PRO FORMA COMPENSATION

USEFUL INSIGHT OR WINDOW DRESSING?

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INTRODUCTION

It has become commonplace for companies to issue supplementary disclosure about their financial results in addition to those required under "generally accepted accounting principles" (GAAP). Approximately one-third of companies issue so-called non-GAAP or pro forma earnings.[1] Academics and professionals have engaged in considerable debate about the motivation underlying the decision to issue non-GAAP earnings. On the one hand, a company might issue non-GAAP earnings to improve investor understanding of financial results by stripping away transitory charges to focus attention on underlying performance. On the other, a company might report non-GAAP figures to mislead investors by inflating perceptions of underlying results. Evidence exists to support both of these claims.[2]

CEO compensation is another metric widely tracked by shareholders and stakeholders. Just as GAAP accounting standards are regulated by the Financial Accounting Standards Board (FASB), corporate disclosure of executive compensation is regulated by the Securities and Exchange Commission and is reported in the proxy statement Compensation Discussion & Analysis (CD&A) section and various summary compensation tables. The summary compensation figures reported in proxies are widely cited (and often criticized) by corporate observers, and journalists rely on these figures to compile annual rankings of the most highly paid CEOs. Critics of executive compensation rely on SEC-designated calculations of compensation to allege that CEO compensation contracts are "too high" and uncorrelated with performance.[3]

However, shortcomings exist with SEC-designated calculations that may make reported compensation figures misleading or incomplete. Compensation packages include a variety of risky pay elements awarded in a given year that vest across multiple years and whose ultimate value—contingent upon the achievement of performance targets or stock price changes—can only be estimated at the time that they are reported. More than one method for calculating compensation exists, and the most appropriate compensation metric will depend on what one is trying to measure: An analysis of the "pay-for-performance" of executive pay will rely on the value of compensation that has been earned or realized, while an analysis of the "incentives" inherent in the compensation program will rely on the expected value and mix of compensation currently held by the CEO. The summary compensation figures required by the SEC do not make this distinction clearly.[4]

ALTERNATIVE PAY DISCLOSURES

In recent years, some companies have begun to voluntarily disclose what might be called "pro forma compensation."[5] Their motivation for doing so is not entirely clear. As with pro forma financial statements, a company might disclose adjusted compensation figures because they are more informative about executive incentives than SEC-designated calculations. Alternatively, they might do so to make their compensation practices and payouts appear more favorable than under SEC rules and mitigate criticism by journalists and shareholders. Because this type of disclosure is relatively new, appropriate approaches for calculating adjusted compensation have not yet been established.

One approach that companies use is to disclose the amount of compensation that the CEO has *realized* in a current year through the sale of equity awards (stock options, restricted stock, and performance units) that were granted in previous years. For example, Cincinnati Financial calculates that its CEO realized total compensation of $2.43 million in 2014, taking into account the values of annual salary, bonus, and the proceeds received through the exercise of stock options and vesting of performance-based restricted stock units. This figure is lower than the total pay reported in the summary compensation table of $2.62 million. Over a three-year period, Cincinnati Financial calculates that its CEO realized cumulative compensation of $6.92 million, 15 percent lower than the $8.19 million reported in the summary compensation tables over these same years.[6] The company compares this figure to its performance relative to peers, which it estimates in the 60th percentile measured both in terms of change in book value and total shareholder return (see Exhibit 1). It concludes that CEO pay is correlated with performance:

> *Generally, the committee expects that when the company's performance adds or preserves more value for shareholders than its peers, that compensation for the named executive officers, including the chief executive officer, will be higher than when the company's performance lags its peers Accordingly, the performance metrics for both annual and long-term performance-based compensation are calibrated to the company's performance compared with the companies in the peer group. At the same time, the committee expects compensation to directionally correlate with the company's actual performance for these metrics, particularly when considered over the long term.*[7]

One shortcoming of using realized compensation to evaluate pay-for-performance is that this approach compares operating and stock price performance in a *single* year against compensation potentially granted across *multiple* previous years. For example, had the CEO of Cincinnati Financial not exercised any stock options during the measurement period, his realized pay would have been lower even though the equity-compensation awards would have remained outstanding (and at risk) until a later date.

