



# Board of Directors

## 2011/2012 Research Series

### Report # 0 Preview of Series



## Board of Directors Survey & Research Report

A Study of Human Capital and Pay Practices among Boards in the United States

Price: Free USD

### **Board Governance & Pay**

Corporate Governance  
Business Strategy, People Strategy  
Pay Strategy & Levels  
Case Studies

# About Grahall

## About the Author



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He is the author of the Grahall Research Reports on the following subjects:

- Executive Compensation
- Board of Directors Governance and Compensation Study
- Hedge Fund Human Capital and Compensation Study
- Private Equity Compensation Study
- Financial Services Human Capital and Compensation Study
- Consulting Industry Human Capital and Compensation Study
- Research Consulting Industry Human Capital and Compensation Study

In conjunction with his fellow Grahall Consultants, Michael is co-authoring additional industry-specific Human Capital and Compensation Studies to better assist Human Capital strategists with creating industry-appropriate people and reward strategies within their firms

# Executive Summary

## Introduction to This Report



The Grahall Research Institute developed the Board of Directors Research Series to help our clients and colleagues view Board governance and rewards practices from new perspectives that include the relationships between Director roles, contributions and firm performance. Through the insights provided in this Series, we encourage readers to reconsider the complexity of Board rewards and to ask tough questions about the relationships between a Board and the industry and company such as:

- Is the degree of contribution of the Board appropriate given the industry's stage of development and the company's state of maturity?
- Are the structure, processes, culture and staffing of our Board appropriate to the needs of the company?
- How does the total cost of our Director compensation compare to other Boards and how connected is it to our company's performance?
- Are the components of our Director compensation providing an appropriate mix of short, medium and long term incentives?
- What are the messages that Director pay is sending to Directors, shareholders, and most certainly, executives?

Point being ... the current and progressively raucous debate regarding Board of Director governance and executive compensation has resulted in unprecedented scrutiny from government and the public. An important and directly related question ... sometimes referenced, but rarely addressed ... is whether Board rewards practices have contributed to the problem. We believe the answer is most definitely "yes."

So, while we agree with most industry experts that the current economic crisis -- and legislative and regulatory changes -- are NOT making it easier or safer to serve as a Director, we go one step further by asserting that Board governance practices need to be situational. Further, that rewards practices for the past few decades have abetted if not contributed to the current state of affairs, rather than being a result of them.

In this series we seek to move beyond a competitive analysis framework -- setting Director pay based on company size and industry category as this framework does not reflect a sufficient rationale in today's environment. We believe Director compensation should be considered within a strategic framework that includes role, industry stage and/or company performance. Not only does this more expansive approach provide a defensible rationale for Director pay, but it sends the right message to shareholders and executives as well.

# Table of Contents – Main Report

## 1. Introduction and Background

Introduction to This Report	11
Data Segmentation	12
Key Findings	13

## 2. The Grahall Perspective

The Headlines Say It All...	19
The Influences on Directors Governance & Total Rewards Design	20
Key Concepts & Definitions	29
Grahall's View of the Future	30

## 3. The Environment & Key Stakeholders

Overview	33
The Eight Phases of Industry Maturity	29
Business Environment Impacts	37
Key Stakeholders	38

## 4. Business Stages & Strategies

Overview	42
Business Stages	43
General Business Strategy	45
Value Chain Strategy	46
Specific Business Strategy	47
The Combined Impact	48

## 5. Governance & People Strategies

Overview	51
Board Governance Framework	54
Board Organizational Structure	58
Roles & Responsibilities	66
Board Organization Processes	72
Board Organization Culture	86
Board of Directors Staffing	95
Board Governance Evaluation	110

## 6. Reward Strategies, Architectures & Components

Overview	121
Board Reward Strategy	122
Board Reward Strategy Architecture	123
Reward Components	124
Architecture – The “Money”	125
Architecture – The “Mix”	127
Architecture – The “Messages”	129
Architecture – The “Management”	130
Determining Appropriate Board Compensation	132

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# Table of Contents – Appendix 1 Governance Data

## Section 1. Data Segmentation

Data Segmentation	139
-------------------	-----

## Section 2. The Environment & Key Stakeholders

Maturity of Industry	141
Government Regulations	141
Ownership / Stockholders	142
Customers	142
Employees	143

## Section 3. Industry Stages & Business Strategies

The Eight Phases of Industry Maturity	145
General Business Strategy	146
Value Chain Strategy	147
Specific Business Strategy	148

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## Section 4. Governance & People Strategy Variables

### Organization Structure

Nominating Committee	151
Compensation Committee	151
Audit Committee	152
Governance Committee	152
Board Structure	153
Chairman / CEO Separation	153
Non-CEO Chair and With Lead Director	154
Committee Prevalence	156

### Organization Processes

Cumulative Voting	157
Governance Guidelines	157
Poison Pill	157
Charter / Bylaw Amendments	158
Vote Requirements – Mergers & Business Combinations	159
Written Consent	159
Special Meetings	160
Board Amendments to Bylaws	160
Capital Structure - Dual Class	161
Full Board Performance Reviews	161
Meetings of Outside Directors	162
Outside Advisors Available to Board	162
Proxy Contest Defenses	163
Changes in Board Size	163
Board Vacancies	164
Auditor Ratification	164
Poison Pill - Shareholder Approved	165
Frequency of Board Meetings	165
Frequency of Committee Meetings	167

## Section 4. Governance & People Strategy Variables

### Organization Culture

Director Stock Ownership	174
Former CEO On Board	174
Boards Served On - CEO	175
Board Independence	175
Executive Stock Ownership Guidelines	176
Director Stock Ownership Guidelines	176
Compensation Committee Interlocks	177
Director Resignation Upon Job Change	178
Officer and Director Ownership	178
Board Independence	179
Director Attendance	179
Boards Served On - Other than CEO	180
Related Party Transactions - CEO	180
Audit Fees	181
Individual Director Performance Review	181
Financial Experts on Audit Committee	182
Related Party Transactions	182
Other than CEO	

### Staffing & Talent Management

Number of Board Members	183
Number of Independent Directors	185
Non-CEO Chair and With Lead Director	191
Number of Committee Members	193
CEO Succession Plan	199

# Table of Contents – Appendix 2 Compensation Data

## Section 1. Level of Rewards

Total Board Cost by Revenue Group	203
Total Board Cost by Revenue Group – Annual Retainer	204
Total Board Cost by Revenue Group – Meeting Fees	205
Total Board Cost by Revenue Group – Additional Leadership Pay	206
Total Board Cost by Revenue Group – Equity	207
Total Board Cost by Industry Group	208

Total Board Member Rewards by Revenue Group	209
Total Board Member Rewards by Revenue Group – Annual Retainer	210
Total Board Member Rewards by Revenue Group – Meeting Fees	211
Total Board Member Rewards by Revenue Group – Additional Pay for Leadership	212
Total Board Member Rewards by Revenue Group – Equity	213

Additional Retainer paid to Lead Director by Industry Group	214
Additional Retainer paid to Lead Director by Revenue Group	215
Additional Fees paid to Committee Chairmen – Audit	216
Additional Fees paid to Committee Chairmen – Comp Committee	217
Additional Fees paid to Committee Chairmen – Comp Committee	218

Audit Committee Chairman Fees by Industry Group	219
Compensation Committee Chairman Fees by Industry Group	220
Governance Committee Chairman Fees by Industry Group	221
Additional Fees paid to Committee Chairmen by Revenue Group	222
Audit Committee Chairman Fees by Revenue Group	223
Compensation Committee Chairman Fees by Revenue Group	224
Governance Committee Chairman Fees by Revenue Group	225

Additional Fees paid to Committee Members by Industry Group	226
Audit Committee Member Fees by Industry Group	227
Compensation Committee Member Fees by Industry Group	228
Governance Committee Member Fees by Industry Group	229
Additional Fees paid to Committee Members by Revenue Group	230
Audit Committee Member Fees by Revenue Group	231
Compensation Committee Member Fees by Revenue Group	232
Governance Committee Member Fees by Revenue Group	233

## Section 2. Mix of Rewards

Compensation Mix For Board Of Directors by Industry	235
Compensation Mix For Board Of Directors by Industry	236
Compensation Mix For Board Of Directors by Revenue Group	237
Cash Retainer vs. Total Compensation by Industry	238
Cash Retainer vs. Total Compensation by Revenue Group	239

