

# Incentives and Risk Taking

Incentives can be an effective means of rewarding performance that benefits the enterprise, but the compensation committee (and the board more generally) must factor in the tension and unintentional risks that incentives can create. No one wants to get it wrong. One has only to look at news headlines from recent years to see the damage that results when incentives are unrealistic and employees feel pressure to put performance and meeting goals above all else. Most boards seem to understand the importance of accounting for risks in incentive plans. In fact, more than half (57 percent) of boards evaluate their company's incentive structure to understand if it could inadvertently create or exacerbate risks, according to the *2016–2017 NACD Public Company Governance Survey*.<sup>1</sup> The challenge is determining which questions directors should ask to jump-start discussions about risks and incentives.

On October 25, 2016, NACD, along with Farient Advisors, Katten Muchin Rosenman, PwC, and Sidley Austin, cohosted the first-ever joint meeting between the NACD Compensation Committee Chair Advisory Council and the NACD Advisory Council on Risk Oversight. Committee chairs from Fortune 500 corporations joined governance stakeholders for an open dialogue on key issues affecting compensation committee agendas and the risk oversight function of the board. Part of that dialogue focused on incentives and risk taking, and six questions that boards and compensation committees should consider emerged:

1. Do we have an appropriate balance of metrics?
2. Are we calibrating goals and upside opportunity appropriately?
3. Are we considering the quality of performance?
4. How robust are the controls on data that is used as inputs to the compensation plan?
5. How are our board's committees collaborating on developing and monitoring incentive plans?
6. Are we actively exercising discretion?

## By the Numbers

**WHICH RISK OVERSIGHT PRACTICE HAS YOUR BOARD PERFORMED OVER THE LAST 12 MONTHS?**

**57%**

Reviewed the company's incentive structure in the light of the risks it faces.

Source: *2016–2017 NACD Public Company Governance Survey*, 25.

<sup>1</sup> National Association of Corporate Directors, *2016–2017 NACD Public Company Governance Survey* (Washington DC: NACD, 2016), 25.

## Do we have an appropriate balance of metrics?

The *Report of the NACD Blue Ribbon Commission on Performance Metrics* states, “Corporate leaders must select metrics that encapsulate the company’s strategy, the balance of risk and reward, and the milestones along the way.”<sup>2</sup> Management chooses appropriate metrics for the company; the board’s role is to decide if those metrics help create long-term value for shareholders<sup>3</sup> and ask management the right questions to make sure there are controls in place to mitigate risks associated with compensation plan incentives.

“Our responsibility is to understand the business and the industry,” said one director at the meeting.<sup>4</sup> “The more we understand the business, the more [any] red flags will become apparent.” Meeting participants added that just as there is no silver bullet or single perfect metric to use when developing incentive plans, there is no one-size-fits-all approach to finding a satisfactory balance of metrics.

“There’s no perfect performance measure because every one of them can be gamed either deliberately or not deliberately,” said Dayna Harris, vice president at Farient Advisors. “In addition, it’s important to factor in trade-offs—for example, between metrics related to earnings and those related to revenue or returns—in order to get a combination that works.”

Considerations include:

- **Qualitative versus quantitative and short-term versus long-term metrics.** Thomas J. Kim, partner at Sidley Austin, said, “Performance metrics for compensation should be consistent with how management and the board think and talk about the business, both internally and externally. Qualitative metrics are generally more appropriate for, and tailored to, specific individuals, rather than for management as a whole.” (See sidebar for examples of qualitative/nonfinancial performance measures in use by public companies and the [Appendix on p. 8](#) for additional detail on long-term-oriented performance metrics.)

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<sup>2</sup> National Association of Corporate Directors, *Report of the NACD Blue Ribbon Commission on Performance Metrics*, (Washington DC: NACD, 2010), 3.

<sup>3</sup> *Ibid.*, 3–4.

