RECORD OF SOCIETY OF ACTUARIES
1984 VOL. 10 NO. 2

EXECUTIVE COMPENSATION

Moderator: FREDERICK J. THOMPSON. Panelists: ROD DUFF, MARK C. UBELHART**. Recorder: KEVIN P. MC GLYNN*

MR. FREDERICK J. THOMPSON: Over the years, companies have developed some methods of relating compensation to the job that has been performed. Some of these are pretty straightforward and could actually help you to pass an exam and subsequently get a raise in pay. For a life insurance agent, if he sells a policy he receives a percentage of the premium as a commission. Factory workers for years have been paid on the basis that if you stamp out so many pieces you get paid by the number of pieces that you stamp out, but it took a little longer to get some method of determining the compensation for jobs that were less easily quantified, such as clerical work. However, nowadays there are pretty straightforward methods of determining compensation packages that are fairer, more equitable, and economical for most jobs in the workforce. This is not necessarily true for the executive group. One question is, should the executive be treated just the same as any other group of white-collar workers? Are there special consideration requirements that would apply to these more senior people who perhaps mandate a special approach to their compensation?

It is something quite different from the type of compensation arrangement you would have for the other clerical or managerial employees. Any executive compensation package, rather than moving upward from the clerical staff, should come downwards as an extension of how the shareholders are paid.

I will mention in passing another rather narrow aspect of executive compensation and this is deciding the amount of compensation to be given to the executive. We are going to concentrate more on how to determine what to pay rather than what to do with it once it has been assigned to the executive.

Both of our panelists have been successful in selling their services as compensation consultants, so I think we can accept as given that there is some element of the practical in their theory. Not surprisingly, both will talk about executive compensation practice with vision colored by United States practice and laws.

* Mr. Duff, not a member of the Society, is a consultant with Haye Associates, Los Angeles, California.

** Mr. Ubelhart, not a member of the Society, is a consultant with Hewitt Associates, Lincolnshire, Illinois.

MR. ROD DUFF: Regarding compensation, the majority of my remarks will be in the area of incentive compensation for executives. Rooted deeply in the collective minds of American business managers are two fundamental beliefs with respect to compensation programs. The first is that pay should relate to performance. The second is that pay should be competitive. Both of these notions are widespread and enduring in the area of compensation.

The problem is that, for as long as I have been in this business, the two have operated in conflict and companies have for years been chasing each other in their efforts to stay competitive or to become competitive in their compensation practices, to the extent that pay for performance has clearly been delegated to second place amongst these two concerns. The double digit inflation that we experienced in the late 70's has exasperated this as companies have felt a compelling need to keep their executives whole in terms of their income. In this context bonus plans began to function less among executives for excellence in performance and more in preferred salary range with an entitlement mentality overwhelming the concept of compensation at risk. In going along with that, the purpose of long term incentive plans has become fuzzier and fuzzier. Way back in 1904 when Dupont initiated the first executive stock acquisition program there was a strong belief that senior management should have ownership in the company to encourage them to view the business through the eyes of the owner. Stock options were devised primarily and originally to provide a vehicle by which executives could achieve that purpose.

However, the problem has swung as companies have now come to treat options more in the form of compensation rather than as a vehicle for ownership. Furthermore, when the options went through a period where they failed to deliver the anticipated values, there came a proliferation of alternative schemes. In that same context we have had about one tax law revision every two and one-half or three years on average since 1964. That year was probably the year that started off the various kinds of catch-up copycat types of methods of executive compensation. I must confess to you that we in the compensation consulting business have contributed to this because of our efforts to stay out in front of the field with the newest type of plan or fad. Nevertheless, in recent years a concern has arisen that compensation has become estranged from performance. We are now seeing more emphasis on strategic planning in the compensation area and the need to have compensation support the mission and the strategy of the enterprise in which the executive is functioning.

In the relationship between compensation and organizational performance, one fact is clear. Compensation is intended to be the modifier of behaviour - it's an instrument to change people's behaviour. Questions raised are: does the compensation program that's in place help to drive the organization in the direction that management and the owners wish it to go? What does the compensation program communicate about the organization guidance system?

The focus of a compensation program must be to ensure that the reward system helps to support the organization's needs in terms of its mission, its business strategy, where it is going, and its management of its human and financial resources. The objective of the whole program, of course, is to improve the return on compensation, and to improve the shareholder value through the effect of the compensation program and its modification of executive behaviour. In looking at a compensation planning process, one must start by having knowledge of where the company is going, what its mission is, and what it is trying to do. In that context, one should establish a compensation philosophy and then with the philosophy in place, develop a strategy that is compatible and consistent with that philosophy. The policy should identify with the strategy and then one would begin to implement the policy with the result being a practice, which is what you are actually paying people. In looking at a total compensation program design, the process might follow a series of steps such as defining the issue and the objective strategy, and assessing the corporate culture - that is very important. There are some cultures in which incentive compensation simply won't work and this is a culture in which executives are risk adverse. There are some people, some organizations, and some sectors in industry where the type of management that has gravitated to these businesses tend to be more concerned with security, not that they are not talented, or competent. This type functions better in a stable environment as opposed to an environment where some of their pay is at risk. Whereas, there are others who thrive at the throw of the hunt and enjoy having some compensation at risk. In the latter culture, you are more likely to have a successful program. Having assessed the culture, one then articulates the philosophies, develops the strategy, and looks into the elements of compensation. The elements of compensation includes looking at the base salary, the incentives, the benefit program, and other things, such as cars, and training programs. When you have put the whole program together you should have an integrated approach to compensation architecture in which the total compensation alternatives are examined, selected and put together so that they blend with business strategy and the culture of the company in order to end up with an effective compensation plan design. Once this is done, you might look at the individual elements of the program and how they should be mixed. Very frequently and almost usually base salary is not even half of the total compensation package. The mixed variable executive benefits including the annual incentive and the long-term incentive in capital accumulation should differ based on the type of company you are dealing with, where the company is with respect to its maturity curve and the level and type of executive that's involved in the program. It should not be the same for all executives in any one program.

