



Choosing performance measures for incentives

March 2007



Topics

- The corporate governance framework
- Performance measurement definitions and frameworks
- Selecting the right measures of success
- Setting challenging goals
- Best practices in top performing companies
- Assessing your company's performance measurement system



The corporate governance framework – extracts from ABI Guidelines of 2006

- Bonuses
- Annual bonuses should be demonstrably related to performance. Both individual and corporate performance targets are relevant and should be tailored to the requirements of the business and reviewed regularly to ensure they remain appropriate.
- Where consideration of commercial confidentiality may prevent a fuller disclosure of specific short-term targets at the start of the performance period, shareholders expect to be informed of the main performance parameters, both corporate and personal, for the financial year being reported on.
- Following payment of the bonus, shareholders will expect to see a full analysis in the Remuneration Report of the extent to which the relevant targets were actually met.
- Maximum participation levels should be disclosed and any increases in the maximum from one year to the next should be explicitly justified. Shareholders will expect increases to be subject to correspondingly more stretching performance



What are measures and goals?

Measures

Examples:

Revenue growth

Economic value

Customer satisfaction

New product development

Goals

The level of performance for which an company or individual strives

Examples: 15%

£900MM

Complete by July 2008

Top quartile

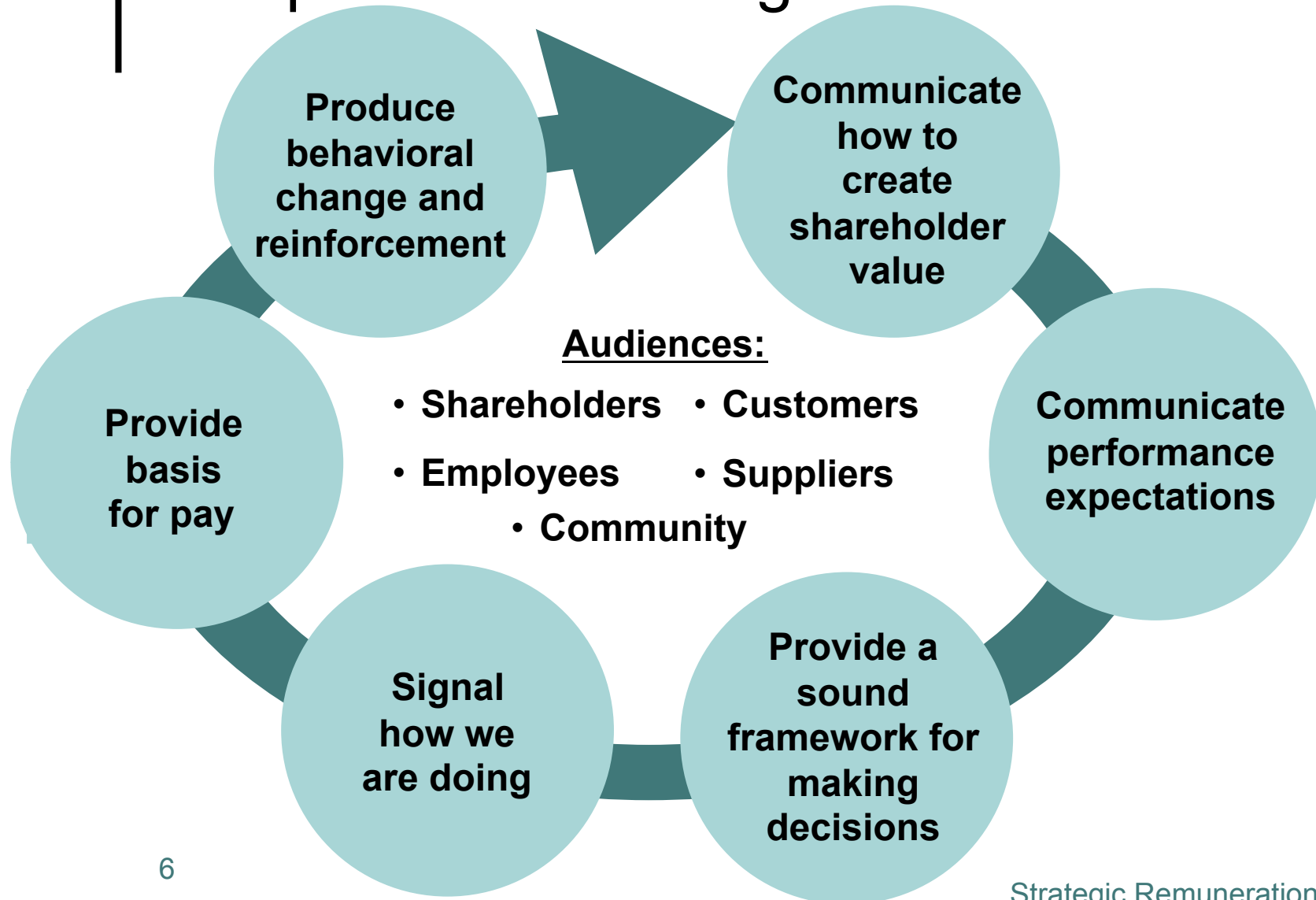
Selecting measures and goals are critical strategic decisions



