



# EXECUTIVE REWARDS & PERFORMANCE EFFECTIVENESS PERSPECTIVE

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## THE ROLE OF REALIZED AND REALIZABLE PAY IN DISCLOSURE, PERFORMANCE MEASUREMENT, AND COMPENSATION PLANNING

Communicating the alignment between executive pay and company performance is an important objective of the proxy statement, but the US Securities and Exchange Commission's (SEC's) mandated tabular disclosures are not well structured to achieve this goal. This is particularly true of the Summary Compensation Table (SCT). The SCT's apples-and-oranges amalgamation of grant-date equity values and cash payout values fails to provide a true picture of either compensation that has been granted or compensation that has been earned in any given year. Particularly, the hypothetical grant-date valuation for equity is an inadequate substitute for actual outcomes when considering pay and performance alignment.

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### IN THIS ISSUE, ANSWERS TO:

*Why are companies disclosing realized/realizable pay in their proxy statements?*

*How do proxy advisors use and define realizable pay?*

*How might the SEC use realizable pay in Dodd-Frank pay-for-performance rules?*

*What should companies consider in developing robust definitions of their own?*

*How can realized/realizable pay be used in performance measurement and compensation planning?*

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To provide a better comparison of pay and performance, an increasing number of companies disclose realized or realizable pay in the Compensation Discussion and Analysis (CD&A) section of their proxy statements. In these analyses, performance-oriented pay elements are arrayed on a more consistent basis than in the SCT, since they typically use actual market values, rather than hypothetical grant-date valuations, and measure long-term compensation over a uniform period of time. Consequently, realized and realizable pay algorithms permit a company to demonstrate how the compensation executives actually receive varies with the company’s performance. Although companies primarily use realized or realizable pay to demonstrate alignment with performance in the CD&A, they can gain enhanced insight from using the same concepts not only for disclosure but also to make pay decisions.

This *Perspective* presents the concepts of realized and realizable pay as companies typically use them in practice, explains how proxy advisory firms use and define them, and also provides guidance on how companies can create their own customized definitions to clarify the pay/performance relationship. In addition, it discusses potential SEC pay-for-performance rulemaking, which may incorporate a realized/realizable pay approach. Also included are examples of how to use the realized and realizable pay concepts in performance measurement and compensation planning.

## REALIZED AND REALIZABLE: WHAT’S THE DIFFERENCE?



There are no standard definitions of realized and realizable pay. Companies define the terms to reflect the moving parts in their specific compensation programs, and consequently it is not surprising that definitions vary most with respect to their treatment of long-term incentives.

**Realized pay** is compensation *received* during a stated period, regardless of when it was granted. Its components are fairly consistent and typically include cumulative salary, the actual payout value of cash incentives, gain at exercise for options/stock appreciation rights, and value at vesting date for stock awards. Despite the simplicity in stating the pay components, complexities arise in considering the timing. A realized pay calculation for 2013 may include salary for 2013, annual bonus paid in 2013 (although earned in 2012), the value of time- or performance-based restricted stock or stock units vesting in 2013 (which may represent value accumulated over a three-, four-, or five-year period depending on the grant date and vesting schedule and which may vary significantly year over year if the vesting tranches are not identical), and stock options that are exercised in 2013 but

may have been granted as far back as 2003 (or even previously, in some cases). The long-term components represent a measurement challenge when comparing executives' pay to the pay of their peers at other companies, because the timing of option exercise is at the individual's discretion and stock-based awards have a range of vesting periods or performance criteria.

**Realizable pay** reflects the impact of company performance (stock price and other performance metrics) on potential pay values. It is typically the actual or potential value of compensation *granted* during a stated period, regardless of when value is realized. It is often presented as cumulative pay over three or five years, with equity awards typically evaluated as of the most recent fiscal year-end stock price. In addition to the issues discussed for realized pay, realizable pay definitions further vary, with the most significant differences being the treatment of performance-based long-term incentives and the treatment of options that have not been exercised. For example, incomplete performance cycles may be measured assuming target or actual performance to date and options may or may not include the option value of the remaining term.

Generally speaking, calculations for realized and realizable pay draw on data that are provided elsewhere in the proxy statement or can be derived using publicly available sources. In that respect, realized/realizable pay presents old information in a new way, but this new presentation may shed light on how past compensation decisions play out over time — a useful counterweight to traditional grant-date perspectives.

“PROXY ADVISORS ...  
MAY CONSIDER  
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ANALYZING EXECUTIVE  
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RECOMMENDATIONS ON  
SAY-ON-PAY PROPOSALS.”

## PROXY ADVISORS' POLICIES: DEFINITIONS OF REALIZABLE PAY



Proxy advisors, such as Institutional Shareholder Services (ISS) and Glass Lewis & Co., may consider realizable pay in analyzing executive pay for purposes of determining vote recommendations on say-on-pay proposals.

