Understanding Executive Compensation

A Practical Guide for Decision Makers

Edited by
Irving S. Becker & William M. Gerek
Hay Group
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Editor: Andrea M. Ozias
Design: Melissa Neubauer, Hanna Norris, Kris Sotelo
Production Manager: Rebecca Williams Ficker

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About the Authors
Prologue

*Understanding Executive Compensation: A Practical Guide for Decision Makers* is a reference guide for compensation committees and other board members, human resources professionals, corporate management and other decision makers. This book’s purpose is to give readers easy access to a wide range of executive compensation topics by providing insight on current best practices, design techniques and trends. This is a hands-on, practical guide that we hope helps in the evaluation and refinement of executive compensation programs.

As companies strive to adjust to dramatic market swings and regain past footing, the challenges of executive compensation have never been greater. If executive compensation policies are to withstand regulator, shareholder and even congressional scrutiny, then they must — more than ever — establish a consistent and transparent connection between pay and value provided. This is the main challenge confronting boards and executive compensation professionals today.

Recent trends and developments in executive compensation have positioned companies well to respond to current challenges. Congress and the U.S. Securities and Exchange Commission (SEC) have raised the bar on governance standards; they and others will continue advancing this process, thus addressing the crucial need to ensure board and senior executive accountability. Enhanced compensation disclosure has vastly improved transparency of the programs and, therefore, competitive analysis, thus providing a clearer idea of how companies think and operate. Most importantly, accounting rules allow flexibility in designing compensation programs that better reflect pay-for-performance principles. Compensation expense no longer dictates plan preference. This level playing field provides compensation committees with additional vehicles
to use in designing executive pay programs that meet business strategy needs. (See “Major Executive Compensation Trends and Challenges Affecting Us Today.”)

These issues are only some of the topics we address in *Understanding Executive Compensation: A Practical Guide for Decision Makers*. The following chapters are a compilation of articles by Hay Group consultants from *The Executive Edition*

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**Major Executive Compensation Trends and Challenges Affecting Us Today**

**Long-Term Incentives**

The trend of adopting performance-based plans — or adding performance features to traditional stock options and restricted stock plans — will continue, thus creating a flexible portfolio approach to long-term incentives. This realignment can be traced to early discussions about expensing stock options and concerns about stock option abuse. Sarbanes-Oxley created a heightened level of scrutiny for boards of directors that has had an effect on compensation committees. Add in more disclosure requirements and the pressure from institutional shareholders to do a better job of linking pay to performance, and it is not difficult to understand the new interest in performance-based equity plans. However, this makes more work for compensation committees.

**Compensation Committees**

Compensation committees will be more involved in the details of executive compensation planning and implementation, especially regarding long-term incentives. In the past, compensation committees mostly focused on annual performance metrics.

With the proliferation of performance plans and the need to quantify and justify total pay, compensation committees will have to focus more on long-term performance drivers. They will spend more time ensuring they are choosing the right metrics, monitoring the metrics to assure they are driving the right executive behaviors, and adjusting them as appropriate. Compensation committees are not always close to the management of the business, and they often worry about how performance is calibrated, not wanting to establish goals that are too easy or too difficult to meet. The most frequently asked question is, “How do we know we have set the right targets?”

**Compensation Philosophy**

An organization’s executive pay programs should be based on a well-conceived compensation philosophy, re-examined annually, and linked to other human resources programs, such as performance evaluation, communications and management succession.

**Institutional Investors**

As companies strive to compete in a volatile global economy, institutional investors will focus even more on performance metrics, thus complicating the work of compensation committees. Twenty years ago, institutional investors simply
series, supplemented by articles written recently specifically for
this volume. This is not a technical reference per se; in focusing
on what works best, we have avoided presenting too much detail
on tax, accounting and regulatory issues. This book is targeted
mainly to a U.S. audience; nonetheless, with its focus on design,
we believe it will be a useful resource for non-U.S. companies
operating in a pay-for-performance environment.

looked at dilution models and voted yes or no. Today, they use detailed financial
formulas or “black box” approaches to determine pay-for-performance relation-
ships and are active in criticizing companies that do not meet their guidelines.
They do this by voting against proposed plans or withholding votes for compen-
sation committee members. A focus on financial metrics can cause companies
to shy away from nonfinancial measures because they are difficult to disclose
and describe. This reliance on only financial metrics may not be in the best
long-term interests of the shareholders.

Institutional investors also are demanding best-practices behavior by forcing
companies to establish a clear link between what management accomplished
and the amount of pay delivered. While there is not yet anything as formal as
Sarbanes-Oxley strictures in executive compensation, institutional investor
activities have an effect on compensation committees similar to that of
Sarbanes-Oxley on audit committees.

