

IRA T. KAY, PH.D.

STEVEN VAN PUTTEN

M Y T H S  
— *and* —  
R E A L I T I E S  
— *of* —  
E X E C U T I V E P A Y



## *Myths and Realities of Executive Pay*

The executive pay model used widely in the United States is essential to both the continued success of companies and to the U.S. economy itself. The successful application of this model, which is built on the foundation of pay for performance, has helped create an economic juggernaut, resulting in trillions of dollars of wealth for shareholders and substantial income and net worth for millions of corporate employees and their families. High executive pay simply reflects the strong demand for top talent and can be evaluated only with consideration of the performance that leads to high pay. Yet, myths of a failed model still abound, perpetuated by occasional excesses, recent corporate scandals and controversy over the use of stock options.

The book, *Myths and Realities of Executive Pay*, to be published this summer, documents the realities of executive compensation by investigating the extent to which the pay-for-performance model governs executive pay levels. It also assesses the relative success of this model in creating value for shareholders and robust job growth for U.S. employees. This preview shares abridged excerpts from the book's prologue and first chapter.

*Abridged excerpts from*

# Myths and Realities of Executive Pay

Ira T. Kay, Ph.D.  
Steven Van Putten

Watson Wyatt Worldwide

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# Prologue:

## The Compensation Committee Meets

*May 23, 2006*

The chair of the compensation committee scans next week's committee meeting agenda. The first several items are perfunctory — approval of minutes from the prior meeting, new-hire and promotional stock option awards, and an update on a succession-planning project. No surprises there. But the last two agenda items leap off the page: *status of employee stock purchase plan (ESPP) and broad-based option awards, and CEO employment agreement renewal.*

These are not unexpected. Several months ago, one of the outside directors called the chair to discuss the ESPP and broad-based option awards, raising a concern that the company was not getting much bang for its buck; that it was incurring significant expense and dilution for these stock-based awards that appeared to have little perceived value among employees.

In effect, the outside director was asking the committee to revisit the preceding year's decision to continue providing broad-based stock option awards and an ESPP — a decision that was agreed to by both management and the committee. That stay-the-course decision had been made in the face of mandatory stock option and ESPP expensing that would go into effect in January 2006. At the time, the decision made sense. But during the year, events had occurred that, in retrospect, called into question the appropriateness of the strategy.

The chair understands that these factors merit a reappraisal. But she is concerned that dramatic changes could subvert several key objectives: fostering a culture of share ownership, promoting long-term retention and perspective, and maintaining alignment with shareholders. She also worries that a transition away from stock options to full-value shares could negatively affect the company's emphasis on pay for performance.

On top of that, and even more visible, is the ironic juxtaposition with the last agenda item — the renewal of the CEO's employment agreement.

Three years ago, to lure the CEO to the then-underperforming company, the board of directors had constructed an impressive pay package. Three years later, the board thinks the CEO has earned every penny of his compensation package and that shareholders, in turn, have earned an above-market return on their investment in the new CEO. The CEO's unrelenting focus on controlling costs

and realizing growth through new distribution channels has spurred the company to its best performance on record, despite a recently sluggish stock price.

Not surprisingly, rumors have been circulating that several companies in need of a well-regarded turnaround expert have placed this CEO at the top of their lists. For his part, the CEO enjoys working for the company, and he and his family want to stay in the area. He has communicated his wish to remain with the company and is interested in entering into a new agreement that would secure his services for the duration of his career. The board wants the same thing, but external pressures are constricting its ability to craft a new, attractive employment deal.

It is apparent to the chair that there are multiple stakeholder perspectives on these issues and that most are in conflict. Therefore, she has asked that the final two agenda items be structured as review and discussion items rather than approval items. She has also asked the head of human resources to survey a cross section of employees about the current equity programs compared with other forms of remuneration. And she has asked the compensation consultant to collect and interpret data on peer practices.

A week before the meeting, the chair and the committee members receive the requested materials and the agenda. The challenge for the chair will be to channel the discussion toward achieving an outcome that benefits all stakeholders and, at the same time, reflects good corporate governance practices that will withstand public scrutiny.

