Fifty years of change in Executive Pay structures in Australia

by John Egan

This article is based on material provided to the Productivity Commission in a submission on its enquiry into director and executive remuneration in Australia.

Introduction

Commentary on executive pay in recent times has tended to concentrate on current disclosures and the recent past. This ignores the long-term influences on remuneration and the environment in which they operate. The longer term history of this area indicates that any regulation or 'moral' pressure must be able to accommodate changes which arise in response to world-wide events and developments as well as local commercial imperatives.

Overview

The structure and level of executive remuneration today is a product of a series of sequential influences, including:

- In the 50s and 60s salary and superannuation was assessed having principal regard to internal relativities and adjusted on the basis of CPI movements.
- Perquisites in addition to salary became a significant source of reward outside the income tax structure during the 70s and 80s following unprecedented wage growth as major corporates endeavoured to contain cost while addressing 'net income' internal relativity. Participation in defined benefit superannuation plans remained an increasingly valuable element of CEO and executive remuneration.
- Fringe Benefits Tax (FBT) introduced in 1986 required the total value of cash and benefits (excluding defined benefit superannuation) to be quantified and costed. Executive remuneration progressively became expressed as a composite of salary plus the cost of providing benefits and FBT.
- Remuneration disclosure by bands introduced (late 1980s). The individual benefit value of participation in defined benefit superannuation plans was not captured.
- Remuneration Report disclosures informed the market on individual executive remuneration with varying accuracy.
- Increasing geographic spread of Australian business and the free movement of talent between national markets. Use of equity in dot com businesses during the IT boom brought equity based incentives into sharp focus (1990s).
- Defined benefit superannuation plans replaced by defined contribution plans.
- AASB2 valuation and disclosure requirements assign a cost to equity based incentives (2005^{+}).

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With regulatory and legislative change paralleling the significant internationalisation of many of the nation's leading corporations, the design of executive reward became more sophisticated and to some extent customised to reflect the commercial challenges facing enterprises across all sectors and of differing scale. Remuneration arrangements were disclosed and by the mid 90s equity plans had clearly become the new value opportunity, particularly when performance hurdles were not commonplace and equity was not valued in a consistent way as a component of executive reward.

By 2004 accounting standards had been introduced to address the value of employee equity, that value being ascribed to individual CEO and executive remuneration disclosures. CFOs and their advisers increasingly adopted accounting values of equity instruments as the basis for equity allocation under long term incentive plans. The realised value of vested securities during the sustained share market boom substantially exceeded the remuneration intent and the expectation of all stakeholders.

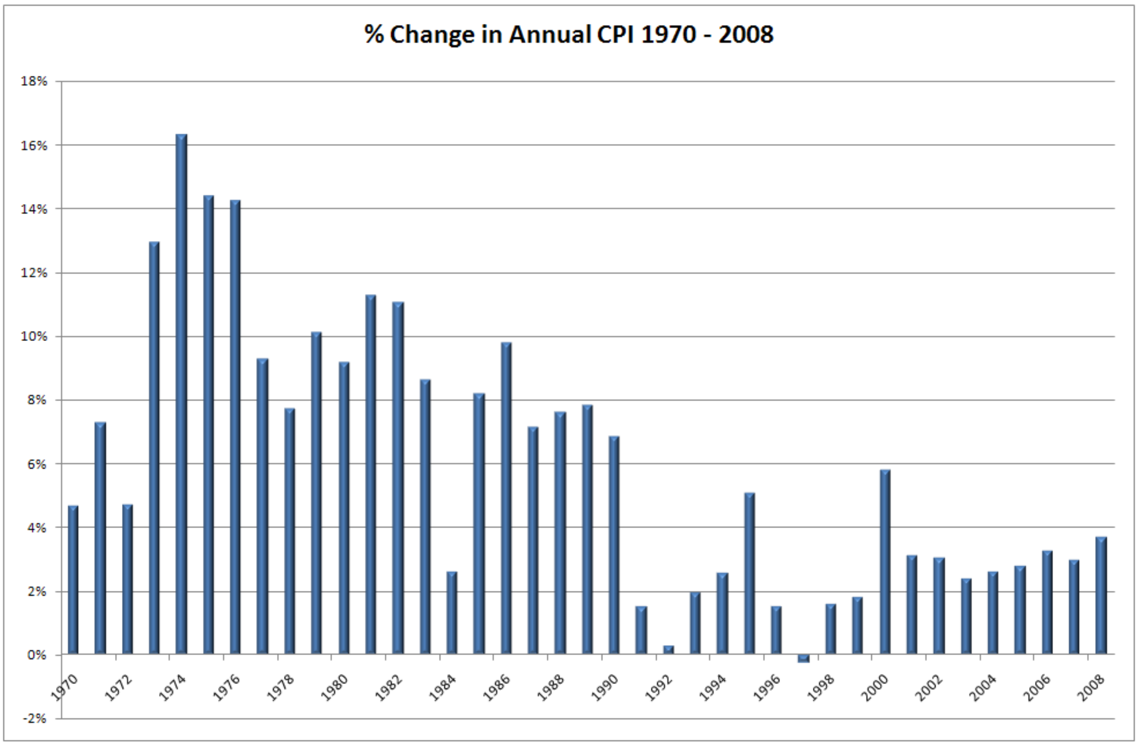
In the 90s and early years of the current decade base remuneration adjustments, while beyond the CPI, were generally contained to single digits. Growth in cash based remuneration arose from a significant uplift in annual bonus opportunities and benefits arising from equity plan participation.

