The Resurfacing of Board Discretion in Variable Pay

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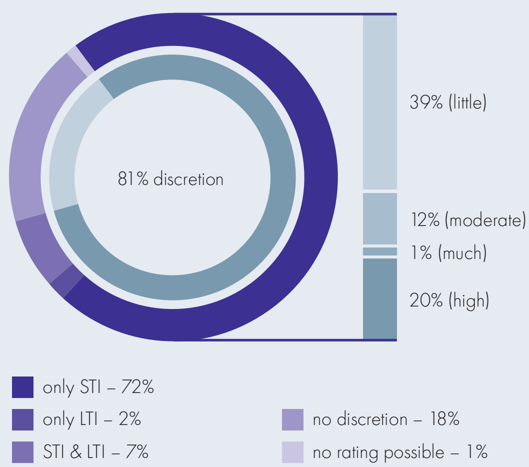
Recent evidence suggests that boards of directors are increasingly applying or at least reserving the right to use discretion in executive variable compensation decisions. For example, among the largest Swiss listed companies, 81% of the boards used or had the option to use some degree of discretion on variable compensation.[1] For these purposes, discretion can be defined as having the option to use own judgment with regard to a pay outcome. This is in contrast to having pay outcomes be based solely on a formula.

However, the use of discretion can differ depending on the pay instrument in question. The figure below shows that significantly more discretion is being applied in the short-term incentive (STI) (72%) than in the long-term incentive (LTI) (2%). Twenty percent of companies showed «high» use of discretion on variable pay. This is noteworthy even though the majority (51%) only permit «little» to «moderate» use of discretion.

Board discretion in variable CEO-pay



1 This article bases on the master thesis «Vergüten nach Ermessen – Eine Strukturierung und Beurteilung der Ermessensspielräume in der variable CEO-Vergütung auf Basis der grössten Schweizer börsennotierten Firmen»(Pedron, 2021) that examined the companies of the UBS 100 Index, which represent the largest listed companies in Switzerland in terms of market capitalization, for the existence of discretion in variable CEO compensation in 2019. For this purpose, publicly available information was analyzed (e.g., annual (compensation) reports). The result was an overall ranking of all companies analyzed with regard to their level of discretion in variable CEO compensation.

Applying discretion is by no means new. As early as 1978, researchers addressed the evaluation of performance for variable compensation contracts through the use of discretion or so-called «judgment» due to imperfect monitoring and agency issues.[2] The differentiation of discretion increased over time due to the growing complexity of compensation designs. However, the same challenges in dealing with discretion remain at the core today, such as discretionary decisions in some cases being based on private information and therefore not being verifiable by third parties, nor being able to be judicially enforced.[3,4]

To remedy the challenges and ensure that stakeholders' interests are protected, the market is increasingly demanding «rules» to provide a framework for dealing with discretion in variable compensation. Boards of directors are gradually confronted with increased regulatory requirements, critical investors, and related changes in their (voting) advisors (so-called proxy advisors) guidelines.

This article aims to define guiding principles for dealing with discretion and is structured as follows:

A Decision structure for variable compensation

B Four types of discretion

C Pros and cons of the use of discretion

D Limitations and guiding principles for applying discretion

E Concluding remarks

A Decision structure for variable compensation

Variable compensation typically entails three decisions:

Award Level Definition

The definition of the intended STI/LTI amount. Since this decision typically is made at the beginning of the performance year or at the time of signing the contract, only the following two decisions are relevant in the context of discretionary decision-making towards the final payout of the STI/LTI.

Performance Assessment

In general, the difference between variable and base compensation lies in the fact that variable compensation is performance- or success-based. Therefore, success or performance must be defined and measured. This is achieved by means of so-called key performance indicators (KPIs), which are measured individually and then combined to form an overall performance.

Payout Decision

Ultimately, a decision must be made as to how much variable compensation will be paid out (subsequently referred to as «result» or «outcome») based on the intended amount and the performance assessment.

