

The Executive Edition

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Executive Pensions: An Approach Based on Five Core Principles

Executive pensions have become increasingly important in recent years. Surveys indicate they are prevalent (in various forms) in over 85% of larger publicly traded companies. Examples of particularly large (and arguably abusive) executive pensions have been reported in the media that have called further attention to these plans, causing many observers and stakeholders to ask:

- Are they reasonable and appropriate?
- What do they really cost?
- How were they designed and approved in the first place?
- Why was their real cost not disclosed prior to the time an executive actually leaves?

Why Is the Cost of Executive Pensions Important?

Executive pensions can be quite costly, often constituting a significant portion of the value of an executive's total remuneration. Historically, many executive pension arrangements were not fully and clearly

disclosed to shareholders. Even where there is disclosure of the basic benefit promises, the costs may not be visible or well understood.

The most highly leveraged executive pension is the defined benefit Supplemental Executive Retirement Plan (SERP). Defined benefit plans are "back-loaded," with the funding cost increasing substantially as pay increases, particularly as the executive gets closer to retirement age.

For example, assume a long-serving executive covered by a 60% of final salary defined benefit SERP is appointed CEO two years before retirement. Further assume that this resulted in his base salary increasing from \$1,000,000 to \$1,500,000. While his projected annual pension benefit increased from \$600,000 to \$900,000, the single lump sum cost increased approximately \$3,000,000.

Even spread over his two remaining years, this would cost roughly \$1,500,000 per year, or 100% of his annual salary per year. This is even before any bonus is included in the pension formula. It would not be surprising to find that no Board or Compensation Committee member was aware of this leverage, and that the salary decision was made without even considering the consequential pension cost.

Although a fairly extreme example (but based on a real case), the above hypothetical illustrates just how important pension issues can be. One year value transfers of 50% to 150% of base salary to executives through final pay executive pensions are common. The closer to retirement age this occurs, the more this "hidden cost" is leveraged. If incentive plans appear unlikely to pay out, final salary pension plans can provide a strong motivation for an executive to negotiate a salary increase.

Five Core Principles

Hay Group believes that employers should reflect on certain core principles as guidelines for appropriate practice in developing executive pension programs:

1. Provision for an executive pension is part of the rewards that the executive receives for work carried out for the organization and as such should be treated as part of the total remuneration package, not as a separate entitlement.
2. Realistic cost estimates of any pension proposals should be disclosed to Compensation Committees or other decision-makers. In the case of defined benefit plans, these cost estimates should reflect the value being transferred to the executive, as well as the leveraging and the phasing of that transfer—not simply the current cost charge or contribution. Salary comparisons—internal or external—and salary adjustments should consider the added impact due to significant pension cost differences.
3. Aside from any pension provision required by law or under a tax-qualified retirement plan available to all employees, it should be the executive who determines the extent, if any, of the total remuneration package that is apportioned to a pension.

Employers should reflect on certain core principles as guidelines for appropriate practice in developing executive pension programs.

4. The provision of executive pensions should be made on a defined contribution basis (rather than on a defined benefit basis). This defined contribution (e.g., a percentage of base salary) then should be a component of the total remuneration package each year. Under a defined contribution approach, deferred compensation is shown as an account balance that recognizes the cost attributable to each year of employment.
5. As proposed earlier this year by the Securities and Exchange Commission, the cost of executive pensions

should be more fully disclosed. Defined benefit plans, in particular, often contain potentially costly ancillary benefits and special features, in addition to the basic target replacement ratio. Examples are subsidized (unreduced) early retirement provisions, the inclusion of long-term incentive awards in the definition of compensation, granting additional years of service for short-term executives, providing unrestricted joint and survivor benefits and numerous other features.

Rationale

In developing these core principles, Hay Group focused on providing a sound overall compensation package to a top executive.

- Senior executives are, relative to most employees, highly paid. They have more opportunity during their working lifetimes to acquire significant assets or wealth to support that lifestyle in retirement.
- In addition, senior executives have more flexibility to determine and apportion the income level to spend currently versus save for retirement. Since this apportionment can vary substantially from person to person, it is more appropriate to allow the executive to make this decision than the employer. It is less appropriate for the employer to take on the financial risks associated with providing a high level of guaranteed benefits or to determine the extent to which executives should defer consumption.