An alternative approach is to calculate the amount of compensation that the CEO earned during the year, without regard to whether this pay was actually realized. So-called *realizable* compensation includes salary, bonus, and the fair value of equity awards vested or received in the current period.[8] Because realizable pay is calculated based on the current stock price, the value of a compensation plan heavily weighted with equity will diverge over time from its original (expected) grant-date value depending on whether the stock price subsequently increased or decreased. In this way, "realizable" pay will always be highly correlated with performance, as measured by stock price returns.

In 2014, C.R. Bard used realizable pay analysis to evaluate the pay-for-performance relationship of its CEO compensation program. The company explains that its compensation committee "considers realizable pay rather than pay opportunity because it reflects a more appropriate measure of executive pay by looking at actual earned cash and the realizable value of equity compensation based on actual performance and the stock price at the end of the measured performance period." The company estimates that the realizable value of CEO compensation over the previous three-year period ranks in the 50th percentile relative to peers while the company's relative three-year performance (based on revenue growth, net income growth, and total shareholder return) places it in the 60th percentile. The company concludes that its compensation program is "in alignment with our performance … with challenging goals relative to our peers." C.R. Bard does not disclose the dollar value of realizable compensation (see Exhibit 2).[9]

By contrast, Adobe Systems discloses the dollar value of realizable compensation and compares this amount to changes in the company's stock price. The company calculates that its CEO had cumulative realizable compensation of $88.7 million over the previous three-year period, roughly double his targeted compensation of $43.9 million. The company demonstrates that this increase in value corresponds to a 272 percent increase in total shareholder return over the period. Adobe does not provide relative rankings of realizable pay in comparison to peers and total shareholder return (see Exhibit 3).[10] Some companies, such as HCC Insurance Holdings, report both absolute dollar values and relative rankings (see Exhibit 4).[11]

Realizable pay disclosure is relatively rare. Among approximately 5,000 publicly traded companies, 182 (4 percent) made disclosures about realizable pay in the last two years (see Exhibit 5).[12] Of these, 58 explain in the CD&A section of the proxy that their compensation committee conducts realizable pay analysis but these companies do not actually disclose the results of this analysis. Those that do disclose this analysis are fairly evenly split in terms of whether they disclose percentile rankings (similar to C.R. Bard) or the dollar value of realizable compensation (similar to Adobe). Approximately 10 percent disclose a combination. The time duration used for realizable pay varies, with companies disclosing one-year, three-year, or five-year data.

In general, total realizable pay calculations are lower than the originally targeted compensation or total summary compensation that they are compared against. Among companies reporting the dollar value of realizable pay, 71 percent disclose that total compensation is lower under this methodology than otherwise reported. The mean (median) difference is a 41 percent (40 percent) reduction. By contrast, 29 percent disclose higher total realizable compensation, with a mean (median) difference of 54 percent (40 percent).

The motivation behind a decision to disclose realizable pay is not entirely clear. Companies that disclose realizable pay use a wide array of compensation consultants—including Pay Governance, Frederic W. Cook, Pearl Meyer, and Towers Watson. Companies that make this disclosure are not significantly more likely to have received lower say-on-pay support the previous year: Average say-on-pay support for these companies was 88 percent compared to approximately 91 percent among all publicly traded companies.[13]

Over time, realizable pay disclosure is likely to increase. Pursuant to the Dodd-Frank Act, the SEC has proposed rules that would standardize disclosure on realizable pay. Companies would be required to disclose "compensation actually paid"

(CAP) over the previous five years and compare this value to five-year total shareholder return. Stock options, restricted shares, and performance stock would be valued on the date of vesting; however, they would not be subsequently revalued to reflect ongoing changes in share price.[14] For this reason, it is not clear whether companies that disclose realizable pay will continue to adjust reported compensation or whether the SEC's standards will satisfy both corporate and investor demands.

