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Like many before it, this year has seen a high level of outrage over the executive compensation payouts of some large corporations. At issue is both the amount executives are paid and whether the compensation amounts they received are justified by the performance of their corporations. It is quite possible that executive compensation levels will continue to rise for at least the next several years since many executives currently hold stock options that were issued when the stock market was significantly lower. Thus, unless there are significant changes made in how boards manage executive compensation, there will continue to be objections to how and how much senior executives are paid.

The debate over what to do about excessive and inappropriate executive compensation has been ongoing for decades. A few steps have been taken to correct the inappropriate compensation levels that are revealed every year. The most visible recent step is the mandating of shareholder votes on executive compensation packages. In the United States, they are required, but the result is not binding. Only in a few European countries—the Netherlands, Norway, and Sweden—are they binding. The EU regulators are now pushing for binding investor votes on all executive pay. At the present time, there is no indication that binding votes are likely to be required in the United States.

The expectation in Europe is that binding votes will cause corporations to be more conservative and strategic with respect to the total amount they pay their executives and that their pay will be more driven by corporate performance. There is reason to believe that this is true, but binding votes will not make fundamental changes in compensation practice unless

shareholders make active, informed use of their votes. Shareholders must seriously consider the compensation plans of their companies and cast informed votes on them. But this is not something that is likely to occur unless major changes are made in the information shareholders receive. Most shareholders simply do not get the information that they need in order to cast “informed” votes and in many cases, they also lack the expertise that is needed to evaluate executive compensation plans.

History of the Problem

It can be argued that most of the executive compensation problems that exists today can be laid at the feet of the major investors and shareholders who in the 1970s told companies the issue was not “how much” top executives are paid but “how” it is earned. At the time, companies placed significant emphasis on bonuses that were based on internal measurement, such as return on assets and return on equity. Threatened with negative votes on board elections, companies shifted their emphasis to stock options. Since it was believed there was little opportunity for significant price appreciation, companies gave out large amounts of stock options.

The stock market, as measured by the Dow-Jones Industrial Average (DJIA), was languishing at less than 1,000. Most stock options were granted at fair market value and were good for ten years. They were exercisable at the grant price, regardless of what happened to the stock price in subsequent years. The table below shows the dramatic increase in the DJIA since 1982 when it closed at 1047.

PERIOD	DJIA END PRICE	PERCENT INCREASE IN DJIA FOR PERIOD
1983-1991	3,169	302.8%
1992-2000	10,787	340.9%
2001-2009	10,428	(3.3%)

Note the appreciation on ten-year stock option's granted in 1982 (302.8%) and the appreciation on those granted in 1991 (340.9%). A stock option of 100,000 shares (not atypical for the CEO of a major company) issued at \$10.47 a share was worth \$30.28 a share (an increase of \$19.81 a share) ten years later. After paying to exercise the option (excluding taxes), this reflects a gain of \$1,981,000. And this is from one grant! Typically, grants were made every year.

By 2000, the DJIA had increased more than ten-fold since 1982. Companies, who based option grant sizes on the assumption of a 5-7% annual increase in market price, found that it doubled. Did they proportionately reduce the size of the stock options? No! Why not? Because no one else was reducing the size of their grants. The result was a dramatic increase in executive pay.

This was also a period of favorable accounting treatment of stock options. Namely, a grant at fair market value had no charge to earnings under APB 25. But this changed in 1995 when the Financial Accounting Standards Board issued FAS 123 stating that if companies continued to use APB 25, they had to show the impact of a present-value model such as Black-Scholes in their financial statements. The door on APB 25 was completely closed in 2004 when FASB issued FAS 123R stating all equity awards must be subject to fair-value accounting. Granting stock options now became an expense. This coupled with a drop-off in most stock prices beginning in 2000 had companies moving away from stock options and into stock awards which had an immediate value but less opportunity for future increase and a smaller charge to earnings. Because companies are required to use present-value accounting in their summary and compensation table in the proxy, reports on executive compensation increased dramatically. Few seemed to be aware of the fact that these values might never be realized.