Executives should have the opportunity (and responsibility) for choosing the level of retirement income or “target replacement ratio” they need and reapportioning their total pay accordingly. In this process, executives can use the equivalent defined contribution schedule that will produce this target. In other words, executive pensions should be considered more of an elective deferred compensation plan.

- Most executives are intelligent, responsible individuals who are relied upon by their employers to make sound decisions on complex issues in their work. They often have responsibilities regarding asset values far in excess of their own pension assets. It is therefore appropriate that they take responsibility for determining the portion of their compensation packages allocated to retirement benefits.

Other Key Issues

What components of pay should be used in determining pensions?

Variable pay has become a standard portion of executive compensation packages, and the level of retirement income generally is considered relative to pay. However, retirement income is not expected to be as volatile as pay can be from year to year. Accordingly, some judgment should be applied in targeting an executive's fixed retirement income to a variable rate of compensation while in active employment.

Hay Group believes that it can be appropriate to include annual bonuses in the definition of pay for purposes of determining pension contributions or benefits. Annual bonuses can be considered as part of the "standard of living" developed for an executive over the years. However, long-term incentives (LTI) represent special awards—often based on performance—that are intended to be capital accumulation devices in and of themselves (as is a SERP). Therefore, the inclusion of LTI in the definition of annual pay for pension purposes is redundant and inappropriate.

In some circumstances, annual bonus inclusion in the pension formula is purely cosmetic. For example, an annual pension of 60% of base salary at retirement is the same as a pension of 50% of total cash compensation for a person with a 20% bonus. A company may believe that one approach appears less controversial than the other even though they both produce the same benefit.

Severance does not justify high pensions

Some companies attempt to justify overly generous executive pension provisions on the grounds that this reduces the severance cost. In reality, that approach usually increases aggregate costs by providing higher benefits than necessary to those employees who are not the subject of a severance, and by disguising the true severance cost. Setting appropriate severance levels is another topic receiving attention, which Hay Group will address in a future issue.

Removing executive distractions

A frequent argument is that defined benefit plans enable an executive to ignore his personal financial security concerns and focus on the company's business, as opposed to the distractions attendant with the variations in a defined contribution structure. If the employer wants to take such a paternalistic

approach, this can be addressed by providing a basic level of defined benefit protection. Beyond such a minimum, core principle 2 should be applied.

General Position on Pensions

Turning from executive pension programs, Hay Group also has honed its views on certain aspects of broad-based retirement programs. Many employers feel a responsibility to provide employees with a basic retirement income or at least a savings vehicle. This philosophy can be reflected in a range of plans from a defined benefit pension plan to a defined contribution 401(k) savings plan (with or without employer contributions).

To protect shareholders and to compete in the marketplace, the risks of such plans should be appropriately apportioned between employer and employee. In particular, open-ended defined benefit programs should be deemphasized. Career average-type plans are preferable to those based on final salary, and there may be advantages in expressing the benefits guarantee in the form of a single lump sum rather than an annual income.

Any pension plan should be subject to a ceiling on the earnings that may be taken into account. Above such earnings maximum, employer involvement should be on a defined contribution basis and, where practicable, there should be a cash alternative on an equal cost basis. This would bring treatment of executive pensions closer to the basic principle of deferred compensation.

To the extent that these steps can be accomplished, it should become easier for Boards and Compensation Committees to apply executive compensation principles in a more consistent and enlightened manner. ■

LTI at Private Companies and Business Units: The Valuation Creation Plan

Long-term incentive (LTI) programs typically are a critical component of executive compensation packages. The appropriate LTI plan can help accomplish various corporate objectives, including:

- Retention of high-performing executive talent;
- Provision of a market-competitive portion of a total remuneration program;

- Motivation of desired executive behaviors and superior financial performance for the benefit of shareholders;
- Facilitation of executives' long-term accumulation of wealth for retirement.

While stock-based incentives are commonly used for LTI awards at publicly traded corporations, equity (such as stock options or restricted stock) may not be the best form of LTI for executives at either private companies or business units of larger companies.

