

**Frederic W. Cook & Co. Testimony  
Before the House Financial Services Committee on  
Executive Compensation**

May 25, 2006

The Honorable Michael G. Oxley, Chairman  
The Honorable Barney Frank, Ranking Member  
House Financial Services Committee  
Room 2129, Rayburn House Office Building  
Washington, D.C. 20515

Dear Chairman Oxley and Congressman Frank:

Thank you for the invitation to participate in the Committee's Panel on Executive Compensation.

**Our Credentials**

Frederic W. Cook & Co. provides management consulting assistance to corporations and their compensation committees in developing compensation plans for their executives and key employees. Our focus is on performance-based compensation programs (salaries, annual incentives, long-term incentives and stock ownership programs) that help companies attract and retain key employees, motivate and reward them for improved performance, and align their interests with those of shareholders.

Formed in 1973, our firm has served over 1,800 clients from offices in New York, Chicago, Los Angeles, and San Francisco. Many of our clients are among the largest companies in the world, including over half of Business Week's 250 largest market capitalization companies. Other clients have been small to mid-size firms, private companies and start-up ventures.

We hold ourselves responsible to be a thought leader in compensation design and practice innovations, and an advocate of leading "best practices" in the governance of executive compensation. As such, we regularly contribute to the knowledge base of compensation practice and philosophy through research, speeches, articles and essays.

**Introduction**

The media has been flooded with multitude of distorted, misleading and oftentimes erroneous statistics chosen to portray U.S. CEOs and Board governance in a negative light. In assessing what's right and wrong with executive compensation, it is critical to establish a sound base of facts. In our presentation we identify and clarify two important issues in executive compensation that have caught the public's attention: **CEO Pay Ratios** and **CEO Pay Increases**.

### **CEO Pay Ratios and Long-Term Trends**

It is often cited in the press that the ratio of average large-company CEO's pay to the average American worker has grown three-fold over the past decade, from about 140x in 1994 to about 430x in 2004<sup>1</sup>.

The calculations behind these statistics have been chosen to produce high CEO pay ratios for maximum propaganda value. **First**, they include realized option gains, which are the payoff from many years of grants and rising stock prices. They are not representative of a single year's compensation. **Second**, they focus on *average* CEO pay, not the *median*. Average pay is inflated above true compensation norms by a few outliers. **Third**, they compare CEO pay to the average pay of production and non-supervisory workers who, unfortunately, have not benefited from trends in the U.S. and global economy as much as other American workers.

What might be a better way of calculating the ratio of CEO pay to average workers? We propose using the **Mercer Human Resource Consulting's CEO Compensation Survey**. It is a large, stable group of 350 companies in diverse industries and sizes, and the data have been collected consistently since 1992. With funding support from Business Roundtable, we accessed this database on CEO pay and asked Mercer to calculate **median** CEO pay (not average), and break it down by component, namely, median base salary, median annual cash pay (salary plus earned bonus), and median total pay (annual cash pay plus stock options and other long-term incentives). For stock options, we had them substitute Black-Scholes option grant values for realized gains. These better reflect the intention of board compensation committees in setting CEO pay levels, and new SEC definitions of total pay.

For the average production worker's pay, we substituted the median annual earnings for individuals ages 25-64 who worked full-time for the full year.<sup>2</sup> This is more representative of the average American worker (blue collar and salaried) and comparable to CEOs, who also work full time and year round.

What was the result? The CEO pay ratio was **90x in 1994**, not 142x as reported by pay critics. And it rose to **187x in 2004**, not 430x. This is a **two-fold increase** over the period, not three-fold as usually reported. The estimated ratio actually went down to **179X in 2005**, as median total pay for CEOs declined slightly to \$6.8 million from \$7.0 million.<sup>3</sup> The CEO pay ratio actually peaked in 2001, following the peak of the tech bubble. The fact that the CEO pay ratio has been trending below its peak level for four years running has not been reported in the press to our knowledge. It is possible that the critics of executive pay levels and practices use pay statistics selectively and only when it portrays CEOs in a bad light.

