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## Chapter 8

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# CEO Performance Evaluation and Executive Compensation

## 8.1 CEO Performance Evaluation

Regular, purposeful, CEO performance evaluation by the board is a cornerstone of effective governance. According to Spencer Stuart's 2007 Board Index, 91% of directors surveyed said their CEO's performance is evaluated annually; the remaining 9% conduct more frequent evaluations. This section is based on Rivero and Nadler (2003). Respondents also noted differences in implementation: 45% of respondents cited the compensation committee as taking the lead; the entire board oversees the process in 20% of the participating companies; the nominating and governance committee oversees in 16% of the companies, and the lead director in 12%. Spencer Stuart Board Index 2007.

Performance evaluation at the CEO level is difficult. Rivero and Nadler (2003) note that the difference between a good evaluation process in which everyone wants to participate and one that becomes mere window dressing is the CEO's attitude toward the process and reactions to the feedback. At the same time, an ad hoc process sprung on the CEO can send the wrong signals about the nature of the board and CEO relationship. Both the CEO and the board need to make an investment to ensure that the process is well planned and part of the normal course of business. Minimizing potential problems at the outset, therefore, raises the odds of creating a successful, sustainable process. Common pitfalls to look for include the following:

- *Uncertainty concerning roles and responsibilities.* Confusion over roles and responsibilities is not uncommon. A clear charter helps, as do descriptions of roles and accountabilities, and timelines and milestones. The director leading the process (typically the chair of the compensation committee) should actively work with other board members to clarify expectations for their participation.
- *Lack of time and energy.* Time is the enemy of many board processes, and an elaborate **CEO evaluation**<sup>1</sup> process that requires significant input from the board may be met with resistance. Yet, a well-designed evaluation brings structure and efficiency to many of the board's other responsibilities, such as oversight and setting executive compensation, thereby actually saving directors time in the long run.
- *Disagreement over criteria for assessment.* Considerable debate over the appropriate criteria for assessing performance is normal and healthy. Before moving forward, however, the CEO and the board must agree on the dimensions of performance and objectives. Disagreements should be resolved by appealing to the strategy and business needs of the organization.

1. The performance expectations of a CEO and the process of evaluating those expectations by a board of directors.

- *Lack of direct information about nonquantitative performance.* Financial and key operational metrics are usually readily available, but measures of softer dimensions, such as leadership effectiveness, often have to be designed specifically for the purpose of the evaluation. Rivero and Nadler (2003).

A well-thought-out process analyzes both past performance and sets goals for the future, and therefore assists the compensation committee of the board in making decisions about the CEO's future compensation and employment. A good process helps the CEO and the board to establish focus on the company's future direction by specifying a set of strategic objectives. This goal-setting aspect of the evaluation can also serve as part of the CEO's ongoing leadership development, with the board providing feedback about areas where the CEO needs to do a better job, learn new skills, or focus additional attention.

An effective CEO evaluation process, therefore, looks backward, focusing on accountability and rewards for past performance, as well as forward, focusing on future objectives and whether the CEO has the vision, strategy, and personal capabilities to achieve those objectives. Although these are distinct objectives, in practice they are often integrated into the same process. Time constraints often force the board to evaluate the CEO's performance over the previous year while simultaneously making compensation decisions, setting next year's targets, and discussing specific areas for improvement, often in a single meeting. As Rivero and Nadler observe, this is unfortunate because when the two objectives are not clearly separated, there is a clear danger that neither gets served very well. Rivero and Nadler (2003).

When time is short the developmental part of the evaluation is often skipped altogether, forcing the board to use the compensation review to set the CEO's future objectives. This approach is likely to emphasize *what* the CEO is expected to achieve (usually framed in terms of short-term financial targets) over *how* the CEO is expected to behave (such as giving more attention to developing future leaders). When this happens, the CEO is unlikely to receive candid, detailed feedback about his or her behavior and personal impact.

### **Dimensions**

Defining an effective set of dimensions to be evaluated represents a major challenge. Based on the distinction made above between a CEO's impact on corporate performance and his or her actions and effectiveness as a leader, Rivero and Nadler identify three generic sets of measurements of CEO performance: bottom-line impact, operational impact, and leadership effectiveness.

