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New Liabilities For Compensation Committees

Your CEO's pay peers may actually be meaningless.

by Mark Van Clieaf

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New Liabilities For Compensation Committees

by Mark Van Clieaf

Board compensation committees have a vast amount of data available for CEO paysetting. Yet how truly useful is it? Does the data tell you if your pay benchmarks are really comparable? Does it honestly weigh your CEO's job compared to similar companies? Does it really link pay with performance?

Directors who ignore the changes underway with key institutional shareholders, regulators and the courts related to executive compensation may be taking unnecessary personal risks. Last year's *Disney* decision significantly changed the standard for determining director liability in determining excessive executive compensation. Although many directors are aware of this decision, what has not fully sunk in is that a finding of lack of "good faith" results in the duties of directors falling outside the protection of the "business judgment" rule. Directors lose their indemnification and D&O insurance, and are personally at risk for millions of dollars, if challenged by shareholders.

Pay-for-performance was—and continues to be—confused with pay delivery. Stock options created wealth for management, but most options are granted without setting any type of multi-year performance target. As a result, they continue to be akin to a gift and possibly corporate waste. Most boards and compensation consultants failed to understand the unintended consequences of the unbalanced incentives they have designed. They failed to link pay to the performance of the underlying *longer-term* economic fundamentals of the company.

Unfortunately an increasing number of boards have not learned from past mistakes and are now turning to time-vested restricted stock as an alternative to stock options. This amounts to another transfer of shareholder wealth to management with no connection to underlying sustained business performance. Some boards going down this route will be at risk once millions of dollars are given to management and no sustainable shareholder value has been created.

Some compensation committees have started to challenge past executive pay practices in an attempt to live up to their fiduciary duty of being truly independent, informed, and representing the shareholder. Today, the committees have to ask themselves three fundamental questions:

- ☐ What are the top officers being held accountable for, and how will performance be measured?
- ☐ What is the total amount of all compensation paid to the CEO and top executives over multiple years, and how does that relate to accountability, performance and shareholder value?
- ☐ Is benchmarking pay across companies truly comparing apples and apples?

Too many executives today are accountable only for short-term results, but are paid as if accountable for long-term value creation.

A fundamental problem in companies today is that too many CEOs and senior executives are being held accountable solely for short-term (one to two year) results. However, they are paid as if they are accountable for longer-term (two to ten year) strategic work and value creation. Yet 50 percent of U.S. listed companies have not disclosed performance measures beyond one year, and nearly 60 percent of the top companies have failed to provide a profit greater than their cost of capital over a period of five years.

This poor five year return on invested capital (ROIC) raises the question of how viable and sustainable the business model is. Is the CEO being

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held accountable for the right strategic objectives that will create long-term value? Further, is the CEO and executive team overpaid if they are only held accountable for one to two year results from current operations?

Too many boards may be at risk of failing in their *strategic duty* to shareholders and managing compensation. For example, if boards have:

☐ Set only one to two year operational metrics and accountabilities to evaluate the performance of management (which is using 10 to 20 year capital provided by pension funds).

☐ Established no process and exercised no judgment in setting long-term strategic metrics and accountabilities to evaluate management performance.

☐ Failed to demonstrate a reasonable basis for not setting longer term metrics for management.

In such situations, a member of the business judiciary suggested directors have breached their duty of care and good faith to long-term shareholders.

Many boards and compensation consultants have no grounding in effective *accountability* design. Lacking an objective framework for understanding and designing accountability, many CEOs define their own role, accountabilities, and level of decision authority. Even those few directors with some knowledge about accountability design fail to utilize their knowledge. More than one director has told us that they have not set clear three to five year accountabilities and performance metrics for their executive team for fear of seeming confrontational.

Size, revenue, market cap and headcount of a company are not the most valid factors for comparing companies and roles for compensation benchmarking. These factors only blur the issues. Nevertheless, they often are used today to compare companies because they are easy to measure and have been ingrained as the traditional way of approaching this issue.

CEOs, boards and shareholders would benefit from a framework called *"Level of Work."* Applying this framework ensures that each management level in a company has its own accountability, authority, and processes and adds unique and sustainable value for customers and shareholders.

Not all senior executives have the same level of work and accountability. Companies may be in the same industry, but not true peers.

The *Level of Work* framework uses six factors. Four of these are innovation complexity, planning horizon, complexity of assets/capital managed, and the complexity of stakeholder groups to be managed (for example, if the enterprise operates a number of different businesses in various countries).

Not all senior executive roles have the same level of work complexity and accountability. For example, the work of the CEO role at Johnson & Johnson is exponentially more complex than it is at Eli Lilly. Similarly, the CEO role at Procter & Gamble is more complex than at Kimberly Clark. In both examples, one company is a significantly more complex enterprise than the other due to a number of factors, including the variety of distinct businesses and countries in which they operate. So even though these companies are in the same industry, they are not true peers.

