Compensation Standards

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The Executive Compensation Newsletter for Directors and Advisors

Wealth Accumulation–And Full "Walk Away" What You Need to Know–And Do

One of the essential tools that compensation committees need in order to evaluate whether they are properly setting a CEO's compensation is the wealth accumulation analysis. Its use is growing and we expect it to be as ubiquitous as the tally sheet within a few years. Indeed, a wealth accumulation/full "walk away" analysis should be part of every company's tally sheet process. Because we expect more companies to be using wealth accumulation analyses—and providing disclosure of the process and findings in this coming year's proxy statement—we are devoting the lead article in this issue to the topic.

What is a Wealth Accumulation Analysis?

A wealth accumulation analysis looks at past, present and future value generated by all compensation elements that an executive has earned (or will earn). It's a series of tables to illustrate the values of various pay elements—and total compensation—over a long time horizon and to determine their effectiveness in achieving the goals of the compensation committee. Among other components, the wealth accumulation analysis typically includes:

- gains from past and future equity grants
- future salaries and bonuses
- non-equity longer-term cash compensation
- pension/defined contribution and other payouts including severance and CIC

While the approach to wealth accumulation analyses may vary, the desired outcome is always the same—for the compensation committee to understand the total wealth potential of certain past and all future compensation elements that an executive may be entitled to under existing arrangements before making additional decisions about that executive's pay package. It helps boards focus on amounts an executive has realized—and could realize in the future—from past pay decisions.

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Wealth accumulation analyses are a necessary complement to tally sheets. Tally sheets provide a window to see what an executive is earning at a specific moment in time; wealth accumulation analyses provide a broader window into what an executive may realize—and accumulate—at future points in time (particularly at retirement or "walk away").

Why a Wealth Accumulation Analysis Is Important

The objectives of utilizing a wealth accumulation analysis and a tally sheet overlap. They allow the board to see and assess what an executive is already entitled to before making compensation decisions with respect to that executive. Use of both of these essential tools is important so that a board can prove it made an informed decision when making pay decisions, thereby fulfilling a director's fiduciary duty of care. Both of these tools provide some context for the impact of new decisions and help the board to gauge whether it is achieving the objectives of its pay program.

A wealth accumulation analysis helps the board decide whether there may be decreasing returns from providing additional compensation to an executive because that person already has sufficient incentive to perform. It assists the board to consider "how much is enough?" and even "how much is too much?" These are difficult determinations to make and a board will need this very relevant data to make such important decisions. Preparing a wealth accumulation analysis requires some effort—but without it, a board is flying in the dark and not considering its ultimate destination.

Another important benefit of conducting a wealth accumulation analysis is that it allows the company to have a better sense of what future proxy disclosures might look like under the company's existing arrangements with its Named Executive Officers. This allows the board to take any "corrective" action now to avoid unintended consequences that can lead to public embarrassment and shareholder activism that could challenge the directors personally.

Corrective action may take the form of reconsidering additional awards that the board might otherwise have granted or even negotiating with an executive to rework a pay arrangement that may no longer be appropriate (*e.g.*, post-retirement and severance arrangements where an executive has already accumulated so much wealth to make these "safety nets" inappropriate).

Another important benefit of these analyses should not be overlooked. A board can test the reasonableness of its decisions today from both an internal and a public perspective. Since wealth accumulation analyses can be used to compare what potentially will be paid out to executives to what wealth shareholders will earn over time, today's directors can more easily put themselves in the shoes of current—and future—shareholders and prevent the angry reactions that are playing over and over in the media these days. Again, corrective action can be taken now to avoid embarrassment and exposure (particularly to address walk away amounts in situations where shareholder returns turn out to be low—"pay for failure").

How to Implement a Wealth Accumulation Analysis

In the following two tables, we provide some illustrative examples. The first step to create a wealth accumulation analysis is to establish a baseline for what is in place today. The primary focus typically is on the equity and retirement benefits that an executive has accumulated to date.

