CAN REGULATIONS CURB **EXCESSIVE** EXECUTIVE PAY?

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On the heels of the Securities & Exchange Commission's (SEC) executive compensation disclosure requirement that became effective in 2007, regulators are once again considering measures to curb escalating executive pay. Spawned by shareholder resolutions of companies such as Aflac and Boeing, a bill that would give shareholders a nonbinding vote on executive compensation was passed by the U.S. House of Representatives in April 2007. A similar bill is pending in the U.S. Senate. Executive compensation continues to be a primary concern of shareholders, analysts, and corporate governance advocates. No surprise, especially since CEO compensation is almost nine times as high as 1992 levels and consumes a growing percentage of income and cash flows despite continuous scrutiny from Congress, regulators, and the financial press.

In their defense, corporate compensation committees argue that executive compensation must be competitive to attract and maintain the best available management talent. Excesses such as the well-publicized case of Home Depot former CEO Robert Nardelli, however, continue to stoke concerns that executive compensation reforms still have a long way to go. While Home Depot suffered from sluggish stock price performance, the company's proxy statement revealed that Nardelli received more than $190 million in compensation during his approximately six years on the job. When he agreed to step down from his CEO post in January 2007, he received a severance package worth $210 million, according to a Home Depot press release.

We will discuss the move toward shareholders' "say on pay," highlight key compliance disclosures the SEC has targeted in its initial review of the new 2007 compensation disclosures, and illustrate vague performance-based disclosures that prompted SEC comment letters to approximately 300 companies.

In the early 1990s, regulators started addressing the issue of escalating executive compensation with a series of requirements intended to improve governance and provide shareholders more transparent compensation disclosures.

HISTORICAL PERSPECTIVE

Over the past 16 years, the SEC, Congress, and the Financial Accounting Standards Board (FASB) have taken action on executive compensation. In the early 1990s, regulators started addressing the issue of escalating executive compensation with a series of requirements intended to improve governance and provide shareholders more transparent compensation disclosures. Here's a snapshot look at the milestones.

In 1992, the SEC adopted a new executive compensation rule mandating specific executive compensation disclosures in corporate proxy statements. The rule required companies to use tables, rather than narrative form, to disclose the total compensation paid to the CEO and the company's next four highest-paid executives. The general shift in executive compensation from traditional salary and bonus awards toward more long-term compensation, such as stock options, contributed to the SEC's 1992 disclosure rule modifications. This change in compensation practices made it more difficult for shareholders to understand the total amount paid to executives—especially since most stock options weren't expensed at that time.

A year later, Congress passed the Revenue Reconciliation Act of 1993, which set an annual corporate tax deduction ceiling of $1 million for CEO compensation and the next four highest-compensated officers. On the surface, the 1993 Act caps the deductibility of executive compensation at $1 million per year per employee. The annual deduction cap, however, applies only to remuneration "for services performed." Compensation committees quickly learned to structure executive compensation packages toward performance-based compensation to avoid the $1 million ceiling. This common tactic simply shifted the bulk of compensation to stock options.

After the passage of the 1993 Act, executive stock options thrived as the "Holy Grail" of executive compensation. Their popularity stemmed from their unique ability to elude the $1 million tax deductibility ceiling while still completely avoiding financial statement expense recognition under Accounting Principles Board (APB) Opinion No. 25, "Accounting for Stock Issued to Employees." Even though most companies didn't recognize any income statement expense under APB Opinion No. 25, when they exercised stock options they received a tax deduction amounting to the difference between the exercise price of the options and the market price of the stock on the exercise date.

Collectively, the SEC's 1992 disclosure rule and the Revenue Reconciliation Act of 1993 provide a baseline for disclosure and deductibility of executive compensation. In the eyes of many, both fell far short of achieving effective executive compensation governance.