The benchmarking of median and 75th percentile pay has had a tyrant's hold on current compensation practices. These practices have contributed to the spiral in executive pay. Yet without proper job matching of roles and compensation calibration to adjust for differences in levels of accountability, the true 75th percentile may be overstated by 50 percent to 100 percent. In one benchmarking example of nine companies the 75th percentile for CEO cash compensation uncalibrated is $2.8 million; properly calibrated, the 75th percentile is $1.4 million, a 100 percent difference. Thus, depending on the peer group selected, some compensation reports cannot be taken at face value. Boards could be misleading shareholders at what true percentile the enterprise has set target pay.

The problem of comparing CEO roles that operate at different levels of complexity and accountability is exemplified by the NYSE board's decision to compare the CEO role and pay of Dick Grasso to those at JP Morgan Chase, Merrill Lynch, and other global financial institutions. The rationale disclosed for using these companies in the peer group was that Grasso could have gone to work for any of these firms.

Yet the NYSE board should have realized how erroneous this comparison truly was. The CEO roles at JP Morgan Chase and Merrill Lynch were *industry* innovators, at a 16*x* compensation multiplier. The CEO role at the NYSE is a *process* innovator, at a 2*x* compensation multiplier. A factor reduction of eight times is needed to create comparable compensation. There are nine research studies that validate why this adjustment for each level of work is appropriate, and Dupont as an example, has used it as a basis for determining its CEO pay. (See page 10.)

The first step in answering, "how much management should be paid" is to clarify the *Level of Work* for which the CEO and executive team are being held accountable. The board should seek expert advice in accountability design to meet the legal test of being informed.

Once a board clarifies the level of work the CEO and executive team is currently accountable for, the second step is to determine the *total cost of management.* Total cost of management is part of an analytical tool kit for board compensation committees developed by The Delves Group, a compensation consulting firm that primarily serves corporate boards. Instead of looking at executive pay only on a position-by-position basis, TCM analyses the cost of the executive team as a whole. The goal is to quantify the total compensation costs of the top executive team and then compare that cost to performance (yielding the "return on management") as well as the total cost of management for other similar companies.

A next step is to compare the total cost of management to key performance metrics. These metrics would include revenue growth, margin improvement, economic profit, return on equity, return on invested capital (ROIC) and relative total shareholder return. Measures of value creation from the business model and wealth creation for shareholders must both be included to evaluate management effectiveness. The performance measurement period in most cases should cover at least three to five years.

Companies fall into one of four value creation categories based on multi-year performance of relative total shareholder return or market value added. MVC Associates' analysis of the top U.S. 700 companies' performance over five years identified four value categories. Surveys used by most compensation consultants do not distinguish among these categories of three to five year true value creation, or the linking of pay with performance (value creation).

"Value Builders" should be paid more than those that fall within the other value categories. No peer group is appropriate for pay-for-performance benchmarking if it neglects performance as a basis for selection. In particular, high pay/low performance companies need to be careful if they use high pay/high performance companies to benchmark, as they could be accused of gaming the compensation system.

Value Builders Or Destroyers?

What Is Your Company's Real Status?

Value Category		Change in Market Value Added	Change in Economic Profit*
Value Builders	24%	*Positive*	*Positive*
Hidden Value	17%	Negative	*Positive*
Value Myths	14%	*Positive*	Negative
Value Destroyers	45%	Negative	Negative

**Economic Profit is net operating profit after tax minus cost of capital.*

Peer companies are ranked and plotted based on total cost of management relative to performance measures like economic profit, return on invested capital and relative total shareholder return. A board should know its overall industry performance benchmarks for ROE and ROIC, along with the peer group selected and its pay/performance category. Otherwise, the board could be seen as failing to be informed and breaching its fiduciary duty to shareholders in making critical multi-million dollar pay decisions.

The Delves Group also developed a significantly

A True "Level Of Work" And Accountability

What Is The Equitable CEO Pay Multiplier?

