EXECUTIVE COMPENSATION
Is It Time to Simplify Your Design?

If senior management doesn’t understand the compensation plans, it’s time to reassess.

Executive compensation is complex. Some of the complexity is out of our control and is the result of complicated rules governing taxes and accounting. Other aspects of complexity come from disclosure and regulatory requirements for executive compensation and the need to address the concerns of shareholders and shareholder advisory firms. However, some of the complexity

By Eric Hosken, Compensation Advisory Partners
When designs are too complex, they are likely to be ineffective as incentive plans.

is self-generated. Compensation committees, management teams and their consultants frequently change incentive program designs, including adding vehicles or performance measures to ensure that every contingency is addressed. When designs are too complex, they are likely to be ineffective as incentive plans.

Earlier this year, Bengt Holmstrom, who shared the 2016 Nobel Prize in economics for his contributions to contract theory, weighed in on executive compensation. “They have to get to something simpler,” he said. Asked what changes he would like to see, he replied “robust plans that don’t change every year.” Holmstrom’s opinion is not just based on ivory tower theories. He served on the board of directors at Nokia and witnessed the complexity of executive compensation firsthand.

It is worth asking if your current design is too complex. If your senior management team does not understand the compensation programs or cannot explain what drives them, it is time to reassess.

What can we do differently to simplify and improve executive compensation design? The following principles provide a foundation for developing simple and effective designs:

1. Ground the design in the long-term business strategy
2. Maintain the core of the design structure for three to five years
3. Focus executive management on the long term
4. Recognize the value of board judgment and discretion
5. Communicate frequently from grant to payout.

Ground the Design in the Long-Term Business Strategy
The fundamental purpose of an executive compensation design is to focus and reward the management team for the successful execution of the long-term business strategy. With this in mind, it is critical to establish incentive compensation plans that are rooted in the business strategy. For example, suppose a company has decided on a long-term strategy to expand into a new market with higher expected returns on investment. In the first year of the plan, the focus is on establishing market share and generating a positive customer experience in the new market. Over a longer timeframe of two to three years, the company expects to see increased financial returns (e.g., return on invested capital) and growth in stock price.

For this company, the annual incentive plan should measure and reward based on growth in market share and a measure of customer experience (e.g., customer satisfaction or customer retention). It would be misguided to focus on returns in the annual plan because they are not expected until the out (later) years of the strategic plan.

In turn, the long-term performance plan should focus on the financial returns and/or stock price gains that are expected to be generated during the longer term. It is critical to set goals that are aligned with the strategy and recognize that different measures may need to be used for short-term versus long-term performance assessments.

Maintain the Core Design Structure for 3–5 Years
A well-developed business strategy does not change every year. While companies may need to modify the expected level of performance they plan on achieving, they should not need to change the definition of performance each year. For a plan to function effectively as an incentive, employees need to understand how they will be paid. While communications efforts can provide information on the design to employees,
there is no substitute for employee experience with the plan design. Employees get a tangible sense of how the plan works from seeing it through from grant to payout. If different vehicles and performance measures are used in each multiyear performance cycle, it is challenging for participants to remain focused.

Focus Management on Long Term Returns
Most senior executive compensation programs place a heavy emphasis on long-term incentive compensation. While many short-term investors are focused on quarterly financial results, long-term financial and stock price returns are the ultimate differentiators of high-performing companies. A performance share plan with rewards tied to long-term drivers of value creation (e.g., a combination of earnings growth and strong financial returns) can provide stability in the executive compensation design while also supporting alignment between management and shareholders.

For companies with strong growth prospects, incorporating stock options into the executive compensation design can serve the dual purposes of focusing management on the long term (stock options are typically not exercised by executives until five or more years from the date of grant) and simplifying the compensation program. Stock options are a much simpler way to reward executives than performance shares based on relative total shareholder return (TSR). It is much easier for executives to relate to an absolute stock price objective than an always-evolving relative performance standard.

Recognize the Value of Board Judgment and Discretion
Some of the complexity of annual incentive compensation design comes from a desire to have a 100% formulaic incentive plan. To some degree, the aversion to discretion is driven by a legitimate concern that shareholders and shareholder advisory firms prefer plans with transparency and a clear link of performance results to plan payouts. However, formulaic plans often have to include multiple performance measures to capture the business performance of the company or require many adjustments from Generally Accepted Accounting Principles (GAAP) accounting to focus on the core financial results of the business. Using multiple performance measures and making adjustments to reported financials has the

You need your compensation plans to hit the mark. Look to the “WorldatWork 2017-2018 Salary Budget Survey,” the longest running and most dependable salary data source, to ensure your pay-increase budgets are competitive and achieve the results you need.
A performance share design
that is simple for one company may be viewed as complex for a business that has never used performance shares.

Potential to make the incentive design overly complex and murky to participants and shareholders. An alternative approach is to allow the board’s compensation committee to exercise judgment at the end of the year to recognize not only how the company performed relative to the business plan, but to examine the quality of the financial performance in terms of sustainability as well as the strength of the company’s performance relative to peers and shareholder expectations. We find that annual incentive plans tied to clear business goals with a discretionary overlay can be simple for management to understand and are acceptable to shareholders as long as there is a correlation between pay and performance over time.

Communicate from Grant to Payout
Consistent communications of plan design and the potential value to executives is one of the most underused tools that management teams have to make their executive compensation programs more effective. Communications should be ongoing with initial communications at the award of incentive compensation, followed up by regular updates on the performance under the plan and the potential value to the executive. It should be completed with a summary of the final performance results and the ultimate payout. While many companies are effective at communicating at the time of grant and time of payout, they often fall short during the performance period. This is unfortunate because the performance period is the time when executives have the greatest ability to influence performance relative to the plan objectives.

Companies are missing a tremendous opportunity to get more value out of their compensation programs if they are not providing status updates on performance on their annual and long-term performance plans. In addition, companies should make available tools for employees to check at any time the value of their unvested stock holdings and unexercised stock options.

Benefits of a Well-Rounded Plan
There is no one path to simplify executive compensation programs. A performance share design that is simple for one company may be viewed as complex for a business that has never used performance shares. Additionally, a plan that uses multiple measures and vehicles but is stable and well communicated can be very effective. Companies will have a leg up on the competition when they employ a compensation program that is firmly rooted in the business strategy, remains stable, focuses management on the long term, exercises board discretion and is consistently communicated to employees.

Eric Hosken is a partner at Compensation Advisory Partners in New York. Contact him at eric.hosken@capartners.com.

Resources plus
For more information, books and education related to this topic, log on to worldatwork.org and use any or all of these keywords:
- Executive compensation
- Compensation
- Performance plans.