EXECUTIVE COMPENSATION

Another Chance for the SEC to Get Pay for Performance Right

The Dodd-Frank bill contains two new disclosure requirements regarding executive pay: the ratio between the CEO's compensation and that of the median employee, and the relationship between compensation actually "paid" to executives and company stock performance.

The new pay ratio is flawed on many fronts: it ignores organizational scope and size, it can be biased by outsourcing lower-paid work, it ignores the inordinately large role of benefits in the pay of lower level employees, and most importantly, it ignores the differences between guaranteed compensation and the risk inherent in equity based pay.

In contrast, the disclosure of pay in relation to performance has the potential to present a true picture of executive pay from which shareholders and the public can draw meaningful comparisons. The key is how the SEC eventually defines "pay".

The Amounts Shown In The Summary Compensation Table Are Not Pay.

Disclosure of executive pay has vastly improved over the last two decades. We now have accurate data on all the relevant components of compensation. While this data is extremely useful in designing competitive pay opportunities, the current required format does not show what executives actually earn—or how that pay might relate to company performance.

Cash bonuses are typically paid for financial performance versus targets, rather than for shareholder gain. Presumably, the cash payment relates to drivers ultimately reflected in stock price, but not necessarily reflected in the current year stock price.

For most executives, the largest portion of their reported pay is the disclosed value of stock awards. For performance based stock, the disclosed value is a "target" value on the date awarded. It does not reflect the actual number of shares earned or the realized value of the stock over the requisite holding period. Similarly, options awards are shown as the expected value from a probability distribution, not the actual realized gains.

These valuations were never intended to represent the actual value the executive would receive, and were only intended to satisfy the accounting world. Consequently, using current proxy data to explain the link between pay and performance is like using a baseball slugger's "at bat" statistics to explain the team's won/loss percentage.

The Best Comparison Comes From a Multi-Year View of Realizable Pay.

To best evaluate board decisions regarding pay and to test the overall alignment of executive pay to investor gains, one must compare the value actually realized by the executive to the returns of investors. For this purpose we look at the cumulative salary and cash bonuses received over a multi-year period (e.g., five years) plus the ending-period value of actual stock awards granted, stock acquired from previous awards, and embedded option gains (e.g., the paper profits).

Such pay comparisons are extremely important when evaluating the relative wisdom of a board and their executive pay decisions. By looking at the cumulative effect of decisions over a 5 year period—perhaps the shortest time period when executive effectiveness can be reasonably assessed—management and the Board can more effectively establish for investors the degree of alignment between executive rewards, business strategy and shareholder gains.

The data required to perform these calculations are readily available through existing public company disclosure in proxy statements, related SEC filings, and commercial data sources. The general public could produce these calculations; however, use of multiple data sources and obscure reporting rules makes it difficult and time consuming.

Our investor and board clients have found this longer-term pay comparison to be an extremely effective tool for understanding the compounding effect of compensation decisions over time, and as an aid in calibrating prospective equity and cash incentive decisions. Perhaps more importantly, the analysis serves to bridge the communications gap between investors, the board and executive management by simplifying pay arrangements in terms everyone can easily grasp.

Conclusion. Much of the public's understanding (or misunderstanding) of executive pay is driven by the annualized and hypothetical values disclosed in proxies. Regrettably, the format of the SEC disclosure also shapes how many boards make annual executive compensation decisions. The SEC will not release new rules until the second quarter of 2011, but regardless of the reporting form eventually chosen by the SEC, forward thinking Boards should supplement their CD&A disclosure with a true pay for performance analysis such as that presented above. For most boards this can convey a critical story line for investors wanting to understand how and why executives are rewarded.

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