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<sup>1</sup> "Executive Excess 2005," Sarah Anderson and John Cavanagh, Institute for Policy Studies; Scott Klinger and Liz Stanton, United for a Fair Economy.

<sup>2</sup> Census/Bureau of Labor Statistics.

<sup>3</sup> 2005 worker earnings statistics are not yet available from Census/BLS, but by aging 2004 earnings at just 1.3% (i.e., equal to rate of increase from 2003 – 2004) the ratio decreased from 187x in 2004 to 179x in 2005.

A chart of CEO pay ratios over an 11-year period using these more-defensible statistics from Mercer Human Resources Consulting is shown on **Exhibit 1**. You'll note in looking at this chart that: (1) the CEO **salary multiple** has hardly moved; it was 24.9x 11 years ago, and it was 25.5x in 2005; (2) the CEO **total cash ratio**, reflecting annual performance bonuses, moved up one-third from 46x to 63x; but (3) the big increase over the period came in the form of at-risk stock option and other equity grants, tied to market appreciation, which raised the **CEO total pay ratio** from 90x to 179x over 11 years, a growth rate of 6.5% per year.

This situation of increased performance-based incentives and at-risk equity grants is quite different than just saying that CEO pay went through the roof at the expense of the average worker.

Now I would like to address the second part of the problem with the CEO pay ratio debate. Regardless of the ratio used, whether 430X, 500X, or 179X, it only applies to the CEOs of very large companies. The public has been subject to such an incessant drumbeat of negative criticism about escalating CEO pay that it now accepts as given that all CEOs are paid "too much."

Even The Wall Street Journal reported as "fact" on January 31, 2005, that "*The average CEO's salary in the U.S. is 475 times greater than the average worker's salary.*" This is patently absurd. There are approximately 15,000 public company CEOs in the U.S. and many more heading private companies. The WSJ later corrected its error by stating, "A Towers Perrin study found that the total compensation of the **average chief executives in the U.S. in 2005 was 39 times the compensation of the average worker**, while the average CEO of Standard & Poor's 500 companies made 212 times the average worker. This article incorrectly said that the average CEO salary in the U.S. was 475 times the average worker's salary."

Note the errors committed by The Wall Street Journal. They used a statistic from a small sample of very highly paid CEOs in very large companies and made the reader believe that *all* CEOs are overpaid. And they took the CEO's *total pay* and called it *base salary*, having you believe that CEO pay is not at risk or variable with performance.

### **CEO Pay Increases**

The Committee's statement regarding "The Problem of Executive Compensation" cited a 30% increase in median CEO compensation and 91% increase in average CEO compensation in 2004 (Corporate Library)<sup>4</sup>.

The distorting issues are similar in this case. **First**, realized option gains and payouts of other long-term incentives were included, so compensation may represent the payoff of many years of service and not a single year's compensation. **Second**, average increases are misleading because they are skewed by outliers. The sample was defined as "2000 of the largest US corporations", but the 91% increase in the average was driven by just 27 CEOs whose increases were over 1,000% because they were off a very low base.

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<sup>4</sup> "Corporate Library 2004 Pay Survey" Paul Hodgson

A more meaningful baseline statistic was constructed using the same Mercer Human Resource Consulting's CEO Compensation Survey referenced earlier. We found that CEO total compensation increased 13% in 2004 and decreased 3% in 2005<sup>5</sup>. For reference, Corporate Library found that median CEO compensation increased 11% in 2005 (down from 30% in 2004).

We found CEO total compensation to have a 5-year compound annual growth rate of 5.5% and a 10-year compound annual growth rate of 9.6%, reflecting changes in the size of companies and their financial and market performance.

Detailed data are provided in **Exhibits 2 and 3**.

### **Conclusions**

Public debate on CEO pay would be enhanced if all parties agreed to: (1) use large data bases of companies, like Corporate Library, and use them consistently over time; (2) use the grant date present value of new stock option grants, not realized gains; (3) focus on market medians, not averages that are distorted by outliers; and (4) report the results consistently every year, whether or not they support a particular point of view.

