COMPENSATION COMMITTEE LEADERSHIP NETWORK
ViewPoints

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Connecting pay to performance and communicating pay philosophy

The core of a compensation committee's responsibility is to set the pay of executives in light of the company's and the executives' own performance. At the CCLN's meeting on November 12 and 13, members discussed the challenge of defining corporate executive performance and linking pay to it, as well as the difficulty inherent in communicating pay decisions internally and externally. This *ViewPoints* briefly highlights member perspectives on these issues.[1]

Linking pay and performance

When the CCLN met in March, members agreed that investors, the media, and the broader public are now focusing more on total shareholder return (TSR) than they did in prior years.[2] A recent survey by Meridian found that TSR and earnings were the most frequently used financial metrics in performance-based full-value awards in long-term plans, each used by 47% of surveyed companies.[3] Relative TSR is used by 88% of companies that have any relative goals.[4]

Success in terms of TSR and relative TSR has come to be equated with pay for performance. But CCLN members said that this was problematic: *"We have let the external world define pay for performance as TSR, but we shouldn't reflexively agree. We have to look at how we want to define it and measure it and articulate it."*

Performance may also be defined in terms of the level of (or growth in) earnings, revenue, cash flow, or the return on investment or assets. Compensation committees must decide which metrics are right for the company and not be overly swayed either by fads or by "how things have always been done."

Non-financial goals

Some companies base a portion of pay on non-financial goals tied to the company's strategy. *"The principal part of non-financial goal setting comes from the company's strategy,"* one member said. Goals that members cited include customer and revenue diversification, new market penetration, merger and acquisition targets, and enterprise-wide succession planning.[5] Members agreed that particular goals are unique to each company's situation and vary widely, but that they identified certain shared qualities:

- Clarity, objective, and quantifiability
- Limited in number

[1] *ViewPoints* reflects the network's use of a modified version of the Chatham House Rule whereby names of members and their company affiliations are a matter of public record, but comments are not attributed to individuals or corporations. Italicized quotations reflect comments made in connection with the meeting by network members and other meeting participants.

[2] Compensation Committee Leadership Network, "Spring 2013: Charting a Course for Tomorrow's Compensation Committee," *ViewPoints,* April 24, 2013, 4.

[3] Meridian Compensation Partners, *2013 Corporate Governance & Incentive Design Survey* (Lake Forest, IL: Meridian Compensation Partners, 2013), 22.

[4] Ibid., 23.

[5] Compensation Committee Leadership Network "A Changed and Changing Executive Compensation Environment," *ViewPoints,* April 12, 2012, 6.

- Developed with, not imposed on, the CEO
- Robustly discussed and evaluated by the committee and board[6]

Discretion

Whether the goals are financial or non-financial, however, the tricky part is determining to what degree performance is due to executive effort and to what degree exogenous factors are responsible. As one member remarked, *"There's no executive mistake that can't be wiped out by a hot summer."* Committees may choose to address the skewing effect of exogenous factors by exercising discretion and changing an award. Some members opposed such intervention, saying that committees should *"stick with the [compensation] plan when it is up and when it is down."* Many others cited reasons for discretionary changes, particularly upward:

- **Fairness.** *"The hardest you will ever work is in a year when the company isn't doing well,"* one member said. But other members countered that committees should view fairness from the shareholders' perspective and not increase payouts when shareholders are not seeing return on investment.
- **Utility.** Adjusting compensation upward can help a company hold onto its people when they are vulnerable to poaching: *"When a company is struggling, the first thing that happens is that your people get recruited by competitors. And it all happens so quickly,"* one member said. But another member noted that *"the company may have employees it doesn't want to let go, but the shareholders sometimes say, 'These are the managers who were at the helm when the stock didn't perform – let them leave.'"*

During the meeting, members focused on discretion in the context of the annual plan. Named executive officers (NEOs) at some member companies receive wholly discretionary annual bonus payments. At one company, there are no underlying formulas that generate a presumptive bonus; at another, the committee can exercise discretion to overrule an award suggested by a formula. Other companies limit committee discretion around annual bonuses to a particular percentage, typically 25%.

Changing the focus

Several members said that the conversation should shift from setting pay to defining and understanding performance. Most compensation committees seek to strengthen the relationship between the two. But one member suggested that pay is not the central issue, commenting that, *"If we really think that good CEOs add value and mediocre ones don't, we should focus on getting rid of mediocre CEOs more quickly."*

Communicating pay decisions

Executive compensation is perhaps the most salient aspect of corporate governance for the media and general public. It was the most commonly identified topic requiring director and general counsel attention in 2013.[7] Compensation committee chairs may be asked to communicate pay philosophy and outcomes to different

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[6] Ibid., 7.

[7] Kimberly S. Crowe, "Law in the Boardroom," *Corporate Board Member,* 16, no. 2 (second quarter, 2013) notes that 60% of directors and 46% of general counsel expect to spend time on executive compensation in 2013, a higher percentage than was true for any other topic for either group.

groups. At the November meeting, members focused on communicating pay decisions to their investors and to the broader public.

