A Say-on-Pay Update — Plus Strategies for Responding to a Negative Recommendation by a Proxy Advisory Firm

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The proxy season is just around the corner for calendar year public companies, and, ahead of the season, two major proxy advisory firms, Institutional Shareholder Services (ISS) and Glass Lewis, recently released their 2019 policy updates. **ISS's 2019 policy updates** and **Glass Lewis's 2019 policy guidelines**, which are generally consistent with the 2018 versions, provide guidance on how ISS and Glass Lewis will make recommendations on companies' "say-on-pay" vote. As a reminder, the say-on-pay vote is a non-binding advisory vote by shareholders of public companies on the compensation of the CEO, CFO and three other "named executive officers" whose compensation is disclosed in the proxy statement.[1] Although a non-binding vote, performing poorly on a say-on-pay vote is not only disheartening, but can impact shareholder votes on election of directors (particularly compensation committee members), result in greater scrutiny of CEO performance, and require management and compensation committee members to expend significant time and resources to address concerns reflected by the vote.

This memorandum provides an overview of the say-on-pay evaluation processes of ISS and Glass Lewis. In this vein, Appendix A explains a possible future shift in ISS's quantitative analysis of say-on-pay proposals from GAAP-based metrics to metrics based on Economic Value Added, which, if applicable, may apply as early as the 2020 proxy season. In addition, this memorandum outlines strategies for companies facing a possible negative say-on-pay recommendation by these firms.

One thing to note—as influential as these proxy advisory firms' voting guidelines are, it is just as, if not more, important to review the voting guidelines of the company's actual institutional shareholders.

How does ISS evaluate say-on-pay proposals?

ISS's process for assessing companies' pay-for-performance mechanics comprises an initial set of quantitative screens followed by a set of qualitative screens.

The quantitative screens are designed to identify outlier companies that have demonstrated significant misalignment between executive pay and company performance over time. If so identified, outlier companies are subject to in-depth qualitative screens to determine:

- the likely cause of the perceived long-term disconnect between pay and performance; or
- factors that mitigate that assessment under the quantitative screens.

All companies, whether identified as an outlier or not, are subject to general qualitative screens that include the examination of, for example, the compensation policies and practices disclosed in the Compensation Discussion and Analysis section of their proxy statements.

The results of all applicable qualitative screens ultimately determine ISS's recommendation for or against companies' say-on-pay proposals.

[1] Emerging growth companies and foreign private issuers are exempt from the requirement to conduct the say-on-pay vote.

What metrics does ISS use in the quantitative screens?

ISS's quantitative screens consist of three primary screens and a secondary screen. ISS focuses on CEO pay in the quantitative screens, because it considers CEO pay to set the compensation pace at most companies, and the compensation committee and board are most directly involved in decisions regarding the CEO's pay. The metrics used for each screen are as follows:

Primary Screens:

- **Relative Degree of Alignment (RDA)**, which compares the percentile ranks of a company's CEO pay and total shareholder return (TSR) performance relative to its peer group as determined by ISS, over the prior 3-year period.
- **Multiple of Median (MOM)**, which expresses the prior year's CEO pay of a company as a multiple of the median CEO pay of the company's ISS peer group for the most recent annual period.
- **Pay-TSR Alignment (PTA)**, which compares the trends of a company's CEO annual pay and the change in the value of an investment in the company, over the prior 5-year period.

Secondary Screen:

- **Financial Performance Assessment (FPA)**, which compares the percentile ranks of a company's CEO pay and financial performance across a combination of GAAP metrics, relative to the company's ISS peer group, over the prior 3-year period. Depending on the industry in which the company operates, ISS will select and weight three or four of the following GAAP-based metrics:
  - return on assets (ROA);
  - return on equity (ROE);
  - return on invested capital (ROIC);
  - EBITDA growth; and
  - operating cash flow growth.