Examples

- Exceed median peer TSR
- Double value in 5 years
- Penetrate markets
- Develop new products
- Revenue Growth
- Return on Invested Capital (ROIC)
- Economic Value
- Incentive determination process
- Working capital
- Customer Retention
- Revenue from New Products
- Strategic Remuneration

Measures and goals create competitive advantage



● ● ● | Every company faces measurement dilemmas

Link to shareholder

Line-of-sight

Strategic goals

Financial goals

Corporate

Unit-specific

Latest innovation

Business fit

Efforts (inputs)

Results (outputs)

Complex

Simple



Financial measures entail accuracy/complexity trade-offs

Least

Accuracy/Complexity

Most



Measure	Revenue	Income	Return	EV / CVA	CFROI	NPV / DCF	Internal TSR	TSR
Definition	Price x Volume	Revenue - Costs	Income ÷ Capital	Income - (Capital x K _c)	IRR	PV of Future Cash Flows	Change in Warranted Value	Change in Value
Added Information		Costs + Capital	+ Risks + Timing +			<u>Future Prospects</u> Internal + External		
Potential Accounting Adjustments		<ul style="list-style-type: none"> • Intangibles • Minority interest • Non-cash items • Asset values 	<ul style="list-style-type: none"> • Non-operating items • Financing costs • Off-balance sheet items • Expensed investments (e.g., R&D) 	<ul style="list-style-type: none"> • Inflation • Extraordinary items • Tax rate • Deferred taxes 				

