Blue Book Version 2

INTENSIFYING PERFORMANCE MANAGEMENT

Guiding Principles

July 2005

BACKGROUND AND OBJECTIVES

"By the year 2020, Malaysia must be a comprehensively developed country, - developed economically, developed politically, developed socially and culturally, progressive and caring[1]". Improving the performance of Government-Linked Companies (GLCs) will help put Malaysia on the right track to secure this outcome.

The Government is continuing to introduce a set of initiatives towards promoting a culture of high performance in GLCs. In May 2004, the Ministry of Finance issued guidelines entitled "Implementation of Performance-Linked Compensation (PLC) in Government Linked Companies (GLCs)", also commonly referred to as the "Blue Book", which introduced the usage of Key Performance Indicators (KPIs) and PLC. In January 2005, The Putrajaya Committee on GLC High Performance (PCG) was established to catalyse the transformation of GLCs by following through on the Blue Book and other 2004 initiatives[2] and launching a series of initiatives in 2005/06.

One of the most important of these initiatives is to **intensify performance management** in all GLCs to ensure focus on the key business priorities – particularly value creation – and to attract, develop, motivate and retain outstanding talent. To inform this initiative, a detailed stock-take of the implementation of the Blue Book was completed in July 2005 (please refer to the attached document titled "Stock-take of Performance-Linked Compensation implementation"). The stock-take revealed that although many GLCs have already incorporated some form of performance management scheme in their business, there is a wide variation in implementation and, in fact, there is still significant room for further intensifying performance management across *all* GLCs.

1 YAB Prime Minister at the Nikkei International Conference on "The Future of Asia", Tokyo, 25th May 2005; as adapted from "Vision 2020 – Malaysia as a Fully Developed Country" which was presented to the Malaysian Business Council by Tun Dr. Mahathir in 1990

2 Announced in the Keynote Address by YAB Dato' Seri Abdullah Haji Ahmad Badawi, Prime Minister and Minister of Finance, at the Seminar on Culture of High Performance for GLCs, dated 14 May 2004

This book ("Blue Book Version 2") builds upon the earlier Blue Book, based on the learnings from the stock-take. Importantly, Blue Book Version 2 is completely consistent with the first version, with no variation in the original principles. Instead, Blue Book Version 2:

1. Illustrates the Guidelines with more details and best practice examples
2. Clearly pin-points the accountability for implementation
3. Includes essential aspects of performance management, namely deriving KPIs from the strategy and the value drivers of the company; conducting rigorous and differentiating reviews of performance; ensuring meaningful financial and non-financial rewards and consequence management

RESPONSIBILITIES FOR IMPLEMENTATION

The CEO and the Board have clear roles and accountability for intensifying performance management in GLCs.

The CEO is responsible for the overall design and the implementation of the performance management scheme – particularly developing the strategy; defining the KPIs and cascading them through the organisation; reviewing performance of the business, taking corrective action and reporting it to the Board; reviewing the performance of the senior management team and delivering meaningful rewards and consequences.

The Board is responsible for contributing and agreeing to the strategy; setting targets for and reviewing the performance of the company and the CEO; and following-up with meaningful rewards and consequences for the CEO.

In addition, GLCs that have not already done so should establish a "Performance Management Committee" to oversee the implementation of the guidelines in this Blue Book. The "Performance Management Committee" should be a Board sub-committee chaired by a member of the Board and should include the CEO, Head of Strategy and Head of Human Resources. The committee is likely to have a finite life of 18-24 months at least, until these guidelines are well institutionalised in the organisation's processes and senior management.

IMPLEMENTATION DEADLINE AND FOLLOW-THROUGH

All GLCs are required to intensify performance management—by fully implementing the guidelines outlined in this document—by the end of the GLC's next annual budgeting cycle (i.e. by December 2006).

GLCs should expect to be requested by their respective controlling Government Linked Investment Company (GLIC) to regularly report on the status of the implementation, starting in December 2005. In December 2005, June 2006 and December 2006, the status of the implementation will be consolidated and reported to the PCG Committee (i.e. CEO of GLC reporting status to its Performance Management Committee; GLICs receiving status through the Nominee Directors at the GLC Boards; GLICs presenting the results at PCG).

While ensuring strict compliance with good governance, GLICs may require the Boards to sign-off on implementation and may request an independent view to assess the effectiveness of the implementation.

Questions on these guidelines should be directed to PCG@treasury.gov.my

SIX CATEGORIES OF GUIDELINES

The Book sets out what is required and the general guidelines to assist GLCs in their effort to intensify performance management. It addresses six relevant areas, and is structured as such:

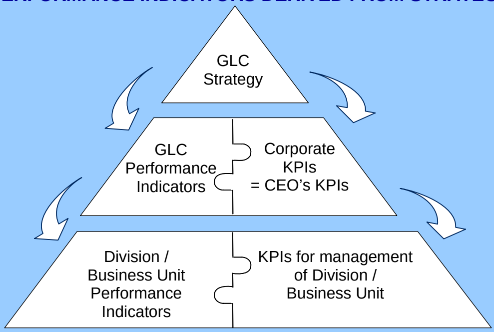
1. Establishing performance indicators and setting targets linked to strategy
2. Establishing KPIs and setting targets for senior management
3. Reviewing business performance
4. Reviewing individual performance of senior management
5. Establishing appropriate compensation framework for senior management
6. Clarifying eligibility for intensified performance management

1. ESTABLISHING PERFORMANCE INDICATORS AND SETTING TARGETS LINKED TO STRATEGY

GLC's performance indicators and targets should be tightly linked to strategy and address *all* relevant aspects of value creation within each GLC - both at the company level and also at the lower levels of the organisation such as divisions or business units. Corporate KPIs for the CEO and KPIs for managers are derived from these broader set of performance indicators (the value drivers of the company) (Figure 1)

Figure 1

CORPORATE KPIs ARE A SUBSET OF OVERALL COMPANY PERFORMANCE INDICATORS DERIVED FROM STRATEGY



DEFINITIONS

Performance Indicators:	• The complete set of measures derived from the company strategy which reflects the underlying value drivers of a company, and helps diagnose areas for action
Key Performance Indicator (KPIs):	• The most important performance indicators required to manage the business, serving as the link between performance and rewards and consequences
Corporate KPIs:	• KPIs for the company and the CEO

The specific requirements and guidelines for designing performance indicators and setting targets for the GLCs are as follows:

Guideline	Description
1.1 Design a set of relevant performance indicators directly derived from strategy (i.e. linked to the company value drivers).	• Performance indicators must be selected according to their relevance to the GLC strategy; hence, these metrics must: – Measure both direct shareholder value creation and any other concrete social/ developmental objectives set by the Board of the GLC.

Guideline	Description
	– Be balanced and holistic to address financial performance objectives as well as health (i.e. measures that support sustainable performance). Dimensions for performance indicators could include financial, customer, operations, and organisation. • Characteristics of good performance indicator are that they should: – Be *well defined*, avoiding or reducing subjectivity. For example, indices and surveys might be used to quantify subjective measures such as employee engagement. – Be both *actionable* and *measurable*. – Ideally, measure *outcomes* rather than inputs. Clear links to value should be defined when an "input metric" (e.g. employee engagement index) is selected. – Avoid damaging side-effects (e.g. while level of safety might be an important indicator for a company, it has to be defined and measured in a way that does not discourage reporting of failures). • Performance indicators should also be cascaded-down to lower levels of the organization (e.g. for each business unit or department). They should aggregate to the performance indicators at the company-level

<table>
<tr><th>Guideline</th><th>Description</th></tr>
<tr><td>1.2 Apply careful judgement to set targets that are stretch, yet achievable, for the performance indicators.</td><td>

Upfront in the budgeting cycle, the Board should clearly state its expectations on the targets for the company. This should be informed by advice that is independent of management.
Set stretch targets that are informed by benchmarking against industry peers. Peer companies are companies in the same industry, of similar size and subject to similar complexity and risk. The Board should approve the selection of the appropriate benchmarks.
Ensure targets are challenging, but achievable, based on bottom-up estimates from senior management, extrapolating historical performance, and an assessment of internal capabilities.
Targets should be agreed upon by the Board and CEO as part of the GLC's business cycle before the beginning of the financial year.
Be explicit about critical assumptions behind the targets (e.g. oil prices, GDP growth).

</td></tr>
<tr><td>1.3 Selectively allow revision of targets for cases where the external environment has fundamentally changed.</td><td>

Targets can only be revised during the year if

Performance has deviated from targets because factors outside management control significantly changed the assumptions behind the targets; and
Management was and is unable to take corrective action.

Board approval or instruction is required to revise targets during the year.

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2. ESTABLISHING KPIs AND SETTING TARGETS FOR SENIOR MANAGEMENT

The performance of individuals in the company is monitored through KPIs. KPIs are also used as a basis for individual performance assessment and delivery of meaningful rewards and consequences. When properly designed they align management's desired behaviours and performance with business objectives.

The specific requirements and guidelines for establishing KPIs and setting targets for senior management are as follows:

Guidelines	Description
2.1 Design a balanced and holistic set of KPIs linked to strategy.	• Corporate KPIs for the CEO are the most relevant performance indicators for the company. Similarly, KPIs for other senior management are a subset the performance indicators for their respective divisions, business units or departments. • Best practices suggest that for clarity and focus, each senior manager should have no more than five to eight KPIs. • Corporate KPIs and KPIs for other senior management may also include major milestones with measurable outcomes (e.g. cost, time and impact of successfully installing a major IT system). • KPIs for senior management other than the CEO, may also include overall company performance • KPIs must be appropriately weighted based on their importance to the business objectives and the person's control over the KPIs

Guidelines	Description
2.2 Ensure senior management formally agree to KPIs and targets.	• The CEO should agree formally with the Board on Corporate KPIs and targets and the Chairman should sign-off this agreement with the CEO. • For other senior management, apply a similar process where the respective superior signs-off. • KPIs and targets should be agreed and signed-off by the first month of the financial year
2.3 Demonstrate clear link upfront between targets and performance ratings.	• The methodology to link KPIs to individual performance ratings should be clearly announced at the beginning of the year e.g. – Performance against KPIs determines ratings, rewards and consequences (commonly known as "Absolute Rating"). – Performance against peers determines rating, rewards and consequences (commonly known as "Relative Rating").
2.4 Report headline performance indicators.	• GLC CEOs should report to investors their objectives, headline performance indicators and priorities, without revealing strategic actions or conflicting with laws or regulations. • These headline performance indicators are a subset of the broader performance indicators. Headline performance indicators should, where possible, include economic profit and at least the main drivers of value creation (e.g. revenue growth, EBITDA, etc.).

Guidelines	Description
	• Headline performance indicators can also be a powerful tool to rally all levels of employees, by providing a common reference point to chart progress. This is especially potent where staff rewards across all levels are linked to the headline performance indicators. • Headline performance indicators should be announced at least annually with the year-end results, and progress against them should be included in the quarterly reports of results.

3. REVIEWING BUSINESS PERFORMANCE

The performance of the company and each division, business unit or department, must be reviewed on a regular basis to ensure early identification of issues and opportunities, as well as to maintain focus on business priorities in order to drive overall performance improvement for the GLC.

The specific requirements and guidelines for reviewing business performance are as follows:

Guidelines	Description
3.1 Conduct Board review of company performance.	• The full Board should conduct detailed reviews of performance against Corporate KPIs in the form of at least one half-day meeting held every quarter. • The output of the meeting should be an action plan that addresses major variances. This action plan should be codified and form the basis for measuring progress at the next review.
3.2 Establish regular performance reviews for all divisions, business units and departments.	• The CEO should review the Corporate KPIs and then each Division's performance indicators with the relevant senior manager or team. • Performance review meetings should take one half-day or a full-day, and be held at least once every quarter. Frequency and duration should be adjusted according to importance and complexity of the business area. • The output of the meeting should be an action plan that addresses specific gaps and opportunities. This action plan should be codified and form the basis for measuring progress at the next review.

4. REVIEWING INDIVIDUAL PERFORMANCE OF SENIOR MANAGEMENT

KPIs for the CEO and other senior management are meaningless without the follow-through of a rigorous individual performance review process.

The specific requirements and guidelines for reviewing individual performance are as follows:

Guidelines	Description
4.1 Put in place a rigorous process for reviewing individual performance.	• Even though there should be a clear link between the performance of a business and the review of individual leading that business area, business performance reviews should be followed by a separate review of individual performance. • The Board should review on a semi-annual basis the actual results of the CEO as well as identify any issues and recommend remedial action if required. • Superiors should review senior management periodically (ideally once every 6 months, but at least annually). • The performance review can be done by the direct superior or, preferably, an evaluation committee. A committee comprised of the superiors' peers will ensure sufficient calibration of reviews across the organisation (e.g. Board reviews CEO and top management; CEO and top management review management in the second level).

Guidelines	Description
	• If competencies, attitudes, values and/or behaviours are included as part of the evaluation, a 360-degree review system may be useful (i.e. feedback received from superiors, peers and subordinates – all with relevant exposure to the person being evaluated). • All reviews should be followed by an extensive and open feedback discussion with the person evaluated. This discussion should cover performance against KPIs, strengths, development actions and overall performance rating.
4.2 Ensure evaluations show real differentiation in terms of overall rating.	• The individual's performance rating should clearly link to their performance against KPIs. • The evaluation process should rate people on a sufficiently broad scale so that a wide distribution of ratings can be achieved. • It is important that the performance rating shows true dispersion across each level in the organisation (e.g. 5 to 10 percent rated at the lowest level of the scale and 5 to 10 percent rated at the top level of the scale, with the remaining employees distributed across several additional ratings).

Guidelines	Description
4.3 Follow up performance rating with meaningful rewards and consequences.	• There has to be a strong link between a person’s performance rating and any subsequent monetary incentives (bonus, salary increases, etc.) and non-monetary incentive (e.g. promotion, public recognition, etc.). The Board should monitor this correlation. • Low performers should be initially coached to improve and/or moved to a new job where their capabilities are better matched. Consistently low performers (e.g. those whose last two reviews have resulted in low overall rating) should be considered for termination.

5. ESTABLISHING APPROPRIATE COMPENSATION FRAMEWORK FOR SENIOR MANAGEMENT

The Government encourages GLCs to review the compensation required to attract and retain the right talent while ensuring that the business remains financially sustainable. As well as base pay compensation, GLCs can use cash and/or shares as performance bonuses to motivate senior management behaviour and performance towards the company's overarching strategy and objectives.

The specific requirements and guidelines for establishing an appropriate compensation framework are as follows:

Guidelines	Description
5.1 Ensure that base pay is competitive in the market.	• In general, the base pay of senior management should be set around the 50th percentile of peer companies' base compensation. • The Board can set higher compensation levels to attract the best talent to the organisation if/when required (e.g. for scarce technical talent).
5.2 Ensure that base pay increments reflect individual performance.	• All increments in base pay must reflect the overall rating of the individual and show true dispersion between high performers and low performers.
5.3 Link bonus and total compensation to rating.	• There should be a minimum performance threshold measured against the KPIs that has to be met before entitling the employee to the performance bonus or an increment in base pay. This minimum threshold should be set by the Board. However, the threshold should not be less than 50%. • There should be high variability in total compensation that is strongly linked to an employee's rating.

Guidelines	Description
5.4 Ensure that total compensation is competitive in the market.	• The Board should set the level of its company's performance bonuses and overall total compensation commensurate with the company's performance and competition for talent. The Board reserves the right to determine the final performance bonus payout. • Benchmarking of performance bonuses and total compensation can be done against both domestic and, where applicable, international peers to ensure competitiveness: – For line positions, peer companies from the same industry should be used (ideally these peers should be the companies selected to set the targets). – For other technical / support positions, peer companies might not be from the same industry, as the talent pool is cross-sector (e.g. finance department). • The variable part of the compensation should be significant: – For companies that give a "company bonus" (i.e. standard compensation for all employees irrespective of performance), Boards should gradually reduce company bonus and increase the performance bonus, to make variable compensation tied to performance more relevant. – The performance bonus should recognise the targets achieved and so total compensation may match or exceed the market average.

Guidelines	Description
5.5 Use cash rewards	• Cash or a combination of cash and shares may be used to align short-term incentives. • A GLC's ability to afford a cash payout must be built into the reward calculation and the payout system needs to ensure that both short- and long-term performance is considered. • Performance bonuses should be self-funded, (i.e., for senior management, the GLC needs to achieve minimum financial targets before bonus payout is made, to ensure that bonus payout is a fair fraction of value created).
5.6 Use share based rewards.	• Where GLCs are in a position to do so, long-term incentives can be based on shares (share options, share-appreciation rights or other forms of share-based instruments). • The shares awarded should be spread over an adequate vesting period to ensure adequate linkage to long-term value creation and retention of key personnel (e.g. 5 years). • The option price offered should be based on market price on the date of award without any discount.

6. CLARIFYING ELIGIBILITY FOR INTENSIFIED PERFORMANCE MANAGEMENT

It is important that GLCs—and their people—are clear about who is eligible for intensified performance management.

The specific requirements and guidelines for clarifying eligibility are as follows:

Guidelines	Description
6.1 Ensure senior management participate.	• Senior management is defined as the CEO and two to three levels below (to be determined by the Board). • Where appropriate, senior management should be offered employment contracts with explicit compensation linked to KPIs. Employment contracts should have defined termination clauses stating how, why and when the contract can be terminated if targets for KPIs are not met. • At the end of the contract period, or in the event of position vacancy, there should be open competition for senior management positions. Executive search firms may be used to locate external talent. Internal and external talent should be benchmarked. • In situations where the contract is terminated prematurely, adequate compensation can be considered (commonly referred to as the “golden parachute” or “golden handshake”) and determined by the Board.

Guidelines	Description
6.2 Ensure that other employees are subject to the principles of performance management.	• GLCs should have most employees on a performance management scheme to further instil a performance culture in the company. • Although these guidelines apply to the CEO and other senior management, the principles of linking rewards (financial and other forms) with performance should be applied at other levels of the organisation through ESOS schemes, bonuses and promotions. • Certain elements applied to senior management might not be applicable to other employees (e.g. employment contracts).
6.3 Ensure Non-Executive Directors do not participate in variable performance-linked incentive schemes.	• Non-Executive Directors are not eligible to participate in variable performance-linked incentive schemes, due to the need to maintain appropriate check and balance, and avoid short-term actions. • However, Non-Executive Directors' total compensation should be set at least around the 50th percentile of Non-Executive Directors' compensation in peer companies.

Objectives and structure	INTENSIFY PERFORMANCE MANAGEMENT	
	Supporting Materials for "Blue Book" v 2.0	Number III.9.1.1.1.(a)

Objectives

- The objectives of these Supporting Materials are:
  - To explain the rationale for the Guiding Principles set out in "Blue Book Version 2 – Intensifying Performance Management, 2005/06" and
  - To illustrate them through "best practices" and "case examples", in order to facilitate the successful implementation of a performance management scheme by GLCs.

