Pearl Meyer

TRENDS & ISSUES

Remuneration 2017: The Top Five Questions Boards Should Ask

Annually, Pearl Meyer shares our top five recommendations for remuneration committees.

Previously, we have suggested that boards go beyond best practice, raise the bar, avoid standard remuneration design, and think strategically and act decisively. Those approaches are even more relevant in today's governance climate.

Here are five questions for boards to consider:

1. **Disparity:** Is the management team fully prepared to address internal and external questions on pay inequality?
2. **Discretion:** At certain times, management may need to take actions that are in the best long-term interests of shareholders, but may negatively impact short-term results and remuneration. How do we manage this?
3. **Depth:** Should our remuneration committee expand its role to encompass broader talent management responsibilities?
4. **Differentiation:** Do we have remuneration programmes that create a competitive advantage; how are our remuneration programmes different than market; and do those differences help with attraction, retention, and motivation?
5. **Disclosure:** How do we get ahead of proxy advisory firms and avoid the front pages?

Q1: Pay Disparity

The pay inequality issue isn't going away. Is the management team fully prepared to address internal and external questions?

'CEO Pay Ratio' legislation is under close review and everyone (corporate communications, investor relations, the board) will be best served if they are well-prepared for any media inquiries about CEO and general workforce pay.

From an internal perspective, awareness about pay disparity will continue to grow, especially among younger staff who will track and share information routinely. Remuneration reports are very visible and draw large audiences. This, together with easy access to pay information on the internet, is certain to raise interest about the fairness of pay.

Here is the challenge: most employees aren't necessarily sophisticated or informed about how their pay is determined. Pay is based on myriad factors, including (but not limited to) individual skills, level of education, tenure, the critical nature of the role in the industry, etc. Boiling this down into concise and universally applicable guidelines people can easily understand is hugely challenging. So what can the remuneration committee do now?

First, operate on the basis that disclosure of ratios of some kind will be required. Even though the signs point toward delay or repeal of required disclosure in the U.S., for example, one has to be prepared:

- Have a strategy for determining the level of detail to provide in annual reports. Address the pros and cons of providing the bare minimum to comply or adding more context and being more transparent.
- Ensure teams within the company are developing an inventory of anticipated questions and answers, by stakeholder group.
- Select those responsible for meaningful conversations about the mechanisms of executive and broad-based remuneration.

Q2: Discretion

At certain times, management may need to take actions that are in the best long-term interests of shareholders, but may negatively impact short-term results and remuneration. How do we manage this?

Companies are under constant pressure to exceed sales and earnings forecasts or risk being punished by a capricious stock market. To motivate management to take actions aligned with achieving and surpassing short-term financial goals, annual incentive plans are put in place that link payouts to the attainment of those goals.

To counterbalance the potential for this short-term focus, 'long-term' incentives are designed to hold management accountable for sustaining performance beyond one year, and share ownership requirements are intended to foster a long-term shareholder perspective. While both mechanisms serve to mitigate the focus on short-term performance to some degree, the reality is that the level of annual bonus funding is viewed as a barometer of management performance against the company's operating plan.

Often over the course of a given year, management may need to take unanticipated actions that are in the best long-term interests of shareholders but have a negative impact on short-term financial results. For example, management may pursue a strong acquisition even though the transaction costs impair short-term results. Likewise, management may need to respond to rapidly deteriorating market conditions with layoffs or plant closures, which often increase expenses in the current year.

Remuneration committees need to ensure that management is not discouraged from taking those actions which are in the best long-term interests of stakeholders. One way is to allow for adjustments to financial results in order to exclude or include the costs or benefits of an unplanned action. Of course, allowing for adjustments can be a slippery slope, so we suggest maintaining clear ‘rules of the road’ in evaluating potential adjustments:

- Materiality—does the action have a material impact on results that warrants adjustment?
- Consistency—is there precedence for the action taken?
- Accountability—should management be held accountable for the result? Was it within their control and influence?
- Disclosure—will the adjustment withstand scrutiny when publicly disclosed?

Role of Discretion in Promoting a Long-Term Perspective

Employing discretion is often uncomfortable for both remuneration committees and management. Most believe that strict adherence to the results preserves the efficacy of the annual incentive plan. However, discretion can play a helpful role in determining incentive payouts and avoiding unintended consequences in a plan.

Ex post application of discretion allows the committee flexibility and the benefit of hindsight in evaluating not only what the results were for the year, but also how they were attained. It allows the committee to consider the context in which the company performed during the year. Did the company successfully navigate unanticipated headwinds or did the company fail to take advantage of available tailwinds? How did the company perform on a relative basis? While not necessarily a replacement for a well-designed incentive plan, discretion—consistently and objectively applied—is another tool at the disposal of remuneration committees to foster long-term focus.

