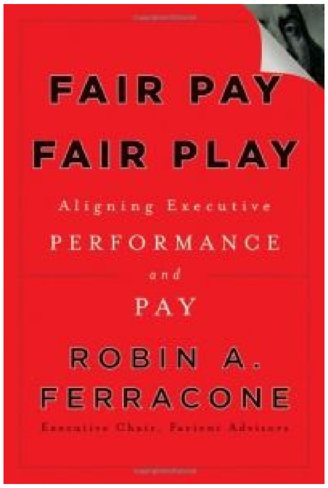

Book Fair Pay, Fair Play

Aligning Executive Performance and Pay

Robin A. Ferracone
Jossey-Bass, 2010
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Recommendation

Given increased public and government scrutiny of executive pay, corporate boards of directors are under more pressure than ever to implement reasonable, competitive compensation packages for their senior managers. Robin A. Ferracone now provides firms with the analytical tools they need to compare their practices with those of other firms and to understand how to set "fair pay." Using her 30 years of experience as an executive compensation consultant, Ferracone offers a relatively simple concept – "pay for performance" – while outlining the actual complexity underlying the idea. She explains the detailed mathematics of deriving critical statistics, including total shareholder return and performance-adjusted compensation. Her case studies and examples of corporate largesse offer readers welcome relief from intense statistical analysis, even though they help sell her "Alignment Report" as the prescription for compensation committee woes. Still, *BooksInShort* applauds her thorough research and recommends her findings to board members, senior executives and human resources professionals eager to pay – and play – fairly.

Take-Aways

- Massive "outlier" CEO pay packages that rouse public anger and attract political attention generally range from 15 times to 250 times the average pay for CEOs.
- Their firms, no more than 5% of companies, pay in the "95th percentile or higher."
- Companies should "pay for performance" by linking compensation to results.
- "Fair pay" represents the levels of reward corporate leaders deserve, while "fair play" describes the methods companies use to determine those levels.
- Despite popular perception, the expansion of average CEO pay has barely exceeded the growth in the US gross domestic product between 1995 and 2010.
- About one in three CEOs is overpaid, the result of compensation "misalignment."
- "Performance adjusted compensation" measures what a CEO makes, not what his "target pay" might promise.
- "Total shareholder return" is a good basis for evaluating executive performance.
- For a more complete appraisal, also measure "customer satisfaction, operational achievements, employee engagement" and "risk management."
- Stock ownership rules and "clawbacks" balance investor and management interests

Summary

The Pot of Gold

The 2008 recession made executive compensation a "hot-button" topic, as media-stoked public ire about excessive payouts and bonuses prodded the US government to appoint a "pay czar" to monitor the compensation practices of federally bailed-out companies. But the compensation of all CEOs and other "named executive officers" also ranks high among the concerns of large institutional investors. Along with executives, board members and board compensation committees, these investors wrestle with two notions:

1. **"Fair pay"** – The level of reward corporate leaders deserve.
2. **"Fair play"** – The "overall pay philosophy, analytic methodologies and decision-making processes" companies use to administer fair pay.

> "Good people, and top executives in general, are intrinsically motivated, but incentives provide a powerful messaging and focusing device."

Balancing these two concerns leads to "pay for performance" – that is, paying executives based on how well they deliver good returns to shareholders. This approach relies on the belief that a CEO's results should determine his or her competitive executive pay.

Despite popular opinion to the contrary, growth in the "absolute level of executive compensation" – adjusted for performance, corporate size and inflation – has tracked just slightly above the pace of growth in the US gross domestic product from 1995 to 2010. Fair pay is "sensitive to company performance over time" and it is "reasonable relative to the relevant market for executive talent and for the performance delivered." Surveys show that typical executive compensation levels don't bother most investors, but controversy rages around "outliers" who make from 15 to more than 250 times the average CEO's pay. Their companies pay in the upper 95th percentile.

Check Your Alignment

"Misalignment" occurs when a CEO's compensation is higher than his or her results warrant. The "The Alignment Model," a statistical measurement derived from executive compensation records for the S&P 1500's senior executives for 15 years, shows that roughly one out of three CEOs are overpaid. This model contains more than 50,000 "data points" on firms in all types of industries. It is designed to give boards of directors an objective, measurable basis for determining whether their pay policies align with their executives' delivered results and the standards in their fields.