## Section 3. Grahall Insights on the Messages of Rewards

Retainer vs. Meeting Fees	242
Retainer vs. Stock Awards	243
Retainer vs. Total Board Cost	244
Retainer vs. Total Named Director Rewards	245
Total Named Director Rewards vs. Meeting Fees	246
Total Named Director Rewards vs. Stock Options	247
Stock Awards vs. Total Named Director Cost	248
Stock Awards vs. Total Board Cost	249
Stock Awards vs. Stock Options	250
Total Board Cost vs. Total Named Director Rewards	251
Total Board Cost vs. Stock Options	252

# Table of Contents - Case Study – Board Effectiveness

<b>Executive Summary</b>	258
<b>Background and Introduction</b>	
About the Client	260
<b>Effectiveness Evaluation</b>	
Background	262
Governance Framework	263
Design Work	264
Process	265
Scoring	266
<b>Challenges</b>	269
<b>Outcomes</b>	
Summary of Results	271
Detailed Results	
• Governance	272
• Effectiveness	273
• Peer Review	274
<b>Conclusions</b>	277
<b>Appendix</b>	278



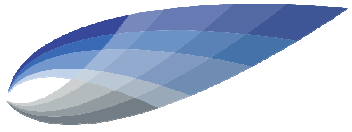
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## Table of Contents - Case Study – Board Compensation

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<b>1.0 Executive Summary</b> .....	293
<b>2.0 Background and Grahall Concepts</b> .....	295
<b>3.0 Findings and recommendations</b> .....	302
<b>4.0 Directors Current Compensation</b> .....	309
ABC History.....	310
Current Program.....	312
<b>5.0 Board Compensation Analysis – Total Board Cost</b>	
<b>Summary</b> of Findings Total Board Cost.....	314
Total Board Cost vs. Peer Groups .....	315
Influence of Size and Performance on Cost....	316
Influence of Board Contribution on Total Cost..	317
<b>6.0 Board Compensation Analysis – Compensation Per Director</b>	
Compensation per Director.....	319
Board Compensation Peer Groups.....	320
Committee Compensation Peer Group.....	321
Membership Rewards (Board Retainers).....	325
Performance Rewards (Equity).....	326
Contribution Rewards (Fees).....	327
Role Rewards (Retainers).....	328





**GRAHALL**

IN THIS SECTION

INTRODUCTION

DATA SEGMENTATION

KEY FINDINGS

# Section 1

## Introduction & Background

# Introduction & Background

## Introduction to This Report



The Board composition and rewards data for this series was retrieved from proxy filings of 1,000 public companies. The data includes general Board composition characteristics, corporate governance guidelines (where available) and statistics on Non-employee Director rewards, including retainers, equity awards, cash bonuses, and meeting, committee, and attendance fees.

Additional notes about the data are provided below:

- Employee Directors have been excluded.
- Director retirement, supplemental retirement, and perquisites data have been excluded.
- Annual Retainer data is based on the actual rate of retainer paid to each Director for the relevant fiscal year.
- Meeting fees are based on the actual number of Board and Committee meetings that occurred, respectively, as reported in the proxy.
- Stock Options are based on the annual accounting expense applicable to the award as reported by the company in its proxy statement, which in turn is based on the company's own assumptions regarding the required inputs into the option pricing model upon which accounting costs are based, consistent with FASB guidelines.
- Full value awards are based on annual accounting expense applicable to the awards, determined consistent with FASB guidelines.

# Introduction & Background

## Data Segmentation

### Companies by Industry and Revenue

The 1,000 companies in this report have been subdivided two different ways, depicted in the tables on this page:

- (1) According to industry classification
- (2) Into 10 equally sized groups (“deciles”), based on Annual Revenues for Fiscal 2010. Each decile contains 100 companies, as illustrated on the table. For example, the 9<sup>th</sup> decile is comprised of companies with annual revenues between \$4.753 billion and \$12.832 billion.

By Industry			By Revenue	
Industry	Number of Companies	Median Revenue in Millions	Revenue Group	Median Revenue in Millions
Banks	51	219.6	1	Less than \$98M
Commercial Services & Supplies	47	1,245.5	2	\$98M to \$203M
Computer & Communications Equipment	43	1,258.4	3	\$203M to \$367M
Construction & Homebuilding	19	2,232.4	4	\$367M to \$608M
Consumer Products	57	2,422.4	5	\$608M to \$977M
Diversified Financials	35	5,228.5	6	\$977M to \$1,548M
Electronic Equipment & Instruments	24	640.2	7	\$1,548M to \$2,564M
Energy	71	2,757.4	8	\$2,564M to \$4,753M
Food & Beverage	28	3,000.5	9	\$4,753M to \$12,832M
Health Care Equipment & Services	76	1,145.8	10	\$12,832M and larger
Hotels, Restaurants & Gaming	40	1,298.9		
Insurance	33	1,696.0		
Manufacturing	76	2,559.5		
Materials	44	3,380.1		
Media	31	2,948.9		
Pharmaceuticals, Biotechnology & Life Sciences	64	232.3		
Real Estate	20	919.2		
Retailing	52	6,954.0		
Semiconductors & Semiconductor Equipment	30	419.1		
Software & Services	60	330.0		
Telecommunication Services	18	1,249.3		
Transportation	36	5,036.8		
Utilities	45	3,776.6		

# Introduction & Background

## Key Findings

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### **Company Environments and Key Stakeholders Vary Dramatically and Challenge Directors**

According to our results, the industry average cash flow return on investment (CFROI) varies from a negative 10% in the biotechnology industry to a high of positive 15% in other key industries. Ownership also varies dramatically as do other key stakeholder groups all creating a multicolored kaleidoscope of conditions for the Board of Directors to operate within.

### **Business Strategies Vary Dramatically and are Changing Substantially and are Challenging Directors**

Although the most popular business strategies are still differentiation and focus the percentage of companies that are refocusing on competitive advantage value chain elements is significant and this change alone represents a major shift in focus for the Board as it will impact almost every area of the business. These shifting business strategies will require review and approval by the Board of Directors and a substantial redeployment of assets.

### **Board Governance and People Strategies Will Need to be Evaluated as the Organization Grows**

As each organization passes through its various business stages it will need to evaluate and most likely change its Board of Directors governance and people strategies. The challenge is similar to the oft repeated phrase, "What got you here, won't get you there!" It appears the more successful governance models at one stage of the industry/company development is likely to be unsuccessful in the subsequent stages.

# The Grahall Perspective

## Key Concepts & Definitions

### Board Rewards Components

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Below is a list of Board reward components addressed in this report.

<b>Membership Rewards</b>	Board Retainers  Annual Retainer Additional Retainer for Leadership
<b>Performance Based Rewards</b>	Equity Awards and Cash Bonuses  Option awards Stock awards
<b>Contribution Rewards</b>	Attendance Fees – Board and Committee Meetings  Attendance Fee (In Person) Attendance Fee (By Phone) Separate Fees for Committee Meetings
<b>Leadership Rewards</b>	Chairman Retainers or Fees  Committee Chair Retainers Committee Member Retainers Chairman of the Board Retainer Lead Director Retainers

### Key Definitions

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**Rewards Mix** is the calculated percentage of rewards elements comprising Total Rewards. For this study we calculate the mix of four rewards elements: retainers paid, meeting fees paid, stock option awards, and full value stock awards.

A **Non-employee Director** is a Director who is not employed by the company. This definition includes:

- (i) **Independent Directors**, who are not affiliated with the company (note that independence standards are defined by major U.S. securities exchange listing rules and thus may differ)
- (ii) **Affiliated Directors**, who are also not employees but do not meet the standards for Independent Director (for example, Directors who are former employees of the company, the company's professional services providers, family members of a company employee, and/or engaged in an interlocking Director relationship).

**Total Rewards** is calculated as Board Retainer Cash + Board Retainer Shares Value + Total Value of Board Meeting Fees + Annual Restricted Stock Awards Value + Annual All Other Stock Awards Value + Annual Option Grants Value.

**Total Board Cost** is calculated as the sum of Total Rewards paid to all independent Directors.

# Governance & People Strategies

## Overview

At Grahall, we think of Board Governance in a very different way than most organizations. We believe that there is no such thing as best practices that apply to all Boards in all situations. We believe, based on our experience and research, that Board Governance must be situational.

This section is broken out into the following areas which will need to be evaluated individually and as a group to determine the best approach to Board Governance given a company's specific situation and conditions.