2 Cf. Harris, M., & Raviv, A. (1979). Optimal incentive contracts with imperfect information. Journal of Economic Theory, 20(2), p. 233; Holmström, B. (1979). Moral Hazard and Observability. The Bell Journal of Economics, 10(1), p. 89.

3 Cf. Baker, G. P., Gibbons, R., & Murphy, K. J. (1994). Subjective Performance Measures in Optimal Incentive Contracts. The Quarterly Journal of Economics, 109(4), pp. 1125-1156., or Ederhof, M., Rajan, M. V., & Reichelstein, S. (2011). Discretion in Managerial Bonus Pools. Foundations and Trends® in Accounting, 5(4), pp. 243–316.

4 Murphy, K. J., & Oyer, P. (2001). Discretion in executive incentive contracts: Theory and evidence, p. 1&30.

B Four types of discretion

The figure below summarizes four types of board discretion - three of them are considered necessary, one is optional:

Type I – necessary
«discretion in assessing KPIs»

Type II – necessary
«discretion in weighting KPIs»

Type III – optional
«additional discretion»

Type IV – necessary
«full discretion»

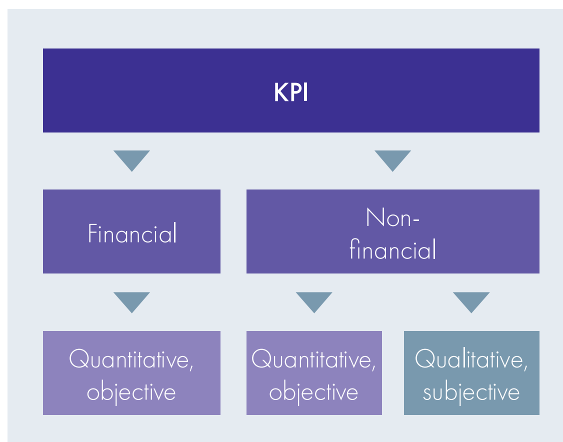
Type I – necessary «discretion in assessing KPIs»

KPIs are used to measure performance. These can be either financial or non-financial. A further distinction can be made between quantitative and qualitative KPIs. Financial KPIs are always quantitative. Non-financial KPIs can be qualitative or quantitative.[5]

Quantitative KPIs are objectively observable measures that third parties can verify. They include, for example, audited accounting figures (such as profit, sales, or assets), share prices, or quantifiable measures (e.g., Net Promoter Score). The measurement of qualitative KPIs is based on private information and a subjective assessment (discretion) of the appraiser (e.g., the board), which leads to the fact that it cannot be verified / checked by third parties.[6] Since qualitative KPIs cannot be measured without a subjective assessment, their use in the performance review context constitutes a necessary (inalienable) discretion.

Accordingly, assessing non-financial, qualitative KPIs is the first (necessary) type of discretion. The following figure provides an overview of the KPIs and the first type of discretion (green).

Although approximately 65% of the largest Swiss listed companies applied discretion type I in their variable CEO compensation, 95% of the companies used predominantly quantitative, objectively measurable KPIs.



5 Ittner, C. D., Larcker, D. F., & Rajan, M. V. (1997). The Choice of Performance Measures in Annual Bonus Contracts. The Accounting Review, 72(2), p. 231f. & 251;
Murphy, K. J. (1999). Chapter 38 Executive compensation. In Handbook of Labor Economics (Vol. 3, pp. 2485–2563). Elsevier, p. 10f.;
Murphy, K. J., & Oyer, P. (2001). Discretion in executive incentive contracts: Theory and evidence, p. 30;
Schiehll, E. (2008). Private performance information in CEO incentive compensation. In (Vol. 18, pp. 323–356): Emerald Group Publishing Limited, p. 326.

6 Ederhof, M., Rajan, M. V., & Reichelstein, S. (2011). Discretion in Managerial Bonus Pools. Foundations and Trends in Accounting, 5(4), 243–316, p. 247f.