In 1995, the FASB joined the attempts to achieve consistency and transparency in the accounting for all forms of executive compensation—particularly stock options. Because of political interference, the FASB failed in its attempt to require expensing of stock options and settled for improved footnote disclosures in Statement of Financial Accounting Standards (SFAS) No. 123, "Accounting

Table 1: Key Regulations Affecting CEO Compensation

REGULATIONS AFFECTING EXECUTIVE COMPENSATION	BRIEF DESCRIPTION OF MAJOR IMPACT
SEC: **Executive Compensation Disclosure, 1992**	This requires companies to disclose tabular information relating to executive compensation components in their proxy statements for the CEO and the next four highest-paid executives. The disclosure change was motivated by a shift toward stock option compensation. There is no total compensation column summarizing all components of compensation.
Congress: **Revenue Reconciliation Act, 1993**	This law sets the threshold for the deductibility of executive compensation for publicly held corporations. The maximum allowable tax deduction for employee remuneration for services rendered is $1 million.
FASB: **SFAS No. 123(R), December 2004**	This accounting standard requires fair value measurement of stock options and expense recognition in the income statement over the vesting period. Corporate tax deductions are unchanged. The deductible amount is measured on the exercise date as the difference between the exercise price of the options and the market price of the stock.
SEC: **Executive Compensation and Related Person Disclosure, 2006**	This regulation requires detailed compensation disclosures for the CEO, CFO, and the three remaining highest-paid executives. These proxy disclosures summarize all types and amounts of executive compensation and provides a total compensation column. The proxy should also identify the *specific* targets that must be achieved before management earns performance-based compensation. This rule also expands director compensation disclosures. Related person disclosures reveal executive officers who are members of the compensation committee, as well as executives from different companies who serve on each other's compensation committee.

for Stock-Based Compensation." But the FASB made a significant impact on the transparency of executive compensation when it issued SFAS No. 123(R), "Share-Based Payment," in 2004, which requires amortization of the fair value of stock options as an income statement expense over the vesting period of the options. Of course, SFAS No. 123(R) doesn't affect the tax deductibility of exercised options. Stock options retain their exclusion from the $1 million tax deductibility cap, so they remain an attractive form of compensation to many corporations.

The most recent move by the SEC to improve the clarity of executive compensation disclosures occurred in 2006 with the passage of a new regulation, "Executive Compensation and Related Person Disclosure." Unlike the 1992 SEC disclosure rule that applied to the CEO and the next four highest-paid executives, the 2006 rule applies to the CEO, CFO, and the remaining three highest-paid executives. The rule's intent is to provide a clear picture of executive compensation. The new rule requires corporate proxy statements to disclose all components of compensation in a single location, the *Summary Compensation Table*. A new total compensation column sums all components to ensure shareholders can easily determine an executive's total compensation.

The disclosure requirements include salary and bonus awards, as well as stock option grants, stock appreciation rights, long-term incentive plan awards, pension plans, and perquisites, such as the personal use of corporate aircraft and personal security services. These disclosures should improve governance as shareholders, and even compensation committees, get a single, high-definition picture of all components and total costs of executive compensation. Table 1 summarizes the four key regulations that affect executive compensation.

SEC TARGETS COMPLIANCE WITH 2006 RULE

With near completion of the second proxy season (2008) under the new SEC rule, the SEC staff has been actively reviewing companies' executive compensation compliance, including the adequacy of explanatory disclosures. John White, director of the SEC's Division of Corporation Finance, tipped his hand on the Commission's early

Table 2: S&P 500 Median CEO Compensation, Median Net Income, and Median Operating Cash Flows (Dollars in Millions)

YEAR	MEDIAN TOTAL CEO COMPENSATION	MEDIAN NET INCOME	MEDIAN OPERATING CASH FLOWS
1992	$1.1	$95.2	$247.5
1993	1.7	123.0	257.2
1994	2.1	173.9	297.9
1995	2.4	178.1	298.7
1996	4.1	195.8	337.1
1997	5.1	231.3	386.4
1998	3.2	242.3	413.8
1999	4.0	282.0	458.1
2000	5.0	308.3	517.8
2001	5.7	236.5	626.0
2002	5.6	239.5	650.8
2003	6.2	365.3	686.6
2004	6.8	467.4	798.8
2005	7.2	577.4	840.9
2006	9.1	629.5	948.3

review of executive compensation proxy disclosures in an August 2007 speech to the American Bar Association in San Francisco. To narrow the scope of this massive task, White explained that the SEC's initial examination would target larger companies. White described their general findings as well as their prime areas of interest:

"We are looking for analysis, particularly on the different components of compensation and on change of control and termination payments. We also are looking at performance targets. Is the description adequate? We're seeing a lot of really vague disclosure in this area about 'individual performance goals and targets' without further discussion."

