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CFO insights:
Executive Compensation: Plan, Perform & Pay

Executive compensation is not only a consideration close to the pocket book of CFOs but also a topic of increasing importance to managements and boards. As major economies show signs of recovering from the 2008 recession, compensation can become more decisive to retaining and motivating critical senior executive talent. But, executive compensation also continues to be scrutinized by major investors, proxy advisory firms and increasingly regulators – given the losses incurred by shareholders over the last couple of years. Thus, companies will have to critically review their existing compensation plans and how they adapt these plans for a changing economy. CFOs can play a critical role in framing the financial impacts of compensation plans and influence the public perception of these plans. This CFO Insights article lays forth some critical considerations for CFOs.

Executive Compensation: Components and Trends

Executive compensation generally consists of a mix of four components:

- Annual base salary
- Annual incentive or bonus plan generally tied to short-term performance measures
- Long-term incentives consisting of a mix of restricted stock, stock options and other long-term performance plans tied to total shareholder return or financial performance
- Benefits plan

As a rule of thumb, the base salary constitutes 30% of total compensation, the annual incentive another 20%, the benefits about 10% and long-term incentives or the wealth creation portion of the compensation about 40%. Indeed, before the financial crisis, there was a lot of board attention to improving the relationship between pay and performance.

As boards sought to achieve pay for performance, one outcome of the trend was to place more emphasis on performance vested restricted stock for the top executives. Thus, an increased portion of executive compensation was primarily tied to what, in the long term, most institutional investors tend to focus on: long-term performance as measured by total shareholder return or performance metrics that drive shareholder return. So, while compensation was high when share prices grew, shareholders made money right alongside executives, and everyone was generally content.

Boards and investors effectively sought a correlation of the executives' long-term incentive compensation – essentially the executives' wealth accumulation – and the five-year total shareholder return of the company. In general, prior to the recession there was a very strong relationship between the long-term incentive compensation and total shareholder return.

The financial crisis also generated heightened attention to executive compensation from the press, shareholders, and regulators. Amidst the worst financial crisis in decades, or maybe ever, executives and their big paychecks became easy targets for criticism. Premised on the notion that incentive compensation systems contributed to the subprime mess, and the ensuing financial crisis, there was a slew of media reports, Congressional hearings, attorney general investigations, etc., into compensation, especially in the financial industry. For example, there were mortgage brokers who were paid commissions based on volumes of mortgages sold, not the quality of the loans; and there were CDO issuers who were compensated on the amount of CDOs issued, without any charge for risk-adjusted capital. These short-term compensation models provide the ability and incentive for increased risk taking.

But accusations of greed were leveled broadly at banking executives, even if these executives lost tens, if not hundreds, of millions of dollars in equity compensation and the stock they accumulated over a lifetime of work. Indeed, executive incentive plans among many banks were quite similar; yet, some got into trouble and others did not. Thus, one could argue executive compensation had very little to do with the financial crisis, otherwise all the banks would have had similar financial results.

The Emerging Context for Compensation

By 2010, the economy bottomed out on many measures, and is now on somewhat of an upswing. Like in many other aspects of finance, the market meltdown has its own upshots on the way executives are paid. For instance, the banks that received government assistance under TARP are now prohibited from paying bonuses, awarding stock options, or paying severance to their senior executives. These companies were also required to limit restricted stock awards to no more than one-third of total compensation, adopt claw-back provisions, and must conduct compensation risk reviews twice a year. Fortunately, these risk reviews have brought about some good changes. A number of TARP banks have increased base salaries to offset the lack of variable pay. Thus, the government achieved what it wanted – the elimination of incentives that might encourage risk taking. Non-TARP banks and other companies learned some lessons, and have adopted claw-back provisions to recoup incentives in the event of a restatement of earnings, fraud, or violation of restrictive covenants; although a recent Federal Reserve Bank report indicates many of the non-TARP banks have not done nearly enough in reforming their compensation packages.

In addition, changes such as putting caps on incentive payouts, utilizing a more balanced mix of cash and equity incentives, placing more emphasis on the long-term performance, and no longer relying on single performance measure (like EPS), has helped reduce increased risk taking. The emphasis by investors and proxy advisory firms today is on senior executives constantly building stock ownership through aggressive stock retention guidelines, thereby creating a large stake in the financial success and long-term viability of the company.

Compensation and the Role Of CFO

With the changes in the environment around the structure of executive compensation, companies are likely to adopt much more transparent compensation processes. We expect CFOs may play a more active role in implementing these processes, especially in four critical areas:

1. **Pay for performance:** CFOs can help shape pay for performance structures by getting to know shareholders' expectations through their interactions with analysts and major investors. This helps ensure that the company's performance metrics reflect those expectations when shaping short- and long-term compensation plans. CFOs are also instrumental in shaping business-unit compensation and ensuring unit-level performance metrics are rigorously set and support the achievement of overall company financial metrics.

2. **Financial discipline:** It's important for CFOs to focus on what is affordable, albeit striking a balance with what is competitive. CFOs, even while struggling with the budget and trying to project out earnings for the next two or three years, should establish acceptable limits on compensation in terms of its dilutive effect on earnings. At the business unit level, CFOs can also establish better financial discipline and controls. They are especially capable of identifying how units may structure budgets that coax the best possible performance out of business unit leaders.

3. **Risk and internal controls:** As executive compensation plans are key to attracting, retaining, and motivating talent, CFOs should establish a rigorous process to understand how incentives influence employee behavior, how those behaviors aggravate risk, and what steps or controls should be put in place to minimize the risk. Some examples include proper selection of incentive metrics, stress testing potential payouts under various performance scenarios, and implementing additional internal controls, as needed to minimize the risky behavior.

4. **Bridging the information gap:** Aside from managing risk, CFOs could spend considerable time with both the audit and compensation committees to bridge the potential knowledge gap on compensation and financial performance. One example is how to best treat unusual or non-recurring items when calculating incentives. The audit committee is likely to have an in-depth understanding of these items, whereas the compensation committee more fully understands the impact such adjustments may have on incentive plans. The CFO can help link the two committees in helping decide which adjustments, if any, should be made for incentive plan purposes.

Contributing to the above four areas requires a more active engagement in the compensation decision cycle. First, CFOs should engage the board and try to attend portions of the compensation committee meeting focused on incentive plan design, compensation cost, and incentive plan risk. Ideally, if the audit and compensation committee meetings are not running at the same time, CFOs may have more flexibility to attend the compensation meeting. Second, the CFO could proactively provide input to the top HR executives and compensation consultants on key compensation leverage points; such as the proper peer group, performance targets needed to support street expectations and the business plan, appropriate cost levels for merit budgets, incentive plan payouts, etc. Third, CFOs and the finance organization should identify potential unintended consequences of certain performance metrics, and ensure that performance targets are reasonably set to avoid excessive risk taking or "swing for the fences" behavior.

By engaging the board, human resources, and risk management organizations, CFOs can more proactively contribute to executive compensation practices to help better align pay and performance in an environment where stakeholders increasingly scrutinize and want to have more say on pay.

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