### ***May 30, 2006***

At the meeting, the chair quickly dispenses with the initial items on the agenda. Diving right into the item on the employee stock option awards and ESPP, she asks the senior vice president of human resources to discuss the results of the employee survey. The SVP notes several pervasive themes: that the ESPP is viewed as an attractive benefit and that most employees value options for the recognition — and the affinity to the company — they provide. Like shares acquired through the ESPP, options are generally cashed in as soon as they vest.

The board's outside compensation consultant then provides an overview of the changing competitive landscape. An increasing number of peer companies are shifting away from stock options, as evidenced by declining annual share usage rates and award sizes. At the executive level, companies are making up for reduced option award levels by introducing long-term performance plans, denominated in cash or shares. Although less clear from publicly disclosed data, it appears that companies are limiting stock option award eligibility for lower-level employees and that several are shifting to restricted stock with award levels that are differentiated on the basis of individual performance.

The chair asks the consultant to work with the SVP and his team to develop alternative approaches and evaluate long-term incentives (LTIs). She says that the committee expects a specific recommendation with supporting LTI rationale.

At this point, the chair excuses senior management, and the committee goes into executive session to discuss the CEO's employment agreement. She tells the committee members that the CEO has said he is looking for more security that will in effect lock him in with the company for the rest of his career. He has mentioned the possibility of an additional restricted-stock award and an enhancement to his supplemental retirement benefit.

One of the committee members objects, saying that maintaining links to performance is the key objective and that the prior restricted-stock and Supplemental Executive Retirement Plan (SERP) credits were used as part of an employment inducement strategy.

The chair asks the consultant to develop alternative approaches and to work with her directly on the issue. With the meeting adjourned, she turns to the consultant and asks how executive compensation became so complicated so fast. "It's an interesting story," he says, "and the myths often overshadow the realities."



# 1

## The Myths and Realities of Pay-for-Performance

The full-blown mythology of a corporate America ruled by executive greed and excess consists of two related components: a failed pay-for-performance model and managerial power. The myth of the failed pay model hinges on the idea that the link between executive compensation and corporate performance never truly existed and, therefore, does not determine executive pay levels. The myth of excessive managerial power accepts the idea of a failed model and puts in its service the image of unchecked executives dominating subservient boards as the explanation for decisions resulting in excessive executive pay.

Even if the critics are somewhat correct about some of the flaws in executive pay — too high, too many stock options, too much managerial influence and manipulation, too little disclosure, too generous pensions and severance — they are wrong about pay for performance, which trumps the other concerns, because it is a good investment by the company. In the worst case, enormous shareholder wealth has been created despite those problems. In the best case, some of those factors allowed U.S. corporations to attract and motivate perhaps the greatest managerial generation in economic history.

The myth that executive pay is not tied to corporate performance includes several components: CEOs receive high pay even at companies with lackluster returns to shareholders; CEO pay rises when performance is strong but does not fall when performance declines; stock options are ineffective rewards and a poor investment for the company.

**MYTH 1: Executives are paid far more than they are worth in relation to the value they create for their companies.**

**REALITY 1: Executives generally receive only a small portion of the substantial value they help create for their companies and their shareholders.**

There is no doubt that U.S. CEOs are well paid. The median CEO at the 1,000 largest U.S. companies had total direct compensation (TDC) opportunity (TDC = salary + bonus + present value of new long-term incentives) of approximately \$3.2 million in 2005. As Figure A shows, CEOs' total pay opportunity increased by only 2.9 percent, down from prior years. The amount these CEOs actually

receive depends on stock performance plus other financial metrics that underlie their incentive programs. But as media and other pay critics often note, CEOs' actual pay is also high relative to that of other employees.

