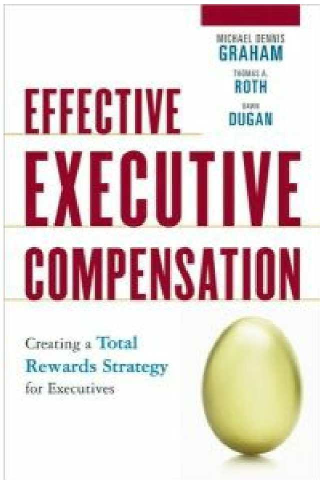

Book Effective Executive Compensation

Creating a Total Rewards Strategy for Executives

Michael Dennis Graham, Thomas A. Roth and Dawn Dugan
AMACOM, 2008
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Recommendation

Compensation can align the interests of a company's CEO with those of its shareholders. Michael Dennis Graham, Thomas A. Roth and Dawn Dugan show you how in their insightful book on effective executive pay, a package they call the "Total Reward Strategy." They explain how to use compensation to get great executive performance, instead of just handing out hefty paychecks and hoping for the best. They demonstrate how each piece of a pay package can focus top executives on the tasks that matter most. Consultants Graham and Roth tapped their considerable experience and expertise to produce a book that is not just a marketing piece. Because it combines readable writing (given the contribution of freelancer Dawn Dugan) with rigorous analysis, *BooksInShort* recommends their book to all interested business readers as well as CEOs, directors, consultants and other professionals directly involved in executive compensation issues.

Take-Aways

- CEO pay can affect your company's image and prospects.
- Many investors consider CEO pay when deciding to buy or sell a stock.
- How your company pays its executives should reflect your corporate compensation culture.
- Directors deserve fair compensation for their talent and time.
- Executive compensation should be a mix of base pay, incentive pay, benefits and even some perquisites.
- Put nothing in a CEO's pay package simply because other companies do it.
- Base pay on performance delivered, not on peer pay levels.
- Set corporate performance standards that exceed the 75th percentile of your industry to avoid rewarding mediocrity.
- Earning incentives over different time horizons balances a CEO's attention on results in the short, intermediate and long terms.
- Provide perquisites if you can publicly make a business case for doing so.

Summary

Making Executive Pay Effective

Even if you think your company's executive compensation package is good, you can likely make it better. Setting executive pay is a balancing act. Paying too much or too little compensation is equally problematic. Everyone likes to get paid as much as possible. Your job is to use pay to properly compensate and motivate the right behavior, which means work that benefits your company. Executive compensation is a significant short-term expense, but the way companies motivate their leaders can have long-term consequences.

> “Total Rewards Strategies” use everything your employee values to create compensation packages that cost effectively create incentives and align interests.

Avoid three “cardinal sins” in structuring executive pay packages. First, do not award below-average or average performance. Only excellent results should trigger executive incentive payments. Rewarding average performance will lead to average results. Second, do not copy the executive pay plans of other companies. Thoughtful, customized compensation is more effective. Third, do not send a mixed message by providing a poorly arranged pay package. Strive for compensation that provides clear, consistent guidance.

> “Every reward component has the ability to carry a message – and that goes for base salary too.”

Give your CEO an annual performance review. This sets the right tone for his or her position, demonstrates to other employees that annual reviews are serious business, and makes it clear that the rules are the same for all employees. No one should get celebrity treatment.

Set executive pay within the cultural context of your organization. Envision your company’s future and align your compensation package with this vision. Without such alignment, trouble will come by the truckload. Top pay is not a private matter. Consider how many stakeholders have an interest in it and be sure they understand your corporate vision. Investors abhor huge executive payouts at laggard companies. Employees want management to be motivated properly because its performance influences their paychecks and retirement accounts. Bankers and suppliers also have a stake in how executive compensation affects the companies they serve. Some corporate bank loans include terms that limit executive compensation, dividend payments and other uses of cash. By using all the resources your company has you can create a “Total Rewards Strategy” to better balance your CEO pay with the interests of your internal and external stakeholders. For example, you want to make sure that your executives cannot collect huge bonuses from putting the future of the company at risk through too much leverage or gutting your infrastructure that provides your future competitiveness.

