

# Performance pay: Correlates of reward – a failure in communication

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

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Pay for improved performance has changed not only in quantum but in complexity, requiring considerably more sophisticated analysis and understanding.

Executive performance awards in the 60s and 70s through to the early 80s reflected more of a modest profit share than the outcome of a multi-factor formal incentive program. Progressively from the mid 80s there was an increasing emphasis on profitability and growth in a company's market value.

Growth in executive remuneration reflected an increased emphasis on annual performance awards and an increased focus on equity awards in relation to sustainable or longer term performance.

Over the period from the 80s to the present day the relative importance of base remuneration compared to total reward opportunity progressively diminished and while salaries continued to increase, the growth in reward opportunity was a derivative of executive participation in enhanced annual incentive plans and long term equity based incentive plans, both performance tensioned.

Our research highlights the diminishing proportion of fixed annual remuneration in executive pay since the 80s. This change is highly relevant in the context of the current proposals to limit termination settlements without shareholder approval to twelve months' salary, which represents around 40% of total annual reward.

There was a progressive shift from the early 80s through to the mid 90s and into the 21st century to a more balanced approach to the determination of total annual reward, particularly under annual incentive plans, with multi-faceted performance-aligned reward programs embracing consideration of earnings (profitability), other financial return measures and cash flow, as well as strategic, tactical, operational and leadership factors, with the relative importance of those factors changing from year to year and increasing by level within an organisation as the proportion of the management workforce participating in these programs grew.

Following the economic downturn in the early 90s there was a progressive emphasis on equity-based, long-term incentives and the meeting of performance hurdles, initially related to share price and then progressively total shareholder return and earnings per share, until the second half of the current decade when an increasing number of organisations' Boards believed there was an inappropriate lottery effect in meeting the hurdles being demanded by proxy advisers and institutional investors, primarily representing superannuants.

Implicit in those demands were that half the companies in which executives participated in these programs would not benefit. This became even more obvious when there was broad market opposition to 'retesting'.

By the mid 90s the dominance of the partly paid share plan and loan backed plan of the prior decade had shifted to option plans, though many major companies moved away from options to rights at the beginning of the present decade in managing unexpected gains in the bull market while containing the allocation of securities.

With a relatively prosperous period of growth in executive remuneration after the economic downturn of the 91/93 era, considerable focus on incentive and at risk reward had commenced to emerge. There was an increasing emphasis placed on equity based incentives, the proportion of those incentives growing from less than 15% of total reward opportunity for executives in leading companies to one where fixed annual remuneration (TEC: total employment cost) was commencing to diminish from being above half the reward opportunity to less than half the reward opportunity, with the most significant growth being in equity based long term incentive plans, predominantly in the form of options.

By the end of the decade share rights or performance shares had commenced to overtake options as the favoured equity vehicle under long term incentive plans, as noted above.

At the conclusion of the 90s target annual incentives on average for senior executives were typically in the range of 20% to 35% of base remuneration, with reward for out-performance being pitched at a premium of 150% of the target award. As we approach the end of the first decade of the 21<sup>st</sup> century annual incentive potential, while not necessarily fully realised in the 2008 and 2009 financial years, particularly among Australia's largest companies, has continued to rise.

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While the predominant global comment in relation to cash incentives has focused on annual payments representing many multiples of base remuneration in the global financial community, particularly investment banks, shareholders do have an expectation that directors have a thorough appreciation of at risk performance aligned payments throughout the organisations on whose Boards they serve.

While concern has been expressed with 40% to 50% of profits being distributed to executives in leading investment banking organisations following a traditional Wall Street model, it may well be that shareholders will in future demand a clear statement in the Remuneration Report of the proportion of either pre tax or post tax profit that is being distributed organisation-wide to all staff reflecting at risk performance awards, not simply a statement of the policy applying to the most senior executives without having an understanding of the value of bonus/incentive awards across the companies in which they invest. This information might reasonably be divided into cash based awards, deferred cash based awards and share based awards.

We believe Board Remuneration Committees will increasingly devote their attention to ensuring 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 achievement of continuing growth and sustainability or improvement in shareholder value.

Given APRA's statement of principles, which substantially replicate observations in relation to executive remuneration by the Financial Stability Forum and our own observations of published Remuneration Reports of the ASX 300 and shareholder comment, it is our perspective that many companies have fallen short of meeting their obligations under Section 300A(1)(ba) of the Corporations Act which requires clear disclosure by way of a detailed summary of the performance criteria which Boards have used in annual incentive plans and the manner in which they have assessed the company's performance which has led to the disclosed executive emoluments. We note that this area of company disclosure has been considered poor by the Securities Exchange Commission in the US and by equivalent authorities in the UK and in Europe. In part, it would be our observation that legal provisions have generally been in place, though have not been strongly enforced.