Throughout the past fifty years, and in particular the last twenty-five years, remuneration has proven to be hydraulic in nature, ie pressure exerted in one area of reward always elicits a compensating response in another area as the market adjusts to addressing their sense of competitive pay equity.

Prior to the global financial crisis and stress in the capital markets substantial wealth was created for many executives through their participation in equity plans. In parallel with the crisis the Australian Government found itself facing a near term shortfall in their revenue collections and as a result increased their scrutiny on tax avoidance and/or minimisation arising from employee and executive participation in these plans.

Today, while the Australian Government has not been required to invest capital in the nation's leading companies, they have (in collaboration with their G20 partners) chosen to focus the spotlight on executive remuneration and its impact on all relevant stakeholders, including themselves in respect of their revenue collections.

The following graphs highlight the volatility in economic indicators influencing executive pay decisions over the past forty years.



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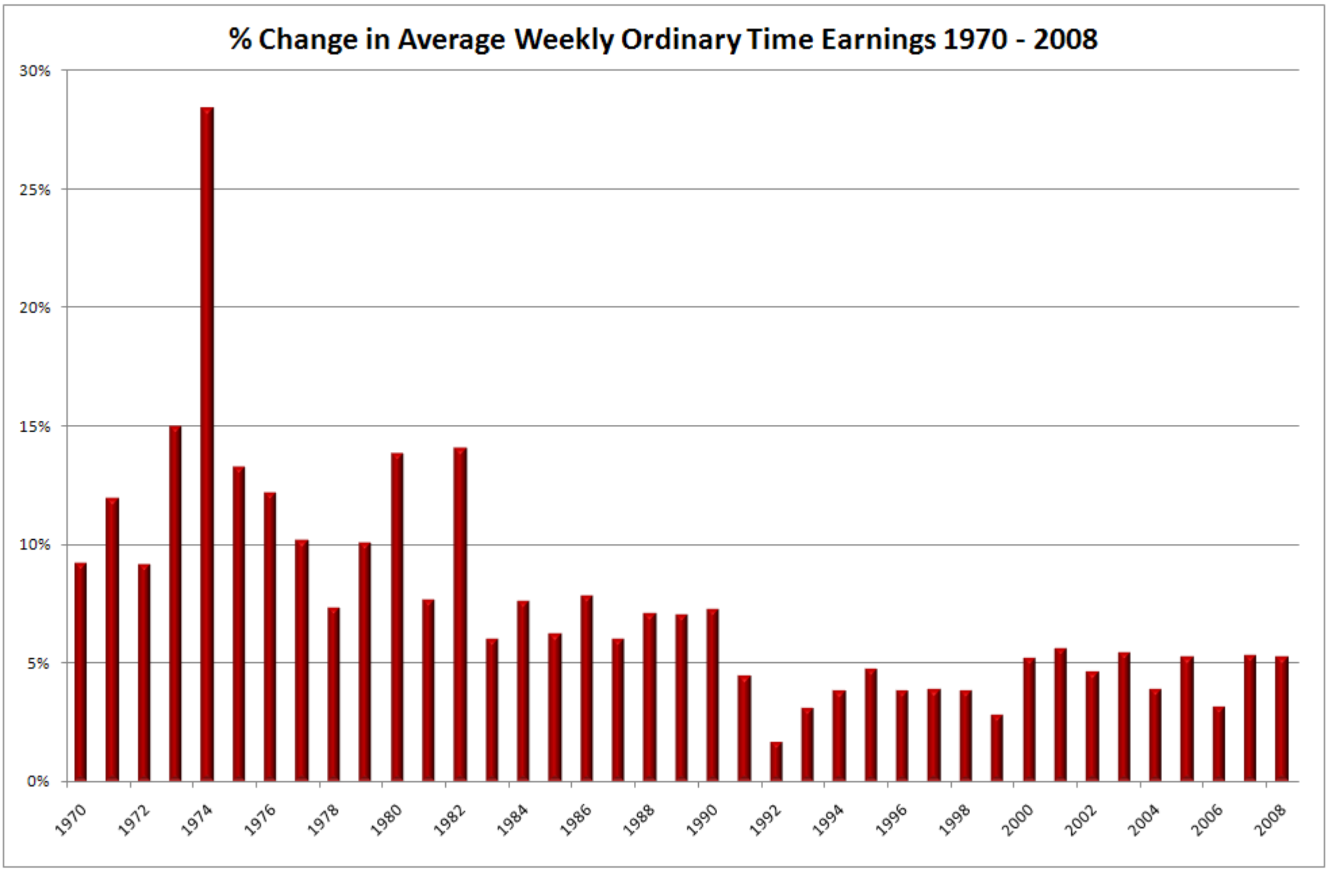

