

OUTSIDE IN—INSIDE OUT

Response to “Outside” Influences through “Inside” Analysis and Actions

—*The Internal Equity Audit*

National Association of Stock Plan
Professionals Annual Conference

November 2005
Chicago



Objectives for Today's Discussion

The Obvious
and Beyond

Discuss the challenges of responsible management of the “OUTSIDE” influences on executive pay practices

Evolving
Framework

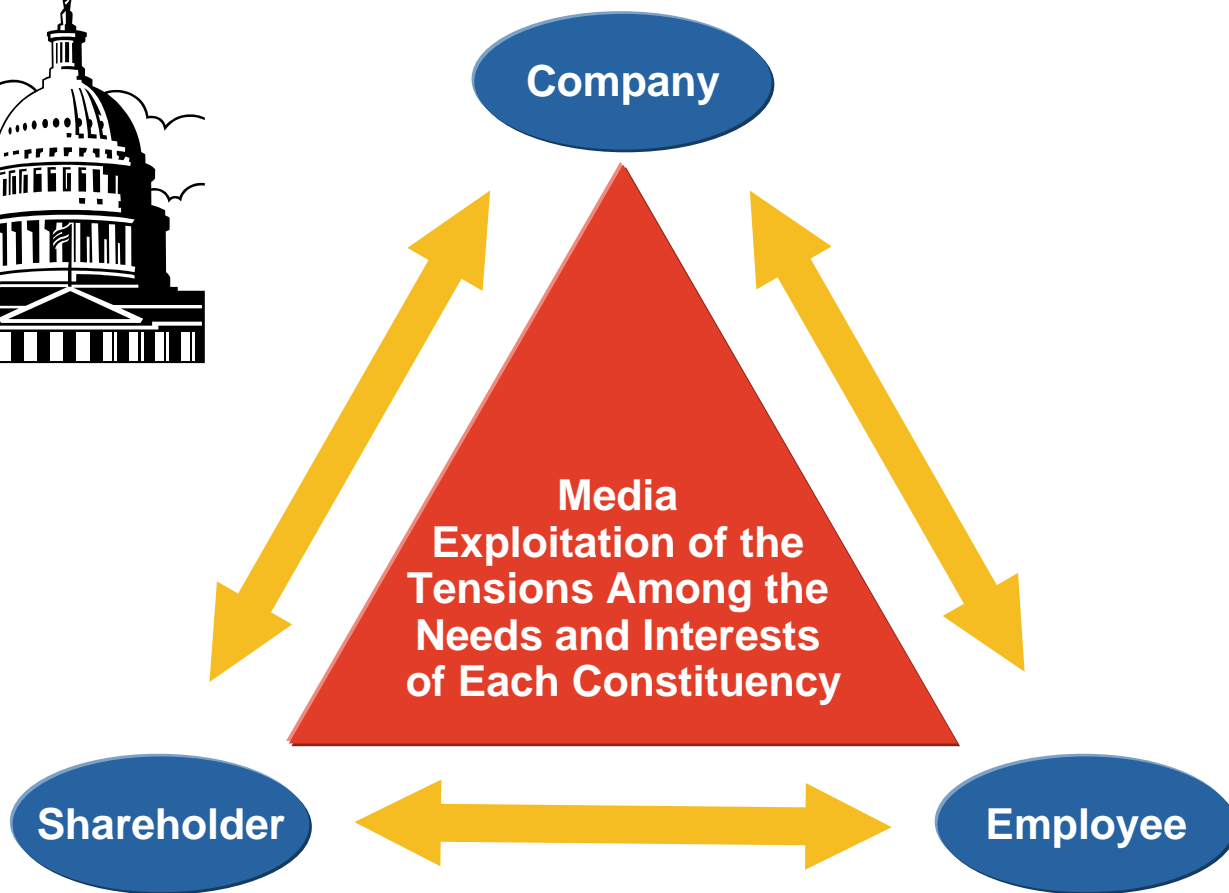
Describe the Internal Equity Audit and its role in an evolving framework of responsible “INSIDE” analyses and actions to restore (establish?) sound governance and decision making, fiscal responsibility, and transparency with respect to executive pay