Strategic Remuneration



Another challenge is goal-setting

Budget

Standard



Internal

External



Long-term

Short-term



Achievable

Stretch



Top-down

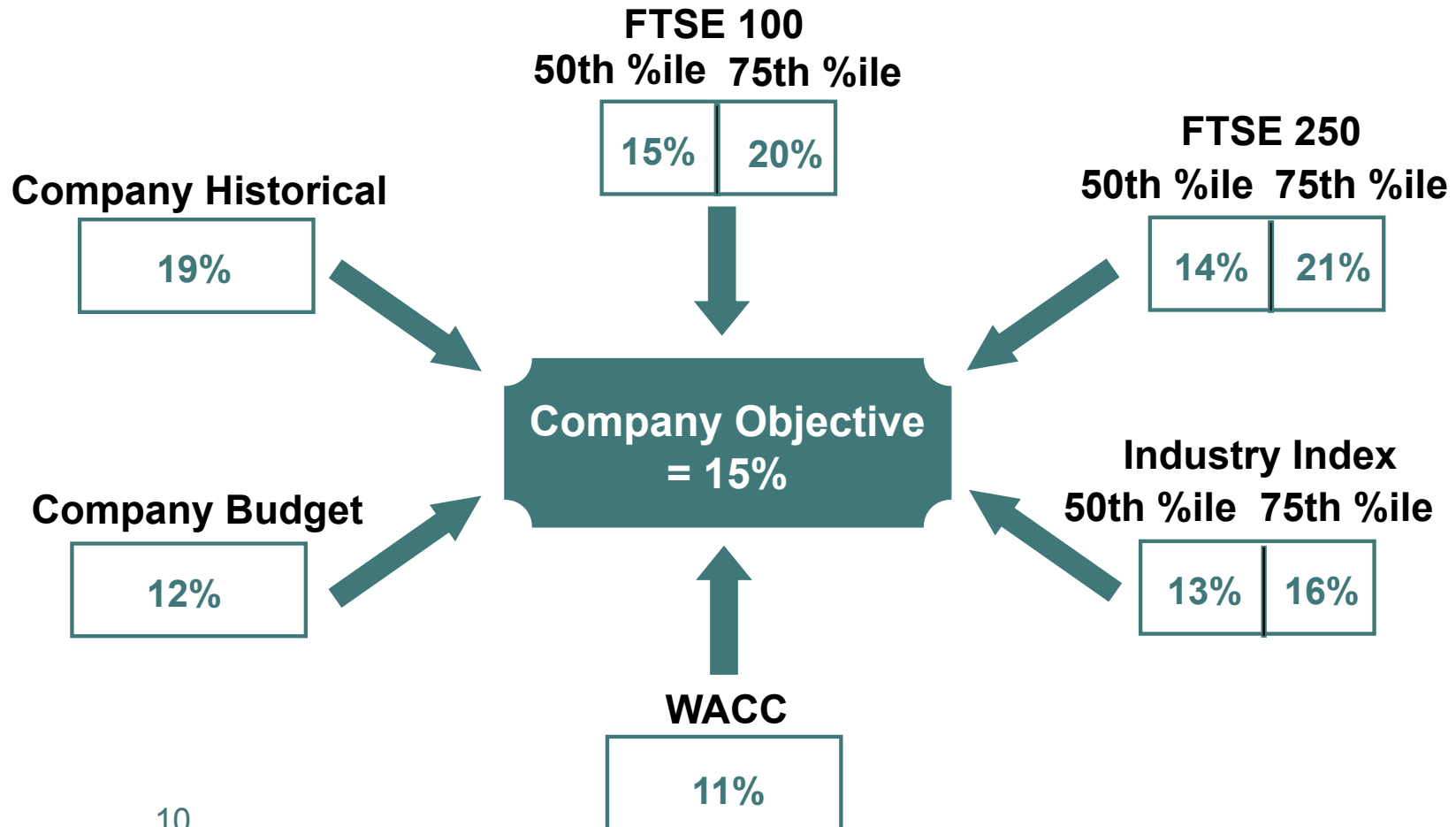
Bottom-up

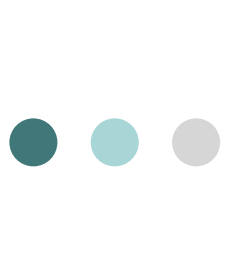




Shareholder expectations should drive long-term goals

Equity Value
Compound Annual Growth Rate – (assumed figures for illustration only)





Companies also face practical measurement issues

Confidentiality

Freedom of information



Quality of measurement


Availability / frequency / timeliness



Use of discretion

Formula-driven





What measurement and goal-setting practices contribute to their success?