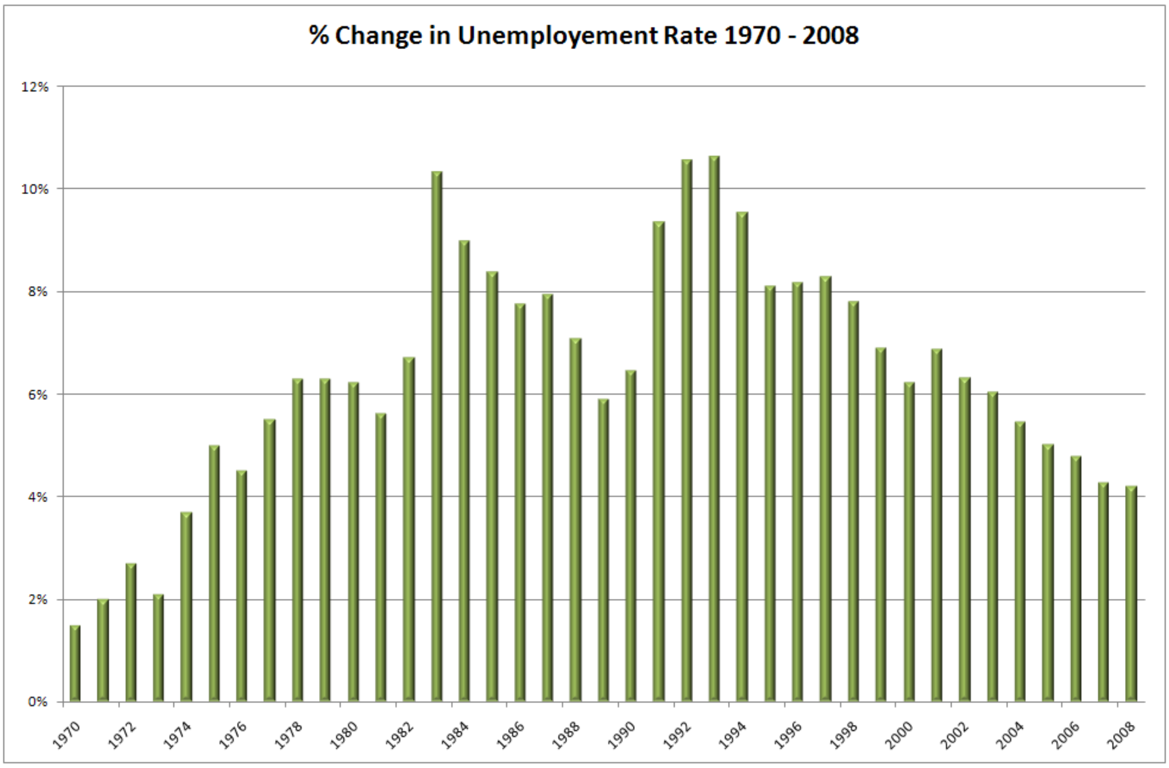

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