

Key Inputs to the New CD&A You Should Be Reviewing Now

By Susan O'Donnell

The priority placed by the SEC on strengthening shareholders' understanding of corporate pay philosophy is reinforced by its creation of two new elements of required disclosure. A key requirement is the new Compensation Discussion & Analysis (CD&A), which is intended as a narrative, principles-based overview of the objectives, policies, and decisions related to executive compensation, by element and as a whole. That narrative will force companies to apply greater rigor to defining, communicating, and acting upon a formal compensation philosophy. As a filed document, moreover, the CD&A will be subject to certification by a company's principal executive officer and principal financial officer. In addition, companies will need to provide a new compensation committee report, essentially stating that members reviewed and discussed the CD&A with management and approved its inclusion in the company's annual report and proxy statement.

Shifting from "Boilerplate" to Specifics—A How-To Guide

Committees can best prepare for the new disclosure requirements by establishing a process to define their compensation philosophy and clarifying their decision-making process. Below are some key guidelines for compensation committees:

Director Summary: The new Compensation Discussion and Analysis (CD&A) required by the SEC should force companies to examine their pay philosophies and to look beyond market analysis and peer groups to pay-for-performance strategies. New tally sheets help foresee payouts in a variety of termination scenarios.

1. Define Total Compensation Program Objectives

Boilerplate will not suffice for the new CD&A. Committees must be prepared to explain each program, its purpose and how the program, in aggregate, supports those objectives. Among the specific questions that must be addressed:

- What are the objectives of the company's compensation programs?
- What is the compensation program designed to reward?
- What is each element of compensation?
- Why does the company choose to pay each element?
- How does the company determine the amount (and, where applicable, the formula) for each element?
- How does each element, and the company's decisions regarding that element, fit into the company's overall compensation objectives and affect decisions regarding other elements?

As an example, while many of the "objectives" listed in the table on page 19 will sound familiar, companies will be called upon to more specifically reflect on and explain how its compensation programs support the desired objectives. See the table for some penetrating questions that can help reveal whether the total compensation program truly "walks the talk."

2. Tally Total Compensation

As recent headlines have made painfully clear, directors do not always understand the cumulative cost of individual compensation components. This is particularly evident when a significant payout is triggered by an executive's retirement, termination, or change-in-control. Acceleration of equity awards and the accrual of deferred compensation accounts over a period of years can result in some staggering values. Without performing the necessary analysis in advance, directors may be hard-pressed to explain these payouts if questioned by shareholders. The new SEC rules will help



companies avoid that predicament by encouraging a broader and deeper understanding of executive pay packages not only by element, but in aggregate.

An increasingly popular tool for assessing and valuing executive total compensation is the “tally sheet.” Tally sheets clearly present each element of pay from salary, incentive compensation, equity and deferred compensation to retirement benefits, medical benefits, perquisites, and miscellaneous payments. Equally important, tally sheets also make clear an executive’s expected payout under different scenarios, including voluntary and involuntary termination, death, disability, retirement, and termination following a change-in-control. Companies should be aware of such payouts and compiling tally sheets can help educate boards and ensure their awareness of aggregate compensation in advance of the actual event.

3. Pick Peers Carefully

Under the new disclosure rules, compensation committees that are not involved in developing and approving peer comparisons do so at their own peril. Several years ago, the New York Stock Exchange was criticized for using peer group data reflective of very large corporations with which it had little in common. While companies have long relied on peer data to help determine the structure and level of compensation programs, under the new disclosure rules compensation committees must be prepared to define and defend their selection and use of comparative data. Ideally, committees should base their selection of a labor market peer group on clearly defined criteria such

as industry, size, complexity, business model/life cycle, performance, and/or other critical scope factors to the industry/company.

4. It’s Not Just Market Competitiveness

Market competitiveness is an important consideration in setting pay program design, but not a sufficient basis in itself for making pay decisions. After all, the market median simply reflects the “half-way point” in a set of data. Actual decisions about pay also must be assessed in the context of each executive’s experience, skill, performance, and contribution; the company performance relative to peers/market; and the requirements of the job.

5. Mix Matters

Competitiveness can influence the “size” of the total compensation pie, but the mix of compensation is equally critical because it defines how pay is delivered. Companies communicate their compensation philosophy and corporate objective through the pay mix—particularly the relative emphasis on variable performance incentives, versus fixed pay elements such as salary, or benefits and perquisites.