In October 2018, ISS proposed modifying the FPA to replace GAAP-based metrics with metrics based on Economic Value Added (EVA). However, in the recently released updates to its 2019 benchmark proxy voting policies, ISS chose <u>not</u> to incorporate EVA-based metrics into the FPA for the 2019 annual meeting season. Instead, the FPA will continue to use GAAP-based metrics for the 2019 season and, for informational purposes, ISS will feature EVA-based metrics in its research reports on a phased-in basis during this period. ISS has indicated that it will continue to explore the potential for future use of EVA metrics as part of the FPA, so companies may wish to familiarize themselves with the EVA methodology over the course of the next year. For more detail on the EVA framework, please see <u>Appendix A</u>.

How does ISS apply the quantitative screens?

ISS applies the primary quantitative screens and, where applicable, the secondary quantitative screen (*i.e.,* the FPA), as follows:

- The primary screens are applied to analyze the company under review and produce an Initial Quantitative Concern Level (IQCL) of low, medium or high.
- If the company has (i) a medium IQCL *or* (ii) a low IQCL that borders on the threshold for a medium IQCL, then the secondary screen, the FPA, is applied. If not, the company's IQCL level is treated as its Overall Quantitative Concern Level (OQCL).

    - If the company is subject to the FPA because it has a medium IQCL, then strong FPA results would deem it to have a low OQCL. Otherwise, the company's IQCL level is treated as its OQCL.
    - If the company is subject to the FPA because it has a low IQCL that borders on the threshold for a medium IQCL, then poor FPA results would deem it to have a medium OQCL. Otherwise, the company's IQCL level is treated as its OQCL.
- If, at the end of the quantitative screens, the company has a medium or high OQCL, then it is subject to more in-depth qualitative screens.

What factors does ISS consider in the qualitative screens?

ISS does not provide an exhaustive list of factors that it considers in the qualitative screens. Some of the factors include:

- strength of performance-based compensation and rigor of performance goals;[2]
- financial and operational performance;
- realized and realizable pay;
- peer group pay benchmarking practices;
- executive transitions; and
- special circumstances, such as responsiveness to receiving low support for say-on-pay proposals in prior years, history of poor pay practices and special one-time grants.

It is worth emphasizing that the above is not an exclusive list of qualitative factors. Importantly, companies' institutional shareholders may focus on other factors that differ from or are in addition to the above, such as the total quantum of executive pay, excessive severance payouts or the use of retention awards, inducement grants or one-time bonus awards.[3]

What are some examples of pay practices that might result in a negative recommendation from ISS?

ISS evaluates pay practices that are not directly based on performance in its qualitative screens, taking into account the company's overall compensation program and philosophy. Pay practices that ISS considers to be highly problematic and sufficient to result in a negative recommendation include:

- repricing or replacing of underwater stock options or stock appreciation rights without prior shareholder approval;
- extraordinary or lifetime perquisites (*e.g.,* unlimited loss coverage);
- tax gross-ups, potentially including gross-ups relating to a secular trust or restricted stock vesting; and
- new or extended executive agreements that provide for:

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[2] ISS does not consider time-based options to be performance-based awards.

[3] For example, Vanguard and Capital Group have both indicated that they expect executive pay to be reasonable on an absolute basis, regardless of how the companies' compensation plans may be designed to reward performance. Vanguard has also expressed concern over excessive severance payments, and Blackrock has cautioned against an overreliance on discretion or extraordinary pay decisions (*e.g.,* severance, retention awards, inducement grants and/or one-time bonus awards).

- excessive change in control payments—payments exceeding three times base salary and average, target or most recent bonus;
- change in control severance payments without involuntary job loss or substantial diminution of duties (*i.e.,* “single-trigger” severance payments);
- change in control payments with excise tax gross-ups;
- liberal change in control definition combined with any single-trigger change in control benefits; or
- multi-year guaranteed awards that are not subject to rigorous performance conditions.

