THE
CONFERENCE
BOARD
REVIEW
IDEAS AND OPINIONS FOR THE
WORLD'S BUSINESS LEADERS

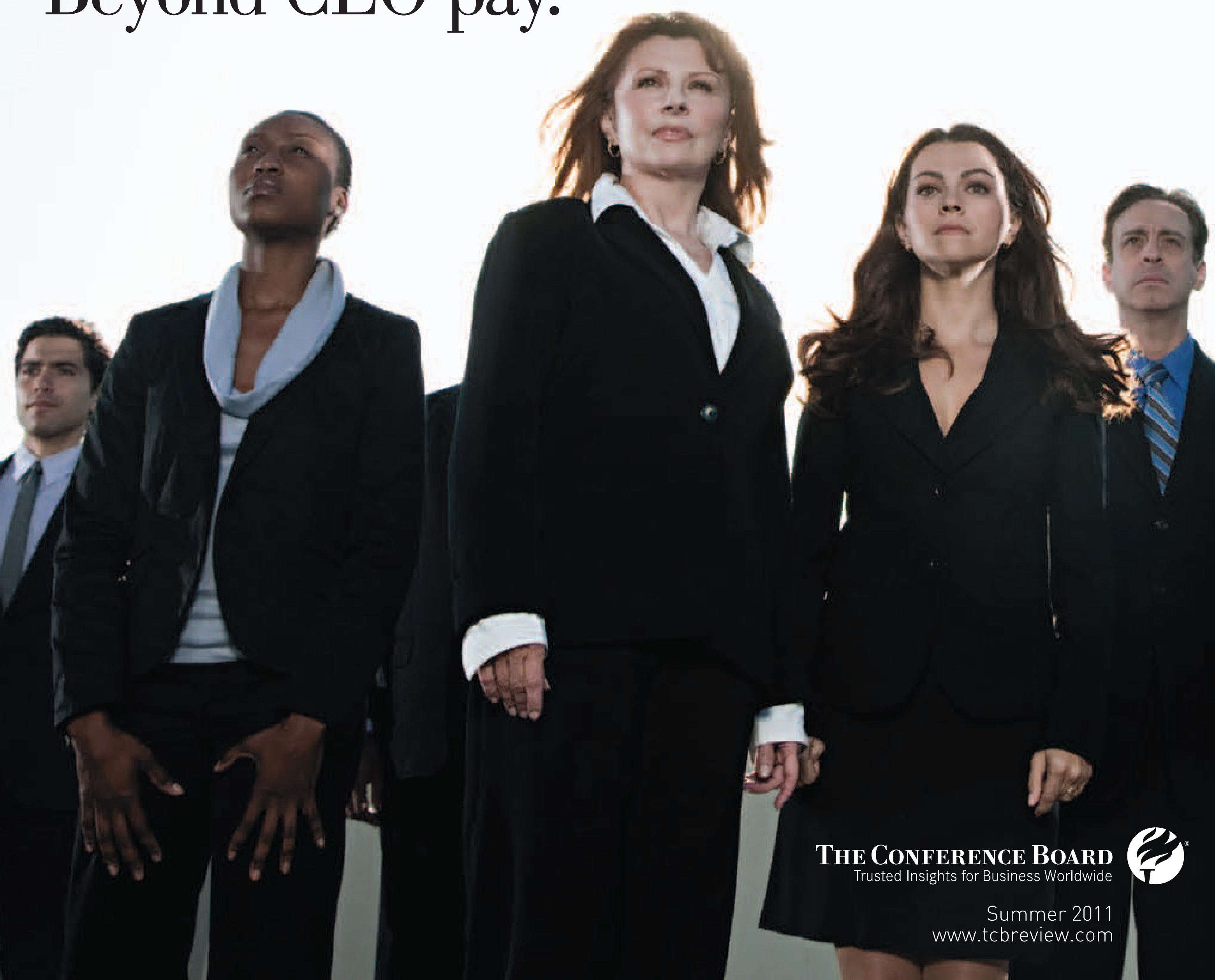
WHAT DO YOU KNOW,
AND HOW DO YOU KNOW IT?