Each ... participant has an ownership interest in a long-term incentive pool that grows or shrinks based upon the private company or business unit's performance relative to the annual expected return on the investment in the entity.

Private companies may be reluctant to dilute ownership by granting stock-based awards to non-founder (or non-family) management, and business unit executives at publicly traded companies may have limited impact on the parent company's stock price. Also, equity at private companies generally is illiquid and subject to numerous restrictions that cause executives to substantially discount the value they place on any such awards (so-called perceived value).

Value Creation Plan Approach

In many cases, a viable alternative to stock-based LTI awards can be found through the use of a Value Creation Plan (VCP) that shares a portion of the earnings above a preestablished threshold with executives. A VCP can be relatively simple to administer, based upon measurable returns at the business unit level or consolidated level (for private companies), and understandable for participants.

In essence, each VCP participant has an ownership interest in a long-term incentive pool that grows or shrinks based upon the private company or business unit's performance relative to the annual expected return on the investment in the entity. A VCP

eliminates the need to settle upon a method to value company stock (for private companies), set multi-year performance goals, or establish peer group or index benchmarks.

Designing the Program

To establish a VCP, a *measure of profit* must be defined and understood by all participants. Examples include: earnings before interest and taxes (EBIT), net operating profit after taxes (NOPAT), or bottom-line net income. Also, a *return measure* must be defined, such as return on equity or return on invested capital (debt and equity). The *threshold return* must be periodically adjusted as the cost of investment funds and/or the debt-to-equity ratio change. Further, as the private company's or business unit's capital base grows, so too would the required profit to meet the expected threshold return to investors.

When you create a VCP, a *sharing ratio* is established, whereby a portion of the private company or business unit's annual *economic profit* is contributed to a long-term incentive pool. The sharing ratio is based upon market target awards, and would be determined at the start of the plan and held constant for a defined period. If an *economic loss* occurs (i.e., earnings below the expected threshold return), then the sharing ratio's proportion is deducted from the incentive pool. The annual contribution (or deduction) is then allocated among the plan participants' account balances using a predetermined formula.

This two-step exercise occurs annually over the life of the plan. To mitigate risk for the participants, a floor could be placed upon deductions from the incentive pool; a corresponding limit could be placed on annual contributions to the pool to limit the company's liability. Special provisions would be crafted regarding a potential sale of the company/business unit or if the private company completes an initial public offering.

An Example

For an example of how a VCP could work, consider that the co-founders of a debt-free private company want to establish an LTI plan for its senior executive team, but are not willing to dilute their ownership in the company. The co-founders decide to set up a VCP that rewards executives for NOPAT above a threshold return on the co-founders' equity in the company.

In this example, the sharing percentage of NOPAT that exceeds the company's cost of capital would be added to the incentive plan pool annually and allocated to the individual participants' accounts according to formula. To the extent that

NOPAT is lower than the cost of capital, the incentive pool would be reduced using the sharing percentage. (See Figure 1 below for an illustrative VCP example.)

Vesting for each year's contribution to the LTI pool would typically be over at least three years, and distribution of a portion (e.g., one-half) of the vested amount could be provided for at that time. The remaining portion of the vested balance could be required to remain in the pool until a fixed date in the event of a below-threshold performance year (which would cause the pool to shrink).

The design would need to take into account the potential application of the tax rules governing nonqualified deferred compensation plans under Internal Revenue Code section 409A. If section 409A applies to the specific design, its deferral requirements would need to be satisfied to avoid taxation and penalties when there is no longer a substantial risk of forfeiture (e.g., on vesting). Distribution could even be in the form of parent-company stock for participants who are employees of a business unit of a publicly traded company.

