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## CEO Pay Unrestrained by 'Good Governance' Push

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The string of corporate scandals and subsequent rash of reforms induced many companies to publicly embrace "good governance" practices. But few have taken the most essential step: cutting executive compensation.

In fact, in 2003 the median payout to CEOs in the **S&P 500** jumped 27% from 2002 to \$4.6 million, according to The Corporate Library (or TCL), a governance research firm. And though some companies have curbed stock-option awards, extra salary, bonuses and other stock awards have more than made up for those cutbacks.

For example, the median value of restricted stock granted to S&P 500 CEOs jumped 32% last year vs. 2002, according to Equilar, a compensation consultancy. Payouts under other types of long-term incentive plans rose 49% in 2003, and cash bonuses were up 19%.

In 2003, executive pay rose largely in tandem with the S&P 500, which jumped 26%. But the index's rally followed three years of sharply negative returns, a decline not matched by CEO salaries. According to TCL, CEO salaries went up about 11% in 2002, while the S&P 500 fell 23%.

"The fact that the market recovered somewhat has been a green flag to say, 'OK guys, it's payday again,'" said Paul Hodgson, a senior research associate at TCL.

Dick Grasso's \$139.5 million pay package from the **New York Stock Exchange** is the most notorious payout in recent years. But at least Grasso could point to a successful track record of managing the exchange.

Harder to defend are the still-lavish compensation packages when companies and executives perform poorly. After recent proxy filings, companies that caught the eye of corporate watchdogs for having pay out of sync with performance included:

- **Viacom** (VIA.B:NYSE) , which paid Chairman and CEO Sumner Redstone \$35.5 million last year, a 4% raise from the year before even though the company's operating profits fell 21% in 2003 and its stock price underperformed both peers and the broader market.
- **SBC Communications** (SBC:NYSE) , where Chairman Ed Whitacre received \$24.8 million last year -- a 20% year-over-year raise -- despite the fact that the company's operating profits declined 25% and its stock fell 4%.
- **Bear Stearns** (BSC:NYSE) , which paid James Cayne \$39.3 million last fiscal year, up 32% from the year before, even as the company's stock underperformed many of its peers.

These companies joined chronic offenders such as **PeopleSoft** (PSFT:Nasdaq) and **Computer**

## Associates (CA:NYSE) .

In a recent report, proxy adviser Glass Lewis highlighted 25 companies in the S&P 500 that overpaid their executives. Last year on average, CEOs and top five executives of these firms received \$13.7 million and \$32.7 million, respectively. Simultaneously, those 25 companies saw an on-average drop in earnings per share of 57% and a negative 2% return on equity.

These packages often amount to a sizable portion of companies' finances. For example, the top five executives at **BMC Software** (BMC:NYSE) earned a combined \$27.8 million in fiscal 2003, a year in which the company posted net income of \$48 million.

Executive pay packages can sometimes turn company profits into losses. **Nortel** (NT:NYSE) , in the first quarter of last year, paid out some \$50 million in bonuses to executives as part of a "return to profitability" program.

But while the company's bottom line was in the black, it posted a loss from continuing operations; more troubling, last week Nortel said restatements would eliminate last year's surprising first-half profit for which those bonuses were paid.

Circumstances such as those at Nortel -- where executive pay rises amid poor or middling results -- trigger alarm bells for compensation experts. Few critics of CEO pay are calling for absolute pay caps. Instead, most want to ensure that executive pay is strongly tied to company performance.

Proxy adviser Institutional Shareholder Services, for instance, targets those executives whose pay has increased over the last three years while their companies' returns have declined. Meanwhile, Glass Lewis grades executive pay on a continuum. Companies whose executives were paid the most for the least amount of returns got "F's." Those whose executives were paid least for the greatest returns got "A's."

The top quartile of S&P 500 CEOs saw its pay rise 80% on average to \$9 million, last year vs. 2002, according to TCL. The firm's statistics on executive compensation include the actual "real world" gains generated by exercising options, not the estimated value of new stock options awards.

