Myths of Executive Compensation: Returning to Basic Principles of Pay for Performance

by Mark Van Clieaf and Janet Langford Kelly

There are many who think that there is a crisis in executive compensation, and many who do not. In an effort to look at the question empirically, we screened the Russell 3000 for five-year performance (both intrinsic value and market value added) and executive pay. Sixty of the lowest decile companies,[1] as an example, lost a total of $700 billion in market value added (MVA) and $485 billion in cumulative negative economic profit over five years, but paid their named executive officers (NEOs) some $9 billion to $12 billion in total direct compensation over the same time period,[2] not including pension benefits or SERPS! Executive pay for performance is clearly in crisis and may be the number one corporate governance problem yet to be fixed today in America.

How did this happen? Prevailing practices have not led to a thoughtful process to assist boards to determine and align both what they expect from executive roles and how much they are paid. The resulting sheer magnitude of executive compensation payouts, the disconnects between pay and performance, the lack of internal executive pay equity, and the specter of NEOs walking away with significant compensation windfalls after destroying large amounts of shareholder value have all increased shareholder activism and put directors at risk.

In this environment, director practices that were routine or "check the box" even a year or two ago are now the subject of proxy solicitations, litigation, and judicial decisions. Directors and their advisors need to start with a blank page if they want to create executive pay packages that drive the creation of long-term value and minimize the risk of being successfully challenged. To help directors start fresh, this article addresses the myths of executive compensation that have led to faulty executive pay principles and practices and shows how boards can create practices and processes that actually tie executive pay to the creation of long-term value, while meeting the test of being equitable versus excessive.

The Fundamental Problems with Executive Pay

Common executive pay practices fail to incorporate an understanding of the basic links among business strategy, organization structure, and executive pay and rewards. The three are best thought of as a holistic triangle, in which the strategy necessary to sustain a viable organization must be determined in order to establish appropriate organizational structure, and all must be agreed on in order to design an effective pay-for-performance plan that drives sustained business results and shareholder wealth creation. Because strategy, structure, and pay rarely are treated as inseparable points of a triangle, three fundamental problems exist today regarding pay for performance:

1. Many boards are failing to design executive compensation programs that create a direct correlation among enterprise performance, organization design that drives sustainable growth and value creation and executive pay—compensation programs that incorporate at least two performance measures over time, namely, shareholder wealth creation and intrinsic enterprise value;

2. Many boards and compensation consultants are establishing operational performance measures for their most senior executives instead of strategic measures, but awarding executive pay at levels appropriate for strategic work that drives growth, future investments, and innovations; and

3. Many boards do not have a meaningful process that would enable them to thoughtfully defend the question of how much executive compensation is appropriate by considering executive pay relative to:

   (a) Organization structure, business strategy, and the value-added contribution of executive management;

   (b) Level of three- to five-year historical and forecasted real economic performance of the firm;

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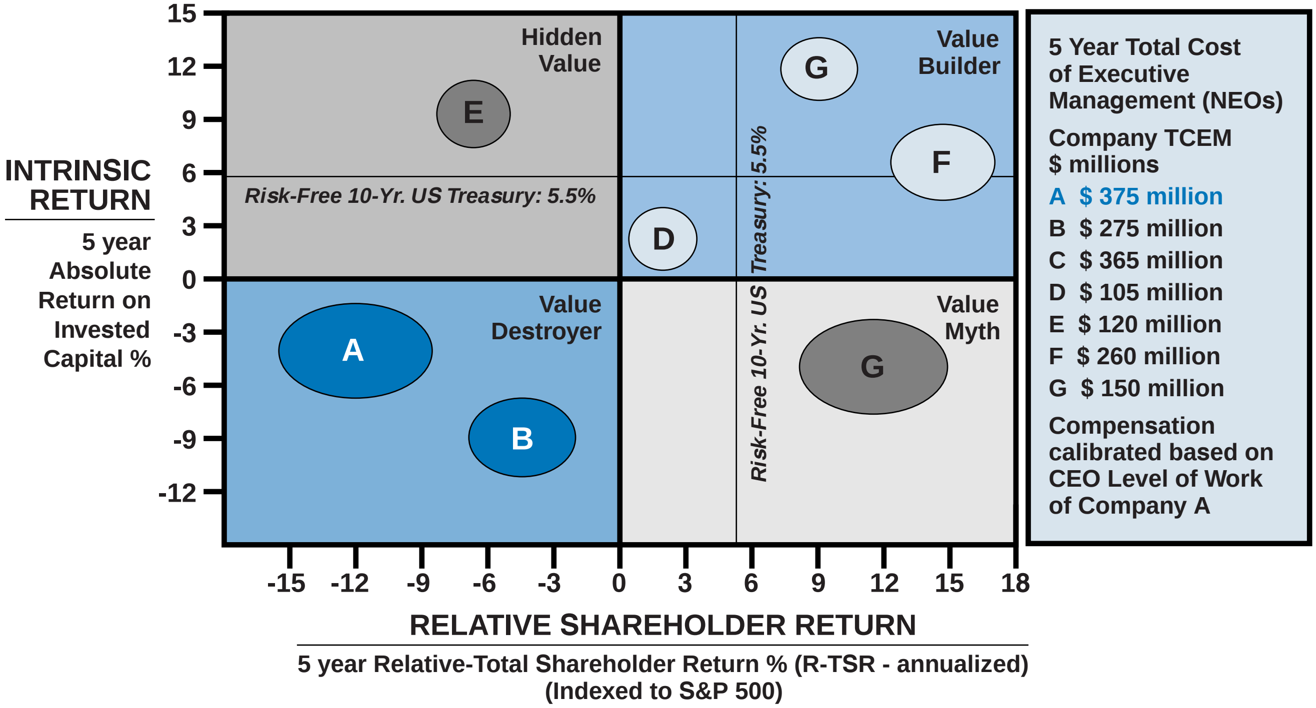
Figure 1

