Position paper — executive remuneration

The governance of executive remuneration[1] within listed entities has been, and remains, the subject of significant media and public policy attention. As a current issue of governance concern, remuneration stands head and shoulders above any other area of governance interest in the public arena. Risks emanating from this concern include increased regulation[2] together with erosion of investor confidence.

The popular focus on the quantum of remuneration is however, misdirected. From a governance perspective, an important focus should be on the alignment of executive remuneration with the rewards of investment performance flowing to shareowners.

The responsibility for improving the alignment of executive remuneration governance rests with company directors. To date, a significant number of companies have failed to effectively disclose remuneration in the context of alignment with shareowner interests. This includes a lack of disclosure around performance hurdle requirements that trigger remuneration benefits and a lack of disclosure on share options as well as how they are valued, despite these being valuable components of remuneration benefits.

Equally, the community of investment analysts and funds managers should be more active in encouraging effective disclosure. This would enable a more proactive culture of governance by investment professionals.

In order to manage risk and ensure effective governance of shareowner interests, companies — via their Board of Directors — should:

→ Review their remuneration committee (or alternative structure) to ensure that it operates to align the remuneration packages of executives with shareholder interests. If it is deemed that a remuneration committee is not required, then the company should communicate why this is the case with a level of detail commensurate with investor needs;[3]

→ Report remuneration governance in accordance with both the form and spirit of the *Corporations Act 2001*[4] and ASX Listing Rules particularly ensuring adequate discussion of how remuneration is related to company performance over the longer term; and

→ Ensure remuneration levels and remuneration policy are reported in a form that is easily understood by investors and with a level of detail that is responsive to widely expressed concerns in relation to remuneration governance.[5]

1_Executive remuneration for the purposes of this research is measured across Managing Director/Chief Executive Officer (MD/CEO), Senior Executive, Executive Director, Non-Executive Director, and Chairman.

2_In an AICD members survey on the ASX Corporate Governance Guidelines 79% conveyed concern as to the risk of increased regulation to address perceived governance concerns.

3_ASX Principles of Good Corporate Governance & Best Practice Recommendations: Principle 9, Recommendation 9.2.

4_s300 and s300A. Also see Corporations Amendment Bill 2002 (Cth).

5_ASX Principles of Good Corporate Governance & Best Practice Recommendations: Principle 9, Recommendation 9.1.

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Background on position paper

The governance of executive remuneration by the directors of companies is a matter of significant corporate and shareowner interest. Australia's high level of shareownership, including the impact of superannuation in making investors of most Australian employed persons, has contributed to this interest.

Investment governance by shareowners, including the long-term interests of superannuation shareowners, requires vigilance in relation to the transparency of executive remuneration disclosure within listed companies. This paper focuses on the processes by which the shareowning community can have trust and confidence in the means by which company directors control company remuneration policies and practices.

Poor governance of remuneration by company directors can give rise to community, regulatory and litigation risks. It is these risks that shareowners seek to mitigate through governance. Good corporate governance therefore refers to robust processes by which shareowner interests are protected and not subordinated to the benefit of those who receive company remuneration.

Community risk

Community risk has been magnified by high profile executive payouts, particularly during the period 2001–2003. One response to these payouts is an increased level of scrutiny from shareowners and other stakeholders as to the validity of the current levels of executive remuneration.

In March 2003 the Australian Council of Superannuation Investors (ACSI)[1] released corporate governance guidelines to provide a benchmark for superannuation trustees to assess the corporate governance practices, including remuneration governance, of companies in which they invest. March 2003 also saw the release of Corporate Governance International (CGI)[2] Remuneration Guidelines for Institutions and Listed Companies.

Research commissioned by the Labor Council of NSW on the remuneration levels of executives relative to average employees further reflects an increasing level of scrutiny by company stakeholders. This research concluded executive remuneration levels in Australia grew from 22 times average weekly earnings to 74 times average weekly earnings over the decade to 2002. The research also found a negative correlation between executive pay and company performance.[3] The Labor Council paper received mainstream media coverage.

Regulatory risk

Recent regulatory and other developments evidence heightened risk relating to remuneration governance disclosure:

→ Corporations Amendment Bill 2002 (Cth) — a bill for an Act to amend the Corporations Act 2001. Key proposed amendments include amendments to strengthen s300 and s300A.

