



# WHAT SHOULD WE PAY FOR?

## GUIDE TO EXECUTIVE COMPENSATION | PART 3

The role of the Chief Human Resources Officer continues to evolve in response to transformational changes in the economy, the workforce and in how work gets done. Yet even as the human capital agenda reflects an increasing emphasis on talent and the workforce of the future, executive pay remains one of the most critical areas of focus for today's CHRO. Over the decade since the financial crisis, significant changes have reshaped the context in which executive pay decisions are made – elevating this topic to one of today's top corporate governance concerns. CHROs face the challenging task of understanding the detailed design decisions that shape a pay program and designing executive pay programs that meet the strategic needs of the business. But many CHROs come to

the role with little experience in this complex field. We have developed this Guide to Executive Compensation as a starting point for CHROs and others who do not have specific subject matter expertise in executive compensation, but whose roles require an understanding of the external context, basic principles, and design considerations that influence pay program design. This Guide will provide a basic foundation for understanding the key elements of pay design, incorporating the perspective of the multiple stakeholders whose views have significantly influenced contemporary pay design. We have also provided links to more detailed resources for those who want to “go deep” on specific topics.

## ABOUT THE CENTER ON EXECUTIVE COMPENSATION

Available only to HR Policy Association members, the Center On Executive Compensation provides deep expertise and advocacy on the top executive compensation and corporate governance public policy and practice issues facing Chief Human Resource Officers and their teams. The Center's 125 corporate Subscribers enjoy access to vast resources on executive compensation regulatory developments and implementation tools as well as detailed guides and resources on developing practices.

In the first two parts of our series, we examined the context in which executive pay decisions are made and the stakeholders who influence those decisions. We also reviewed the two factors companies consider in determining the right level of executive pay – establishing the appropriate target pay level (“how much?”) and selecting the right comparative benchmark (“compared to whom?”).

One of the most important strategic decisions that companies must make in designing executive pay programs is deciding what determines the amount executives actually earn in any given year, and how that varies from the target level. Most companies adopt a pay-for-performance philosophy that establishes performance as the most important factor in determining how much executives actually earn. In this installment of our series, we examine the critical decisions underlying how companies establish the link between executive pay and performance, including how performance is defined, how goals are established, and how performance levels and pay levels are linked. The answers to these questions convey meaningful information about a company’s goals, strategies and values – information that is important to its key stakeholders.

## DEVELOPING A PAY STRATEGY: THE THREE QUESTIONS

- **How much should we pay?**
- **What should we pay for?**
- **How should pay plans be designed?**

# 01

## DESIGN CONSIDERATIONS

### SELECTING PERFORMANCE METRICS

The selection of incentive plan performance metrics sends a strong signal about what actions and outcomes the Board of Directors considers most important. Because the majority of a typical executive compensation package is delivered in the form of incentive compensation, this signaling is especially important to the executives of the company – those whose actions most directly impact business performance. Shareholders also have an interest in the metrics used to measure performance, seeking to ensure that their interests are aligned with those of the management team running the business. Balancing the needs and interests of executives and shareholders requires selecting metrics that are linked to the company’s strategy, reflect management’s performance, and measure value creation for shareholders.

As the architect of the organization’s pay programs and strategies, the CHRO plays a key strategic role in this process by ensuring that incentive plans reward performance on those metrics that are true indicators of a company’s ability to create value and are challenging yet viewed as reasonable and realistic by executives. A strong partnership with the CFO is essential in achieving these objectives.

## Metric prevalence

While increasing attention in recent years has been focused on non-financial factors - especially in the environment, social and governance (ESG) areas - most executive incentive plans use financial metrics to assess performance. The prevalence of specific incentive metrics varies, depending on whether the plan rewards short-term or long-term performance.