1. **Bottom-line impact**<sup>2</sup>. Most CEO evaluation and “pay-for-performance” plans are based on the assumption that the top executive has a direct and significant impact on corporate performance, and therefore hold CEOs accountable for the company’s overall financial health. While important, relying solely on shareholder-oriented, accounting-based bottom-line measures as indicators of CEO performance has severe deficiencies. Most CEOs know that their ability to affect the company’s bottom line is indirect and often limited.
2. **Operational impact**<sup>3</sup>. Operational impact refers to the CEO’s influence on the company’s effectiveness in operational areas, such as customer satisfaction, new product introduction, or productivity enhancement, and how well the firm implements its strategy. Operational impact measures often give a better indication of a company’s underlying potential to create value because they are directly related to the immediate stock price, which is subject to market-wide volatility. While still subject to external and internal forces outside of the CEO’s immediate control, this type of performance is more closely related to the CEO’s actions.
3. **Leadership effectiveness**<sup>4</sup>. Leadership effectiveness addresses how well the CEO carries out his or her responsibilities, both in terms of executing specific role responsibilities—identifying a successor, meeting with key customers and investors, developing a long-term strategy—and the quality of those actions—communicating with external stakeholders, energizing the organization, and gaining the confidence of investors. Rivero and Nadler (2003).

2. The direct impact of a CEO’s performance on corporate performance and overall corporate financial health.
3. A CEO’s influence on a company’s effectiveness in operational areas, such as customer satisfaction, new product information, and productivity enhancement.
4. The successful actions of a CEO in carrying out his or her responsibilities, and the quality of those actions.

The three categories described above are generic. While the specific dimensions and objectives that are used vary for each company, there are some general principles that leading companies follow in selecting CEO performance objectives. First, their evaluations reach *beyond bottom-line performance*. Financial measures of corporate performance, while critical, capture only one aspect of CEO performance. To compensate for some of the limitations of bottom-line measures, it is important to include objectives that reveal how the CEO behaves as a leader, as well as the CEO’s impact on the effectiveness of the organization. Second, they *focus on a manageable number of objectives*. One risk in attempting to capture multiple aspects of CEO performance is that the list of performance dimensions may grow too large to be workable. Too few dimensions, on the other hand, cause the process to be dominated by short-term financial objectives. Best practice is to use between 5 and 10 dimensions. Third, they *use separate objectives for chairman and CEO performance, even if it involves the same person*. In most North American companies, the CEO also serves as chairman of the board. It is important to evaluate performance in both roles. The chairman role can be assessed either as one component of a formal board evaluation process, or the dimensions of chairman effectiveness can be added to the CEO’s evaluation process. Fourth, they *define measures for each objective*. Creating

explicit measures to track performance against the particular objective is relatively simple for all bottom-line and most operational impact objectives. For “softer” dimensions this is more of a challenge but can be achieved. For example, leadership behaviors can be measured through rating methods that ask board members to indicate how often the CEO demonstrates desired behaviors and what impact these have. Finally, they *specify performance levels for each rating measure*. Explicit measures for each objective assist in setting performance expectations with the CEO. Specificity helps create shared understanding of the performance standards between the CEO and the board.

Best practice also suggests that an effective CEO performance evaluation process is integrated with the company’s calendar of business planning and compensation review: Step 1 is focused on *defining the CEO’s objectives*. Before the start of the fiscal year, the CEO should work with the compensation committee of the board to establish key business objectives for the coming year. Using the strategic plan as a starting point, this dialogue should produce an initial set of personal performance targets and associated measurements. After reviewing and amending them if needed, the final set should be discussed and approved by the full board. These targets can then be used to create an integrated goal-setting process that aligns the objectives of each leadership level in the company.

Step 2 is a *mid-year review*. Six months into the year, the compensation committee and the CEO should review the targets and progress against them. Such a mid-year review can provide great value for two reasons. First, it helps the board see how the CEO is meeting or exceeding targets and to identify areas that require closer attention. Second, it provides an opportunity to amend the targets in light of changed circumstances, such as rapidly changing business conditions.

Step 3 is the *year-end assessment*. At the end of the fiscal year, the CEO’s performance should be measured against the previously established objectives. As part of this step, the CEO should be invited to provide a self-evaluation and be given an opportunity to address areas where targets were not met. The self-assessment is shared with the compensation committee and then the full board for input on the CEO’s performance. Evaluations by all board members go to the compensation committee, which uses the results to determine the portion of the CEO’s pay that is linked to performance. Before providing feedback to the CEO, the evaluation should first be discussed by the board in executive session, that is—without the CEO or other inside directors present. Rivero and Nadler (2003).