Beginning with annual meetings held on or after February 1, 2014, ISS will include realizable pay in its research reports for S&P 1500 companies (currently ISS does this only for S&P 500 companies). ISS also will continue its policy of comparing realizable pay to grant pay as part of its qualitative pay-for-performance analysis. This is one of several qualitative factors that ISS may consider if the quantitative pay-for-performance tests demonstrate “significant unsatisfactory long-term pay-for-performance alignment” among Russell 3000 companies (and may be applied as well to non-Russell 3000 companies if “misaligned pay and performance are otherwise suggested”).

Both proxy advisors measure realizable pay over a three-year measurement period. The ISS and Glass Lewis definitions differ in their treatment of equity-based long-term incentives as follows:

Compensation element	ISS	Glass Lewis
Share-based awards	Value (based on stock price as of the end of the measurement period) of awards made during the period (less any shares/units forfeited due to failure to meet performance criteria)  If awards remain ongoing, the target level of such awards	Value based on stock price at end of the measurement period
Options	Net value realized with respect to granted options that were exercised during the period  For options granted but not exercised during the measurement period, Black-Scholes value as of the end of the measurement period	Value based on intrinsic value at the end of the measurement period

“IF THE SEC’S FINAL PAY-FOR-PERFORMANCE RULE INCLUDES A HARD-AND-FAST DEFINITION OF REALIZABLE PAY, COMPANIES WILL HAVE TO DECIDE WHETHER THEY WILL ABANDON THEIR HOME-GROWN CALCULATION OR PRESENT IT IN ADDITION TO THE SEC’S MANDATED APPROACH.”

## THE SEC ‘WILD CARD’: DEFINITION OF REALIZABLE PAY



Dodd-Frank requires proxy statements to discuss the relationship between “compensation actually paid” to executives and corporate financial performance. The statute does not define “compensation actually paid,” leaving the SEC some interpretive leeway in drafting implementing rules, which the SEC plans to propose by October 2014. The growing corpus of disclosures that voluntarily include realized and realizable pay may help influence the SEC’s rulemaking by highlighting the usefulness of the disclosures to shareholders and helping to define the terms through common usage.

Some shareholders have welcomed the additional insight provided by realized and realizable pay analyses, with the California State Teacher’s Retirement System noting that “... in the future, [we hope] we will see more companies include additional tables which describe pay that was actually realized by the executives in an effort to demonstrate a better alignment.” Discussions of realized/realizable pay also may help satisfy the current SEC requirement that the CD&A address how “amounts realizable from prior compensation” influenced pay decisions for the current fiscal year, if material.

If the SEC’s final pay-for-performance rule includes a hard-and-fast definition of realizable pay, companies will have to decide whether they will abandon their home-grown calculation or present it in addition to the SEC’s mandated approach. This supplementary disclosure would be most useful if the SEC definition fails to reflect a crucial aspect of the company’s pay-for-performance relationship.

## DEVELOPING ROBUST REALIZED/REALIZABLE PAY ALGORITHMS



There are advantages and disadvantages to realized and realizable pay approaches. Realized pay has the advantage of simplicity. Subjective judgment is generally not needed to compute cash received, options exercised, and shares vested. However, it may ignore a sizeable portion of accumulated compensation that has been awarded but not yet paid. The utility of realized pay for cross-company comparisons also is limited since it is influenced by individual decisions (such as the timing of option exercises) and variable vesting periods. But it provides a fairly reasonable approximation of an executive's taxable income for a given year (in the absence of deferrals, at least). Averaging several years of these data might mitigate volatility due to exercise timing decisions and provide a more stable basis for peer comparisons (though this approach is not the only or even the best solution in all cases).

Realizable pay can be harder to define than realized pay and using different assumptions may result in different outcomes, such as the number of years of compensation to include and whether to use intrinsic value or a "fair value" model for stock options. In any event, all pay is measured cumulatively from the beginning of the observation period to a consistent end point (typically the most recent fiscal year end). Ideally, the number of years should correspond to a complete business cycle. Assumptions about typical vesting cycles or exercise behavior should be based on the company's own plans and experience. When making comparisons to other companies, identical assumptions should be used.

**"REALIZABLE PAY CAN BE HARDER TO DEFINE THAN REALIZED PAY AND USING DIFFERENT ASSUMPTIONS MAY RESULT IN DIFFERENT OUTCOMES ..."**

### ISSUES TO CONSIDER IN DEVELOPING A REALIZED/REALIZABLE PAY ANALYSIS

- What is the purpose of the analysis — to measure compensation *actually earned* in a given year or range of years or to measure compensation that can be *potentially earned* over a period of time?
- What elements of pay should be included?
- Over what length of time should pay be measured?
- How should incomplete performance cycles be treated?
- Do the company's own definitions of realized/realizable pay differ materially from those applied by proxy advisors (or potentially mandated by the SEC)?
- How will the realized/realizable pay perspective supplement the company's other compensation planning and monitoring tools?