There are four key factors that impact good situational Board of Director governance. They are the following factors:

- The Board Structure
- The Board Processes
- The Board Culture
- The Board Staffing

Not all of these dimensions of Board of Directors Governance are able to be measured directly. In many cases we need to measure them by proxy. Therefore, in this research study, we have reviewed a number of proxy pieces of information in order to "measure" the level or type of structure, processes, culture, and staffing.

By reviewing all of the above factors in detail we can get a very good picture of the Board's governance and people strategy.

We first start this section off with a quick review of the different contextual factors that impact the conditions that the Board of Directors must perform under.

The first set of factors is a function of the industry and business environment. This consists of the various power groups that regulate, finance, compete with and purchase the company's products. Most companies share these industry conditions which we have bucketed into eight phases that seem to apply in more than 25 industries

The second set of forces include the company's key stakeholders, such as owners, suppliers, customers, partners, and employees. Their concerns and impact on Boards is discussed more thoroughly in Section 3.

The actual business strategy or model is also an important condition for the development of Board Governance and People Strategy.

# Governance & People Strategies

## Overview Continued

The following pages outline a series of transformations that we have witnessed within our clients over the last 40 years. In some cases, we have been with the clients at each of the 5 stages we have discussed in the previous section. In each of the stages, life settles down to “Board of Directors normal”.

At each transition, we have experienced significant organizational trauma. The following conceptual slides are based on Grahall’s experience in advising Boards of Directors – it is intended to describe an aggregated approach to organization and roles and does not reflect any single client.

While we do see a commonality of organizational and role issues which we term “People Strategy” among Boards of Directors for all sizes of organizations, we do not see a commonality of approach until the firm reaches the “Established” phase of development; i.e. typically \$500 million to \$3 billion in revenue.

Regardless of size, the organization of the Board of Directors and the roles of key Board committees and members primarily reflect the experience, leadership styles and personal competencies of the Chairman of the Board and/or the Chief Executive Officer. But the importance of effective organizational structure and roles clearly increases as an organization grows in size.

## We also classify Board of Directors “People Strategies” based on their operating characteristics:

**Organization Structure Type** – Simple versus Complex – Simple with few committees to Boards with up to five committees and an executive committee. In addition, the more complex Boards have a Chairman, Lead Director and Chief Executive Officer as separate positions. The simple organizations have a single Chairman and Chief Executive Officer.

**Organization Processes Type** – Boards also evolve considerably when it comes to Board processes. Generally, the simpler Boards will meet less frequently and will have substantially fewer committee meetings with a large number of ad-hoc decision and communications processes.

**Organization Culture Type** – We characterize cultures as 1) command & control, 2) process, 3) time based and 4) network. These cultures are often reflected in the shares that the Directors own, the number of “professional Directors”, the requirements for a Director to resign if they experience a job change and many other factors.

**Staffing and Talent Management Type** – There is significant variation in the approach to talent management by the different Boards of Directors we have worked with. Some of the variation is a function of the size and business model of the firm. However, there are some variations that are more a function of the firm’s prior history and less a function of its current and future needs.

The first two (structure and processes) Board people strategies are mainly a function of the business strategy and business model. However, the third (culture) is more a function of the ownership and other key stakeholders. Staffing and talent management are often the differentiators between firms and between success and failure.

# Governance & People Strategy

## Board Governance Framework



The best governance is situational. Most Board members have known this for some time. What works in terms of governance in a start-up industry does not work in a mature industry. Most high performing companies at each stage of the industry cycle have appropriate governance for both the industry and the company.

We have defined a “Grahall Contribution Index” (gBOD-CI) which measures the degree of authority within a band from 100% Board to 100% Management. It is clear, based on research, that the very best performance can be attained by providing the correct balance in authority between the Board and management and that this balance is situational based on both the industry and the company’s stage.

We can only repeat our lament when we hear about Board of Directors Best Practices as if the Board Governance were simple and resulted from simply more and more governance. What we believe, and is supported by research, is that the best practice in Board Governance is the best practice for your company.

# Governance & People Strategies

## Board Governance Framework Continued

As we saw earlier, Grahall divides the industries into eight phases:

- **Start-up**
- **Growth**
- **Peak**
- **Mature – Flat**
- **Decline**
- **Consolidation**
- **Negative – Bottoming out**
- **Negative – Declining**

Interesting enough, the highest performing companies in each industry segment have different levels of Board contribution. The table on the next page illustrates this relationship. Descriptions of the phases themselves are found on page 29.

In order to remove the statistics from the discussion we have identified four levels of Board Contribution.

**Consensual Boards** require their consent before any major strategic or operational decisions are made. Boards at this level of control are making strategic and operational decisions.

**Conventional Boards** require only the strategic decisions to be approved before management acts on them. While they may be informed on key operating issues, management is left to run the organization.

**Advisory Boards** do not make any key decisions on business strategy or operations but provide a level of input to management to operate the organization. They are advisors to the management team who run both the strategy and the operations.

**Contractual or Informational Boards** make no key decisions and are responsible for providing information when requested. Most of these Boards are unlikely to meet with any standard frequency.

While these are not perfect analogies, they do make the next few pages easier to grasp for the non-statisticians.

# Governance & People Strategies

## Board Governance Framework Continued

### Industry Stage and High and Low Performing Companies Board Contribution

Industry Stage	Indicative of High Performing Companies Boards of Directors Contribution level	Indicative of Low Performing Companies Boards of Directors Contribution Level
<b>Stage 1-</b> Start Up Industry	Contractual (Informational) Board Low Board Contribution Index	All other types of Boards (Conventional, Advisory or Consensual) Middle to High Board Contribution Index
<b>Stage 2</b> – Growth Industry	Conventional (Shared Authority) Board Middle Board Contribution Index	Consensual or Informational Boards High or Low Board Contribution Index
<b>Stage 3</b> – Peak Industry	Conventional to Consensual Board Middle to High Board Contribution Index	Informational or Advisory Boards Low Board Contribution Index
<b>Stage 4</b> – Mature Flat	Consensual Boards High Board Contribution Index	Informational, Advisory or Conventional Boards Low to Moderate Contribution Index
<b>Stage 5</b> - Decline	Consensual Boards High Board Contribution Index	Informational, Advisory or Conventional Boards Low to Moderate Contribution Index
<b>Stage 6</b> - Consolidating	Conventional Board Middle Board Contribution Index	Consensual Boards High Board Contribution Index
<b>Stage 7</b> – Negative Bottoming Out	Consensual or Contractual Boards Either High or Low Board Contribution Index	Advisory or Conventional Boards Middle Board Contribution Index
<b>Stage 8</b> – Negative Declining	Consensual or Contractual Boards Either High or Low Board Contribution Index	Advisory or Conventional Boards Middle Board Contribution Index

# Governance & People Strategies

## Board Organizational Structure

The following section is a review of the organizational structures typical of Boards of Directors. The range of organizational structures among Boards is significant. It is difficult to describe them in any standard way because the Chairman of the Board of Directors can make a determination as to the degree of complexity of Board roles and the degree of diversification among Directors.

Having said that, there are a significant number of changes that take place as a Board of Directors governs the organization from start-up to maturity. There is no one path and as far as we know, no one set of roles or committees that provide a better chance of success than another. However, the following series of characteristics are useful in identifying the organization structure of any one Board:

**1) The Leadership Roles** – One of the first Board structure decisions is to determine the separation of “church and state”. Specifically, to answer the question of whether there will be a separate chairman of the Board of Directors, a Lead Director or solely a Chairman who is also the CEO. This is the power concentration question that all organizations face. While there is no one answer and much of the success or failure should be allocated to the quality of the job the individuals perform, there are some strong trends reported in the press. One trend indicates that those companies with separate Chairman and CEO roles tend to perform better. We at Grahall see the issue in a more complex way. Again it is situational. If the company is in a start up industry and the Founder’s vision is critical, separating the positions is more probably than not going to be less satisfactory than keeping the roles unified.

**2) The Number of Directors** – Initially, small start-ups are governed by a single individual who is both the Chairman and Chief Executive Officer. All of the members of the Board normally report to this Chairman, who may also be the organization’s founder. As the organization grows, and if it is successful in attracting customers, then the number of independent, non-employee Directors will increase proportionally. In the mature organization there may be as many as 10 or 15 Board members.

**2) The Number of Committees** – Initially, the number of committees is minimal. “We all wash windows” is a typical way to express that everyone does whatever needs to be done and the level of specialization is more by experience and knowledge than it is some formal organizational committee accountabilities.