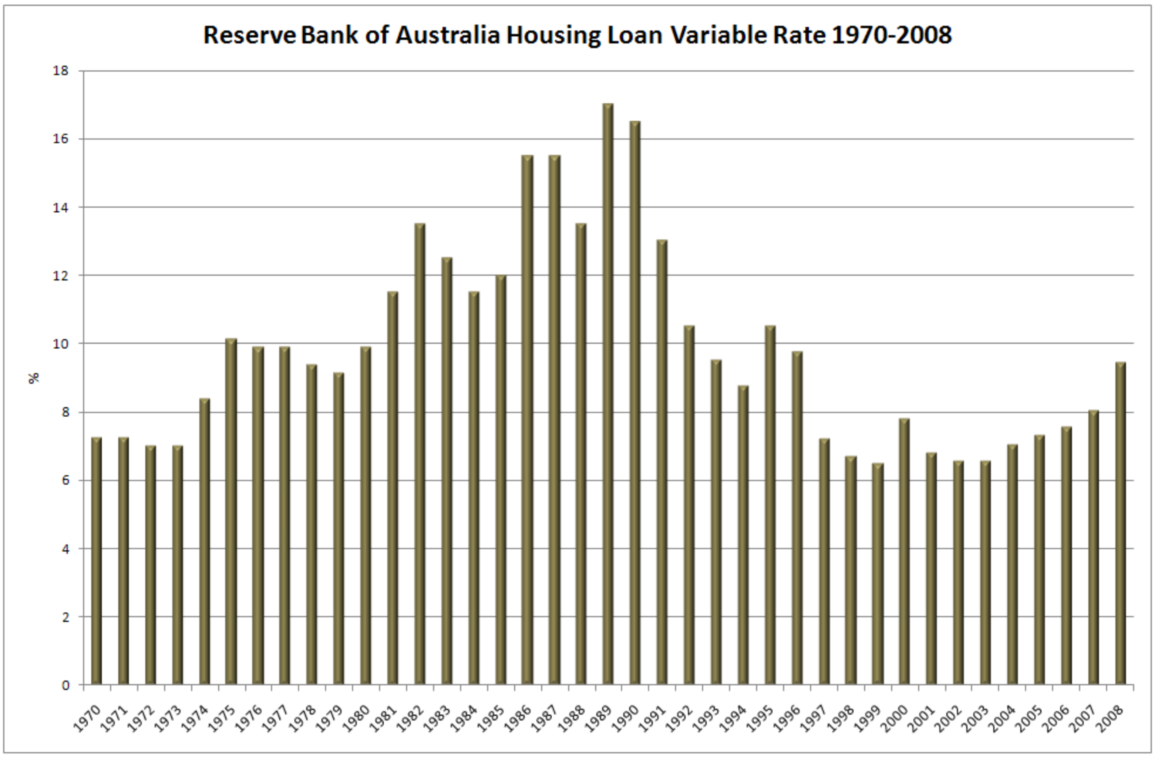
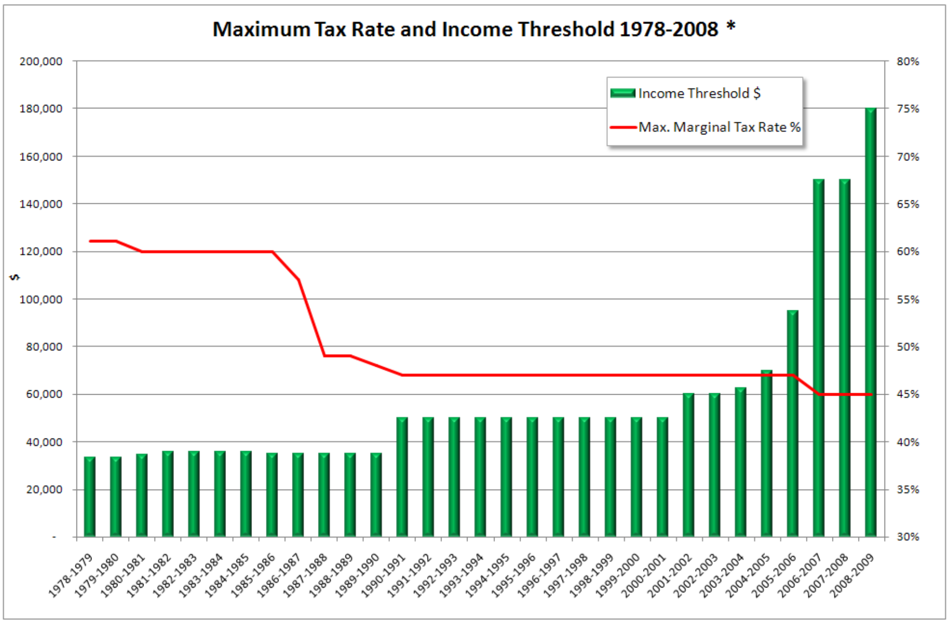