> "Nearly every board in America states that its philosophy for executive compensation is to align pay with performance."

The Alignment Model considers "performance-adjusted compensation" (PAC), which is the pay and benefits executives receive based on their accomplishments, not the motivating "target pay" packages companies promise them up front. PAC is made up of salary, benefits, short-term "incentives," valued options and restricted shares. The average PAC for a chief executive, measured in constant, inflation-adjusted dollars, increased from $2.2 million in 1995 to $3.9 million in 2008. Fixed salary and benefits run less than a third of current PAC. Because the US fiscal code abolished corporate tax deductions on salaries of more than $1 million, now variable stock options and restricted shares make up most executive pay packages.

> "The populist view is that executive compensation is the root of all evil."

A CEO's impact over time on "total shareholder return" (TSR) – a firm's "stock price appreciation plus dividends reinvested in the stock" – is a good basis for evaluating performance. External events, like recessions or industry slowdowns, can tamp down TSR growth, so a complete CEO assessment also should include other evaluative measures, such as "customer satisfaction, operational achievements, employee engagement" and "risk management."

> "Repricing options or doing an option exchange is equivalent to a goal reset. Goal resets are not considered to be 'fair play.' It's like heads – I win; tails – you lose."

The full brunt of media scrutiny fell on the compensation General Motors paid its former CEO Rick Wagoner. His 2008 target package came to $14.9 million, a seemingly out-of-touch figure for an executive at a company seeking a government bailout. But Wagoner's actual PAC turned out to be $3.3 million, far less than projected, because his incentive shares in bankrupt GM turned out to be worthless; in addition, Wagoner took only $1 in annual salary in both 2006 and 2009.

"The Performance and Pay Alignment Zone"

In their financial statements and filings, all corporations proclaim their intentions to pay for performance, yet what constitutes "performance" is unclear. Should an adequate CEO benefit from a rising market? Should a superior leader sacrifice compensation if the market falls? How much do pay and perks motivate accomplished leaders? Should companies pay more for fear of losing top talent? To coordinate pay and performance, firms could allow their PACs to vary with total shareholder return "within an acceptable range compared to the relevant market over time."

> "Just as overpaying for poor performance is not in shareholders' best interests, underpaying for good performance is not in their best interests either."

The Alignment Zone offers a range of comparative results that lets firms judge whether they pay their executives reasonably, based on market returns relative to the competition. This model shows that, starting in 1997, Tyco was paying former chair and CEO Dennis Kozlowski above average. Tyco's board based Kozlowski's compensation on the number of mergers and acquisitions he engineered. In a rising stock market, his compensation "had the opportunity to defy gravity." Despite a stable $1 million annual salary, his equity incentives gave him more than $12 million in annual compensation, in addition to a realized gain of $240 million on his options. By the time Kozlowski was convicted and sentenced to 25 years in prison for "securities fraud, grand larceny and conspiracy," Tyco's share price had dropped from almost $100 to less than $20, and the firm had halved in size. Brought in to save Tyco, Ed Breen became CEO in 2002. He set about to change a corporate culture focused on short-term, outsized rewards. He instituted goals that required team cohesion and tied "long-term incentives" to TSR.

"Patterns of Misalignment"

Two out of three companies in the Alignment Model's database have misaligned pay and performance criteria, resulting in overpaid or underpaid executives. These firms fit five patterns:

1. **"Compensation flatliner"** – Firms that award consistent annual performance-adjusted compensation that is largely unrelated to total shareholder return may

not be doing all they can for their executives and their shareholders. Often, these boards authorize "special discretionary bonuses" outside their established pay schemes.
2. **"Compensation riskseeker"** – Pay in these firms is "highly sensitive" to performance, so the upside can be very good, but the downside can be painful. Boards should resist the temptation to shield executives in bad years, and should acknowledge and account for any excess risk taking prompted by their compensation model.
3. **"Compensation dogleg"** – These firms pay well for good performance but address less-than-stellar performance with special "retention" bonuses to keep their CEOs on board.
4. **"Compensation highflier"** – The managers of these firms express their explicit desire to pay at the upper end of the competitive scale, regardless of performance, perhaps because they can. ExxonMobil is an example, but its new compensation committee is working on reversing that tendency.
5. **"Compensation lowlier"** – The PAC for such organizations is regularly below the norm despite performance. Frequently, they offer executives "intangible" perks – location, job security and "work-life balance" – that make up for the pay deficit.