Companies use a wide variety of metrics in their short-term incentive plans, and typically use more than one measure. The most commonly used are earnings measures, such as Operating Income, EBITDA<sup>1</sup>, Net Income, and Earnings per Share. In performance-based long term incentives, Total Shareholder Return (TSR) is predominant, used in over 60% of such plans<sup>2</sup>. Return measures, such as Return on Capital and Return on Assets, tend to be more frequently used in long-term plans, reflecting a company's interest in ensuring an efficient use of capital and delivering sustained value to investors over time.

The focus of proxy advisory firms on TSR has been a significant factor in driving its adoption

### UNDERSTANDING FINANCIAL MEASURES

For a detailed look at financial measures and their use by HR professionals, we suggest [Financial Analysis for HR Managers](#) by Steven Director.

in long term incentive plans. In its 2014 [Executive Compensation Reimagined](#) series, the Center addressed the limitations of TSR as a performance metric, noting that:

*“While TSR is arguably the ultimate measure of management’s performance, it is very much like the score at the end of a baseball game. That is, TSR is the best measure of the final outcome, but it’s not particularly helpful in determining what it takes to actually win.”*

In the next section, we’ll discuss how companies can select performance metrics that both drive shareholder value creation and effectively focus management attention on actions within their control.

## Identifying the right metrics

Identifying the right incentive plan metrics starts with a simple assumption: to create superior shareholder value, a company must consistently outperform its peers on industry-specific financial and non-financial measures over time. No single measure will be right for every company for all time periods, so it is important to analyze actual data to uncover the right metrics for a specific company and its industry.

<sup>1</sup> Earnings Before Interest, Taxes, Depreciation and Amortization.

<sup>2</sup> Meridian 2019 Executive Compensation Trends and Developments Survey

*“Identifying the right incentive plan metrics starts with a simple assumption: to create superior shareholder value, a company must consistently outperform its peers on industry-specific financial and non-financial measures over time.”*

Fortunately, the analysis does not have to encompass the entire universe of potential metrics; instead, a reasonable starting point can be to evaluate the metrics the executive team already uses to manage the business. Those metrics should then be assessed in light of what is important to the company’s investors. For example, if a company is focused on operating margins but its investors continually question its ability to grow, it may be advisable to include a revenue metric in the data analysis.

Once a group of metrics has been selected, they should be analyzed using historical data. Each of the identified metrics (alone and in various combinations) should be tested for correlation against a measure of shareholder value creation – typically TSR – over various time periods. It is important that the analysis be conducted on a broad data set (for example, a company’s industry competitor group) not just on historical data for a single company. This will help ensure a more robust analysis, minimizing the impact of anomalies and non-recurring events that may impact any single organization.

By engaging in a collaborative effort with their finance and business strategy teams, CHROs can ensure the right expertise is brought to the table. Expertise in financial metrics, business analysis and industry dynamics are critical in interpreting the results of the statistical analysis. By definition, correlation analysis is backward looking – it shows how changes in the metrics being tested related to changes in TSR in the past. This backward looking analysis should be informed by the judgment of finance and strategy professionals as to how macroeconomic and industry conditions in the future may differ from

prior years to help put the correlation results in the appropriate context.

While correlation is not the same as causation, using statistical analysis as an element of incentive plan metric selection adds an element of rigor to an often subjective process, helping companies and boards tailor incentive designs to meet the needs of their companies and industries.

## **SETTING PERFORMANCE GOALS**

Once the right metrics are identified, the target level of achievement for each metric can be determined. Establishing performance targets is one of the most challenging aspects of incentive plan design. To understand the dynamic influencing this process, it is important to first understand the role performance goals play in an organization. Companies use goals for three purposes – to facilitate planning their operations, to monitor progress toward objectives, and to reward performance. When performance against goals is used to determine management’s compensation, the potential for a conflict is created.

Management has an incentive to select performance metrics that are within its control and goals that are attainable, in order to maximize the likelihood of favorable compensation outcomes. Shareholders, however, favor the best possible performance at the lowest possible cost – and as such prefer aggressive performance goals and a strong and direct link between pay and performance. The CHRO plays a critical role in helping the Board achieve the right balance between these important stakeholders with potentially conflicting interests.

