Executive Compensation Strategies

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July 2006 | Vol. 2, No. 4

PEMs: The Magic Bullet?

Pay Equity Multipliers can help compensation planners see the bigger picture

By Mark Van Clieaf

Here's a perfect example of why Directors shouldn't accept traditional "comparative" pay data at face value:

The 2005 cash compensation for Johnson & Johnson's CEO was $4.5 million, compared with the $3.8 million Eli Lilly paid its CEO. If taken at face value, you might assume the Eli Lilly CEO role was underpaid, given that both are CEO positions at major pharmaceutical firms. But when you look beneath the surface and incorporate appropriate executive job analysis factors, you find the CEO role at J&J is over five times more complex than the CEO role at Eli Lilly.

When properly "job-matched" for the level of role complexity/added value and then calibrated to reflect a role five time less complex, the *true* comparable J&J compensation that Eli Lilly Directors should use would be $1.7 million rather than $3.8 million – more than a 100% difference.

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Are You Prepared for Change?

Caution: New regs may not ultimately have the desired effect

By Paul R. Dorf, Ph.D., APD

The annual review and analysis of corporate filings for public companies is in full swing. Almost invariably, this scrutiny brings with it an outcry concerning the exorbitant levels of executive compensation and the lack of a direct relationship between what some executives made and the financial performance of their companies. In addition to articles that highlight some of the more egregious excesses, there are investigative reports that identify illegal – or at best, highly questionable – activities. Given the propensity of the public and investors to recoil at the issue of excessive executive compensation, it's no wonder that these two groups have put considerable pressure on regulators to control and/or reduce executive pay in recent years.

Market-Driven

With recent regulations and structural changes as the baseline, this raises the question of what the future holds. In trying to answer this question, it's important to understand how compensation levels are set. Assuming that the underlying purpose is to enable an organization to recruit and hire the best talent to meet its business needs, it naturally follows that a

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If Directors and their compensation consultants lack a meaningful process for job matching and compensation calibration, they could be making pay decisions with compensation data that's not truly comparable or legally defensible, and may be overstated by 50% to 100%.

'Felt Fair Pay'

The framework behind this calculation of truly comparable compensation is called Levels of Work, which also incorporates related research on organization design, differential pay and what are known as Pay Equity Multipliers (PEMs). Although our example concerns CEO roles at two competing firms, PEMs have just as much (if not more) value when used as an *internal* measurement tool for job design of truly differential work that justifies differential pay.

Pay Equity Multiplier analysis has identified excessive pay at the CEO management level, as well as excessive total enterprise compensation as a result of redundant management layers.

Over the last 25 years, starting with work that Elliott Jaques and a U.K. university organization called BIOSS initiated, more than a dozen research studies have investigated the relationship between differential pay, position in the corporate hierarchy and the time-span of discretion of a particular role. These studies involved over 1,000 participants – from CEO to manager levels in the U.S., Canada and the U.K. – concluding that the "felt fair pay" and differential compensation between the real work in organizations consistently differed by a multiple of two. In other words, the research identified that each work level should be worth two times more in total compensation than the level directly below it *if roles are designed properly and truly perform differential work*.

That last part is important, because not all companies get organization and differential work design right. In fact, a recent analysis we did for one client identified eight distinct levels of management with an average total compensation at each management level ranging from $52,500 to $3 million (*see chart on page 12*). For management levels four through eight, the PEMs between upward cascading management levels were all below 1.5, indicating possible lack of differential and value-adding work in the management hierarchy, and also that the company is probably over-layered – wasting shareholder capital through poor organization/compensation design. In this case the compensation costs of this over-layering and over-titling was contributing to *excessive enterprise compensation* estimated at over $55 million a year. But such a compensation analysis won't provide insights into how to effectively re-align the organizatioal structure and compensation design to create improved customer and shareholder value without an appropriate analysis of the "real work" — and to what extent it adds real and differential value at each management level.

The analysis also revealed an excessive gap (a PEM of over 3) between CEO compensation and that of second-tier management, and a further excessive gap (a PEM of over 7) between the CEO role and third tier management. So what should have been an evenly sloped downward curve depicting differential work and equitable total compensation at each level in the management hierarchy instead resembled a steep drop from the mountain peak of the CEO role followed by a flat prairie of lower-level redundant management layers.

Red Flags

This real world example is the worst of both worlds for shareholders, Boards and management, because the Pay Equity Multiplier analysis has identified excessive pay at the CEO management level, as well as excessive total enterprise compensation as a result of redundant management layers.

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Executive Compensation Strategies is published monthly by Thompson Publishing Group, Inc., 1725 K St. NW, 7th Floor, Washington, DC 20006.

POSTMASTER: Send address changes to: *Executive Compensation Strategies*, Thompson Publishing Group, Inc., 5201 W. Kennedy Blvd., Suite 905, Tampa, FL 33609-1823. Please allow four to six weeks for all address changes.

For subscription service, call (800) 677-3789.
For editorial information, call (202) 872-4000.

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Insight you trust.

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Why is this important? Because a recently-released Moody's Investor Service memo states that a CEO-to-direct-report Pay Equity Multiplier greater than 3.0 ("…when CEO pay is more than triple that of any other executive named in the proxy statement…") will be a red flag when it comes to evaluating how executive pay structure affects a company's creditworthiness and debt rating. Thus, poorly designed compensation structures will impact the firm's cost of capital. Moody's also says such disparities tend to indicate a weak Board and poor corporate governance.

