Directors&Boards
www.directorsandboards.com
WINTER 2005

Boardroom Briefing

A publication of Directors & Boards magazine

CEO and Executive Compensation

The Myths of Executive Compensation

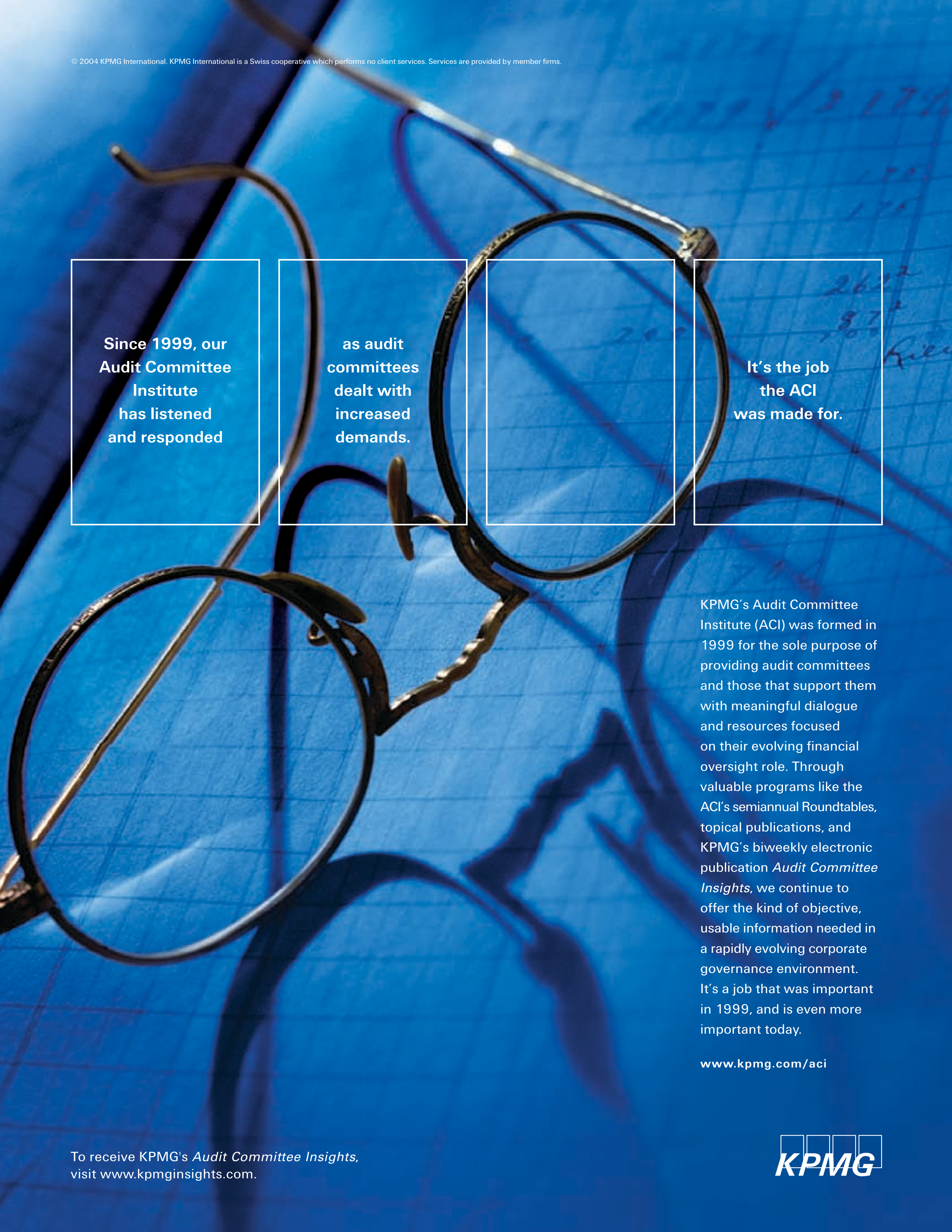
Survey: CEO Compensation

Best Practices for Compensation Committees

SPECIAL BONUS:

Critical Issues 2006
A SPONSORED SUPPLEMENT TO DIRECTORS & BOARDS' BOARDROOM BRIEFING

Doug Raymond on Advisory Committees for pre-IPO Companies


© 2004 KPMG International. KPMG International is a Swiss cooperative which performs no client services. Services are provided by member firms.
Since 1999, our Audit Committee Institute has listened and responded
as audit committees dealt with increased demands.
It's the job the ACI was made for.
KPMG's Audit Committee Institute (ACI) was formed in 1999 for the sole purpose of providing audit committees and those that support them with meaningful dialogue and resources focused on their evolving financial oversight role. Through valuable programs like the ACI's semiannual Roundtables, topical publications, and KPMG's biweekly electronic publication *Audit Committee Insights*, we continue to offer the kind of objective, usable information needed in a rapidly evolving corporate governance environment. It's a job that was important in 1999, and is even more important today.
www.kpmg.com/aci
To receive KPMG's *Audit Committee Insights*, visit www.kpmginsights.com.
KPMG

SPECIAL SUPPLEMENT

Boardroom Briefing
Vol. 2, No. 4
A publication of
Directors & Boards magazine

David Shaw
GRID Media LLC
Editor & Publisher

Scott Chase
GRID Media LLC
Advertising & Marketing Director

Directors & Boards

James Kristie
Editor & Associate Publisher

Lisa M. Cody
Chief Financial Officer

Barbara Wenger
Subscriptions/Circulation

Jerri Smith
Reprints/List Rentals

Robert H. Rock
President

Art Direction
Lise Holliker Dykes
LHDesign

Directors & Boards
1845 Walnut Street, Suite 900
Philadelphia, PA 19103
(215) 567-3200
www.directorsandboards.com

The Quest for Rationality in How to Reward Executive Performance

By James Kristie

These remarks were made a quarter of a century ago, but see if you agree with me that they could have been made yesterday.

James Kristie

Like looking for a cure to the common cold, the quest to come up with a cure for what ails Corporate America's executive compensation practices remains an elusive goal. (The chief ill, one that threatens the integrity of the whole system, is compensation perceived as egregious and seemingly unhinged from appropriate performance metrics.) The task of crafting a rational reward system keeps top management, compensation committees, and comp consultants busy devising their own stopgap solutions. But, to date, there has been no silver bullet that nails a pay-for performance standard that would be widely hailed for determining fair and reasonable executive pay.

I've monitored this quest for 25 years. An article that made a great impression on me was "Is Any CEO Worth $1 Million a Year?" Published in **Directors & Boards** in 1982, it was one of the first compensation articles I worked on in my early days with the journal. The article was a major, prescient treatment of the duties and dilemmas of the compensation committee. Nine senior executives of the day—all board chairmen and CEOs, most of whom were serving as compensation committee chairs or members—participated in this discussion that was captured for posterity.

Let's listen in to some of those comments. They illuminate the issues that were proving insoluble then and, truth to tell, remain unresolved. Remember, these remarks were made a quarter of a century ago, but see if you agree with me that they could have been made yesterday:

- "Hinging things on numerical results is easy when you are growing. But it may very well be that somebody is performing very, very well in a period of distress and managing well in a hard environment—even if earnings are lower. How do you evaluate that?"

- "Increasingly, the chief executive officer is dealing with external problems—legislation, regulation, and a variety of other things that aren't measured by the bottom line. As much as 40% of the CEO's time is spent in that kind of work. But the bottom line doesn't register that fact."

- "The CEO is involved in laying out where the company ought to be at a future point. Trying to compensate him for results today is not only unrealistic but unfair."

- "Current CEO and top management are really being evaluated by decisions made by someone else four or five years ago—in effect, they are implementing existing strategies. How should that influence their compensation?"

- "In a vast majority of companies, the endeavor to match compensation and performance will be dwarfed by the characteristics of the stock market today."

- "One of the problems we have to face is that chief executives are very conscious of what they are paid *vis-a-vis* the fellows they play golf with. It is almost a matter of relative compensation. The incentive is not so much more money as it is the feeling they are being paid reasonably well in comparison to others whom they regard as having similar responsibilities in the same size company."

- "It's bad enough that publications like *Business Week* or *Forbes* list salaries, but what about your local newspaper? That's worse. In my city they call it the 'Fortunate 50.' And last year I wasn't on it. How do I explain that to my wife?"

How to explain, indeed. Well, explanations that add to the continuing discovery of what's fair and rational are forthcoming in this Boardroom Briefing. This is the fifth in **D&B's** series of single-focused reports on matters of utmost concern to enlightened board decision making. We trust the advisories in the following pages will further advance board members' skillful evaluation and rewarding of executive performance.

James Kristie is editor and associate publisher of Directors & Boards. He can be contacted at jkristie@directorsandboards.com.

The Myths of Executive Compensation

By Edgar S. Woolard, Jr.

We can do something about excessive compensation.


Edgar S. Woolard, Jr.

There's a major concern out there for all of us: the perception of excess compensation received by CEOs. And it's getting worse year by year. I'd like to deal with this concern by describing several myths about compensation.

CEO pay is driven today primarily by outside consultant surveys.

Myth #1: CEO Pay by Competition

The first myth is that CEO pay is driven by competition. To that I say "bull." CEO pay is driven today primarily by outside consultant surveys and the fact that many board members have bought into the concept that their CEO has to be at least in the top half, and maybe in the top quartile, of pay scales.

So we have the "ratchet, ratchet, ratchet" concept. We all understand it well enough to know that if everybody is trying to be in the top half, everybody is going to get a hefty increase every year.

In 1990, we addressed this issue at DuPont by using "internal pay equity". It's a simple concept. I went to the board and the compensation committee and said, "We're going to look at the people who run the businesses, who make decisions on prices and new products with guidance from the CEO—the executive vice presidents—and we're going to set the limit of what a CEO in this company can be paid at 1.5 times the pay rate for the executive vice president."

That to me seemed equitable. And this is the way we have done it at DuPont ever since then.

Give serious consideration to having your HR people and the compensation people look at what's happened to internal pay equity and seriously consider going in that direction. That will solve this problem in a great way.

Myth #2: Compensation Committees are Independent

The second myth is that compensation committees are independent. Well, I give a "double bull" to that one.

Let me describe it this way—the compensation committee talks to an outside consultant who has surveys that you could drive a truck through and pay anything you want to pay. The outside consultant talks to the HR vice president, who talks to the CEO. The CEO says what he'd like to receive. It gets to the HR person, who tells the outside consultant—and it pretty well works out that the CEO gets what he's implied he thinks he deserves so he will be "respected by his peers." Now the compensation committee is happy that they're independent, the HR person is happy, the CEO is happy and the consultant gets invited back next year.

There are two ways to change this.

When John Reed came back to New York Stock Exchange to try to clean up that mess, he made the decision, which I admire him for, that the board was going to have its own outside consultant who was not going to be allowed to talk to internal people—not to the HR vice president, not to the CEO.

I'm the head of the compensation committee at the NYSE and when we talk with our outside consultant, they give us their ideas of what they think the pay package ought to be and we make a decision. Our compensation committee is independent and it works extremely well. You can do that.

You can also truly insist on pay–for–performance, which everyone likes to talk about but no one does. They pay everybody in the top quartile if they have good performance or bad performance or if they're going to be fired.
I was on a board 15 years ago with four CEOs on the compensation committee and for

two consecutive years, we gave the CEO and the executives at the company no bonus, no salary increase and modest stock options, because their performance was lousy those two years. After that, they did extremely well and we paid them extremely well.

Myth #3: Look How Much Wealth I Created

This myth is really a joke and it was born in the 1980s and 1990s during the stock market bubble, when all CEOs were beating their chest about how much wealth they'd created for shareholders.

And I'd look to the king, Jack Welch. Jack's the best CEO of the last 50 years and I've told him this. He says, "I created $400 billion worth of wealth." I don't care how much money Jack Welch made, that's wonderful. God bless him. I think he's terrific.

