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*Following the publication of the Productivity Commission's (PC) Issue Paper on the regulation of director and executive remuneration in Australia in April, a significant diversity of proposals have been submitted to the Commission for its consideration.*

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The PC Issues Paper addressed a number of aspects of the Government's reflection of community concern about the magnitude and nature of executive remuneration. A number of the PC's observations and those included in submissions refer to the significant growth in executive remuneration levels and poor alignment with performance, leading to an observation that bonus payments have come under increasing shareholder scrutiny in recent years and more so recently arising from the global financial crisis.

A report commissioned by the Australian Council of Superannuation Investors also revealed a shift in the proportion of total reward attributable to performance, while at the same time acknowledging a progressive uplift in base salaries. The PC submissions indicate that issues surrounding executive pay have been the subject of doctoral dissertations and academic research, both locally and internationally.

Given the observations arising from this research which revealed a relationship between pay and performance far less than that which might be anticipated on reading the Remuneration Reports of Australia's top 100 companies, Egan Associates (who have maintained collections of disclosures since public disclosure in the late 80s) decided to explore the efficacy of these observations by undertaking similar research dating back to the 2004/2005 period through until the end of the reporting cycle for companies reporting executive emoluments for the period ending December 2008, as well as some trend analysis covering the prior decade.

#### **The Effect of the Rate of Growth**

Given my engagement in remuneration advice through the 70s, 80s and 90s to the present day, I have an awareness of many of the drivers of growth in executive remuneration, not the least of which has been the rapid growth, including an expanding international footprint, of the leading listed companies in Australia.

Immediately prior to the dramatic decline of values in the global capital markets arising from the sub prime financial crisis, the previous decade saw the market capitalisation of Australia's top 50 companies on average increase from \$6.2 billion to \$21.6 billion (as at June 2009 the average top 50 market cap stood at \$15.9 billion). For the top 100 companies the figures are from \$3.5 billion to \$12.7 billion (\$9.1 billion as at June 2009).

Annual revenues of the top 100 companies in the last decade increased from \$2.9 billion to \$7.5 billion, operating profits from \$353 million to \$931 million. This represents a decline on the previous year where the average operating profits stood at \$1.15 billion. Total assets in the same period increased from \$12.6 billion to \$37.3 billion.

By way of comparison the Federal Government's expenditure and receipts in the 1998 financial year were around \$140 billion, increasing to approximately \$295 billion in the 2008 financial year, an increment reflecting marginally in excess of 200% growth.

The graphs following illustrate the significant growth in the enterprise value of Australia's leading companies having regard to key financial metrics rebased to 100 at the beginning of the 1998 calendar year, as well as the incremental adjustment to average weekly ordinary time earnings, the CPI and CEOs' annual cash compensation (fixed annual remuneration together with the value of annual incentives).

When exploring the differential rate of growth in the top 100 companies' level of market capitalisation, their annual revenues and operating profit it is obvious the extent to which in the last five or six years the rate of growth has dramatically outstripped the Consumer Price Index. It is this elevation in scale which triggered the rapid growth in CEO reward.

A key question in the current environment is the extent to which CEO reward reflects the relative decline in profitability, market capitalisation and the value of total assets on a marked to market basis.

Initial evidence is that annual bonus payments in the 2008 financial year mirrored a decline in earnings with the significant decline in operating profit and what is a continuing decline in the level of market capitalisation over the past financial year.

## SERVICES AVAILABLE

Speak to us if you need advice on

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- CEO REWARD STRATEGY
- INCENTIVE PLAN DESIGN
- RETENTION PLAN DESIGN
- EQUITY INCENTIVES
- IPOs

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# CEO Reward Looking Back and Looking Forward

*A key challenge in the immediate future will be the structure of annual incentive plans and the relative weighting of financial returns...*

