

# **5 Levels of CEO Accountability & Pay for Performance That Can't be Gamed!**

**Compensation Standards  
Chicago , Oct 31, 2005**



**Consultants in  
Organization Design,  
Leadership &  
Shareholder Value**

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# Off the Rails U.S. Executive Pay For Performance

MVC Research / Analysis

- Just 60 U.S. Listed Companies over 5 yrs:
  - Lost \$ 700 billion in Market Value Added
  - Destroyed \$ 485 billion in Economic Profit
  - Yet Paid \$ 12 billion to Named Executive Officers in Total Direct Compensation
    - 300 officers - average \$ 40 million / officer
    - 20 of these companies provided full disclosure of metrics and 2 to 3 yr performance periods and would get a “check the box” on Pay For Performance

# 50 % of CEO roles Designed Wrong Too Operational

- MVC / Corporate Library / McKinsey
  - ✓ > 50 % top 1800 public companies in North America have failed to create a ROIC > Cost of Capital over 5 years - Business Model /Strategy NOT Viable
  - ✓ 55 % Directors had NO meaningful process or metrics to evaluate CEO role / performance
  - ✓ 85 % not held accountable for business performance (not stock market performance) beyond 3 years
  - ✓ 90 % of disclosed LTIPs are NOT linked to meeting performance conditions before AWARD of incentive pay

