From the Editor

Populism, Process, and Transparency: The Missing Link in Executive Pay

Do top executives earn their keep? Senior executives get paid a lot, but that does not necessarily translate into being overpaid. The real litmus test of worth is whether performance in a job has generated sufficient corporate value, as measured by share price, profitability, and avoidance of major disasters, to justify the paycheck. Astonishingly, largely missing in the tumult over executive compensation is a cost-benefit analysis that would reveal whether shareholders are getting their moneys' worth.

Historically, senior managers have always earned the top dollars in any organization, on the principle that the quality of management can make all the difference between corporate riches or financial ruin. What has changed over the years is critical thinking on just *how* executives should be paid. A few decades back, compensation and management experts advised corporate boards to keep their executives disinterested from the interests of shareholder. Equity-based compensation was considered anathema, because awarding stock to executives might jeopardize their objectivities and long-term outlooks by focusing their financial interests on stock price movements. The standard executive pay package consisted of salary, bonus, and a few perks.

That all changed starting in the late 1970s and early 1980s when thinking shifted to the idea that investors would fare better if the management's interests were aligned with shareholders by having some "skin in the game." Initially, boards provided executives with a piece of the action primarily through grants of restricted stock. Over time, however, there was growing criticism that such full-value awards were overly generous because executives profited even when stock prices declined. The focus shifted to stock options, providing gains to executives only when shareholders' investments also grew as a result of rising share prices. Options also offered the major advantage of no-cost accounting and soon surpassed restricted stock as the primary vehicle for providing executives with corporate equities.

At the same time, the 80s M&A boom led boards to add golden parachutes to the mix as an incentive to executives to support a proposed takeover if it was in the best financial interests of shareholders, rather than fighting any and all bids to preserve their own jobs. Moreover, the longest bull market in US history spawned previously unheard of and, in the eyes of many critics, outsized gains by senior executives cashing in their equities.

Concerned with how corporate boards were setting pay levels and revelations of abusive compensation practices, Congress jumped into

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the act. The unintended result: a surge in compensation levels following each new round of legislation.

> Phase one: starting in 1984, Internal Revenue Code (IRC) Section 280G imposed an excise tax on golden parachutes in excess of three times average pay. Within a short time, severance pay of 2.99 times average compensation became the *minimum* standard, and boards additionally granted gross-ups to top executives to cover the cost of the new excise tax.
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> Phase two: starting in 1994, IRC Section 162(m) penalized companies for providing executives with non-performance-based pay in excess of $1 million. Predictably, $1 million in base pay soon became the new minimum wage for CEOs and incentives such as stock options and equity awards became *de rigueur*.
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> Phase three: starting last year, IRC Section 409A imposes new penalties for violations of a broad array of complex new rules affecting deferred compensation vehicles. It is too soon to know the impact of this latest legislative attempt to rein in executive pay, but if history is any guide, it also will boomerang.

The sharp rise in executive pay levels of the past decade is well-documented. A recent study by professors Lucian Bebchuk and Yaniv Grinstein (of Harvard and Cornell, respectively) revealed that the top five executives at the largest 1,500 public companies took home $122 billion during the 1999 thru 2003 period—a two-fold increase over the previous five years. Over the ten-year period ending in 2003, compensation for the average CEO of an S&P 500 company soared from $3.7 million to $9.1 million. (All amounts are in 2002 dollars and exclude the value of retirement pay.) The same study showed that only 40 percent of the increase in pay was attributable to growth in corporate size (given that larger companies are harder to run) or improvement in company profits. The remaining 60 percent could not be explained by any measure of objective performance.

Ignoring populist outcry over fairness (please), it is very clear that executive pay has been taking a significant bite out of profits. The same academic study showed that in the three years ending in 2003, compensation for the top five corporate executives amounted to nearly 10 percent of aggregate corporate after-tax profits—double the level of a decade earlier.

Because Congress has been unable to "protect" shareholders from super sized compensation levels through the tax code, the focus has shifted to reforming the process through which executive compensation programs are approved. Critics are questioning exactly how boards go about deciding the structure and level of executive compensation. Are members truly independent of management? Is the

compensation-setting process transparent? Is the final package based on "pay for performance" or "pay for pulse"? Enter the Securities and Exchange Commission (SEC).

The SEC's first overhaul of disclosure rules in well over a decade will (when finalized) require public companies to disclose to shareholders a single, total compensation value for the CEO, CFO and their three highest-paid colleagues. Included in the total will be standardized values for option and equity awards, the value of perks above $10,000, and detailed information on the price tag for retirement and other post termination benefits and deferrals and deemed income on deferred compensation. Additionally, the board's compensation committee will have to issue an annual compensation and analysis report that explains in "plain English"—no boilerplate—their compensation philosophy. The SEC has made a point of stating publicly that its intent is not to set executive pay levels but to make it easier for investors to understand and evaluate complex compensation programs for themselves. SEC Chairman Christopher Cox describes it as "wage clarity, not wage controls."

Will the new rules have a positive effect? Perhaps, it is hard to imagine how providing more compensation information to investors could be harmful. More widespread use of tally sheets will make it easier for outsiders to analyze and compare executive salaries with the caveat that the pay levels reported annually will gyrate with extraneous factors like stock prices, performance cycles, and interest rates. To be sure the tabloids are sure to have a field day listing the gory details of the most outrageous-sounding packages. Legal and consulting fees will certainly increase. Companies, concerned about optics, may shy from flashy executive perks like courtside sport tickets and country club memberships. It's likely that many executives will simply be compensated for the value of those lost perks through other, more politically correct forms of compensation. Improved disclosure also will make it easier for executives to measure themselves against the pay provided to their peers at other firms and, if they fall on the wrong side of the top quartile, to lobby their boards for a raise.

Still, disclosure does not go to the heart of the matter: what is an appropriate level of compensation for a top executive? For years, companies have hired compensation consultants to help them determine how much, and in what form, to pay the top brass. The consultants' responsibilities, however, are most often limited to researching and reporting to directors on the market rate of pay for leading executives at comparable companies. What is missing is a cost-benefits analysis: would the company be just as well-off hiring a somewhat less experienced or well-known chief, possibly sacrificing some performance but coming out ahead? In other words, if the executive is not adding value, then it is time for a pay cut or a new CEO. If he or she is adding value, however, then smile and sign the check.

There are reams of data and established methodologies for deciding whether to build a factory, relocate a distribution center, or invest in research and development. What is needed is a similarly rigorous quantitative approach to setting executive pay at public companies. Money managers, investment bankers, and venture capitalists routinely make such judgments when deciding how and how much to pay the top brass at privately help companies. Why not apply the same analysis to public companies?

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Due to a printer's error, the IRS Update column in the Spring issue was missing its last two pages. We apologize for any inconvenience and are rerunning the column in its entirety starting on page 102.