Companies within a particular industry may utilize very different pay mixes, or vary the mix during the course of their growth cycle. Companies should periodically review their total compensation mix to assess whether it remains appropriate to corporate objectives and desired compensation philosophy.

Common Objective	Does Your Company “Walk the Talk”?
Attract, motivate and retain top talent	<ul style="list-style-type: none"> • Is the current program truly designed to achieve these goals? If so, how? • Could the current program unintentionally put more emphasis on one or more of these objectives? • Is the executive total compensation package competitive with market? • Do incentive plan measures motivate high performance? • Are there retention elements in place to retain top talent?
Create shareholder value	<ul style="list-style-type: none"> • How are executives motivated to create shareholder value? • Do executives have an appropriate portion of their total compensation in long-term/equity compensation? • Is there a balanced approach to the company’s equity strategy? • Are executives holding appropriate levels of ownership in company stock?
Provide pay-for-performance	<ul style="list-style-type: none"> • What percentage of total compensation is performance based/at risk? • Do the performance goals support strategic goals? • Is there an appropriate balance of performance measures – individual vs. company, short-term vs. long-term; financial vs. operational/strategic? • Is there a visible alignment of pay and performance – i.e., does total compensation vary by year, by performance, and by executive?



6. Keep Pay-For-Performance the Ultimate Objective

Enhanced disclosure addresses only the “symptoms” of excessive executive pay—a lack of specific, transparent proxy information. The ultimate goal is to promote stronger pay-for-performance alignment. While the concept has routinely been cited in compensation philosophies, boards must now be rigorous about setting specific performance goals and structuring clearly defined and consistent means of measuring and rewarding results. Among the defining elements of a pay-for-performance philosophy:

- What are the critical performance measures?
- What is the appropriate balance of corporate and individual performance?
- Do the performance goals truly support the company’s strategic business goals?
- Should performance be measured on an absolute or relative basis?
- Are performance targets appropriate and challenging?
- Is there an appropriate balance of short/long-term performance goals and quantitative/qualitative performance measures?
- Is there true leverage in the pay program (does executive pay fluctuate with actual performance)?
- Is executives’ total compensation and performance aligned appropriately with peer companies?

The following table illustrates different performance “views,” performance measures, and timeframes for individual pay components. Most organizations will reflect several of these elements in their total compensation program.

An emerging tool for effectively assessing the link between pay and performance is an economic impact analysis, sometimes referred to as a “Tally Sheet on Steroids.”

Similar to how regular tally sheets reveal termination payouts under various circumstances, these more extensive analyses examine the range of payouts possible under multiple performance scenarios. The resulting due diligence clarifies for the compensation committee how total compensation relates to company performance and shareholder value, including the leverage of the total compensation program and the payouts for different levels of performance. It provides reassurance that the committee’s established compensation philosophy is meeting its objectives.

7. Don’t Stop Here

Once a framework is in place for defining the appropriateness and effectiveness of compensation programs, compensation committees must review results annually to ensure that written standards have been followed, that strategic and business goals were met to the extent required for the payment provided, and that the program accords with the stated compensation philosophy.

Creating a valid and meaningful compensation philosophy and decision process takes significant effort, but it is both necessary and valuable. It will help compensation committees better align executive compensation with strategic goals and shareholder value through more meaningful pay-for-performance strategies. Ultimately, those benefits will extend far beyond technical compliance with the new rules. ■

Susan O’Donnell is a managing director of Pearl Meyer & Partners.

Performance Perspective	Possible Measures	Time Period	Pay Component
Company	<ul style="list-style-type: none"> • Financial Metrics (e.g., profitability, earnings, revenue) 	1-3 years	Annual Incentive Long-term Incentive
Division/Unit	<ul style="list-style-type: none"> • Operational Metrics (e.g., quality, service, efficiency, expense) 	1-3 years	Annual Incentive Long-term Incentive
Individual	<ul style="list-style-type: none"> • Strategic Goals (e.g., growth, expansion) 	1 year (typically part of annual incentive)	Annual Incentive
Shareholder	Stock price, EPS, Equity Growth	3+ years	Equity Awards (e.g., stock options, SARs, performance shares, restricted stock, RSUs)