Ultimately the decision to move to a multi-committee based Board structure versus a single “omni-issue” Board of Directors indicates that the organization believes it can provide additional benefits to the organization. Typically, these committees focus on audit, governance and compensation topics. Additional committees with narrower areas of focus may also be created

**4) Degree of Specialization in Board Committees** –An additional issue that is very driving of the organizational structure for the typical Board of Directors is the determination of how much expertise will be brought into the Board rather than available through outside professional firms. We have spent considerable time working through the benefits and disadvantages of the alternative degrees of Board “outsourcing”. These are decisions that can be made by the Board. For example, it is not unusual to outsource some accounting, legal and even human resources expertise while the organization is developing before “insourcing” to the Board of Directors.

The following section on organizational structure is designed to answer some of the most important questions based on the report data. We expect that in future years we will get to study more of the issues regarding this important organizational/people strategy issue.

# Governance & People Strategies

## Board of Directors Staffing – Director Competencies



We are often asked for competencies for Board members. While we believe that the specific competencies can only be determined in a situational way, in the following pages we have provided a series of generic competencies we have identified for a Board members. These competencies should be used only as a starting point. As you can see, they are presented in alphabetical order, not order of priority.

- Analytical Thinking
- Building Alliances
- Business Acumen
- Customer Service Orientation
- Developing Others
- Driving for Results
- Flexibility
- Impact and Influence
- Initiative
- Integrity
- Organizational Commitment
- Project Management
- Self-Confidence
- Self Control
- Strategic Orientation
- Team Leadership
- Teamwork
- Technical Expertise

# Governance & People Strategies

## Board of Director Staffing - Board Size

### Number of Board Members by Revenue Group - Non-Employee Directors

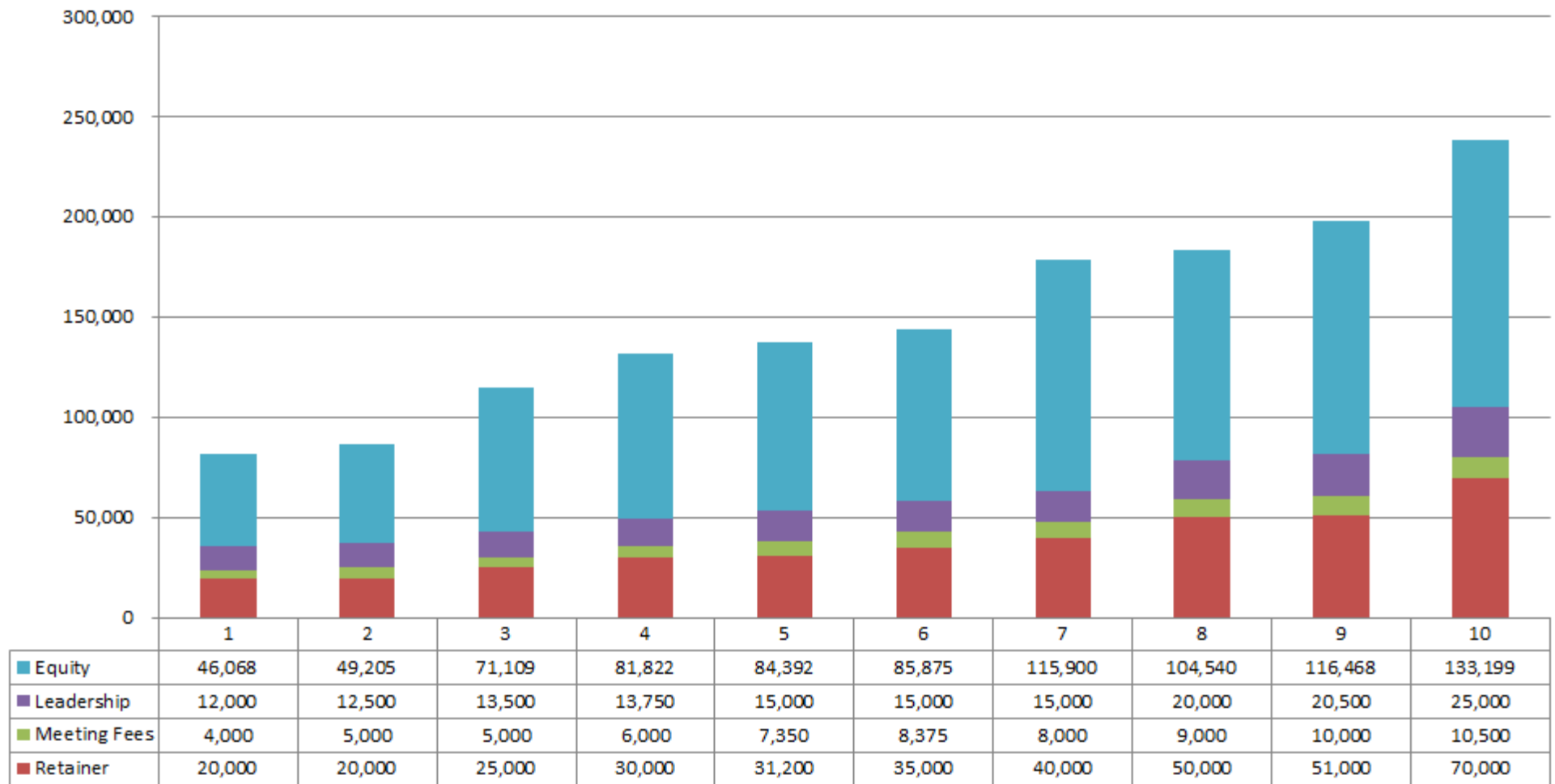
#### Results by Revenue Group

Revenue Group	# of Firms	10th	20th	30th	40th	50th	60th	70th	80th	90th
Group 1 (less than \$98M)	100	3	4	5	5	6	6	7	7	8
Group 2 (\$98M to \$203M)	100	4	5	5	6	6	6	7	8	9
Group 3 (\$203M to \$367M)	100	4	4	5	5	6	6	7	8	9
Group 4 (\$367M to \$608M)	100	4	5	5	6	6	7	7	8	9
Group 5 (\$608M to \$977M)	100	5	5	6	6	7	7	8	8	9
Group 6 (\$977M to \$1,548M)	100	5	6	6	7	7	7	8	8	9
Group 7 (\$1,548M to \$2,564M)	100	5	6	7	7	7	8	8	9	11
Group 8 (\$2,564M to \$4,753M)	100	6	7	7	8	8	9	9	10	11
Group 9 (\$4,753M to \$12,832M)	100	6	7	8	8	9	10	10	10	11
Group 10 (\$12,832M and larger)	100	8	9	9	10	10	11	11	11	12

# Reward Strategies, Architectures & Components

## Architecture – The “Money” Continued

### Total Board Member Rewards by Revenue Group



# Reward Strategies, Architectures & Components

## Architecture – The “Mix”

### The Different Components of Rewards

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**Membership-based rewards** include Board and Committee retainers

- When the contribution level and time demands are relatively consistent among Directors – more often found on Boards with fewer number of Directors – we recommend that relatively greater weight be placed on the Board and committee retainers versus meeting fees
- For some Boards, it may be appropriate to completely eliminate Board and committee meeting fees

**Performance-based rewards** are typically equity denominated awards (e.g., restricted stock, restricted stock units, and/or stock options) with vesting, often ratable over two to three years

- We recommend that equity-based awards be expressed as a dollar valuation, not as a number of shares or options

**Contribution-based rewards** include Board and committee meeting fees, and the relative weighting of committee retainers versus Board retainers:

- When the contribution level and time demands vary by Director – more often found on Boards with a relatively large number of Directors – we recommend that a relatively greater weight be placed on the Board and committee meeting fees versus retainers
- In the same manner, for companies where the majority of the work is done at the committee level rather than at the full Board level (again, more often found on Boards with a relatively large number of Directors), we recommend that a greater weight be placed on committee retainers versus Board retainers, noting that committee-based compensation differentiation is now commonplace