Figure 1

A. Calculate NOPAT at end of year	\$5,000,000
B. Calculate Owners' Equity	\$40,000,000
C. Factor in Cost of Capital ...	x <u>10%</u>
D. ... To get Threshold Return	\$4,000,000
E. Subtract Threshold Return from NOPAT to get Economic Value Creation	\$1,000,000
F. Apply the Sharing Ratio ...	x <u>10%</u>
G. ... To get Contribution to Incentive Pool:	\$100,000
H. Allocate Contribution Among Plan Participants (as shown below)	

$$\frac{\text{Individual's Target}}{\text{Sum of Participants' Targets}} \times \text{Contribution to Pool}$$

Source: Hay Group

Summary

A Value Creation Plan rewards investors before rewarding executives by motivating the executive team to focus on attaining an earnings level above the cost of the investors' capital. For executives in business units, a VCP gives them a performance metric directly connected to their business unit's financial performance, which they can influence more directly

than the parent company's overall stock price. A VCP can be easy to administer and explain, and it provides executives an alternative to company stock where such an award is not always practical or desirable. ■

hot topics

Tally Sheets: Adding up the Cost of Executive Compensation

Due to the increased scrutiny of executive compensation in recent years, corporate boards are turning to "tally sheets" to obtain a comprehensive view of the true size of executive pay packages. A tally sheet is a detailed compilation of all major components of executive remuneration, including base salary, annual incentives, long-term incentives, retirement programs, and various benefits and perquisites.

While the particulars vary from company to company, the essence of a tally sheet is a summary of an executive's total pay package. To present a true picture, a tally sheet should consider not only what an executive receives during employment, but also what he or she may receive upon varying termination events.

The Emergence of Tally Sheets

The term "tally sheet" only was coined recently to reflect the result of summing up the various components of executive remuneration—not just base pay, bonus, and long-term incentives (LTI). In just a few years, the value of tally sheets has been recognized as an important tool for Compensation Committees; their use has become a common (and best) practice. It appears that a substantial majority of public companies already are using or are considering tally sheets.

At many companies the Board members may not have a "big picture" perspective on all elements of compensation,

particularly the benefits and perquisites an executive may receive. For example, this can occur where different elements of compensation and benefits packages are addressed at different times, perhaps without considering how a change in one piece may affect another. Tally sheets can provide Boards with a holistic and long-term look at each pay component, the relationships among these elements, and the potential future value of each element under different scenarios (particularly termination events).

Especially at large organizations, decisions on executive pay often are made on a piecemeal basis. Compounded with the fact that many Compensation Committee members serve on a rotational basis, a Committee may lack the historical or other perspective to make comprehensive pay decisions. Too often tally sheets have revealed unexpectedly high (even shocking) aggregate pay packages, causing directors to experience the dreaded “Holy Cow!” moments.

The power of “hindsight”

The well-publicized case of former New York Stock Exchange (NYSE) Chairman and CEO Richard Grasso illustrates how many Board members apparently failed to realize the total value of an executive compensation package. Jaws dropped when the NYSE revealed its \$140 million payout to Mr. Grasso, representing \$51.6 million accumulated in his pension plan, \$40 million in a “supplemental” executive saving account, and another \$47.9 million in “incentive awards.”

This payout resulted in part from the multiplicative effect of executive pay decisions made in a “silo.” The use of tally sheets can avoid such oversights by creating greater transparency and by assuring that all appropriate information can be considered when making executive pay decisions.

Benefits of Tally Sheets

Understanding the costs attendant to executive terminations

A Compensation Committee should be aware of the aggregate value of amounts payable to the CEO and other top executives upon a termination of employment. These scenarios should include retirement, death, disability, dismissal, dismissal for cause, voluntary resignation, resignation for good reason and termination in connection with a change in control. To simplify the presentation, those termination events that call for the same payouts can be grouped together.

By understanding what has been promised under executive contracts and various programs, directors can avoid surprise and/or embarrassment. Tally sheets help ensure that Boards are aware of the cost and timing of potential payouts as well as the terms and conditions that trigger payment.

Revealing the true value of executive benefits and perquisites

Although Compensation Committees are accustomed to “tallying up” top executives’ base salaries, annual and long-term incentives, they often have overlooked benefits and perquisites. Compensation Committees need to know more than the types of benefits provided— they need to understand the *value* of the benefits and perquisites. Before approving executive compensation changes, Compensation Committees should understand the costs, tax treatment, and financial accounting consequences of these changes to their benefits and perquisites program.

To present a true picture, a tally sheet should consider not only what an executive receives during employment, but also what he or she may receive upon varying termination events.

