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By Mark Anson, R. Theodore White, William McGrew, and Bridgette Butler

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Fair or excessive? A reliable model for determining the appropriateness of executive compensation

A divergence of interests between a company's shareholders and executives is at the root of the "agency problem." No issue illuminates just how acute the problem is than executive compensation. Who's right and what's fair compensation. Managers with CalPERS, one of the vocal and visible institutional shareholders, have developed a model that will reveal if a certain executive compensation is warranted or not.

By Mark Anson, R. Theodore White, William McGrew, and Bridgette Butler*

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One of the key issues associated with corporate governance is the alignment of shareholders' interests with those of the executive management of a public corporation. Normally, this is achieved with a compensation plan that rewards executive management for good financial performance. In this article, we present an empirical analysis that provides a basis to determine whether the interests of the owners and agents of a corporation are aligned.

The agency problem

In a public corporation, shareholders, or shareowners, are the ultimate decision makers.

*This article reflects the insights and opinions of the authors and not the authors' employer.

(CalPERS refers to itself as a shareowner, not a shareholder. For a fuller discussion on this topic see Robert Carlson, Charles Valdes, and Mark Anson, "Share Ownership: the Foundation of Corporate Governance," *The Journal of Investment Compliance*, 2004.) After all, shareholders own the company and can do with it as they please. However, it is not practical for equity holders to make every day-to-day decision.

Therefore, shareowners delegate the day-to-day decision making authority to the directors and executives. The executive management of the corporation acts as the agent for the equity owners (the principals) of the company. However, directors and executives may not always act in the shareowners' best interests. This leads to what is known as "agency problems."

Agency problems arise when the management of a public company pursues its own economic self-interest ahead of shareowners' interests. This behavior may manifest itself in the form of golden parachutes, long-term employment contracts, corporate jets, and other perquisites. Managers are susceptible to human nature and may pursue their own economic agendas without any concern for maximizing the wealth of the shareowners.

Nowhere is this agency problem more acute than in the determination of executive compensation. Even though the independent directors on the board of directors of a public company are elected to protect the interest of the shareowners, the agency problem between the owners of the corporation and the executive management can manifest itself in a number of ways:

- 1 Frequently, the role of chairman of the board and chief executive officer are combined. In this dual role, the chairman of the board controls the board of directors, whose job it is to set the pay for executive management. This same chairman is also the president, and part of the executive management team that receives the compensation package. It is in the chairman's economic interest to press the other directors to adopt a generous pay package for executive management.
- 2 Even when the roles of chairman and CEO are split, the chairman will often defer to the CEO's recommendation when setting the compensation for the executive management team.
- 3 The chairman and the other directors typically receive information only from the executive management team with respect to their performance and recommended level of compensation.
- 4 Even when compensation consultants are hired, they are often hired by the executive management team and so receive their information and other input from the executive management team.

In sum, there are many ways that the agents of the corporation (executive management) can enrich themselves at the shareowners' expense. We portray the disconnect between executive and shareholder wealth in Exhibit 1.

Exhibit 1 examines the change in executive compensation for the five most senior executives of corporations in the S&P 500. The information for this table came from the corporations' own annual proxy statements. We can see that in the year 2001, when the total return on the S&P 500 was minus 12%, average executive compensation increased by almost 27%. The year 2002 showed a better, but still, not total alignment of interests between senior management and shareowners; the S&P 500 declined by 22% while executive

compensation declined by 11%. Over the period 2001-2002, executive compensation increased about 16% while the return to shareowners was almost -33%.

In the next section, we provide an overview of what a competitive compensation program should look like.

Key principles of an executive compensation program

Rather than provide detailed instructions on how executives should be compensated, it is better to set out some broad principles that can be implemented in publicly traded companies.

Broad Principles

- An executive compensation program should be designed to ensure the alignment of long-term interests between the executive management and the shareowners.
- An executive compensation program should consist of a combination of cash and equity-based compensation.
- The executive compensation program must be transparent.

Starting with the first principle, the key point is the long term interests of shareowners. Exhibit 1 demonstrates that passive investing in the U.S. increased to over \$3 trillion in 2003. Indexed, equity investing forms a base of "permanent capital." Passive equity investing provides a very efficient stock market exposure but it must accept the good with the bad. This type of investing does not "vote with its feet" and walk away from poorly run companies with excessive compensation packages. Therefore, it is critical for all investors, but especially for index-based, equity investors, that the long term interests of executive management are aligned with those of the shareowners.