Type II – necessary «discretion in weighting KPIs»

To determine the overall performance (or a target achievement level), a combination of the KPIs used (if multiple) is required. The combination of KPIs is performed by weighting each KPI, whereby the weighting can be determined ex-ante or be decided ex-post (at the discretion of, e.g., the board). A closer link between pay and performance can be achieved by including ex-post information such as a changing market environment.[7]

Where the weighting of KPIs is decided ex-post, a necessary (inalienable) discretion is assumed since no overall performance assessment can be made without such weighting. Accordingly, the ex-post weighting of the KPIs used for the performance assessment constitutes the second (necessary) type of discretion.

In contrast to discretion type I, used by a majority of the companies analyzed, discretion type II in variable CEO compensation was only used by approximately 11% of the companies. Particularly in the LTI, discretion type II was not observed. However, it should be emphasized that only 4% of the companies that had an LTI instrument requiring a performance assessment applied discretion.

Type III – optional «additional discretion»

In addition to the performance assessment, there may be discretion that complements the explicit contract or exceeds the formula so that ex-post adjustments become possible.[8] Special circumstances are taken into account that, according to the subjective opinion of the board of directors, are of importance in the decision-making process for variable compensation and are not or only insufficiently covered by the performance assessment.

Examples of such circumstances include outperformers and underperformers, external factors, reorganization and the impact of new business units on performance, unrealistic budgets, or the perpetuation of internal equity.[9] These circumstances are considered optional discretion that can be applied if needed. Optional discretion is allocated to the payout decision. The performance assessment is adjusted from an ex-post perspective to strengthen the link between pay and performance.[10]

In general, optional discretion can be quantified because, according to the explicit contract or formula, without the ex-post adjustment of the board, a lower (if positive discretion is applied) or higher (if negative discretion is applied) payment would have been made. Cases in which the performance assessment itself is amended from an ex-post perspective belong to this type of discretion but cannot at all times be quantified. In summary, the ex-post modification of the performance assessment outcome to improve the link between pay and performance in the payout phase constitutes the third type of discretion. In contrast to the first two types, the use of this discretion type is optional.

In 24 (ca. one-fourth) of the companies surveyed, the board had the option for additional discretion in determining the final STI payout. Of these, one company used positive discretion (upwards correction), two companies used negative discretion (downwards correction), and two companies used no discretion. 18 companies did not indicate whether the option of discretion type III was exercised. Only 9% of the boards whose variable CEO compensation included LTIs had the option for additional discretion.

7 Höppe, F., & Moers, F. (2011). The Choice of Different Types of Subjectivity in CEO Annual Bonus Contracts. The Accounting Review, 86(6), p. 2041.

8 Ederhof, M. (2010). Discretion in Bonus Plans. p. 1929; Gibbs, M., Merchant, K. A., Van der Stede, W. A., & Vargus, M. E. (2003). Determinants and Effects of Subjectivity in Incentives. The Accounting Review, 79(2), p. 412.

9 Murphy, K. J., & Oyer, P. (2001). Discretion in executive incentive contracts: Theory and evidence, p. 22.

10 Höppe, F., & Moers, F. (2011). The Choice of Different Types of Subjectivity in CEO Annual Bonus Contracts. The Accounting Review, 86(6), p. 2041.

Type IV – necessary «full discretion»

It may be that the payout amount is not triggered by a formula nor by a supplemental or overriding decision, but rather a decision by the board that is detached from the explicit contract. In other words, there may be no formula-based or contractually specified causal link between the performance assessment and the payout. This form of discretion is called «full» discretion.

This does not mean that no performance assessment is required or that no link between pay and performance must be made. «Full» discretion can be applied by including the performance assessment in the basis for the decision. However, not being decisive for the absolute amount of the payout. Accordingly, «full» discretion is again necessary since a payout, without a formula-based contract, is dependent on the assessment and decision of, e.g., the board regarding a potential payout and its level. Thus, (necessary) «full» discretion in determining the result is the fourth and last type of discretion.

