

The Devil is

in the
Details

Analytical Pitfalls in Executive
Compensation Benchmarking

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be considered when reviewing compensation surveys:

- Do the survey participants include direct peer companies, competitors or appropriate comparison firms?
- Is necessary data reported (e.g., salary, bonus and long-term incentives)?
- Are relevant data cuts available?

For this case, surveys A and D in Figure 1 are strong choices because they have relevant participants and data cuts. They report salary, bonus and long-term incentive data. Survey B may be useful if the appropriate industry cut has relevant peer companies. This survey also may be useful for benchmarking executive positions where industry experience is not critical. Survey C is less ideal. These participants are smaller startups. The survey lacks long-term incentive data but may be useful if one of the executives in the study heads a

startup or Internet division.

Other issues to keep in mind when using compensation surveys include:

- Carefully review the survey methodology, especially with regard to long-term incentive values. Different surveys use different valuation methodologies.
- Use multiple survey sources (three per position is ideal) to verify the sources against one another.

Case 3: Blending Proxy and Survey Data

You are benchmarking executive compensation levels for a public company with \$4 billion in revenues. Use the survey and proxy data (20 peers) in Figure 2 to make your judgement. How would you blend the data together to arrive at competitive compensation levels?

Several pitfalls can arise when combining proxy and survey data — overweighting proxy data for positions that are frequently

not in the top-five highest-paid, using survey or proxy data that are outliers relative to other sources and overweighting sources with a small sample size.

For this case, all data sources for the chief financial officer position look reasonable — the data is consistent and large enough sample sizes are available. Because all survey sources are reasonable, they can be weighted equally for this position.

However, this is not the case for the general counsel position. Survey 1 has only five organizations reporting while 10 or more is preferable, and the data is low relative to the other sources. Only seven of the 20 proxy peers included the general counsel in the top-five highest-paid executives. As a result, the proxy data significantly exceeds the two survey sources that have larger samples. For the general counsel position, it is reasonable to use only surveys 2 and 3, and seek another data source to round out the analysis.

Case 4: Actual vs. Target Bonuses

You are benchmarking short-term cash compensation levels (base salary plus bonus) for your company's executives. Based on the analysis in Figure 3, what do you think of your company's bonus levels? Are you paying competitively or below?

When analyzing competitive bonus levels, it is important to consider whether the competitive data is reporting target or actual bonus levels. When target

FIGURE 1: COMPENSATION SURVEY CHOICES

Survey	Description	Sample Participants	Data Cuts
A	High-tech survey with salary, bonus and long-term incentive data for 70 executive positions	Cisco, McAfee, Qualcomm, Broadcomm, Intel, Texas Instruments, Avaya	Size
B	General industry survey with salary, bonus and long-term incentive data for 200 executive positions	Wells Fargo, Mattel, Hewlett-Packard, Walgreens, Verizon, IBM, Dell	Size, industry
C	Information technology (IT) survey with salary and bonus data for 30 executive and other IT positions	TiVo Inc., Stamps.com, Ariba, Register.com, Merix Corp., eCollege.com	Size (largest cut is \$250 million-plus in sales), geography
D	High-tech survey with salary, bonus and long-term incentive data for 60 executive positions	Lucent, Cisco, Hewlett-Packard, PeopleSoft, Qualcomm, Computer Associates, Novell	Industry focus (e.g., networking, hardware, software)

FIGURE 2: SURVEY AND PROXY DATA

Chief Financial Officer	Number of Organizations	Weight	Salary			SVP & General Counsel	Number of Organizations	Weight	Salary		
			25th	Median	75th				25th	Median	75th
Survey 1	20	?	300	320	440	Survey 1	5	?	165	200	260
Survey 2	38	?	320	350	455	Survey 2	38	?	200	250	325
Survey 3	40	?	350	365	480	Survey 3	44	?	205	270	340
Proxy	18	?	345	370	490	Proxy	7	?	250	325	400
Competitive			?	?	?	Competitive			?	?	?

bonus levels are compared in this case, the company is paying competitively. When actual bonus payouts are compared, the company is below competitive. To sort out the discrepancy, try to understand your company's performance relative to peers. Is your company lagging the industry? In this scenario, target bonus levels are preferable for the analysis. Your company provides a competitive target opportunity, but actual payouts are lagging, as they should, because of performance. Does your company have an aggressive budget, which may make target bonus payouts less likely? If this is the case, then pay-for-performance needs to be calibrated so that your company's executives are paid competitively given the firm's level of performance.

Case 5: Pay Positioning Philosophy

Your company targets 75th percentile compensation levels. What would you recommend for the CEO package given the competitive data in Figure 4?

Aggressive pay positioning, especially for base salaries, can be a major compensation pitfall. Furthermore, 75th percentile pay positioning cannot be applied to all components of compensation. This would result in total direct compensation that is well above the 75th percentile when each component is added together. Always consider the total direct compensation level relative to the market to ensure that the overall package is reasonable.

As this case illustrates, positioning base salary at the 75th percentile means that if the company wishes to pay competitive incentives, total direct compensation will exceed the 75th percentile of the market. A preferable strategy is to provide a median base salary with more aggressive incentives. While it is difficult to cut base salary levels, the salary can be frozen for several years until the competitive market catches up. In the meantime, less-aggressive incentives should be given so that total direct compensation levels do not exceed the intended total

pay positioning.

Case 6: Valuing Long-Term Incentives

You have been asked to review executive stock option grant guidelines for 2004 after your company's stock price dropped 50 percent in the last year. Your consultant gives you the analysis in Figure 5 on page 26. What do you think?