Through the years there have been some forces that have played a role in the influence of compensation design packages. For example, during the 1970's base salary was principally fueled by inflation. There was what we in the consulting business call a Q3 mentality, so that if you are not paying at the 75 percent percentile you are not competitive, which in itself is a contradiction because the average is where the market has valued the jobs. Annual incentives grew to entitlement mentality, which I mentioned and became a bonus as opposed to an incentive. The term "bonus" being defined by Webster's dictionary as something in addition to that which is required, whereas an incentive is something that incites people to act, changes their behaviour. Long term incentives were market-based and technically focused. The escalation that took place in the benefits programs was all part of the strive to find what has been called tax efficient compensation. Executives would come to us and say, "Find us a way to take our pay in such a way that the government will take less of it," and so a lot of gimmicks were developed, the focus of which was tax planning as opposed to performance planning. Furthermore, the total compensationary orientation was kind of bottoms-up where the people at the top of the organization said what you can do and then set the goals based on that and used a national policy for setting pay where they did not differentiate between people who worked in the midwest and people who worked in the sunbelt. Also, in the 70's we saw changes in big salaries and inflation began to abate where there were reduced expectations and there were reductions in force taking place. And so the people began to think more about keeping their jobs than getting pay raises. There was more uniqueness developed into the treatment of individual executives and performance came into play more importantly when companies began to realize that the salary dollars that were available for increases in the coming year were a limited resource. If they didn't pay attention to the allocation of that resource and give the most money to the good performers good people were not going to hang around when they knew that the bums were getting the same kind of raises that they were. In the annual incentive plans there was a movement toward a total compensation perspective where companies and consulting firms began to ask - what must we do to be competitive in the total cash market? Furthermore, how do we mix it in terms of base salary and annual incentive. The long term incentives became more performance based and strategic focused. Companies began to think about building shareholder value which had not been an issue in the 70's. At that time, the issue was to stay competitive and keep your executive whole. We also began to see separation of pay practices by geographical locations and by types of jobs. We began to see EDP people, for whom a premium was necessary in the market, get higher pay policies than the run-of-the-mill executives. Petroleum engineers probably were the ones who were most marked. The graduate petroleum engineer 6, 7 or 8 years ago could command a $50,000 - $60,000 starting salary, right out of school. With all that, we saw some changes in the way pay would be put together in terms of the prevalence of incentive plans. In 1972 the manufacturing sector had the most incidence of incentive plans but at that time it was only about two-thirds. It has not come to be universal in manufacturing companies for all practical purposes and you see that retail has gone from 50% in 1972 to 78% recently. Back in 1972, only 1 out of 4 insurance companies had incentive plans, it is now 2 out of 3. In looking at utilities we are seeing some marked changes but we have a long way to go. Healthcare has gone from 0 to 18% and it is quite remarkable, and I suspect that with the present high momentum we are going to see a dramatic difference in 1984. The sectors of business, at least in the United States, that traditionally have been viewed as lethargic, inefficient, almost bureaucratic, are the utility industry, the transportation industry, and the healthcare industry. These are the industries that traditionally have shunned incentive compensation. We are urging these companies to begin putting in incentive plans to shake up the troops a little bit, rattle some cages, and get some more creative, innovative, and efficient performance among these kinds of people. From my personal perspective I think it is happening more in the health care industry than any other. The utilities are still afraid of it because they don't know what to measure since their profits are regular. But with the break-up of AT&T there is no question that we are going to see some real incentive in that area.

In designing an incentive plan there are three phases. First is the feasibility. One has to examine your organization to determine whether an incentive plan is going to work, because it can be disastrous if you put one in and it doesn't work. One must also look at the overall context of the company - what is it trying to do? What are the support systems currently in place in terms of planning, controlling, and measuring? Then look at the culture, and the style of management, and the other issues that are appropriate in the environment. Then you get to the design elements where you decide who is going to be in the plan, the kind of performance dimensions you will set, standard against which you will measure performance, what awards will be available, and the controls you will put in the plan.

Finally, one considers the implementation, how to appraise performance, communicate and document the plan. This involves establishing and weighing measures such that the executive's pay will be based on the total corporate performance for the piece of the company that he manages.

