CEO pay: the short and long-term of it

Recent Canadian CEO pay trends indicate more boards are shaking up their pay mix and incentive design to align pay to long-term performance. For those that haven't, some self-appraisal might be in order

By Ken Hugessen with Allison Lockett

With the 2013 proxy season now behind us, it is worth pausing to consider the evolution in CEO compensation levels, mix and incentive design over the past few years. The trends observed—including moderate increases in pay opportunity, bonus payouts at or near target, continued focus on multiple measures for short-term incentives, shifts in weighting toward long-term incentives, and decreases in the weighting of stock options—all reflect a general attitude by today's boards to proceed with care given the still modest pace of recovery, actively manage risk, and take the long view.

Median target total direct compensation for TSX60 CEOs increased by approximately 10% in 2012 compared to 2011. Over the same period, base salaries increased 5%, short-term incentive targets grew 9% and long-term incentive grants increased 14%. While these increases are much larger than those in the general working population, they point to a somewhat moderate year in the executive pay universe. At the same time, median short-term incentive plan payout as a percentage of target came in at 100% in 2012, versus 105% in 2011 and closer to 130% in 2010. This could be due to several factors—more challenging goals, tougher evaluations, weaker performance—and likely a combination of all three.

CEO pay mix continued to shift from 2010 to 2012. Target total incentives as a proportion of total direct compensation increased to 84% on average, up from 79% in 2010. The increased incentive shifted primarily into long-term incentives, which comprised approximately 65% of target total direct compensation in 2012, versus approximately 60% in 2010. These changes in the mix of target pay are fully aligned with the current environment, where increasing pay-at-risk and generating strong performance over the long-term remain the focus.

Short-term incentive scorecards are continuing to evolve to include more measures, primarily financial. Among TSX60 CEO scorecards in 2012, 97% included financial measures, with earnings and cash flow measures being the most common. Three out of every four also had nonfinancial measures, including operational, strategic and safety measures, among others. Just under half of TSX60 CEO short-term incentive scorecards include an individual component.

In terms of long-term incentive trends, the declining use of stock options continues. While almost 80% of TSX60 CEOs still received stock options in 2012, the weighting of options as a portion of CEO long-term incentives declined to 34% in 2012 from 48% in 2010. Close behind stock options by prevalence are performance share units (PSUs), which were granted to approximately 70% of TSX60 CEOs, followed by restricted share units (RSUs), deferred share units (DSUs) and cash.

Boards and management teams that are contemplating changes to their pay levels, pay mix and incentive design for 2014 have now begun the process of reviewing the landscape and considering alternatives. Those that decide to act should consider the incentive performance framework as a starting point. Begin with a gut check—did last year's pay level, both realized and realizable, match up with the performance level? Is there alignment between the strategic plan, industry outlook and the scorecards associated with incentives for this year? Are the most relevant measures given appropriate weightings when making incentive grant and payout decisions? And, is the pay for performance system sophisticated enough to be effective, while being simple enough to be understood and administered? Perhaps most importantly, does the committee and board have in place a process that allows them to make independent, fact-based decisions about how well the corporation and the CEO have done, and how the CEO should be paid?

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Philosophies and frameworks for executive compensation are evolving at a decent clip. It is worth taking the time to be aware of the trends and evaluate which ones apply in the various companies where you play a role.

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