But what did the wealth creation myth do? It set a new level for CEO pay based on the stock market.

Myth #4: Severance for Failing

The last myth is the worst of all. Why are we giving these huge severance pay packages to CEOs who fail—Phil Purcell, according to the press, got $114 million, Carly Fiorina at Hewlett Packard got $20 million? No one else gets paid excessively when they fail. They get fired, they get fair severance.

We Can Do Something About It

We can do something about excessive compensation:

Some CEOs show leadership and say they're going to use internal pay equity. It's easy to get the data and then you can decide what you think is fair and how much you think the CEO contributes versus the other business leaders who make their companies so strong.

Compensation committees should seriously consider implementing internal pay equity. Pay only for outstanding performance. Quit

There's nothing in the Bible that says that you have to give increased stock options again every year.

giving people money just because Joe and Sally are getting it.

Consider going to an independent consultant who deals only with the board. Keep the consultants away from the CEO and the HR people, because they all benefit too much by being able to "cook the cake" together.

Lastly, take a look at stock option packages. If you've given huge stock option packages for the last five years, look at the value of those. There's nothing in the Bible that says that you have to give increased stock options again every year. Give a smaller grant. Give a different kind of grant. Put on some kind of limits. There are many ways to do it.

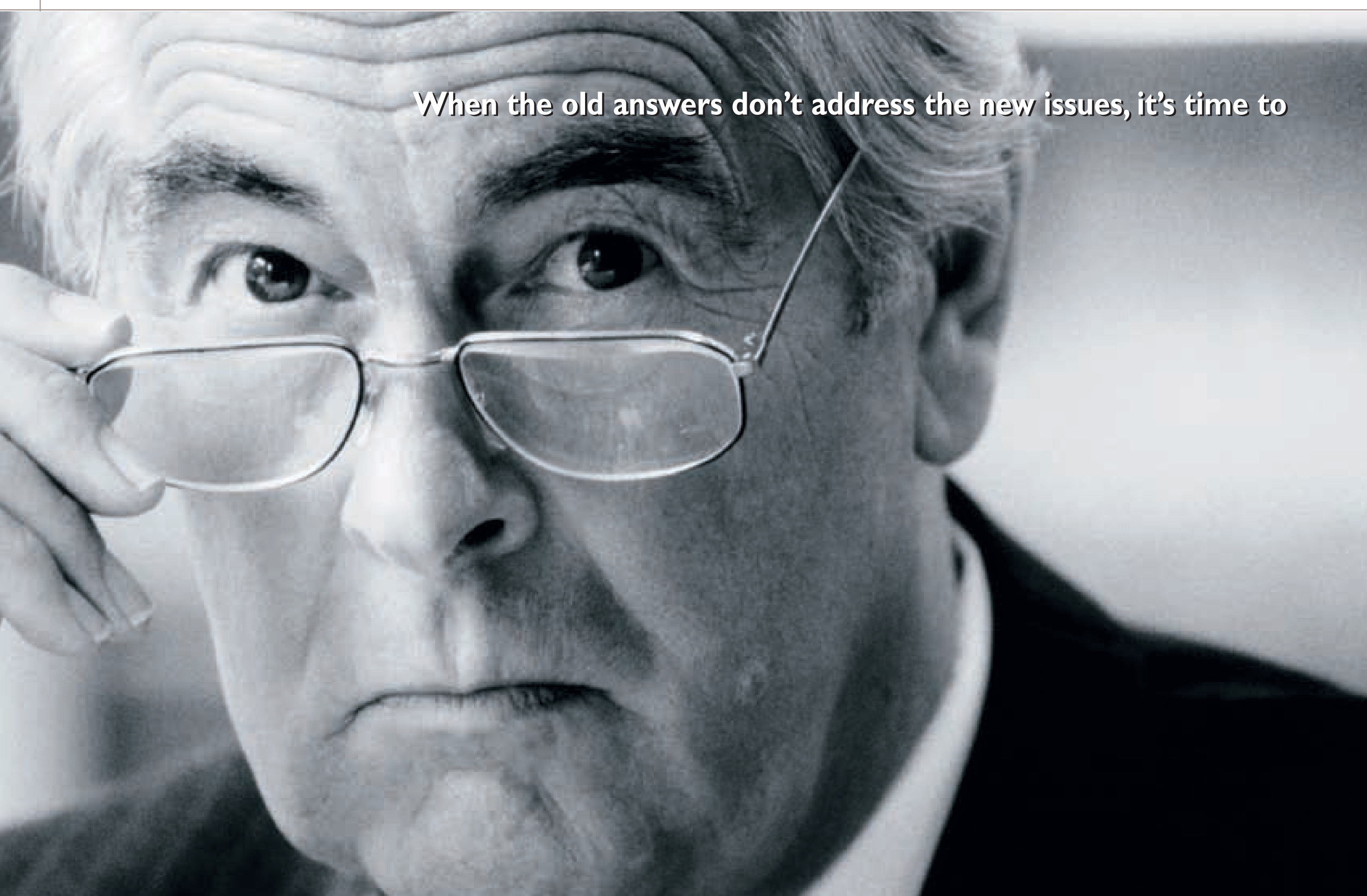
This piece is adapted from an address delivered to CompensationStandards.com's 2nd annual Executive Compensation Conference. A video of these remarks is available at www.compensationstandards.com.

Edgar S. Woolard, Jr. retired as chairman of the board of directors of DuPont on October 29, 1997. He remained a director until his retirement from the board on January 1, 2000.

Woolard joined DuPont in 1957, was elected president and chief operating officer in 1987, and became chairman and chief executive officer in 1989. He relinquished the chief executive position on December 1, 1995, and retired from the company at the end of that month.

Woolard received a Bachelor of Science degree in industrial engineering from North Carolina State University. He was a lieutenant in the Armed Forces.

He is a member of the board of the New York Stock Exchange and Telex Communications, Inc. He is a former director of Citigroup Inc., IBM, Apple Computer, Inc. and Bell Atlantic Delaware. He is also a former Chairman of the Business Council. He is also a member of the board of trustees of the Christiana Care Health System and the North Carolina Textile Foundation., Inc., and a member of the National Academy of Engineering, the American Philosophical Society, and the Bretton Woods Committee.



Directors' Views

How Seriously Do You Regard the Public's Perception of Excessive CEO Compensation?

"Is it a very serious issue to affected stakeholders? Absolutely. However, the majority of the public either doesn't care or are too lazy to take corrective action. Most Americans are too far removed from the CEO's office and the Boardroom to get informed, motivated, and engaged to correct the very real problem of executives' excessive compensation."

"What the public's perception is or is not really has little bearing on the issue. In point of fact the public has almost no ability to do anything about the subject. Now if you begin to define the public as powerful institutional investors, or the likes of Warren Buffet, that could be a different matter. Even then I am skeptical…just like the hurricane season, it may be bad for a while but it always seems to blow over."

"Directors tend to think their executive deserves his/her compensation. Directors who are also CEOs themselves are even more inclined to think this way. The supply of executives who are sufficiently competent and capable to be CEOs warrants lower compensation. CEO compensation needs to be tied closer to the long range performance of the company."

"Excessive compensation is seen as unfair and likely unethical while extreme excesses are seen as unethical and abusive by the typical shareholder and/or observer. With our society's sense of fair play, extreme abuses should and generally do get corrected. Is corporate America ready for the US Congress to help with this problem? On another level, extreme pay practices distract the recipient who must now manage this great wealth as well as the corporation he has pledged to manage. Why dilute his attention and energies from the corporation's needs?"

"The public often has little understanding of the challenges faced by and the value that can be created by the CEO. If I were to say that an excellent CEO should get 0.5% of the wealth that he creates for the shareholders, a lot of people might say "that seems fair" (and, believe me, a CEO really can make a significant difference in the success of an organization. We only need to look at Warren Buffet or Jack Welch to see that). However, if it is presented as "the CEO just earned a million dollars," many people would complain bitterly, primarily out of lack of knowledge, but also out of jealousy."

(From a **Directors and Boards**' *e-Briefing survey conducted in October 2005.)*

Linking CEO Strategic Accountability with Pay for Performance

By Mark Van Clieaf and Robert Ferchat

The status quo is not working for shareholders.

Mark Van Clieaf

Robert Ferchat

Too many executives are not poorly paid, just badly paid.

Our analysis shows that only 39% of the Russell 3000 companies had both an increase in shareholder wealth (market value minus all capital employed) and a year- over-year increase in enterprise intrinsic value (net operating profit after tax minus cost of capital) over the last five years. The executives in these companies created great value for shareholders and deserve fair and equitable compensation for the sustained value they created.

However, more than half of the Russell 3000 companies did not earn their cost-of-capital and their value creation trends were poor, as their strategic plans were becoming obsolete, or worse. How did the executives at those companies fare? 60 U.S.-listed companies from the Russell 3000 paid $12 billion in total direct compensation to their named executive officers over five years; these companies lost $695 billion in market value and $486 billion in economic profit.

Excessive pay is the unintended consequence of poorly designed executive compensation programs that rely overly on stock options and are not linked to longer-term enterprise performance, versus two to five year stock market performance.

Who's Accountable?

Too many directors are simply not doing their job. McKinsey's 2005 study of board practices identified that 55% of directors reported that they had no meaningful process and metrics by which to evaluate the performance of the CEO role. The Corporate Library 2004 proxy statement review identified that 85% of companies have failed to set multi-year performance targets to set healthy incentives and compensate executive officers to create the expected future value and innovation already built into enterprise valuation.

Unfortunately, directors have relied on compensation consultants to tell them what level of compensation is fair and competitive. Part of the compensation problem is that the much of compensation data that boards have relied on has been driven by faulty compensation surveys that do not compare apples to apples. Not all CEO roles are created equal. Too few directors have challenged the quality of the compensation data they are getting, and the result for most companies is that compensation is not linked to either executive accountability or performance.