In focusing on general performance criteria you have to select what the competitive target bonus for each position will be and this means going into the marketplace and finding out what the other companies are providing in terms of bonus compensation and how does it mix with salaries. You then establish a range which will generally start at about 15% of base salary at the lowest level of participation and perhaps going up to 50-60% at the Chief Executive Officer's (CEO) level. These are target bonuses, which may be exceeded. Percentages can be exceeded if performance justifies it. You then sum all those target bonuses to establish what your bonus fund target is for the year and have your unit funding relative to the acceptable range of performance that you are looking at, whether it be cash flow, return on investment (ROI), or sales growth. Then you develop goals for each participant in the plan, measure results and adjust those results for individual performance participation.

For example, you might establish for a CEO position that the threshold level of performance will generate an award equal to 30% of the base salary. That basically says that if the company's performance achieves a minimum level of performance, at which the board would be willing to pay some incentive, the CEO would receive a 30% bonus.

The theory here is that if you're going to pay a man, say, $300,000 a year, you don't give him a cheque for $179 at the end of the year just because he barely made it over the threshold. You have to give him something that is meaningful or you don't give him anything at all and this filters down to the other positions in the organization.

Very common now are opportunities where there's a lid being put on what will be paid on an annual incentive plan and this has become more prevalent with the advent of the long term incentive plans that have been developed in the last few years. Then taking that opportunity you might set up a weighting which says that the CEO's incentive opportunity will be totally based on how well the overall company does in terms of the goals that were set for the company. The theory being that as the company goes, so goes the CEO. More and more Boards have been saying "No, we want to go with a 80/20 or 75/25 plan which will give us a chance to say to the CEO at the end of the year, alright the numbers weren't there but we want to give you some kind of a token recognition of your efforts." They like to remain flexible and have the ability to do that. For other positions in the organization you would change the weighting depending on where they are in the organization. At lower levels of participation those individuals have such a remote influence on overall corporate results, that it may be inappropriate to have any part of their awards based on how well the company as a whole does. This is where the problems arise, such as where a plant manager did a whale of a job by decreasing costs, but the rest of the company did not do a good job and the sales people did not sell it so the company lost money so there is no fund to pay the plant manager.

Another issue is whether to pay a bonus to an executive who does a good job but where the shareholders do not receive anything, and it comes back to the issue of how do you define return to shareholders. I think of an example in which I was dealing with an executive in Los Angeles who had operations all over the country and he had an operation in Boston that was doing very poorly and had been for years, and an operation in Pittsburgh that was doing terrifically whose executive was earning good bonuses every year. The executive in Boston was washing out every year so they fired him and said to the executive in Pittsburgh, "I'm going to put you up in Boston and ask you to turn it around. It will take you two or three years to get it turned around and until then you don't get a bonus." It really doesn't make a lot of sense when you think about it. These are the kinds of issues that companies and management are wrestling with all the time in designing incentive plans.

There are many techniques for funding plans and this is just one that has been used. It is not necessarily the right way in any given environment but it basically says that you set a target award and 100% of the fund will be created if target performance is achieved. If you reach the threshold which might be 90% of the target performance you will create 25% of the fund. It may be different from one part of the business to another depending on maturity, the growth cycle, or the business the company is in. What has become fairly popular now is the matrix approach to measure performance where across the top you measure growth which could be sales, revenues or market share. Then on the vertical column you measure return. There is a strong sense now in management that to create shareholder value, you must measure a combination of growth and return.

Looking at the long term incentive plans now, over the years companies have used many vehicles including stock options, phantom stock and a fairly recent phenomena, namely junior common stock. What seems to be a good method, is something called Time Accelerated Restricted Stock Plans (TARSP) which says you allow executives to purchase stock at a discount and you place restrictions on the stock. If the executive leaves within five or ten years, he has to sell it back to the company for the price he paid for it, unless certain performance goals have been achieved during that timeframe. If those goals are achieved the restrictions on the stock will lapse.

In designing your plan, you must consider emphasis on long versus short term criteria, you must look at the position and the portfolio at the top part of the company for which you are putting in the plan. If you are dealing with cash you would tend to place more emphasis on the short term. This could be thought of as milking the cash cow of a mature business and getting as much money out as you can to fund growth in other parts of your company.

Furthermore, you have to consider a series of issues with respect to choosing performance measures. They include looking at the usefulness of the measures. How sustainable are they? How well can they be measured? How can you control them? How can they be communicated to the people in the plan? Do the measures have some universal applications throughout the organization? Do the lower levels work with the higher levels? Finally, are there any outside influences that will affect the results?

You must have good balance between long term and short term incentives. I am currently working with a company where I have reached the conclusion and the board has agreed with me that a long term incentive plan at this time is totally inappropriate for this client. So as much as they want one they are going to wait until they get other things in shape. You must avoid being too optimistic, you cannot take productivity and efficiency out of any plan, top management must have a stake in this plan and most of all management has to be involved in the strategic as opposed to the administrative fashion.

MR. MARK C. UBELHART: Basically, the focus of my talk will be on how you link the compensation and planning systems of a company together to enhance shareholder value. This is primarily done through the performance measurement aspects of the two schemes being considered.