**FIGURE A**  
S&P 1500 CEO Compensation Opportunity, 2004–2005 (Percentage Change)

|                             | CHANGE (MEDIAN) | PERFORMANCE   | MEDIAN |
|-----------------------------|-----------------|---------------|--------|
| Salary                      | 3.3%            | TRS           | 8.0%   |
| Bonus                       | 2.3%            | Change in EPS | 15.0%  |
| Total cash                  | 4.2%            |               |        |
| Restricted stock*           | 0%              |               |        |
| Target LTIP*                | 12.0%           |               |        |
| Stock options (grant value) | -4.0%           |               |        |
| Total LTI                   | 1.5%            |               |        |
| TDC                         | 2.9%            |               |        |

\*For those who received grants in the fiscal year.

Note: Covers same 1,313 CEOs who were in job 2004–2005 and whose proxies were filed by June 1, 2005.

Source: Watson Wyatt.

In reality, CEO pay is a very small part of a company's overall cost structure. Total CEO pay in 2004 was less than 0.09 percent of sales, 0.06 percent of market capitalization, and 1.3 percent of net income for the Standard & Poor's 500.

**MYTH 2: There is no pay for performance.**

**REALITY 2: High executive pay correlates with and contributes to high company performance.**

While there are certainly instances of pay without performance, we tested the idea that at the vast majority of companies, actual pay is highly aligned with company performance. But before getting to the results, it is important to note that even if we can prove a statistical correlation between pay and performance and not causality, it is essential from a corporate governance policy perspective that compensation committee members understand that their pay policies motivate and, consequently, cause the higher level of performance. The correlation does not prove causality; it merely demonstrates that there is a statistical relationship. High pay could cause high performance, or high performance could cause high pay. We evaluate both possibilities.

Our study of nearly 1,000 companies verifies that performance is dramatically better at companies with high actual CEO pay (salary + bonus + profit from stock options exercised). As shown in Figure B, CEOs who had higher total actual pay in 2004 worked at companies that had higher five-year total returns to shareholders (TRS).

**FIGURE B**

High CEO Realized Pay Correlates with High Corporate Performance

|      | TOTAL ACTUAL<br>CEO PAY**<br>(MMS)* | ONE-YEAR<br>ANNUALIZED<br>TRS* | THREE-YEAR<br>ANNUALIZED<br>TRS* | FIVE-YEAR<br>ANNUALIZED<br>TRS* | ROE*  | ROA* | ONE-YEAR<br>EPS<br>GROWTH* | TOBIN'S Q* |
|------|-------------------------------------|--------------------------------|----------------------------------|---------------------------------|-------|------|----------------------------|------------|
| High | \$4.7                               | 20.7%                          | 14.4%                            | 12.9%                           | 14.3% | 5.4% | 26.6%                      | 1.33       |
| Low  | \$1.0                               | 11.8%                          | 7.7%                             | 6.8%                            | 8.3%  | 3.1% | 16.3%                      | 1.23       |
| All  | \$2.1                               | 16.8%                          | 10.7%                            | 10.0%                           | 11.8% | 4.1% | 22.1%                      | 1.28       |

\*\*Total Actual Pay = 2004 Salary + Bonus + Profit from stock options exercised + Long-term incentive plan payout.

\*Significant at 0.05 level.

Note: Financial information as of December 31, 2004; Sample size = 1,398 companies.

Source: Watson Wyatt.

The data also indicate that CEOs at companies performing above the median had larger increases in actual pay — a 47 percent increase for firms with a median TRS of 34.3 percent. On the other hand, CEOs at low-performing firms, with a median TRS of 1.2 percent, had only a 10 percent increase in realized pay.

**MYTH 3: Executive pay only rises.**

**REALITY 3: Executive pay rises and falls in tandem with stock prices and the financial performance of the company.**

Critics claim that executive pay rises when performance improves but does not decline when performance drops. However, our data demonstrate that this is not the case. For both 1999 to 2000 and 2000 to 2001, total pay decreased with the decline in corporate profits and stock prices. At the largest 1,200 companies, total pay fell by nearly 30 percent, with 72 percent of the CEOs experiencing a decline.

It is possible to find examples of companies where executive pay rose while profit and stock prices declined, but these are the exceptions — and institutional investors and the media quickly call out these inconsistencies.