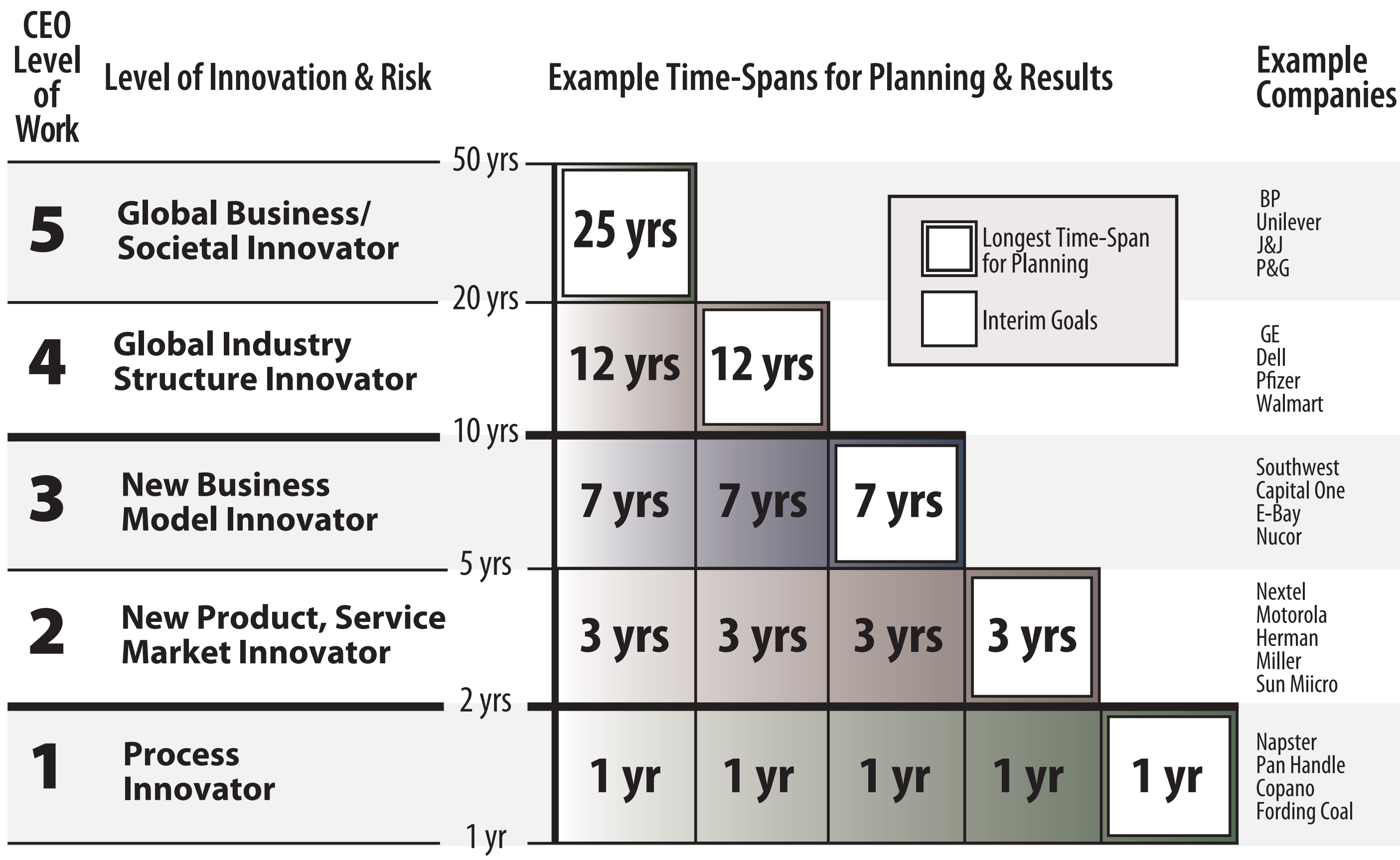
The question that has eluded too many directors and their compensation consultants is "What is it named executive officers are being paid for?" Does the CEO's pay vary with long-term strategic results? Or have the goals been set at short term "hit the budget" objectives and or stock price targets?

It appears that too many executive pay decisions have been undertaken with no link to strategic challenges, the economic viability of the business model, or the organization design required to sustain and grow enterprise value. Too many pay practices fail to differentiate between strategic versus operational work and measurement, and strategic versus operational pay.

Recent interviews with a number of leading executive compensation consultants confirm they typically

Too many pay practices fail to differentiate between strategic versus operational work and measurement, and strategic versus operational pay.

FIGURE 1



Based on 400 + MVC Interviews at the Global CEO, Group President, President, and VP/General Manager Levels

do not even see the client company's multi-year business plan, strategy and goals, much less use them as key inputs into the design of executive pay. These consultants are in the business of executive compensation and pay delivery design, not pay-for-performance. Directors need new processes, tools and input from both types of experts to make defensible executive pay decisions.

Level of CEO Work Analysis

The litany of corporations in serious danger includes household names such as General Motors, Nortel, Lucent, Pfizer, Kodak and Mattel. These companies have not returned a profit greater than their cost of capital in five years or more. Poor intrinsic value performance and lack of apparent economic viability signals a fundamental business strategy and business model problem facing these companies.

The long term matters, as does the big picture. A few years ago Motorola was so focused on innovating with new analog cell phones they missed the need to change the business model to focus on new digital technologies. Microsoft also almost missed the need to innovate at the business model level with the advent of the Internet and its impact on their core business.

Are companies just striving for corporate compliance and measuring against operating plans over one to two years? Or do they have a 10 to 20 year strategic horizon that includes stewardship of the businesses and their corporate responsibilities to the broader societies that ultimately provide—or refuse to provide—their license to operate?

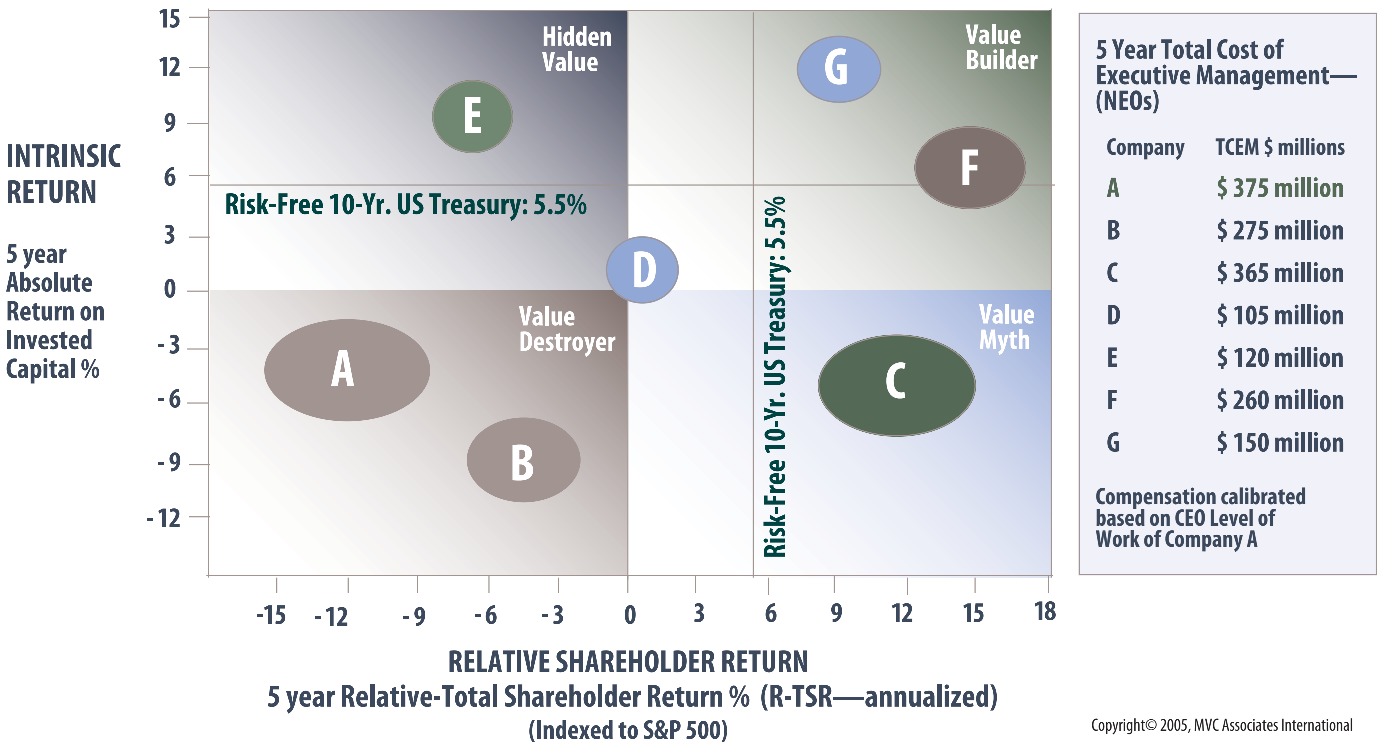
Strategic goals are not budgets or financial plans but rather describe a compelling rationale for economic viability and reasons for growth in the markets. Strategies must describe the customer needs that will be filled if the strategy is executed effectively and how this corporate strategy is unique compared to competitive offerings.

The strategic challenge and therefore the level of CEO work, innovation and accountability can be defined at one of five levels. Defining the work and incentive system for named executive officers at too low a level of strategy and innovation is one reason for the

FIGURE 2

Pay-for-Performance Analysis
Select Peer Group

Intrinsic & Shareholder Value Returns Compared with Executive Pay



continued poor performance of too many companies.

In determining what a 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 level of work and the level of capability required, and, as we show later, the level of equitable executive pay.

Figure 1 shows a chart from our article in the Boardroom Briefing: CEO Succession Planning (Spring 2005), which outlines five levels of CEO work defined by using six factors based on principles of complexity and how each level relates to innovation and value creation, *not* the size of the company. The higher the level of work required by the enterprise to create value and sustain itself, the higher the level of risk to shareholders' capital—and usually the longer the time horizon to make new investments and create a positive return on invested capital.

A CEO accountable for Level 3 work (a new business model over 5 + years) should be paid two to eight times more than a CEO accountable for Level 1 work (process innovation focused mostly on maintaining the existing business). This compensation differential is based on over 10 research studies on differential work and "felt fair" pay.

Using such tools as the CEO Level of Work and Level of Equitable Executive Pay enables directors to fulfill their strategic duty to shareholders by matching the strategic challenge facing the enterprise with the level of CEO accountability, appropriate organization design and defensible executive compensation.

Pay-for-Performance Analysis

To make defensible pay decisions in today's new era of corporate governance and more active shareholders, boards require new tools such as:

a) Three to five year pay-for-performance look back analysis; and

b) Three to five year forecasted pay-for-performance payout tables linked to business strategy, key metrics and targets.

> These companies are "value myths" which demonstrate that an increase in stock price is not a good performance measure of management's effectiveness in creating an economically viable business model.

As an example, Figure 2 (see page 13) shows a five year pay-for-performance look back analysis and identifies the five year total cost of named executive officers relative to (i) absolute return on invested capital (which subtracts cost of capital), (ii) relative total shareholder return (indexed to an appropriate index), (iii) a 10-year Treasury (the benchmark for the risk free rate of capital), and (iv) six selected true peer companies with comparative compensation calibrated to the level of work complexity of the enterprise/ named executive officer roles.

Directors need performance periods and metrics that help them assess the viability of the business strategy, whether it will enable the company to create value with the capital provided from shareholders, and if so, how much.

Performance Periods

To make defensible pay decisions boards need to look beyond the past one to two years of operational performance, unless the business is up for sale. Three to five year performance periods should be the minimum standard for pay-for-performance planning and analysis.

Metrics

Measures like EPS, EBITDA and ROE can be too-easily manipulated through both earnings engineering and stock repurchase programs and they fail to take into account the level of risk to capital, the capital intensity and returns of an industry, and the future free cash flow potential of the business.

A simple total shareholder return (TSR) is also deficient, in that it ignores the fact that some 70% of changes in stock price result from macro-economic factors (such as interest rates, currency exchange rates, GDP growth, commodity prices). A simple TSR and stock price metric and the use of vanilla stock options or restricted stock with no business performance conditions allow executives a free ride when the total equity market or sector goes up.

Indeed, 29% of the Russell 3000 over five years had an increase in their stock price and enterprise value, but over the same time period had not returned a profit greater than their cost of capital. These companies are "value myths" which demonstrate that an increase in stock price is *not* a good performance measure of management's effectiveness in creating an economically viable business model. Instead, metrics like return on total invested capital—not just equity capital—are required to evaluate the effectiveness of executive management in deploying capital to create economic value.

If the directors of the 60 High Pay/ Low Performance companies cited earlier ($12 billion in executive compensation and negative economic profit of $485 billion) had these new decision tools could they have made the executive pay decisions they did?

Directors can leave no better legacy than ensuring the viability and sustainability of the enterprise over which they have strategic oversight. To accomplish this, directors require new processes and new tools to help them clearly define the executive work accountability and performance metrics of the named executive officers that will ensure alignment with the strategic plan for the business. To make pay-for-performance a reality, directors need to be fully informed and test—both backward and forward—to ensure the executive pay policy and programs they approve lead to the creation of real and sustainable value for shareholders.

Mark Van Clieaf is managing director of MVC Associates International. His background includes an early career in the marketing and advertising industries, followed by a numbers of years in the business strategy and executive search consulting practices at Price Waterhouse. He is a guest lecturer on corporate governance at the Ivey School of Business; was a member of the NACD Blue Ribbon Commission on CEO Succession Planning; a founding member of the Executive Selection Research Advisory Board, Centre for Creative Leadership; and past president of the Strategic Leadership Forum. His research has resulted in over 100 articles on CEO accountability, succession planning and pay-for-performance. He can be reached at Mark@MVCInternational.com.