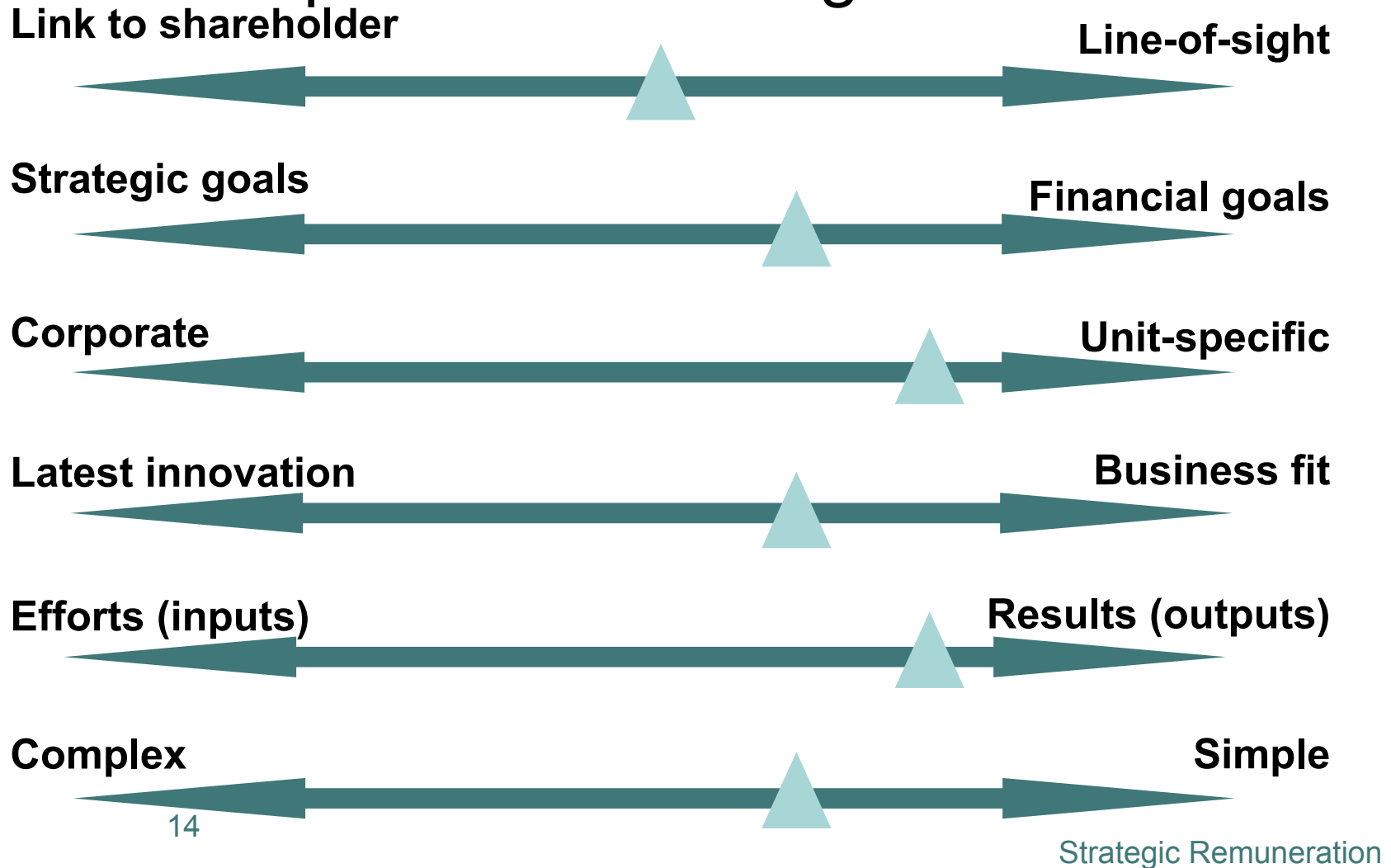
- **What measures were selected? Why?**
- **What considerations were given?**
 - Short vs. long-term?
 - Simplicity?
 - Accuracy?
- **Degree of customisation?**
- **Are goals:**
 - Achievable or stretch?
 - Top-down or bottom-up?
- **How are goals communicated?**
- **Do employees believe in the goals?**
- **How are measures reinforced?**
- **Impact on decisions?**
- **Frequency of updates?**

