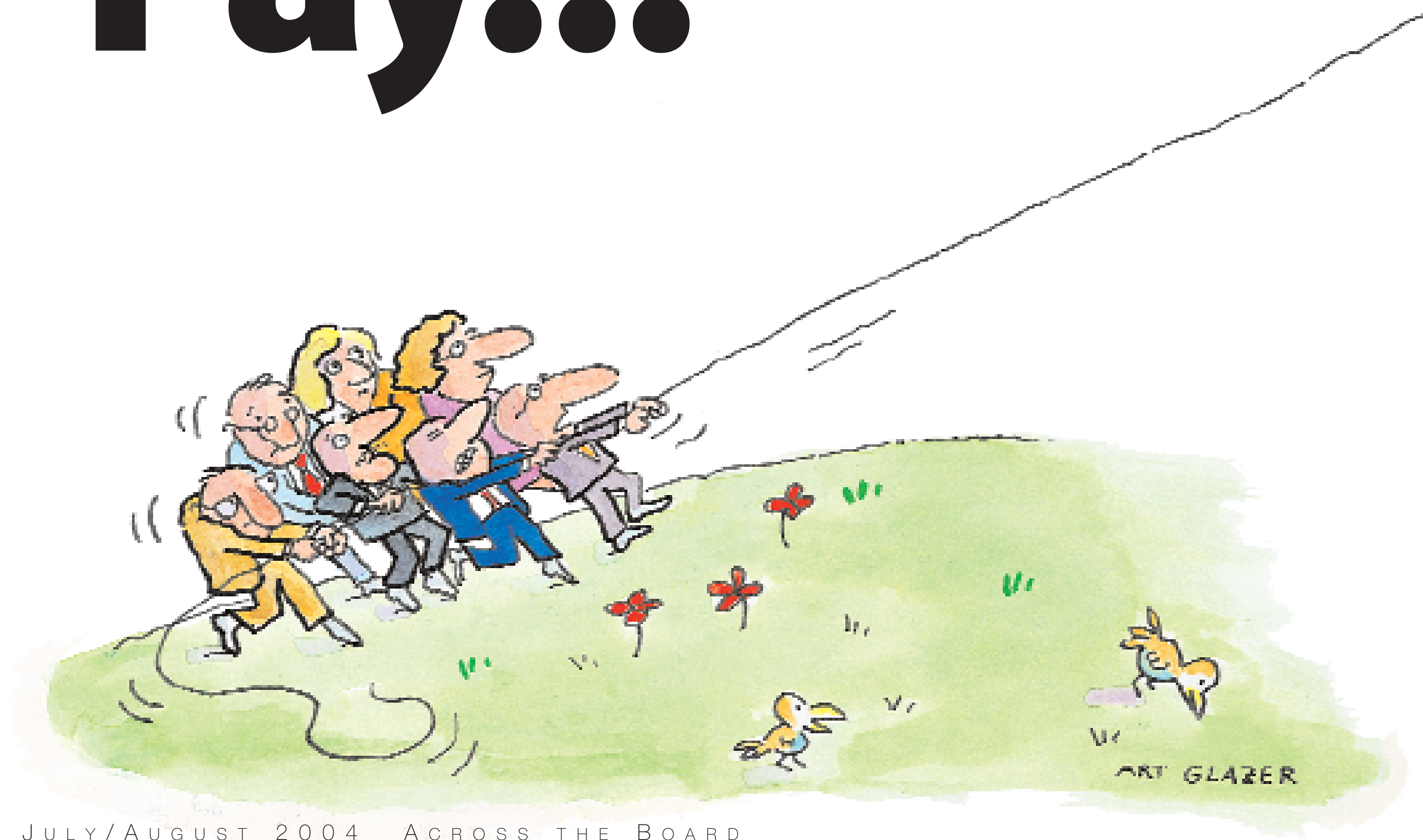
How Much Pay...



. . . for how much performance?

