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Why You Need a Holistic View of Pay and Performance

Setting an overall pay strategy involves more than just defining pay and performance.

AS companies continue to refine their executive compensation strategies for a shifting business landscape and closer shareholder scrutiny in the say-on-pay era, one key goal is ensuring a close link between executive pay and company performance. Often, executive compensation strategies seem to be focused on narrow definitions of pay and performance — for example, target compensation for pay and total shareholder return (TSR) for performance.

However, there are various ways to define pay and performance that are useful to consider in setting the overall pay strategy and in measuring the effectiveness of the pay programs on an ongoing basis. At the authors' company, part of the guiding principles for executive compensation is a recommendation that organizations take a holistic view of pay and performance to reflect a broad range of financial outcomes as well as strategic considerations that affect whether and how the company creates value for its shareholders and other stakeholders. To ensure an effective pay strategy, the creation of value needs to be viewed from quantitative and qualitative perspectives, over multiple timeframes, and in light of short- and long-term outcomes.

Effective Strategies for Challenging Times

Taking a holistic view of performance is especially critical in times when various indicators of business performance send mixed signals. For example, corporate revenues

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and earnings growth decelerated in 2012, while stock price performance for the year was better than in 2011 when earnings results were stronger. Figure 1 shows the correlation (or lack of it) in recent years between TSR, a key metric for many investors and proxy advisers in assessing pay-for-performance alignment, and corporate earnings growth, a key metric used in many executive incentive plans.

The tenuous correlation between corporate financial performance and stock returns in any one year underscores the ongoing struggle companies face in trying to appropriately reward executives for meeting key corporate performance goals while maintaining a strong linkage with shareholders. Metric selection and goal setting may prove especially challenging for 2013 as companies balance conservative outlooks with an appropriate level of stretch in future performance goals.

Beyond Benchmarking Target Pay Levels

Beyond pay strategies that set target pay relative to market benchmarks, companies are under growing pressure to demonstrate the effectiveness of their compensation programs by analyzing pay outcomes and performance results. In the "Executive Compensation Flash Survey," conducted by Towers Watson in October 2012, slightly more than half of the 253 respondents reported using summary compensation table (SCT) pay in their pay-for-performance analyses, although one-third reported using some form of realizable or realized/earned pay. For the definition of performance, most companies reported using TSR and one other measure of operating or financial performance. Figure 2 shows the components of pay commonly included in the various definitions.

A strategy that moves beyond traditional target and SCT concepts to include earned and realizable pay allows companies to assess actual pay outcomes and what is ultimately being delivered to executives on a multiyear basis. By conducting rolling analyses of earned and realizable compensation over, say, three- and five-year periods, companies can test how actual pay levels compare with their own target levels and with the market. Often, such comparisons will generate important insights about:

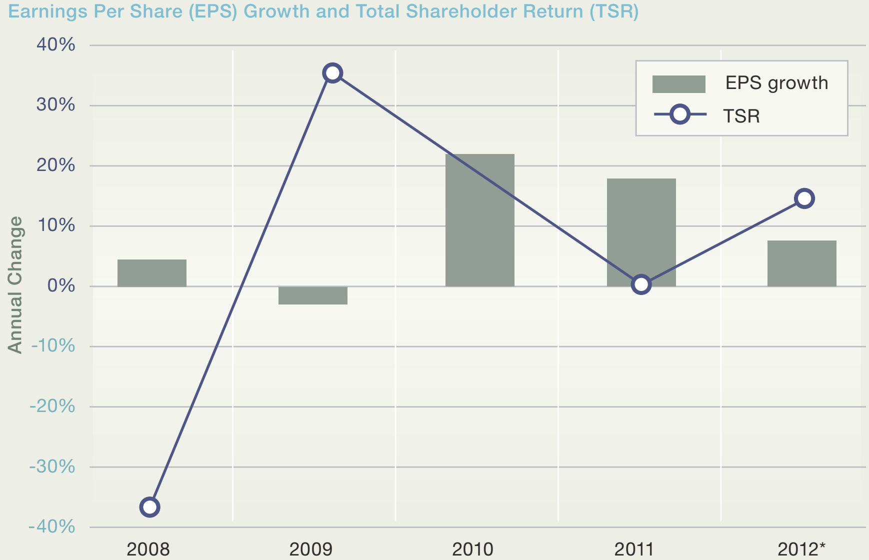
- The effectiveness of the company's target-setting for bonus and performance plans (either too soft or too hard)
- Differences in pay and long-term incentive mix and how these can generate significant differences in actual pay outcomes
- How companies can refine their pay programs over time.

A Wider Lens on Performance

As highlighted previously, most companies focus heavily on TSR and earnings growth in assessing pay and performance. At a high level, this is a reasonable starting point. But at a more strategic level, this approach ignores many important drivers of sustainable value creation, such as growth, profit margin, cash flow generation and appropriate leverage. Thus, the baseline assessment of

Figure 1 | S&P 500 Median

Earnings Per Share (EPS) Growth and Total Shareholder Return (TSR)



*EPS through the first three quarters of 2012, annualized; TSR through Dec. 31, 2012

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financial performance in pay-for-performance analyses by the authors' company uses a composite score that considers each of the company's financial statements, as well as market-based results. Applying this approach to the S&P 500 index shows rather modest overall performance in 2012 compared with recent years.

