Fundamentals *of* Executive Compensation

MAY 22, 2025 | PART THREE

Fundamentals *of* Executive Compensation

PART ONE
Design Fundamentals

PART TWO
The Regulatory and Governance Context

PART THREE
Finance and Measurement Basics

today's agenda

all times Eastern

11:00 a.m.	**Part Two Quiz**
11:15 a.m.	**Executive Compensation Accounting Basics**
11:45 a.m.	**Executive Compensation Tax Basics**
12:15 p.m.	*Break*
12:30 p.m.	**Performance Metrics**
1:30 p.m.	**Hot Topic and Q & A**
1:55 p.m.	**Wrap Up**

Part Two Quiz

The Regulatory and Governance Context

1

Which statements are true about the regulation of executive pay?

a. Corporate scandals have led to increased scrutiny of executive pay

b. Economic downturns and the financial crisis have led to increased disclosure of pay programs

c. Executive pay practices are influenced by proxy advisory firms

d. All of the above

2

The Compensation Discussion and Analysis is a principles-based disclosure.

a. True

b. False

3 What is Realized Pay?

a. A type of supplemental disclosure adopted by companies to illuminate their pay for performance story

b. A term defined strictly by the SEC

c. A calculation that values unearned equity at target using year-end stock price

d. None of the above

4 What year was a Say on Pay vote first required for U.S. companies?

a. 2007

b. 2011

c. 2013

d. None of the above – the regulations aren't yet final

5 Which of the following are required as part of the CEO pay ratio disclosure?

a. The change in year-over-year CEO pay

b. The pay of the median worker

c. The pay of the CEO

d. All of the above

e. Items b and c only

6

Dodd-Frank required several disclosure requirements including Say on Pay, Pay Ratio and Pay for Performance.

a. True

b. False

7 Which statements about Proxy Advisory firms are true?

a. They advise institutional investors about proxy voting matters

b. They are subject to criticism from companies

c. They have significant influence on Say-on-Pay votes

d. All of the above

8

Which board committees must companies have as required by stock exchanges?

a. Compensation, Audit and Finance

b. Nominating and Governance, Executive, and Risk

c. Audit, Compensation, and Nominating and Governance

d. None of the above are true

9 Compensation Committees should have a charter because:

a. It’s considered a good governance practice

b. It’s required by Dodd-Frank

c. It’s required to be listed on most stock exchanges

d. None of the above

e. Items a and c only

10 Which of the following is true of a compensation committee's independent consultant?

a. They must be lawyers

b. They are not allowed to do work for management

c. They must rotate off of their assignments every five years

d. None of the above

Executive Compensation
Accounting Basics

Generally Accepted Accounting Principles (GAAP)

- Rules that govern the information published in financial statements
  - Developed jointly by the Financial Accounting Standards Board (FASB) and the Governmental Accounting Standards Board (GASB)
- Ensure that information in financial statements is consistent and accurate
- Financial statements prepared using GAAP have limitations when used in incentive design

Accounting for pay components

Base Salary, Annual Incentives	• Amount recorded as expense when earned
Long-Term Compensation	• Accounting is complex - governed by FASB Accounting Standards Codification (ASC) 718 • ASC 718 covers stock-based compensation, including awards paid in cash if amount is linked to the price of company stock

Accounting for LTI

- Two steps in determining accounting treatment:
  - What is the **value** of the award at grant?
  - How is that value **expensed** over time?