This more even-handed approach, however, may not serve the purposes of those who attack CEO compensation as a means of undercutting the trust of the American people in our system of board governance. It is likely the critics will continue on their path of selective and distorted reporting of CEO pay abuses. If so, we should expect and welcome the business community to defend itself by:

1. Countering misleading facts with better facts,
2. Advocating pay for performance and executive ownership,
3. Extending performance-based compensation broadly in the organization, and
4. Promulgating and defending best practices, while marginalizing and excoriating bad practices.

Are there CEO pay abuses? Of course there are, just as there are abuses of power in all large institutions. If there was not the potential for abuse in our free enterprise system, we would not have a free enterprise system. The job of those who defend our systems is not to defend the abusers but to encourage the adoption of evolving best practices in corporate governance and executive compensation so that additional and burdensome regulation is not required

### **Comments on "The Protection Against Executive Compensation Abuse Act"**

We do not believe the proposed Act is necessary or desirable. We favor full disclosure of top executives' compensation along the lines of the SEC proposal. This is well underway and will happen.

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<sup>5</sup>All incumbents; continued incumbents increased 17% in 2004 and 1% in 2005.

We do not support requiring shareholder approval of an "Executive Compensation Plan." This usurps the traditional role and responsibility of the independent board of directors acting as the shareholders' representatives. Shareholders already are required to approve the use of equity in compensation plans. Combining this with enhanced SEC disclosure of all executive compensation (cash, stock, benefits, SERPs, perks and other special benefits, and termination/change-in-control payments) is all that is needed to give directors the added discipline and incentive they need to reform bad practices and adopt good ones.

Disclosure of performance measures or targets used to determine top executive compensation is already part of the proposed SEC rules. And requiring companies to "claw-back" incentive payments based on fraudulent accounting is already part of the Sarbanes-Oxley Act.

