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**Y**ou don't get better performance just by paying people more money — so why do companies throw money at executives for less-than-stellar performance? Historically, a major factor was the closeness

between top management and boards of directors, which made many directors reluctant to say “no” to requests for more money or new programs.

That day is over, but even many conscientious boards still find themselves providing payouts

whether the peer job's organizational structure and role requirements are truly comparable; and how executive pay decisions affect employee relations overall.

After all, market “median” is simply the halfway point in the data — it's not an absolute standard. It's naive to assume that if you pay executives at the 75th percentile, they will deliver 75th percentile performance. It may be both necessary and appropriate to pay a long-time, high-performing executive at or above the 75th percentile to retain her services, but to pay another executive 8 percent less than the market median due to his experience and contribution.

## Essentials For Avoiding Overcompensating

**Executive pay practices and disclosure have come a long way, but many conscientious boards are still designing packages that are out of proportion to the results delivered.**

By  
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that are out of proportion to the results delivered. Where are they going wrong in the design and administration of pay-for-performance programs? We'll look at some of the most common pitfalls facing companies and suggest some remedies.

**1 Don't be a slave to the data.** The talent market is not Walmart, it's Sotheby's — a place where value to the beholder is determined by more than price alone. Unfortunately, both management and boards tend to rely too heavily on compensation data in setting pay levels. The value of a particular executive's work and performance should be assessed relative to the company, the environment and the team — essentially, the level and form of compensation needed to attract, retain and motivate that executive in that particular situation.

Rather than relying on competitive practices alone, pay judgments must take into account the individual executive's experience, skill, performance and contribution; the company's performance relative to its peers/market;

**2 Compare peer performance.** The selection and use of peer group compensation data is fraught with peril. To ensure apples-to-apples analysis, competitors should be picked on the basis of multiple, clearly defined criteria: industry, size, complexity, business model/life cycle, performance and/or other critical scope. That became a major issue for the then not-for-profit New York Stock Exchange, where the board was severely criticized for including the biggest Wall Street firms in its peer group.

A closely related problem is the failure to compare a company's actual performance against that of its peer group companies, so that performance expectations and goals can be calibrated against the competition. Actual performance should be analyzed over a three- to five-year period (and total shareholder return, known as TSR, over a 10-year period). That makes it more likely that higher-than-median payouts are provided only for performance that is consistently above-median.

**3 Consider relative equity risk.** A long-term incentive plan is like an investment portfolio in which the executive holds various instruments with varying levels of risk. From an investment analyst standpoint, stock options are inherently a much higher risk instrument than restricted stock. For that reason, a grant of restricted stock that is provided in place of an option grant should not deliver the same value.

Yet, as companies in recent years have moved equity value out of stock options and into restricted stock, few have considered the significant difference in risk and adjusted grant values accordingly, or compared the equity risk of their own long-term incentive packages with those offered by peer companies.

Typically, a company will simply add the Black-Scholes value of any options and restricted stock to the value of any cash compensation provided by their peers, and provide the same total value to their own executives. Yet there is a major difference between giving an executive a single \$4.0 million option grant, as compared with providing separate grants of \$2.0 million in options and \$2.0 million in restricted stock.

The executive with a mix of stock vehicles is ultimately more likely to realize much of the full \$4.0 million value — first, because restricted stock is less risky and second, because investing in a mix of equity vehicles increases the chances the award will perform well under different financial circumstances.

Employees in most companies will accept less value when it is provided in the form of restricted stock, because they intuitively understand the reduced risk profile. Companies should be taking a portfolio approach to equity awards by having their service providers quantify the risk associated with the various instruments in their long-term compensation programs and that of their competitors, and adjust awards accordingly.

**4 Balance the scorecard.** Executives' jobs are multifaceted, and their compensation programs should be structured to reflect that complexity. That requires

determining the most critical measures of corporate and individual performance, given the company's particular circumstance and its strategic goals, and where they should be measured on an absolute or relative basis.

There should be an appropriate balance of short-/long-term performance goals and quantitative/qualitative performance measures. And there should be sufficient leverage in the pay program so executive pay will fluctuate with changes in actual performance.

Too many executive incentive plans depend on the same few common measures of corporate success such as earnings per share (EPS) or earnings before interest, tax, depreciation and amortization (EBITDA). Corporate America has not done a terribly good job of rewarding executives for focusing on less-visible indicators of the underlying strength of the firm's growth engine or of its investment in the future.

Executives should have a built-in financial incentive to focus on R&D, customer satisfaction, management development and other corporate building blocks that don't provide an immediate financial return and are temptingly easy to cut when belt-tightening. For example, the percentage of a consumer product company's revenues driven by products that are less than two years old, or the percentage growth in its customer base, are critical indicators of competitive strength and important measures of executive performance.

Similarly, executives should be assessed in regard to how well they are protecting the company's investment in its people in the form of performance measures related to turnover and opportunities for training and development. It may sound mundane to predicate a portion of executive pay on whether all employees receive a performance review or a CEO succession plan is being developed, but in organizations where it hasn't been happening, it needs to be brought into focus.

