



Executive pay issues trending in the boardroom



Executive compensation continues to pose a significant challenge for boards and compensation committees. As we've seen in recent months, shareholders, regulators, and the media have a laser-like focus on CEO compensation packages. In this environment, it's important that boards understand the issues that are at the center of the compensation debate, and help ensure that the company has in place the governance processes and controls essential to the development and administration of an effective compensation and incentive plan system.

Below, we have summarized a number of important issues that are shaping the compensation discussion today.



Use of Non-GAAP metrics in incentive plan design

Boards will debate incentive compensation metrics.

Financial statements prepared in accordance with GAAP don't always tell the whole story of a company's performance. To bridge the gaps, many companies supplement the GAAP numbers with "non-GAAP financial measures" that they believe more accurately reflect the results of operations and are better indicators of future performance.

The use of non-GAAP financial measures has garnered scrutiny and comments from the SEC over the past year. In a keynote address in 2016, then SEC Chair Mary Jo White expressed a concern that companies were increasingly using non-GAAP financial measures to shape their key messages—thereby overshadowing the GAAP results. This issue has been a key area of SEC staff focus in recent months.

The national conversation has expanded to the use of non-GAAP financial measures in incentive plan design, and to the correlation of the non-GAAP measures to the actual state of the business and results—i.e., whether the non-GAAP measures result in incentive payments that are consistent with actual performance.

Management and boards will have to respond to many questions surrounding this topic: What is the process to determine which non-GAAP financial measures are used? Are the non-GAAP measures consistent with those used by industry peers? What controls does the company have around the development and use of the non-GAAP measures? The bottom line: Boards and management should be aligned on the measures that best support the goals of their incentive plans.



Plan analytics

Companies will test the rigor of incentive plan goals and targets. Companies are beginning to take advantage of the

advanced analytics that are becoming increasingly available and vital to making informed decisions.

Predictive analytics can support the goal setting process and performance targets, enable the comparison of multiple performance and payout scenarios, provide more robust analysis to guide decision making, and assist in sharpening shareholder communications on a topic of critical importance to them.

Boards should encourage management to evaluate new analytical capabilities to better design, refine, and defend their company's incentive plans. These models can drive cost savings, improve the alignment of pay and performance, and respond to the external market's concerns regarding the rigor of performance targets.



Revenue recognition impact on incentive compensation

New revenue standard will impact compensation incentive plans. Under the new standard (effective January 1, 2018 for calendar year companies), the period in which revenue is recognized will be different than under the old standard. Because the new standard affects the timing of when revenue is recognized, it can have a material impact on bonuses, commissions, and incentive compensation plan payouts that are linked to revenue-related metrics.

Revenue is a commonly-used metric in incentive plan design and is a key influencer of other common financial statement metrics that are used to assess performance and payouts in incentive compensation plans.

With implementation right around the corner, boards and management teams should be well along in their discussions regarding how they are addressing the impact of the new revenue standard on their various compensation arrangements, and preparing appropriate communication plans for employees and shareholders. Investors will clearly be focused on disclosures regarding the determination of new performance metrics and targets.



Aligning culture, conduct, and compensation

Culture will more directly influence your compensation strategy. The Federal Reserve has strongly encouraged banks to implement culture and conduct programs to help manage risk and improve governance—with incentive compensation identified as a critical tool to develop, support, and maintain the culture.

As companies in all industries navigate the rapidly changing global business environment, boards and management teams are increasingly focused on culture—the potential risks it poses, as well as whether it encourages execution of strategy. But the discussion about culture can be difficult, particularly when the underlying drivers of culture are often not readily apparent to directors who have limited interactions with employees beyond the C-suite.

Some of the key questions for boards today include: Where is culture on the board agenda? Is it a priority? Do we understand the organizational culture and risks, and the possible need for change? What is our company culture today and what should it be in the future? Is management shaping a culture that is aligned with strategy? How are we using compensation programs to support culture—and to foster a culture change when necessary?



Clawbacks for incentive pay

Companies will be expected to have clawback provisions and the processes to enforce. While Dodd-Frank extended incentive compensation clawback to all executive officers for restatements on a no-fault basis, the SEC has not issued final clawback regulations. However, institutional investors have pressured companies to voluntarily adopt clawback policies as part of their incentive compensation plans; as a result, many companies have implemented clawback policies of their own.

Today, clawbacks remain a hot topic for institutional investors and proxy advisors. Most governance observers consider clawbacks to be a key element of sound corporate governance, and recommend that boards consider establishment of a policy if they have not already done so.

Possible questions for consideration in developing a clawback policy include: Who should be covered—all executive officers (as provided by Dodd-Frank), or a broader group who may be “at fault”? What triggers the clawback—e.g., a financial restatement or other conduct, action or inaction? How much (and what kind of) compensation gets clawed back—e.g., cash, options, long-term compensation?

For more information on these issues as well as other compensation and benefits challenges, please contact:

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CEO pay ratio

Be prepared for the CEO pay ratio disclosure. The CEO pay ratio, adopted in 2015, requires companies to disclose the ratio of CEO compensation to that of the median employee for fiscal years beginning on or after January 1, 2017. Companies have been actively preparing for the disclosure with draft analyses and test runs in preparation for the first disclosure.

The pay ratio disclosure has been openly criticized by the new administration, with the then Acting SEC Chairman, Michael Piwowar, opening a review of the SEC’s pay ratio regulations. Despite this uncertainty, companies should continue to prepare to include the pay ratio disclosure in their 2018 proxies.

Understanding your CEO’s pay ratio versus the peers, as well as the disclosure of the “median” employee’s pay will be critical in formulating proper messaging both internally and externally. Boards are encouraged to continue discussions with management for the timely preparation of the ratio and the communications.



Gender pay equity

Companies will be forced to address pay equity. Recent studies suggest the continuing existence of a gender wage gap in the U.S., with women on average earning only 78 cents for a dollar earned by men.

In response, several states (California, New York, Massachusetts, and Maryland) have enacted legislation with other states expected to follow—to address the gender wage gap in their states. These laws generally increase pay transparency and lower the threshold for an employee to bring an equal pay lawsuit against an employer. Separately, in the recent proxy season there were a number of shareholder proposals calling for companies to disclose action plans to address any gender pay equity disparities in their organizations.

Boards are encouraged to engage with management on this important issue. A comprehensive gender wage gap assessment, if not already undertaken, may be in order; and, if there are pay disparities, a plan to address the disparities is essential. Today, a company needs to see “gender pay equity” as both a matter of principle and a strategic imperative—and the board has a key role to play in setting the tone and expectations to make this happen.

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