According to the August 31, 2007, edition of *The Wall Street Journal*, approximately 300 companies, including Pfizer, Inc., received comment letters from the SEC requesting additional explanations about executive compensation disclosures in 2007. The following excerpt from Pfizer's 2007 proxy statement explains how the company will calculate the 2007 bonus for CEO Jeffrey B. Kindler. Given the lack of specificity regarding these performance targets, Pfizer's proxy statement illustrates the type of vague disclosures the SEC is trying to eliminate.

"In 2007, 60% of Mr. Kindler's bonus will be based on the Committee's assessment of the Company's financial performance in the following measures as well as total shareholder return, as disclosed by the Company:

- *Total Revenues*
- *Adjusted Diluted Earnings per Share*
- *Cash Flow From Operations*

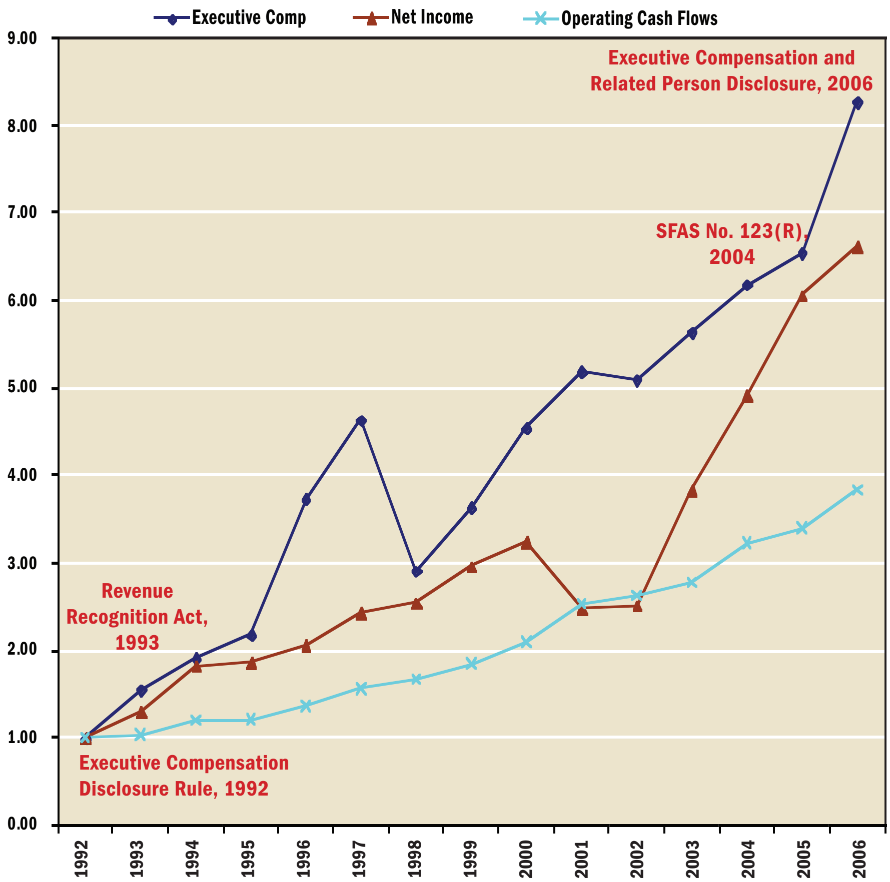
The other 40% of his bonus will be based on the following strategic objectives:

- *Research products and pipeline development*
- *Establishing lower, more flexible cost base and instituting fundamental change within the organization*
- *Implementing business development strategy to drive additional sources of revenue*
- *Improving internal and external relationships and engaging collaboratively with patients, customers and business partners"*

In contrast to Pfizer, Lowe's Companies, Inc., which wasn't identified as having received an SEC comment letter, disclosed in its 2007 proxy statement *specific* performance-based targets the company must achieve before its CEO can earn cash incentive-based compensation. For fiscal year 2006, Lowe's compensation committee based the award of bonuses on achieving specific earnings targets:

"For the Fiscal Year ended February 2, 2007, the performance measure selected by the Compensation