Robert Ferchat is the presiding director for Brookfield Homes and former chairman of Airgate PCS , GTS Telecommunications, BCE Mobile and Atomic Energy of Canada. His current and past directorships include such companies as Digital Equipment, Rockwell, Chemical Bank, Coscan Home Builders and Automation Tooling Systems. Ferchat also served as CEO/president of BCE Mobile and Northern Telecom. He is the author of two books: *One+One=Three* and *Tangled Up In The Past.*

CEO Pay is Finally Changing

By Josh Lurie and Peter Lupo

But compensation remains very much in transition.

> When looking at total cash compensation levels, the research shows a healthy rise in pay ranging from a 9% increase for small companies to a 21% increase for large companies.

Josh Lurie

Peter Lupo

Why do CEO pay levels continue to make headlines? Because the disconnect between executive compensation levels continues to reflect dynamics outside of balanced consideration of how pay rates should be structured. An examination of CEO pay practices from 2002 to 2004 as disclosed in 2005 proxies, shows that compensation levels are not just rising, more importantly the components of CEO pay are finally changing. But CEO compensation is not changing uniformly across all market segments. Big differences in CEO pay practices remain when looking across different market segments.

Understanding Market Segments

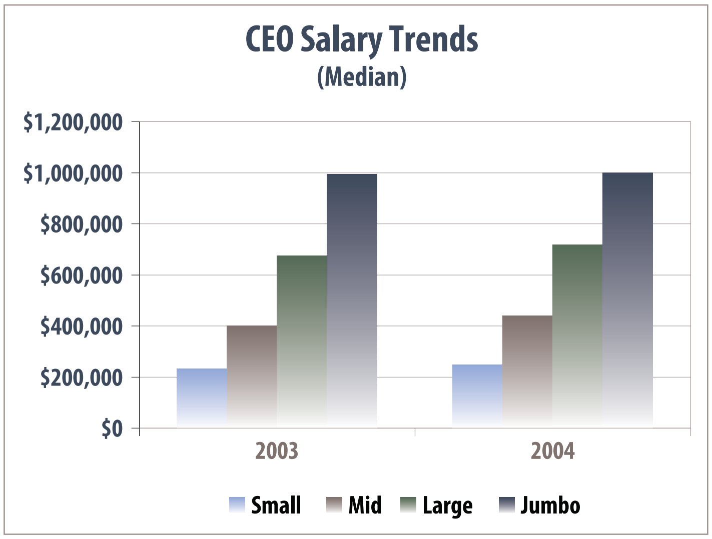
As a general observation, the pay practices of large companies do not serve as a proxy for all size companies. We examined the CEO pay practices of approximately 3,900 public companies representing the small, mid, large and jumbo market segments as noted in the chart.

	Company Size			
	Small	Mid	Large	Jumbo
Revenue Range	$1m- $99m	$100m- $999m	$1b-$4.9b	$5b+
Median Revenues	$30m	$329m	$1.92b	$10.95b
# of Companies	1,369	1,509	678	317

Salaries On The Move, Again

During the past few years, overall salary budgets generally were running from 3% to 4% of revenues per year. Further, currently published studies are again showing average budgets running around 3.5%. Given this, you might conclude that the most recent salary increases for CEOs would mirror these near-term historical trends. If you did, you would be wrong. With the exception of salary increases for CEOs of jumbo companies, increases ranged from 6% to 10%.

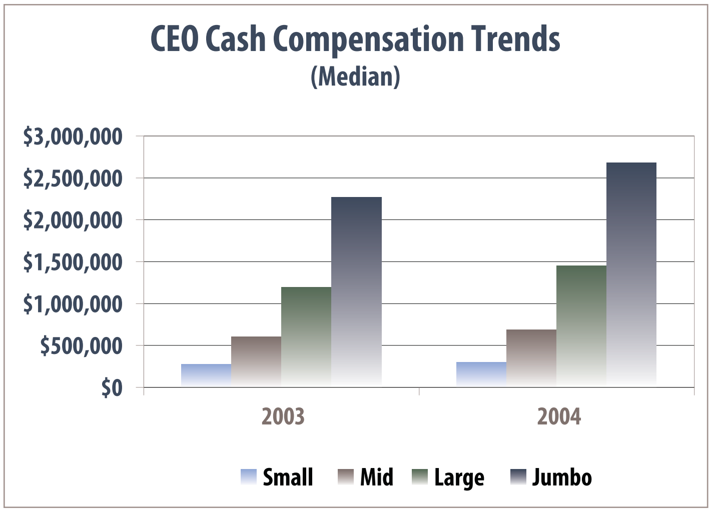
Although salaries only increased by 1% for jumbo companies, we believe this has more to do with the IRC Section 162 (m) $1million non-deductible compensation limit than any real attempt to limit the growth of fixed compensation.



What about Bonuses and Total Cash Compensation?

Not surprisingly with an improving economy, bonuses were up sharply, ranging from an increase of 10% for small companies to a high of 36% for large companies. With the exception of the small company segment, bonus increases were fairly uniform, ranging from 30% to 36%.

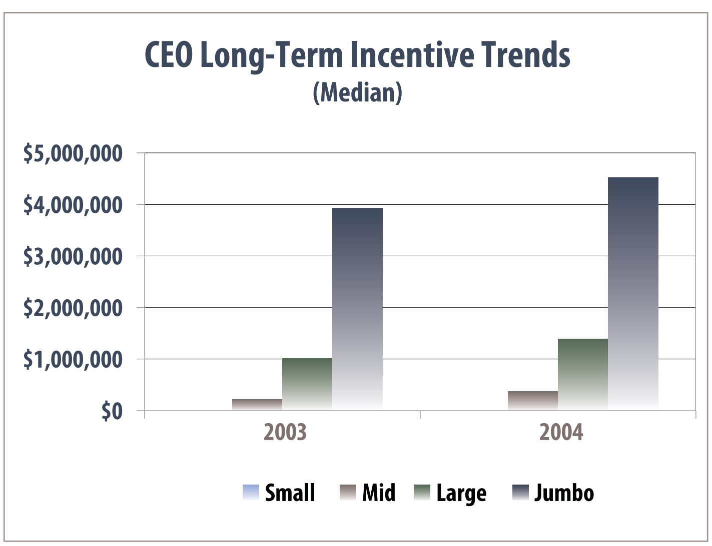
When looking at total cash compensation (salary plus bonus) levels, the research shows a healthy rise in pay ranging from a 9% increase for small companies to a 21% increase for large companies.



The Big Change—Long-term Incentives

Many current studies are reporting healthy increases in long-term incentive compensation levels. We found that although long-term incentive compensation levels are increasing, the level of increase among the different market segments varies dramatically. Small companies showed no increase in long-term incentive compensation levels while mid-sized companies showed a whopping 66% increase. Although both of these results are completely unexpected, the analysis of pay across different market segments shows, once again, that CEO pay practices are not at all uniform across the market segments.

But the big news is not an increase in long-term incentive compensation levels but rather the decrease in



The big news is not an increase in long-term incentive compensation levels but rather the decrease in the use of stock options.

the use of stock options. The chart that follows shows the average stock option grant values expressed as a percentage of the total long-term incentive grant value. This chart compares the 2004 long-term incentive compensation value to the 2002 value.

Large and jumbo companies are leading the charge by changing their equity mix practices. For large companies, stock options represented about 75% of the 2002 total long-term incentive value but only 59% of the 2004 value. This is in stark contrast to small companies where stock options represented 93% of the 2002 value versus 88% for 2004.

Market Segment	2002 Stock Option Grant (value as % of entire grant)	2004 Stock Option Grant (value as % of entire grant)
Small	93%	88%
Mid	84%	72%
Large	75%	59%
Jumbo	76%	63%

Share Usage is Declining, But is Value Declining?

Companies are beginning to pay attention to shareholder concerns about shareholder dilution. The amount of shares used to deliver long-term incentive compensation has been declining over the past several years. Shown below is a comparison of the average number of shares used in the 2002 grant compared to the 2004 grant. In the most extreme example, small companies used, on average, about half as many shares in 2004 as they did in 2002. But regardless of the market segment analyzed, the average number of shares used under long-term incentive compensation plans has dramatically decreased. This is an interesting result given that the value of long-term incentive grants continues to increase.

Market Segment	Number of Shares underlying the 2002 Grant	Number of Shares underlying the 2004 Grant
Small	125,300	62,930
Mid	144,644	86,524
Large	433,490	301,409
Jumbo	236,567	156,545

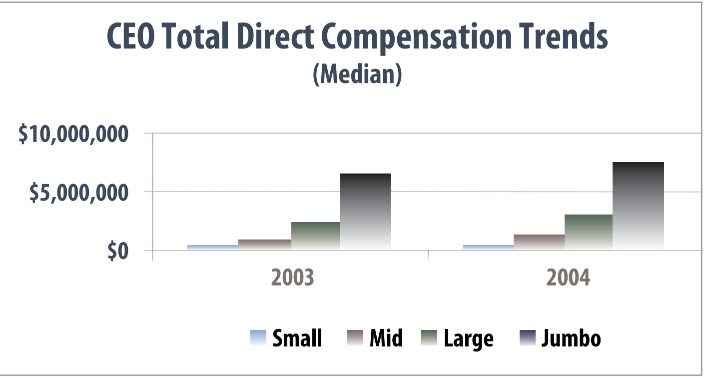
The Total Pay Picture

When adding up all the pieces, two interesting outcomes appear when comparing CEO pay practices among the market segments:

- First, there are big differences in the number of stock option grants to CEOs. Small companies are still relying heavily on stock options while large companies have expanded their use of whole shares.

- Second, the level of CEO pay increases among the market segments is disparate. Small company CEOs saw a 12% increase in total direct compensation while large company CEOs enjoyed 29% increase.

But the one consistent trend is that total CEO pay is increasing, regardless of the market segment, at a clip that far outpaces all other employees.



Where Do We Go From Here?

To recap, salaries, bonuses and long-term incentives have generally increased across-the-board for all market segments. Companies clearly are decreasing their reliance on stock options yet long-term incentive values are increasing.

Executive compensation is still very much in transition. Shareholders may be delighted that companies are using fewer shares in their long-term incentive compensation programs. But is this trend desirable? Will companies continue to use fewer shares and grant more valuable long-term incentives in the future? Our experience tells us that no conclusion is yet on the horizon.

Companies will introduce more performance-based equity vehicles (such as performance shares) and find the appropriate balance between share usage and long-term incentive value delivery. No doubt, stock option expensing in 2006 will help companies find this balance sooner than later.

About Our Study

This study examined salaries, bonuses and long-term incentives. We specifically excluded the impact of indirect pay (mainly deferred compensation). Although the prevalence of indirect pay is an important aspect of total pay, the analysis of that trend is best left to a separate study.

Options were valued using the Black-Scholes methodology and restricted stock was valued based on the stock price at date of grant with no discount for illiquidity. Also included was the value of awards paid out under any cash long-term incentive plans instead of using the present value of the target payout of the current grant.

A few notes:
- Only proxies filed in 2005 were included in the study.

- We excluded those companies from this study that had a change in the CEO position during the three-year period.

Unless otherwise noted, data represents market median levels.

Peter Lupo has more than 20 years of consulting experience and is currently the national compensation practice leader for Aon's Compensation Consulting Practice. He currently provides executive compensation consulting services to organizations in a wide range of industries and specializes in the design and development of executive compensation programs.

Joshua Lurie has more then 15 years of consulting experience and is currently a vice president in Aon's Compensation Consulting Practice. He also manages the eComp Data Services Group which maintains the most comprehensive executive compensation database on the market—eComp. He currently advises companies on executive and director compensation studies covering the executive class of employees as well as conducting dilution analyses.