- Awards are valued at “fair value” at the date of grant
  - Use similar financial instruments in the market as reference, or
  - Use a valuation methodology, such as an option pricing model

Accounting for LTI: Expense

- Expense is recognized based on the vesting conditions and the form of payment (cash or stock)

- Vesting Conditions
  - ”**Market Condition**” – a condition relating to the company’s share price
  - “**Performance Condition**” – a condition relating to a performance target defined solely by the company’s operations
  - “**Service Condition**” – a condition relating solely to the rendering of service over the vesting period

Valuing LTI Awards

- Depends on the type of award and performance objectives
  - Time-vested restricted stock is valued at price on date of award and the probability of vesting in the award
  - Stock options are valued using an option-pricing model, generally Black-Scholes
  - Performance-based award value depends on the nature of the performance objectives

Performance Conditions → EPS, EBITDA, IPO, revenue, etc. → Stock price at grant

Market Conditions → Total shareholder return (TSR) → Monte Carlo simulation

Stock Options: Black Scholes

- Black-Scholes is the most popular way to calculate the expected value of a stock option. Black-Scholes Factor = RR + V + T – D
  - RR = risk free rate of return
  - V = volatility
  - T = term, or number of years to exercise option
  - D = dividend
- Grant date value: number of options granted x stock price x Black-Scholes value
- Example:10,000 options x $10.00 x .25 = $25,000
  - The expected value/gain from this option award is $25,000.

Accounting Treatment: Stock Options/SARs

Type	Paid in stock	Paid in cash
Options and SARs	The value is calculated at grant using an option pricing model, including a forfeiture estimate. Over the vesting period, expense is accrued, adjusting for the number of actual employment terminations.	The value is calculated at grant using an option pricing model, including a forfeiture estimate. Expense is accrued over the vesting period but is *adjusted each quarter* until the SAR is exercised to reflect changes in the stock price and the actual number of employment terminations.

Accounting Treatment: Restricted Stock

Type	Paid in stock	Paid in cash
Restricted stock	The value is the share price at grant, including an estimate for forfeitures prior to vesting. Over the vesting period, the company accrues the expense, adjusting for the number of actual terminations.	The value is the share price at grant, including an estimate for forfeitures prior to vesting. Expense is accrued over the vesting period but is *adjusted each quarter* until the award vests to reflect changes in stock price and number of actual employment terminations.

Accounting Treatment: Performance Plans – Market Conditions

Type	Paid in stock	Paid in cash
Performance plans – ***market conditions***	Value is calculated at grant using a valuation model that accounts for the market condition. Value includes an estimate of forfeitures. Expense is accrued over the performance period adjusting for actual terminations. The expense recognized over the period can't be reversed if performance goals aren't met and no award is paid.	The expense is similar to being paid in stock but the expense is *adjusted each quarter* to reflect changes in stock price and the number of actual employment termination.

Accounting Treatment: Non-Market / Service Conditions

Type	Paid in stock	Paid in cash
Performance plans – *non-market or service conditions*	The expense is fixed at the grant date, including an estimate of forfeitures. Expense is accrued over the performance period, adjusting for the actual number of shares expected to vest (but *not adjusting for stock price changes*), including adjustments for the number of actual employment terminations.	The expense is similar to when the performance award is being paid in stock but the expense is *adjusted each quarter* to reflect changes in stock price and the number of actual employment termination.

Summary of Accounting for LTI

- Accounting for LTI is complex – consult the experts in your Finance organization
- Summary from Meridian provides a basic guide

Vehicle	Paid in Stock	Paid in Cash
Stock Options	Fixed expense calculated at grant date using valuation model (e.g., Black-Scholes) and accrued over vesting period. Must estimate forfeitures due to terminations at grant date and adjust for actual forfeitures thereafter throughout the vesting period.	N/A
Stock Appreciation Rights	Fixed expense calculated at grant date using valuation model (e.g., Black-Scholes) and accrued over vesting period. Must estimate forfeitures due to terminations at grant date and adjust for actual forfeitures thereafter throughout the vesting period.	Expense adjusted quarterly until exercise as fair value changes; mark to fair value accounting.
Restricted Stock (time-based)	Fixed expense based on share price at grant date accrued over vesting period. Must estimate forfeitures due to terminations at grant date and adjust for actual forfeitures thereafter throughout the vesting period.	Expense adjusted quarterly throughout vesting period as stock price changes; mark to fair value accounting.
Performance Plan (market condition)	Fixed expense calculated at grant date taking into account the market condition and accrued over performance period. Must estimate forfeitures due to terminations at grant date and adjust for actual forfeitures thereafter throughout the vesting period. No reversal of previously recognized expense for awards where performance has eliminated payout.	Expense adjusted quarterly throughout performance period as performance changes; mark to fair value accounting.
Performance Plan (non-market condition)	Fair value per share fixed at grant date. Expense estimated at grant date and accrued over performance period. Expense adjusted quarterly for changes in the number of shares estimated to vest (but not stock price changes). Must estimate forfeitures due to terminations at grant date and adjust for actual forfeitures thereafter throughout the vesting period.	Expense adjusted quarterly throughout performance period as performance changes; mark to fair value accounting.