## 8.2 Executive Compensation

A reasonable and fair compensation system for executives and employees is fundamental to the creation of long-term corporate value. However, the past 2 decades have seen an unprecedented growth in compensation for top executives and a dramatic increase in the ratio between the compensation of executives and their employees. “Runaway” executive compensation has become the subject of editorials, political debates, and battles between directors and shareholders. The reasons are not hard to understand; the numbers involved are large.

### How Much Is Too Much?

In 2007, the CEO of a Standard & Poor’s 500 company received, on average, \$14.2 million in total compensation, according to the Corporate Library, a corporate governance research firm. The median compensation package received was \$8.8 million, more than 350 times the pay of the average U.S. worker. Data from The Corporate Library is based on 211 proxy statements filed in 2008 through April 9.

According to the Economic Research Institute (ERI), executive compensation has grown substantially faster than corporate earnings in recent years. The study of 45 randomly selected public companies found that executive compensation increased 20.5% in 2007, while revenues grew just 2.8%. Economic Research Institute (ERI) press release, February 15, 2008. Moreover, while performance-based bonuses for chief executives of large public companies dropped in 2007, companies more than made up for that decline by giving out bigger discretionary bonuses and other payments not tied to a specific financial target, according to Equilar, the executive compensation research firm. *Financial Week*, March 28, 2008. See also Equilar (2008). Equilar found that the median value of bonuses tied to performance fell 18.6% in 2007, from \$949,249 to \$772,717. Thanks, however, to sizable increases in discretionary awards and multiyear performance awards, overall CEO bonuses for 2007 increased 1.4 % to a median value of \$1.41 million from \$1.39 million in 2006.

Excessive CEO pay takes dollars out of the pockets of shareholders—including the retirement savings of America’s working families. Moreover, a poorly designed executive compensation package can reward decisions that are not in the long-term interests of a company, its shareholders, and employees.

Some CEOs may have far greater control over their pay than anybody previously suspected. Angelo Mozilo, chairman and CEO of Countrywide Financial Corp.,

brought in a second compensation consultant to renegotiate his package in 2006 when the first consultant said his pay package was inflated.

In an e-mail message to John England of Towers Perrin, the executive compensation consultancy who helped redo his pay package, Mozilo complained, “Boards have been placed under enormous pressure by the left-wing anti-business press and the envious leaders of unions and other so-called ‘CEO Comp Watchers.’” E-mail from Angelo Mozilo to John England, November 24, 2006, released by the U.S. House Oversight and Government Reform Committee. Mozilo renegotiated his contract with Countrywide for an annual salary of \$1.9 million, an incentive bonus of between \$4 million and \$10 million, perks and fringe benefits, as well as \$37.5 million in severance benefits. Under public pressure, he subsequently agreed to give up the severance package.

While simply comparing a CEO’s compensation to that of an average worker is not appropriate because it does not consider value creation, it makes for good press. So do high-profile reports of CEOs receiving compensation packages worth millions of dollars while shareholders lost a major part, if not all, of their investment and workers suffered benefit or job cuts. Such headlines fan the perception that despite new NASDAQ and NYSE rules mandating greater board autonomy, many directors remain beholden to management when it comes to compensation.

The CEO pay debate achieved international prominence in the early 1990s. An important milestone was the publication of Graef Crystal’s exposé on CEO pay, *In Search of Excess*, which clearly demonstrated the prevalence of excessive executive compensation practices in U.S. companies. Crystal (1992). *Time* magazine labeled CEO pay as the “populist issue that no politician can resist,” and CEO pay became a major political issue in the United States. McCarroll (1992). Legislation was introduced in the House of Representatives disallowing deductions for compensation exceeding 25 times the lowest paid worker, and the Corporate Pay Responsibility Act was introduced in the Senate to give shareholders more rights to propose compensation-related policies. The Securities and Exchange Commission (SEC) preempted the pending Senate bill in February 1992 by requiring companies to include nonbinding shareholder resolutions about CEO pay in company proxy statements, and announced sweeping new rules affecting the disclosure of top-executive compensation in the annual proxy statement in October 1992. *Wall Street Journal*, February 14, 1992. In 1994, the Bill Clinton tax act (the Omnibus Budget Reconciliation Act of 1993) defined nonperformance-related compensation in excess of \$1 million as “unreasonable” and therefore not deductible as an ordinary business expense for corporate income tax purposes.

