Should Companies Use Individual Performance Measures in Executive Annual Incentive Plans?

According to the Meridian 2017 Governance and Incentive Design Survey[1], 43% of *Meridian 200* companies use an individual performance component in their executive annual incentive plan, typically as a supplement to financial measures. Actual usage may be higher as the 43% does not account for Compensation Committees using discretion to adjust awards for individual performance.

When evaluating whether including an individual performance component is appropriate, companies may want to consider the following questions:

- Does the company's culture support differentiating executive payouts based on individual performance or is it more of a team-based approach?
- Is it appropriate to focus and reward executives for individual performance that may not directly align with financial performance?
- Might individual performance modifiers help mitigate extremely high or low short-term incentive outcomes?
- Is the company comfortable disclosing individual goals and achievements, or failure to achieve them, within the Compensation Discussion and Analysis section of the proxy?

Design Alternatives

There are generally two ways companies use individual performance measures. More than half (58%) of *Meridian 200* companies use an individual component as a separately weighted measure, generally 10% to 30% of the overall plan weighting. The other 42% use individual performance as a modifier to the financial results, generally ranging from +/- 15% to 30% of the financial performance results.

Each design has its own advantages and challenges.

Individual Performance Measures as a Weighted Component
▪ Allows for a portion of payout independent of financial goal achievement. — If desired, can require threshold financial performance before any payout on individual components can be made. However, companies facing performance challenges may prefer that executives can earn a portion of the bonus separate from financial performance. ▪ Can be challenging to set a range of achievement levels for individual components (e.g., how to define over-achievement). Can result in individual goals being all or nothing with no under- or over-achievement potential, which in turn may result in overall incentive plan leverage reduction. ▪ Can create expectations of similar payouts year after year as any reduction may be viewed as a negative indicator of performance, even if still above target. ▪ Can be awkward to rate proxy-named executives below target and disclose details in the proxy. Similarly, it can be viewed cynically if all individual goals are achieved at well above target or maximum levels.

[1] http://www.meridiancp.com/2017-meridian-corporate-governance-incentive-design-survey/

Individual Performance Measures as a Modifier
▪ Requires at least threshold financial performance be achieved to have a value that can be modified. ▪ Works well in high-performing companies since a higher percent of target earned based on financial performance provides for a larger base value to modify. — Modifying above-target financial performance is viewed more favorably by shareholders vs. modifying below-target performance to target or higher. — Designs often provide that payouts cannot be modified above a certain level (e.g., 200% of target). ▪ Can reduce the need for special individual cash or stock recognition awards outside the traditional programs. ▪ Requires accruing for a modifier pool beyond the financial measure performance tracking, or using a zero sum approach which can be challenging for high performing executive groups. ▪ Can create expectations of similar adjustments year after year as any reduction can be viewed as a negative indicator of performance, even if still a positive modifier. ▪ Can be awkward to rate proxy-named executives below target and disclose details in the proxy. Similarly, it can be viewed cynically if all executives receive positive modifiers.

The best fit for a particular company will be based on business circumstances, company history, performance expectations and the executive team. The key is to consider how the advantages and disadvantages of each design fit into each company's culture, compensation philosophy and program objectives.