Table 1

	Wealth Accumulation Today ($millions)					
Name	Total Cash Compensation[1]	Current Equity Holdings ($M)[2]	Value of Shares Sold Past 10 Years ($M)[3]	Future LTI Grants[4]	Retirement Benefits[5]	Total
Executive A	$2.6	$15.0	$0.0	N/A	$0.6	$18.2
Executive B	$1.6	$7.0	$3.0	N/A	$0.3	$11.9
Executive C	$1.3	$8.0	$1.2	N/A	$0.3	$10.8
Executive D	$1.0	$5.0	$0.5	N/A	$0.1	$6.6

Estimated future values are shown in millions

(1) Equals current base salary plus 2008 target annual incentives.
(2) Current holdings includes vested and unvested stock options and restricted shares.
(3) Represents the realized value, before taxes, of any shares sold between 12/31/98 and 12/31/08.
(4) Not applicable as shows wealth accumulation as of 12/31/08.
(5) Includes total balance of 401(k) and deferred compensation plans.

From there, projections should be made to determine what the executive's wealth accumulation will look like going forward. This will help you to understand what that executive's proxy disclosure will look like in a future year. Considerations include factoring in gains from option exercises so that executives who hold their options and stock until retirement are not perversely penalized.

Note that Table 2 only projects out five years. The actual table the board reviews should project further out (in five year installments) to the executive's estimated retirement date so that the compounding impact of growth and ongoing grants on the executive's final walk away amount is fully understood by the board.

Table 2

	Estimated Value at 12/31/13 ($millions)							
Name	Total Cash Compensation[1]	Current Equity Holdings in Total ($M)[2]	Increase in Value of Current Equity Holdings ($M)[3]	Value of Shares Sold past 10 years	Future LTI Grants[5,6]	Retirement Benefits[7]	Total Value Using Final Equity Value	Total Value Using Incremental Equity Value
Executive A	$14.2	$19.7	$4.7	$0.0	$10.5	$1.0	$45.4	$30.4
Executive B	$8.7	$9.2	$2.2	$4.8	$6.2	$0.5	$29.4	$19.4
Executive C	$7.1	$10.5	$2.5	$1.9	$4.4	$0.5	$24.4	$15.2
Executive D	$5.5	$6.6	$1.6	$0.8	$2.1	$0.2	$15.1	$9.6

Estimated future values are shown in millions

(1) Equals the sum of base salary and 2008 target bonus based on current base salary and target annual incentive % grown at 3% over 5 years (does not include any additional interest).
(2) Current holdings includes vested and unvested stock options and restricted shares.
(3) Only includes the incremental growth in equity value from 12/31/08 to 12/31/13.
(4) Represents the realized value, before taxes, of any shares sold between 12/31/98 and 12/31/08, assuming subsequent growth in equity value.
(5) Assumes annual 3% per year growth in the expected value of LTI grants.
(6) Assumes 75% of the target share award vests and 40% of the vested shares are sold to pay taxes.
(7) Only includes employer-related balances. Assumes 3% annual growth in 401(k) and Deferred Compensation balances per year with ongoing employer contributions equal to those made in 2008. Represents total, not incremental, value.
* Only future LTI grants have been adjusted for taxes. All other components are pre-tax amounts.

A Full Blown Chart

For simplicity sake, Table 2 does not include additional amounts that would be paid out in the event of severance or change in control. These are essential amounts that should be provided in the wealth accumulation/walk away chart reviewed by the board. Space does not permit inclusion here of a full blown chart. Please see the model "Wealth Accumulation/Full Walk Away Amounts" chart (an excellent chart that is the product of a joint effort by Watson Wyatt and Deloitte Consulting) that we have posted in the "Wealth Accumulation Analysis" Practice Area of CompensationStandards.com.

Compare Against Wealth Created for Shareholders

Ultimately, the incremental wealth creation for each of the NEOs should be compared to the wealth created for shareholders. Readers are directed to the tables we have posted on CompensationStandards.com prepared by Towers Perrin that compares projected wealth accumulation even in situations where shareholder returns are flat.

A Few Additional Pointers

When conducting a wealth accumulation analysis, there are a few things to bear in mind. First, it's just a tool and common sense still needs to be applied to any decisions. Second, the assumptions used are critical—they must be reasonable and be capable of being supported. Third, the timeframes used should be reasonable. Failing to project far enough can mask the potential growth over time. Note the importance of including a projection to retirement to gain a full understanding of the final walk away amounts—which may help the compensation committee assess whether severance and post-retirement "safety nets" are no longer appropriate. Finally, peer group comparisons have no place here—this is an internal look.

