Executive Compensation:
A New Solution to an Old Problem

Contrary to media "noise," the issue of executive compensation is not a modern dilemma: economist Adam Smith analyzed it more than 200 years ago. Weak boards, dispersed ownership and an ill-informed financial community all contribute to the problem. But is there a solution?

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Summary

How do leaders ensure compensation is aligned to long-term value creation? FTI's Charles Diamond says executive compensation and governance must better align incentives in ways that reduce opportunism at all levels.

Illustrations: Superstock/John Holcroft

"CEOs, and in many cases, directors, have long benefited from oversized financial carrots; some meaningful sticks now need to be part of their employment picture as well."

Warren Buffett,
Berkshire Hathaway
Annual Letter to Shareholders, 2010

Executive compensation has become a hot button in the media and in Washington. It is easy to see why: the deep economic recession, with its links to giant financial institutions, recent CEO scandals and distribution of government bailout money, has been a big story.

Executive compensation does not simply mean base salary; it is the total remuneration an upper-level manager receives in a corporation. This typically includes benefits such as bonuses, deferred and restricted stock, vesting periods, pensions and perquisites, as well as terms of employment including performance metrics, clawback provisions, and golden parachutes.

A Real Opportunity to Improve Incentives

Today's situation risks more than bad public relations for public companies: there is a danger of missing out on an opportunity to improve incentives for top managers to increase the long-term value of their enterprises. Taking advantage of this opportunity has major ramifications not only for corporate stakeholders, but for society in general, as it has the potential to create more productive, durable, and valuable companies.

There is a real need to bring a dispassionate analysis to executive compensation and go beyond the superficial caricatures of unbridled greed. Economics can help by shining a light on the purpose of a corporate form of organization and the costs and benefits of comparative mechanisms for aligning executives' behavior with shareholders and the broader stakeholder community. Keep in mind that well-constructed executive compensation packages are necessary but not sufficient for long-term value creation.

Recognize the Objective

What is the goal of a corporation? Maximizing the long-term total enterprise value of the firm has long been understood as the chief corporate mission. Simply put, this means expanding the organization's market reach or improving real productive capacity. Establishing a culture of long-term value creation entails gaining the loyalty and commitment of all constituencies, including employees, suppliers, and the wider community. The key challenge for management is to create the corporate vision, strategy, and tactics to unite and guide all constituents. So much depends on the stock of trust and flow of honest information.

Aligning Interests

A corporation needs to ensure that executive leaders' incentives are aligned with shareholder interest in long-term value creation. Unlike owner-managers of small firms, executives at large enterprises often have only a small portion of their own equity at stake. However, this disparity leads to a gap in their interest as the "agent" looking after the interest of the "principals" (e.g. shareholders and debtholders). What's more, they have an information advantage over principals, which can give rise to a serious conflict of interests and accountability problems. The economics of principals and agents helps organize thinking about how the structure of the CEO's compensation will affect managerial behavior in pursuit of the objectives of the firm's various stakeholders.

The principal-agent relationship is difficult and costly to maintain effectively over the long run, which means it is critical to take advantage of alternative alignment forces and mechanisms such as government regulation to monitor against fraud and accounting manipulation. In addition, the market for corporate control offers outside active investors and strategic companies a way to act as a disciplinary force against managers who do not maximize the value of their firms and stray too far from their shareholders' interests. But recent events suggest that this discipline has limitations, especially in the recent era of overvalued equity.

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The Role of Corporate Governance

Corporate governance is a mechanism for aligning principal-agent interests and incentives, encouraging accountability. How does it accomplish this? Corporate governance seeks to reconcile the relationships among the CEO, board members, stockholders, and the outside financial community of analysts, bondholders, and other creditors by clearly assigning responsibilities, measuring performance, and rewarding or penalizing managers in line with their impact on the firm's long-term value creation.

There are some convincing examples that the *sine qua non* of a well-run, healthy company is effective coordination of the terms of executive compensation with the corporate governance function: rules, monitoring, and other incentives promoting effective relationships among important constituencies. Corporate governance, in theory at least, serves as a kind of "check and balance" for a corporation to ensure that executive compensation packages attract and retain the right people, hasten the departure of the wrong people, and provide incentives for high performance.