Creating greater alignment with the company’s compensation philosophy

When compensation decisions on various components of an executive’s total remuneration are made at different times throughout the year, the Compensation Committee needs to consider how each program fits in the company’s overall compensation philosophy. Tally sheets look at the compensation and benefits in totality, allowing the Compensation Committee to determine the appropriate mix by considering relationships among pay components. A Compensation Committee should test its tally sheets annually against its compensation philosophy and determine whether the pay philosophy is delivering the appropriate value over time.

Tally Sheet Guidelines

While any tally sheet will have to be tailored to a company's specific programs, Hay Group suggests some basic guidelines on the level and scope of data that should be included:

1. Provide a recent history (e.g., three to five years) of base salary, target annual incentives, actual annual incentives, long-term incentives, and benefits and perquisites.
2. Identify all vested and unvested equity awards.
3. Quantify the current spread values of all outstanding vested and unvested options and stock appreciation rights (SARs) and the current value of all other LTI awards (e.g., restricted stock, performance shares, performance units).
4. Estimate the size of the next long-term incentive plan (LTIP) payout and any other LTIP cycles in progress.
5. Determine the current value of an executive's interest (both vested and unvested) under all tax-qualified retirement plans and under all non-qualified supplemental executive retirement programs, as well as project future payouts.
6. Quantify the amounts payable on various termination events (as identified above).

Endorsement of Tally Sheets

Tally sheets also are favored by proxy advisors such as Institutional Shareholder Services (ISS). In its most recent policy update, ISS strongly encouraged companies to use tally sheets. According to ISS:

"The current SEC requirements on pay disclosure are inadequate for shareholders to readily determine a complete executive pay package and understand the linkage between pay and performance. Companies should meet the spirit of the requirements by providing more details and the rationale of executive pay. A tally sheet...should be detailed, explained and totaled."

Looking Ahead

Tally sheets can be valuable tools for Boards in making the most appropriate executive pay decisions. Given the current focus on executive compensation and the new disclosure rules proposed by the Securities and Exchange Commission earlier this year, Compensation Committees likely will rely more and

more on tally sheets when considering the compensation packages for top executives.

Since Boards are ultimately responsible for executive compensation, it is essential that members are fully aware of all elements of compensation. No Compensation Committee should feel comfortable approving an executive pay program without understanding its potential costs, especially payments due after employment terminates. The tally sheet is such a simple yet useful concept that, in hindsight, one wonders why it only recently emerged. ■

regulatory

How ISS Evaluates Executive Pay Proposals

Institutional Shareholder Services (ISS), the leading U.S. proxy advisory firm, updated its policies in advance of the 2006 proxy season. In view of the potential impact of ISS recommendations on institutional votes regarding equity plan proposals and elections of directors, it is increasingly important for companies to understand the key executive compensation and equity issues that ISS reviews, and how companies might work with ISS.

Who Is ISS?

ISS provides guidance and voting recommendations to over 1,600 institutional and corporate clients on corporate governance and equity and executive compensation issues. ISS' policies cover a wide range of issues, from director term limits to poison pills to the Kyoto Protocol. Competing advisory services, such as Glass Lewis and Proxy Governance, have emerged in the last few years, but ISS remains the most influential.

With respect to executive compensation, ISS may review and provide voting recommendations on:

- Cost of equity compensation plan proposals;
- Poor compensation practices;
- CEO pay-for-performance test;
- Performance test for directors; and
- Tally sheets for CEO pay.

Equity Compensation Plan Proposals

ISS uses a proprietary methodology to evaluate equity compensation plan proposal cost and reasonableness.

Historically, ISS has calculated the cost using two analyses: Shareholder Value Transfer (SVT) and Voting Power Dilution (VPD), weighted 95% and 5%, respectively. For 2006, VPD no longer is used in the calculation of the total cost of a company's proposed equity plan, as SVT now will receive a 100% weighting in the total cost calculation. SVT is expressed in dollar terms and as a percentage of company market value.

ISS adopted a formal policy to recommend withholding votes from Compensation Committee members if the company has "poor compensation practices."

