Positive Trends In US Compensation

A differentiated compensation strategy can become a driving force that will benefit shareholders over the long term.

There are plenty of naysayers when it comes to executive compensation in the US. The rise in CEO pay in the post-crisis era regularly gets compared to the relatively stagnant wage increases for average American workers and there is rarely a week without a story about an executive who received a multimillion dollar payout as the result of being hired, fired or acquired. However, we see many positive trends in executive compensation since the financial crisis and specific actions being taken by board members to use compensation as a driver of strategic value.

US companies have just completed the fourth proxy season with Say-on-Pay (SOP) voting. For most companies, the vote itself has proven uneventful; as of 15 September 2014, 98 per cent of the more than 3,000 US companies holding a vote passed with an average favourable vote of more than 90 per cent. But SOP has helped usher in more important transformations in executive compensation governance in the US.

■ Elimination of ‘red flag’ pay practices. Most companies have eliminated ‘irritants’ such as post-retirement perquisites and tax gross-ups. Societal norms regarding ‘reasonable’ elements of compensation have been shifting for several years, but SOP was the final nail in the coffin for many of these practices. Streamlining compensation to the key elements has focused pay discussions, both between management and the Board and between the company and its shareholders, on the areas that are critical to driving business results.

■ Better explanation of compensation programs and committee decision making. Again the Compensation Discussion and Analysis (CD&A) section of proxy statements pre-dates SOP. However, SOP created the impetus for companies to transform their CD&As from compliance reports to communications documents. A recent survey by PM&P found that over half of the public companies responding were already including supplemental information in their CD&A (for example, alternative charts and graphs) and an additional one-third of companies were planning to add supplemental information in their 2015 proxies.

■ Improved engagement with key shareholders. Outreach to shareholders regarding SOP has served as a gateway for broader conversations between companies and investors. Furthermore, because discussions of executive pay create a perceived conflict for management, SOP has fostered increased dialogue directly between investors and directors.

Where We’re Going

The trends noted above have been the silver lining to SOP. However, SOP has not been cloudless. One of the most disturbing trends we saw early on was an increased focus on ‘conformity and compliance’. Many companies became overly concerned with ‘best practice’ lists circulated by advisors such as Institutional Shareholders Services (ISS). In the rush to ‘check the boxes’, and thereby ensure a favourable vote, we saw the strategic objectives of a company’s compensation plans take a back seat to industry prevalence and compliance. In the past year or two, though, we’ve seen a clear shift as more companies show a willingness to chart their own course. Whether the result of ‘ISS fatigue’, or simply increased confidence bred from better shareholder engagement, the new trend is positive and bodes well for the future.

Specifically, compensation committees are elevating and expanding their agendas: elevating their discussion to focus on strategy over compliance and expanding their view to consider a broader array of organisational issues and consequences beyond the core decisions about salaries and incentive design.

Elevate Your Discussion

First and foremost, compensation strategy should be a management tool to drive company performance. Committees are moving their agendas beyond compliance and regulation, and spending an increasing amount of their time and attention on the alignment between compensation programs and business strategy.

As shareholders continue to press for demonstrable pay-for-performance, committees continue to hone the analytical underpinnings of their decision-making. Committees have long relied on advisors and management to provide
Leading committees are broadening their discussions to understand the role that corporate culture plays in the achievement of business strategy and how talent and leadership strategy should influence compensation design. As part of this expanded purview, committees have started to look beyond the limited scope of senior executive pay to consider more long-term organisational issues including succession planning, training and development, diversity and employee engagement.

In fact, a number of committees have publicly signalled the importance of these non-compensatory issues by formally changing the committee name (for example, Compensation and Succession Committee, Compensation and Talent Development Committee, Human Resources Committee, etc) and the committee charter.

Key questions committees are addressing include:

- What characteristics define our organisation? (for example, ‘we are an R&D company’, ‘we are entrepreneurial’ etc) Are those characteristics consistent with our business strategy?
- Does our management team reflect our business and leadership strategies? Are our criteria for hiring, recognition and promotion linked to the drivers of success?
- Are our compensation plans consistent with our leadership style? (for example, is the leverage in our pay opportunity consistent with our views on risk-taking? Is the weighting between company and individual metrics consistent with our decision making? etc)

Of course, the messaging behind compensation plans also impacts effectiveness. As noted, over the past several years committees have focussed much more time and attention on improving the communication of programs to shareholders. However, committees are also increasingly conscious of how those same disclosures are interpreted by the employee audience. A prime example is the pending CEO Pay Ratio disclosure showing CEO pay as a multiple of the median employee pay. Most committees recognise that while the disclosure is technically intended to provide additional information to shareholders, it will also require additional internal communication and context.

Committees Are Raising The Bar

In an environment of exhaustive scrutiny of executive compensation plans, committees will always have to demonstrate a certain level of ‘good corporate hygiene’ with regard to compliance and conformity. But following the pack seldom results in competitive advantage. Committees are realising that a differentiated compensation strategy, linked to the company’s distinct business and leadership strategies, can become a driving force that will benefit shareholders through both superior value creation and corporate sustainability over the long term.

Data in support of pay levels. Now committees also expect quantitative analyses that support the selection and calibration of incentive metrics.

Key questions committees are addressing include:

- Are the metrics used in our incentive plans really the drivers of sustained shareholder value?
- Are financial metrics (often lagging indicators) coupled with leading indicators (for example, strategic or operational goals)?
- Does the mix between short-term and long-term metrics reflect our business focus?
- Do performance periods for the incentive plans reflect our business cycles?
- Is our goal-setting calibrated appropriately?
- How does our budget compare to peer performance?
- What expectations for future performance are already embedded in our current stock price?
- Is the pay-for-performance leverage curve (downside risk and upside reward) in our incentive plans appropriate for the expected variability in our business?

Expand Your View

As the renowned Peter Drucker noted, ‘culture eats strategy for breakfast’. And yet, historically, discussions of corporate culture and the associated people management issues have seldom been a regular part of the committee agenda. Committees have been reluctant to ‘meddle’ in these areas traditionally considered to be the purview of management. Increasingly, though, we see committees engaging senior leaders in discussions about leadership and talent management issues that are critical to the successful implementation of business strategy.

PM&S’s recent survey, Looking Ahead to Executive Pay Practices in 2015, asked respondents about various aspects of their executive compensation programs and practices.