Ironically, although the objective was to reduce “excessive” CEO pay, the ultimate outcome was a significant increase in executive compensation, driven by an escalation in option grants that satisfied the new IRS regulations and allowed pay significantly in excess of \$1 million to be tax deductible to the corporation. Once the act defined \$1 million compensation as reasonable, many companies increased cash compensation to \$1 million and then began to add on performance-based pay components that satisfied the act. Rose and Wolfram (2002, pp. S138–S175) document a “spike” in base salaries at \$1 million that did not exist before the new tax rules.

## Stock Options

A principal driver behind the dramatic increases in executive pay in large U.S. firms over the past 3 decades has been the explosion in grants of stock options. A **stock option**<sup>5</sup> is a right to buy shares at a particular price—the so-called strike price—at some future date. If an employee receives an option to buy 100 shares at a \$5 strike price and the stock has risen to \$10 by the vesting period, the employee can buy at the lower price and reap a quick profit. The idea is to align employees’ interests with those of shareholders’ to encourage productivity and profits. In reality the excessive use of options created a mechanism for companies to transfer profits directly to employees—mostly top executives—at the expense of shareholders.

The significant increase in the use and value of stock option awards was driven by a greater focus on equity-based compensation and changes in disclosure and tax rules that reinforced stronger linkages between stock performance and executive pay. Regrettably, there also is evidence that many boards and executives viewed options as a low-cost or even cost-free way to compensate executives.

In economic terms, the cost to the corporation of granting an option to an employee is the opportunity cost the firm gives up by not selling the option in the market, and that cost should be recognized in the firm’s accounting statements as an expense. When a company grants an option to an employee, it bears an economic cost equal to what an outside investor would pay for the option. However, because employees are more risk averse and undiversified than shareholders, and because they are prohibited from trading the options or taking actions to hedge their risk (such as short-selling company stock), employees will naturally value options less than they cost the company to grant. This argument ignores possible inside information held by the employee about the prospects of the firm, and the potential incentive benefits accruing to shareholders when employees hold options. Thus, because the company’s cost can exceed the perceived value to the employee, rather than being a low-cost way of compensating employees options constitute an expensive compensation mechanism. Its use can therefore only be justified when

5. A right to buy a company’s shares at a particular price at some future date.

the productivity benefits the company expects to get from awarding costly options exceed the pay premium that must be offered to employees receiving the options.

Until recently, many U.S. companies were not very diligent in assessing the cost and value of options and treated options as being cost-free. Option grants do not incur a cash outlay and, until the recent change in accounting rules, did not bear an accounting charge. Moreover, when an option is exercised, the company incurs no cash outlay and receives a cash benefit in the form of a tax deduction for the spread between the stock price and the exercise price. These factors make the “perceived cost” of an option to the company much lower than the economic cost, and often even lower than the value of the option to the employee. As a result, many options were granted to many people, and options with favorable accounting treatment were preferred over better incentive plans with less favorable accounting treatment.

The impact of the excessive use of stock options, especially by leading technology companies, however well intended (ostensibly to attract, reward, and retain executive talent), goes well beyond the realm of executive compensation; it transferred a significant amount of wealth from shareholders to employees.

More recently the image of stock options was tainted further by two illegal acts—backdating and spring loading. **Backdating**<sup>6</sup> involves picking a date when the stock was trading at an even lower price than the date of the options grant, resulting in an instant profit. **Spring loading**<sup>7</sup> involves the granting of options right before a company announces news guaranteed to drive up the share price.

Backdating and spring loading violate existing accounting rules, state corporate law, federal securities laws, and tax laws. In a few instances, the U.S. Department of Justice has concluded that CEOs who backdated options committed criminal fraud. The recent backdating scandals forced numerous CEOs and other corporate officials to resign or be fired, and the SEC continues to investigate possible options backdating at more than 100 companies.

6. An illegal act in which a date is chosen for when a stock was trading at an even lower price than the date of the options grant.

7. An illegal act that involves granting of stock options right before a company announces news that guarantees driving up the share price.

Backdating and spring loading also harm shareholders. The money paid to CEOs who improperly backdate or spring load their stock options belongs to shareholders, and when companies have to restate their earnings and pay additional taxes, shareholders lose even more. Since the Sarbanes-Oxley Act became law in 2002, companies must report stock options grants to their executives within 2 business days. Thanks to this investor protection law, it is much harder for executives to backdate stock options. But, Sarbanes-Oxley notwithstanding, CEOs can still inappropriately time stock option exercises based on inside information or by spring loading their stock option grants.