The first step in establishing incentive plan performance goals is to determine the reference point – what is the benchmark against which performance will be measured? Is it an internal reference point – for example, the company’s operating budget or performance against prior year results? Internal goals have the advantage of being easier for an organization to understand and embrace; but shareholders may be skeptical that management is manipulating the goal for its own purposes.

Alternatively, goals may be established relative to an external competitor group. When set on a relative basis – such as relative Total Shareholder Return – external goals can be more effective in situations where goal setting is difficult due to economic disruption or uncertainty. External goals that use standard accounting measures are also more objectively determinable than internal goals. However, effective external goals require a robust and relevant peer group (discussed in Part 2 of this series) and as such may be difficult to construct for companies with diverse businesses and competitors.

## DETERMINING THE PERFORMANCE PERIOD

Deciding on the right time horizon over which performance will be measured also requires the balancing of potentially diverse interests, even within a stakeholder group. For example, not all shareholders have the same investment time horizons – institutional shareholders typically view performance over a much longer timeframe than activist shareholders. Similarly, individuals differ in their career objectives, personal preferences for risk and the transferability of their skills to other companies, all of which influence an executive’s views on the appropriate length of a performance period.

The company’s business strategy also influences the selection of the appropriate performance period. At times, the ability to accurately set multi-year goals is limited, as when a company is undergoing a period of transformation. Macroeconomic factors also play a role, as in the recession of 2008 and the swift and massive deceleration of economic activity in the wake of the COVID-19 pandemic.

While there are exceptions, most companies define the performance period as follows:

- For short-term incentive plans: performance over a single year
- For long-term performance plans: performance over a multi-year timeframe, typically three years.



### WANT TO KNOW MORE?

Check out the Center publication [Setting Incentive Targets in a Time of Economic Volatility and Increased Uncertainty](#) for more insights on alternative incentive plan design approaches in the event of an economic downturn.

## ESTABLISHING THE PAYOUT CURVE

The performance goal serves as the “anchor” of what is known as the “payout curve”. The payout curve is the mathematical representation of how pay is related to performance. It answers the question, “how much pay is delivered at a given level of performance?”

Typically, the performance goal is “anchored” at a target payout – so that if the performance goal is achieved, the plan will pay out at 100% of its targeted level. For performance goals that are set relative to an external benchmark, it is common to deliver target pay if performance on the metric is at the median of the peer group. For plans that use a company’s internally established performance goal (such as operating profit), target pay is often anchored to the company’s annual budget or operating plan.

The key decision in designing the pay for performance relationship is to determine how much the actual amount paid will vary up or down with performance that exceeds or falls short of the goal. That relationship is determined by answering two important questions:

- What performance level is too low to justify any payout at all?
- What performance level is the “upper limit” beyond which we no longer want to create a pay-performance incentive?

