

Board Governance Series

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Four Tests for Executive Compensation

Blair Jones, senior vice president and practice leader, Leadership Performance & Rewards, Sibson Consulting, provides guidelines for compensation committees to assess the pay/performance relationship.



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Compensation committees are bombarded with so much information these days, they need some analytics to make sense of it all. Our firm has been talking to companies about four tests that will help them understand the elements of their executive compensation program and how they work together.

The first set of tests involves the use of tally sheets to help compensation committees understand the elements of pay and how they interact with each other. Tally sheets add together all of the pay elements—base salary plus annual incentive plus long-term incentive plus the value of any retirement benefits—to show the worth of the total package. This analysis shows both pay mix and total pay level, enabling the committee to compare the mix and total levels to the competition and see how these aspects have changed over time. Compensation committees should conduct this analysis at least once a year, or anytime a program changes. For instance, a change to the annual incentive program may have implications for the value of retirement benefits or other pay elements. Tally sheets are also useful in helping new committee members gain an understanding of the different pay elements and how they add together.

Another application of tally sheets is to illustrate the pay implications of different scenarios, such as a CEO termination or a change of control. This analysis clarifies where the different pieces of value might come from and in case an issue arises; it also ensures there will be no surprises. For instance, if an equity program might deliver a tremendous amount of value during a change of control, the committee can adjust the program in advance rather than get surprised on the back end.

A third application of tally sheets relates to the executive compensation

program's retentive aspects. In this case, we tally up the equity and retirement components of the program to look at what executives might have on the table at any given point in time. The idea is to look at unvested equity and retirement benefits, to gauge what might be left behind if executives choose to resign from the company. This exercise helps the compensation committee decide whether to add benefits or whether the retentive power of the program is sufficient. In this way, the committee can make decisions about future equity grants and crediting.

The second series of tests relates to pay for performance and helps the committee gauge whether it's getting what it's paying for. There are three applications of this test as well. The first has to do with examining the internal correlation between pay and company performance. Simply put, if a company's performance moves up, to what extent does pay move up? If performance moves down, does pay move down? Another application looks at value sharing and the amount of cash being paid out in base salary and annual incentives as a percentage of cash and earnings generated by the company. It also looks at total pay, including base or annual incentives, long-term incentives, and retirement pay as a percentage of shareholder wealth created. This test allows the committee to assess whether the percent shared with the CEO or executive team is the right amount given what is occurring internally (e.g., a situation where it is advantageous to share more for a short period of time) and what the competition is doing. The committee needs to consider the business circumstances to interpret whether the sharing rate is appropriate.

The final application considers the pay/performance relationship relative to competitors. While the first test looks

at the internal relationship between pay and performance, the third test looks at executive compensation relative to the competition with the idea being that if the company is performing at the 75th percentile of the competition, is it also paying at the 75th percentile? Conversely, if the company is performing at the 25th percentile, is it paying at the 25th percentile?

The pay/performance relationship should be reviewed from all three angles because none of the analyses alone is sufficient. Each gives a different perspective on the pay/performance relationship. Considering them together gives the compensation committee a better handle on whether the pay/performance relationship is appropriate for the business situation.

The third series of tests focuses on understanding the internal relationship

the competitive data suggests. We suggest that committees look at how those relationships have changed over a long period of time, whether it's five or 10 years, and try to understand what led to the current pay structure and composition. The test can also identify any pay components that may have been relevant in the past, but are not relevant now. For example, perhaps an incentive program was put in place to deal with an urgent business need that no longer exists, yet the program still resides in the total pay package. As another example, say equity opportunities were adjusted to create internal equity among the team during a merger. After the integration took place, those equity opportunities were preserved when they should have been reversed over time. Those are the kinds of situations committees should look for to determine if the relationship between CEO pay and other executive pay makes sense.

under the 162M regulations legislation (or the \$1 million-cap legislation as it's more commonly called). As the new deferred compensation regulations become more defined, the committee will need to consider the implications for different programs and how the company will deal with them. It's very important that the committee understand those nuances because these are the kinds of issues that creep up three or four years down the road, when they can cause bigger problems.

In summary, these four tests give the committee ways to tee up issues as well as ensure understanding. While none of the tests are prescriptive, per se, each will help the committee look at the different analyses and ask: "Does this make sense for our company?" When we look at our business situation, our talent needs, and the performance and awards strategy we're trying to

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between pay for the CEO and pay for other executives. This test is important in order to ensure that that relationship reflects not just competitive practice, but also the company's operating style and the strategic importance of different positions. For instance, a company in which the executive team has a strong team orientation may want the executive pay relationships to be closer than what competitive data suggests. Or in a situation where a certain position is going to be highly strategic for a certain period of time, it might be desirable to pay that position closer to the CEO's pay, which goes against what

Test four has to do with auditing the accounting and tax implications of the different executive compensation programs. With so many changes in companies' annual and long-term incentive designs and with changes in tax and accounting regulations, it's difficult for committees to keep track of the implications of different programs. At a minimum, we suggest an annual audit of the tax and accounting implications of the different programs. For instance, if changing from stock options to restricted stock, the committee should understand that restricted stock is not tax deductible

implement, do the pay opportunities make sense, does the pay/performance relationship measure up, and do we have the kinds of internal relationships we want while still complying with accounting and tax rules? These four sets of tests can give compensation committees a sense of comfort that they're at the right place, and if they aren't, then they have the opportunity to make mid-course adjustments.