### **What Would Be Helpful?**

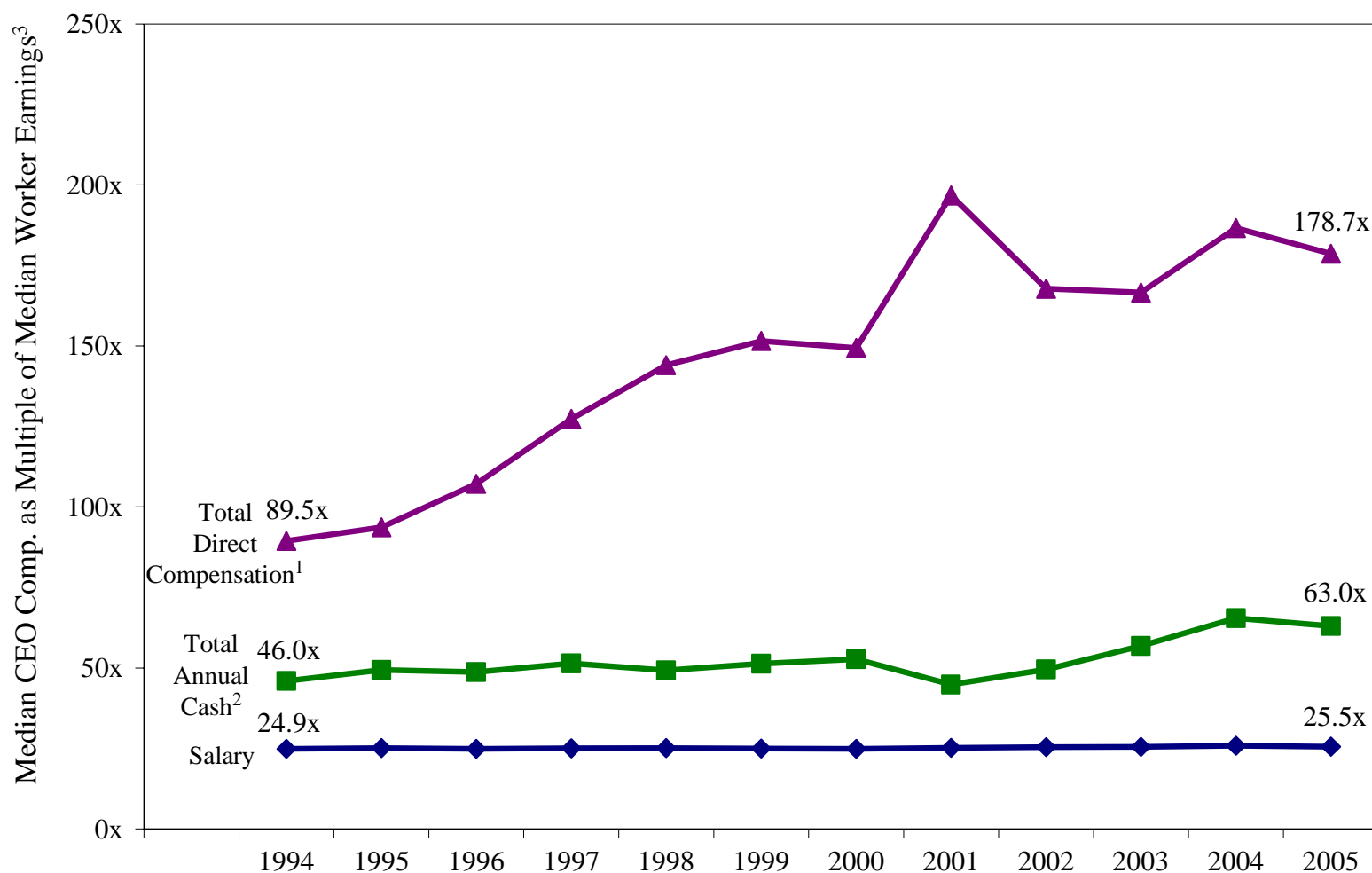
There are areas where your Committee could be helpful to boards and managements. This includes governmental action to encourage the adoption of good practices by reducing the tax incentives for perks. You also could encourage the spread of concepts of performance-based compensation and equity incentives to lower levels of the company, thereby narrowing the CEO pay gap in companies, not by lowering the top, but by raising the bottom.

I would be pleased to advance these ideas with you in a follow-up memo or discussion if desired.

Thanks you,

Frederic W. Cook

## CEO Pay Ratio (vs. Worker Earnings)



<sup>1</sup> Salary, earned annual bonus, grant value of restricted shares and stock options, and target value of earnout of any other new performance-based cash or equity awards

<sup>2</sup> Salary and earned annual bonus

<sup>3</sup> Wage and salary for full-time workers ages 25-64 who were employed for the whole year.

Source: Mercer 350 database (350 large-cap general industrial and service companies with median revenue of \$10 billion); U.S. Census/BLS