Pay-for-Performance Analysis Select Peer Group

Intrinsic & Shareholder Value Returns Compared with Executive Pay



(c) Three- to five-year historical and forecasted shareholder wealth creation compared to investor expectations;

(d) Level of wealth already awarded to management over the last five years;

(e) Level of wealth management can earn if they achieve targeted goals for intrinsic value creation and shareholder wealth creation over the next three to five years;

(f) Level of executive internal pay equity; and

(g) Level of market competitiveness of current compensation with peer groups using compensation data that is properly job matched and compensation calibrated.

These deficient practices result from systemic issues that cause talented, well-meaning directors to become hostage to a system that overly measures and overly rewards short-term results without showing adequate concern for the long-term strategy and viability of the business.[3] They also result from some deeply, perhaps even unconsciously, held beliefs about executive pay and value creation.

The Myths of Executive Compensation

The following myths about executive compensation need to be shattered.

Myth # 1: Total Shareholder Return (TSR) and Earnings per Share (EPS) are good measures to use in executive pay-for-performance plans.

Too many directors believe that the ultimate measure of managerial success, and indeed of their own success as directors, is the company's stock price or total shareholder return (TSR). Of course, a rising stock price over time is an important goal. However, there are several serious problems with using stock price or TSR as a pay-for-performance measure.

First, stock price and intrinsic value can be completely disconnected over the short term.[4] Indeed, our research and financial analysis of the Russell 3000 identified that 29 percent of the 2171 companies analyzed were value myths and had a positive increase in stock price and market value (MV) over the five years ending in 2003, but had a return on invested capital less than their cost of capital over the same time period—the intrinsic or current value (CV) of operations (net operating profit after tax minus cost of capital) was negative over five years. Over time, of course, if the CV continues to be negative, the stock price will fall to reflect the underlying intrinsic value of the enterprise and the current market value will not be sustainable, as happened in the dot.com bust.

But, if compensation is paid out in the shorter term based on rising TSR and stock price or is paid out in equity that can be sold, management can be rewarded for taking actions that destroy long-term value (or for not taking actions that build it), while the long term shareholder is left with a significant loss in the economic value of the company.

The second, and closely related, problem is that stock price or TSR (without some type of sector or market index) is not a good measure of management's contribution or effectiveness. Some 70-plus percent of stock price movement, on average, is determined by macro economic factors such as interest rates, GDP growth, currency rate, etc., all of which are beyond the control of management.

Third, TSR reveals nothing about the effectiveness of managerial decisions in deploying capital because it does not measure cash invested in the company throughout the performance period. Thus, if new cash or assets are acquired, a company's TSR could be positive, while its ROIC is negative, meaning that management has not productively used the new capital provided.

TSR also does not take investors' expected risk adjusted return into account. As an example, the risk-free US 10-year Treasury note provides a 5.5 percent annual return with no risk. Viewed from that light, if the past and forecasted annual TSR from a stock is 5.5 percent, the company's performance is hardly positive on a risk-adjusted basis, yet it is presented as positive by TSR measures.

Finally, and most troubling, creating an executive focus on the stock price instead of the health and future viability of the company can incentivize management to increase the stock price in the short term, while harming the long term business, such as by decreasing marketing, advertising, training, and R&D investments to boost year-end earnings.[5] If the recent scandals have taught us anything, it surely is that boards must be extremely careful not to design and approve incentives for management to enhance the stock price in the short term through actions that will harm the company in the long term.[6] Thus, TSR and too much reliance on stock options can focus management on driving stock price in the short term to the longer-term detriment of the enterprise and its shareholders.

Earnings per share is not a measure favored by corporate finance experts or pension funds because it fails to take into account the capital intensity, risk to capital, time value of money, and future free cash flow potential of the business. On top of that, EPS targets can be too easily manipulated through both earnings engineering and stock buy-back programs. Indeed, both Enron and WorldCom had 20-plus consecutive quarters of positive EPS growth before declaring bankruptcy.

Michael Mauboussin, the former head of equity analysis at CSFB, and co-author with Northwestern University professor Al Rappaport of *Expectations Investing,* said it best, "Managing earnings at the expense of value creation is undesirable . . . . I wish managers would throw earnings per share overboard and have the fortitude to run their businesses based on more appropriate long term economic measures."

Neither TSR nor EPS measures by themselves tell the board or investors anything about the future value creation potential of the business, the viability of a particular business strategy, or the alignment of management behavior and rewards in creating sustainable enterprise value. As the global head of performance and rewards for a FTSE top 50 global company recently commented to the authors, "Boards and executive compensation consultants in America have not accepted the number of American companies that are really myths in creating value and they appear to use TSR and EPS because they are simple measures, not the most effective measures." Boards, pension funds, and proxy advisory services would be well advised to use measures other than a simple TSR (or TSR relative to a discretionary peer group) and EPS in pay-for-performance plans and analysis.

