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Understanding Pay for Performance in Executive Compensation Plans

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PRINCIPAL

This is the sixth in a series covering Executive Compensation Essentials—a resource for every board, compensation committee, and management team.

"Pay for performance" is one of the most common phrases in [executive compensation](). The idea is simple—executives should be rewarded when the company performs well, and payouts should reflect business results. But while the concept is widely accepted, actually achieving alignment between pay and performance can be much more challenging in practice.

Incentive plans may look good on paper, but without clear goals, thoughtful calibration, and consistent review, they may deliver outcomes that do not fully reflect company performance or shareholder expectations.

In this 6th installment of our Executive Compensation Essentials series, we examine pay for performance—its true meaning, ways to assess alignment, and practices that sustain it over time.

Defining Pay for Performance

At its core, pay for performance means a significant portion of an executive's compensation is not guaranteed, but rather is tied to achieving specific performance goals that reflect both the company's strategy and its long-term success.

A well-aligned program typically includes:

- A strong link between pay outcomes and company performance
- Performance goals that are well defined, credible, and aligned with strategy
- Payout structures that adjust with performance, paying more for stronger results and less when performance lags

Incentive plans ultimately succeed or fail based on how they are structured and assessed. The measure is simple—pay outcomes should align with performance outcomes.

Do Your Plans Deliver?

Short- and long-term incentives are the primary vehicles for executing a pay for performance strategy. We have previously covered how these plans are built, but from an alignment perspective, the key question is: **Do they actually reward meaningful results?**

It is not unusual to see well-designed programs fall short because the performance goals are too easy, the payout ranges are compressed, or discretion is overused. If payouts stay at or above target even when company performance is flat, it is worth a closer look.

So, what does strong alignment look like, and where do incentive plans typically fall short?

Signs of True Alignment

To assess whether your compensation program is really paying for performance, consider the following key questions:

- Do payouts move up or down in line with business results?
- Are the performance metrics clearly tied to strategic priorities?
- Are performance targets challenging, but realistic?
- How does the actual pay compare to the company’s results? How does this compare to peer companies with similar performance?
- Does actual pay align with the shareholder experience?

When plans are truly aligned, executives earn more when the company performs well and less when it doesn’t. The outcomes make sense, and the link between pay and performance holds up under scrutiny. When that connection weakens, even well-constructed programs can deliver outcomes that are difficult to defend.

Common Pitfalls

Breakdowns in alignment often stem from a few recurring pitfalls:

- Setting target pay opportunities too high relative to the role or market, creating misalignment from the start
- Establishing performance goals that are too easy, lack transparency, or fail to motivate excellence
- Using too many metrics, which dilutes focus and line of sight
- Relying too heavily on discretion or applying it inconsistently
- Prioritizing short-term goals at the expense of long-term priorities

With thoughtful design and regular oversight, these pitfalls can be avoided, helping to strengthen alignment between pay and performance.

Measuring Alignment

Boards, investors, and proxy advisors increasingly expect companies to demonstrate that executive compensation outcomes are tied to performance. Here are some ways to evaluate alignment:

Realized and Realizable Pay

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- *Realized pay* reflects compensation *actually received* during the measurement period (e.g., base salary, cash bonuses, and vested equity)
- *Realizable pay* considers what *could be earned* if current performance levels hold, factoring in unvested equity and outstanding awards

Both offer a more complete and up-to-date view of whether pay is truly tied to results. These perspectives also allow boards to assess outcomes over time and compare alignment relative to peers.

Peer Comparisons

Executive pay should be reasonable on its own and in the context of industry norms and the competitive market. Comparing realized or realizable pay and company performance against a well-constructed peer group provides a necessary reality check. It provides the context to assess whether outcomes are competitive and defensible.

When both performance and pay are tracking near median, alignment is clear. But when performance falls short and pay remains near the top, it is harder to defend.

And while boards and investors increasingly look to peer comparisons, regulators have pushed for their own test of alignment.

SEC Pay vs. Performance Disclosure

The SEC's Pay versus Performance disclosure was intended to illustrate the link between executive compensation and company performance. In practice, it often falls short. The standardized calculations may check a regulatory box, but they rarely capture the full story behind incentive plan design or long-term value creation.

It may meet the disclosure rule, but it offers little insight into whether pay and performance are truly aligned.

Best Practices for Strong Alignment

Whether you are building a plan from scratch or adjusting an existing one, these principles can help reinforce alignment:

- Choose performance metrics that reflect strategic priorities, not just what is easy to measure
- Ensure participants have a clear line of sight between their actions and the results being measured
- Review and recalibrate targets annually based on performance expectations and market conditions
- Include both absolute and relative metrics to account for external influences
- Revisit incentive designs regularly to reflect evolving business goals and shareholder expectations

Applied consistently, these practices help ensure incentive plan pay outcomes align with performance outcomes.

Effective Pay for Performance Plans Do More than Connect Pay and Results

They reinforce strategy and accountability, aligning leadership with shareholder interests.

But achieving and sustaining alignment requires thoughtful plan design, supported by regular testing and credible goal-setting. Goal-setting is often the area most closely reviewed when pay and performance appear misaligned, and it will be the focus of our next installment.

About the Author

Kimberly is a principal at Pearl Meyer providing analytical and project management support for client endeavors across the country. She is committed to providing clients with efficient and effective analytical support and solutions to achieve desired objectives and help enhance performance. She is experienced in executive, board, and broad-based employee compensation assessments and strategies.

About Pearl Meyer

Pearl Meyer is the leading advisor to boards and senior management helping organizations build, develop, and reward great leadership teams that drive long-term success. Our strategy-driven compensation and leadership consulting services act as powerful catalysts for value creation and competitive advantage by addressing the critical links between people and outcomes. Our clients stand at the forefront of their industries and range from emerging high-growth, not-for-profit, and private organizations to the Fortune 500.