ALERT

March 14, 2023

OBSERVATIONS FROM INITIAL PAY VERSUS PERFORMANCE DISCLOSURES

2023 proxy statements that include the new SEC Pay Versus Performance (PVP) requirements are beginning to be filed. FW Cook reviewed the first 75 public companies' proxy statements that were filed, excluding smaller reporting companies, and key findings include:

- The most common financial performance measures that companies chose as their Company Selected Measure (CSM) were earnings per share (EPS) (32%), revenue (13%), return on equity (ROE) (12%), and operating income (11%). All but one company used a financial performance measure that was used in their annual or long-term incentive plan
- Sixty-eight percent (68%) of companies used a non-GAAP financial performance measure as their CSM
- Most companies (76%) used their 10-K published industry or line-of-business index as their total shareholder return (TSR) peer group
- Despite three financial performance measures being the minimum requirement, most companies included additional financial performance measures, with five measures (31%) being the most prevalent
- Most companies (85%) used graphs/charts as the clear description requirement, and the remaining 15% used a narrative only description

Background

Last August, the SEC released the long-awaited final rule implementing the requirement in the Dodd-Frank Act that proxy statements contain a "clear description" of "information that shows the relationship between executive compensation actually paid and the financial performance of the issuer, taking into account any change in the value of the stock."

- The foundation of the disclosure is a PVP table (PVP Table) that includes a new measure of compensation called "compensation actually paid" (CAP). CAP is based on the Summary Compensation Table (SCT) total compensation value, adjusted to (1) reflect the change in fair market value of equity awards, and (2) the cost of pension benefits attributable to service during the year (as opposed to the overall change in the present value of an executive's pension benefits).

- The PVP Table requires presentation of four financial performance measures:
  - Company TSR
  - Peer group TSR
  - Net Income (GAAP)
  - A CSM, which reflects the most important financial performance measure (not already included in the PVP Table) used by a company to link CAP with company performance for the most recent fiscal year

PVP Table Example

					Value of Initial Fixed $100 Investment Based On:			
Year (a)	SCT Total for PEO (b)	CAP Paid to PEO (c)	Average SCT Total for Non-PEO NEOs (d)	Average CAP to Non-PEO NEOs (e)	Company TSR (f)	Peer Group TSR (g)	GAAP Net Income (h)	Company Selected Measure (i)
2022								
2021								
2020								

- Separate from the PVP Table, companies must also list three to seven most important financial performance measures, including the CSM, used to link CAP to company performance in the most recently completed fiscal year
- Finally, companies must provide a "clear description" of the relationship between CAP and various financial metrics. The clear description can be made via narrative, tables, or a combination of both

The new rule is effective for proxy statements with fiscal years ending on or after December 16, 2022. For detailed information on the new PVP rule, please see our prior postings here and here.

Introduction

As of mid-March 2023, numerous companies subject to the PVP rule have filed proxy statements for fiscal year 2022. FW Cook reviewed the first 75 filings, excluding smaller reporting companies,[1] and analyzed their PVP disclosures. These 75 companies had the following profile:

Industry Sector (# of companies)	**Percent of Companies Reviewed**
Financials (n=23)	31%
Industrials (n=13)	17%
Consumer Discretionary (n=8)	11%
Materials (n=7)	9%
Energy (n=6)	8%
Utilities (n=5)	7%
Consumer Staples (n=5)	7%
Health Care (n=4)	5%
Information Technology (n=4)	5%

Market Cap ($M) (as of 12/31/2022)	
75th Percentile	$28,328
Median	$7,443
25th Percentile	$2,235

[1] A smaller reporting company is generally defined as a public company with a public float of less than $250 million (rising to less than $700 million if revenues are below $100 million). Smaller reporting companies are subject to scaled disclosure under the new PVP rule.

Company Selected Measure

Included in the PVP Table is the company's CSM, which represents the most important financial performance measure (not otherwise required to be disclosed in the table) used by the registrant to link CAP for the most recently completed fiscal year, to company performance. Companies may use non-GAAP financial performance measures as their CSM as long as there is disclosure as to how the CSM value is computed from the audited financial statements. Among the 75 companies analyzed, four financial performance measures appeared at least 10% of the time: EPS (32%), revenue (13%), ROE (12%), and operating income (11%). In assessing the implications of these percentages, one should take into account the industry sectors represented in these initial filings since prevalence may reflect the industry sector makeup of the sample (for example, 31% of the total sample are financial institutions). One company did not provide a CSM because it notes that it does not use any financial performance measures in its executive compensation program.