Myth # 2: All equity compensation (including plain vanilla stock options and time-vested restricted stock) creates alignment with longer-term interests of shareholders.

In the early '90s, in the wake of perceived managerial resistance to restructurings and takeovers that created shareholder value, institutional shareholders and the SEC attempted to more closely align the interests of management with those of shareholders. Many thought that creating an ownership stake for executives, thereby focusing them on increasing the stock price, would create alignment between management and shareholder interests.

As originally contemplated, stock options were not compensation; they never displaced existing compensation and were not intended to be granted annually.[7] However, as compensation surveys annualized option and stock grants for purposes of presentation, equity grants became an annual event. As grants that were originally intended to be episodic became annual, the aggregate value of amounts granted became huge.

Unfortunately, stock options did not drive alignment between managerial behavior and shareholders' interest in long-term value creation. The fact that plain vanilla stock options enable grantees to profit from industry-wide and macro-economic trends unrelated to their own effectiveness has been extensively detailed elsewhere.[8] But far more concerning than the possibility that options allowed managers to benefit from unearned windfalls is that they seem to have driven behavior *at odds* with the creation of long-term value.

As Don Delves of The Delves Group, an executive compensation consultancy, has pointed out, "option grants created . . . enormous incentives for executives to think and act like option-holders, with far shorter-term and riskier perspectives than is healthy for most companies."[9] The truly enormous amounts of money to be made from increasing the stock price over the short term led, in case after case, to managerial decisions that were highly risky but would create huge increases in stock price, at least over the short term, if successful.[10] Yet, despite these issues, historically option grants have been overwhelmingly free of performance conditions or holding requirements.[11] This nearly universal approach to issuing stock options, with no three- to five-year or longer business performance conditions prior to vesting, created much of today's compensation crisis and arguably many of the corporate scandals of recent years.

In response to concerns about the incentives created by stock options and in view of the likely need to expense options, many companies have shifted some or all of their option grants to time-vested restricted stock. These grants do remove some of the skewed incentives caused by plain vanilla stock options. Restricted stock grants are not viewed as "free" the way that options used to be because they must be expensed. Because increases in stock price have less leverage with fewer affected shares, restricted stock grants don't distort managerial incentives to swing for the fences the way that options did. They also remove the managerial disincentive to pay dividends caused by options, at least as long as the stock bears dividends while restricted, as is typical.

However, lest boards and compensation consultants once again implement a wave of compensation practices with unintended consequences, it is important to remember that there are many problems with time-vested restricted stock grants as well. First is that companies are approaching the need to restructure compensation by assuming that executives need to be kept whole against the inflated packages created by the stock options experiment. What was not supposed to be compensation on the way in has become a birthright on the way out. Now that the myth of the compensation report to the board is clear, compensation committees must step back and ask the same question about executive compensation that we expect directors to ask whenever they approve corporate expenditures: whether the company is truly receiving corresponding value and return for the money spent.

Another question is whether options are being valued too generously for the purposes of converting their value into time-vested restricted stock. Finally, there is the concern that time-vested restricted stock does not create appropriate performance incentives. Some term it "pay for pulse," arguing that the only difference between stock options and restricted stock is less downside risk for executives, or correspondingly a guaranteed gift or transfer of shareholder wealth, as long as the executive is breathing. At the very least, such grants seem inadequate to drive long-term behavior if they have no three-year or longer performance conditions for award prior to vesting (as is typical) and can be sold as soon as they vest.

Myth # 3: Executive compensation surveys and benchmarking reports accurately reflect the market for executive talent and can be used at face value.

Boards have long assumed that the competitive pay benchmarking report that they receive from compensation consultants and related compensation data providers reliably reflect the market price of a particular executive position. The resulting mindset has been that the company should pay the "market" price. Much like going to a grocery store and buying a can of green beans at the price marked, the presumption has been that, if the company wants the executive talent, it must pay the price as marked. The reality is that these reports (compensation surveys and proxy statement reviews) are significantly flawed and have been a major contributor to the executive pay spiral as has recently been recognized by such organizations as the National Association of Corporate Directors, Business Roundtable, Council of Institutional Investors, CompensationStandards.com, and a few leading compensation consulting firms.

While these surveys suffer from many flaws, perhaps the most critical is the poor choice of peer groups. Most companies and their compensation consultants are applying an industry-based compensation model versus an employment-based model. Typically, compensation consultants work with management, and sometime (ideally) the board, to choose the company's peers and then determine the comparable pay of executive roles with the same title in the various peer companies. The problems with this approach are manifold.

First, it is not at all clear how peers should be selected. For example, Johnson & Johnson is used as a peer for many consumer products companies. Although Johnson & Johnson does offer some consumer products, such as Q-Tips and Johnson's Baby Shampoo, it also develops and markets ethical drugs and medical devices, making its status as a consumer products group peer somewhat questionable. With a high degree of discretion about how the peer group should be selected, very natural human instincts tend to favor the inclusion of companies that are high performance and high pay and the exclusion of those that are not. This practice, along with the tendency of companies to target executive pay at the 75th percentile, has resulted in a ratcheting effect of executive compensation that lifts the whole market over time as companies chase the 75th percentile.[12]

A second and related problem is that the executive roles and related pay are compared by using titles with little attempt to delve beneath the title to understand the scope and true nature of the executive roles being compared. Particular roles may have the same title and may even be in the same industry, but have very different levels of job content, accountability, and complexity. In other words, roles with the same title can be quite different in terms of the drivers of any well-functioning market: the scarcity of executive talent able to successfully execute the role and the ability of the executive to add value by executing the accountabilities of the position. As a result, the surveys and proxy comparisons are flawed because they are not truly comparing apples and apples; instead, they are comparing apples and oranges and sometimes even kiwis.