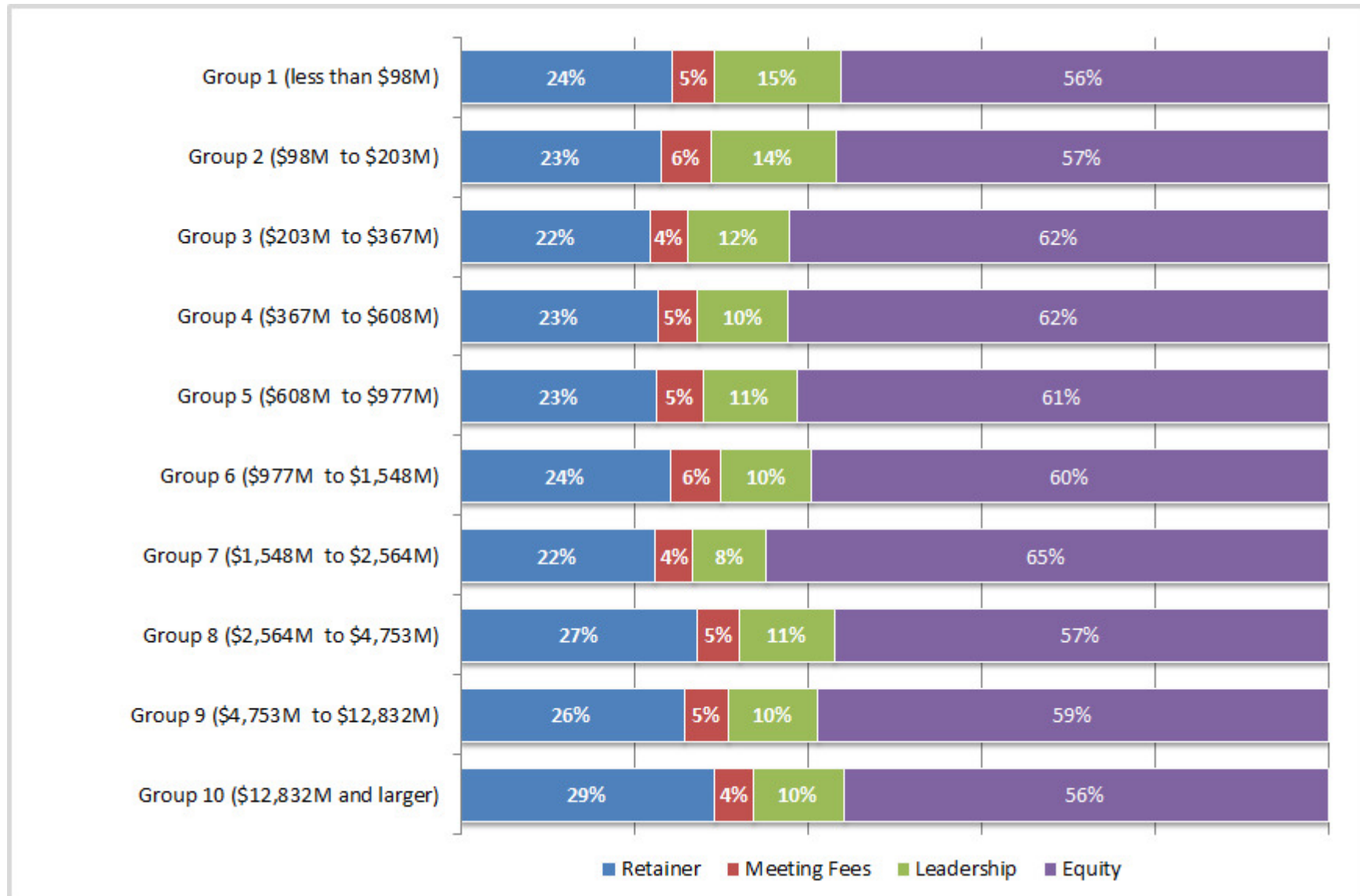
**Leadership-based rewards** are the premiums provided for Directors that agree to take on either Board (Chairman of the Board) or committee (Chairman of the Audit, Compensation or Governance) leadership roles.

**Status or Perquisites** based rewards are a function of the willingness of the company to provide reward programs in the form of company products or to meet Board of Director needs. These status based rewards can be as insignificant as first class travel to Board Meetings to much more significant as in providing the Directors with a retirement plan.

# Reward Strategies, Architectures & Components

## Architecture – The “Mix” Continued

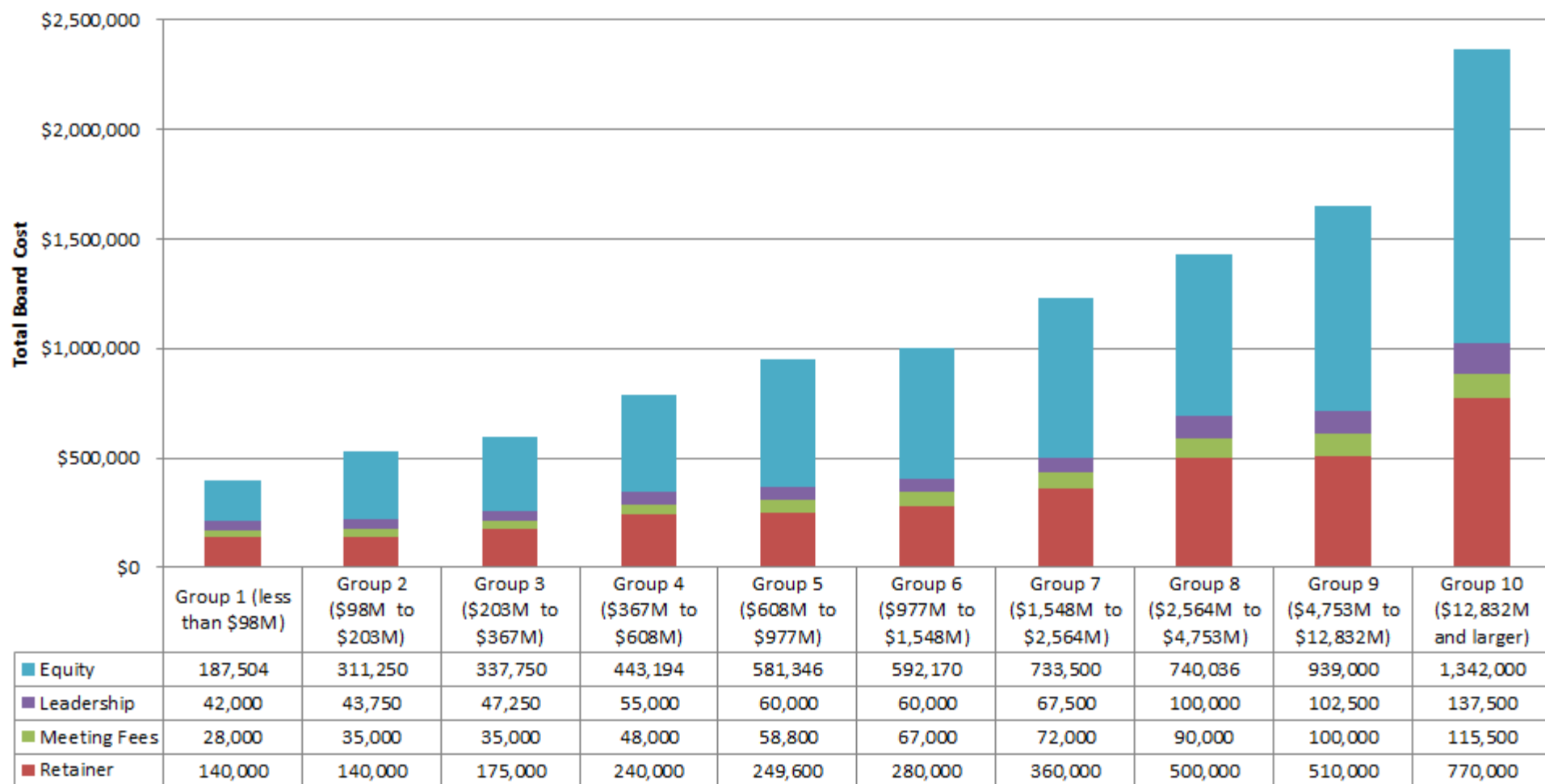
### Compensation Mix For Boards Of Directors by Revenue Group



