THE DILUTION OF INCENTIVE COMPENSATION

By Jamie McGough

EXECUTIVE INCENTIVE COMPENSATION is losing its focus and effectiveness as the number of metrics has grown. This is made worse as newly added metrics are often assigned relatively low weight, with a corresponding reduction in weighting of traditional financial and critical operational metrics. In addition, many of these new metrics often defy the precision historically expected of incentive compensation measures. For example, ESG metrics are frequently low weighting and low precision metrics although they are not the only ones.

Incentive compensation is a managerial/governance tool to motivate and align behaviors with essential criteria and outcomes that are fundamental to the purpose of the organization. For commercial enterprises, historically these criteria have been self-evident and nearly universal—profitability, growth, value creation and, in select instances, critical operational outcomes.

What's Happened

The number of performance metrics used in executive short-term incentive plans has increased by up to 50 percent among large public companies. Among the S&P 500, the number of annual incentive plan metrics typically used in 2022 was four to six measures, up from approximately three measures used in 2012. Also, the percentage of the S&P 500 with measures with less than 20 percent weighting has grown from 15 percent in 2012 to 35 percent in 2022. There has also been a material growth in individual and/or scorecard metrics that involve a multitude of criteria, which means further dilution/erosion in the focus and precision of these plans.

Incentive compensation is, in many ways, a blunt instrument for directing and reinforcing certain behaviors. Consequently, this tool is well suited for a very limited and unique number of tasks. When the number of measures grows and weighting and/or precision of those metrics declines, there are several problematic outcomes:

- **Diffuseness.** More measures mean less focus on mission critical financial and operational goals.
- **Reduced effectiveness.** With reduced focus comes lower impact over time in driving behaviors to achieve these essential and enduring business goals.
- **Complexity.** More measures mean greater complexity, increased risk of misunderstanding and more intricate administrative mechanics.
- **Disclosure challenges.** The description of incentive plans in the proxy involving many measures can take up many words and pages, which is difficult to draft, that invariably frustrates and confuses shareholders.

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These practices reflect the increasing tendency that incentive plans should be a repository for all that an organization values and use it as a platform for communication. This should not be the case. Absence from an incentive plan neither means irrelevance nor indifference. Every day executives/employees are involved in innumerable activities that are not in their incentive plans, involving organizational habits, operational execution, financial decisions and the continuation of a company's culture. For example, civility, integrity, reliability, professional development, waste reduction and cybersecurity are just a few criteria organizations attend to regularly but are almost never in an incentive plan. These are baseline expectations, self-evident tasks, and/or areas that simply may not lend themselves to the typical mathematical regimen of incentive plans. This does not make them unimportant but simply not fitting for incentive compensation.

Evaluating Measures: Suitability for Incentive Compensation

There are some questions that can be posed to assess whether an incentive plan is becoming diffuse and therefore diluting its effectiveness.

1. Are there metrics (and if so how many) with less than 10 percent or even 15 percent weighting?
2. Are there metrics that require considerable discretion and/or involve criteria where it is unclear what constitutes success or failure?
3. Does the plan include measures that, if results were below target, a company would be highly uncomfortable to discuss, approve and disclose this in the proxy? (Note: Many social metrics fall into this category.)
4. Are there metrics where setting precise goals is either highly challenging or potentially a source of risk for the organization if publicly disclosed?

There are no absolutes to incentive compensation. There are industries, such as those that are commodity price sensitive, where greater discretion/judgment is needed. However, in general, answers to these questions can illuminate whether incentive plan metrics and structure pose a risk to the plan's effectiveness. Again, this does not mean these criteria are unworthy areas of attention, only that such criteria are not well suited for the narrow purposes of incentive compensation.

Path Forward

Incentive compensation has a narrow range of effectiveness. It is well disposed to reinforce the fundamental priorities of commercial enterprises—profitability, growth, value creation and highly selective operational criteria pivotal to success. Restraining the number of metrics and maintaining focus on a few, essential measures makes for greater plan effectiveness and corresponding improvements in business outcomes.

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