Internal Pay Equity

We expect to see considerable attention paid to internal equity. Compensation
committees are frustrated in relying only on external market data. While many
companies disclose that they use both internal and external pay factors,
approaches to establishing internal pay equity often suffer from shortcomings
in methodology. Internal pay equity too often focuses solely on comparing pay
levels without looking closely at what executives actually do in their jobs. By
going beyond job titles and pay ratios, companies can better judge what is unique
about given executive positions and determine pay levels that are defensible and
fair. Once accomplished, however, there is still the need to reconcile internal pay
equity with external benchmarking.

Total Remuneration

Often, in focusing on the technical and motivational aspects of an annual or long-
term incentive plan, we neglect to put the parts together and look at the total
picture. In the future, more attention will be paid to total remuneration, both in
terms of total amounts actually or potentially delivered to executives and the role
each element plays in achieving organizational goals. This far-reaching exercise
encompasses extrinsic pay elements (salary, annual and long-term incentives,
benefits and perquisites) as well as intrinsic elements (work culture, job satisfac-
tion, work environment and development opportunities).
For each chapter, one or more consultants have refined and updated articles previously written on the topic. In some instances, they have written a new article. The chapters are grouped in three sections:

- “Executive Pay Design and Strategy” examines issues relating to overall executive compensation strategy and includes design issues relating to the basic components of pay — base salary, annual incentives, equity and nonequity long-term incentives — plus discussions of related topics, such as peer group selection, performance measurement, competitive benchmarking, executive benefits, equity retention and employment agreements.

- “Governance and Compensation Committee Initiatives” begins with an overview of executive compensation governance issues and then goes on to discuss the tools compensation committees have at their disposal in overseeing executive compensation. In addition, we discuss approaches to management and CEO succession planning and board compensation.

- “Executive Compensation in Special Settings” addresses the compensation issues that arise in extraordinary situations, such as IPOs and mergers and acquisitions. We also include a chapter on executive and board compensation in not-for-profit organizations, as well as a chapter on international compensation.

I would like to thank WorldatWork for publishing *Understanding Executive Compensation: A Practical Guide for Decision Makers*, and Hay Group for its ongoing support of our executive compensation practice. I also want to thank our clients who furnished insights in working together on executive pay projects. Special thanks go to Bill Gerek, my co-editor. As editor of Hay Group’s *The Executive Edition*, he has created a consistent theme and tone for our executive compensation publications over the years. Most of all, I would like to thank Hay Group consultants who have contributed their time, effort and intellectual capital to making this book possible.

— Irving (Irv) S. Becker
National Practice Leader,
Executive Compensation Practice
Hay Group
A Synthesis of Current Knowledge and Best Practices

*Understanding Executive Compensation: A Practical Guide for Decision Makers* is a desk reference for compensation committees and other board members, HR professionals, corporate management and other decision makers who need a better understanding of the main components and issues involved in executive pay, especially from a design perspective. Editors Irv Becker and Bill Gerek have carefully selected and organized the chapters to cover the basic areas affecting executive pay, specifically focusing on design and governance. Through a collection of articles, this book synthesizes current knowledge and best practices, providing relevant discussion of trends.

This book is a useful piece of work on multiple levels. It provides a very thorough but broad review of the strategic issues at play in the design and deployment of contemporary executive compensation. At the same time, it is destined to be a reference to be consulted again and again over the years. Irv Becker and Bill Gerek have hit that optimal balance of providing enough of a review of the technical issues of executive compensation so that the reader gets more than a conceptual overview while not being tied to the short shelf-life of rules and regulations.

— William Strahan, Senior Vice President, Compensation & Benefits, Comcast

*Understanding Executive Compensation: A Practical Guide for Decision Makers* is a valuable resource to both the executive compensation professional and the executive or board member who is called into service in this area. Each chapter begins with a useful summary that allows the reader to grasp the basic principles to be covered and individually determine whether he/she needs to read on for additional detail. Illustrative charts and examples within each chapter aid readability and add to the reader’s understanding. While covering each topic in detail, the authors avoid technical and legal jargon. I learned from this book.

— Michael S. Melbinger, Partner, Chair of the Employee Benefits and Executive Compensation Practice, Winston & Strawn LLP

This book is not about the controversies or media reports surrounding executive compensation today. Rather, it focuses on the fundamentals of total executive compensation design. With easily digestible articles, this compendium is properly designed to provide compensation committee members solid grounding to understand and, more importantly, critically challenge and assess proposed executive pay programs.

— Jill Kanin-Lovers, Corporate Director and Compensation Committee Chair