Discussion

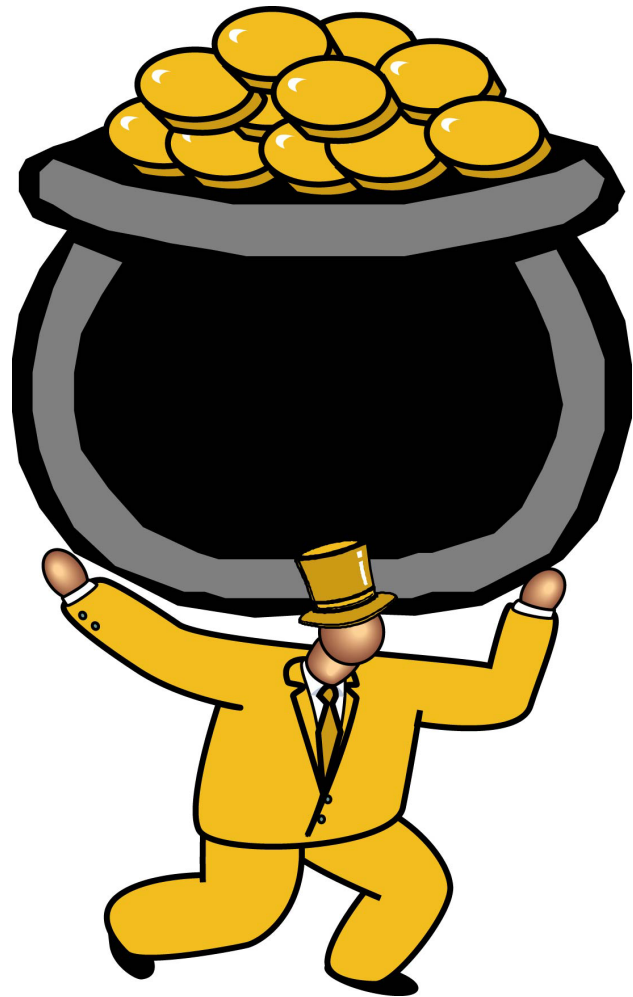
Discuss how you can make the Internal Equity Audit actionable inside of YOUR company



OUTSIDE "voices" have fueled increased awareness, concerns, cynicism, and questions about executive pay excesses



...and yet, OUTSIDE “competitive practice” data continues to accelerate executive expectations about pay



- **Flawed Comparisons.** “I’m at least as talented and valuable as (insert name) at (insert name) Corporation who gets big bucks.”
- **Deal Maker.** “I need a big package to get me to stick around/to come. Look at what I could get/am getting at (insert name) Corporation.”
- **Indispensable.** “They can’t run/fix this place without me [thus they’ll pay me what I want].”

Meanwhile, INSIDE our companies employee related cost risk has been passed like a “hot potato” to everyone except those at the top

Top Executives

Everyone Else

Economic
and
Employment
Security

From

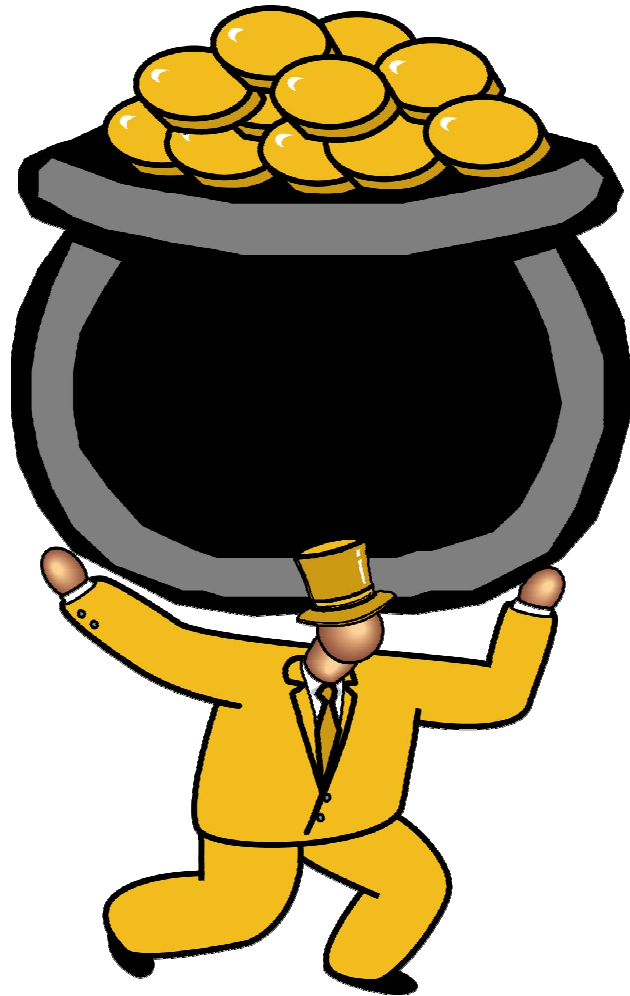
- Entitlement
- Fixed pay
- Welfare security
- Indemnity coverage
- Defined benefit
- Full service
- Employment security

To

- Meritocracy
- Variable pay
- Welfare self-management
- Consumer education
- Defined contribution
- Self-service
- Employability



...thus creating a series of questions about executive pay packages whose answers are found uniquely INSIDE each enterprise



Including:

- **Internal Equity.** Is it “fair” and equitable to enlarge executive pay packages while we pass on financial risk like a “hot potato” to our other employee groups?
- **Pay Multiples.** What *IS* the differential between the value of the total rewards paid (and payable) to the CEO and each of our other executive and employee levels? What should it be? How and why has that multiple changed over time?
- **Accountability.** Who should be held accountable by shareholders for what appears to be excessive executive pay?