Does ISS’s Governance QualityScore, which in part evaluates companies’ compensation practices, impact ISS’s say-on-pay vote recommendations?

ISS uses the Governance QualityScore to evaluate the corporate governance practices of widely held companies, primarily those listed on major stock indices. Under the Governance QualityScore framework, a company receives an overall score and separate scores in the following four categories: (i) board structure, (ii) compensation and remuneration, (iii) shareholder rights and (iv) audit and risk oversight. Governance QualityScore is a decile-based measure with “1” representing the highest quality of governance practices and the lowest level of governance risks, and “10” representing the opposite.

ISS includes companies’ Governance QualityScores in its proxy reports that provide the proxy advisor’s say-on-pay vote recommendations. However, according to ISS, the Governance QualityScores have *no impact* on the vote recommendations.[4]

Where can companies find more information about ISS’s methodology?

ISS maintains the following resources on its **Policy Gateway** webpage to help companies navigate its methodology for evaluating say-on-pay proposals:

- Pay-for-Performance Mechanics;
- Proxy Voting Guidelines;
- Compensation Policies – FAQs; and
- Equity Compensation Plans – FAQs.

ISS updates its evaluation methodology on an annual basis. It generally announces proposed updates (and solicits comments to those proposals) to the evaluation methodology of a given year’s proxy season during the September or October immediately before that year, and then finalizes the changes in December or the following January.

The commenting period has concluded for the 2019 proxy season. ISS has announced that updated Proxy Voting Guidelines and FAQs will be published on December 7 and 31, 2018, respectively. We expect updated Pay-for-Performance Mechanics to be published in December 2018 as well. In the

[4] In February 2018, ISS introduced the E&S QualityScore to measure the quality of disclosure regarding environmental and social issues for companies operating in industries such as energy, materials, and consumer durables and apparel. Like the Governance QualityScore, the E&S QualityScore is disclosed alongside ISS proxy reports but has *no impact* on ISS’s vote recommendations.

meantime, ISS has released **an executive summary** of the changes to its Proxy Voting Guidelines, as well as **preliminary FAQs** on U.S. compensation policies.[5]

How does Glass Lewis evaluate say-on-pay proposals?

Like ISS, Glass Lewis's process for assessing say-on-pay proposals comprises a quantitative and a qualitative component.

How does Glass Lewis conduct the quantitative assessment?

Under the quantitative assessment, Glass Lewis evaluates the alignment between executive compensation and company performance by applying a proprietary pay-for-performance model that compares, relative to its peer group as determined by Glass Lewis over a weighted 3-year period, a company's (i) compensation paid to its named executive officers (*i.e.,* not only the CEO) and (ii) stock and business performance.

- **Compensation** is measured as the sum of all cash and equity compensation paid to the executives, net of severance and forfeitures and excluding any changes in pension value and non-qualified deferred compensation earnings.
- **Stock and business performance** is measured by reference to the following five metrics, weighted differently depending on the industry in which the company operates:[6]
  - ROA;
  - ROE;
  - TSR;
  - earnings per share growth; and
  - change in operating cash flow.

Depending on the company's relative percentile rank in executive compensation and company performance and the magnitude of the gap between these measures, Glass Lewis assigns a letter grade between A and F, as follows:

- **A** – the company's percentile rank for executive compensation is significantly less than its percentile rank for company performance;
- **B** – the company's percentile rank for executive compensation is moderately less than its percentile rank for company performance;
- **C** – the company's percentile rank for executive compensation is approximately aligned with its percentile rank for company performance;[7]

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[5] The preliminary FAQs covered three topics. First, ISS noted that they will not be using EVA as part of their quantitative screens for the 2019 proxy season. Second, ISS noted that they will not be issuing adverse recommendations in connection with director pay for 2019. Third, ISS provided a non-exhaustive list of updates to their Equity Plan Scorecard methodology for 2019.