Company directors are showing new spine in bringing CEO compensation down to earth.

By Donald P. Delves

When I started working recently as a compensation consultant to a publicly traded energy company, the chair of the compensation committee called me aside and gave me a strong directive. "You're working for me now," he said, pointing a finger at my chest. "I don't want any information filtered through management. Anything they see, I see."

This was a dramatic departure from my experience of the past twenty years, when I have been hired directly by management. Typically, my job has been to provide reams of data to management, from which a report would be tailored specifically for the board. Now, as proactive boards are demonstrating, directors are increasingly concerned about doing a better job of governance, particularly when it comes to executive pay.

Boards aren't waiting for public scrutiny or shareholder outcries—those at even exemplary companies are moving to increase oversight. Across many industries and types of firms, boards are beginning to take more seriously their roles as stewards of shareholder interests. As the compensation-committee chair told me, "It's not

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that I think anybody did anything wrong. But it's my job to look out for the shareholders."

For executives, this is both a wake-up call and an invitation to work more closely with increasingly empowered and independent-minded boards. While the CEO retains responsibility for the design, structure, and administration of pay programs, boards are undertaking more comprehensive oversight and review of compensation. Together, management and boards can bring meaningful change to compensation practices and make sure that shareholders are getting what they are paying for from their investment in executives.

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Going Back for the Future

At another publicly traded firm for which I'm consulting, the board recently asked me to take a much more long-term look at the company's compensation program. Specifically, the board said, "We want to see a ten-year retrospective of the company's stock-option program for the top fifteen executives. How much were they granted and when? How much gain are they currently sitting on? How many options have they exercised? How much money did they make? How many shares did they sell? How many do they still own?"

Then, the most interesting question of all: "How much money will they make or lose if the stock price goes up or down by a dollar?"

These insightful questions illustrate the need for a new approach. This means breaking the patterns of the past, when boards did little more than review and approve management's compensation recommendations and the competitive analyses provided by the (management-hired) consultants. Specifically, companies must stop looking at compensation solely as an annual event and take a longer-term view, of at least three to five years. For equity-based incentives such as stock options and restricted stock, the time frame should be even longer—up to ten years.

An analysis of historical stock-option grants, showing the prices at which grants were exercised, gives the board a perspective on what has been authorized and how much money executives have made on past option grants. Additional tables should show dollar amounts by executive, illustrating cumulative shares granted, gains recognized from options exercised, unrecognized gains from unexercised options, shares sold, and shares still owned. The analysis should also include the impact of restricted stock and other equity-based incentive plans.

This type of thinking and analysis is critical if we are to move away from the overreliance on "median pay," which until now has had a tyrant's hold on compensation practice. One of the most common tools in compensation practice has been the competitive survey, which includes statistics on how several hundred companies pay their executives. Based on the data, a median pay level for each position is determined. (For compensation analyses, the median is usually a more accurate reflection of the *common* practice of a group than the *average*.) The median pay level then becomes the natural target for companies, since most want to pay at or above the middle of the range.

The obvious problem is that, by definition, half of the companies will be above the median and half will be below. As more and more companies try to pay above the median and jump into the upper half of the range, the net effect is the raising of the bar of pay levels—often without a commensurate increase in performance. This tendency has been most pronounced with spiraling stock-option grants. There was no negative consequence—in the form of an increased expense—to dampen the rampant ratcheting effect. As a result, option grants increased by 20 to 40 percent annually for almost a decade. The value of option grants for CEOs increased by nearly 44 percent in 2001, according to figures prepared for CalPERS. The trend may finally be reversing, however—the following year, the number fell almost 19 percent.

Other elements in my experience indicate that the ever-increasing annual grants of options and stock may be coming to an end. For example, at a recent board meeting, the directors looked at my analysis of competitive annual stock and option grants and said, "This situation makes no sense to us. Why should we continue granting more options every year just because somebody else does? Shouldn't we be more interested in how many options management already has and how much money they will make if the stock price goes up by 10 or 20 percent? Maybe they already have enough."

