

Compensation Discussion & Analysis *Lessons Learned*

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For those who argue that executive compensation may be the litmus test for good governance, the Compensation Discussion and Analysis (CD&A) in the 2006 proxy statements should prove most instructive. This narrative overview will open for inspection the underpinnings of a company's executive compensation program and the philosophy that guides decision-making. Programs that rest on a foundation of sound logic will present a compelling case to investors and other stakeholders. Those on less solid footing will likely face questions and challenges.

The CD&A requires companies to explain, in plain language, the "whys and wherefores" of their executive compensation program. While developing the CD&A can be tedious, the exercise is also practical and enlightening, prompting critical reflection and dialogue about compensation policy and practices in many boardrooms. After digging into the details, one director remarked that the board finally understood the company's program.

The process has been illuminating in other ways as well, revealing incongruities related to program design and governance, such as the following:

- **The absence of a solid executive compensation philosophy and strategy.** The executive compensation components may have been pieced together over a period of years, harkening back to different business challenges under different leadership. Or perhaps the primary justification for pay levels and practices was a desire to mirror the "competitive market" or compete successfully for executive talent. As a result, the current program fails to hang together. More egregiously, it does not promote current business strategy.
- **The philosophy exists, but it's "mom and apple pie."** An oversimplified philosophy may sound smart but ring hollow, such as a nebulous directive about "paying for performance" or "aligning pay with shareholder interests." Another may have the intention right—to attract, retain and motivate highly talented executives—but fail to specify how the program has been designed to accomplish those goals.
- **The program's potential for total wealth creation comes as a surprise.** The value of the total compensation package may be one of the biggest eye-openers for compensation committees. If a company has not used a tally sheet in the past to capture and clarify

QUICK LOOK

- ⇒ Developing the CD&A is practical and enlightening, prompting critical reflection and dialogue about compensation policy and practices in many boardrooms.
- ⇒ The CD&A may mark the first time a committee sees all parts of the total compensation package brought together.
- ⇒ A compensation strategy allows management and the board to make decisions within a mutually agreed-upon framework, rather than face each pay decision as if for the first time.



compensation details, including the interplay and cost consequences of multiple elements, the CD&A may mark the first time a committee sees all parts of the total compensation package brought together.

- **Program goals are not defensible.** The visibility of goal setting is clearly one of the major concerns emerging from the CD&A exercise. Boards have been confronting the issue of goal “toughness” and concerns related to the relationship between incentive goals and earnings guidance. Analysts will be assessing how compensation goals align with historical guidance and looking to performance ranges as to what levels of performance may be possible.
- **No policies are in place to safeguard the company against the appearance of impropriety regarding equity grant timing, clawback provisions and hedging.**

Following are thoughts on how to address these issues and ensure the executive compensation program is grounded in a solid compensation strategy, balances cost with value, truly drives and rewards

business results, and compels good governance practices in order to support the interests of all stakeholders.

Ensure Sound Underlying Logic

Stakeholders expect a well-thought-out compensation strategy that provides logic for the program design and provides the compensation committee and the external world with the basis for evaluating whether the programs make sense.

The compensation strategy should summarize the company’s enduring beliefs about compensation and explain how the compensation program fits the company’s unique business and talent characteristics. (See Figure 1.)

The company’s business needs and market characteristics focus on internal strategic, macroeconomic and industry-related drivers of value. Talent needs address the role of pay in the employee value proposition, the types of employees needed to drive strategy and the nature of leadership responsibilities and performance expectations. For example, a recruiting and staffing firm found its industry consolidating, creating stronger