Readers will not want to miss important panels addressing wealth accumulation and walk away amounts at the upcoming "5th Annual Executive Compensation Conference."

Importance of Wealth Accumulation: The Consultants Speak Out

"If you don't know where you are going, you might wind up someplace else."

—*Yogi Berra*

"If you don't know where you are going, any road will do."

—*Lewis Carroll, Alice in Wonderland*

Below are two sets of commentary from respected compensation consultants on the importance of wealth accumulation in analyzing—and setting—a CEO's total pay package:

From Mike Kesner, Head of Deloitte Consulting's Executive Compensation Practice:

> "A wealth accumulation analysis is essential for determining the current and projected value that a CEO has accumulated (or may accumulate) under the company's incentive and retirement programs. Unlike the traditional annual benchmarking and pay-setting process, a wealth accumulation analysis allows the compensation committee to evaluate the reasonableness of past compensation decisions based on what was actually earned and what future values would be under multiple projected performance scenarios. Wealth accumulation analysis also considers realized compensation from stock option gains, performance share payouts, etc. It allows committees to compare actual results to the targeted level of pay, when pay decisions were initially made and to company—and executive—performance.
>
> Critics argue that any adjustments to pay (presumably downward) as a result of a wealth accumulation analysis would be unfair; a penalty for success. Some companies indicated in this year's proxy that such analyses had no impact on current pay decisions. That is unfortunate. A wealth accumulation analysis should be a key aspect of every compensation committee's analysis and decision-making.
>
> Wealth accumulation analyses allow the compensation committee to ask if there is a point at which the CEO's accumulated and/or projected wealth makes severance necessary or appropriate. It also allows the committee to question the types of long-term incentive awards being provided and the degree of risk built into such awards.
>
> Wealth accumulation analyses can be the compass that helps guide future decisions on CEO pay. Armed with this information, it can help ensure pay-for-performance, internal equity and defensible pay policies."

From Eric Marquardt, Principal in Towers Perrin's Executive Compensation Practice:

> "Information on the relative and absolute value of potential wealth accumulation from long-term incentives for top executives is a critical part of the Compensation Committee's due diligence responsibilities. Timely information on potential wealth accumulation provides input the Committee can use to make adjustments before long-term incentive pay becomes outsized. And it can help in communicating the pay opportunity to executives themselves, improving retention and even individual commitment."

A Think Piece for Directors and Consultants

The Challenges of Relative Financial Measures: What Measure(s) to Use?

By Michael Kesner, Head of Deloitte Consulting's Executive Compensation Practice

Under the SEC's new disclosure rules, we have heard about the challenges of disclosing metrics. Based on my experience, trying to establish a three year financial target to be used in a long-term incentive plan (LTIP) can be very challenging. Some companies will use—or consider—using relative financial performance, figuring "if we perform at least as well or better than our peers, we deserve to be paid our LTIP award."

What Measure(s) to Use?

While the use of relative financial performance is very appealing—as it avoids the need to (a) establish three year financial targets and (b) disclose targeted financial results in the CD&A—there are many practical challenges, including:

1. What measure(s) should be used?
2. Who is the relevant peer group?
3. Do we rely on reported results or make adjustments for unusual items?

Relative financial measures—such as EPS and revenue growth, three-year average ROIC and ROE, etc.—may all provide a useful gauge about how well the company is doing relative to peers. However, depending on a company's particular strategy, relative results may fall below the peer group median.

For example, a company may be willing to give up a little ROIC to attain higher revenue growth. Similarly, a bottom quartile ROIC performer may need to focus on profit improvement to exit the profitability cellar. As a result, revenue growth may be negative. Thus, the selection of the right relative financial measure must support the company's business objectives.

Also, relative performance—particularly EPS growth—can be significantly impacted by your starting point. For example, if a company barely broke-even last year, any improvement will yield a large percentage increase in EPS, vaulting the company to the upper quartile of its peers. Not many compensation committees are willing to pay maximum incentives for an increase in EPS of $.03 to $.06, even though it represents 100% growth and 90th percentile relative performance.

Who is the Relevant Peer Group?