- The case examples, involving companies operating in various industries and geographies - including Malaysia - have been chosen for their applicability to multiple industries and different stages of a company's life cycle, so that they can be relevant for all GLCs.

Structure

- The first section is structured in five parts:

1. *Establishing performance indicators and setting targets linked to strategy*: This part further explains why performance indicators and targets are critical elements of a successful performance management scheme, and provides some best practices and case examples to help with implementation.

2. *Establishing KPIs and setting targets for senior management*: This part addresses how such indicators can be used to provide incentives to management.

3. *Reviewing business performance*: This part demonstrates the monitoring process at company, business unit and department levels.

4. *Reviewing individual performance of senior management*: This part illustrates different options of performance management schemes that can be developed at GLCs.

5. *Establishing appropriate compensation framework for senior management:* This part outlines common principles that can be applied when linking performance to compensation and career paths.

Note: Section 6 has not been further developed as the Guiding Principles are self-explanatory

Objectives and structure	INTENSIFY PERFORMANCE MANAGEMENT	
	Supporting Materials for "Blue Book" v 2.0	Number III.9.1.1.1.(b)

- A second section develops a full "case example", based on General Electric, along the five segments listed above, indicating best practices in the dimensions considered.
  - The main goal of this section is to exemplify the linkages between all the concepts depicted in the Guiding Principles.
  - There is more than one way to establish a successful performance management scheme. Therefore, the case example developed in this section does not aim to provide GLCs with a ready-to-use template for their performance management scheme. Its purpose is to illustrate the consistency and robustness of the whole performance scheme in a world class organisation.

Help Desk

- Please contact the Transformation Management Office (TMO) to the PCG Committee at PCG@TREASURY.GOV.MY if further information is required.

1. Establishing performance indicators and setting targets linked to strategy – Objectives and guidelines covered	INTENSIFY PERFORMANCE MANAGEMENT	
	Supporting Materials for "Blue Book" v 2.0	Card number III.9.1.2.1.(a)

Objectives of part 1

- Provide rationale and clarify the guidelines in the Blue Book related to section 1 of the Guiding Principles: "*Establishing performance indicators and setting targets linked to strategy*"
- Provide best practices and case examples on the guidelines in the Blue Book

Guidelines

1.1 Design a set of relevant performance indicators directly derived from strategy (i.e. linked to the company value drivers)

1.2 Apply careful judgement to set targets that are a stretch, yet achievable, for the performance indicators

1.3 Selectively allow revision of performance indicators targets for cases where the external environment has fundamentally changed

Supporting materials

- Best practice 1, Card III.9.1.2.1(b)
- Case example 1, Card III.9.1.2.1(d)
- Case example 2, Card III.9.1.2.1(e)

- Best practice 2, Card III.9.1.2.1(c)
- Case example 3, Card III.9.1.2.1(f)

1. Establishing performance indicators and setting targets linked to strategy – Rationale and best practices	INTENSIFY PERFORMANCE MANAGEMENT	
	Supporting Materials for "Blue Book" v 2.0	Number III.9.1.2.1.(b)

Rationale

- Identifying performance indicators which are linked to strategy is an effective way to align top management and drive overall execution.

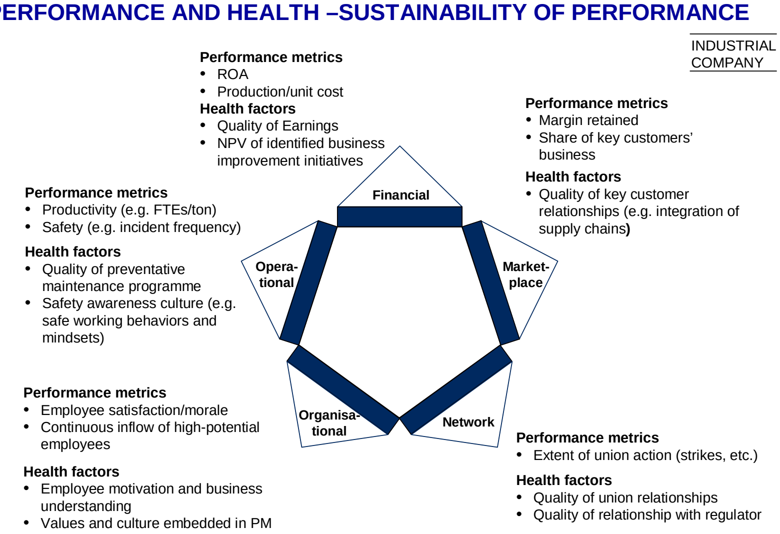
<u>Best practice 1</u>: Designing performance indicators

- Designing the right set of performance indicators for a GLC is a rigorous process that requires a deep understanding of the business. However, it can be simplified into three broad steps: (a) define a clear strategy for the GLC; (b) derive performance indicators from the strategy (value drivers) (c) translate and measure the performance indicators at all levels in the organisation

- A "corporate scorecard" to monitor and track performance indicators at all levels of the organisation help the company identify any deviation from its set course, and take actions early on.

- Indicators should comprise both backward-looking 'performance metrics' – to take stock of the company's performance to date and forward-looking 'health factors' to assess long-term sustainability. (Figure 1)

Figure 1
ILLUSTRATION OF METRICS USED TO MONITOR SHORT-TERM PERFORMANCE AND HEALTH –SUSTAINABILITY OF PERFORMANCE



1. Establishing performance indicators and setting targets linked to strategy – Best practices	INTENSIFY PERFORMANCE MANAGEMENT	
	Supporting Materials for "Blue Book" v 2.0	Number III.9.1.2.1.(c)

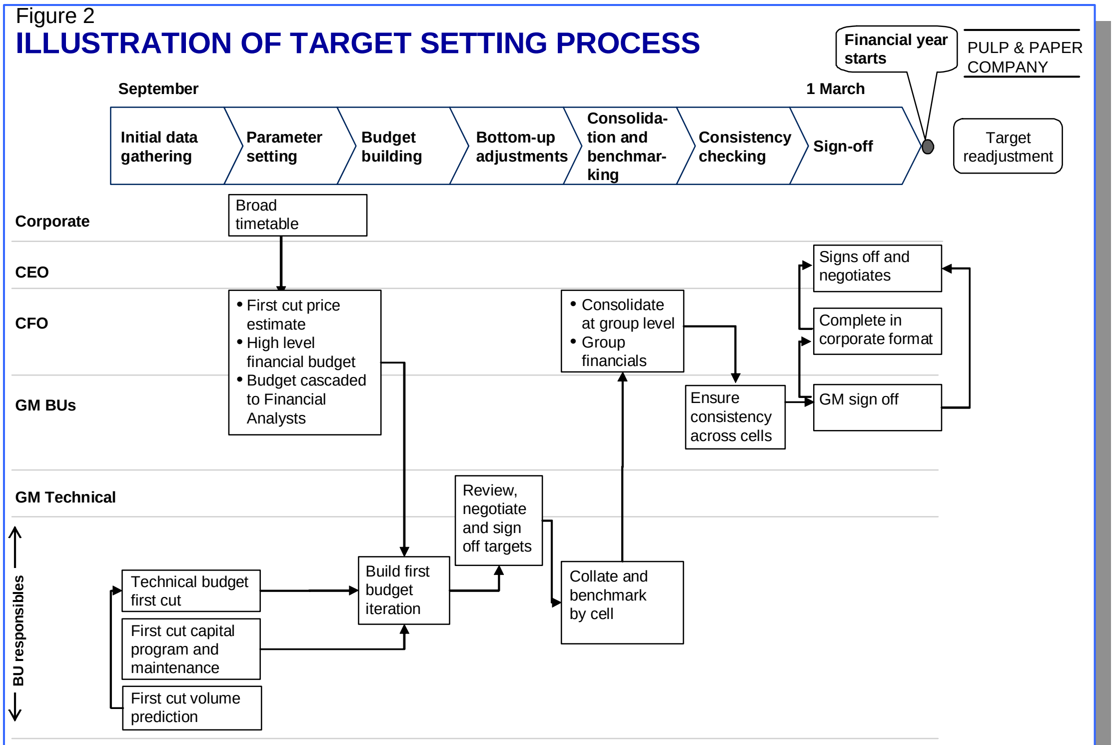
Best practice 2: Setting targets for performance indicators

- Figure 2 illustrates how a high-performing company sets targets for the year.
  - The target setting process described here is based first on an initial bottom-up approach for collection of information, where all Business Units (BUs) provide input on the targets at the start of the process in September. Then, after taking this into account, targets are set "top down".
  - Generally, this process takes about 6 months and requires several iterations before the targets are finally signed-off.

- The advantage of such a lengthy process is that all relevant stakeholders have an opportunity to provide input and to sign-off on the final targets. This ensures that realistic targets are set and that staff is well-informed, which results in the targets having greater credibility in the organisation.

Figure 2

ILLUSTRATION OF TARGET SETTING PROCESS



1. Establishing performance indicators and setting targets linked to strategy – Case examples	INTENSIFY PERFORMANCE MANAGEMENT	
	Supporting Materials for “Blue Book” v 2.0	Number III.9.1.2.1.(d)

Case example 1: Designing performance indicators – a Financial Institution example

Issues:

- With increased competition and regulatory changes, first sign of profit erosion were visible followed by underperformance in shareholder return.

Diagnostic:

- The diagnostic revealed a number of problems – particularly around the health factors. The bank’s customer satisfaction trailed its major competitors and the bank’s brand was rated among the 10 worst among all major companies in the bank’s home market.
- The cost-to-income ratio was higher than competitors’ and its productivity much lower.

Actions:

- The results of the diagnostic led to identifying strategic imperatives along the five key dimensions (Figure 3)

Figure 3

PERFORMANCE AND HEALTH METRICS WERE DEFINED BASED ON STRATEGIC IMPERATIVES FOR A FINANCIAL INSTITUTIONS

	Strategic/performance imperatives	Performance metrics	Health metrics
Financial	• Sustainable earnings growth of ~8-10% pa • Contain costs of distribution channels	• Earnings growth • ROE • Cost/income ratio • NPLs ratios	• NPV of identified cost saving initiatives • Quality of book (measured in % of interest income derived from low-risk loans)
Operational	• Deliver consistently good customer service • Improve CRM capabilities	• Number of complaints • Cost per bill payment transaction • Time taken to complete transaction	• Errors identified by bank as share of total errors • Quality of customer data
Organisational	• Compete for talent as I-banks hire again	• Number of high performers leaving • Leadership strength	• Employer of choice score • Level of voluntary attrition • Strength of succession plans
Network	• Develop and maintain good working relationships with regulators • Maintain public trust	• Fines levied by regulators • Number of surprise moves by regulators	• Perception by regulator as being a leader in social responsibility • Number of negative stories in press
Marketplace	• Improve cross-selling and product-bundling • Improve customer segmentation • Develop products to appeal to ageing and wealthier customer base	• Number of products per customer • Proportion of customers expressing satisfaction • Market share in significant segments	• Perception of brand • Market share in fastest-growing market segments • Number of new customers

Case example 2: Designing performance indicators – a Mining example

Issues:

- Regulatory changes and decline in demand due to product substitution left the company without a viable long term strategy.

Diagnostic:

- Higher production costs than competitors, poor product quality, aged assets and over time, increasing problems with unions.

Actions:

- This investigation led to the introduction of a set of performance indicators (which reflected both performance metrics and health factors) to support the company's strategic imperatives (Figure 4).

Figure 4

HOW PERFORMANCE AND HEALTH METRICS ARE SET FOR A MINING COMPANY

	Strategic/performance imperatives	Performance metrics	Health metrics
Financial	• Improve ROCE and EBIT • Reduce production costs to level of major competitors	• ROA/ROCE • EBIT • Production costs per unit	• Capital productivity • Return on risk-weighted assets
Operational	• Improve productivity • Reduce work accidents • Improve production reliability	• Productivity (e.g. FTEs/ton) • Average age of assets	• Quality of preventive maintenance program • Safety awareness culture
Organisational	• Retain best employees • Reduce absenteeism	• Number of high performers leaving • Employee satisfaction	• Employee satisfaction • Absenteeism
Network	• Improve relationships between management and unions • Improve brand quality	• Number of strikes • Rating of brand strength	• Quality of union relationships
Marketplace	• Improve customer service • Improve relationships with regulators	• Number of customer complaints • Number of fines from regulators	• Processing time for customer requests • Number of new customers

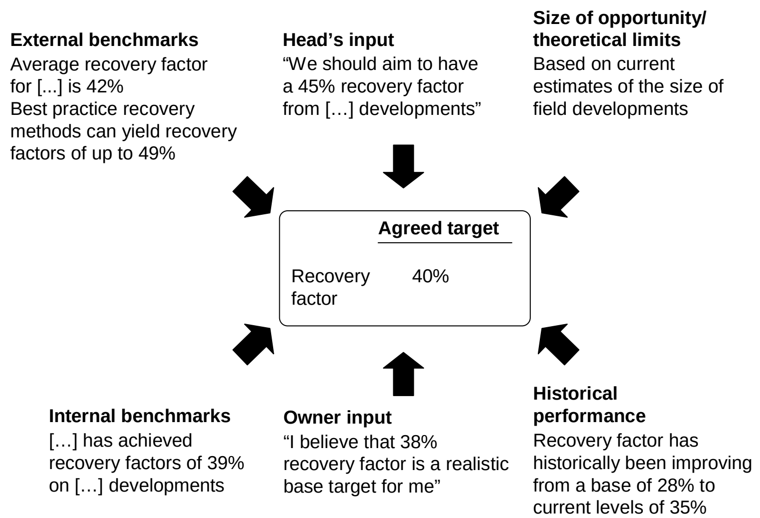
Case example 3: Setting targets for performance indicators - an Oil & Gas example

Actions:

- An Oil & Gas company addressed the challenge of setting performance indicators targets by gaining information from as many sources as possible. This was done through a series of benchmarking processes—internal (e.g. one department against another), external (e.g. one company against another) and historical performance. Figure 5 shows an example of how one specific target was defined.

Figure 5

INTERNAL AND EXTERNAL BENCHMARKING IS USED TO CALIBRATE TARGETS



Results:

- Such a rigorous process ensures that targets are fact-based, and therefore realistic and credible. Furthermore, key stakeholders in the organisation all have an opportunity to provide input, which makes it difficult to dispute targets later – even though the final decision has to be made by one person.

2. Establishing KPIs and setting targets for senior management – Objectives and guidelines covered	INTENSIFY PERFORMANCE MANAGEMENT	
	Supporting Materials for "Blue Book" v 2.0	Card number III.9.1.2.2.(a)

Objectives of part 2

- Provide rationale and clarify the guidelines in the Blue Book related to section 2 of the Guiding Principles: *"Establishing KPIs and setting targets for senior management"*
- Provide best practices and case examples on the guidelines in the Blue Book

Guidelines	Supporting materials
2.1 Design a balanced and holistic set of KPIs linked to strategy	▪ Best practice 1, Card III.9.1.2.2(c) ▪ Case example 1, Card III.9.1.2.2(e)-(f)
2.2 Ensure senior management formally agrees to KPIs and targets	▪ Best practice 2, Card III.9.1.2.2(d)
2.3 Demonstrate clear link upfront between targets and performance ratings	
2.4 Report headline performance indicators	▪ Case example 2, Card III.9.1.2.2(g)

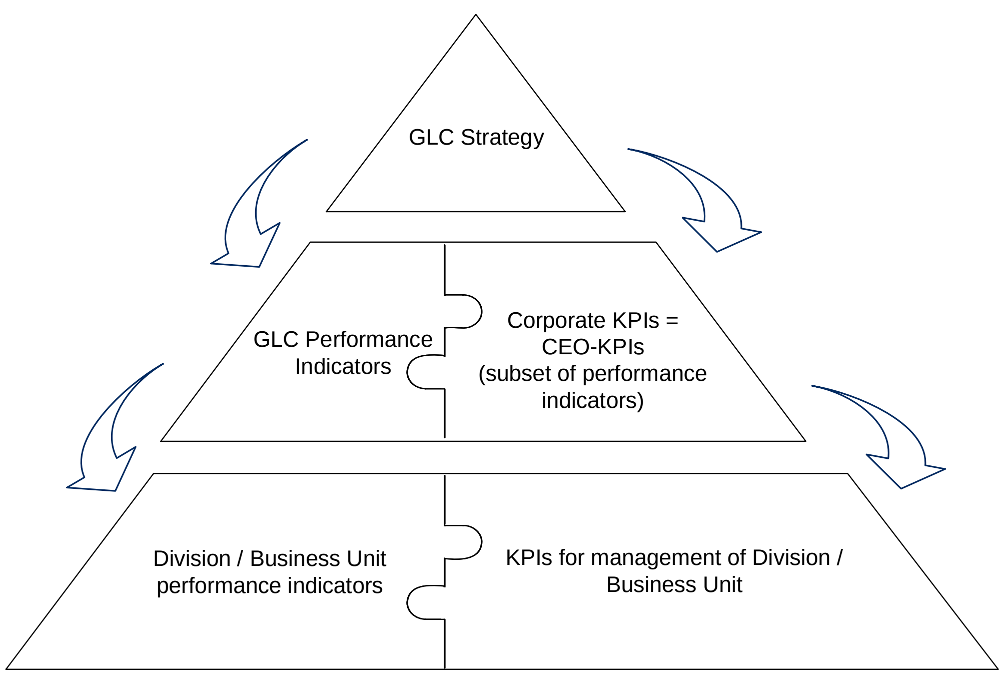
2. Establishing KPIs and setting targets for senior management – Rationale	INTENSIFY PERFORMANCE MANAGEMENT	
	Supporting Materials for "Blue Book" v 2.0	Card number III.9.1.2.2.(b)

Rationale

- Investing time in designing KPIs is imperative to ensure alignment of effort of people in the organisation to the overall business goals, by:
  - Clarifying expectations for each employee
  - Instilling a culture of 'accountability' for results and outcomes
  - Providing basis for determining rewards and consequences for performance or non-performance

Figure 1

CORPORATE KPIs ARE A SUBSET OF OVERALL COMPANY PERFORMANCE INDICATORS DERIVED FROM STRATEGY



2. Establishing KPIs and setting targets for senior management – Best practices	INTENSIFY PERFORMANCE MANAGEMENT	
	Supporting Materials for "Blue Book" v 2.0	Card number III.9.1.2.2.(c)

Best practice 1: Establishing KPIs

- Effective KPIs should meet eight key criteria (Figure 2)

Figure 2

ESSENTIAL QUESTIONS ASKED TO ENSURE VALIDITY AND RELEVANCE OF KPIs

Characteristics of KPIs	Related questions
• Linked to strategy	• Can the measure be aligned with an strategic objective or specific customer value?
• Controllable	• Can results be controlled or significantly influenced under a specific span of control?
• Can be acted on	• Can action be taken to improve performance on the measured dimension?
• Measurable	• Can the desired performance measured be quantified in a meaningful, realistic way?
• Simple	• Can the measures be explained easily and clearly by managers?
• Few in Number	• Do the measures focus management attention in key areas?
• Credible	• Are the measures resistant to manipulation?
• Integrated	• Are they compatible with related processes functions?