“IN SIZING FUTURE INCENTIVE GRANTS, COMPANIES SHOULD MODEL HYPOTHETICAL REALIZABLE PAY OUTCOMES BASED ON A RANGE OF POTENTIAL STOCK PRICES AND NON-STOCK-BASED PERFORMANCE RESULTS.”

In addition to determining the method of calculating realized or realizable pay, companies should consider how to analyze and use realized and realizable pay data. For example, it may be useful to compare realized or realizable pay to the targeted grant date value of pay. When used to compare against peers, a consistent definition of realized or realizable pay should be applied, along with a consistent performance benchmark. For example, should performance be measured by total shareholder return (TSR) — and if so, should the metric be relative or absolute TSR? Should an additional financial or strategic measure be used?

## BEYOND DISCLOSURE



The concepts of realized and realizable pay are not new and have been applied in a variety of situations beyond proxy disclosure. For example, historical pay analysis is used when considering the potential impact of a change in control or other event. Recently, however, the terms have been applied to clarify the pay-for-performance relationship in the proxy statement. But these disclosures offer only a rear-view perspective. Realizable pay concepts, in particular, can be used internally for pay planning and monitoring purposes as well as for proxy disclosure. These analyses offer enhanced insight into the impact of pay decisions down the road under a variety of performance scenarios.

Specifically, realizable pay could be modeled to ensure that an executive’s hypothetical payout is reasonable given stock price performance, cash flow, revenue growth, or other key criteria. These metrics, which reflect the overall health of the company, should be considered regardless of whether they are used for determining specific incentive payouts.

In sizing future incentive grants, companies should model hypothetical realizable pay outcomes based on a range of potential stock prices and non-stock-based performance results. This analysis will help refine the incentive mix of cash and equity, including options, units, and whole-share awards. It also may help determine the most efficient contractual term for options or the most appropriate vesting periods for restricted shares.

**Example:** A company's strategic goal is to effectuate a sale of the company at the end of five years. It believes the optimal way to maximize the company's value is to increase revenue and market share for three to four years and then maximize profitability in the final year. A realizable pay analysis may help demonstrate that a long-term incentive program with three-year vesting on full value shares and a 10-year term on options will not align with the strategic goals.

**Example:** After a five-year retrenchment, an industry is poised to rebound in 2014. The compensation committee of a company considering a special off-cycle incentive for its CEO conducts a realizable pay analysis of the years 2009 to 2013 to calibrate the size and structure of the award. It determines that, if the company's stock price climbs 10%, then 60% of the options granted to the CEO in the preceding five-year period will still be underwater (30% if the stock price rises 15%). From a competitive perspective, if the shares of each industry peer in 2014 increase by 10% (or 15%) as well, the CEO's aggregate five-year realizable pay will be at the 35th percentile (or 65th percentile) of peer companies. This insight helps calibrate both the size and the mix of the 2014 off-cycle award — size in order to align total realized pay at the median and mix to stabilize the leverage of the 2014 reward opportunity.

## MERCER'S PERSPECTIVE



Companies should consider performing a realized/realizable pay analysis, regardless of whether they intend to present the results in the proxy statement or whether the SEC adopts a realizable pay approach

to the Dodd-Frank mandate. Ultimately, the purpose of these analyses is to effectively and clearly understand the company's pay-for-performance story — an objective best served by taking an inventory of each compensation plan, identifying the most relevant performance levers, and illustrating how the actual outcomes track over time.

The one-size-fits-all algorithms used by the proxy advisors, or potentially the SEC, are unlikely to satisfy this objective. Given the variety and complexity of pay programs, even if the SEC rule uses a realizable pay approach, it may not eliminate the need for companies to develop their own definitions. Accordingly, companies should consider disclosing their own realized/realizable pay analysis — much as some companies have provided an “official” SCT and an alternate version in their CD&A.

“COMPANIES SHOULD CONSIDER PERFORMING A REALIZED/REALIZABLE PAY ANALYSIS, REGARDLESS OF WHETHER THEY INTEND TO PRESENT THE RESULTS IN THE PROXY STATEMENT OR WHETHER THE SEC ADOPTS A REALIZABLE PAY APPROACH TO THE DODD-FRANK MANDATE.”

Because the proxy advisors may consider, and eventually SEC rules may require, a realizable pay analysis, companies should evaluate their pay plans taking into account the proxy advisors' and potential SEC definitions. These yardsticks — not a company's customized algorithm — will be used to measure the effectiveness of a company's pay-for-performance programs relative to peers. But companies should not overlook a golden opportunity to tell their pay-for-performance story using definitions and criteria that most closely align with the intent and mechanics of their own plans, and to use that insight on an ongoing basis not only for disclosure but for planning and monitoring as well.

#### Additional resources

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