Executive Accountability and Defensible Executive Pay

By Mark Van Clieaf and Janet Langford Kelly

Executive pay for performance is clearly in crisis. Too few boards have a thoughtful process to determine and align both what they expect from executives—what they are paid for—and how they are paid. The resulting sheer magnitude of executive compensation payouts, the disconnects between pay and performance, the lack of internal executive pay equity, and the trend for some named executive officers (NEOs) to walk away with significant compensation windfalls after destroying large amounts of shareholder value have all increased shareholder activism—and put directors at risk.

In this environment, practices that were routine or "check the box" even a year or two ago are now the subject of proxy solicitations, litigation, and judicial decisions. Directors and legal counsel need to start with a blank page if they want to create executive pay packages that drive the creation of long-term value and minimize the risk of being successfully challenged.

The Fundamental Problems

A review of executive pay and corporate performance over the past five years reveals three basic problems with current executive pay practices, which should raise a red flag for boards. Directors too often fail to:

- Design executive compensation policy and programs that create a direct correlation with executive pay, enterprise performance, and sustainable value creation.
- Integrate executive compensation with organization structure and business strategy.
- Differentiate clearly between strategic vs. operational performance measurement and strategic vs. operational executive pay.

These process problems are evident because of the missing guiding principle that if a board has not clearly defined what is the work executives are being held accountable for that adds enterprise value, then directors cannot make a truly defensible executive pay decision.

The Missing Link Between Executive Pay and Enterprise Performance

Consider the following executive compensation facts:

- Median CEO compensation in the S&P 500 grew from $1.7 million in 1992 to $10.3 million in 2003—a multiple of more than 6 times.
- Executive pay consumed 6 percent of total corporate profits between 1993 and 1997; it consumed 10 percent of aggregate corporate profits from 1998 to 2002.
- The named executive officers of U.S. public companies received $ 250 billion in executive compensation over 10 years ending in 2002.

Now consider these business performance facts:

- From 1990 to 2003, the aggregate market capitalization of the S&P rose by a multiple of 2.4 and corporate profits rose by a multiple of 1.3.
- Our financial analysis of the top 2100 publicly traded corporations (representing over 90 percent of U.S. market capitalization) identified that 59 percent of those companies studied failed to provide an increase in net operating profit after tax greater than their cost of capital over the five years ending in 2003. This five-year performance and negative return on invested capital should raise a red flag for directors of these companies to question whether the business model/strategy is viable, and if they are holding named executive officers accountable for the right level of work and innovation

Director Summary: The authors explode commonly held executive compensation myths, and encourage directors to begin by examining what it is executives are being paid for, before deciding how much to pay. Align compensation with innovation and performance.

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Clearly senior executive pay has risen dramatically and without relation to performance and the viability of the enterprise. This conclusion is further reinforced by our recent analysis of 60 U.S. listed companies. These companies destroyed $700 billion in shareholder wealth and $485 billion in intrinsic value between 2000 and 2004. But the real news is these 60 companies paid over $12 billion in total direct compensation to their named executive officers alone over the same five-year period.

No Link Between Executive Pay, Organization Structure, and Business Strategy

Unfortunately, too many companies are currently setting executive compensation with no linkage to the company's business strategy or organization structure. Indeed, recent interviews with a number of executive compensation consultants lead us to believe that these consultants typically do not even see the client company's multi-year business plan, strategy and goals, much less use them as a key input into the design of executive pay. A number of independent directors also confirmed this based on their years of board experience.

Confusion between Operational Work and Pay and Strategic Work and Pay

Recent studies indicate that, for the median of the Russell 3000, approximately 59 percent of enterprise market value (MV) is based on expectations of future growth, innovation, and expected future value (FV) compared to profits and cash flow from current operations (CV). These expectations represented $7 trillion in U.S. market value as of May 2003.

Directors have a "strategic duty" to ensure that the future value inherent in today's stock price is realized through focusing senior management on creating new products, new services, new markets, and new businesses. Indeed, the ability to create future value (FV) beyond a company's existing operations is the true job of executive management, and justifies differential executive compensation.

In order to realize the promise inherent in their current stock price, most companies must have a value-added organizational architecture that drives senior executives to focus on the creation of future value (FV) from new innovations beyond current operations. This architecture includes three-year or longer strategic metrics by which the board can evaluate management performance in creating these innovations and return on invested capital (ROIC).

Yet a review of 2004 proxy statements by The Corporate Library concludes that 85 percent of companies have failed to set multi-year performance targets to encourage management to pursue the creation of that longer-term value and innovation. McKinsey's 2005 study of board practices further supports that conclusion: 55 percent of directors surveyed said they had no meaningful process and metrics from which to evaluate the CEO role.