Executive Compensation

Tax Basics

Taxation of Executive Compensation

- Employee comp is deductible to the company for tax purposes, if:
  - "ordinary, necessary and reasonable"
  - Less than $1,000,000 for proxy-reported executives
  - Not an "excess parachute payment" under IRS section 280G
- If paid in the first 2 ½ months after year-end, payments are deductible for prior year tax purposes (i.e. annual incentives)
- Three significant sections of the Internal Revenue Code impact executive compensation design

By The Numbers: IRC Section 162(m)

The $1,000,000 limit

- Section 162(m) limits the deductibility of compensation paid to “covered executives” to $1,000,000
  - Covered executives will expand to include #6-10 highest paid in 2027
- Covered executives are those reported in the proxy; for the top five, “once covered always covered”
  - As a result, post-retirement compensation is impacted
- Exclusion for ”performance-based” compensation no longer applies

By The Numbers: IRC Section 409A

Nonqualified Deferred Compensation (NQDC)

- A NQDC plan is any legally binding right to compensation that is promised to be paid in a subsequent year
  - Not subject to ERISA's requirements on eligibility, non-discrimination, etc.
  - Taxed to executive (and deductible to company) when paid out
- NQDC plans must meet strict rules governing elections to defer payment and how distributions can be made
- Significant penalties if plan does not comply – assessed against the executive (not the company)

By The Numbers: IRC Section 280G

Change-in-Control Arrangements

- If payments received in connection with a change-in-control are considered “excess payments,” they are not deductible to the company, and trigger a 20% excise tax for the executive
- “Excess payments” are those that equal or exceed three times the average of the executive’s prior 5-year W2 amounts
- Companies sometimes “gross-up” the payments to cover the executive’s taxes, although gross-ups are a governance “red flag”

By The Numbers: IRC Section 280G

Change-in-Control Arrangements, *continued*

- If change-in-control related payments equal or exceed three times the five-year average W2 amounts, an excess payment exists
- The amount of payments greater than one-times the average five-year W2 is considered the "excess" and is subject to 20% excise tax
- Companies often employ strategies to avoid a full tax gross-up
  - Cutting back payments to avoid excess
  - Gross up on a portion of the excess
  - "Best net" approach

Calculating the Excess Parachute on Change-in-Control (Example #1)

Current base salary	$1,000,000
Most recent bonus	$1,500,000
Total	$2,500,000
Times severance period	x 3
Total severance	$7,500,000
Plus options acceleration	$8,250,000
Total parachute	$15,750,000

Average five-year W-2 taxable wages = $5,000,000

Safe harbor: $5 MM x 2.99 = $14,950,000

Excess parachute = $15,750,000 – $5,000,000 =$10,750,000

Tax on excess parachute = $2,150,000.

Net after excise tax = $13,600,000

The executive would have been better off if the company cut back the payment to the 280G limit ($14,950,000)

Calculating the Excess Parachute on Change-in-Control (Example #2)

Current base salary	$1,000,000
Most recent bonus	$1,500,000
Total	$2,500,000
Times severance period	x 3
Total severance	$7,500,000
Plus options acceleration	$28,250,000
Total parachute	$35,750,000

Average five-year W-2 taxable wages = $5,000,000

Safe harbor: $5 MM x 2.99 = $14,950,000

Excess parachute = $35,750,000 – $5,000,000 =$30,750,000

Tax on excess parachute @20% = $6,150,000.