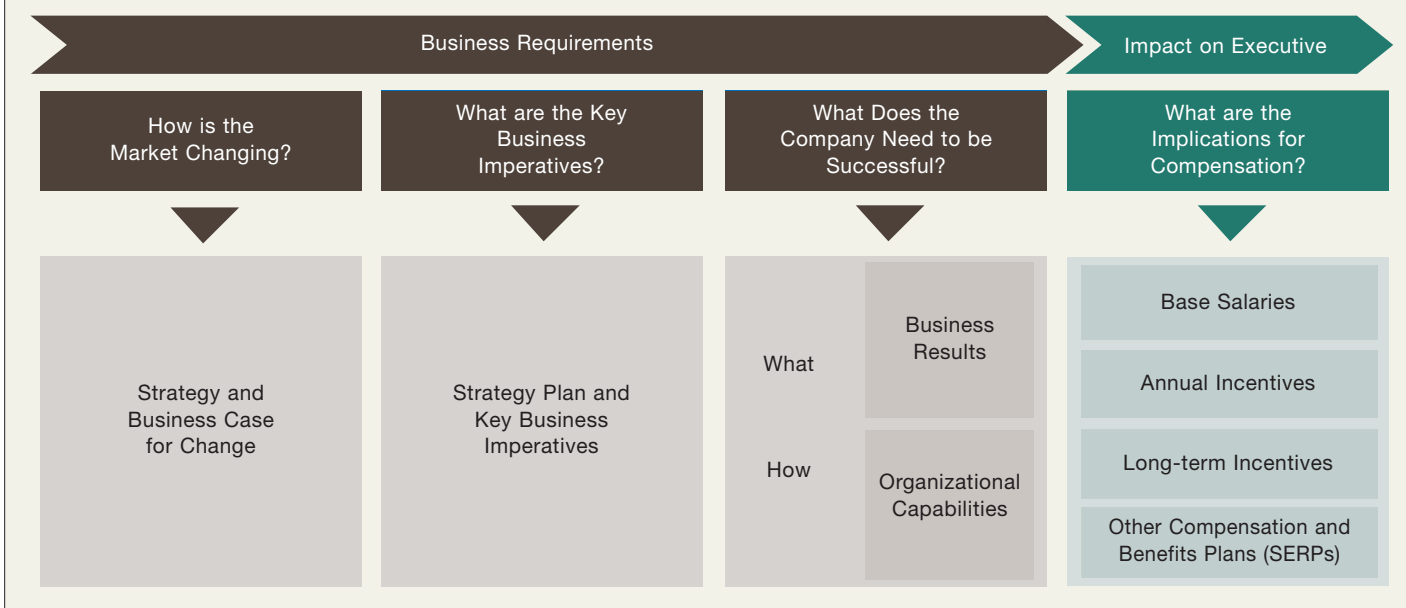
competitors with broader footprints. At the same time, customer needs were changing. With the “war for talent” over, the market was shrinking, and clients were focused on improved productivity. In order to survive and retain key talent, the company knew it had to not only grow, but grow faster than its peers. Keys to success lay in increased penetration of larger accounts, reduction in account churn, acquisition of new accounts, and rationalization of the corporate and field infrastructure. To achieve these objectives, the company required more collaboration across business units to sell and service customer accounts, better systems, a more proactive sales mentality, and higher individual and joint accountability for results.

From a compensation strategy perspective this meant:

- Increasing the level of pay prominence to support the business transformation (e.g., more line of sight, material rewards if the company was successful)
- Establishing metrics and goals that required shared accountability and collaboration
- Balancing market-based long-term

FIGURE #1: COMPENSATION STRATEGY MUST REFLECT BUSINESS AND TALENT NEEDS

Answering these questions can guide strategic decisions about executive pay.



- vehicles (e.g., stock options) with vehicles that would drive sustained top-line growth, profitability and investment.
- Including some relative measurement to reinforce the need to excel versus competitors (not just versus plan)
 - Using a flexible multiyear time line to recognize the time required for transformation.

Beyond providing an underlying logic for the CD&A, a compensation strategy allows management and the board to make decisions within a mutually agreed-upon framework, rather than face each pay decision as if for the first time. The principles provide a yardstick for retrospective evaluation and a framework to guide the future direction of program design and administration.