Companies seek measures that are simple and provide line-of-sight



- The “best” performance measure is not necessarily the most sophisticated
- Rather, a performance measure is successful as long as it:
 - Is easy to understand
 - Provides line-of-sight
 - Enables employees to generate insights and evaluate alternatives
- 13 ● Rewards outcomes, not inputs

● ● ● | Performance measures among top companies are focused on outputs and provide line-of-sight



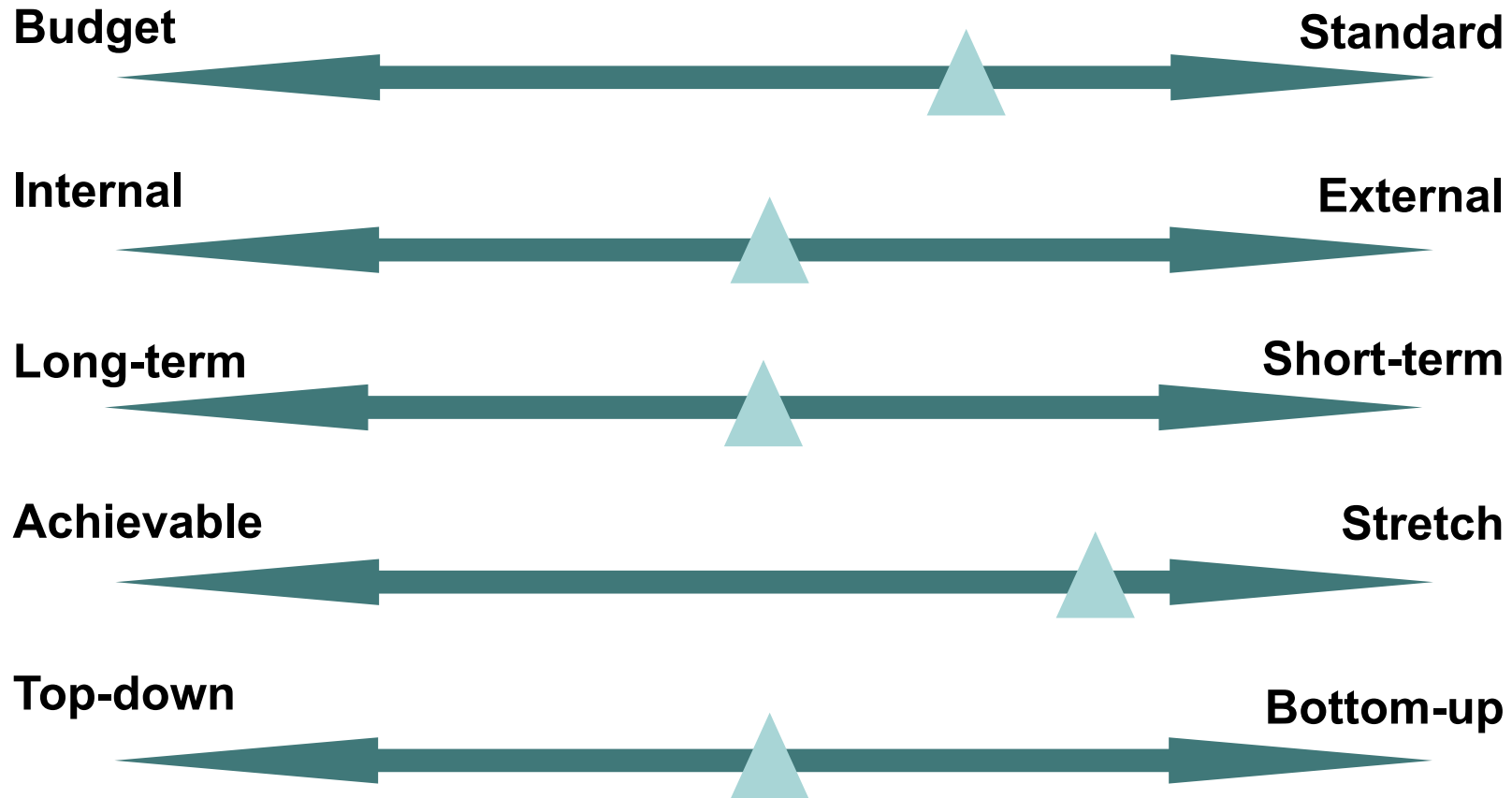
Challenging goals should be used to motivate the entire organization