Tax and Government policy initiatives

In Australia over the period, with rising wage levels, particularly in the 70s, governments were forced to reduce both the level at which the maximum marginal rate of tax applied and the level of tax, an approach which has been consistently applied, though not always on a regular basis, for the last quarter of a century. From time to time, arising from rapid wage rates and enterprises' engagement in cost mitigation, there has been an observation by the government that there was a leakage of revenue to the Commonwealth, the most prominent initiatives in this regard being the introduction of fringe benefits tax in 1986 and more recently, in a period of declining Commonwealth revenues, the expression of concern in relation to the leakage of tax and the adequacy of regulations surrounding taxation on employees' participation in share plans.

The table below illustrates the changes in the maximum marginal rate of tax, excluding the Medicare levy, and the remuneration level at which the maximum marginal tax rate applies.



* Excludes the impact of the Medicare levy introduced in November 1986

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The mid 70s to the mid 80s
Trends in executive remuneration

From the early 50s until the 80s there was greater focus on internal pay relativity rather than external pay relativity. In that era, issues of criticality were the cost of living (CPI), movement in average earnings and award rates, unemployment levels, interest rates, tax rates and associated employment cost mitigation. External factors influencing pay decisions related to relative company growth (revenue) together with expenditure, being key measures of executive accountability in work value assessment.

CEOs and their Boards managed to contain executive employment costs during the 60s, 70s and 80s, with marginal tax rates averaging above 60%, periods of CPI growth and average weekly earnings growth above 10%, the latter reaching 28% following the metal trades decision in 1974.

The issue of pay relativity and annual adjustment, both economic and merit, was severely jolted in the 70s by the metal trades award decision which led to underlying annual salary adjustments traditionally aligned to the CPI more than doubling on an annual basis in the latter half of the 70s as the level of competition for talent and a shift toward external market relativity and away from internal relativity gathered pace. The latter was a derivative of sophisticated job classification and evaluation systems, principally adopted by multinationals.

With the introduction of numerous benefits and the commencement by employers to highlight the value of benefits, as noted, including entertainment allowances, spouse allowances, payment for club memberships (both sporting and business), defined benefit superannuation, selective educational and recreation benefits, including use of holiday facilities, attending conferences (both internationally and domestically), companies were able to provide free cash flow or net income benefits through significant tax mitigation.

From the mid 70s to the mid 80s, at the time of the introduction of fringe benefits tax and the emergence of pay disclosures, the tax regime was considered by many to be punitive and led to a flight to benefits.