Figure 1: Growth of S&P 500 Median CEO Compensation, Median Net Income, and Median Operating Cash Flows Graphed Relative to 1992 Base-Year Amounts



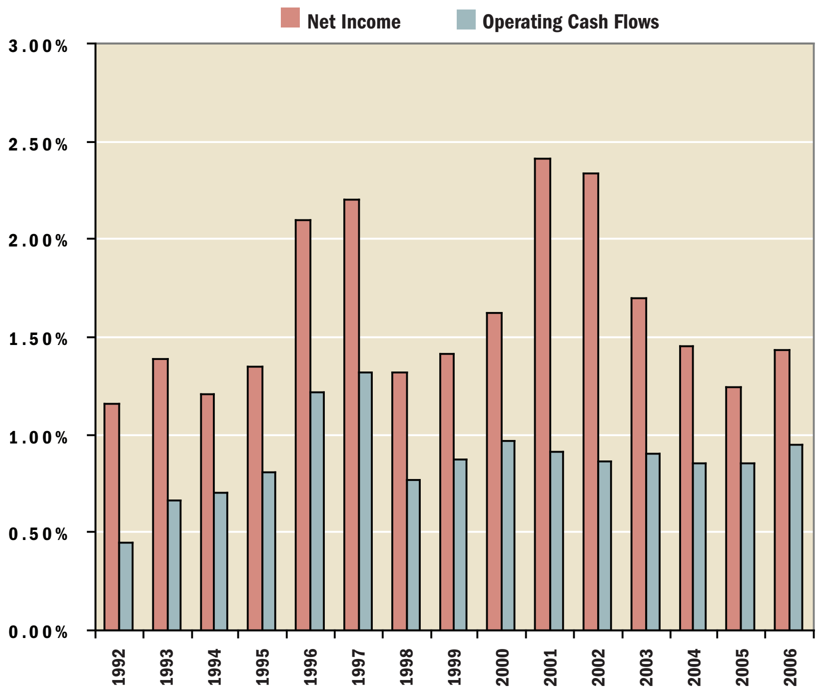
Committee was the percentage increase in the Company's earnings before interest and taxes ("EBIT") over the immediately preceding year. The Compensation Committee established a threshold rate of 8% EBIT growth that must be achieved before any non-equity incentive compensation amounts would be earned, a 14% EBIT growth rate for which target non-equity incentive compensation amounts would be earned and a 20% EBIT growth rate for which the maximum non-equity incentive compensation amounts would be earned. The Company's EBIT growth rate for the 2006 Fiscal Year was 10.7%. Based on that EBIT growth rate, Mr. Niblock (CEO) earned non-equity incentive compensation equal to 109.25% of his base salary."

GROWTH IN CEO COMPENSATION

Table 2 tracks the changes in median CEO compensation, median net income, and median cash flows for S&P 500 companies from 1992 through 2006. We obtained financial statement and CEO compensation data from Standard & Poor's Compustat Database. (Since companies release 2007 executive compensation data in their 2008 proxy statements, 2007 data was unavailable on Compustat for most companies as of this writing.) Total CEO compensation includes the fair value of stock options measured on the grant date in accordance with SFAS No. 123(R). Despite repeated attempts to regulate executive compensation over this period, total median CEO compensation jumped from $1.1 million in 1992 to $9.1 million in 2006. Perhaps more alarming, the rate of growth in CEO compensation outpaced the rate of increase in both net income and operating cash flows.

Figure 1 shows a timeline of changes in median CEO compensation. Changes in median net income and median operating cash flows provide benchmarks to help assess the reasonableness of the increases. The data spans from 1992 through 2006 to incorporate the passage of the four major regulations we discuss. Each component (compen-

Figure 2: S&P 500 CEO Compensation as a Percent of Median Net Income and Median Operating Cash Flows



sation, net income, and cash flows) is graphed relative to its respective 1992 base-year figure. Ironically, CEO compensation rapidly accelerated after the passage of the Corporate Pay Responsibility Act of 1991.

