

# Managing Salary Increases in Challenging Times

by John Egan

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*In recent years executives and senior management have been the beneficiaries of regular annual adjustments to their fixed remuneration. These adjustments have been in response to the company's preferred market position; the prosperity of the industry sector in which each company operates; the supply and demand for talent, (which has driven variable rates of adjustment at an occupational level, e.g. accountants, IT, engineering, HR and legal); and the general market movement which has been, amplified by low levels of unemployment.*

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Over the past decade the majority of listed companies have embraced a more formalised approach to reward strategy through the establishment of Board committees dealing specifically with executive remuneration. Management submissions to boards have had as a primary focus market movement among comparator organisations for particular management levels, with some focus on specific skills and expertise shortages.

There has not been a nexus between adjustments to executive reward in response to movements in wages arising from AWAs or EBAs. For most organisations the cost of living metric has not been used as a criteria or key factor in the mix when reviewing executive remuneration. Market factors are generally the primary drivers in the rate of increase in executive salaries which has been typically more than double that of the CPI.

**The cost of living metric has almost disappeared as a key factor in executive remuneration, as the rate of increase in executive salaries in recent years was typically more than double that of the CPI.**

In the present era of uncertainty, volatile sharemarkets, tightening of credit, increased cost of funds, global trade uncertainty and a growth in business failure, boards in adjudicating on executive reward face a very different market. The management teams within many organisations are today essentially populated by executives with limited previous exposure to significant economic downturn and clearly no exposure to recent market volatility. The IMF recently described the global economic environment as the most challenging in six decades.

In the current environment companies in the financial services sector and businesses which are highly leveraged have faced greater difficulty than many others. Within the resources sector demand for many commodities is falling along with prices, while infrastructure and construction (as distinct from home building) is still experiencing a degree of growth in revenue and earnings.

Other industry sectors across the landscape of enterprise in Australia are reporting variable performance in the 2008 year and variable prospects in respect of earnings growth in the 2009 calendar year.

At the most recent annual general meetings leading companies are reporting a decline in share value over the previous year and are being exposed to dialogue with shareholders and/or their advisors seeking assurances that executive remuneration is being, and will be managed prudently.

There is an expectation that executive remuneration will be managed in a manner which is responsive to the circumstances of the shareholders, their previous growth and profit record and the prospect of continuing profit growth and returning value to the shareholders.

In the context of the current market and the dynamics within which board remuneration committees and senior executives are required to manage, it is our view that a framework within which to adjudicate adjustments to fixed annual remuneration and short term (annual) or long term (three or more years) future incentive plans, be they equity based or cash based, requires careful consideration.

While the CPI index increase over the 2008 calendar year was higher than prior years it had commenced a significant decline by year end (5% to 3.7%) with the prospect by mid 2009 of being around 3%. Notwithstanding, we do not believe that the CPI should be a key index. Despite the fact that the CPI Index has increased over the past twelve months and with the prospect of it remaining at or around 4% for the balance of the current year and around 3% for the balance of the 2009 calendar year, we do not believe that the CPI should be a key index for the adjustment of salaries, particularly where the executive's base remuneration exceeds \$250,000 and has absolutely no relevance where base remuneration exceeds \$500,000.

The market and talent shortage clearly remains an issue. It is our judgement that shareholders have an increasing expectation that the substantial increases in fixed executive remuneration over the past five or more years have not placed management in a position of disadvantage within the current economic climate.

Shareholders would clearly expect boards to place more emphasis on rewarding management for improving profits while managing growth and returning share values to their former levels safely, though in the shortest possible time.

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*It is our judgement that there is less pressure for a remuneration adjustment for executives with high salaries, than middle management whose fixed annual remuneration is below \$250,000*

We have developed a matrix and a series of modifiers to provide guidelines for boards in relation to their management of current fixed remuneration competitiveness (market positioning), earnings prospects, exposure to sector talent supply and demand challenges and prevailing executive pay levels.

Note the improved net income position of all executives and senior management from changes to the tax rates.

The tables below provide general guidance in relation to the management of executive salary increases in the current climate. These indices have not factored in the improved net income position of all executives and senior management arising from the changes to tax rates and have ignored the Consumer Price Index as having any relevance.

