

By Peter Lupo, Pearl Meyer & Partners

tips

for your year-end
executive-compensation
reviews

The drill has become somewhat familiar. Fall is here, and it's time for the year-end executive-compensation review. The process is somewhat automatic for many public companies. Typically, it starts with a request to the firm's executive compensation consultant to conduct the annual analysis, followed up by a phone call to discuss any changes that will be needed in the study or particular issues that should be addressed.

However, the process has become more challenging in the wake of new proxy-disclosure rules that took effect in 2007. The new mandates are intended to give shareholders a clearer and more complete picture of a company's executive compensation practices by requiring broader and more detailed reporting. The availability of so much more and different types of information will significantly influence how executive compensation analyses are best conducted. The rub is that while the newly available data can

QUICK LOOK

- ⇒ The new proxy-disclosure mandates require broader and more detailed reporting.
- ⇒ Most governance experts agree that executive compensation consultants should be retained in writing by the compensation committee.
- ⇒ An overly thorough analysis can double the size and cost of the usual presentation—without necessarily providing much more useful information.



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improve decision-making, it may lead companies to look at so much extraneous information that the most important issues become muddled.

Senior-management team or compensation committee members should consider the following eight options to get the most of this year's annual review:

1 To whom does the compensation consultant report? Most governance experts agree that executive compensation consultants should be retained in writing by the compensation committee, but have access to all written and oral information from management that is needed to conduct the assignment.

There are two traps to avoid:

- Even if the same consultant has several years of service to the company, specific responsibilities and reporting relationships may never have been sufficiently clarified and documented. The respective roles of the compensation committee, management and the consultant should be defined at the beginning of the assignment.
- It is critical in the governance environment to check veteran consultants and/or their firms for real or perceived conflicts. They should address any issues before the assignment begins.

2 Has the compensation consultant interviewed you recently? A compensation consultant who has been working with an organization for several years should already have an in-depth understanding of its strategic direction and the specific compensation analyses that are most appropriate. However, the vast amount of additional required disclosure and new regulatory mandates may add material to this year's study. Rather than assume the consultant will provide all relevant new information and analyses, compensation committees and management should actively direct consultants on the scope of this year's assignment.

Newly available data that could provide important new insights or more depth to traditional studies might include the following:

- Narrative information provided in the new compensation discussion and analysis (CD&A) regarding policies and the reasoning behind pay-related decisions, as well as qualitative and quantitative information on performance goals
- A separate breakdown of executive bonuses that were awarded on a discretionary basis versus nonequity incentive-plan awards, which are short-term or long-term cash incentives

- paid for the achievement of specific, predefined goals under a "formal" incentive plan
- More detailed identification of perquisites and their values
- The fiscal year accounting value of current and past equity awards made to each disclosed executive
- The unvested value of restricted stock awards
- The value of pension and nonqualified deferred compensation, including company contributions to deferral plans
- Potential payouts upon termination or change in control.

While the core of executive compensation studies traditionally has been a detailed analysis of competitive pay levels, future studies may also incorporate:

- Summaries of decisions and policies related to how peer groups pay (e.g., stated competitive pay positioning targets)
- An analysis of incentive metrics and leverage that shows the extent to which bonuses can deviate up or down from target
- A closer look at the design and value of nondirect sources of pay, such as pension and deferred-compensation programs.

3 Is all this data really necessary?

Although it is tempting to study every nuance of newly disclosed executive compensation data, an overly thorough analysis can double the size and cost of the usual presentation—without necessarily providing much more useful information.

Following are a few suggestions for tailoring the available data to an organization's specific needs:

- If one is benchmarking salaries, bonuses and long-term incentives, one can probably skip an analysis of pension and severance arrangements on an annual basis.

With mandatory option accounting, there is a **greater variety of methodologies** being used to report and calculate option values, including the use of other **binomial option-pricing models** or the participants' self-reported **FAS 123(R) expense**.

- Agree in advance on the definition of “compensation” for purposes of the study, based on how the data will be used. Which is more relevant—target-pay opportunity or actual pay earned? Equity value expensed during the year or equity value granted? Will “compensation” include perquisites or not? This way, you can select the disclosure data that is most important and ignore the rest.
- If you want to understand severance paid under a change in control for the CEOs in a peer group, determine which termination circumstances are most relevant to your issues—death, disability, with good reason, without good reason, etc. There may not be a need to conduct and compare severance calculations under all circumstances.

1 Does your peer group still pass muster?

There is greatly heightened scrutiny by the media and shareholders of the composition and use of peer groups, which are subject to disclosure under new reporting rules. It is more important than ever that the compensation

committee and management fully concur on how peer-group companies are chosen and how their data are used.