- In addition, KPIs should:
  - Be a subset of performance indicators, i.e. contribute to the overall company's KPIs but translated to specific activities within the individual's domain
  - Integrate KPIs for the individual's performance as well as to the team he/she belongs to. This promotes a balance between accountability and teamwork.

2. Establishing KPIs and setting targets for senior management – Best practices	INTENSIFY PERFORMANCE MANAGEMENT	
	Supporting Materials for "Blue Book" v 2.0	Card number III.9.1.2.2.(d)

Best practice 2: Establishing performance contracts

- While target setting is a 'top-down' process, individuals should review and agree on individual targets with their superiors, and formalise such agreement in a "performance contract".
- Performance contracts should include short-term targets, i.e. for the upcoming year, and also lay out longer-term expectations, i.e. for 2007-2008. Naturally, longer-term targets should be revisited every year to ensure its validity
- While the contract might not be legally binding, it is recommended that individuals and their respective superiors sign such a contract within the first months of the new financial year, as a symbolic act of the commitment to deliver upon expectations for the year. (Figure 3)

Figure 3

EXAMPLE OF PERFORMANCE CONTRACT

EXAMPLE ADAPTED TO MALAYSIA

Specific goals/objectives

- Maintain a presence in all Southeast Asian markets
- Complete VSS with 10% participation rate
- Design and implement a risk assessment and monitoring system by year end 2005
- Develop a human resource plan by 3Q 2005 to promote commercial skills development through training and hiring personnel

"Personal KPIs"

Measure	Unit	2005	2006	2007
• Financial				
– Gross margin	Percent	50	50	55
• Operational				
– Operating cost	RM/unit	1.05	0.95	0.90
– Transportation cost	RM/unit	0.30	0.26	0.24
– Demurrage	RM/shipment	0	0	0
• Commercial				
– Market share	Percent	20	23	25
– Average discount	Percent	10	9	8
• Organisational				
– Annual training	Percent of employees	80	85	90
– Personnel hiring	Number	30	35	40
– Employee satisfaction survey	Percent above 3 (1-5 scale; 5 = very good)	60	70	75

2. Establishing KPIs and setting targets for senior management – Case examples	INTENSIFY PERFORMANCE MANAGEMENT	
	Supporting Materials for “Blue Book” v 2.0	Card number III.9.1.2.2.(e)

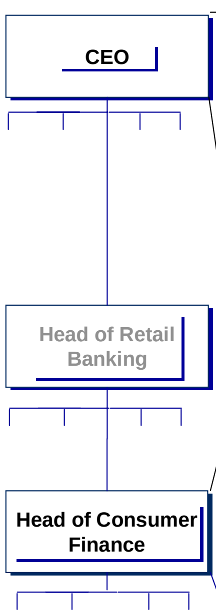
<u>Case example 1</u>: Establishing KPIs – a Financial Institution example

Overview:

- The new priorities of the bank following a 3-year restructuring were integrated in a new set of KPIs for both the CEO and the Head of Consumer Finance (see Figure 4)
- Bank now focused on growth of “quality” credit book, as it had been suffering from high default rates.

Figure 4

KPIs BASED ON KEY VALUE DRIVERS



KPIs

CEO:

Performance

Financial
- Top line growth
- ROE

Operational
- Improvement in costs from centralisation process

Organisational
- Launching new KPI system (down 4 levels)

Network
- Management of previous year’s VSS

Market place
- Increase proportion of clients with both Fee Income and Interest Income products

Health

Financial
- Change in NPLs

Organisational
- Level of voluntary attrition by sales force

Head of Consumer Finance:

Performance

Financial
- Overall growth of the loan book
- Delta on risk-adjusted new mortgages per sales-person

Operational
- Submitted loans over approved (%)

Organisational
- Launching new KPI system for sales-force

Network
- Signing of partnerships for affinity-group sales

Market place
- Referrals to the Investment unit

Health

Financial
- Change in NPLs

Organisational
- Overall satisfaction of new recruits

Marketplace
- Customer satisfaction

- The CEO has eight KPIs aligned and selected among the more than 40 company-level performance indicators. Highlights include:
  - Financial KPIs including “Change in NPLs” to account for higher quality customer acquisition required over time to reduce default rates
  - Operational and Network KPIs based on projects currently sponsored by the CEO as key cost-saving measures

2. Establishing KPIs and setting targets for senior management – Case examples	INTENSIFY PERFORMANCE MANAGEMENT	
	Supporting Materials for "Blue Book" v 2.0	Card number III.9.1.2.2.(f)

- As the bank was revamping its KPI and compensation systems (particularly for the sales force) to increase retention, this was reflected in the CEO's KPIs as "Launching a new KPI system" and "Level of voluntary attrition by sales force".
- Similarly, as the CEO was seeking to increase the average number of products per client through cross-referral programs, this was reflected in his KPIs as "Increase proportion of clients with both Fee Income and Interest Income products".

- The Head of Consumer Finance was two levels down from the CEO. Therefore, her KPIs included similar metrics, although tailored to her area of responsibility:
  - As her focus was to grow a 'high quality' loan book, her KPIs were "Overall growth of the loan book", "Delta on risk-adjusted new mortgages per sales-person", "Customer satisfaction" and "Change in NPLs"
  - To enhance sales, she was pursuing new partnerships to sell products to specific affinity groups, which was reflected in her KPIs as "Signing of partnerships for affinity-group sales"
  - Finally, to increase referrals to other business units in the bank and to ensure that the new recruits adapt quickly to the bank, KPIs also included "Referrals to Investment unit" and "Overall satisfaction of new recruits".

- Both the CEO's and the Head of Consumer Finance's KPIs were weighted according to their importance, and it had direct implications on the CEO and the Head of Consumer Finance's total compensation, as explained in part 5.

Case example 2: Reporting Headline Performance Indicators – a Telco example

- This European telecom company has high levels of transparency to the financial markets. For instance, it publicises key *projected* metrics of its business priorities. This forces the company to set stretched, yet realistic, targets while also increasing market confidence in its performance.

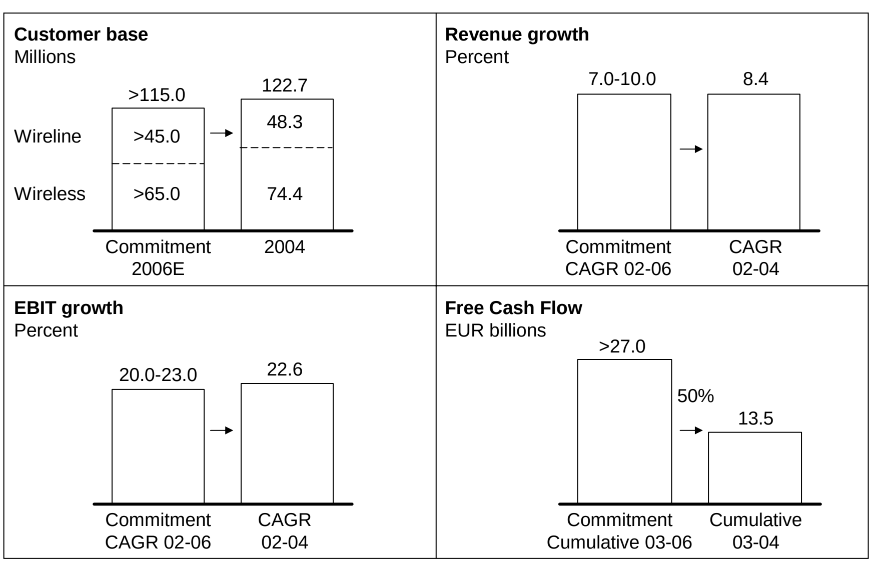
- Within the last few years, the company has also announced several different Headline Performance Indicators, for example reduction in number of employees (as part of a significant program to increase labour productivity), lines per employee etc.

- Figure 5 illustrates examples of Headline Performance Indicators communicated to the financial markets in 2002 and 2003.

Figure 5

FOLLOW UP ON PREVIOUSLY ANNOUNCED HEADLINE PERFORMANCE INDICATORS

Only financial indicators selected



- In addition to reporting projections, the company also regularly reports on its performance against previous targets. The examples shown, are follow ups during 2004/05 on previous commitments (i.e. Headline Performance Indicators) to the market.

3. Reviewing business performance – Objective and guidelines covered	INTENSIFY PERFORMANCE MANAGEMENT	
	Supporting Materials for "Blue Book" v 2.0	Card number III.9.1.2.3.(a)

Objectives of part 3

- Provide rationale and clarify the guidelines in the Blue Book related to section 3 of the Guiding Principles: "*Reviewing business performance* "
- Provide best practices and case examples on the guidelines in the Blue Book

Guidelines	Supporting materials
3.1 Conduct Board review of company performance	▪ Best practice 2, Card III.9.1.2.3(c)
3.2 Establish regular performance reviews for all divisions, business units and departments	▪ Best practice 1, Card III.9.1.2.3(b) ▪ Best practice 3, Card III.9.1.2.3(d) ▪ Case example 1, Card III.9.1.2.3(e)

3. Reviewing business performance – Rationale and best practices	INTENSIFY PERFORMANCE MANAGEMENT	
	Supporting Materials for "Blue Book" v 2.0	Card number III.9.1.2.3.(b)

Rationale

- In an increasingly complex and fast-evolving environment, regular performance reviews at all levels of the business are necessary to ensure that potential issues are identified early and addressed properly. Such reviews also provide opportunity for an adequate discussion around business trends and potential opportunities.

<u>Best practice 1</u>: Regular business performance review as part of annual cycle of key management processes (Figure 1)

Figure 1

OVERVIEW OF KEY MANAGEMENT PROCESSES

CONGLOMERATE

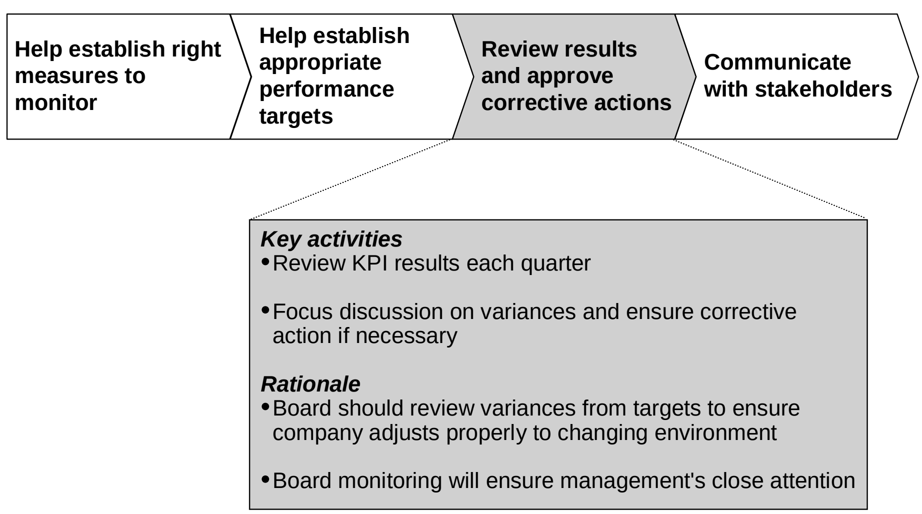
Jun-Jul	Aug-Sep	Oct-Nov	Ongoing	Ongoing	Dec-Jan
Strategic planning	**Operational planning**	**Budgeting**	**Resource commitment approval and issue resolution**	**Performance review**	**People development** (**Top 500** / **Other staff**)
• Determines where and how the company should compete in the market	• Translates strategy into initiatives and finalises targets for next year	• Allocates resources for implemen-tation of operational plan	• Gives final approval to commitments approved in the budget	• Reviews actual performance vs. targets as set in operational plan and budget	• Links business performance to individual performance and to HR management
• Plan ahead on the basis of an issue driven approach	• Defines resource needs and priority actions for next year	• Is predomi-nantly a mechanistic exercise	• Gives opportunity to review resource commitments in the light of recent developments	• Drives implementa-tion throughout the organisation	• Ensure quality of management throughout the company

3. Reviewing business performance – Best practices	INTENSIFY PERFORMANCE MANAGEMENT	
	Supporting Materials for “Blue Book” v 2.0	Card number III.9.1.2.3.(c)

<u>Best practice 2</u>: Business performance review at company level led by the board (Figure 2)

Figure 2

BOARD PERFORMANCE REVIEW AS PART OF THE BOARD’S ROLE IN OVERALL PERFORMANCE MANAGEMENT PROCESS



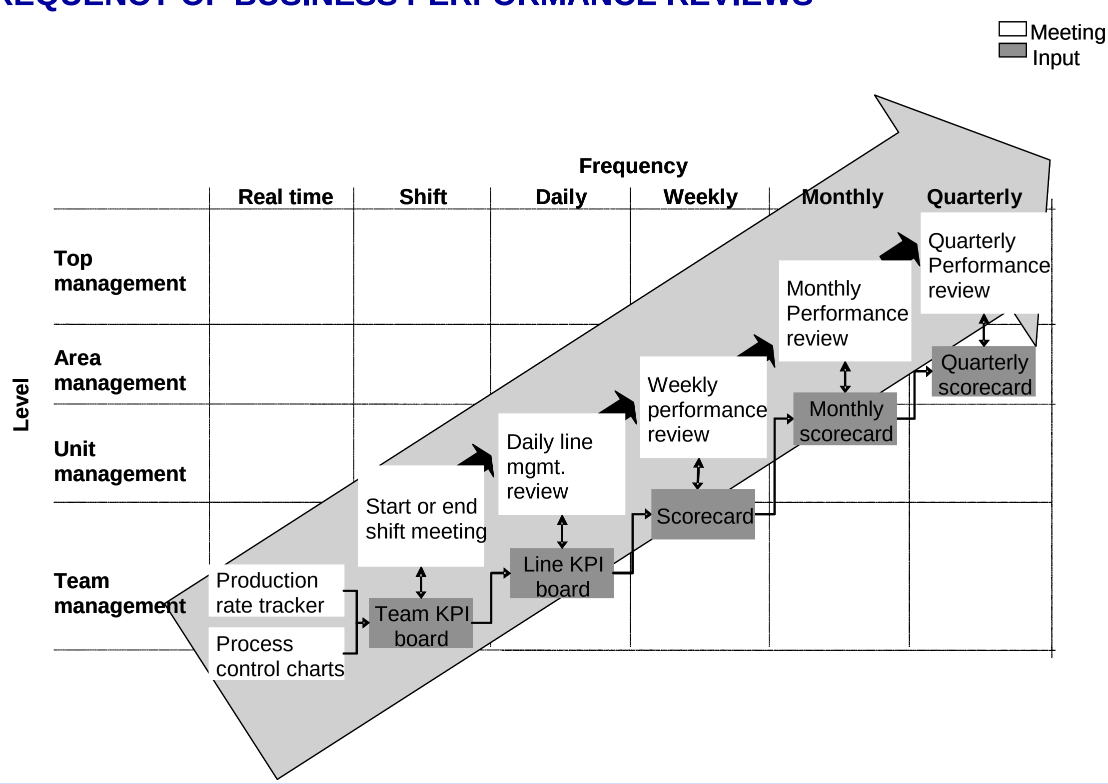
3. Reviewing business performance – Best practices	INTENSIFY PERFORMANCE MANAGEMENT	
	Supporting Materials for "Blue Book" v 2.0	Card number III.9.1.2.3.(d)

<u>Best practice 3</u>: Business performance reviews cascaded down at different levels throughout the organisation

- While the board reviews the overall company's performance, the CEO will review the performance of the business units, and the heads of the business units will review their departments' performance. This process is cascaded down to the level of individual teams. (Figure 3)

Figure 3

FREQUENCY OF BUSINESS PERFORMANCE REVIEWS



3. Reviewing business performance – Case examples	INTENSIFY PERFORMANCE MANAGEMENT	
	Supporting Materials for “Blue Book” v 2.0	Card number III.9.1.2.3.(e)

Case example 1: Review of a business unit – Manufacturing example

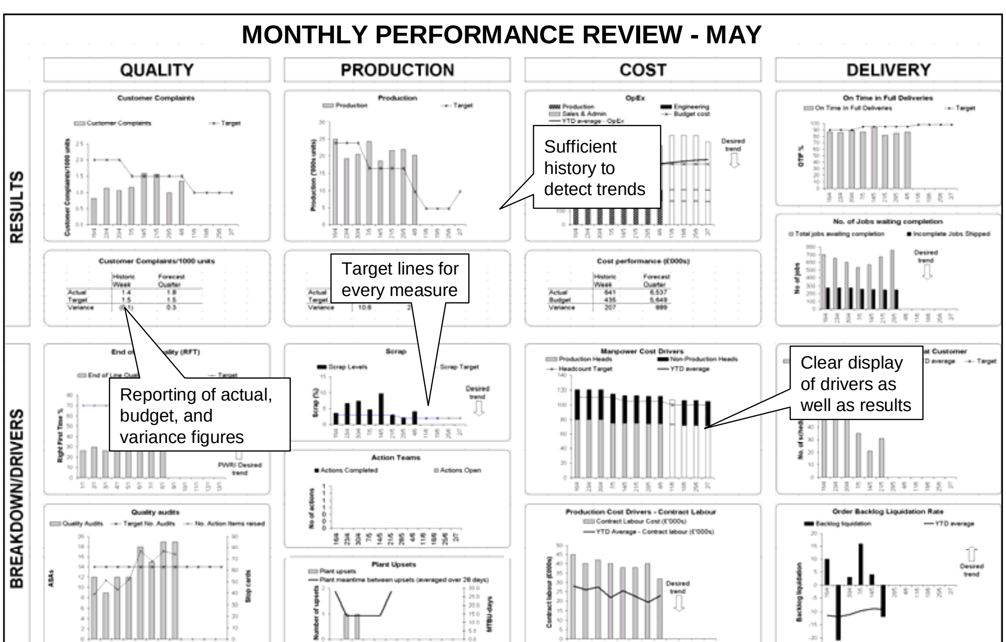
- In this manufacturing company, each business unit undergoes a monthly formal review on the basis of a pre-defined scorecard (Figure 4).