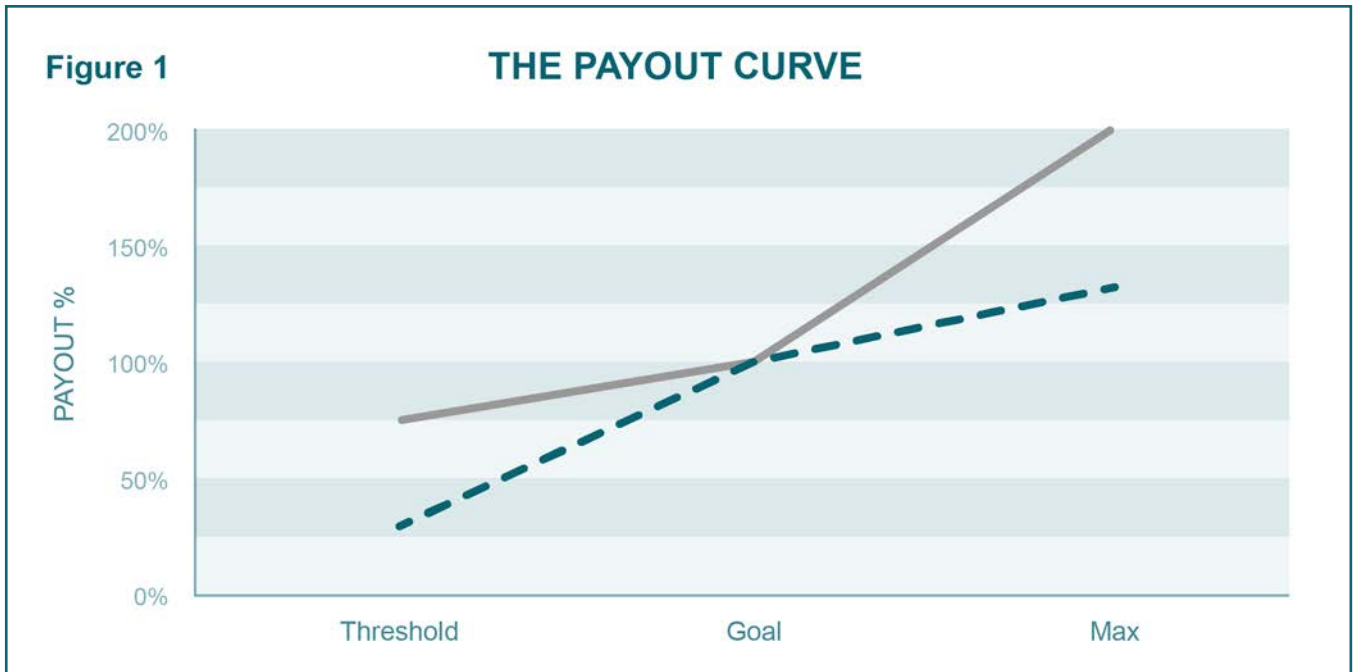
### *Establishing the minimum*

A pay for performance approach is based on the idea that as performance falls short of the expected level, pay will also decline; and at some point, performance may deteriorate to such a low level that no pay should be earned. This minimum level of performance is known as the threshold and sets the starting point for the pay-performance relationship.

Setting the appropriate threshold level of performance is made easier by analyzing historical data for the performance metric that is being used. If the metric shows a high degree of variability from year to year, it is advisable to have a greater distance between the threshold level of performance and the goal. This anticipates the fact that in any given year, performance may fall well short of target – and still provides executives an incentive to drive performance even in difficult years.

Once the threshold level of performance is set, the next question to be answered is “how much pay will be earned at the threshold level?” The lower the level of pay earned at threshold, the “steeper” the curve is between threshold and target, as is illustrated in Figure 1.

A lower percentage payout at threshold means that every incremental improvement in performance results in a bigger jump in potential earnings, creating a stronger pay-performance link. Conversely, if the percentage payout at threshold is only slightly lower than at target (say, 75% payout at threshold, 100% at target), changes in pay are less sensitive to changes in performance. The decisions made regarding the performance and payout thresholds send a clear signal to management about the Board’s expectations and its risk-return tradeoff.



### ***Determining the maximum***

The last step in creating the payout curve is to decide “how much is too much?” In a perfect world, it may seem puzzling to set a limit on how much performance will yield additional incremental pay; after all, if high performance is good, isn’t higher performance even better? In practice, incentive plans have maximum payouts in order to limit management’s ability to realize windfall gains, and to inhibit excessive risk taking. Just as management’s downside risk is limited to a zero payout, its upside risk is also capped, most commonly at 200% of target<sup>3</sup>.

The payout percentage at maximum establishes the pay-performance relationship between target and maximum – the slope of the payout curve. It is not uncommon for the slope of the payout curve to be different from threshold to target than from target to maximum. By varying the slope of the curve, the Board can tailor the message it sends to management about the incremental value of performance below and above expectations – and the level of risk-taking they are comfortable encouraging at each point along the curve.