The second principle ensures that executive management has "skin in the game." Simply put, a shareowner of a company becomes very careful about the company's expenses and the residual cash flows to the company's equity owners. By creating shareowners out of executive management, executive management will act in its best interest as a shareowner, something that will benefit all equity investors.

The third principle is equally simple: the compensation plan should be comprehensible. Investors should not be forced to decipher the minutia of a proxy statement to figure out the compensation of the key executives. It should be clear and plain, and if the executive team is paid a lot of money, this should be stated clearly in the company's proxy.

Executive compensation policy

Every corporation should establish a compensation policy to guide directors and executives in rewarding the key employees. Financial rewards and incentives for productive employees should be encouraged, but the rewards need to be performance based. Key elements of a compensation policy include:

- A clearly stated mix of base salary, bonus range, long term incentive compensation, and equity ownership.
- Clearly identified drivers of incentives and bonus compensation.
 - ◆ Return on assets
 - ◆ Return on invested capital
 - ◆ Return on equity
 - ◆ Increase in share price
- The philosophy of the company with respect to the dilution of existing shareowners through the distribution of compensation-based equity grants.
- Whether equity may be distributed to employees in shares, options, rights, warrants, or some other form of equity-based

compensation.

- The parameters for assembling and awarding severance packages (golden parachutes and exits).

Guidelines for option plans

Perhaps the greatest abuse of executive compensation occurs when stock options are awarded. One reason for abuse is that stock option plans are often constructed with little input from shareowners, who may also have no control over the plans. Key issues are:

- Option plans that allow the directors or executive management to set a new strike price for outstanding employee stock options without the approval of shareowners.
- Stock-option plans that provide for "evergreen" options-essentially options that never expire.
- A plan that provides for "re-loading"-meaning that the board of directors can reload a new set of options for executive management if the old options are worthless when they expire.
- An option plan that is "top-heavy," one that provides options for the most senior management but not for the average employee.
- An option plan that provides for the immediate vesting of executive management's right to exercise the options instead of a vesting period over several years.

The presence of any of these provisions in an executive stock option plan is a warning flag signaling that management has looked after its own economic self interest but not shareowners'.

CalPERS executive compensation model

In 2002, CalPERS began to scrutinize executive pay as part of its normal Focus List process of

engaging corporations on issues of corporate governance. (More details regarding CalPERS' Focus List may be found in Mark Anson, R. Theodore White and Ho Ho, "The Shareholder Wealth Effects of CalPERS' Focus List," *The Journal of Applied Corporate Finance*, Winter 2003; and Mark Anson, R. Theodore White and Ho Ho, "Good Governance Works: More Evidence from CalPERS," *The Journal of Asset Management*, Spring 2004.) As part of its corporate governance review, CalPERS noted that many executives had enriched themselves at shareowners expense. In fact a recent study demonstrated that, in 2003, the average chief executive officer earned 400 times more than the average worker in his/her company. This is a considerable increase from 1980 when the average chief executive earned 100 more times than the average employee.

Further, the numerous corporate accounting scandals that unfolded in 2001 and 2002 demonstrated a clear pattern of corporate greed that destroyed both employee jobs and shareowner wealth. CalPERS developed an executive compensation model to determine whether the pay of a corporation's most senior executives was consistent with the value of services delivered. We examined public companies in the S&P 1500.

There are three components of the model.

1. Compensation Metrics.

CalPERS cannot determine the pay of every senior employee in a public corporation. Instead, CalPERS relies on a public corporation's proxy statement, which, by the laws of the Securities and Exchange Commission, must list in detail the compensation for the five most highly compensated executives in the corporation.

We recognize that the total executive compensation for a public company might be skewed by the excessive pay of one individual,

typically the CEO. Therefore, CalPERS considers the total compensation of the CEO as well as total compensation awarded to the five most highly compensated employees as its measure of executive compensation for a public company. Compensation components include:

- Salary
- Bonus
- Option grants
- Long term incentive plans
- Restricted stock grants
- Other compensation (use of company jet, guaranteed loans, etc)

2. Financial Metrics

Next, CalPERS measures the financial performance of the public company. Nine different metrics are used to determine financial performance:

- Return on assets
- Return on equity
- Return on invested capital
- Operating profit margin
- Net profit margin
- Cash flow generated by continuing operations
- Change in EPS year over year
- One year total return to shareowners (dividends plus change in stock price)
- Three-year total return to shareowners

Return on invested capital, change in EPS and total return are given twice the weight as the other factors (total weight = 100%).