Hearing these comments, I was more than happy to share with the board a new type of analysis that I had, in fact, already completed: one that looked at compensation in the aggregate, including its impact on the wealth accumulation of executives.

An executive-by-executive wealth analysis, which demonstrates what each person will earn based on hypothetical stock prices, shows the cumulative impact of stock and option grants on each individual's personal wealth—say, for example, that a $10 increase in share price would boost the CEO's personal wealth by $1 million. For many boards, this type of analysis may be a real eye-opener when it comes to answering the question: Do executives really need more stock or options?

The Million-Dollar Question

To make the analysis of executive pay more effective as we move forward, it is critical to look at performance as well as compensation. As another director recently stated in a compensation-committee meeting, "If you want us to pay the executives at the 63rd percentile, then the company has to perform at the 63rd percentile." This would mean that executive pay in the aggregate, relative to peers, must directly follow the company's performance relative to its peers. While this type of comparison is nothing new, boards are applying it with much more rigor than in the past.

Meaningful compensation analysis leads to the development of a definitive answer to the question, "How much pay for how much performance?" For too long, companies have focused on *how* executives were paid while overlooking the key question of *how much*. As a director who sits on the board of several Fortune 100 companies told me pointedly, "You guys have got to come up with a better answer to the question, 'How much?' You've all dodged that question for too long. Simply telling us what other CEOs are paid does not answer the question. We need some logical rationale for determining *how much* a CEO should be paid based on some logical criteria other than the size of the company and 'competitive practice.'"

The first step in addressing "how much" is to determine the *total cost of management*. This means moving away from looking at compensation on a position-by-position basis to considering the executive team as a whole. The goal is to quantify the total cost of managing the company and, then, comparing that cost to other similar companies. For example, an oil-drilling and exploration company I work with measures the total cost of management per barrel of oil—and compares that measure to other industry firms.

The second step is to compare that total cost to performance, using a variety of measures such as increase in revenue or profit, margin improvement, or return on capital measures. Most well-managed companies continually monitor these measures and make comparisons to other companies. The logical extension would be to bring these performance and cost-of-management measures together, enabling the company to see how much it is paying executives for how much performance.

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This is not rocket science, and I am already doing this type of analysis for several companies, but it needs to become more of a standard practice. (I can't tell you how many compensation consultants' reports I've seen that compare annual pay levels by position without looking at the total cost of management or making appropriate comparisons to performance.) In its simplest form, a company is ranked among its peers—in a list from high to low—according to various performance measures. These lists are then compared to similar rankings of each company's relative compensation. The visual comparisons are a startling illustration of how well—or poorly—pay follows performance. For example, a series of tables comparing performance to compensation in the financial-services industry might show that one firm compensates its management team more generously than any of its peers, even though its net margin and ROA are both significantly lower.

Measurement's Next Generation

The ideal next step, which most companies have not yet taken, is to calculate a *return on management*, a standard that could be compared across companies and industries. The concept of return on management is no different than the return on investment that companies regularly calculate on any major commitment of capital. It is also no more—or less—complex. The goal is to show what return is being delivered for investment in management using specific criteria, such as:

- The increase in earnings compared with the total cost of management over a specific time frame (three years, five years, etc.).
- The economic value added over this time period relative to the total cost of management.

Armed with these internal comparisons, companies can begin to look at the return on management at other companies, including peer firms and the market as a whole.

Some of the companies I am working with are beginning to develop these measures. In the process, we are creating some standards for what normative practice is and should be. This is a work in progress driven by boards and exec-

Risky Business

When a company grants options on 10 to 15 percent of its stock—which is not uncommon—it becomes a major-league risk-management issue. It makes sense, then, that the CEO and the board of directors should look at this issue from a risk-management perspective. Shouldn't this prompt the board to seek answers on why the company is engaged in such a risky transaction as granting a significant portion of the company's stock (and future growth) in return for services? Shouldn't the board want to know how the company is being protected against this risk, and demand details about the return the company is getting for taking on this risk? To my chagrin, this has not been happening. What's been happening is nothing less than poor corporate governance.