<sup>4</sup> Italicized comments are from delegates or guests who participated in either the meeting on Oct. 25, 2016, or related teleconferences on Nov. 3, 2016, and Nov. 4, 2016. Discussions were conducted under a modified version of the Chatham House Rule, whereby names of attendees are published but comments are never attributed to individuals or organizations (excepting cohosts of the event).

- **Activity-based versus outcome-based metrics.** One delegate said, “Activity- or volume-based metrics can be gamed, so they need to be balanced with outcome-based metrics.”
- **Relative versus absolute measures of performance.** A compensation committee chair reported, “We don’t just look at our own company, we also look at competitors’ goals and their actual results. How did our team do in terms of relative performance, and why?”

## Are we calibrating goals and upside opportunity appropriately?

In addition to selecting performance measures, compensation committees must ensure the pay plan keeps the firm’s risk appetite in mind. The goal is to avoid unintended consequences that might compromise the enterprise’s reputation or its long-term viability. At one delegate’s company, “the chief risk officer does a risk analysis of the executive compensation plans and shares it with the board. We can assess where it nets out on the risk spectrum. The analysis is repeated at the end of the year to look at incentive payouts and whether any business area took undue risks.”

Participants highlighted two areas for compensation committees and boards to consider:

- **Incentive thresholds.** “Stretch goals are great and often important to strategy execution. But the board needs to ask whether high incentive thresholds may encourage bad behavior.”
- **Slope-of-the-payout curve.** Harris advised, “Make sure the upside [payout] opportunity is not excessive, especially for annual incentives. Three hundred to four hundred percent payout ranges can be dangerous.”

Several council participants reported that their compensation committees do some form of modeling of incentive payouts during the design process as a form of risk mitigation. Said one, “We developed our plan based on three different scenarios, so we could estimate how the actual bonus payouts would look and determine whether we were comfortable, as the board, with that level of compensation.”

## By the Numbers

### WHICH NONFINANCIAL CORPORATE MEASURES DO YOU ANALYZE FOR THE PURPOSES OF SENIOR EXECUTIVE COMPENSATION? (PLEASE SELECT ALL THAT APPLY.)



Source: National Association of Corporate Directors, 2016–2017 NACD Public Company Governance Survey (Washington DC: NACD, 2016), 35.

## Are we considering the quality of performance?

At the meeting, council delegates also emphasized that it is essential for compensation committees—and, indeed, for all board members—to ask probing questions about the way in which management achieves results, not just whether or not a particular performance target has been met: *“How you get there makes all the difference: we have to look at the quality of earnings. If our incentive plan is heavily weighted toward rewarding revenue, did we end up with a bunch of low-margin or bad deals?”* One compensation committee chair reported, *“To make sure that our results are sustainable, we’ve introduced strong metrics around employee satisfaction and engagement, along with customer satisfaction. These can count for as much as 25 percent of the CEO’s annual bonus.”*

Questions about the quality of performance have risen to the top of many boards’ agendas in the wake of intensive criticism over the consequences of aggressive incentive plans at companies such as Wells Fargo and Mylan. Reflecting on what has been publicly reported about these two situations, participants identified the following takeaways for directors:

- Exercising skepticism is essential in times of good performance—when it is often most difficult to do. *“It can be hard for directors to push back when they’re in the boardroom of a high-functioning organization and hearing lots of great stories from management,”* observed one participant. Several delegates pointed out that executive sessions can be particularly useful in this regard.
- Question overperformance as closely as underperformance. *“If it looks too good to be true, it probably is,”* a director said. *“Wells Fargo’s cross-selling numbers were significantly above industry standard. As directors, we need to look very closely at outlier-level performance—it might be a red flag.”*
- Reputation risk can be material, even when financial losses are relatively small.

## How robust are the controls on data that is used as inputs to the compensation plan?

The goal of compensation plan development is to create a plan that supports and encourages reaching strategic goals ethically, with appropriate

controls around risk.<sup>5</sup> Failure to have strong internal controls in place could mean that the quality of the data being used in the compensation plan could be flawed.

