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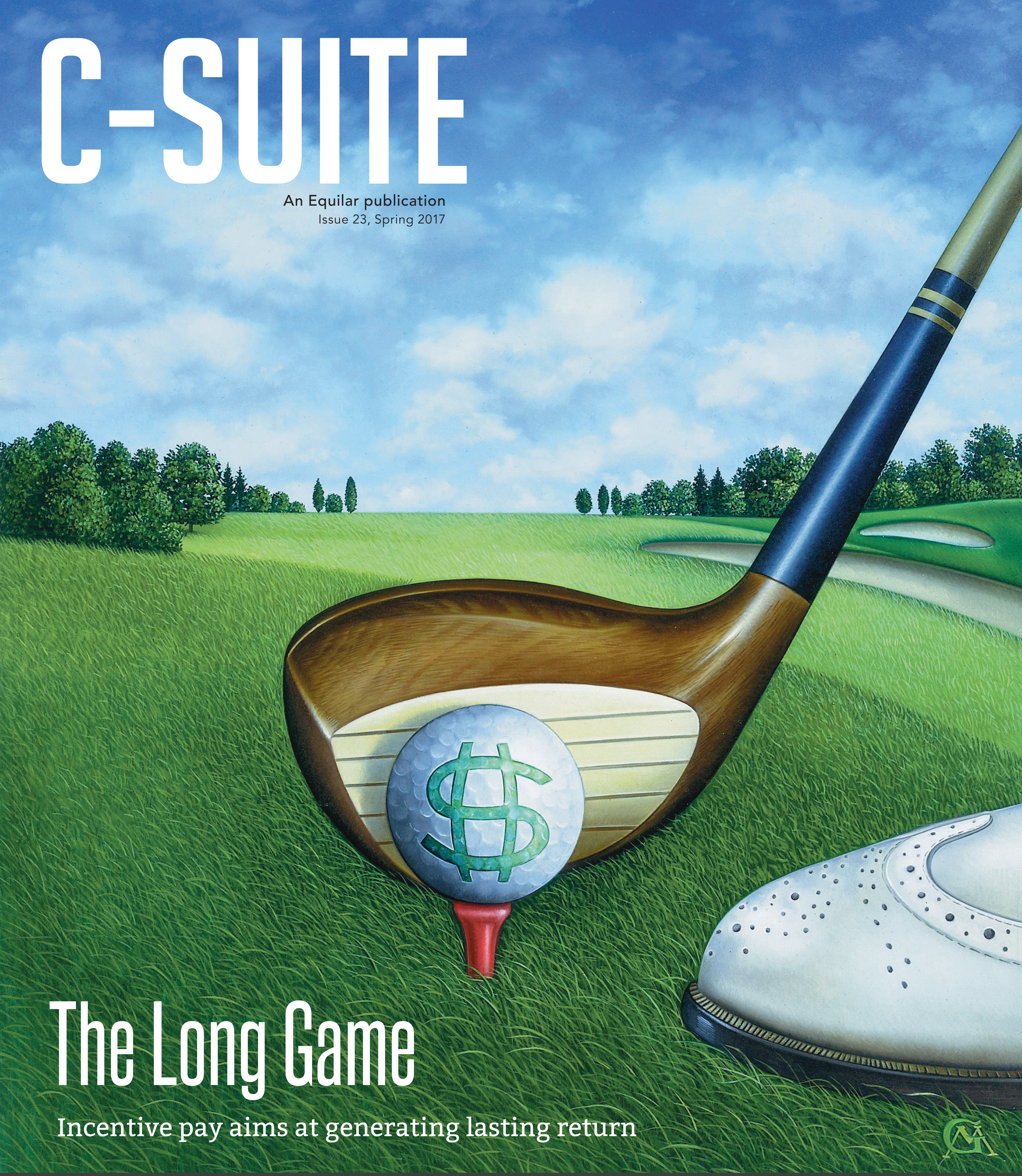

The Long Game

Incentive pay aims at generating lasting return

The board's role in M&A transactions

Defining a "high-performance" board

How regulatory uncertainty will affect executive compensation and governance

Interviews with Steve Odland, President and CEO of the Committee for Economic Development, and Glenn Booraem, Principal and Investment Stewardship Officer at Vanguard

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Incentive Compensation Adjustments for Special Items

Perhaps one of the most important and difficult duties delegated to compensation committees is the annual discretionary evaluation of whether adjustments should be made to the calculation of incentive plan performance or the performance goals themselves to account for non-operational, unbudgeted, unusual and/or infrequent special items in financial results prepared under Generally Accepted Accounting Principles, or GAAP. This annual rite is applicable to both annual bonus and long-term incentive plans, and necessarily involves the application of some science and some art.

In practice, companies accomplish the science part by using one or a combination of the following approaches. The most common approach is to align the financial calculations used for incentive plan purposes with the same non-GAAP financial calculations reported to investors. This approach is straightforward and transparent, and avoids having to maintain multiple sets of books. Another approach is to establish general adjustment guidelines or explicit performance measure definitions that may or may not align with reported non-GAAP financial calculations. Some companies also establish a materiality threshold so that only material adjustments are brought forward for the compensation committee's consideration. Under either approach, the compensation committee retains discretion to evaluate additional adjustments as circumstances warrant.