As an aside, I was involved with one company where they made a major divestiture and when the news of the divestiture leaked to the capital markets their stock price increased. That is, the financial community thought that the divestiture was a good one. The management of this particular company certainly did enhance shareholder value. About a month later the compensation committee of the board met and as with the managements of many companies their compensation is related to the size of the company. So what you had was a company that was smaller by their measuring system. Subsequently the Board decided to drop management salaries for the top 10 or 12 people. So, here was a management that did what they were supposed to do and according to the textbooks had enhanced shareholder value and yet a month later had their salaries cut. I know the company hasn't made another divestiture since, so this is a case where the compensation and plan schemes didn't work well with one another.

In terms of what companies are doing currently, most are using earnings per share to link strategy and compensation as the focus point in the measurement system. Our surveys of long term incentive plans indicate that roughly two thirds of the companies use earnings per share as the focus measure. There are more and more companies using return on equity but still sticking very much to the accounting measures of performance. This has been true since the adoption of performance plans in the early 1970's. There are some problems with this. Earnings per share measures do not relate very well to what the shareholders actually get. It is an accounting result that comes from the accounting treatment of the financial statements and is affected by inflation and various other factors but does not correlate with shareholder value creation.

Some other problems in terms of earnings per share measures, that have been talked about in the media, include companies whose earnings per share when looked at under a magnifying glass include anticipated income items which are not certain to occur.

There have been some academic articles which address the issue of accounting techniques being used to manipulate earnings per share. I would like to read a sentence from two of these. One is from the Journal of Accounting and Economics and the title of the article is The Effect of Owner Versus Management Control On The Choice of Accounting Methods. Basically, this study looked at between 100 and 150 companies over a period of 10 to 20 years. It concluded and I quote, "Management controlled firms are more likely than owner controlled firms to adopt accounting methods that result in increased or early reported earnings." The second article appeared in the Bell Journal of Economics entitled Corporate Control and Managerial Misrepresentation of Firm Performance. Again, the same type of a study. It concluded managers of management controlled firms attempt to control the information in annual accounting reports in a manner which causes firm performance to be misinterpreted.

I was at one Compensation Committee meeting of the Board where the chairman actually handed out these articles and asked the members to read them because he was concerned that the performance measurements that they were using were not tying into shareholder value. What companies are doing, those that are looking into this seriously, is focusing more and more on cash flow because it has been found that cash flow relates better with shareholder value.

Historically, there have been various stages that companies have gone through in terms of their use of cash flow analysis. The first stage was about twenty years ago when business started using cash flow and present value analysis to decide whether or not to invest in a new plant, add a new facility or buy new equipment. It basically just looks at the present value of cash flows to see if the cash in-flow exceeds the cash out-flow on a present value basis. A second stage occurred about six years ago when mergers became particularly popular and companies used cash flow to price their business.

In a capacity prior to my joining Hewitt Associates I ran a financial consulting group and we would price a business based on cash flow analysis, submit those reports to the board of directors, and that would then be used to negotiate the value of the company. Again, you are departing from the traditional accounting methods and looking more at cash flow, in this case to price the business, for either buying or selling. The third stage that many companies are in right now is strategic planning, the terminology of strategic business units and so forth. Fewer companies are using cash flows to decide how to allocate resources by division and if they sell a strategic business unit what price to sell it at. But again the whole planning aspects are focusing more on cash flow.

Once you have used cash flow to make decisions to build plants, to sell your company or to evaluate a business unit, it then makes sense to use cash flow to evaluate your performance later on. Currently, only a few companies are doing this but there is increasing pressure to use it because of the kinds of articles I referred to a minute ago.

What I would like to do is briefly outline three approaches that are being tried. The first one is a present value analysis converted to future value analysis. What is basically being said is that, if you have already developed a cash flow forecast to make this decision, have information inhouse and have computed present values, why not just compound all those numbers rather than discount them. Compound them and assign future value goals to them. If you do that and want to tie it to incentives you set a target value that is based on your business unit's success.

For example, you might say to the executive if the business has an $11 million value by 1988 we will give you 10,000 shares of stock. On the other hand, if you only hit the threshold level, which might be some kind of constant cash flow from where you started, we will give you perhaps 40% of that opportunity and if you don't hit the threshold then you don't get anything.

So basically, take the cash flows you use for planning, convert them into a future value and then tie your incentive scheme in. Only a few companies are doing this but it is currently being studied more because of the better tie to shareholder value as well as strategic planning that it offers.

MEMBER OF AUDIENCE: Will stock price be a factor in that?

MR. UBELHART: The cash flows will be reflected in the stock prices. This particular example is not actually using stock prices. It is using present value of cash flows and if this is done right it should coincide with stock prices. Again if you look back to what I was talking about before, when we priced the business based on cash flow, it relates to what is going on here.

The second approach is to focus more on the components of value themselves. Many people are not used to dealing with aggregate value but rather are more used to dealing with components of value, namely return on investment (ROI) and growth. However, we define ROI and growth very differently than what you will find in traditional accounting. ROI is defined to be net cash flow where assets are inflation adjusted.