- This scorecard has several levels: the highest level provides an overall summary of key performance indicators for the business unit while the lower levels contain more detailed performance indicators. This allows focus on key metrics, while retaining the ability to “drill down”, when needed, on areas where there variations from the targets have to be understood.

- Typically, such a review meeting would involve the head of the business unit and her/his superior, as well as the business unit’s production and finance/accounting managers. As a frequent and focused meeting, the review would rarely take more than 2-3 hours.

Figure 4

SCORECARD EXAMPLE – TRACKING OF OUTPUT AND KEY DRIVERS



4. Reviewing individual performance of senior management – Objectives and guidelines covered	INTENSIFY PERFORMANCE MANAGEMENT	
	Supporting Materials for "Blue Book" v 2.0	Card number III.9.1.2.4.(a)

Objectives of part 4

- Provide rationale and clarify the guidelines in the Blue Book related to section 4 of the Guiding Principles: *"Reviewing individual performance of senior management "*
- Provide best practices and case examples on the guidelines in the Blue Book

Guidelines	Supporting materials
4.1 Put in place a rigorous process for reviewing individual performance	▪ Best practice 1, Card III.9.1.2.4(b) ▪ Case example 1, Card III.9.1.2.4(e)-(g)
4.2 Ensure evaluations show real differentiation in terms of overall rating	▪ Best practice 2, Card III.9.1.2.4(c) ▪ Case example 1, Card III.9.1.2.4(f) ▪ Case example 2, Card III.9.1.2.4(i)-(j) ▪ Case example 3, Card III.9.1.2.4(l)-(m)
4.3 Follow up performance rating with meaningful rewards and consequences	▪ Best practice 3, Card III.9.1.2.4(d) ▪ Case example 1, Card III.9.1.2.1(h) ▪ Case example 2, Card III.9.1.2.4(k)

4. Reviewing individual performance of senior management – Rationale and best practices	INTENSIFY PERFORMANCE MANAGEMENT	
	Supporting Materials for "Blue Book" v 2.0	Card number III.9.1.2.4.(b)

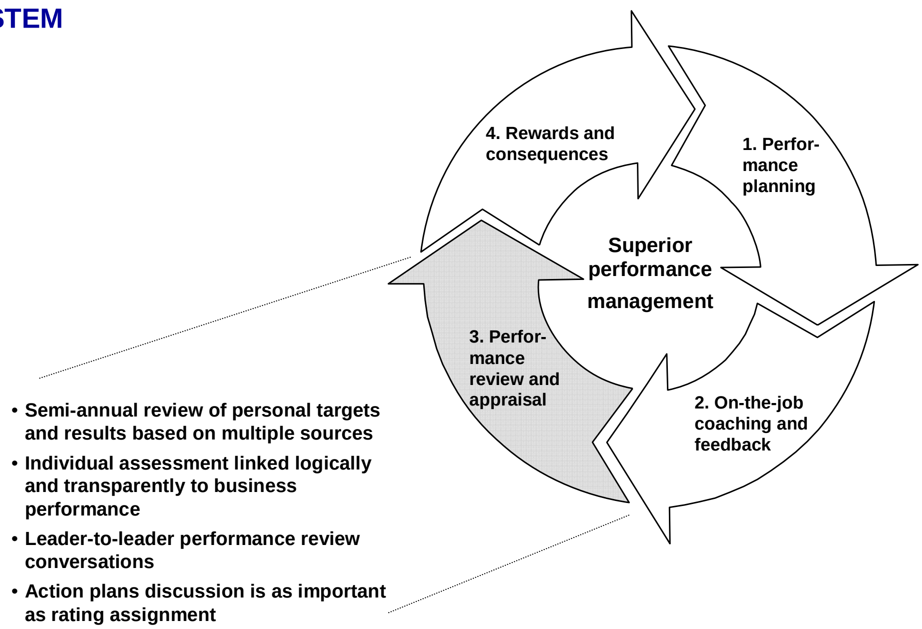
Rationale

- Reviews are necessary to properly evaluate employees against achievements, identify their strengths and weaknesses and serve as a basis for designing appropriate rewards.
- Thus, the individual performance review process is a critical step to build a strng performance culture and ensure that KPIs translate into alignment of effort of people in the organisation to the overall business goals.

Best practice 1: Performance review and appraisal as a key element in the people performance management system

Figure 1

KEY ELEMENTS IN A SUPERIOR PEOPLE PERFORMANCE MANAGEMENT SYSTEM



- *1. Performance planning*: Covered in segment III.9.1.2.2.
- *2. On-the-job coaching and feedback*: Not covered
- ***3. Performance review and appraisal*: Covered in this segment**
- *4. Rewards and consequences*: Covered in segment III.9.1.2.5.

4. Reviewing individual performance of senior management – Best practices	INTENSIFY PERFORMANCE MANAGEMENT	
	Supporting Materials for “Blue Book” v 2.0	Card number III.9.1.2.4.(c)

<u>Best practice 2</u>: Choose a performance rating scheme in line with company culture and strategy

- **Absolute rating**. This scheme is based on the employee’s actual performance compared with his or her KPIs - irrespective of the performance of other people in the organisation.

- **Relative rating**. This scheme is based on the relative performance of the employee vs. its peers. For example, under such a scheme, regardless of how well all business unit managers perform, there will always be a certain number of them rated “low performers”.

- **Normalised rating**. This scheme takes elements of both absolute rating and relative rating. It is based on adjusted KPIs to ensure a reasonable performance distribution across the entire organisation.

Figure 2

EACH PERFORMANCE RATING SCHEME HAS ITS PROS AND CONS

	Pros	Cons
Absolute rating	• Upfront clarity on which performance leads to which rating • Easy to communicate and justify	• Reasonable dispersion in ratings not automatically ensured • Ratings sensitive to changes in external environment (e.g. sales prices increase makes target easy to achieve) • Requires high quality target-setting
Relative rating	• Dispersion in people ratings is ensured • Strong performance culture is promoted	• Possible de-motivation of employees if average and/or low performers are not dealt with correctly
Normalized rating	• Reasonable dispersion in ratings ensured throughout organisation • Dispersion in people ratings is ensured • Adapts performance distribution to departments	• Complicated rating system • Limited transparency to employees

4. Reviewing individual performance of senior management – Best practices	INTENSIFY PERFORMANCE MANAGEMENT	
	Supporting Materials for “Blue Book” v 2.0	Card number III.9.1.2.4.(d)

Best practice 3: Setting targets and dealing with uncontrollable factors

- Many companies struggle to set the right targets because external factors, on which the employees cannot act, affect how easy or difficult it is to reach their targets. For instance, airlines might find it difficult to set financial targets and hold the managers responsible because fuel prices and other events outside the manager’s control significantly impact the financial results and thereby the KPIs.

- GLCs should use mechanisms to correct the targets:
  - The most common solution to such issues is to pre-agree on some key assumptions (e.g. fuel price for an airline) and a “deviation band”. If the parameter deviates outside the “deviation band”, the overall company’s financial previsions would be recast and financial KPI targets recalculated.

  - Another solution is to use a set of complementary indicators sensitive to different external factors. For example, when an airline is affected by rising fuel costs, its market share would probably not be affected as much as its financial targets.

4. Reviewing individual performance of senior management – Case examples	INTENSIFY PERFORMANCE MANAGEMENT	
	Supporting Materials for "Blue Book" v 2.0	Card number III.9.1.2.4.(e)

<u>Case example 1</u>: Performance review process, absolute rating and management of non-performers - an Oil & Gas example

- In this company, business and individual performance management processes are tightly integrated but distinct. (Figure 3)

Figure 3

BUSINESS AND INDIVIDUAL PERFORMANCE REVIEW PROCESSES

Business (light grey) / Individual (dark grey)

	Performance Planning		Ongoing Reviews	Performance Review and Rewards	
	Full-year business planning	**Individual performance planning**	**Quarterly reviews** **Coaching/feedback**	**Full-year business review**	**Individual performance review**
When	• Oct - Mar	• Mar- April	• Ongoing	• Mar - April (non-audited year-end)	• Semi-annual reviews: Oct (mid-year) April (full year)
Business	• Top-down expectation setting tightly linked to long term aspirations • Combination of "hard" and "soft" targets		• Quarterly business reviews	• Full-year business review	
Individual	• Signed performance contracts, KPIs derived from business targets • Discussions to link targets to overall corporate goals • Discussions to set expectations in terms of development and consequences		• Formal and informal on the job coaching around critical tasks • Individual business performance reviews conducted separately	• Individuals evaluated on performance and leadership behaviors • Rigorous individual review with multiple inputs and multiple judgments resulting in real rating differentiation • Leader-to-leader performance review conversations that emphasize specific development actions • Meaningful rewards and consequences	

4. Reviewing individual performance of senior management – Case examples	INTENSIFY PERFORMANCE MANAGEMENT	
	Supporting Materials for “Blue Book” v 2.0	Card number III.9.1.2.4.(f)

■ This Oil & Gas company has recently chosen an absolute rating scheme, and is in the process of rolling it out (Figure 4):

Figure 4

DESCRIPTION OF ABSOLUTE PERFORMANCE RATING SCHEME

Rationale for absolute rating

- Aligns personal and business performance management
- Motivates leaders with unambiguous and upfront link between their individual targets and performance ratings
- Gives little flexibility in assigning ratings because process is simple and involves limited judgment
- Focuses individual performance review meetings on action plans because performance ratings are straightforward

Performance rating categories

Rating	Performance requirement
① Outstanding	All stretch targets achieved
② Exceeds expectations	Majority of stretch targets achieved with remainder hitting base target
③ Meets expectations	All base targets achieved
④ Below expectations	One or more base targets not achieved

■ From their experience, robust target setting is critical for the success of this rating scheme.

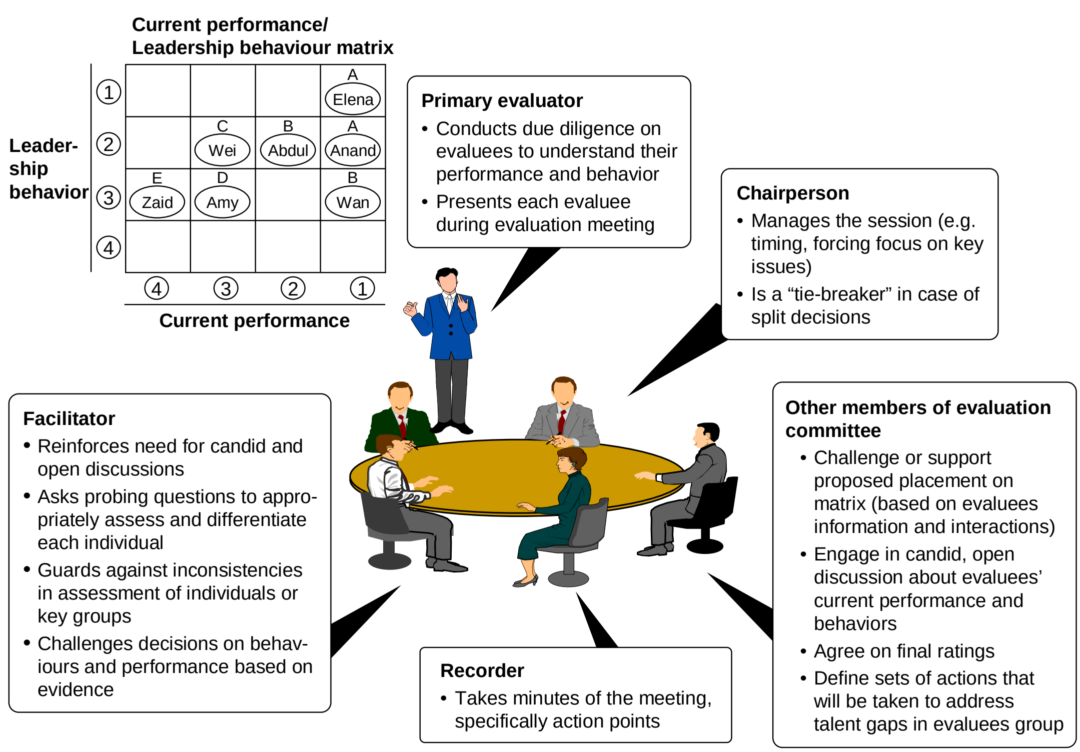
■ A second dimension of the rating is leadership behaviour, based on a 360-degree assessment with anonymous input from the individual’s relevant subordinates, peers as well as superiors. This feedback is consolidated by the direct superior and codified.

4. Reviewing individual performance of senior management – Case examples	INTENSIFY PERFORMANCE MANAGEMENT	
	Supporting Materials for "Blue Book" v 2.0	Card number III.9.1.2.4.(g)

- During performance review meetings, the performance of individuals is reviewed by their superiors (Figure 5):

Figure 4

ROLES TAKEN IN REVIEW MEETING



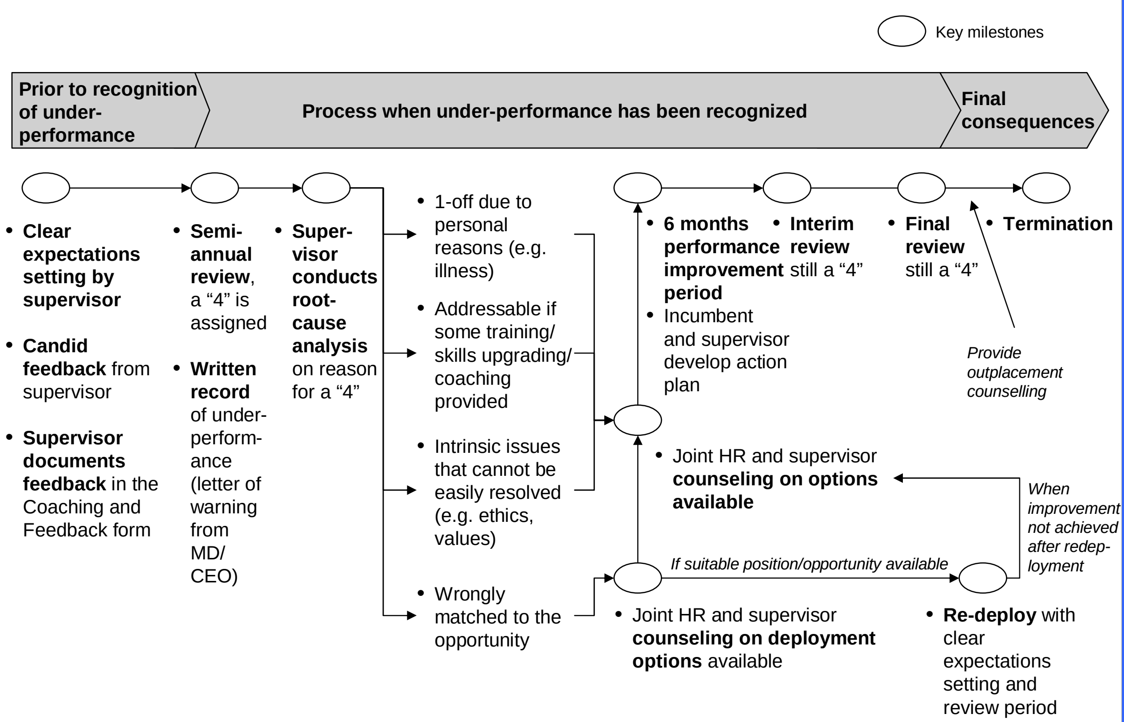
- After the meeting, the primary evaluator develops a 1-page action plan for the next 6 months (until next review) that sets out areas in which the individual is strong as well as areas that the individual needs to work on. Then, he meets with the individual to discuss based on the action plan.

4. Reviewing individual performance of senior management – Case examples	INTENSIFY PERFORMANCE MANAGEMENT	
	Supporting Materials for "Blue Book" v 2.0	Card number III.9.1.2.4.(h)

- The company rigorously manages under-performers with clear expectations setting and feedback – consistent under-performers are terminated.

Figure 6

END-TO-END PROCESS FOR MANAGING UNDER-PERFORMERS



4. Reviewing individual performance of senior management – Case examples	INTENSIFY PERFORMANCE MANAGEMENT	
	Supporting Materials for "Blue Book" v 2.0	Card number III.9.1.2.4.(i)

Case example 2: Relative rating - a Conglomerate example

- This conglomerate has consistently outperformed the market over the last decades, which is believed to be partly driven by its performance culture and high-quality staff. It uses a relative rating scheme whereby people are evaluated along two dimensions: current performance and the extent to which they "live the company's values" (Figure 5).

Figure 5

DESCRIPTION OF RELATIVE RATING SCHEME

Current performance (based on objective KPIs)

	Low	Medium	High
Top 20%	Stock options	Stock options, Elite training school	Promote, stock options, Elite training school
Middle 70%	Inform, no further promotion possible		Encourage, Elite training school
Bottom 10%	Out	Out	Out, unless mitigating circumstances

Living company values (based on 360° evaluation)

Review process

All employees in a team are ranked against one another

- Current performance is judged on whether they are making the numbers
- Long-term potential is driven by intrinsic adherence to values (the 4 E's: Edge, Execution, Energy, and the ability to Energize)– "Are they people who can thrive in this company?"

- It is interesting to note that the CEO is very significantly involved in people performance management, spending over 50% of his time on people issues, specifically performance reviews and training sessions.

4. Reviewing individual performance of senior management – Case examples	INTENSIFY PERFORMANCE MANAGEMENT	
	Supporting Materials for "Blue Book" v 2.0	Card number III.9.1.2.4.(j)

- To determine their long-term potential ("do they live the company values?"), employees are evaluated against four dimensions: Energy, ability to Energize others, competitive 'Edge', and ability to Execute (Figure 6).

Figure 6

4E's TO DETERMINE EMPLOYEES' LONG-TERM POTENTIAL

Energy "Individuals with energy love to 'go, go, go.' We all know people like this—the ones with boundless energy, who get up every morning just itching to attack the job at hand. These are people who move at 95 miles-per-hour in a 55-miles-per-hour world."

Energizers "Know how to *spark others* to perform. They outline a vision and inspire people to act on that vision. Energizers know how to get people excited about a cause or crusade. They are selfless in giving others the credit when things go right and quick to accept responsibility when things go awry. Why? Because they know that sharing credit and owning blame *energizes* their colleagues."

Edge "Those with edge are *competitive* types. They know how to make the really difficult decisions, never allowing the degree of difficulty to stand in their way. These are leaders who don't hesitate to make the 'life and death' decisions: hiring, promoting, and firing."

Execute "The first three E's are essential, but without *measurable results*, they are of little use to an organisation. People who execute effectively understand that activity and productivity are not the same thing. The best leaders know how to convert energy and edge into action and results. They know how to execute."