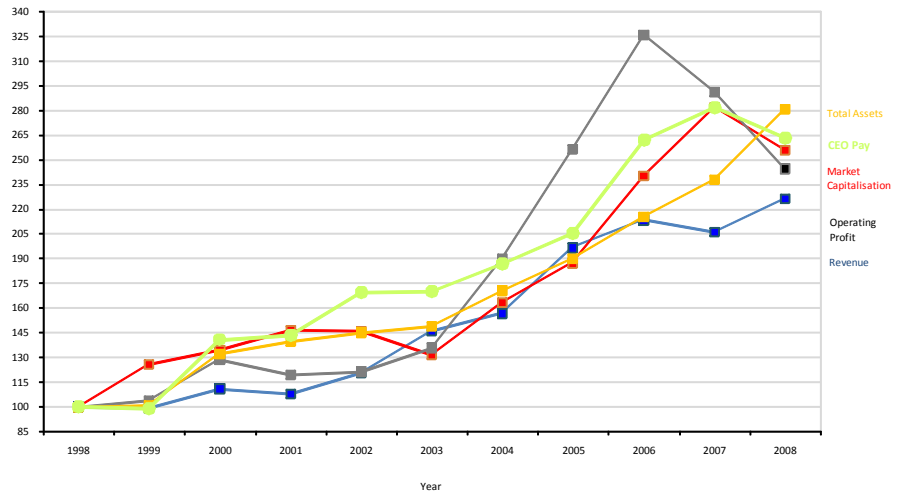
## Structure of Incentive Plans and the Significance of Risk

A key challenge in the immediate future will be the structure of annual incentive plans and the relative weighting of financial returns compared to strategic and operational objectives that might be set for Chief Executives and their direct reports and the prevalence of substantial awards (say between 50% and 75% of a target bonus) being payable at threshold, which in many instances falls 10% or more below budgeted levels of performance.

Equally, in a significant proportion of annual incentive plans, having regard to the achievement of strategic objectives or financial objectives, there has been limited regard to the embedded or underlying risk in pursuing growth. This may prove particularly sensitive given the research where companies have achieved substantial growth in revenue, though in parallel assumed significant increases in debt, and in more recent times observed that the value of assets acquired to secure growth have been marked to market at a substantially reduced value from acquisition cost.

It is in part in considering issues of this nature that we believe board Remuneration Committees will increasingly devote their attention to ensure that substantial bonuses are not being paid for suboptimal performance and when paid have regard to the underlying risk in the achievement of annual results, with increasing consideration being given to the deferral of bonuses determined annually, subject to the sustainability of those outcomes.

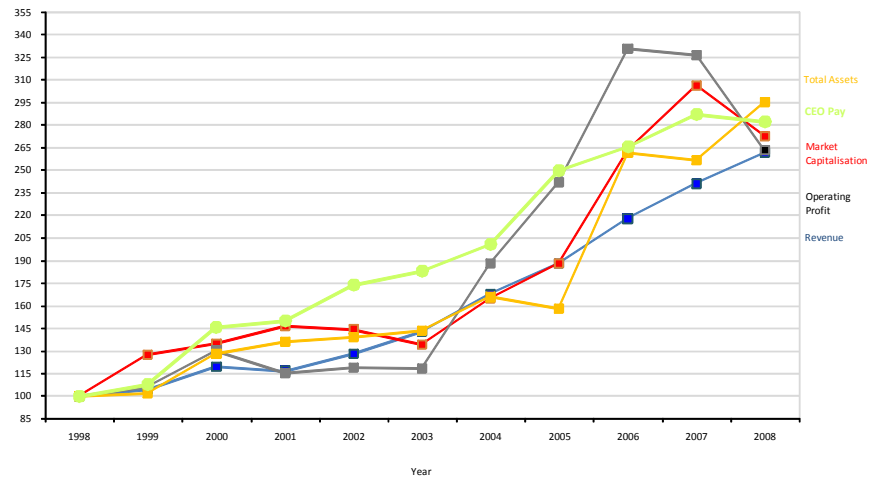
Average of the Top 50 Companies  
CEO Pay, Revenue, Market Capitalisation, Operating Profit, & Total Assets  
30 June 1998 - 30 June 2008



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# CEO Reward

## Looking Back and Looking Forward

A further issue which troubles many Remuneration Committees, and indeed CEOs, where the construct of threshold, target and stretch is embraced under an annual incentive plan is the positioning of threshold in relation to a prior year's performance, the level of payment available for above plan or target achievements and the degree of stretch incorporated before significantly enhanced incentive payments are on offer.