Net after excise tax = $29,600,000

The executive would be better off paying the excise tax rather than being cut back to the 2.99 280G limit ($14,950,000)

Special Focus: Taxing Perks

- As mentioned in Part One, perquisites declined in use in the past decade
- Some perks – such as the use of corporate aircraft - require the calculation of ‘imputed income’
  - IRS provides guidance
  - Requires accurate recordkeeping
- Cost of perquisites deductible to the company (subject to 162(m) limits)

Summary: Taxation

- **Section 162(m): the $1,000,000 limit**
  - Compensation to proxy executives only deductible up to $1,000,000
  - Once covered, always covered
- **Section 409A: Nonqualified Deferred Compensation**
  - Covers any binding promise to pay in a future year
  - Penalties for non-compliance fall on executive
- **Section 280G: Change-in-Control**
  - Excess payments - equal or exceed three times the five-year average W2
  - Gross-ups are used, but increasingly scrutinized as a governance red flag

Fundamentals of Executive Compensation

INTERMISSION

Our session will resume shortly

Executive Compensation

Performance Metrics

Performance Metrics

- Selecting Metrics
- Setting Goals
- Establishing the Payout Curve
- Using Judgment

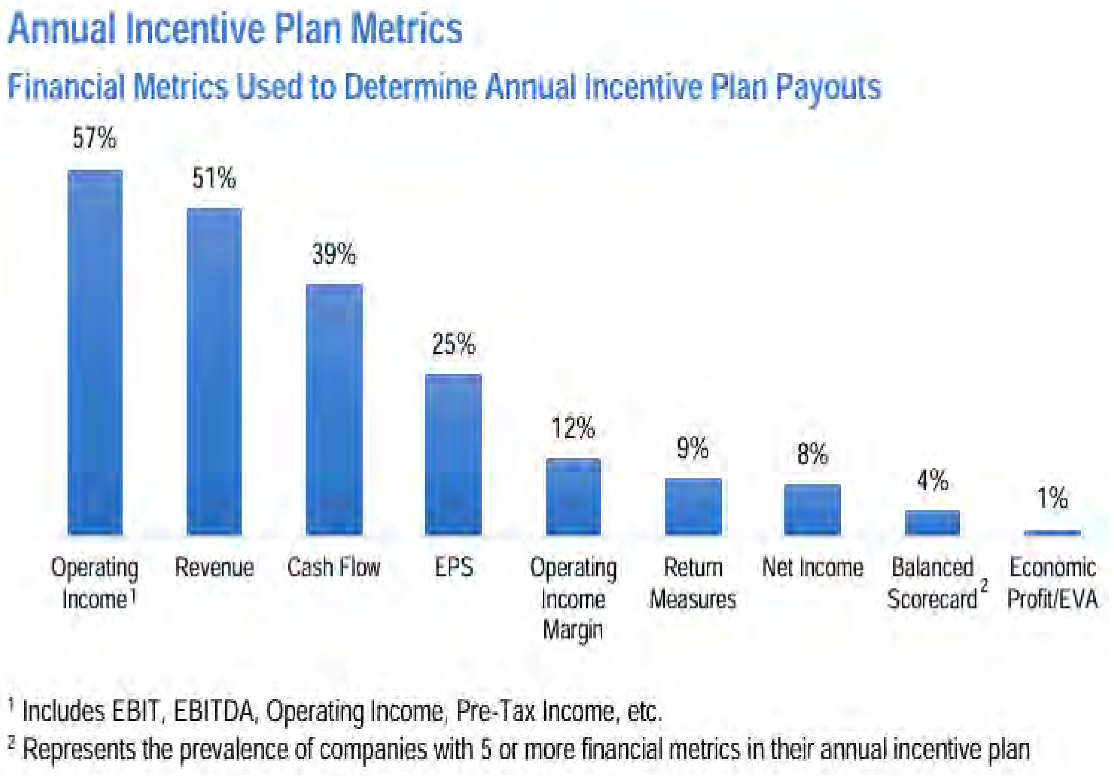
Selecting Metrics: Pay for What?