*“The precursor of what we do in incentive and compensation [planning] is a question of tone at the top,”* one council delegate said. *“It’s [about] ethics programming and internal controls. The number one thing we look for is reputation risk.”*

Directors—particularly compensation committee members—should help ensure that there are adequate controls on data being used in the compensation plans of both senior executives and those outside the C-suite. “You’ve got to do a significant amount of stress testing,” said Paula Loop, leader of PwC’s Center for Board Governance and Investor Resource Institute. “You have to reach deeper into the organization and understand the internal controls. Internal audit plays a critical role, because non-GAAP and nonfinancial metrics do not fall under the scope of the external auditor’s processes.” Directors agreed with a delegate who said, *“Any number that is used should be auditable—not necessarily always audited, but auditable. Internal audit has to sign off as to the performance, and the internal auditor [reports that information to] the audit committee, then to the compensation committee.”* Another director reported, *“At my company, internal audit reviews the entire compensation plan, including data sources, how the numbers are calculated, and how incentive awards are determined.”*

## How are our board’s committees collaborating on developing and monitoring incentive plans?

Several delegates emphasized that compensation committees must consider whether and what type of cross-committee activity is helpful during the process of developing and monitoring incentive plans:

- *“The [compensation] discussion takes place first in the compensation committee, then goes to the full board,”* one director said. *“The chairs of the audit and compensation committees also serve on each other’s committees.”*
- *“We have a risk committee, and we have a joint meeting [about incentives] with compensation and risk at least once a year—more,*

*“Any number that is used should be auditable—not necessarily always audited, but auditable.”*

<sup>5</sup> National Association of Corporate Directors, *Report of the NACD Blue Ribbon Commission on Performance Metrics* (Washington DC: NACD, 2010), 12.

*if needed,” a delegate shared. Another director described a different approach to compensation and risk committee coordination: “Our risk committee chair and chief risk officer join [certain] compensation committee meetings during the year, first to discuss the incentive plan and then to affirm they’ve reviewed the pay outcomes.”*

- Regarding goal setting, one director said, *“Our finance committee has responsibility for doing a deep dive on setting goals related to overall strategy. We’re looking at how to bring them together with the compensation committee to discuss degrees of difficulty and how that will factor into the incentive plan.”*

Other participants believed this type of coordination is best done at the full-board level. One delegate said, *“We don’t have cross-committee participation because the workload would be too heavy. We just have a more robust full-board discussion.”*

## **Are we actively exercising discretion?**

Given the increased scrutiny executive pay has garnered, compensation committee chairs should ask themselves whether their committees are actively exercising discretion in finalizing decisions on pay outcomes.

Council members mentioned that concern from investors, proxy firms, and stakeholders about potential abuses in discretion may have put a damper on discretion as a whole, partly because of questions related to the quality of results, as discussed earlier. “Anytime you have incentives and someone is receiving payouts at a high level for a long time, you want to do a little more testing to be a bit skeptical,” Harris cautioned, adding, “Understand the risk.” One director said, *“Discretion is a huge lever and definitely part of our process. Even if management makes the numbers, we still might not approve the full payout.”* Another director said, *“We use discretion too, in both directions. But if a committee finds itself doing this too frequently, it could be a sign of problems in the design of the pay plan. Over time, overusing discretion can also undermine executives’ trust in the board.”*

## Conclusion

By incorporating into their board discussions the above-listed questions on appropriateness of metrics, strength of controls, board committee collaboration, and the use of discretion, directors will be strengthening responsible oversight of incentives. *“It’s our responsibility as directors to understand the business and the industry in depth—trends, competitors, pricing models,”* one director said. *“That gives us a much deeper understanding about what is possible and what we’re asking management to do when we set goals and targets. It will also help us see potential risks and red flags much earlier.”*

## For Further Reading

Katten Muchin Rosenman LLP, “SEC Adopts Enhanced Executive Compensation and Governance Disclosure Rules,” *Client Advisory: Securities*, Jan. 7, 2010.