### Glass Lewis' Overpaid 25

Companies with the worst correlation between executive pay and corporate performance in fiscal 2003

Rank	Company	Top Five Pay*	Total Return**	Net Income (loss), in millions
1 (worst)	Applied Micro Circuits	\$13,152,482	-59%	\$(643)
2	Viacom	\$92,335,452	9%	\$1,435
3	Qwest	\$20,538,632	-14%	\$(1,313)
4	Computer Associates	\$30,303,846	-37%	\$(267)
5	Micron Technology	\$23,710,786	-17%	\$(1,280)
6	BMC Software	\$27,840,276	-22%	\$48
7	Allegheny Energy	\$12,779,639	69%	\$(334)
8	Schering-Plough	\$28,279,935	-19%	\$(92)
9	Sprint FON Group	\$52,629,303	18%	\$294

10	Visteon	\$11,518,054	55%	\$(1,213)
11	MedImmune	\$32,623,493	-7%	\$183
12	Tenet Healthcare	\$14,129,163	-2%	\$(1,404)
13	Raytheon	\$21,887,503	0%	\$535
14	Computer Sciences	\$39,845,169	-36%	\$440
15	Jones Apparel Group	\$25,489,074	0%	\$329
16	SBC Communications	\$42,231,561	2%	\$5,971
17	Delphi	\$14,850,558	31%	\$(56)
18	National Semiconductor	\$16,289,207	-19%	\$(33)
19	Compuware	\$11,911,682	-74%	\$103
20	Northrop Grumman	\$20,557,604	0%	\$808
21	Verizon Communications	\$40,770,277	-6%	\$3,509
22	AFLAC	\$24,310,171	21%	\$795
23	Bear Stearns	\$160,770,251	13%	\$1,156
24	Hartford Financial Services Group	\$19,066,260	33%	\$(91)
25	Norfolk Southern	\$18,961,779	20%	\$411
	<b>Median of group</b>	<b>\$23,710,786</b>	<b>0%</b>	<b>\$103</b>

\*The combined compensation of the company's top five most highly paid executives.

\*\*Total Return = annual stock price appreciation plus dividends.

Note: In calculating performance, Glass Lewis looked at earnings per share, return on assets, return of equity, stock price and change in book value, relative to a company's industry and market cap peers.

Source: Glass Lewis

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Meanwhile, CEOs are now paid about 300 times that of the average front-line worker, according to the American Federation of State, County and Municipal Employees. CEO pay has fallen since the late 1990s market boom but still dwarfs CEO compensation a generation ago and that of peers in Germany or Japan.

"This is the lingering, unsolved issue as far as corporate governance goes," said Pat McGurn, special counsel at proxy firm Institutional Shareholder Services. "Even when there's good performance, the packages are just excessive."

### **Perversity Leads to Reform**

Much of the bump in executive pay in the last two decades was the result of stock options. Loose accounting standards and favorable tax rules encouraged companies to issue options instead of paying cash or issuing other stock awards.

As executives' options awards grew steadily larger over the years, they often resulted in perverse payouts. In 1998, **Walt Disney** (DIS:NYSE) CEO Michael Eisner gained \$570 million by exercising

stock options -- an amount 760 times greater than his base salary of \$750,000 -- which were more than 25% of the company's net income that year and more than 10% of Disney's operating cash flow.

Worse yet, by rewarding short-term movements in stock prices, options may have encouraged the shortsighted and sometimes illegal actions that led to recent corporate scandals.

In the wake of such scandals and the concurrent stock market collapse, corporate reformers zeroed in on executive compensation, particularly stock options. A proposed accounting rule by the Financial Accounting Standards Board, or FASB, would require companies to begin expensing options next year. Governance and compensation experts expect that rule to lead most companies to either stop issuing options or to drastically downsize their awards.

Companies that have voluntarily chosen to expense stock options, such as **Amazon.com** (AMZN:Nasdaq) and **Microsoft** (MSFT:Nasdaq), have largely replaced options awards with restricted stock and other forms of compensation.

Reforms such as the Sarbanes-Oxley Act and new listing standards at the stock exchanges focus on encouraging boards of directors to do a better job of keeping shareholders' best interests in mind.

Additionally, shareholders and regulators are filing lawsuits seeking to recoup excess pay. Those lawsuits are targeting not only executives but also, as in the case of Dick Grasso, members of the compensation committees that rewarded them.

"Compensation is one of few tangible ways to evaluate the performance of a board," said Ann Yerger, deputy director of the Council of Institutional Investors. "When you see poor pay decisions, that's reflecting on the functioning of the board."

### **Reasonable Compensation**

Some boards seem to be listening to the reform movement.

