The Basics of Executive Pay Packages

Executive compensation differs substantially from typical pay packages for either hourly workers or salaried management and professionals in that executive pay is heavily biased toward rewards for actual results. Hence if a company underperforms, the executives typically receive a smaller fraction of their potential pay. Conversely, if a company meets its annual objectives and the stock price responds long term, the executives stand to receive a much larger payout.
This section of the site describes the typical Executive Compensation program and explains the most commonly used terms. It includes several charts, including one below that shows the share of compensation that is at risk by executives, as compared with managers and hourly employees.
The pay packages given to the senior executives of corporations often consist of six components:

- Base salary
- Performance based annual incentive (bonus)
- Performance based long term incentive
- Benefits
- Executive perquisites
- Contingent Payments

Executive pay is structured to reward company performance and align executive pay with shareholder value. As a result, unlike most other employees, a majority of executive pay is at-risk; in other words, executives may never receive it. However, if executives and the company perform well, they along with the company's shareholders stand to gain much more from superior performance.

<u>Base Salary</u>
The base salary for executive pay is normally stated as an annual salary, although it is typically paid monthly or bi-weekly, similar to other salaried staff.

The pay for the Chief Executive Officer (CEO) for S&P 500 companies ranges widely, depending on the company, the industry and the tenure of the executive. However, since 1993, federal tax law has limited to $1 million the amount of cash compensation that companies can deduct as an expense for tax calculations. Under the 1993 law there was an exception to the $1 million cap on deductibility for certain compensation that is “performance-based” as designated by the statute. The performance-based exception was repealed under the 2017 Tax Cuts and Jobs Act and now compensation for the CEO, CFO and the three other highest paid executives is capped at $1 million regardless of whether compensation is performance-based or not, with transition rules for binding contracts in effect on or before November 2, 2017. The 2017 changes also provide that once an executive is covered under the provisions of Section 162(m) he or she will be subject to the $1 million cap for all payments received for the remainder of tenure with the company and applies to payments made after termination and retirement.

Performance based annual incentive (bonus)

The purpose of the annual incentive is to compensate executives for achieving the company's short-term business strategy. Thus, it is based on achieving a number of goals specified for the company by the company's Board of Directors. The nature of these goals varies depending on the business, company strategy and other conditions. Annual objectives can include such items as:

- increasing revenue or market share
- improving profit margins
- implementing a new corporate strategy
- development of new products
- expanding to a new market, and completion of a critical project

Typically, the annual incentive is paid in cash and is expressed as a percentage of the CEOs annual salary. Most annual incentives include a two-tier structure: a "target" level, which is the executive's normal expected performance, and a "stretch" component, meaning that the company would have to obtain extraordinary results for the maximum incentive to be paid. This is done to encourage executives to achieve superior results.

Performance based long term incentive

By far the largest potential component of executive pay is the long term-incentive. The purpose of the long-term incentive is to reward executives for achievement of the company's strategic objectives that will maximize shareholder value. Typically these have been provided in the form of stock-based compensation, such as:

- stock
- stock options
- restricted stock
- performance-vested stock, options, or similar devices

The performance period for a long-term incentive typically runs between three and five years, with the executive not receiving any pay from the incentive until the end of the performance period. Long-term incentive goals vary by company but the most prevalent are focused on total return to shareholders, earnings per share and other return measures, such as return on assets. Like annual incentives, long-term incentives typically have a target and a stretch component to encourage executives to achieve superior performance.

Benefits

Benefit programs run the normal range familiar to salaried employees. They include statutory benefits such as Social Security, Medicare, Workers Compensation, and Unemployment Insurance. Executives also participate in other company benefits such as vacation, holidays, sick days, severance pay, life insurance, and medical insurance.

In addition to the benefits provided salaried employees, executives are often eligible to participate in special retirement plans. These plans, unlike those that apply to all employees, are not protected by federal tax and pension rules and are not typically secured by a trust. Instead, the amounts in these plans are at risk, and if the company is unable to pay them, such as in insolvency or bankruptcy, the executive would be at risk to lose such benefits.

These special plans include the following:

- nonqualified deferred compensation plans which allow executives to voluntarily defer salary and bonus amounts until a date certain, death or retirement (much like a non-tax-favored 401(k) plan).
- Supplemental Employee Retirement Plans (SERPs) which are meant to supplement traditional pension plans, but are at risk

Many nonqualified deferred compensation plans and SERPs are "restoration plans" designed to allow executives to save the same percentage of income as other employees may save in tax-favored plans.

Executive perquisites

Executive perquisites or "perks" constitute additional compensation for senior executives which are not available to other salaried employees. These extra benefits are normally structured to recognize the value of the executive to the company, extraordinary demands on his or her time and other unique conditions.

Some perks are structured to maximize executive work time including drivers to and from work, convenient parking, installation of home communications systems, financial planning, and even the use of company airplanes for personal travel. Others recognize the unique positions of executives, especially CEOs, by providing security both at home and when traveling. Typically, executive perks constitute a modest component of executive.

