Board oversight of executive pay: A fresh approach

We suggest a new way forward for board decision making on executive pay tied to company performance — building from the traditional budget-based goals, but also more directly acknowledging the increasing variability in management's budgets.

By Casandra Rusti and Barry Sullivan

Executive pay has long been in the spotlight for shareholders, boards, management teams, and commentators alike. More recently, the connection of executive pay outcomes with company performance has taken center stage. It's been a key focal point in the past, but today the pay-for-performance relationship carries a heightened sense of urgency and a greater degree of precision than ever before. It's become a balancing act across multiple stakeholders, from executives to the broader base of employees, to outside analysts, regulators, and investors.

External stakeholders — investors, regulators, proxy advisors — have the benefit of assessing the pay-for-performance relationship after the fact, when performance has already been delivered and incentives already paid. Yet boards and management teams have the more difficult task of defining expectations and setting performance requirements (i.e., goals) at the outset of a performance period, such that those after-the-fact assessments hold true. Instead, why not allow for judgment after-the-fact for boards and management teams, as well? Not as an excuse for performance below expectations, but as a means of testing the expectations themselves — were they too hard, too soft, or just right . . . knowing what actually happened during the performance period?

Variability vs. visibility

Today, many companies face significant variability, both in their end markets and in their operating models. Increasing variability diminishes forward-looking visibility, and the task of

Casandra Rusti is an associate consultant and **Barry Sullivan** is a managing director with executive compensation consulting firm Semler Brossy (www.semlerbrossy.com).

setting meaningful goals becomes that much harder. By extension, we see management teams increasing the 'hedge' in their business plans. Most often, these hedges are well intended — to address variability and unknowns, and to feed external guidance. Naturally, boards are cautious with these hedges — careful not to soften expectations too much, being mindful of investor interests and outside scrutiny. From time to time, a real disconnect, and even distrust, can develop between boards and management teams when setting performance requirements for the period ahead.

We see management teams increasing the 'hedge' in their business plans.

(*Side note:* At least to a degree, the rise of relative TSR stems from these observed goal-setting disconnects between the board and management team. First, relative TSR is an easy 'out' for boards that fear their management team may be sandbagging goals. Second, management teams will sometimes gravitate to relative TSR when forward-looking visibility is low, or where they fear their board may perceive sandbagging.)

We suggest a new way forward — building from the traditional budget-based goals, but also more directly acknowledging the increasing variability in those budgets. More on this later; first, a deeper dive into the goal-setting challenge.

A new way forward:
A simple framework for determining incentive outcomes

incentive outcome

performance relative to market	below	at/around	above
above	$$	$$$	$$$$
at/around	$	$$	$$$
below	–	$	$$

performance against internal expectations

Source: Semler Brossy

Crystallizing the goal-setting challenge

At the beginning of each performance period, companies set goals based on internal expectations. Commonly, goals are pegged to a company's annual budget and/or longer-term strategic plans. Generally, these internal expectations reflect the best available information at the time, including expectations for major external factors (e.g., key input prices, currency rates, industry conditions, larger economic conditions). Of course, actual market conditions during the performance period can, and often will, be different than those beginning-of-period expectations.

When external conditions shift significantly from expectations, the goals set at the beginning of a given performance period may be overly aggressive or overly conservative. Incentive outcome determinations against those now-out-of-date expectations can be disconnected from a broader view of company performance. With an unexpected industry tailwind, a company might blow through its performance goals, but underperform versus competitors. Conversely, where external conditions sour for a given company, a clear 'miss' against performance goals may underappreciate significant efforts in softening the downturn and positioning for the next upturn. In our view, both of these incentive outcomes are suboptimal: reminiscent of Goldilocks and her porridge, the first outcome is 'too hot,' the second 'too cold,' and neither is 'just right.' The traditional 'pay-by-the-numbers' approach strikes us as too simple at times, unable to fully capture company performance. The fresh approach (outlined below) builds from budgets/plans, but allows for a 'rear-view mirror' assessment of those budgets/plans, which we believe to be a more true assessment of actual performance.

A new way forward

So, rather than rely solely on the traditional 'make or beat budget' approach, we suggest this approach:

1. For each performance period, continue to set targets against internal expectations.

2. Then also test those internal expectations and the company's actual performance against external market conditions (including, for many companies, competitors' performance), at the end of the performance period.

Governance Book of the Year

The Compensation Handbook

It has been a number of years since executive compensation has been such a scorching topic in the boardroom and the media. Just take a gander at a few press headlines from earlier this year:

• "Goldman Shareholders Revolt Against Top Executive Pay"

• "Google CEO Gets $199 Million Equity Award"

• "Ex-Valeant Chief Pearson Walks Away with $10 Million Despite Shares Falling 90%"

• "Investors Want Mutual Funds to Get Tougher on CEO Pay"

• "Why It Is Time to Curb the Madness of CEO Pay"

• "Boards Are Responsible for Limiting Pay Excess"

With media focus like this — a time when executive pay is described as "galactic," as the *Financial Times* did so recently — attention must be paid. *Directors & Boards* has selected *The Compensation Handbook [Sixth Edition]* as the 2015 Governance Book of the Year. Subtitled *A State of the Art Guide to Compensation Strategy and Design*, the book was published in July 2015, well timed to ride a mounting wave of concern about the level of executive pay and the board's role in crafting and approving exec comp. The 600-page book includes 51 chapters, each written by experts in the tools and tactics of comp design and strategy. (*Directors & Boards* Publisher Robert Rock, drawing on his extensive board service, contributes a chapter on the workings of the compensation committee of the board.) The author/editors are Lance A. Berger, managing partner of Lance A. Berger & Associates Ltd. and a longtime specialist in compensation and talent management, and Dorothy R. Berger, a partner in the firm. The Bergers collaborated on earlier editions of *The Compensation Handbook*. According to the book's publisher, McGraw-Hill (www.mhprofessional.com), this latest edition "continues the value-creating heritage established by its predecessors." A passage from Lance Berger's introductory chapter follows.

