



More balanced metrics for short-term executive incentives?

In their efforts to motivate excellence, company boards typically award executives an annual bonus based on the attainment of performance targets. Traditionally, boards have used short-term financial metrics, such as year-on-year profits growth, as the basis for these bonuses.

One problem with structuring short-term remuneration schemes in this way is that they can distort incentives, encouraging a focus on short-term financial success at the expense of long-term drivers of value creation. For example, if the CEO of a pharmaceutical company is remunerated on profits growth, and not for success in developing the pipeline of new drugs, he or she may be tempted to under-invest in the latter in order to boost the former. Moreover, it is possible that if the CEO focuses excessively on short-term targets, the objectives and performance targets for all operating divisions and senior managers will be distorted. Chief executives have been criticised on numerous occasions in recent years – in some cases even by former board directors – for becoming too obsessed with meeting short-term financial targets and failing to invest in the developing assets necessary for long-term growth.

One standard response to this problem is for boards to seek to balance short-term incentives with long-term rewards. If the CEO of a pharmaceutical company also has a stake in the share price of the company in, say, five years time, an incentive to focus on the drug pipeline as well as today's profits is created. If long-term incentives are sufficiently large and linked to success sufficiently far in the future, then such long-term schemes can have this balancing effect.

A complementary approach adopted by a number of companies is to use a more balanced set of performance indicators to structure short-term incentive plans.

These companies award annual bonuses on the basis of performance against a 'balanced scorecard' of indicators that reflect the range of strategic factors the board believes are necessary to generate long-term success. The kind of metrics used vary from sector to sector. BT and Vodafone use customer satisfaction, whereas Rio Tinto and BHP Billiton use the safety performance of their mining operations.

The selection of appropriate metrics is fraught with challenges. Not everything that is strategically significant for a company can be accurately measured. Some things that can be measured can also be manipulated by staff (e.g. if safety performance is used as an indicator, staff may be tempted to under-record safety incidents in order to achieve the desired targets). Another concern is that such schemes often involve more discretion and judgement being left in the hands of the board remuneration committee possibly resulting in a loss of transparency. However, companies that have experimented with a more balanced approach to measuring performance have found ways to address some of these problems.

Insight's view is that the practice of using a more balanced set of metrics for short-term incentive plans has much to recommend it, as it is more likely to encourage executives to pay attention to the full range of factors necessary for commercial success. In 2006, Insight plans to discuss the benefits of this approach with companies that do not appear to use such metrics at present and encourage them to adopt this approach. In addition, it is not always easy to determine from companies' remuneration reports what metrics they use for annual incentives. We will therefore also raise with companies the question of how they might make their reporting on this topic more informative.

October 2005

Produced by the Insight Investor Responsibility Team

Web: http://www.insightinvestment.com/responsibility/investor_responsibility_home.asp
Tel: 020 7321 1162