



GRAHALL

845 Third Avenue, 6th Floor
New York, NY 10022

Phone: (646) 290-5129
Fax: (646) 290-5001
Online: www.grahall.com

A White Paper

BASE SALARY

WHAT TO PAY YOUR EXECUTIVES IN ORDER TO MAINTAIN YOUR COMPETITIVE ADVANTAGE

Many organizations and their executives don't pay all that much attention to base salary. It's the more "exciting" components like long-term investments, perquisites, and retirement plans that get the attention. However, the average CEO today makes between \$500,000 and \$1 million dollars a year in base salary pay. That's not exactly chump change.

GARBLED MESSAGES

When it comes to how most organizations determine base pay for their chief executives, the systems are not pay-for-performance oriented. In most total reward strategies, a CEO's base salary is not structured to reflect how well they **perform** in their various responsibilities. Rather, when it comes to base salary most companies look at the average market "going rate" for a CEO, then pay at or just above the 75th percentile. The CEOs *know* they are going to get paid their base salary, regardless of whether or not they perform well. The entire system is built around blending in with the **average** market, rather structuring a base pay that drives company success.

IF YOU CAN'T FIGURE OUT WHAT YOU PAID YOUR CEO THEN IT'S PROBABLY TOO MUCH

Executive compensation should never be something that's hard for an organization to be accountable for. In one well-known example, the total compensation package for a CEO was so complex that the company wouldn't divulge it. Not because they didn't want to, but because they actually *weren't able to*. It took about a month to figure out where the CEO finally weighed in on their pay scale – at \$8.1 million. Some of these inflated, out-of-control, complex pay plans are simply a story of good intentions gone wrong.

GOOD INTENTIONS – GONE HORRIBLY WRONG

In 1993, Congress voted to cap the tax deductibility of base salaries at \$1 million. Not surprisingly, shortly thereafter CEO salaries suddenly started weighing in at just about \$1 million. But because companies still needed to hire and retain the best, they found other innovative, unique, and tricky ways to ensure their executives are adequately compensated. One of the more innovative methods was showering executives with stock options. This gave executives a pretty good reason to capitalize all company profits back into the stock price, rather than paying out dividends to shareholders. Stock options tempt people to make the wrong decisions.

So while obscenely large base salaries are annoying to the general public, rarely serve the best interests of shareholders, they haven't ruined lives and companies like many of the numerous stock option scandals did. We don't doubt that Congress laid down this law with good intentions. But history shows that they made a mistake.

SIZE MATTERS

Executive salaries are, in fact, generally a function of the size and complexity of the organization. For many years, executives have increased their compensation levels in lockstep with the size of the organization that they have managed. Logically base salary levels should be a function of the market value of the organization. However, more often executive salaries are a function of revenues (in the consumer good industry) or assets (in the financial services industry) or number of beds (in the hospital industry), etc. Size matters, but there are many different ways of measuring it.

The competitive level for executive salaries is generally thought to be a function of job-to-job comparisons within the industry, in addition to comparisons within the organization. The vast majority of companies assume—incorrectly—that the market for executive salaries within their organization is a singular group of competitive peer companies. However, every executive position within an organization may have a substantially different competitive market group of peer companies.

WE'RE ALL IN THIS TOGETHER – BUT SHOULD WE BE?

Many companies believe that the competitive strategy for base salary be consistently applied throughout the executive ranks. In a situation where base salary is consistently applied throughout the ranks, *all* executive positions will subsequently be slotted at the same percentile.

We believe using the value chain strategy is a better approach. This strategy says executives in areas that are **critically important** to the success of the organization should be compensated accordingly. Analyses of an organization will provide information on executives indicating which jobs are critically important to an organization and which jobs are less important.

Once you've defined the critically important jobs, they should be positioned in the upper percentiles of the most stringently applied competitive market. Those jobs that are progressively less important should be paid at levels that are competitive with a more general market—in most cases no higher than the 50th percentile, and in some cases substantially lower in base salary.

And we'll even go one step further. It may be appropriate—and a good strategy—for certain job families which are not critical to the delivery of the organization's products or services to be priced at the general industry markets, at the 25th percentile of base salary with a range maximum of no more than the 50th percentile.

Use of this strategy is a good indicator that an organization truly understands the value of each position's capacity and how the executives in those positions to contribute to the organization. This type of strategy creates and maintains an organization's competitive advantage.

I DON'T CARE WHAT YOU CALL ME, JUST SHOW ME THE MONEY

When clients come to us for advice on titles, we tell them to put their efforts into something else. Titles are like the "third rail" of organizations. If you attempt to change them, you may get "electrocuted". That being said, in some organizations job titles are awarded in lieu of compensation. We've all seen it. Our opinion: anyone willing to accept a title over base salary probably deserves the deal, and any company that places more importance on titles than base salary deserves the type of executive who find this practice acceptable.

WHY MERIT INCREASES TURN DOWN THE BASE PAY VOLUME

Most executives receive an increase on an annual basis. And usually that increase reflects the average increase in the marketplace, plus or minus a relatively small amount. Resulting in little differentiation between extremely high performers and the average performer within the organization. Under this scenario, the exceptional performer will quickly learn to pay more attention to the messages sent through the other reward components, like short- and long-term incentive plans, and will ignore any messages sent through the base salary.

REVENGE OF THE PROMOTION SEEKERS

When merit increases are ineffective, executives quickly learn that one way to make more money is by seeking promotion to a position of greater importance. Promotions tend to produce large increases that are disproportionate to any merit increases. This sends the message that the executive's main focus should be not on the job at-hand, but on frequent promotions.

WHAT'S FAIR IS FAIR – EQUITY INCREASES

Organizations would fare much better if, on an annual basis, they reviewed compensation for all executives who resided in horizontal bands of similar responsibility. If an individual executive's base salary is too low or too high given his contribution, responsibility, and potential compared to other executives at his same band, his salary should be adjusted by whatever amount was required both upward and downward. Addressing internal equity in this manner could help reduce executive turnover.

Another type of equity increase is the market equity increase. Like any supply and demand situation, certain job families, industries, or situations may need more executives than the pool of the qualified candidates. To avoid a potential deficit in a critical job category, you may need to make a market equity increase to retaining critical employees. The reverse is also true, and sometimes there is a glut of talent. Remember, it is not written in stone that an executive's base salary can never go down!

SO WHAT IF IT'S NOT SEXY?

When it comes to determining an executive's base salary, performance is very rarely the focus. The development of performance factors for say, short-term and long-term incentive plans are much more "sexy" and interesting.

Base salary administration program should be the location for those threshold operating norms that an executive needs to exhibit consistently in order to remain an executive at the organization. The base salary administration program should emphasize factors such as teamwork, integrity, stewardship, and other critical behavioral norms. And performance should be a factor in determining the executive's pay after these special conditions are met.

HOW CAN THE BASE SALARY REVITALIZE?

Base salary administration, with respect to its role within the overall executive reward strategy, is, for the most part, in a sorry state. However, in most organizations there is significant opportunity to revitalize motivational portion of the executive reward program. The formula is fairly simple. Set the appropriate competitive level against a well-chosen marketplace, then deliver pay increments on a frequent enough basis to be meaningful, and in a dramatically differentiating amount to be motivational.

The base salary program is, in effect, the foundation for an organization's overall reward strategy. So if you want average executives, pay them average base salaries based on the market's best practices. But don't be surprised when your organization is *average*. If, on the other hand, you want outstanding executives—executives who perform—well then, pay them in a way that motivates them to perform. Start with base salary.