HaRe Group newsletter: **5 February 2006**

Subject: **Executive bonus flood**

A recent BRW article included the following quote from PwC: **95% of chief executives received their full bonus amounts in 2005**. In most cases, this flood has been triggered by the profit performance of many Australian companies during last year.

While the greater remuneration cost would have been funded by company profit, there remains the question of *HOW* the incentive plans deliver a maximum payment to so many CEOs – and *IF* the incentive plans help improve the sustainability of company profit.

In my experience, many incentive schemes are just elaborate profit share plans – ie. the greater the profit, the greater the bonus payment. Very often, profit targets are set in isolation of market performance, so when an industry as a whole is booming (like the resources sector), executives can receive bonus payments irrespective of the performance of their industry peers. Bonuses are usually calculated using internally derived forecasts.

For example, if profit is measured as a percentage of revenue and the bonus is a percentage of the Fixed Remuneration Package:

Company X	Profit	Bonus (% of FRP)
Forecast Threshold	7.5%	10%
Forecast Target	10%	25%
Forecast Maximum	12.5%	50%
Actual	14%	50%

Industry Profit Actual
P25 = 10%
Median = 15%
P75 = 20%

In this example, actual profit exceeds the forecast maximum, but industry performance has boomed and Company X's performance is under the industry median. In this case, the executive still receives his maximum bonus payment. Such a simple plan fails to benchmark industry performance and does not consider what creates sustainable profit – eg. customer strategy, product innovation and streamlining business processes.

However, while the current market trend is so strongly profitable, the simplicity of many incentive plans seems to be acceptable to most shareholders who vote at AGMs. Everyone is a winner, so where is the hitch? No doubt, problems will arise when:

- market trends are not so favourable;
- competition strategies are inevitably exposed for their weaknesses;
- there is insufficient differentiation in pay between truly talented people and other "average" performers.

Simplistic incentive plans are not sufficient to properly reward the talented executives who are needed to create sustainable value – they will expect to be fairly paid for their contributions to business success. However, many companies still operate without a reward strategy and have difficulty defining the links between executive performance and business strategy that should underpin incentive pay.

With a properly aligned reward strategy in place, most companies will benefit from short-term incentive plans that do more than share company profit – an incentive plan should always focus executives on the things that matter most to sustaining company profit; ie. the long-term *DRIVERS* of profitability.

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