BDO

Introduction

In an effort to establish more transparency in pay, the Securities and Exchange Commission (SEC) adopted new **pay versus performance disclosure requirements in 2022**, which require companies to show how their executive pay programs tie to the company's financial performance. These requirements are effective for fiscal years ending on or after December 16, 2022, and require a prescriptive disclosure of the relationship between executive compensation actually paid (CAP) in a new table, along with additional information related to both financial and nonfinancial performance metrics. These new disclosure rules represent one of the most comprehensive and complex changes to public company reporting requirements in recent years.

To evaluate the approaches companies are taking to meet these new requirements, BDO analyzed proxy statement disclosures from the companies included in the ***BDO 600 2023 Study of CEO and CFO Compensation***. The purpose of our analysis was to identify themes in how companies are approaching the disclosure requirements based on the perceived link between pay and performance for middle market companies. We also wanted to determine if there were any trends associated with industry affiliation, which could then be used to guide the approach to the same set of disclosures in the 2024 proxy season.

INDUSTRY	TOTAL ORGANIZATIONS	REVENUE/ASSETS AVERAGE	REVENUE/ASSETS MEDIAN
Retail	66	$1,201	$811
Real Estate	66	$1,080	$953
Technology	62	$1,180	$1,006
Manufacturing	50	$1,519	$1,275
Energy	65	$1,515	$1,261
Healthcare	69	$1,204	$999
Financial Services–Nonbanking	56	$2,736	$2,477
Financial Services–Banking	63	$3,088	$2,739
Total	**497**		

USD $MM; Financial services company size based on assets; all other industries based on revenue.

The BDO 600 pay versus performance analysis summarized the trends based on five different reporting criteria for approximately 497 of the 600 companies:[1, 2]

- Total compensation in the summary compensation table (SCT) vs. compensation actually paid (CAP)
- Total shareholder return (TSR) peer group
- Company-selected measure (CSM)
- Tabular list of metrics
- Disclosure style and placement

1 Emerging growth companies are exempt from compliance with the pay versus performance rules and therefore have been excluded from this analysis.

2 Small reporting companies (SRCs) omit certain disclosures; therefore, although included in this study, their responses were not disclosed for all categories.

Trends in Pay Versus Performance Reporting Requirements

SCT VS. CAP

At a high level, CAP adjusts total compensation in the SCT for equity awards and pension benefits. When analyzing the relationship between CAP values and the SCT, we found that CAP values varied widely across industries for both the CEO and average non-CEO named executive officer (NEO), but generally trended below the SCT values for seven out of the eight industries. The exception to this rule was the energy industry, in which the average CAP value was approximately 1.5x above the average SCT value for both the CEO and non-CEO NEOs.