Tax Deductibility

Note that both the actions identified above—adjustments and discretion—can impair the ability of the company to qualify incentive plan payments as tax deductible. For US firms, Section 162(m) of the Internal Revenue Code is critical. In the U.S., for example, we would recommend implementation of a 162(m) umbrella funding mechanism, which ensures such actions are treated as negative discretion and preserve tax deductibility.

Q3: Direction

Should our remuneration committee expand its role to encompass broader talent management responsibilities?

We believe the answer is ‘yes’.

Increasingly, boards understand that talent strategy is as integral to a company’s success as business strategy. And, if that is the case, then the board should exert similar oversight. As a result, leading remuneration committees are looking beyond the narrow responsibilities of approving remuneration and benefits programmes for a handful of senior executives and taking on more when it comes to leadership development.

Many companies consider talent management—and succession planning in particular—a full board responsibility. Even in that case, we think it’s appropriate for the remuneration committee to stay in touch on these issues throughout the year. The full board’s time is precious and assigning talent management to the committee for them to remain in close touch ensures that the topic gets the appropriate attention. We see committees expanding their agenda to cover a range of talent and leadership topics, including:

- Succession planning, leadership development, and performance management;
- Employee engagement and corporate culture; and
- Environmental, social, and governance issues.

CEO succession has long been one of the main responsibilities of the board. We see leading boards expanding their purview beyond the executives to include succession plans for other top positions, including some positions two or three levels removed from the CEO.

Beyond a simple annual review of succession, board members are looking for a deeper understanding of the company’s leadership development plans for high potential employees. Many companies draw on board member experience to provide one-on-one mentorship. While boards don’t generally delve into individual succession plans below the senior management level, a broad understanding of the company’s approach to performance management can give the board a sense of the company’s ‘bench strength’. In the same way that a remuneration committee reviews incentive plans at a broad programmatic level (e.g., eligibility, target opportunities, leverage, metrics, etc.) and oversees setting individual pay for senior executives, so should a committee have a high-level overview of how the company manages and rewards individuals below the management team. This includes how the company identifies and supports its high potential employees.

Boards should have a ‘whistleblower’ protocol in place and many companies conduct periodic employee engagement surveys. Both are formal methods that can highlight cultural concerns and/or strengths. Board members can augment these findings with other informal data, (e.g., Glassdoor employee website posts, customer chat room posts, secret shopper results, trade show attendance, etc.).

Furthermore, as companies consider how to appeal to a new generation of employees and consumers, discussions around corporate culture and values also include ESG (environmental, social, and governance) issues. Externally-focused ESG issues such as environmental sustainability, resource efficiency, and good corporate citizenry likely fall under the aegis of a committee other than the remuneration committee. But some ESG issues have an internal stakeholder aspect as well. For example, while good corporate citizenry can be accomplished through ‘checkbook charity’, leading companies also use charity to garner goodwill with employees and potentially solidify their loyalty by providing opportunities for company-sponsored support of their personal pursuits and reinforcing a concerned global outlook. This is particularly important as younger staff come into leadership roles.

Q4: Differentiation

Do we have remuneration programmes that create a competitive advantage; how are our remuneration programmes different than market; and do those differences help with attraction, retention, and motivation?

Over the past twenty plus years, much of the focus for remuneration committees has been on aligning their company’s pay programmes with market norms. Conventional wisdom has been that by having a competitive remuneration programme, a company can effectively attract and retain individuals, which is typically a hallmark of a company’s remuneration philosophy. This logic certainly has merit and can be an effective approach, but is it an effective *strategy*?

By mimicking others, companies are standardizing pay and thereby eliminating any differentiation in their programmes that could drive a competitive advantage. Remuneration *strategy* by its very definition should be doing something different to drive better results. In fact, a lack of differentiation could ultimately deter from attraction and retention of the top-tier talent needed to win in today’s environment. Maybe ‘best practice’ is not actually best?

We think companies should explore their programmes for opportunities to achieve some level of competitive differentiation. First, take a step back and evaluate the programmes in the context of business and employees and not necessarily entirely in the context of market practice or proxy advisor views. What is the long-term business and talent strategy and how is the company executing against it? How does that impact the current and future workforce and what remuneration attributes will best support those company and HR strategies? We suggest looking at the programme holistically in the context of your business plan to ensure that the annual and long-term incentives are in-sync and not operating as distinct programmes:

- Are specific operational goals reflected in the annual business plan?
- Are projected (or unanticipated) changes in the external business environment accounted for?
- Is the long-term strategy reflected in the annual business plan?
- Are the specific actions that the management team must execute laid out clearly and do those actions march toward a longer-term objective?

