COMPENSATION COMMITTEE PRIORITIES FOR 2023

BDO

Contents

While evolving economic, societal and business factors continue to make board oversight of talent management complicated, corporations recognize the importance of talent in driving success. As a result, many compensation committees have expanded their roles and responsibilities beyond executive and board compensation into increased human capital and social issues impacting the organization. Directors who have **prioritized** values, culture, strategy, purpose and resilience will continue to lead companies through the next iteration of challenges provided in 2023. The charge of compensation committees has become aligning the needs of corporate talent beyond simply executive compensation and performance to encompass broader business strategy and the creation of long-term value for all stakeholders. This requires directors to stay abreast of compensation trends, enhance the human capital experience and provide frequent and transparent communications and reporting.

Executive and Board Compensation Considerations

The **2022 BDO Board Pulse survey** reported that adjusting compensation packages was the top tactic to attract and retain talent, followed by reimagining flexible and remote work strategies, enhancing employee benefits, upskilling the workforce, focusing on corporate social responsibility/philanthropy and supporting employee mental health. How are companies continuing to adjust compensation to attract and retain top talent? For the C-Suite, according to the **2022 BDO 600 Compensation Study** of 600 publicly-traded, middle market companies, fiscal year 2021 CEO and CFO pay levels increased by an average of 22% and 21.3% respectively, the largest increase over the past five years. Within these compensation packages the following trends were noted:

- Annual incentives (bonus + performance based) increased the most - 38% for the CEO and 43.5% for the CFO - for an overall jump in the average award size from 121% to 169% of salary.
- Pay continues to be highly correlated with company size; with mid-size company CEOs and CFOs having the largest pay increases.
- Stock options continue to be only a small fraction of the long-term incentive (LTI) mix, as most companies regardless of size opted to give both CEOs and CFOs full value stock.
- 85% of pay for CEOs was in the form of some kind of incentive compensation with 63% being LTIs.
- 77% of pay for CFOs was in the form of some kind of incentive compensation with 54% being LTIs.

Compensation committees are tasked with designing incentives to support leadership's execution of the business strategy, and specifically align to the organization's unique goals and time horizons for achieving them. When **asked** specifically about the actions directors are taking to align executive compensation with business objectives and/or stakeholder expectations, boards have not significantly changed actions from the previous year:

67% of respondents continue to align performance goals with probability of achievement, while

36% also intend on shifting incentive compensation from a periodic bonus structure to longer-term equity grants.

Pearl Meyer found similar **results** with 60% of its survey respondents replying they do not anticipate making changes to short-term and long-term incentive designs for 2023. However, 12% of those making changes plan on adding ESG metrics within short term incentive plans. Tying specific ESG key performance indicators (KPIs) to executive compensation is becoming a best practice in larger organizations. Benchmarking against peers can help define the appropriate non-financial metrics to incorporate into executive compensation as more and more companies of all sizes seek to incentivize sustainability efforts; but execution requires an increased level of ESG maturity within the organization to be effective.

From a board perspective, we **noted** an average 7.4% increase in director compensation in fiscal year 2021 over the prior period which breaks down into a mix of 38% cash and 62% equity. The trends that seemingly have driven this include:

- Increased director time and effort during the height of COVID 19.
- Evolving director responsibilities in the face of increasing risks and geopolitical factors - e.g., cybersecurity and data privacy.
- Inflationary pressures and soaring prices for fuel, food, goods and services.
- Supply chain disruptions.
- Significant focus on social and talent issues.
- Rapidly evolving regulation and rule-making.

Even as COVID-19 is becoming less of an issue, we expect the other factors to continue well into 2023.

In our experience, companies have generally favored equity compensation over cash compensation in recent years as equity better aligns compensation with shareholder returns over a director's tenure. Additionally, many institutional and long-term shareholders expect compensation of individual directors to hold meaningful equity in the companies they serve and seek transparency in the company's approach since directors set their own compensation.

With respect to committee pay, we are seeing companies re-evaluate committee workload when analyzing the compensation packages for committee service. In prior years, it was very typical for the audit committee to have the highest compensation given regulatory scrutiny. In recent years, however, the workload – and associated compensation – for the compensation committee has increased the fastest given the advent of Say-on-Pay and the increased focus on human capital matters. The emphasis on how a company approaches material ESG factors has created a new wrinkle given there is no clear or standard approach to how companies are delegating these responsibilities across their board/committee structure. As companies align pay with the expected time commitment and workload for their specific situations, there is more variation across companies making it hard to pinpoint broader compensation trends.