This type of discretion was used significantly more often than expected. 21% of the companies let their board decide the amount of the CEO's STI at its «full» (or sole) discretion. In the LTI, this type of discretion was not observed.

C Pros and cons of the use of discretion

There are numerous reasons why discretion in variable compensation can be advantageous or disadvantageous for companies (or their owners, boards, or executives from the appraiser's perspective) and their employees (from an appraisee's perspective). The following figure summarizes the reasons for and against discretion.

Reasons for discretion	Reasons against discretion
1. Consideration of individual performance 2. Inclusion of new information becoming available during the performance management year 3. Reduction of compensation-related risks 4. Increase in fairness and satisfaction with compensation 5. Reduction of «gaming» 6. Future-oriented perspective	1. Risk of inaccurate, unfair, untruthful assessment, mainly due to cognitive limitations of the appraiser Subsequent problems: – Loss of incentive effect of variable compensation – Loss of causal link between pay and performance – Decrease in morale of the appraisee 2. Manipulation risks of the appraisee 3. Lack of verifiability, auditability, and legal enforceability of discretionary contracts

Reasons for the use of discretion

1. Consideration of individual performance

One of the main reasons for discretion in variable compensation is the possibility of including individual performance more easily and comprehensively in performance assessments. Quantitative or objectively measurable KPIs are imperfect and too broad. The reason is that they usually refer to company performance and do not (fully) encompass the performance of an individual.[11]

11 Murphy, K. J., & Oyer, P. (2001). Discretion in executive incentive contracts: Theory and evidence, pp. 1&30&32;
Gibbs, M., Merchant, K. A., Van der Stede, W. A., & Vargus, M. E. (2003). Determinants and Effects of Subjectivity in Incentives. The Accounting Review, 79(2), p. 411.

This can be addressed by including qualitative KPIs so that an improvement in contract design can be achieved through an overall performance assessment.[12] The inclusion of individual performance in the overall assessment thus can solve the multiple task problem, in which tasks of the appraisee cannot be adequately translated into success criteria.[13]

2. Inclusion of new information becoming available during the performance management year

Another reason for discretion in variable compensation for companies and employees is the possibility of including relevant information or circumstances that only become available during the contract period. This refers to the inclusion of unforeseen events and the correction of error-prone metrics.[14] Research indicates that discretionary adjustments are made, particularly when the results of quantitative KPIs are either high or low but not in the middle range.[15]

3. Reduction of compensation-related risks

By filtering out uncontrollable factors with subsequent discretionary adjustments, compensation risks for employees can be reduced, and better alignment of incentives can be achieved from the company's perspective. Uncontrollable factors are circumstances or events that affect the company's performance but over which the employee has little influence, referred to as «noise».[16]

4. Increase in fairness and satisfaction with compensation

By using subjectively assessed, qualitative KPIs, companies can include performance dimensions that otherwise might be hard or impossible to include in explicit compensation contracts. Using such discretion raises opportunities to restore the perceived fairness of variable pay or increase satisfaction with the outcome from an employee's perspective.[17]

5. Reduction of «gaming»

Quantitative KPIs are susceptible to manipulation given that the employee has a (temporal) information advantage over the appraiser (e.g., especially over the board) and can use it to his or her advantage regarding the performance assessment, so-called «gaming».[18] Using discretion, the company can reduce such manipulation risks, as part of the assessment is made ex-post. This reduces the incentive and the employee's ability to manipulate KPIs in his or her favor.[19]

6. Future-oriented perspective

Another reason for discretion from a company's perspective is the mitigation of the excessively short-term or past focus of quantitative KPIs. Accordingly, qualitative KPIs, which are discretionary and only visible to contracting parties, can reward future expected performance.[20]

12 E.g., Holmström, B. (1979). Moral Hazard and Observability. The Bell Journal of Economics, 10(1), 74–91, p. 89; Hayes, R. M., & Schaefer, S. (2000). Implicit Contracts and the Explanatory Power of Top Executive Compensation for Future Performance. The RAND Journal of Economics, 31(2), p. 292.

