Myths and Realities of Executive Pay

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The views in this statement are those of the author and do not necessarily reflect the views of Watson Wyatt Worldwide or any of its other associates.

Introduction

Executive pay practices have been controversial in the United States for the past 15 years. In the late 1980s and early 1990s, critics argued that there was not enough pay-for-performance -- that executives did not have their pay linked to the performance of their companies' stock. Over the years there has been a tremendous increase in the size of executive pay increases -- 15% to 20% annual compound growth rates at the typical billion dollar company. Most of that increase has been in the form of stock-based compensation, primarily stock options.

During that time the performance of many American companies and the U.S. economy has been spectacular. Whether that performance is a *coincidence* with the rise of stock-based incentives or whether this type of executive pay played a significant role in *causing* that superior performance has been hotly debated. Despite the high-profile examples of extremely high pay for low performance, *I believe that these pay practices*, in combination with many other factors ranging from low interest rates and favorable demographics to globalization, *were an important component in creating the successful U.S. economic model.*

Executive pay, especially CEO pay, is *currently* controversial for a number of specific reasons. CEO pay levels in a few instances have reached into the hundreds of millions of dollars for a single year. Is any employee worth that type of money? Also, in some instances, there have been examples of CEOs being highly rewarded for mediocre or even poor performance. Is that fair? The examples of overstated profits or even outright fraud make this situation even worse. And the situation is compounded by the ability of executives to time the exercise of their options and the sale of their stock. Added into this stew is the peculiar fact that stock options are accounted for differently from other forms of compensation.

It is no wonder that this area is so criticized. However, I believe that it is essential to take a hard objective look at the data. It is a well-researched area by academics. Watson Wyatt also has done numerous studies looking at these questions and others. *And most importantly, I believe that shareholders -- the final arbiters of this controversy -- need to look at the typical individual company and not the outliers.*

In this spirit, I present the following list of Myths and Realities of Executive Pay:

Myths and Realities of Executive Pay

1. **Highly Paid CEOs:** CEOs of billion dollar companies are well paid by the standard of regular employees.

TRUE: The typical CEO of the largest 1200 companies had salary, bonus, plus stock options exercised equal to $1.3 million.*

And yes there are those $100 million paychecks (seven of them in 2001).

However, relative to the enormous economic value created by these executives, they appear to be worth the expense and they look even better in comparison to lower-paid Japanese CEOs who run troubled companies.

Further, looking at other labor markets (athletes and movie stars, for example) these pay levels seem far less extreme, given the accountability, job creation and value-creating opportunities of the typical corporate CEO.

2. **No Pay-for-Performance:** There is no pay-for-performance for executives. All CEOs became rich on their stock options, which went up in value because the stock market went up, under the "rising tide lifts all boats" theory. CEO pay only goes up, and never goes down, even if the performance of the company is poor.

FALSE: Watson Wyatt and much academic research show two important findings:

*a. The highest paid CEOs work for the highest performing companies. This is true both in terms of pay opportunity "before-the-fact" and actual pay "after-the-fact." I believe that the pay opportunities in the form of stock incentives, in fact, help to **cause** the superior performance at many companies and at the macroeconomic level.*

*b. Executive pay levels at most companies go up **and down** with the performance of their company in a given year. Over the past 10 years, it is true that total pay (cash plus exercised stock options) has gone up at the typical company at the same time that performance has been excellent. The big test has come over the past two years when profits and the stock prices have been flat or declined for many companies.*

We found for both 1999-2000 and 2000-2001 that total pay went down significantly, commensurate with the decline in performance (profits and stock price). For example, looking at those largest 1200 companies, we found that total pay went down by nearly 30%, with nearly 72% of the CEOs experiencing a decline. For a smaller sample of larger companies in 2001, we found an additional 50% of CEOs experiencing a decrease in total pay, netting to a 1% decline. These are clear examples of pay-for-performance.

Are there examples, where pay goes up while profit and stock prices go down? Yes -- but these are much more the exception than the rule. And these inconsistencies are quickly called out by institutional investors, the media and the like.

* 2000 Data

3. **Stock Options are Ineffective:** Stock options have had no positive impact on the financial and stock market performance of the typical U.S. company and have been a waste of shareholder resources.

*FALSE: Our studies and numerous academic studies, including one by the Fed,** have shown that there is a positive correlation between grants of stock options and the financial and stock market performance of most companies. This is true in both compensation opportunity as well as the resulting actual compensation (see Watson Wyatt's studies, Executive Pay in 2002, and Managing Stock Option Overhang in Today's Economy, 2002).*

4. **Too Many Stock Options:** However, there are a number of companies who have stock option levels beyond a comfort zone for shareholders and are not receiving an adequate return on that investment.

TRUE: Our research and academic studies have shown that companies with excessively large amounts of stock option "overhang" have lower returns to shareholders than companies with more moderate usage. (Stock option overhang is defined as the number of stock options granted plus those remaining to be granted as a percent of a company's total shares outstanding.)

5. **Stealth Compensation:** There are massive amounts of "stealth" compensation out there, where executives are getting paid under the table when they do not earn money on their bonuses and stock options.