CEO pay and LTI opportunity clearly rise and fall with the stock market. We estimate that the total economic value of stock options granted by the S&P 1500 fell from \$120 billion in 2001 to \$50 billion in 2004. This is explained by pressure from institutional investors and new accounting rules.

Executives' stock option profits also rise and fall. Figure C shows a five-year history of changes in option profits and how they move with total returns to shareholders. The large increase from 2002 to 2003 is explained by the stock option grants in 2000, 2001, and 2002 at low strike prices combined with the resurgence of the stock market in 2003.

**FIGURE C**

In-the-Money Value of Stock Options

| YEAR      | % CHANGE | TRS   |
|-----------|----------|-------|
| 2000–2001 | –9.2     | 0.8   |
| 2001–2002 | 1.4      | –10.5 |
| 2002–2003 | 192.0    | 30.8  |
| 2003–2004 | 33.0     | 17.1  |
| 2004–2005 | 12.3     | 7.7   |

Source: Watson Wyatt.

Figure D shows the results of a Watson Wyatt study of 95 companies. From 2004 to 2005, the higher-TRS companies had an increase in potential stock option profits of more than 47 percent, up more than \$1 billion. The lower-TRS companies saw declines of more than 50 percent, a decline of nearly \$500 million.

**FIGURE D**

In-the-Money Value of Stock Options, 2004–2005

| TRS PERFORMANCE | MEDIAN TRS | % CHANGE IN IMV |
|-----------------|------------|-----------------|
| High            | 24.5       | 47.3            |
| Low             | –3.2       | –51.6           |

Note: Number = 95; Watson Wyatt estimates.

Source: Watson Wyatt.

**MYTH 4: The labor market for top executives does not function properly because of managerial power and does not justify high levels of executive compensation.**

**REALITY 4: The labor market for top executive talent is highly competitive and compels companies to offer attractive pay packages to recruit the talent they need.**

The labor market for CEOs does not function as a free market, critics argue, but as a rigged market in which CEOs stack boards with their cronies, who set pay as high as possible. The compensation committee — comprised mostly of directors who are under the control of the CEO — approves egregious compensation programs that are not approved by the shareholders.

Our research shows that the CEO labor market meets all the criteria of any free market, including independent supply and demand, transparency, and liquidity. In the thousands of board and compensation committee meetings we have attended, we have observed that board members are generally thoughtful and independent and take their responsibilities seriously. They often vote down or modify management's proposals on pay matters.

The managerial power myth states that executives collect “rents” that they do not deserve but obtain via sociological “power.” One piece of evidence cited by the “power” advocator is that as a result of the rent, most CEOs are paid the same, irrespective of performance.

The executive labor market has tremendous variations in pay, which is consistent with an efficient market. Some of our studies have shown differences of 1,000 percent or more from the lowest paid to the highest, mostly due to stock options granted in a given year.

**MYTH 5: High levels of executive compensation take money out of the pockets of shareholders and employees and act as a drag on the U.S. economy.**

**REALITY 5: High levels of executive compensation generated by effective performance pay practices contribute to successful companies that yield high returns for their shareholders, generate millions of jobs and drive U.S. economic growth.**

The U.S. economy has performed extremely well in the last 10 to 15 years, despite large trade and budget deficits, outsourcing, a weakening dollar, soaring health care costs, and rising oil prices. This stellar performance has coincided with and can be linked to the explosion in stock-based compensation and rising executive compensation levels.

The World Economic Forum’s 2005 competitiveness ranking shows the United States as the second most competitive country in the world, the same position as in 2004.<sup>1</sup> No other major industrialized country ranks in the top 10. Finland holds the first position and Japan ranks twelfth. This stunning accomplishment speaks volumes about corporate America, the engine of the U.S. economy.

**MYTH 6: Out-of-control executive pay is one item in a long list of poor U.S. corporate governance practices.**

**REALITY 6: Many experts consider U.S. corporate governance to be among the best and most successful in the world. The model reflects the unique institutional factors in the United States, particularly highly dispersed shareholders.**

Critics say that excessive executive pay is emblematic of the overall problems with how corporations are governed. There are several responses to this:

- The U.S. corporate governance model is very effective.
- U.S. corporate governance has improved dramatically over the past 10 years, a time of explosive executive pay increases.

