

## **Daniel Summerfield**

### **Executive Compensation:**

*General weaknesses in remuneration systems and practices which generally provide inappropriate and inadequate incentives for directors.*

#### **Evidence that this is a problem:**

*Disconnect between incentives and long-term performance objectives & indicators:*

- Warren Buffet in his recent letter to shareholders wrote that “With most of the results now in, the acid strip is bright red: Corporate reform has failed. Not only does executive pay seem more decoupled from performance than ever, but boards are conveniently changing their definition of performance”<sup>1</sup>
- The long-standing debate about executive compensation has focussed primarily on trying to align interests in the short-term or to stop what is wrong (curbing excesses and rewards for failure). Investors have not developed their own ideas for aligning directors’ objectives with long-term investors’ interests.
- There has been an excessive use of options<sup>2</sup> which has i) fostered a culture of short-termism with no link to individual performance<sup>3</sup> and ii) has aligned executive and investor interests on managing share price.<sup>4</sup>
- Investors and boards have put in places systems which, based on what peers are doing, make it almost inevitable that executives will feel under pressure to generate short-term gains even if they put long-term performance at risk.<sup>5</sup>
- Measures which have been used in the past to assess the overall performance of the company, such as Earnings Per Share, are now increasingly understood to provide an inaccurate snapshot of corporate performance.<sup>6</sup>

*Inappropriate Incentivisation*

- There is a strongly held assumption that without the “right” executive compensation package, organisational success is threatened. This leads to considerable attention, by boards, remuneration consultants and increasingly investors, on the details of the “right package”. Despite this effort, and according to Jim Collins’s highly regarded research, there is no systematic pattern linking executive compensation to the process of going from “good to great”. According to Collins, “it’s not how you compensate your executives, it’s which executives you have to compensate in the first place.”<sup>7</sup> Indeed having the wrong remuneration system in place could contribute to the problem of recruiting the wrong leaders and certainly draws into question the board’s strategic understanding of the recruitment challenge.
- According to recent research undertaken in the UK, there is no evidence to suggest that companies can motivate their executives to outperform simply by paying them higher salaries.<sup>8</sup> Nevertheless, huge remuneration packages have been widely granted bearing little relationship to sustainable corporate performance.<sup>9</sup>
- US pay norms have become global benchmarks with boards simply claiming that they cannot “buck the market” and are unable to prevent the effects of “US contagion”.<sup>10</sup>
- There is a growing divergence between the pay at the top of an organisation and the rest of the company which is seen to be “driving a wedge between the

leadership and the led” and creating problems in motivating and incentivising employees.<sup>11</sup>

***Potential solutions:***

*Ensure that corporations disclose what is being incentivised:*

- a) Incentives should be linked to progress in long-term value creation.<sup>12</sup> Executives should be compensated appropriately for their contribution to this process and not for market or industry wide rises in stock prices.<sup>13</sup>
- b) In particular, incentive systems should not result in benefits to senior managers from growth through acquisition for its own sake. Rather there should be a clear strategy to pursue the right type of growth at the right time.<sup>14</sup>

*Ensure appropriate measures are used:*

- a) There is a need to balance the elements of executive compensation and tie them more closely to the organisation’s mission, annual business performance and the creation of real shareholder value over time.<sup>15</sup>
- b) Other quantifiable measures are more appropriate than EPS. One option is TSR for which organic growth is considered to be the dominant driver in both the short and long-term. Another option is to employ the ‘cash value added’ principles and in particular, cash flow return on investment (CFROI). Firms with highest CFROI are deemed to withstand unexpected shocks, such as economic downturns, more effectively.<sup>16</sup>

*Ensure that the performance of the individual counts:*

- a) There needs to be more of a focus on specific responsibilities by linking individual rewards more materially to their performance in advancing the corporation’s strategy<sup>17</sup> This should reflect improvements in performance or durable changes in analysts’ expectations for which the executives themselves were responsible,<sup>18</sup> with a particular focus on their specific responsibilities and personal targets.<sup>19</sup>