Because of the 50 percent drop in the stock price and option value, a traditional market-based analysis would imply that the stock option guidelines should be nearly doubled to approximate 2004 competitive values. However, shareholders who lost 50 percent of their value will not like to see executives being rewarded with nearly double the options granted at a lower exercise price.

Using executive compensation benchmarking to determine equity grants is tricky. Competitive long-term incentive values can be difficult to assess because many surveys do not report this data. Surveys also may use different valuation

methodologies, and long-term incentive values are volatile because of year-to-year market fluctuations.

Because of the difficulties, most companies use multiple factors to triangulate the data points to arrive at equity grant levels. In

addition to competitive market analysis, companies consider historical award levels, individual performance, annual dilution and discretion to determine equity awards.

Beyond Benchmarking

For companies that do not want to rely entirely on benchmarking to set their executive pay levels, other analyses can be conducted:

FIGURE 3: TARGET VS. ACTUAL BONUSES

	Your Company					Competitive					STC Deviation	
	Base Salary	Target Bonus	Actual Bonus	STC	STC	Base Salary	Target Bonus	Actual Bonus	STC	STC	Target vs. Target	Actual vs. Actual
	(\$000s)	(% of base)	(\$000s)	(% of base)	(\$000s)	(\$000s)	(% of base)	(\$000s)	(% of base)	(\$000s)		
CEO	\$600	70%	\$1,020	42%	\$852	\$575	75%	\$1,006	100%	\$1,150	-1%	-26%
CFO	\$375	50%	\$563	33%	\$499	\$350	60%	\$560	75%	\$613	0%	-19%
General Counsel	\$250	50%	\$375	35%	\$338	\$250	50%	\$375	65%	\$413	0%	-18%

Note: STC = short-term cash

FIGURE 4: CEO COMPENSATION — RECOMMENDED PAY PACKAGE

	Current Package (\$000s)	Competitive			Recommended Package (\$000s)
		25th Percentile (\$000s)	Median (\$000s)	75th Percentile (\$000s)	
Base Salary	\$770	\$480	\$620	\$775	?
Target Bonus (% of base)	\$578 75%	\$310 50%	\$465 75%	\$651 105%	?
STC	\$1,348	\$940	\$1,070	\$1,275	?
Target Long-Term Incentive (% of base)	\$1,540 200%	\$558 90%	\$1,054 170%	\$1,550 275%	?
Total Direct Comp	\$2,888	\$1,775	\$2,125	\$2,550	?

FIGURE 5: EXECUTIVE STOCK OPTION GUIDELINES ANALYSIS

	2003		2004	
	Option Guidelines	Value ⁽¹⁾	Competitive Value ⁽²⁾	Proposed Guidelines ⁽³⁾
CEO	75,000	\$750,000	\$700,000	140,000
Tier 2 Executive	35,000	\$350,000	\$325,000	65,000

(1) Based on a \$30 stock price and a Black-Scholes value of 33%

(2) Competitive data is from surveys and proxies, and is valued using the Black-Scholes model

(3) Based on a \$15 stock price and a Black-Scholes value of 33%

- Reviewing internal equity to ensure that relative pay levels are reasonable, and fit the company's culture, strategy and organization
- Taking performance into account when determining executive pay levels
- Using a wealth-accumulation analysis to assess the richness of executive compensation packages.

While these analyses are quantitative and number driven, they depend heavily on subjectivity and judgment.

The goal of an internal equity analysis is to compare the pay differentials between positions, incumbents and/or grade levels within an organization to determine if they are reasonable. One way to do this is to convert compensation levels to a percentage of a certain position's pay (e.g., executive salaries as a percentage of CEO salary). The results are then reviewed subjectively.

- Are internal relationships reasonable given your company's strategy and culture?
- Are individuals with similar levels of responsibility, skill and experience paid comparably?
- Are high performers receiving greater compensation than low performers?
- Do inequalities exist between business units or divisions?

The purpose of this analysis is not to compare company pay differentials to typical differentials in the competitive market. One company may have a traditional executive pay structure with typical market differentials, while another may take a team-based approach to

managing the company and have very little differentiation between executives' pay levels. Neither approach is right or wrong, but depends entirely on the company's strategy, culture and organization.

Executive compensation levels also must be considered in the context of company performance. One way to accomplish this is to compare executive compensation levels and performance against a peer group. By conducting this type of analysis, companies can assess whether they are paying reasonably given their level of performance.

Wealth accumulation analysis offers a longer-term perspective than traditional benchmarking. Where traditional benchmarking is an annual, "income statement" approach, wealth accumulation analysis is a longer-term "balance sheet" approach. Traditional benchmarking focuses on the annualized present value of each element of compensation, and ignores past equity grants and deferred compensation/retirement that continue to provide significant value. In contrast, wealth accumulation analysis projects the future cumulative value of compensation and more closely approximates the way executives and shareholders think about pay.

For wealth accumulation analysis, all elements of compensation are tallied over a period of time. If the analysis takes a five-year look, five years of salary and bonus payouts are tallied, as are five-year projected equity gains. Wealth accumulation analysis also can

accommodate deferred compensation and other executive benefits arrangements. The results of the analysis can be assessed subjectively, relative to projections for peers or against shareholder value creation over the same time period.

Despite the recent criticisms, competitive pay benchmarking continues to be a useful tool, although it is admittedly an imperfect one. By applying good judgment and using other available analytical tools, it becomes easier to make good decisions based on competitive analysis. WS

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