4. Reviewing individual performance of senior management – Case examples	INTENSIFY PERFORMANCE MANAGEMENT	
	Supporting Materials for "Blue Book" v 2.0	Card number III.9.1.2.4.(k)

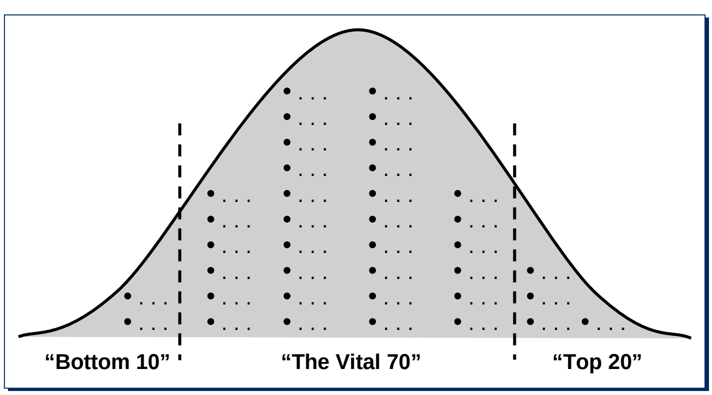
- In alignment with the relative ranking scheme, the company has defined three categories of employees (Figure 7):
  - Employees rated in the "Top 20%" are high performers who embody corporate values. They are well supported and advance rapidly up the organisation. They are offered special training programs. It is a key priority for the conglomerate to retain employees in this category (it estimates that it loses less than 1% of these people per year and all people in this category that choose to leave are interviewed in order to understand their reasons for doing so).

  - Most employees are in the "Vital 70%". Although not on the "fast track", they are critical to the business and the company ensures they remain motivated.

  - Employees in the "Bottom 10%" are likely to be dismissed unless there is an improvement within 3 months, or there are mitigating circumstances.

Figure 7

PERFORMANCE RATING BOUNDARIES



Case example 3: Normalised rating - a Financial Institution example

- This bank has adopted a normalised rating scheme based on two types of evaluation criteria: Results against goals (“What achieved”) and Skills/competencies (“How achieved”) (Figure 8):

Figure 10

BASIS OF PERFORMANCE RATING SCHEME

Results against goals “What achieved” + **Skills/competencies ”How achieved”** = **Overall evaluation rating “Bottom line performance”**

Results against goals “What achieved”

- Results achieved against the 4-10 quantitative targets are reported as “target achievement ratios” (result/target)
- Target achievement ratios are translated to a score on a 1-4 scale
- This part could also include achievement for 1-3 projects

Skills/competencies ”How achieved”

- The skills/competencies required to be successful in this company and in the current and subsequent position are evaluated on a 1-4 scale
- The four overall skills/ competencies needed are
  - Relevant product knowledge
  - Negotiation and communication skills
  - Analytical capabilities
  - Follow-through and execution

Overall evaluation rating “Bottom line performance”

- A single rating on a 1-4 scale that summarizes overall performance
- Provides basis for rewards and consequences

The weights of “what achieved” and “how achieved” differ according to department and position

4. Reviewing individual performance of senior management – Case examples	INTENSIFY PERFORMANCE MANAGEMENT	
	Supporting Materials for “Blue Book” v 2.0	Card number III.9.1.2.4.(m)

- To determine the *“results against goals”* a four-step procedure is followed (Figure 9):

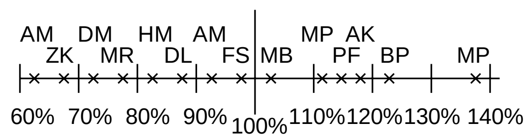
Figure 9

INDIVIDUAL PERFORMANCES ARE RANKED IN A FOUR-STEP PROCESS

1 Target achievement ratios for each key performance indicator is reported by IT system

Result/target =
Target achievement ratio (%)

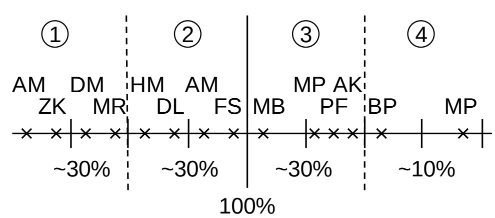
2 Target achievement ratios for each KPI is plotted on a chart for all individuals in the same position



3 Management should determine the percentage of employees to get 1, 2, 3, and 4 based on the budget and the overall results

All 4 steps are done separately for each KPI

4 Cut-off lines are drawn on the chart to identify the individuals that get 1, 2, 3, and 4 on that KPI



- To determine the rating from the *“skills and competencies”* category, the individual is rated by his or her direct superior.

- The bank has opted for complete transparency on individual performance. For example, it makes all “KPI” results public within the organisation – although in such a way that it is only possible for individuals to identify themselves and their ranking. The bank is well aware that this level of transparency can be demoralizing for low performers and that it also has to recognise “improvement over time”.

5. Establishing appropriate compensation framework for senior management – Objectives and guidelines covered	INTENSIFY PERFORMANCE MANAGEMENT	
	Supporting Materials for "Blue Book" v 2.0	Card number III.9.1.2.5.(a)

Objectives of part 5

- Provide rationale and clarify the guidelines in the Blue Book related to section 5 of the Guiding Principles: "*Establishing appropriate compensation framework for senior management* "
- Provide best practices and case examples on the guidelines in the Blue Book

Guidelines	Supporting materials
5.1 Ensure that base pay is competitive in the market	▪ Best practice 1, Card III.9.1.2.5(b)
5.2 Ensure that base pay increments reflect individual performance	▪ Case example 3, Card III.9.1.2.5(i) ▪ Case example 4, Card III.9.1.2.5(j)
5.3 Link bonus and total compensation to rating	▪ Best practice 2, Card III.9.1.2.5(d) ▪ Case example 1, Card III.9.1.2.5(f) ▪ Case example 2, Card III.9.1.2.5(g)-(h)
5.4 Ensure that total compensation is competitive in the market	
5.5 Use cash rewards	
5.6 Use share based rewards	

5. Establishing appropriate compensation framework for senior management – Rationale and best practices	INTENSIFY PERFORMANCE MANAGEMENT	
	Supporting Materials for "Blue Book" v 2.0	Card number III.9.1.2.5.(b)

Rationale

- Compensation systems work most effectively when it is aligned with business strategy, structure and culture. Compensation is an important tool to:
  - Attract and retain the right people
  - Incentivise and motivate employees on key priorities, and thus can instill accountability for results

Best practice 1: Compensation as part of the employee value proposition

- In determining the appropriate level of compensation, a company should consider (1) the type of candidates it is seeking to attract and (2) the level of compensation offered to such candidates on the market

- Figure 1 illustrates an approach to determining compensation levels:

Figure 1

HOW MUCH SHOULD WE PAY TO RETAIN AND ATTRACT TALENT?

What is our pay philosophy?	How to determine total compensation amount?
Objectives • Attract and retain the right people – those who fit our desired profile • Avoid paying more than necessary • Structure compensation to fund significant variable incentives	**Recruitment/retention experience** • Ease/difficulty in recruiting new hires – Feedback from candidates and search firms – Acceptance rate of employment offers – Average time to fill vacancies • Retention rates of above-median performers
Methodology • Determine profile of desired candidates • Set target pay philosophy in terms of percentile in comparable talent market	**Market surveys** • Comparison of internal compensation ranges with external market data on – Base salaries – Total targeted compensation (base salaries plus target bonuses) – Total maximum compensation (base salaries plus maximum bonuses)

5. Establishing appropriate compensation framework for senior management – Best practices	INTENSIFY PERFORMANCE MANAGEMENT	
	Supporting Materials for "Blue Book" v 2.0	Card number III.9.1.2.5.(c)

- Figure 2 provides three different compensation philosophies followed by three successful companies. These options range from a highly individual and variable compensation structure to an approach where compensation is not a key part of the employee value proposition.

Figure 2

COMPENSATION WITHIN EMPLOYEE VALUE PROPOSITIONS

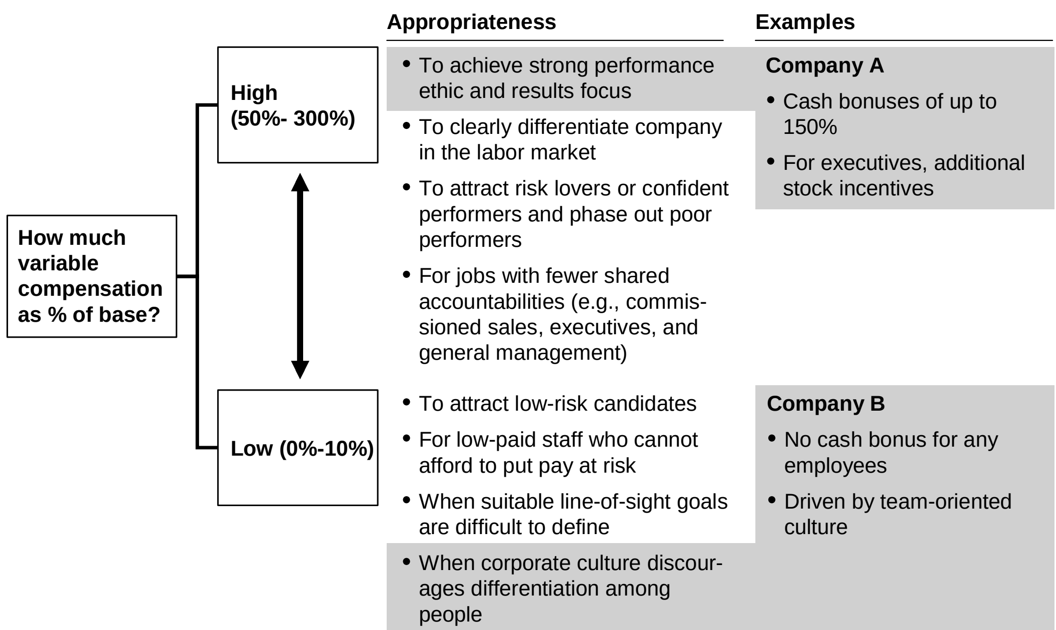
	Company in fast moving consumer goods	Conglomerate	IT company
Key elements in the Employee Value Proposition	• Best education in the business on how to get things done • Fast-track career opportunities (within and outside the organisation) • Employability growth • Very good compensation • "Perform or leave" • Freedom to act	• "Working for a winner" with an unmatched record of earnings growth • Greatest general management jobs – demanding, challenging, lots of freedom • Job security and stability	• Public status and recognition for good performance and innovation • Peer accolades • Opportunity to work on leading-edge, interesting technologies and products • High job security • Environment of integrity
Importance of compensation	*High* • Base salaries set at 75th percentile of 50 other high performing companies • Salaries plus bonuses at 90th percentile to attract top talent and to compensate for low job security • Large cash bonuses of 25%-75% with 150% cap for delivering results against tough goals • For non-executives, all cash/no stock, in keeping with short tenures • For executives, long-term stock incentives	*Medium-high* • Competitive compensation • Average base salaries • Significant annual cash bonus plan for maintaining continuously high revenue and earnings growth targets • Long-term stock program tied to rolling 5-year results – very important factor for encouraging people to stay	*Medium* • Base salaries at median of market (compared with others' salaries and bonuses) • No cash bonuses • Stock options for 20,000 of 90,000 employees to encourage long tenure and focus on company results • Rich benefits program

<u>Best practice 2</u>: Establishing variable compensation

- Figure 3 illustrates a range of options in establishing variable compensation. In general, the proportion of variable pay to total compensation tends to increase with the seniority of the person’s position within the organisation (i.e. the relative variable pay element is likely to be more significant for a CEO than for a lower level manager). However, in the recent years, the trend has been for compensation of all employees to have a higher degree of variability.

Figure 3

OPTIONS FOR COMPOSITION OF COMPENSATION



- There are many ways through which compensation policy can provide incentives, including performance-based bonuses and salary revisions, stock options, and performance-based dismissal actions.

5. Establishing appropriate compensation framework for senior management – Best practices	INTENSIFY PERFORMANCE MANAGEMENT	
	Supporting Materials for "Blue Book" v 2.0	Card number III.9.1.2.5.(e)

- Best practices indicate that variable pay, in whatever form it takes (for example, cash bonus or stock options), is an important part of the total compensation for executives, and in particular for CEOs. Examples include:

  - Year-to-year grants of stock-options provide incentives where the size of the grant is linked to and based on performance. In particular, potential value changes in unexercised stock options tend to provide a very strong incentive.

  - Stock ownership is another method to directly tie to an executive's welfare the performance of his or her firm.

  - Variable cash compensation for performance measured relative to aggregate performance in the industry or market also provides a strong incentive. It allows executives to increase shareholder value while filtering out industry and market-wide factors that are beyond their control.

  - Non-financial rewards associated with the position of an employee can also be a good incentive (e.g. public recognition, benefits, e.g. club membership).

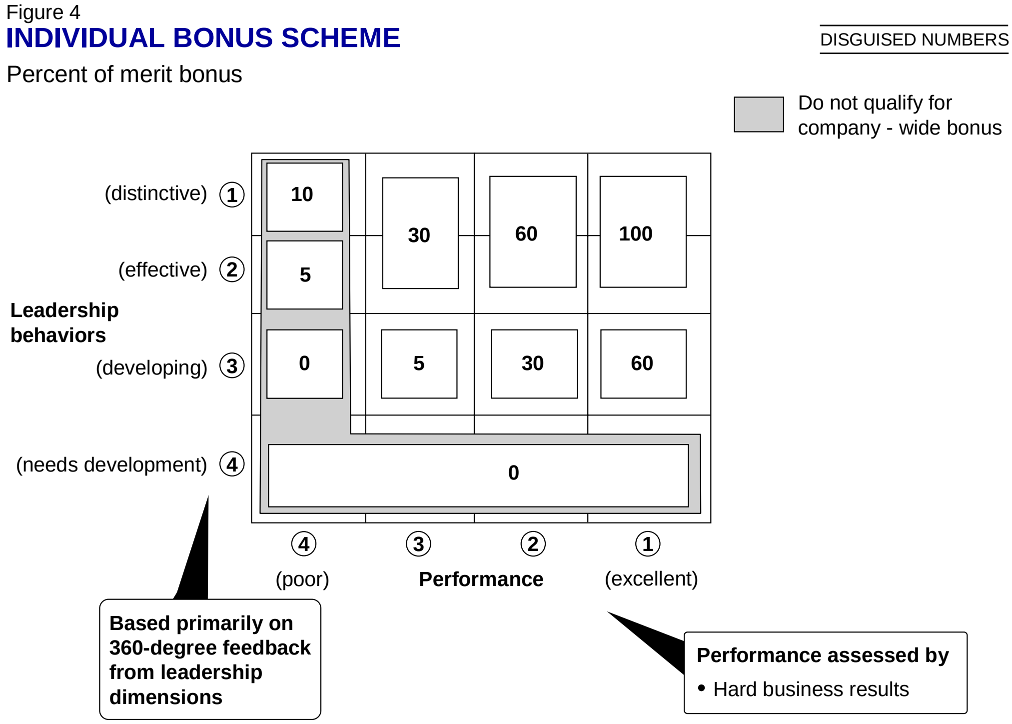
5. Establishing appropriate compensation framework for senior management – Case examples	INTENSIFY PERFORMANCE MANAGEMENT	
	Supporting Materials for "Blue Book" v 2.0	Card number III.9.1.2.5.(f)

Case example 1: Performance-linked bonus - an Oil & Gas example

- There are a number of different ways in which a bonus payout can be determined. This Oil & Gas company adopted a very simple approach based on the practice of rating its managers on two dimensions: first, on their leadership behaviours and second, against quantifiable and objective KPIs. The final individual bonus is then decided by the ratings of both dimensions (Figure 4).

- It is also clear that the company's bonus payout scheme is biased towards the "performance" dimension, since improvements on this dimension are better rewarded: moving from a 2 to a 1 rating on the "leadership" dimension will not improve the bonus but the same improvement on the "performance" dimension.

Figure 4
INDIVIDUAL BONUS SCHEME
Percent of merit bonus



5. Establishing appropriate compensation framework for senior management – Case examples	INTENSIFY PERFORMANCE MANAGEMENT	
	Supporting Materials for “Blue Book” v 2.0	Card number III.9.1.2.5.(g)

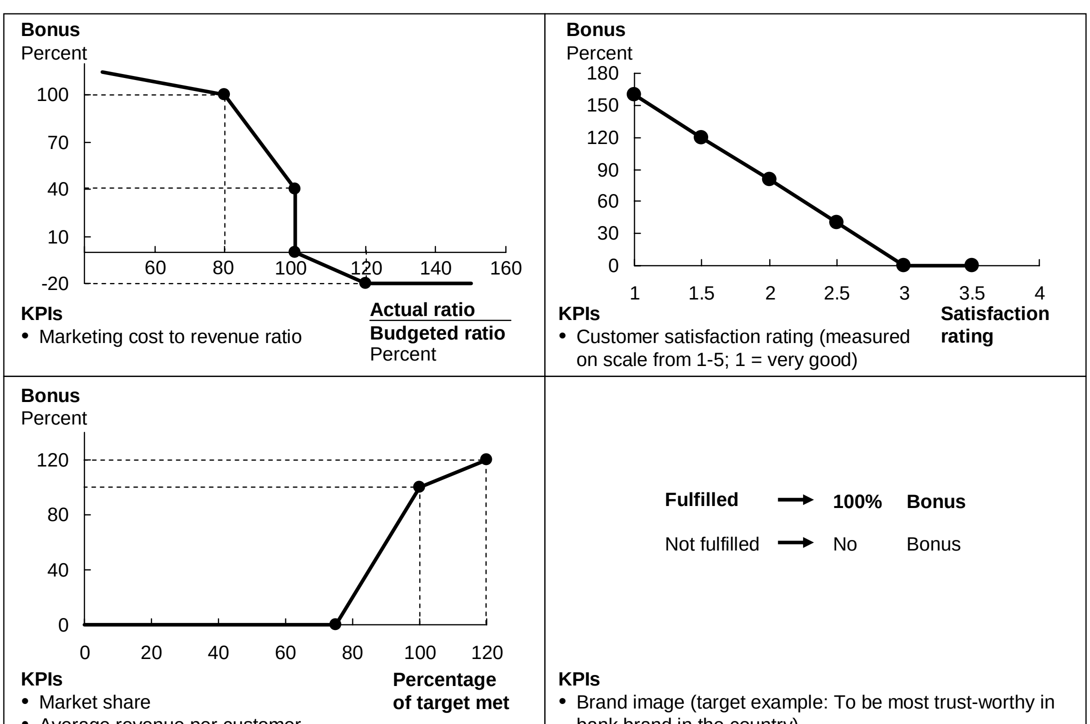
Case example 2: Bonus system for a marketing manager - a Bank example

- This bank’s bonus system for its marketing manager provides a good insight into how a bonus system can be designed. The marketing manager has five KPIs:
  - Marketing costs to revenue ratio
  - Customer satisfaction (determined by external agency)
  - Market share (determined by external agency)
  - Average revenue per customer
  - Brand image (determined by external agency).

