Managing the complex relationship between executive pay and performance

A well designed pay program must attract and retain high caliber executives. Meeting this challenge has become more intense and complex since stock options began to fall out of favour. These authors, specialists in executive compensation, put forward alternative programs that can complement, or possibly replace, options. If adopted, they can force organizations and their boards to understand different measures of performance.

By Jeff Kozan and Claude Boulanger

Jeff Kozan and Claude Boulanger are executive compensation consultants with Towers Perrin Canada.

Managing the relationship between pay and performance in executive compensation has never been more challenging. Boards of directors and their compensation committees are charged with ensuring that executive pay programs are aligned with complex business strategies and address increasing shareholder concern about their level and appropriateness. Directors must not only meet these challenges, but do so in such a way that allows the company to attract and retain the critical executive talent needed to create sustained value for shareholders.

In addressing these challenges, both sides of the pay/performance proposition need to be examined. From an executive pay perspective, this means considering the multiple goals that are accommodated through a variety of executive pay programs (in particular, salary, annual bonus, long-term incentives and pension benefits). From a performance standpoint, it involves assessments from multiple perspectives, including short-term versus long-term, absolute versus relative, objective versus subjective, stock market-based versus internal financial, and the role of other critical strategic, operational or customer-related objectives.

The primary focus of this article is the relationship between pay and performance as it relates to long-term incentive compensation. Long-term incentives, especially stock options, represent a significant portion of the total pay package for executives of most Canadian public companies, and to date they have been the primary focus of investor and public concern. Historically, stock options have been a simple, objective and independent way of linking a major portion of executive pay to company performance. However, as investor pressure moves some organizations away from stock options (fully or partially), the challenge to link executive pay to performance will accelerate, since other incentive plans require performance measures that are less straightforward.

This article will discuss and provide:

- Context on the changing corporate governance and regulatory environments and the subsequent impact on executive pay

- Information on the challenges in defining the complex relationship between executive pay and performance

- Issues to consider in developing effective long-term incentive plans to ensure there is an appropriate balance between pay and performance, and

- Guiding principles to consider when designing executive pay programs to strengthen the link between pay and performance.

The changing executive compensation environment

Governance groups, institutional investors and the media have been pressuring corporations to improve the relationship between executive pay and performance. Concerns include the size of executive pay packages, the perceived disconnect between profits generated or stock price performance during the year and the level of annual bonuses paid, perceived abuses of stock option plans (size of awards, focus on absolute performance and lack of sustained performance after options have been exercised) and the size and role of fixed pay elements (i.e., salary and executive pensions) relative to the total compensation package.

Shareholders have been active on a number of fronts in attempting to guide and shape the design of executive pay programs. Activities range from the increasing number of direct shareholder proposals, to institutional investor groups publishing proxy voting guidelines, to direct lobbying with companies for change.

The shifting regulatory environment also makes the challenge of improving the relationship between pay and performance more complex. Recent regulatory changes in Canada that impact executive pay include:

- Proposed new TSX stock exchange rules (plus new NYSE and NASDAQ rules in the US that apply to inter-listed Canadian companies),

- New Ontario Securities Commission (OSC) investor confidence rules (as well as the U.S. Sarbanes-Oxley legislation that applies to inter-listed Canadian companies), and

- New Canadian accounting rules requiring the expensing of stock options.

All of these changes impact the environment in which executive compensation programs are developed, managed and disclosed.

Defining the pay/performance challenge

The overall guiding objective for most organizations is to maximize shareholder value. However, this deceptively simple goal can be interpreted in many ways. For executive compensation, the challenge is to strike a balance to ensure:

- An appropriate balance between fixed and variable pay (performance versus retention)

- An appropriate balance between short-term and long-term compensation (maximizing short-term profits versus investing for future profits)

- An appropriate range of financial and non-financial performance measures are used that are aligned with the business objectives of the organization (e.g., growth, efficiency, improvement, etc.),

- Performance is measured at different levels in the organization, ensuring participants have an appropriate "line-of-sight" over the results that they will be held accountable for,

- The level of performance required under incentive plans is commensurate with the level of pay generated, and

- That performance measures are not manipulated to produce unwarranted compensation.