As Figure 1 shows, by 1997 CEO compensation at S&P 500 companies was almost five times higher than 1992 levels. This vastly outpaced the rise in net income, which grew only 2.5 times as high as 1992 levels, and operating cash flows, which increased slightly more than 1.5 times its 1992 level. CEO compensation dropped sharply in 1998 but continued to increase well beyond increases in net income and operating cash flows through 2006. Despite a sharp drop in net income in 2001, CEO compensation continued to rise annually through 2006, except for a slight decrease in 2002. Unexpectedly, after the enactment of SFAS No. 123(R) and the SEC's 2006 "Executive Compensation and Related Person" rule, CEO compensation shot up from about 6.5 times 1992 levels in 2005 to well over 8.0 times 1992 levels in 2006.

Figure 2 expresses median CEO compensation at S&P 500 companies as a percent of median net income and median cash flows from 1992 through 2006. In 2006, CEO compensation accounted for approximately 1.5% of net income and 1% of operating cash flows. Perhaps of most interest to governance advocates: CEO compensation consumed about twice as much operating cash flows in 2006 vs. 1992 and accounted for more than 2% of median net income during four of the 15 years. The percentages can be considerably higher for specific companies. In our sample, CEO compensation is as high as 8.1% of net income and 12.6% of operating cash flows.

WHY REGULATIONS HAVE FAILED

The SEC has been a strong advocate of full disclosure to enhance transparency and accountability, and its 1992 and 2006 executive compensation disclosure rules significantly improved clarity. Proxy statements now prominently display tabular summaries of all types of compensation awarded to top executives and are generally easy for shareholders to understand.

But it seems that an unintended effect has proven more powerful since full details of total compensation packages are now available to everyone, not just the shareholders of affected companies. Compensation disclosures have fueled bidding wars for top talent. Compensation committees may feel intense pressure to ensure their top management team is competitively compensated. When Aflac CEO Daniel P. Amos was asked what his reaction would be if shareholders wanted him to stop receiving stock options, he provided an interesting insight about his perception of CEO compensation. As quoted in the March 7, 2008, edition of the *The Wall Street Journal*, Amos replied:

> *"I will have to make a decision at that time. Will I be as motivated if you cut my pay below everybody else's? The answer is no. I would be insulted that a rookie CEO that has never done anything his whole life could walk in and make more than I do. I have more money than I will ever spend. But there's got to be a scorecard to tell what you are worth. And compensation is the way the scorecard is kept."*

Not surprisingly, as 2008 proxy statements began to appear, top management compensation continued to rise, frequently without regard to company performance. Based on 2008 proxy statements filed through March 2008, the April 5 edition of *The New York Times* identified John Thain, CEO of Merrill Lynch, as the highest-paid CEO in 2007. His total compensation of $83.8 million consisted of a $750,000 base salary, $15 million cash bonus, $33 million in stock awards, $35 million in stock options, and approximately $4,000 in perquisites. Although governance advocates would probably applaud the compensation committee's structuring of Thain's pay package to ensure maximum tax deductibility, perhaps the more important issue is whether his total annual compensation is fair and reasonable from the shareholders' perspective. Considering Merrill's stock price declined 42% in 2007, many shareholders may question the fairness of his compensation. Oracle's CEO Larry Ellison was next on the list with total 2007 compensation of $61.2 million, but Oracle's stock price did increase 29% in 2007.

To counter criticism and avoid further regulations, boards may want to consider voluntarily giving their shareholders a nonbinding advisory vote on executive compensation.

GOVERNANCE ADVOCATES INFLUENCE SAY-ON-PAY INITIATIVES

The latest legislative initiative targets the advisory role of shareholders in executive pay decisions. In April 2007, the U.S. House of Representatives passed H.R. 1257, "The Shareholder Vote on Executive Compensation Act." Although only a simple majority was required to pass the bill, H.R. 1257 passed with a 67% favorable vote. A similar bill is pending in the U.S. Senate. Senator Barack Obama introduced S. 1181, "Shareholder Vote on Executive Compensation Act," which was referred to the Senate's Committee on Banking, Housing, and Urban Affairs. The bill, which the Senate hasn't yet approved, proposes an amendment to the Securities Exchange Act of 1934, giving shareholders an annual nonbinding advisory vote on executive compensation as well as a vote on new severance agreements. A spokesman for Obama's presidential campaign said the candidate would push for the bill's passage if he is elected this fall, according to the February 27, 2008, edition of *The Wall Street Journal*. Similarly, at the June 10 National Federation of Independent Business and eBay 2008 National Small Business Summit in Washington, D.C., presidential hopeful John McCain pledged to give shareholders approval rights for CEO pay and severance arrangements.