Once you make assessments and arrive at any recommended changes and designs, then overlay the market context to understand differences from prevalent practice so you can start to craft communications that explain the business rationale behind your unique programmes.

With the broad direction of your programme in place, look at the human element of remuneration and ensure the plan is well-understood:

- Do the CEO and senior leaders have clear line-of-sight—understanding how their actions impact short- and long-term goals and how their remuneration is designed accordingly?
- Are they communicating in the same way down the organization?
- Is the mix of pay appropriate to the goals and properly motivational to the team?
- Is it clear that goals are fair and that accountability for results will be balanced with discretion for circumstances beyond management's control?

An executive remuneration programme that is carefully calibrated in this way, with an eye to your company's very specific short- and long-term goals, is thereby distinctive. Taking this approach will lead to a differentiated executive remuneration plan designed to drive your unique strategy; effectively attract, retain, and motive the right team; and work in service of long-term value creation.

Q5: Disclosure

How do we get ahead of the scrutiny of proxy advisory firms and avoid being sent to the penalty box?

Virtually all remuneration committees ask their advisors to summarize key governance trends annually and to supplement these updates as needed throughout the year. Of course, this is a best practice. But don't stop there. Set aside some time in 2017 to establish a proxy advisory firm response strategy.

Proxy advisory firms establish policies they consider to be best practices. And in a stable economy with a company that is performing well, these policies are generally benign. But throw in a CEO pay-for-performance disconnect, a proxy advisory firm peer group that substantially misses the mark, or an ingrained legacy policy that can't be easily changed, and these seemingly benign proxy advisory polices may result in a failed say-on-pay vote.

Strategy Development

A committee can follow these steps to get ahead of a potential proxy advisory firm predicament:

- Ensure you are up to date on current proxy advisory firm policies. ISS publishes extensive policies while Glass Lewis does not. Furthermore, some institutional investors maintain their own policies with limited or no disclosure.
- Understand which proxy advisory firm has the most influence with your major institutional shareholders and assess your programmes relative to their policies. It may be possible to make modest changes to your plans to better align with their preferences without impacting the strategic direction of your overall remuneration programme.
- Review the proxy advisory firm research reports going back several years and understand whether there is a progression in their criticisms. Also understand what criticisms really matter. Published policies will not help if a committee is trying to understand the impact of four or five negative comments. Your advisors may be able to help in this area. Remember, not all comments are created equal. Some appear in many research reports and carry little weight but it may not be obvious.
- Ask the management team to summarize feedback from your major institutional shareholders to understand if their executive remuneration programme feedback is consistent with the proxy advisory firm research reports. Also understand if your major institutional investors generally support your programme. If so, it is unlikely the next proxy advisory firm research report will materially change the say-on-pay results. But remember, some institutional investors blindly follow ISS recommendations. It is important to ask your major institutional investors how much influence the proxy advisory firm research reports have on their say-on-pay votes.
- Don't feel you need to react to all negative criticism. A committee might be compelled to change one or several aspects of a programme based on proxy advisory firm negative comments. But if the prior say-on-pay vote was strong and the executive remuneration programme supports the company strategy, no change might be the right answer especially if major institutional shareholder feedback was generally supportive.
- When it is clear the programme needs to change, agree on plan changes and begin drafting the forward-looking disclosure for the upcoming CD&A. A well-written CD&A, with a plain English approach and abundant charts, graphs, and bullets, matters. Pages and pages of dense text will not help explain and highlight the key executive remuneration programme features or why the programme changes support the company's strategy.

Proxy advisory firms have significant sway with institutional investors and, in some cases, can influence a failed say-on-pay vote. This result (or even the threat of such a result) can change the personality of a remuneration committee from a group that has a focus on strategically designing the executive remuneration programme to one that simply complies. Avoid this roll-back of the committee's influence by discussing, debating, and adopting a proxy advisory firm response strategy.

Conclusion

Pearl Meyer recommends that remuneration committees weather change by focusing less on short-term adjustments and more on asking questions of themselves to get at the heart of what matters most—the long-term prospects for value creation.

About Pearl Meyer

Pearl Meyer is the leading advisor to boards and senior management on the alignment of executive compensation with business and leadership strategy, making pay programs a powerful catalyst for value creation and competitive advantage. Pearl Meyer's global clients stand at the forefront of their industries and range from emerging high-growth, not-for-profit, and private companies to the Fortune 500 and FTSE 350. The firm has offices in New York, Atlanta, Boston, Charlotte, Chicago, Houston, London, Los Angeles, and San Francisco.

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