# Reward Strategies, Architectures & Components

## Determining Appropriate Board Compensation Continued

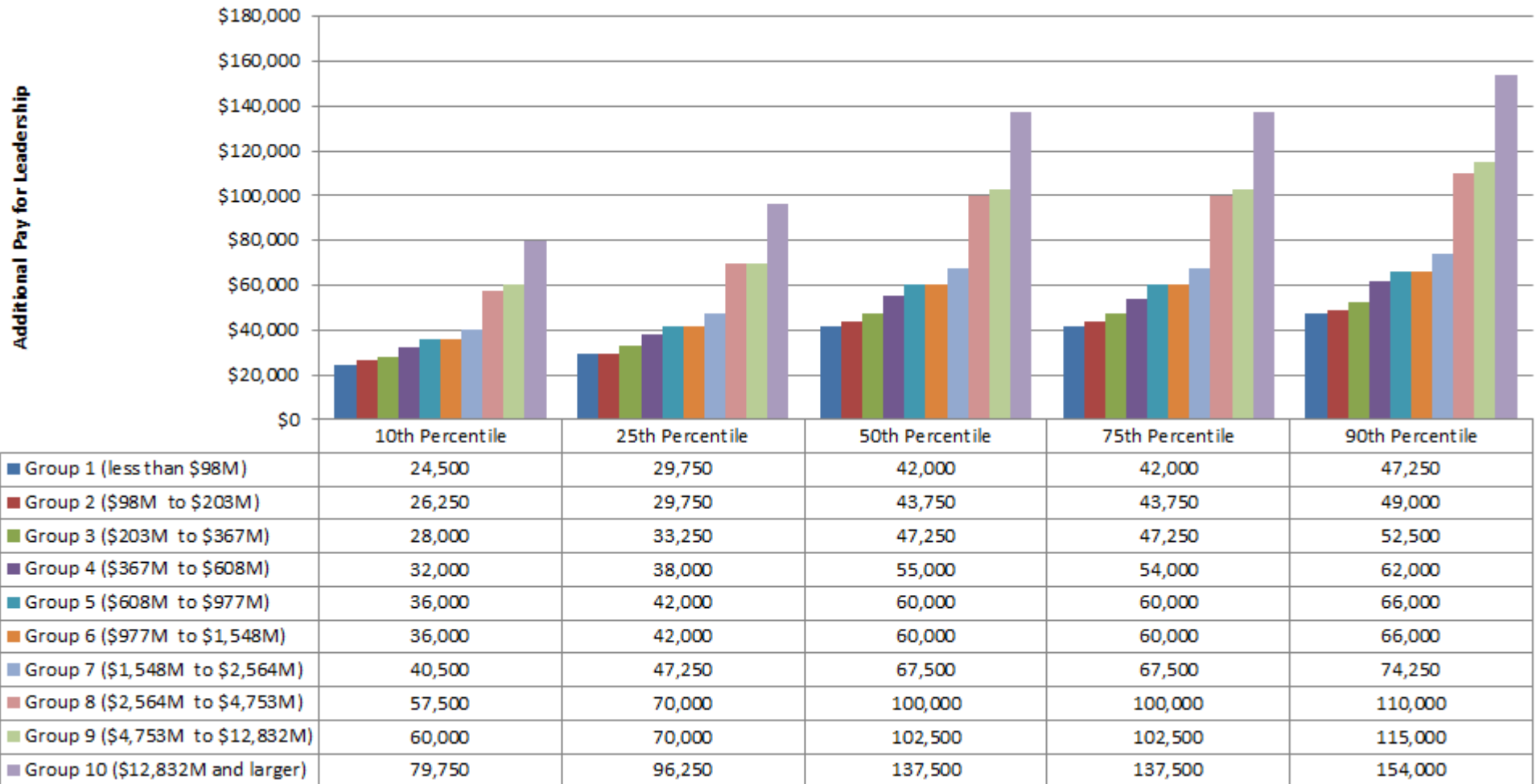
### Total Board Cost by Revenue Group



# Level of Rewards

## Total Board Cost

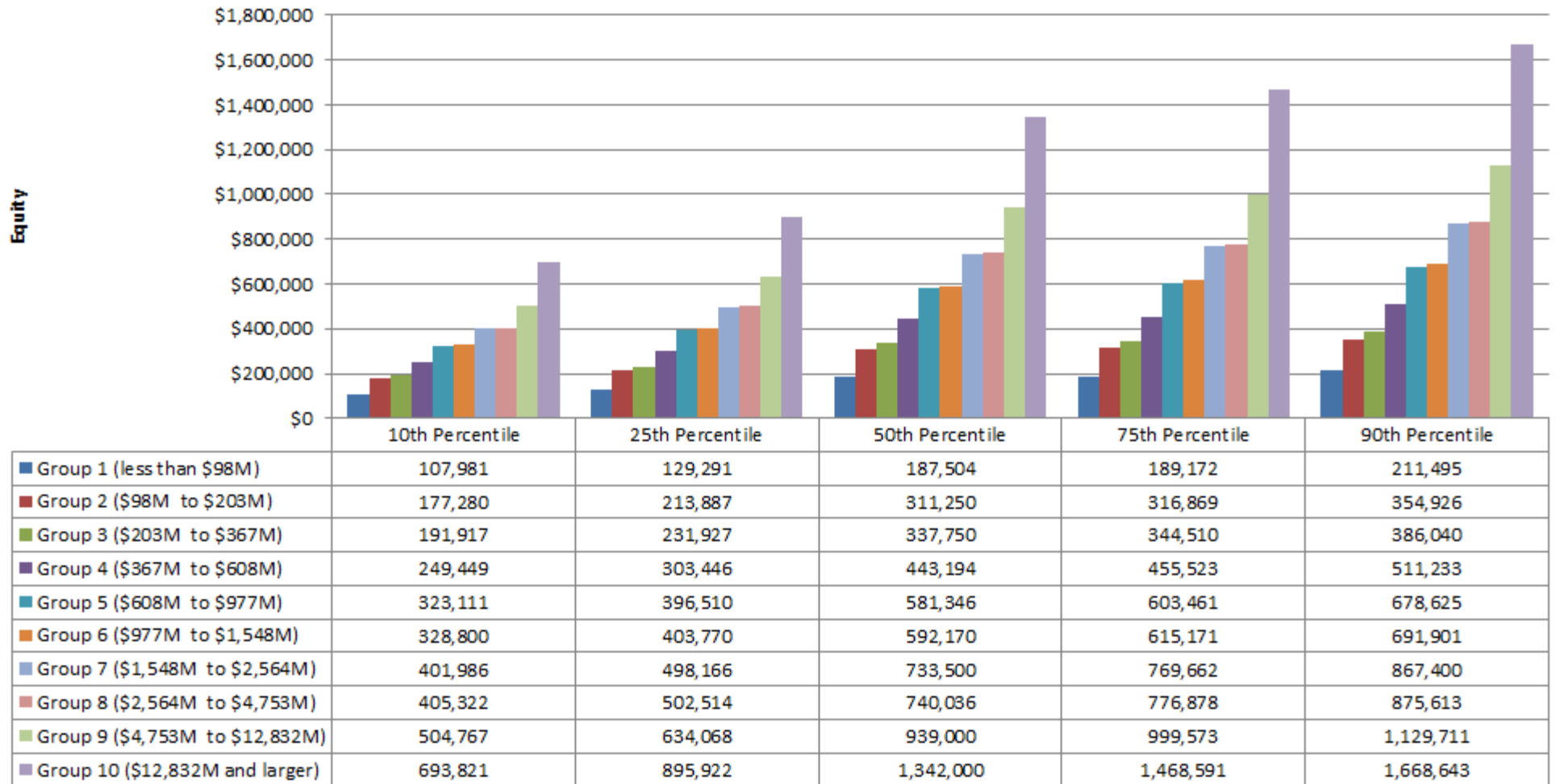
### Total Board Cost by Revenue Group – Additional Pay for Leadership



# Level of Rewards

## Total Board Cost

### Total Board Cost by Revenue Group – Equity



# Level of Rewards

## Total Board Cost

### Total Board Cost by Industry Group

#### Results by Industry

Industry Group	# of Firms	Median # of Directors	Median Total Board Cost
Banks	51	10	425,525
Commercial Services & Supplies	47	8	1,063,942
Computer & Communications Equipment	43	7	829,335
Construction & Homebuilding	19	8	1,048,988
Consumer Products	57	9	961,500
Diversified Financials	35	9	816,948
Electronic Equipment & Instruments	24	8	886,845
Energy	71	8	1,192,740
Food & Beverage	28	9	1,131,967
Health Care Equipment & Services	76	8	993,980
Hotels, Restaurants & Gaming	40	8	913,286
Insurance	33	10	886,375
Manufacturing	76	9	1,101,122
Materials	44	9	1,211,146
Media	31	9	1,020,000
Pharmaceuticals, Biotechnology & Life Sciences	64	9	1,326,097
Real Estate	20	9	845,687
Retailing	52	9	1,177,375
Semiconductors & Semiconductor Equipment	30	7	790,800
Software & Services	60	7	875,196
Telecommunication Services	18	9	1,119,033
Transportation	36	9	844,290
Utilities	45	10	1,250,324