Dealing With Short-Termism

A significant part of the problem in executive compensation can be traced to how compensation packages evolved and became more closely tied to short-term stock prices. For example, pay plans have tended to move away from using fixed salaries. Compensation plans are now concentrated in stock options. And deferred stock and stock purchase options, which tend to vest over short time periods, are common. Moreover, options are typically tied to short-run publicly traded stock prices. The table overleaf shows the recent trend of executive compensation increasing in the form of equity. Of course, CEOs are supposed to be paid for performance, but this shift in the make-up of compensation packages has led to some unexpected consequences: it has skewed managerial decisions to favor the short term and created a marketplace hothouse of overvalued equity.

The introduction of stock options and restricted stock grants with such features as short-term vesting periods seemed to be the panacea for aligning shareholder and manager interests. Equity compensation soon evolved into the greatest portion of total executive compensation. Simultaneously, its growth facilitated a climate where information became less reliable, although superficially more plentiful, making it increasingly difficult for analysts or investors to make reliable decisions – for example, financial analysts underestimated Microsoft's quarterly earnings 41 out of 42 times, according to an SEC investigation and cease and desist order in 2002.

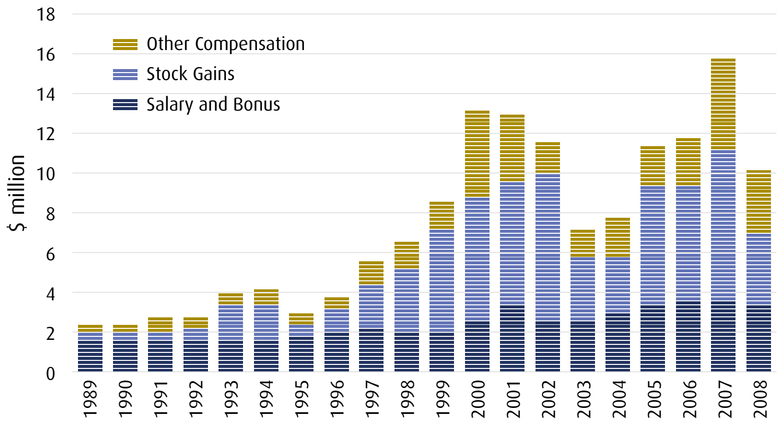
Imagine the CEO of an international engineering and construction company wrestling with whether to bite the bullet and overhaul the firm's engineering software and invest in an even more costly three-year employee training program. If implemented, the costs of the investment could impact earnings and the company's share price, affecting the CEO's various stock options and restricted stock share over the next three years. Delaying the investment may benefit the value of the CEO's personal stock options, but the longer he waits, the greater the decline in long-term company and shareholder value as his engineers continue to fall behind.

Linking Compensation and Corporate Governance

So, what can this analysis tell us about the present controversy over executive pay packages? Is the controversy symptomatic of a real problem, or an unfortunate matter of timing and appearances? What is clear is that executive compensation and corporate governance are inextricably linked and substantial effort and cost are required to better align incentives and reduce opportunism of all corporate stakeholders – top executives, board chairs and members, stockholders, debtholders – and the financial community.

The seminal idea behind the use of restricted stock grants and stock options was to enhance the performance of managers, or make

Evolution of Compensation Packages: CEO Pay



Compensation Data Based on *Forbes* Magazine's Annual Survey (2007 Constant Dollars)

"pay for performance" a reality in the corporate world. But the situation was still far removed from the ideal of all responsibility and the fruits of performance concentrated in the owner-manager. Granting stock options or restricted stock shares that vested quickly or over short time-horizons contributed nothing toward managers having "skin in the game." (Private equity, hedge funds, LBOs and other similar entities have largely solved the "skin in the game" problem in the way that managing partners are compensated.)

It soon became clear that grants of stock options and restricted stock were not free of cost to companies and were

also failing to have the desired effect of making top management more vested in companies' long-term goals. In response, a number of corporations began to require CEOs to purchase and hold stock with after-tax dollars or variants with similar effects. Some companies that exchanged cash bonuses, grants of options or restricted stock for their longer-term equivalents include ADC Telecommunications, Arkla, Avon, Baxter, Black & Decker, Clorox, EKCO and General Mills. FTI Consulting will be monitoring the performance of these companies and others that adopt similar compensation strategies over the coming years.