# Fundamental Problems

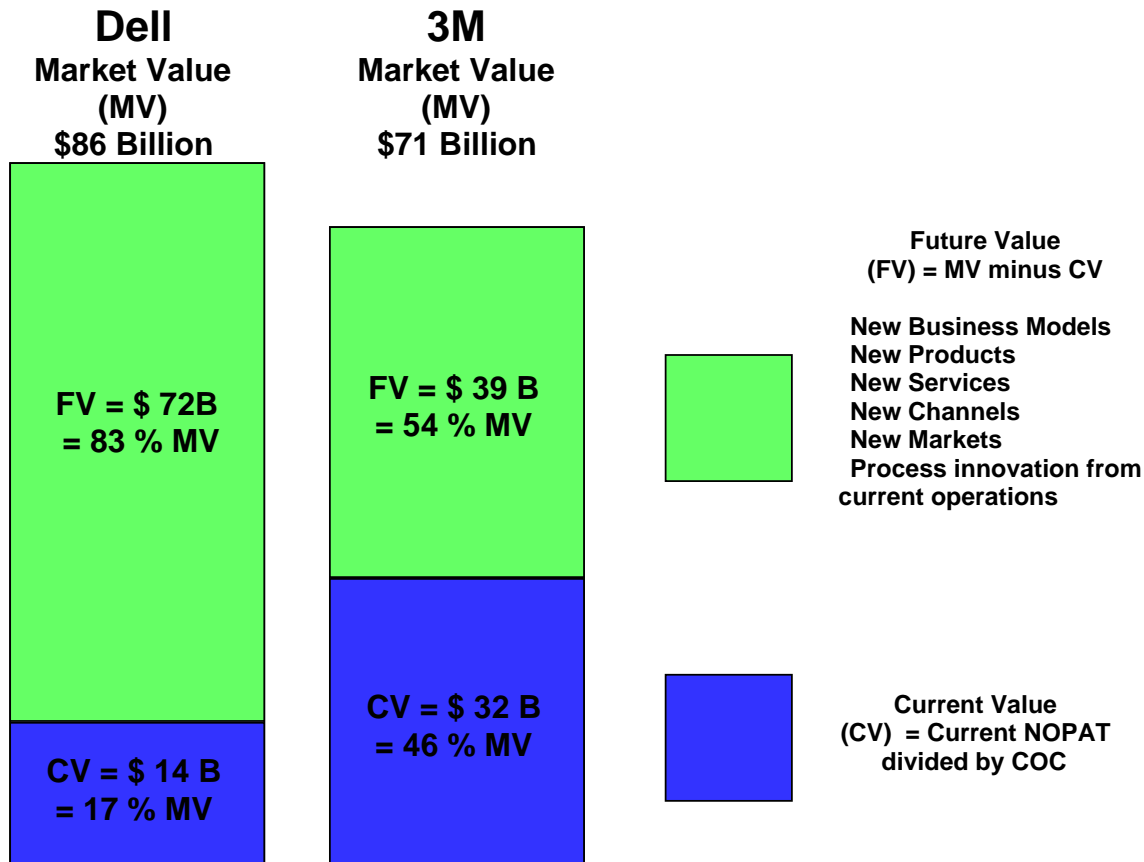
## Executive Compensation Model

- Minimal link to 3 to 5 yr + Business Strategy & Performance Metrics
- Minimal link to Organization Design
  - Confusion over Operational Work, Measurement & Pay vs. Strategic Work, Measurement & Pay
- Minimal link to 3 to 5 yr + Business Performance
  - Confusion over Intrinsic Value vs. Shareholder Wealth
  - Confusion that equity compensation without longer-term performance conditions creates alignment of longer-term executive decision making in growing the business, driving innovation and positive ROIC

# CEO / NEO Accountability, Value Add & Performance Metrics

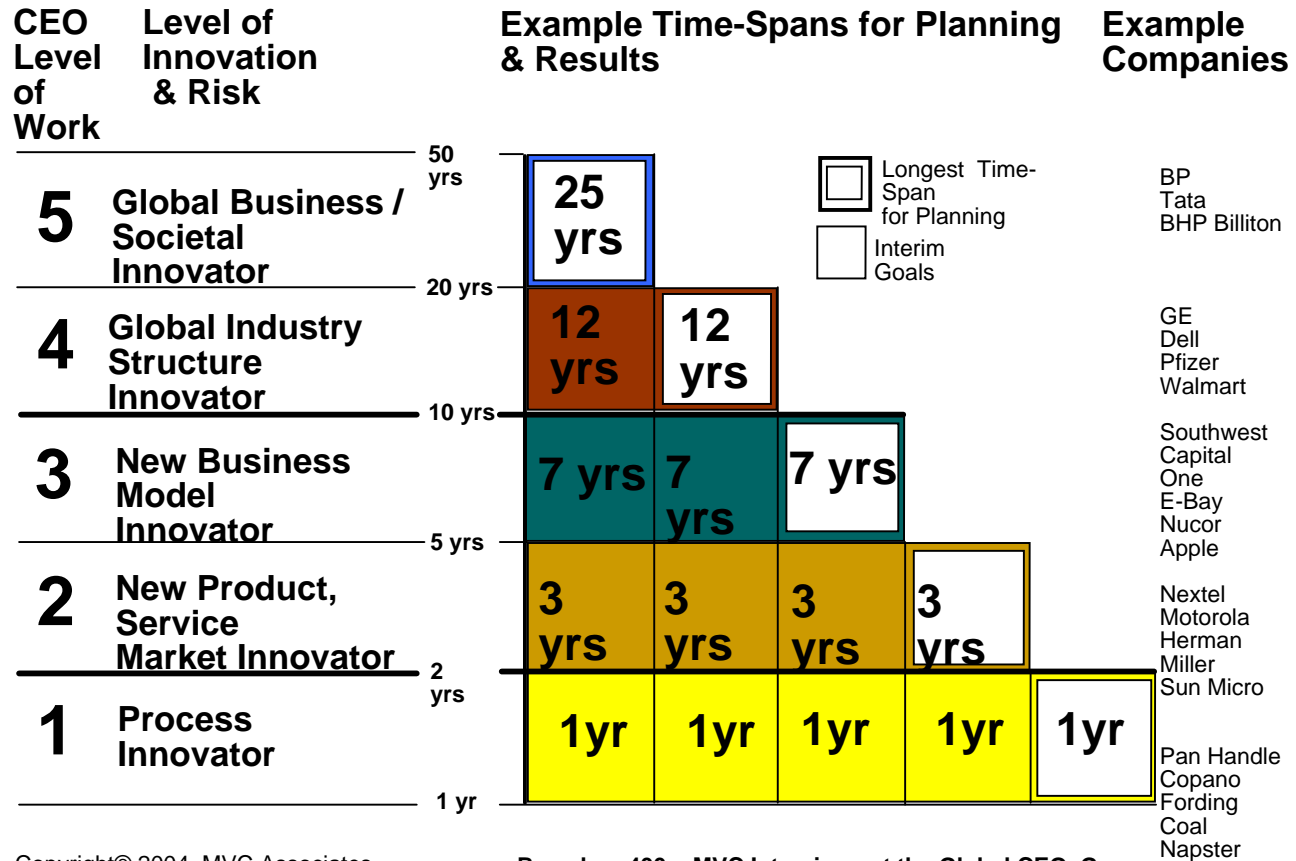
- What is it that CEOs are really paid to accomplish and how should performance be measured ?
- How many levels of management does an enterprise require, what is the value add of each level and what determines this ?
- Too many Executive Pay for Performance models are linked to Current Operations and are mismatched to compensation that should be aligned with Strategic & Innovation Work
- Too many CEOs are overpaid for mostly Operational Work = “wasted compensation”