Critics of this latest legislative proposal claim the SEC's disclosure regulations on executive compensation are adequate. Others believe government regulators should let the private sector determine executive compensation decisions. While advisory shareholder approval isn't required in the U.S., a nonbinding vote on executive compensation is common in Australia and several European countries.

In May 2008, Aflac became the first U.S. public company to permit its shareholders a say-on-pay vote on the company's executive compensation policies and procedures. Although Aflac's shareholder vote is nonbinding, it opens the door for increased scrutiny of executive compensation. In its March 24, 2008, proxy statement, Aflac described the shareholder vote as follows:

> *"Resolved, that the shareholders approve the overall executive pay-for-performance compensation policies and procedures employed by the Company, as described in the Compensation Discussion and Analysis and the tabular disclosure regarding named executive officer compensation (together with the accompanying narrative disclosure) in this Proxy Statement."*

According to Aflac's May 6, 2008, press release, its shareholders overwhelmingly approved the measure, casting 93% of their votes in favor of Aflac's compensation policies and procedures as well as the CEO's 2007 compensation package. The 2008 proxy statement provided to shareholders before the vote reported Aflac CEO Daniel P. Amos's total compensation in 2007 was $14,834,713, only a slight increase from his 2006 compensation. His 2007 compensation package was composed of $1.3 million in salary, $2.8 million in stock awards, $5.6 million in stock options, $2.8 million in incentive compensation, $2 million in pension benefits, and approximately $300,000 in perquisites.

So far, at least seven other companies have approved say-on-pay votes for their shareholders. Beginning in 2009, shareholders of Verizon, Par Pharmaceuticals, RiskMetrics, Blockbuster, H&R Block, Tech Data, and MBIA will cast their nonbinding votes on executive compensation. Shareholders of numerous other U.S. companies have passed say-on-pay resolutions but must await board approval before an actual say-on-pay vote takes place. According to the Lawyer Links database, Motorola and Ingersoll-Rand shareholders passed resolutions in 2007 and again in 2008, but the companies' boards of directors haven't yet approved the resolutions clearing the way for a say-on-pay vote. In addition, activist groups targeted about 100 companies in 2008 with similar say-on-pay resolutions, according to the March 7, 2008, edition of *The Wall Street Journal*.

Despite growing support for increased shareholder governance, approval of say-on-pay initiatives is far from a sure thing. For example, a dissident shareholder of Rackable Systems added a proposed say-on-pay amendment to the May 2008 annual shareholder meeting. Management opposed the measure and stacked the deck in its favor by establishing ground rules that counted shareholder abstentions as a negative vote, according to the company's proxy statement. Although shareholders cast more votes in favor of say-on-pay than against, the amendment failed because of counting abstentions as negative votes.

THE FUTURE

It's very difficult to regulate fairness in executive compensation. Ultimately, payment of equitable executive compensation is the board of directors' responsibility. Linking executive pay to performance is a good first step, but recent actions by the SEC and the U.S. Congress indicate compensation committees may need stronger criteria and specific performance targets to justify their executive compensation decisions. Compensation performance targets must be meaningful, challenging, and measurable. The SEC has already demonstrated companies can no longer justify executive compensation by simply stating that it is similar to that of executives of competitor companies.

Although regulations generally have been ineffective in controlling what many observers view as excessive compensation, regulations have mobilized shareholders to scrutinize executive compensation decisions. Armed with transparent executive compensation data, compensation committees should expect shareholders and others to continue demanding accountability for the stewardship of corporate assets. Careful compliance with the latest SEC disclosure rules and design of equitable executive compensation packages is imperative if companies hope to satisfy governance advocates. To counter criticism and avoid further regulations, boards may want to consider voluntarily giving their shareholders a nonbinding advisory vote on executive compensation. Otherwise, Congress may act further. This time it could include a mandatory shareholder vote on executive compensation. ■

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The authors acknowledge the assistance of Ritu Rampuria on an early draft of this article.