Leadership Domain	Level of Work And Innovation	CEO to CEO Comparison*	Example Pay Bands ($US Dollars)
Global Industry ☐ Current/future societies ☐ 10 to 20 year-plus balance sheet strategy, optimizing total shareholder return and cash-value-added for societies ☐ Transform industry structure/culture ☐ Create change globally ☐ Leadership of business leaders ☐ Identity and policy control	**CEO Level 5:** **Global Business/Societal Innovator** Creates enterprise sustainability, new industries (R&D), and wealth creation for global society, by managing the interdependencies between economic, social, military and political factors worldwide *(stratum 7)*	**32*x***	**$3.84m** **$2.88m**
	CEO Level 4: **Industry Innovator** Model corporate citizenship/stewardship, policy and investment strategies leveraging *business models* across multiple geo-political, socioeconomic, technological boundaries *(stratum 6)*	**16*x***	**$1.92m** **$1.44m**
Business Development ☐ Current/future stakeholders ☐ 2 to 10 year investment plans ☐ New products, new businesses and return on invested capital ☐ Anticipate change nationally and globally ☐ Indirect leadership ☐ Strategy and management control	**CEO Level 3:** **New Business Model Innovator** Transform the business model leveraging customer, competitor, regulatory, capital market, NGO's and other socio-economic factors *(stratum 5)*	**8*x***	**$960,00** **$720,000**
	CEO Level 2: **New Product/Service Innovator** Integrate and synthesize stakeholder needs resulting in development of new products, services, markets and channels *(stratum 4)*	**4*x***	**$480,000** **$360,000**
Operational ☐ Current customers ☐ 1 to 2 year profit plan/EPS/ROIC ☐ Operational and executional efficiency ☐ Respond to change locally and nationally ☐ Direct leadership ☐ Operational control	**CEO Level 1:** **Process Innovator** Optimize process, technology and people to deliver a suite of products and services to meet the needs of current customers *(stratum 3)*	**2*x*** ***x***	**$240,000** **$180,625** **$120,000**

**The multiplier identifies the value added contribution of a CEO role and requisite total compensation relative to a CEO Level 1 role.*

Source: MVC Associates International, Copyright 2004. Based on over 400 interviews at the global CEO, group president and president levels.

expanded view of what the compensation committee should be reviewing on a regular basis. Based on discussions with key institutional investors and boards, I have added a few further analyses and the combined new compensation report includes:

☐ *Level of Work/accountability analysis.* Compensation calibrated to the Level of Work. Is an accountability audit required? (See below.)

☐ *Compensation philosophy/policy analysis.* How does the compensation policy that is disclosed to shareholders align with business strategy and pay for performance?

☐ *Pay relative to performance and industry benchmarks* for ROIC, economic profit and TSR.

☐ *Wealth sensitivity analysis.* How much money will management make or lose if stock prices go up or down by how much.

☐ *Wealth position analysis.* How much money has management made over five to 10+ years including all equity that has been exercised or is still vesting.

☐ *Historical equity grants* relative to performance.

☐ *Severance/change of control review*. Triggers for change of control and link to performance.

☐ *Tally sheets* with all compensation including SERPS and other perquisites.

☐ *Internal executive pay equity multiplier calibration.* This calibration identifies the pay multiplier between the CEO, direct reports, and direct reports once removed and assesses the "fair pay" differential. Companies such as Dupont, Unilever and others have implemented this globally.

☐ *Dilution and overhang analysis* showing a table detailing unexercised options and shares available for award and their impact on earnings per share.

To properly set accountabilities and compensation which will drive long-term shareholder value, key questions must be answered.

To properly set executive accountabilities and compensation that drives longer term shareholder value, boards, compensation committees, CEOs, and investors must ask themselves:

☐ How many levels of management does the company require to meet the expected growth and return targets? What is the unique contribution of each management level to customer and shareholder value that justifies differential pay at each level?

☐ Are there too many layers of management doing the same work and wasting compensation?

☐ What level of work, accountability and metrics is the CEO role held accountable for today? (There are five possible levels.)

☐ Have an organization structure, strategic accountabilities, and three to five year metrics been designed for the CEO and executive team that will drive sustainable longer term value?

☐ What "should be" the level of work and accountability for the CEO and executive team based on the business strategy?

☐ Is the board providing the right level of cash pay for the CEO and executive team based on the current level of work and accountability?

☐ Do the metrics above need to be raised to better match the current level of total compensation for the top five to 10 officers?

☐ Does the compensation committee have the level of informed analysis required to make defensible pay-for-performance decisions? Does it know the total cost of management relative to five year revenue growth, economic profit, ROE, ROIC, etc. (not just EPS or total shareholder return)?

☐ How reliable is the external compensation benchmarking data? How defensible is the methodology for job matching and compensation calibration?

☐ Is total executive compensation equitable and fair—or excessive given the level of accountability and comparison of internal and external roles and markets for executive talent?

Boards and CEOs must recognize that expertise in accountability design and performance management is not the same as expertise in compensation. Only through informed decisions about accountability (asking what they are paying for) can boards and CEOs carry out their fiduciary duty, defend their decisions of how much to pay, and create the appropriate linkage between the level of executive accountability, performance and executive pay. ■

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Man is not the creature of circumstances.
Circumstances are the creatures of men.
— Benjamin Disraeli