LISTEN UP—BEFORE
THE WHISTLE BLOWS

WHO IS WAL-MART
AFRAID OF?

What About The Rest of Us?

Beyond CEO pay.



THE CONFERENCE BOARD
Trusted Insights for Business Worldwide

Summer 2011
www.tcbreview.com

WHAT ABOUT THE Res

BY VADIM LIBERMAN

VADIM LIBERMAN is senior editor of *TCB Review*. His pay package includes use of the corporate microwave.

t of Us?

Beyond CEO pay.

Viacom's Philippe Dauman earned $84.5 million in 2010. But this article isn't about the nation's highest-paid CEO.

Paul Otellini, Intel's chief executive, made $15.7 million last year. But this article isn't about him either.

The average American worker took home just over $40,000 last year. But again, this article isn't about Average Joe.

This article isn't about them because you've already read that piece enough times to write it yourself. You know, the one about escalating executive compensation and its relationship to how much—or how little—others get paid. You get it: CEOs make a lot; average employees don't. That's unfair, or fair, or neither, and so it goes.

Through it all, there's one story you're probably not reading—and it's this one, about people like Stacy Smith, Andy Bryant, David Perlmutter, and A. Douglas Melamed. You may not recognize the names of Intel's next four highest-paid execs, but combined, they made $26.3 million last year. Add to that the compensation of the company's other senior leaders, and you begin to see that Otellini's pay is just a fraction of the organization's total executive compensation. Yet despite the huge aggregate sums paid to non-CEO executives (we chose Intel's at random), the press and the public continue to pant over the compensation of CEOs and only CEOs. Why?

"Because people are always looking for sensationalism," says Lisa Emerson, VP of global total compensation at McDonald's. In other words, eight figures are sexy. Six or seven? Meh.

A load of cash widens our eyes, but the payment of it to one individual causes them to pop. It's convenient to focus attention, sometimes anger, on one person rather than ponder the nebulous concept of a management team. "It's more fun to talk about CEO pay because you know that person is the big kahuna," explains compensation consultant Steven Hall. "It gets cloudy for the general public talking about a CFO or a CMO, because what do these people do?" Whatever the answer, companies are paying them a lot to do it.

It's time to stop allowing CEO obsession to drown out the scrutiny of other senior leaders. In thinking about executive, not just CEO, compensation, how does—how *ought*—your organization pay its top people? What kinds of issues should you contemplate regarding appropriate payment for the C-suite and beyond? As with CEO pay, the elusiveness of right answers shouldn't keep us from asking the right questions.

IT'S THE MARKET, STUPID

Before exploring *how* companies pay their top people (salary, stocks, etc.), it's worth examining *how much* they pay them—especially now, as CEO compensation surges again. Although there seem to be, strikingly, no studies specifically on non-CEO executive pay, most observers agree that it rises and falls along with that of the chief executive. In fact, over the past three decades, CEOs have gone from making thirty times to sixty times the salaries of the top 5 percent of employees, those earning over $100,000. (Chief executives made 150 times that of the bottom 5 percent of workers in 1980, compared to 400 times today.) Therefore, one can assume that since CEOs of S&P 500 firms saw their total compensation climb 24 percent from 2009 to 2010, to a median of $9 million, other senior leaders also saw a significant—albeit not quite as dramatic—earnings jump. The same critics who slam sky-high CEO pay may consider pointing their remaining fingers at others in senior management—or at least at the boards that sign off on their comp programs.

Oh, but it's not nice to point, say defenders of current exec-comp levels, especially when you fail to understand what you're pointing at. Compensation consultants—who else?—readily cite numerous reasons why senior leaders receive pay packages that are not just great but greater than in the past. Business demands far more of everyone these days, particularly those expected to have an enterprisewide perspective. Your IT head isn't simply ordering the newest version of Microsoft Office for everyone's PCs, and your supply-chain chief is transporting goods not from A to B but through the entire alphabet.