WHY THIS MATTERS

1. In recent years, companies have begun to disclose alternative measures of CEO compensation that differ—sometimes substantially—from those reported in the summary compensation table of the annual proxy. Are these measures more useful in assessing the desirability of CEO compensation? Are they indicative of shortcomings in SEC standards? Or do they reflect a desire by corporations to mislead investors about how much they are paying their CEOs?
2. In general, shareholders are dissatisfied with the disclosure they receive about CEO compensation and contend it is too long and confusing.[15] Would realizable pay analysis improve satisfaction, or would it contribute to the sense that pay disclosure is overwhelming?
3. Any CEO who receives a large percentage of total compensation in the form of time-vested equity-awards will see the realizable value of those awards fluctuate over time with changes in stock price. In this way, realizable pay will almost perfectly correlate with performance. Are these two terms basically synonymous? Does realizable pay disclosure "solve" the controversy over pay-for-performance?[16]
4. Proposed SEC rules would standardize the methodology companies use to disclose "compensation actually paid" to CEOs. By doing so, the SEC is requiring companies to demonstrate a more explicit link between pay and performance. Is it better to let companies experiment with the format of this disclosure based on shareholder demand, or should the SEC standardize their approach? Once SEC rules are adopted, will the need for alternative pay disclosure disappear, or will companies continue to make adjustments to convey what their CEOs were "actually paid"?
5. Proxy advisory firms (Institutional Shareholder Services and Glass Lewis) evaluate executive compensation when assessing corporate governance and making say-on-pay recommendations. Glass Lewis uses realizable pay (calculated over a three-year period and includes: actual salary received; actual incentive cash granted and earned; the intrinsic value of time-vesting equity granted; the intrinsic value of performance-based equity granted and earned; and actual all other compensation paid) as their primary evaluation metric.[17] However, ISS appears to look at realizable pay (at companies in the Standard & Poor's 1500 index) when their standard analysis assigns a "high or medium" concern that compensation policies are not linked to corporate performance.[18] Which proxy advisor approach is more sensible? ■

[1] Ervin L. Black, T. Taylor Joo, and Roy Schmardebeck, "The Relation Between Earnings Management and Pro Forma Reporting," *Social Science Research Network* (March 2014), Available at: http://ssrn.com/abstract=2259379.

[2] For evidential support of the information hypothesis, see Mark T. Bradshaw and Richard G. Sloan, "GAAP versus The Street: An Empirical Assessment of Two Alternative Definitions of Earnings," *Journal of Accounting Research* (2002); Nilabhra Bhattacharya, Ervin L. Black, Theodore E. Christensen, and Chad R. Larson, "Assessing the Relative Informativeness and Permanence of Pro Forma Earnings and GAAP Operating Earnings," *Journal of Accounting and Economics* (2003); and Lawrence D. Brown and Kumar Sivakumar, "Comparing the Value of Two Operating Income Metrics," *Review of Accounting Studies* (2003). For support of the deception hypothesis, see Sarah E. McVay, "Earnings Management Using Classification Shifting: An Examination of Core Earnings and Special Items," *The Accounting Review* (2006); Kalin Kolev, Carol A. Marquardt, and Sarah E. McVay, "SEC Scrutiny and the Evolution of Non-GAAP Reporting," *The Accounting Review* (2008); and Dirk E. Black and Theodore E. Christensen, "U.S. Managers' Use of 'Pro Forma' Adjustments to Meet Strategic Earnings Targets," *Journal of Business Finance & Accounting* (2009).

[3] For example, see Michael J. Cooper, Huseyin Gulen, and P. Raghavendra Rau, "Performance for Pay? The Relation between CEO Incentive Compensation and Future Stock Price Performance," *Social Science Research Network* (October 2014). Available at: http://ssrn.com/abstract=1572085.

