HaRe Group newsletter: **25 October 2013**

Subject: **Executive bonus bonanza – boost or brake**

At this time of the year, AGMs attract a lot of attention for their directors' remuneration reports. In particular, institutional investors get agitated by "undeserved" incentive payments – if a company's financial targets are not met, then any executive bonuses based on "vague" criteria are good reason for putting the brakes on (voting against) the remuneration report.

As I've written previously, the basis for a financial incentive plan is: ***offer employees more pay for achieving agreed objectives and they will focus their efforts on what's important and help boost business results***. The business theory is sound, but the practice is often flawed. In many cases, the performance objectives agreed at the start of a year are too hard, or too soft, or become irrelevant as the year develops. Too often, the formula that determines the incentive payment is so convoluted that the between results and reward are broken.

Of course, most companies feel compelled to have an executive incentive plan because it's such common practice. It's also common for executive remuneration to be measured and compared in total; ie. the sum of all salary, benefits, superannuation, bonuses and long term incentives. Each component is intended to meet particular objectives – for both employer and employee – and the outcome is often a complex blend that shareholders struggle to understand.

Market comparisons of executive remuneration are also complex. While salary, superannuation and other benefits are fixed in current remuneration, bonuses are variable payments that reflect past performance. The reported values of long term incentives are amortised predictions based on several variables that are at the mercy of accounting standards. Nevertheless, regulators demand that remuneration reports add all the components together as if it is reasonable to compare the totals.

The perspective of many executives is probably the same as most other employees – they would like to prevent their total annual remuneration falling from one year to the next. For example, if some factory workers were on a $50,000 wage in 2012, then they would probably want more in 2013, regardless of how their employer fared; likewise, if an executive received $500,000 in 2012, it's reasonable to expect s/he would want the same or better in 2013 – but how accountable should the executive be for the fortunes of the company? Such is the design challenge for company directors.

Executive remuneration design often includes some tension between three objectives: (a) keep the executive focussed on driving business outcomes, (b) keep the executive engaged, and (c) keep good corporate governance standards. Directors will always want to drive positive outcomes, but if there are circumstances they cannot control and the business falters and a key executive doesn't receive a bonus, what is the risk of losing this executive because his annual remuneration falls dramatically? In unpredictable conditions, directors may need to increase fixed remuneration and put less emphasis on short term incentives that are based on soft or vague targets.

In general, incentives make sense when:

- Objectives are properly resourced by the employer and not subject to any unreasonable external interference
- Outcomes will deviate within a range controlled by participating employees
- Funding reflects the organisation's bottom line performance
- Measures are quantitative, impartial and respected by employees

Directors will still need to consider if executives would work that much harder or smarter with a large part of their remuneration held at risk. Corporate governance is another concern of directors that should have its own chapter.

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