A "Culture of Misalignment"

Why are so many firms out of sync on executive compensation? The 2008 recession revealed a few reasons: Some organizations never considered adjusting the timing that allowed CEOs to cash equity awards quickly, leaving shareholders to suffer long term; most never thought to mandate "clawbacks" to force CEOs to refund the compensation they earned on failed strategies or ventures; and the majority did not account for required delays in vesting and selling awarded shares. A culture of misalignment can creep up on firms through five "pay design forces":

1. **"Aggressive target pay"** – Organizations aiming for above-average returns use compensation plans to award those who achieve lofty goals. But very few firms deliver exceptional growth year after year. Companies would be better advised to target "50th percentile pay positioning," thus paying for results in line with the competition. They could add supplemental rewards for extra achievements. Routinely paying above the market leads firms to "leapfrog" each other, pushing compensation standards higher. "Peer group abuse" can ratchet up pay levels: Not every bank is a peer of Citibank's, nor should every hotel compare itself to a Disney resort. Boards that want to retain top talent convince themselves that their CEOs are the best, so they end up paying even average executives as if they were stars.
2. **"Turbo-charged upside"** – Organizations embarking on chancy ventures often coordinate the levels and types of reward to the inherent risks, but making rewards turbo-charged can have unintended consequences. Case in point: In 2009, Copart, a dealer in salvage vehicles, approved a plan to grant its CEO and its president $2 million each in upfront stock options in return for their giving up salaries and bonuses for five years. Copart granted the options in a bear market; if the executives achieved the average expected TSR over three years – which was likely given the then-depressed market – they'd reap three times what salaries and bonuses would have paid. The deal had a risky downside, but the timing of the option awards skewed the plan in the executives' favor.
3. **"Conventional goal-setting"** – Most firms consider what they can accomplish and base their executive compensation goals on those internally derived standards. Contrast those "mark-to-budget" goals with a "mark-to-shareholder" model, which starts by determining what returns stockholders expect from their investment, based on the market, the industry and, finally, the company's capabilities. These "externally conceptualized" targets work best for setting "long-term incentives." Repricing options when stocks are down generally undermines the integrity of goal setting and can bump up overall compensation in bad times. Instead, recalculate stock options on a "value-for-value" basis, exchanging the present worth of underwater options for new option awards based on current values.
4. **"Short-term gain; long-term pain"** – Equity is pivotal in compensation, ostensibly to align management's interests with shareholders'. But realistically, short vesting periods and minimal holding rules mean that CEOs often cash out before long-term investors. Annual option grants with staggered vesting periods bring investor and management interests more in sync than do one-time or "episodic" awards. Other ways to cut "short-termism" are share ownership requirements and "clawbacks" of previous compensation.
5. **"Flattening the curve"** – Overall compensation levels need thoughtful management: Boards should determine the relative position of their "pay line (high, medium, low)" and its slope. For example, a company that wanted to raise its pay profile shifted from granting shares based on value to awarding fixed numbers of shares.

"Design to Align"

Be aware of the damage that off-the-cuff decisions can do to compensation policies. Misalignment occurs when boards approve special awards or consideration for extraordinary occasions. Allow "planned, bounded discretion" on about 25% of the bonus pool so you can make prudent changes in payouts based on unusual or one-time events. Carefully deliberate before authorizing retention bonuses; most CEOs don't work strictly for the money. Focus instead on succession planning. Steer clear of "decision-making influences" that can skew compensation policies. For example, "asymmetric performance attribution bias" ascribes good performance to your or your team's efforts and bad performance to extenuating circumstances, while "asymmetric information bias" causes you to perceive your team as the best simply because of your familiarity with them.

> "As the old saying goes, 'Be careful what you pay for because you're going to get a lot of it'

Now more than ever, scrutiny falls on boards of directors to make careful decisions about executive compensation. Aim for "convergence" in aligning the results your company seeks with the pay your executives deserve.

About the Author

Robin A. Ferracone founded and chairs Farient Advisors LLC, consultants in executive compensation. She has advised corporations on executive pay issues for more than 30 years.