The Compensation Mix

Executive pay practices vary depending on a company’s maturity. Start-ups are usually short on cash, so long-term incentives and stock options dominate their top pay packages. Long-established companies tend to pay executives large salaries plus incentives to motivate their productivity and high-level performance.

> “A total rewards system must be in line with the company’s vision, mission and values. In other words, the strategy must make it easy to do the right thing and hard to do the wrong thing.”

No single approach works best. The idea is to develop a compensation strategy that fits your company. One valuable tool is the “grahall Economic Impact Analysis” (gEIA). It helps the user create a properly motivational pay package, not a grab bag that makes executives rich at the expense of shareholders.

> “Companies whose executives have real share ownership tend to outperform those that do not.”

Think about an executive pay package in terms of architecture. Assess the functional purpose of each piece of the package. Providing perquisites might make sense if they help your CEO do his or her job more effectively. For example, some companies offer CEOs personal financial-planning services as a fringe benefit. If you are considering other forms of executive pay, deferred compensation is becoming increasingly common. Many companies also provide noncash benefits, such as protecting executives from certain legal liabilities associated with doing their jobs.

> “The 1980s brought us the idea that tying cash bonuses to rising sales or earnings would boost performance...Executives made decisions based on short-term results that often yielded long-term catastrophes.”

Effective incentive pay helps your company attract talented leaders and guides their decision making. Pay out incentive income over a mix of time horizons to balance executives’ attention to your company’s goals in the short, intermediate and long terms. The short term is usually defined as one year or less; intermediate terms run from three to five years. Long-term incentives pay off after five years.

> “We don’t advocate ‘best practices’ unless a company comes to us and tells us their goal is to be average.”

Strive for simplicity and predictability. Some pay packages are so complex that no one can calculate up front what they will cost the company. Executive compensation should be predictable and resistant to tampering. The CEO should be unable to grab incentive pay without providing real benefits to the company. Make sure that no executive can walk away with a small fortune in severance pay if the company fails.

Base Salary and Incentive Pay

The base salaries of many chief executive officers range beyond $500,000. But, for a variety of reasons, very few CEOs have salaries well in excess of $1 million a year. One reason that base salaries are rarely more than $1 million in the U.S. is that the IRS does not allow companies to deduct any higher salary amounts from taxable income. Other constraints weigh on base salary amounts as well. Providing salary increases as pay for performance may prove ineffective, for example, because a performance-based salary increase is a permanent reward for temporary results.

> “When Congress imposed their tax penalties on all base salaries above $1 million, performance-based pay became the latest fashion.”

Poorly structured incentive pay poses different problems. For example, if you make bonus payments based on corporate performance within the 75th percentile of your industry or lower, you are rewarding mediocrity, or worse. Never use incentive pay that way. Make incentive payments contingent on the achievement of specific, measured goals that result in superior corporate performance.

> “We are big fans of midterm incentives. They are often ‘tipping point’ incentives in that a little money, mixed well, can carry a lot of messages and provide a huge ‘return on incentives’ for shareholders.”

The first step in designing an incentive pay plan is deciding how to assess work well done. Will you measure against historical results, your business plan or the performance of peer companies? Decide which members of management to include in the plan. Exclude executives from incentive pay plans if they have no influence on the output measured.

> "Employees fund 401(k) plans with their own pay, so they don't create corporate debt or liability."

Avoid overloading executive pay packages with incentive income payoffs based on performance during periods shorter than one year. Incentives that pay after three to five years reflect successful management more than short-term luck. A company may adjust incentives if it takes a new strategic direction or if the incentives are eliciting the wrong response.

> "Compensation fell by up to 25% at companies that restructured their boards."

Use long-term incentives judiciously. Choosing the right incentive to motivate an executive over a period of five to ten years is far from simple. An executive's real contributions should trigger incentive rewards, not the company's luck or natural growth. Reward executives who consistently make profits for shareholders by keeping the company healthy. Long-term rewards commonly take the form of restricted stock awards or stock purchase options that vest over time. These rewards can closely align the interests of executives and shareholders. Executives who make their shareholders wealthier increase the value of their own stock-based compensation as well.

