

COMPLIANCE WEEK

How To Say What You Mean On Pay

By Melissa Klein Aguilar — February 6, 2007

With everyone from the president on down to the smallest shareholder these days demanding that executive pay be pegged more closely to corporate performance, scrutiny of just how boardroom directors forge those ties is likely to reach new heights this spring.

Shareholders have already filed more than 40 proposals seeking to link executive compensation to performance, versus 17 that came to a vote in 2006. Critics of Corporate America such as U.S. Rep. Barney Frank, chairman of the House Financial Services Committee, strongly favor the idea. Even President George W. Bush just last week urged that “the salaries and bonuses of CEOs should be based on their success at improving their companies and bringing value to their shareholders.”



“Outside of the boardroom, the general impression is there’s a problem with performance pay and it needs fixing,” says Paul Hodgson, senior research associate at The Corporate Library.

Governance activists want companies to provide more and better information on how they tie pay to performance, including the metrics they use. In a report issued in January, the Florida State Board of Administration, which oversees that state’s pension investments, called on companies to provide better disclosure around the specific metrics used to assess executives’ eligibility for performance-based compensation.

The Florida SBA said the disclosure of plan metrics, performance periods, and company and external shareholder-wealth targets “are critical to investors’ ability to understand and evaluate what behaviors are being encouraged, and whether the company is actually using a pay-for-performance plan.”

Yet, the SBA continued, few companies clearly disclose such information. “After reviewing hundreds of U.S. companies’ compensation plans, we have repeatedly seen laundry lists of performance measures that seem to allow overly wide discretion to compensation committees and represent dubious links to performance,” the board wrote in its 34-page report.

Among other things, the SBA called on companies to identify each metric to be used, rather than using lists of multiple metrics that may or may not be used to; to define each metric sufficiently so shareowners know the explicit metric being used; to disclose the percentage weights of each metric if more than one is used; to reveal the explicit thresholds for each performance measure; and to attribute the portion (as a percentage) of the compensation

RELATED RESOURCES

-  [Florida SBA's Executive Compensation Review](#)
-  [Intel's 2006 Proxy Statement \(March 28, 2006\)](#)
-  [Motorola's 2006 Proxy Statement \(March 10, 2006\)](#)
-  [TCF Financial Corp.'s 2006 Proxy Statement \(March 8, 2006\)](#)

Related Coverage

-  [New SEC Guidance On Pay Disclosure Rule \(Jan. 30, 2007\)](#)
-  [Pay Issues Top List Of Shareholder Concerns \(Jan. 30, 2007\)](#)
-  [SEC Comp Rule Change Reboots Proxy Work \(Jan. 9, 2007\)](#)
-  [Compliance In 2007: Implementing 2006 \(Jan. 3, 2007\)](#)
-  [In Wake Of Comp Rule, Perks In Crosshairs \(Nov. 7, 2006\)](#)
-  [Some Companies Embracing SEC Pay Proposals Now](#)

plan that is categorized as commercially confidential, upon which disclosure of performance objectives isn't currently made. The report also includes a list of pay-for-performance metrics it says companies should consider. (March 7, 2006)

While there are companies using some of the "more sophisticated value-add measures," Hodgson says, "There are too many companies using only short-term operational metrics like revenue and earnings per share."

"There are no bad measurements really, but some are appropriate for certain industries or companies at certain points in their economic development," he says. For example, stock price or revenue are often the primary measures used by startup companies. "But a lot of companies never progress beyond that and they're using the same measures 40 years later."

Hodgson says an incentive plan should include "some sort of economic value-added measure," a metric devised by Stern Stewart & Co. that measures net operating profit minus the cost of all capital. However, he notes that it can be a complicated calculation, since there are "all sorts of ways" of measuring the cost of capital. "The rest depends on the strategic plan of the company and what it's trying to do," says Hodgson.

Indeed, all of the experts who spoke to Compliance Week agree that an appropriate pay-for-performance formula will vary from industry to industry and company to company. "Just as companies don't have [the] same business plan, they shouldn't have the same incentive plan," says Paula Todd, managing principal at compensation consulting firm Towers Perrin. "There are a lot of ways to skin that cat. The challenge is finding the best fit for a company."