Directors are the custodians of shareholder interests. In this role, they are charged with assessing performance and balancing that assessment with other compensation objectives and regulatory constraints in arriving at pay decisions. Often, this process involves exercising discretion to make appropriate decisions. This is contrary to the more objective and formulaic approaches that most investor and shareholder groups are advocating for determining pay. Ultimately, a formula can never replicate the discretion and judgment of experienced directors in assessing a wide range of factors and circumstances for a particular company. But, the situation could often be improved if directors were to follow a more transparent approach and fully disclose details on plan designs used, the decisions made, and the factors taken into account.

Investor and public frustrations with executive pay are based partially on the limited information that is available to validate the rationale for decisions; these frustrations are only increased by the complex nature of the relationship between executive pay and performance, including:

- **Different time periods over which performance is measured and pay delivered**. This creates challenges in balancing time perspectives and communicating results. For example, long-term incentive payouts may have been earned over a multi-year period, but the payouts look unusual relative to current annual performance.

- **Multiple ways in which performance can be measured**. Performance can be measured in many ways, yielding different conclusions. The challenge is compounded if there is a limited correlation between different measures of performance, and/or the measures of performance selected are subject to volatility or short-term swings. For example, annual incentive plans often focus on annual profitability, while long-term incentive plans are often based on longer-term share-price based measures of performance. The table below highlights performance measures commonly used in executive pay programs, and the related rationales and challenges.

- **The need to balance performance with other compensation objectives**. Maintaining or improving performance is often only one objective of an executive compensation program. Another important objective is retention, which can be critical if an organization is in financial distress or if the executives' skills are in high demand.

- **The impact of various regulatory constraints**. These include accounting, tax and disclosure requirements. For example, stock options provide preferential tax treatment for participants, which make them attractive regardless of their challenges in aligning with performance or other compensation objectives.

Investors and other shareholder groups often take a narrow view of the pay/performance relationship and understate some or all of the challenges identified above.

Practical considerations also need to be addressed, including the availability of accurate and current data for the desired performance measures, ability to accurately predict the future to set relevant and sufficiently challenging standards of performance (e.g., versus budget, an absolute standard, an amount of improvement, etc.), and assessing the volatility of market-based measures versus the need for adjudication for other measures of performance.

Other questions that should be addressed in assessing and defining the role of performance in executive pay programs include:

- Can too much emphasis on performance encourage unacceptable risk taking and drive undesirable behaviors?

- At what point is pay too high, regardless of performance?

These issues are at the root of some shareholder and public concerns with stock options. Did large grants and the opportunity for significant wealth drive executives to overstate short-term profits in a bid to gain from stock options? Also, at some point were grants just too large and was this due to the absence of a requirement to expense options? This leads us to a fundamental question: Are stock options the problem, or are the perceived problems more related to the process use to determine and approve compensation?

Long-term incentive challenges in the Canadian context

For most Canadian companies, stock options have historically been the primary form of long-term incentive. This is partly because options enjoy a tax advantage for participants over other forms of long-term incentives, but also because they are simple, objective and appear to have been inherently aligned with performance, that is, participants only gained if shareholders gained. However, increasingly aggressive granting practices and the bull stock markets over the late 1990s and early 2000s led to significant wealth opportunities for executives. In this context, shareholders and the public began to question the appropriateness of stock options as an effective long-term incentive. Specifically, they began to question whether granting stock options really does align the interests of executive and shareholders:

- Stock options do not expose executives to a decrease in stock prices relative to shareholders (no downside risk)

- Executives often gain from stock options simply because the market as a whole rose, rather than the actual performance of their company (no relative performance)

- Executives rarely hold the shares they acquire through option exercise, and therefore are immune to falling share prices after exercise (no sustainability of performance), and

- Executives participate only in share price appreciation, while shareholders also enjoy the benefits of dividends (no alignment on a total return basis).