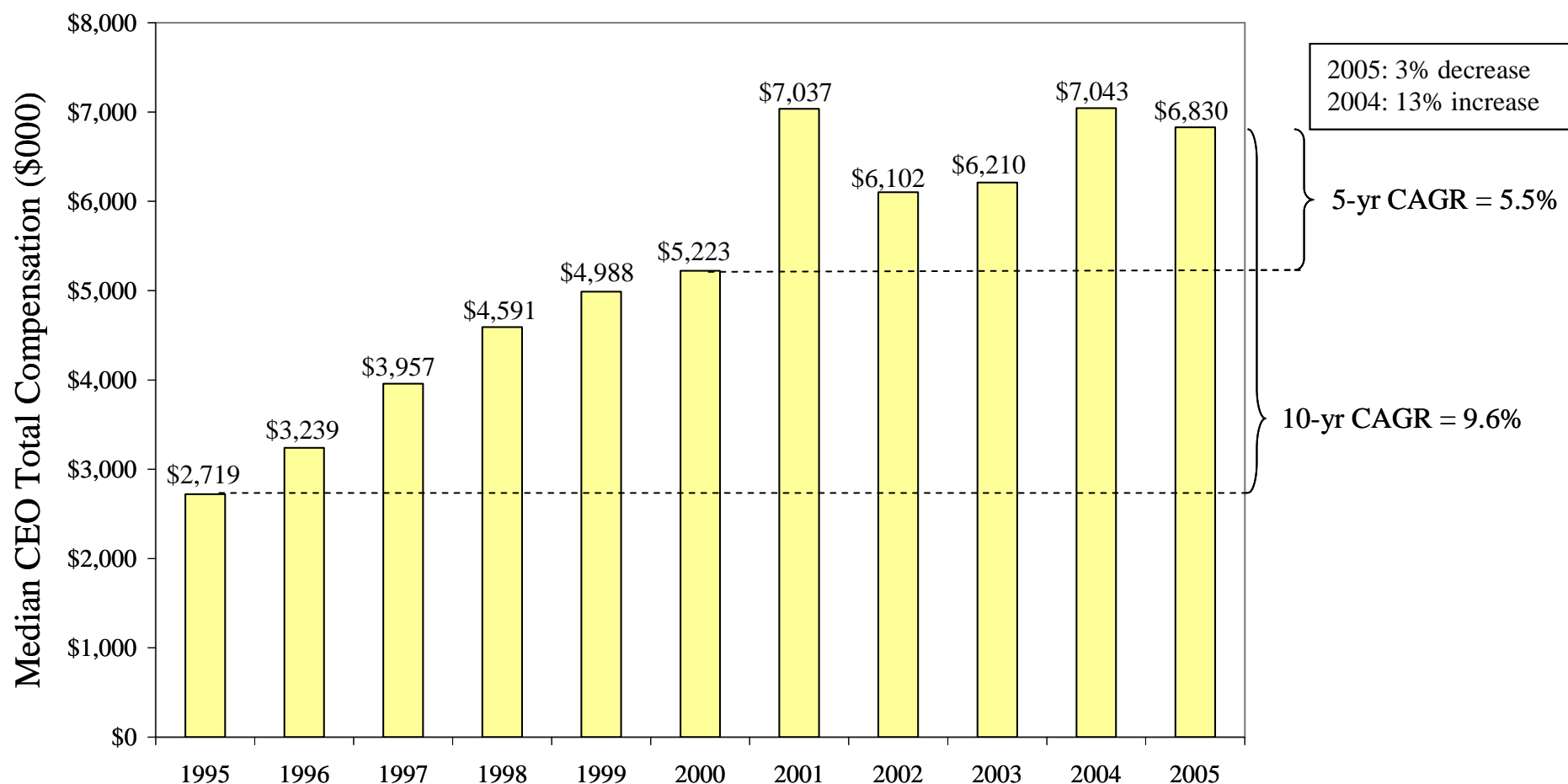
**MERCER MEDIAN CEO PAY TREND DATA**  
(\$000)

	<b>1995</b>	<b>2005</b>	<b>CAGR</b>
<b><i>Mercer 350 Median CEO Pay (\$000)</i></b>			
1. Salary	\$729.0	\$975.0	3.0%
2. Bonus <sup>6</sup>	703.0	1,433.7	7.4%
3. Long-Term <sup>1</sup>	<u>1,287.5</u>	<u>4,421.5</u>	13.1%
4. Total	\$2,719.5	\$6,830.2	9.6%
<b><i>Mercer 350 Median Financial Metrics (\$mil)</i></b>			
1. Revenue	\$5,055.7	\$7,627.5	4.2%
2. Net Income	261.5	590.5	8.5%
3. Market Cap	4,324.6	10,078.4	8.8%
4. TSR Index	1.00	3.32	12.7%

<sup>6</sup> Derived median

## Growth in Median CEO Total Direct Compensation

- Total compensation includes salary, earned annual bonus, grant value of restricted shares and stock options, and target value of earnout of any other new performance-based cash or equity awards.



Source: Mercer 350 database (350 large-cap general industrial and service companies with median revenue of \$10 billion); all incumbents.