*Focus on long-term incentivisation and motivation strategies:*

- a) Corporations need to significantly decrease their emphasis on stock options. Restricted shares granted under conditions relating to executive tenure and performance should make up a higher proportion of the remuneration package.
- b) Corporations should consider restricting the sale of a significant portion of the CEO’s stock awards for a period beyond the end of his tenure (perhaps 5 or 10 years) to ensure that the CEO’s focus is on creation of long-term value and not on short-lived bumps in stock prices. It would also encourage the CEO to focus more on succession planning.
- c) The package that goes to the directors and senior executives should set the culture for pay deals all the way down the organisation.<sup>20</sup> For example, if an organisation depends on several drivers for success (e.g. R&D productivity, reputation, sales, etc), there should not be unbalanced recognition of only issue (e.g. sales targets).

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<sup>1</sup> Quoted in *Fortune Magazine*, 14 April 2003.

<sup>2</sup> S&P data show that in 1992, options were 27 percent of median CEO compensation, whereas by 2000 options were 60 percent of median compensation. *The Conference Board*, 2003.

<sup>3</sup> Pearl Meyer in Charles Elson, 'What's Wrong with Executive Compensation,' *HBR*, January 2003. According to McKinsey research, standard stock options which form a significant component of CEO's remuneration "do not differentiate between value created by external factors and individual performance." The research shows from 1991 to 2000, market and industry factors drove about 70 percent of the returns of individual companies, company-specific factors only about 30 percent. (J.C. de Swaan and Neil W.C Harper, 'Getting what you pay for with stock options,' *McKinsey Quarterly*, 2003, no.1.)

<sup>4</sup> T. Koller, 'Numbers investors can trust,' *McKinsey Quarterly*, no.3, 2003

<sup>5</sup> 'Beyond Shareholder Value,' *The Economist*, 26 June 2003.

<sup>6</sup> *Succeed in uncertain times: A Global study of how today's top corporations can generate value tomorrow*, The Boston Consulting Group. The paper suggests that EPS does not measure what shareholders materially receive, could be manipulated and cannot be used to valid intercompany comparisons.

<sup>7</sup> Collins, pp.49-50. "The purpose of a compensation system" he says, "should not be to get the right behaviours from the wrong people but to get the right people on the bus in the first place and keep them there."

<sup>8</sup> D. Oakey, 'The real scandal behind directors' pay,' *Investors Chronicle*, 16 August 2002.

<sup>9</sup> R. Monks and A. Sykes, *Capitalism without owners will fail*, CSFI, November 2002

<sup>10</sup> The Sunday Times, 18 May 2003.

<sup>11</sup> H. Mintzberg, R. Simons, K. Basu, *Beyond Selfishness*, April 2002 (working draft). According to a recent survey over the 1990s by the Institute of Policy Studies – *Executive Excess 2001*- CEOs' pay rose by 570%, while profits rose by 114% and average worker rose by 37%.

<sup>12</sup> CalPERS' memo to its Investment Committee, 16 June 2003.

<sup>13</sup> Why Leaders Should Reconsider Their Measurement Systems, Michael Hammer, Leader to Leader Institute, No 24, Spring 2002

<sup>14</sup> Several studies have shown that in 60-70% of cases mergers and acquisitions destroy long-term shareholder value. 'Mergers: Why Most Big Deals Don't Pay Off,' *Business Week*, 14 October 2002.

<sup>15</sup> Why Leaders Should Reconsider Their Measurement Systems, Michael Hammer, Leader to Leader Institute, No 24, Spring 2002

<sup>16</sup> Boston Consulting Group, *Succeed in uncertain times*, p.7.

<sup>17</sup> J. Fuller, A Letter to the Chief Executive, *HBR*, October 2002, p.7.

<sup>18</sup> J.C.de Swaan and Neil W.C. Harper, 'Getting what you pay for with stock options'.

<sup>19</sup> Tough Executive Pay Choices for 2003, The Segal Group, 2003.

<sup>20</sup> The UK's Greenbury Code refers to the need for remuneration committees to be sensitive to the wider scene, in particular pay and employment conditions elsewhere in the company, so that their decisions may, as far as possible, be consistent and fair, and be seen as such." (6.13, Greenbury Report, 1995)