

No More ‘Holy Cow’ Moments

It's tough these days to escape the controversy over executive pay. You can't pick up a newspaper, watch the news, or surf the Internet without someone weighing in on how much corporations are paying their top executives.

Such scrutiny makes it essential that boards, compensation committees, and management fully understand the extent to which the complexities of their executive compensation programs affect the value of final payouts. While competitive analyses and tally sheets are useful, what's needed is a broader analysis that provides the potential total compensation that will be provided to executives under all possible performance scenarios.

One way of obtaining such an in-depth review is through an Economic Impact Analysis, or EIA. In a nutshell, an EIA is not limited to just a “static,” point-in-time snapshot of the amount of compensation that will be delivered at target performance. This broader and longer-term look at pay and performance also factors in the impact of plan leverage—that is, the degree to which performance plan payouts will be affected by incremental changes in stock price or company performance.

The key to the EIA is the assumptions used to forecast potential future performance, each of which can substantially impact value. The assumptions are based on a careful analysis along three dimensions:

- A look back at the firm's

historical performance.

- A look around at the historical performance of a peer group, or an industry or a financial index.

- A look forward based on management's expectations for future company performance.

As boards and compensation committees review their pay programs, an EIA should help them answer three important questions:

Do we understand the range of potential payouts associated with the current compensation program? The EIA provides a comprehensive analysis of potential payouts between the 10th and 90th percentile performance over time, based on forecasted future performance. EIA reviews current base salary, potential short-term incentive payouts based on assumed financial results, and potential long-term incentive award values, based on simulated financial and/or stock price performance over the term of the award, as well as benefits and perquisites. The result? An in-depth look at what an executive can earn under all circumstances.

Is our compensation program appropriate? Only when all of the potential scenarios are laid out can organizations judge if the range of executive payouts is reasonable and appropriate to the performance achieved. For example, an organization that considers compensation at target performance to be reasonable might realize—after looking at an EIA—that payouts at the 40th and 60th percentiles will be inad-

equate to retain that executive. Or worse, it might discover that its CEO's compensation for company performance between the 10th and 40th percentile is likely to result in unexpected and unwelcome headlines.

Does our compensation plan adhere to our strategy and philosophy? By providing a comprehensive picture of the total value of executive compensation, an EIA enables an organization to delve more deeply into how programs are structured and identify potential pitfalls in the overall performance orientation and/or mix of compensation instruments. The board can then evaluate whether the current program is appropriately and effectively aligned with the company's overall compensation strategy.

The best compensation programs don't just “happen”—they are the product of a proactive board and compensation committee that takes the time to truly understand how the organization's executive pay programs work. Combined with competitive analysis and tally sheets, an EIA provides the tools to fully evaluate your comp program—and make those “Holy Cow” moments a thing of the past.

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An innovative way of reviewing executive compensation that provides a more complete picture of total pay.

By Melissa Means