— *James Kristie*

The first edition of *The Compensation Handbook* was a snapshot of the compensation practice as it had evolved prior to 1972. Each subsequent edition was a time capsule containing a rich trove of information representing the cumulative successes of its predecessors as well as the best new practices, issues, procedures, and processes that would be useful in the future. This sixth edition extends this evolution of knowledge to the current time.

Every organization needs a designated group of people with a sufficient level of expertise in compensation practice to develop and implement or outsource effectively their pay programs. This group could include any combination of compensation professionals, human resource generalists, and line managers.

Level of expertise can be classified in many ways, including basic, operational, tactical, and strategic.

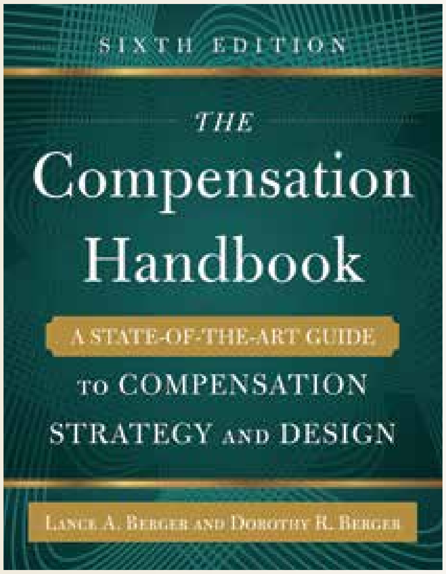
1. *Basic*. Knows the fundamental principles, terminology, concepts, issues, applications, and vendors associated with the compensation discipline. This is the minimal level of expertise expected for a line manager.

2. *Operational*. Able to implement compensation programs provided by, and with guidance from, others with higher levels of expertise. This is a realistic level of expertise for most managers, entry-level compensation professionals, and human resources generalists.

3. *Tactical*. Develops and implements compensation programs with minimal assistance from outsiders. Can coach others in implementing a compensation program. This is the expected level of an experienced compensation professional.

4. *Strategic*. Creates, implements, provides guidance, troubleshoots, and answers questions related to the compensation discipline. This is a recognized expert in the compensation discipline.

Over the course of time, the various editions of *The Compensation Handbook* have shown that readers have been seeking guidance in moving toward the strategic level of expertise. The chapters in this book seek to provide a context relevant to all four levels of expertise.



Every organization needs a designated group of people with a sufficient level of expertise in compensation practice to develop and implement their pay programs.

Under this approach, a company that achieves its internal expectations can then adjust the incentive outcome up or down, based on a rear-view mirror assessment of actual external conditions. For example: a company that exceeds internal expectations and also outperforms competitors during the period *(top right quadrant in the nine-box graphic on page 22)* will earn more than a company that beats internal expectations but underperforms competitors *(top left quadrant)*.

> THE TRADITIONAL 'PAY-BY-THE-NUMBERS' APPROACH STRIKES US AS TOO SIMPLE AT TIMES, UNABLE TO FULLY CAPTURE COMPANY PERFORMANCE.

In this way, boards and management teams can stand clear of negotiated budgets, taking a "trust, but verify" approach, giving comfort that the end-of-period assessment will account for actual external factor variability.

Keys to success using this new approach:

• ***Maintain (and even enhance) the rigor in the traditional budgeting/goal-setting process.*** This approach, with its end-of-period assessment of budget/goals, works best when those beginning-of-period goals are well-informed and carefully thought through.

• ***Clarify at the beginning of the period what factors/events will play into the end-of-year assessment.*** Said simply, what information will the board/compensation committee review to determine whether goals were overly soft or overly hard? Common things to consider include:

Currency movements during the period — look no further than 2015 for a period during which currency moved 'bigger and faster' than most expected.

Significant shift in input prices — e.g., fuel costs for airlines; lumber costs for homebuilders; cotton prices for retailers.

Political or regulatory change — e.g., an election cycle that drives demand for a company's products in anticipation of a political/regulatory change. (*Important note:* The year-end assessment is not intended to provide forgiveness for true competitive action. If an established competitor takes a new tact, or if a new competitor arrives on the scene, management must respond accordingly and the incentive plan/board must hold the team accountable for that response — in the period and going forward.)

• ***Adjustments, if any, can and should work both ways.*** Over time, companies must expect (and practice) end-of-period judgments to work both ways, both up and down from budget-based incentive outcomes.

Practical pointer: 162(m)-umbrella structures can help safeguard the tax deductibility of incentive outcomes where judgment plays a role. These 'umbrella' structures are well established at this point for annual incentive administration, and they are now an emerging practice for longer-term incentives, as well. ■

Barry Sullivan can be contacted at bsullivan@semlerbrossy.com.