# Grahall Insights on the Messages of Rewards

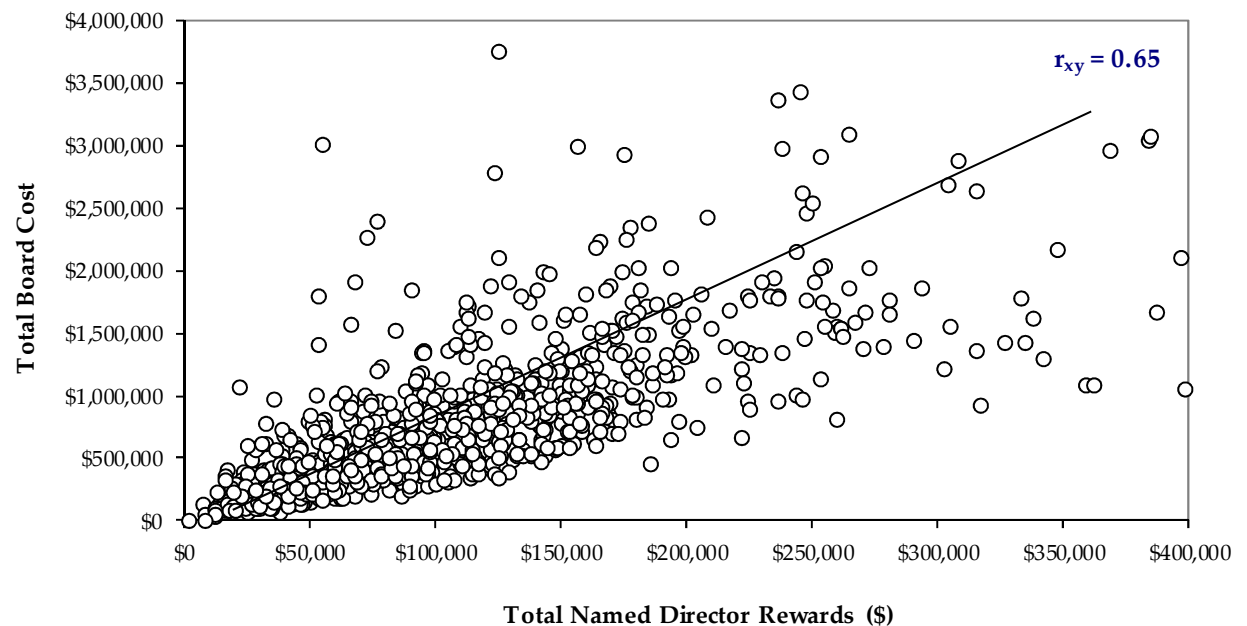
## Total Board Cost vs. Total Named Director Rewards

### 1. Statement

Total Board Cost and Total Named Director Rewards are highly correlated. In simple terms, the greater the overall value of Total Named Director Rewards, the greater the Total Board Cost on a 1:1 basis.

### 2. Analysis

As illustrated in the chart, Total Board Cost which ranges from zero to nearly \$4,000,000 and Total Named Director Rewards which ranges from zero to nearly \$400,000 are highly correlated. For two-thirds of the sampled companies, it's simple math: the greater the sum of Total Named Director Rewards, the greater the Total Board Cost. The exceptions in this study can be explained primarily by the number of independent Directors on Boards. Because independent Directors comprise most Boards, and the average number of independent Directors is generally eight, the total cost of a Board is approximately eight times the amount paid to the average Director.



### 3. Observation

With few exceptions, there is a 1:1 relationship between Total Board Cost and Total Named Director Rewards.

## **Effectiveness Evaluation - Process**

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There are many processes one can use to evaluate the Board of Directors' effectiveness. One would be to interview Board members to get their feedback on specific performance metrics as well as peer-to-peer contributions. We felt that an on-line survey tool with mostly objective questions as well as an opportunity to answer open-ended questions would be more appropriate for this initial evaluation.

A few things we did that we feel made the evaluation process effective are:

1. We worked with the VP of HR for the Company to create relevant content and ensure that the survey instrument communicated well given the environment and culture of the organization.
2. We kept the survey instrument brief without compromising on any area of focus.
3. We provided Directors with the opportunity to answer open-ended questions in addition to the multiple choice questions that formed the majority of the survey.
4. As outside consultants, we ran the survey so anonymity could be maintained.
5. The Chairman of the Board announced and invited Directors to participate in the survey indicating buy-in at the highest level.
6. Directors were told up front how the data would be used and when they would see the results.

All Directors were given ample time to complete the survey as well. All results came back to the NoviSurvey System and we also kept the VP of HR apprised of the progress of Directors in completing the survey on time. At this level in the organization, one would expect 100% participation, which we did get. However, we were pleasantly surprised by how quickly Directors participated and how willing they were to make this a priority. We had one Director who was on vacation when we learned we had an opportunity to review the findings with the Chairman of the Board in person two weeks before the survey was set to close. That Director completed the survey within 24 hours so we could present complete findings.

## Effectiveness Evaluation - Scoring

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The final Grahall Survey assessed Board Effectiveness and Director Performance across the following dimensions:

- Dimension 1: Board Responsibilities (11 questions)
- Dimension 2: Group Dynamics (5 questions)
- Dimension 3: Information Architecture (4 questions)
- Dimension 4: Director Level of Knowledge (7 questions)
- Dimension 5: Director Role Fulfillment (5 questions)
- Dimension 6: Director Input to the Board (5 questions)
- Dimension 7: Director Behavior (6 questions)

To improve comprehension of the Board Effectiveness survey results and facilitate comparison of this year's results (2010) to future results, Grahall devised a simple but effective "scoring" methodology and applied it to each Dimension. This methodology assigned the following numerical score to the responses to each question:

- 5 points - Most positive response
- 4 points – Positive response
- 3 points - Neutral response
- 2 points – Some opportunity for enhancement
- 1 point – Greatest opportunity for enhancement

All responses to each question submitted by the Directors were aggregated, and then the total actual score for each Dimension was divided by potential "perfect" score to arrive at a "Efficiency Rating". The Efficiency Rating, expressed as a percentage of a perfect score, helps normalize the results to ease comparison, both year to year and across dimensions. For example, dimension 1 has eleven questions, and eight respondents. Accordingly, there are 88 total responses, each of which can be scored up to 5 points, for an aggregate total of 440 points. If we assume that each Director gave each response a neutral (or 3 points) to each question, it would result in a score of 264. The associated efficiency rating is 60% (264/440 potential points), and can be compared to the prior year, or other dimensions.

## Executive Summary

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- Grahall Consulting Partners, LLC (“Grahall”) has been engaged by ABC Corporation (“ABC”) to conduct a review of its Director (“Director”) compensation program
- Grahall has reviewed both Total Board Cost and Individual Director Pay
- Grahall has compared ABC’s Board Pay Program to three distinct groups:
  - Peer Group 1: 4 public companies closest in character of business model to ABC Corporation
  - Peer Group 2: 13 public companies with similar operations but different in size or complexity
  - Peer Group 3: 177 publically listed service industry firms
- The total cost of the Board is found to be competitive; however, the pay of individual directors is below market levels
- We have developed three alternatives which we believe would be appropriate to consider based on the current and future plans of ABC Corporation
- We are recommending that the Board consider a combination of alternative **#1 Increase the Performance based (equity)** and alternative **#3 of increasing the Contribution based pay (Committee Chair retainers)**
  - Financial impact would be an increased cost of \$190,000 per year
    - \$100,000 of the increase is appropriate if the organization doubles in the next 5 years
    - At least half of the second \$90,000 could be offset by combining committees
    - We recommend implementation of the increase in stock appreciation rights to be staged over the next 5 years
  - Director impact of an increase in the following areas:
    - Chairman retainers for Committees will be viewed as an appropriate recognition of reality of the time and expertise commitment
    - All Directors should understand the logic behind the increase in the stock portion of the program
  - Organizational impact of an increase in the effectiveness of the Board
    - More responsibility and work done at the committee level
    - More willingness to accept the additional responsibility of Committee Chairman roles