Company Selected Measure	Percent of Companies Reviewed
Earnings Per Share	32%
Revenue	13%
Return on Equity	12%
Operating Income	11%
Cash Flow	9%
EBITDA	8%
Return on Assets	7%
Other	7%
No CSM	1%

In order to release this data as quickly as possible, we have not yet completed a full analysis of CSMs among filers relative to the metrics used in incentive plans, but among FW Cook clients the emerging trend is typically to use the financial performance measure that is the highest weighted measure in either the company's annual and/or long-term incentive program.

The majority practice among companies was to use a non-GAAP CSM instead of a GAAP CSM. Since many companies use adjusted measures in their incentive plans, this was expected.

CSM: GAAP vs. Non-GAAP	Percent of Companies Reviewed
GAAP	32%
Non-GAAP	68%

Of the sample reviewed, the CSM was used in the annual incentive plan at 65% of companies and in the long-term incentive plan at 53% of companies (the percentages add up to more than 100% because of situations where the same financial performance measure is used in both plans). For companies that use the same financial performance measure in both their annual and long-term incentive plans, it was not surprising that this financial performance measure was considered the most important when linking compensation actually paid to performance. One company used a metric as its CSM that was in neither its annual nor long-term incentive plan (it has a discretionary bonus plan and does not grant performance-based equity awards).

CSM: Incentive Plan	Percent of Companies Reviewed
Annual Incentive Plan	46%
Long-Term Incentive Plan	34%
Both (Annual and Long-Term Incentive Plans)	19%
None	1%

Three companies also provided a supplemental measure in addition to the CSM in the PVP table; the supplemental measures had the same weight as the CSM in either the annual or long-term incentive plan.

The Tabular List of Financial Performance Measures

Another disclosure requirement is the list of at least three and no more than seven financial performance measures that represent the most important financial performance measures used by the registrant to link CAP for the most recently completed fiscal year to company performance (the Tabular List). There is no requirement that the measures be ranked and, as long as the list includes three financial performance measures, companies can also include non-financial metrics.[2] The rule notes that separate Tabular Lists can be provided for (1) the principal executive officer (PEO) and the other named executive officers (Non-PEO NEOs) as a group or (2) as separate tabular lists for each named executive officer (NEO).

Most companies chose to use just one list for all of their NEOs. Companies that chose to use an individual list for each NEO were typically doing this because a business unit head was among their NEOs. For example, one company had two NEOs who were presidents of business groups, and thus the company used a list for each NEO. Each NEO had his or her own list, but the corporate officers had the same five financial performance measures, while the list for the two business group presidents included specific business group financial performance measures.

Tabular List: Type	Percent of Companies Reviewed
One List for all NEOs	92%
Individual list for each NEO	7%
No List (no financial performance measures)	1%
One list for the PEO and another for the other NEOs	0%

Unless fewer than three financial performance measures are used by a company (in which case the Tabular List must include all the measures that were used), the Tabular List must include three to seven financial performance measures. Most companies chose to include additional financial performance measures, with five measures being the most prevalent.

[2] Companies may include less than three financial performance measures if they use fewer than three financial performance measures to link CAP to financial performance. If fewer than three financial performance measures were used, the Tabular List must include all the measures that were used.

Tabular List: # of Measures	Percent of Companies Reviewed
< 3	4%
3	25%
4	21%
5	31%
6	16%
7	3%

The rule allows companies to include non-financial performance measures in the Tabular List, provided that at least three financial performance measures are included (assuming there are three financial performance measures) and no more than a total of seven measures are listed. Most companies did not include a non-financial performance measure.

Tabular List: Non-Financial Performance Measures	Percent of Companies Reviewed
Does Not Include Non-Financial Performance Measures	78%
Includes Non-Financial Performance Measures	22%

This finding is interesting in light of the fact that FW Cook's 2022 Top 250 Annual Incentive Plan Report, which can be found here, indicates that 78% of the 250 largest companies use non-financial components in their annual incentive plan. Among companies that included non-financial performance measures in the Tabular List, environmental, social, and governance-related and safety goals were prevalent.

Most companies included measures (at least one) from both their annual (97% of companies) and long-term (91% of companies) incentive plans. Forty-one percent (41%) of companies included TSR (relative or absolute) or stock price as a financial performance measure.