Some solutions include limiting executive pay through salary caps

We have a policy that limits the cash compensation paid to any officer in the calendar year to 14 times the average salary of all full-time Team Members. For 2004, this salary cap was approximately \$427,000.

—*Whole Foods Market*

Sounds good. Is this the right multiple?
Is the focus on just salary too limited?

Salary caps don't tell the whole story about an executive's pay...

John P. Mackey, Chairman & CEO, Whole Foods

In 2004, John P. Mackey raked in \$885,216 in total compensation including stock option grants from Whole Foods Market.

From previous years' stock grants the Whole Foods Market executive cashed out \$1,013,893 in stock option exercises.

And, John P. Mackey has another \$4,370,735 in unexercised stock options from previous years.

—*AFL-CIO Executive Pay Watch Database*

Is this package still “reasonable”
and internally equitable?

At another company, CEO pay “passes” a frequently suggested “reasonableness test”

SALARY (\$000 Omitted)

Year	CEO	Next Highest Paid Executive	Average Four Highest Executives	CEO Salary as Multiple of	
				Next Highest	Four Highest
2004	\$1,400	\$975	\$822	1.44	1.70
2003	\$1,242	\$989	\$809	1.26	1.54
2002	\$1,000	\$925	\$738	1.08	1.36
3-Year Average	\$1,214	\$963	\$790	1.26	1.54

TOTAL CASH (\$000 Omitted)

Year	CEO	Next Highest Paid Executive	Average Four Highest Executives	CEO Total Cash as Multiple of	
				Next Highest	Four Highest
2004	\$2,969	\$1,521	\$1,228	1.95	2.42
2003	\$3,344	\$1,718	\$1,299	1.95	2.58
2002	\$3,931	\$1,800	\$1,521	2.18	2.58
3-Year Average	\$3,415	\$1,680	\$1,349	2.03	2.53

Even looking at all cash payments plus grant date PV of equity, the “reasonable test” is met

**2004 ALL CASH PAYMENTS PLUS EQUITY
(Grant Date PV) (\$000 Omitted)**

Compensation Components	CEO	Next Highest Paid Executive	Average Four Highest Executives	CEO Total as Multiple of	
				Next Highest	Four Highest
Total Cash	\$2,969	\$1,521	\$1,228	1.95	2.42
Other Cash	\$135	\$109	\$60	1.24	2.26
Grant Date PV Options	\$4,342	\$3,102	\$2,016	1.40	2.15
Grant Date PV Restricted Shares	\$660	\$330	\$330	2.00	2.00
Total	\$8,106	\$5,062	\$3,634	1.60	2.23

Is this package still “reasonable”
and internally equitable?

How much more is there in the economic package?

...YES, there's more for the CEO

Carly may get \$42 million

NEW YORK (CNN/Money) - Ex-Hewlett-Packard CEO Carly Fiorina will get a severance package worth about \$21.4 million, but stands to reap another \$21 million after she was forced out by the computer maker's board last week...

The additional amount reflects the estimated value of her Hewlett stock and options as well as her pension, which was not included in her severance package...

...and for others

What happened at H-P has happened at many companies. A rewards package like this...

ALPHA CORP 1995 PAY PROGRAM (Excerpt)