So we have got an ROI figure that's cash based and inflation adjusted. From a performance evaluation and compensation standpoint it is a lot easier to look back and judge performance if you remove inflation. From a planning standpoint as long as you know what inflation factors you are using it probably doesn't make quite as much difference. Basically there is a correlation between real ROI's and value to cost ratio, that is, the higher the ROI the higher the value to cost ratio. Historically, the value to cost ratio for the better performing companies in terms of real ROI's is higher. So again, the capital market (stock market) is seeing right through the clouded conventional accounting statements to the real information which they contain.

The traditional basis of performance that many managements have relied upon, that is earnings per share,does not correlate with the market in any way, and again, that was pointed out by the article earlier on.

I know of a very large company that is paying its executives on the basis of the information I have just described here in terms of the second approach, the real ROI. They are changing their entire accounting system internally to produce this kind of information. That's the only one I know of in the country. I know there are about 20 or so companies that are using this kind of information for planning purposes only.

The third approach is to look at shareholder return, which we will define as stock appreciation plus dividends. You calculate what the shareholders received over some time period and compare that to other companies. So, in effect, you are washing out the ups and downs of the market as a whole since you are just comparing yourself relative to everybody else.

To translate that in terms of long term incentives is very simple. Rank yourself again against a group of companies and then determine what percentage opportunity you earned based on the relative shareholder return concept.

There is still a lot of research going on. In terms of incentives, one particular study looked at the adoption of long term performance plans by companies, and found that companies which adopted such plans increased their capital expenditures. I know of a study which looked at banks and found that following the adoption of an incentive plan by a bank the discretionary expenditures of these banks declined. That is, the money they were spending on having nicer office fixtures, furniture, and so forth, they saved because they were going to get paid in company compensation instead.

A third study dealing with selection of accounting practices, the Rochester approach, found that if you were a company doing very poorly and were not going to meet your earnings goal this year and thus not be entitled to any bonuses, the accountants would change their accounting methods so that you could take a big bath this year. You wrote off everything you could so that next year you would have a better chance of being over the threshold. Similarly, if you are at the top end where if you increase your earnings any further, you are not going to increase your bonus because you are already at the maximum bonus level you do the same thing. You write-off all the expenses you can so that next year you will have more earnings for bonus purposes. In the middle you do everything you can to accelerate earnings. Again, it isn't surprising that this is done. It is just that now there is more evidence and it is more widely known.

The last study I will cite looked at companies in terms of those that had before-tax vs. after-tax incentive plans, and found that when investment tax legislation came out, the latter group invested more. They took more advantage of the investment tax credit. Those that were tied to before-tax earnings didn't.

The point of all this is that in every case behaviour has been affected and the incentive plan has had an affect consistent with the design of the incentive plan. It may not be what was wanted but it certainly had an affect.

Just to summarize, the basic three approaches that can be used are the future value or cash flow approach, the real return on investment and growth which is a specialized definition, and thirdly shareholder return. I might add in conclusion that since these kinds of compensation plans are communicated proxies they communicate directly to the investors the goals of the company. You can have in your proxy something that says, we're looking for earnings per share or for shareholder return and real return on investment. It communicates different things to investors just as it does to employees, so we find security analysts now are paying more and more attention to the design of compensation plans.

MR. THOMPSON: It does sound as if there are numerous methods for the executives to jimmy the results. It reminds me of the agent's contracts where you can encourage him to do almost anything you want depending on how you are going to pay him. One thing to consider is: can these kinds of schemes be applied to organizations like insurance companies? Can you have schemes that would work in something like that or is an insurance company an organization where you can't have the incentive type of compensation?

MR. DUFF: I do believe you can measure people's performance. It may be more difficult to do in one type of organization than it is in another. One of the problems I run into in insurance companies is the issue of shared accountability. The underwriter blames the salesman, or rather the salesman blames the underwriter, and the underwriter blames the claims adjusters, and it goes on and round so that nobody wants to take the blame.

But I believe these kinds of plans will work in virtually any environment. If you are in a local government, of course, you can't measure return on investment, but I think you can certainly do it in an insurance company whether its a stock company or a mutual company. In other words, there is no such thing as a non-profit organization, it's surplus instead of profit.

MR. THOMPSON: How often are incentive plans changed? How much adjustment and modification goes on in these kind of plans? Do the people put them in and tend to stick with them for better or for worse?

MR. UBELHART: They change frequently, maybe every two or three years, so it depends on the changes in the companies doing the planning and so forth.

MR. DUFF: I would agree with that. I think the compensation plan has the durability of sandstone as compared to diamond, it will crumble. In a relatively short period of time if attention is not paid to keeping it tuned into what the company is attempting to do and keeping it at a point where it supports what the company is attempting to achieve , the company may run into trouble.

MR. THOMPSON: Does TEFRA have something to do with paying executives differently than other people? Can you do that? Can you tie that into it at all?

MR. DUFF: TEFRA put a limit on the pension an executive can collect from his company. TEFRA and an earlier act, ERISA, have given rise to a proliferation of what we call supplemental executive retirement plans. Companies have adopted plans which will provide an executive with the pension that was anticipated when the basic pension plan formula was contrived, which may well have delivered him a pension of $½ million a year. But the government says he can only get $90,000 under a qualified retirement plan, so the company says to the executive we will give you on a non-qualified basis what the government is taking away. The difference is that the company cannot take a tax deduction for any funding it may do of the benefit that it is going to provide outside of the qualified plan. However, it must accrue the liability and take a charge to earnings during the years that it is accruing. So it is a negative aspect in that respect.