3. Scoring methodology

Executive compensation and financial performance are determined on a relative basis compared to an industry peer group within the S&P 1500 stock index. Each corporation is assigned a peer group of similar public companies

operating in the same industry or sector based on GICS (Global Industry Classification System) codes. (We further divide each industry peer group by stock market capitalization to provide an even better "apples to apples" comparison.)

The total compensation for the five most highly compensated executives within each industry is ranked from largest to smallest and the median compensation is established as the benchmark for that GICS industry classification. (The median value is used as the benchmark instead of the average value to minimize the effects of large outlier observations.)

Also, CEO compensation is ranked individually within the GICS industry, and the median CEO compensation is established. Last, each individual component of compensation—salary, bonus, options, long term incentive plans, restricted stock, and other compensation—is ranked to establish the median for each category.

Individual companies within the GICS industry are then benchmarked to the median compensation level for the top five executives, CEO compensation, and the 6 components of compensation. Positive points are awarded if the company's score on any one of the compensation factors is greater than the industry median. Negative points are awarded if the individual company's compensation factor is less than the industry median value. Each company's total compensation score is based on a weighted tally of the points earned (both negative and positive points).

Next, for each of the 9 measures of financial performance, we determine the industry peer group median using the same GICS industry group that we used to benchmark executive compensation. Once again, positive points are awarded if the company's financial performance for any one factor exceeds that of the industry median and negative points are awarded if the

individual company's financial measure is below that of the industry median. The scores across all 9 measures of financial performance are then added up to determine a final score that is compared to the industry media.

4. The model in action

An example of a specific company will help readers better understand our model. We choose a company with the GICS classification code 4520: Technology Hardware and Equipment. All of the information used in this paper is publicly distributed by the company through its annual financial statements and proxy statement. For purposes of this paper we call the company XYZ. (We include company XYZ in calculating the peer group average. We realize that including company XYZ as part of the benchmark to which it is measured does present a potential bias, but we believe that this is appropriate for determining a fair estimate of each industry's peer group average.)

Exhibits 4 and 5 provide the ranking of the data for Company XYZ. Exhibit 4 presents the data for executive compensation. The points that can be awarded to a company for any given factor of compensation or performance range from -100 to +300. If a company receives 100 points on any given factor, it is considered "in-line" with its peer group. A company will receive or lose 10 points for every 25% of out-performance or under-performance it receives relative to its peer group. Bonus points are awarded (either negative or positive) if the absolute number of the measured factor is greater than or less than 15 times the absolute peer group median. Bonus points are awarded to recognize exceptional out-performance or under-performance of an individual company.

In both Exhibits 4 and 5, the peer group median is calibrated to a score of 1200. Therefore, if any company achieves a positive score of 1200, it is deemed to be "in-line" or "neutral" with respect

to its peer group.

Finally, in Exhibit 6, we provide a graphical reference for company XYZ, where we compare its Executive Compensation Score to its Financial Performance Score on the same scale. A company score of 1200 is considered neutral or "in-line" with the rest of the industry. From Exhibit 6 we can see that company XYZ significantly exceeds its industry peer group in terms of compensation, but significantly lags its peer group in terms of financial performance. We conclude that company XYZ's executives are over compensated for the financial performance that they provide.

In this article, we have provided an empirical model to determine whether executive compensation for a public corporation is fair or excessive. Rather than rely on gross performance numbers or gross compensation, we define a relative scale to an industry peer group. We believe that it is important to consider a peer group because compensation practices and financial performance vary greatly across industries. This also allows for differences in the type of pay awarded. For example, cash-trapped software and technology companies tend to be generous in stock option awards while financial services industries with greater cash flows tend to tilt towards more cash compensation. Regardless of the industry, the analysis contained in this paper can be applied to any group of companies operating within any economic sector.

It must also be pointed out that the article stops short of providing recommendations for correcting excessive compensation. There are many ways to attack overly generous executive compensation, such as shareholders' demands that the board compensation committee be comprised exclusively of independent directors, voting against overly generous stock option plans, and supporting stock option plans where the ability to receive options is widely dispersed throughout the corporation. These are all shareholder activist

strategies, but we will leave them as topics for another day. ■

(Exhibits on following pages)

Exhibit 1: S&P 500 Executive Compensation

Compensation Category	2001	2002
Median Salary	10.1%	4.2%
Median Bonus	-17.6%	8.8%
Stock Options	43.6%	-18.6%
Restricted Stock	-21.0%	1.3%
Overall Compensation	26.7%	-10.9%
S&P 500 Total Return	-11.90%	-22.00%