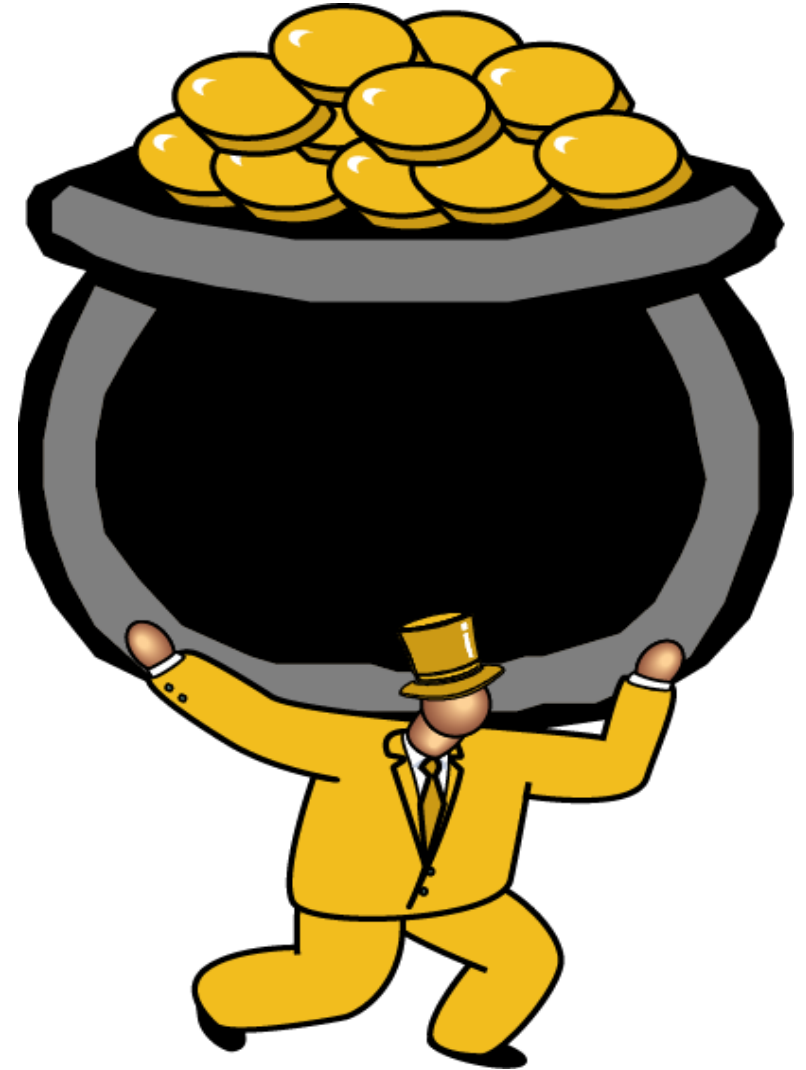
Program	Senior Executives			Executives		Management		Staff
	CEO	4 Proxy	EVP	SVP	VPs	Director	Mgr	Other Exempt
Cash	Base Salary							
	Annual Incentive							
Equity	Stock Options							
Other	Pension							
	Enhanced Pension							

Over time became a rewards package like this...

ALPHA CORP 2005 PAY PROGRAM (Excerpt)

Program	Senior Executives			Executives		Management		Staff
	CEO	4 Proxy	EVP	SVP	VP	Director	Mgr	Other Exempt
Cash	Base Salary							
	Annual Incentive							
	Long-Term Cash					Discretionary Cash Award		
	Matched Deferral							
Equity	Stock Options							
	Restricted Stock							
	Special Grants					Discretionary Awards		
Other	Pension							
	Enhanced Pension							
	Severance/COE							

...And the accumulated financial exposure associated with a (never expected) “breakup” had not been made transparent to shareholders



What's called for is a shift in how executive pay data is disclosed and informs decisions ...both inside and outside