[6] For companies in the banking, diversified financial and insurance sectors, change in operating cash flow is replaced by tangible book value per share growth. For REITs other than mortgage and specialized REITS, change in operating cash flow is replaced by growth in funds. ROA and ROE are calculated for the year under review. The other three metrics are based on weighted average data of the year under review plus the previous two years. Glass Lewis does not disclose the weightings.

[7] Glass Lewis recently clarified that it considers a "C" to represent alignment between pay and performance (*i.e.,* a grade of C or above would be considered as a "good" grade by Glass Lewis).

- **D** – the company's percentile rank for executive compensation is higher than its percentile rank for company performance; and
- **F** – the company's percentile rank for executive compensation is significantly higher than its percentile rank for company performance.

How does Glass Lewis conduct the qualitative assessment?

Under the qualitative assessment, Glass Lewis evaluates the structure *and* disclosure of the company's executive compensation program and assigns a grade of **"Good," "Fair"** or **"Poor"** to each. The grades have the following meanings:

- With respect to the evaluation of executive compensation program structure:
  - "Good" means little to no concerns;
  - "Fair" means some concerns; and
  - "Poor" means significant deviation(s) from best practices or one or more egregious compensation practices.
- With respect to the evaluation of the disclosure of the executive compensation program:
  - "Good" means a thorough discussion of all elements of compensation;
  - "Fair" means an adequate discussion of all or most elements of compensation; and
  - "Poor" means an incomplete or absent discussion of compensation.

Glass Lewis takes a holistic approach in its assessment of say-on-pay proposals. As a result, although a company receiving a "D" or a "F" under the quantitative assessment is more likely to receive a negative recommendation, such a grade does not automatically result in a negative recommendation. Similarly, an "A" does not guarantee a positive recommendation. Glass Lewis weighs all of its findings under the quantitative and qualitative assessments to determine a final recommendation on a say-on-pay proposal.

What are some examples of pay practices that Glass Lewis considers deficient?

Examples of deficiencies in executive compensation program structure and disclosure that, individually or weighed together with other findings (including a finding of disconnect between pay and performance under the quantitative assessment), may cause Glass Lewis to issue a negative say-on-pay recommendation include:

- insufficiently challenging performance targets;[8]
- benchmarking of pay levels based on inappropriate or outsized peer groups;
- limited information on benchmarking processes;
- limited rationale for performance metrics or targets;
- limited rationale for significant changes to performance metrics or targets;
- payment of guaranteed bonuses or excessive retention grants, severance payments or golden parachutes;
- payment of discretionary bonuses when short- or long-term incentive plan targets were not met;

[8] Like ISS, Glass Lewis does not consider time-based options to be performance-based awards.

- targeting overall levels of compensation at higher than median without adequate justification; and
- inadequate responses to significant shareholder opposition in prior years' say-on-pay votes (*e.g.,* lack of meaningful shareholder engagement and/or policy changes).

How can companies obtain a copy of ISS's and Glass Lewis's say-on-pay vote recommendations?

ISS's say-on-pay vote recommendations are contained in ISS proxy reports. For a company in the S&P 500 index that has **registered** with ISS, ISS will provide to the company, on a "best efforts" basis, a draft of the ISS proxy report approximately two to four weeks before the shareholder meeting. The company will then have one or two business days to verify the information in the draft report. ISS publishes the final proxy report approximately 13 to 30 calendar days before the shareholder meeting. All companies can access their final ISS proxy report without charge through ISS's **Corporate Analytics online platform**.

Glass Lewis provides a participating company with a data-only version of Glass Lewis's proxy report, the Issuer Data Report (IDR), approximately 16 to 28 calendar days before the shareholder meeting. Participation is free, through Glass Lewis's **Meetyl platform**. The IDR contains data central to Glass Lewis's analysis of the company's compensation practices, but does not contain the proxy advisor's analysis or voting recommendations. When the IDR is available for viewing, the company will have one or two calendar days to comment on the IDR for factual inaccuracies or relevant omissions. The final Glass Lewis proxy report will be available for purchase after it is published in advance of the shareholder meeting. Glass Lewis will notify the company of the availability of the final Glass Lewis proxy report at the company's request.