Human Capital Oversight – A Broader Remit

As discussed in BDO's **2022 Compensation Committee Priorities**, the role of the compensation committee is expanding into human capital management (HCM) oversight. A recent Center On Executive Compensation **survey** found that almost two-thirds of member companies have formally broadened the role of the compensation committee by either expanding the charter (35%) or both the charter and the committee name (32%) – e.g., Human Capital Committee. This extends the committee's purview beyond C-Suite and board compensation into overall talent strategy including talent attraction, retention and development in an era of a vanishing workforce. Pearl Meyer's annual **survey** concurs with the expanded responsibilities, noting a 28% year over year increase in compensation committees reporting responsibility for employee engagement. Publicly traded company compensation committees in the same survey indicated oversight prevalence as follows:

79%
Board of director pay

74%
Executive succession planning

49%
Diversity and inclusion

43%
Leadership/talent development

32%
Employee engagement

30%
Culture

Pay equity is yet another ESG component being included in the broader HCM remit. But considerations extend even further.

Oversight of talent strategy requires an understanding of management's process and procedure for identifying who and what skillsets are needed and how to secure that talent for the long term. Execution of a sound talent strategy includes engagement of employees as the key stakeholders to better understand the more intrinsic workplace benefits being sought: diverse culture, inclusion, development, flexibility, advancement, transparency and trust. Cali Yost, Founder and the CEO of Flex+Strategy Group, recently **discussed** the new reality of work reminding directors that a flexibility strategy goes beyond policy and requires a framework that includes full leadership buy-in, organization-wide training, communication, experimentation and innovation.

Activities that the compensation committee is paying closer attention to include: formalized performance review cycles, employee feedback loops through pulse surveys, and human resource reports on attrition and absenteeism, just to name a few. Additionally, access to relevant whistleblower hotline trends, normally the purview of the audit committee, may be another source of important HCM information.

TYING HUMAN CAPITAL MANAGEMENT TO STRATEGY AND CORPORATE PURPOSE

Directors should be asking the following questions in their oversight of HCM. Management's responses should align people with the organization's purpose and ensure talent is being utilized to support corporate strategy:

What are the company's most desired skillsets and attributes? Do these align with achieving strategic goals?

Is there a pipeline for leadership roles? Who is being developed and how were they identified? Companies are embracing formalized programs of sponsorship and challenging executives and board members to broaden sponsorship of talent to allow for more diversity and fresh perspectives.

What training is being offered and how are employees made aware of training opportunities? Is there a process for re- and up-skilling?

Who is being recruited, how and from where? What diversity traits are being considered and tracked? The expansion of remote work has allowed for the expansion of recruitment outside immediate geographic areas. Further, broadening sources (e.g., recruiting from a wider selection of colleges and universities, disciplines and industry experiences) may allow companies to engage previously untapped factions that may more quickly fill skill gaps and other objectives.

Are current employees satisfied? How are we soliciting this feedback? What actions can be taken to drive improvement?

How can directors help impact talent objectives? The board can and should be leveraged to demonstrate a tone at the top that fosters a culture where employees feel supported and rewarded. Consider inviting a director to sit on company committees related to diversity, equity and inclusion. Directors may also serve as mentors and sponsors, as appropriate. Involvement of directors helps to demonstrate the importance of initiatives, while further exhibiting the accessibility of leadership and allowing the board to hear feedback firsthand.

Communications and Reporting

Stakeholder engagement under the oversight of the compensation committee extends beyond employees to include a variety of stakeholders wishing to be informed and to inform. Feedback from stakeholders regarding social and human capital related concerns is abundant in today's environment. The compensation committee should ensure that the company is engaging stakeholders and appropriately considering their feedback in the execution of the company's talent strategy.

Directors are reminded that management's communication with stakeholders, which should include responses to their requests and priorities, should be a top concern. Amanda Shpiner, Managing Director at Gashalter & Co. LP **discusses** considerations for boards to contemplate as part of an overall communications governance strategy in the face of numerous disruptions impacting the business including management accountability, activism and a vulnerability with stakeholders. Disclosure is an opportunity to tell the company's story, and in the absence of an explanation stakeholders will likely make assumptions.