“Some” Assembly Required



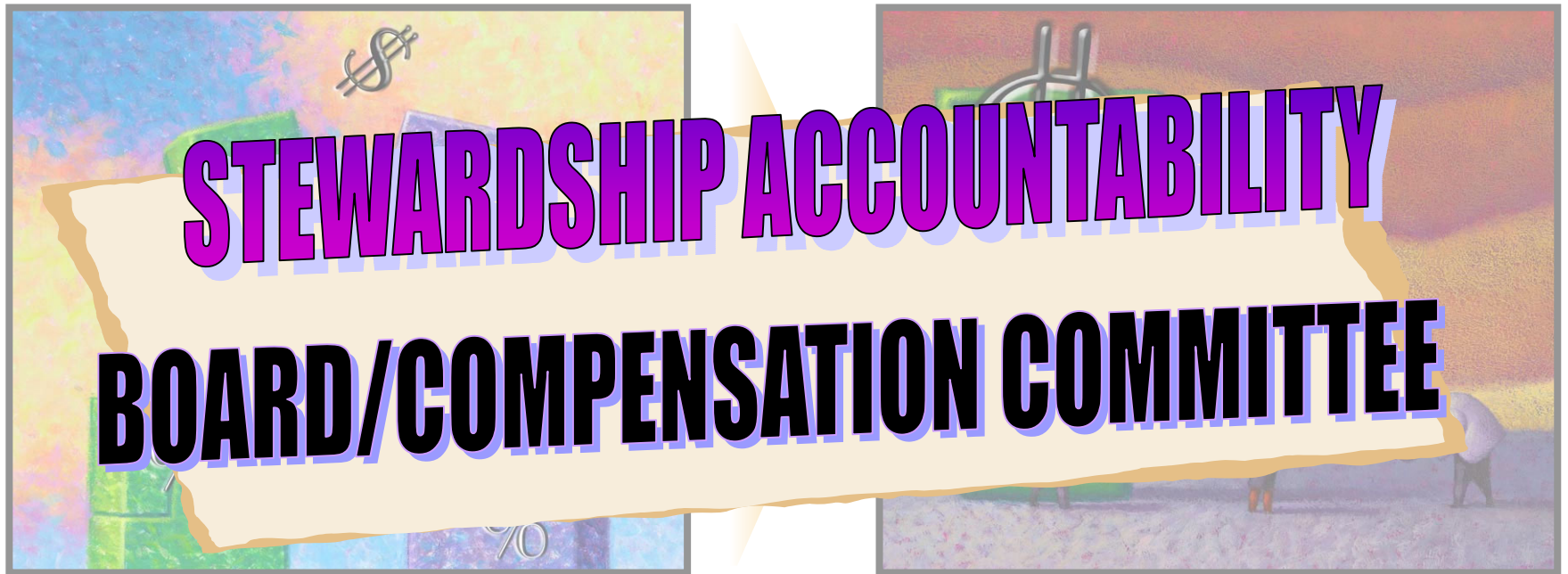
Fully Assembled



What's called for is a shift in how executive pay data is disclosed and informs decisions ...both inside and outside

“Some” Assembly Required

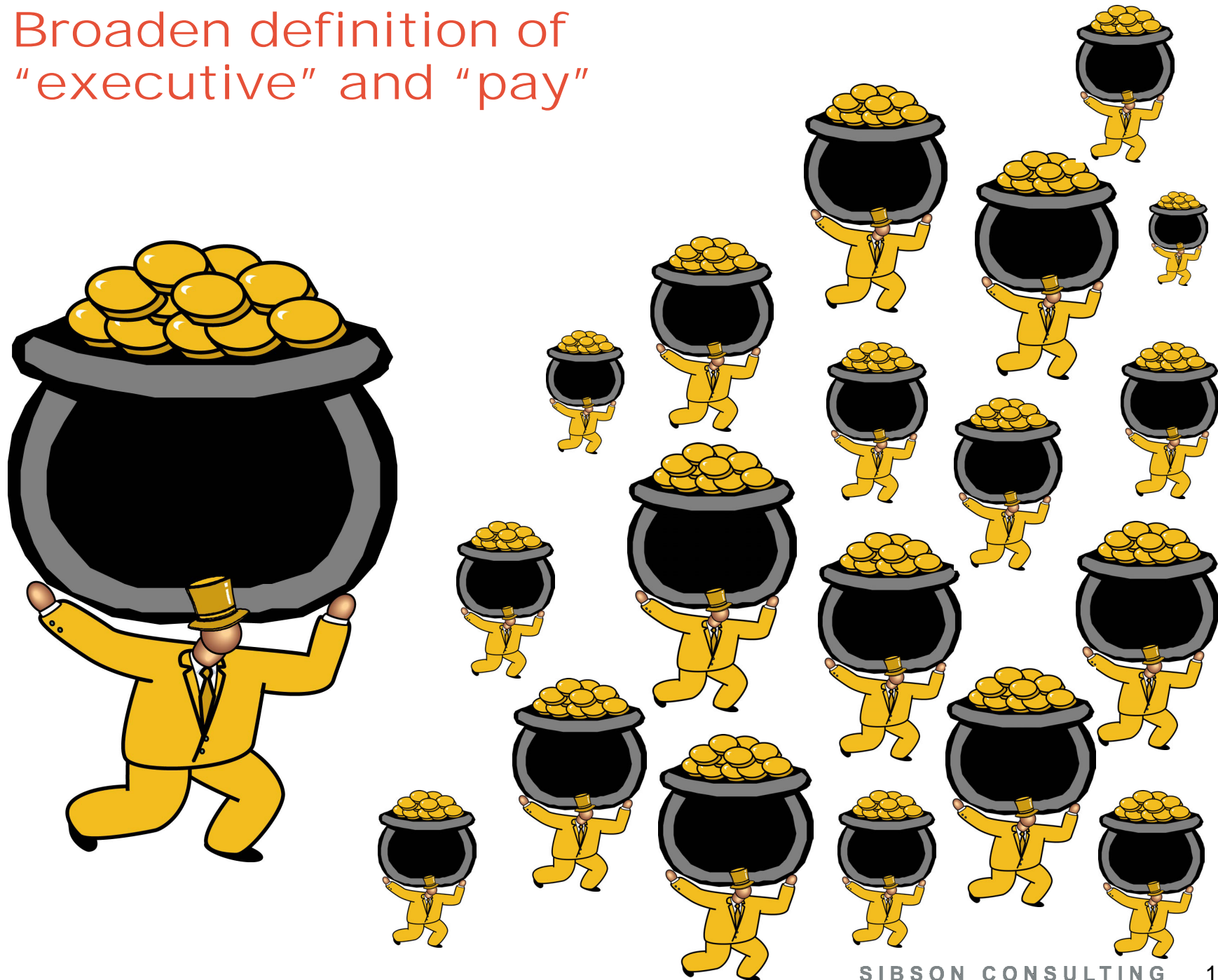
Fully Assembled



1. Seek no “magic multiples” or specific financial comparisons that establish a “safe harbor” for executive pay levels and designs

...and the survey says...