Executive compensation is an extremely technical and complex issue. To say the least, it is hard for most shareholders to cast informed votes based on the information they typically get in proxy statements. Although large investment funds often do have the knowledge needed to evaluate executive pay plans, in part because they get reports that are prepared by shareholder advisory services, many shareholders do not. All they see is the total compensation of executives and the financial performance of the company. Based on these, they are outraged, delighted, or as is most commonly true, oblivious to the executive compensation practices and policies of their company. This leads to the conclusion that even instituting binding votes will not necessarily be effective in improving executive compensation practices. Something more is needed.

It is possible to identify and make shareholders aware of the most common bad practices that almost always should receive a “no” vote. They include:

- Stock options are based on fair market value at time of grant and not price adjusted during the term of the option.
- Cancel-and-reissue stock options are granted when option price is below market price.
- Executives are not required to hold a significant number of shares received after exercising the stock option.
- Restricted stock awards are not performance-based.
- Neither short nor long-term incentive awards are based on performance relative to peer companies.
- New plans are added on top of existing plans without replacing outdated plans.
- Top executives receive generous employment contracts.
- Executives receive personal executive benefits other than those specifically related to business performance.

- Taxed perquisites are grossed up to pay for income taxes.
- Departing executives receive significant severance pay packages as a reward for failure.

But this is not enough. Shareholders need better information about how corporations are paying their executives so that they can determine where these bad practices exist.

Is an audit needed?

One possible addition is a mandatory audit. An annual audit program could be required of corporations. It could include a report to the shareholders on whether they should or should not vote in favor of the executive compensation amounts and practices of their company. It should be based on an analysis of the fit between a corporation's business strategy and its executive compensation strategy, objectives, practices and amounts.

The compensation audit could be conducted by independent firms that have the same type of role that public accounting firms have with respect to the reporting of corporate financial results. It would require corporations to develop a statement of objectives for their executive compensation program. The statement would include the types of performance it is expected to motivate and the market position it is trying to achieve for executive pay. The audit firm would then look at the actual plan and its results to determine how well it accomplishes the objectives laid out for it.

If the audit firm determines that the plan does not have a structure and payouts that are consistent with the objectives stated by the corporation, they would issue a noncompliance report to be distributed to the shareholders. In addition to providing shareholders with expert guidance, the audit process should be a powerful motivator of board restraint with respect to compensation amounts. It also should put pressure on boards to analyze the impact of their company's executive compensation practices. In order to develop the report, boards would need to think

through the objectives and the positioning of their company's executive compensation plan. The report should also provide the shareholders with the information they need to make an informed vote on the executive compensation programs of their company.

Is anyone currently reviewing the executive pay programs in corporations to determine the extent to which they pay-for-performance? Yes, proxy advisors, large investment houses and pension funds do review them. Unfortunately, their analyses usually are not shared with others. Proxy advisor information is typically available only to those who are members of their service or who independently contract for the data.

Large investment houses also do an analysis to determine whether to buy, hold or sell company stock. Typically, they take a short-term view of particular companies. They are investors not shareholders who take a long-term view of a company's future. Pension funds are major shareholders and they often do take a long-term view. Two of the biggest are CalPERS (California Public Employees' Retirement System and TIAA-CREF (Teachers Insurance and Annuity Association and College Retirement Equities Fund). Rather than sell the stock, as an investor would if they do not agree with the executive compensation program, pension funds often meet with management and the board of directors to see if appropriate change can be made. Since they rarely go public with their concerns the analyses they make are not a major help to most small investors.

At the present time, we are not aware of any group calling for independent public executive compensation audits to occur and, of course, they are only likely to become a reality if there is support for them. Possible supporters include: the company's board of directors, its compensation committee or its audit committee; the company's independent auditor; the company's shareholders; proxy advisors; and the Securities Exchange Commission (SEC). For a

variety of different reasons, all of them are unlikely to support a mandatory audit at this point in time.

The company's board of directors, its compensation and audit committees believe the designing and administration of the executive compensation program is their responsibility. If the shareholders do not like what they are doing, they can vote them off the board. They can also express their displeasure with a "no" vote on the executive compensation plan as now required by Dodd-Frank Act. Few have taken overt action on displacing board members and it has been reported that about 90% of shareholders have voted "yes" on the "typical" executive compensation programs. Some argue they do not have enough information to make an informed decision, but if that is true, why do they close the issue with a "yes" vote?