[4] For a detailed discussion, see David F. Larcker, Allan McCall, and Brian Tayan, "What Does It Mean for an Executive to 'Make' $1 Million?" Stanford Closer Look Series (December 14, 2011).

[5] This practice was largely nonexistent five years ago. See Equilar Inc., "2015 Innovations in CD&A Design: A Proxy Disclosure Analysis" (2015).

[6] Realized compensation was lower than reported compensation in part because the CEO received fewer shares in previous years (that vested and were realized during this period) than he received in the current period.

[7] Cincinnati Financial, form DEF 14A, filed with the SEC March 18, 2015.

[8] Note that this approach still requires discretion. To calculate realizable compensation, the company might include a) all vested equity awards outstanding and eligible for sale during the year, without regard to the period in which they were granted, b) only the equity awards that vested in the current year, or c) the value of equity awards granted in the current year *as if* they were exercisable and revalued based on the year-ending stock price. Companies also have the choice of measuring vested equity grants on the date of vesting (as the IRS does for tax reporting purposes) or at year end.

[9] C.R. Bard, form DEF 14A, filed with the SEC March 13, 2015.

[10] Adobe Systems, form DEF 14A, filed with the SEC February 27, 2015.

[11] HCC Insurance Holdings, form DEF 14A, filed with the SEC April 9,

2015.

[12] Sample includes 5,526 companies in 2014 and 4,112 in 2015. Companies reporting realizable pay calculations were identified using a textual search of all proxy statements filed in Edgar as of early July 2015. For firms reporting realizable pay calculations in both years, only the more recent year (2015 disclosure) is used for the analysis in this report.

[13] Average say-on-pay results are reported by Semler Brossy. See Semler Brossy Consulting Group, LLC., "Year End Say on Pay Report" (2014).

[14] For a discussion of the proposed rules and potential shortcomings of the SEC's methodology, see: Ira Kay and Blaine Martin, "SEC's Pay-for-Performance Methodology Is Misguided," *Agenda* (July 13, 2015); and Securities and Exchange Commission, "Pay versus Performance," Release No. 34-74835 (April 29, 2015).

[15] RR Donnelly, Equilar, and the Rock Center for Corporate Governance at Stanford University, "2015 Investor Survey: Deconstructing Proxies—What Matters to Investors" (2015).

[16] Note that a correlation between pay and stock price does not necessarily indicate that the pay levels themselves are "correct." It still might be the case that a CEO's pay levels are too high or too low.

[17] Glass Lewis, "Say on Pay FAQS," Accessed July 17, 2015. Available at: http://www.glasslewis.com/issuer/say-on-pay-faqs/.

[18] Sidley Austin, LP, "ISS Publishes Policy Updates for 2014 Proxy Season."

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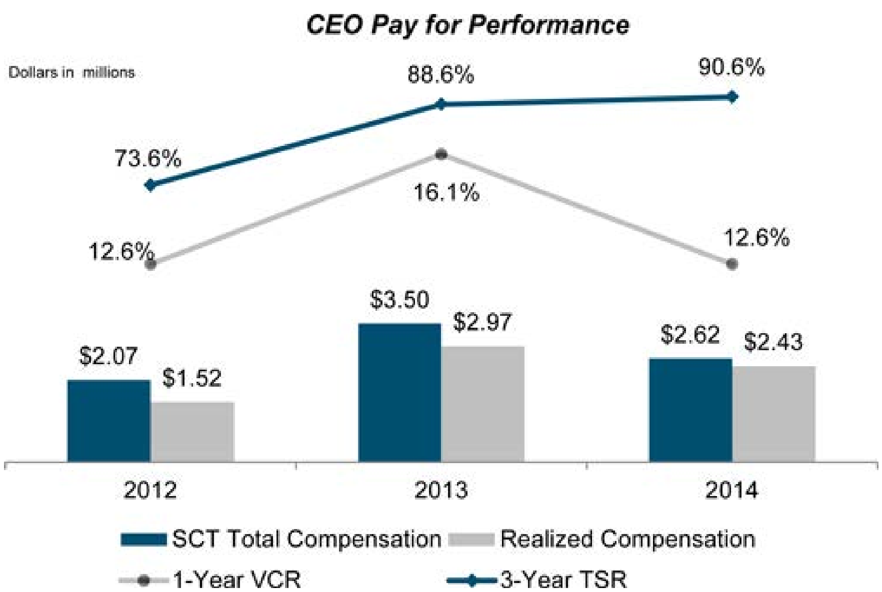
EXHIBIT 1 — EXAMPLE OF REALIZED PAY DISCLOSURE: CINCINNATI FINANCIAL