FIGURE 1: SCT vs. CAP: CEO

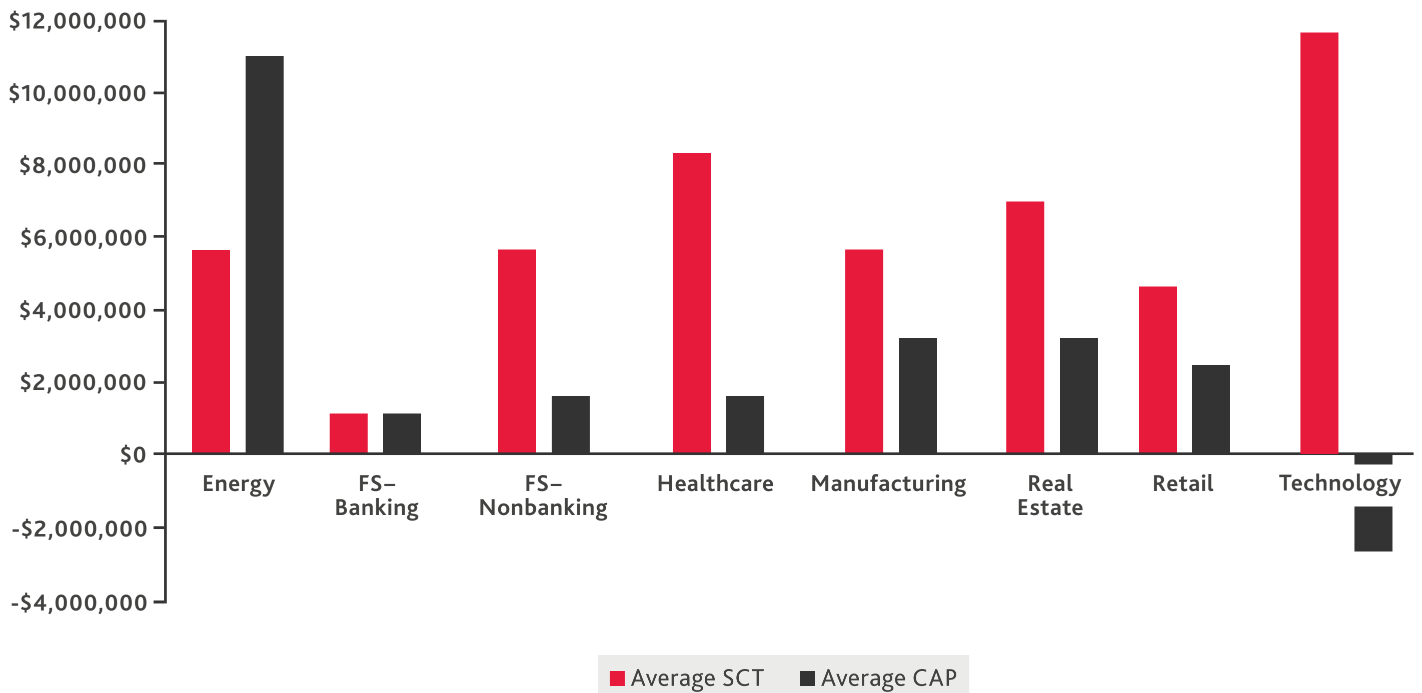
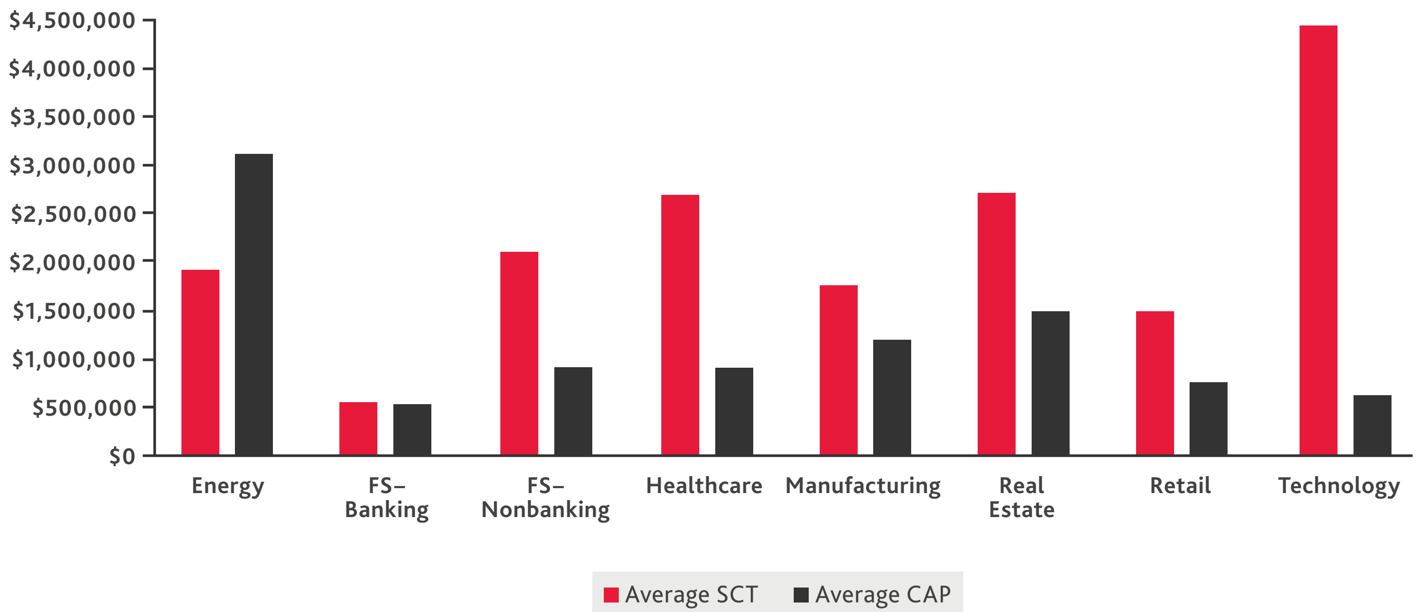


FIGURE 2: SCT VS. CAP: NON-CEO NEOs



In addition, negative CAP values for individual companies were present in all industries except financial services–banking and appeared to be most common among CEOs in the technology industry, as illustrated in figure one.