In Figure 1, the dashed line reflects a flatter curve above target and a lower maximum, indicating that incremental performance improvements above target are less valuable than those below target. In this way, the Board can signal its expectation that target should be achieved but discourage aggressive risk-taking above that level. In contrast, the solid line in Figure 1 shows a flat curve between threshold and target (driven by a higher threshold payout), with an aggressive sloping curve above target, sending the clear signal of the importance of stretch performance.

<sup>3</sup> FW Cook, 2019 Annual Incentive Plan Report

## THE USE OF DISCRETION IN INCENTIVE PLAN DESIGN

The majority of executive incentive plans use a formulaic approach, where the amount earned is based on the measurement of actual results compared to a quantifiable and measurable target. The use of discretion to modify an award that results from a plan's formulaic calculation is typically viewed negatively by key stakeholders such as investors and proxy advisors.

However, Compensation Committees do exercise discretion that impacts incentive pay in other less visible ways. They make adjustments to standard GAAP financial measures, often to improve the alignment of pay and performance by removing items that are unanticipated and are not reflective of a company's underlying operations. They also exercise discretion in establishing the size of an executive's incentive opportunity. The use of discretion to alter the operation of an established incentive plan formula is less frequent – but may be appropriate under certain circumstances, as the COVID-19 pandemic illustrates.

Compensation Committees who choose to use judgment to alter the amount paid under an incentive plan will be best served by clearly stating their rationale, and by limiting the frequency with which they exercise discretion – especially in ways the increase awards over what otherwise would have been earned.

# 02

## SHAREHOLDERS AND STAKEHOLDERS

### STAKEHOLDER EXPECTATIONS FOR SELECTING PERFORMANCE METRICS

Traditionally, the selection of performance metrics has been viewed as the responsibility of management, under the oversight of the Board of Directors. In recent years, however, certain investors have focused increasing attention on the performance metrics used in executive incentive plans. Two areas of particular interest are the growing prevalence of non-financial metrics (specifically, ESG measures) and the proliferation of “non-GAAP” metrics (metrics whose calculations do not follow the standardized definitions established by Generally Accepted Accounting Principles, or GAAP.)

#### *The Rise of ESG in Incentive Plans*

Responding to a growing interest on the part of institutional investors, there has been an increase in the use of ESG metrics in incentive plans. Over 25% of large companies who use a metric-driven annual incentive plan disclosed using at least one ESG goal, with human capital goals being the most common<sup>4</sup>. However, these metrics typically are used in annual incentive arrangements, impacting a relatively small portion of the incentive opportunity and have been viewed as being mostly symbolic<sup>5</sup>. However, as ESG issues increase in importance and metrics become more standardized, more companies may begin to incorporate them into their incentive plans.

## The Use of Non-GAAP Metrics

Another area of investor interest is the increasing use of non-GAAP metrics in incentive plans. According to a recent study, in 1996 only 59% of the Standard and Poor's 500 used non-GAAP measures in their financial reporting; by 2018, that number had increased to 97%<sup>6</sup>. The use of non-GAAP metrics to supplement traditional GAAP reporting is a response to investor demands for additional information upon which to evaluate performance, as well as management's desire for metrics that are more closely linked to underlying operating performance.

Incorporating non-GAAP metrics into incentive plans reflects the desire to create an effective incentive plan – one that actually creates an inducement to drive differentially better results in a manner that is perceived as fair by executives. GAAP metrics can be significantly impacted by events beyond management's control; and in some cases, can actually discourage managers from making decisions that are in the best interest of the business. For example, managers may avoid a significant but disruptive restructuring of the company because the near-term impact of that decision on reported financials may result in a lower incentive payout. Non-GAAP metrics also provide flexibility that allows the plan to operate effectively in periods of uncertainty, such the rapid economic recession caused by the COVID-19 pandemic.