**5 Don't make excuses for performance shortfalls.** Nothing raises the hackles of shareholders more than a company that provides payouts to executives for

performance they didn't deliver. Whether it's an industry slump, torrential rains, raw material price spikes, a misalignment of the stars — it doesn't matter what exceptional circumstances are used as a rationale.

"Risk" inherently covers factors not within executives' direct control — including potential events that may rebound to their benefit. Carving out exceptions to pay out for missed targets creates an artificial truncation of downside risk, particularly since the company rarely, if ever, reduces payouts when performance gains through outside circumstances.

However, a performance plan based on a careful calibration and balancing of upside and downside risk will reward employees to the greatest extent possible for things over which they do have influence. That includes the performance of those working directly under the executive, since successfully employing influence and persuasion is part of any manager's job. Conversely, if an annual bonus plan for division heads is based heavily on EPS results — over which those executive have limited impact — participants will often lose interest.

**6 Make people feel like winners.** Although it may sound counterintuitive, incentive programs ultimately should promote a "winner" mentality among participants. That doesn't mean overpaying, just structuring plans such that over time, payouts average slightly more than target and thereby exceed expectations, even if that requires setting the actual target awards lower. Just a few extra percentage points can make a huge difference in participants' level of satisfaction — people don't need to be blown away.

**7 Grow your own top management.** Two of the most contentious issues in recent years have been outsized payouts at the start and at the end of employment, particularly for executives of relatively brief and less than stellar tenure. Such arrangements are most common among companies that have neglected to nurture top-flight managers from within the organization. Doing so would eliminate the need to lure new talent by providing lavish sign-on

packages, including compensation for equity left on the table at their previous employers and a guarantee of hefty payouts in the event of termination.

Growing management and promoting from within capitalizes on the fact that top-level executives are focused primarily on maximizing their long-term capital accumulation while they're in their prime earning years. Smart companies create opportunities for executives to build that long-term wealth over the long-term within the company, rather than having to hand it over to an incoming executive who may or not work out.

**8 Make executives long-term owners.** Share ownership by executives is good governance and good business. We all want to protect what's important to us. Requiring a level of equity ownership and/or requiring that executive retain a portion of equity payouts promotes a long-term performance perspective and can reveal the extent of an executive's commitment to the organization.

Worried about pushback? An executive who insists on bigger, quicker cash payment on the grounds that he can't predict if he'll be with the company in 10 years is probably not the ideal employee in which a company should make a long-term investment.

**9 Keep a running tab.** In recent years, some of the most prestigious corporate boards have been caught off-guard by the size of executive payouts that had accrued under their purview, particularly executive deferral accounts. Evaluated in a vacuum, the individual elements of those compensation and benefits plans probably sounded

reasonable. But avoiding overcompensating requires a big-picture view: a holistic, integrated approach that considers the cumulative value and impact of each decision on the total compensation package.

The Securities and Exchange Commission's (SEC) proposed changes in proxy disclosure will provide a better presentation and explanation of total compensation, but not a complete picture.

For many boards, tally sheets have become the go-to tool for keeping track of pay, allowing for more easy calculation of the current and accumulated value of every pay component, including deferred compensation, accumulated pension benefits, equity awards, option holdings and exercises, as well as modeling out potential future values.

A related tool for assessing the pay-for-performance link is an economic impact analysis, often dubbed the "Tally Sheet on Steroids." While a regular tally sheet looks at termination payouts under various circumstances, the more extensive analysis examines the range of payouts possible under multiple performance scenarios. The resulting due diligence clarifies for the Compensation Committee how total compensation relates to company performance and shareholder value, including the leverage of the total compensation program and the payouts for different levels of performance. It provides a degree of assurance that the pay for performance program is working as planned.

**10 Explain your thinking.** Not all shareholder perceptions of overcompensation are warranted. Outside observers

are quick to assume a huge payout was excessive, but really knowing whether a plan paid out for genuine performance requires knowing the complete performance picture, as well as the detailed goals and leveraged payout structure.

Under the SEC's proposed rules, the board's "Compensation Philosophy" — long treated as a proxy formality — will become a key component of the new Compensation Discussion & Analysis (CD&A) discussion. It requires disclosure to shareholders, in "plain English," of the underlying goals of executive pay programs, how decisions were made and the relationship between performance and payouts. Aside from the legal obligations, the CD&A offers a prime opportunity for boards to clarify their own thinking and do a better job explaining to shareholders exactly how the company's executive compensation program is driving value-creating performance over the long term.

There will be no shortage of critics who continue to second-guess board pay decisions without ever having actively managed such programs themselves. However, boards increasingly possess the resolve and the tools needed to effectively manage their compensation programs, address critical governance issues and successfully attract and retain the kind of quality executive teams who will drive real long-term value generation.

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takeaways

- There's been a continuing disconnect between company performance and executive pay, even though boards have become more conscientious.
- Peer performance must be carefully structured to make sure it captures the right criteria, and it should be analyzed over a three- to five-year period.
- Too many incentive plans focus on the same few measures of corporate success, such as EPS, and neglect less-visible indicators of performance.
- Boards need to take a holistic, big-picture view of the cumulative impact of various decisions on an executive's total compensation package.

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