TSR PEER GROUP

We found more consistency across industries when analyzing the approach to selecting a peer group for TSR comparisons.[3] In general, companies can select from industry-specific, line-of-business indexes, or they can use their compensation peer group. Our analysis indicated that approximately 80% of all companies used an industry-specific or line-of-business index as opposed to their compensation peer group. Within this category, approximately 70% of companies chose an industry-specific benchmark, although this fluctuated based on industry affiliation. The industries most likely to use a compensation peer group were energy and financial services–banking, in which 14% to 15% of companies selected this alternative.

3 SRCs are not required to provide peer group TSR.

COMPANY-SELECTED MEASURE

The CSM is meant to be the most important financial measure linking CAP to company performance, aside from TSR and net income, which are required disclosures in the CAP table. Our analysis indicated that of the companies disclosing this metric, profitability/income,[4] earnings per share, and total revenue were the most common CSMs.[5] A notable — though not surprising — departure from this trend was found in the real estate industry, which emphasized funds from operations per share.

In addition to the type of CSM, we also analyzed the prevalence of GAAP vs. non-GAAP measures and found non-GAAP metrics to be far more common. In fact, all companies in the energy industry used a non-GAAP measure, with over 90% of those in retail and real estate following suit. Healthcare was the industry most likely to use a GAAP measure, at approximately 33% of participants.

TABULAR LIST OF METRICS

Companies (other than SRCs) are also required to disclose at least three[6] and up to seven of the most important performance measures used in setting NEO compensation in the most recently completed fiscal year. The CSM must be selected from this list and the "most important" determination should be made considering only the most recently completed fiscal year. At least three of these must be financial performance measures, but the remaining may be nonfinancial metrics. Our analysis indicated that the vast majority of companies disclosed three financial metrics, which is the minimum number required, and this proved true across all eight industries. The most common number of non-ranked financial metrics disclosed was also three, found in seven out of the eight industries, with real estate being the exception to the rule with four. The company with the largest number of non-ranked financial metrics was found in the retail industry, with 10.

Although the use of nonfinancial metrics is allowed once three financial performance metrics are included, only 20% of companies, regardless of industry, chose to incorporate those metrics in their disclosures. Of those that chose to disclose a nonfinancial metric, 66% included only one. This may be due to the challenges associated with accurately measuring qualitative performance, but it also indicates that the presence of environmental, social, and governance (ESG) metrics remains noticeably absent for middle market companies.

DISCLOSURE STYLE AND PLACEMENT

The SEC guidelines allow for a substantial amount of discretion and judgment when it comes to both the style and placement of the disclosures within the proxy statement. The style of the disclosures can be broadly described as falling into one of three categories:

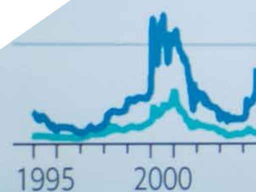
- Graphical only
- Narrative only
- A combination of both

In our analysis, only 4% of companies chose a narrative disclosure, while the vast majority of companies included a graphical representation. The heavy emphasis on graphical representation may be due to uncertainty as to what would constitute an adequate level of narrative prose.

Similarly, when it comes to the placement of the pay versus performance analysis, there were also three broad categories to choose from:

- Within the Compensation Discussion and Analysis
- Near the SCT
- Aligned With the CEO Pay Ratio

Although proxy statements are not required to be organized in the same way, the vast majority of companies (approximately 80%) chose to place this new disclosure near the CEO pay ratio disclosure.



4 EBITDA, EBIT, operating income.

5 This disclosure can be omitted if the company did not use any financial performance measures when setting compensation or if the company only used performance metrics already found in the CAP table. Note: SRCs are not required to disclose a CSM.

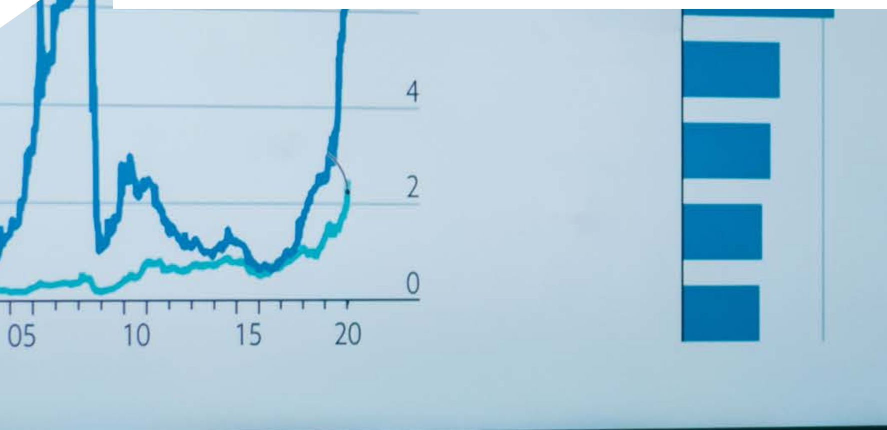
6 There are a handful of exceptions to this requirement related to the long-term incentive plan vehicles used.