In the early 80s, with salary levels having increased over the prior half dozen years quite significantly (average weekly earnings increased by 28% in 1974), pay levels for leading executives had broken the $100,000 barrier. In larger companies in the early 80s there was growing evidence of Chief Executives receiving salaries upward of $200,000, with an increasing flow of benefits, including the provision of more than one car, club memberships, entertainment and spouse allowances, attractive defined benefit superannuation contributions, with growing international travel accompanied by spouse.

There were two significant opportunities for the establishment of wealth by the business executive in the early 80s. One was through participation in company share plans and the other significant uplifts in base remuneration to reflect both the growing presence of Australian public companies with an increasing international footprint and in recognition of many leading executives' entrepreneurial flair. The fastest way to achieve wealth creation through share ownership was through the creation of the partly paid share paid to 1 cent, with dividends being minimal and the issue of bonus shares being more frequent among the entrepreneurial companies.

The adoption and rapid growth of the partly paid share and loan backed share survived for a decade from the early 80s through to the economic decline in the early 90s, with options by the end of the 80s taking on an increasing presence in Australia. This was reflective primarily of growing trends in North America and the observation that with significant growth in share prices it represented a meaningful opportunity for the creation of wealth – more than ten Australian companies had a market capitalisation above $1 billion in the early 80s, reaching twenty-four by 1988.

This era was typified by the growth in the entrepreneurial class, the most notable Australian entrepreneurs and astute businessmen including John Elliott and Robert Holmes à Court and, in New Zealand, Ron Brierley. These individuals with growing public profiles, together with the Chief Executives of local public companies, increasingly engaged in complex and significant financial transactions requiring talented team members throughout the 80s.

The 80s saw the beginning of a more sophisticated and internationally aligned approach to executive remuneration structuring and planning with the requirement to report remuneration, though organise it in the most efficient form.

In parallel with these changes, incentive plans, both cash based and equity based, received greater attention from Boards and CEOs and progressively greater prominence as a proportion of total reward opportunity in the next decade.

Tax reform, pay disclosure and FBT

The decade 1978 to 1988 commenced with the maximum marginal rate of tax at 62.9% and finished with the maximum tax rate at 49%, though the reform of tax levels in relation to earned income had a sting in its tail, with the introduction of FBT. The Hawke Government of the day and Treasurer Keating were also observant of the emerging structure of reward, much of which, while benefiting executives, escaped the *'employee tax net'* and led to the introduction of fringe benefits tax legislation in June 1986 in parallel with a shift in the executive class away from managing internal relativity to addressing external competitiveness in a market under-resourced for talent, particularly young executives with international work experience and training. This market sensitivity increased further with the introduction of mandatory pay disclosure in the 1987 and 1988 financial years.

1988 – 1998

Trends in executive remuneration

Given John Egan's engagement in providing remuneration advice through the 70s, 80s and 90s to the present day, Egan Associates' research archives have documented many of the drivers of growth in executive remuneration, not the least of which has been the expanding international footprint of Australia's leading listed companies.

With these changes over the period of the mid 80s through to 1990, the shift in thinking about reward had moved from salary plus benefits to a construct of total employment cost and a recognition by the early 90s that market comparisons needed to address total employment cost, not just salary.

The 1987 and 1988 financial years saw the introduction of a requirement for remuneration disclosure within pay bands which operated in parallel with these changes in reward. Without doubt, prior to the economic downturn in the 1991/92/93 period, disclosure had led to a significant realignment of reward arrangements for executives and CEOs in the Australian marketplace.

Initial disclosures were highly variable in relation to what companies and their advisers incorporated in their disclosed pay bands. Holding company size relatively constant, the gap in the disclosure of the highest paid executive or CEO between the 90th percentile and the market median was quite extraordinary, in many instances the market median represented less than a third of the 90th percentile and a modest proportion of the 75th percentile among the largest companies.

We observe in our research that the growth in senior executive reward over the decade from 1988 to 1997 reflected a virtual doubling of reward, though given the initial gap between CEO pay and their direct reports the actual rate of increase over the period for CEO's direct reports outstripped the CEO. Annual remuneration among the top 100 company CEOs increased from around $460,000 to $900,000, whereas their direct reports on average increased from around $200,000 to $450,000.