- An effective goal-setting process:
 - Matches bottom-up perspective with top-down view of market expectations
 - Forces hard dialogue and avoids compromise
 - Sets challenging, yet attainable, goals
- Goals set without bottom-up input can lead to disconnects



Goal-setting among top performing companies reconciles company goals with shareholder expectations





Corporate Performance Goals

- Top quartile sales growth among competitor companies
- Preserve profitability through operating efficiency and organisational effectiveness



Business Unit Performance Goals

- Driven by corporate strategy
- Integrated with individual performance goals



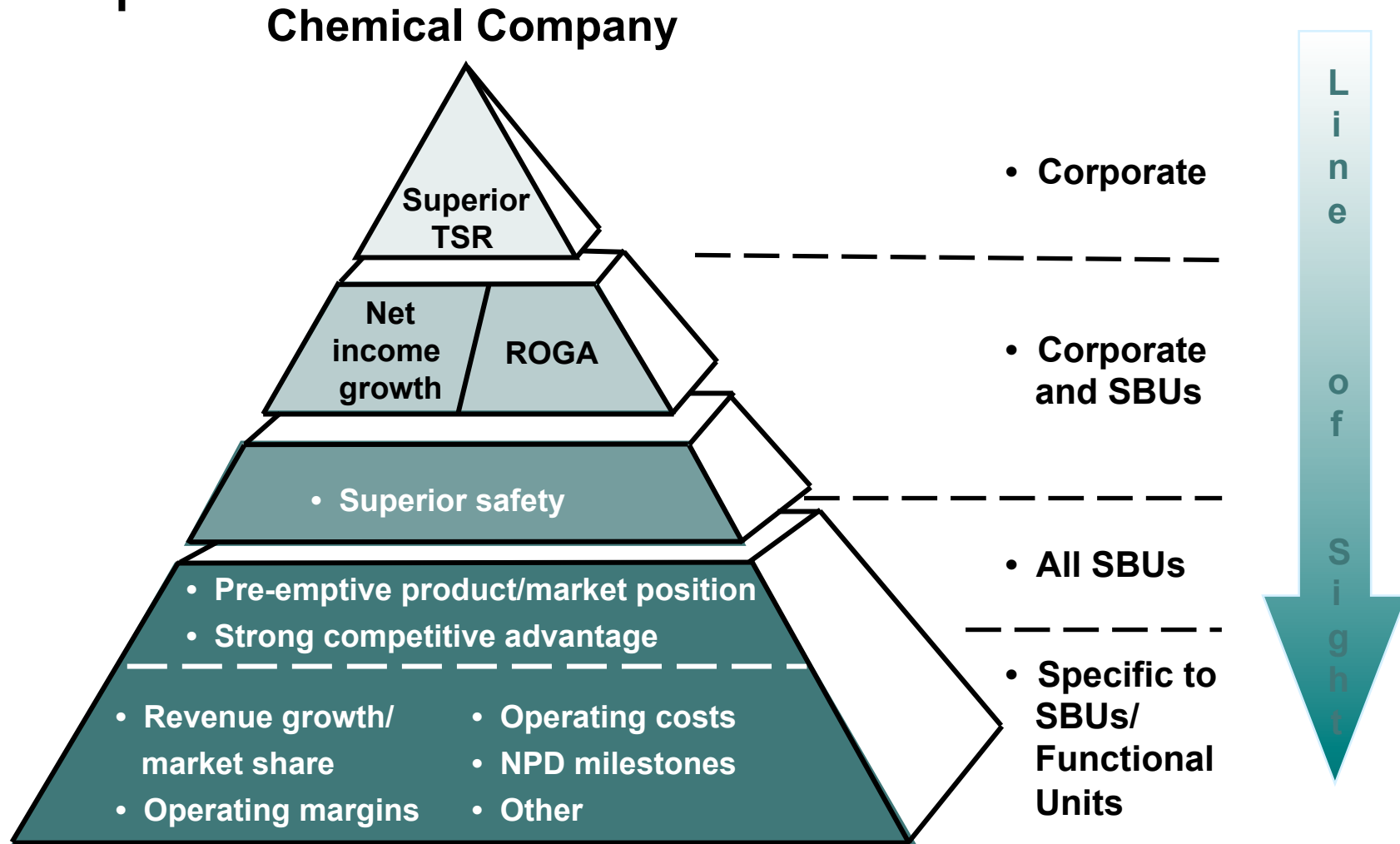
Individual Performance Goals

- Determined by individual employee, with guidance from manager
- Highly customised
- Directly actionable by the employee

Consensus on stretch goals that are actionable and motivating

Strategic Remuneration

To drive behavior, financial goals must translate into operating measures



Strategic Remuneration

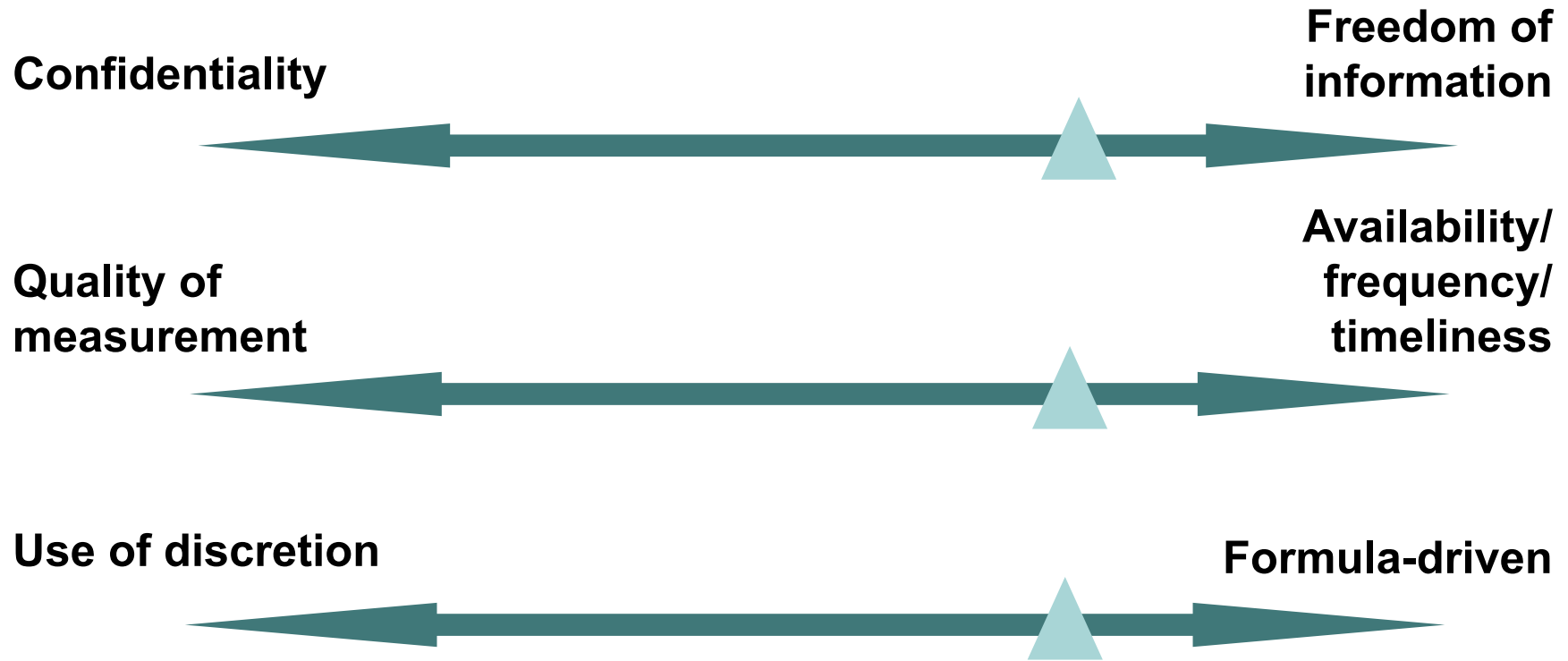
Performance measures and goals must have a cultural impact to be effective



