HaRe Group newsletter: 13 October 2003

Subject: Executive pay update

From time to time, there are media reports that provide worthwhile information on developments in executive pay. This email summaries two recent reports and includes comments on market trends.

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Executive pay justified?

On 11 October, The Age published a Business Roundtable report on a discussion with Don Argus, Michael O'Sullivan, Ian Ramsay and Graham Kraehe, which included these observations (paraphrased and ordered by topic):

- most of the top ASX100 have international operations - we cannot expect to keep the best executives in these companies if we don't pay globally competitive salaries
- boards cannot control the premium that the market attaches to what and where business value is created
- in 1992, (the average CEO) was paid 22 times AWE - s/he is now paid 74 times AWE due to imported global pay trends (see 2nd report below)
- but it's "nonsense" to relate global billion dollar accountabilities back to a basic wage - executive pay growth should relate to business value growth
- executive base pay structures should relate to enterprise value and forward cash flow
- the CEO must have the ability to lead the company, generate growth and generate shareholder value
- the CEO is held solely accountable for the total span of the business - s/he holds subordinate managers less accountable for less distinct parts
- but however good a person is, they cannot be credited solely for adding value
- the top 100 CEO base salaries rose by only 1.9%, but cash incentives increased by 7.6%, and equity by 22% (2001-2002)
- many boards are failing to design an effective alignment of pay and performance
- careful selection and application of key performance indicators (KPIs) should determine incentive payments
- but there is a general lack of evidence that companies succeed in linking CEO pay growth to long term performance
- the alignment is very complex, often involving peer group performances and uncontrollable investor perceptions
- long-term value creation targets should underpin the delivery of long-term incentive payments, but market research says this hasn't usually happened
- disclosure of the top five highest paid executives has pushed up market pay rates and also put pressure on internal pay rates
- a non-binding shareholder vote on executive pay is proposed for introduction next year - current ASX guidelines for disclosure are sufficient

Debunking the myth

In analysing almost 50 annual company reports, The Age (4 October) reported that the average total remuneration for CEOs was almost $3.9 million p.a.. Unfortunately, this statistic is flawed because so much data on bonuses, benefits and shares was shown to be not available. Only 25 companies in The Age's table had data for all remuneration items. The median total remuneration for this smaller group was $2.9 million p.a.; median base pay was about 40% of total remuneration; a median 30% was paid as a bonus.

The Age article also referred to a report for the Labor Council of NSW that claimed no positive correlation exists between executive pay levels and company performance. In part, the report said:

- in 1992, executive pay levels were 22 times AWE, and 74 times AWE in 2002
- very high CEO pay is more often associated with below-par company performance
- shares & options, as a percentage of total CEO pay, have risen from 6.3% to 35% during the decade to 2002
- the average cash payment to CEOs grew twice as fast as the share price of the top 200 companies, during the decade to 2002

The Age also quoted Don Argus: "...the real failure in incentive-based remuneration is in setting key performance indicators (KPIs)...if you get your KPIs right and the weight of the incentives to the long term so that the executive still has skin in the game after he has left, you will get proper decisions made..."

Quoting Jack Welsh again, "by *not* aligning measurements and rewards, you often get what you are *not* looking for."

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