# Expected Business Growth & Innovation Embedded in Stock Price



- **Current Value “CV” and Future Value “FV” Already in Stock Price & Enterprise Market Value “MV”**

# Level of Strategic Challenge and CEO Work / Accountability



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Based on 400 + MVC Interviews at the Global CEO, Group President, President, and VP/General Manager Levels

## Level of Work Equitable Pay Multiplier

Leadership Domain	Level of Work & Innovation	CEO to CEO comparison	Example Pay Bands \$ USD	
<b>Global Industry</b> <ul style="list-style-type: none"> <li>Current / Future Societies</li> <li>10-20 yr + Balance Sheet Strategy, optimizing TSR and Cash-Value-Added for Societies</li> <li>Transform Industry Structure / Cultures</li> <li>Create change globally</li> <li>Leadership of Business Leaders</li> <li>Identity &amp; Policy Control</li> </ul>	<b>Level 5) Global Business / Societal Innovator</b> <small>Creates enterprise sustainability, new industries (R&amp;D), and wealth creation for global society, by managing the inter-dependencies between economic, environmental, social and political factors worldwide (Stratum 7)</small>	<b>32X</b>	\$3.84m	
			2.88m	
			<b>16X</b>	1.92m
	<b>Level 4) Industry Innovator</b> <small>Model corporate citizenship / stewardship, policy and investment strategies leveraging business models across multiple geo-political, socioeconomic, &amp; technological boundaries (Stratum 6)</small>	<b>8X</b>	1.44m	
<b>Business Development</b> <ul style="list-style-type: none"> <li>Current/Future Stakeholders</li> <li>2 to 10 yr Investment Plans</li> <li>New Products, New Businesses &amp; Return on Invested Capital</li> <li>Anticipate change nationally and globally</li> <li>In-Direct Leadership</li> <li>Strategy &amp; Management Control</li> </ul>	<b>Level 3) New Business Model Innovator</b> <small>Transform the business model leveraging customer, competitor, regulatory, capital market, NGO's and other socio-economic factors (Stratum 5)</small>		720,000	
		<b>4X</b>	480,000	
	<b>Level 2) New Product / Service Innovator</b> <small>Integrate and synthesize stakeholder needs resulting in development of new products, services, markets &amp; channels (Stratum 4)</small>	<b>2X</b>	360,000	
<b>Operational</b> <ul style="list-style-type: none"> <li>Current Customers</li> <li>1 to 2 year profit plan / EPS</li> <li>Operational &amp; executional efficiency</li> <li>Respond to change locally and nationally</li> <li>Direct Leadership</li> <li>Operational Control</li> </ul>	<b>Level 1) Process Innovator</b> <small>Optimize process, technology and people to deliver a suite of products &amp; services to meet the needs of current customers (Stratum 3)</small>		180,625	
		<b>X</b>	\$120,000	

## Defensible Executive Pay

9 + Studies - found  
2 X compensation differential  
& “Felt Fair Pay” for each  
Level of Work (Elliott Jaques, etc)