As an example, the 2003 cash compensation for Johnson & Johnson's CEO was $3.2 million compared to $2.6 million that Eli Lilly paid its CEO. Taken at face value, this data seems to indicate that the Eli Lilly CEO role was underpaid. However, when you look under the surface with appropriate executive job analysis factors (which we describe later), the CEO role at J&J is more than five times more complex than the CEO role at Eli Lilly. When properly calibrated to reflect a substantially less complex role, the *true* comparable J&J compensation number for Eli Lilly's CEO would be $1.2 million, not $3.2 million, more than 100 percent lower than the number presented in compensation reports that compare positions primarily by title. This is a material difference in what is truly the comparable compensation number that the board should rely on as an input for its deliberations.

Some leading executive compensation authorities are now highlighting, for corporate boards and their members, the flaws and risks in the use and over-dependence on external executive compensation surveys and proxy analysis to set pay. As Fred Cook, Chair of Fredrick W. Cook & Co., said in a recent webcast on *CompensationStandard.com*, "We have been so dependent on surveys because we do not know how to value the job of management." As we explain later in this article, we believe that there is a way to rigorously and defensibly value the job of management, but most compensation consultants lack a defensible process for executive job matching.

Directors must delve beneath the surface of the comparative compensation report that they receive to understand and approve the process used to select peers and evaluate and properly match executive jobs. Too often, boards fail to perform this quality assurance check on the compensation report. Those who do will usually find that the only attempt (if any at all) that the compensation consultant has made to properly match roles and adjust compensation levels accordingly was to consider the relative revenue size of the companies being compared.

Yet, size of revenue and market capitalization tells us almost nothing about the complexity of an executive role, nor will a regression analysis of compensation data correlated to company size tell us much. Most compensation consultants have no defensible process to evaluate and properly match executive jobs and to calibrate compensation when the roles are at different levels of complexity and accountability. Therefore, boards should *not* accept the compensation data presented at face value; directors who accept this flawed data and have little in the way of a quality assurance check may be seen to have consciously ignored their fiduciary duties in approving executive pay levels.

Myth # 4: Money is the key driver of senior executives and named executive officers, and they will leave if boards renegotiate pay and pay-for-performance programs.

Many directors fear that CEOs and their key executive team members will leave if the company negotiates in good faith with them, rather than pay them the going rate as revealed by flawed compensation surveys. While there is always a risk of losing executive talent, our experience is that executive talent is much stickier than most board members realize. Some of the reasons for this are obvious: An executive's accumulated knowledge may not be easily transferable outside his or her industry; spousal employment may not be mobile; children may be in school and reluctant to move; the unique opportunities for growth offered by a particular job; long-term friendships at and loyalty to a company. Furthermore, the executive marketplace for talent, while robust, has calmed down from its highly overheated state during the dot.com boom of the late '90s.

It is also possible that executives are reasonable when presented with a compensation package determined by a rigorous assessment of the position's level of accountability and ability to create value. Indeed, Elliott Jaques, in his research on work, equitable pay, and level of capability, found that individuals are unconsciously aware of the consistency (or lack thereof) among work (Level of Work), capability (Level of Executive Capability), and earnings (Level of Equitable Pay) and are actually happiest when the three are in equilibrium, not when they are earning the highest amount of money.[13]

We are aware of a few examples of when CEO and NEO pay was recently negotiated downwards, and the CEO and executive team, while not happy, both accepted the change and did not leave. In one recent case, the independent chair of a large technology company became concerned that no rigorous analysis underlay the compensation data presented to the board; he questioned whether the companies and roles presented were truly peers. Using our level-of-work principles and six-factor framework (*see* below), the board had a discussion and agreed that the complexity of the company and CEO/NEO roles and their accountabilities were *not* directly comparable to most of the 11 selected peer group companies. We are not aware of anyone else who had asked this important question before!

The board and the CEO agreed that the company/CEO role was not as complex, and the board decided to move targeted total compensation for the CEO/NEO from above the median of the peer group to the 25th percentile to better reflect the true level of work/accountability relative to the selected peer group.[14] The result was a 35 percent downward adjustment in targeted total direct compensation that was negotiated with and agreed to by the complete executive team.

As another recent example, one of the authors completed two executive searches at the presidential level for US-based clients. In the end, the successful candidates left behind close to $1 million of unvested equity compensation for which they were provided no financial consideration from the new employers. Both finalist candidates were "A" players whose current employers sought to retain them with even more money, but in the end, these candidates left for the unique career opportunity and the ability to impact the total industry. They neither left nor stayed solely for the compensation.

In the above two examples, both the candidates and potential employers negotiated in good faith to create a win/win situation. It is this type of good faith bargaining by the board that Professors Lucian Bebchuk and Jesse Fried, authors of *Pay Without Performance*, suggest is missing from too many executive pay decisions and has been a significant contributor to the executive pay spiral.

First Principles of Pay-for-Performance

Having dispelled some of the myths of executive compensation, let's look at the first principles of pay-for-performance. Where does a board or compensation committee start if it wants to be beyond reproach?