2. Broaden definition of "executive" and "pay"



3. Act as if proxy disclosure was required

ANNUAL EXECUTIVE “COST OF MAINTENANCE”

Compensation Component	CEO		20 Next Highest Paid Executives ¹		CEO as Multiple of 20 Next Highest Paid Executives	
	Current Year	Benchmark Year	Current Year	Benchmark Year	Current Year	Benchmark Year
Salary						
Annual Incentive Cash						
Long-Term Incentive Cash Paid						
Equity Grant Date PV						
• Plan #1						
• Plan #2						
• Plan #3						
Cash Amounts Deferred						
Matches (e.g., Sup 401(k), on deferred amounts)						
Dividends						
• Paid Currently						
• Credited/Reinvested						
Other ²						
TOTAL						
TOTAL AS A % OF FULLY DILUTED EARNINGS						

¹ Footnote to include names of 20 individuals included in the top 20.

² Includes all W-2 items (e.g., financial counseling, tax preparation, company provided transportation, facilities for personal use at net operating cost, perk allowance, car allowance, clubs, gross ups, other reimbursements, etc.). Also includes director's fees from company or affiliated entities and payments related to special arrangements between company and executive.

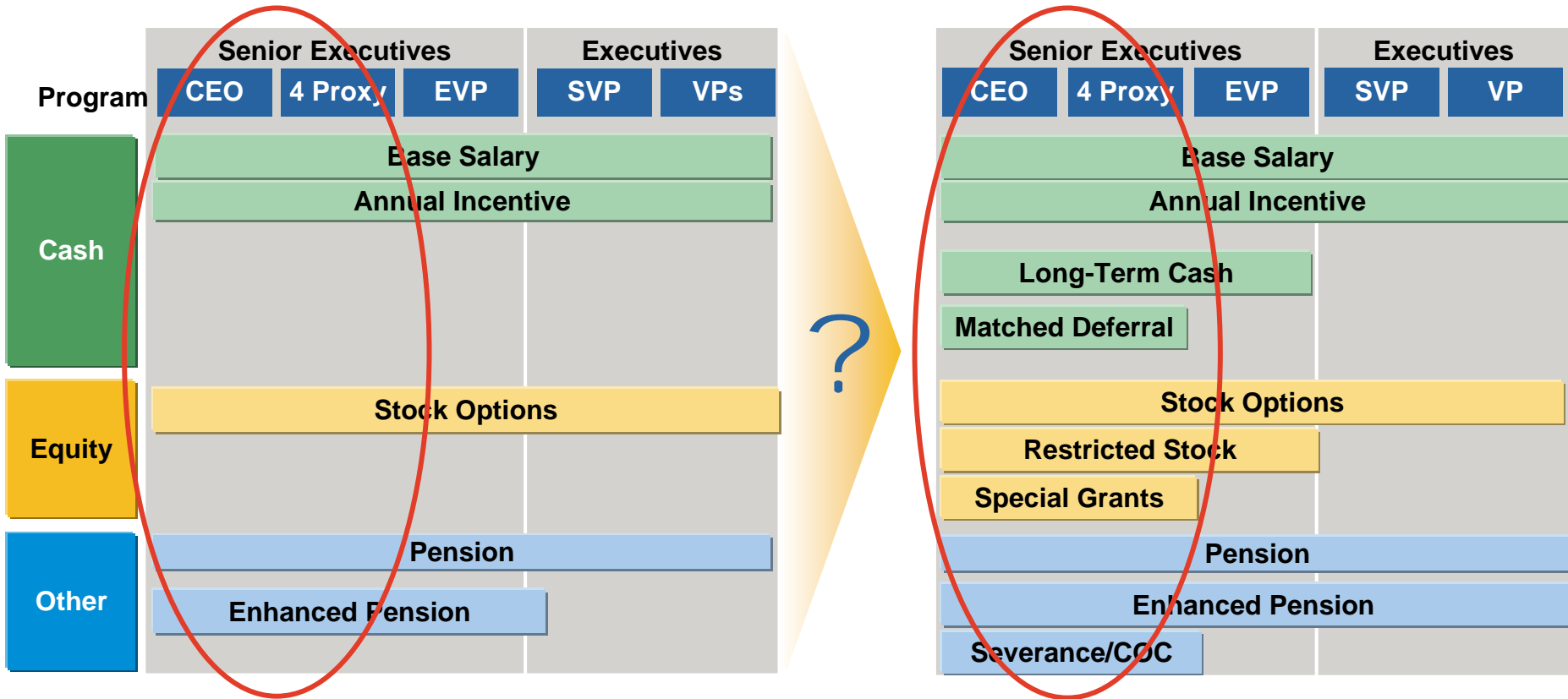
3. Act as if proxy disclosure was required *continued*