The Directors & Boards Survey: CEO Compensation

Methodology

This **Directors & Boards** survey was conducted in October 2005 via the web, with an email invitation to participate. The invitation was emailed to the recipients of **Directors & Boards**' monthly e-Briefing. A total of 354 usable surveys were completed.

About the respondents

(Multiple responses allowed)

A director of a publicly held company	35.1%
A senior level executive (CEO, CFO, CxO) of a publicly held company	11.5%
A director of a privately held company	39.1%
A senior level executive (CEO, CFO, CxO) of a privately held company	31%
A director of a non-profit entity	39.1%
Institutional shareholder	6.3%
Other shareholder	23.6%
Academic	10.3%
Auditor, consultant, board advisor	13.8%
Attorney	9.8%
An investor relations professional/officer	3.4%
Other	8%

Revenues

(For the primary company of the respondent)

Average Revenues	$2.134 billion
Less than $250 million	52%
$251 million-$500 million	9.7%
$501 million to $999 million	12%
$1 billion to $10 billion	20%
More than $10 billion	6.3%

Board Service

(Average number of boards respondents serve)

Public Company	1.26
Private Company	1.45
Charitable	1.66
Total	**4.37**

CEO Compensation

At your primary company, what was the total CEO compensation, including salary, bonuses, long term compensation, benefits and perquisites, for the most recent year? ($US)

Less than $250,000	33.6%
$251,000 to $500,000	20.6%
$501,000 to $999,000	9.9%
$1 million to $2.5 million	20.6%
$2.6 million to $5 million	7.6%
$5.1 million to $7.5 million	3.8%
$7.6 million to $10 million	0%
More than $10 million	2.3%
Other	1.5%
Average Total Compensation	$1.327 million

69.45 %

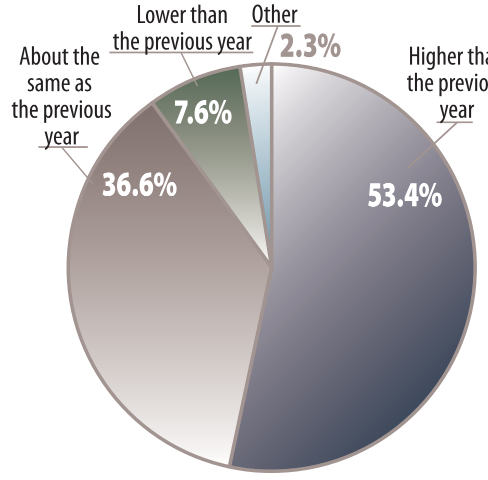
Percentage of your CEO's pay package is cash compensation (salary and bonus), as opposed to long term incentives and perquisites at your primary company

38.5:1

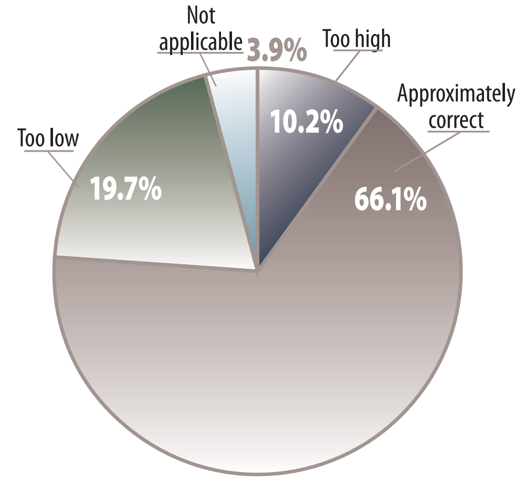
Approximate ratio of CEO pay to average worker pay at your company, including benefits and perquisites

Was this total compensation:

(Other responses indicated a new CEO in place, or not applicable.)



As a board member, do you feel that CEO compensation for your primary company is generally:

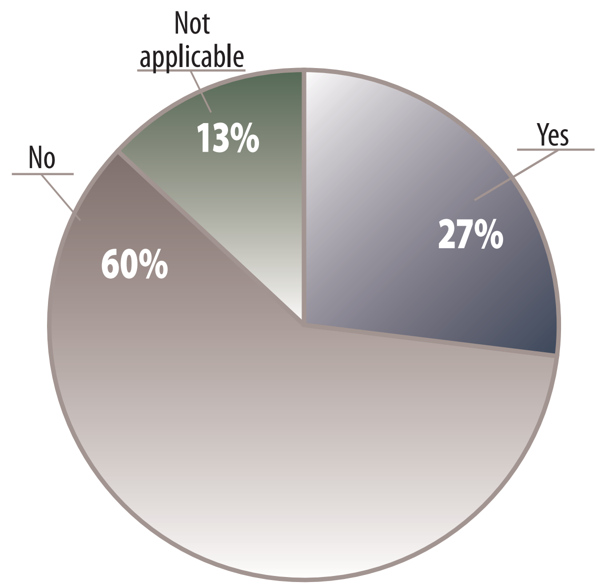


CEO Compensation Practices

Please offer your opinions on the following statements, using your primary company.

	Agree Strongly	Agree	Neither Agree Nor Disagree	Disagree	Strongly Disagree
CEO compensation levels accurately reflect superior performance against stated goals and objectives	23%	43%	10%	20%	3%
My company has a comprehensive and easily understood method for computing CEO and executive compensation	20%	39%	18%	15%	8%
The compensation of our top executives is in line with and consistent with our company's revenue and profit performance and expectations	25%	47%	16%	9%	3%
CEO and executive compensation is tied directly to sustaining and increasing shareholder value	22%	35%	18%	15%	9%
The compensation of our CEO and top executives is in line with comparable industry and company standards	21%	48%	11%	13%	8%
All employees at our company can determine through available company documents and regulatory flings the compensation program of our top executives	30%	24%	9%	23%	14%

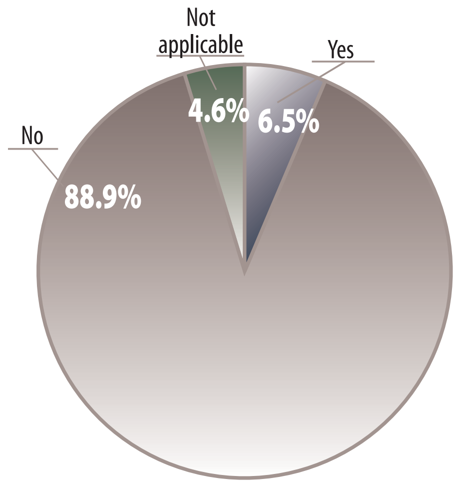
Does your company expense options?



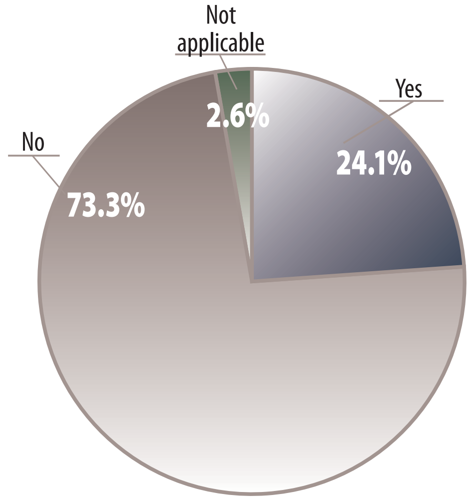
If yes, has this practice changed the use of options in executive compensation programs?

Yes, we use options more	0%
Yes, we use options less	43.5%
No	47.8%
Not applicable	8.7%

Has your company ever repriced "underwater" options?

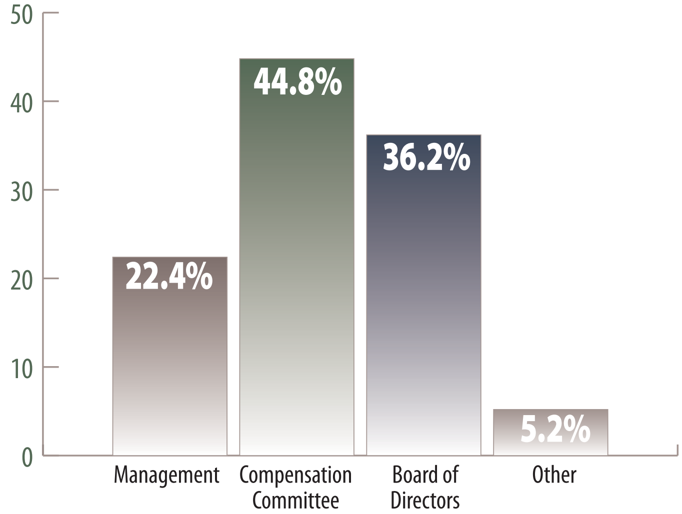


Have you reduced or withheld a bonus for your CEO or senior executives within the past 12 months?



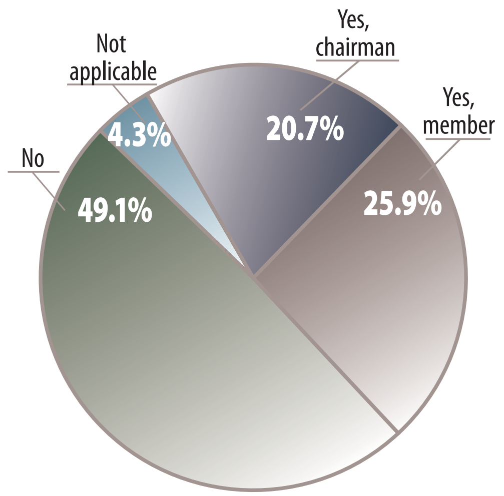
Compensation Committees

In your opinion, who really controls the compensation process in your primary company?

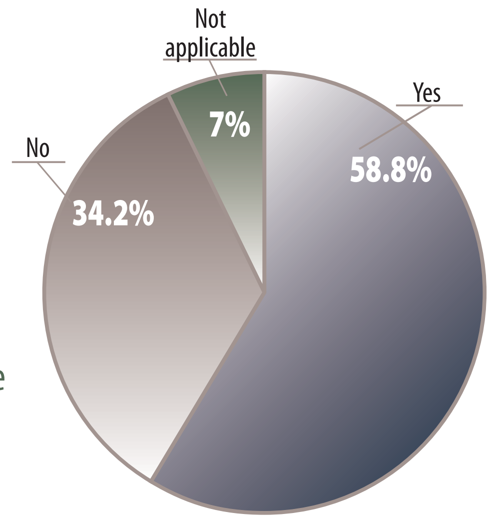


(Other responses include board chairman, CEO, management and compensation committee together, major shareholders.)

Are you a member of a compensation committee?



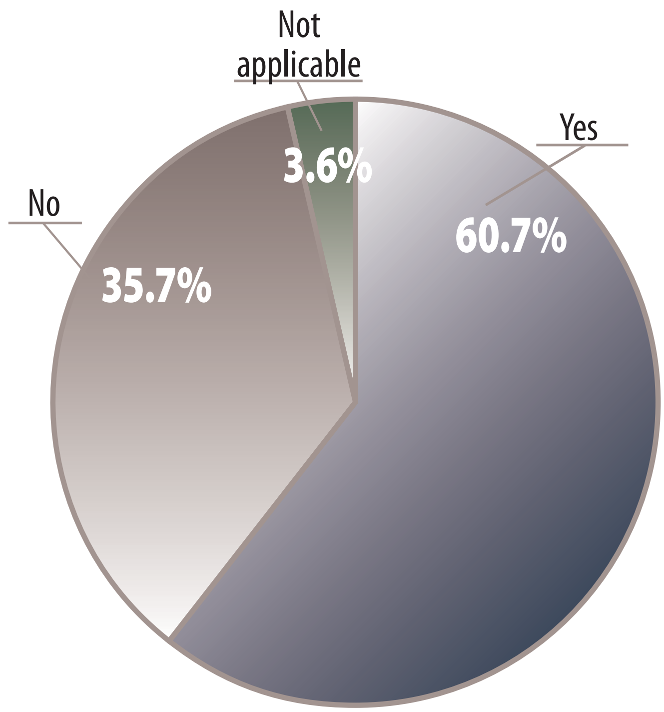
Is your compensation committee composed entirely of independent, non-employee directors?