13 Gibbs, M., Merchant, K. A., Van der Stede, W. A., & Vargus, M. E. (2003). Determinants and Effects of Subjectivity in Incentives. The Accounting Review, 79(2), p. 411.

14 Gibbs, M., Merchant, K. A., Van der Stede, W. A., & Vargus, M. E. (2003). Determinants and Effects of Subjectivity in Incentives. The Accounting Review, 79(2), p. 410&411; Bol, J. C. (2008). Subjectivity in Compensation Contracting. 27, 1–32, p. 8.

15 Rajan, M. V., & Reichelstein, S. (2009). Objective versus Subjective Indicators of Managerial Performance. The Accounting Review, 84(1), p. 227; Ederhof, M. (2010). Discretion in Bonus Plans. Vol. 85, pp. 1922f. &1941.

16 E.g., Gibbs, M., Merchant, K. A., Van der Stede, W. A., & Vargus, M. E. (2003). Determinants and Effects of Subjectivity in Incentives. The Accounting Review, 79(2), p. 410&412; Oyer, P. (2004). Why Do Firms Use Incentives That Have No Incentive Effects? The Journal of finance (New York), 59(4), p. 1645; Rajgopal, S., Shevlin, T., & Zamora, V. (2006). CEOs' Outside Employment Opportunities and the Lack of Relative Performance Evaluation in Compensation Contracts. The Journal of Finance, 61(4), p. 1842.

17 Rajan, M. V., & Reichelstein, S. (2009). Objective versus Subjective Indicators of Managerial Performance. The Accounting Review, 84(1), p. 210; Bol, J. C. (2008). Subjectivity in Compensation Contracting. 27, p. 12.

18 E.g., Baker, G. P. (1992). Incentive Contracts and Performance Measurement. The Journal of political economy, 100(3), p. 612; Ittner, C. D., Larcker, D. F., & Meyer, M. W. (2003). Subjectivity and the Weighting of Performance Measures: Evidence from a Balanced Scorecard. The Accounting Review, 78(3), p. 754.

19 Bol, J. C. (2008). Subjectivity in Compensation Contracting. 27, p. 11; Gibbs, M., Merchant, K. A., Van der Stede, W. A., & Vargus, M. E. (2003). Determinants and Effects of Subjectivity in Incentives. The Accounting Review, 79(2), p. 412.

20 Gibbs, M., Merchant, K. A., Van der Stede, W. A., & Vargus, M. E. (2003). Determinants and Effects of Subjectivity in Incentives. The Accounting Review, 79(2), p. 412; Hayes, R. M., & Schaefer, S. (2000). Implicit Contracts and the Explanatory Power of Top Executive Compensation for Future Performance. The RAND Journal of Economics, 31(2), p. 292; Ederhof, M. (2010). Discretion in Bonus Plans. p. 1941.

Reasons against the use of discretion

a. Risk of inaccurate, unfair, untruthful assessment, mainly due to cognitive limitations of the appraiser

The most significant risk of discretion in variable compensation revolves around any potential abuse of it, such as assessing the employee inaccurately, unfairly, or even untruthfully. When discretion is applied, it is always assumed that the judgment is made truthfully and to the best of one' s knowledge and belief, partly due to the duty of care and loyalty under 717 para. 1 CO. Nevertheless, a discretionary assessment makes it impossible for a court to examine the accuracy of the contract so that promises can be breached by the company (or the appraiser, e.g., the board), and the perceived transparency may be lost.[21]

A primary factor for biased assessments is the cognitive limitations of humans. For example, known features are used to infer unknown characteristics of an employee, the so-called «halo effect». Further, a more or less randomly memorized performance behavior serves as the basis for personal assessment. Personal preferences of the appraiser lead to some dimensions being considered more important than others in the assessment.[22]