CEO “EXIT FEES”¹

Compensation Component	PV Amounts Payable	
	Current Year	Benchmark Year
Severance Pay [e.g., PV of (base + bonus) x # years]		
PV Defined Benefit (Pension + SERP)		
Defined Contribution (e.g., 401k + SERP)		
Other Savings/Profit Sharing		
Deferred Cash + Matches		
Equity Payouts		
• Plan #1		
• Plan #2		
• Plan #3		
Gross-up Payments		
Company Lost Deductions		
PV Welfare Benefit Commitments		
PV of Other Welfare Benefits/Insurance		
PV of Other Compensation Continuation/Commitment		
TOTAL		
TOTAL AS A % OF FULLY DILUTED EARNINGS		

¹ Company’s financial exposure if CEO terminated at end of fiscal year under the most favorable conditions for the executive.

4. Make compensation decisions informed by a thorough understanding of how/why compensation plans and their associated costs have evolved over time



5. Unambiguously disclose decisions

~~“Some assembly required”~~



Fully Assembled



Two evolving tools based on INSIDE information provide the data needed by the Compensation Committee to step up to its stewardship responsibility

- **Internal Equity Audit.** Documents the historical evolution of the **components** of the **total** economic package provided by the company to its CEO and to each of its (key) employee segments

Specifically: How and why has the differential between the total rewards paid (and payable) to the CEO and other executive and employee levels changed over time?

- **Tally Sheet.** Documents the **value** of the **total** economic package currently provided and the potential liability for the economic package to be provided in the future

The “nuts and bolts” of the Internal Equity Audit are straight forward

Step 1: Determine “Comparator” Dates

- “Current Date”
- “Benchmark” (e.g., new CEO, new contract for CEO, merger/acquisition, significant legislative/regulatory changes, new chair of compensation committee, etc.)

Step 2: Inventory the Programs and Design Status on the “Benchmark Date” (RAW FactsSM Tool)

Step 3: Inventory the Programs and Design Status on the “Current Date” and annotate in detail the “what/why” of changes in comparison to Programs and Designs at the “Inflection Date” (RAW FactsSM Tool)

Step 4: Use Tally Sheet Calculations (by employee groups) to determine financial exposure “then and now”

Step 5: Use Data to Inform Compensation Committee Decision Process

Step 6: Disclose in Proxy Statement that the audit was completed and what action was taken by the Board as a result

Organization of the Internal Equity Audit Tool

- Divides fact finding process into three “timeframes”
 - **Entry “Fees”** programs and policies that come into play when there is a new entrant to the organization
 - **Cost of Maintenance** programs and policies that impact the employee during his/her active employment
 - **Exit “Fees”** programs and policies that deliver post-termination compensation and benefits
- Within each “timeframe” identifies (a) the existence of a given program and (b) key design characteristics
- Identifies the eligibility by distinct employee groups for a given program or design feature
- Identifies what has changed since the prior evaluation period

SIBSON RAW FACTSSM REWARD AUDIT WORKSHEET

Current Date

Prior Evaluation Date

Governance Compensation Committee Members (name, affiliation)

<input type="radio"/>	¹	<input type="radio"/>	<input type="radio"/>
<input type="radio"/>		<input type="radio"/>	<input type="radio"/>

Other Board Committees with Governance, Rights Over Rewards (Stock Plan, Benefits Plan, Succession)

		Employee Group				Change ¹	Comments		
		CEO	20 Next Highest Paid Executives	Group #1	Group #2				
Entry "Fees"	Programs	Number of Employees				<input type="radio"/>			
		Employment Contract				<input type="radio"/>			
		Change of Control Protection				<input type="radio"/>			
		Severance Protection				<input type="radio"/>			
		"Parachute"				<input type="radio"/>			
		Cash Signing Grant				<input type="radio"/>			
		Welcome Equity Grant				<input type="radio"/>			
		Prior Er Equity Buy-outs				<input type="radio"/>			
		Relocation Allowance				<input type="radio"/>			
		Perquisite Allowance				<input type="radio"/>			
		Other				<input type="radio"/>			
		Other				<input type="radio"/>			
		Design		1 st Year AI Guarantee				<input type="radio"/>	
				LTI Guarantee				<input type="radio"/>	
				Service/Vesting Enhancement				<input type="radio"/>	
Tax Gross-ups						<input type="radio"/>			
Other						<input type="radio"/>			
Other				<input type="radio"/>					
Other				<input type="radio"/>					

¹ Check circle if different from prior evaluation.