The independent auditor is unlikely to take the initiative on executive compensation audits, unless it is troubled by the payouts. Proxy advisors are unlikely to take any action, as it would lessen the need for their services. The SEC is the most logical choice for support of audits. But it is still trying to issue the necessary regulations under the Dodd-Frank Law and has little ability to take on another major initiative. But clearly they are the most logical choice as they are charged with the obligation of ensuring shareholders have sufficient information to buy, hold, or sell a company stock, thus in the future they could support the creation of an audit.

Some of those who can mandate an audit could also do them. But none of them are good candidates since the auditors would have to be free from conflict of interest issues and it would require reaching out to independent executive compensation experts. However, this would not be easy because there is an insufficient supply of qualified executive compensation experts to even meet the requirements of advising compensation committees on the design and administration of the executive compensation program. Over time, this problem is likely to be solved as supply rises to meet demand but at this point in time, it is a significant obstacle.

A Better Answer

Overall, the timing does not appear to be right for mandatory executive compensation audits. However, this does not mean that no changes in executive compensation practices should be made. There is a simpler solution than mandatory audits that can be implemented now. The company proxy statement is currently required to have a summary compensation table that shows:

- . The names of the principal executive officer, the principal financial officer, and the next three highest paid executive officers.
- .. For each of the last three completed fiscal years for each named executive: the dollar value of their: salary, bonus, stock awards, option awards, non-equity incentive compensation, change in pension and deferred compensation; and all other compensation and a total of all of the items.

The only difficulty in using this pay information to see how and how well a company is paying its executives is that the stock awards and stock option data reflect costs to the company. The stock information is not synonymous with income to the executive since discounted present value formulas are used and the amounts are never likely to be the same as (or even close to) what the executive will receive at some time in the future.

The simple solution is to introduce another summary compensation table for the same individuals, with the same column headers but with the reported information being W-2 income. This information is readily available to the company and it provides the shareholder with the real not the hypothetical earnings of the top executives.

Although this simple addition to the proxy statement goes a long way to answering the question of how much the top executives are paid, more is needed. The next step is for

shareholder's to compare the pay of executives with the performance of the company stock and make a determination if it is pay-for-performance.

Companies need to make one change in order to make it clear to shareholders how executive pay relates to performance. They need to change the required Compensation and Discussion Analysis (CD&A) section. They should slim it down and make it more pertinent. They should precede the CD&A, which runs for pages in most proxies, with an overview summary of the design and administration of the executive compensation plan and how it relates to company stock performance. It should also include a clear statement of the market position it feels is appropriate for executive compensation in the company and where they feel it currently falls. If it is not at the desired level, they should state what changes they are going to make to it so that it is at the desired level.

The CD&A needs to describe the executive compensation program, principles rather than processes, and the reasons behind the numbers in the compensation plan. What are the objectives? What are the measurables? How much risk is built into the programs? The risk should not be sufficient to jeopardize the well-being of the company, much less the economy on the whole. One only has to remember the problem of rewards associated with subordinated mortgage debt to understand that pay for actions associated with excessive risk is disastrous.

The CD&A should be simple, understandable and not unnecessarily lengthy. Few of those issued today receive a passing grade. They require reading with a dictionary in hand and typically use five words when one would be sufficient. One can see the fine hand of lawyers in the text. In their desire to get it right, they fail to deliver a simple, understandable product. All the more reason for an overview summary preceding the section.

Who will push for changes in reporting? Most likely it will have to come from board members although proxy advisors and large shareholders could also encourage the changes, as

could the SEC. One reason they might support these changes is to make unnecessary audits and other changes that they see as dysfunctional unnecessary.

Summary

There is a clear need for an improvement in the information shareholders receive about company executive compensation programs. One way to accomplish this is to require an audit. It also can be accomplished by making some changes in the compensation discussion and analysis report that would make it clearer and more concise. This could give shareholders the information they need in order to cast informed votes. If boards do this, there is a good chance that support for mandatory audits will not develop. If they do not do it, support for mandatory audits may develop in order to provide shareholders with the information they need in order to make informed votes on executive compensation programs.