In addition, appraisers may tend to evaluate employees too leniently («leniency bias») or too well («severity bias»), regardless of their actual performance. Reasons for this are, for example, interpersonal relationships such as a friendship between the appraiser and the appraisee, negative feelings towards the appraisee, or the avoidance of confrontation.[23]

According to empirical research, appraisees are assessed inaccurately when the appraiser pursues self-interest.[24] Another factor for distorted performance appraisals is information asymmetries of the appraiser (especially the board) concerning an employee's (actual) performance. These are reinforced by general trends, such as home office, or special events, such as the Corona pandemic, which accelerate the trends. Ultimately, significant time and monitoring costs for performance assessments combined with time pressure can lead to inaccurate assessments.[25]

Inaccurate, unfair, or untruthful performance assessments can result in subsequent risks for companies. For example, compensation contracts may lose their incentive effect, the causal link between pay and performance may be lost, or employee morale may decline. Lower motivation can lead to lower performance or, in the worst case, fluctuation.[26]

21 Bol, J. C. (2008). Subjectivity in Compensation Contracting. 27, p. 14; Fulk, J., Brief, A. P., & Barr, S. H. (1985). Trust-in-supervisor and perceived fairness and accuracy of performance evaluations. Journal of business research, 13(4), p. 307;
Prendergast, C., & Topel, R. (1993). Discretion and bias in performance evaluation. European Economic Review, 37(2), p. 363;
Baker, G. P., Gibbons, R., & Murphy, K. J. (1994). Subjective Performance Measures in Optimal Incentive Contracts. The Quarterly Journal of Economics, 109(4), p. 1227.

22 Thorndike, E. L. (1920). A constant error in psychological ratings. Journal of applied psychology, 4(1), p. 25;
Becker, F. G. (2003). Grundlagen betrieblicher Leistungsbeurteilungen, Leistungsverständnis und -prinzip, Beurteilungsproblematik und Verfahrensprobleme (4., aktualis. Aufl. ed.). Schäffer-Poeschel, p. 224ff.;
Bailey, W. J., Hecht, G., & Towry, K. L. (2006). Dividing the Pie: Do Managers Fully Incorporate Non-Contracted Information into Full and Partial Discretionary Bonus Allocations? In G. Hecht (Ed.): AAA 2007 Management Accounting Section (MAS) Meeting Paper, p. 25.

23 Feldman, J. M. (1981). Beyond attribution theory: Cognitive processes in performance appraisal. Journal of applied psychology, 66(2), 127-148, p. 140;
Bol, J. C., Hecht, G., & Smith, S. D. (2015). Managers' Discretionary Adjustments: The Influence of Uncontrollable Events and Compensation Interdependence. Contemporary Accounting Research, 32(1), p. 157;
Cardy, R. L., & Dobbins, G. H. (1986). Affect and Appraisal Accuracy: Liking as an Integral Dimension in Evaluating Performance. Journal of applied psychology, 71(4), p. 673;
Klimoski, R., & Inks, L. (1990). Accountability forces in performance appraisal. Organizational behavior and human decision processes, 45(2), p. 202; Baker, G. P., Jensen, M. C., & Murphy, K. J. (1988). Compensation and Incentives: Practice vs. Theory. The Journal of Finance, 43(3), p. 598.