A CEO-to-direct-report Pay Equity Multiplier greater than 3.0 will be a red flag when it comes to evaluating how executive pay structure affects a company's creditworthiness and debt rating.

The research on felt fair pay backs up Moody's assessment of what constitutes equitable compensation, noting that a PEM of 4.0 between the CEO role and direct report roles *once removed* from the CEO (i.e., between the first tier and third tier of management) is felt fair pay for truly differential levels of work and decision authority. The CEO-to-third-management-tier Pay Equity Multiplier is a better analysis, because it's difficult to overpay the third tier of management and not disrupt the total pay structure of the company. An executive pay multiplier of *more than six times* across the top three levels of executive management should be a red flag for Directors and shareholders as it relates to excessive CEO compensation.

The core problem today is that too many Boards and compensation consultants fail to recognize the difference between *operational* work, measurement and pay and *strategic* work, measurement and pay. It's the more strategic work of creating growth, profit and return from new products, new markets and new business that defines the "differential work" that justifies the higher levels of strategic pay PEMs are intended to measure.

What we usually find, however, is that too many CEOs are being overpaid for doing primarily operational work, and this operational focus tends to create organizations with redundant layers of management and wasteful compensation practices.

What To Do

Now that Moody's has included a CEO/internal pay multiplier analysis and internal pay equity on its list of criteria for debt rating and corporate governance, Boards and Compensation Committees should expect pressure from global institutional investors, money managers and the proxy voting community to change proxy voting guidelines to include internal executive pay equity analysis. Given this new scrutiny, Boards and Compensation Committees should:

- Conduct an enterprise-wide pay multiplier analysis that identifies, at each management level, average total compensation and the corresponding Pay Equity Multipliers.
- Take the average total direct compensation for direct reports once removed from the CEO role (roles reporting to the level of management who report directly to the CEO role) and multiply by four to get a fair and equitable PEM for the CEO role, then compare this internal pay equity target for the CEO role with current CEO compensation.
- Look for evidence in the PEM analysis of either excessive compensation at the Named Executive Officer level and/or possible excessive enterprise compensation resulting from over-layering in the lower management levels.
- If you find that CEO Pay Equity Multipliers are excessive, create a plan to further review and align management accountabilities relative to executive pay structures to make them equitable and defensible.

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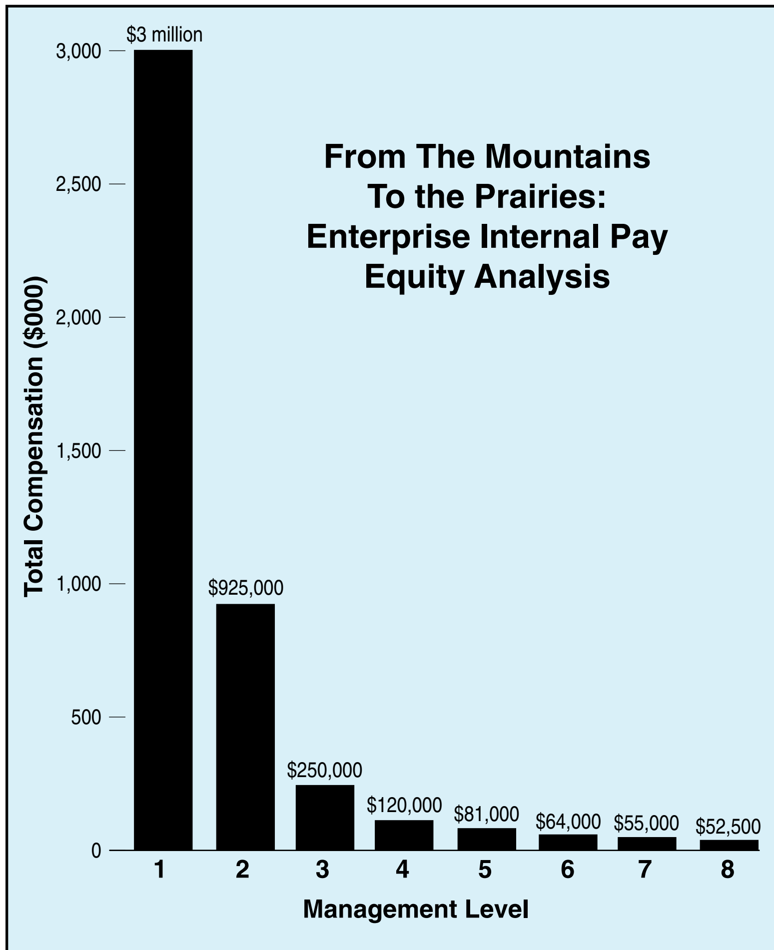

- Design and approve strategic metrics and longer performance timeframes for Named Executive Officers that are linked to the company's innovation and growth strategies, aligning them with executive pay and the appropriate PEMs.
- Ensure that each management level is accountable for differential and value-adding work and not wasting compensation, using such executive job analysis factors as levels of innovation, levels of resource complexity and the planning horizon, rather than traditional factors like the size of business, budget or headcount.
- Realign and redesign enterprise-wide work and accountability structure so that each management level is accountable for differential work that creates differential value for customers/shareholders and justifies differential pay.

Mark Van Clieaf is Managing Director of MVC Associates International, a consultancy focused on aligning organization design, pay for performance and succession planning with shareholder value. For more information, go to: http://www.mvcinternational.com/.

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