THE IMPORTANCE OF PAY AND PERFORMANCE LOOKBACKS

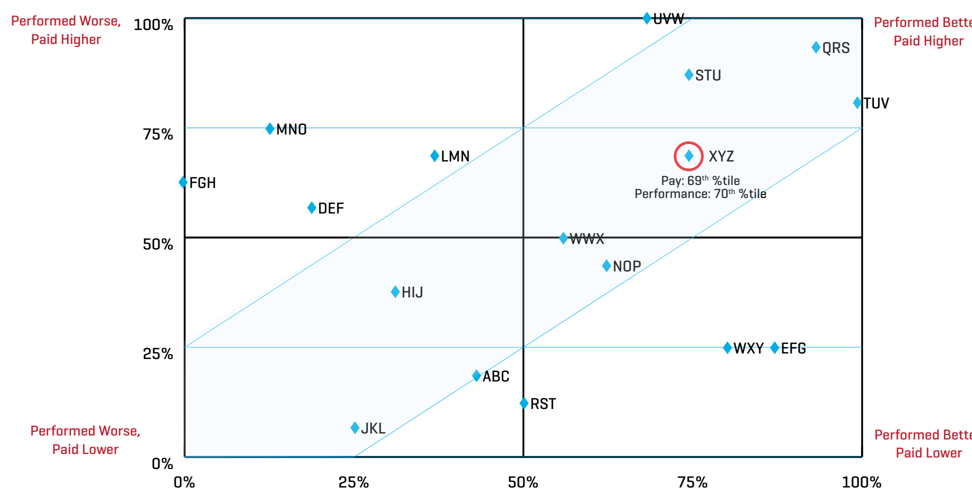
Ensuring alignment between company performance and executive pay is essential to maintain effective compensation plans. By Caroline Montalbano and Anthony Bailey

EXTERNAL CRISES OR STRATEGIC shifts can wreak havoc on compensation plans. Periodic pay and performance lookbacks provide crucial insights into the efficacy of compensation structures. There are four key considerations for effective lookbacks:

▪ **Measurement Period:** Selecting the appropriate timeframe for a lookback is critical. It should be long enough to capture meaningful trends, while considering the current executive team tenure. Using a three- and five-year lookback provides a comprehensive assessment of performance patterns while acknowledging the impact of short-term fluctuations and long-term trends.
▪ **Absolute vs. Relative Analysis:** Determining whether to assess performance on an absolute or relative basis depends on the availability of a reliable peer group and the comparability of performance metrics across companies. Relative analyses can help identify whether the issues impacting the company are external (global pandemic) or internal (pay and performance disconnect). Absolute analyses can provide insight into historical goal-setting and achievement patterns.
▪ **Executives in Scope:** It's important to determine whether the CEO's pay outcomes are indicative of companywide results or if including additional executives is necessary.
▪ **Company Performance Measures:** Financial metrics are most common and typically offer stronger alignment with shareholders versus operational metrics. Total Shareholder Return (TSR) is often favored for its simplicity and shareholder alignment but can be viewed as an outcome that management has limited control over. Supplementing TSR with metrics used in the company's incentive plans may offer a more nuanced understanding of performance. Some metrics are challenging to replicate across companies, but GAAP figures can be proxies for more customized financials.

Subject Company and Compensation Peers

3-Year Avg. Performance vs. 3-Year CEO Total Realizable Compensation



There are three common types of analyses:
▪ **Pay and Performance Alignment Evaluation (Relative and Absolute):** This analysis compares executive pay with company performance both internally and against peers. It assesses the effectiveness of incentive plans in rewarding performance and maintaining alignment with organizational goals. In the example above, the subject company is within the blue-shaded zone, indicating alignment between pay and performance. Positioning outside the zone indicates a potential disconnect between pay and performance (e.g., higher pay with lower performance) and provides opportunities to understand the underlying drivers.
▪ **Assessment of Incentive Goals and Actual Performance (Absolute):** This evaluation focuses on the attainment of performance goals within incentive plans. It measures the extent to which actual performance aligns with targets and highlights patterns of overachievement or underperformance, which may signal opportunities to revisit the goal-setting process.
▪ **Assessment of Incentive Targets and Actual Performance (Relative):** This analysis compares the achievement of targets relative to industry benchmarks or peer performance. It provides insights into the degree of "stretch" in targets and the company's performance compared to peers.

Conducting pay and performance lookback analyses offers invaluable insights into the effectiveness of compensation programs. To prepare a lookback:

1. Perform Tests: Gather historical data. Meridian can help companies conduct analyses using robust methodologies and industry expertise.
2. Evaluate Results: Assess findings to identify trends and areas for improvement.
3. Take Action: Armed with insights, consider adjustments to incentive design, goal-setting or performance metrics to enhance program effectiveness and strengthen alignment with company objectives and the shareholder experience.

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