Plus, your top execs open a stage door the moment they close their home door. To cope with growing regulations and a public that demands to know what, where, when, how, and why, executives receive larger comp packages. For example, a CFO's position demands accounting as much as accountability—and liability. For that, according to a study of fifty Fortune 500 CFOs, the job's median compensation is $5.23 million, up 21.4 percent from 2009 to 2010.

"People like to talk about what compensation executives get," Emerson says, "but they don't necessarily want to talk about what these executives are giving in return: the personal sacrifice, the 24/7 nature of the job, everything being subject to criticism, the amount of time they are on the road, and the inherent risk of making a mistake that can cost them a job or career."

"Executives tell me stories of their kids coming home from school upset that classmates are telling them how much their fathers make," since the SEC mandates that proxies list a company's top five earners, Hall reveals. "Officers have actually told me that they would be happy to trade down their level of pay to avoid being included in the proxy."

So why don't they reject their pay and kill the violin playing in the background? Probably for the same reasons you don't say no to raises and bonuses—because, damn it, you're worth it. But what does that mean? The answer may be plain: It's the market, stupid. Geography, industry, company size, personal experience and education, and other factors guide the invisible hand so that Adam Smith ultimately decides your worth. Consequently, it's a mistake to claim that the market "rewards"—or "penalizes"—leaders for their performance. A job market doesn't make value judgments. It just *is*. If we're going to rely on the market to establish pay, let's choose our language better by moving away from the notion of "deserving" to one of simply "receiving" earnings.

The marketplace, however, doesn't employ people. A company does. Regardless of what the market says, individual organizations set pay. Besides, we've all witnessed how markets can act funny in unfunny ways. Nevertheless, whether it's the market, stupid, or the stupid market, you risk damaging recruitment, retention, morale, and productivity when paying below market value. Asks Russell Miller, managing director at ClearBridge Compensation Group, "If we don't look to the market to determine if we're paying competitively, where else should we look?"

HOW ABOUT INSIDE?

Relative pay within a company matters too. Yes, critics who contrast CEO compensation to that of other workers are comparing apples to oranges, but that's because none of us is paid in a vacuum. We think of our earnings not just in relation to the external market but to each other, to our co-workers, to our bosses, to our subordinates, to our top management teams, and, that's right, to our CEOs. Pay-ratio objections aren't necessarily complaints about who makes too little, who too much. They're about unreasonable and imbalanced relationships.

Today's colossal corporations at least partly explain the widening gulf between top executives and other workers. "An organization with people all over the world needs to have many more levels of management, career tracks, and promotion opportunities," says Linda Amuso, president of Radford, a compensation consultancy. An extended ladder requires more compensation rungs, which inevitably entails a higher climb to significantly higher pay.

Building that ladder may begin at the top step. "CEO pay is a window into the overall compensation-setting process at the organization," says Wayne Guay, the Wharton School's Yageo Professor of Accounting. It sets the tone and the upper limit for the rest of the company. The thinking goes: Get the CEO's pay wrong, and you'll get everyone's pay wrong.

Really? Imagine constructing pay from the bottom up instead. Get the janitor's pay wrong, and you'll get everyone's pay wrong? You're just as likely or unlikely to screw up regardless of your starting line because setting people's compensation is more a simultaneous than a linear process. Anyhow, Emerson asks, "How can you compare a person in a retail store and someone running the entire chain?"

Chris Dodd and Barney Frank made an effort to do just that: The Dodd-Frank Wall Street Reform and Consumer Protection Act, signed into law last July, requires companies to disclose the CEO's total compensation as a multiple of the median pay of all other employees in the organization. Even if we were to replace CEO compensation with that of the entire senior management team, what would such a ratio accomplish? What would it say about compensation for top leaders, or anyone else?

Not much. For starters, a company that designs products will have a lower multiple than one that also manufactures them because the latter includes a larger workforce of lower-paid factory workers. Similarly, an organization with many low-wage overseas employees will show a higher ratio than one with a solely U.S.-based workforce.

