Understanding Performance Measurement in Executive Compensation

by: Andrew McElheran

Performance measurement as we exit the pandemic

In times of economic uncertainty, senior executive compensation design often comes up for revision. The economic uncertainties presented by 2020 and the COVID-19 pandemic have given this type of conversation new momentum. According to our recent research, a majority of companies are considering changes to their 2021 annual incentive plans as a response to these uncertainties. The most common change under consideration is the flattening of the performance slope—the relationship between the performance goals and the corresponding incentive payout. Changes to long-term incentive plans are less common, based on available data so far.

The current economic environment and related spotlighting of social justice issues has also increased company and investor focus on Environmental, Social, and Governance (ESG) indicators. Many companies are considering whether and how to incorporate (non-financial) ESG criteria into their incentive plans.

Historically, “performance measurement” referred mostly to financial performance - e.g., earnings growth - and share price performance. As organizations reevaluate their executive compensation plans for 2021, they should consider which financial metrics are most important as well as how to incorporate more non-financial indicators into the overall program. This is certainly important for public companies whose shareholders have a vote in executive compensation packages, but many organizations are expanding their definitions of what “good performance” means, whether public or private.

Financial vs. non-financial performance measurement: trends

Financial performance measurement has historically referred to earnings performance and absolute or relative share price performance/total shareholder return (TSR). More recently, there has been investor interest in performance metrics that incorporate the balance sheet - e.g., returns on capital. One proxy advisory firm moved to using Economic Value Added (EVA), which is a measure of performance based on returns on capital over cost of capital. Depending on the company’s business strategy, more differentiated metrics might make sense. Generally, organizations looking to use financial metrics in performance measurement should look for a mix of growth-focused and profitability-focused metrics, in some combination. “Outcome” measures such as share price performance have historically had a significant weight in a long-term plan context, and this is likely to continue given uncertainty and difficulty with setting performance goals for financial metrics, post-pandemic.

Trends in non-financial performance measurement reflect a shift from a shareholder-centric to a stakeholder-centric corporate philosophy. In 2019, 181 CEOs signed the Business Roundtable’s Statement on the Purpose of a Corporation and committed to leading their companies for the benefit of all stakeholders, including customers, employees, suppliers, communities, and shareholders. Implementation of this vision has happened mostly through ESG indicators, some of which are becoming compensable metrics (e.g., employee engagement, diversity and inclusion, environmental impacts). Our research shows that 42% of organizations surveyed plan to add or increase the use of non-financial metrics in the wake of COVID-19, (at a relatively minor weighting of the total, at least initially).

Which indicators are right for my business?

Of all the possible financial performance indicators, the correct ones for a business to choose are the ones that align with the business strategy and plan. It is relatively simple to look at readily available organizational data and develop a compensation plan using the most prevalent metrics. Yet just because a metric is popular does not mean that it is the right one to use. Consider this example from Harvard Business Review:

Take Frederick Reichheld's widely used Net Promoter Score, which measures the likelihood that customers will recommend a product or service. The NPS is a useful indicator only if recommendations play the dominant role in a purchase decision; as its critics point out, customers' propensity to switch in response to recommendations varies from industry to industry, so an NPS is probably more important to, say, a baby-food manufacturer than to an electricity supplier.

Which metrics are ideal is highly dependent on several factors including company size and maturity, industry, business strategy, and current financial position. For a company that talks to investors in financial performance terms, those are likely the metrics that will be included in the compensation plan.

The linkages between non-financial performance indicators and value creation are much harder to discern and measure correctly. The "stakeholder" view of the corporation also implies that some metrics ought to be included because it is "the right thing to do", irrespective of a demonstrable link to shareholder value creation. Either way, non-financial performance measurement is growing in importance - a trend that was already underway has accelerated, post-pandemic. Unlike financial data, the frameworks for ESG performance measurement are relatively undeveloped, particularly for metrics tied to incentive compensation. Companies must essentially set their own standards for progress and success against ESG initiatives, many of which may rely on either qualitative or quantitative analysis to truly determine performance.

Moreover, the most straightforward measurement approaches - measuring outcomes based on lagging indicators - may have unintended consequences. For example, addressing a business objective of improving workplace diversity is most efficiently accomplished by measuring changes in percentage representation from diverse groups. Some would argue that such an approach would treat the symptom rather than the disease. The unintended consequence would be a focus on improving "headline" numbers through quotas, without addressing any underlying workplace issues that could be undermining the organization's objective of a more diverse workforce. However, this does not mean that an organization should not be proactive in increasing diversity. If diversity is a key strategic initiative, the company must consider either trying to accomplish goals without resources at all or to "pay up front" and use leading indicators to help determine success of diversity programs. (For example, a company could invest in improving interview processes to achieve diversity goals organically, rather than compensating executives for fulfilling desired statistics after the fact.)

Just like financial performance measurement, ESG metrics should ideally align to the business strategy if they are factored into compensation plans. However, not all indicators lend themselves well to being compensable metrics. In general, companies should consider initiatives they will *pay for* as a subset of initiatives they will *pursue*. There are too many possible ESG indicators for any company to address well. It is up to each individual organization to prioritize ESG initiatives and decide which ones should be incentivized, at least at present.

The right place for measurement - the short-term incentive plan versus the long-term plan

Most companies have both an annual (short-term incentive) plan and a long-term incentive plan, and they have different advantages and disadvantages. Most organizations use some form of both. Generally, annual plans are more focused on creating incentives to drive executive and employee behavior. They encourage more specific action steps to achieve certain outcomes. For a variety of reasons (some technical - e.g., related to financial accounting and reporting), non-financial performance goals are also usually included in annual plans, not long-term plans. This despite the fact that some issues are ideally measured over a longer time frame - including most ESG metrics, arguably. It tends to be easier for leadership to sustain motivation and behavior change for ESG, strategic, or operational goals on a short-term basis, in part because they cannot be measured in clear financial terms.

Long-term incentive programs are relatively less about influencing individual behavior and relatively more about establishing clear alignment between shareholder value and organizational performance. It is difficult to set financial goals over a multi-year period, so many companies rely on external indicators such as share price/TSR, and *relative* performance measurement, in a long-term plan context. (Relative TSR remains the most prevalent long-term performance measure, for example).

Conclusion

Performance measurement is both an art and a science. Selecting the right performance indicators is highly dependent on industry, company size, business strategy, and other factors. As we continue to recover from a chaotic 2020, it is more important than ever to take a step back and reassess. If the business strategy has changed, performance measurement indicators should likely be adjusted as well. Most organizations should use a mix of growth-focused and profitability-focused metrics to evaluate financial performance annually. Non-financial performance indicators should be carefully chosen to support the business strategy with the understanding that no company can tackle every ESG challenge at once. Long-term incentive planning might seem outdated in these chaotic times, but it is business critical to keep an eye on trends and external factors that will affect short-term goal setting.