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The Crystal Report on Executive Compensation



by Graef Crystal

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IN BAD COMPANIES, SOME BONUSES MAY BE DESERVED

The media, not to mention key U.S. congressmen and congresswomen, are going crazy over the fact that some of the companies being kept alive by the U.S. Treasury are accruing millions, even billions, to be paid out in bonuses at the end of their 2008 fiscal years.

On first hearing, that behavior on the part of companies recalls to mind the immortal words attorney Joseph Welch hurled at Senator McCarthy: “Have you no decency, sir? At long last, have you left no sense of decency?”

It is certainly the case that a company that performs terribly ought not to be paying bonuses to its CEO and to other executives with corporate-wide responsibility, e.g., the chief financial officer.

But most companies are decentralized. So just because the company as a whole screwed up does not rule out that one or more divisions (call them business units, if you prefer) had a comparatively fine year.

Some firms run like holding companies, i.e., totally independent divisions and almost no corporate staffs. In those cases, it would not be wrong, in my view, to predicate 100 percent of a division head’s bonus on the results of his own division.

But most companies do have some corporate structure. And in many cases, divisions are not as independent as they seem. For example, they may buy product from a sister division or sell product to a sister division, requiring the imposition of transfer prices that may or may not be real world.

In cases like that, you would think that part of the total bonus should be predicated on corporate results (meaning no bonus for that part if the parent company has performed terribly) and part on divisional results.

Good People

There is also the practical question of retaining good people in bad times.

Perhaps your first reaction is: “How could there be good people in a bad company? If there were good people, the company wouldn’t be bad.” But just because the company is a dog is not conclusive proof that every executive in the company is a serious contender for the Westminster Kennel Club finals.

If you “zero out” a terrific performer because the company has had a terrible year overall, you may risk losing that terrific performer to a competitor who is more appreciative of talent.

So where is all this going? Maybe it comes down to this: If your company is a terrible performer, you need to have a good story line to pay anyone a bonus. But if you have one, and that person is not one of the top executives with corporate-wide responsibility, then go ahead and pay it.

But in cases like that, the CEO is going to have to accept that, in that year, he may not be the highest-paid executive in the company, or if he is the highest-paid executive, he may not be the highest-paid by much.

Consolation Prizes

Still, while the media remain fixated about bonuses, they are likely to miss an even bigger outrage: What I like to call consolation prizes.

For example, you give someone no bonus and trumpet loudly that you are indeed a pay-for-performance company. But much more quietly, you hand the person a one million share stock option – say, three or four times the size of the executive’s normal option grant. That way, if the company returns to profitability and the stock market validates that profitability, the executive will get his bonus after all – delayed to be sure, and in a different form to be sure, but maybe even larger than had he received the normal bonus and the normal-sized stock option.

But wait. Supersizing that stock option creates large charges to earnings, which show up in the proxy statement. So, the theory goes, consolation prizes really don’t hide anything from shareholders.

Wrong. First, there is the fact that the U.S. Securities and Exchange Commission (SEC) blinked when it created new proxy disclosure rules about two years ago.

Originally, the SEC specified that the full grant date fair value (otherwise known as the present value or the Black-Scholes value) had to be included in the company’s Summary Compensation Table (SCT) and added into total pay.

But then the SEC changed its mind. It said the charges shown in the SCT should mirror the charges on the financial statement. So if I give you a million-share stock option as a consolation prize and I tell you that it becomes exercisable at the rate of 25 percent a year over four years, then only one-quarter of the grant date fair value will be included in this year's SCT. The remainder will be stretched out over the ensuing three years' SCTs.

Because of this, most shareholders will miss the full import of a consolation prize.

On top of that, if the prize is a stock option, the company may legitimately be able to lower the ultimate charges to earnings, and hence the pay impact, by adopting some less-than-real-world assumptions.

For one example, a company is allowed to use as a term assumption, not the nominal (and almost always) 10-year term of the option, but rather a term that matches the company's own past exercise experience.

Now suppose we go back to 2000. Between that date and the end of 2007, the company's stock price soared. And most optionees exercised early. As a result, the company could declare that the typical optionee had exercised his option four years after its grant and then could use that as a future assumption for option valuation instead of the 10-year nominal term.

But we are in a different environment today. The way things are going, optionees may need every day of their 10-year terms to make a buck. Yet by continuing to use a four-year term in its valuations, the grant date fair value is materially lowered – at least for now.

And finally, if the prize is a stock option, the company can argue to shareholders that the grant date fair value is a theoretical cost that can handily be ignored.

If a company insists on handing out “consolation prizes”, how about giving stock options, albeit small in size, to any employee who is laid-off? If the CEO is being offered a chance to recoup, why not help out the laid-off employee, too? That seems fair to me.

