egan associates

"Pay Reports Hide Wealth of Information"

(23rd November 2011/Australian Financial Review - 'Chanticleer' /Tony Boyd)

Have a look at a chart showing the rise in total remuneration of chief executives at the top 100 companies over the past 10 years and compare it with the less than spectacular performance of the S&P ASX 100 Index over the same period and you will unde3rstand why there is growing concern among small and large shareholders about executive pay.

The only conclusion to draw is that over the past decade CEOs have been adept at convincing boards of directors to adjust the mix of cash, short-term incentives and long-term incentives to deliver increased pay, despite flat or declining share price.

This trend is particularly noticeable in the past five years, according to an analysis for *The Australian Financial Review* by John Egan, of consultants **Egan Associates**. Five years ago, total remuneration of a CEO at a top 100 company was about one-third salary and superannuation, one-third short-term incentives, usually in cash, and one-third long-term incentives in shares.

Today, the mix is different. Egan's analysis shows that salary and super are now about 56 per cent of the total remuneration package, short-term incentives about 26 per cent and long-term incentives about 18 per cent.

That significant shift can be sheeted home to the Global Financial Crisis in 2008 and 2009. It was a catalyst for a pause in the relentless rise in executive remuneration. But CEOs and remuneration consultants, who advise them both CEOs and boards, responded in a rational way. They came up with pay structures that made them less beholden to the vagaries and volatility of global markets.

The response is rational when you consider the context. Leading up to the collapse of Lehman brothers in September 2008, executives were riding high because the surge in share prices had delivered unexpectedly large gains from long-term equity incentives. Those gains were far beyond the expectations of those who approved them, including boards and shareholders.

But the crisis meant that not only did CEOs have to accept a pause in fixed remuneration tho show sensitivity to the economic impact of the financial crisis, they were about to take a hit on their long-term incentives. Australia was rescued from recession by the huge spending of the federal government and the rapid move to provide liquidity to the banking system.

But, as Egan points out, the longer-term impact of the crisis was that a large proportion of equity incentives granted to CEOs and senior executives in 2006, 2007 and 2008 did not vest. The hurdles set by boards, in consultation with remuneration consultants, were appropriate for a pre-crisis world but to high after the crisis.

As more and more equity reward shares lapsed, boards were forced to revisit standard incentive hurdles. The cliff approach to vesting, whereby no shares vested below growth in earnings of 10 per cent, was soon abandoned in favour of graduated vesting, whereby any growth vests.

Adjustments to remuneration packages to keep CEOs happy were in keeping with he widely held belief that there is a shortage of executive talent in Australia. That shortage is a real problem in many sectors of the economy. Also, it can be a source of conflict between shareholders and boards.

A recent example was the Pacific Brands annual meeting in October, in which chairman James MacKenzie was forced to defend the pay packages of senior executives in the face of criticism from proxy advisers and major shareholders. The company suffered a first strike against its remuneration report.

But the fact is, Pacific Brand is competing with Myer, David Jones and Just group for people with exceptional retail skills. MacKenzie told the annual meeting that remuneration at the company in 2011 was a one-off and would not be repeated in 2012.

The debates at annual meetings before votes on remuneration reports have highlighted the lack of understanding among shareholders of the packages put in place to reward executives. The 15 or so first strikes against remuneration reports this annual meeting season have exposed a breakdown in communication between boards and shareholders and between boards and proxy advisory firms.

The lack of communication between proxy advisers and boards was well highlighted in a report released earlier this month by the Australian Institute of Company Directors. It revealed that some remuneration committees were talking to the wrong people at funds management companies, that companies did not understand the timetables and work schedules of proxy advisers and that everyone was in favour of improvements in the lodgement, counting and security of proxy votes.

Boards could be forgiven for thinking they are being placed under unwarranted pressure from shareholders. As Egan's long-term research into remuneration packages shows, boards are merely responding to market practice which is for steady increases in salaries and the payment of higher annual incentives.

But it is impossible to ignore the relative strength of Australian remuneration packages because of the rise in the Australian dollar.

The old argument that we have to keep paying more to match the pay rates in overseas jurisdictions worked well when the dollar was at US60¢ but it does not hold water when the dollar is at parity.

Also, there is a danger that the boardroom obsession with monitoring and matching market practice will go too far. Some remuneration consultants involved in developing cutting-edge packages are believed to be involved in blatant tax-evisceration strategies.

The entire purpose of these packages is to shift the tax liability of the CEO or senior executive from income to capital gains. That can have a dramatic impact on the ultimate take-home pay and exacerbate the trend towards excessive remuneration.

Another issue that needs to be addressed by boards is the proliferation of incentive packages that include relative total shareholder return measures that are unrelated to the company's performance under the direction of management. It is particularly true in the mining industry where an iron ore company can be measured against an index dominated by gold miners.

The growing size of remuneration reports is making it harder for shareholders to get their minds around the reports. Chanticleer thinks Egan is right in saying that boards and shareholders will not find their perspectives aligned until remuneration becomes simpler in its form, communication more transparent and the rate of change in remuneration better aligned with shareholder welfare.

…end.