A recent Radford study of the technology sector bears this out. The consultancy found a 25.8 CEO pay ratio among 253 public companies surveyed, meaning that the CEO earns almost twenty-six times that of the median employee. However, for corporations with more than $3 billion in revenue, the multiple shoots to 78.1. Likewise, firms employing more than five thousand people showed a 68.7 ratio. Finally, the multiple for non-U.S. workers was 42.5, more than double the figure for American employees.

The SEC is still figuring out how to implement the rule and deal with a number that few know how to count—or what it would count for. If anything, it describes rather than prescribes. It's not as if Dodd-Frank asserts an ideal multiple. How could it? There are too many variables: industry, location, etc. Also, picture the questionable actions that companies could take to skew numbers, such as laying off people at the bottom or using more contract workers. "Institutional investors are saying these are stupid numbers and we don't need them," Hall says.

This is missing the point, say others. It's not about a perfect number or benchmarking against other companies—it's about tracking the ratio's evolution within an organization, forcing management to justify any changes over time.

RELATIONS AT THE TOP

If top executives earning X times more than those below them may not matter, earning X times less than the CEO might. J.P. Morgan allegedly wouldn't invest in a company whose CEO earned more than 50 percent above the next officer down. Likewise, GE chief executive Jeffrey Immelt told the *Financial Times* that to motivate staff and avoid excesses, CEO pay should remain a small multiple of that of the most senior twenty-five managers. "Should the CEO make five times, three times, or twice what this group make?" asked Immelt. "That is debatable, but twenty times is lunacy." (Immelt's 2010 compensation was $21.4 million, about 1.5 times that of GE's next-highest-paid executive.)

WILLIAMS+HIRAKAWA

"I get concerned when I see that a CEO makes five times more than the Number Two," says Jim Heim, managing director at compensation consultancy Pearl Meyer & Partners. "Some groups of investors get concerned when it's more than three times more." When a company head earns far more than his management team, the logic goes, it indicates that the CEO is king and everyone else a courtier.

High ratios are uncommon. Depending on the industry, the median multiple of the top to the second-highest-paid executive is anywhere from 1.35 to 2.34, according to a recent Conference Board report. Furthermore, the multiple ranges from 2.95 to 4.61 when comparing the first and fifth highest-paid people. (In dollars: $2.5 million, $1.3 million, and $763,000 median comp for Numbers One, Two, and Five, respectively.)

Ratios skew lowest in financial- and business-service sectors and highest in food and tobacco industries, indicating the extent to which companies in various fields distribute power between the CEO and the executive team—not surprising given the prominence in finance of the CFO, who's often in the second role, making between 40 and 60 percent of the CEO's pay. A C-suite may also wield less power at other, especially smaller, firms, where the CEO wears many hats. Still other times, "the chief executive is the main strategist, with more value wrapped up in his personality," Amuso says. "You can see this at companies in the retail market, like Ralph Lauren, where without that person, the value of the enterprise is reduced."

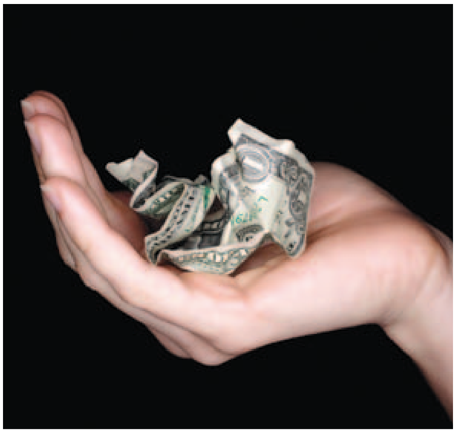
A large CEO-to-Number Two gap may hint that there really is no Number Two—at least not in terms of succession planning. "It suggests you don't have a strong candidate for the top spot, so what happens tomorrow if the CEO is gone?" asks Yonat Assayag, a partner at ClearBridge Compensation Group.

Obviously, there are three ways to close a gap: decrease the CEO's pay, increase the next person's, or both. But face it, there's only one realistic solution, because, damn it, the CEO feels he deserves everything he gets. You risk unintended consequences, cautions Russell Miller, adding: "Even if the second-highest-paid executive isn't demonstrating anything to warrant increased pay, for external optic reasons, the company will increase that person's pay to decrease the gap. That would be an upsetting outcome"—or a succession-planning mirage, in which the problem may be not increased compensation but reluctance to dial a headhunter.