Suppose either ISS or Glass Lewis issues a negative say-on-pay recommendation . . .

What can companies do before the shareholder vote?

Companies that receive a negative say-on-pay recommendation from either ISS or Glass Lewis may wish to consider the following responses:

- **Review the proxy advisor's recommendation for errors.** Companies should carefully review ISS's or Glass Lewis's basis for the negative recommendation and confirm that there are no factual errors. If such errors are present, companies should promptly respond to the proxy advisor and also communicate these findings to key investors. While ISS and Glass Lewis will correct and re-issue reports to correct a truly factual error (and not a disagreement with respect to policy interpretation), ISS and Glass Lewis will only change their vote recommendation if they view the factual error to be material and to warrant such change under their proxy voting guidelines. Regardless of any changes to the vote recommendation, companies may wish to communicate directly with shareholders to explain any factual errors.
- **Begin shareholder outreach as soon as possible.** We recommend that companies directly engage with their shareholders to explain why they should vote in favor of the company's executive compensation program, despite the negative recommendation from ISS or Glass Lewis. We do not recommend that companies criticize either ISS or Glass Lewis. Rather, companies tend to be more credible when they focus on the merits of their programs. Early shareholder outreach is important to give the company time to respond to shareholders' concerns, and to give shareholders an opportunity to digest and consider the company's response. In the course of shareholder outreach, companies should:
  - **Highlight positive components of pay practices and provide context.** To facilitate shareholder outreach, companies should craft discussion points highlighting the positive features of their pay practices and the alignment between their pay-for-performance philosophy and business strategy, as well as the specific circumstances leading to pay

decisions and why those decisions were in the best interests of the company and its shareholders.

  - **Consider appropriate company representatives.** Companies should carefully consider the best team to communicate the nuances of their compensation practices. A cross-disciplinary team comprising members of senior management and/or internal experts—such as human resources, finance, investor relations and in-house counsel—can often be effective. It is important to emphasize that in any such discussion with shareholders, members of the compensation committee can be particularly effective and provide significant credence to the governance of compensation decision-making. The team can be assisted from the sidelines by external advisors, such as compensation consultants, other proxy advisors and outside counsel.

- **Make supplemental proxy filings.** Supplemental proxy filings can help to (i) draw attention to issues or factors particular to the company that the company feels may not have been fully considered, (ii) provide an additional opportunity to highlight positive pay practices that may not have been thoroughly addressed in the definitive proxy statement and (iii) set a foundation for further shareholder engagement.

What can companies do after the shareholder vote?

ISS and Glass Lewis consider a company to have received low shareholder support on a say-on-pay proposal if more than 30% and 20% of shareholders, respectively, voted against the proposal. Low shareholder support can have implications for the proxy advisory firms' recommendations for re-election of board members in subsequent years. If ISS and Glass Lewis do not believe a company has been sufficiently responsive to the shareholder concerns relayed by the say-on-pay vote, they may recommend against the re-election of compensation committee members or the entire board.

To avoid a negative ISS or Glass Lewis recommendation in future years and be responsive to low shareholder support from the previous year, companies may wish to consider the following strategies:

- **Improve disclosure.** Companies may wish to review their disclosure carefully to identify enhancements and additional disclosure to help clarify their compensation practices.
- **Implement a formal outreach program with shareholders.** Companies may wish to conduct shareholder outreach and engagement throughout the year to better understand shareholders' concerns and to proactively communicate pay-for-performance philosophies and considerations.
- **Disclose shareholder engagement.** It is recommended that, in the upcoming proxy statement, companies disclose the details of shareholder outreach efforts and internal review processes to demonstrate their commitment to understanding and addressing shareholder concerns. In addition to disclosing the fact of such outreach, information disclosed may include (i) number of shareholders contacted, (ii) percentage of outstanding shares that such shareholders represent, (iii) topics discussed and (iv) actions taken.
- **Engage in dialogue with proxy advisors.** ISS and Glass Lewis typically engage with companies throughout the year to discuss their policies, as well as the company's practices. Engagement with proxy advisors provides companies with an opportunity to explain and discuss the interplay between their pay philosophy and the proxy advisor's policies. ISS and Glass Lewis prefer to engage with companies after companies have completed their shareholder outreach.
- **Consider substantive changes to compensation programs.** Companies may wish to make substantive changes to their compensation programs that are responsive to shareholder concerns.

If you have any questions regarding the matters covered in this publication, please contact any of the individuals listed below or your regular Davis Polk or Semler Brossy contact.

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Appendix A

What is Economic Value Added (EVA)?

ISS explains in its literature that EVA is equal to a company's net operating profit after tax (NOPAT), less a charge on its debt and equity capital (capital charge).[1] The capital charge is equal to the company's weighted average cost of capital (WACC) multiplied by its total invested capital. EVA represents the after-tax profit that the company must earn to cover its interest expenses and to provide a minimally acceptable return to shareholders. According to ISS, EVA measures are preferred over GAAP measures in the evaluation of companies' financial and operational performance, because they measure economic profit rather than bookkeeping profit.

How does EVA differ from GAAP metrics?

EVA is focused on the total cash amount investors can take out of a company versus the total cash amount investors have invested in the company. It differs from GAAP metrics in the following important respects:

- **Outlays with the potential to generate future earnings are capitalized.** Under GAAP, outlays must be expensed as soon as they are incurred. EVA considers outlays with the potential to generate future earnings to be assets, rather than expenses. As a result, outlays for research and development, advertising and promotion, rent and even restructuring operations are considered investments in intangible assets and are added back in the computation of EVA. The intangible assets are then amortized over their economic useful lives.
- **Impairment charges are reversed.** Under GAAP, the value of certain balance sheet assets is written down by way of "impairment charges" when it is determined that there is an erosion of value. A core tenet of GAAP is the principle of conservatism, which generally prohibits reversing impairment charges when it is perceived that the assets may have recovered their value. However, EVA focuses on the residual wealth from capital investments (*i.e.*, the economic value of a company in excess of its original invested capital). As a result, GAAP impairment charges are reversed and added back in the computation of EVA.

What are the components of the EVA framework?

When discussing proposed changes to its 2019 proxy voting guidelines, ISS indicated that it intended to focus on the following components of the EVA framework: EVA Spread, EVA Margin and EVA Momentum:

- **EVA Spread** is equal to EVA divided by invested capital, or the spread between a company's return on capital and WACC. It represents the company's efficiency in converting invested capital into economic profit.
- **EVA Margin** is equal to EVA divided by sales — a company's profit margin net of all operating and capital costs. It represents the overall profitability of the company's business model.
- **EVA Momentum** indicates whether a company's EVA is trending up or down. It measures how a company's EVA changes over a period. As a result, a start-up business that is developing a

[1] ISS has disclosed that, in February 2018, it acquired the business of EVA Dimensions LLC, a business intelligence firm that measures and values corporate performance based on the EVA framework. ISS describes EVA as "an established standard in measuring, analyzing, projecting, valuing and discounting a firm's underlying economic profit rather than its bookkeeping profit." It acknowledges that several providers, other than ISS, produce EVA measurements, with a methodology similar to the one used by ISS.

leaner capital structure may have a negative EVA but a positive EVA Momentum. Conversely, a mature company with a fatiguing business model and plateauing sales may have a positive EVA but a negative EVA Momentum.

What types of business activities generate EVA?