- Figure 5 provides an example of the marketing manager’s “KPI” targets and actual results, as well as the computation of the total bonus.

Figure 5

OVERVIEW COMPENSATION SCHEME –Head of Marketing



- For all five KPIs, the size of the manager's bonus depends on the achievement ratio – that is, the result divided by the "KPI" target. A different weighting is assigned to each "KPI", depending on its importance.

- The graph in the top left hand corner of Figure 5 can be interpreted as follows:
  - If the "KPI" target for the "marketing costs to revenue ratio" is 3% and the marketing manager achieves exactly that (he then gets an actual ratio of 100%), then he will be eligible for a 40% bonus on this specific "KPI".
  - Thus, if the bonus sum for this "KPI" is RM 10,000, then the marketing manager is eligible for a bonus of RM 4,000.
  - However, had the marketing manager not met this "KPI" target, this would have resulted in a negative bonus, capped at -20%, which is deducted from the total bonus paid out, not the manager's base pay.

- Figure 6 presents a example of total bonus calculation: here, the marketing manager is eligible for 77% of the bonus pool allocated to him. So if the bonus pool is RM 100,000 the marketing manager is eligible for RM 77,000. Where the marketing manager's total bonus is more than 100%, he would be eligible to more than RM 100,000 or 5 months pay.

Figure 6

EXAMPLE OF TOTAL BONUS CALCULATION

ILLUSTRATIVE

KPI	Actual		Target		Percentage of target met	Percentage of bonus (see Fig. 6)		Weight		Contribution towards total
Market share	17%	⊘	20%	⊜	85%	40%	⊗	20%	⊜	8%
Marketing costs/ revenues	2.5%	⊘	3%	⊜	83%	90%	⊗	20%	⊜	18%
Average revenue per customer	188	⊘	200	⊜	94%	76%	⊗	20%	⊜	15%
			Score							
Customer satisfaction	. . .		2.00		. . .	80%	⊗	20%	⊜	16%
			Status							
Brand image	. . .		Target met		. . .	100%	⊗	20%	⊜	20%
Total bonus										**77%**

<u>Case example 3</u>: Overall performance determines base pay increments - a Conglomerate example

- In many cases, performance is not only reflected in the bonus level but also in the increments of the total base pay. This conglomerate rates its people along two dimensions:
  - First, employees are rated against what the company calls ‘soft goals’ such as people development, integrity and leadership capabilities.
  - Second, employees are measured against ‘hard goals’, which are typically quantifiable and objective “KPI” targets (Figure 7). These two dimensions form a matrix and, based on the rating of the individual, this matrix will determine which pay increment the person is eligible for.

Figure 7

IMPACT OF EVALUATION ON SALARY INCREASE

Soft goals
- People development
- Leadership
- Execution
- Integrity

Soft goals \ Hard goals	Doesn’t meet goals	Meets goals	Exceeds goals
Exceeds standard	C	B	A
Meets standard	D	C	B
Below standard	D	D	C

Hard goals
- Results against quantitative goals

Performance rating	Salary increase
A	Average ++
B	Average +
C	Average increase
D	No or below average increase

<u>Case example 4</u>: Overall performance determines base pay increments - a Conglomerate example

- This company uses two ‘hard’ and ‘soft’ dimensions to rate its employees. The “KPI” achievement—which is equivalent to the “hard goals” and leadership competence—is weighted to an overall performance rating using a scale of 1 to 5, where 1 is good performance and 5 is poor performance (Figure 8).

- However, as this company is concerned about the salary dispersion between its employees , it has added another dimension, which describes where the person is positioned in terms of salary ranges. This means that two individuals with the same overall rating and same position in the company would get different salary increases if they are not in the same quartile in terms of the salary range. As shown here, it is also clear that employees with a below average performance rating—that is, a rating of 4 or 5—would not get any salary increase.

Figure 8

ADDITIONAL DIMENSIONS COMPLEMENTING PERFORMANCE RATING WHEN CALCULATING COMPENSATION

KPI achievement (1-5 scale) (50% weighting)

Leadership competence (1-5 scale) (50% weighting)

Overall performance rating (1-5 scale 5 = poor performance)

Salary increase grid

Performance rating	Position in salary range (quartiles) 1Q	2Q	3Q	4Q
1	Average +++	Average ++	Average +	Average
2	Average ++	Average +	Average	Average -
3	Average +	Average	Average -	Average --
4	No increase	No increase	No increase	No increase
5	No increase	No increase	No increase	No increase

GE case example – Introduction	INTENSIFY PERFORMANCE MANAGEMENT	
	Supporting Materials for "Blue Book" v 2.0	Card number III.9.1.3.1

- This section provides a "full case example" of how GE has designed its performance management scheme. The case example is organised along the six sections in the Blue Book. Some of the elements of this company have been described in the previous section but – for completeness – they are also included here.

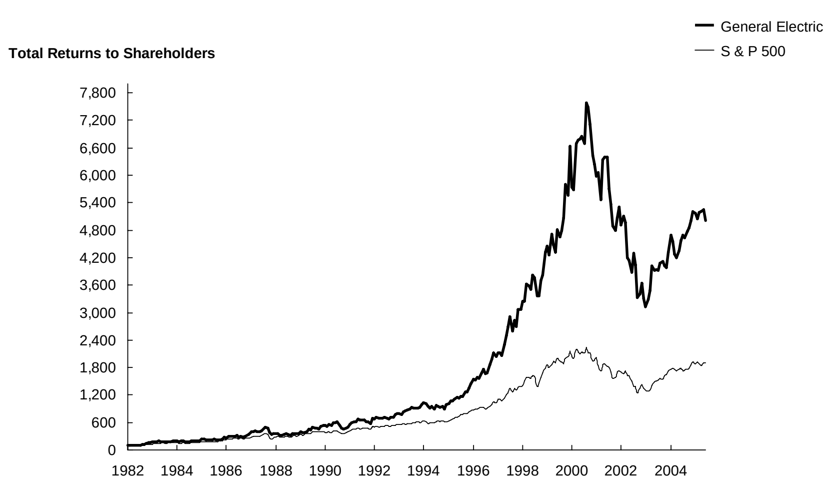
- GE is 100 years old and has almost 300,000 employees worldwide. It is widely diversified, operating in many businesses - such as financial services, technology, and manufacturing – and across more than 100 countries.

- GE is known as one of the world's most admired and organisationally innovative companies – as well as one of the most consistently profitable. The financial performance has not only been consistent but also phenomenal, outperforming its peers for more than 20 years (Figure 1).

- GE is known for its performance management scheme as one of the main pillars of its ongoing success – all employees know that *making the numbers* requires absolutely everyone to give all they have got.

Figure 1

GE HAS EXPERIENCED PHENOMENAL TRS GROWTH



* 1982 = 100

Sources: DataStream and Compustat

GE case example – 1. Establishing performance indicators and setting targets linked to strategy	INTENSIFY PERFORMANCE MANAGEMENT	
	Supporting Materials for "Blue Book" v 2.0	Card number III.9.1.3.2.(a)

- **Has clear aspiration and business strategy.** The company fills its portfolio with businesses that operate in stable industries that consistently generate reliable profits. It avoids industries in which earnings are volatile or can change rapidly. One of the driving forces for this company is the aspiration to always be Number 1.

  "A decade from now I would like [our company] to be perceived as a unique, high-spirited, entrepreneurial enterprise… a company known around the world for its unmatched level of excellence. I want us to be the most profitable, highly diversified company on earth, with world-quality leadership in every one of its product lines"
  "We operate in four strong long-cycle businesses […] These businesses are strong, number one, with multiple levers to grow…" (Jack Welch, CEO)

- **The aspirations are also "headline KPIs" –** constantly communicated to the market and in internal communications to managers and employees.

- **Strategy is directly translated to KPIs, using both financial and non-financial measures.** (Figure 2)
  - A key shareholder priority, profitability, is measured by residual income.

  - Personnel development, essential to the company's long-term sustainability, is captured by measuring the inventory of promotable people. Measurement at this company provides the vital link between current performance and future performance. Links to individual performance makes it actionable.

Figure 2

KPIs ARE LINKED TO STRATEGIC OBJECTIVES

Strategic Objectives ("themes")	Typical KPIs for a BU
• Profitability	• Residual Income
• Market position	• Market share
• Productivity	• Output
• Product leadership	• Competitive standing
• Personnel development	• Inventory of promotable people
• Employee attitudes	• Percent of satisfied employees

GE case example – 1. Establishing performance indicators and setting targets linked to strategy	INTENSIFY PERFORMANCE MANAGEMENT	
	Supporting Materials for “Blue Book” v 2.0	Card number III.9.1.3.2.(b)

- **The aspirations and strategy are translated to top-down stretch targets.**
  - As a guideline, the CEO proposed upfront that earnings should grow at between one-and-a-half and two times the growth of GDP

  - Performance is not “about making the budget” - It is about “raising performance expectations” to be “as good as possible”.
    “Stretch means using dreams to set business targets – with no real idea of how to get there . . . We certainly didn’t have a clue how we were going to get to 10 inventory turns [a year] when we set that target. But we’re getting there, and as soon as we become sure we can do it – it’s time for another stretch”
    “Changing the culture – opening it up to the quantum change – means constantly asking not how fast am I going, how well am I doing versus how well I did a year or two before, but rather, how fast and how well am I doing versus the world outside. Are we moving faster, are we doing better against that external standard?” (Jack Welch, CEO)

- **Final targets are set by reconciling top-down targets with bottom-up validations.**
  - Each business develops bottom-up basic and stretch targets which are rigorously challenged by the corporate centre
  - Managers develop their operating plans to meet stretch targets that are statements of their aspirations for the business

- **The corporate centre (which operates like a Board) plays a critical role in the target setting process.** 80% of managers in the corporate centre are devoted to financial and strategic planning
  - Formulate and maintain vision of “Number 1 or 2 globally” as strategic boundary
  - Engage in annual “no holds barred” formal strategy reviews
  - Hold quarterly strategy sessions between CEO and business heads
  - The corporate controllers prepare a set of financial objectives and market assumptions for each operating unit in order to reflect each unit’s prospects and to reduce “gaming” in target-setting

- **The budgets are subject to revision** as economic or competitive conditions change. Line managers can propose changes if it can be proven that the original assumptions have changed substantially

GE case example – 2. Establishing KPIs and setting targets for senior management	INTENSIFY PERFORMANCE MANAGEMENT	
	Supporting Materials for "Blue Book" v 2.0	Card number III.9.1.3.3

- **Very strong linkage between 'business KPIs' and 'individual KPIs' for the leaders of the businesses.** For the CEOs of each business these are identical

- **Measures must have 8 characteristics before becoming an 'individual KPI'**

Figure 3

ESSENTIAL QUESTIONS ASKED TO ENSURE VALIDITY AND RELEVANCE OF KPIs

Characteristics of KPIs	Related questions
• Linked to strategy	• Can the measure be aligned with an strategic objective or specific customer value?
• Controllable	• Can results be controlled or significantly influenced under a specific span of control?
• Can be acted on	• Can action be taken to improve performance on the measured dimension?
• Measurable	• Can the desired performance measured be quantified in a meaningful, realistic way?
• Simple	• Can the measures be explained easily and clearly by managers?
• Few in Number	• Do the measures focus management attention in key areas?
• Credible	• Are the measures resistant to manipulation?
• Integrated	• Are they compatible with related processes functions?

GE case example – 3. Reviewing business performance	INTENSIFY PERFORMANCE MANAGEMENT	
	Supporting Materials for "Blue Book" v 2.0	Card number III.9.1.3.4

- **GE promotes an open active dialogue about performance and improvement opportunities**
  - The corporate centre is armed to review performance with comprehensive operational and financial information for all levels of the organization
  - The corporate centre has instituted simple, yet rigorous full-day review sessions with each business area. The review meetings are characterised by a rigorous drill down into key drivers of performance and "pushback" from both the business leaders and the corporate centre

- **All key meetings in business planning process are tightly synchronised,** ensuring that the planning process is tightly linked with other core management processes (see Figure 4).

Figure 4

KEY BUSINESS PLANNING PROCESSES IS SYNCHRONISED WITH KEY MEETINGS

Jun-Jul	Aug-Sep	Oct-Nov	Ongoing	Ongoing	Dec-Jan
Strategic planning	**Operational planning**	**Budgeting**	**Resource commitment approval and issue resolution**	**Performance review**	**People development** **Top 500** / **Other staff**
• Determines where and how the company should compete in the market	• Translates strategy into initiatives and finalises targets for next year	• Allocates resources for implemen-tation of operational plan	• Gives final approval to commitments approved in the budget	• Reviews actual performance vs. targets as set in operational plan and budget	• Links business performance to individual performance and to HR management
• Plan ahead on the basis of an issue driven approach	• Defines resource needs and priority actions for next year	• Is predomi-nantly a mechanistic exercise	• Gives opportunity to review resource commitments in the light of recent developments	• Drives implementa-tion throughout the organisation	• Ensure quality of management throughout the company

GE case example – 4. Reviewing individual performance of senior management	INTENSIFY PERFORMANCE MANAGEMENT	
	Supporting Materials for "Blue Book" v 2.0	Card number III.9.1.3.5.(a)

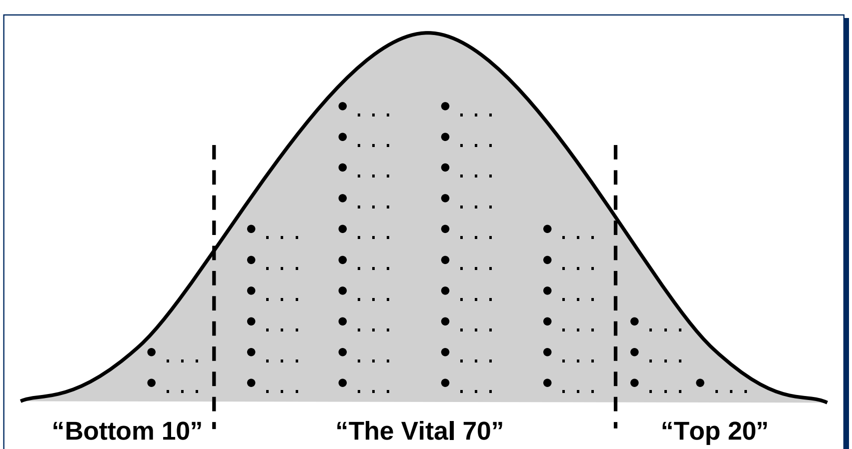
- **The CEO is personally involved in the individual performance management of the top 500 people.** The time spent on this is a large part of the 50% of his overall time he spends on people issues

- **Individuals are reviewed semi-annually along two dimensions: current performance and the extent to which they "live the company's values"**
  - Current performance is judged on whether they are "making the numbers" (i.e. on their KPIs)
  - **"**Living the company values" is measured through a 360-degree evaluation with input from the immediate superior, subordinates and customers with exposure to the employee.

- **All employees are ranked against each other and forced to a distribution**. (Figure 5)

Figure 5

PERFORMANCE RATING BOUNDARIES



GE case example – 4. Reviewing individual performance of senior management	INTENSIFY PERFORMANCE MANAGEMENT	
	Supporting Materials for “Blue Book” v 2.0	Card number III.9.1.3.5.(b)

- **Individual performance reviews are followed through with meaningful rewards and consequences** eg. bottom 10% terminated
  - Employees rated in the “Top 20%” are high performers who embody corporate values. They are well supported and advance rapidly through the organization. GE loses less than 1% of these people per year.
  - Most employees are in the “Vital 70%”. Although not on the “fast track” they are critical to the business and the company ensures they remain motivated.
  - Employees in the “Bottom 10%” are likely to be dismissed unless there is an improvement within, 3 months, or there are mitigating circumstances

Figure 6

DESCRIPTION OF RELATIVE RATING SCHEME

Current performance (based on objective KPIs)

	Low	Medium	High
Top 20%	Stock options	Stock options, Elite training school	Promote, stock options, Elite training school
Middle 70%	Inform, no further promotion possible		Encourage, Elite training school
Bottom 10%	Out	Out	Out, unless mitigating circumstances

Living company values (based on 360° evaluation)

Review process

All employees in a team are ranked against one another

- Current performance is judged on whether they are making the numbers
- Long-term potential is driven by intrinsic adherence to values (the 4 E's: Edge, Execution, Energy, and the ability to Energize)– “Are they people who can thrive in this company?”

- **Performance also directly drives the increments of the total base pay**

GE case example – 5. Establishing appropriate compensation framework for senior management	INTENSIFY PERFORMANCE MANAGEMENT	
	Supporting Materials for “Blue Book” v 2.0	Card number III.9.1.3.6

- **GE makes extensive use of different compensation elements**. One common characteristic of the compensation for the company’s top management is that the variable part of their total compensation is significant (i.e. typically 50-60% of total compensation). Figure 11 provides an overview of the different compensation elements that the company uses as well as its compensation philosophy

Figure 7

COMPENSATION ELEMENTS FOR TOP MANAGEMENT

Compensation philosophy

- Our compensation goals are to hire, motivate, reward and retain executives who create long-term investor value
- We use a variety of compensation elements to achieve these goals

Compensation elements

- *Salary and bonus:* We pay salaries that are designed to attract and retain superior leaders, and we pay annual bonuses to reward exceptional performance
- *Stock options and stock appreciation rights:* We award these to provide incentives for superior long-term performance and to retain top executives because the awards are forfeited if the executive leaves before they become fully exercisable five years after grant
- *Restricted stock units:* We grant RSUs to more closely align executives’ interests with investors’ long-term interests, to retain top executives because the awards are paid out only to executives who remain with the company for extended periods
- *Long-term performance awards:* We use these to provide a strong incentive for achieving specific performance measurements over multi-year periods

Objective and rationale for reporting Headline Performance Indicators and Economic Profit	INTENSIFY PERFORMANCE MANAGEMENT	
	Enhance market monitoring	Number III.9.2.1

Objective

- GLCs to report relevant Headline KPIs (e.g., revenue growth, Return on Equity or other profitability measures) and Economic Profit to the financial markets on a quarterly basis. It is recommended that this initiative is started immediately in order for it to be implemented in conjunction with the next quarterly reporting cycle.

Rationale

- Currently, GLCs announce/report company's performance on a regular basis but focus only on historical financial performance. Hence, the reporting methods do not communicate utilization of company's capital and company's projected future performance.