The composite performance scorecard provides a quantitative assessment of financial performance and market-based results. This approach provides insights into growth, quality of earnings and balance-sheet management as well as how the market perceives the company's stock. Quantitative results need to be understood because this information is public and, thus, largely representative of how shareholders are likely to assess performance. The corollary is that qualitative assessments of performance can and should be considered by compensation committees, although shareholders generally don't have the same access to information to draw similar qualitative conclusions.

Beyond financial measures, nonfinancial drivers of value creation should certainly be considered as part of a company's executive compensation strategy. For example, strategic measures like new sources of revenue, innovation, customer service, brand value and leadership pipeline all contribute to a company's long-term value creation. Companies should seek ways to ensure that these and other important qualitative measures are reflected in compensation decisions. There are a number of ways to do this, from linking assessments of individual contribution to bonuses and long-term incentive award levels to allocating incentive pools based on a balanced scorecard of financial and nonfinancial measures. The key is to create a process that ensures these broader areas of performance are in some way considered and remain on the radar screen of the broader executive team.

Interestingly, recent research about high-performing companies suggests that they are more likely to consider a broader range of financial and nonfinancial measures in their executive compensation programs than are other companies.

So, while we endorse the use of a composite performance scorecard on a consistent basis over time, its purpose is informational; the scorecard is not meant to be used as a litmus test that produces a pass/fail grade. However, it is recommended that some form of composite assessment that can be consistently used over time become a part of the compensation strategy to ensure a more balanced perspective on the relationship between performance and pay. This should support better measure selection and help avoid surprises if performance falters on measures not included in the ongoing incentive plans.

Figure 2 | Common Definitions of Compensations

	Summary Compensation Table (SCT) Pay	Target Pay	Earned Pay	Realizable Pay
Base salary	Reported in SCT	Most recent	Reported in SCT	
Annual incentive/bonus	Actual bonus	Target bonus	Actual bonus in both the bonus and nonequity incentive columns	
Restricted stock/units	Grant value	Grant value	Value of shares vested during period	Intrinsic value of grants during period valued at end of period
Stock options/stock appreciation rights			Value gained from options exercised during period	
Performance shares/units			Value of payouts earned during period, even if performance period began in a prior period	The payout value for award cycles that start and end during the period For award cycles that remain outstanding: Intrinsic value of target awards at end of period
Performance cash	Actual payout, even if performance period began prior to measurement period	Target bonus	Value paid out during period, even if performance period began prior to measurement period	Completed award cycles: Value paid out during period Outstanding award cycles: Target value at end of period
Change in pension value	Change in value	Optional (present value of average annual benefit)		
All other compensation	All other compensation	Optional		

Companies should evaluate several alternative definitions of pay and performance that capture **multiple stakeholder perspectives.**

Pay for Performance

Regardless of the pay and performance definitions used by companies in their own pay-for-performance assessments, it's important to understand the range of stakeholder views and why these perspectives may result in different views of the degree of pay-for-performance alignment. Proxy advisers continue to define performance either exclusively as TSR or heavily weighted on TSR outcomes. Wall Street analysts and the boards of directors also tend to focus on other measures of operating and financial results and how those translate into earned pay. A comprehensive approach to assessing pay and performance provides insights into whether and how the different perspectives are in agreement.

As companies prepare for the coming proxy season amid challenging economic conditions and ongoing market uncertainty, they should evaluate several alternative definitions of pay and performance that capture multiple stakeholder perspectives. Once they have a general idea of how pay and performance outcomes align, companies should look to see whether the various pay-for-performance perspectives corroborate a common story.

The benefits of a comprehensive assessment of pay for performance are twofold. First, such an assessment provides insights that may prove useful in formulating effective pay disclosures to garner support for the company's upcoming say-on-pay vote. Second, even for companies whose pay and performance appear to be on track for a successful say-on-pay vote in 2013, a comprehensive approach may identify operating and financial weaknesses that, left unchecked, may escalate into future challenges.

Ultimately, companies should conduct robust, multidimensional pay-for-performance analyses and use the findings to assess the soundness of their long-term executive compensation strategies — e.g., determine if current pay plans are appropriately supporting a high-performance culture, and if not, consider what improvements could be made. ws

Figure 3 | **Towers Watson Composite Scorecard**

	S&P 500 Median		
Measures	**2011**	**2012[1]**	**Trend**
Income statement			
Revenue growth	8%	3%	↓↓
Earnings before interest and taxes (EBIT) growth	11%	5%	↓↓
Earnings per share growth	18%	7%	↓↓
EBIT margin	17%	17%	—
Net income (NI) margin	10%	9%	↓
Balance sheet			
Return on net assets[2]	28%	29%	↑
Return on common equity[3]	15%	15%	—
EBITDA/interest expense[4]	12.4	11.8	↓
Cash flow			
Cash flow growth	8%	-3%	↓↓
Cash flow return[5]	13%	11%	↓
Market-based			
Price/earnings ratio	15.7	16.7	↑
Total shareholder return (one year)	0%	15%	↑↑
Total shareholder return (three years)	18%	12%	↓↓

Source: Towers Watson

1 Financial measures through the first three quarters of 2012, annualized; TSR measures as of Dec. 31, 2012
2 EBIT divided by average net assets
3 Net income divided by average common equity
4 Earnings before interest, taxes, depreciation and amortization divided by interest expense
5 Operating cash flow divided by average net assets

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