According to EVA Dimensions, business activities that generate EVA include the following:

- **Streamlining costs, including taxes.** When a company streamlines operating costs and lowers its tax burden, the company's EVA increases due to an increase in NOPAT. The capital charge remains constant because there are no changes to the invested capital in the company.
- **Exercising discipline in asset management.** Discipline in asset management practices allows a company to maintain a leaner capital structure, thereby increasing its EVA by reducing the capital charge. Increasing working capital turnover, utilizing production assets at their full capacity and outsourcing functions that can be performed more efficiently by external service providers are a few examples of ways to improve asset management.
- **Accounting for the full cost of capital in investment decisions.** EVA is the incremental difference in a company's return on capital over its cost of capital. Therefore, by only investing in assets that are expected to earn a rate of return greater than its full cost of capital, a company's EVA increases.
- **Increasing leverage.** Within appropriate limits, a capital structure shift from equity to debt can lower a company's WACC and increase its EVA. This is because the cost of debt is generally lower than the cost of equity since interest payments are tax deductible. Furthermore, greater leverage tends to increase executives' equity interests and their incentive to maximize EVA.

If ISS does modify its Financial Performance Assessment (FPA) to replace GAAP-based metrics with EVA-based metrics, what impact should companies anticipate?

Will companies be provided their EVA data?

When discussing proposed changes to its 2019 proxy voting guidelines, ISS indicated that EVA data would be provided free of charge to all covered issuers for their own company. Such EVA data would be provided in advance of their annual meeting and ISS analysis. This data would include EVA metric results, basic benchmarking data and selected data points along with a data dictionary to help understand the information.

Does ISS anticipate that the change to EVA would have a significant impact on companies?

When discussing proposed changes to its 2019 proxy voting guidelines, ISS stated that it did not expect that the implementation of the EVA-based measures would have a significant impact on the number of companies that receive "low" and "medium" quantitative concern levels as part of ISS's analysis. It expected that companies that receive a "high" concern on the primary TSR-based screens would continue to receive a final concern level of "high," and the FPA screen would not contain a provision to mitigate the most severe concerns on the initial TSR-based assessment.

ISS stated that the size of the impact of the EVA-based FPA should be approximately the same as the current assessment using GAAP-based measures. ISS noted that, in the 2018 proxy season, fewer than 5 percent of companies with a "low" concern level were upgraded to "medium" concern, and a very similar number of "medium" concern companies were downgraded to "low" concern.

Should companies address EVA in their proxy statement?

Companies typically use their proxy statement disclosure to describe their pay-for-performance philosophy. Unless a company has already been using EVA as part of how it has granted compensation or measured performance, we would recommend that companies continue to describe the fundamentals of their compensation program. That said, to the extent that a company could demonstrate strong financial and operational performance in EVA-based metrics, it might wish to emphasize those points.

Proactive disclosure of which aspects of a company's business model and strategy make it different from peers can also be helpful. This discussion helps explain why the company uses the metrics it does and not other common metrics, as well as provide context for why results may vary from peers (for example, frequent or significant M&A or effecting a turnaround). This additional context would be helpful with the current FPA, but could be more pressing should the less well-understood EVA measures become more prominent in ISS's evaluations.

As companies consider potential changes to their compensation program, is it recommended that they change their performance metrics to be based on EVA?

Companies typically review the design of their compensation program and the selection of performance metrics on a periodic to ensure they continue to effectively align executive pay with the company's strategic plan. If performance metrics continue to drive the company's fundamental levers of performance, particularly growth and returns, then, at least in theory, the company's EVA should increase accordingly.

We suggest that companies work with their finance groups to better understand EVA and the EVA component metrics in order to help the management team and the compensation committee better understand how the company might be evaluated with an EVA lens. It may also be helpful to start to consider what comparisons against peers might look like, including the factors that might contribute to significant differences from peers, and how EVA comparisons would differ from the current FPA comparisons. This analysis will help companies consider how to better explain why they have selected the metrics they have, how their incentive metrics create long-term value and why their measurement approach might differ from peers.