We suggest starting with four fundamental questions regarding CEO and NEO compensation and rewards:

1. What are we paying for?

2. How can we link pay with longer-term performance and value creation for shareholders?

3. How much should we pay?

4. How should we structure and deliver the pay?

1. What Are We Paying For?

Not all CEO roles are created equal! More than 40 years of research and consulting have revealed a relationship between enterprise strategy and innovation, organizational structure, CEO accountability, and executive pay. Building on three streams of earlier management research worldwide know as Work Levels, Requisite Organization, and Viable Systems Model,[15] MVC Associates has developed a framework called "Levels of CEO Work" (LOW), which provides an empirically proven set of tools, processes, and principles to define executive work complexity, accountability, and decision-making authority. This framework integrates business strategy, organization design, executive talent management, and total rewards/performance management with long-term shareholder value.[16]

There are five levels of CEO work, which are defined based on principles of complexity and how each level relates to innovation and value creation, *not* the size of the company. At any given time, a company's strategic needs will be at one of these five levels. The LOW framework uses six factors to determine which of five Levels of CEO Work and innovation is required by an organization to sustain itself as a viable business system. Four of these factors are the level of innovation complexity; the planning horizon; the level of complexity of assets/capital managed; and the level of complexity of stakeholder groups to be managed given the number of different businesses and countries in which the enterprise may operate. The higher the LOW required of the enterprise to create value and sustain itself, the higher the level of risk with shareholders' capital and usually the longer the investment time horizon to make new investments and create a positive return on invested capital.

In determining what the company is paying for, the board must look to the external environment to determine at which level of strategy and innovation the firm and CEO role should be operating and the level of risk the shareholders are prepared to take. This in turn defines the LOW, requisite skills and level of capability (LOC), and, as we show later, the level of equitable executive pay (LOP).

For example, if a company is primarily an investment trust (oil and gas, real estate, or a mine winding down its ore body), then the board should focus on maximizing free cash flow and earnings from the current assets and operations and should set more operational measures focused on productivity and capital efficiency for the CEO. Such an organization only requires a Level 1 CEO role and probably does not need more than three levels of management from the CEO to the front line. Depending on the industry and location of the organization, total cash compensation in the $180,000 to $240,000 range would be appropriate for the CEO position.

If, however, a company is expected to create future growth and long-term shareholder returns not generated today by the current operations, it will require more than three levels of work in the enterprise and its organization design. In such a company, the primary focus of the CEO (and the primary metrics for performance-based pay) should be on future innovation and growth from new products/services and new markets (CEO Level 2) or on creating a fundamentally new business model (CEO Level 3).

Companies such as eBay, Southwest Airlines, Pixar, and Nucor created fundamentally new business models and challenged the existing paradigm in their industries. Depending on the industry and location of such a company, total cash compensation in the $480,000 to $960,000 range would be appropriate for the CEO Level 3 role.

If the CEO is held accountable primarily for operational work in such a company (which may have four, five, or more levels of management), organizational compression results, with two or three senior management layers being held accountable for the same Level of Work. This includes the same metrics and same performance period for measurement. The result of this organizational compression or jam-up is:

- Slowed decision making;

- Wasted executive compensation due to poor organization design and ineffective executive job evaluation methodologies;

- Frustrated career development; and
- Named executive officer roles usually providing limited value-added to the management levels below.

McKinsey's recent 2005 study of directors found that 55 percent of those surveyed said that they had no meaningful process or metrics by which to evaluate the CEO role. Yet, current statutes and case precedents in the field of employment law are clear that a hiring or pay decision is not defensible or *bona fide* if there is no proper job analysis defining the role and the work. One could make an argument that a board has failed in one of its most critical fiduciary duties, the hiring and compensation of the CEO role, by failing to thoughtfully and clearly define the work and accountabilities of the CEO role for which compensation is set.[17]

What the CEO is being paid for changes at each of the five levels of CEO work. The first step for a compensation committee that seeks to make decisions beyond reproach is to determine the LOW required to achieve the company's purpose and to set the CEO and NEO accountabilities, metrics, and decision authorities so that they align with the company's organization structure and business strategy.

2. How Can We Link Pay with Longer-Term Performance and Value Creation?

To create pay-for-performance structures that drive long-term value creation, compensation committees must ask themselves three questions:

1. Are we using the right metrics to assess the level of value added to the enterprise?
2. Are we using the right targets—targets that are based on creation of value instead of meeting a budget?
3. Are we measuring over the right performance period?

Metrics. The metrics for performance-based pay should be based on the CEO accountabilities specifically defined by the board in relation to the company's LOW and strategic intent—what the board has determined the executive role should be accountable for to add value to the company. As we explained in our first article of this series, "Strategic Pay,"[18] more than 50 percent of the current enterprise market value (MV) of many companies is based on an expectation of the creation of future value (FV); LOW analysis (as well as common sense) would indicate that such a company's most senior executives should be charged primarily with the strategic work of creating future innovations and their resulting value.

So, what metrics should boards be using? Depending on the LOW and resulting organization design, we estimate that most NEOs should be spending some 30 percent to 40 percent of their time on governance oversight of the current business, which aligns with profits created from the current business operations (CV), and 60 percent to 70 percent of their time focused on the future and new growth and innovation (FV). Thus, the metrics for a substantial portion of NEO performance-based compensation should be tied to future revenues, profits, and return on total invested capital (ROIC) from new products, services, markets, and business models.