FALSE: There are examples of CEOs getting special perquisites from their companies, ranging from use of the corporate jet to consulting contracts. These perks, however, represent a tiny part of the total executive pay program. We estimate these at substantially less than 1% of total pay.

Watson Wyatt's Human Capital Index® research shows that companies that are hierarchical and have lots of status distinctions perform more poorly than those with fewer perks. Therefore, I typically advise companies to minimize these programs.

6. **Stock Options are Perfect:** Stock options perfectly align the interests of executives with those of outside shareholders.

FALSE (or, rather, not entirely true): Stock options have no downside risk and therefore are an imperfect substitute for real share ownership by employees. Stock options also do not generally end up as shares owned, but are more likely to be exercised and sold than held as shares. Furthermore, our research and others have shown that options may motivate executives to undertake riskier business strategies.

7. **Executive Stock Ownership:** Executive stock ownership is very helpful to companies.

TRUE: Research has shown that companies with significant amounts of executive stock ownership perform better than companies with low stock ownership.

** "Recent Trends in Compensation Practices," David Lebow et al., 1999

8. **CEO Labor Market:** The labor market for executives is a "rigged" labor market where the CEO stacks the Board with his or her friends and they in turn set pay at as high a level as possible. The compensation committee is comprised mostly of insiders who do whatever the CEO wants them to do. These Board members spend their time approving egregious compensation programs that are not approved by the shareholders.

FALSE: The CEO labor market meets all of the criteria of any market, including independent supply and demand, transparency and liquidity.

My experience in attending compensation committee meetings is that these Board members are thoughtful and independent and take their responsibilities very seriously. They frequently vote down or modify management's proposals on pay matters. And as a general course of business they send most (90%+) stock-related proposals to the shareholders for their approval.

9. **Stock Option Re-pricing:** Options are frequently "re-priced" when the stock price declines. (By re-priced, I mean that the strike price is lowered some time after the original stock option grant is made thereby creating a huge advantage for the employees relative to the shareholders.)

FALSE: While some companies have re-priced their stock options over the past few years, this is far more the exception than the rule. Our research shows that no more than a few hundred companies of the more than 10,000 publicly traded companies, have re-priced. This represents a few percentage points at most.

10. **Inside Information:** Executives have inside information that allows them to time their sale of stock as well as the timing of their stock option grants and exercises.

TRUE AND FALSE: Executives have more information than outside investors, which is why many companies have "blackout" periods on sale of stock. However, I think this is an area that companies could police better, for example requiring executives to announce ahead of time that they are going to sell (something already covered under securities laws).

11. **Accounting for Stock Options:** Current accounting rules for stock options are unfair to shareholders and there is no logical reason why these rules differ so much from the corporate tax rules for options.

*FALSE: Watson Wyatt and academic research show that shareholders are incorporating the amount of stock options into today's stock price despite the fact that stock options are only **disclosed** and are not, in fact, **expensed**. This is consistent with the current footnote disclosure combined with the efficient market hypothesis.*

While the accountants may feel a need to change the accounting rules for options, there is a basic logic to how the current rules were developed in 1973. The FASB did not look to the IRS for guidance, but to other accounting rules relating to corporate derivative securities, (e.g., puts and calls). They basically made the accounting for employee options consistent with those rules for derivative securities, namely no impact on the income statement.

Conclusion

In conclusion, while executive pay remains controversial, I believe that the U.S. pay model has been much more helpful to our companies than harmful. Investors need to look at the typical company's behavior and not the most extreme examples. Many of the perceptions about executive pay out there are false, and not at all reflective of reality. I do believe, however, that there are some areas—notably increasing stock ownership and managing stock sales—that could be improved.

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Mr. Kay is the Practice Director in charge of Watson Wyatt's Compensation Practice. His primary objective is to help Watson Wyatt's clients to use compensation programs to drive business, organizational and cultural change.

Mr. Kay has worked closely with U.S. public, international and private companies, helping them to develop annual and long-term incentive plans to increase shareholder value. His clients include AIG, KPMG, Lowe's Companies, Qwest, AXA, UBS Warburg Dillon Read, Dun & Bradstreet, The Limited, Pall Corporation, Duke Energy, among many others. He has experience in mergers, initial public offerings, turnaround and bankruptcy situations.

Mr. Kay conducts research on stock option overhang, executive pay and performance, and CEO stock ownership. This research is extremely useful to clients and receives significant media coverage.

Before Watson Wyatt, Mr. Kay was the Managing Director of the Executive Compensation Practice for The Hay Group. Previously, Mr. Kay held executive positions at two prominent Wall Street firms.

Mr. Kay has a B.S. in Industrial and Labor Relations from Cornell University and a Ph.D. in economics from Wayne State University. He has written and spoken broadly on executive compensation issues. He is a co-author (with Dr. Bruce Pfau) of the book, **The Human Capital Edge**, published by McGraw-Hill. He is also the author of **CEO Pay and Shareholder Value: Helping the U.S. Win the Global Economic War,** published by St. Lucie Press, and **Value at the Top: Solutions to the Executive Compensation Crisis**, published by Harper Collins. He has been published in the Harvard Business Review and the McKinsey Quarterly. Mr. Kay has presented analysis of executive compensation issues before the Federal Reserve Board, the S.E.C., the F.A.S.B. and a U.S. Senate subcommittee.