RELATIONSHIP BETWEEN COMPANY PERFORMANCE AND CHIEF EXECUTIVE OFFICER COMPENSATION

Generally the committee expects that when the company's performance adds or preserves more value for shareholders than its peers, that compensation for the named executive officers, including the chief executive officer, will be higher than when the company's performance lags its peers. Accordingly, the performance metrics for both annual and long-term performance-based compensation are calibrated to the company's performance compared with the companies in the peer group. At the same time, the committee expects compensation to directionally correlate with the company's actual performance for these metrics, particularly when considered over the long term. The following graph illustrates the directional relationships between company performance, based on the two performance metrics used in our performance-based awards and the compensation of our chief executive officer for each of the three years ending 2014.



CEO Pay for Performance	2012	2013	2014
SCT Total Compensation	$ 2,068,916	$ 3,501,957	$ 2,623,807
Realized Compensation (1)	$ 1,524,600	$ 2,971,137	$ 2,434,715
1-Year VCR	12.6%	16.1%	12.6%
3-Year Total Shareholder Return (2)	73.6%	88.6%	90.6%

(1) Realized compensation is the sum of salary and annual incentive cash compensation reported in the Summary Compensation Table for the year plus the value realized from the exercise of stock options and vesting of time-vesting or performance-based restricted stock units, if any, reported in the Option Exercises and Stock Vested table for the year

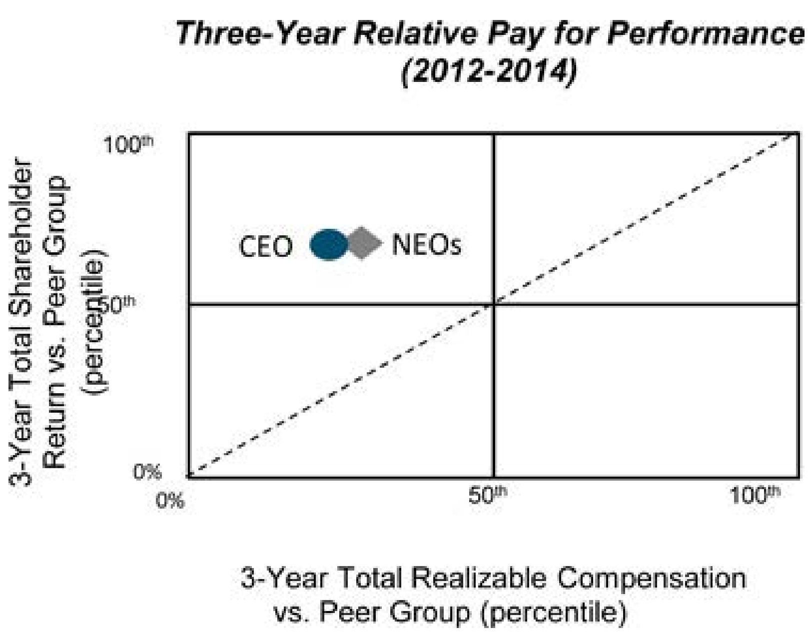
(2) 3-Year Total Shareholder Return is total shareholder return for the 3-year performance period ending December 31 of a given year, as calculated by and displayed on Bloomberg LP.

Over the last three years, compensation for our chief executive officer varied in line with the improving trend in overall company performance, even as the committee adjusted base annual salary and targets for performance-based compensation. Payouts of annual incentive and long-term performance-based awards throughout the period also directly align with company performance.