Metrics related to the current business should attempt to measure true value creation from the company's operations using value-based performance measures, such as economic profit, EVA, free cash flow, and ROIC, and should avoid measures that can be easily manipulated (such as EPS) and do not reflect the level of capital efficiency in creating value. However, a recent survey of large global companies conducted by Stern Stewart indicated that most companies surveyed use short-term GAAP accounting measures (that tend to focus on current operations and the current value that the existing business is generating) as the performance metrics for bonus plans.[19]

Targets. In designing proper strategic pay-for-performance, boards should focus on both absolute and relative value creation of the company in the mid to long term. Absolute performance metrics and specific targets for ROE and ROIC are important, as they are the main link to the business strategy and operational results and how capital is deployed. However, too many companies use internal absolute performance measures to set specific targets. The problem here is that the business plan and related targets are proposed by the very managers who will be the recipients of rewards if the targets are hit! It is just human nature for management teams to set targets that are easy to hit if the board will accept them. Boards need to have a process for their own quality assurance check on industry growth rates, key competitors, and performance hurdles from which to validate the level of stretch in the targets/goals. They should focus less on meeting budgets and more on the absolute level of value that is being created.

Relative measures and targets against a properly identified peer group should help the board in this validation process. They indicate whether the company's goals for growth are aggressive enough compared to the growth in the rest of the industry sector and the economy in which the company operates. They also provide flexibility to deal with unforeseeable events. For example, even though a company may have missed its absolute numbers due to a widespread act of God or terrorist act, it may still have managed the fallout and sustained the enterprise and created return on invested (ROIC) capital better than the rest of the industry. Relative measures and targets enable a board not only to reward absolute performance but also to exercise business judgment in ultimately evaluating an executive's effectiveness and the related ability of that executive to navigate through uncertainty and create value with the capital that has been entrusted to the executive.

Performance Periods. Choosing the right period to measure performance is an integral part of choosing the right strategic metrics and targets. The innovation and strategy work that is truly the domain of most senior executive roles has performance periods over three-, five-, seven-, and twelve-year periods or even longer cycles. The achievement of an innovation accountability for new products to new business models could take some three to seven years to execute and should have a corresponding multiyear measurement period. In other words, NEO compensation should be awarded using a long-term incentive plan design that has three-year or longer performance conditions for innovation and growth outside current operations before the executive compensation is awarded.

Yet, a recent review of 2004 North American proxy statements by Paul Hodgson of The Corporate Library found that most companies still use annual performance periods for their long-term incentive plans. He found that only 15 percent of the S&P 500 made payments that were linked to performance periods of three years or more, and the average total amount of compensation that was linked to long-term performance was less than 6 percent of total direct compensation.

In designing pay-for-performance programs that truly align executive incentives and behavior with longer-term shareholder value, key pay components should have at least three to five-year business driven performance conditions that must be achieved *before* the compensation can be triggered and awarded. If the pay component is equity, there should be a further vesting period because share price and intrinsic value can be totally disconnected in the one- to five-year period. Therefore, we believe that a true long-term incentive plan time period will look something like: Grant Date + Performance period (three to five years) + Vesting Period for cash or equity (three to five years) = LTIP.

An LTIP that aligns executive pay with long term value creation should measure the growth or change in dollars from current operations value (CV = NOPAT divided by cost of capital) over three to five years, and the growth or change in future value measured in absolute dollars (MV minus CV = FV) over three to five years. Looking at growth from both perspectives over a three- to five-year period will ensure that longer-term market value (MV) is being created for shareholders.

3. How Much to Pay? (Performance Driven, Internally Equitable, Market Competitive)

Boards need a number of critical inputs to make defensible how-much-pay decisions:

The Executive Work

At what LOW (Level of Work) are the CEO and NEOs being held accountable?

The LOW sets the baseline for defensible base salary and annual bonus compensation. Without having clearly defined what is the CEO work and accountability, a board cannot defend what is equitable base salary and bonus compensation.

LOW research is integrated with research on the Internal Pay Equity multiplier. This research, which involves 13 different studies over the past 15 years, investigated the relationships among differential pay, position in the hierarchy, and the time span of discretion of the role. These studies involved more than 1,000 participants—from CEO to manager levels in the Untied States, Canada, and the United Kingdom—and identified that the "felt fair pay" and differential compensation between the real work in companies consistently differed by a multiple of two. In other words, the research identified that each work level is worth two times more in total compensation than the level directly below it, if roles are designed properly and truly perform differential work. Because the LOW analysis identifies the necessary number of layers of management, it can be combined with "felt fair" pay research to identify the appropriate compensation for the value added at each level.[20]

So, if the CEO role is primarily an operational role (CEO 1) leading a significant oil and gas company doing little exploration and primarily exploiting existing oil wells, a board might expect that that role could be paid in Total Cash Compensation some 16 to 32 times less than the CEO of BP (CEO Level 5).

The Performance of the Business

What level of business performance was achieved against the absolute targets, including ROE and ROIC, over a rolling multiyear period (which should be at least three years and ideally five years), and how much did new innovations, which are the true Organization Value Added-OVA™ of executive management, contribute to those results?

How was the business performance relative to the rest of the industry sector and broader economy using such median or average measurement standards as five-year ROE and ROIC? Relative performance will provide an indication of management effectiveness.

