

# Performance pay— what is it worth and what does it cost?

*Valuing performance pay is difficult and often subjective. Charles Macdonald explains why it is important and how it is done.*



Charles Macdonald

Performance pay continues to be topical, and maybe always will be. While this is especially true for executives, it applies to most groups of employees and to all industries.

For many listed companies, the AGM has become a public platform allowing disgruntled shareholders to criticise 'excessive' executive pay and question directors on the robustness of their performance pay programmes. There is real scepticism about the rigour of 'performance pay'. Some see it as simply a transfer of wealth from shareholders to executives and the news media are only too keen to pick up on these exchanges.

In this article, performance pay means all forms of performance-based remuneration, and includes discretionary bonus plans, short and long-term cash incentive plans and equity-based plans.

## **Current trends in performance pay**

There continues to be much discussion about the need to increase the proportion of variable pay within the total remuneration package, especially for executives. However, there remains considerable variance in both the amounts and the designs of variable pay. At least part of this variability reflects the different strategic needs of companies and is expected to remain.

A study by Hewitt Associates in 2002 showed that most larger New Zealand companies had some form of incentive plan—only six out of 47 companies surveyed for that study didn't have an executive incentive plan. Of the 41 companies with an incentive plan, virtually all had a short-term (i.e. 12 month) plan, with a number also having an equity-based plan, typically an option plan, or a cash-based long-term incentive plan.

Of the companies in the NZSE50, over half have an executive option plan. Several of these companies have established an option plan or modified an existing plan in the last 12 months.

So why value performance pay? A clear understanding of the objectives and the details of performance pay is helpful in:

- the development of incentive plans;
- pitching the level of reward under the incentive plan at the desired level (eg, at \$30,000 or at 30 percent of the employee's base remuneration);

- informing employees of the value of their remuneration package; and
- costing remuneration for financial purposes.

Valuing performance pay assists with each of these. In particular, the information and considerations required to value performance pay often help in the design or modification of the plan and in explaining performance pay to employees.

The purpose of the valuation will influence the way the valuation is undertaken, and in particular the level of sophistication required or justified. It can also result in different values, eg, the cost to the company may well be different to the value to the employee.

## **Effective performance pay**

For performance pay to work, it needs strong alignment between the interests of employees and the owners (ie, shareholders). Of course, this is well known and has become something of a mantra.

Achieving alignment is diffi-

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cult. However, it is not enough. Employees also need to:

- understand what they must do to deliver good performance; and
- want to make the effort.

This is illustrated in the diagram below.

Employees will typically assess the value of their performance pay by reference to both:

- the amounts available; and
- the certainty of payment.

Certainty depends on the perceived 'line-of-sight' between the actions of each employee and the achieved performance, ie, how much influence each employee believes he or she has over achieved performance. Of course, it also depends on how achievable the performance targets are.

If line-of-sight is weak, employees can treat performance pay as a lottery and will not alter behaviours if they don't see a strong link to the payment. This can happen with share based plans.

The value to shareholders depends on the extent of alignment of performance pay with the interests of shareholders. If this alignment is strong, and employees understand what they have to do to deliver performance, shareholders will see value in performance pay.

Of course, shareholders often don't have a clear understanding of performance pay. Increased disclosure requirements are changing this, but only in relation to executive remuneration and then often only equity-based remuneration.

Shareholders can see executive incentives, and in particular executive options, as simply the transfer of wealth from them to executives. Often it can appear that performance payments are made irrespective of the per-

formance of the company. In particular, executives forced from a struggling company can trigger the payment of substantial performance pay amounts.

### Accounting for performance pay

The financial cost to the company is different from its value. This cost is the dollar cost relating to employee services. This is relatively simple for performance pay where the payment is made in or shortly after the accounting period.

However, for long-term performance pay, where performance is measured over three years or longer, the cost has to be estimated. Practice in accounting for these has varied, with executive options often not being shown as a cost at all.

There is a proposed accounting standard covering share-based incentive plans (Exposure Draft 93, November 2002, issued by the Financial Reporting Standards Board of the Institute of Chartered Accountants of New Zealand). This standard requires all share-based incentive plans to be shown as a cost in the year of allocation to employees.

Of course, the cost shown for long-term performance pay may differ significantly from the eventual cost to the company. For example, options shown at a cost on allocation may be 'underwater' (ie, exercise a price greater than the market price of the share) and so never be exercised by employees.

### Valuing performance pay

There is a wide range of valuation methods from the simple (eg, what was paid last year) to complex mathematical models that are understood only by the really dedicated. The discretionary nature of bonus plans makes

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it difficult to develop a structured method for valuing them. However, the on-target reward method is used to value some bonus plans.

All valuation methods assume that the performance pay is reasonably 'well behaved', ie, can be predicted with a certain amount of confidence. This is clearly not the case for some plans.

Under any of the methods, the actual performance-based payments are likely to vary significantly from the valuation amount. This, of course, merely reflects the variable nature of performance pay.

For long-term incentives, there can be an issue in ensuring that an appropriate annualised valuation amount is provided. For example, there may not be an annual allocation of options. The approach adopted depends on the purpose for the valuation.

### Does it matter?

There will be organisations that won't have a pressing need to value their performance pay. This includes those companies that haven't adopted a total remuneration approach and so treat incentive pay in relative isolation from their other remuneration components.

We believe that is important to have a reasonably sound valuation of incentive pay for those companies:

- which want some rigor relating to the amount of

- incentive pay provided to employees, both in absolute terms and in relation to their total remuneration. (Care is required when determining such amounts from remuneration surveys to ensure that credible and relevant market data is being used);
- which require all stakeholders, including shareholders and employees, to understand the value of the remuneration packages;
- where internal relativity is important amongst groups of employees on different remuneration packages; and
- which will have to comply with the proposed accounting standards (ED93—Share-based payments).

Valuing performance pay is difficult and often subjective. There is a range of methods to undertake these valuations, and each method has its merits and its shortcomings.

There is increasing demand from shareholders and from management to implement performance pay that is both robust and clearly aligned with business objectives. This requires a clear understanding of the cost of performance pay and its value to the business.

We believe that this will lead to the adoption of more sophisticated methods for the valuation of all types of performance pay.



*Charles Macdonald is a remuneration consultant with MCA NZ Limited. He advises both local and regional companies on the development of remuneration strategy and the design of reward programmes, including incentive and employee ownership plans. He has a degree in mathematics and is an actuary.*