In the last few years, investors submitted dozens of shareholder proposals seeking to limit executive severance and realign pay with performance. Although boards have tended to resist such proposals, contending they constrain their ability to attract, retain, and motivate managers, they have started to change their pay practices to better align interests with shareholders. PepsiCo, for example, replaced its traditional stock options with performance-based restricted shares that are worthless unless earnings targets are met. And at Merrill Lynch, all but 2% of the CEO's pay package now consists of restricted shares untouchable until 2009. In 2003, almost 50% of the CEO's pay package consisted of cash.

### Golden Parachutes

A “**golden parachute**<sup>8</sup>,” or change-of-control agreement, is an agreement that provides key executives with generous severance pay and other benefits in the event that their employment is terminated as a result of a change of ownership of the company. Golden parachutes are voted on by the board and, depending on the laws of the state in which the company is incorporated, may require shareholder approval. Some golden parachutes are triggered even if the control of the corporation does not change completely; such parachutes open after a certain percentage of the corporation's stock is acquired.

Golden parachutes have been justified on three grounds. First, they may enable corporations that are prime takeover targets to hire and retain high-quality executives who would otherwise be reluctant to work for them. Second, since the parachutes add to the cost of acquiring a corporation, they may discourage takeover bids. Finally, if a takeover bid does occur, executives with a golden parachute are more likely to respond in a manner that will benefit the shareholders. Without a golden parachute, executives might resist a takeover that would be in the interests of the shareholders to save their own job.

As golden parachutes have grown more prevalent and lucrative, they have increasingly come under criticism from shareholders. Their concern is understandable since many golden parachute clauses can promise benefits well into the millions. The CEO of Gillette Co., for example, collected \$185 million when Procter & Gamble acquired the company. What is more, many golden parachute agreements do not specify that an executive has to perform successfully to be eligible for the award. In a few high-profile cases, executives cashed in their golden parachute while their companies had lost millions of dollars under their stewardship and thousands of employees were laid off. Large parachutes that are awarded once a takeover bid has been announced are particularly suspect; they are little more than going-away presents for the executives and may encourage them to work for the takeover at the expense of the shareholders.

8. An agreement that provides key executives with generous severance pay and other benefits in the event that their employment is terminated as a result of a change of company ownership; also referred to as a *change-of-control agreement*.

In previous years, it was difficult to ascertain the value of executive severance packages until an executive actually left a company. New SEC executive compensation disclosure rules now require companies to disclose the terms of written or unwritten arrangements that provide payments in case of the resignation, retirement, or termination of the “named executive officers” or the five highest paid executives of a company. The SEC rules also require companies to detail the specific circumstances that would trigger payment and the estimated payment amounts for each situation.

Though this new rule will show whether an executive has an excessive severance package, it does not provide investors with a way to limit them. Congress is considering legislation that will require public companies to hold a nonbinding vote on executive pay plans, including an advisory vote if a company awards a new golden parachute package during a merger, acquisition, or proposed sale.

Despite best efforts to reign in and realign CEO pay, competition for talent keeps driving compensation to higher levels. CEO turnover has reached a record level, both in the United States and abroad, with more than one in seven of the world’s 2,500 leading companies making a change in 2005. According to a Lucier, Kocourek, and Habbel (2006), almost half of this turnover involved involuntary dismissals, four times the number a decade ago. The reason for the increase is not entirely clear. One interpretation is that recent reforms are working and that boards—under pressure from shareholders—have become more proactive in firing underperforming CEOs. The survey also shows, however, that CEOs are just as likely to leave prematurely as retire normally, either for a top job at another company or to become a “consultant”—evidence that in many companies the board–CEO relationship still is more adversarial than constructive.

Another factor pushing up compensation is the increasing prevalence of filling CEO openings through external hires rather than through internal promotions. CEOs hired from the outside typically get paid more than CEOs promoted from within. In addition, CEOs in industries with a higher prevalence of outside hiring are paid more than CEOs in industries characterized by internal promotions. Murphy and Zabojnik (2003). The competitive CEO job market also makes retention a more critical issue, further driving up pay, as boards will err on the side of paying more because of the difficulty, disruptiveness, time, and cost associated with finding a replacement.