- Reporting Economic Profit and Headline Performance Indicators will increase transparency on both business performance and priorities of the GLCs. Improved transparency will make the GLCs more attractive from an investor perspective, leading to greater market confidence. Furthermore, it will increase accountability of the GLC CEO and other senior management members and is thus expected to further improve the performance of GLCs.

- In addition, it is considered 'best practice' financial reporting to report Headline KPIs and to focus on Economic Profit (a concept that is being used by an increasing number of Malaysian companies).

- Finally, it will build GLC capabilities to self-assess performance and to set realistic targets for their portfolio companies.

Expected output from this initiative

- Headline KPIs and Economic Profit to be reported by all GLCs on a quarterly basis

- Increased market value of GLCs (market confidence in GLCs expected to improve because of increased transparency in business performance and priorities)

TERMS OF REFERENCE

Prerequisites for success and risks	INTENSIFY PERFORMANCE MANAGEMENT	
	Enhance market monitoring	Number III.9.2.2

Prerequisites for success

- Appropriate skills within the GLCs to self-assess and report on company’s performance
- Reporting to be consistent and on a quarterly basis
- Reporting to be made public to create pressure for implementation of initiative on GLCs

Risks

- Limited capabilities in GLCs to implement initiative
- Data reported inaccurate due to inconsistency in assessment methods

Key activities and next steps	INTENSIFY PERFORMANCE MANAGEMENT	
	Enhance market monitoring	Number III.9.2.3

Next steps and key activities to be undertaken by PCG to complete the initiative

- PCG to draft Guidelines for GLCs
  - GLCs should start reporting their Headline Performance Indicators and Economic Profit no later than by the end of 2005
  - Reporting should happen on a quarterly basis in conjunction with the publishing of quarterly results

- PCG Secretariat to follow-up on status of implementation in the GLCs
  - Ensure that GLCs can direct potential questions to the PCG Secretariat for clarification
  - Follow-up on progress well in advance of deadline (i.e., Secretariat to follow-up in September, 2005) by contacting the GLCs

TERMS OF REFERENCE

Objective, rationale and expected output when tightening CEO KPIs	INTENSIFY PERFORMANCE MANAGEMENT	
	Tighten CEO KPIs	Number III.9.3.1

Objective

- Strengthen performance management by focusing on the CEO and other senior management members, based on the Guidelines in the 2005 version of the "Blue Book".

- This entails tightening the "personal KPIs" and Performance Linked Compensation (PLC) schemes for the CEO and senior management members with the appropriate consequence management (i.e., rewards and consequences) put in place.

Rationale

- Performance management is a key lever for corporate performance and implementation of all performance management systems should start with the CEO and other senior managers.

- GLCs have been moving toward improving performance management since the 2004 when the KPI/PLC initiative was codified in the "Blue Book".

- However, a recent audit in some of the major GLCs has shown that the quality of implementation of the 2004 KPI/PLC is inconsistent across GLCs, in particular in terms of linking personal KPIs with corporate strategy and value creation plans, and of formalising CEO contracts including personal KPIs. Hence, there is a need to standardise the performance management systems in all GLCs.

Expected output from this initiative

- Guidelines for GLCs to:

  - Establish process to review individual performance of senior management. CEO and top management evaluated according to their contribution to value creation

  - Define appropriate compensation system for senior management according to their performance

  - Set-up programs focused on training the board in the two pilot GLCs on how to use KPIs linked to value creation and ensure quality of performance management system

TERMS OF REFERENCE

Prerequisites for success when tightening CEO KPIs	INTENSIFY PERFORMANCE MANAGEMENT	
	Tighten CEO KPIs	Number III.9.3.2

Prerequisites for success

- Must be driven by Chairman and CEO, with support from Board members of pilot GLCs
- Full access for initiative working team to existing KPIs, evaluation and compensation information for CEO and Top Management in the pilot GLCs

Risks

- Top management of pilot GLCs are reluctant to grant the working team access to key documents, such as the CEO contract and PLC scheme.
- Lack of buy-in from board to review current performance management system, e.g., board reluctant/unwilling to review current CEO contract and/or PLC scheme

Objective and rationale for tightening CEO KPIs	INTENSIFY PERFORMANCE MANAGEMENT	
	Tighten CEO KPIs	Number III.9.3.3

Key activities to be undertaken by PCG to complete initiative

- Determine pilot candidate

- This pilot will provide valuable learnings for the implementation of similar systems in other GLCs and will ultimately improve the performance of the pilot GLCs through an increased focus on the most important business priorities

- Within the pilot the following activities should be undertaken:
  - Understand existing performance management system focusing on the CEO and senior management in the pilot GLCs
    - Review existing KPIs for CEO and senior management
    - Understand current PLC scheme
    - Review current people review process (including rating of managers, feedback discussions and system for rewards and consequences)
  - Design new performance management system covering the CEO and other senior management members
    - Based on value creation levers and strategy identify gap between existing KPIs and company's value creation plan
    - Revise current CEO contract with the Board in order to tighten it and link CEO KPIs to corporate value creation
    - Initiate process to cascade down to Top Management KPIs, including PLC scheme design
    - Design/revise people review system (e.g., participants, frequency, format etc.)
  - Train board members
    - Conduct workshop with board to:
      - Share conclusions of the diagnosis and suggested changes in KPIs, PLC scheme, and people review processes
      - Elaborate on benefits from good performance management systems based on best practice case examples
  - Codify learnings from the implementation in the Transformation Manual

- It is important to note that this initiative should not prevent any non-pilot GLCs from taking the necessary steps to improve or develop their own performance management system consistent with the Guidelines in the "Blue Book" Version 2.0 (per III.9.1)

TERMS OF REFERENCE

Objectives, rationale, key initiative outputs and preconditions for success	INTENSIFY PERFORMANCE MANAGEMENT	
	Manage non-performers	Card number III.9.4.1

Objective

- The objective of this initiative is twofold:
  - Develop best practices and case examples on how to manage low- and/or non-performers including identifying root causes for low performance, providing training, deployment, and potentially termination.
  - Clarifying the current labour laws for the benefit of all GLCs, in particular to better understand the existing labour laws and required processes in managing low- and non-performers

Rationale

- The presence of low- or non-performers in organisations can negatively impact its overall morale, culture, and ultimately performance. First, low- or non-performing managers are unable to develop, attract or retain high performers. Second, it signals to average and high performers that low- and non-performance is acceptable, thereby undermining the development of performance cultures
- Termination of such low- or non-performers should not be the first, or only answer:
  - Training should be provided where the root cause of poor performance is the lack of skills/capabilities
  - Where training is insufficient, then low- or non-performers should be considered for re-deployment but only where another better-matching opportunity exists
  - However, where neither of the above apply, then termination should be considered.

Expected outputs from this initiative

- Guidelines, best practices, and case examples on managing low-and non performers, including a report on current Malaysian labour laws on legal circumstances, processes and framework under which low-and non-performers can be fairly terminated

Prerequisites for success

- Strong drive from CEO of GLC and top management, including buy-in from HR
- GLCs' willingness to begin and continue execution momentum

Risks

- Corporate culture in GLCs resistant to developing a performance culture
- Public backlash against the termination of employees

TERMS OF REFERENCE

Objective and rationale for implementing EVA	INTENSIFY PERFORMANCE MANAGEMENT	
	Implement EVA	Number III.9.5.1

Objective

- The objective of this initiative is to implement Economic Value Added/Value-Based management (EVA/VBM) at GLCs to improve the management processes and systems in order to help manage the main value drivers of the company:
  - It is a system that attempts to improve company performance by focusing the attention of managers at all levels of the organisation on how their decisions affect shareholder value
  - Since shareholder value can be approximated by Discounted Cash Flow (DCF) value analysis, EVA/VBM attempts to instil skills and processes that lead GLC managers to make decisions which maximize the company's DCF value rather than the usual accounting-based measures

- This initiative will help the GLCs to develop a stronger emphasis on value creation within corporate culture. In the longer term it will help improve both the health and performance of GLCs – supporting the "Intensifying Performance Management" effort

- Establish centre of excellence that can give the adequate support to other GLCs on the implementation of similar processes

Rationale

- EVA/VBM broadens the capabilities of operating managers to include long-term balance sheet factors in decision making and can significantly improve dialogue across an organisation
  - DCF and Return On Invested Capital (ROIC) are the foundation of Value-Based Management, based on the premise that a core objective of any corporation is to maximize shareholder value
  - Although DCF is generally accepted as the best way of making investment decisions, it is not universally used, especially in GLCs. The use of DCF and ROIC for all management decisions including strategy evaluation, divestitures, and new product introductions is an integral part of EVA/VBM

- In many GLCs the management processes and systems to set strategy and business targets can be improved. The lack of optimal systems often leads to poor visibility in the key drivers of the companies' performance and therefore there is often a low emphasis on value creation in GLCs

TERMS OF REFERENCE

Expected output, pre-conditions for success and Risks of implementing EVA	INTENSIFY PERFORMANCE MANAGEMENT	
	Implement EVA	Number III.9.5.2

Expected output from this initiative

- Implementation of the initiative at a pilot GLC:
  - Increased focus on value creation
  - Enhanced visibility of GLC's performance
  - Improved financial performance
  - Codified learnings to be included in the Transformation Manual and leveraged by other GLCs

- Learnings from pilot codified for dissemination to other GLCs

Prerequisites for success

- Other GLCs properly leveraged learnings which must be adequately codified

- Achieve right level of complexity as there is a danger in going too deep in several dimensions and becoming unable to work the necessary links between all the value-creation levers identified (particularly on cross-unit activities)

Risks

- EVA/VBM efforts are slowed down due to complicated nature of the business structure of some GLCs (multiple business units with different core businesses)

- Tendency to lose priority over other business activities due to requirement for heavy involvement of many managers

TERMS OF REFERENCE

Key activities and next steps to implement EVA across GLCs	INTENSIFY PERFORMANCE MANAGEMENT	
	Implement EVA	Number III.9.5.3

Key activities to be undertaken by to complete the initiative

This process will be initiated with a pilot

- Codify key learnings from EVA/VBM implementation at selected GLC by Q2 06

- Leverage learnings to ease implementation of EVA/VBM in other GLCs (where relevant) and feedback experience into codified material to ensure the creation of a centre of excellence

- Selected GLC to engage external help to support EVA/VBM implementation and transfer needed skills

- Assessment of current management processes and systems and strategy
  - Understand current management processes and systems
  - Understand current strategy
  - Clarify gaps in current management processes and systems
  - Revise current strategies and develop action plans

- Complete design of EVA/VBM
  - Develop organisational blueprint for relevant business unit(s)
  - Launch EVA/VBM in relevant business unit(s)

- PCG to ensure codification of EVA/VBM learnings including
  - Implementation plan
  - Pitfalls
  - Procedures in policy paper
  - Rough estimate of budget
  - Benefits from implementation

Key success factors for successful implementation of EVA	INTENSIFY PERFORMANCE MANAGEMENT	
	Implement EVA	Number III.9.5.4

- **Go beyond the usual process**
  - Combine financial perspective, for example Return on capital employed (ROCE) with analysis of strategic issues
  - Bring in the business perspective through focus on core processes
  - Start top-down to set the stage for discussion

- **Address the dilemma between focus and completeness**
  - Select value drivers in each year as the basis for agreement of targets
  - Monitor all value drivers through a comprehensive reporting system

- **Bring in the business perspective**
  - Understand front-line business perspective through discussion with centre managers
  - Involve key personnel

- **Secure impact through consequent incentive design**
  - Ensure EVA/VBM impact through tailor-made incentive system, e.g.,
    - Higher variability of pay
    - Focus on few targets
    - Non-financial incentives
  - Create transparency of individual performance

- **Control complexity through constant prioritizing**
  - Concentrate on core processes
  - Limit
    - value drivers per process
    - value drivers per centre
    - criteria per value driver

Stock-take of the Implementation of Performance-Linked Compensation (“PLC”) in Government-Linked Companies (“GLCs”)

PUTRAJAYA COMMITTEE • GLC HIGH PERFORMANCE •

Interim Report
29 July 2005

1. BACKGROUND

In May 2004, the Ministry of Finance issued guidelines entitled ‘Implementation of Performance-Linked Compensation (“PLC”) in Government Linked Companies (“GLCs”)’, also commonly referred to as the ‘Blue Book’, which introduced the usage of Key Performance Indicators (KPIs) and PLC. In January 2005, The Putrajaya Committee on GLC High Performance (PCG) was established to catalyse the transformation of GLCs by following through on the Blue Book and other 2004 initiatives[1] and launching a series of initiatives in 2005/06.

Having crossed the one year milestone since the release of the Blue Book, it is timely to assess the progress of the KPIs/PLC implementations to date. With this objective in mind, the stock-take was launched to develop an understanding of the PLC implementation and harness ‘on the ground’ experiences to strengthen the Guidelines further. The Guidelines that follow incorporate the collective experiences and learnings from the implementation at the G-15.[2]

The scope of the stock-take does not cover a detailed audit of the KPIs/PLC implementation. The goal was to obtain a high level understanding by studying the process rather than the details. For example, we would identify whether there was a process to ensure KPI alignment to strategy rather than understanding the strategy of the respective companies and linking it back to their respective KPIs.

The stock-take at present is still on-going and therefore the findings are preliminary, but minimal change is anticipated. The first round of interviews with management and analyses has been completed.

2. METHODOLOGY

The stock-take has been conducted over a one month period with over 40 perspectives sought from the G-15. Focused interviews are carried out with the following target groups:

- Board of Directors
- CEOs and senior management from Corporate Planning & Strategy, Human Resource, Finance
- External consultants

The purpose of the interviews is to obtain various perspectives from management and external parties to form a holistic picture of the state of PLC implementation at the G-

1 Announced in the Keynote Address by YAB Dato’ Seri Abdullah Haji Ahmad Badawi, Prime Minister and Minister of Finance, at the Seminar on Culture of High Performance for GLCs, dated 14 May 2004

2 The “G-15” is a selection of 15 GLCs held by the GLIC constituents of the PCG and represent approximately 65% of market capitalisation of all listed GLCs

15. The findings from these interviews are further supported by desktop reviews of key documentation on KPIs/PLC, employment contracts and processes.

Scoring

The assessment was carried out along two main criteria: compliance to the Blue Book (the “Form”) and effectiveness of implementation (the “Substance”). Using the scores from the assessment, each of the G-15 was then rated on a 5-point scale of Strong, Good, Moderate, Weak and Poor.

The compliance assessment evaluates whether the G-15 have complied with the elements prescribed in the Blue Book[3]. Factors used to measure compliance include CEO and senior management on contract, existence of formal corporate strategy, KPIs implemented and cascaded, base pay benchmarked, and formal performance management process in place.

The effectiveness scale measures the quality of the implementation and whether the KPIs and PLC support long term performance transformation (within the context of high-level interviews rather than detailed audits).

Factors used to measure effectiveness include active Board involvement in KPI design and review, timely achievement against targets discussions at monthly management meetings, active management of strategy and linking it to KPIs, clear programme to manage talent, and transparent link between performance and rewards or consequence management.

3. KEY FINDINGS

Most G-15 have implemented some form of KPI/PLC in compliance with the Blue Book. However, the effectiveness of the implementations differs greatly across the G-15 with many companies not as yet enjoying the full impact of the program. Figure 1 provides an overview of the stock-take findings across the G-15.

[3] Elements of the Blue Book: eligibility, KPI design, performance monitoring and review, base pay and performance bonus.

G15 Compliance-Effectiveness Grid

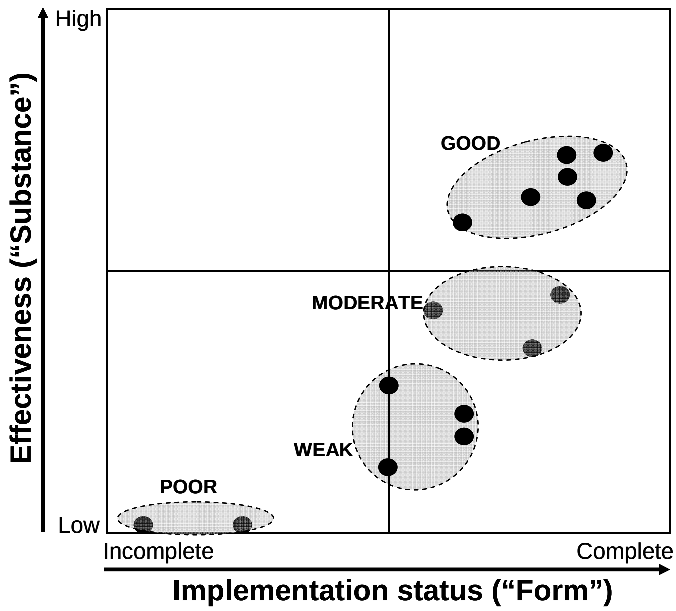


Figure 1: G15 Compliance-Effectiveness Grid

The stock-take findings are structured around five key categories of KPIs/PLC implementation – eligibility, KPI design, performance monitoring and review, base pay and performance bonus. The findings have been aggregated across the G-15

Category	Guidelines	Key findings
Eligibility	• CEO and 2-3 levels down to go on contract • KPIs/PLC implemented and cascaded to all executives	Compliance - Moderate • Most CEOs on fixed term contracts • Approximately half of direct reports to CEO on contracts • Most G-15 have cascaded KPIs to executives Effectiveness - Weak • Communications with management 2-3 levels below CEO and incentives programme was insufficient to convince them to move to fixed term employment contracts • Contract lacks specific terms on performance and reward

Category	**Guidelines**	**Key findings**
KPI Design	• Aligned to strategy • Balanced • Stretched and benchmarked targets • Focused KPIs (5-8)	Compliance - Moderate • Most companies do not have formal strategy • Most companies have 5-8 KPIs • Most companies obtain Board endorsement of their KPIs Effectiveness - Weak • KPIs not strongly driven by strategy as evidenced by lack of KPI alignment process • KPIs are used more of a 'HR tool' rather than a strategy execution tool, with KPI development process being driven by HR unit, not Corporate Strategy • KPIs financially skewed and not balanced • Low incidence of benchmarking resulting in targets not stretched and poorly supported when challenged • Significant skill gaps for the KPIs/PLC implementation within the organisation • Low incidence of G-15 using 'corporate scorecards' (i.e. regular monitoring of important value drivers that are not part of CEO's KPIs) to manage business • Relative lack of Board engagement in KPI development

Category	Guidelines	Key findings
Performance Monitoring and Review	• Regular review of business and individual performance • Systematic process of setting, monitoring and reviewing targets at divisional, management committee and Board levels • Process to derive and track action points from the review	Compliance - Moderate • Most companies have a regular performance appraisal process • Few review KPIs in monthly management committee meetings • Few have quarterly Board reviews for business KPIs Effectiveness - Weak • Board and middle management are not adequately engaged in KPIs review • Insufficient spread of performance scores • Poor consequence management processes, both for high and low performers • Approximately half are able to accurately measure KPIs on a timely[4] basis every month • Poor internal infrastructure[5] • No formal interim review of KPIs with detailed action points for the second half of the year

[4] Timely measurement of KPIs would differ between industries, but the rule of thumb used here is no more than 15 days

[5] Infrastructure is defined as processes, systems, organisation structure, board governance

Category	Guidelines	Key findings
Base Pay	• Market competitive, benchmarked at market median within similar industry, size, customer base	Compliance – Good • Most companies benchmark base pay using data from surveys conducted by HR consultants • Few benchmark their cash compensation at market median and above Effectiveness - Weak • Most companies find it difficult to attract and retain the desired talent • Approximately half have a link between increments and performance
Performance Bonus	• Minimum threshold • Transparent and directly linked to performance • Mix of short and long term incentives	Compliance - Good • Approximately half have bonuses which are directly linked to individual performance • Non banking G-15 commonly use a fixed to variable compensation ratio of 70:30 • In some G-15, Board does not have full discretion in approving bonuses Effectiveness - Moderate • Resistance to differentiated rewards, most do not significantly differentiate high and low performers

4. CONCLUSIONS

Generally, G-15 have made significant progress in implementing the Blue Book - many have already complied with most of the Guiding Principles. However, the stock-take has found that the effectiveness in implementation could be significantly improved to move beyond the form to substance.