Tabular List: Measure from Incentive Plan Included	Annual Incentive Plan	Long-Term Incentive Plan
Includes Financial Performance Measure from Plan	97%	91%
Does Not Include Financial Performance Measure from Plan	3%	9%

The table below shows the prevalence of the number of measures companies used from both the annual and long-term incentive plans. The data show companies most often used two or three measures from their annual incentive plan (54%) and two from their long-term incentive plan (50%). It is typical for companies to have more measures in their annual incentive plan compared to their long-term incentive plan, so it was not a surprise that four measures was the maximum disclosed for long-term incentive plan measures. Seven companies included financial performance measures not included in any of their incentive plans. These non-plan financial performance measures included absolute TSR, stock price, and efficiency ratio. This is expected to be more common among start-ups and biotech companies where in many cases it is difficult to predict financial results in a meaningful way or select financial measures with a meaningful correlation to shareholder value. The SEC's recent interpretations have caused some experts to conclude it is unclear whether companies are limited in the Tabular List to the metrics that are used in their incentive plans.

Tabular List: # of Measures in Plan	Annual Incentive Plan	Long-Term Incentive Plan
0	3%	9%
1	20%	15%
2	24%	50%
3	30%	18%
4	11%	8%
5	11%	0%
6	1%	0%
7	0%	0%

TSR Peer Group

Companies must select a specific peer group for presentation of relative TSR values in the PVP table. Permitted choices include a compensation peer group disclosed in the Compensation Discussion and Analysis (CD&A) or the published industry or line-of-business index used in the Form 10-K performance graph. Most companies chose to use the published industry or line-of-business index in the Form 10-K, and we are aware of some companies changing their historic Form 10-K index or peer group in consideration of the new PVP disclosure requirements.

One of the primary reasons for selecting an index used in the Form 10-K is it avoids the need for additional calculations where changes are made year over year to a custom peer group.

Peer Group	Percent of Companies Reviewed
10-K Performance Graph – Published Industry or Line-of-Business Index	76%
CD&A Compensation Peer Group	12%
10-K Performance Graph – Custom Peers	11%
10-K Performance – Broad-Based Index	1%

Clear Description Requirement

The rule requires companies provide a “clear description” of the relationships between CAP of the PEO and the NEOs with the company’s TSR, the company’s net income, and the CSM. Companies must also include a comparison of the company’s TSR to the peer group TSR. The rule provides no guidance on what constitutes a “clear description,” other than noting that graphs may be used. Most companies are using graphs or charts in their narrative. For this review, if a graph or chart was used to show a clear description, the prevalence was captured as such, even if additional narrative was provided. For comparison to CAP values, two companies also included SCT pay in their bar charts.

Clear Description Requirement	Percent of Companies Reviewed
Includes Graphs / Charts	85%
Narrative Only	15%

Compensation Actually Paid Compared to Summary Compensation Table

What can one learn from a company's CAP value? The key take-away is that the CAP values will differ from SCT-disclosed amounts based on short-term stock price performance. The degree of difference, however, depends on many factors including leverage in the overall program (e.g., use of stock options versus other equity awards), correlation between metrics used in the incentive structure and changes in shareholder value, and overall pay mix (e.g., cash versus equity).

It is too early to draw definitive conclusions, but we examined the relationship between CAP and SCT by dividing CAP by SCT (CAP/SCT) over the three reported fiscal years, both annually and cumulatively, to evaluate potential patterns relative to companies' TSR over the same timeframe. We express this as the percentage that CAP is above or below SCT values. As noted above, in assessing the importance of these additional findings, one should take into account the industry sectors represented in these initial filings since prevalence may reflect the industry sector makeup of the sample.

During 2020, when many companies were severely impacted by COVID-19, CAP values for most companies were below reported SCT amounts. At median, the PEOs' CAP/SCT was -7% below the SCT-reported value and Non-PEO NEOs' was at -4%, while at median these companies' TSR was 1%.

In 2021, the ratios reversed; at the median, the CAP/SCT values were 45% and 39% for PEOs and Non-PEO NEOs, respectively, while at median these companies' TSR was 28%.

In 2022, due to a difficult financial year, CAP/SCT values for PEOs and Non-PEO NEOs (at median) and the companies' TSR (at median) were negative.

Over the cumulative three years, predominately due to a very strong 2021, the NEOs' CAP/SCT ratios and companies' TSR at median were positive. The companies' TSR at median was 6%, while the PEOs and Non-PEO NEOs' CAP/SCT values at median were 16% and 9%, respectively.

