

Responsible Executive Compensation

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Compensation and the Chief Executive Officer

Executive compensation has come under increasing scrutiny in recent literature in the wake of the growing publicity surrounding managerial failures and executive self-interest. Financial experts have long been examining the problem of aligning the performance of executives with their salaries and benefits. Public discontent with the visible top-heaviness of the compensation structure has brought this issue into the spotlight throughout the business world. Experts point to the flaws of traditional payment schemes and offer a number of different solutions. Shareholder value and the success of the firm can be significantly affected by executive performance. Hence, understanding the advantages and costs of the current trends in executive compensation is crucial to the compensation committee of a Fortune 500 corporation.

The compensation committee has a difficult task upon its shoulders. It must construct pay programs that attract and retain the best talent to address the individual organization's needs. It must design a strategy that generates superior returns for investors, appropriately measure managerial performance, and institute a pay practice that is fair to both employees and shareholders and that really drives business results (Mercer p.4). There is abundant theory and research on the strategies thought to accomplish these goals, and the emerging trends in executive compensation seem to be highly successful.

The growing public criticisms of ultra-high executive pay are not unfounded. According to Mr. Meizhu Lui, “the ratio of CEO pay as a multiple of average worker pay has grown tremendously, from 41 to 1 in 1960 to 411 to 1 today” (Master para. 10). According to the Corporate Library, total compensation for CEOs in the S&P 500 rose by a median 22.18 percent in 2003, which is double the increase in 2002. Increases in compensation of over 1,000 percent were seen at four of these companies: Oracle, Apple Computers, Yahoo! and Colgate-Palmolive (Corporate Library para.1). These companies have had great successes and deemed their respective CEOs worthy of such high pay.

Aligning Managerial Performance with Owners’ Visions

Before the compensation committee can decide how much to pay its Chief Executive Officer (CEO), the committee must first understand why effective managerial pay strategies are important to the corporation. Executive pay must function not only to attract the most talented and dedicated managers, but also to align CEO intentions with shareholder wishes. These so-called agency problems are at the heart of the debate over executive payment schemes. Michael Jensen explains in a 2002 article, “a rational manager with no investment in his firm would have little incentive to maximize its value, and every incentive to use it for his own ends” (Jensen para. 3). This is exactly the conflict that the compensation committee must avoid. The most basic (and practiced) method of avoiding this problem is to issue a portion of an executive’s compensation as stock and/or require the executive to hold a certain amount of stock ownership in the company. “A CEO who does not own a portion of the residual claims of the firm faces little direct incentive to maximize shareholder value” (Traichal para. 1). While this idea is

still pertinent, modern pay structures go far beyond mere stock ownership to include stock options of many kinds.

The Challenge of Aligning Pay with Performance

“Attempts...to minimize or control this agent-principal conflict can be classified into three basic categories: market discipline, compensation structure, and monitoring mechanisms,” says Patrick Traichal (para. 1). The market discipline category is composed of the various markets in which “the activities of the firm, the CEO or the firm’s product are valued” (Traichal para. 2), which necessitate the successful performance of the CEO. Specifically, if a CEO’s performance is not up to par, then his or her job is threatened by replacement by a new manager or by hostile takeover (leveraged buyout). The monitoring mechanisms category is the direct supervision of the executive by various stakeholders, including the board of directors, large stockholders, and the legal and regulatory environment (Parrino para. 9). Robert Parrino explains, however, that there is an inherent problem with these two methods of avoiding agency conflicts, i.e., that “each requires that someone observe the performance of a manager, decide whether the manager is making the appropriate decision, and take action if the manager is deemed to be acting counter to stockholder interests” (para. 10). This is why the third category, compensation structure, the central focus of the compensation committee, is important.

Total Executive Compensation

The equivalent dollar amount of an executive's total compensation is a function of a dozen or more variables. This is extensively addressed and supported by several empirical research reports, including James Cordeiro's "Beyond pay for performance." He asserts that "salary is related to the magnitude of the responsibility, risk, and effort shouldered by the CEO as a function of the firm's scale, complexity, and risk of the firm's operations" (para. 4). As the size of the firm grows, so does its CEO's overall influence, power to increase shareholder value, and capability to squander cash in pursuit of his or her own self-interest. Therefore, executive pay increases with increasing firm size, latitude of options, and level of firm risk (Cordeiro para.14-18). Compensation is also influenced by an individual's tenure as CEO. If all other variables are held the same, an executive's compensation should increase with time to encourage continuity of strategies and avoid high CEO turnover rates.

Measuring Performance

An executive's pay should be fundamentally linked to his or her performance as a decision-maker and manager. However, measuring the performance of a CEO is deceptively difficult. Traditionally speaking, a CEO's ultimate goal should be the maximization of shareholder value. However, stock price may not always be the best indicator of an executive's contribution to the firm. Traichal explains, "empirical evidence suggests that numerous economic factors render stock returns too noisy and insensitive to a manager's actions to make it the primary factor in setting compensation" (para. 8). Justin Martin agrees: "share price is neither the only nor the best metric by which to gauge a CEO's performance" (para. 1). Executive accountability was lost in the

bull market of the 1990s as share prices skyrocketed across the board, with little regard to performance (Mercer p.3). Traichal recognizes the importance of “both market and accounting measures, [specifically] shareholder returns and accounting return on equity as performance metrics” (para. 8). Mercer suggests both financial results and operation objectives as alternative measurements (p.3).