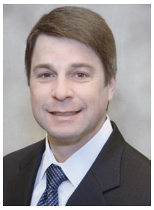
The art part is the subjective determination of whether a special item is operational or non-operational. Operational items typically include actions or inactions attributable to incumbent management, such as product recalls, compensation and interest expense, and labor disruption costs. Non-operational items typically include unplanned and unbudgeted events and uncontrollable items such as the following:

- Strategic restructurings
- In-process research and development
- Natural disasters
- Business portfolio changes/acquisitions and divestitures
- Foreign currency exchange rate changes and devaluations
- Accounting, tax and other regulatory changes
- Unplanned share buybacks
- Asset impairments
- Legacy litigation costs

In practice, compensation committees typically include operational items and exclude non-operational items in the calculation of incentive plan performance or the performance goals. However, the distinction between operational and non-operational special items is often not black and white and there are exceptions to the generalizations above based on the facts and circumstances. The intent of these adjustments is to eliminate the volatile distorting effect of unusual items, align award payments with the underlying performance of the core business and eliminate certain counterproductive short-term behaviors such as refraining from the acquisition of new technologies, deferring the disposition of underutilized assets, or deferring the settlement of legacy legal proceedings to protect current incentive payments.

With regard to business portfolio changes, most companies regard the one-time transactional costs as non-operational and exclude them from the calculation of incentive plan performance. The operating results from acquisitions and divestitures are typically either included or excluded from the calculation of incentive plan performance as determined by the compensation committee at the time of the transaction.

Finally, to avoid emotional surprises at year-end, a good and common practice is for companies to update the compensation committee periodically throughout the year on potential adjustments that may be requested at year-end.



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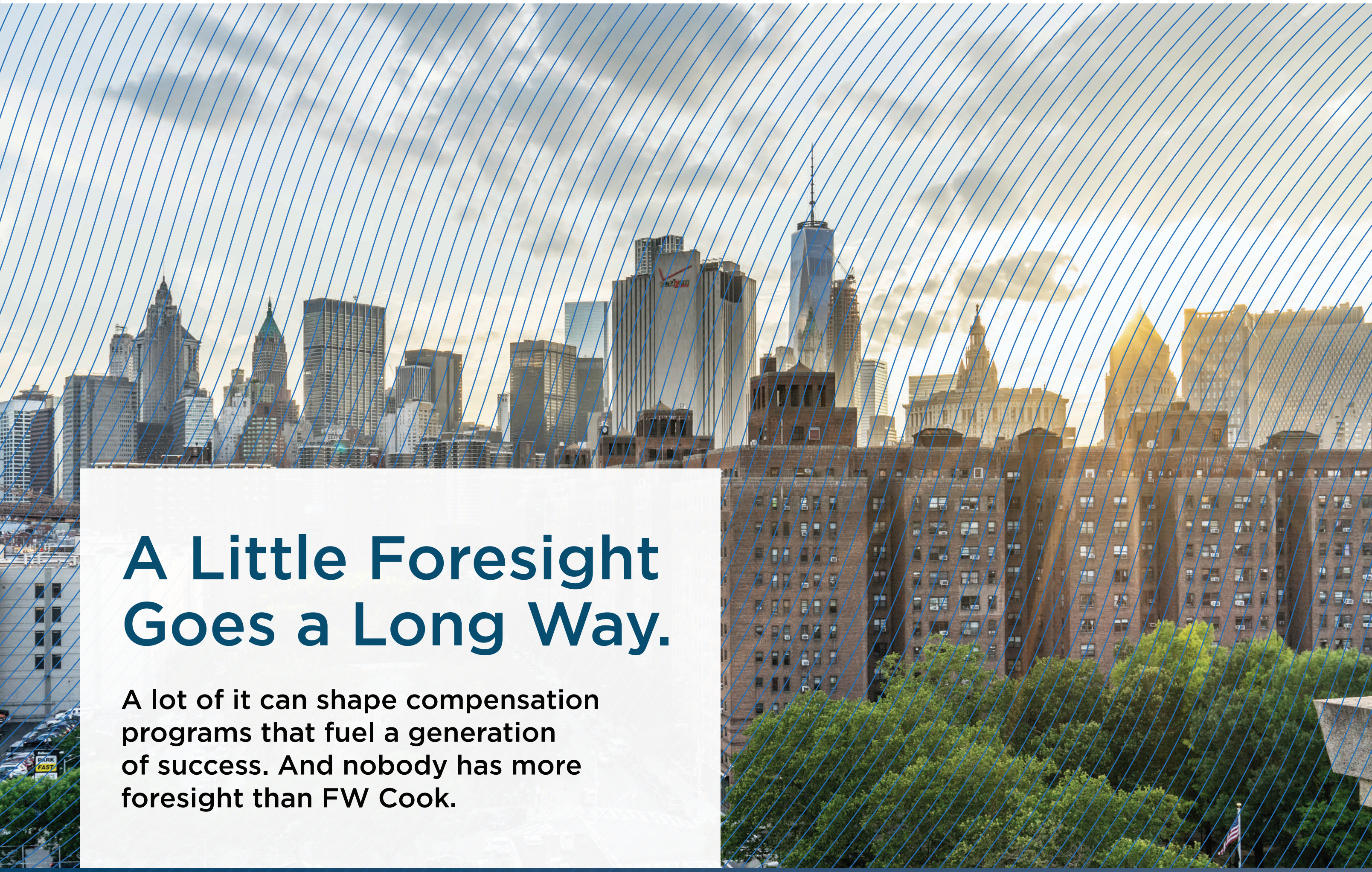

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