Contingent Payments

Many executives are also covered by severance which provide for payments to executives in the case of involuntary termination except in the event of termination for cause. They are often included in agreements for executives hired from outside the company to encourage him or her to leave a prior employer in case the new arrangement sours.

Change-in-Control agreements, also known as "golden parachutes," compensate executives for loss of job due to mergers or sale. They are structured to provide additional protection to executives in the event of a change-in-control thereby allowing executives to focus on sale or merger opportunities that are in the best interests of shareholders without being overly concerned as to the potential impact on their career.

Glossary of Key Executive Compensation Terms

http://www.execcomp.org/basics/basics_glossary.aspx

Black-Scholes Model
An accounting model used to value stock options based on prior average experience of options. Factors used in the model include share price volatility, risk-free interest rate, dividend yield, forfeiture rates, and a suboptimal exercise factor. The result is stated as a percentage of the current share price. By was of example, an option on a stock with a market price of $40, and a Black-Scholes factor of 35%, would be valued in financial statements at $14.

Equity -based compensation
Pay which takes the form of company stock or that varies with the stock price. Equity pay is frequently used as a long term award for executives since it aligns executive reward with an increase in shareholder value. Equity pay is also used in many startup operations which lack cash to attract executive or technical talent.

Equity compensation valuation
Financial Accounting Standards Board (FASB) Accounting Standards Codification Topic 718 (ASC 718, which supersedes Statement of Accounting Financial Accounting Standards 123R (FAS 123R)) requires evaluation of restricted stock or option grants using one of several models for estimating the fair value of the grants as of the grant date. These estimated values are charged as an expense and reported in the Summary Compensation Table of proxy statements, but do not reflect actual realized value of the equity compensation. See Black-Scholes Model or Binomial Lattice Model.

Golden parachute
Payment to senior executives awarded due to a merger or sale, usually when the executive's position is lost due to the change.

> Double Trigger
> In the change-in-control context, "double trigger" means that in order for the executive to receive the change-in-control amount, there must be a change-in-control and the executive must lose his or her job.

Perquisites or 'Perks'
Personal benefits given to executives, such as financial planning, which are in addition to standard company benefits available to salaried employees.

Restricted stock
Grants of stock that have restrictions such as vesting periods or other performance requirements before they are owned by the recipient.

Say on Pay
The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank) mandates that public companies must include in their proxy materials a separate non-binding shareholder vote to approve the compensation of the named executive officers. The vote must be held not less frequently than once every three years.

Section 162(m)
A section of the U.S. tax code, adopted in 1993, and amended in 2017, which limits corporate tax deductions for executive compensation for the CEO, CFO and each of the top three other most highly compensated executive officers to $1 million. The provision is regarded by all sides as a failure at limiting executive compensation.

Section 280G
A section of the U.S. tax code, adopted in 1988, designed to limit the size of "golden parachute" payments made to executives in the event of a change-in-control of the company. Section 280G imposes a 20 percent excise tax on parachute payments that exceed 2.99 times the average taxable cash compensation over the last five years. Despite its aims, Section 280G established 2.99 times base and bonus as the standard change-in-control amount.

Severance Pay
Payments (cash, acceleration of unvested equity and other benefits) to employees when dismissed without cause or due to a substantial reduction in duties ("for good reason"). Severance is normally seen as compensation to bridge the time until a new job can be found.

Share Ownership Guidelines
Requirements set by the Board of Directors that executives must own a minimum number of shares of stock in the company. This provision is to assure executives' and shareholders' interests are aligned.

Stock Appreciation Rights (SAR)
A type of equity-related compensation in which the recipient receives pay that represents the increase in the company's stock price over a specified period of time. Like stock options, SARs have a strike price, a vesting period and carry a certain term. For example if a 500 unit SAR is granted when the current stock price is $30, and if after a 3 years vesting period, the price has risen to $50, the SAR would pay the $20 increase times the number of units or a total of $10,000. The payment could be either in cash or stock.

Stock Options
A stock option gives the holder the right to purchase a fixed number of shares of company stock at a set price for a set period of time, usually 10 years. The price at which the options may be "exercised" is usually the price of the company's stock on the date the options are granted. If the company performs well, the stock price will increase over the exercise price, giving the options value and rewarding the executive for his role in the company's success. Typically, such options may not be exercised for a period of time, usually between one and five years, before they "vest," or can be exercised.

Exercise (or Strike) Price
The price at which an option allows the holder to purchase a share of stock. The strike price is normally the market price on the date that the option is granted. Premium priced options set a strike price above the market price on the grant date.

Summary Compensation Table (SCT)
A required table in the company's annual proxy statement setting forth pay for the CEO, principal financial officer and the top three other most highly paid executives of publicly traded companies.

Vesting Requirement
The amount of time or the level of performance required before an individual has an unconditional right to exercise a stock option or SAR or sell restricted stock. Vesting can be "time based", such as three years, or "performance based" in which some other objective must be met before the benefit is vested. Time vesting can be "graded" such as having 25 percent of granted stock options vest per year for 4 years or 'cliff' vesting when 100% is vested after a period of time.