

Calculating Compensation

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Managing the alignment of interests between shareholders and management is a fundamental challenge for any publicly traded company. A critical tool in managing that challenge is the structure of executive compensation.

In recent years, investors and regulatory bodies have either taken action or are contemplating proposals to change how executive compensation is determined or reported. Part of the reason is that investors see this as an increasingly important issue. According to the 2006 Global Institutional Investors survey, published by Institutional Shareholder Services, a corporate governance consultancy, executive compensation was considered one of the three most important aspects of corporate governance in Canada, the continental EU, the US and the UK.

This article will focus on the role of shareholders in aligning executive compensation with overall company performance.

Negotiating contracts at arm's length

In theory, one of the goals of executive compensation is to align the interests of senior managers with those of the shareholders of the company, and to provide incentives to optimise overall company performance.

On a daily basis, managers make operating decisions that have the potential to affect the returns to shareholders. In this context, executives often encounter situations in which their decisions could be personally beneficial but costly to shareholders. For example, a manager could use company money to buy a corporate jet to be used for both business and personal. Mitigating this type of conflict of interest is a common reason given for basing management's compensation, at least in part, on company performance.

In recent years, however, high rates of executive compensation have been criticised for bearing little relation to performance. Moreover, many argue that rather than aligning the interests of managers and shareholders, high executive compensation packages actually do the opposite.

In *Pay without Performance*, Lucian Bebchuk and Jesse Fried examine the issue by comparing executives with star athletes. They argue that while compensation for the latter reflects individual skill and performance, the same rationale should not be applied to executives.

The authors say that a key difference is that contracts of star athletes are negotiated “at arm’s-length”. This means that each party negotiates directly in its own self-interest without undue influence from other interested parties. In contrast, the shareholders of a publicly traded company negotiate via the board of directors whose appointment, compensation and potential future business transactions could be influenced by the very executive whose compensation they are trying to determine.

My own research with Peter Joos and Joseph Weber has confirmed this view. We looked at US companies before 2003 that implemented equity-based compensation packages with and without seeking a formal vote from their shareholders. At that time, if a company wanted to include stock options as part of a compensation package, it was legally required to implement a plan that specified issues such as the number of shares of equity that could be awarded, the period over which awards could be made, the grounds for making awards and the employees who might be eligible to receive the awards. In the process of implementing this plan, the company could either have the board of directors (as the representative of the shareholders) ratify the plan, or it could place the plan in its proxy statement and seek a formal vote from shareholders.

We found two interesting patterns in how companies made this choice. First, in periods of poor performance, a business was likely to avoid a formal shareholder vote and instead seek only board ratification. Logically, as performance worsens, shareholders are more likely to vote “no” if asked to approve a stock option compensation plan for management.

Second, management prefers to seek board approval rather than risk a “no” vote from the shareholders. This is not a problem if the board is strictly representing the interests of managers and, thus, functioning at arm’s length. Unfortunately, the evidence is not consistent with what you would expect in arm’s length transactions. We found that as the proportion of “insiders” (company executives) on the board increased, the more likely it was that management would avoid formal shareholder votes. We observed a similar trend in companies where the same person was both CEO and chairman.

We also found that in companies with no large block shareholdings, avoiding a shareholder vote was more likely than in companies that had them. Since large block holders often get a seat on the board, such shareholders are likely to follow the company closely and actively advocate the shareholder rights.

Finally, we discovered in the three years after the implementation of stock compensation plans without a formal shareholder vote, performance continued to be poor.

Companies are now required to submit all equity-based compensation plans to shareholders for a vote. Our study suggests this new requirement will increase the extent to which stock option-based compensation plans are implemented at arm’s length, as long as the decision to seek a vote is not symptomatic of other underlying problems.

The role of transparent disclosure

Shareholders typically face a series of legal and structural hurdles if they try to influence compensation policies. For example, their ability to affect compensation practices through voting is quite limited: they can only approve or reject compensation plans proposed by management and the board; or initiate non-binding shareholder proposals, whose voting outcome is not mandatory.

Certain actions may, however, influence public opinion and allow shareholders to overcome the structural and legal barriers they face. Fabrizio Ferri, Tatiana Sandino and Garen Markarian recently examined proxy statement proposals made by union fund shareholders at various companies in 2003-2004. They wanted to determine the types of actions that shareholders can take and the extent to which they can be strategic and effective. These proposals all sought the voluntary expensing of employee stock options and cited excessive compensation as part of their motivation. Bear in mind that stock options were blamed for numerous accounting scandals and, at the time, regulators were debating whether to mandate the expensing of employee stock options (this eventually became effective in June 2005).