Understanding investors

All investors are not equal when it comes to comprehending compensation. Some are deeply knowledgeable: *"I just participated in a meeting with nine investor groups who said that TSR is not a metric, it's a tool to look back over time,"* one member said. Another said, *"[One investor] wanted to see interim performance measures and objectives and to understand how the company was thinking about performance during the period."* But other investors are not so well informed. *"I talked with 40 investors,"* one member said. *"One said no one should make that kind of money, others thought say on pay was binding, another got Glass Lewis confused with Glass-Steagall. Very discouraging."*

Disclosures and written alternatives

Members are seeking better ways to communicate their pay philosophies and outcomes. Some discussed improving the compensation discussion and analysis (CD&A) by shifting from a focus solely on compliance to one that is both compliant and communicative. *"The legal voice is an important part of the CD&A, but it can't be the only voice,"* one member said.

Changing the order of drafting the CD&A can have an effect. "I drive my lawyers nuts [with my revisions]," one member said at a past meeting. Another member suggested that a more regular, thorough redesign of the CD&A could benefit readers: *"Maybe we need to have more fresh thinking. We don't really draft a new CD&A each year – we mark up the prior year's version and add to it."*

Members suggested alternatives to the CD&A, such as better executive summaries and other forms of written communication, such as a letter from the board to its shareholders.

Board-shareholder engagement

Members were divided on the value of meeting with shareholders. These meetings are more likely after an unsatisfactory say-on-pay vote, but some members found value in regular investor meetings. *"It's risky, and it's different from the standard 'we communicate this way and this way only because it is expected,' but [with the standard approach] we end up not really communicating with anyone … Because of the conversations [the CCLN] had, I went back to management to say we should meet more with our investors."*

Many companies represented in the CCLN have gone out to generate support for their pay plans in advance of an annual meeting. Most have relied on executives to make the pitch, but a few have included directors as well.

One member suggested that the appropriate distinction wasn't between engaging shareholders before or after the annual meeting, but rather was between proactive and reactive discussions: *"I think that management should include compensation as part of their pitch on company strategy. When compensation is aligned* *with strategy, there's an advantage to the company that we should tout."* Another member added, *"When you are clear that you are on the right path and not just fighting a fire, it can be powerful."*

Engaging with the broader public

Investors are not the only audience for executive compensation news. Over several meetings, CCLN members have noted a rise in the public's interest in – and, frequently, concern with – their work. A 2012 Rasmussen survey found that 69% of Americans believe that the level of pay and bonuses for executives at major US companies is too high.[8] "Committees are more deeply involved in all aspects of pay for performance because the public thinks that we are paying outrageous salaries," one member said at a prior meeting.

"We should not be so defensive," one member said. *"Let's explain the thinking behind our pay plans and behind our companies' overall pay philosophies."* These disclosures – in such forms as public ad campaigns[9] and Web pages that prominently and clearly discuss the company's overall pay philosophy – may look quite different from the materials prepared for the investor base. Communication aimed at the general public may take on extra importance after the first publication of CEO-to-worker pay ratios,[10] which will undoubtedly generate additional public interest in executive compensation.

About this document

[8] Rasmussen Reports, "17% Favor Government Regulation of All Executive Pay," April 23, 2012. But Steven Kaplan, a professor at the University of Chicago's Booth School of Business, notes that since 2000, average pay for Standard & Poor's (S&P) 500 CEOs has declined by 46%. Relative pay equity has also improved: in 2000, CEOs made 350 times median household income; now, a CEO only makes 200 times as much. CEOs also make relatively less than hedge fund and private equity leaders; the ratio of average CEO pay to the average pay of the ".1 percenters" is comparable to or lower than the ratio in the early 1990s. See "Bargain Bosses," *Schumpeter* (blog), *Economist,* September 8, 2012.

[9] In a conversation focused on the effects of the SEC's proposal concerning CEO-to-average-worker pay ratios, members cited Wal-Mart's "The Real Walmart" campaign as an example of this approach. See Wal-Mart Stores, "The Real Walmart," 2013.

[10] For more on this topic discussed at the November meeting, see Compensation Committee Leadership Network, "Pay Ratios," *ViewPoints*, December 11, 2013.

Appendix: Contributing members[11]

The following members participated in the discussion:

- Thomas A. Dattilo, Harris Corporation
- Errol Davis, Union Pacific Railroad Company
- Thomas J. Donohue, Union Pacific Railroad Company
- David R. Goode, Caterpillar and Delta Air Lines
- Karen N. Horn, Eli Lilly and Company
- Annette Leckie, Meridian Compensation Partners
- Mel Lagomasino, Avon Products and The Coca-Cola Company
- Marjorie M. Magner, Accenture
- Mary McDowell, AutoDesk
- Steven S. Reinemund, Marriott International
- Marc Ullman, Meridian Compensation Partners

The following members took part in pre-meeting or post-meeting discussions:

- Lloyd H. Dean, Wells Fargo
- Marshall O. Larsen, Lowe's Companies
- Samuel C. Scott, III, Bank of New York Mellon Corporation
- Laurie Siegel, CenturyLink
- Anne Stevens, Lockheed Martin Corporation
- Kelvin R. Westbrook, Archer Daniels Midland Company

[11] The compensation committee leaders are identified by their compensation committee membership. Annette Leckie and Marc Ullman participated in their capacity as compensation experts.