Companies will benefit from proactively analyzing the clarity of their compensation strategy, the success of the actual program in measuring up to that strategy and the actual pay/performance relationships.

One caution: The strategy is not a statement of aspiration. Companies should steer clear of overpromising and underdelivering. The CD&A is a filed document; companies that overpromise could be exposed.

Balance the Cost and Potential Value of Payouts

It is not unusual for companies to assemble executive compensation programs over several years. In addition, compensation decisions about different program elements are not always made at the same time during the year. Consequently, a company may not have considered a program in its entirety or appreciated the program's total value and cost. When confronted with the size of the ongoing total compensation package, compensation committees must ask whether it is too much (or maybe even too little), particularly in light of how it might be viewed by outside observers.

To address this question, a good place

to start is with competitive positioning. Stakeholders want to see a clear rationale for selecting benchmarks—do the chosen peers represent true competitors for talent? If not, what are the other reasons for using this particular group of companies? Stakeholders also want to know how pay has been set relative to those benchmarks. If pay positioning is different from the median, what business purpose drives this decision (e.g., performance targets are set materially above those of competitors)?

Pay positioning, however, provides only part of the answer. Another critical question is whether pay is justified by performance. Pay and performance relationships (i.e., the relative positioning of pay versus peers compared to performance versus peers) should be examined historically and prospectively. These analyses must always consider the business situation and talent characteristics; if the pay/performance relationships break down, the program design may be out of alignment, or it may be poorly implemented (e.g., “slam-dunk” goals).

A final consideration is the sharing of value between the named executive officers and shareholders. Value sharing helps a company determine whether it is sharing too much or too little gain with executives compared to shareholder gains.

By taking a multiview approach to compensation design, compensation committees get a much better assessment of the alignment and relationships among shareholder gains, executive rewards and company performance.

After assessing the appropriateness of pay levels in the ongoing program, companies must determine if the safety net for failure or the benefits delivered upon a transaction are too large or create incentives that are not aligned with the best interests of shareholders. The contents of compensation packages for termination without cause may seem less appropriate when considered in terms

of the full value delivered as severance, benefits continuation, acceleration of equity versus the purpose of the program (e.g., providing reasonable security while an executive may be looking for a new job). Compensation committees should fully understand the true value of change-in-control provisions, SERPs and gross-ups, and consider the potential unintended signals such components might send to the public.

As committees have taken a closer look at the total picture, some elements have been quick to fall out of favor. Extreme perquisites, in particular, are being eliminated. If they are offered, companies frequently ask executives to cover some or all of the costs.

Assure Robust Goals

Perhaps the biggest issue committees face relative to the CD&A is disclosing performance goals. This disclosure has highlighted the importance of committees gaining comfort with the toughness of the performance goals in order to feel as if they are defensible in the public forum.

In analyzing the details of their executive compensation programs, companies may well discover they need a more robust process for setting goals. Goal setting is often where a program falls apart. Companies may lack a methodical way of assessing the appropriateness of their goals. They may have a general belief that the goals make sense, but they do not use relevant benchmarks to test the accuracy of their theory. Other common goal-setting mistakes include an overreliance on negotiation (i.e., the best negotiators win rather than those who set and meet the highest performance hurdles) and mandated goals from the top, for which executives feel little ownership.

The solution is a process that determines goals from both a top-down and a bottom-up perspective. Top-down goal setting focuses on what companies should do to meet their obligations to

shareholders. Bottom-up looks at what can be done based on the current business model. These two perspectives then must be reconciled to determine what a company will do. It is only in this way that an organization can establish sustainable goals that are achievable and that also have adequate stretch. Fundamental to the approach is that goal setting is driven by facts (e.g., how goals compare to competitors' performance and market expectations for the company and the industry, how much improvement is required versus historical results), not by negotiating prowess. While this approach may seem intuitive, surprisingly few companies address goal setting in this way.