The growing intensity of the competition for talent is not limited to CEOs. Compensation committees increasingly deal with the compensation demands of second-tier managers, especially CFOs. And even if senior executives are not threatening to leave, base salaries and target levels for bonuses are getting higher

because of “benchmarking.” Many boards, acting on the advice of compensation consultants, have adopted a policy of setting their CEO’s pay above median levels, a practice known among pay critics as the “Lake Wobegon” effect where most every CEO is considered above average.

## 8.3 The Role of the Compensation Committee

The board of directors is responsible for setting CEO pay. Well-designed executive compensation packages are tied to an effective performance evaluation process, reward strong current performance, and provide incentives for creating long-term value. They must be structured to attract, retain, and motivate the right talent, and avoid paying premiums for mediocre or poor performance, or worse, for destroying long-term value. They should be designed to align the interests of management with those of shareholders and other stakeholders in both the short and the long term. While responsibility for CEO performance evaluation (and that of other key senior executives) often rests with the full board, determining appropriate compensation policies for the company's CEO and most senior executives normally is the task of the board's compensation committee.

The role of the compensation committee has changed significantly in recent years. In the wake of the Sarbanes-Oxley legislation, the new SEC rules, and other regulations, many boards are reevaluating the composition, charter, and responsibilities of the compensation committee. This also reflects the fact that the mission of the compensation committee has grown in recent years to include two distinct elements. Strategically, the committee has the responsibility to determine how the achievement of the overall goals and objectives of the company is best supported by specific performance-oriented compensation policies and plans. This includes designing and implementing executive compensation policies aimed at attracting, retaining, and motivating top-flight executives. Administratively, the committee has responsibility for ascertaining that the company's executive compensation programs (covering base salary programs, short- and longer-term incentives, as well as supplemental benefits and perquisites) remain competitive within the market.

Within the context of this expanded mission, compensation committees must

- provide the necessary transparency required by the regulations through proper disclosures within the company's SEC filings;
- recommend for board approval the specific performance criteria and annual and longer term performance targets for awards under the executive compensation program;
- review the performance of the top five officers relative to the achievement of performance objectives for use in calculating award levels under the executive compensation program;
- provide periodic oversight of all short- and long-term incentive plans, perquisites, and other benefits covering the company's executives to

- ensure that such programs meet the stated performance goals of the organization;
- ensure that all committee business is conducted in a moral and ethical fashion, maintaining the highest levels of personal conduct and professional standards, and taking action to notify the board of any issues—as well as the necessary corrective action—that may affect the committee’s ability to objectively fulfill its duties and responsibilities.

## 8.4 Executive Compensation: Best Practices

The challenges facing compensation committees today are formidable. Increased public scrutiny, stronger pressure from shareholders, new regulations, and intense competition for executive talent are causing compensation committees to change their focus beyond providing transparency and compliance to creating value by adopting compensation policies and structures that assist in attracting, developing, and managing executive talent and driving performance.

A review of best practices of companies with a track record of overseeing successful management teams suggest that the most effective compensation committees do the following:

- *Think strategically about executive compensation.* Proactive compensation committees integrate their compensation policies with the company's overall strategy. A move to a new business model, for example, may require different incentives from other growth strategies.
- *Integrate compensation decisions with succession planning.* Very few events have a more dramatic impact on a firm than the unexpected loss of a successful CEO. Winning companies have a succession plan in place that not only addresses "who takes over and when," but also "why" and "how." This requires that the board agrees on the set of skills and competencies needed to execute the company's long-term vision—that is, adopts an objective framework for identifying the right talent to implement the company's chosen strategy.
- *Understand the limitations of benchmarking.* External benchmarking is widely blamed for escalating executive pay levels. Analysis methods should not be blamed, however. The problems arise in their application. Benchmarks can be useful for assessing the competitiveness of compensation packages but should only be considered within the context of performance.
- *Understand how executives view compensation issues.* Executives often take a different perspective from directors in looking at compensation issues. Whereas boards are preoccupied with issues, such as the associated accounting expense, tax consequences, potential share dilution, alignment with the business strategy, and administrative complexity, executives often take a more personal, risk-based perspective.
- *Communicate with major shareholders.* Investors increasingly value an open dialogue about matters, such as potential board nominees or

equity grant reserves; their input can give compensation committees a sense of broader shareholder views.

- *Carefully select, monitor, and evaluate their advisers and advisory processes.* NYSE listing standards require boards to evaluate themselves at least annually, and board self-evaluations are quickly becoming a governance best practice. The evaluation process should include the performance of consultants and other outside advisers.