In your opinion, do the members of your company's compensation committee have the skill and knowledge to perform their duties?

Yes	43%
Yes, but could use some additional training and education	31.6%
Yes, but could use significant additional training and education	8.8%
No	11.4%
Not applicable	5.3%

Does your compensation committee use outside consultants and attorneys?



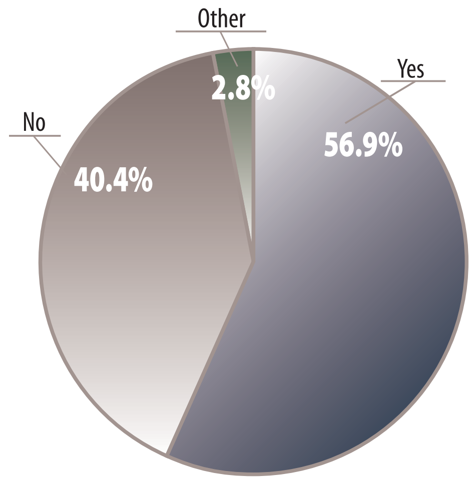
Are these consultants/attorneys selected by:

Management	13.3%
Board/compensation committee	55.4%
Both board/compensation committee and management	24.1%
Separate compensation consultants/attorneys for board and management	1.2%
Not applicable	6%

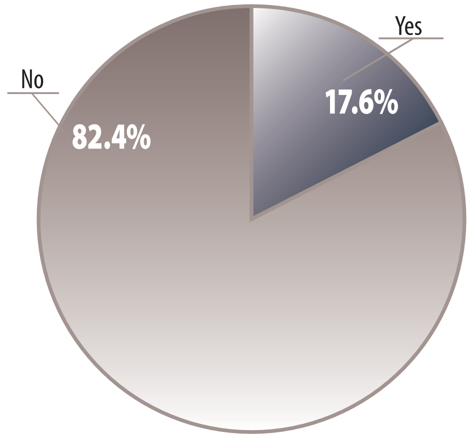
CEO Retention and Recruitment

Is compensation a key differentiator in attracting the best qualified candidates to executive positions in your firm?

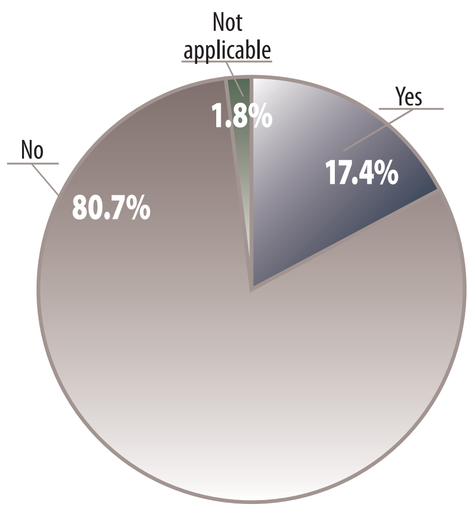
(Other responses include: don't know yet, unclear.)



Within the past year, have you had to renegotiate CEO or senior executive compensation to avoid losing these executives to other firms?



Has publicity about executive compensation made recruitment of talent more difficult for your firm?



If you were recruiting today for a new CEO, would you expect to:

Pay significantly more than you pay now	25.5%
Pay somewhat more than you pay now	27.3%
Pay the same amount as you do now	40%
Pay less than you do now	7.3%

Director Feedback

What, in your opinion, could be done to improve CEO compensation package design and implementation?

Greater publicity about the compensation offered at other organizations is the best way to improve packages. More public details about the perqs, benefits, and other forms of compensation will make it easier for the marketplace to appropriately reward excellent CEOs. Boards fear making these details public because they worry about being viewed as extravagant. But this is a mistake. More information will make the playing field more level for all organizations.

The most important issue is to be sure CEO compensation is based on the company's progress (both short term and long term), and that objective measures are in place to both access that progress and provide relevant feedback on compensation.

1. *Rescale to reduce the difference between the highest paid to lowest paid employee. This will be critical to reviving the US' old/low tech industries business—see Delphi, the airlines.*

2. *Have the boards of public companies be more involved with top 50 executives of the companies they serve.*

Develop a compensation package with significant ties to diluted per-share income.

The issue I see is that implementation of CEO compensation is inconsistent and therefore is viewed as discretionary.

Full transparency of all aspects of current compensation, benefits, and severance arrangements

1. *Stop thinking of compensation only in terms of financial rewards. This is tough, because most board members wouldn't want to give up their own*

financial rewards, despite the fact that money is less important to them and to those whose compensation they set than psychological factors and other "soft" things companies can, but don't know how to, offer.

2. *Educate both management and directors to think about things besides dollar-denominated rewards that management and other employees value. Teach how to reward using those things, as well as how to withhold rewards when performance is poor. This is not so very different from parenting.*

Regarding stock and options, restrict the CEO and directors from selling a significant percent of their holdings over a period of years.

Fairly reward individuals based on what is important to them (i.e. time off, bonuses, benefit packages, etc.)

Link salary to performance. Provide stock (not stock options) for performance.

Better education for directors on how to tie compensation to results and what results to tie compensation to.

CEO and executive compensation policy should be based solely on performance, EVA, and stockholder equity appreciation. The blanket compensation policy that rewards CEOs and executives for providing meager returns and is constantly adjusted so that the management of the firm can reap large financial rewards lacks stewardship and betrays the interests of the owners (stockholders).

Provide more specific guidance (benchmarking) for smaller companies that are tech-based and not currently generating large top line or EBIT numbers. This could include all elements of compensation.

Look at the package as a whole and not just as a set of pieces and review the total that might occur under several possible outcomes.

Ensure that compensation is tied to the company's strategy and corporate performance. Rely less on surveys/consultants. Pay attention to internal equity. Implement total compensation tally sheets for executive officers. Better educate compensation committees on a number of subjects, e.g. the math of option valuation. Have committees composed of people who not only are knowledgeable, but tough-minded. Better disclosure to investors.

Have a strict pay-for-performance culture. Issue only performance-driven options. Ensure that your compensation packages meet industry standards.

Put more emphasis on net cash flow, and less emphasis on "accounting" income.

Create a widely-held standard in the form of a suggested checklist of specific components for evaluation based on metrics that reflect corporate goals and shareholder goals.

Shareholders Want What the CEO Wants

By Paul Hodgson

Institutional shareholders want to be paid, too.


Paul Hodgson

Shareholders only want to make money, just like the CEO. It's as simple as that. And the entire focus of institutional shareholders on executive compensation is driven by that consideration, in two ways:

1. Are incentive compensation plans designed so that executives are encouraged to create long-term shareholder value and are only rewarded when they do so?

2. Is all other compensation set at a level that does not cost the stockholder more than is appropriate, and is it disclosed properly?

The first concern arises from the fact that institutional stockholders are often, by their very nature, long-term stockholders and are more concerned with long-term value growth. So companies with executives who are focused entirely on achieving short-term operational targets, or short-term gains in stock price because of inappropriate incentive plans often come under fire.

Yet for the vast majority of companies, the only effective incentive plans are those that reward short-term operational achievements. The link between long-term value growth and long-term incentive awards is broken—if it was ever forged properly in the first place—and institutional investors are not only aware of this problem, but are vigorously championing improvements to long-term incentive plans to rectify it.

Survey Says

That such plans are broken is not an idle claim. We recently conducted a special study, part of The Corporate Library's latest CEO compensation survey, that was designed to test whether the highest compensation increases in the S&P 500 were tied to long-term improvements in company performance.

The results of the study showed that the largest percentage increases in total compensation had very little connection to long-term value creation, whereas the more moderate percentage increases in total annual compensation generally reflected positive changes in year-on-year company performance. (Total compensation included all compensation paid or earned during the year, including the value of restricted stock awards and profits from the exercise of stock options. Total annual compensation consists of base salary, annual bonus and the annual value of perquisites.)

According to the study, six of the ten companies whose CEOs received the highest increases in total compensation underperformed their peers in stock price appreciation over the previous five years. In contrast, the ten highest total annual compensation increases appeared justified by short-term achievements.

If these are the results taken from a study of the top ten highest increases, then extrapolating these figures to the rest of the sample would probably illuminate an even worse situation. Put plainly, the current and most common forms of long-term incentive—stock options and restricted stock—are blunt instruments. They reward everyone in a rising market and penalize everyone in a falling one.

But if the situation is considered from an investment standpoint, the solution becomes a simple one. To bring this down to basics, say an account manager is trying to decide on a long-term investment in one of two companies—Johnson & Johnson and Colgate Palmolive, for example. With current management and current strategy, it is likely that both investments will yield profit, but what is important is which one will yield the most profit. In other words, it is not Colgate Palmolive's absolute stock price increase, or return on capital or any

Put plainly, the current and most common forms of long-term incentive—stock options and restricted stock—are blunt instruments.

other measure that is important, but the company's performance compared to any other company or investment. That is the issue that will drive the investment decision. It, therefore, should also be the issue that drives any incentive arrangements.

Aiming at the Right Target

But it is not simply the comparison of performance with peers that is missing from most current arrangements; also unsatisfactory are the types of targets that are commonly used, even where a company has applied long-term performance measures to some part of long-term compensation. There are many companies that use operational targets like revenue, net income and earnings over the long term, sometimes replicating those already used to pay out annual bonuses, effectively paying executives twice for the same achievements.

However, what are needed are true measures of value increase, both those that measure the direct delivery of value to stockholders, such as total stockholder return, and those that measure absolute value creation, such as a return on capital that exceeds the cost of capital. The most appropriate design and choice of performance metrics for all incentive plans will be different for each company, but the general principles laid out above should be adopted in most cases.

Plain vanilla stock options and time-restricted stock are not driven by such measures at all, and are fast falling out of favor with institutional investors, who increasingly expect more complex and finely-tuned incentive plans to be in place, especially if significant levels of compensation are being contemplated.

Disclose It

The second major concern of institutional stockholders—is all other compensation set at a level that does not cost the stockholder more than is appropriate and is it disclosed properly?—has a more straightforward answer. Despite the continued furor surrounding executive compensation levels, at the vast majority of companies, compensation levels are not excessive, though in general they are poorly disclosed.

But the furor surrounds a significant minority of very high-profile companies, where compensation levels are regularly perceived as inappropriate. These companies will continue to be targeted by institutional stockholders unless and until they begin to rein in CEO pay levels.

There are a number of ways to achieve this. The most direct is to ensure that all pay above a certain limit—preferably $1,000,000—is effectively tied to performance. This would eliminate windfall profits from stock options based on stock price increases that owe 90 percent to general market increases, and it would eliminate excessive time-restricted stock, and very high annual bonuses based on short-term and easily manipulated targets. A second method, and one that received much attention at a recent compensation standards conference in Chicago, is to recalibrate CEO pay so that it is based on internal pay scales, not a comparison to so-called peers. This would tie the compensation of the CEO and other strategic officers to that of their colleagues at the next level of management.

Paul Hodgson, senior research associate, executive and director compensation for The Corporate Library, has been researching and writing about executive compensation for 13 years. Prior to joining The Corporate Library in 2001, he was an active researcher in the compensation field with Incomes Data Services in London. He is the chief architect of Board Analyst's Executive Comp Analyst and Director Comp Analyst tools and author of numerous compensation reports for The Corporate Library. His most recent book is *Building Value Through Compensation,* a title in the CCH Board Perspectives series. Hodgson is a graduate of Durham University (U.K.) and University College, Cardiff, Wales.