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<sup>1</sup> World Economic Forum, “Global Competitiveness Report,” September 28, 2005

- There are legitimate economic and institutional reasons why U.S. executives have so much economic bargaining power, including both an abundance of employment alternatives and a more dispersed shareholder base relative to Europe and Japan.
- To the extent that there is statistically solid pay for performance, any criticisms of corporate governance are either wrong or irrelevant.

The overall myth about U.S. executive pay is false. But the elements that are true — that shares should be handled more carefully, SERPs should be better disclosed, and stock sales should be preannounced — are being addressed. Corporate America needs to fix what it can and keep doing what it does best: create enormous wealth for shareholders.

## ABOUT THE AUTHORS

**IRA T. KAY, PH.D.**, global practice director of executive compensation consulting at Watson Wyatt Worldwide, headquartered in Washington, D.C., is a nationally recognized expert on executive compensation. He has helped U.S. public, private, and international companies develop annual and long-term incentive plans to increase shareholder value. Dr. Kay has written and spoken extensively on executive compensation issues and conducted research on executive pay, stock ownership, and stock options. He is coauthor of the book *The Human Capital Edge* and is the author of *CEO Pay and Shareholder Value: Helping the U.S. Win the Global Economic War* and *Value at the Top: Solutions to the Executive Compensation Crisis*. Dr. Kay has published articles in the *Harvard Business Review*, *McKinsey Quarterly*, *Journal of Deferred Compensation* and *Across the Board*. He has also presented analysis of executive compensation issues before the Federal Reserve Board, the Securities and Exchange Commission, the Financial Accounting Standards Board, and a U.S. Senate subcommittee. He is frequently quoted in the major business press and speaks globally on executive compensation issues.

**STEVEN VAN PUTTEN** is the east division practice leader of Watson Wyatt's executive compensation consulting practice. He focuses primarily on advising compensation committees and senior management on executive and director compensation matters. Mr. Van Putten has written and spoken on executive and incentive compensation, and specializes in the design and development of annual and long-term incentive programs that drive business strategy and support organizational objectives. He is also an expert on FAS 123(R) and its implications for stock-based incentives.

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## PRAISE FOR *Myths and Realities of Executive Pay*

“Kay and Van Putten have aptly titled their new book. Unfortunately, the public in general has little understanding about executive compensation and in many cases the information in the public press is confusing and inaccurate. *Myths and Realities of Executive Pay* is a clear road map to the new realities. It is must reading for CEOs, HR executives and board members of public companies.”

- **FORMER SENATOR WARREN RUDMAN**, chairman of the compensation committee at Boston Scientific Corp., former chairman of the compensation committee at Raytheon Company, and former member of the compensation committee at The Chubb Corp.

“In an environment in which U.S. CEOs and boards are heavily criticized for governance and executive pay practices, Kay and Van Putten present the other side of the story. Many of those practices in the United States encourage and lead to shareholder value creation and productivity increases rather than executive enrichment at the expense of shareholders and others.”

- **STEVEN KAPLAN**, Neubauer family professor of entrepreneurship and finance, University of Chicago

“A very timely review of the key issues confronting corporations in devising and implementing executive compensation programs. The very experienced and highly regarded authors offer very well thought out, and some unique, solutions. This is must reading for compensation committee members and HR executives.”

- **MARTIN LIPTON**, founding partner of Wachtell, Lipton, Rosen & Katz

“Written by one of the country’s leading compensation consultants, this book is a significant addition to the debate on executive pay. Ira Kay’s defense of current pay practices should be read by anyone seeking to assess whether these practices are well designed to serve the interests of investors.”

- **LUCIAN BEBCHUK**, Friedman Professor of Law, Economics, and Finance at Harvard Law School, and coauthor of *Pay without Performance: The Unfulfilled Promise of Executive Compensation*