Compensation

Testing Pay for Performance

By Chris Havey and James Limmer

A key pillar of most compensation philosophies is to pay for performance, but how do directors know if it's working? To answer this question, compensation committees are increasingly testing the pay and performance alignment after the payouts have been made. This feedback process is vital to ensure the continued effectiveness of the compensation programs.

Rationale for Testing Alignment

Typically, when compensation committees benchmark their company's executive pay, they focus on the target opportunity. This helps ensure that the company is providing competitive opportunities to attract and retain qualified talent. However, this ignores the payout determination process (goal-setting, subjective assessment, etc.) and what is eventually realized from these compensation programs. Testing the alignment can help ensure that your company is setting goals that are not substantially more or less challenging than your peers', thereby impacting the competitiveness of the program.

Additionally, testing the alignment helps the company understand its pay for performance story (i.e., how pay and performance are aligned). This can guide proxy disclosures and critical shareholder outreach efforts.

Testing the Alignment

There is no silver bullet analysis that will definitively determine whether pay and performance are aligned at every company. However, there are a number of ways companies can test the pay and performance alignment relative to peers or historical results. A few examples include:

- Testing annual bonus payouts and key performance indicators relative to peers. Example: actual bonus as a percentage of target compared to operating margins.
- Testing aggregate officer bonuses as a percentage of key income or cash flow metrics relative to peers or historical results. Example: aggregate officer bonuses as a percentage of earnings before interest, taxes, depreciation, and amortization tracked over time.

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- Testing total realizable compensation and shareholder-return performance relative to peers. Example: CEO total realizable compensation for the past three years relative to three-year shareholder return (similar to recent Securities and Exchange Commission (SEC)-proposed rules).

When reviewing these analyses, it is important to understand the assumptions made and the key drivers of the results. By reviewing this information, directors can use their judgment to assess whether the information indicates appropriate alignment and degree of stretch, or not.

Translating to Action

If the analysis does not tell the story directors were expecting, changes may be needed in terms of program structure, goal setting, or pay levels. By understanding the key drivers of incentive plan outcomes, the compensation committee can discuss an action plan for improvement. For example, if the company has performed near the top of its peers, but realizable pay is near the middle of its peers, it could be a result of not enough leverage in the program, goals that were more difficult than peers', or target pay levels set lower than the market.

If directors conclude that pay is appropriately aligned with performance, this analysis can help in the development of proxy disclosures in a couple of ways. First, the compensation committee can disclose that it regularly reviews the alignment of pay outcomes with performance, demonstrating its focus on strong governance of the compensation programs.

Secondly, it can help the company describe how its pay is aligned with performance. This will be particularly important after the SEC's new rules on pay and performance disclosures are finalized. The rules as currently proposed may create confusion for shareholders about the alignment of pay and performance, so companies with a clear and compelling story will be able to more effectively demonstrate pay and performance alignment to their shareholders.

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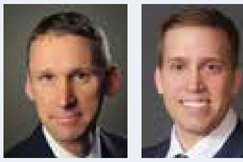

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