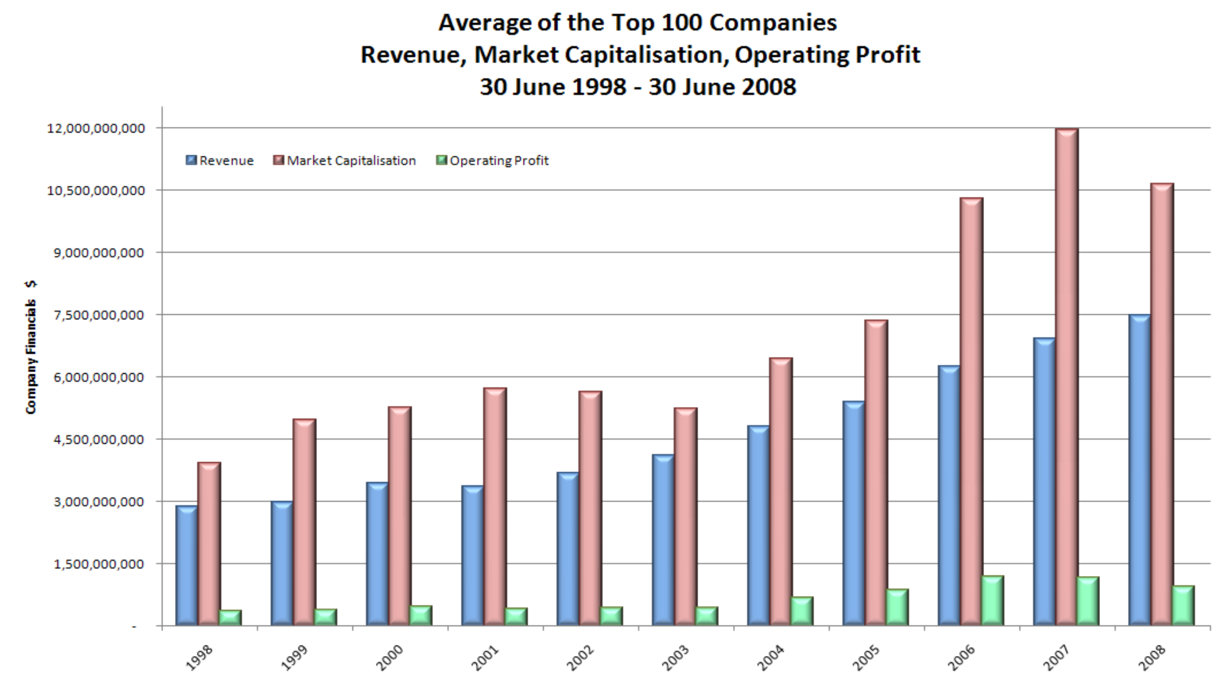
1998 – 2008

The Corporate Environment

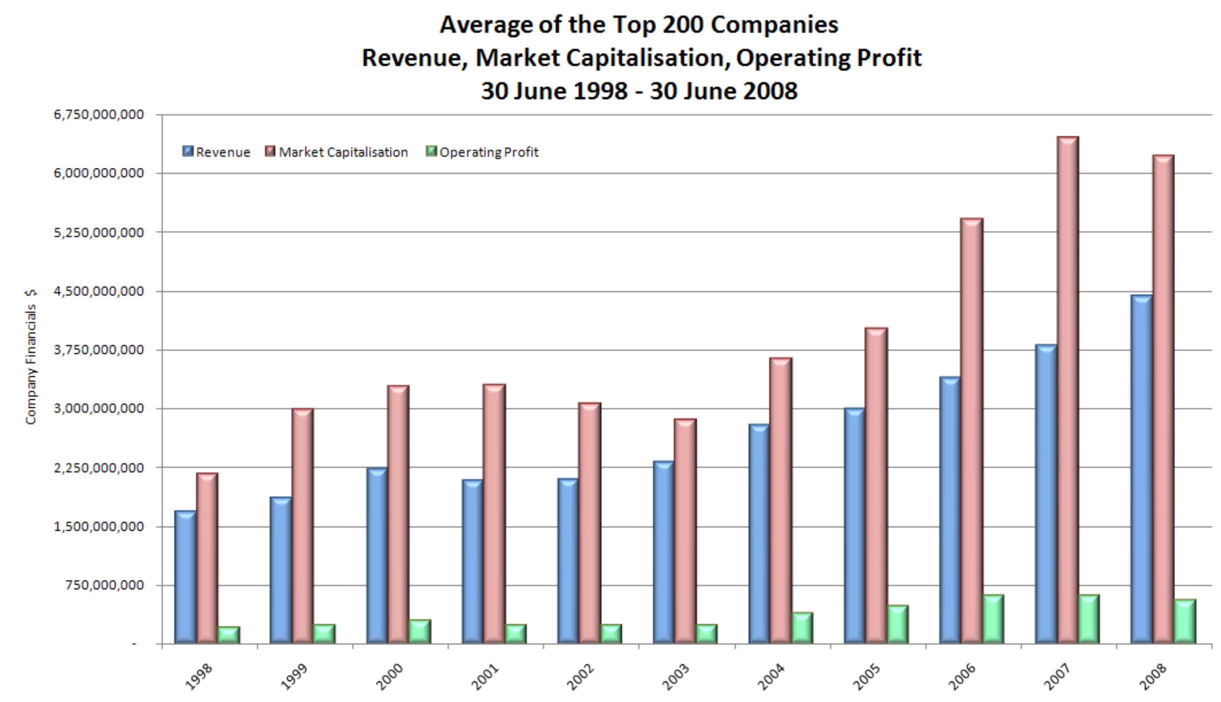
The most significant rate of growth in the decade was in assets under management (funded by significant debt) in Australia's top 100 companies where the value of those assets grew three-fold on average from marginally in excess of $12 billion to in excess of $36 billion.

In the 1998 financial year the average revenues of Australia's top 50 ASX listed companies were marginally in excess of $5 billion. By the end of the decade the ASX 50's average revenues approached $12 billion. Among the top 100 companies the respective figures were $2.8 billion and $7.5 billion. The average market capitalisation of Australia's top 50 and top 100 companies in 1998 stood at $7 billion and $3.9 billion respectively.

By the end of the decade the market value of companies in the above ASX indices stood at $17.9 billion and $10.6 billion respectively (at 30/6/2007 the figures were $19.7 billion and $11.9 billion). This represented a decade of growth in the order of 250% in respect of both annual revenues and market capitalisation.



Companies are ranked as at 30 June of each year (and excludes property trusts, funds, overseas entities and subsidiaries).



Companies are ranked as at 30 June of each year (and excludes property trusts, funds, overseas entities and subsidiaries).

Trends in executive remuneration

The period from the mid 90s until the present day has also been one reflecting a significant decline in defined benefit superannuation plans toward a defined contribution plan and in many instances compliance with the maximum contribution required under the superannuation guarantee legislation.

During this period there has been a significant focus of executives on securing future wealth through participation in equity-based long-term incentive plans, with an influential proportion of senior executives in leading companies investing their personal funds in acquiring shares in their employer as well as holding a proportion of the securities earned under the long term incentive plan for a period well beyond the vesting period.

Our research reveals a decline in senior executive total annual cash reward (fixed annual remuneration plus annual bonus payments) in the 2008 calendar year, reflecting the decline in the annual incentive component clearly responsive to the economic conditions prevailing during the calendar year, paralleling the decline in profitability and market capitalisation of a number of Australia's leading companies.

The data, however, reveals an increase in annual reward opportunity over the decade 1998 to 2007 through both an adjustment to fixed annual remuneration and the receipt of annual incentives in the order of 180% (which represents a compound annual rate of increase marginally less than 11%), representing a significant uplift in the rate of increase of the prior decade, though the data also reveals a sharp decline in earnings in the 2008 calendar year with a relative fall between 20% and 25%.

On the basis of preliminary research in relation to the 2009 financial year ending 30 June, we anticipate a further decline in aggregate earnings across the S&P/ASX 200, with the most noticeable decline being awards made under annual incentive programs during a period when expected corporate returns will be mixed.

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