US and Canada Policies – ISS Pay-for-Performance Model – Financial Performance Assessment Methodology (secondary screen)

Background and Overview

Pay-for-performance alignment is an important concern for investors when they evaluate executive compensation programs. ISS utilizes a robust quantitative screening methodology to assess the degree of alignment between CEO pay and company performance. The ISS pay-for-performance model for US and Canada measures performance on both a relative and absolute basis and over multiple time horizons. Prior to 2018, company performance was measured using total shareholder returns (TSR) alone. Beginning in 2018, ISS introduced an additional modifier, the "Financial Performance Assessment" or FPA as part of the pay-for-performance screen to provide a broader picture of company performance. The FPA is a secondary screen that provides an assessment of company performance currently based on unadjusted GAAP accounting data. ISS proposes to update the FPA performance measures to use Economic Value Added (EVA) in place of unadjusted GAAP measures as an enhancement to the FPA screen. For clarity, this proposal concerns purely the metrics used under the secondary FPA screen, which impacts a limited number of pay-for-performance assessments.

Why EVA?

EVA[1] – Economic Value Added – can best be thought of as a company's Net Operating Profit After Tax (NOPAT) less a "capital charge" – the cost to the company of providing an acceptable return to all capital providers (including equity owners and debtholders). EVA can be used in a variety of ratios and measures to help put the economic profit of a company into more appropriate context. EVA provides a standardized view of economic performance, versus accounting results, by applying a series of uniform, rules-based adjustments to financial statement data. Those adjustments improve comparability of companies across different industries. They allow for comparisons of firms with different operating models and/or capital structures as well as companies at different points in their business cycles. ISS believes that using EVA measures for its secondary screen (FPA) creates a more reliable and accurate view of company performance, and back-testing confirms that EVA measures are superior to GAAP-based measures in identifying companies where shareholders have demonstrated concerns through say-on-pay opposition.

Key Changes Under Consideration

ISS proposes to update ISS' secondary FPA screen (the Financial Performance Assessment screen) by replacing existing unadjusted GAAP accounting measures with improved EVA-based measures. The intent is to align the measures with the long-term interests of shareholders by replacing accounting-centric measures with economic-centric measures. Specifically, the FPA would shift its capital productivity and profitability measures from GAAP-based measures of ROA, ROE, and ROIC to EVA concepts of EVA Spread and EVA Margin, measured over a three-year period. In addition, measures of company progress no longer would be based on EBITDA growth and cash flow growth; rather, EVA

[1] On Feb. 12, 2018, ISS announced the acquisition of the business of EVA Dimensions LLC, a business intelligence firm that measures and values corporate performance based on the Economic Value Added (EVA) framework. EVA is an established standard in measuring, analyzing, projecting, valuing and discounting a firm's underlying economic profit rather than its bookkeeping profit. Several providers, other than ISS, produce EVA measurements, with a methodology similar to the one used by ISS.

concepts of EVA Momentum, denominated by capital and sales, would be used to measure a company's economic growth trajectory.

This proposed update centers on the measures in the secondary Financial Performance Assessment screen – the framework of the screen (meaning, its use as a secondary screen following the primary screens which will still rely on TSR) is maintained. The Financial Performance Assessment will still be used only to potentially adjust upwards the concern level of companies that receive a marginal "low" concern on the primary screens, but demonstrate poor economic performance, and to adjust downwards the concern level of companies that receive a "medium" concern on the primary screens, but have shown strong economic performance. The proposal would simplify the FPA methodology: each EVA metric will be weighted equally, and the weightings will be the same for all companies in all industries.

EVA data will be provided free of charge to all covered issuers for their own company in advance of their annual meeting and ISS analysis. This free data will include EVA metric results, basic benchmarking data, and selected data points along with a data dictionary to help understand the information. This information will be made available well in advance of a company's annual meeting.

Impact

The implementation of the EVA-based measures is not expected to have a significant impact on the number of companies that receive "low" and "medium" quantitative concern level results as part of ISS's analysis. Companies that receive a "high" concern on the primary TSR-based screens will continue to receive a final concern level of "high" – just as applied currently using GAAP-based measures, the Financial Performance Assessment screen will not contain a provision to mitigate the most severe concerns on the initial TSR-based assessment.

The size of the impact of the EVA-based Financial Performance Assessment should be approximately the same as the current assessment using GAAP-based measures. In the 2018 proxy season, fewer than five 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.

Request for Comment

While we will appreciate any comments on this topic, ISS specifically seeks feedback on the following:

1. Under this proposed update, the framework of the primary ISS pay-for-performance model methodology is unchanged and will continue to use TSR as its main performance metric. Does your organization agree with that approach? If not, please explain.

2. If the existing FPA screen performance measures are replaced with EVA-based measures, would you prefer that ISS continue to display GAAP performance data for informational purposes?