Clinging to egalitarian pay encourages a tournament management model in which executives compete to move up, especially when the prize is bountiful booty.

In addition to fostering fairness externally and internally among various employee levels, organizations must also do so within each echelon. This holy trinity of equality is vital because, as studies have shown, when employees perceive fairness in compensation, they perform better. The problem is, the different versions readily clash, so that achieving a

What $1 Still Buys



Is an officer more valuable to a company because he's paid more, or is he paid more because he's more valuable to a company? Don't think too long. The answer may be neither the chicken nor the egg. Here's why: Fully a sixth of the highest-paid officers at companies are *not* CEOs, according to Conference Board findings. A tiny minority of chief execs are third or lower on the pay scale.

For example, one buck was all it took for Citi to keep its chief executive. CEO Vikram Pandit earned $1 last year, down from $38.2 million three years ago. Back in February 2009, Pandit transformed himself into the corporation's lowest wage-earner by recommending to the board and accepting a $1 salary and no further compensation until the organization returns to sustained profitability. (Beginning this year, the company increased his salary to $1.75 million and is considering incentive compensation.) Despite toiling for below minimum wage, it's doubtful Pandit ceded any power with his decision. (You could say such a noble act increased his stature, for who among us is in a position to work for the price of a single iTunes download?) Regardless, the example implies that the relationship between compensation and power isn't straightforward.

Meanwhile, the top earner at Bank of America last year made $11.4 million. It wasn't CEO Brian Moynihan, who earned $1.9 million in the number-four spot. It was chief risk officer Bruce Thompson. Much of the explanation centers on when Moynihan took office and when the board granted parts of his pay package, but still, three executives out-earned the firm's head.

Without sitting in on meetings, we can never definitively know which officers wield real power (at Bank of America, Moynihan would still be a good bet), but just having to ponder the thought means we shouldn't leap to conclusions based on pay alone. "There's no rule of thumb that a CEO should get paid a certain amount more than someone else," remarks Wharton School professor Wayne Guay. In fact, to bolster profits, Alfred Candrilli, a partner at the Organization Consulting Group, recommends a system that permits—even encourages—salespeople to out-earn the CEO. All of which implies that value to the organization and paying for position aren't automatically linked. —V.L.

sensible triad inevitably entails triage. Hence, no dearth of compensation critics.

So how should a company compensate leaders sitting around the same table? In a *Go, team!* spirit, you might claim that each chair is as valuable as the next. But why lie? Neither positions nor people are ever *equally* valuable. Some executives perform better than others. And at Apple, a head of technology is likely more essential than a diversity chief.

Clinging to egalitarian pay encourages a tournament management model in which executives compete to move up, especially when the prize is bountiful booty. Hypothetically, this breeds high performance, but not really. First, there's irony when an organization attempts to promote equality using a system whereby individuals must struggle against each other to overcome the lower-paying trappings of equality. Secondly, a tournament model can prevent rather than encourage teamwork if executives view each other as rivals. Additionally, equal pay would frustrate shareholders, who'd be unable to identify a CEO successor. "There's already obvious motivation and ample financial incentive at the top of an organization. There's no need to create extra competitiveness," says Jamie McGough, a partner and senior consultant at Meridian Compensation Partners.

"If you want to have a more egalitarian pay structure, go for it," McGough adds, "but you'll find over time that people will believe their total compensation is being held below what they can get elsewhere, and it will be hard to keep them." It's also worth remembering that egalitarianism doesn't necessarily command paying equally but based on people's abilities and a range of other considerations. To do otherwise would paradoxically undermine fairness.

Inevitably, you'll have no choice but to pay depending on significance to the corporation. Indeed, proxy statements offer a good indication of the roles that organizations value most. A Towers Perrin study recently revealed that CFOs, heads of legal, and HR leaders showed up among the top five highest-paid execs 76, 38, and 5 percent of the time, respectively. The takeaway? Sorry, HR folks. (Before you send hate mail, see "What $1 Still Buys" above.)

