



Pearl Meyer & Partners  
*Comprehensive Compensation*



# **IOMA's Complete Guide to Best Practices in Pay-for-Performance**

## **Top 10 Issues in Executive Compensation**

SEPTEMBER 2007

[www.ioma.com/HR](http://www.ioma.com/HR)

There are a myriad of issues swirling around the topic of executive compensation today, but what are the top 10 most critical? **Michael Enos, Vice President** at compensation consultancy Pearl Meyer & Partners ([www.pearlmeyer.com](http://www.pearlmeyer.com)) outlined his own David Letterman-style list as part of his July 2007 presentation "Current Trends in Executive Compensation" at a meeting of the National Association of Corporate Treasurers (NACT).

"Executive compensation is a hot topic—not a day passes when there isn't a mention of it in the media," Enos points out. "The landscape is certainly changing due to such issues as Sarbanes-Oxley, the new SEC disclosure rules, shareholder activism, and increasing pressure on boards and compensation committee members."

According to Enos, the top 10 executive comp issues in this challenging landscape are:

**1. Say on pay.** "The House has passed the Shareholder Vote on Executive Compensation Act, otherwise known as the 'say on pay' act," Enos points out. "Under this act, shareholders would vote on companies' executive compensation plans and on change-in-control and previously undisclosed retirement packages that were approved by the board."

"Say on pay does have its critics who argue that increasing investor activism will create a shift in the board's role and wrest too much control from the board. Critics also say that boards will be subject to criticism if they fail to recruit top executives and directors will be criticized for paying excessive executive compensation. So say on pay also may impact the ability of companies to attract qualified people to act as directors."

On the other hand, "proponents argue that it will give shareholders a voice and may limit instances of excessive pay."

**2. Stock-option backdating.** "This issue is still making headlines," Enos says. "Executives have lost jobs and companies have gotten into legal trouble, and I don't think we've heard the end of it."

*Related issues:* "The next big issue may be

'spring-loading'—the selection of grant dates based on any insider info that the value of the company's stock is going to rise. This is being watched just like stock-option backdating," Enos says. (There is also a practice called "bullet dodging," whereby companies delay grants until after negative news has come out and stock price has declined.) Companies that spring-load have been accused of violating securities laws by disclosing untruthful stock-option grants and intentionally misleading investors.

**3. Change-in-control pay.** "The issue of change-in-control pay piggybacks on post-separation pay," Enos says (post-separation is discussed below). "Often, companies provide gross-ups, which shield executives from the tax consequences of their severance packages. The gross-ups reimburse executives for any excise tax incurred on their severance packages."

In 1984, Congress passed legislation to penalize what is considered to be excessive golden parachutes. The tax reform imposed a tax penalty of 20% excise tax if parachute payments exceeded three times the value of an executive's pay over the previous five years, Enos explains. But some companies have been making executives whole by agreeing to pay the excise tax on their behalf if the excise tax is triggered.

"In some cases, the gross-up payment can amount to millions of dollars," Enos points out. "The cost to the company can outweigh the benefits, in part because the company also loses eligibility for corporate tax deductions on the excess payments. Boards now are paying greater attention to this practice in light of the increased scrutiny of executive pay practices."

**4. Post-separation pay.** "There has been extensive negative publicity regarding executives who have received large values for separation pay packages. There is going to be greater and greater scrutiny in this area, because the new SEC rules require that companies disclose such payments," Enos stresses.

**5. Pay-for-performance.** Enos points out that it can be tricky to define pay-for-performance. "You don't usually hear companies saying, 'We didn't do well this year, but let's pay the CEO anyway.' Pay-for-performance is multidimensional, complicated, and means different things to different people, depending on the organization and how 'performance' and 'pay' are defined."

When determining and defining pay-for-performance in your organization, it can be helpful to ask questions such as the following, Enos suggests:

- Is performance absolute or relative (e.g., based on peer performance)?
- Is performance measured over a long or short term?
- What are the appropriate measures of performance—e.g., total shareholder return, return on investment capital, total revenue?
- Does performance differ by factors related to the industry, life cycle of a product, etc?
- How is pay defined—is it on an annual basis or cumulative?
- Should unrealized pay—for example, unexercised stock options—be included as total compensation?