PAY VS. PERFORMANCE

Companies have a significant opportunity to communicate with stakeholders through reporting. The already robust compensation committee disclosures continue to increase with the **SEC's Adoption of Pay Versus Performance Disclosure Rules**. The **final rules** add Item 402(v) to Regulation S-K and will require issuers to disclose the relationship between executive compensation actually paid and financial performance of the issuer for fiscal years ending on or after December 16, 2022, which includes this upcoming proxy season. In the short term, this new disclosure will require compensation committees to invest resources into the nuances of the requirements including peer group selection and company selected measurements for disclosure. This information is intended to provide additional transparency and readily comparable disclosures for investors to evaluate a registrant's executive compensation policies.

SAY-ON-PAY

Say-on-Pay is a tangible example of investor evaluation of executive compensation policies. Sullivan and Cromwell **report** that although public companies continue to perform strongly in Say-on-Pay votes, with overall support levels averaging 88% among the S&P 500 and 90% among the Russell 3000, more companies failed during the 2022 proxy season compared to prior years. Qualitative factors reflected in votes against included limited, opaque or undisclosed performance goals and the use of above-target payouts. These qualifiers provide further support for increased compensation disclosure and highlight the demand for pay-for-performance assessment - the most important factor being alignment of CEO pay with relative total shareholder return.

CLAWBACKS

The SEC has also **adopted** accountability rules and amendments to implement the clawback requirements required by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. The provisions of new **Rule 10D-1** will require a an issuer, upon preparing a financial statement restatement, to recover incentive-based compensation awarded to any current or former executive officers during the three years preceding the date of the restatement. Additionally, issuers are required to disclose their clawback policies and any actions taken in response to those policies, file them as exhibits to their annual reports, and indicate whether the financial statements reflect the correction of errors and necessitated a clawback analysis by a new checkbox on their annual report.

ANTICIPATED RULE-MAKING: HUMAN CAPITAL

There is an anticipation of further SEC rulemaking regarding human capital disclosures on the horizon. SEC Chair Gensler **stated** in September 2022 remarks to the SEC's Investor Advisory Committee, *"The Commission adopted **rules** in 2020 regarding human capital, and we would benefit from the Committee's insight on the current requirements and opportunities for further enhancements."* The current rules are principles-based leaving judgment to the filer. A recent **study** analyzing first year human capital disclosures concludes that the disclosures are *"extremely heterogeneous in terms of their length, numerical intensity, tone, readability. . . tend to be very positively-toned. . . [and] are generally not numerically intensive"* which make them insufficient for investors' needs.

OTHER REPORTING CONSIDERATIONS

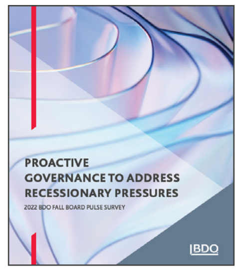
As disclosures expand, so does the necessity to ensure adequate controls, policies and procedures around the information disclosed including consistent methodology when reporting quantitative data. Tim Mohin, former CEO of the Global Reporting Initiative (GRI) and Chief Sustainability Officer of Persefoni, **notes** that as corporate responsibility shifts from reputational risk to a business imperative, there is significant pressure from investors and the regulatory community that is forcing communication within the company regarding needed changes in controls, policies and procedures to accommodate sustainability and financial disclosures fully into integrated reporting. These controls should further ensure consistency of reporting. Metrics selected should align with internal reporting to both management and the board, other external reports including company website, and industry peers. Finally, like other ESG-related disclosures, stakeholders are looking for the evolution of the disclosure to include progress toward stated goals (e.g., diversity). And finally, with increased data collection and analysis comes the risk and rewards of digital transformation. Compensation committees should collaborate with other committees and the full board to ensure data privacy and appropriate data governance.

Next Steps

We encourage compensation committees to remain up to date on evolving compensation trends and work with your advisors on continuing education plans. For your convenience, here is a recent listing of resources that may be of interest to you from the BDO Center for Corporate Governance:

Board Compensation Trends and Year-End Planning Considerations

The BDO 600 2022 Compensation Studies



2022 BDO Fall Board Pulse Survey

Does Your Board Comprehend the New Reality of Work?

Communications as a Governance Strategy

Today's Compensation Committee: Impacts, Trends and Informed Decision-Making

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