24 Bol, J. C. (2008). Subjectivity in Compensation Contracting. 27, p. 14.

25 Murphy, K. J., & Oyer, P. (2001). Discretion in executive incentive contracts: Theory and evidence, p. 31;
Boyon, N. (21. Juli, 2021). Workers want more flexibility from their employers after COVID. Ipsos. https://www.ipsos.com/en/return-to-the-workplace-global-survey

26 Bol, J. C. (2008). Subjectivity in Compensation Contracting. 27, p. 14; Gibbs, M., Merchant, K. A., Van der Stede, W. A., & Vargus, M. E. (2003). Determinants and Effects of Subjectivity in Incentives. The Accounting Review, 79(2), p. 433;
Baker, G. P., Gibbons, R., & Murphy, K. J. (1994). Subjective Performance Measures in Optimal Incentive Contracts. The Quarterly Journal of Economics, 109(4), p. 598f.

b. Manipulation risks of the appraisee

Another risk of discretion in variable compensation is the appraisee's activities and efforts to inappropriately influence the appraiser. Once the appraisee knows which activities are of particular importance to the appraiser, he or she will distort the effort to win the appraiser's favor.[27] Subsequently, the risk of manipulation («gaming») of quantitative KPIs described above is transferred to influencing the appraiser using discretion. Accordingly, manipulation risks are a problem for assessments in general.

c. Lack of verifiability, auditability, and legal enforceability of discretionary contracts

Ultimately, discretionary decisions and contracts based on private information cannot be reviewed or verified by third parties or legally enforced in court.[28, 29]

D Limitations and guiding principles for applying discretion

When applying discretion in variable compensation, framework conditions for Swiss listed companies mainly arise from a regulatory, proxy advisor, and large investor perspective (also representing small investors).

The main framework conditions for the use of discretion from a regulatory perspective derive from:

- the Transparency Act (Ordinance against Excessive Compensation in Listed Companies; VegüV)
- the Swiss Code of Best Practice for Corporate Governance (Swiss Code)
- the Directive on Information Relating to Corporate Governance (RCLG) of SIX Swiss Exchange AG
- the Circular on Remuneration Schemes of FINMA (particularly for its subordinated banks and insurance companies)
- the labor law, in particular Art. 319 para. 1 CO (salary), Art. 322d CO (gratuity) and the Business Judgment Rule (BJR)

The primary proxy advisors defining framework conditions for the use of discretion are:

- ISS
- Glass Lewis
- Ethos

The key investors defining framework conditions for the use of discretion, among others, are:

- BlackRock
- Fidelity
- UBS Funds Management AG

What guiding principles can be derived from the framework conditions?
The framework conditions mentioned above result in the following guiding principles, which ought to be followed or are recommended when dealing with the above-defined discretion types:

Framework conditions

Regulatory | Proxy advisors | Investors

Guiding principles for the use of discretion

«Ensuring the transparency of variable compensation»

a. Disclosure of the performance assessment methodology

b. Disclosure of the amount and direction of (optional) discretionary payments

c. Showing the link between (individual) pay and performance

d. Justification of the use of discretion with financial results

e. Avoidance of excessive or unjustified discretion

f. Acting in good faith, with sufficient information, and in the best interests of the company

27 Bol, J. C. (2008). Subjectivity in Compensation Contracting. 27, p. 21; Milgrom, P. R. (1988). Employment Contracts, Influence Activities, and Efficient. The Journal of political economy, 96(1), p. 58; Prendergast, C. (1993). A Theory of «Yes Men». The American economic review, 83(4), p. 769.

28 Ederhof, M. (2010). Discretion in Bonus Plans. p. 1923f.; Rajan, M. V., & Reichelstein, S. (2009). Objective versus Subjective Indicators of Managerial Performance. The Accounting Review, 84(1), p. 210.

29 Murphy, K. J., & Oyer, P. (2001). Discretion in executive incentive contracts: Theory and evidence, p. 1&30.

«The top priority is to preserve the transparency of variable compensation!»

a. Disclosure of the performance assessment methodology

The KPIs used should be described to understand whether they are quantitative or qualitative (discretion type I). Furthermore, their selection should be justified. Finally, the weighting of the KPIs must be disclosed (if ex-post, discretion type II) to understand the performance assessment better.

b. Disclosure of the amount and direction of (optional) discretionary payments

If the option of additional discretion is applied (discretion type III), it should be stated to what extent (quantified amount) the actual result, determined by the explicit contract or formula without additional discretion, has been changed. Likewise, a clear indication should be given as to whether the change has increased or decreased the outcome.