These pressures have led most Canadian organizations to revaluate their long-term incentive programs to respond to the concerns expressed by shareholders and the public. Companies have reacted in different ways. A few have eliminated stock options altogether, some have retained them as the sole form of long-term incentive, while others have reduced the use of stock options and introduced another form of long-term incentive to replace the value of stock options.

We fundamentally believe stock options should still play a strong role in executive compensation programs. However, we also believe that changes to stock option plans are warranted in addressing shareholder concerns, including:

- **Incorporating share retention requirements and/or share ownership guidelines to address sustainability of performance**. If executives are required to hold the shares they acquire (net of exercise costs and taxes) for a minimum period and/or to sustain minimum ownership levels, we believe they will be focused on the sustained performance of the organization's share price.

- **Moderating grant levels to address concerns over dilution levels**. Organizations can moderate grant levels by replacing a portion of stock options with another form of long-term incentive, and/or limit participation in the stock option plan to more senior executives who have greater influence (line-of-sight) over decisions that impact the organization's share price.

- **Considering performance vesting requirements to augment the focus on absolute performance**. Performance vesting conditions could be share price hurdles (to ensure a minimum return to investors), relative performance, and/or other key financial, operational or strategic objectives.

- **Introducing other plan design changes**. This could include shorter option terms (e.g., 5 or 7 years versus 10 years) to reduce the chance of a windfall gain, and/or longer vesting requirements to encourage executive retention.

While we believe stock options should remain an important part of executive pay programs, we also think there is a role for other long-term incentives to complement options, address other shareholder concerns and provide a balanced perspective between pay and performance. The primary alternative long-term incentive vehicle used by Canadian companies is Restricted Shares or Restricted Share Units (RSUs). Restricted Shares are grants of real shares that are subject to time and/or performance restrictions. Given tax regulations in Canada, many organizations use Restricted Share Units (RSUs) instead. RSUs are phantom shares that exactly track the value of a real share, and are settled in either cash or real shares at the end of the performance period.

Restricted Shares/Units offer the following advantages over stock options:

- They are based on the full value of a share, rather than simply the appreciation in the value. This feature offers the advantages of introducing downside risk, incorporating a total return perspective (share price appreciation and reinvested dividends) and introducing an element of retention (i.e., there is still a compensation value even if the share price declines).

- They can be structured to incorporate other measures of performance to complement absolute share price increase. Many organizations are incorporating relative Total Shareholder Return (TSR) measures into RSU plans, a measure that provides a total-return focus and rewards for both absolute and relative performance.

- They are a tax deductible expense, whereas options are not. (Note this is different from the U.S. where stock option gains are tax deductible to the organization).

However, Restricted Shares/Units also have some disadvantages, including:

- They can be seen as "free shares" where compensation is earned regardless of share price performance, unless a performance-vesting requirement is incorporated (in addition to time vesting). To date, in Canada, there has been significant pressure to incorporate performance criteria on Restricted Shares/Units; however, some organizations have introduced plans with only time-vesting requirements. Restricted Shares/Units with both performance and time vesting offer an attractive balance between performance and retention.

- It is difficult to select and calibrate non-share price based measures of performance. Relative measures require selecting an appropriate peer group, and calibrating pay levels versus different levels of performance within the group. Financial, operational or other key strategic objectives can be difficult to predict and often require adjudication based on unanticipated events.

- Participants are taxed on the full value of Restricted Shares/Units once the time and performance criteria have been achieved. This is less favourable than stock options, where participants generally are taxed only on ½ of the option gain (in Quebec, ¾ of the option gain is taxable). To date, most Canadian companies have not recognized this tax difference when replacing stock options.