SVT is calculated using a binomial model that assesses the amount of shareholders' equity flowing out of the company as options are exercised. An estimated dollar value for each award is determined by factoring award features into the option pricing model to determine the potential plan cost.

After determining how much the plan will cost, ISS evaluates whether the cost is "reasonable" by comparing the cost to an allowable cap. The allowable cap is industry-specific (based on GICS codes described below), market cap-based, and pegged to the average amount paid by companies performing in their peer grouping top quartile.

ISS assessments also consider plan features such as eligibility, plan administration, award types, payment terms, vesting provisions, transferability, individual limits, and the ability to re-price underwater stock options.

Burn Rate Policy

In addition to the SVT analysis, ISS will vote against an equity compensation plan proposal (even one under the allowable cap) if the company's three-year average "burn rate" exceeds the industry group's mean by more than one standard deviation, and is more than 2% of common shares outstanding.

Burn rate is calculated by taking the number of shares awarded during the fiscal year and dividing by fiscal year-end common shares outstanding. For the calculation, full value shares, such as restricted stock and performance shares, are converted to option equivalents. The conversion ratio, which ranges from 1 restricted share for 1.5 options to 1 restricted share for 4 options, is based on the company's annual volatility.

If a company fails the burn rate test, ISS nevertheless will recommend a vote for the equity plan if the company commits in a public filing to a three-year average burn rate not in excess of its GICS (Global Industry Classification Standard, which has 24 industry groups) group burn rate mean plus one standard deviation—assuming all other conditions to receive a "for" vote recommendation have been met. If a company then fails to meet its burn rate commitment, ISS will consider recommending votes be withheld from Compensation Committee members.

Poor Compensation Practices

In 2006, ISS adopted a formal policy to recommend withholding votes from Compensation Committee members if the company has "poor compensation practices." The ISS definition of poor compensation practices includes:

- "Egregious" employment contracts, including excessive severance provisions;
- Excessive perks that dominate compensation;
- Huge bonus payouts without justifiable performance linkage;
- Performance metrics that are changed during the relevant performance period;
- "Egregious" SERP payouts;
- A new CEO with an overly generous new-hire package; and
- Internal pay disparity.

The terminology and adjectives in the preceding list are those of ISS. Even if a Compensation Committee agrees that these

reflect appropriate goals, its view on what might be egregious or excessive may differ markedly from that of ISS.

However, the new ISS policy on poor compensation practices, in tandem with the proposed new rules on the disclosure of executive pay released earlier this year by the Securities and Exchange Commission (SEC), should cause Compensation Committees to take increased care in making their decisions on executive pay—especially regarding the rationale for any amounts or packages that appear unusually high.

CEO Pay-for-Performance Test

ISS will generally recommend “withhold” votes for Compensation Committee members if fiscal year one- and three-year total shareholder return (TSR) are negative and the CEO’s total direct compensation from the prior year was increased (and more than half of the increase in total direct compensation was attributable to the equity component).

However, if the Committee members indicate in a public filing with the SEC how they have improved Committee performance, ISS may reconsider its withhold recommendation. In addition, if the company has an equity plan proposal, ISS likely will recommend against the plan if the CEO is a participant.

Performance Test for Directors

In another new feature this year, ISS, on a case-by-case basis, may recommend that its clients withhold votes for director nominees at companies that fail to meet its predetermined performance test. This applies to companies within the Russell 3000 index. The worst performers within each industry group (GICS based) will be identified using a weighted average total shareholder return. The weightings are as follows:

- Twenty percent weight on one-year TSR
- Thirty percent weight on three-year TSR
- Fifty percent weight on five-year TSR

In determining whether to recommend “withhold” votes against directors, ISS will review the company’s response to its performance issues and consider other factors, such as current year performance, recent transactions, changes in management or board composition, and overall governance practices.

Tally Sheets for CEOs

Starting with the 2006 proxy season, ISS is encouraging companies to provide better and more transparent disclosure related to CEO pay using a “tally sheet” and description. The tally sheet should address the details and rationale of the following elements of executive pay:

- Salary
- Annual incentive (target and actual)
- Equity programs (e.g., stock options, restricted stock, performance shares)
- Deferred compensation
- Supplemental retirement benefits
- Executive perquisites
- Change-in-control and severance payouts (including gross-up provisions)
- Post retirement pay (e.g., consulting arrangements).