Most "long-term" incentives plans (LTIPs) in North America, do not hold senior executives accountable for creating the long-term intrinsic value of the enterprise. Rather, typical metrics and targets today that are linked to executive compensation for named executive officers include annual improvements in earnings, cash flow, and sales from current operations. Thus, most CEOs and other named executive officers lack true accountability regarding the expected value of future growth and innovation beyond the current performance of existing operations.

Recognizing the Myths of Executive Compensation

These destructive pay practices have resulted from some deeply—perhaps even unconsciously—held beliefs about executive pay and value creation. The following myths about executive compensation need to be shattered.

Myth # 1. Total shareholder return (TSR) and earnings per share (EPS) are good measures to use in executive pay-for-performance plans. In fact, neither is a good measure. Using a basic TSR metric ignores the fact that some 70% of changes in stock prices result from macro-economic events outside executives' control (such as interest rates, GDP growth, currency exchange rates, commodity prices) and allow executives to benefit from a free ride when the total equity market or sector goes up. EPS is easy to manipulate through both earnings engineering and stock repurchase programs and fails to take into account the level of risk to capital, the capital intensity and returns of an industry, the time value of money, and future free cash flow potential of the business.

Myth # 2. All equity compensation (including plain-vanilla stock options and time-vested restricted stock) creates alignment with longer-term interests of shareholders. In fact, plain-vanilla stock options enable grantees to profit from industry-wide and macro-economic trends unrelated to managerial effectiveness. Of even greater concern, according to Don Delves, they seem to have driven behavior at odds with the creation of long-term value as they create "enormous incentives for executives to think and act like option-holders, with far shorter-term and riskier perspectives than is healthy for most companies." Time-vested restricted stock grants solve some of these problems but create others, as they represent a guaranteed transfer of shareholder wealth as long as the executive remains employed.

Myth # 3. Executive compensation surveys and benchmarking reports accurately reflect the market for executive talent and can be relied on at face value. In fact, these surveys and reports suffer from many flaws, including questionable peer group choices. Most lack any process to delve beneath titles to understand the job content, accountability and complexity of the roles being compared. Without a defensible process for compensation calibration based on the true level of complexity of the roles being compared, the reports could mislead boards and shareholders by up to 100 percent.

Myth # 4. Most compensation consultants are experts in strategic pay for performance and the board is protected if they rely on their input as an expert advisor. In fact, most compensation consultants are experts in executive pay design and pay delivery, and would not meet the test of being experts in pay for performance, which requires an understanding of effective organizational design and business strategy.

Myth # 5. Money is the key driver of senior executives, who will leave if boards renegotiate pay and pay for performance contracts. In fact, executive talent is much stickier than commonly assumed, as lack of transferability of accumulated knowledge, lack of geographic mobility, and the opportunities a job offers an executive to grow and contribute and work "in flow" can all cause an executive to be satisfied with less than is theoretically available according to benchmarking reports. Indeed, Elliott Jaques, in his research on work, equitable pay, and level of capability, found that individuals are unconsciously aware of the consistency or lack of consistency among work, capability, and earnings, and are actually happier when the three are in equilibrium, not when they are earning the highest amount of money.

Fixing the Fundamental Executive Pay for Performance Problems

So what should directors be doing? Many of the larger and more sophisticated pension funds in the world, who together make up some 60 percent of global equity capital, have made their expectations as shareholders very clear. Through policy statements and proxy voting guidelines on executive compensation, these shareholders have indicated they would like to see management performance evaluated using value-based metrics measured over at least three, and ideally, five years. Indeed, corporate finance and equity research over many years validates the high correlation between the above metrics of intrinsic enterprise value and longer-term sustained equity market and shareholder value.

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To fix these fundamental issues of executive pay, directors, in executing their duty of care, must recognize the:

- Current executive pay for lack of performance correlation.
- Disconnects among organization design, business strategy, and executive compensation design.
- Myths of executive compensation.
- Need to challenge the executive compensation reports and have a quality assurance process that ensures only comparable jobs are being benchmarked (or if not comparable, then compensation levels are properly calibrated for any differences using executive job complexity not size of the company).
- Need to apply performance metrics that drive and measure the creation of long-term value for the enterprise over an appropriate performance period.

Only by engaging in these types of rigorous processes can board members truly determine the appropriate performance measures and incentives that drive longer-term value creation for shareholders. Directors who ensure the integration of organization design, business strategy, and pay for sustainable performance will truly fulfill their "strategic duty"—their duty to ensure the future viability of the corporation by focusing senior management on the proper balance between growth and return on invested capital from the existing business, and from creating new products, new services, new markets and new businesses.

Directors can leave no better legacy than ensuring the sustainability of the enterprise over which they have strategic oversight. ■

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