For one thing if you get a company that does not have an executive who is going to be entitled to a pension over $90,000, then there is no sense in putting in one of these plans. But a very high percentage of the multi-billion dollar organizations have adopted these plans and the uses that they have been put to are numerous. Of these plans that were reported in our survey, about one-half of them were solely to restore the ERISA and TEFRA limitations, but the other half, 52% of them, did that plus more, such as including incentive compensation for pension purposes. We do a survey every year of the companies in the United States that have incentive compensation plans. Roughly half of them include incentive compensation within the definition of plan compensation for pension purposes. In addition, 18% of the companies in our survey adopted a supplemental executive retirement plan which included incentive compensation for selected executives on a non-qualified basis. These plans can discriminate to the degree appropriate in their environment, and they don't have to include overtime pay and other types of pay that would have to be included if you included the incentive under the qualified plan. Furthermore, our data showed that 28% of the coverage is used for enhancing short term benefits. For example, if you hire an executive at age 50 who has a career service with his prior employer of 25 years and has a fully vested pension plan, that executive in leaving his company and going to yours will lose a great deal of retirement benefit. I can cite an example with a company I worked with where the CEO had come from another large company. The exact situation - he had 25 years service and the prior employer's plan said if you hit 25 years service you have maximum pension - the guy was 52 years old at the time and when he negotiated his deal with his new employer where he was going, he said to himself "Gee, I've got a fully vested pension where I'm coming from, I don't need to worry about that". Exactly seven years later he was 59 and thinking about retiring at 62 and he began to do some calculations on his pension, he found out that the pension from the prior employer gave him 55% of his final average pay with that prior employer which was at a level of $75,000 a year, thus about a $40,000 pension. Lo and behold here he was making $275,000 a year as the CEO of his new employer and had a pension that began to seem somewhat inadequate. He would only have 12 years of service under his new employer to accrue benefits. So that highlighted the need to do something. He in fact did do something but he excluded himself, I give him a lot of credit for it. He put in a plan that said any other executive we hire at an advanced age we will commit to him that he will get a career pension for his service in our company with some certain restrictions, such as he has to stay until age 62. The pension under this non-qualified supplemental executive retirement plan (SERP) will be comprised of whatever he has accrued under the qualified pension plan during the years that he was with us, plus whatever he gets from the qualified plan of his prior employer, plus social-security benefits, and we'll supplement this under the SERP to bring him to where he would have been had he had his entire career with us. That gives the company a real advantage in hiring mid-career executives in the marketplace. About 13% are using this for an early retirement supplement in order to have some control over either getting people to retire when they want them to or keeping people from retiring before they want them to.

Deferred compensation packages were included in 14% of the plans. I think one of the reasons for this is that deferred compensation is not all that common in the U.S. About 1 out of 4 employers allow their executives to optionally defer the incentive award portion of their salary. The situation here is that if you defer your incentive award and incentives are included under the base qualified incentive plan, the law says you can't include deferred compensation within the definition of plan compensation for pensions. Thus companies set up a plan which says what the law takes away we will give you back. We'll give you a supplemental pension which will be equivalent to what you lost by reason of deferring your incentive award. It's a no cost item, it's just an issue of how you accrue it.

Finally, there were 6% of the companies that told us they just use the plan to improve benefits and did not have any specific idea in mind when the plan was designed. There are other advantages and disadvantages with the plan. Under a SERP the company is now required to make a cash outlay. Typically, it is an unfunded plan. Some companies that do funding use insurance instruments or actually put money in a shoe-box or in an investment vehicle somewhere. As the underlying qualified benefit plan's security improves, the accrued liability under the SERP is relieved. You can establish uniformity in executive benefit levels rather than individually negotiating contracts where the equity begins to become pervasive when you negotiate with each individual executive separately. As I mentioned earlier it can help you to attract and retain key executives. It can help you control the retirement policy of executives. The only ERISA reporting requirement is to keep the fellow abreast of what his accrued benefits are. The executive doesn't have to pay tax until he actually receives the money and the benefits are not subject to the Social Security taxes when they are received. The principal disadvantages are that the liability accruals can be very, very substantial. If you hire an executive at age 55, and you are going to have to accrue for a supplemental pension of $100,000, that would be about $1 million purchase price at age 65. This means in ten years you must have $1 million set aside. The company has to take a current charge to earnings of the accrued liability or they don't get a tax deduction. Some creative financial people in companies have managed to establish a deferred tax reserve and really treat it as if it were being currently tax deductible.

Finally, from the executive's point of view, the most important point is the danger of the company going belly-up for whatever reason and thus reneging on its promise to pay. The executive has no protection other than as an unsecured creditor of a corporation. This is true of any deferred compensation plan. A SERP is basically a deferred compensation plan, except that it is something that the company brings in and says we'll give you this as an extra whereas most of your non-qualified deferred compensation plans are optional. That is, the executive can take his incentive award today or have it held for him until some time in the future.

MEMBER OF THE AUDIENCE: With reference to the $1,000,000 you talked about, is there any accounting requirement for accruing the liability on the balance sheet?

