HaRe Group newsletter: **31 October 2008**

Subject: **Executive pay reality check**

What's happening to executive pay practices in this GFC (that's "global financial crisis")?

During the good times (at least the five years up to 2007), local company boards were approving numerous long term incentive (LTI) plans based on share options that could deliver great wealth to their senior executives. Of course, this wealth comes from an ever increasing share price – but what happens when the share market gets stuck in reverse?

In a recent case, a major Australian company paid their executives over $50 million as compensation for the loss of share option value after a demerger. The valuation assumed a generous increase in share price, but the GFC has driven it down by 40%. Compounding this error, the board was advised by its auditor to pay cash, instead of converting the flawed valuation to a grant of shares. It's no wonder the shareholders were unhappy!

With so many executive share options now underwater, there will be many remuneration committees that are tempted to cancel their options plans and establish replacement plans with a far lower strike price. These committees will need to consider carefully the current market volatility and their shareholders' perspective, in the context of their reward strategy, before they take any action.

While every executive pay situation will be different, there are some broad principles that should guide the decisions made by company boards, including:

1. Establish a long term reward strategy that anchors all decisions about fixed remuneration, market pricing, performance measures and incentives. Every organisation must understand its employment brand and its competitive market (local or global) for executive talent and judge what should be done to attract, retain and motivate the best people.

2. Align executive performance pay with the expectations of shareholders – for example, if they expect high growth in share price and market capitalisation, then design share option plans (with performance hurdles) that reflect these expectations; if they expect dividend returns, then design share grant plans (with performance hurdles) – if the reasonable expectations of shareholders are not met, then this should be reflected in incentive pay levels.

3. If expert advice is needed, get it from a truly independent remuneration specialist. Many of our Australian boards take the soft option by accepting advice on LTI design from their local auditors. Best practice is demonstrated by companies registered with the US Securities Exchange Commission that are prohibited from taking such advice from their auditors. (ref: Sarbanes-Oxley Act 2002)

Simon Hare

www.haregroup.com.au