For those companies that do not meet a minimum standard of tally sheet disclosure, ISS will note the deficiency in its analysis. For 2006, ISS generally will not withhold votes from the Compensation Committee for providing rules-based disclosure and boilerplate language in the Compensation Committee report. However, for the 2007 proxy season, ISS may recommend withhold votes from the Compensation Committee and potentially recommend votes against proposed or amended equity plans if compensation disclosure is not improved and enhanced proxy disclosure in the form of a tally sheet is not provided.

The new rules proposed this January by the SEC focused even more attention on executive pay disclosure, and thus further promote the use of tally sheets.

What You Should Do

The influence of shareholder advisory services such as ISS continues to grow each year, spurred by investors’ growing concerns regarding executive compensation. In this evolving environment, companies and their directors must be knowledgeable about the policies of these firms and their potential impact.

In addition, directors and management are well-advised to take a proactive approach in addressing any perceived concerns

regarding their executive pay programs. Hay Group recommends that companies work with large block and institutional shareholders to identify and understand any “hot-button” issues. Clear and thorough disclosure in SEC filings can help shareholders understand the rationale behind executive pay and equity compensation proposals.

While the challenges can seem daunting, in this new era, best practices require that executive remuneration arrangements that are aligned with shareholder expectations and reward executives for performance. ■

so companies need to take a fresh look at long-term incentive plans to ensure that current plans are appropriately balanced between performance and retention, and operate within expense and share usage constraints.

Participating Companies

In conducting its 2005 study, Hay Group analyzed executive compensation practices of more than 300 companies and 10,000 corporate and business unit executives. These companies are U.S.-headquartered, with revenues of more than \$1 billion. The study provides an overview of executive compensation practices and highlights differences by sector, executive role, and company size.

Annual Incentives

As expected, CEOs were found, by far, to receive the highest annual incentives relative to other positions; they are followed in descending order by chief operating officers (COOs), chief financial officers (CFOs), and group heads. The heads of health, safety, and environmental affairs and of engineering placed at the low end of the market.

Performance Measures

According to the study, U.S. companies use goal achievement measures such as individual development, employee satisfaction and retention, and profit, to measure performance. Of the companies surveyed, less than four in 10 were measured against an external peer group. The primary performance measures used to gauge plans are net income/profit, total shareholder return, growth, and earnings per share.

Total Cash

Hay Group determined that, when combining annual incentives with base salaries for total cash compensation, CEOs, COOs, CFOs, and group heads have the highest total cash levels. According to the study findings, the heads of health, safety, and environmental affairs and of engineering have the lowest total cash levels.

Executive Benefits

Executive benefits and perquisites have become a major component in the worth and impact of overall executive

data

Executive Compensation Study

A recent Hay Group study found that, despite the recent changes to the legal, accounting, and overall regulatory environment for long-term incentives, most companies are still using stock options as an important portion of executive pay packages. However, many organizations are transitioning to a portfolio approach, which may include restricted stock and increasingly prevalent performance vehicles. The challenge for companies today is to balance the need of attracting, motivating, and retaining top talent in a package that is acceptable to Boards, shareholders, and regulators.

According to the Hay Group 2005 Executive Compensation Study, long-term performance plans are designed with a range of potential awards from 100% of target through an unlimited award. More than one-third of the plans have a maximum opportunity of 150% of the target, while almost 40% of the plans are designed to pay out at two times (or 200%) of target levels if exceptional performance is achieved.

The study supports the view that the death of stock options in executive pay packages has been greatly exaggerated. Stock options alone can be a relatively inefficient long-term incentive,

compensation packages. With the continuing public outcry over excessive levels of executive payouts, management and corporate directors need to scrutinize compensation plans for special retirement arrangements, deferred compensation, severance, and change-in-control payments. They also should scrutinize other hot-button issues such as restrictive covenants (e.g., non-competition, non-solicitation, non-disclosure) and post-retirement consulting arrangements.