- Metrics signal what's important to both executives and shareholders
- Most performance metrics in executive compensation plans are financial
  - Non-financial metrics in the ESG area are gaining in prevalence
    - 74% of S&P 500 companies use at least 1 ESG metric in either their annual or LTI plan
- Annual plans use a variety of metrics, while Total Shareholder Return (TSR) dominates long-term incentives

Source: Semler Brossy 2024 ESG and Incentives Report

Metric Prevalence: Annual Incentives

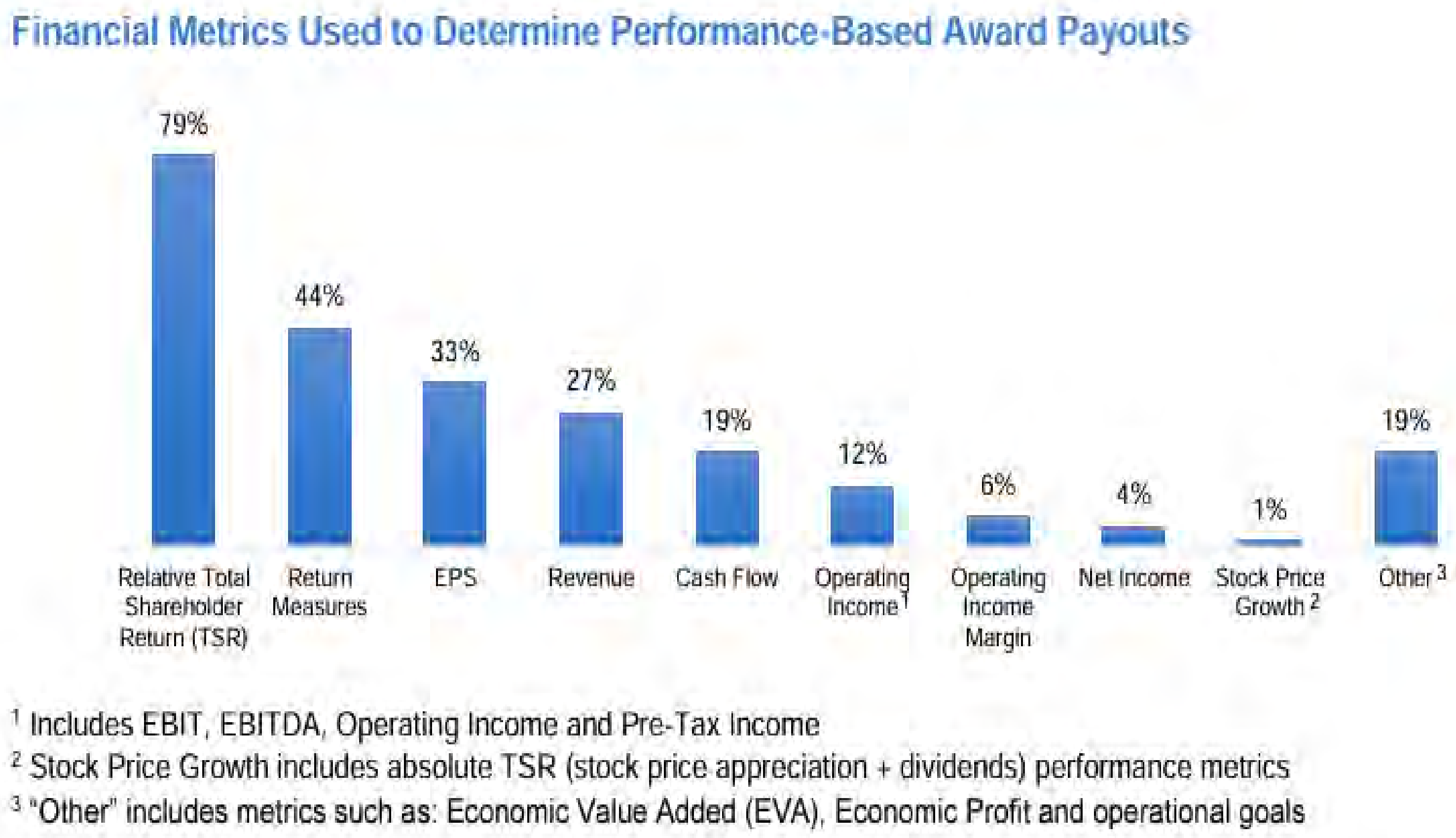
Income and cash flow measures predominate in annual incentive plans…