Experts also agree that companies should tie performance pay to more than one metric. "If you only have a single metric, it's easier for management to manipulate the results so they hit that target all of the time," Hodgson says. "A system of checks and balance[s] makes sense in politics, and it also makes sense in executive pay."

Evolving Toward Sophisticated Plans

Irv Becker, of the compensation consulting firm Hay Group, says the design of pay-for-performance programs is changing, thanks to new rules for accounting for stock options. Because options now must be fully expensed under Financial Accounting Standard No. 123R, *Share-Based Payment*, he says, more companies are moving toward performance-vested equity plans.



"Performance-vested equity plans were never really considered because they had bad accounting results under the old rules," Becker contends. "FAS123R created a level playing field for different forms of equity. That's having an impact on compensation plan design and on the performance metrics being used for performance share plans."

Becker Todd agrees that compensation committees are moving "away from the world where stock options are the be-all and only long-term incentives ... companies realize that they can't do everything."

Becker says more companies may turn to non-market-driven metrics, such as EPS, return on capital, or return on equity. In such long-term performance-share plans using those metrics, no compensation is delivered if the goal is not met, and the company can reverse the expense of the grant.

Still, he says, total shareholder return remains the most widely used metric for performance-share plans. "Some compensation committees take the position that TSR is the ultimate metric of success for

shareholders,” Becker says. “If compensation committees believe TSR is the right metric, they won’t let the accounting drive the answer.”



Todd says she sees companies crafting steady diets of long-term incentives where executives get two or three types of compensation, usually some combination of options, performance shares, and restricted stock. “That allows companies to more finely craft the totality of their long-term incentives,” she says.

Todd While some companies have moved to indexed stock options, where the strike price moves up or down depending on based on the performance of a peer group of companies, Todd says there are “practical problems” with the execution of indexed stock options, “so they’re not common.”

Generally, Todd says, companies should choose two to four measures that “capture the bulk of what they care about, and balance them so there’s no chance that executives are going to exploit one at the expense of the others.”

Todd also recommends including “circuit breakers” in pay-for-performance plans to prevent undeserved windfalls. For example, a provision might state that even if the company hits its other goals, if return on equity doesn’t hit a certain level, the plan doesn’t pay out.

Alexander Cwirko-Godycki, senior analyst at compensation research firm Equilar, says the most commonly used measures relate to total shareholder return, earnings per share, revenue, and net income—but they are only the tip of the iceberg. “There are hundreds of metrics companies use,” he says. “Different metrics guide people in different directions.”

Cwirko-Godycki says more companies are measuring performance relative to their peers, but doing so can bring “administrative difficulties,” since peer groups can change during the year as companies merge and new companies enter the market.

He cites the 2006 proxy statement of three companies as some examples of good disclosures of pay-for-performance strategy: Motorola, TCF Financial Corp., and Intel Corp. For links to those companies proxy statements, see the box, above right. “The disclosures clearly show how the companies chose the metrics used and what they’re trying to achieve,” Cwirko-Godycki says.



Jesse Fried, a law professor at the University of California at Berkeley, says there are several things most firms can do to tie pay to long-term shareholder value. He suggests that companies should require executives to hold a large portion of their equity-based incentives for a significant period of time—ideally, until after they retire. Second, companies should avoid short-term metrics, especially ones that are easily manipulated, “like short-term earnings, which executives

PAY RATES

Pay-for-performance metrics recommended by the Florida State Board of Administration:

- Return on equity
- Return on assets
- Return on capital/return on capital employed
- Return on invested/average capital
- Economic profit
- Shareholder value added
- Cash value added
- Economic value added
- Internal rates of return
- Sales, revenue, earnings or cash flow (using target amounts or growth rates)
- Division, group or corporate business objectives (e.g., operating margins targets)

Source

 [Perspectives On Executive Compensation Florida SBA; January 2007\)](#)

Fried can increase by doing things that reduce long-term shareholder value.” To the extent executives are permitted to sell stock, Fried says boards should require them to unwind the shares according to a fixed schedule.

He also says the amount of any severance payment should be reduced over time. “Severance payments are meant to protect newly hired CEOs from the risk that things will not work out in the short-run, and the CEOs will be required to look elsewhere for work,” Fried says. “Thus, there is no need to provide severance payments to long-serving executives.”

Finally, he says boards should resist giving CEOs retirement packages, which he says don’t tie pay to performance: “Wealthy executives don’t need them for financial security.” ■

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