One change being made is in the size of peer groups. A dozen companies used to be standard, but it is becoming more common to include 18 or more companies, depending on the size and complexity of the company's business. There is a two-step evaluation process for picking a suitable comparison group of companies:

- **Step 1: Define the role of the peer group.** Peer groups are most commonly used to benchmark executive compensation levels and company performance. But they also can be used to measure equity usage, understand incentive-design practices, quantify reasonable severance programs, understand pension values, look at best practices of high-performing companies, etc. Companies should consider if more than one peer group is needed to provide additional information.
- **Step 2: Build the peer group.** The two most common considerations are generally company size and primary

line of business. If more than half of a potential peer company's business is different than yours, this should send a red flag about comparability. A typical sizing standard calls for annual revenues of the potential peer company to fall within one-half to two times the size of the company under study. However, revenue size is not always the most appropriate metric. For example, financial service companies may be better compared based on assets, while peers for venture-backed startups may have minimal revenues and be better chosen on the basis of employee count and organizational complexity.

5 How are you combining all that data?

Because most benchmarking studies cover compensation for more than the top five paid executives, preparation requires the use of both proxy and survey compensation data. The challenge is to use the data in a uniform way that ensures a seamless integration of both sources. A common approach is to combine proxy and survey data to develop a market consensus, or going pay rate. This avoids getting a bifurcated result where, for example, the total pay of proxy-disclosed executives is substantially greater in the proxy analysis than the corresponding levels produced by a survey analysis.

However, blending proxy and survey data for long-term incentive practices can present issues. Prior to the adoption of FAS 123(R), most compensation surveys reported stock option values using the Black-Scholes methodology, with a full term and a fairly consistent set of assumptions. With mandatory option accounting, there is a greater variety of methodologies being used to report and calculate option values, including the use of other binomial option-pricing models or the participants' self-reported FAS 123(R) expense.

These alternatives often rely on assumptions, such as expected life of the option or implied volatility, which result in decreased option values. Forfeiture and nontransferability discounts also vary, if they are used at all.

Although there is no “right” way to blend data under a compensation benchmarking study, the method used should be clearly disclosed, along with any implications of using that approach. In studies that utilize multiple survey sources, the summary data should provide an understanding of market practices and trends, but should not be considered the right number. Remember, the market data provides an estimation of the “going rate” for a position, not an exact answer.

6 How many years does the data cover?

Although in the past, companies typically reported multiple years of compensation data, in 2007, most opted to disclose only one year of information, as permitted during the three-year phase in the new proxy-disclosure rules. In 2008, two years of data will be required and, in 2009 and beyond, three years.

As a result, for now, year-over-year comparisons will be complicated for all elements of compensation and unavailable for the newly disclosed elements. Likewise, the ability to compare actual awards earned relative to incentive opportunity provided will phase in over the next few years. For example, most 2007 proxies reported both targets and actual payouts for annual incentive plans. However, the target disclosures for long-term performance plans cover forward-looking periods. Understanding how actual awards compare to these long-term target-incentive levels won't be possible until future proxies are filed.

7 Is it total compensation, total remuneration or total something else?

The good news is that under the new disclosure rules, total executive pay


data now can be crunched in a number of ways. The bad news is that you will probably spend more time on the calculations to arrive at a number that fits your preferred definition of pay. To illustrate, stock and option awards that are now reported in the Summary Compensation Table reflect the cost recognized for financial reporting purposes for the fiscal year in accordance with FAS 123(R). That number is not at all the same as the executive's W-2 earnings or the value granted in a fiscal year, the latter of which traditionally has been used by organizations to benchmark pay levels.

It is more important than ever to be clear about what pay elements or total pay amounts are being compared and whether the approach to comparing pay is clearly documented. In using the Summary Compensation Table to arrive at a total pay figure, one should note the following:

- Stock and option awards may be overstated because they are not adjusted for awards that may be forfeited in the future
- Nonequity incentive compensation may be abnormally high or low if a company has a multiyear cash-incentive plan
- “All Other Compensation” represents the company's cost of providing the benefit or perquisite, not necessarily the “value” to the executive (e.g., personal use of the company aircraft is reported based on the incremental cost to the company, not the market value of private jet travel).

8 Have you allocated enough time to conduct the study?

It may sound obvious, but executive compensation studies are likely to be significantly more time-consuming due to the increased data available for consideration and governance pressures for more rigorous analysis.

- On the front end of the assignment, it makes sense to review the new elements of pay that must be disclosed and decide which will be used going forward. This may involve one or more conversations between management, the compensation committee and consultant.
- During the study, more time will be needed to analyze additional data. For example, will the study include pension and severance arrangements along with direct-pay elements (salary, bonus and long-term incentives?) If so, the analysis will need to describe how to equate pay elements such as salaries and bonuses that are paid immediately or in the near future against compensation that is contingent on an executive's years of service (pensions) or merger and acquisition events (change-in-control severance).
- On the back end of the assignment, more time will be needed to understand the implications and recommendations of more sophisticated studies. 

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