UNWRAPPING THE PACKAGE

Most senior leaders don't earn all that much—at least not when looking only at their base pay. But salary, of course, is but one ingredient in the pot. Blend in a bonus, pour in some perks, stir in insurance benefits, add a pinch of pension—oh, and don't forget to dump in a whole lot of stock—and *voilà!* A super-sized serving of compensation, but is it a value meal?

That depends on how you answer a fundamental question: Are you paying for performance, and if so, what role should each component play?

It's commonly said that just showing up earns you a salary. A salary, yes, but coming in to work isn't enough to get a *bigger* salary. Last year, according to a Mercer survey, average base pay for workers with the highest performance ratings increased 4.2 percent, while the lowest-scoring group earned a 0.4 percent raise. Meanwhile, there's little salary variation within a company between a chief executive and the senior management team. Base pay tends to skew at or below $1 million due to an IRS stipulation that non-performance-based payments above that amount aren't tax-deductible.

The focus, then, is on short-term incentives (STIs), either annual payouts that are based on a pre-determined formula (like meeting or exceeding sales targets) or straightforward bonuses, doled out after the fact. Today, bonuses are the fastest-growing element in pay packages; two-thirds of executives got bigger ones last year than in 2009.

It makes sense that top performers at every organizational level would receive larger bonuses. It also makes sense that the highest- and lowest-rated executives received respective bonuses that were 50.8 and 15.6 percent of their salaries, according to estimates by Mercer. However, things get weird down the ladder. With an average bonus of 13.7 percent of base pay, the *best* (non-sales) professionals earned a *smaller* bonus than the *worst* executives. Regarding total cash compensation (salary plus STIs), executives are enjoying not just bigger sums but higher rates. There's performance and there's Performance. We can all agree on the merits of paying for it; the uncomfortable dilemma is figuring out what exactly we're paying for and why we're paying differently for it.

Long-term incentives (LTIs), usually stock, involve a measurement period exceeding one year. For decades, businesses have been steering away from offering simple stock options: Last year, 41 percent of stock grants for CEOs were performance-based, while one-fourth were time-vested, according to the Hay Group, a global management consultancy.

A key advantage of LTIs is that they're not STIs. Whereas the latter are especially useful at companies bringing new products to market rapidly, LTIs are particularly integral to businesses that require a longer R&D timeline or at start-ups lacking cash to pay workers, explains Kevin Hallock, director of Cornell University's Institute for Compensation Studies. Also, linking pay to equity helps keep execs from making decisions that benefit themselves rather than the sustained interests of the organization.

Finally, what's an executive pay package without a pension plan, a corporate jet with a golden parachute to catch you if you fall out, and other perquisites? Bruce Ellig, author of *The Complete Guide to Executive Compensation*, explains that there are three types of perks: those related to an executive's job, such as a company car and jet; those pertaining to personal use, such as a corporate apartment; and the most egregious of all, perks on perks, when companies increase an executive's pay to cover taxes on personal perks. "Wouldn't we all like to have tax-free everything?" Ellig asks.

"The concept behind perks is that you want your executive to be focused on the job, as opposed to things that are considered distractions," Heim explains. Some very expensive distractions: $250,000 for corporate-jet travel (Yum Brands), $140,000 for local car service (American Express), $32,000 for estate-planning services (Campbell Soup).

To give an idea of the state of perks, one company is severely cutting back—on people: Minnesota-based Hutchinson

The further you are from the top, the less risk, responsibility, and influence you have on overriding business success (or failure).

COMSTOCK IMAGES

Technology, having downsized three times since 2008, with plans to shed up to 40 percent of its workforce over the next year, paid $430,000 in perks to seven senior execs last year. United Healthcare Group, on the contrary, insists that perks aren't necessary to attract and retain executive talent, nor are they consistent with the benefits provider's pay-for-performance philosophy.