While it remains our view that directors and their advisers are in the best position to improve this area of reporting, it is our judgement that the Productivity Commission should address these deficiencies which are likely to influence two out of three reporting companies in the interest of transparency and completeness of disclosure. We acknowledge in this context, as noted in the submissions by others, that their disclosure can be transparent and comprehensive though not reveal strategic initiatives which are commercial and in confidence.

We note in APRA's discussion paper of proposed extensions to governance requirements for APRA regulated institutions nine principles for sound compensation practices. While there may be a number of responses to this paper, particularly in relation to Remuneration Committee membership, the source and independence of advice, we anticipate that there may well be responses from regulated entities and their advisers in relation to the identification and measurement of risk and requests for further clarification in relation to APRA's approach to the certification of compliance, whether that certification is required to be provided by a company's auditors or legal advisers.

We note that the FSA in the UK have established evidential requirements which, if embraced and adjusted by APRA to reflect local circumstance, may clarify some of the outstanding issues arising in the consultation process. Notwithstanding the challenges of a principles based approach, which we strongly endorse, it is our view that APRA's approach is clearly in the right direction.

## **Correlates of executive annual reward**

The complexity of reward structures has not transparently revealed that performance aligned awards reflect incremental and sustainable shareholder value creation.

In relation to the scale of Australia's top 100 and 200 companies, our research has revealed that revenue over the decade 1998 to 2008 steadily increased. Our research in respect of the 2006, 2007 and 2008 financial years, indicates that annual company revenue is the strongest correlate of an executive's fixed annual remuneration, with the exception of the 2006 financial year in respect of CEOs when it was market capitalisation. The correlation between company revenue and market capitalisation for the top 50, 100 and 300 companies averages above 0.8, and the correlation between market capitalisation and operating profit is higher over the 2006, 2007 and 2008 financial years. Revenue and market capitalisation are also highly correlated with assets, as is a Chief Executive's fixed annual remuneration.

What is revealed in our research, given the alignment and high correlation between revenue, market capitalisation, operating profit and net assets, is the relatively poor relationship between annual bonuses and operating profits or market capitalisation. Annual bonuses are more highly correlated with revenue than either operating profit or market capitalisation. The correlation between market capitalisation and operating profit with annual bonus payments in the 2008, 2007 and 2006 financial years averages less than 0.3 or approximately half the correlation between fixed annual remuneration with both revenue and market capitalisation.

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Total annual remuneration, which is the combination of fixed annual remuneration and annual incentive payments or bonuses, had the highest correlation with the company's annual revenue, though an aggregate correlation of less than 0.5 with both market capitalisation and operating profit. Our research reveals virtually no correlation between improvement in a company's profit or market capitalisation and the reported remuneration of either a Chief Executive Officer or Chief Financial Officer.

This research, which in principle confirms the work undertaken by a number of proxy advisers, ASIC, ASCI and academics highlights a key accountability for Board Remuneration Committees and Board Chairmen in relation to ensuring the integrity of annual incentive plans and clarity in respect of the value drivers considered by the Board as critical in delivering shareholder returns. We note in this context that a reasonable proportion of named executives in Annual Reports are receiving annual incentives on the basis of business group, divisional or regional performance outcomes, not the corporate result which is adequately captured under long term incentive plans where performance hurdles embrace either or both total shareholder return and earnings per share growth.

A key question which arises from this research (which broadly reflects the conclusions of a number of academic studies, though has not adopted comparable comprehensive statistic analyses), is whether Boards in determining the performance requirements of a company's executives are weighting the factors considered in research studies, which primarily reflect upon levels of profitability, growth in revenue and market capitalisation in respect of both the year in which data is reported and on a look back basis, as distinct from a number of other measures which are expected to flow through to shareholder returns. These factors might include a Board's assessment, at either a corporate or business group level, of business sustainability, the accomplishment of strategic objectives and the effective management of tactical initiatives in meeting competition, both on a domestic and global footing.

A concern which we have is that measures of profitability or market capitalisation may well not represent the key value drivers on an annual basis where there is often a lag in reporting of outcomes and those considered critical by a Board, which should have an intimate understanding of not only the key value drivers for an organisation but also the extent to which management is achieving the performance hurdles set for them.

We note that for example the highest correlation in the three years charted exists between total assets and annual incentives (2008), demonstrating that annual incentives may be triggered by strategic and other initiatives and incentives paid regardless of movement in profitability.

A key challenge in this context 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 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 of where companies have achieved substantial growth in revenue, though in parallel assumed significant increases in debt. In recent times we have observed that in some disclosures the value of assets acquired to secure growth have been marked to market at a substantially reduced value from acquisition cost.