Clearly in preparing this matrix we have also ignored the minimum wage adjustment of July 2008 brought down by the Fair Pay Commission of \$21.66 per week or \$1,126.32 annually taking the minimum annual adult wage to \$28,276.56.

A further factor which could overlay the above indicative fixed remuneration increase would be the executive's current salary level. It is our judgement that there is less pressure for a remuneration adjustment for executives with salaries above \$400,000, than middle management whose fixed annual remuneration is below \$250,000.

Guide to Fixed Remuneration Increases			
	Profit Forecast		
Market Positioning	Increased Earnings	Neutral	Declining Earnings
Top Quartile	0-3%	0%	0%
75 <sup>th</sup> percentile	0-3%	0-2%	0%
Median/Average	2-3%	0-3%	0%
2 <sup>nd</sup> Quartile	3%+	3%+	0-3%
1 <sup>st</sup> Quartile	4%+	4%+	0-4%

The following modifier is suggested as a possible overlay to discount the above increases.

Base Pay Level	Modifier
< \$250,000	Nil
\$250,000 - \$500,000	0.8
\$500,000 - \$1,000,000	0.6
\$1,000,000+	0.4

In addition to the current base remuneration level being a modifier in either having a neutral or diminishing impact, we believe that talent shortage and sector specific recruitment challenges will have the impact of uplifting a general market indicative pay increase requirement.

### Talent shortage is a decisive factor.

Where talent shortage is extreme, we believe the indicative pay increase range should be adjusted to 1.25, where noticeable but not extreme 1.1, where neutral, nil.

### Staff Resource Scarcity

Where industry or sector pressures are leading to contract or international sourcing of staff a further modifier may be required. Where extreme shortages of talent exist, the multiplier would be in the range of 1.25 – 1.5, with noticeable employment pressure between 1.1 – 1.25. Where unemployment is expected to be a sector attribute, the modifier would be 0.5 – 0.8.

While this provides an overlay for consideration in annual remuneration reviews, it is focussed on fixed remuneration or salary.

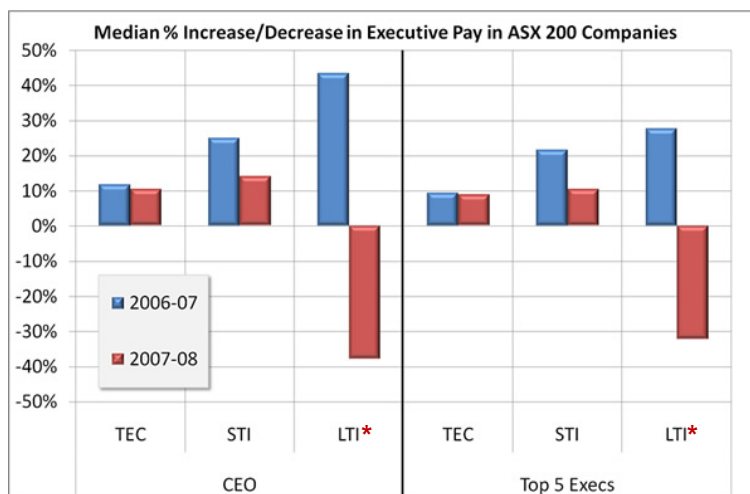
As reflected in many notices of meeting, boards are of necessity reviewing both annual incentive plan participation and earnings opportunities as a result of the relative decline in value of equity based long term incentives.

In this context the prime deliberation is centred on the choice of performance hurdle which will be acceptable to shareholders and not seen as a lottery by executives.

There is no doubt that all companies are operating in challenging times. It is in our judgement absolutely essential that senior management, led by CEOs and boards, adopt appropriate measures and strategies to ensure that legislators do not need to become involved in establishing rules or laws which endeavour to control this key strategic area of executive reward.

### Period of prosperity precedes an uncertain 2009 and 2010.

The following graphic reveals the rate of year on year decrease in fixed remuneration, annual incentive and long term incentive over the past three years. The recent decline in share values further illustrates the strategic reward challenge highlighted above.



\* Remuneration values are marked to market at 31.12.06, 31.12.07 and 31.12.08 - reflecting movement in the value of equity based incentives year on year