Those companies which have bonus programs which cap pay out on achievement of budget or stretch targets will not face this problem other than to the extent that targets are positioned above prior year results.

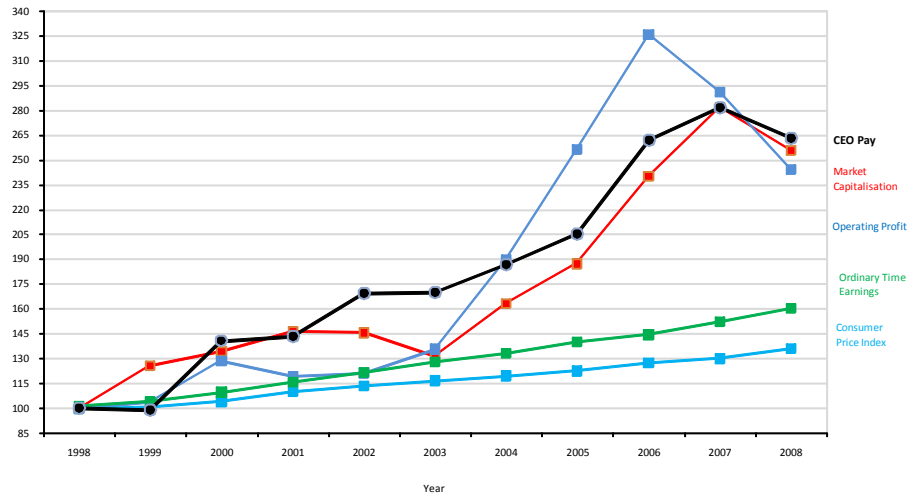
A further question will be the share of profit available to CEOs and others for out-performance, as well as the absolute level of incremental reward opportunity for achieving stretch outcomes.

From a shareholder's perspective, and increasingly the view of boards, significant incentive payments should only reflect exceptional performance where the probability of achieving those attainments is less than a one in five year event and the probability of failing to meet threshold is a one in five/seven year event.

The graphs adjacent indicate the initial impact of the economic downturn, particularly on annual incentive payments.

The graphs do not illustrate the significant loss of opportunity under equity based long term incentive plans arising from the initial downturn in market values reflective of the third and fourth quarters of the 2008 calendar year.

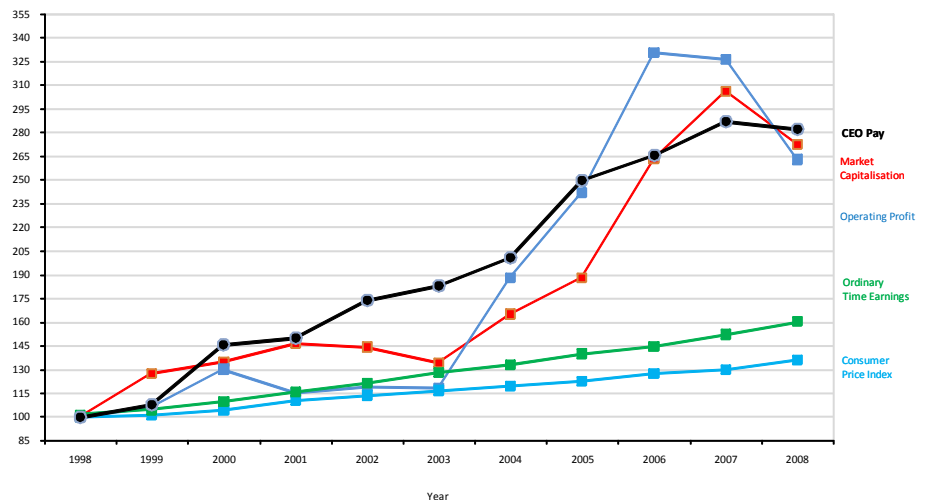
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# CEO Reward

## Looking Back and Looking Forward

### The Measurement of Performance

In parallel with these challenges other issues include the focus of performance measurement under the annual incentive plan, that is group, business unit and individual, and the proportionality between those elements, as well as the key metrics (for example, financial, strategic, operational and leadership) considered to be the primary drivers of value creation. The CEO and board view regarding profit is also critical.