National Association of Corporate Directors, *Report of the NACD Blue Ribbon Commission on Performance Metrics* (Washington DC: NACD, 2010).

National Association of Corporate Directors, *NACD Compensation Committee Advisory Council: Setting Incentive Goals and Targets* (Washington DC: NACD, 2015).

Robin Ferracone, “Is Discretion Good or Bad in Determining Incentive Awards?” *Forbes*, Jan. 4, 2011.

PwC, *Making Executive Pay Work: The Psychology of Incentives* (New York: PwC, 2012).

Farient Advisors, “Farient Study—Performance Metrics and Their Link to Value,” Farient Advisors blog, Apr. 26, 2013.

## APPENDIX

### Long-Term-Oriented Performance Metrics

*Excerpted from National Association of Corporate Directors, Report of the NACD Blue Ribbon Commission on the Board and Long-Term Value Creation (Washington DC: NACD, 2015), 28–29.*

As the *Report of the NACD Blue Ribbon Commission Report on Performance Metrics* notes,

*Sustainable corporate growth, by definition, cannot develop without careful coordination between strategy and the company's short- and long-term goals. While boards must oversee both sets of goals, they should place their attention on long-term performance. When approving metrics for managers, directors must consider the implications of management's actions on the long-term corporate strategy.<sup>6</sup>*

There is no one-size-fits-all way to measure performance: in addition to strategic considerations, each company will select a combination of metrics best suited to its industry, life-cycle stage, and business model and will utilize external benchmarks as relevant. The following list includes examples of long-term-oriented performance metrics—which could include analysis of changes in short-term measures over a period of time—in nine different categories. While the list is not intended to be comprehensive or exhaustive, board members can use it as a reference in discussions with fellow directors and with management. Some metrics might be most appropriate for discussions at the committee level, e.g. audit, compensation, finance, health and safety, and so on.

#### 1. Business Development

- Changes in percent of revenue from new products/services/regions
- Changes in market share: overall and specifically resulting from new products/services
- Changes in customer satisfaction rates

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<sup>6</sup> NACD, *NACD BRC Report on Performance Metrics*, (Washington, DC: NACD, 2010), 6.

- Changes in new customer acquisition and/or conversion (lead-to-sale) rates

## **2. Company Culture**

- Changes in results of employee engagement surveys (particularly during periods of transition, e.g. following major strategy changes, acquisitions/divestitures, and so on)
- Opinions of the internal and external auditors regarding “tone at the top, middle, and bottom”
- Improvement in leadership and integrity scores for managers, drawn from performance management data
- Changes in the number of helpline reports
- Reduction in number of dismissals as a result of code of conduct or compliance violations
- Patterns in comments about the company on job-listing and career-focused websites

## **3. Corporate Governance**

- Number and nature of gaps in the current board skills matrix in relation to future skill needs
- Recruiting pipeline for anticipated board vacancies in 3, 5, or more years
- Number of identified successors for committee chairs and other key board roles

## **4. Environment, Health, and Safety (EH&S)**

- Changes in key resource consumption, emissions, product life-cycle management efficiency, etc.
- Changes in incident and near-miss rates
- Changes in results of audits of EH&S compliance, including time-to-resolution of issues and action items<sup>7</sup>
- EH&S training-program participation rates and results

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<sup>7</sup> Campbell Institute, *Transforming EHS Performance Measurement Through Leading Indicators* (Washington, DC: National Safety Council, 2013), 9.