The key issues uncovered above can be summarised as the following:

- Lack of focus on business priorities by not tightly linking KPIs to strategy
- Talent management is poor across G-15, specifically in the areas of attracting top talent, differentiating between individual performance, managing rewards and consequences

- KPIs and targets are sometimes not objective and balanced, frequently not fact-based
- Poor engagement and skills gap at the middle management to effectively cascade the KPIs throughout the organisation
- Lack of communication from the leadership and show of commitment to KPI implementation process

Looking forward, Blue Book version 2 will be an attempt at addressing these issues, and provide clarifying examples to guide the implementation.

4 GUIDELINES TO HEADLINE KPI REPORTING

- Headline KPIs are forward looking company targets, designed to get everyone (e.g. market, workforce, Board, management) focused on the medium-term strategic objectives and targets of the company. Kindly refer to Initiative 9.2 of the Transformation Manual for details.
- The right Headline KPIs should be used and it should reflect the company's strategy.
- Headline KPI targets should be stretched but achievable. The announcement should cover:
  - The appropriate benchmarks (e.g. versus previous year's performance, local/regional/international peers)
  - The assumptions, constraints and conditions in order to achieve this
- Headline KPIs should be medium-term in nature (e.g. 3 years) with intermediate one year forward targets in between.
- Both internal and external Headline KPIs are to be consistent and sanctioned by the Board.
- GLCs are required to report progress against Headline KPIs every 6 months.
- GLCs should explain that the Headline KPIs are aligned but do not represent the company's KPIs in its entirety (if this is indeed the case).

Headline KPIs are intended to increase the accountability of GLCs' CEOs and other senior management members and it is thus expected to further improve the performance of GLCs.

Headline KPIs should be reported to Bursa through the electronic reporting format, together with the quarterly financial reporting.

STANDARD DISCLAIMER WHICH MUST BE INCLUDED IN ALL HEADLINE KPIs ANNOUNCEMENTS

These Headline KPIs are targets or aspirations set by the company as a transparent performance management practice. These Headline KPIs shall not be construed as either forecasts, projections or estimates of the company or representations of any future performance, occurrence or matter as the Headline KPIs are merely a set of targets/aspirations of future performance aligned to the company's strategy.

5 GUIDELINES TO EP REPORTING

Definition → EP is a measure of the value created by a business during a single period. It is the return that a business makes over its cost of capital.

Formula → EP = (ROIC – WACC)*Invested Capital
ROIC: Return On Invested Capital
WACC: Weighted Average Cost of Capital

EP should be reported to Bursa through the electronic reporting format, together with the quarterly financial reporting.

TWO DIFFERENT APPROACHES FOR EP CALCULATION

1. Spread Approach
EP = (ROIC – WACC) * Invested Capital

2. Residual Approach
EP = NOPLAT – (Invested Capital*WACC)
NOPLAT: Net Operating Profit Less Adjusted Tax

COMPUTATION OF EP

For Non-Financial Institutions

Economic Profit = Spread × Invested Capital; Spread = ROIC − WACC

For Financial Institutions

Economic Profit = Spread × Total Equity; Spread = ROE − COE

To ensure consistency, some assumptions in EP calculation are aligned

Invested Capital = **Average** Operating Working Capital + **Average** Net PPE + **Average** Net Other Operating Assets

WACC

- Risk-free: 10-year MGS yield as at financial year-end (can be obtained from https://fast.bnm.gov.my)
- Market Risk Premium: Long-term premium of 5.2%
- Beta: 5-year Bloomberg Beta as at financial year-end

  Debt: GLCs are encouraged to use market values of debt. However, if market value is unavailable, book value of debt can be used
- Equity: Market capitalisation as at financial year-end
- Cost of debt: GLCs are encouraged to use their actual cost of debt and their assumptions in arriving at the cost should be spelt out clearly
- Tax rate: Existing corporate tax rate

For Financial Institutions

- Return on Equity: Net profit before minority interest/total equity
- Total Equity: Average total shareholders' fund including minority interest at group level

6 DELIVERING HEADLINE KPI RESULTS

Process	Actions
Announce results	• Revisit what was announced as Headline KPIs for the past financial year • Deliver to the market full-year Headline KPIs results – e.g. Actual vs. Forecast • State reasons for achieving those targets, in particular certain targets that are being exceeded tremendously – e.g. one-off transactions or recurring, new IT systems in place, regional expansion
Provide target for upcoming financial years	• Unveil a set of new targets for current year and mid-term (e.g. 2-3 years) • Revise previously announced mid-term targets as appropriate based on previous year's results and new information/development • Communicate briefly the process of arriving at these new targets • Provide concrete plans to meeting these targets to assure investors and workforce of their achievability
Track progress	• Track progress towards achieving targets and conduct regular update sessions to the investors and workforce • Deliver consistent messages to both internal and external stakeholders

7 COMMUNICATION CHECKLIST FOR GLCs

The following represents an illustration of suggested sequencing of major intervention prior and subsequent to the proposed announcement date for Headline KPIs and EP.

- **T-30**: • Review of financial result by Board
- **T**: • Issue Bursa release with more detailed explanation of key drivers • CEO and CFO hold press conference to discuss results and high-level plan
- **T + 1**: • Issue press release on earnings and provide explanation on key drivers
- **T + 2**: • If further clarification is necessary, CEO may arrange an interview with a leading newspaper
- **T + 60**: • CEO and top management hold press conference and analysts briefing to provide details of turnaround plan
- **Quarterly**: • CEO updates market on progress against plan

Note: 'T' refers to the date for proposed announcement of quarterly results

8 GOOD CORPORATE GOVERNANCE - KEY COMMUNICATION THRUSTS

1 Identify
- Conduct thorough analysis to determine drivers leading to performance
- Quantify degree of targets shortfall to the business
- Dissect components of EP to identify key drivers and problem areas (eg. working capital management, operational efficiency etc.)
- Conduct a trend analysis in EP

2 Acknowledge
- Management to acknowledge shortfall
- Management commits to be accountable and take responsibility to implement turnaround plans
- Avoid finger-pointing and blame-shifting. Instead focus on remedial actions

3 Formulate
- Communicate business/ turnaround plan to address challenges and opportunities
- Establish a transparent process in developing the plan
- Engage internal and external stakeholders while developing plan
- Reshuffle management as necessary

4 Communicate
- Communicate with internal workforce prior to public announcement of business/ turnaround plan to garner support
- Unveil plan to the market
- Ensure consistent messages both internally and externally

5 Track
- Monitor progress of plans
- Provide regular updates to workforce and investors
- Alert market for any hurdles to achieving turnaround plan and provide alternative approaches to reduce uncertainties

9 GOOD CORPORATE GOVERNANCE - MANAGING POOR/MISSED RESULTS

Missed expectations require the restoration of trust in management.

Process	Actions
Openness and transparency about the problem(s)	• Clear picture of financials and extent of missed targets • Business-by-business explanation of the drivers of the results • Ensure explanation addresses issues previously raised by analysts
Acceptance of the problem(s)	• Management communicates that they see it as a real problem • Management accepts accountability and is responsible for remedying the situation
Reliability will be restored	• Provide a turnaround plan that investors can track progress on, but do not give precise guidance that could lead to further disappointed expectations • Provide regular and accurate updates on what has been achieved relative to what was promised in the plan
Alignment of messaging	• Ensure consistent internal and external stories • Ensure actions of top management are consistent with programme (e.g., if focus is domestic, CEO spends majority of time on domestic business)

INITIATIVE 9.2

GUIDELINES ON ANNOUNCEMENT OF HEADLINE KPIs AND ECONOMIC PROFIT

1 INTRODUCTION

The GLC Transformation Manual launched on 29 July 2005 by the Putrajaya Committee on GLC High Performance (PCG) sets out a framework to guide GLCs in their transformation efforts. One of the main policy thrusts of this transformation framework is the adoption of corporate best practices in GLCs which include among others, the requirement that Headline KPIs and Economic Profit are reported by GLCs on a half -yearly and quarterly basis, respectively.

This is in line with the 3 underlying principles of the GLC Transformation (GLCT) programme, namely to support the national development agenda, to create economic and shareholder value through improved performance at GLCs, and for GLCs to implement this initiative through their Board of Directors in line with the principle of good governance.

2 OBJECTIVES

As we enter Phase 3 of the GLC Transformation to deliver tangible and sustained results, it is timely that these guidelines are reinforced so that improved transparency will make GLCs more attractive from an investor perspective, leading to greater market confidence.

These guidelines, launched in February 2006, were prepared based on market best practices after due consultation with all relevant parties. These guidelines provide a comprehensive reference to GLCs to ensure uniformity and consistency in their reporting.

GLCs are required to follow these guidelines to ensure that reporting to the financial markets and Bursa Malaysia are carried out on the following basis:

- **Headline KPIs on a half yearly basis; and**
- **Economic Profit on a quarterly basis.**

3 RATIONALE

Why Economic Profit (EP) and Headline KPIs?

EP and Headline KPIs measure a company's performance in two dimensions:

– EP: profit vs capital, and risk vs return
– Headline KPIs: short-term vs medium-term, and financial vs operational indicators

Why disclose?

Disclosure of these measures will provide better insights to all stakeholders (Board, employees, shareholders and debtholders) on the health and strategy of the company to facilitate decision-making processes that will ultimately lead to increasing shareholder value. A summary of the rationale is listed below:

EP

Supplements accounting profit to provide a more accurate picture of the underlying economic performance

- Analyse a company's return on invested capital, operating margins and capital efficiency
- Take into account required rate of return for equity capital and cost of debt capital

Facilitates better decisions by both management and regulators

- Should be used by all levels of management for goal setting, benchmarking and performance measurement

Empirical evidence shows that this leads to greater investor interest and confidence

- Independent research has shown that there is a stronger correlation between improvement in EP to shareholder value than there is to accounting profit
- Improvement in the long-term trend in EP signals fundamental improvement that will lead to greater investor confidence

Headline KPIs

Align expectations and interests at all levels

- Headline KPIs should be made known to all shareholders to align their interests and expectations of all stakeholders

Promote results-driven culture

- KPIs should trickle down to all levels in the company so that everyone is accountable and working towards achievement of the targets

Progress reporting serves as a stocktake

- Half-yearly updates set the pace and direction of company's strategy for the next six months in order for underperformers to catch up or for outperformers to excel further

REPORTING REQUIREMENTS FOR HEADLINE KPIs

GLCs' subsequent announcement of their Headline KPI achievement vs target should be done half-yearly. Please see below for the sample template:

ANNOUNCEMENT OF COMPANY XYZ'S HEADLINE KPIs FOR 1HFY2007

Company XYZ would like to provide a half-yearly update on its Headline Key Performance Indicators ("KPIs") for FY2007. These Headline KPIs have been set and agreed by the Board and management of Company XYZ as part of the broader KPI framework that Company XYZ has in place, as prescribed under the GLC Transformation programme, and is disclosed on a voluntary basis.

Headline KPI	Target	Achievement as at to date	Variance	Explanation

[Insert Standard Disclaimer]

RECOMMENDED ECONOMIC PROFIT REPORTING TEMPLATE

Economic Profit shall be reported on a quarterly basis in a format that is similar to how accounting profit is reported, supported by a list of the underlying assumptions.

ECONOMIC PROFIT STATEMENT (For Non-Financial Institutions)

	INDIVIDUAL PERIOD		CUMULATIVE PERIOD	
	Current Year Quarter 2Q2007*	Preceding Year Corresponding Quarter 2Q2006*	Current Year to Date 1H2007*	Preceding Year Corresponding Period 1H2006*
Earnings Before Interest and Tax		689.5		1,586.8
Adjusted Tax		(193.1)		(444.3)
NOPLAT		**496.4**		**1,142.5**
Economic Charge				
Average Invested Capital		51,753.4		51,753.4
WACC (%)		7.1%		7.1%
Economic Charge		**(918.6)**		**(1,837.2)**
Economic Profit		**(422.2)**		**(694.7)**

ECONOMIC PROFIT STATEMENT (For Financial Institutions)

	INDIVIDUAL PERIOD		CUMULATIVE PERIOD	
	Current Year Quarter 2Q2007*	Preceding Year Corresponding Quarter 2Q2006*	Current Year to Date 1H2007*	Preceding Year Corresponding Period 1H2006*
Profit After Tax Before MI		**703.2**		**1,271.9**
Economic Charge				
Cost of Equity (%)		10.2%		10.2%
Total Equity		15,605.5		15,605.5
Economic Charge		**(397.9)**		**(795.9)**
Economic Profit		**305.3**		**476.0**

Average Invested Capital for every quarter is calculated by using the Invested Capital t=0 as the base capital

Note: *Actual date should be inserted

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IMPLEMENTATION SUPPORT AND ROLES

The successful development of a performance management system requires effort and commitment from key stakeholders primarily the CEO, Senior Management and the Board of the Directors.

In line with the GLC Transformation Plan that all GLCs should develop, the CEO and his management team should state a convincing case for performance change and articulate key company actions required to pursue this. Then, the change process should engage employees at all levels, where effective performance management can add significant value throughout the process.

In the implementation of this programme, the CEO together with the Board of Directors have clear roles for institutionalising performance management best practices in their respective GLCs.

1. **The CEO** sets overall priority and implementation approach, particularly the scope and relative phasing of performance management improvement actions.

2. **The Implementation Champion,** potentially the CFO, Head of Strategy or Head of Human Capital, will lead the effort together with the team.

3. **The Board of Directors** will be important stakeholders in reviewing and committing to annual GLC performance management improvements.

To introduce this programme, a kick-off session will be conducted in January 2007 to establish and describe the components of the four modules to support implementation activities. These modules are instrumental in achieving PCG's aspiration for major GLCs to have implemented stage 2 by 2010, of which more than half the GLCs would have also implemented stage 3.

THE 4 MODULES OF THE PROGRAMME

The effort to deliver the 3-stage value-based performance management framework will be supported by four modules which will be implemented over a four-year horizon.

2007

Module 1: Setting aspirations

Runs in 2007 for 3-6 months

Conduct preliminary diagnostics to identify potential improvement opportunities and set aspirations. Each G-20* will then have a clear performance management roadmap to roll-out over the next few years with main focus on the coming twelve months.

Module 2: Boosting capabilities

Begins in 2007 and continues in 2008

Expand skill set of implementation champion and team through a series of education sessions, training and workshops.

2008

Module 3: Sharing success

Begins mid 2007 and continues in 2008

Share success from implementation experiences (including pilots at selected GLCs) through the Performance Management Circle and other communication channels e.g. newsletter and electronic forums.

2009

Module 4: Ensuring continuous improvement

Runs across 4 years from 2007 to 2010

Equip GLCs with monitoring proficiencies such as conducting annual review in order to propel continuous improvements. Initial focus will be on G-20 and extended to remaining GLCs in a second tranche during 2008.

2010

** a selection of twenty main GLCs held by the Government-Linked Investment Companies (GLICs)*

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INITIATIVE 9.5

PROGRAMME FOR IMPLEMENTING VALUE-BASED PERFORMANCE MANAGEMENT

IMPLEMENTING VALUE-BASED PERFORMANCE MANAGEMENT

In May 2004, the Blue Book was issued to introduce guidelines on the implementation of Key Performance Indicators (KPIs) and Performance-Linked Compensation (PLC) in Government-Linked Companies (GLCs).

In July 2005, Blue Book Version 2 on 'Intensifying Performance Management' was launched to establish best practice for successful performance management.

Since then, GLCs began to roll-out performance management initiatives including the announcement of Headline KPIs and establishing performance management structures. This four-year programme is launched to build on the initial efforts by broadening implementation of value-based performance management.

OBJECTIVES

The main objectives of this programme are to:

- Support performance management implementation efforts of GLCs, from building capabilities, through to running pilots and monitoring progress
- Tailor performance management implementation to the unique needs of each GLC
- Create a link that integrates all performance improvement activities including the GLC Transformation Initiatives

This programme will support GLCs in implementing improvement initiatives that will create a performance oriented culture and drive sustainable value creation.

VALUE-BASED PERFORMANCE MANAGEMENT FRAMEWORK

STAGE 1

IMPROVE REPORTING AND ANALYSIS OF FINANCIAL AND MANAGEMENT INFORMATION

- Reliable information that improves speed and efficacy of decisions and actions
- Timely and accurate reporting e.g. no more than 45-60 days after financial closing, with minimum revisions afterwards
- Concise and standardised reports e.g. monthly reporting packages, brief Board reports
- Rigorous and coherent financial forecasting and planning

STAGE 2

ENHANCE ROBUSTNESS OF CORPORATE PERFORMANCE MANAGEMENT PROCESSES

- Strategies grounded on shareholder value creation
- Metrics aligned to targets and strategy
- Health metrics incorporated into overall performance indicators
- Company performance determines the performance measurement of top two layers below CEO
- Intergrated strategy, business planning and budgeting process

STAGE 3

CASCADE PERFORMANCE MANAGEMENT INITIATIVES THROUGHOUT THE COMPANY

- Majority of employees are held accountable for their performance outcomes which are linked to company's value creation
- A culture where health metrics are introduced in all functions and levels
- Metrics for employees are a derivative of their supervisors and managers
- Incentive plans in place to build change ownership