Special Benefits

Top executives face risks associated with their work, particularly employment insecurity. CEOs can lose their jobs due to sales, mergers or corporate collapse. Mitigating this risk with compensation package design may require provisions that protect your CEO's financial future.

> "When an organization provides a tremendous number of status-based perquisites that do not have the requisite business benefits, then executives learn to focus on appearance rather than results."

Top executives may deserve more benefits than average employees, but medical insurance and retirement benefits are among the goodies that all employees share evenly at many companies. The current trend in compensation emphasizes equal company benefits for executives and the rest of the staff. Whatever the merits of this sentiment, many companies provide a number of the same benefits to all employees.

> "If the perk is not helping the executive reach company goals, then it's quite simply not good business sense to keep it."

Modern executive perquisites pale in comparison to the lavish lifestyle enhancements that were common in past decades. The regulatory disclosure duties of public companies discourage lavishness. The Securities and Exchange Commission (SEC) requires public disclosure of any perquisite worth more than $10,000. However, neither the SEC disclosure requirement nor a public backlash against fancy fringe benefits has eliminated them.

> "If the directors are not rewarded appropriately, then it's very doubtful that the executive reward program will be effective."

Some perks are perfectly justified. Although people widely deride corporate jets as a symbol of greed, they can boost the productivity of executives who run far-flung global businesses. Paid sabbaticals can refresh and energize your top people. Golf club memberships can enable access to potential customers, partners and financiers. What distinguishes appropriate perks from overboard extravagances? The rule of thumb is this: If you can explain a perquisite's benefit to the SEC and your investors, you can provide it.

Looking Within for Leadership

Experience is not always the best indicator of a chief executive's worth. Studies show that hiring a former CEO or a first-timer produces about the same results. Paying filet mignon prices for a Big Mac still gets you only a Big Mac.

Looking within your company for a successor to your current CEO might make more sense than bidding top dollar for outside talent. Some forward-thinking companies have instituted programs to develop the leadership talent of their best internal prospects, including incentives to encourage them to acquire the skills the company needs, to recruit new hires with such capabilities and to demonstrate exceptional leadership.

Directors ultimately hire and fire the company's top officers, so management teams are beholden to executive boards. Few modern CEOs tell directors what to do. The days of the CEO as absolute monarch are over and most say good riddance. At the same time, stricter regulation of public companies has increased the responsibility of sitting on a board of directors.

Director pay has increased along with board responsibilities. Qualified board members no longer settle for the nominal pay that was common when serving on a board was relatively easy, enabling them to serve on two, three or more boards at the same time. Now you need directors with specific expertise who can provide top-level advice on running your firm.

Dynamic Compensation Plans

Effective executive pay is dynamic, not static, because companies face market conditions that constantly change. Companies' pay scales evolve along with their staffing needs. Changes in the market may mean that your company's employees, including executives, need different skills. What talents will tomorrow's workforce need? What skills do current employees lack? How can your existing workforce acquire such skills? Can such talent be recruited? In addition, each company has a slightly different mix of vertical and horizontal organization. You must design your management team to handle that mix effectively.

The best guide for each decision about executive compensation is the impact it will have on your company's competitiveness. Shareholders demand a solid return on their investment, and you can achieve that only by satisfying your customers with great products and services. Your top executive must inspire stakeholders with a shared vision of your company's purpose and its positive corporate culture. This is a tough job that requires more than just a competent bureaucrat.

The companies that recruit and retain the best leaders use compensation that sends the right message throughout the company and to the individual executive. To focus your CEO on the mission the board has set, use the potential for incentive income over different time horizons plus benefits that aid productivity. Don't look at what your competitors are doing. Base your executive pay packages on what is really driving your business. Make your CEO's success contingent on more than just money. A well designed "Total Rewards Strategy" will ensure that your top executive compensation will make sense to all your shareholders and reflect a consistent message that every employee understands and appreciates.

About the Authors

Michael Dennis Graham and **Thomas A. Roth** are consultants with more than 30 years experience each. They have designed more than 300 "Total Rewards Strategies." **Dawn Dugan** is a freelance writer.