## ***Findings, Conclusions, Alternatives and Recommendations***

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- Total board cost of \$640,000 approximates the 50<sup>th</sup> percentile of organizations of similar characteristics of three peer groups representing the “most similar” to the “general services industry”
- Board compensation elements are similar to those used in other organizations
  - Board Retainers are somewhat low
  - Chairman of the Board Retainer is high
  - Chairman of a Board Committee Meeting Fees are high
  - Committee Meeting Fees are high
  - Equity awards are very low
- The mix of the various Board reward components is uniquely mixed compared to the equity heavy publically traded companies
- Board Contribution is high and company performance is low
- The proportion of the reward components reflects some uniqueness specifically when compared to publically listed organizations. The equity portion of the reward program is substantially under market by \$40,000 to \$60,000 per Director

## **Findings, *Conclusions*, Alternatives and Recommendations**

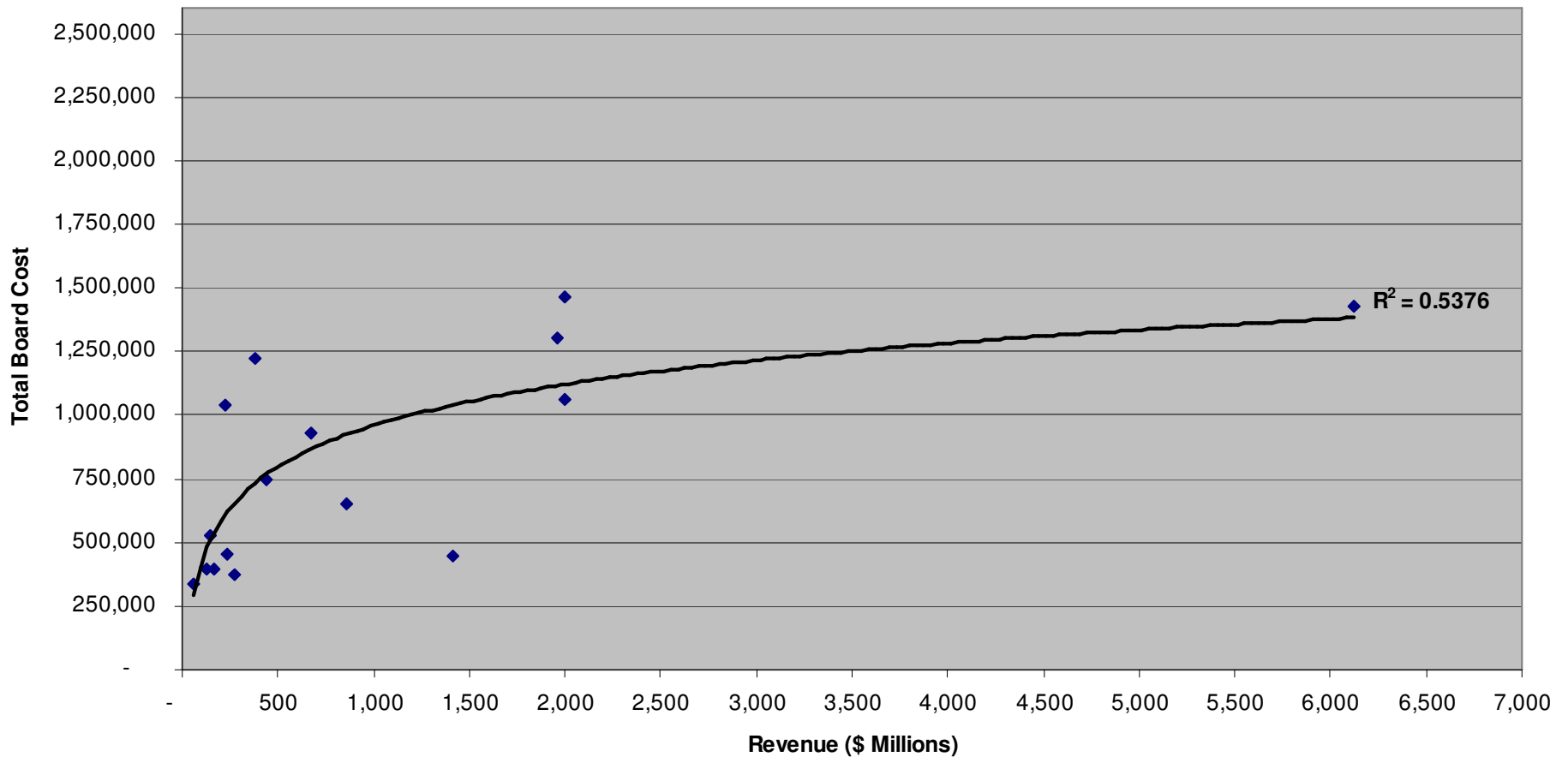
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- As a result of the interviews and the Grahall Contribution Index (GCI) score, we conclude that the ABC Corporation Board of Directors is more involved in the strategic and operational decisions than is typical of at least the publically listed peer group companies
- This level of involvement would normally lead to an expectation of high relative pay for the ABC Corporation Board of Directors however, the current performance is not competitive with the publically listed organizations in our peer groups which would under normal circumstances lead to a discount from the competitive levels of Board Pay
- We also believe that in the recent past, the Board may have been the central forum for decision making on both the strategic issues and operational issues and as the organization grows in size and complexity there will be an increased need to have committees carry a greater portion of the administrative and problem solving Board issues. We expect Board administrative and problem solving responsibilities to increasingly be fulfilled at the committee level. The Board itself will be left to deliberate on the critical strategic and leadership issues facing the organization
- While the Board is currently also involved in a wide range of issues at a relatively deep level, we believe this may not be effective as the ABC Corporation organization grows in size and complexity as predicated in the strategic plan and the current pay for Board Members will be low for the planned size in revenues of \$600 million
- It would be our conclusion from our experience and research on 1000 publically listed companies and the ABC interviews that as the organization grows, the Board will naturally give up some of the accountability it currently has first to the Board Committees and then to the management team

## Board Compensation Analysis

### Total Board Cost vs. Revenues of Companies in Peer Groups 1 & 2

- If and when ABC Corporation grows from \$300 million to \$600 million in revenues there appears to be a significant initial increase in the Total Board Cost which then levels out as revenues increase.



## ***Influence of Size and Performance Factors on Aggregate Director Cost***

- How does organization performance factor into total board cost after accounting for the impact of organizational size?
  - The following table summarizes the percentiles for total board cost and total shareholder return (3, 5, and 10 year) based on the same sample firms
  - Based on 106 service industry companies from peer group 3 for which we had size and performance data
  - The decile of each size and performance factor was configured independently. The table provides a beginning framework on which to identify, analyze, and critic company performance

<b>Decile</b>	Total Board Cost	Most Recent Sales	Market Cap	Assets	1 Year ROS	3 Year ROS	1 Year ROE	3 Year ROE	1 Year ROA	3 Year ROA	1 Year TSR	3 Year TSR	5 Year TSR
10	2,315,509	1,118.8	2,326.3	9,630.7	39.5	35.7	54.3	37.4	17.6	15.3	34.5	32.2	25.7
9	1,356,398	698.8	1,381.8	4,090.2	31.4	32.8	22.3	20.8	9.6	10.0	16.6	18.0	14.6
8	999,489	534.3	1,075.3	2,467.2	26.7	29.6	15.6	15.7	6.2	6.7	7.8	7.7	9.0
7	819,016	437.0	834.1	1,536.0	23.4	26.0	11.8	14.0	4.7	5.0	(4.2)	2.4	4.1
6	689,577	352.7	652.0	1,039.7	20.4	21.8	8.8	10.2	2.3	3.1	(15.0)	(1.4)	0.8
5	537,404	279.5	463.3	816.3	18.4	19.0	6.1	8.4	0.8	1.0	(27.1)	(4.6)	(3.1)
4	383,592	228.1	377.2	597.6	15.5	16.8	4.0	5.8	0.6	0.7	(35.9)	(10.6)	(6.2)
3	285,573	190.1	312.1	398.4	10.2	13.1	(0.4)	2.0	(0.2)	0.1	(46.6)	(17.9)	(8.6)
2	202,500	154.1	191.1	259.6	(0.0)	7.6	(14.1)	(5.8)	(4.8)	(2.7)	(58.5)	(26.4)	(13.4)
1	130,670	119.5	78.8	132.7	(29.1)	(65.6)	(91.4)	(524.3)	(33.7)	(26.4)	(74.3)	(41.4)	(29.1)
ABC	\$643,272	302.0	66,087.0	101,892.0	0.0	0.0	0.2	0.2	0.0	0.0	7.0	21.0	12.0