Most of my clients struggle with determining the right peer group for performance comparisons. You might say: What do you mean? Don't you already have a peer group you use for compensation purposes? What's wrong with those companies? As I have learned, in some—but very limited—cases, the compensation peer group is reasonable for relative financial performance comparisons. For example, it might be reasonable for a specialty chemical company to use a relatively broad chemical group for pay comparisons—but because it only has two true competitors, relative performance comparisons to the entire peer group may be unreasonable as the demand for their products, cost of goods, etc. can be vastly different from the broader peer group.

Similarly, an oilfield services company might have a well-defined peer group, but relative financial performance comparisons should probably be limited to just the capital intensive peers, rather than the entire peer group.

And what about companies with a unique niche or conglomerate status? These companies often defy categorization, and trying to build a relevant peer group can be quite difficult. Some companies might default to a broad index, like the S&P 500, but I think such broad market comparisons are relevant only if you are using relative total shareholder return (as opposed to an earnings, return or growth measure).

Reported or Adjusted Results?

In my experience, relative financial comparisons become very complicated and lose credibility with the compensation committee and senior management team when the results are skewed by unusual items. For example, if a peer company had an asset impairment last year, this year's ROIC may be at the top of the peer group. Why? Not because of improved financial performance, but because its capital has been largely written-off. Thus, even a modest profit makes the company look like it is batting .400.

Do you adjust for this, or simply use the "as reported" figures? Same goes for companies that have unusual gains or losses, severance costs associated with a plant closing, etc. If you decide to adjust for these items, you often end up having to restate the financials for the entire 15-20 company peer group. If you decide to "play it where it lies" you may unjustly penalize or reward your executives.

My Preference

Generally, I prefer to use relative TSR based on the same peer group used for compensation purposes and three-year budgeted financial goals (like cumulative EPS or 12% ROIC). That way, management is being rewarded based on both a shareholder friendly measure (*i.e.,* TSR) and a measure that they can more directly influence (*e.g.,* a three-year internal goal). Although this approach has its own set of challenges and issues, it has served my clients and their shareholders pretty well over time.

Heads-Ups

Hold 'Til Retirement Provisions

We expect Hold 'Til Retirement policies for CEOs and top executives to be one of the biggest changes that companies will be implementing (and that institutions will be focusing on) in time to disclose in this year's proxy statements. Anyone who has not yet seen the excellent piece on HTRs in the September-October 2008 issue of *The Corporate Executive* will find it a "must" read. Be sure that your CEO sees this issue. This is one area where we can see companies taking the lead with very little downside cost.

A Roadmap to Comply with the SEC's New Regulation FD Guidance

Now that the SEC has made dramatic changes to its positions on what companies can—and should—do online, opportunities (and pitfalls) abound. The Fall issue of the *InvestorRelationships.com* newsletter provides important practical guidance that our readers who counsel public companies need right now. It includes numerous specific examples of what you should—and should not—be doing to comply with the SEC's new positions.

The newsletter is an integral part of the important new website—*InvestorRelationships.com*—that Broc Romanek has created to help all those responsible for investor relations and corporate governance keep abreast of the fast-paced changes impacting this area. Be sure that you are taking advantage of this invaluable, new resource.

To receive the Fall issue of *InvestorRelationships.com* and to access the critical upcoming Webconference "The SEC's New Corporate Website Guidance: Everything You Need to Know—And Do Now," we encourage all our readers to go to InvestorRelationships.com and take advantage of the no-risk membership offer.

The Upcoming "5th Annual Executive Compensation Conference"

Sign–ups for this year's "5th Annual Executive Compensation Conference" are running ahead of last year's record attendance. In view of the increased scrutiny of compensation arrangements and practices this coming year, this year's Conference will be even more critical than last year's.

If you have not yet made arrangements to view the Live Nationwide Video Webcast (with unlimited access to the archive of the Conference video—and the critical course materials), we urge you to do so now. We have enclosed a form for your convenience. Or, go to CompensationStandards.com to sign up online.

The "3rd Annual Proxy Disclosure Conference"

Our readers should also be sure to take in key sessions from the upcoming "3rd Annual Compensation Conference." The enclosed form will enable your company to access the Nationwide Video Webcasts of both these critical conferences.

Our Upcoming Fall Issue

We have already begun work on our upcoming Fall issue of *Compensation Standards* which will address, among other things, key compensation fixes to implement for this year's upcoming proxy season.

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