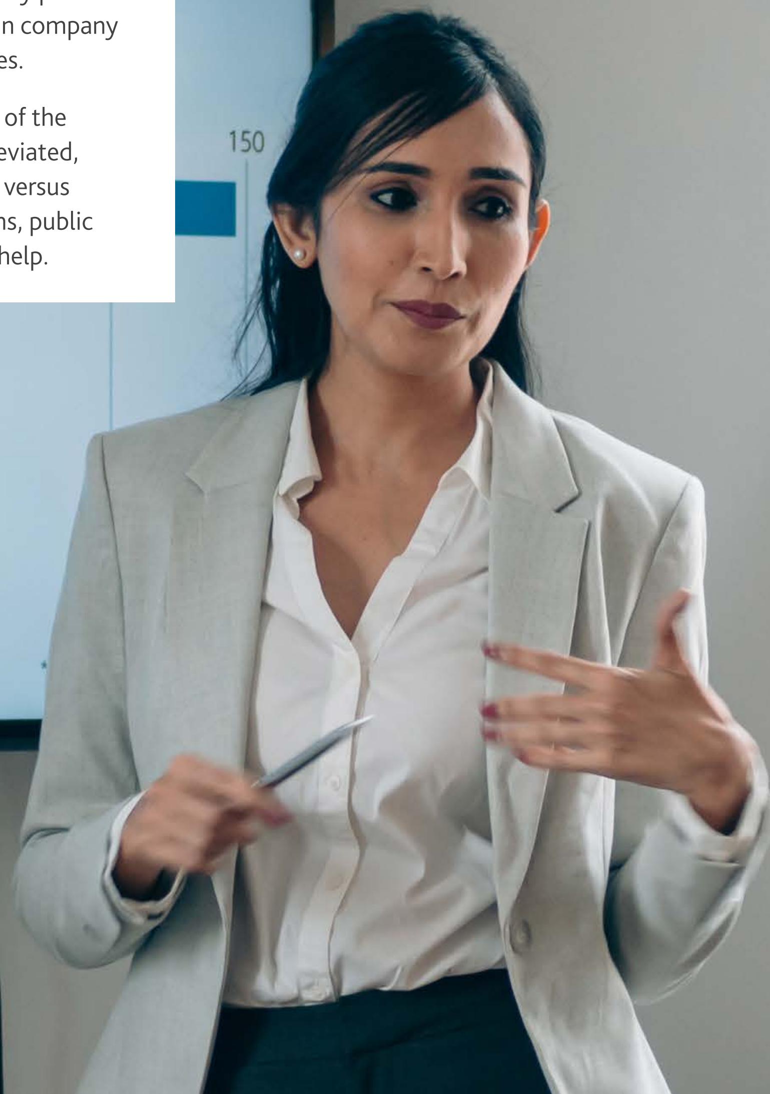
Key Takeaways and Recommendations for the 2024 Proxy Season

It is hard to say if the pay versus performance disclosures met the SEC's intended goals. At this point, we are not aware of any companies that are making drastic changes to the structure of their executive compensation packages as a result of the new disclosure requirements, although it does seem to have brought heightened awareness to the selection of performance metrics associated with long-term incentives.

The heightened awareness related to long-term incentives is likely a response to some of the significant limitations of these disclosures, as they are heavily skewed toward measuring the impact of equity holdings for the NEOs as opposed to holistically evaluating the executive compensation package in its entirety. This is further exacerbated during periods of high economic volatility and political uncertainly, which impact market conditions that are largely outside the NEOs' control. As a result, the pay versus performance disclosures may prove most beneficial when attempting to clarify perceived discrepancies in company performance and the SCT on an annual basis for individual companies.

Fortunately, as we move into year two of the new disclosures, some of the challenges related to how to perform the calculations have been alleviated, allowing companies to focus on how to tell the broader story of pay versus performance. If your company is looking to revisit incentive programs, public disclosure, or broader human capital management issues, BDO can help.





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