EXHIBIT 1 — CONTINUED

	Annual Incentive Compensation (VCR)		Long-Term Performance Equity Compensation (3-Year Total Shareholder Return)	
	Performance Relative to Peer Companies	Performance Level Earned	Performance Relative to Peer Companies	Performance Level Earned
2014	> 6 Peers	Target	> 6 Peers	Target
2013	> 9 Peers	Maximum	> 10 Peers	Maximum
2012	> 7 Peers	Target	> 10 Peers	Maximum

Our performance over the last three years exceeded the majority of the 10 companies of our peer group as measured by three-year total shareholder return. As suggested by the Three-Year Relative Pay for Performance graph below, total realizable compensation for our chief executive officer and the other named executive officers over the same period remains comparatively low, ranking below the 25th percentile, largely reflecting the size of several of the companies included in the peer group. Because we do not benchmark executive compensation to the peer group, our performance is judged against those companies against whom we compete every day for each insurance policy we write, regardless of the size of those companies.



Source: Cincinnati Financial, form DEF 14A, filed with the SEC March 18, 2015.

EXHIBIT 2 — REALIZABLE PAY DISCLOSURE: C.R. BARD

ANNUAL PAY-FOR-PERFORMANCE ANALYSIS

Pay-for-performance represents a significant element used in the development of our executive compensation program. The Compensation Committee structures our executive pay so that a substantial portion of the total compensation opportunity consists of variable compensation and is dependent upon our operational, financial and stock performance.

In October 2014, the Committee reviewed a historical pay-for-performance analysis conducted by the compensation consultant to evaluate the alignment of realizable pay to performance at the Company versus our peer group for the most recently completed one- and three-year periods (2013 and the three-year period from 2011 through 2013). In this analysis, the Committee considers realizable pay rather than pay opportunity because it reflects a more appropriate measure of executive pay by looking at actual earned cash and the realizable value of equity compensation based upon actual performance and stock price at the end of the measured performance period. The analysis reviewed during 2014 considered how each of the following compared with our peer group:

- the Company's relative one-year and three-year performance using operational and shareholder performance metrics, specifically revenue growth, net income growth and total shareholder return;
- the short-term alignment comparing our executives' 2013 annual bonus payouts and the Company's one-year relative performance; and
- the long-term alignment comparing our executives' potential long-term incentive compensation for the three-year period from 2011 through 2013 and the Company's three-year relative performance.

The analysis concluded that our executives' short-term pay for 2013 and long-term pay for the three-year period from 2011 through 2013 was in alignment with our performance and indicative of the performance orientation of the Company's compensation programs with challenging goals relative to our peers. The chart below illustrates the comparison of our CEO's realizable three-year long-term incentive value and total shareholder return relative to our peer group.

Source: C.R. Bard, form DEF 14A, filed with the SEC March 13, 2015.

EXHIBIT 3 — REALIZABLE PAY DISCLOSURE: ADOBE SYSTEMS

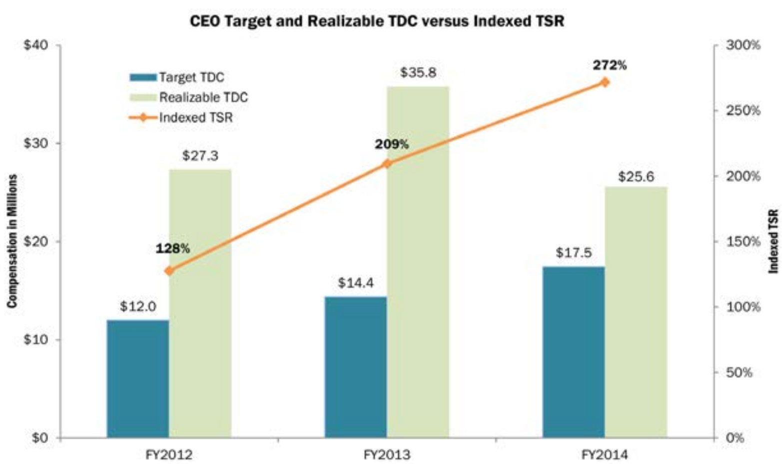
REALIZABLE PAY

Realizable pay reflects the real value of equity awards and increases or decreases with fluctuations in market value. When determining the annual equity grants to our executives in January of each year, the Committee believes it is important to take into account not only the grant date values included in our Summary Compensation Table, but also to consider the effect of the value of our stock on those awards at the end of our fiscal year.