- Performance measures and goals are frequently communicated
 - Ensures employees understand measures
 - Encourages employees to challenge/validate goals
- Performance updates and rewards are highly visible
 - Fosters healthy internal competition
- No forgiveness if goals are not met



Top performing companies deeply embed performance measurement in their cultures





An effective measurement system is tailored to the unique demands of each situation

ISSUES

ALTERNATIVES

<ul style="list-style-type: none"> • Cyclical business (e.g., chemicals) 	<ul style="list-style-type: none"> ➤ Multi-year measurement ➤ Relative performance ➤ Ongoing standards
<ul style="list-style-type: none"> • Business results driven by uncontrollable factors (e.g., mining) 	<ul style="list-style-type: none"> ➤ Relative performance ➤ Discretion ➤ Use controllable elements only ➤ Absolute performance
<ul style="list-style-type: none"> • Significant timing differences between large investments and positive returns (e.g., biotech, internet) 	<ul style="list-style-type: none"> ➤ Measures that don't count the investments ➤ Phase-in capital recognition ➤ No adjustments
<ul style="list-style-type: none"> • Business is "structurally disadvantaged" (e.g., foreign-owned bank) 	<ul style="list-style-type: none"> ➤ "Handicap" performance ➤ No adjustments

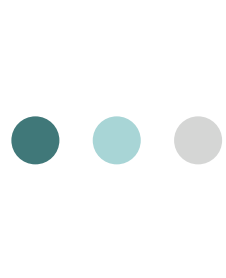


Diagnose your Company's situation:

Performance Measures

- We use the same performance metrics to communicate to employees, shareholders, and the Board
- Employees make good business decisions based upon our performance measures
- People understand their performance measures
- Our performance measures are customized to fit the unique characteristics of each of our businesses
- Our measurement system focuses on both profitability and growth
- Our performance measures provide insight into how our businesses are doing and how we can improve
- Our performance measures drive our stock price over time

Strongly Disagree		Strongly Agree		
1	2	3	4	5
1	2	3	4	5
1	2	3	4	5
1	2	3	4	5
1	2	3	4	5
1	2	3	4	5
1	2	3	4	5

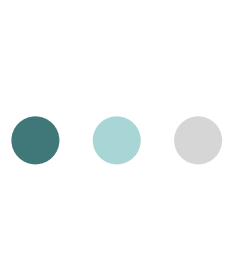


Diagnose your Company's situation: (cont.)

Goal-setting

- Shareholder expectations drive our internal expectations over time
- Our managers have ownership in developing value creating business plans
- Goals are expressed in clear terms that encourage accountability
- We use challenging stretch goals that motivate employees

Strongly Disagree		Strongly Agree		
1	2	3	4	5
1	2	3	4	5
1	2	3	4	5
1	2	3	4	5



Diagnose your Company's situation: (cont.)

Cultural Reinforcement

- Leaders keep employees well-informed on progress toward goals
- Employees feel that all levels of the organization are equally accountable for results
- Our lowest level employee can clearly describe their role in achieving our strategic and financial objectives
- We resolve business problems as soon as they occur, as indicated by our performance measurement system
- Our evaluation process has real integrity (“We play by the rules”)

Strongly Disagree					Strongly Agree	
1	2	3	4	5		
1	2	3	4	5		
1	2	3	4	5		
1	2	3	4	5		
1	2	3	4	5		



In summary, how you use your measures drives sustainable shareholder value creation