MR. DUFF: I just went through a case like this. The auditors insisted that there be an accrual for this anticipated liability at some future date. There are a number of ways you can accrue for that. You accrue only until the day he retires or you can accrue with an assumed life expectancy. If you have a large enough group of people you can use some turnover and interest assumptions.

MEMBER OF AUDIENCE: In answer to that gentleman's question, I believe the answer is that APB8 would apply to expensing for a non-qualified deferred compensation arrangement, the same accounting pronouncement which applies to an ERISA qualified plan.

MR. DUFF: You are basically right with one exception.

On that ERISA qualified plan you put that money into a trust and you take that tax deduction when you put it in the trust.

MEMBER OF AUDIENCE: It's a question of expensing and the expensing is a separate issue from the funding. APB8 at least currently provides guidelines for expensing pension arrangements.

MR. DUFF: There are a number of alternatives, however, by which you may expense these things.

MEMBER OF AUDIENCE: Just one amendment to that, APB12 applies if it is only one single deferred compensation contract.

MR. THOMPSON: The fact is, if you promise a pension you have got to reflect it in your accounting statement one way or another.

MR. DUFF: It's a real liability. It's a promise to pay that the company has made and it's just like borrowing money from an executive for all practical purposes.

MR. JEFFREY D. MILLER: I would just like to mention one deferred compensation case we have been involved in with a public utility where we were trying to design a compensation program that would not necessarily show up in their cost basis for justifying their rate increases to public service commissions. Evidently the public service commissions were taking the position that they didn't see why any executive with a public utility should be paid more than what the governor of the state was earning. So it became a very sensitive subject as to how they were going to compensate their key executives in this public utility and I was wondering if any of the panel has had any experience with this kind of problem and what solutions you proposed.

MR. DUFF: I sure have. In fact, I was recently involved with a public utility. We examined their compensation practices and found that even amongst other utilities, the general manager was paid down in the lowest quartile of practice, and very near the lowest of all the utility general managers that we had in our data base. We went to him and reported that we were going to suggest to the Board that they should start moving it up, and the guy said to us "If you recommend a salary increase for me you guys are out of here tomorrow and you will never darken our doors again". "But why?",I asked. He said, "My wife told me if I take another raise she is going to leave me because of the telephone calls she gets every time a raise appears in the newspaper." So that's a very sensitive situation. It is also very common in the utilities, because of the public scrutiny on the top compensation. This is why the salary and pay practice is so flat in utilities. The union pressures are driving it up at the lower levels and public opinion is driving it down at the CEO, general managerial level. My view is to stand up and take the heat, if it is appropriate. If you want to attract good people, if you want to shake the lethargy so associated with utility industries in the United States you have got to start paying people who will take some risks and do something innovative and be willing to get fired in three years if they aren't doing well, rather than get a sinecure to just be there and manage the business. It's a very basic problem that the whole utility industry is dealing with today and they are all wrestling with the same problem. Even those utilities that have gone into non-regulated diversifications. Pacific Lighting in

Los Angeles is into real estate development, property management, oil and gas drilling and they are into a million things so that the utility part of the business is probably only 40% of their revenues and 70% of their people, of course. It's a problem but no one has come up with an answer that the utility commission is willing to buy as yet.

MR. UBELHART: Let me just add a few comments on a case we are working on now. We came to the conclusion that we are going to have to be responsive to the people to whom their Board answers and since they get so many criticisms about rate increases, we are in affect designing an incentive plan that will pay out if the rate increases are less frequent and less in amount. The idea being that the Board can stand up in front of the TV cameras and say, "We have an incentive plan here that is only going to pay out if there are no rate increases." They are more willing to defend it and management is more likely to get an incentive plan. This still is not in place yet, so it may not happen.

MR. DUFF: It's a good idea. We have tried a similar thing. It is very difficult to manage doing that, because you have got to be careful how they keep their rates down.

MR. MILLER: One of the programs that we proposed was an interest-free loan program where the company would loan the executives money to pay the first four out of seven life insurance premiums in a leverage life insurance program. Of course, the concern of that program was the potential limitation on the deduction for policy loan interest, that it would not be as attractive. But it seems quite likely with the new tax law going through that the limitations on the deductions for policy loan interest will be liberal or non-existent.

Do you see a major expansion in the use of these leverage life insurance plans for executive compensation programs if this tax legislation goes through in a favourable manner?

MR. DUFF: I have to confess that I am not terribly familiar with that aspect of the business, but I can make a couple of observations. One, you are basically talking about a split dollar life insurance plan or at least a company owned life insurance plan to fund some kind of a vehicle. We keep reading in the newspaper or in the trade magazines that company-owned life insurance is the new thing and is growing rapidly. But for the 10 years that we have been doing our survey the incidence of this in our survey base has not changed. About 8% of the survey companies have company-owned life insurance for executives. It just isn't catching on. I'm not sure what the reason is and I don't know whether the new tax legislation will change it. It will probably give it a pulse of activity I suspect. But, for your specific situation, I'd be scared to death of shareholder reaction or public reaction to interest free loans to people in the utility field. I think that would be worse than a raise in terms of the adverse reaction you are likely to get.