Source: Meridian, Trends & Developments in Executive Compensation, 2023 Report

Metric Prevalence: Long-term Incentives

...while TSR is most common in long-term plans



Source: Meridian, Trends & Developments in Executive Compensation, 2023 Report

How do you choose?

- Company strategy – what are our business and talent goals?
- Data analysis – what metrics are most closely associated with our long-term goal(s)?
- Industry prevalence – what do peers use?
- Investor views – what do they value?

What are your company's long-term goals?

Identifying Performance Metrics

- Using basic statistical analysis, you can assess the empirical connection between potential metrics and your long-term goal
  - Example: if your goal is driving shareholder return, you could analyze the correlation of potential metrics to TSR over time
- Correlation analysis can be applied to any quantitative metrics – including non-financial measures

GAAP v. Non-GAAP

- Most companies supplement their financial disclosure with metrics that are not standard as defined by GAAP

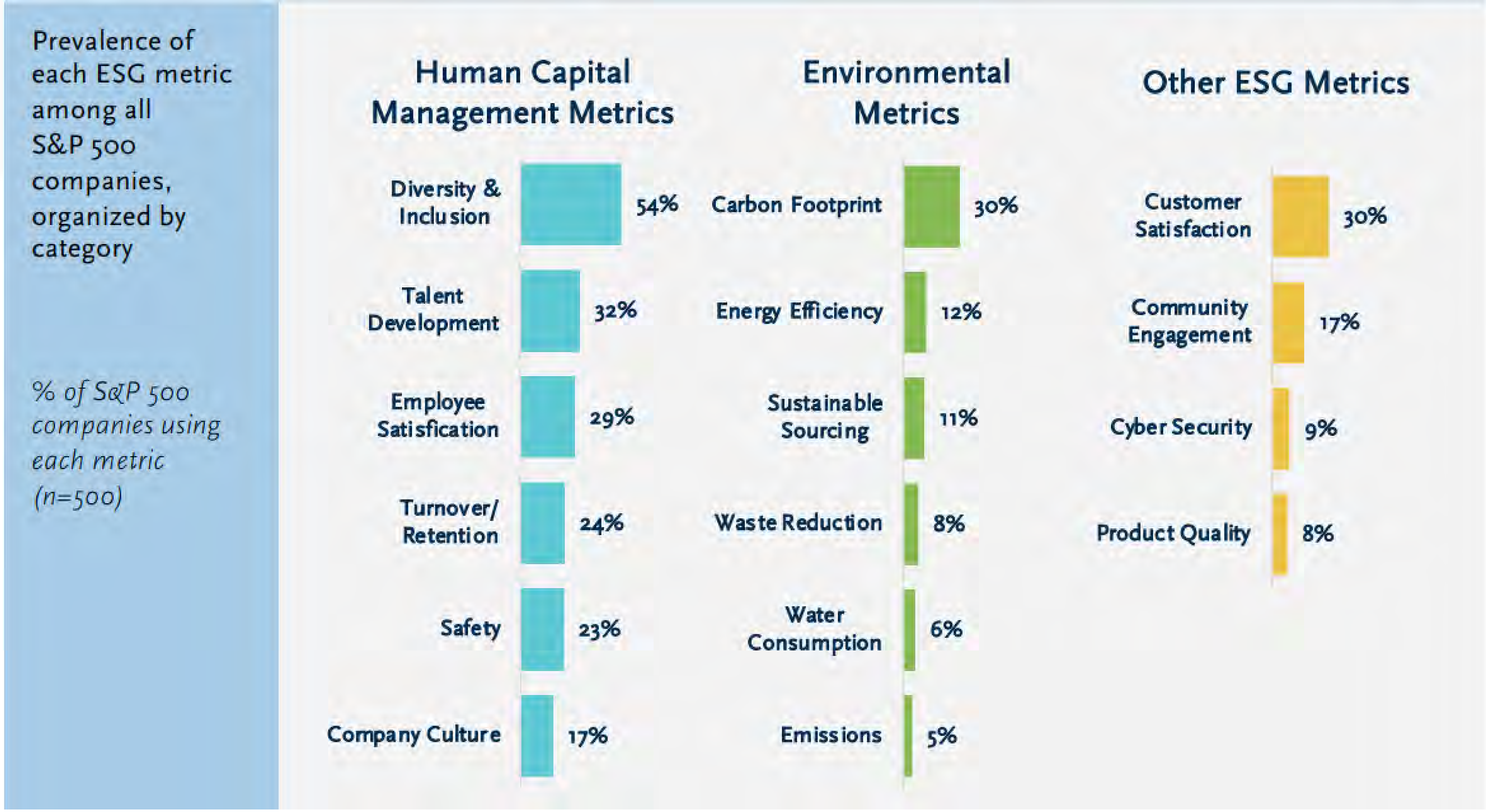
- Concern arises when non-GAAP metrics are used in incentive plans
  - Investors concerned about management motives
  - Boards need to balance needs of executives and interests of shareholders