Exhibit 2: Growth of Index Investing

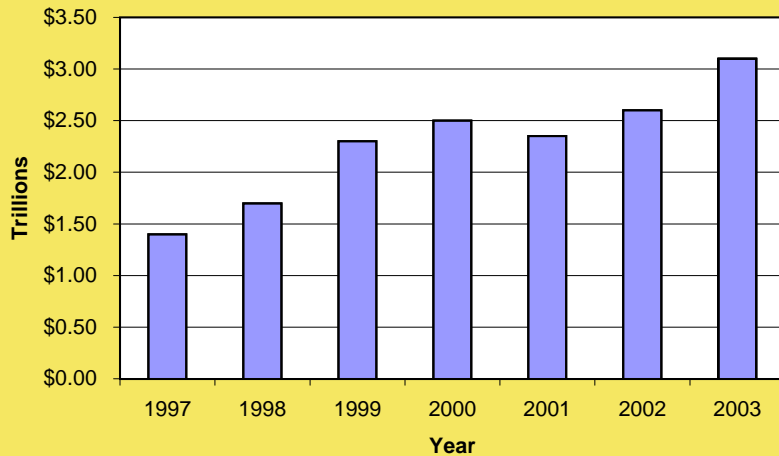


Exhibit 3: Institutional Equity Ownership in the United States

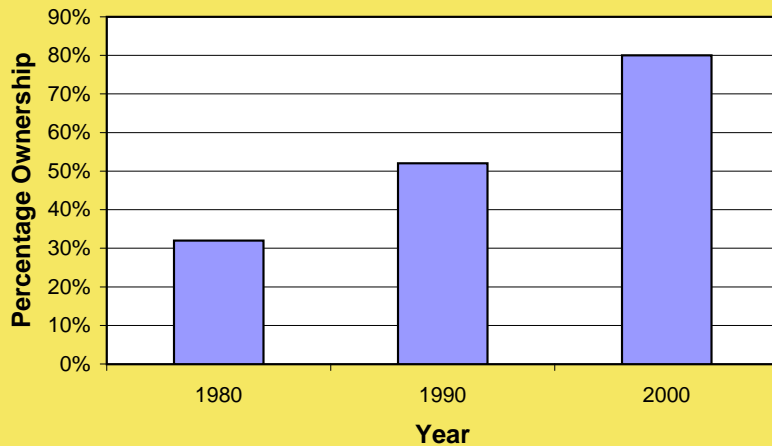


Exhibit 4: Executive Compensation for Company XYZ

Compensation Category	Company XYZ	Peer Group	% Difference	Points	Extra Points	Weight	Final Score
Top Five Executive Compensation	\$66,694,605	\$14,343,822	464.97%	250	0	2	500
CEO Executive Compensation	\$38,240,423	\$6,447,153	593.14%	300	0	1	300
CEO Salary	\$1,200,000	\$673,500	178.17%	140	0	1	140
CEO Bonus	\$1,800,000	\$382,278	470.86%	250	0	2	500
CEO Other Compensation	\$583,203	\$46,824	1245.52%	300	0	2	600
CEO Long Term Incentive Plan	\$0	\$0	0.00%	100	0	1	100
Restricted Stock Grants	\$11,005,000	\$0	0.00%	300	300	1	600
Stock Options	\$23,652,220	\$4,661,015	507.45%	270	0	2	540
Total Points Company XYZ							3280
Peer Group Median Score							1200
Spread between XYZ and the Industry Peer Group							173.33%

Exhibit 5: Financial Performance for Company XYZ

Financial Performance	Company XYZ	Peer Group	% Difference	Points	Extra Points	Weight	Final Score
Net Margin	-96.00%	1.20%	-81.00%	-100	-200	1	-300
Return on Assets	-46.00%	1.40%	-33.50%	-100	-200	1	-300
Return on Equity	-241.30%	2.40%	-102.50%	-100	-200	1	-300
Return on Invested Capital	-66.60%	1.70%	-40.10%	-100	-200	2	-600
Operating Margin	-37.80%	5.20%	-8.30%	-100	0	1	-100
One Year Stock Price Change	-66.40%	-29.70%	-1.20%	60	0	2	120
3 Year Stock Price Change	-94.50%	-54.90%	-0.70%	80	0	1	80
Cash Flow from Operations	-\$756,000,000	\$177,800,000	-5.30%	-100	0	1	-100
Change in EPS	0.30%	0.20%	150.00%	110	0	2	220
Company XYZ Total							-1280
Industry Peer Group							1200
Spread between XYZ and Industry Peer Group							-207%