business and are often used to determine compensation. As metrics may garner close attention from analysts and investors, boards should understand how their companies' metrics are chosen, developed and reported.

Choosing and Defining Metrics

Many different considerations go into choosing and defining which metrics are appropriate for a company. Ideally, the metrics will reflect the important aspects that show how the business is performing; whether measuring the number of customers or employees or amount of products or services provided to customers. Directors may inquire of management:

- How does each metric relate to the company's strategic objectives and provide useful information to assess the company's progress?
- How do the metrics track the company's performance and prospects?
- Do the metrics serve as indicators of risk for the company?
- Which metrics do peer companies and others in the industry use, and in what ways are the company's metrics intended to differ or align?

Calculating Metrics

Board members should understand how the metrics are defined and calculated. Metrics should be readily verifiable with a transparent calculation methodology that explains any changes to the calculations. Directors could ask:

- How are our metrics calculated compared to our competitors?
- What judgment on the part of management goes into calculating the metrics and how can that change over time?
- What internal controls and procedures are in place to check the calculation of the metrics?
- Have we publicly explained the areas where our metrics require judgment on the part of management?

Disclosing Metrics

Companies generally disclose key metrics on a quarterly and annual basis in their public reporting. Directors might inquire:

- How much public emphasis do the metrics warrant?

- Does the reporting sufficiently explain the calculation and impact of the metrics?
- How does the management's discussion and analysis (MD&A) narrative use those metrics to explain changes in the company's financial results?
- How do the risk factors relate to potential changes that may affect the metrics?
- Are the metrics GAAP measures, non-GAAP financial measures requiring additional disclosure or operational measures?
- Are the metrics reported consistently and publicly in compliance with Regulation FD?

Using Metrics in Compensation

Pay-for-performance and say-on-pay measures have increased the focus on the interaction between performance metrics and executive compensation. Directors can ask:

- What is the intended relationship between the metrics and executive compensation?
- What impact do the metrics have on incentivizing behavior that could increase risks or undermine the company's strategic objectives?
- What discretion does the compensation committee retain based on the chosen performance metrics?
- How will proxy advisory firms view the impact of the metrics on compensation?
- How will proxy advisory firms and investors, who often focus on the rigor of performance goals, view the impact of the metrics on compensation?

Conclusion

Directors may benefit from open dialog with management on these issues and from understanding external views on the company's metrics. These steps can assist boards in understanding the business, considering the views of investors, assessing risks and determining appropriate levels of compensation.