  The situation is different in the U.S., where the individual tax treatment is the same for stock options and Restricted Shares/Units. This treatment has provided an opportunity for many U.S. companies to lower their overall cost by exchanging stock options for a lesser number of Restricted Shares/Units. This practice may evolve in the future in the U.S. as governance concerns increase, and more challenging performance criteria are introduced, reducing the perceived value of these plans to participants.

- They are subject to variable accounting based on changes in the share price over the period. In contrast, stock options have a fixed expense based on the fair value at time of grant (determined using Black-Scholes or another option-pricing methodology). Some organizations fix the accounting liability by funding some or all of the Restricted Shares/Units required through an Employee Benefit Trust, although it has the disadvantage of requiring an upfront cash expense.

At the end of the day, alternatives to stock options pose significant design challenges. They require selecting appropriate measure(s) of performance, calibrating an appropriate level of performance, and adjudicating results. However, despite these challenges, these plans can act as a complement to stock options and may have the added benefit of forcing organizations and their boards to take a deeper look and develop a better understanding of a range of different performance measures.

Final thoughts and guiding principles

Below, we offer five guiding principles organizations can follow to improve the link between pay and performance when designing executive compensation programs.

1. Start with your own organization's business strategy and goals, rather than with the practices of competitors.

2. Consider the total compensation package when making any pay decisions.

3. Incorporate a range of different performance measures in the executive pay package, and consider multiple perspectives (e.g., internal budget, investor expectations, etc.) when calibrating the right level of performance.

4. Be creative, but also keep it simple because complexity adds confusion.

5. Communicate the rationale for plans both to participants and outside stakeholders.

In the final analysis, compensation is not a "one-size fits all" solution, as each organization has unique challenges and goals. In the new governance environment, this could provide an opportunity for companies to differentiate themselves and provide a competitive advantage through the design of their executive pay programs. This is in contrast to past practices where stock options were used in a similar manner across organizations regardless of their situation, goals or objectives.

Ultimately, it is important to remember that performance is critical, but a well designed pay program must also attract and retain high caliber executives to increase shareholder value.

Different Ways of Measuring Performance

Type of Performance Measures	Rationale for Measure	Challenges with Measure
Stock Market Measures Share price TSR (Total Shareholder Return)	Objective and independent measures of performance Forward looking and all encompassing measure (share price considers current profitability, expectations of future profitability and tradeoffs between profitability and competitive positioning)	Absolute performance may reflect overall stock market performance, rather than company performance Market can be volatile and inefficient based on changing investor expectations Cannot be measured at the business unit level Absolute performance is aligned with returns delivered to shareholders, however many investors look for relative returns as part of balanced portfolio
Used as a relative measure	Rewards for providing superior returns relative to peers Can offset some market and industry factors	Difficult to select relevant peer group (imperfect industry comparators and/or different sensitivities – e.g., foreign currency, interest rates, geography) Difficult to calibrate appropriate level of performance
Profitabilit y Measures Examples include: — Profit, — Cash flow, — EPS, — ROE, — ROCE, — EVA, etc.	Results-based measures that tend to have stronger line-of-sight Profit measures consider both revenues and expenses Return measures recognize the investments needed to generate profits Economic value added measures reflect the value added to the business (profits after a charge for capital)	Difficult to establish appropriate multi-year measures and standards of performance Backward and time discrete measure (versus forward looking for market-based measures) Inevitably requires adjudication based on unanticipated events (e.g., special gains/losses, restructuring, mergers and acquisitions, etc.) Not always a correlation to stock market performance
Used as a relative measure	Considers industry or peer group performance	Difficult to establish fair comparisons across companies (e.g., different debt/equity structures, carrying capital at different values reflecting the age of the assets, etc.)
Other Measures Examples include: — Strategic, — Operational, — Customer-based, etc.	Provides measures that indicate ability to generate future profits Focus on critical elements of performance other than profitability	Can be less results focused and subjective in interpretation Very difficult to set standards and calibrate pay to various levels of performance (difficulty compounded over multi-year periods) Not always a correlation to stock market performance May not be relevant at all levels within the organization Can lead to lack of focus with too many measures