

## Executive Bonus Plans

# Recent Trends in Equity Compensation

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Possibly the most effective tool for driving change is renewed shareholder demand for an adequate return on a company's executive compensation investment. These changes have forced compensation professionals and the boards of directors to turn a more critical eye to the value and method of delivering executive compensation packages—specifically bonus plans.

A company interested in a more responsible approach to executive compensation can start to re-establish credibility with shareholders and employees by following some current trends in evaluation of annual bonus and equity incentive plans. This article looks at trends within executive incentives in the biotech industry via recent survey results and relates how these changes can benefit other industries, as well.

### Bonus Plan Adjustments

A bonus plan's intent should be straightforward—to meet or exceed established levels of performance across two to three measures, and to present a predetermined cash payout at the end of the performance period. Traditionally, bonus plans at the executive level have one or two key financial performance measures such as revenue growth, earnings per share or profit, as well as a discretionary aspect of the bonus, usually for use by the

board for determining how individual subjective measures impacted the overall bonus payout.

Given that the planning process is annual, bonus plans provide the compensation department and the board considerable flexibility. They also offer the ability to fine tune the performance measures and the performance levels that are expected of senior management. However, it seems that all too often, bonus plans are consistently the most ignored and poorly managed component of executive compensation.

The first, and most critical, step that has routinely been ignored is ensuring that the goals set for performance measures align with the corporate

strategy. By meeting these goals and generating an annual incentive payout to executives, there is a corresponding increase in shareholder value.

Failure to achieve this basic principal of aligning executive performance goals across each measure with critical corporate success factors will negate any possible benefits of a pay-for-performance plan. Failure to create a clear distinction between what constitutes bonus-eligible success and what is considered simply meeting status quo can lead to large bonus payments for relatively poor performance compared to competitors. Recently, companies have started to question if simply keeping up with competitors annually is an acceptable level of performance to the extent that it merits an annual cash bonus.

The second key trend in bonus-plan analysis is limiting the impact of the subjective or discretionary component of the bonus plan. Nearly 20 percent of the biotech companies that paid a bonus to CEOs did so in spite of their company reporting a drop in revenue, market capitalization *and* stock price in the same year of the calculated bonus performance period, according to the 2006 Presidio Pay Advisors Executive Compensation Biotech Survey. Granted, these three measures may not be used in all bonus plans, but by most standards, a CEO who oversees an annual drop in stock price, market capitalization and revenue would likely not be considered meeting performance expectations.

### QUICK LOOK

- ➔ A company interested in a more responsible approach to executive compensation can start to re-establish credibility with shareholders and employees by following some current trends in evaluation of annual bonus and equity incentive plans.
- ➔ A bonus plan's intent should be straightforward—to meet or exceed certain levels of performance across two to three performance measures and to provide a predetermined cash payout at the end of the performance period.
- ➔ During the past three years, many companies have been slowly reducing the number of stock options that are being granted to employees in preparation for the impact of FAS 123R and associated requirements to recognize expense in the income statements.



For the biotech companies that did pay a bonus but had negative growth across these key measures, there is likely limited alignment between the measures that are used and what the stock market is rewarding. Or there is aggressive use of the discretionary component of the bonus plan. In response to shareholder demand for executive compensation accountability, boards have started to reconsider how much discretion can be used when financial performance lags by limiting the weighting that can be given to the subjective bonus-plan measures.

where the expense associated with stock options is much larger.

For example, in the biotech industry, companies with more than 1,000 employees disclosed a stunning 45-percent decrease in current fiscal-year stock-option grants during the last year, and a 58-percent decrease from two years prior. Conversely, companies with less than 150 employees granted options at a three-year high, suggesting that shareholders are more willing to forego dilution in smaller companies in an effort to conserve cash that would otherwise go toward offsetting a lower stock-option grant.

board of directors must be aware is that restricted stock maintains value regardless of what a company's stock price does over the vesting period. Therefore, it is critical for companies considering offering restricted stock to add performance criteria to the vesting of these awards to maintain a pay-for-performance environment. By not attaching performance criteria to these types of plans, the company effectively eliminates any benefit for executive talent that the reduction in dilution and competitive advantage provides.

Although the data presented focuses on the biotech industry, these trends and methods that compensation professionals and boards of directors are using to re-evaluate executive compensation are valuable to any company. Ultimately, aligning executive and corporate performance, applying consistent methodology for rewarding executive and broad-based employees, and ensuring that the company is making sound cash and equity investments in executive talent on behalf of shareholders will benefit company morale and the relationship between shareholders, executives and the board of directors. **WS**

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### Managing Dilution

Short-term performance is usually measured annually and rewarded through annual cash payments. Long-term performance is usually measured over three to five years through the use of stock options, other equity-based incentives or occasionally cash. The changes that are made to these plans can be quickly instituted, but the real benefit is not recognized until the legacy plans or incentive vehicles have time to lapse.

During the past three years, many companies have been slowly reducing the number of stock options that are being granted to employees in preparation for the impact of FAS 123R and associated requirements to recognize expense in the income statements. This has been most noticeable in companies with high employee populations,

For the larger companies, one of the most popular trends to accomplish a reduction in dilution is to issue restricted stock in place of stock options. In fact, the use of restricted stock by biotech companies jumped to 33 percent in the most recent fiscal year in a random sampling of biotech companies. Using restricted stock, if distributed properly, allows a company to provide the same intrinsic benefit to the executive, but greatly reduces the number of shares that are required to deliver this benefit. In the biotech industry, companies issuing restricted stock granted nearly 25 percent fewer options than companies not offering restricted stock to senior management.

However, one of the biggest problems with restricted stock of which compensation professionals and the

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