Executive Compensation
Frequently Asked Questions

1. What is "executive compensation"?

Executive compensation is simply the financial reward given to an executive for his or her services on behalf of his or her organization. It is earned income, because it is paid, usually after the fact, for services rendered to the organization and can be distinguished from unearned, or passive income, resulting from, say, stock dividends or bond interest, which typically require no effort by the recipient.

2. What types of organizations pay executive compensation?

Pretty much any organization which has one or more executives. This means, for example, that an executive working in a large, publicly-traded company; in a small, closely-held family business; in a public charity; or in a private foundation can be the recipient.

(Public charities and private foundations are commonly tax-exempt organizations subject to unique rules on "intermediate sanctions" and "self-dealing," respectively. Here, we'll focus instead on the general case of for-profit, or commercial, enterprises.)

3. What does executive compensation consist of?

Overall, executive compensation involves one or more of:

- Salary,
- Bonus, or annual incentive, and
- Long-term compensation

(We are not including benefits and perquisites, which vary so much from person to person and organization to organization. They are a better subject for another FAQ.)

4. Where does executive compensation fit within a company?

Generally, with any desired executive or officer position. To Illustrate, executive compensation can fit within and down an enterprise like this:

CEO
President
C-Level Officers (COO, CFO, CIO, etc.)
Vice Presidents (EVP, SVP, VP, etc.)

5. What is covered by the term "salary," and how is it paid?

Salary, or base salary, is a component of compensation, usually expressed in annual terms and paid periodically in cash. It can be received when earned or deferred, if permitted by the company.

Since salary is invariably fixed by contract, it is one component of compensation---the only one, in fact---that is not at risk. Consequently, the at-risk segments of executive compensation, such as bonuses or option grants, are commonly formulated as a percent of salary or as a multiple of salary, respectively. Similarly, executive severance packages are typically defined in multiples of annual base salary.

6. What is covered by the term "bonus," and how is it paid?

A bonus, or annual incentive, is paid in cash and based upon a cumulative twelve-month period of performance. Executive performance is frequently expressed in language such as:

- Threshold – the minimum performance necessary to receive any bonus (and usually a small one, at that)
- Target – a good performance, meeting the company's expectations and justifying an average bonus level
- Excellent – an outstanding level of performance, meriting a comparatively large bonus

Although bonuses were often awarded with discretion as to the executive and the amount granted, today bonuses are more commonly awarded according to explicit, pre-determined performance measures and standards, with limited, if any, room for subjectivity. Such criteria can include both financial measures, relying upon some measure of accounting profits, and non-financial personal measures. They can be very attractive to less risk-averse, more entrepreneurial managers.

7. What is covered by the term "long-term compensation," and how is it paid?

Let's be clear: "long-term compensation" does *not* refer to retirement pay. Retirement plans are, instead, a benefit rather than a part or form of ongoing executive compensation.

Long-term compensation is an incentive payment made, usually in other than cash, for an executive's efforts over a period of longer than one year. The frequently stated objective of long-term compensation is to align an executive's focus and compensation with the long-term objectives of the corporation and rewards to its shareholders. Thus, it acts as a counterbalance to the myopia that can result if corporate officers devote too much attention to satisfying their bonus criteria. As with bonus payments, long-term incentives can be attractive to entrepreneurial executives.

Common long-term incentives include:

- Stock options
- Restricted stock
- Phantom stock
- Stock appreciation rights
- Performance shares
- Performance units

A company need not elect one of the above to the exclusion of any others; a well-conceived executive compensation plan can include more than one of these items.

8. What does a total package of executive compensation look like?

Because of the complexity of setting the design of the selected executive compensation components, they are usually governed by a compensation philosophy expressed in a compensation program. This is how it might work out in practice over one year:

Salary	$300,000	
Bonus	+150,000	(50% of salary)
Long-term compensation	+590,000	(3-year total)
Total	$1,040,000	

Figure 1 shows such a program in action over a period of years.