How was shareholder wealth performance over three to five years using such measures as the change in Market Value Added or TSR relative to the median of an industry, to a market benchmark and to a 10-year U.S. Treasury bill?

Defensible Internal and External Compensation Benchmarks

How much has management already been paid in total over the past three, five, and seven years or longer, including all equity compensation that has already vested? The board should have a complete compensation tally sheet for each of the past five years in order to monitor how much total compensation has been paid and should compare that total against intrinsic and market value generated over that time period.

How much could management earn from existing grants based on various scenarios of performance? What does a sensitivity analysis of the equity grants reveal? The board should ask for an analysis showing how much the equity compensation previously granted and currently considered for award could be worth over the next three to seven years if earnings, returns, enterprise value, and stock price change by various amounts under various scenarios.

If the board awarded the target amount of compensation to the named executive officers, what percent of profit and free cash flow would that be? The board should ask whether that percentage would seem fair and reasonable to shareholders and how the percentage has changed in the past five years. Ideally, it should also ask to see an analysis showing the percentages at any threshold levels and any above-target levels and analyze whether the percentages appropriately reward the difference in performance.

How valid and reliable is the compensation report prepared for the board? Was the peer group used in any compensation benchmarking survey or proxy data analyzed properly and compensation calibrated to reflect differences in job complexity? Is the compensation data really comparing like jobs, and thus are the pay percentiles truly defensible?

Depending on the peer group selected, we have found that compensation benchmark surveys can overstate comparable pay by as much as 60 percent to 100 percent because they do not properly match jobs based on LOW principles and calibrate reported compensation accordingly. This leads to a material misstatement of peer group pay practices.

Executive Pay Relative to Performance

Exhibit 1 is the type of pay-for-performance analysis that a board requires today to make defensible compensation decisions. This chart identifies the five-year Total Cost of Executive Management relative to (1) Absolute Return on Invested Capital (which subtracts cost of capital), (2) Relative TSR (indexed to the S&P 500), (3) a 10-year Treasury (the benchmark for the risk free rate of capital), and (4) six selected true peer companies with comparative compensation calibrated to the LOW complexity of the enterprise/NEO roles.

Did the board rely on independent pay-for-performance and compensation design experts to advise it? We distinguish between the two types of expert input for the board because most compensation consultants, who are expert in executive pay design and pay delivery, would not meet the test of being experts in pay-

Exhibit 1			
The New Model CEO Pay for Level of Work and Level of Performance Model			
Compensation Component	**Payout Formula**	**Pay out Timing**	**Example**
Base Salary	Based on the Level of Work and complexity of the role with appropriate internal and external market job matching and compensation calibration.	Paid Monthly	$700,000 annual salary for a CEO Level 3 role
Short Term Incentive Plan STIP (yearly bonus)	Bonus pool determined based on 10 percent of yearly economic profit targets. Twenty percent of annual bonus pool shared among top five named executive officers.	One-third paid out in the following year and the balance deposited into a bonus bank. One-third paid out in full in years two & three, assuming the company meets its year two and three economic profit targets; pay outs will be reduced by level of economic profit shortfall vs. target.	Year 1 $100 million Economic Profit achieved from current operations = 10 percent, or $10 million operational bonus pool for the company x 20 percent for NEOs (including the CEO) = $2 million $600,000 paid out in cash year one to NEOs and the balance in the bank for year two & three payout.
Long Term Incentive Plan (LTIP)	Based on an agreed payout matrix for achieving both three- and five-year cumulative economic profit targets from new innovations and Market Value Added (MVA) or Market Value (MV) targets indexed to the S&P 500. *See* the "Strategic Pay" article in the May/June2005 issue of the *Corporate Governance Advisor* for the payout table.	Trigger based on meeting three-year business goals for Economic Profit and MVA, quality control checked for unique value added and economic profit from new products/new services/new markets/new business models. Once triggered, the grant (restricted stock or stock options) will then vest over an additional three to five years.	Three-year goals met • $400M economic profit growth from current operations—CV • $500M for new innovations —FV • $5 billion in three year Δ in market value added—MVA = NEO pay out scenario at target levels $190 million in restricted stock to vest over three years. The distribution of the $190 million is at the joint discretion of the board and CEO.
Total Compensation (tally sheet of all compensation)	Total compensation calibrated against a pay equity multiplier of two times for each Level of Work.		The CEO pay equity multiplier should not exceed six times compensation of the Direct-Reports-Once Removed from the CEO. Four times is the "Felt Fair Pay" standard based on research.

for-performance, which requires an understanding of effective organizational design, business strategy, and performance measurement design linked to the structure and strategy.

4. How Should We Structure the Pay?

There are, of course, a variety of ways to structure and deliver a total compensation package that appropriately motivates executives to increase the long-term value of the company. In Exhibit 1 we offer one design that will reduce opportunities and incentives to maximize short-term measures at the cost of long-term value growth, balances current operations (CV) with expected future innovation (FV) that is already built into enterprise market value (MV) and appropriately shares the value created between executives and shareholders and among executives and other employees.