That is, what proportion represents an annuity and/or has to be earned each year.

- What proportion of pre-tax profit should be available company wide for incentive payments?
- Should incentive payments be made in years when there is a decline on the prior year's level of profitability?
- What share of return above an agreed level represents superior performance?
- What proportion, if any, of the annual incentive payment determined should be deferred/banked in order to reward sustainable performance?

We comment further in another paper reflecting our submission to Treasury's consultation process in relation to equity plans on the highly variable impact of performance hurdles required to be met under long term incentive plans in respect of ultimate benefits flowing through to executives, including Chief Executive Officers.

In our judgement not only are there significant challenges in addressing appropriate and well reasoned remuneration for Chief Executives managing organisations of diminished value in the period ahead, there is also a significant requirement, in our judgement, for companies to address performance hurdles in relation to annual incentive plans, as well as the financial opportunity flowing to Chief Executives under these plans, while in parallel reviewing the problematic nature of long term equity based incentive programs having regard to the lottery effect of meeting performance hurdles on the one hand and the unintended consequences of applying accounting valuation standards for the purpose of allocation and risk mitigation on the other.

It is not our view that these matters will be resolved in the coming twelve months, though we do believe it is important that boards devote increased attention to these issues to ensure that the CEO and his or her management are fairly rewarded and appropriately motivated to return value to shareholders in these most challenged times which have not been faced by the vast majority of executives with stewardship of enterprises that are significantly more substantial in scale and valuable to shareholders since the last economic downturn of the early 90s when the average market capitalisation of a top 50 company was around \$2.5 billion compared with the highs of 2007 above \$20 billion and prevailing market values of approximately \$16 billion.

# CEO Reward

## Looking Back and Looking Forward

### Correlates of CEO Pay

Our more detailed research covering the 2006, 2007 and 2008 financial years indicates that annual company revenue is the strongest correlate of a CEO's fixed annual remuneration. The correlation between a company's revenue and its market capitalisation for both the top 50 and top 100 companies is above 0.8%, though the correlation between annual bonuses or incentive payments and operating profits is relatively modest, averaging 0.3 or less than half the correlation between fixed annual remuneration and both revenue and market capitalisation.

The correlation between year on year profit growth and CEO bonus payments over that period was virtually non-existent, averaging less than 0.1. Egan Associates' preliminary research in principle confirms the work undertaken by a number of proxy advisers, the Australian Council of Superannuation Investors and academics. In parallel with this research we are also undertaking more detailed research dating back over an extended period between listed corporations' financial metrics and changes in the level of remuneration of not only the CEO but CFO, second highest paid executive and the top 5 highest paid executives excluding the CEO.

We acknowledge that traditionally, where work value methodologies have been adopted to provide guidance to boards in relation to internal relativity between the CEO and direct reports, and indeed the senior management team, that a key measure of accountability has been annual revenue. This is strongly endorsed in the ranked correlations which we have undertaken in the present research.

My own experience over the last two decades is that work value methodologies have become a less influential point of reference for boards than competitive market influences, where growth in enterprise scale, increased international engagement of Australia's leading companies and the pressure on securing top talent has been a more dominant influence. The level of at risk pay has also increased significantly. It would be surprising to many that the correlation between year on year profit improvement or the absolute level of profit appears to have a poor correlation with actual outcomes on both a current year or lagged analysis basis.

It is equally our observation, particularly over the last decade, that long term equity based incentive plans which have required either fixed rates of earnings growth or relative or absolute growth in total shareholder return has generally ensured that benefits under these plans are aligned to a company's return to shareholders or profit growth. While we acknowledge that there are many challenges in the structuring and allocation of equity under long term incentive plans, the performance considerations have endeavoured to align outcomes with relative or absolute performance improvement.

