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A White Paper

THE STATE OF EXECUTIVE PAY BETTER KNOWN AS THE DON QUIJOTE WAY

You can't escape the controversy that surrounds executive pay. But, much of what you read or see is hyperbole, exceptions to the norm being presented as the norm, guilt by inference, and maybe even a small amount of envy. And some of it is reality.

THE PROBLEM

Most of America thinks that CEOs are overpaid. And it's not a case of sour grapes where the little guy who is barely scraping by is incensed by the millions being raked in by corporate titans. In a poll taken in February and March 2006, 84 percent of respondents that identified themselves as earning over \$100,000 annually said they believe CEOs are paid too much. This may be the one thing that both rich and poor in American can agree on. The rich may get richer in America, but clearly there is a limit to how rich the rich want the richest to become.

THE BLAME GAME

The problem with executive pay is multi-layered and complex, and goes well beyond the sound bites and sensationalism of the media. But as Americans, we've been raised on a steady diet of short news bites. We want someone to be credited for the success of a particular endeavor, or blamed for the failure.

When you pour through all the reports, you find that there are at least ten targets of blame for the shape of the U.S. executive compensation situation: the CEOs themselves, the economy, economists, the government and certain government agencies, the Boards of Directors, customers, institutional investors, lawyers (we couldn't leave out lawyers!), human resources people, and consultants (as consultants ourselves, we doubly couldn't leave out consultants!).

GREEDY CEO'S ARE TO BLAME

It can be argued the CEOs cashing lavish paychecks are themselves to blame for the state of executive pay. Greed can cause CEOs to simply not pay attention to the curious things going on around them. These executives keep their heads in the ground, and then profit from it.

Then something like the issue of backdating option arises and the media gets a hold of it. As of the end of 2007, the Securities and Exchange Commission had opened investigations on hundreds of companies because it appeared that they had back-dated options of their executives.

So the media blames the CEOs and we can't argue with that, even though it's easy to assume the CEOs, to some degree, victims of media hype.

THE ECONOMY IS TO BLAME

In industries where business is booming—the way oil, housing, and defense are right now—economic windfalls are to blame for the largesse of the lucky executives in these fields. These CEOs claim since their companies did fabulously, they should profit, which, they say, is what "pay for performance" is all about. But there is something fundamentally wrong with compensating executives for success that has nothing to do with the executive performance or decision-making.

THE ECONOMIST IS TO BLAME

Occasionally, economists will try to weigh in on the state of executive pay. But economists are notoriously bad at crafting the simple sound bite that Americans crave. So, let's blame the economists. Whatever they say to defend themselves won't be understandable, anyway.

THE GOVERNMENT IS TO BLAME

When it comes to criticism of executive pay packages, stock options usually bear the brunt of the critique. The government gets the blame because lawmakers essentially took a ten-year hiatus on the issue and allowed stock

options not to be expensed. The Securities and Exchange Commission, and those responsible for accounting standards, deserves the spotlight. Two of the most critical contributing factors for the executive pay mess are 1) the accounting system, which for years treated stock options as freebies and 2) the proxy disclosure rules set by the exchanges which did not require complete disclosure of executive compensation.

THE BOARD OF DIRECTORS IS TO BLAME

Certain company Boards have very easy to blame. After all, a company's Board of Directors has the power—and the responsibility—to review and approve the pay packages of company executives. In one case, what a Board did with that power and responsibility landed them in court.

THE CUSTOMERS ARE TO BLAME

Customers are to blame for not being more proactive, and it's surprising that more aren't of them objecting to the extremes of executive compensation. Customers have great influence when marshaled correctly.

INSTITUTIONAL INVESTORS ARE TO BLAME

Institutional shareholders are to blame for essentially not using the power they wield to be working in the best interest of their shareholders. When they sit by silently, they're saying that big executive pay days are okay by them.

LAWYERS ARE TO BLAME

Lawyers are the advocates of their client at the expense of everyone else in the system, with no need to provide an outcome that balances the needs of many, but that's their job.

HUMAN RESOURCES PEOPLE ARE TO BLAME

When human resources professionals take the opportunity to obfuscate compensation information and not portray the true cost of a contract to the compensation committee, there is room to blame them for the state of executive pay.

CONSULTANTS ARE TO BLAME

Some consultants are just inexperienced and easily swayed by the commentary of chief executive officers. But it's a different story when a consultant is blinded to an obvious conflict of interest. So of course executive compensation consultants are to blame.

The fact of the matter is that there's enough blame for this problem to go around and around and around.

ON THE OTHER HAND....

There are also stories that refute the generalization that all executives are overpaid including CEO's who accept virtually no salary (just \$1 per year) and examples where poor performance of the organization has resulted in substantial reductions to the chief executive officer's pay.

Looking at the aggregate picture, executive pay has correlated to and risen with the value of the U.S. stock market. From 1973 until 2003, total cash compensation, paid to CEOs, which includes bonuses paid, rose from around \$350,000 to \$3,250,000 per year. The stock market index rose from approximately \$1,000 to \$11,000. Admittedly, these are averages. But still, they would lead us to conclude that on average, the compensation paid to executives is directly proportional to the value they create in the stock market.

WHAT DOES IT ALL MEAN?

Things have gone wrong with the state of executive compensation, and there's plenty of blame to go around for how we got into this mess. But there is a way to fix it by using a methodology that that relies on a more thoughtful and intense evaluation of the organization's condition to develop a better executive reward strategy. It's the framework that Boards of Directors and compensation committees should be reviewing, and that the executives themselves should be abiding by. It's a framework that leads to compensation strategies that reward organizational and individual's performance.