A board that can show that it has followed a rigorous process, documented its analysis, and met duty of care in exercising judgments about the level of equitable executive pay relative to the:

- Organization Design, Level of Work accountability of key executive roles (LOW) and the business strategy;
- Level of Intrinsic Value created (absolute and relative) over three to five years or more;
- Level of Executive Wealth already awarded or granted over the preceding five years; Total NEO Compensation as a percent of economic profits and free cash flow over three to five years;
- Level of Internal Executive Pay Equity Level of Market Competitiveness (with proper job matching and compensation calibration)

and has deliberated about the structure of the compensation package thoughtfully in order to mitigate incentives for executives to increase short-term results at the expense of long-term value, should be able to make CEO/executive pay decisions that are beyond reproach.

Notes

1. Out of 2,171 Russell 3000 companies for which we could find reliable five-year data ending in 2003, we concluded that 579 (or 27 percent) were value destroyers—companies that had both a negative economic profit and negative change in market value added (market value minus capital) over the five-year period. Of that 579, we selected 60 companies that do not appear to have a viable business model; those whose current return on invested capital relative to cost of capital had been negative for five years or longer. We then compared the amount of five-year change in the market value added (market value minus capital) and the cumulative five-year economic profit (net operating loss after tax after an imputed cost of capital). The financial data and analysis was from our own MVC performance database and was further validated with information from Matrix Investment Research and Stern Stewart. The five-year executive compensation data was provided by AON Ecomp Data Services. This compensation data was then further validated by 3XCD, a pay-for-performance consultancy and its proprietary pay-for-performance database. None of the US companies with significant accounting frauds were included in the data set for analysis.

2. The five-year compensation data was provided by AON Ecomp Data Services. The total face value of total direct compensation for the 60 companies was more than $12 billion. Discounting this amount to reflect performance-based pay that may not be earned results in an estimated $9 billion cumulative total direct compensation number for the 60 companies.

3. *See* "The New DNA of Corporate Governance" Directorship (March 2005), which identifies the strategic duty of directors; Allen Sykes, Capitalism For Tomorrow (Capstone Publishing, 2000); David Skaal, Icarus in the Boardroom (2005 Oxford University Press); Bob Monks and Allen Sykes, "Capitalism Without Owners Will Fail," Centre for Study of Financial Innovation, 2002 white paper July 25 Final Draft.

4. Warren Buffett recently said, "The market is the greatest game in the world. There is nothing else that can, at times, get this far out of line with reality." Interview, May 6, 2005, appearing in *The Fool Community, Hot Topics,* July 21, 2005.

5. Working paper of John Graham, Campbell Harvey, and Shivaram Rajgopal summarized in Patrick Bolton, Jose Scheinkman and Wei Xiong, Pay for Short-Term Performance: Executive Compensation in Speculative Markets (Princeton University, Oct. 13, 2004) ("Pay for Short Term Performance").

6. The Nortel back-to-profit incentive design for NEOs is another example of a board's approving an executive pay plan that encouraged fraudulent and short-term management behavior.

7. *See* "Fred Cook Speaks to Directors," video Web cast from June 21, 2005, at *www.compensationstandards.com*.

8. *See* Lucian Bebchuk and Jesse Fried, Pay Without Performance, pp.137-146.

9. Delves, Stock Options & The New Rules of Corporate Accountability, p.3.

10. *See* Delves, *supra*, n.9. "Yet looking back at the unraveling of Enron, there is no doubt stock options were a powerful incentive that helped to reinforce a high-risk corporate culture."

11. *See* Bebchuk and Fried, *supra*, n.8, p.143. "In 2002, only 8.5 percent of large public firms issuing options to executives conditioned even a portion of the grant on performance."

12. *See* Paul Hodgson's new book discussing this ratcheting effect, Building Value Through Compensation (CCH, 2005), pp.128-129, as well as the May-June 2004 issue of *The Corporate Counsel*.

13. Elliott Jaques, MA, MD, PhD, FRCP, Creativity and Work (International University Press, 1990), pp.191-207.

14. The compensation consultant played a minimal role in the board discussion, except to concur that the end result seemed to make sense. They had no defensible process for executive job matching and compensation calibration for the data that the board was relying on to approve executive compensation policy, make pay decisions, and provide disclosure to shareholders.

15. This earlier research includes the work of Elliott Jaques, Gillian Stamp, David Billis, Warren Kinston, Luc Hoebeke, and Stafford Beer. The research of MVC Associates includes inter-

views with more than 400 executives at the Global CEO, Group CEO, President, Vice President, and General Manager levels about executive job design and executive competencies related to driving shareholder value.

16. *See* MVC Associates, "The New DNA of Corporate Governance" Directorship (Mar. 2005) and "Are Boards and CEO's Accountable for the Right Level of Work?" *Ivey Business J.* (May 2004).

17. *See CorporateCounsel.net* interview with Mark Van Clieaf on a *bona fide* CEO selection process and "Executive Accountability and Excessive Compensation: A New Test For Director Liability" *Corporate Governance Advisor*, Nov. 2004, Vol. 12 No. 6.

18. Mark Van Clieaf, "The New DNA of Corporate Governance: Strategic Pay for Future Value" *Corporate Governance Advisor*, May/June 2005, Vol. 13, No. 3.

19. Stern Stewart & Co. "How Companies Worldwide Pay Their Executives," p.8.

20. Mark Van Clieaf, "Levels of Work and Internal Pay Equity," Executive Compensation Strategies—Toolbox (July 2005) Thompson Publishing, and "Executive Accountability and Excessive Compensation: A New Test For Director Liability," *Corporate Governance Advisor* (Nov./Dec. 2004) Vol.12, No. 6.