CAP % Above/Below SCT	PEO	Non-PEO NEOs	Companies Reviewed TSR
2020			
75th Percentile	50%	30%	17%
Median	-7%	-4%	1%
25th Percentile	-31%	-28%	-13%
2021			
75th Percentile	106%	74%	44%
Median	45%	39%	28%
25th Percentile	6%	6%	11%
2022			
75th Percentile	13%	10%	4%
Median	-12%	-3%	-8%
25th Percentile	-56%	-38%	-23%
Cumulative (2020 – 2022)			
75th Percentile	37%	25%	12%
Median	16%	8%	6%
25th Percentile	0%	-2%	0%

Only a small portion of the sample disclosed a negative CAP value, meaning that even though values are closely tied to changes in shareholder value, few NEOs saw their overall wealth creation opportunity turn negative.

Negative CAP Value in Any of Years	PEO	Non-PEO NEOs
Yes - Includes Negative CAP Value	17%	15%
No Negative CAP Value	83%	85%

PVP Disclosure Location within the Proxy

A threshold question is where to place the PVP disclosure in the proxy statement. Among the 75 companies, the most prevalent practice is towards the back of the proxy, after the CD&A, compensation tables, and typically right after the CEO Pay Ratio disclosure, similar to how the CEO Pay Ratio disclosure occurs after the compensation tables of the proxy for most filers. This was the general expectation after the PVP rule was announced. One company chose to include this section before its SCT.

Proxy Location	Percent of Companies Reviewed
Towards the Back of Proxy Statement (After Termination Tables and CEO Pay Ratio)	69%
Between Termination Tables and CEO Pay Ratio	16%
Between SCT and Termination Tables	13%
Above the SCT	1%

Numbers do not add up to 100% due to rounding.

Additional Information: Footnotes and Word Length

Companies differed in how many footnotes were included under the PVP Table. Most companies (69%) used between five and eight footnotes.

# of Footnotes	Percent of Companies Reviewed
1	0%
2	3%
3	9%
4	12%
5	23%
6	12%
7	13%
8	21%
9	4%
≥10	3%

Some clients have asked how long their PVP section should be. The median word count was around 1400 words.

Word Count of PVP Section	
75th Percentile	1,677 words
Median	1,395 words
25th Percentile	1,086 words

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General questions about this Alert can be addressed to the following individuals:

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Appendix – Companies Studied

A. O. Smith Corporation
AutoNation, Inc.
Avery Dennison Corporation
Bank of America Corporation
Bloomin' Brands, Inc.
Carrier Global Corporation
Cass Information Systems, Inc.
Celanese Corporation
Central Pacific Financial Corp.
CNB Financial Corporation
ContextLogic Inc.
Corteva, Inc.
Dow Inc.
EQT Corporation
Equitrans Midstream Corporation
Fastenal Company
Fifth Third Bancorp
First Business Financial Services, Inc.
Genuine Parts Company
Harsco Corporation
Home Bancshares, Inc. (Conway, AR)
Humana Inc.
Huntington Bancshares Incorporated
Independent Bank Corporation
Interactive Brokers Group, Inc.
International Business Machines Corporation
IQVIA Holdings Inc.
Kaman Corporation
Kellogg Company
Kimberly-Clark Corporation
Kontoor Brands, Inc.
L3Harris Technologies, Inc.
Lakeland Financial Corporation
Liberty Energy Inc.
Lithia Motors, Inc.
M&T Bank Corporation
M.D.C. Holdings, Inc.
Magellan Midstream Partners, L.P.
ManpowerGroup Inc.
Moody's Corporation
MYR Group Inc.
Newmont Corporation
Nicolet Bankshares, Inc.
Northwest Bancshares, Inc.
NuStar Energy L.P.
Otter Tail Corporation
Owens Corning
Park National Corporation
Parsons Corporation
PerkinElmer, Inc.
Pinnacle Financial Partners, Inc.
Portland General Electric Company
PPG Industries, Inc.
Public Service Enterprise Group Incorporated
Regions Financial Corporation
Schlumberger Limited
Schneider National, Inc.
Select Medical Holdings Corporation
ServisFirst Bancshares, Inc.
Silicon Laboratories Inc.
SJW Group
Teledyne Technologies Incorporated
Texas Capital Bancshares, Inc.
Textron Inc.
The AES Corporation
The Andersons, Inc.
The Bank of New York Mellon Corporation
The Boeing Company
The Coca-Cola Company
The First of Long Island Corporation
The Sherwin-Williams Company
U.S. Bancorp
Weis Markets, Inc.
West Bancorporation, Inc.
Whirlpool Corporation