Given that approximately 86 percent of our CEO's and 80 percent of our other NEOs' target pay is equity based, the Committee and the company consider it especially important to focus on realizable pay when evaluating pay for performance. If stock options awarded in previous years were "out of the money," they could expire without any realized value or dilutive effect to the company. In addition, decreases in our stock price could cause other stock-based awards to have realizable values that are less than what was targeted at the time of grant.

As the table below illustrates, when the company's stock price increases and generates positive returns for Adobe's stockholders, the increase impacts an executive's realizable pay during the present fiscal year and for past fiscal years during which the executive received equity awards that are held or still subject to vesting. Accordingly, a significant portion of our NEOs' TDC is closely linked to the performance of Adobe's stock over time, motivating our executives to generate positive returns to Adobe's stockholders.

The following chart demonstrates the relationship between the target and realizable values of our CEO's total direct compensation and Adobe's indexed TSR for fiscal years 2012, 2013 and 2014:



Target TDC: Target TDC is calculated using (1) our CEO's target base salary as disclosed in the "Fiscal Years 2013 and 2014 Base Salaries" table (or, in the case of fiscal year 2012, in our definitive proxy statement dated February 28, 2014), (2) cash bonus targets, which are based on a percentage of target base salary, and (3) equity award target values based on the number of RSUs and performance shares granted in each year using grant date fair value. No target value for All Other Compensation is included.

EXHIBIT 3 — CONTINUED

Realizable TDC: Realizable TDC is calculated using (1) our CEO's actual earned base salary, (2) cash bonus and all other non-equity compensation as disclosed in the "Summary Compensation Table," (3) equity award values (based on the stock price on the last day of fiscal year 2014 of $73.68) of all restricted stock units granted in each year, and (4) equity award values (based on the stock price on the last day of fiscal year 2014 of $73.68) of the number of performance shares credited under the fiscal year 2012 performance award program and the number of performance shares that would be credited under the fiscal year 2013 and 2014 performance share programs if performance achievement were measured as of mid-November 2014 rather than the end of the applicable performance period (accordingly, the number of performance shares that may be credited under these two programs will vary).

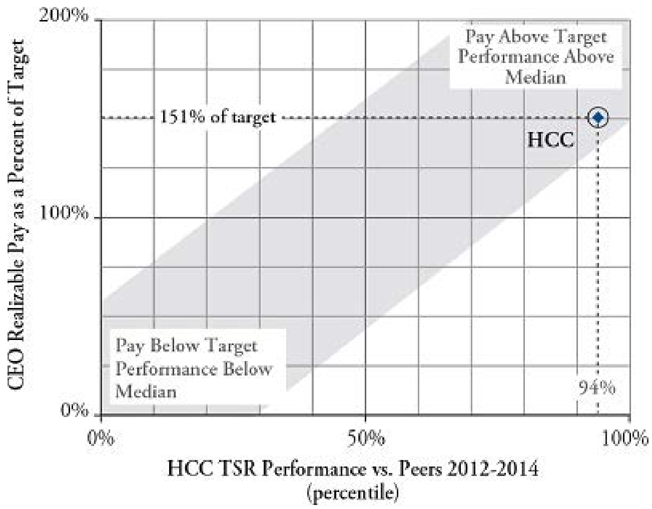
Indexed TSR: Indexed TSR is calculated by taking the stock price on the last day of fiscal years 2012, 2013 and 2014 of $34.61, $56.78 and $73.68 respectively, and dividing each by the stock price on the last day of fiscal year 2011 of $27.11.