Adjusting GAAP metrics to take account of these factors is a reasonable action taken to recognize the need to balance the interests of shareholders and executives. However, recent research found that the use of non-GAAP metrics was associated with significantly higher than expected levels of CEO pay, without any corresponding evidence that those metrics were better predictors of company performance<sup>7</sup>. As a result, companies should take care in determining what kind of non-GAAP metrics they will use in their incentive plans and strive for transparent disclosures about not only the mechanics of the adjustments, but their rationale as well.



### WANT TO KNOW MORE?

Check out the Center publication [“The Use of Adjustments to GAAP Metrics in Executive Incentives”](#) for a detailed discussion on the advantages and disadvantages of the use of non-GAAP metrics in incentive plans.

## STAKEHOLDER VIEWS ON PERFORMANCE GOALS

Stakeholders – especially shareholders and proxy advisory firms – also take a serious interest in the performance goals used in executive incentive plans. Proxy advisory firms and some investors expect companies to set more challenging performance goals, insisting that a given year's performance goal is always higher than the prior year's actual results. Companies are responding to the pressure, with over three quarters of companies setting their threshold performance goal at or above the prior year's actual performance<sup>8</sup>. The insistence that performance goals must always be set above prior year performance may provide challenges to companies who are in cyclical industries, who have divested significant operations, or during periods where macroeconomic conditions are deteriorating.

<sup>4</sup> F.W. Cook 2019 Annual Incentive Plan Report

<sup>5</sup> “How should environmental, social and governance (ESG) performance be reflected in executive compensation?” Meridian Insights Blog Post, January 22, 2020

<sup>6</sup> Non-GAAP measures and the ongoing dialogue: What you should know” PwC, October 2019

<sup>7</sup> “High Non-GAAP Earnings Predict Abnormally High CEO Pay,” Nicholas Guest, S.P. Kothari and Robert Pozen, September 2017.

<sup>8</sup> F. W. Cook, 2019 Annual Incentive Report

# 03

## GOVERNANCE AND DISCLOSURE

### TELLING YOUR STORY

Investors want a clear, concise description of the relationship between performance and a company's pay program – and most often do not feel that proxy statements effectively meet their needs. Most feel that the link between pay and performance is not clear; and in response many companies have broadened their disclosure beyond what is required in the proxy statement. In 2018, 56% of the Equilar 100 companies provided a supplemental disclosure in addition to what was required.

If the pay for performance relationship is one of the most important concerns for investors, why is disclosure falling short? One reason is that the standard required proxy statement disclosure does a poor job of showing how actual pay varies with performance. The cornerstone of the standard proxy disclosure, the Summary Compensation Table (SCT), reports pay actually earned as well as accounting estimates of the “potential” or “expected” value of other types of pay; and even includes calculations that have no relationship to an executive's pay or company performance (see Figure 2).

As Figure 2 shows, only the amounts disclosed for base salary and annual bonuses reflect the amount actually paid to executives in a given year. Because of the limitations of the SCT, companies have adopted alternative ways of showing the pay for performance connection. Two of the most common are Realized Pay and Realizable Pay. Realized Pay gives a clearer picture of the total amount actually received by an executive, while Realizable Pay shows a “point-in-time” picture of the value of pay that allows more effective assessment of the alignment of pay to a company's performance.

Each of these alternative approaches allow companies to show more clearly the connection between pay actually received and performance; however, because there is no commonly accepted standard for these approaches, comparisons between companies (or of a single company's results over time) are difficult and adoption has not been consistent or universal.

**Figure 2 SUMMARY COMPENSATION TABLE ELEMENTS**

PAY COMPONENT	SUMMARY COMPENSATION TABLE REPORTING
Base salary, annual bonus	Amount actually paid, including any elected deferrals
Restricted stock, Stock options	Value at the date of the grant; for options, value typically established using an option pricing model
Long term performance plans	Value that can be earned if performance target is achieved
Other compensation	Non-performance-based compensation, including any increase in actuarial value of pension, above-market credits to deferred compensation amounts

## THE DODD-FRANK PAY FOR PERFORMANCE RULE

The 2010 Dodd Frank Act contained provisions requiring the disclosure of the relationship between executive pay and performance. In April 2015, the SEC published proposed rules implementing the Act’s mandate. The proposed rule, which has not been finalized, defines compensation “actually paid” as a mixture of actual compensation received by the executive, along with point-in-time estimates of equity compensation and accounting estimates of the value of stock options. The proposal also relies solely on total shareholder return as the measure of company performance.