→ Corporations Law Economic Reform Program (CLERP) Paper No.9[4] — reform proposals are aimed at achieving further improvement in audit regulation and the wider corporate disclosure framework. A further recommendation to give shareowners the right to register a non-binding resolution on executive remuneration packages was subsequently included under the proposals.

→ The release of the ASX Corporate Governance Council Guidelines and Best Practice Recommendations in March 2003:
  — principle 9 of the Guidelines recommends companies ensure that the 'level and composition of remuneration is sufficient and reasonable and that its relationship to corporate and individual performance is defined… it is important that there be a clear relationship between performance and remuneration, and that the policy underlying executive remuneration be understood by investors'.[5] The ongoing relevance and effectiveness of the guidelines will be reviewed annually by the ASX Corporate Governance Council.

1_ACSI is a not for profit organisation representing 23 superannuation funds formed in April 2001. ACSI provides independent research and education services to superannuation funds, in relation to the corporate governance practices of companies in which they invest.
2_CGI is a proxy voting advisory service for institutional investors.
3_Shields, John et al, A report prepared for the Labour Council of NSW 'The Bucks Stop Here: Private Sector Executive Remuneration in Australia.' (2003) — http://council.labornet.au/community/public/buckstop.
4_CHERP (Audit Reform & Corporate Disclosure) Bill — draft provisions were released October 2003.
5_ASX Corporate Governance Council Guidelines, March 2003, p.43.

— ASX Listing Rule 4.10.3 requires companies to provide a statement in their annual report disclosing the extent to which they have followed the best practice recommendations, on an 'if not why not basis'.[1]

→ **Corporations Amendment (Repayment of Directors' Bonuses) Act 2003** passed on 11 April 2003. The Act adds a new category of 'unreasonable director-related transactions' to the categories of transactions that may be clawed back by a liquidator under the voidable transaction provisions of the Corporations Act 2001.[2]

→ **ASIC draft guidelines on the value of options in directors' reports** — to ensure shareholders are properly informed about the full value of the remuneration of the directors and executive officers, ASIC has issued final guidelines about the way Australian listed companies should include the value of options in the disclosure of directors' and executive officers' emoluments in the annual directors' reports.[3]

Litigation risk

Litigation risk is less prominent among governance risks relating to remuneration, however this has the potential to change should legal precedents refine the understanding of directors' duties. This will have implications for the setting of Directors and Officers liability insurance premiums to be paid by companies.

Responding to remuneration governance risk

The main concerns driving potential community, regulatory and litigation risks are that:

1_Directors and executives seem to be being rewarded at the expense of shareowners; and
2_There should be significant ongoing systemic vigilance on these matters.

As a result of these concerns BT Governance Advisory Service (GAS) was mandated to test for correlation between levels of remuneration, remuneration governance structures and commonly accepted financial performance measures such as the Return on Equity (ROE).[4]

Governance measures used

The following governance criteria were applied:

1_Presence of a remuneration committee.
2_Remuneration committee composition (executive vs non-executive representation).
3_Disclosure of detailed remuneration policy.
4_Disclosure of remuneration data.
5_Discussion and evidence of alignment of remuneration policy to shareowner return.

To ensure research validity, the governance measures were selected to reflect the ASX Principles of Good Corporate Governance & Best Practice Recommendations, and the **Corporations Act 2001** s300 and s300A in particular.

Other Australian guidelines drawn upon include:

→ IFSA Bluebook
→ ACSI Corporate Governance Guidelines
→ Corporate Governance International Remuneration Guidelines

Research metodology[5]

Rem = f (size, complexity, risk, industry, performance, governance structure).

The research universe was comprised of 172 S&P/ASX 200 Index companies listed in both 2001 and 2002.[6]

1_Origin: Listing Rule 3C(3)(1), amended 1/1/2003. The corporate governance statement may be given to ASX as a separate report but must be given to ASX at the same time as the annual report and be clearly identified as the corporate governance report: http://www.asx.com.au/ListingRules/chapters/ch04.pdf
2_Allens Arthur Robinson 2003, Focus: Corporate Governance — May 2003 linking remuneration to directors' performance http://www.aar.com.au/corpgov/pubs/focg2may03.htm.
3_Refer http://www.asic.gov.au/asic/ASICPUB.NSF/byid/E4BDB282DE36BFF5CA256D1F00035B2B?opendocument, dated 7 May 2003.
4_ROE as a ratio of Net Profit After Tax to total shareholder equity.
5_Refer to Appendix 1 for further discussion of the Research Data and Methodology.
6_The 28 exclusions were companies not listed in both years, externally managed property trusts and other entities where management is external to the reporting entity (on account of their remuneration governance occurring in a different legal entity).

