

Talking Points: Executive Pay Concerns

Doug Friske

Managing Principal

October 31, 2005

Factors Contributing to Executive Pay Concerns

- Excessive reliance on market data
 - Market data is an important input into decision making, but too often judgment is not applied
 - Need to recognize there is no single market point, but rather market is a range of practice that reflects many factors (individual, performance, company-specific issues)
 - The tool itself (whether survey or proxy study) is not the problem, but rather it's the use of the tool
- Lack of discipline and consistency
 - Compensation programs play out over long periods of time
 - Too often plans are modified or scrapped because they don't provide immediate gratification
 - Companies need to stick with well-designed plans through peaks and troughs
 - Mark of admired companies: simple, consistent incentives

Factors Contributing to Executive Pay Concerns (cont'd)

- Difficulty saying no
 - Boards/management (and the rest of us) generally want to assume a positive outcome
 - Stopping short of a CEO candidate's desired pay package or paying no incentives may be perceived as lack of confidence or inability to think about bigger picture
 - All investments (including pay) are bad if the price is too high
- Poor succession planning
 - Has led to increased need to recruit externally, driving up costs
 - External hires tend to produce internal pay equity issues, spiraling pay higher
- Lack of accountability
 - Too often incentives are seen as the silver bullet to improve performance; when the management or the strategy is wrong
 - Boards need to look at management and business strategy first to ensure they have the right people doing the right things; if so, incentives should pay something in most situations
 - If poor management, soft landing to be avoided

Factors Contributing to Executive Pay Concerns (cont'd)

- Excessive focus on best practice, as opposed to best fit
 - Strong desire to mirror best practice (it's easy and safe)
 - Not enough attention is given to what works in your situation, leading to application of programs that don't make sense
 - See IBM, GE and Microsoft's handling of long-term incentives; three distinct approaches to plan design, all fitting their needs
 - Should learn from best practice, not be guided by it
- Missing big picture
 - Too often programs and pay decisions are decided in isolation
 - When viewed in the context of total rewards, different perspective may emerge

Action Items

- View market data as an input, not a decision
 - Market data is important to ensure full understanding of external environment and potential opportunities
 - Management and Boards need to apply significant judgment to make pay decisions and be willing to deviate from market practice when it makes good business sense
 - All programs and individual pay levels need not be, nor should be, at market at any given point in time (some higher, some lower)
- Ensure Compensation Committees have complete understanding of all relevant factors
 - Includes thorough performance information (individual, company and peers), tally sheets, wealth creation, accumulated holdings, total reward statements, internal pay comparisons
 - Information needs to be provided in a simple, easy to follow format (avoid analysis paralysis)

Action Items (cont'd)

- Allow thoughtful discussion and apply judgment
 - Executive pay is a highly visible, often complex matter; thorough review and discussion is required to ensure all parties understand implications of decisions
 - Allow sufficient time for meetings and have a process that encourages discussion between management and committee and within committee
 - Pay should not be reduced to a formula; formulas lead to problems
- Build stronger performance management system, including succession planning
 - Adds value at all levels, including committee performance
 - Will drive more consistent, thoughtful application of pay programs
 - Avoids the need to enter the spot market for talent, identifies problem areas before they arise