The Evolution of the Compensation Committee

By Nayla Rizk and John Ware

Compensation committees, like the board as a whole and other primary board committees, are meeting more often.


Nayla Rizk


John Ware

CEO pay packages and perks are a regular topic for coverage by the news media and a target for activist investors. Regulators, too, are paying more attention to the issue; boards are required to disclose more detail about management compensation and scrutiny of disclosure practices has increased. Compensation committees even face more questions from their own boards, concerned about being held accountable for egregious pay packages.

> Despite the criticism they face, compensation committees are giving CEO pay, in particular, greater scrutiny than in the past.

How have these forces affected the committee's work and workload? Compensation committees, like the board as a whole and other primary board committees, are meeting more often. They report feeling a greater sense of having to explain executive compensation decisions externally and internally to the rest of the board. Despite the criticism they face, compensation committees are giving CEO pay, in particular, greater scrutiny than in the past, examining the entire pay package, including the appropriate mix of cash and equity compensation, retirement packages, severance agreements, exit bonuses and perqs—and hiring their own compensation experts.

In discussions with compensation committee chairs and research on committee practices, several observations have emerged about how the responsibilities of the committee have evolved.

The Time Crunch

Compensation committee chairs report spending more time than in the past determining the rationale for executive compensation and reviewing the components

of executive pay. Beyond the CEO, many are evaluating the compensation of the CEO's direct reports and, more often than in the past, the layer of management beneath that. For example, Intuit's compensation committee evaluates the compensation and performance reviews of vice presidents, in addition to the CEO and his direct reports. While this provides the committee with a strong sense of the company's bench strength, it also is time consuming, according to William V. Campbell, chairman of Intuit and compensation committee chairman for Apple Computer. "Compensation committee work takes an enormous amount of time," he says. "As we get to the end of the year, we do a lot of work on the CEO's compensation. It's taking a lot of work, a lot more than we would have ever done before."

The Impact of Investors

Where they might have quietly accepted executive compensation plans in the past, institutional investors and shareholder advisory firms today are willing to take very public stands in opposition to compensation proposals and even to the re-election of compensation committee members who approve unpopular pay increases.

"The biggest change for compensation committees, in my view, is investors' power in influencing compensation plans," says Steven G. Blank, chairman of the Macrovision compensation committee. "Where shareholders would generally rubber stamp a new option plan in the past, today they are turning them down. The irony is, of course, right after the bubble we were able to recruit almost any level of executive without going crazy on compensation. Now, with Sarbanes-Oxley on one side and a reinvigorated Silicon Valley increasing demand for executives on the other, we're starting to face boundaries that I don't remember having had before."

Acknowledging this new scrutiny, compensation committees are, within limits, responding to investor calls for change. More institutional funds are suggesting performance-based stock plans that include equity, and many compensation committees are establishing those plans and others designed to link executive pay with company performance.

"My first test is: 'I'm a shareholder, does this make sense?'" says William B. Elmore, chairman of the compensation committee of Wind River Systems. "One thing that I've done in hiring new CEOs is provide out-of-the money stock option. When the institutions see that, they see a plan in place where the CEO is rewarded if the stock performs. I've found that is something that is very powerful for shareholders. If the stock goes up 50 percent, would I be happy to have additional stock options kick in for the CEO? You bet."

> Of the 333 new independent directors added to the boards of S&P 500 companies…only four–1 percent of the total—are active or retired senior human resources leaders.

The Role of Outside Consultants

With investors, regulators and colleagues on the board looking over their shoulders to a degree unheard of in the past, compensation committees are much more likely to engage an external consultant to review executive compensation practices. These resources help committee members to understand the details of compensation plans, compare compensation with like companies and also can identify trends and new compensation approaches.

"The use of outside consultants to benchmark compensation at peer companies was something that was used optionally in the past, and today is used, I would say, almost without exception and fairly rigorously," notes Intuit's Campbell. "From a shareholder perspective, making sure that we do these things rigorously and quantitatively is really important."

The Impact on Director Recruiting

What is the effect of these trends and the current environment on director recruiting? The new demands on compensation committees suggest that they may benefit from having members with expertise in accounting, tax, ERISA requirements, and the costs and benefits associated with the most common compensation programs. While we see evidence that some boards are recruiting senior-level human resources directors, boards continue to express a preference for senior general management executives, who have a broad-based business perspective and leadership experience. Of the 333 new independent directors added to the boards of S&P 500

(continued on page 34)

Best Practices for Compensation Committees

By Donald P. Delves

How to exercise good business judgment.

Donald P. Delves

Exercising "good business judgment" requires a skeptical, inquisitive mind, the courage to ask tough questions, and the tenacity to request and review thorough data and analysis. More than anything, it requires board members who insist on being satisfied that their decisions are well informed, well considered, and in the best interest of shareholders.

Good compensation committees ask good questions—and expect thorough answers. They follow consistent, defined processes throughout the year. They operate by a set of understood principles. Most importantly, they are students of the company's pay and performance. They are dedicated to making sure that shareholders are getting what they are paying for, and that management has the incentive tools necessary to drive exceptional performance.

The "Four P's"

In our work with a variety of compensation committees, especially those intent on improving their effectiveness, we have seen best practices in four areas: Process, Principles, Pay and Performance. Let's examine each of these separately:

Process

Compensation committees of effective boards have *defined processes* that ensure the successful execution of their responsibilities. These processes include developing a calendar of key meetings and required decisions, scheduling time to meet in executive session as part of each meeting, and reviewing defined sets of data that are provided by management or outside advisors at specified times during the year. Effective boards also draw clear lines of demarcation between the responsibilities and "decision rights" belonging to the committee, the board, and management. Clearly defined responsibilities empower both management and the board.

Principles

By defining and following a set of decision-making principles, compensation committees in general have an easier time with difficult issues. Examples of principles include *accountability, responsibility, consistency,* and *measurability*. With these principles as navigation points, committees can draw a roadmap for their decision-making. The principles also provide benchmarks against which the integrity of its actions can be judged. For example, when faced with a difficult decision, the committee can assess its actions by asking: Have we held management accountable for what they said they would do? Are we holding executives accountable for the actions and results for which they are responsible? Are we evaluating performance on a consistent basis? Are pay levels consistent with performance levels?

Good compensation committees ask good questions—and expect thorough answers.

Pay

Exemplary compensation committees are asking for—and getting—from management and consultants compensation data that has more breadth and depth. Committees are no longer satisfied with being "spoon-fed" small amounts of compensation data; they want in-depth data and analysis to grasp the context and implications of their decisions. Data and analyses may include:

- **Total Cost of Management—**The total cost for the top 10 to 25 executives in the senior team, including base pay, incentives, equity, benefits, and perquisites.

- **Historical Perspective—**The total cost of management over the past three to five years.

- **Historical Equity Incentive Analyses—**The amount and value of equity granted to management over the past five to

A compensation committee that looks *only* at compensation data is doing half its job.

10 years; the amount and value of equity that has been exercised, sold, and retained; and the amount of stock and options still held by executives, individually and collectively.

- **Wealth Effect**—The amount of stock and options held by executives, and the value that will be gained or lost if the stock goes up or down by $1 a share, $5 a share, etc.

- **Retention Analysis**—An analysis of what executives lose when they leave; how deep are the company's "hooks," and how strong and enforceable are its non-compete agreements?

- **Hidden Costs**—The potential financial impacts of the current SERPs, severance, and deferred compensation plans, and the estimated total costs in the event of a change in control (including gross-ups). Exemplary committees are looking at these issues before an incident arises, rather than waiting for it to hit the headlines.

Performance

A compensation committee that looks *only* at compensation data is doing half its job. Given its responsibility for overseeing incentive payouts, committees need a clear understanding of the appropriate measures and levels of company performance. Committees should also regularly review analyses of company performance relative to peers. Specific data and analyses include:

- **Pay-for-Performance**— Examining how the company's pay position correlates to current and past performance. For example, if executive pay levels are at the 75th percentile, then performance must also be at the 75th percentile. The committee should request and review a thorough analysis of the company's three year performance relative to peer companies on a variety of key measures. While this may seem obvious, many compensation committees receive woefully inadequate data in this area.

Committees are no longer satisfied with being "spoon-fed" small amounts of compensation data.

- **Historical Pay-to-Performance Sensitivity**—How the total cost of management has varied with performance over the last three or more years; how well increases and decreases in performance are correlated with increases and decreases in pay.

- **Future Pay Sensitivity**—The degree to which pay is expected to vary with performance in the future. What will the total cost of management be at different levels of performance over the next year or longer? Addressing this question is essential to assuring that shareholders are getting what they are paying for from executive compensation.

The era of management and their consultants spoon feeding small bits of well-managed compensation data to board committees is coming to an end. Compensation committees have a legal and ethical duty to adopt current best practices of "good business judgment" and scrutinize data that is comprehensive and illuminating. Committee members should never have the uneasy feeling of making decisions with nagging questions unanswered and concerns unresolved. Nor should management feel hesitant about sharing the whole picture with the compensation committee. Tough questions have answers. The best compensation committees are using good process, data and discussion with management to build effective incentives, set challenging goals and pay-for-performance in ways that both management and directors can be proud of.

Donald P. Delves, principal of The Delves Group, is the author of *Stock Options and the New Rules of Corporate Accountability: Measuring, Managing and Rewarding Executive Performance,* McGraw-Hill, 2003; and *Accounting for Compensation Arrangements,* Commerce Clearing House, 2005. Delves writes and speaks regularly on equity compensation, performance measurement and value creation, and has testified before the U.S. Senate and the Financial Accounting Standards Board on stock option expensing. He holds an M.B.A. degree in finance from the University of Chicago, a B.A. summa cum laude, in economics from DePauw University, and is a Certified Public Accountant.

The Importance of a Compensation Philosophy

By James F. Reda

Without a well-thought-out compensation philosophy, incentive plans may be poorly designed and thus not effective.

James F. Reda

Due to a variety of reasons, including new accounting rules, response to investor concerns and a desire to strengthen the link between pay and performance, many companies are shifting their emphasis in executive long-term incentive programs from stock options to performance shares. A major cause for this shift to performance shares is driven by the desire to use a variety of performance measures rather than simply using stock price as the only measure to better align financial performance with incentive payouts.

The new rules for accounting for stock awards (FAS123R which replaces APB Opinion No. 25 no later than January 1, 2006) have dramatically improved the accounting for performance shares in relation to stock options. In fact, the new rules even allow for a discount to be applied to performance shares that are based on market price conditions. Further, many companies are exploring performance shares that vest based on non-stock price measures because the expense can be reversed for non-performance (unlike stock options, time-based restricted stock, and performance shares with stock price related performance measures).

> The selection of the peer group is extremely important to a compensation philosophy.

To help navigate through the maze of new rules and investor concerns, we recommend that the company's compensation philosophy be reviewed and in some cases recreated from scratch. Without a well-thought-out compensation philosophy, incentive plans may be poorly designed and thus not effective.

Simply put, a compensation philosophy consists of four main components:

- Peer group comparisons.
- Pay positioning strategy.
- Internal vs. external pay equity.
- Performance alignment with business plan.

Constructing a Peer Group

Peer groups are used basically for two purposes. First, they are used to set the base salary, annual bonus, long-term incentive and other compensation and benefits such as health & welfare plans and other compensation and benefit plans. Second, they may be used to measure the company's financial success compared against the peer group.

The first step in determining competitive compensation levels is to carefully select a peer group. This peer group should consist of at least 13 companies, and usually no more than 17 companies. The considerations for the selection of this peer group are as follows (in order of importance):

- Direct competitor companies. Companies that you compete with directly in the marketplace for your product.
- Same industry companies with comparable revenues. There are many cases where companies do not compete directly but are in the same industry segment. Care should be taken to select companies with similar profit and growth opportunities.
- Companies ranked by stellar corporate performance, or shareholder return. This practice has been deemed somewhat controversial, as it is less likely that executives can jump industries.
- Companies that you gained executives from or lost executives to in the past 18 months.
- Companies in the same business sector.