To be most effective, accurate, and responsible, companies must take a broader perspective of how options are used, why they are used, and what gains are realized from them. Luckily, a vast body of knowledge can be applied to these tasks, from valuation models to actuarial calculations. Talking with people from human resources, finance, corporate treasury, options trading, mathematics, and economics, one can get a variety of different points of view on the subject. These disciplines must be brought together to develop and implement an accurate and workable means of valuing options, determining the cost and risks to the company, and recognizing the depth of this commitment and investment in human capital. The logical question, then: What return does the company expect from this investment? Those who should be asking the question are, of course, the board of directors.

—D.P.D.

utives that want to develop intelligent solutions to what has become one of the business world's most important and perplexing problems.

After addressing direct forms of compensation, including base salary, bonus, and long-term incentives, the next step is to look at what I call "stealth" compensation. Stealth compensation—which flies under the radar of public attention until an event triggers its disclosure—includes severance packages known as golden parachutes.

Golden parachutes are attracting a great deal of attention from shareholders, whose resolutions on executive compensation often focus on limiting parachutes and other forms of severance pay believed to be excessive. To understand the shareholder perspective on this issue, management needs to think outside the executive suite for a moment. Typically, golden parachutes dole out payments worth three times salary and bonus, plus immediate vesting and cash-out of all stock options and long-term incentives, and even the taxes paid on all of the above. Does any executive worth his salt really need a *three-year* package? Isn't it conceivable that a talented, competent executive could find a new job in twelve to eighteen months? So if a severance package were intended to ease a person's transition from one corporate position to another, wouldn't a payment of a year's salary and bonus be more reasonable? And wouldn't that be sufficient to keep an executive in his position while the company was subject to takeover and management change?

Even though these issues are likely to be tomorrow's front-page news, I've yet to see any meaningful action on the part of boards. For the moment, most boards appear to be consumed by the more pressing issue of what to do with more direct forms of compensation such as bonuses and stock options.

Who Decides What's Fair?

As companies pursue how much executives should be paid, it's almost impossible to avoid the issue of "fairness." Executive compensation has evolved over the past few decades into a preferential treatment for senior executives; there is an immense and growing disparity between the pay for the upper echelon and the rank-and-file worker. Several directors of Fortune 500 companies have surprised me by citing the statistic that the average CEO is paid more than four hundred times what the average worker is paid, up from forty-two times two decades ago. It's not the figure that's surprising—it has been widely publicized for years. But until recently, I've rarely heard it discussed in a boardroom setting.

Very few companies have tried to institute limits on CEO pay as a multiple of workers' salary. The most notable was Vermont ice-cream maker Ben & Jerry's Homemade, which mandated a maximum 5-to-1 top-to-bottom ratio until 1990, when it upped the number to 7-to-1 to assist in recruiting. In 1995, when the company moved to hire a CEO externally, it abandoned its numerical target, but the ratio remained far lower than in comparable firms—just 16-to-1—at the time Unilever bought Ben & Jerry's in 2000.

At this time, while more board members are aware of this growing disparity in pay and are concerned about it, very few companies are putting such limits or multiples on the table. Despite its endorsement by the likes of Plato, J.P. Morgan, and Peter Drucker, this is still by and large considered a radical concept that would hamper a company's ability to compete for top talent. I suspect, however, that boards will start to at least monitor this ratio and—just as they are doing with pay and performance—compare themselves with other companies. This is a logical first step: Before companies can implement "internal fairness measures," they must understand how they work, their dynamics, and the potential implications.

Executive compensation has become the top governance issue for most boards of directors. Ultimately, this is good news. Greater scrutiny of executive pay by boards, and greater creativity and accountability in paying for performance by management, will result in healthier companies and a much-needed improvement in the public perception of American business. ♦