"There are so many factors to consider. It's important to know what's going on in your industry and what's most important to your firm," Enos says. "You also have to consider your gut feeling as to when pay is disproportionate to the executive's actual achievements."

*"Perceptions are important.* Keep in mind that investors are looking closely at total shareholder return. If it's negative and your executives are getting significant increases each year, they are likely to view it as a misalignment between pay and performance."

**6. New SEC disclosure rules.** "Proxy statements disclose more information than they did in prior years. Now, companies are required to report the value of retirement benefits, severance payouts, long-term

incentives, and perquisites—all the various elements that make up compensation," Enos says.

"Unfortunately, many companies are making their proxies and CD&As much too complex and verbose and including too much data."

**7. Competitiveness.** "You'll hear directors say, 'We know CEO compensation is really high, but our CEO is the best and needs to be paid,'" Enos warns.

"For each executive on your company's team, you need to answer the question, 'What does this executive mean to this company at this time and in this place?' That consideration can impact pay in either direction. If the executive's performance is high, it may make sense to pay more than the market median, in order to remain competitive in terms of talent retention. If the executive is a low performer, it may be appropriate to pay below the 50th percentile."

**8. Consultants' roles in executive compensation.** "One of a compensation consultant's main responsibilities is to provide data and trends to help boards in their decision-making around executive compensation," Enos explains.

"Consultants can say to boards, 'Here's what executives at this level are making in the market,' But no matter how good the data might be, what ultimately matters is the board's judgment as to what is right and fair for their firm. The consultant also should be advising the board in developing programs that will be effective and responsible."

*The bottom line:* Don't be a slave to the data. "Don't get stuck thinking that you have to set pay to a specific percentile. The market may show one thing, but you have to do what is best for your particular business," Enos advises. And one way to do that is to tie pay to executive performance. In determining pay, other issues to consider are:

- The importance of the job to the company (How "mission critical" is the position?)
- The amount of experience the executive has in his or her role

- The level and quantity of job responsibilities (Enos points out that some jobs are not typical in the marketplace. For example, an executive at your company may be playing dual roles as both General Manager and Chief Operating Officer.)

**9. Internal equity.** It's not a good strategy to ignore the market, since executives are savvy enough to keep abreast of how their peers are being compensated by reading proxy statements, Enos warns. "Some firms that are looking at the relationships of equity within their companies set up a guideline—or ceiling—to determine at what multiple of a front-line employee's pay an executive's pay may be set.

"This is all well and good, but if the executive's peers in the market have significantly higher earnings—and executives can find this out very easily

by simply looking at proxy data—firms run the risk of losing top talent."

**10. Fairness.** This is the "How much is too much?" question. "CEO pay can be hundreds of times that of the company's median worker," Enos points out. Based on such data, a lot of people will conclude that CEOs are way overpaid.

"It's difficult to answer the question of how much pay is too much for a particular executive. There have been some examples of egregious pay practices. But what shareholders really are looking for is a strong correlation between pay and performance. If companies did a better job making sure that executives were rewarded appropriately for meaningful performance, there would be far less controversy." □

---

*Mike Enos is Vice President at Pearl Meyer & Partners ([www.pearlmeyer.com](http://www.pearlmeyer.com)).*

This article was originally published in *IOMA's Complete Guide to Best Practices in Pay-for-Performance, v. 11.07*, and is republished here with the express written permission of IOMA. © 2007. Further use of, electronic distribution or reproduction of this material, unless specified in a copyright agreement, requires the permission of IOMA. For more information about IOMA or to subscribe to any IOMA publication, go to [www.ioma.com](http://www.ioma.com). For information about copyright permissions or any other form of content license, please call Jonathan Wentworth-Ping at 212-576-8741, or e-mail: [jpings@ioma.com](mailto:jpings@ioma.com)