- Companies in the same local business area.

The selection of the peer group is extremely important to a compensation philosophy. In some cases, compensation committees will select a different peer group for their chief executive officer than other executives, and a different peer group for less senior employees. The rationale for this is simple. Executive searches for senior executives are national and in some cases international in focus. As you move down the organization chart the focus shifts from national to regional and for relatively junior management positions to a local basis.

Developing a Pay Positioning Strategy

If superior levels of corporate goals are planned, it is necessary to position and target compensation levels accordingly. A typical pay positioning strategy is as follows.

Percentile ranking in comparison to the market is a very important concept in communicating a compensation philosophy as it allows management to translate the board's intention into practice. Base salary should be compared against the market on a percentile basis. For example, the 50th percentile is also referred to as the median. That is, 50% of the salaries of the peer group are above the salary of interest, and 50% of the salaries in the peer group are below the salary of interest.

The purpose of a pay strategy is to increase the company's profitability. You don't want to under-compensate employees as they will leave the company due to low pay, and you do not want to over-compensate employees resulting in corporate waste. There is a relationship between turnover rate and competitive market positioning.

Salaries may exceed market median rates for those whose skills are superior to typical executives with similar responsibilities, or for those who hold positions that are uniquely important to the corporation. For certain key management positions in which the corporation must ensure the highest level of talent and performance, the corporation might target the 75th percentile. Conversely, salaries may lag median market rates for those who are new to a job or who hold positions of lesser importance.

> What other benchmark data do companies really have? How do you properly pay executives?

To avoid increased fixed costs, extraordinary accomplishments or contributions should generally be recognized through annual incentive payouts, rather than through salary increases. Exceptions are acceptable for incumbents whose salary falls below targeted levels.

We recommend aligning pay and performance by reviewing industry data for one, three and five years in comparison with company performance and short- and long-term corporate outlook. The pay-for-performance curve should be calibrated so that median performance results in median payout and great performance (75th percentile of industry performance) results in 75th percentile payout levels.

Internal vs. External Pay Equity

In general, a company should not rely primarily on peer group comparisons in setting pay. At best, base salary levels should be compared against a broad-based peer group, but should only be used as a general guide for short- and long-term incentive opportunity amounts.

Peer group comparisons have been criticized by almost every pension fund, watchdog group and every special report on executive compensation such as those published by the Conference Board and the National Association of Corporate Directors. However, what other benchmark data do companies really have? How do you properly pay executives?

Top management is less likely to move on to another job as they have invested their career with the company. For them, internal equity is very important. The relationship between pay and performance may have to be adjusted. For example, median payout should follow 60th percentile of performance. This will anchor the long-term plan in median payout for higher than median performance.

Alignment with the Business Plan

Annual bonuses must be primarily based on results. However, there must be an override for personal performance. The bonus pool must be affordable and should be based

(continued on page 34)

Three "Simple" Solutions

By Joseph R. Rich

For every complex problem, there is a simple solution that is patently wrong.

Joseph R. Rich

Few would argue that executive compensation pay should be fair, equitable and performance-based. When a company is performing well under the stewardship of a particular management team—and investors and shareholders are benefiting—its leaders should be compensated accordingly. Yet each year, executive compensation continues to escalate, even though not all companies are performing better. So, the question becomes, is this increased payday at the top based on fair, equitable and performance-based measures?

Executive compensation contracts are complicated documents. In fact, the intricacy of those agreements and the subsequent payouts are so complex that they have not been fully understood, even in some instances by the board members that approved them. As a result, in some cases there have been unexpectedly large payouts, and those payouts struck a public chord. The result has been an outcry for simplification.

Unfortunately, simple solutions, while ideal, don't dispatch complex problems.

Three key solutions (and their presumed outcomes) have been proposed to simplify the difficult issue of executive compensation:

- Greater disclosure. If investors know what top executives are making that will ensure that compensation stays in check.
- Tally sheets. If the compensation committee tallies up all compensation elements and reaches "one number," then knowing how large that number is will keep executive pay in check.
- A designated consultant for the compensation committees. If compensation committees have their own consultant who is uninfluenced by management, the board will have a straight answer and that will definitely ensure that pay stays in check

Should boards consider these things? Probably. But it is unlikely that these simple solutions will ensure that pay is fair, equitable and performance-based.

> The real value in completing tally sheets is that they push firms, compensation committees, and service providers to re-think and possibly re-approach how they reach those compensation decisions.

Greater Disclosure

The SEC, ISS and Congress all operate under the notion that disclosure of executive compensation levels provides investors with a window into corporate governance. And recent activities by all three suggest there will be a bigger push for more and more disclosure.

And while better disclosure is probably a good idea, disclosure in and of itself will not keep executive pay in check.

On the contrary: disclosure, and the availability of data in compensation surveys, instead often provides fuel for the ever-increasing levels of executive compensation. This disclosure provides firms and their advisors with the ability to compare programs; program comparison leads to gap identification and gaps get filled.

Companies will make choices about pay levels and structures with or without information. The availability of competitive information allows firms to identify best practices, and the prospect of disclosure likely keeps most potential bad-actors in check. However, the availability of information provides air-cover for all the generally good-actors to fill gaps to be competitive.

Let's think about the distribution of pay: Bad-actors who are the egregious pay-recipients at the top may be checked by greater disclosure. But, the rest of the distribution—the good-actors—will

> Should compensation committees have their own consultant? Under certain circumstances the answer is: probably.

now have additional information with which to assess their programs and ensure that they are providing their executives with competitive packages. So while the few may be restrained, more than likely, the masses will be enabled.

There is a social good in keeping executive compensation fair. And in order to keep pay in check, we need to address and remember that being competitive is not the eleventh commandment. The data and information aren't the problem; it's that we have substituted being competitive for the real goals: to be fair, equitable, and performance-based. Absent this change in mindset the cost of greater disclosure will inevitably be greater pay.

Tally Sheets

The high profile executive paydays we've seen over the past several years have often been associated with acquisitions and terminations. In some cases it has been argued that committee members may not have been fully cognizant of the high-dollar value of these payments prior to their occurrence. The resulting public out-cry has created the desire to have a complete aggregation of all elements of compensation distilled into one number summarized in the format of a tally sheet.

You and I both know that in reality, there isn't one simple number, because the number differs based on the scenario: whether or not there is a separation, and if so under what circumstances; whether or not there is an acquisition; how the individual and the firm perform over time, and other factors.

The real value in completing tally sheets is that they push firms, compensation committees, and service providers to re-think and possibly re-approach how they reach those compensation decisions. It's doubtful that tally sheets alone can keep pay in check, but tally sheets can prevent firms and committees from overlooking how program elements interact (thereby avoiding unintended consequences), and it may keep some of the bad-actors in check.

In the end, a firm and its committee must know what they are trying to accomplish with their executive pay program, otherwise a tally sheet is merely a good measurement tool.

Committee Consultants

Should compensation committees have their own consultant? Under certain circumstances the answer is: probably.

The fact is much of compensation consulting is based on business judgment framed by analytical processes and tools. If a consultant is qualified and has ample time and exposure to the comp committee, it's likely that s/he could avert the actions of bad-actor management, or identify the mistakes of a poor consultant to management. And the mere presence of a committee consultant could temper managements' recommendations.

Certainly the analytical processes and tools can be vetted and assessed, and definitive determinations about their appropriateness and accuracy can be made. But business judgment is more difficult to assess, and the results of differing choices might not be visible for many years.

The true value of a designated comp committee consultant is that there is an additional experienced person considering the problem, identifying and evaluating potential solutions, and making recommendations accordingly.

Better disclosure, tally sheets and a designated comp committee consultant are ways to help make executive pay fairer, more reasonable, and more performance-based. The key is to recognize that implementing relatively simple solutions is beneficial, but in the end, only good judgment can make pay programs effective and appropriate.

For more information on tally sheets, visit www.pearlmeyer.com/tallysheets.

Joseph R. Rich is president of Pearl Meyer & Partners where he consults in the areas of executive, sales and employee compensation. Rich was previously a managing director of the firm and an executive vice president of Clark Consulting, Pearl Meyer & Partner's parent company. Rich was co-founder and managing partner of Executive Alliance, a compensation consulting boutique that was acquired by Clark Consulting in 2001.

Prior to forming Executive Alliance, Rich was a principal and elected officer of William M. Mercer, Incorporated, where he served as a member of the national executive compensation practice. Rich was also a consulting manager in the human resource practice of KPMG/Peat Marwick and held a variety of positions at Data General Corporation.

Rich holds an M.S. in Human Resources and Statistics and a B.S. in Economics from Cornell University, where he served as a Lecturer in Economics and Statistics. He can be reached at joseph.rich@pearlmeyer.com.

“I’ll take CEOs on my compensation committee every day.”

(Rizk and Ware, from page 27)

companies, 32 percent are active CEOs and chief operating officers. Of the 11 percent of new directors who are other corporate executives, only four—1 percent of the total—are active or retired senior human resources leaders.

“The audit committee was the first committee where companies recruited an ‘expert,’ and that was driven by regulations. In the other major committees, having independent, strategic, executive-thinking people in those positions is the right way to go, as opposed to having a ‘compensation expert,’” Wind River Systems’ Elmore says. ”We’re trying to align the incentives of the management and employees with shareholders. That requires strategic CEO-level thinking. I’ll take CEOs on my compensation committee every day.”

As scrutiny of executive compensation has intensified, compensation committees are more rigorously reviewing the components of executive pay, looking for new strategies to link executive pay with performance and ensuring that disclosure of compensation is accurate, complete and transparent. As they become more knowledgeable about the details of pay packages and overall compensation strategies, compensation committees will continue to make strides toward the goal of aligning executives’ compensation with the objective of maximizing shareholder value.

Nayla Rizk and John Ware are consultants in Spencer Stuart’s Technology, Communications & Media Practice, focusing on board of director, CEO and C-level recruitments. Rizk specializes in working with clients in the software, telecommunications systems and services, storage, hardware systems and professional services sectors. Ware specializes in recruiting assignments for infrastructure software and services, software, storage and mobile technologies and services companies. Both are based in the firm’s San Mateo office and, together, they author the annual Spencer Stuart Silicon Valley Board Index.

Investors are more impressed by those with the courage to convey bad news and are suspicious of “spin.”

(Reda, from page 31)

on cash-based measures. The “up-ticks” must equal the “downticks.” It has to be a zero sum game.

There are two main issues to consider in setting financial measurement goals. First, should you compare against a plan target based on the budget or compare against a basket of companies? Second, should you base success on corporate financials and/or shareholder return and in what mix?

There are two ways to address these issues. First, the goal can be an absolute objective such as a business or operating plan. Second, the goal can be a relative objective such as relative performance as compared against a peer group.

There are ways to integrate an incentive plan so that it contains both a relative and an absolute element. Most relative performance plans have an absolute governor or threshold that must be achieved before the relative measure is applicable. If the threshold is not achieved, the plan does not pay out.

James F. Reda, managing director of James F. Reda & Associates, LLC, has served for more than 17 years as advisor to the top managements and boards of major corporations here and abroad in matters of executive compensation, performance, organization and corporate governance.

Reda is regularly quoted by major news organizations and is a frequent contributor to business periodicals. He has served as speaker for The Conference Board, the National Association of Corporate Directors, American Society of Corporate Secretaries, AICPA and WorldatWork, as well as for seminars for Penn State, University of Georgia, Yale, Northwestern and other leading business schools. He is the author of the *Compensation Committee Handbook* (John Wiley & Sons).

Reda has a B.S., Industrial Engineering, Columbia University and a S.M., Management, Massachusetts Institute of Technology, Sloan School of Management.