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WHAT'S NEXT FOR Executive Incentives NOW THAT OPTIONS ARE LIMITED?

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During the past 30 years, executive pay has skyrocketed, primarily propelled by the increasing use and value of stock compensation. This article examines how executive pay arrived at its current state, whether stock compensation is an effective motivator of performance and how executives might be more appropriately rewarded for improvements in company stock price.

In the past, under Generally Accepted Accounting Principles (GAAP), when companies granted stock options they were not required to report any compensation expense in their publicly filed financial statements. In addition, when certain options were exercised, companies received a tax deduction, which provided significant income tax savings. Who could resist getting a tax deduction without seeing earnings penalized?

QUICK LOOK

- In the past, when certain options were exercised, companies received a tax deduction, which provided significant income tax savings.
- In retrospect, because stock options had minimal underlying value, option grants tended to be generous.
- Companies can reward executives for stock price growth without offering stock-based compensation.

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Among Standard & Poor's 500 CEOs, from 1990 to 2000, equity compensation as a percentage of total compensation rose from 40 percent to 78 percent.

Stock options were clearly an efficient way to deliver executive compensation, but now that the tax and accounting advantages of stock options are being stripped away, it may be possible to more objectively address their power as a motivator of executive performance.

Brief History of Executive Pay

To understand the rise in popularity of stock options and stock compensation, let's look at a brief history of executive pay. Carola Frydman, a doctoral candidate at Harvard, and Raven E. Saks, an economist at the Federal Reserve, analyzed the compensation of top executives at 102 large companies from 1936 to 2003. According to the study, from the mid-1940s through the 1970s, the ratio of executive pay to average-worker pay stayed pretty consistent, with the pay of both groups growing at about 1.3 percent per year. Starting in the 1980s, the growth of executive compensation began to dramatically outpace average-worker pay. There are three primary reasons for this acceleration: First, was a new definition of executive pay, second was the increasing use of stock options and third was a raging bull market.

New Definition of Executive Pay

For many years, total pay was defined as cash compensation (base pay plus short-term incentives). This was a straightforward, easy-to-collect value, which was consistently and accurately reflected in pay surveys. But for those companies that provided long-term incentives, this definition understated the value of the total executive-pay package. Compensation consultants addressed this issue by introducing long-term incentive plan (LTIP) surveys. As these surveys grew in sophistication and stature, the annualized net present value of long-term incentive gains became a viable component of "total direct compensation" (base pay plus short-term incentives plus long-term incentives). As such, when companies that did not offer LTIPs compared their total direct compensation to this new market value, they fell short of the competitive level, which ultimately led them to close this gap by introducing new LTIPs.

Use of Stock Options

With the new and improved definition of total compensation and the formal legitimacy of stock compensation came a wave of organizations looking to introduce or modify their LTIPs to ensure that their executive teams were competitively paid. It was no longer enough to pay a fair base wage and offer a fair bonus, it was now obligatory to offer a long-term incentive. With the tax and accounting advantages offered by stock options and the talking points about getting executives to "act more like owners" and work even harder to ensure the success of the company, the appeal of options was difficult to resist. In retrospect, because stock options had minimal underlying value, option grants tended to be generous.

Raging Bull Market

From Dec. 6, 1974, forward (as of press time), the Dow Jones Industrial average has risen from 578 to more than 13,000. The general market has performed accordingly. As the vast majority of long-term incentives are tied to company stock price, it's easy to see how the value of these long-term incentives could skyrocket.

As the value of long-term incentives increased, so did their proportion of executive total compensation. Among Standard & Poor's 500 CEOs, from 1990 to 2000, equity compensation as a percentage of total compensation rose from 40 percent to 78 percent, according to the 2005 *Oxford Review of Economic Policy*. Therefore, as boards and executives examined market rates for senior management, the emphasis was increasingly placed on ensuring competitive long-term incentives.

Tying a portion of pay to stock price is a small step away from tying pay to the performance of the Dow Jones Industrial Index.

Stock Options Change the Game

Short-term and long-term incentives were initially devised to deliver a level of pay for performance that base salary, because of its relatively fixed stature, could not. Incentives were often referred to as "pay at risk." If executives met expectations, they received only base salary. If they performed beyond expectations, they received an incentive. Typical incentive plans had a threshold (point at which expectations are exceeded and the plan begins to fund), target (payout for meeting a stretch performance goal) and maximum (payout for performing at an outstanding level). Some companies took an even more aggressive posture—especially with salesforces—reducing base pay to below-market levels but providing above-market total compensation opportunities through large incentive payouts for high performers.