Of course, companies, though professing their humaneness, will respond that, humaneness aside, they could't afford to do that. Funny, though, that they can do just that, and so easily, for a senior executive.

It's going to be quite interesting when the 2009 proxy season rolls around (starting about the last 10 days of February) and we find out what top executives earned for 2008.

CEOs With Tin Bonus Ears

There may be more bonus discipline than usual, but if 2007 is any guide, we will still encounter plenty of CEOs with tin bonus ears.

I went through a 507-company database I created containing 2007 pay information on CEOs running companies with \$3 billion or more of market cap.

Herewith a list of 24 of those executives, all of whom share two characteristics in common:

- In their 2007 fiscal years, their company underperformed the Standard & Poor's 500 Index by a staggering 20 percentage points or more. This series is referred to as "excess return".
- Yet the CEO received at least a \$2 million bonus.

And when you look over the list, check out the large number of financial companies, 11 of them to be precise.

COMPANY	CEO	2007 TOTAL RETURN	EXCESS RETURN	2007 BONUS (000)
ADVANCED MICRO DEVICES	RUIZ, HECTOR	-63.1%	-68.6%	\$2,599
MERRILL LYNCH & CO INC	THAIN, JOHN	-41.3%	-46.8%	\$15,000
FIFTH THIRD BANCORP	KABAT, KEVIN	-35.4%	-40.9%	\$3,013
COMCAST CORP	ROBERTS, BRIAN	-35.3%	-40.8%	\$7,770
SPRINT NEXTEL CORP	HESSE, DANIEL	-30.1%	-35.6%	\$2,650
XL CAPITAL LTD	O'HARA, BRIAN	-28.6%	-34.1%	\$3,523
MARRIOTT INTERNATIONAL	MARRIOTT, WILLARD	-27.9%	-33.4%	\$2,167
ALLIED CAPITAL CORP	WALTON, WILLIAM	-27.6%	-33.1%	\$5,301
BB&T CORP	ALLISON, JOHN	-27.1%	-32.6%	\$2,622
HALF ROBERT INTL.	MESSMER, HAROLD	-26.2%	-31.7%	\$6,339
WYNDHAM WORLDWIDE	HOLMES, STEPHEN	-26.2%	-31.7%	\$2,212
ELECTRONIC DATA SYST,	RITTENMEYER, RONALD	-24.1%	-29.6%	\$2,250
MANPOWER INC	JOERRES, JEFFREY	-23.3%	-28.8%	\$2,801
TIME WARNER INC	PARSONS, RICHARD	-23.3%	-28.8%	\$7,500
COMERICA INC	BABB, JR., RALPH	-22.2%	-27.6%	\$2,016
APPLERA CORP	WHITE, TONY	-5.1%	-25.7%	\$2,214
BANK OF AMERICA	LEWIS, KENNETH	-18.9%	-24.4%	\$4,250
INTUIT INC	BENNETT, STEPHEN	-7.2%	-23.4%	\$3,250
AMER. INTL. GROUP	SULLIVAN, MARTIN	-17.7%	-23.2%	\$9,232
ALLSTATE CORP	WILSON, THOMAS	-17.6%	-23.1%	\$3,551
WESTERN DIGITAL CORP	COYNE, JOHN	-2.3%	-22.9%	\$2,664
GENENTECH INC	LEVINSON, ARTHUR	-17.3%	-22.8%	\$2,725
LEHMAN BROTHERS HLDGS	FULD, JR., RICHARD	-14.2%	-22.0%	\$4,250
CNA FINANCIAL CORP	LILIENTHAL, STEPHEN	-15.6%	-21.1%	\$3,161
	LOW	-63.1%	-68.6%	\$2,016
	MEDIAN	-23.7%	-29.2%	\$3,087
	AVERAGE	-24.1%	-31.4%	\$4,294
	HIGH	-2.3%	-21.1%	\$15,000

NOTES:

- o Excess Return is company's actual return less return on the S&P 500 Index

- o Data Source: Equilar Inc.

Data for this article were obtained from Equilar, Inc., a leading provider of executive pay data (www.equilar.com) .

2009 marks Graef Crystal's 50th anniversary in the executive compensation field. He has been a director of compensation for General Dynamics and Pfizer, worked as a consultant for Booz, Allen & Hamilton, served as worldwide practice director at Towers Perrin for 18 years, was a professor at the University of California at Berkeley's Haas School of Business for 10 years and a syndicated columnist for Bloomberg News for almost nine years. He has written six books and more than 1,600 articles on executive pay. In the Spring of 2009, he will be teaching a course in executive compensation at the University of California at Berkeley's Boalt School of Law.