In the economic analysis of the proposed rule, the Commission admitted that the disclosure had the potential to be misleading, and suggested companies use additional narrative disclosure to clarify any misleading information. Many observers, including the Center, do not believe this provides a sound and rationale basis for a securities disclosure and has urged the SEC to revisit the proposed rule and replace it with a principles-based approach.



### WANT TO KNOW MORE?

**Realized and Realizable Pay are alternative approaches to pay disclosure that allow investors a more realistic assessment of the relationship between executive pay and performance. There are no standard definitions of these approaches, making comparisons challenging and inhibiting widespread adoption. For more information, check out these Center resources:**

[Supplemental Pay Disclosure: Overview of Issues, Proposed Definitions, and a Conceptual Framework](#)

[Comparison of Different Approaches to Calculating Total Executive Compensation](#)

[Five Alternative Approaches to Disclosing Executive Compensation](#)

# 04

## FINANCIAL IMPLICATIONS

As paying for performance has become the foundation of executive pay programs, the importance of understanding the drivers of company performance has increased. CHROs and rewards professionals now work in partnership with finance and strategy teams to determine the right performance metrics for their executive incentive plans, and the target levels of performance that must be met to earn competitive rewards.

Given the inherent potential for conflict between management and the Compensation Committee in selecting metrics and setting goals, the use of a data-based approach to informing incentive plan design is important. An analysis of the correlation of incentive plan metrics to shareholder value creation over time gives management and the Board an objective foundation to guide incentive design.

Investors and other stakeholders are also interested in understanding how much of a company's profit is paid out in the form of compensation. This is typically called a "sharing percentage" – for example, the total value of

incentive compensation divided by an earnings measure, such as operating profit or earnings per share. Because these percentages differ widely based on industry and company-specific factors (such as labor strategies, incentive plan eligibility, etc.) there are no well-developed standards or benchmarks for an appropriate sharing percentage. Boards and Compensation Committees rely on their judgment and on historical trends for their company to gauge whether the portion of profit shared with management is appropriate.

Similarly, shareholders are also interested in how many shares are reserved for use in compensation plans. This is typically done by looking at the percentage of shares reserved for compensation plans as a percentage of total shares outstanding, a calculation called "overhang". Overhang levels vary considerably by industry and reflect the unique talent, rewards and capital allocation strategies of each company. Shareholders watch overhang levels to make sure that their ownership interest is not unduly diluted by diverting too much equity to management.

## TERMS TO KNOW: OVERHANG AND BURN RATE

**Overhang:** a measure of how much stock is being given to management and employees in the form of equity compensation. Sometimes referred to as dilution. Typically calculated as follows:

$$\frac{\text{Number of shares available for use in compensation plans}}{\text{Total shares outstanding}}$$

The numerator includes shares available to grant, outstanding stock options that haven't been exercised, as well as outstanding restricted stock and performance shares that have not vested.

**Burn Rate:** a measure of how fast shares are used by compensation plans. Sometimes referred to as run rate. Typically calculated as follows:

$$\frac{\text{Number of shares actually granted in a year}}{\text{Weighted average total shares outstanding}}$$

## REFERENCES AND RESOURCES

[Executive Compensation Reimagined](#)

[Council of Institutional Investors SEC Petition regarding non-GAAP metrics](#)

[Proposed Pay for Performance Rule Fact Sheet](#)

## UP NEXT

In part 4 of our series we'll explore the detailed elements that comprise an executive pay program.