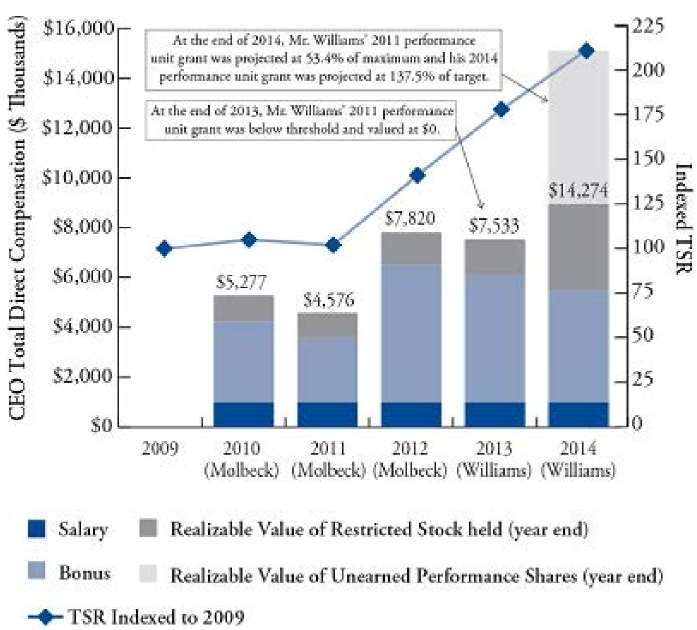
Source: Adobe Systems, form DEF 14A, filed with the SEC February 27, 2015.

EXHIBIT 4 — REALIZABLE PAY DISCLOSURE: HCC INSURANCE HOLDINGS

PAY FOR PERFORMANCE

The Company's executive compensation programs, which include significant annual incentive awards and long-term equity awards, are designed to encourage our executive officers to achieve exemplary results and are strongly aligned with the long-term interests of our stockholders. We emphasize pay for performance and structure our compensation programs to provide appropriate incentives to executives to drive business and financial results. Our Named Executive Officers received annual incentive awards based, in part, on Company performance relative to operating return on equity, GAAP combined ratio and growth in book value per share (ex-AOCI). In addition, there is a positive correlation between the Company's executive compensation and performance on both a relative and an absolute basis.





For purposes of both the relative and absolute alignment charts, realizable pay consists of base salary, plus the actual amount of the annual incentive award received for the period, plus the realizable value of unvested equity awards (valued at the end of the period).

Source: HCC Insurance Holdings, form DEF 14A, filed with the SEC April 9, 2015.

EXHIBIT 5 — REALIZABLE PAY DISCLOSURE: SUMMARY STATISTICS

Total Realizable Pay Disclosure	
Reference "realizable compensation"	182
Disclose realizable pay analysis	124
In text only	9
In table or graph	115
Disclose relative (percentile) rankings versus peers	56
Disclose dollar value of realizable pay	80
Disclose dollar value of realizable pay and indexed total shareholder return	38
Disclose dollar value of realizable pay and relative rankings versus peers	13
Among companies that disclose dollar value:	
Dollar value of realizable pay is lower	57
Percent lower, mean	-41%
Percent lower, median	-40%
Dollar value of realizable pay is higher	23
Percent higher, mean	54%
Percent higher, median	40%
Average say-on-pay support:	
All companies	91%
Companies disclosing realizable pay	88%
Companies disclosing realizable pay lower than summary compensation table	87%

Note: Sample includes 5,526 companies in 2014 and 4,112 in 2015. Companies reporting realizable pay calculations were identified using a textual search of all proxy statements filed in Edgar as of early July 2015. For firms reporting realizable pay calculations in both years, only the more recent year (2015 disclosure) is used for the analysis in this table. Say-on-pay support based on voting outcomes in the year preceding realizable pay disclosure.

Source: The authors.