Stock options broke the mold on executive incentive-pay design because the payout maximum was removed and the rewards knew no bounds, and because the notion of pay at risk was lost because the company had no expense, so controlling compensation costs with a pay-at-risk/pay-for-performance model was unnecessary. Payout targets for stock-based incentives had more to do with delivering a predetermined target compensation level to executives than with achieving a stretch company performance level.

Long-term Incentive Pay Becomes an Entitlement

Entitlement was born when companies began establishing executive pay philosophies that targeted compensation at the 50th or 75th percentile of the market's total direct compensation. Let's say that the 2007 market's total direct compensation for a CEO is $10 million, broken down as follows: base pay equals $2.5 million, annual incentive pay equals $2 million and stock options equal $5.5 million. To realize its philosophy of "paying at market," the company has to deliver $10 million to the CEO. This total pay target becomes an expectation, separate from any notion of pay for performance. But if the stock price goes into decline and options become worthless, the CEO's pay could fall by as much as 55 percent, well short of the 2007 "target" compensation level. At this point, many companies scramble to find other reward vehicles to keep their executives whole and ensure that they don't receive a pay "cut." Stock options are, in effect, just a means to deliver a compensation level. If they fall short of their intended purpose, companies must find another means to justify the compensation end. The compensation end is no longer based on executive performance, it is based on market.

As evidence of this, prior to the 2001 bear market, only 20 percent of the Standard & Poor's 500 companies granted some form of restricted stock to their CEOs. Within the next four years, 58.5 percent of these companies were granting restricted stock, according to Mary Ellen Carter in the March 2007 *Compliance Week.* This dramatic increase in the use of restricted stock is primarily driven by the fact that restricted stock promised guaranteed compensation through its underlying stock value at a time when the value of stock options was unpredictable, or underwater and worthless.

Stock Options as a Motivator

For a performance factor to be a powerful motivator, two things are necessary: 1) improvement in the factor must relate to the success of the business, and 2) the factor must be largely under the control of the employee/executive. Even if we assume that stock price meets the first criteria (which is often debated), it most certainly does not meet the second. Of the many factors that drive stock option value, executive performance may not even be in the top few (overall market performance, industry performance, option grant date, option exercise date). Tying a portion of pay to stock price is a small step away from tying pay to the performance of the Dow Jones Industrial Index. Incentives can be an effective way to shape, change and direct behavior. But in this regard, does anyone really believe that stock price does a better job at shaping, changing or directing executive behavior than Economic Value Added (EVA), risk-adjusted return on capital (RAROC) or free cash flow?

Rewarding Stock Performance

For those who stubbornly insist that only stock-based incentives can effectively align the interests of executives and shareholders, there is

a viable alternative to current stock-compensation vehicles. Companies can reward executives for stock price growth without offering restricted stock or stock options. Consider one of the following alternatives:

- **Use stock price as one of several incentive criteria.** Just as companies have selected and weighted key measures in designing executive cash-based incentives in the past, the same process can be followed using stock price as one of these measures. Stock price can be treated the same as any other measure, such as Return on Invested Capital (ROIC) or sales growth or Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA). Just as with these other factors, a threshold, target and superior performance level can be established and a cash payout associated with each of these performance levels.
- **Use stock price as a modifier to an incentive pool.** Although stock price increases directly benefit the shareholders, it is difficult to quantify the value of a stock price increase to the company. For that reason, it may be prudent to use the change in stock price as a modifier that increases or reduces an incentive-payout fund. For example, one could fund an incentive based on ROIC above plan and then increase or reduce the amount in that fund based on stock price performance. These are only two of several ways to reward executives for stock price performance, while insisting that the metrics most directly under their control and for which rational performance targets can be set are the primary influencers of the executives' long-term view.

Summary

In the end, paying for performance by relying on either stock options or restricted stock represents an abdication of one of the board of director's fundamental responsibilities: setting objectives for executive performance and measuring results against those objectives. Executive incentives that depend primarily on stock price effectively say to executives, "We're not clever enough to develop meaningful objectives for you, but we'll pay you as long as the stock price continues to grow." It's time to return to incentive design basics: define threshold, target and superior performance for the executive, and then define the pay that is appropriate for those levels of performance. A pay-for-performance culture doesn't grow from the ground up. It must start in the corner office. ws

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