Compensation: Putting the 'earn' back in 'earnings'

Movement afoot to base exec pay on performance

By CLAUDE SOLNIK

In an effort to connect an executive's earnings to a company's revenues, some are pushing for "pay-for-performance" models linking compensation to results.

Imagine a world where a CEO's paycheck dwindles when his or her company's stock values and income are in the dumps, or the CEO's coffers fill nicely when the company is a roaring success. Many in the business world want to do more than imagine this not-so-Wall-Streetish scenario.

They're calling for a greater use of rewards – in the form of bonuses, restricted stock and other options – that kick in when revenue, share price and/or income goals are met. They're also envisioning an end to rewards that accrue automatically.

The main concern of advocates of performance-based compensation is that too often, executives' earnings are completely independent of a company's performance. Restricted stock, for instance, often vests after three or four years, and as long as the executive is still with the company; regardless of how the company is doing, a Teflon CEO doesn't have to worry about being paid.

The drumbeat to match money and merit is growing louder, even if it sometimes falls on deaf ears. A study by Mercer Management Consulting, for instance, concluded "accountability for results" is still missing in most executive compensation packages.

Another study – "Enablers of Excess: Mutual Funds and the Overpaid American CEO," compiled by the American Federation of State, County and Municipal Employees and The Corporate Library – criticizes compensation structures at public companies as too rarely linking pay and performance.

"The time is now for mutual funds to use their voting power in the interest of shareholders to tie executive pay to actual job performance," said Nell Minow, founder of The Corporate Library.

Executive compensation at public companies, the "Enablers of Excess" study found, is rising far faster than that of non-executive workers. Some see it as an institutional inflation completely independent of a company's performance.

In 2004, executive compensation at more than 1,500 large U.S. public companies rose at more than twice the rate of the previous year, with CEOs receiving14.5 percent raises, up from 7.2 percent in 2003, according to "Enablers."

Worker pay remained flat during the same time, with total compensation for non-supervisor employees rising 2.2 percent in 2004, according to a 2005 Pearl Meyer & Partners study.

AFSCME International President Gerald W. McEntee pointed to glaring examples of compensation divorced from a company's performance. Home Depot CEO Robert Nardelli, for instance, took home an average of $31.4 million in annual salary, stock and bonuses from 2002 to 2004. But Home Depot stock tumbled 17 percent since the beginning of 2002, McEntee noted.

Meanwhile, Lowe's Home Improvements shares rose 47 percent during the same period, and the Lowe's CEO earned $2.4 million in 2005.

"Giving CEOs record raises for record corporate losses is bad business, sends the wrong message to the corporate community and compromises the value of investments," said McEntee.

Compensation doesn't always show up immediately, complicating ways pay is gauged. In some cases, huge payouts to people leaving companies or to employees when companies change hands are causing uproars.

"What employers have been doing is tremendously large retirement packages," said Bruce Schwartz, a partner at Jackson Lewis LLP, a White Plains labor and employment law firm. "You get deferred compensation when you go."

The Internal Revenue Service has imposed hefty taxes on stock options that can be cashed in immediately, even if executives choose to hold them. "I'm already hearing companies say we'll pay the tax for you," said Schwartz.

One might expect entrepreneurs who created public companies and retain large stakes to walk off with big compensation packages regardless of company performance. But that's not usually the case, experts said.

"It doesn't always look like they make a lot of money," said Paul Hodgson, senior research associate with The Corporate Library. "Typically, owners are relatively modestly compensated. Most of their income comes from dividend or the rise of their value in stock holdings." ■