Secondly, I remember John Todd, I believe it was, who designed the General Electric split dollar plan which is the prototype for all the split dollar plans that followed. He was talking to a group of salesmen at his company and he made a couple of comments. He said, "How would you guys like to sell a million dollar deal", and he paused and said, "I'm not talking about a million dollar face amount", and he paused again and said, "and I'm not talking about a million dollar premium. I'm talking about a million dollars in commission." That has stuck with me for so long. Who is paying that commission? Everybody says its cheaper than doing it other ways but somehow or other that million dollar commission seems to be disappearing in the process.

MR. THOMPSON: It does seem simplistic, but surely the main reason for selling insurance is so that the agent gets a commission. With respect to anything that I have ever seen, a life insurance policy that accumulates cash values is not only a bad savings plan but it is probably a very expensive way to buy insurance.

Mr. Miller, what is the reason for doing that? Is your firm licensed to take commissions, perhaps?

MR. MILLER: No sir, but this is an area that we are entering quite actively and we propose to use no load, no commission insurance contracts and provide our services on a fee for service basis. There are a couple of advantages to that. The life insurance premiums paid into these kind of schemes are not deductible and commissions paid out of life insurance premiums are in effect a non-deductible expense. However, consulting fees are a deductible expense and we found that this is a program where we can combine our employee benefits consultants with our life insurance consultants to design life insurance programs that pay no commission to anybody. We put out bids to various life insurance companies. The whole purpose is to take advantage of the tax status of a life insurance product as a funding vehicle. In fact, if the new law goes through, especially the Senate version of the new law, there will be substantial tax advantages. I don't think that you should necessarily associate high commission contracts with all of life insurance. I think there will be a new trend towards fee for service type consultants, such as our firm, that design these programs using life insurance only because of the tax advantages and for no other reason.

MR. THOMPSON: Do you mean that you can control it so that the tax advantages outweigh any investment disadvantages?

MR. MILLER: Yes. In fact, there will be some substantial investment advantages. The life insurance companies are competitive in the interest rates they credit to their policyholders. There may be long term interest guarantees through these contracts which would be quite favourable to all participants. It's a competitive environment. There would be no investment disadvantages.

MR. DUFF: One of the problems with funding things through life insurance is that the life insurance vehicle tends to start providing things that we didn't want to begin with, such as a disability benefit or a pre-retirement death benefit which isn't what we are doing it for. I think that if you can come up with a vehicle that can be constrained so that it doesn't add all these excess goodies, I think you will really have something.

MR. MILLER: The insurance vehicles that we design do provide unwanted pre-retirement death benefits, to the extent required by the tax law, in order to qualify as a life insurance policy. The products that we design and recommend do provide life insurance benefits we don't want. But it is our primary objective to provide supplemental retirement income. By using a life insurance policy we can obtain these tax advantages. Fortunately, the law does not place such onerous restraints on us so that the life insurance we have to purchase poses such a major problem. For example, for a program which we designed recently, we assumed that a 10% interest rate was credited to the policyholder's fund by the life insurance company. The existence of life insurance benefits caused the rate of return realized through retirement to decrease to 9%, so there is a 1% spread in there that went to pay for the unwanted pre-retirement death benefits. However, that 1% was more than made up for by the 4½ or 5% additional return that was gained from the tax advantage status in the life insurance product.

MR. THOMPSON: I agree with what you are suggesting, if you can get rid of those commissions and charge a fee that is appropriate for the amount of work that is done, and if you can control the insurance companies from throwing in a lot of hidden things that are pushing your rate of return down below where it should be.

MEMBER OF AUDIENCE: What kind of evidence is there that these well designed incentive compensation arrangements actually improve the performance results with respect to earnings for the company?

MR. DUFF: Not very much.

MR. UBELHART: Not very much, for two reasons. First, financial performance has not been accurately defined until lately. Recently, we have been gaining new techniques to define financial performance. So, one side equation hasn't been defined well. Secondly, when you look at compensation, most of the studies have been done based on salary and short term incentives. Only through the last couple of years have we been able to price the value of stock options, long term incentives and value benefits on a present value basis and thus arrive at a value for total compensation. So, we didn't have either side of the equation. Total compensation was not accurately defined nor was financial performance accurately defined.

MR. DUFF: I wouldn't suggest that there is no correlation at all, but it is not the kind of correlation that you would have expected to find. I think all of us have suddenly come to realize that we have a more important role and our major objective has become to bring a correlation to the picture between pay and performance. It really isn't very good now, but there is some.

MR. THOMPSON: We can see that it does have an effect. Mr. Ubelhart was talking about how the accounting department changes the way they are doing things. If you are near the limit of your bonus you are going to do everything you can to pull the profit down so that it doesn't exceed that limit. If you are around the bottom, push it down as well, take a bath this year and push it off into the future years. Those may not be the effects you want. But what we are hoping for is an incentive compensation arrangement that is going to produce the effects that you do want. I don't think there could be any doubt that these schemes do have an effect in that they cause the executive to react in a particular way. After the fact, one finds out that, indeed that's the way the scheme encourages them to react, but it wasn't the way you wanted them to react, so you have to make some adjustments.