How executive pay lost its way

Two misguided notions are making it exceptionally difficult for directors to create strong incentives at reasonable cost to the shareholders.

By Stephen F. O'Byrne and S. David Young

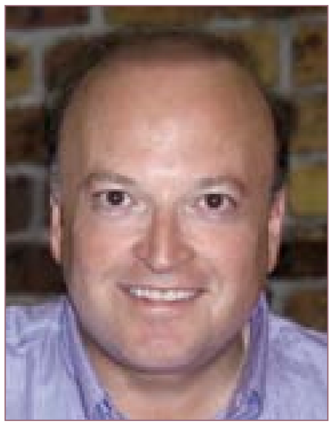
The effort of the investment banks to target compensation as a percentage of revenue is a rare, but misguided, effort to provide a comprehensive formula for executive pay. Few companies make any effort to define a comprehensive formula. But a share of revenue is more appropriate for movie stars than managers, and even movie stars don't get to raise their share when times are tough. Value-sharing formulas designed to protect the shareholders used to be common. Understanding why they've disappeared will help directors see what they need to do to re-assert the shareholders' interest.

In 1922, General Motors adopted a bonus plan that gave management 10% of profit in excess of a 7% return on capital. The formula was a comprehensive management-shareholder bargain, covering all incentive compensation, both cash and equity, and all bonus-eligible managers. Moreover, it lasted for 25 years without any change in the sharing percentage or threshold return. Similar formulas were quite common before World War II. A 1936 study by future Harvard Business School dean John Baker found that 18 of 22 companies analyzed gave management a share of economic profit or profit above a dollar threshold.

Comprehensive incentive formulas started to wane in the 1950s for two reasons. Special tax benefits led more companies to grant stock options, but few companies developed an option value formula so they could charge the option grant value against the bonus pool. Instead, they used a bonus pool formula to manage cash incentives and a stock option reserve to manage stock option grants. More importantly, changing management practice led to new focus on "job value" and "competitive pay" and less concern about management's contribution to shareholder value. The Hay Guide Chart for job evaluation was standardized in 1951 and the first American Management Association survey of executive compensation was conducted in 1950. The early compensation surveys used profit as a measure of company size, but soon switched to revenue — regardless of profit — as the key measure of company size.

Tracing the shift at IBM

IBM provides a good example of the transition to modern human resource practice. When Tom Watson joined Computer Tabulating Recording Co. as CEO in 1915 he had a salary and a 5% share of



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undistributed after-tax profits. As late as 1960, IBM had 90 executives with individual shares of corporate profit. In the mid-1960s, a major consulting study led to a new compensation program that eliminated the individual profit shares, introduced formal job evaluation, and established target compensation levels. For top management, target cash bonuses ranged from 33% to 100% of salary and target stock option grants were three times cash compensation.

The shift from a share of economic profit to a target incentive as a percent of salary has a profound effect on management incentives. With a fixed share of economic profit, bad decisions today, e.g., a new product with a low return on capital, reduce current and future pay. With a target incentive as a percent of salary, bad decisions today often led to higher future pay. The new product's revenue leads to an increase in target pay levels and the lower capital return is offset by an adjustment in the target profit level.

The compensation history of IBM CEO John Akers illustrates the negative consequences of target incentive levels. In his first year as CEO, 1986, Akers received an option on 19,000 shares exercisable at $145. In each subsequent year, the stock price dropped and he received an option on more shares exercisable at a lower price. In 1990, he received an option on 96,000 shares exercisable at $97. When he was forced out at the end of 1992, with the stock below $50, his option and stock grants had put him in a position where he would have earned more than $17 million just for getting the stock price back to where he started.

'Paid like bureaucreats'

The perverse incentives created by competitive pay policies led to a counter-reaction beginning in the 1980s. Professors Michael Jensen and Kevin Murphy, in a celebrated article, said "corporate America pays its most important leaders like bureaucrats" and urged boards to "provide big rewards for superior performance and big penalties for poor performance" and require CEOs to become "substantial owners of company stock." This shareholder value movement led to a huge increase in option grants. In 1992, S&P 500 companies granted options worth $11 billion; by 2000, they were granting options worth $119 billion.

The counter-reaction greatly increased incentive compensation levels, but had a much smaller effect on management's incentive to increase shareholder value because it never abandoned the concept that managers were entitled to competitive pay regardless of prior performance. The best measure of a manager's incentive to increase shareholder value is "wealth leverage" — the ratio of the percentage change in the manager's wealth to the percentage change in shareholder wealth. A manager's wealth leverage is a weighted average of the leverages of the manager's stock (1.0), options (about 1.5 on average), and expected future pay. When a company is committed to competitive pay regardless of performance, the wealth leverage of expected future pay is zero. The wealth leverage of the average S&P 1500 CEO dropped from 0.74 in 1997 to 0.61 in 2007 despite an increase in stock and option holdings from $21 million to $29 million. About a third of the decline is due to lower option holdings, but the rest is largely due to the increase in annual total compensation from $1.9 million to $4.1 million and the associated increase in the present value of expected future pay.

> ***The concept of competitive pay regardless of performance — that's the real problem.***

Not the proper role

Today, two misguided notions are making it exceptionally difficult for directors to create strong incentives at reasonable cost to the shareholders. The first is that excessive pay is the result of bad peer groups. The peer group isn't the real problem — it's the concept of competitive pay regardless of performance. The second misguided notion is that a director's proper role is to provide discretionary judgment about appropriate pay. Discretion should be the exception, not the rule. The more part-time directors rely on discretion, the more incentive full-time managers have to overwhelm them with multiple performance measures and complex pay vehicles.

Directors need to abandon the concept of competitive pay regardless of performance and adopt a governing formula for incentive compensation that protects the shareholders and ties future pay to current performance. ■

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