

# Determining **Executive** Pay

Four perspectives Directors should keep in mind

By Dr. Hans Kothuis



**M**ANY DIRECTORS serving on Remuneration Committees are not experts in compensation. Yet, they have a duty of due care. They need to ensure that they have been informed and advised, so that they can make decisions in good faith. Hence, they require a viewpoint, a perspective, an opinion based on analysis on how to determine executive pay. Compensation advisors and management need to improve the tools of analysis that are to be placed at the disposal of members of Remuneration Committees. It is not enough to just tell directors that pay for a certain executive is reasonable or in-line with market. What is required is analysis on the basis of which directors can make their pay decisions.

This article presents four perspectives on how executive pay can be determined, and each of these ways of setting executive pay should be kept in mind when making pay decisions. They are:

- Market assessment
- Internal pay equity
- Wealth accumulation
- Profit "set-aside"

### Market Assessment

The first step in conducting a market assessment is "Peer Group Selection" in light of the level of role complexity and job worth differences. The appropriateness of the peer group is an important issue that is raised constantly by members of Remuneration Committees.

The rule of thumb is that one should select 12 to 20 companies, and that the market capitalization or revenue size of these peer companies should be plus or minus 50% of the revenue or market cap of the company being benchmarked. The industry should be as close as possible to that of the company, and the performance of peer companies should be representative. Of equal importance is organizational complexity, risk profile, domestic versus international operations, and whether the business operations are pass-through or manufacturing.

Oftentimes there are major problems in conducting a benchmarking study, in that the business and the top jobs included in the survey are not comparable. Data is mixed together from companies whose business models are not comparable. Regressing pay on the basis of revenue is inaccurate. In addition, many studies do not contain an analysis of business performance. Hence, apples and oranges are being compared.

Even though revenue sizes may be comparable, the business complexity and the geographic and regulatory complexity among the peer companies can be very different. Directors should no longer accept peer groups and the resultant pay percentiles at face value. They have to exercise their own judgment as to the process that should be used in developing peer groups and in conducting pay analysis. Hence, the Compensation Committee should conduct a quality assurance check on the reports being presented. Directors are often quick to pick up on data integrity and analytical problems and, at the end of the day, should exercise their own judgment.

They can do so by checking whether the report mixed executive roles in terms of level of work and the complexity across industries and sectors. They need to review whether industry sub-sectors have been mixed together, which would lead to unreliable pay percentiles. They should not accept reports that regress on revenues, or that are based on peer companies whose revenue size or market capitalization are so much bigger than those of their company, so that the information would be skewed to the larger companies. Finally, they should also check that there is no mixing up of jobs with a domestic, regional and international scope. Not all C-level jobs are created equal!

### Internal Pay Equity

The information obtained from benchmarking and pay surveys is just one aspect of how executive pay should be determined. Another perspective would be to keep an eye on how CEO pay is set in relation to that of their direct reports. How is compensation distributed around the organization? The internal equity approach would remove concerns that pay is too much driven by competitive market data and by outside consultant surveys, and it would help mitigate market biases.

Some say that CEO pay should be roughly twice the amount paid the next management level, and that a differential by a factor of two is 'felt fair.' There seems to be something to this ratio, in that the difference in every 'real' level of work would lead to a doubling of pay.

In the table on the next page, we show that among S&P 500 companies the median does indeed approximate a factor of two. But the problem is that there are many outliers. We have seen differentials of 27 times, or even of 50 times!

# “Some say CEOs should be paid roughly twice the amount paid the next management level”

Pay Components	Multiple of S&P 500 CEO vs. 2nd Highest Named Executive Officer
Total Compensation	2.16
Base pay	1.67
Long-term Incentive Multiple	2.40

Source: “Analysis of Internal Pay Equity”, Equilar, Inc., 2007.

In conducting an internal equity check, directors should look at all the elements of the pay package and not just at the differential in base salary. While base pay may show the right differential, when including equity incentives or benefits, the differential is often much larger.

So, it is as if there is a constant, a natural stability or scale in the relation between compensation and the number of people in an organization. Hence, an entire management pay structure could be built with a scaled model that has a differential factor of 2.0 or 2.5 at the most, across the levels, from the single global CEO (level 1), to the group of COO / Sector CEO / Sector President (level 2), to a larger group of Business Unit Presidents (level 3), and onto a broader group of Business Unit VPs or SVPs (level 4), and finally to the large group of Senior Managers / Directors (level 5).

If the differential is less than 2.5, then your organization may have too many levels in its management structure. Real differential in work is the only justification for pay differentials. Directors can set certain red flags and tell the company to reduce over-layering and over-titling.

If CEO pay is more than three times that of their direct reports, then this could be an indication of a weak Board and poor corporate governance. Pay differentials that are larger than a factor of 3.0 could also be an indication of person risk and potential CEO succession problems. It often points to excessive company compensation, poorly structured performance metrics, and poor delegation of work cascading down the organization. Such a structure would give the impression that only the CEO, and not the senior management team is accountable for the future value of the company, its growth and innovation. It could impel towards acquisitions rather than organic growth and excessive balance sheet leverage at the risk of long-term sustainable value creation. It could also be indicative of broader and more systemic governance risks.

Of course, the danger of the internal equity approach is that you might be underpaying compared to the market. In response, the Committee could study what the internal relativities are in the same industry. One could study CEO pay in relation to that of the company’s whole workforce, or the aggregate pay of all senior managers against that of the company’s total employee population.

## Wealth Accumulation Targets

Another approach to determine executive pay is to set wealth accumulation targets over a number of years, given a pre-determined level of performance. Once executives start to exceed these levels, pay would be adjusted in terms of future base pay increase or future equity awards. This approach would limit pay that is due solely to increases in the stock price. Again, this approach could leave pay uncompetitive against the market or penalize executives for (so-called) “success.” But, it makes sense for the Board to have longer term perspective, especially for new hires, and say “If we reach X level of performance over the next 3-5 years, our new CEO should have accumulated approximately \$Y in terms of wealth.”

## Profit Set-Aside

The last perspective on determining pay is to set it in relation to the company’s profits or net revenue, as is done in many ‘professional’ service firms, such as by investment banks, private banks and consulting firms. For example, among the investment banks or commercial banks with a substantial investment banking arm, total compensation and benefits typically constitutes between 30% and 50% of net revenues. A percentage of profit could also be used to determine the value of the merit increase pool, cash bonuses and equity awards. This pool would then be allocated to the executives based on their performance. The advantage of this approach is that it ties compensation of senior executives to the success of the firm. The disadvantage is that pay could either be far in excess or far below the market rate, depending on business performance and the divergence of the profit from stock price growth.

## Conclusion

In summary, this article has provided Directors serving on Remuneration Committees with four perspectives that they can use in interpreting executive pay. Not all perspectives may be relevant in every single instance. All things considered, it would still be useful to keep these in mind, and apply them when necessary. In this way, Directors on the Remuneration Committee can exercise their duty of “due care” to the Corporation. **W**



**Dr. Hans Kothuis,**  
**Director Executive Compensation,**  
**Asia Pacific**

[hans.kothuis@watsonwyatt.com](mailto:hans.kothuis@watsonwyatt.com)