There are other examples of large corporations changing the way in which they incentivize their leading talent. The CEO and COO of fuel wholesaler World Fuel Services have introduced compensation plans with equity grants that vest only after five years or more and the CEO is reported by Forbes.com to have two-thirds of his personal wealth tied up in stock in the company. Meanwhile, energy holding company PG&E Corporation uses an earnings-per-share hurdle to set its bonus for its CEO. To receive the full amount, the CEO must also meet customer and employee satisfaction targets.

The president of upscale retailer Nordstrom, who happens to be a descendant of the company's founder, receives a portion of pay in performance shares that vest three years after they are granted and only if total shareholder return is positive and above the average among retail peers. His shareholdings in his company have an approximate worth of $60 million.

Changing Corporate Culture

Building a culture of responsibility and accountability is essential to address issues around executive compensation. Greater transparency and credible, independent checks and balances are the minimum requirements to regain shareholder and broader stakeholder trust. Companies should also put in place a system that identifies potential conflicts of interests and implements countervailing measures. These include:

- Avoid the inherent risk of hiring the same compensation firm for the rank-and-file employees and the CEO or other top managers.
- Implement a set of measures to monitor accounting and other reporting practices that suggest weaknesses in corporate governance.
- Do not provide multi-period compensation packages.
- Carefully monitor CEO and financial analyst relationships.
- Establish an independent compensation committee composed of board members without CEO participation.
- Commission financial analysis of compensation packages with alternative scenarios and expected outcomes in terms of attraction, separation, and incentives.
- Limit to only the CEO and certain top executives the grant of options and deferred stock, and with these, make every effort to establish true estimates of costs to the company and their impact on the CEO and firm value.

As a critical component of corporate governance, executive compensation must constantly strive to align the incentives of top managers with shareholders and broader stakeholders. As the value added by management is difficult and costly to measure, monitor and verify, this is a complex and challenging undertaking for which much is at stake.

Clearly, ensuring effective measurement and monitoring of the value added by top management is complex and costly but, equally, it is essential for protecting stakeholders and increasing long-term total enterprise value of the firm.

COMMUNICATING EXECUTIVE COMPENSATION

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Each year during proxy season, certain company executives and directors wince in anticipation of publicly disclosing executive compensation. For the majority of workers, pay and benefits are a private matter between them and their employers, but financial regulators require full disclosure of the compensation of key leaders.

For the companies affected, this is one of the more challenging moments of the year. Compensation practices signal to the marketplace what companies do to reward and retain talent, as well as align financial incentives with corporate performance. However, in the media "executive compensation" is often equated with "greed," so how does a company release this information and expect anything but bad publicity?

There are two key guideposts to keep in mind. The first surrounds the transparency of the process and the benchmarks used to set compensation. For the most part, corporate boards use painstaking care in setting executive compensation. However, when communicating these packages, boards need to put themselves in the shoes of the employee, the customer, the investor, and the regulator. If one of these people read the numbers would they make sense? How are you disclosing the process used to arrive at the numbers? How is it related to compensation policies for all employees? Were benchmarks used? What discretion does the board have if the executive over-achieves or under-achieves?

Being able to answer these questions succinctly, either as part of the executive compensation disclosure or in answer to questions addressed to management or the board, is critical.

The second surrounds how a company communicates throughout the year. Executive compensation disclosure is an important moment and says a lot about how a company operates, but it is just one of the occasions when a company communicates. From our research, much of what concerns key stakeholders is a lack of clarity about long-term corporate vision, business objectives and key milestones. Without this critical context, there is a significant risk that issues such as compensation are perceived as arbitrary or even irresponsible. Moreover, with the economic crisis only now beginning to fade, executive compensation remains a hot issue in the media and with policy makers. Management and the board must examine the ways in which they publicly lay out their long-term goals and objectives so they are understood by all stakeholders, and fit yearly compensation into that framework. Lastly, management must communicate regularly with its key stakeholders to ensure that messages are understood.

There is no easy way to satisfy every critic. But by articulating what goes into deciding corporate practices, the board and management can make the case for the investment in leadership.

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