- Boards should exercise judgment when using non-GAAP metrics

Key Considerations: Non-GAAP

- Consider the **type of adjustment** – not all are created equal
- Set **guiding principles** – such as treatment of windfalls
- **Communicate** in advance - and review regularly
- **Disclose** clearly and completely – both the ‘how’ and ‘why’
- Watch for **unintended consequences** – unwanted motivations
- Use **judgment** – consider all stakeholders

Using Non-Financial Metrics



Source: Semler Brossy 2024 ESG and Incentives Report

Setting Performance Goals

- Once metrics are selected, performance goals are set

- One of the most challenging aspects of incentive design
  - **Management**: incentive to set achievable goals
  - **Shareholders**: prefer aggressive goals and strong performance link

- Goals have a reference point – internal or external – and a timeframe
  - *Internal*: performance against budget, improvement over prior year
  - *External*: performance against peers or an index

Internal v. External: Which is best?

	Positives	Drawbacks
Internal	• Easier to understand • Greater internal engagement	• Shareholders may be skeptical of management's motives
External	• Can be more effective in uncertain economic conditions • More objectively determinable, so may be more credible	• Can be difficult to establish robust and relevant peers

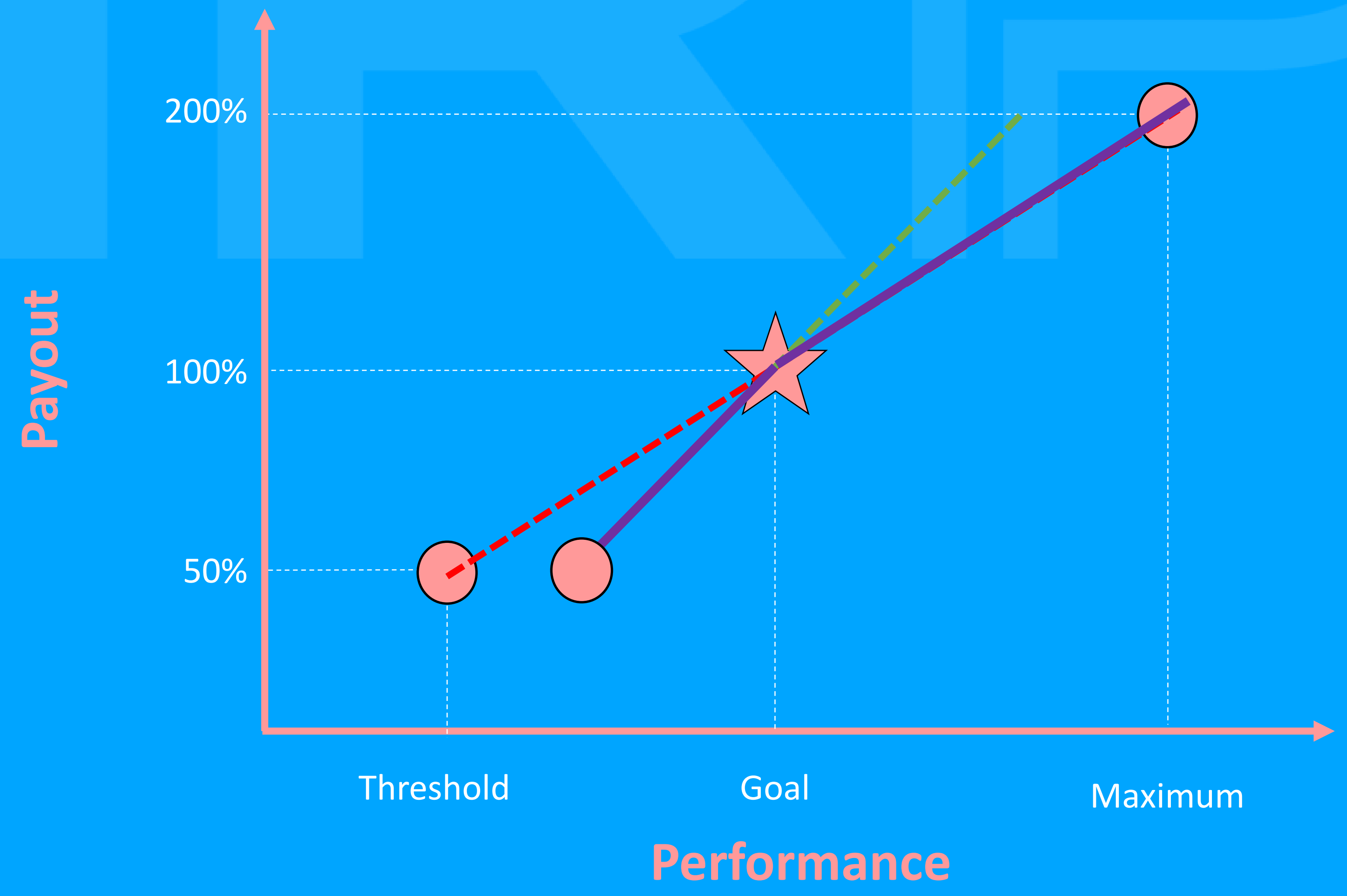
Performance Period

- **Short-term incentives**: goals typically measure performance over one year
- **Long-term incentives**: most common performance period for performance plans is three years

The Payout Curve

- The ‘payout curve’ embodies the pay-performance link
  - Answers the question: “How much pay is delivered at a given level of performance?”

- Three elements
  - Target
  - Minimum
  - Maximum


Payout
200%
100%
50%
Threshold
Goal
Maximum
Performance

The Sharing Percentage

- Another consideration in determining the shape of the payout curve is a concept called the ‘sharing percentage’

$$\textit{Sharing percentage} = \frac{\textit{Total Incentive Plan Payout}}{\textit{Income Measure (such as operating earnings, net income)}}$$

Using Judgment

- Incentive awards generally determined by the objective calculations produced by the payout curve
- However, awards are influenced by the subjective judgment of the compensation committee in several ways, including:
  - The use of non-GAAP metrics
  - Adjusting results due to unforeseen or unusual events
- In the wake of COVID-19, committees were more inclined to consider discretion in determining payouts

Hot Topics: Q&A

Submitted Questions

Submitted Questions

Thank You