9. Who is responsible for an executive compensation program?

Especially in light of recent federal legislation and rules, the best party is the board of directors, particularly a compensation committee within the board. Because executive compensation has evolved over the years into a sophisticated endeavor requiring the assistance of dedicated experts, the design and implementation of an executive compensation plan is usually assigned to compensation consultants, who report to the board.

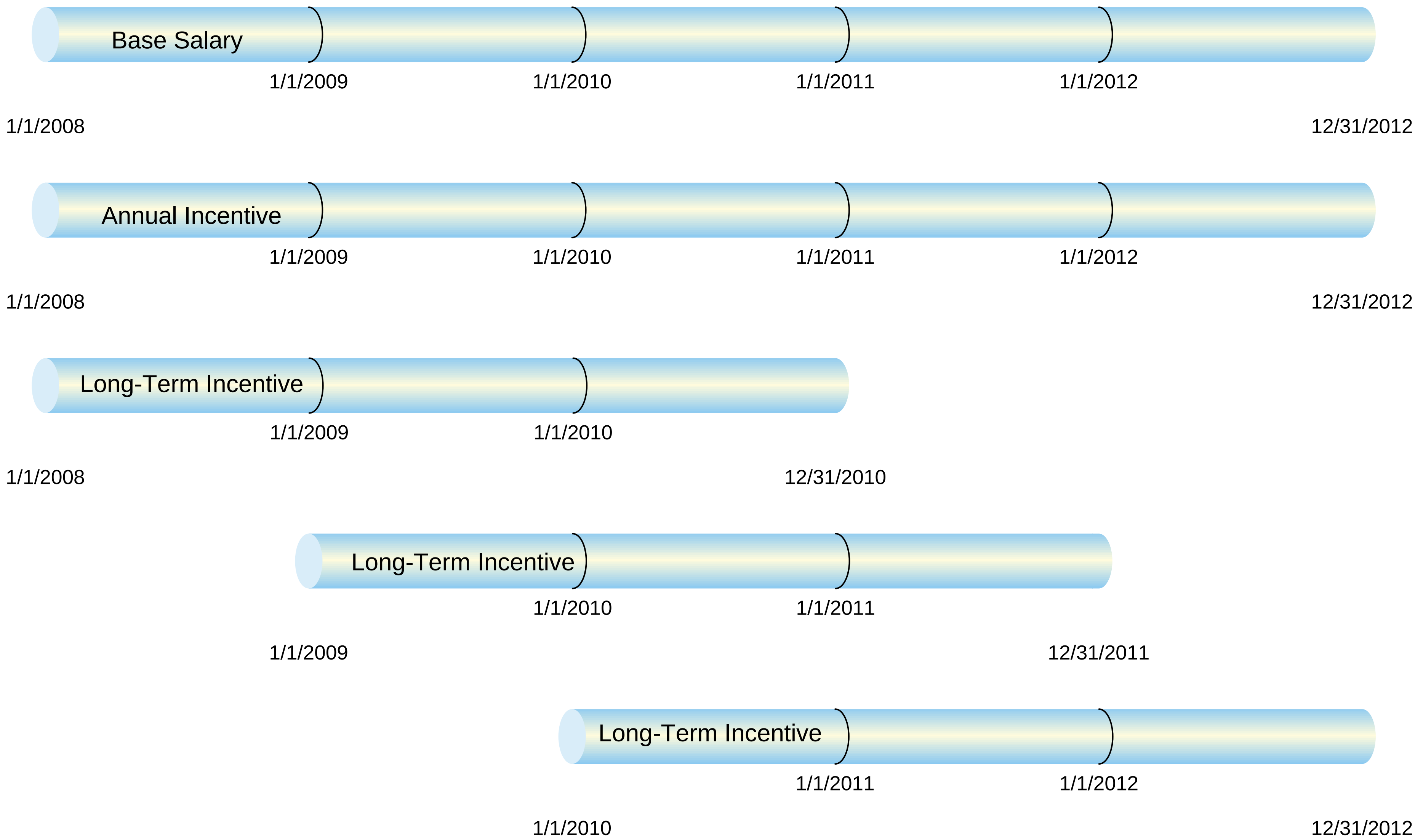

Figure 1: Interplay of Components of Executive Compensation