## 5. Financial Performance<sup>8</sup>

- Economic profit, or economic value added (EVA)<sup>TM</sup>
- Return on capital employed (ROCE)
- Return on invested capital (ROIC)
- Changes in credit rating

## 6. Innovation/Research and Development (R&D)

- Changes in number of new patents, copyrights, and/or trademarks
- Changes in R&D spending as a percentage of sales Productivity of R&D investment relative to competitors<sup>9</sup>

## 7. Operations

- Changes in production cycle time
- Changes in product quality/defect rates, Six Sigma program/initiative implementation, etc.
- Supplier performance and financial strength
- Results of major process improvement initiatives, systems implementation projects, and the like

## 8. Reputation

- Changes in results of surveys on brand strength, net promoter score (NPS)<sup>®</sup>, etc.
- Changes in ratings by recognized independent parties, such as Fortune Most Admired Companies, Dow Jones Sustainability Index, etc.
- Changes in results of financial, legal, and/or regulatory compliance audits

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<sup>8</sup> For additional details, see *NACD BRC on Performance Metrics*, 33–34.

<sup>9</sup> Anne Marie Knott, “The Trillion-Dollar R&D Fix,” *Harvard Business Review* (May 2012)

## 9. Talent<sup>10</sup>

- Number of designated successors for key positions who are considered to be “ready now” and “ready in 2 to 3 years”
- Number and percentage of employees in high-growth-potential and high-performance categories, and their rates of retention
- Changes in employee turnover (including regretted and non-regretted departures), vacancy rates, and median recruitment time for key positions
- Changes in demographic profile of current workforce and candidate pool

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<sup>10</sup> For additional details, see *Report of the NACD Blue Ribbon Commission on Talent Development: A Boardroom Imperative* (Washington, DC: NACD, 2013)

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\*This list includes delegates, partners, stakeholders, and guests who participated in all or part of the meeting on Oct. 25, 2016, and/or in a related teleconference on either Nov. 2, 2016, or Nov. 4, 2016.

## About the Advisory Council on Risk Oversight

With a focus on the common goal of a sustainable and profitable corporate America, the National Association of Corporate Directors (NACD) created the Advisory Council on Risk Oversight. Since 2012, this council has brought experienced risk and audit committee chairs from Fortune 500 companies together with key shareholder representatives, regulators, and other stakeholders to discuss ways to strengthen corporate governance in general—and risk oversight in particular. PwC and Sidley Austin LLP collaborate with NACD in convening and leading the council.

Delegates of the council have the opportunity to engage in frank, informal discussions regarding their expectations for risk governance practices, processes, and communications, and to share observations and insights on the changing business and regulatory environment. The goal of the council is threefold:

- Improve communications and build trust between corporate America and its key stakeholders.
- Give voice to directors engaged in risk oversight and related matters and improve the quality of the national dialogue on the board's role in risk governance.
- Identify ways to take risk oversight practices to the next level.

NACD believes that the dialogue facilitated by this advisory council is vital to advancing the shared, overarching goal of all boards, investors, and regulators: a sustainable, profitable, and thriving corporate America.

## About the Compensation Committee Chair Advisory Council

In support of a sustainable, profitable, and thriving corporate America, the National Association of Corporate Directors (NACD) created the Compensation Committee Chair Advisory Council. Since 2011, this council has brought experienced compensation committee chairs from Fortune 500 companies together with key shareholder representatives, regulators, and other stakeholders to discuss ways to strengthen corporate governance in general and the work of the compensation committee in particular. Farient Advisors LLC and Katten Muchin Rosenman LLP collaborate with NACD in convening and leading this council.

Delegates of the council have the opportunity to engage in frank, informal discussions regarding their expectations for compensation practices, processes, and communications and to share observations and insights on the changing business and regulatory environment. The council's purpose is threefold:

- Improve communications and build trust between corporate America and its key stakeholders.
- Give directors engaged in the compensation arena a voice and a forum in which to exchange perspectives with regulators, standard setters, investors, and other important constituents on committee-related matters.
- Identify ways to take board leadership and compensation committee practices to the next level.

NACD believes that the open dialogue facilitated by this advisory council is vital to advancing the shared, overarching goal of all boards, investors, and regulators: to build a strong, vibrant capital market and business environment that will continue to earn the trust and confidence of all stakeholders.

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