Car allowances continue to be the most popular perquisite offered. Many employers have started providing executive flex plans and offering executives a fixed annual dollar allotment from which they can be reimbursed for selected perquisites.

Methodology

The Hay Group 2005 Executive Compensation Study covers heads of organizations/business units and functional areas—those individuals with primary accountability for enterprise success. Survey participants match their executive positions to a set of generic titles and descriptions furnished by Hay Group; they also provide additional information on the scope of each position's responsibilities within their organization. ■

worldwide

Top Executive Pay in Europe

Hay Group conducted a study in 2005 of top executive compensation practices in publicly traded European companies. In addition, we sought information on the major executive compensation issues and likely trends. The study also included an overview of remuneration practices and levels for non-executive directors.

Participating Companies

The executive compensation study covers 233 listed companies and 1,700 top executives across 14 European countries. These

companies have their main stock market listing in Europe, and sales revenue or market capitalization of at least €1 billion as of May 1, 2005.

To compare against executive compensation practices in the United States (U.S.), data was extracted from the Hay Group U.S. executive compensation database for U.S.-listed companies with sales or market capitalization over €1 billion.

Key Executive Pay Findings

The study's executive compensation findings address base salary, annual incentives, long-term incentives, total direct compensation and executive pay packages as compared among European countries and to the U.S. Highlighted below are the key findings:

- Executive compensation levels and practices in major European companies vary widely both within and between countries. However, compensation levels across most countries overlap to a significant extent.
- Base salary levels tend to be highest in Italy, Spain, and the United Kingdom (U.K.). For the highest job levels, salary levels in these countries are 10% to 30% above the European average. Base salaries in the U.S. are about 20% below the European average.
- When annual bonuses are taken into account, total cash is highest in France, Germany, Italy, Spain, and U.K. Germany is consistently higher across all different job sizes, up to 50% above the European average.
- Bonuses paid were significantly higher in the U.S. than in Europe as a percentage of base salary, especially for chief executives of the largest companies. As a result, total cash for top U.S. jobs is very close to typical European levels in spite of the lower base salaries in the U.S.
- Long-term incentive plans are used in the majority of European companies. The awards are most valuable in France, Italy, and U.K.
- Compared to Hay Group's 2004 study, the use of stock options has fallen and the prevalence of restricted or performance shares has increased significantly. The percentage of companies with LTIs that maintain a stock option program decreased from 88% to 78%. In contrast, the proportion using restricted or performance share

plans increased from 23% to 41% of companies with LTIs.

- Long-term incentive awards tend to be substantially higher in the U.S. than in Europe, particularly for chief executives. In the U.S. there tends to be greater differentiation between jobs for both annual and LTIs than in most European countries.

The use of stock options has fallen and the prevalence of restricted or performance shares has increased significantly.

- If LTIs are valued and added to total cash, the highest levels of total direct compensation in Europe are in Germany, up to 60% above the European average, followed by France, Italy, and U.K.
- The high value of LTI awards in the U.S. takes total direct compensation to about 50% above average European levels for the largest jobs.

Compensation of Non-executive Directors

Hay Group analyzed the remuneration of non-executive directors in 153 of the European companies participating in the study and in 783 U.S.-listed companies.

- A fixed annual fee or retainer is the core of non-executive director remuneration in all European countries and in the U.S. Other elements of remuneration vary greatly, mostly according to established country practices.
- Additional fees for committee chairmanship or membership are common in a number of countries including the Netherlands, France, Spain, U.K., and U.S.
- Fees for board or committee meeting attendance are common in Belgium, Finland, France, and Spain.
- Fee levels are substantially higher in countries with mainly single-tier boards, such as Belgium, Italy, Spain, and U.K., than in countries with two-tier boards such as the Netherlands.
- Bonus plans and pension plans for non-executive directors are rare.
- Typical total annual cash fees vary widely between countries. The median total fee is €45,000 in Europe and €46,000 in the U.S., where part of the fees often may be paid in stock instead of cash.
- Equity-related remuneration is rare for non-executive directors in Europe. In the U.S., equity-related remuneration is the norm, with 85% of companies awarding either stock options or shares in addition to cash fees. Equity-related compensation in the U.S. is typically comparable in value to the cash fees. ■

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