The study found that shareholders could be strategic and effective. For example, to bring executive compensation into the spotlight, shareholders employed the following tactics: they picked a topic of interest to a broad set of constituencies (accounting for stock options); and they selected large companies (to obtain media attention) with large employee stock option plans and potential dilution (that is, where the cost to shareholders was likely to be high). Support for these proposals was much higher – on average, 47 per cent in favour – than for any previous compensation-related shareholder proposals – on average, 20 per cent in favour. Furthermore, the proposal increased the rate of voluntary adoption of option expensing both by targeted companies and by their peers (an indication of spillover effects).

This example suggests that, by appealing to public opinion, shareholders can be effective even in the presence of legal barriers. Moreover, while there is no guarantee that employee stock option expensing will result in better compensation practices, the fact that shareholders sought to rely on option expensing as a way to curb excessive compensation suggests that they consider other mechanisms, such as compensation committees, votes on compensation plans and litigation, potentially weaker.

In the past decade, shareholder activism has increased but a lack of transparency has limited its effectiveness. Whereas the owner of a sports team can see the contract under which his/her star athlete is paid, shareholders of publicly traded companies are rarely able to see the contract under which executives are compensated. So, often they have little information to judge whether executive pay practices are reasonable or not.

Disclosing executive compensation

In the wake of the controversy over executive pay and recent corporate scandals, regulators have stepped up efforts to improve transparency. In January, the Securities and Exchange Commission (SEC) introduced a proposal for changes in the disclosure of compensation to executives and directors of publicly traded US companies. Christopher Cox, chairman of the SEC, explained in a written statement: “Over the last decade, the compensation packages awarded to top executives and directors have changed substantially. Our disclosure rules haven’t kept pace with the changes in the marketplace, and in some cases, current disclosure obfuscates rather than illuminates the true picture of compensation.”

The specific changes in the SEC proposal include expanded disclosure of pay, value of stock options and “all other compensation”, including the actuarial value of pension plans, and of perquisites for the CEO, CFO, the next three most highly paid executives and the directors. It also includes a provision for disclosure in “plain English” to encourage understanding for shareholders, many of whom may not be investment professionals.

Have US changes gone far enough?

The current wording of the US proposal makes it unclear whether disclosure requirements will go as far as they have in other countries, such as the UK. Currently, the UK requires two interesting elements that are not explicit requirements in the SEC proposal.

First, UK companies must disclose the name of the compensation consultant that was engaged in setting the executive package. Using compensation consultants is a common practice among larger companies in both the US and the UK, but such consultants may not be operating at arm’s length. For example, they often handle general employee benefits and pension administration activities in the company. Currently, neither the US nor the UK mandates the disclosure of the extent of these types of related activities.

Second, if the process of setting compensation relies on comparisons with similar companies, the peer group must also be disclosed. Typically, boards justify using peer groups by arguing that the company must be able to “attract and retain” the best and most talented executives. A problem is that they only compare compensation, and if a peer group of companies all benchmark against each other, and all seek to compensate managers at an above average level in order to attract and retain, the result will be compensation that is perpetually escalating at all of the companies irrespective of performance.

Economists refer to this as the “ratchet effect.” If shareholders knew this type of benchmarking was occurring, they would be in a position to analyze both compensation and performance in the peer group and might target their activism to rein in this effect. In other words, while the current and proposed SEC disclosure requirements focus on

disclosing the outcome of the compensation process, comparison to the UK shows that the compensation process is important, too.

But disclosures could come at a cost. Some companies argue that revealing their peer groups would give away proprietary information and place them at a strategic disadvantage that would harm the shareholders to a greater degree than non-transparency. In the UK, it has been suggested that there is another cost: the best executives might prefer to leave UK companies to join US counterparts where pay is less transparent and potentially higher.

Conclusions

In the final decision-making process, regulators must take both the expected costs and benefits of a regulation into account. There are many difficult and complex issues in determining the appropriate rules to govern the setting and disclosure of executive compensation, and the extent to which shareholders need to be involved in this process.

To deal with these issues, it is essential to understand the concepts of arm's-length contracting and transparent disclosure. The better we understand these notions, the more likely we are to decode the intricacies of executive compensation, and eventually succeed in creating better alignment of interests between shareholders and owners.

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