Avoiding Pitfalls and Getting Optimum Results with Executive Compensation Decision-Making

By: David Bixby & Andrew Stancel

When it comes to making decisions around executive compensation packages, things can get complicated fast. Especially in the face of rapidly changing regulations and expectations, organizations now have to be very conscientious about how they prepare for these decisions.

Companies are now required to document and report information about key employees' compensation, linked to their job performance.

Why do companies need a good executive compensation plan?

Making decisions around executive compensation is not a quick or simple process. As David says, "It's kind of inherently fraught with conflict. Executive compensation decisions are increasingly subject to external scrutiny and potential criticism."

On top of this difficulty, there are also plenty of opportunities for the process to go completely off the rails. Since the compensation committee meetings only happen a few times per year, there are only a few small windows to get key decisions made.

It's critical for businesses to make the most of the time they have. If things go wrong, you can end up with reactive decision-making, reputational harm, potential internal conflict, and eventually, declining performance.

One of the most important ingredients for success here, says David, is communication between team members, answering key questions, allowing people to state objections, and making sure everyone is always aligned around the same mission and compensation philosophy. "It's about keeping that open communication. It's particularly important in building trust and helping to discuss some decisions that are more fraught with challenges, right when management in the committee may have a difference of opinion."

And one way to think about communication when aligning various parties in this context is through what David calls, the "two bites at the apple" approach.

What is the "two bites at the apple" approach?

The "two bites at the apple" approach comes into play when you're facing challenging decisions such as an incentive plan redesign or goal-setting period. This is particularly true, David explains, when you're setting new goals in the annual or long-term incentive plan.

Getting things right in these situations sometimes requires you to review, or take one “bite at the apple,” in one meeting when there’s no approval on the table. Then, allow some time for the compensation committee to think about it and provide direction for management to actually incorporate that direction into a final recommendation that can work.

This means that when you finally get to a meeting where a decision has to be made, ideally, you’ll just need to make a few tweaks at that point. Nobody feels rushed, and nobody feels backed into a decision they’re not ready to make. David says, “It's a good process for some of the more challenging and detailed decisions that the committee estimate.”

Aligning the compensation process with your business strategy

One of the challenges facing decision-makers is the need to align the compensation process with the wider business strategy.

When making decisions around compensation planning, it’s important to keep in mind that annual salaries, base pay, benefits, bonuses, incentives like retirement plans or sick leave, and all other types of compensation are ultimately supposed to drive business outcomes — they’re intrinsically linked.

“With that in mind,” says David, “You want your business strategy to be your North Star, if you will, in thinking about what's the right decision, what's the right direction to take.”

Any compensation decision comes with a myriad of considerations for employers attached to it. People in the room will likely have points of view on all of them. With all this often conflicting input, it can be easy to lose focus. It can be a tough job, but it’s crucial to stay true to your strategy and make firm decisions when needed.

David says, “I think that business strategy is where you come back to your business, and your talent strategy guides the design of the compensation program. Which means sometimes you may have to make some decisions that weren't exactly right down the middle of somebody else's checklist.”

Incorporating an annual calendar and compensation dashboard

One of the most useful tools when making compensation decisions is an annual compensation committee calendar, used to follow the meeting and public disclosure cadence.

Andrew says, “It helps to lay out the events during the year to manage the compensation cycle, especially for the fourth and the first quarter meetings that have a really heavy agenda with items that are critical to the annual reporting and compensation cycle.”

In addition, the calendar is also useful in the second and third-quarter meetings, to plan and take advantage of any downtime and make sure no agenda items are missed throughout the year.

Third-party advisors and the executive compensation committee

“I think every company should have an independent advisor, and many companies actually do have an independent advisor on the committee,” says Andrew. “The advisor can provide assistance in a number of ways, such as providing a memo in advance of each committee meeting which summarizes the materials and provides comments on areas that warrant more in-depth review, consideration or discussion by the committee.”

Another area where an independent advisor can add value is when commenting on difficult decisions. Here, an advisor can bring their own, often impressive experience to the table, and offer context and insights to tricky issues or unusual situations.

Thinking about optics

A particularly important thing to consider around compensation strategy is optics. When you disclose information about employees, how will it sound?

David says, “One way I like to put it, is when I say this out loud, how does it sound? You can get into conversations focusing on the business strategy, the talent strategy and the individuals involved… but you do, at some point, have to step back and think about how this is going to sound when you put it out in front of shareholders and other third parties who are going to review this information.”

Although it’s important to remember that shareholders aren’t the primary concern, it’s also essential to be aware that they still have an important voice, and any confusion or disagreement in this area can distract from your business objectives.

For this reason, David says, it can be helpful to show up to committee meetings prepared to respond to any shareholder concerns and have established narratives around the decisions you make, along with addressing potential pitfalls.

“Those are all very important things to understand,” says David. “They won't necessarily change the decisions. But you need to know how this decision will sound when you say it out loud.”

When dealing with potentially controversial issues, like a substantial retention award, it’s even more important to prepare draft disclosures ahead of time in this way.

“Have you provided a clear and compelling and disclosable rationale for the decision that you made around that retention award?” says Andrew. “Preparing that draft disclosure in advance really lets everybody have a look at how this is going to be communicated to investors and shareholders.”

Another benefit of drafting the disclosure in advance is avoiding unexpected outcomes. One example David gives is of a large one-time retention award to a specific executive or officer, which could push that person into the top five named executive officers that need to be disclosed in a proxy circular.

In this scenario, if you don’t prepare a draft in advance, you might find yourself completely surprised to learn that that executive officer is required to be included in the top five. If you take the steps to prepare, you’ll catch that unexpected outcome and avoid what could otherwise be a stressful situation.