Pay for performance

Andrew McElheran and Andrew Stancel, partner and lead consultant, respectively, at the executive compensation consulting company **Meridian Compensation Partners**, explain what pay for performance should mean to corporate boards and management teams.

Over the past ten years or so – since the widespread adoption of shareholder 'say on pay' votes on executive compensation at public companies in the US and elsewhere – arguably no single idea has animated the analysis and design of CEO compensation programmes as much as the goal of 'paying for performance'. For a long time, it was possible to make such an assertion, without having to demonstrate that it was also a reality.

However, in today's governance environment, companies increasingly have to 'show their work' and explain how their programme rewards correspond with performance. This is particularly true as more investors are required to maintain their position in a company's stock – for example, because of an indexing policy – they will seek changes to improve lagging performance, instead of selling their investment.

The backward-looking analysis

A formal retrospective pay for performance analysis is one essential but ultimately insufficient tool. It assesses CEO – or senior executive – pay outcomes in light of observed company performance, and can include a comparison to peer companies. Typically, a company's historical performance on multiple indicators is compared with CEO pay over the same time frame, and these results are evaluated against the same data from peers, to assess the relative degree of alignment of pay and performance, with two key points:

- **Performance:** measured using whatever metrics make sense for the company, incorporating any suitable adjustments from GAAP data.
- **Pay:** measured in realised or realisable terms, not target or grant-date ones, to capture the impact of performance assessments and share price movements.

Proxy advisory companies use a similar method to review the CEO pay/performance

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relationship, but these are often flawed as they rely on equity-based pay values at grant date, not on actual pay earned.

A single year showing a misalignment between pay and performance would not be cause for any programme changes, but a trend of misalignments persisting for multiple years would prompt additional investigation of root causes.

A wider picture

A backward-looking analysis of whether pay for performance exists provides additional context for a company to engage in a more informed discussion around pay programme design and quantum, and confirm that pay programs are operating as intended – or not.

However, corporate boards must evaluate management proposals on incentive plan designs critically, and administer executive pay arrangements prospectively, considering pay mix, stock-based vehicles, performance measures and goals for performance for future periods. Pay for performance means more than a good mark on a review.

In particular, pay for performance implies paying for successful execution of the business strategy. For example, a company could be strategically shifting from a growth focus to a profitability focus, in which case, setting growth goals sequentially higher than the prior year's goals, if that has been the practice, could incentivise precisely the wrong outcomes.

Ideally, when it comes to goal setting, the pay for performance relationship should be informed by a broader context, which could include three elements:

- **Internal perspectives:** the company's own history, business goals and strategy.
- **External perspectives:** from the industry and the capital markets.
- **Sharing ratios:** the sharing of value or profits with management, over time.

For many companies the foundations of future success are laid in non-financial, qualitative goals. Pay for performance also means understanding how these goals translate to future financial performance and value creation. This will require potentially difficult and highly subjective evaluation of the qualitative goals. Further complicating matters is that performance goals – financial and non-financial alike – may be set when the business forecast is substantially uncertain and/or changing.

In each case, board members and management teams should be willing to insert informed business judgment into the performance evaluation process, particularly if a 'course correction' is indicated from when the original goals were established. Indeed, nothing is potentially more destructive to future value creation than 'sticking to the plan' – and paying for it – if the landscape has dramatically shifted.

Pay for performance should be at the centre of a well-designed executive compensation programme, but paying for performance properly involves a much broader mandate than is initially implied. Understanding how the compensation programme supports the business strategy is of pivotal importance, because that understanding helps companies avoid the trap of 'paying for X while hoping for Y'. ●

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