



## COMPENSATION RISK ASSESSMENT AND OVERSIGHT

*Saado Y. Abboud, Ph.D.*

*Keystone Compensation Group LLC*

*Ph. 612.810.3522 or 763.229.3522*

[info@keystonecomp.net](mailto:info@keystonecomp.net)

[www.keystonecomp.net](http://www.keystonecomp.net)

*Summer, 2010*

# EXECUTIVE OVERVIEW

---

1. Background on SEC's disclosure requirements
2. Categories of risk to be assessed
3. What are compensation programs risks?
4. Framework for assessing compensation risks
5. Risk assessment – practical considerations
6. What should the compensation committee look for?
7. Compensation risk oversight
8. Conclusions
9. Research sources



# BACKGROUND ON SEC REQUIREMENTS

---

- ❖ In response to investors' concerns, the Security and Exchange Commission (SEC) finalized the disclosure requirements for publicly traded firms in December of 2009. Disclosure rules are effective 2/28/2010.
- ❖ Requirements included, among other things, disclosure of potential excessive risks in an organization's compensation policies and practices.
- ❖ Publicly traded companies must discuss in their annual proxy statements if their compensation plans or practices create risk-taking incentives.
- ❖ Disclosing incentives that are reasonably likely to have a material adverse effect on the organization is a key task for the compensation committee.
- ❖ Disclosures are not limited to executive compensation, but cover all organization's incentive programs including commission-based plans.
- ❖ Disclosure should describe board's role in the oversight of the risk and its partnership with the senior management to manage material risks.



# CATEGORIES OF RISKS TO BE ASSESSED

---

- ❖ **Strategic risks:** relate to the execution of business strategy of the organization and its ability to compete in the marketplace.
- ❖ **Financial risks:** involve factors that affect shareholder value and investments. They may be driven by the economic environment, credit risks or other financial related elements.
- ❖ **Operational risks:** cover company's ability to create products and services and manage its people. They also include processes and technology critical for the survival of the organization.
- ❖ **Compliance risks:** relate to the regulatory requirements of various industries, fraud issues, and threats of doing business globally.
- ❖ **Reputation risks:** relate to the ability of the company to project a positive image and favorable reputation in the business community.



# WHAT ARE COMPENSATION PROGRAMS RISKS?

---

- ❖ The role of compensation in encouraging behaviors that lead to taking excessive risk is an important element of program assessment.
- ❖ There is no universal definition of the level of risk that has “adverse material effect” on the future value of the company.
- ❖ Taking an appropriate level of risk is part of the business model; if there is no risk there would be no performance.
- ❖ Key to compensation risk assessment is determining the balance in performance measures and their relationship to incentives.
- ❖ Balance among performance measures and the incentives they provide helps reduce the motivation of employees to engage in conduct detrimental to the organization or focus on the wrong metric.
- ❖ The degree of risk in compensation programs is closely tied to the mix of fixed and at-risk pay (how leveraged are the programs?).



# WHAT ARE COMPENSATION PROGRAMS RISKS? (CONT.)

---

- ❖ Assessment process must include the analysis of the leverage built in the design of the program and the likelihood of employees “going for broke” in order to receive large incentives.
- ❖ The design of compensation programs and policies is the main source of risk in compensation. Poorly designed programs may motivate focus on the wrong business metrics and lead to destruction of the value of the organization.
- ❖ Risk in compensation programs may be tied to the decisions making process about pay, the extent of discretion, and the design and implementation of the compensation strategy (pay mix).



# FRAMEWORK FOR ASSESSING COMPENSATION RISKS

---

- ❖ Compensation risk assessment begins with creating a cross functional team responsible for reviewing each program.
- ❖ Assessment requires a partnership between human resources, finance, legal, risk management ,and the business functions.
- ❖ Create an inventory of all policies, practices, and program documentations.
- ❖ Conduct the necessary analytics and what-if scenarios to model how compensation programs deliver payouts under various assumptions.
- ❖ Develop risk mitigation conditions for each potential risk area or change the design of the compensation program to avoid excessive risk-taking.
- ❖ Report findings to the compensation committee on programs that could have material adverse effect on the value of the company.
- ❖ Document process in the compensation committee meeting and discuss them in the CD&A section of the proxy statement.



# RISK ASSESSMENT- PRACTICAL CONSIDERATIONS

---

1. Evaluate goals relative to your competitors and think about the degree of risk it may take in order to achieve them.
2. Check if the program motivates focus on the right metrics and ensure these metrics are aligned with the business strategy.
3. Evaluate the balance between fixed and variable pay that encourages reasonable level of risk-taking (consider market best practices).
4. Examine the balance between short- and long-term incentives. More incentives should be based on achieving long-term performance.
5. Analyze the relative incentive payout relative to the performance achieved. High incentives paid out for achieving weak results are red flags.
6. Evaluate the balance between individual, team, and organization focus.
7. Balance and diversify the vehicles for delivering long-term incentives (stock options, whole shares, cash).