Size of Revenues & Assets  
does NOT determine  
Level of CEO Work

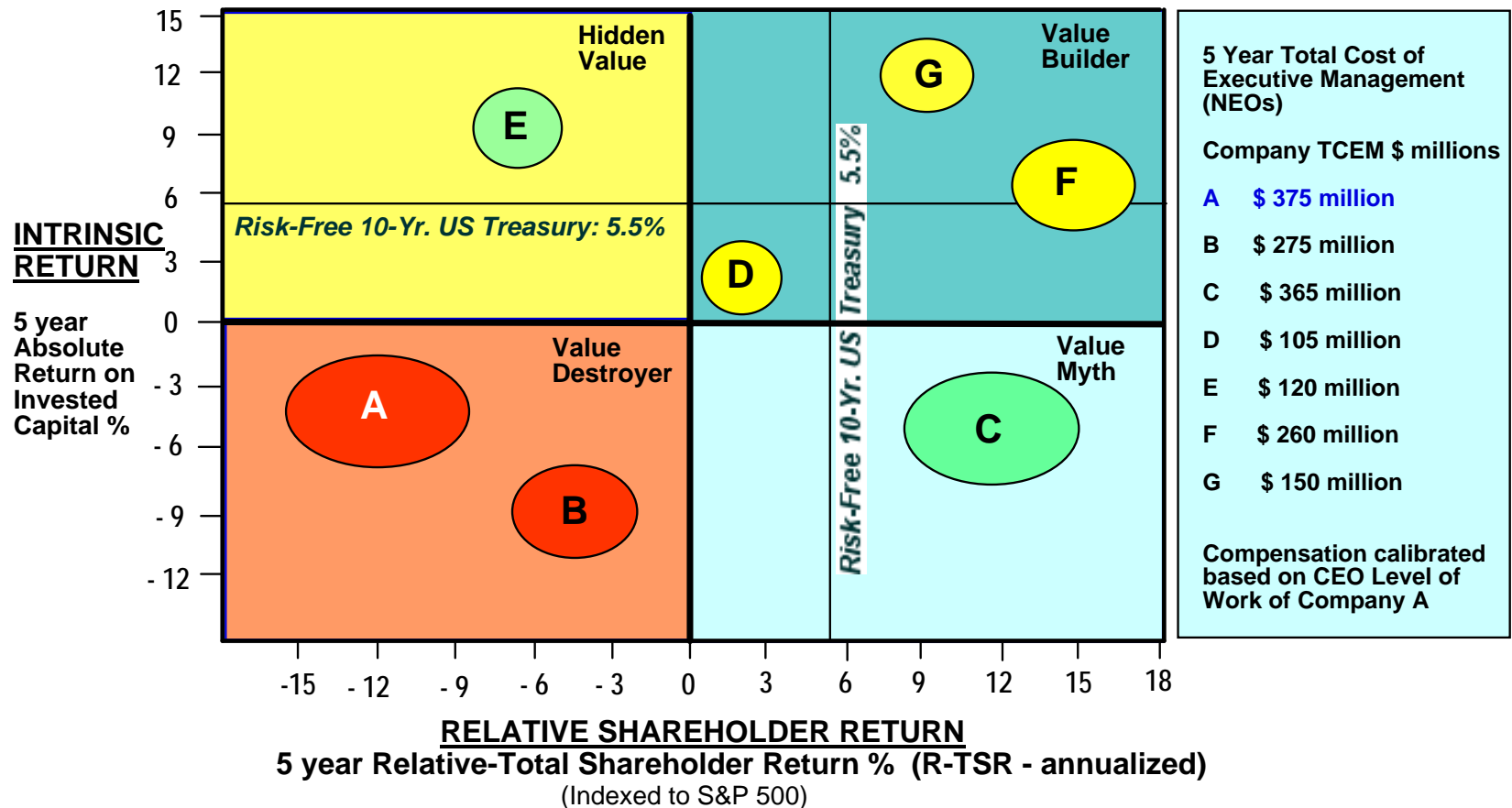
Differential executive work,  
accountability & level of value  
creation merits Differential  
Levels of Pay (LOP) that is  
defensible to shareholders



# A Total Picture for Defensible PFP

## Pay-for-Performance Analysis Select Peer Group

### Intrinsic & Shareholder Value Returns Compared with Executive Pay



# What Boards Need to Do Now!

- Clearly Define the CEO / NEO Level of Work & Accountability beyond just Current Operations
  - “Strategic Duty” of Directors as a Fiduciary for Shareholders
  - Set / Measure 3 to 5 yr performance periods before the AWARD of longer-term incentive compensation ( LTIP )
  - Clarify Executive Accountability for Growth & Innovation ( 4 levels of Future Value - “FV” beyond current business - “CV” )
- Hire expert advisors in Pay-For-Performance
  - Most compensation consultants as experts in Pay Design & Delivery may NOT meet the legal test to protect the Board as expert in Pay-for- Performance ( Risk of being challenged is for PFP )
  - Tie Executive Incentive design into business strategy, organization design & longer-term measures of BOTH Intrinsic Value & Relative Shareholder wealth creation
- Proactively disclose to shareholders Performance Metrics, Performance Periods and PFP policy