Getting from A to pay

Setting annual CEO and C-suite compensation is supposed to be a rigorous process. But active dialogue between boards, management and pay consultants, combined with careful planning, can help it run smoothly

By Ken Hugessen

For compensation committees and senior management involved in executive compensation decision-making, the first quarter of the year can be a stressful time. Most issuers are determining bonuses for the year just ended as well as long-term incentive grants (e.g. stock options, performance share units, etc.) and salary increases. In today's environment of increased shareholder scrutiny, boards will only make these decisions once they are certain they are fully informed and confident they can explain the rationale for their decisions in the proxy circular. As if this is not enough to deal with, management is often also seeking final approval for current year performance targets on which bonuses will be determined a year hence.

For some issuers, this process is well established and reasonably straightforward, but for others it feels rushed—sometimes creating friction between management and the board. High-stress situations have increased, as newly assertive boards, responding to ongoing pressure from shareholders and their advisers (e.g. ISS), become more directly involved in decisions once substantially led by management. With the sharply increased focus on corporate performance and activist shareholders, and a new pay-for-performance test from ISS, boards are more willing to reject management proposals, even if it means uncomfortable meetings, confusion, and sometimes extensive rework of incentive payments by management.

The decisions that can generate stress are generally in three areas:

1. Last year's corporate performance score to be used to determine bonus payouts.

2. Corporate performance targets for the current year to be used to determine bonuses a year hence.

3. CEO performance assessment and related pay decisions.

Oftentimes, discussion in advance of the compensation committee meetings where these critical decisions are made is limited, with little or no committee and management interaction on potentially contentious matters. While it is good to get the "easy" items checked off the list, it is critical to start the dialogue early on the bigger, often tougher, decisions. The result of not doing so can be stressful, with a lot of last minute back-and-forth, sometimes only beginning at the committee meeting during which these items are supposed to be approved. At best, this risks creating tension between the committee and management; at worst, it may lead to the committee rejecting management's recommendations and approving something different.

As some issuers demonstrate, a better-planned and less fractious process is available: an active exchange, "early and often," between management, the board and any consultants regarding key decisions can go a long way in developing mutually acceptable solutions. Important steps typically include:

- ➔ Prior to year end (i.e., at the last committee meeting of the fiscal year), the CEO discusses with the committee how he/she sees the performance for the year, both corporate and individual, and provides his/her initial thoughts on pay implications for top officers. While these views are preliminary, they nonetheless provide the committee with the ability to provide early input and direction. The committee also begins the CEO performance and pay review process;
- ➔ At the following meeting (i.e., after fiscal year-end), the CEO provides near-final performance assessments and pay recommendations for top officers. At this time, the committee also recommends the CEO performance assessment and related pay decisions for board approval. Recommendations remain subject to adjustment for audited financials and final discussions. A first draft of key sections of the proxy, e.g. a "Letter to Shareholders," offering an overview of performance during the year and pay decisions with supporting rationale, can help guide this discussion;
- ➔ At the next meeting, typically in late February, the committee gives its final approval for the CEO's corporate and individual performance assessments and related pay recommendations, and confirms its own recommendations to the board on CEO performance and pay. With the proper groundwork laid, this is often a relatively straightforward ratification process.

Today, compensation committees and boards have little alternative but to take a much more active and assertive role in compensation decisions, so a solid process for the committee, board and management to work together is important. While the ideas presented above need to be discussed and tailored to each issuer, they should provide a framework for a less stressful and better organized decision-making process.

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