Employ Sound Governance

The new disclosure rules require that a number of governance policies be disclosed and discussed in the CD&A. With greater investor awareness around these topics, it is an important time for companies to review their own policies and evaluate the need for implementation or changes in the future. Companies that lacked formal policies in the past are now examining such issues closely to avoid any suggestion of impropriety. Three topics receiving scrutiny are the timing of equity grants, clawback provisions and hedging.

Equity-Grant Timing

The option practices of nearly 140 companies are under scrutiny by federal authorities, according to the Jan. 20, 2007, *Wall Street Journal*. Companies must ensure their grant practices are not inadvertently giving advantage to management by fortuitous timing or timing when in possession of material nonpublic information.

Yet the concerns go beyond options to all equity grants where the value and/or number of shares can be affected by timing. Key features of timing best

practices can include: compensation committee approval (i.e., no delegation of authority), predetermined approval and grant dates, grant dates that occur within open-window trading periods, "collars" around the value that can be delivered on the actual grant dates and provisions for grant timing when the committee may be in possession of material nonpublic information or during a blackout period.

Clawback Provisions

Clawbacks are the recovery of gains from employees that occur in the event of financial restatements. The recovery can be as narrow as the Sarbanes-Oxley financial-restatement provision that applies to the CEO and CFO, or can be broadened to cover other circumstances.

In 2006, most companies did not have substantial clawback policies. In fact, fewer than 10 of the Fortune 100 had broad clawback policies in place last year. However, pressure is increasing from institutional investors and their advisers. Last year, the California Public Employees' Retirement System (CalPERS) promoted the adoption of clawbacks by sending letters to 47 of the largest corporations in 10 industry sectors, according to "CalPERS to Take Clawbacks to Shareholders," from *Base and Bonus*, Nov. 7, 2006. CalPERS plans to submit shareholder proposals to the companies that do not respond or respond positively to these letters. The California State Teachers' Retirement System (CalSTRS) has taken a stand to support Congressional Bill, H.R. 4291, which would require companies to adopt clawback policies. Glass-Lewis has supported shareholder proposals for clawback policies and believes that all companies should have them. The ISS is formulating a policy that would encourage voting for clawback proposals.

The adoption of increasingly aggressive clawbacks may create some unintended

consequences. For example, to avoid potential penalties, executives might tend to exercise options sooner rather than later. They might avoid opportunities for deferral or be less willing to identify situations which might trigger a restatement. Companies must weigh such unintended consequences against good governance practices when selecting the most appropriate clawback approach.

Hedging


Companies must disclose any stock ownership requirements or guidelines in their CD&As. So that shareholders can understand whether these requirements or guidelines have teeth, companies must also disclose any policies regarding hedging the economic risk of such ownership. Lax policies regarding hedging can subvert the alignment, which ownership requirements/guidelines were intended to achieve. The company's message regarding any alignment with shareholder interests would have to be examined in light of these policies.

Conclusion

Executive compensation used to be the purview of human resources and the compensation committee. Now shareholders weigh in, and more people are involved in the discussion, including regulators and customers. In the United Kingdom, shareholders actually vote (on a nonbinding basis) on whether to accept the company's compensation philosophy. They also vote on CEO pay, something that U.S. shareholder groups are pushing.

Even without a vote, investors and the public are certainly going to have an opinion. So companies must consider how compensation actions and decisions will be perceived in the external market, and what information to provide to stakeholders to help them understand and get comfortable with these decisions.

Ensuring the compensation program

rests on a meaningful strategy, balances costs with value, supports rigorous goal setting and employs sound governance practices will ensure the program not only stands up to scrutiny, but furthers the business goals and drives successful performance. 

EDITOR'S NOTE:

Go to www.worldatwork.org/workspan to see a brief from these authors on how to analyze program components and consider the need for redesign.

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