# RISK ASSESSMENT- PRACTICAL CONSIDERATIONS (CONT.)

---

- ❖ Are there subjective and qualitative measures of performance to avoid paying incentives resulting from uncontrollable events?
- ❖ Are there fail-safe mechanisms in place, such as claw backs, bonus banking, and deferred incentive payments (subject to 409A provisions) to recover any erroneously-paid incentives?
- ❖ Caps on incentives to limit windfalls in sales compensation programs.
- ❖ Ensure that compensation payments are matched to performance period when performance can be measured.
- ❖ Conduct benchmarking of various types of pay to ensure that compensation is aligned with the marketplace.



# WHAT SHOULD THE COMP. COMMITTEE LOOK FOR?

---

- ❖ Alignment of incentives with the short- and long-term business goals.
- ❖ Have a thorough understanding of the potential consequences of their decisions on rewards. Request sufficient information to back up decisions.
- ❖ Balance the weighting of performance metrics to ensure their alignment with the strategy of the organization.
- ❖ Consider the appropriate mix of base, bonus, and long-term incentives.
- ❖ Ensure that risk mitigation measures are established. Examples are:
  - ❖ Multi-year performance periods - no quick kill
  - ❖ Equity ownership guidelines – maintain skin in the game
  - ❖ Sufficient analytics and what-if scenario modeling to support decisions - no gut-based decisions
  - ❖ Bonus banking, deferred payout (subject to 409A provisions), and claw backs – strings attached
  - ❖ Balanced portfolio of rewards – reduce volatility in rewards paid out



# COMPENSATION RISK OVERSIGHT

---

- ❖ Risk oversight is the responsibility of the full board.
- ❖ Compensation risk oversight flows out of assessing company strategy.
- ❖ Each committee should have oversight responsibilities for the risks specific to its functional area.
- ❖ Management need to establish an ongoing process for assessing, managing, and reporting on risk exposure.
- ❖ Boards need to communicate to management about its expectations with respect to the information they need on a regular basis in order to remain informed about the level of risk being taken by the organization.
- ❖ Degree of risk must be commensurate with expected rewards.
- ❖ Management and board need to have a long range plan for how risk is monitored, assessed, mitigated, and communicated to stakeholders.



# CONCLUSIONS

---

- ❖ Compensation risk disclosures are not limited to executive pay but cover all incentive programs.
- ❖ Taking calculated risks is part of successful business undertakings.
- ❖ Incentive mix (short-term vs. long-term) and performance measures are determined based on organization's business strategy.
- ❖ Sufficient modeling and analytics are essential for board members to evaluate the potential risk in compensation programs design.
- ❖ Risk-mitigation measures are vital fail-safes to ensure that incentives are not paid in cases when performance is restated.
- ❖ The full board has responsibility for risk oversight with strong support from management to provide the necessary information to make good decisions.
- ❖ There appears to be an increased tendency toward making compensation programs resemble that of the competition and avoiding plans that stand out and generate misunderstanding by shareholders or regulating agencies.



# RESEARCH SOURCES

---

- ❖ Boardmember.com: Are you ready for compensation risk assessment?
- ❖ Hay Group, The Executive Edition 2009: Risk in executive compensation
- ❖ National Association of Corporate Directors: SEC's new disclosure rules on risk, compensation, and governance, February 2010
- ❖ National Association of Corporate Directors: Risk oversight, February 2010
- ❖ Workspan, Strategies for assessing compensation risks, May 2010



# KEYSTONE COMPENSATION GROUP CAPABILITIES

---

- ❖ Compensation and Rewards strategy development
- ❖ Base pay program design and management:
  - ❖ Competitive analysis
  - ❖ Grade structure design and administration guidelines
  - ❖ Program review and recommendations
- ❖ Short- and long-term incentive program development and design:
  - ❖ Identify key business objectives and quality measures
  - ❖ Assistance with development of performance standards
  - ❖ Link incentive payout to level of goal attainment
  - ❖ Program document development and communication
- ❖ Executive and Board of Directors Compensation:
  - ❖ Compensation strategy development
  - ❖ Competitive market analysis and pay recommendations
  - ❖ Relative pay mix recommendations between fixed and variable compensation



# WHY KEYSTONE COMPENSATION GROUP

---

- ❖ We emphasize researching and understanding of our clients' business to effectively contribute to their success.
- ❖ Our experience as consultants and corporate compensation managers positions us to provide practical solutions and anticipate challenges.
- ❖ Responsiveness to our clients and intentional effort to build strong relationships.
- ❖ Broad knowledge and experience in designing and managing compensation programs and linking them to business priorities.
- ❖ Project management expertise to ensure clients are informed about expected deliverables, timelines and investments in getting the work done.
- ❖ To contact us:
  - ❖ Call: 612.810.3522 or 763.229.3635
  - ❖ Email us at: [info@keystonecomp.net](mailto:info@keystonecomp.net)
  - ❖ Visit us on the web: [www.keystonecomp.net](http://www.keystonecomp.net)