c. Showing the link between (individual) pay and performance

When using «full» discretion (discretion type IV), particular caution is required. It is recommended to make use of qualitative KPIs for individual performance assessments. Ultimately, the option of additional discretion can increase the link between pay and performance, which may not be sufficiently evident from the explicit contract or formula.

d. Justification of the use of discretion with financial results

When applying any type of discretion, it is crucial to ensure that financial performance is measured in the performance assessment. Accordingly, a performance assessment of purely qualitative (discretionary) KPIs is not feasible. To conclude, discretion should not be in strong contrast to financial performance.

e. Avoidance of excessive or unjustified discretion

Although no definition is given as to how much discretion is «excessive», it can be guessed that «full» discretion, in particular, is critical. This does not mean that its use is prohibited. As a rule, however, a higher degree of discretion is accompanied by a higher requirement for transparency in its use.

f. Acting in good faith, with sufficient information, and in the best interests of the company

According to most legal systems, including in Switzerland, boards of directors and executives are bound to standards of good faith, due care, and acting in the best interest of the company and its shareholders. Hence the company's board and management are duty-bound to also observe these principles when applying discretion on compensation.

What are the potential consequences of non-compliance with the guiding principles?

Possible consequences directly alleged in the context of compensation can be identified, particularly in the voting results of the Annual General Meeting. In this regard, possible consequences are, among others:

- rejection of the compensation report;
- rejection of members of the compensation committee;
- rejection of the amount of the variable compensation of the management;
- rejection of the amount of the total compensation of the management.

Moreover, legal consequences may arise from non-compliance, e.g., with the duty of care and loyalty, or not adhering to regulatory rules or guidelines, such as from SIX or FINMA.

E Concluding remarks

A glance at the Swiss market shows that discretion in variable compensation is becoming standard market practice at listed companies, particularly for STIs.

The analysis of the 97 largest Swiss listed companies reveals that a large majority of the companies (77) have at least one type of discretion in the STI of their CEO. In the LTI, only nine companies show discretion. Seven companies have «little» discretion in the payout decision, and two companies have «moderate» discretion in both the performance assessment and the decision on the final payout amount of the LTI.

Board's discretion in variable compensation can be divided into four different types, of which three are considered necessary and one optional. Discretion in (I) the assessment and (II) weighting of KPIs are «necessary» types of discretion. (III) Discretion to adjust the performance assessment result upwards or downwards is an «optional» discretion type. Lastly, (IV) discretion to determine the result solely at the boards' judgment taking into account the performance assessment but not relying on a formula-based or contractually specified causal link between the performance assessment and the payout. The most frequently used discretion type, with 65% of the companies surveyed, is discretion type I (discretion in assessing KPIs).

Next in line are discretion type III (additional discretion) and discretion type IV (full discretion) with 25% and 21%, respectively. Discretion type II (discretion in weighting KPIs) is only used in the STI, if at all (11%).

A juxtaposition of the advantages and disadvantages shows that the use of discretion may well be justifiable. For example, by including discretion in variable compensation, individual performance or performance that is difficult to assess can be considered, information that becomes available during the performance management year can be included, and compensation risk can be limited. Additionally, the use of discretion in variable compensation can lead to higher satisfaction by the employee with the outcome, can support a future-oriented perspective, and can reduce manipulative behavior on quantitative KPIs.

The principal risks of discretion revolve around any potential abuse of it, such as if the assessment is inaccurate, unfair, or untruthful. This can be due to cognitive limitations of the appraiser or manipulation by the appraisee. Framework conditions can partially mitigate these risks, as they allow discretion in principle but require a high degree of transparency in its use. The fact that discretion cannot be easily verified or reviewed by third parties or that it can face enforcement challenges legally underlines the importance of transparent disclosure of discretion.