2 | 2014
workspan
The Magazine of WorldatWork©

Pay-for-Performance Communication:
Going Beyond Proxy Disclosures

The new compensation discussion and analysis is an integral part of helping shareholders understand how top executives are rewarded.

When the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 gave us say on pay, it came with a new set of executive compensation disclosure rules for public companies; and the compensation discussion and analysis (CD&A) writing began. Four years later, what started as a compliance-driven document has evolved into a critically important strategic business communication. Of course, CD&As must comply with the U.S. Securities and Exchange Commission's (SEC) disclosure rules and be technically accurate. However, CD&As are also expected to incorporate a level of marketing education to help ensure shareholders understand and support exactly how the companies in which they invest reward top executives for performance.

Incentive plans now dominate executive compensation designs, and shareholders have expressed high levels of support for executive pay plans that strongly tie performance to pay outcomes. However, while companies are spending significant time and resources to develop the perfect storylines for their CD&As, they often tend to overlook the obvious: this information is just as important internally as it is externally.

By Sharon Podstupka, Pearl Meyer & Partners

> **...just like best-in-class disclosures, the most effective pay-for-performance communications don't start with a technical description of how payouts work...**

The problem is that on the outside the primary pay-for-performance message sounds simple: "When the company performs well, shareholders and executives will do well." And as a result, many organizations neglect to fully articulate what it really means for their executives below the C-suite. There's a perspective that the term "pay-for-performance" is intuitively understood by executives at senior levels (i.e., vice presidents and above). But given the intricacies of performance-based pay programs and what they're designed to do from a behavioral perspective, it's more complicated than that. Executives may misunderstand or misinterpret what's expected of them and how it will impact their pay. This is especially true if a company's pay philosophy has changed and performance-based measures and plan provisions have taken the place of more traditional executive pay plan features.

There are significant risks associated with not getting internal communications right:

- **Poor explanations leave things open to interpretation.** Not only is there risk that an executive will misinterpret how the plan works, but if not carefully positioned, the rationale for implementing performance-based pay could be misinterpreted as a "takeaway," which could lead to decreased engagement and unwanted turnover.
- **The plan doesn't do what it's intended to do.** Fundamentally, performance-based pay is intended to link executive pay to shareholder value. As mentioned, CD&As do the job of explaining what happened when performance targets were missed, met or exceeded. However, if the executives who are accountable for driving those results aren't clear about what they can do day to day to positively influence the metrics, the results are likely to be disappointing to all parties.

The Internal Executive Audience Spectrum

Fundamental to any communication strategy is defining your key audiences. So before putting pen to paper (or fingers to keyboard), you should have a clear vision of who your executives are, what they do and the critical information they need to know about your performance-based pay program.

As you would expect, the sites for key audiences targets typically narrow toward more senior-level employees (e.g., vice presidents and above), which makes good sense. However, it's not as straightforward as one might think. That's because even in the high-ranking levels of an organization, there are different profiles of executives in the tiers just below the C-suite. Some lead specific business segments or head corporate functions. Many are up-and-comers or high-performers who have been promoted over time. This means it is critical to recognize that depending on where an executive falls on the spectrum there will be different performance accountabilities and expectations by role; the connections to performance measures that drive overall business strategy and create shareholder value will also vary. In other words, one-size executive pay-for-performance communication does not necessarily fit all.

Reinventing Internal Executive Pay Communication

The most strategic organizations are expending the same (if not more) energy and resources on their internal executive pay communications as they are on their shareholder engagement strategies. They've seen the payoffs of taking shareholder outreach to another level and have recognized how effective the same approach can be internally, especially with discussions about executive pay cascading beyond the C-suite. They have recognized that shareholders and proxy advisers are not the only ones interested in what's being disclosed in their proxies. To this end, they want to ensure that the executives and their teams who influence results also understand and support what it means to get paid for performance.

Discussions about reinventing executive pay communication are happening at the highest levels of HR management and making their way into the boardroom. That's because just like best-in-class disclosures, the most effective pay-for-performance communications don't start with a technical description of how payouts work, they start with line of sight to the business strategy.

Business strategies and their respective executive pay programs are designed by management and approved by the board to ensure the people who are running the business are doing so in the best interest of shareholders, the company and its executives. They choose specific financial and nonfinancial measures for these programs that they believe are the best indicators of performance. They set performance goals to provide focus for executives. However, these processes do not offer a road map to how an executive in a specific role can control parts of his or her job to positively influence performance results.

Bringing Line of Sight to Life

Most executives have some understanding of high-level measures like top-line revenue, cash flow, earnings and shareholder returns. However, they often fail to connect the dots of why specific measures are chosen for their respective businesses and what they need to do in their jobs to positively affect their results. This means deconstructing performance measures in a way that is specific, clear and meaningful.

Let's take a very high-level scenario using earnings per share (EPS), which is one of the most common metrics in performance-based plans. Because EPS is affected by many operating and financing activities, it means different things to various parts of a business, which means individuals will have different roles in affecting it. The communications to executives about performance expectations — and the impact on their pay — must be tailored to their specific roles. For example, executives responsible for inventories should know how much EPS may increase if they reduce inventory by a certain percentage. Customer account executives should know how many accounts they need to secure to make a measureable difference. At the same time, they all need to know how it affects their pay.

Even using this simple example, effectively communicating line of sight goes a level beyond discussions between managers and participants about annual individual performance goals. It requires business leaders to have tools and resources (e.g., value trees and performance dashboards) to help demonstrate to executives how driving business priorities affects long-term shareholder value and pay. Taking it one step further, leaders need to be prepared to discuss to what extent corporate and other business unit performance will influence pay outcomes.

Start at the Beginning

- How do you build line of sight into a communications strategy? A good place to start is with the structure of your CD&A, using it as a checklist of fundamental topics that need to be covered with executives to give them a foundation for what their pay program is all about: Business strategy and how it connects to pay outcomes
- Pay philosophy and comparator groups
- Pay mix (fixed and variable)
- Incentive pay (individual and corporate performance measures, targets and use of discretion)
- Shareholder-friendly features, such as stock ownership/holding guidelines
- How decisions are made (the roles of the board of directors and management).

But it is only a starting point. What needs to be fleshed out is how you will use what you have to build a comprehensive strategy that defines key messages, from whom (corporate versus business leadership) and to whom they will be delivered (participant eligibility), the media methods by which they will be distributed (high touch versus low touch) and the optimal timing for delivery (coordinated with year-end discussions or throughout the year or if changes have been made).

Effectively educating and engaging your executive workforce about business strategy and performance pay is easier said than done. It requires disciplined stakeholder management, commitment to transparency, continuity of messages and careful planning at a level different from any other HR communication initiative.

...effectively communicating line of sight goes a level beyond discussions between managers and participants...

It requires involvement at the highest levels of an organization and must be socialized (and likely approved) by many people, including internal and external counsel, investor relations, corporate communicators and the board. There is also extra sensitivity because of limitations associated with communicating "insider information." But these are not excuses to take executive pay communications off the priority list. In fact, it makes it even more important to make sure it happens... and happens flawlessly to ensure shareholders and executives are well informed about the things that matter most to them. ws

Sharon Podstupka is a vice president at Pearl Meyer & Partners in New York. She can be reached at sharon.podstupka@pearlmeyer.com.

resources plus

For more information, books and education related to this topic, log on to **www.worldatwork.org** and use any or all of these keywords:

- Pay for performance
- Proxy disclosure
- Strategic communication.