

Evolving Oversight of Executive Compensation

It's been a few years since the landmark Sarbanes-Oxley Act (sometimes known as SOX) was enacted to improve corporate governance practices. SOX sets forth increased reporting disclosures and key prohibitions aimed at curtailing certain corporate abuses.

The evolving impact of SOX with its associated increased scrutiny from regulators and investors and the state of the economy and the expensing of stock options has forced Boards to reassess their executive compensation programs and the processes by which they oversee normal course of business practices. In general, Boards are taking a more proactive approach to their fiduciary responsibilities as a result of SOX.

This more proactive approach takes form in two ways: first, Boards are increasing the quality level of their fiduciary responsibilities by re-educating themselves about the designs, terms and conditions, and implications of the various executive compensation instruments. Second, to improve their prudent oversight of corporate assets, Boards are beginning to utilize alternative combinations of executive compensation instruments that more closely link delivery of executive rewards with achievement of key financial and strategic business goals.

Fiduciary Responsibility

The current environment has given rise to an increased desire by Boards (and/or Compensation Committees) to more clearly understand the ramifications of their actions regarding compensation of executives. Directors, and particularly members of Compensation Committees, are not only becoming more knowledgeable about the details of executive compensation instruments they have been used to (e.g., stock options), but also about alternative instruments available (e.g., performance units, restricted stock and stock appreciation rights).

The background analysis provided to Compensation Committees is becoming increasingly more sophisticated. For example, multi-year shareholder dilution analyses of annual equity grant rates and the level of potential dilution from unexercised stock options have become cornerstone decision points for future grants. Also, in reviewing alternative executive incentive opportunities, the pro-forma multi-year expense and impact on earnings of each instrument becomes another key decision point.

Executive Pay and Achievement

During the boom of the 1990s, a major factor in determining levels of base salaries and awards of equity compensation was the competitiveness of those levels to peer companies. When the demand for executives and seniors managers far exceeded the supply, the balance among factors shifted dramatically to this consideration. Hence, the need to attract and retain employees resulted in a rapid escalation in salaries and equity compensation.

In today's environment, the focus is more balanced between competitive and corporate needs. Competitiveness relative to similar companies is still important, but the need to be ahead of the competition has abated and other business factors have become more prominent. For example, company performance (measured by achievement of key financial and strategic goals) has become a central theme.

Evolving Role of Compensation Committees

The role of a Compensation Committee is not to micro-manage compensation practices or be the devil's advocate in the approval process. It is, however, much more than being a passive stamp of approval.

Since SOX, many firms have adopted charters for their Compensation Committees. These charters spell out the foremost charge of the committee to develop, implement, monitor and report the company's executive compensation strategy. The charters typically address process issues, such as, composition of members and meetings as well as authority and responsibilities.

With of the current state of the business environment, compensation *planning* by a Compensation Committee has become a key function. This encompasses two principal duties: first, assessing the effectiveness of compensation plans and the degree that they support corporate business strategies. Second, developing a compensation strategy that provides appropriate compensation instruments which enhance incentive and retention values of executive pay packages.

Next

The process around approving executive compensation actions by Boards requires more informed and discerning participation and review. Credible survey evidence is beginning to show that award and rewards to executives are becoming more reflective of clear goals and the achievement of those goals. Executive compensation has become one of the most important aspects of Board oversight.