"There was a time when perks were considered a guaranteed part of compensation packages," Assayag explains, "but over the years, they received a lot more scrutiny. Their value and proportion to total compensation are so small, so the shift has been to minimize or eliminate them." Indeed, a 2010 Towers Watson survey of 251 companies revealed that a third had eliminated some perks, mainly those tied to severance packages and taxes. But not the corporate jet. Research by the Hay Group shows that the majority of companies providing planes for execs aren't grounding them.

"Perks should not be part of a compensation package," Ellig argues. "They are pay for position, not performance."

MISALIGNMENT?

And so we're back to performance. What sort are we paying for?

That depends on where you are in a company. Last year, stocks (not including those that are part of deferred compensation) accounted for 54.7 percent of average CEO pay at S&P 500 companies, according to the AFL-CIO. Salary and bonus came in at 9.6 and 2.2 percent, respectively. (Though there aren't specific breakdowns of compensation for non-CEO execs, a chief executive's plan is a good indicator of the way in which a company pays other top leaders. Identical elements tend to appear in packages of both the CEO and the organization's top people.)

Compensation for officers just below the chief executives plausibly had somewhat less pay tied to equity and other incentives. For instance, at Bank of America, incentives comprise 70 percent of CEO pay but 60 percent for executives beneath him. The deeper you travel within a company, the more proportions shift toward salary and bonuses.

That's because the further you are from the top, the less risk, responsibility, and influence you have on overriding business success (or failure). A mid-level manager exerts far less—if any—control over policy and, consequently, overall financial results than a top officer. Thus, divisional and eventually individual accomplishments and efforts define performance lower down, while corporate financial success delineates it higher up. Hence, as you ascend the hierarchy, organizations tie a greater proportion of pay to shareholder value creation, particularly via stocks.

Some organizations extend executive-pay elements beyond their top people, like providing stock down to the receptionist. But stocks can be difficult for mid-management to understand, and granting them is administratively burdensome, Jamie McGough points out. Obviously, you also don't want to tie half of someone's $50,000 pay to equity. The concept of marginal utility eventually kicks in, where ten bucks in cash is more valuable to a marketing assistant than to the CMO. Nonetheless, granting stocks creates alignment, right? After all, why shouldn't *all* employees care about the organization's financial performance?

Well, they should. But there's a difference between caring about something and having the ability to affect it. Organizations don't need to give stock to all their workers, explains McGough, who adds that "people lower down don't have the impact, the line of sight. You want to pay them for what they can affect."

And that may be the problem. That individual employees cramped in cubicles can't affect stock price is obvious. That those luxuriating in corner offices can is taken for granted. Many contend that stock price rises and falls for reasons other than organizational performance. In other words, senior leaders may have a closer line of sight, but that doesn't mean they can influence what they're seeing. Worse, they're not the ones making final determinations. That's a CEO's job. Suppose a chief executive makes a decision that damages the company's stock price. That others in the C-suite may have disagreed with him is hardly relevant to their compensation. Misaligning pay, regardless how much of it, to the corporation's financial performance—or rather, to the CEO's performance—mocks the entire concept of pay for performance. Never mind that, as Ellig points out, "You'd be hard-pressed to find anyone to say that the CEO *really* is doing things that drive up stock price."

By now, it's predictable that champions of present executive-pay levels compare athletes and celebrities to top managers to justify the latter's earnings. Oprah Winfrey and Derek Jeter earn millions, so why shouldn't business leaders? But if we're going to draw parallels, here's another one, to a group of workers rarely associated with business titans: Like senior executives, they too work hard and long hours. They too spend much of their job thinking on their feet, juggling multiple demands. Their performance has a direct impact on the company's fortunes. And most significantly, the majority of their earnings are based on performance. Restaurant waitstaff, however, don't get golden parachutes. And so: The waitress at the Main Street diner barely earns a livable wage, so why should business leaders?

If the logic sounds ludicrous, it is not more so than invoking Oprah. Instead of posing such distracting questions, we should ask a better one: Would top leaders perform differently were we to revamp current compensation schemes? We can't know until we try. And we can't try until we begin speculating about whether we're paying for what we think we're paying for. ■