SIBSON RAW FACTSSM REWARD AUDIT WORKSHEET

		Employee Group				Change ¹	Comments
		CEO	20 Next Highest Paid Executives	Group #1	Group #2		
Cost of Maintenance (Annual Cash)	Programs	Base Salary				<input type="radio"/>	
		Annual Variable Pay				<input type="radio"/>	
		Commissions				<input type="radio"/>	
		Current Dividends (e.g., on deferred RS)				<input type="radio"/>	
		Deferral of BSal/Bonus				<input type="radio"/>	
		Other				<input type="radio"/>	
	Vacation				<input type="radio"/>		
	Supplemental Sick/Disab				<input type="radio"/>		
	Supplemental Health Care				<input type="radio"/>		
	Perquisite Allowance				<input type="radio"/>		
	Car Allowance				<input type="radio"/>		
	Financial Counseling				<input type="radio"/>		
	Tax Preparation				<input type="radio"/>		
	Other Transportation				<input type="radio"/>		
Club Membership				<input type="radio"/>			
Supplemental Benefits				<input type="radio"/>			
Other				<input type="radio"/>			
Design	Total Cash Comp Mix (Base/AI)				<input type="radio"/>		
	Base/AI Pay Positioning				<input type="radio"/>		
	AI Range ² (threshold, target, max)				<input type="radio"/>		
	Annual Incentive (AI) Metrics				<input type="radio"/>		
	BSal Increase Guarantee				<input type="radio"/>		
	Match on Deferred BSal/AI				<input type="radio"/>		
	Tax Gross-ups				<input type="radio"/>		
	Other				<input type="radio"/>		

¹ Check circle if different from prior evaluation.

² As a percent of base salary.

SIBSON RAW FACTSSM REWARD AUDIT WORKSHEET

		Employee Group				Change ¹	Comments
		CEO	20 Next Highest Paid Executives	Group #1	Group #2		
Cost of Maintenance (Long Term/Cash Equity)	Programs	Cash Settled LTI					
		Carried Interest					
		Deferral of Cash LTI					
		Other					
		Other					
	Incentive Stock Options						
	NQSO						
	Restricted Shares (time)						
	RS (performance)						
	Performance Units						
	SARs						
	Other						
	Other						
	TDC ² Mix (Base/AI/LTI)						
	TDC Positioning						
	LTI Range ³ (threshold, target, max)						
	LTI Metrics						
	Design	Cashless Exercise					
Match on Deferred LTI							
Tax Gross-ups							
Front-loaded Equity Grants							
Ownership Guidelines							
Require Equity Hold to Ret.							
Other							
Other							

¹ Check circle if different from prior evaluation.

² TDC = Total Direct Comp (Base + Annual Incentive + Long-Term Incentive).

³ As a percent of base salary.

SIBSON RAW FACTSSM REWARD AUDIT WORKSHEET

		Employee Group				Change ¹	Comments
		CEO	20 Next Highest Paid Executives	Group #1	Group #2		
Exit "Fees"	Programs	DB Qualified Pension					
		Frozen DB Pension					
		DB SERP					
		401(k)					
		SERP/401(k)					
		Profit Sharing					
		Savings Plan					
		AI / LTI Payouts					
		Stock Plan					
		Deferred Cash/Dividends					
		Change of Control					
		Severance					
		"Parachute"					
		Benefit Continuation					
		Other					
Other							
Design		DB Target Benefit Amount ²					
		Enhanced DB SERP Amount ²					
		401(k) Match/Maximum Match					
		DC SERP					
		Match on Deferred Cash					
		Interest on Def Cash/Dividends					
		Tax Gross-ups					
		Accelerated Vesting					
Other							

¹ Check circle if different from prior evaluation.

² As a percent of base salary.

Outside In—Inside Out: A Compensation Committee and Board Stewardship Responsibility

- 1** **Seek no magic “multiples” and “safe harbors”**
- 2** **Broaden definition of “executive” and “pay”**
- 3** **Act as if complete disclosure is required**
- 4** **Use cost and design findings from internal equity audit in executive pay decision making**
- 5** **Unambiguously disclose executive pay decisions**



