Realisable pay

What is realisable pay and why is it different?

Dr Mark Bussin and Elmin Smit

In recent years, shareholders, the media and RemCo alike have increasingly focused on the relationship between executive pay and performance. The metric that these groups most often use to calculate performance, total shareholder return, is relatively uncontroversial. Yet, how to calculate the pay component is not as simple. This article is based on recent discussions and articles by Equilar.

Recently an increasing number of organisations have supplemented their remuneration disclosures with reports of “realised” pay and/or “realisable” pay, which, some argue, provide a more accurate depiction of the relationship between pay and performance. In this article, we look at realisable pay, realised pay and target pay.

The wide range of complexity and variability found in market long-term incentive plan objectives and designs should be expected to improve analytical precision. Businesses provide different long-term incentive mixes, including share schemes, time-vested limited shares, performance equity and/or long-term incentive cash, with different funding timing schedules and performance periods. Performance-based equity plans are the most challenging as pay-outs may not be known until a later date. However, relatively simple adjustments to the realisable pay analysis, such as using performance adjusted target pay-outs, varying weighting of different performance cycles or referencing the target level of pay out for incomplete performance cycles can help keep the results comparable.

In the US, the Summary Compensation Table (SCT) is the cornerstone of the Securities and Exchange Commission’s (SEC) required disclosure which defines the most general pay disclosure used in the SCT.

Target Pay

Target Pay is a calculation of the envisioned level of pay that an executive can realise at the targeted or desired level of organisation performance. Target Pay is almost the same as SCT in that it values fairness at the award date the performance-based awards included are dependent on the same period being analysed.

Components of realisable pay and target pay by Equilar 2013 report:

- Realisable pay is intended to capture the value of incentive compensation granted during the period for which pay is being measured, even if the compensation has not yet been realised by an executive. Share schemes granted during the period are included in realisable pay based on their intrinsic value as of the end of the period, regardless of whether or not they have been exercised.

- Likewise, restricted share and restricted share units are included based on their value as of the end of the period, regardless of conferring.

With respect to performance awards, if the performance period both begins and ends within the relevant period, the actual payout is included in realisable pay. If the performance period begins in, but does not end prior to the end of, the period for which pay is being measured, realisable pay will include the fair market value of performance shares and the target value of performance cash awards. As year-end values and target values are used when calculating realisable pay even though these amounts may never be earned by an executive, realisable pay has flaws similar to SCT pay.

The advantage of realisable pay is that it shows the alignment between the total value of outstanding executive remuneration awards and share price at a point in time. However, realisable pay also has its limitations:

- Realisable pay is a point in time measure and may significantly differ from the actual pay received and thereby understate or overstate the pay for performance relationship.

- There is no one defined or accepted approach to defining realisable pay, and there may be difficulties in comparing companies because of the different ways that companies define and calculate realisable pay; and

- Further, because realisable pay is still a hypothetical measure of pay, it recognisably does not measure actual pay outcomes and does not take into account potential events – for example, the penalty of remuneration that could occur due to failure to attain certain performance goals. Still, of the various methods of defining “pay” for pay-performance alignment purposes, realisable pay appears to hold the most promise for study and use by companies.

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Summary Compensation Table (SCT) Pay

The SEC rules entail standardised remuneration disclosure which defines the most general pay definitions used in the SCT.

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Components of realisable pay and target pay by Equilar 2013 report:

<table>
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<tr>
<th>Remuneration components</th>
<th>Realisable Pay</th>
<th>Target Pay</th>
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<tr>
<td>Base Salary</td>
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<td>Discretionary bonus and actual bonus payout values from SCT.</td>
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<td>Intrinsic value of awards granted during the measurement period, valued at fiscal year end</td>
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<td>Time Vested Options &amp; SARs</td>
<td>Intrinsic value of awards granted during the measurement period, valued at the end of the period</td>
<td>Original target amount of awards that were set to be earned during the measurement period, valued at the grant date</td>
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<tr>
<td>Performance Equity</td>
<td>Actual payout for awards with performance periods ending within the measurement period, valued at the end of the period</td>
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<tr>
<td>Performance Cash</td>
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<tr>
<td>All other Remuneration</td>
<td>Summary of Compensation Table (SCT) value</td>
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Realised Pay

An important difference between realisable pay and realised pay is that the former includes the intrinsic values of equity awards outstanding as of the end of the relevant period, whether or not they are exercised or paid or vested. This inclusion eliminates the unstable impact on pay of the timing of share options and the payment of other equity awards, which may be deferred at the election of the executive. Further, the realisable pay analysis looks at the value of such awards based on company performance over an extended time period.

Realisable Pay trends

Since realisable pay is affected by the achievement of performance metrics relating to performance awards, and by share price gratitude or decrease, significant changes to CEO pay can be expected each year.

Once the realisable pay analysis is completed, Directors should review the relative positioning among a peer group of comparator companies and consider whether it reflects performance, pay opportunity or other factors. Comparing realisable pay to total shareholder return illuminates whether the realised pay result is directly related to company performance. Including additional performance metrics may provide a more reasonable explanation of the pay and performance relationship.

Conclusion

Realisable pay takes a snapshot of the value of the remuneration an executive has earned during the relevant performance period, by assuming the executive cashes out all equity earned at the end of that period.

By conducting realisable pay and performance analysis by digging into the underlying drivers or principles of these concepts can be helpful for organisations in preparation for their proxy statements. Organisations should explore these definitions to see if they would suit their executive pay models and goals, both for internally setting and measuring pay and for reporting to payers to shareholders.

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