Even though the expensing rule is not yet in force, many companies have scaled back their options awards. In its survey of S&P 500 companies, TCL found that the estimated value of the median options grant awarded last year fell 17.1% from 2002.

And according to Glass Lewis, some companies seem to be doing a good job of matching pay with performance. In its survey of CEO salaries, the proxy adviser assembled a list of the top 25 underpaid executives.

Among this group, a CEO on average received \$3.7 million in total compensation -- or about 27% of the average compensation of their top 25 overpaid peers. These executives saw their firms' earnings per share grow 58% last year on average and post a 24% return on equity.

### **Glass Lewis' Underpaid 25**

Companies with the best correlation between executive pay and corporate performance in fiscal 2003

<b>Rank</b>	<b>Company</b>	<b>Top Five Pay*</b>	<b>Total Return**</b>	<b>Net Income (loss), in millions</b>
1 (best)	Caremark Rx	\$6,867,574	56%	\$291

2	Public Service Enterprise Group	\$5,900,513	44%	\$852
3	Sealed Air	\$4,601,545	45%	\$240
4	Adobe Systems	\$4,781,747	38%	\$266
5	Coca-Cola	\$17,687,136	18%	\$4,347
6	Apache	\$7,810,249	50%	\$1,095
7	Altera	\$4,176,694	84%	\$155
8	Paccar	\$8,902,097	90%	\$527
9	Southwest Airlines	\$3,316,719	16%	\$442
10	United Parcel Service	\$5,941,538	20%	\$2,898
11	International Game Technology	\$16,517,581	64%	\$375
12	Family Dollar Stores	\$7,556,749	46%	\$247
13	Rockwell Collins	\$3,198,994	17%	\$258
14	ChevronTexaco	\$22,170,944	35%	\$7,426
15	Citrix Systems	\$8,088,073	72%	\$127
16	Synovus Financial	\$3,290,935	53%	\$389
17	Sigma-Aldrich	\$5,657,544	19%	\$190
18	Johnson & Johnson	\$23,697,317	-2%	\$7,197
19	Emerson Electric	\$9,801,028	24%	\$1,013
20	Genuine Parts	\$3,786,236	12%	\$354
21	Unocal	\$6,672,654	24%	\$710
22	Boston Scientific	\$16,054,202	73%	\$472
23	Fortune Brands	\$13,348,103	57%	\$579
24	3M	\$23,982,501	41%	\$2,403
25	Sears Roebuck	\$10,938,761	95%	\$3,397
	<b>Median of group</b>	<b>\$7,556,749</b>	<b>44%</b>	<b>\$472</b>

\*The combined compensation of the company's top five least highly paid executives.

\*\*Total Return = annual stock price appreciation plus dividends.

Note: In calculating performance, Glass Lewis looked at earnings per share, return on assets, return of equity, stock price and change in book value, relative to a company's industry and market cap peers.

Source: Glass Lewis

Some firms are making particularly bold strides in matching pay with performance.

- Last year, Microsoft moved to expense stock options, a virtual lone act by a technology company at the time. Instead of posting big options charges, the company has moved away from awarding options to giving out restricted stock to its executives and employees.
- **General Electric (GE:NYSE)** revamped executive pay packages last year, decreasing the amount of stock options it hands out, in favor of restricted stock and other forms of stock-based compensation. For CEO Jeff Immelt, GE replaced stock options and restricted stock with performance share units, a type of stock-based compensation that Immelt will receive only if the company meets specific stock price and operating targets.

- **IBM** (IBM:NYSE) has begun to award top executives options that have a strike price 10% higher than the market price. In other words, IBM's stock would have to rise 10% before the executives' options are in the money.

Other forms of compensation that Microsoft, GE and IBM are using to replace traditional stock options include restricted stock, premium-priced options and performance share units, which reward shares of stock to executives who meet specific performance targets.

Despite the pressure and scrutiny, companies still may be able to avoid radically changing how they pay executives. Opponents of options expensing are fighting a bitter battle against the FASB proposal.

Likewise, the outcome of the proxy access skirmish is still in doubt. In the interim, instead of scaling back CEO pay, most companies seem to have simply shifted from options to other forms of compensation.

"The campaign to rein in executive pay has missed the boat," said TCL's Hodgson. " [Investors] had a chance when the markets were bad and people were not making any money. But CEO pay didn't seem to go down very much, if at all."

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