Trends in Executive Compensation

There is an important distinction to be made between *how much* to pay a CEO and *how* to pay a CEO. There is prolific empirical evidence supporting the effect of many firm-level variables on executive compensation. The debate continues, however, over what form CEO compensation should assume. This is where the true difficulty of the compensation committee’s task lies. The committee must first accurately measure an executive’s performance and, more importantly, design a pay structure individualized to the unique characteristics of the firm, the industry, and the current economy.

Traditionally, executive pay has been linked directly to share price. This practice, however, is widely falling out of favor. This is in part because “stakeholders perceive that executives are benefiting from market performance rather than underlying corporate performance” (Mercer p.1). Jensen agrees:

In the [stock market] bubble, [this practice] encouraged a focus on short-term highs with destructive long-term consequences. Once a firm’s shares became overvalued, it was in managers’ interests to keep them that way, or to encourage even more overvaluation, in the hope of cashing out before the bubble burst (Jensen para. 7).

Mercer reports a similar situation:

In many companies, the magnitude of equity compensation completely overshadowed the other elements, often making them irrelevant. Companies are now facing the painful process of cutting back their equity programs, often at the same time that salaries are frozen and incentive plans are not paying out because of weak performance (Mercer p.3).

Mercer instead suggests that the most important aspect in a pay structure is “balance among elements: cash and equity, short- and long-term incentives, fixed and variable components” (3).

Restricted Stock

The challenge of actually balancing these elements remains. Justin Martin claims that “the compensation strategy most likely to be widely adopted is performance-based restricted stock” (Martin para. 3). It is a variation on the traditional equity-based compensation. Under traditional methods, CEOs are compensated with stock holdings but are entitled to the actual ownership of these shares only upon completion of a certain amount of service, typically three to five years. In contrast, “performance-restricted stock vests based on achieving goals, such as growing return on invest capital” (Martin para. 3).

Campbell Soup, International Paper, and General Electric have already made the switch to performance-restricted plans. GE compensated CEO Jeffrey Immelt with 250,000 performance shares. He is entitled to these shares upon completion of five years of service based on two performance targets: an operating cash flow growth of ten percent annually, and total shareholder return that meets or exceeds the S&P 500. He is

granted ownership of all 250,000 shares if GE meets both of these goals, only half of the shares if it meets just one, and he is entitled to none of the shares if GE meets neither goal (Martin para. 5). This plan helps to increase the balance between elements because the CEO now has the incentive to increase operating cash flow (an internal measure) as well as shareholder value (an external measure). The performance-restricted stock incentive offers the advantage of versatility because “a company can tie vesting to an array of metrics, everything from return on assets to top-line growth” (Martin para. 7).

Long-term Incentives

The incentive for long-term success is another important strategy element to address:

The major advantage of long-term bonuses is that they allow a company to achieve a better-balanced compensation mix. Many companies feel their CEOs have too large of an equity stake. Long-term bonuses provide a countervailing cash incentive. Such plans also present an opportunity for companies to balance short- and long-term goals (Martin para. 11).

In 2003, for example, Lucent Technologies initiated a long-term bonus plan for CEO Pat Russo, based on achieving various operating income targets. At the end of the allotted time, Russo stands to be paid anywhere from zero to 200 percent of the base amount depending on Lucent’s performance.

Stock Options

The use of premium options is also rapidly gaining in popularity. A premium option, also known as an underwater option, is one that cannot be exercised by the CEO until the share price meets a certain minimum, at which time the exercise price is

somewhat higher than the actual market price (Martin para. 12). Traditional option packages lost their motivational capabilities in the sluggish economy of recent years. IBM recently granted CFO Sam Palmisano 250,000 premium shares. The price must rise ten percent before Palmisano can exercise these shares (Martin para. 13).

Holding Period Guidelines

An increasing number of corporations are requiring CEOs to hold more stock for longer periods, so-called Share Ownership Guidelines. Justin Martin claims that this is an appealing theory, but not as effective as it may seem. While it serves to tie an executive's pay more closely to his or her firm's long-term goals, it does little to change a CEO's incentives in practice. Proctor & Gamble requires its CEO A.G. Lafley to hold \$9.6 million in company stock. This is barely half of the \$18 million he already owns (Martin para.15). Justin Martin describes these ownership guidelines as "mere window dressing...they're meant to mollify institutional critics but are hardly a substitute for more vigorous compensation reform" (Martin para. 16).

The Final Verdict

As the compensation committee can see, there is no perfect answer to the problem of agency costs and pay/performance alignment. Hence, the task of the committee is to design a plan that *best fits* the needs and characteristics of its firm. One thing is certain, however: diversification in pay structure is the key to best avoiding agency costs. CEOs of almost all Fortune 500 companies will welcome a change in compensation structure after losing interest in stocks and options that are languishing at their lowest prices in decades.

The committee should neither look to tie the CEO's pay entirely to stock price fluctuations, nor abandon these prices as a gauge of an executive's contribution. Instead, the committee must implement a system in which the executive is paid with performance-based restricted stock, cash bonuses, premium options, and traditional stock holdings, all of which should be linked to his or her performance measured against both internal and external yardsticks. The committee must decide what are optimal levels of cash flow growth, shareholder return, market value, accounting profits, and market capitalization numbers for its particular firm. It must examine competitors in its industry and set goals that are realistic but progressive. The committee must attract and maintain a leader whose goals are aligned with the shareholders. Maximizing the performance of a talented leader is the best way to increase value and guarantee future success.

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