Governance

To establish the extent to which the universe of 172 listed companies adopted good corporate governance policies, our preliminary research found that in the 2002 reporting year:

- Only 9 companies (5%) did not have a remuneration committee with a further 9 dealing with remuneration of executives and directors via alternative structures. (2001; 13 and 10 companies respectively).
- 51 companies (30%) had executives on the remuneration committee with only 6 companies stating that the executive did not participate in discussions on his/her own remuneration (2001; 58 and 8 companies respectively).
- 43 companies (25%) did not disclose a detailed remuneration policy (2001; 52 companies).
- 12 companies (7%) did not disclose all remuneration data for directors and executives (2001; 11 companies).
- Only 45 companies (26%) disclosed information on individual performance hurdles and how hurdles link to shareholder value (2001; 41 companies).
- Of the 107 companies that reported issuing options, 50 companies (47%) did not report the value of those options (2001; 125 and 82 companies respectively).

Although some improvement was achieved between the 2001 and 2002 reporting periods, these outcomes invite long-term shareowners to maintain vigilance of remuneration governance, particularly in the areas of effective disclosure and alignment of executive and shareowner reward.

Although 95% of the listed companies had an executive remuneration committee, 74% did not disclose information on individual performance hurdles and how the hurdles link to shareowner value. This suggests that despite having governance structures in place there is a lack of disclosure, signalling that the governance policies are not working and potentially leaving companies exposed to risk.

Governance and remuneration

BT GAS examined these governance findings in a larger project investigating the correlation between various categories of executive positions with executive remuneration, remuneration governance and company performance. The study sought to control for company size and complexity.

Research hypotheses

Research hypotheses were:

- Size
  The larger the company the greater the expected remuneration level.[1]
- Complexity
  The more complex the company the greater the expected remuneration.[2]
- Risk
  The riskier a company the greater the expected remuneration.[3]
- Industry
  The type of industry is a significant factor in determining expected remuneration. Different industries are likely to remunerate at different levels.[4]
- Performance
  There is a direct relationship between company performance and remuneration levels. Higher levels of performance are expected to be associated with higher levels of remuneration.[5]
- Governance
  There is a direct relationship between company governance policies and company size, and between governance policies and total executive remuneration:
  — larger sized companies will have better governance policies; and
  — companies with better corporate governance policies will have more appropriate total remuneration packages.[6]

1_Company size is proxied by market capitalisation rather than total assets to eliminate the inherent bias within highly leveraged financial companies.
2_Complexity is measured on two dimensions (industry complexity and global complexity) as defined by BT.
3_Company risk is proxied by share price volatility.
4_Companies are categorised into Services, Finance, Resources, Manufacturing and other sub-industry types, based on GICS classifications.
5_Performance is measured based on Return on Equity (ROE) and relative share price performance over the previous financial year.
6_Where 'appropriate' may include paying not too much as well as not too little.

Results[1]

The following table summarises the research findings on correlation between total remuneration paid and the GAS hypotheses:

Variable	MD/CEO	Chair (preliminary)	Senior Executives
Size	Positive[1]	Positive[1]	Positive[1]
Complexity	Positive[1]	Positive[2]	Positive[1]
Industry	No significant finding	Positive[2] (Finance)	Positive[1] (Finance)
Risk	No significant finding	No significant finding	Positive[1]
Performance (ROE)	Positive[3]	No significant finding	No significant finding
Governance	Negative[3]	No significant finding	No significant finding

1_Significant at the 1% level.
2_Significant at the 5% level.
3_Significant at the 10% level.

- Size
  Larger companies do pay more. There is a significant relationship between company size and executive remuneration.
- Complexity
  More complex companies do pay more. There is a significant relationship between company complexity and executive remuneration.
- Risk
  Risk was not a significant factor for explaining CEO remuneration, but was significant for Senior Executives.
- Industry
  Industry classifications were not found to be significant for explaining CEO remuneration, however finance industry executives and chairs were found to be paid significantly more than their counterparts in other industries.
- Performance
  The research was unable to find a direct relationship between company performance and change in executive remuneration levels.[2] Better or worse company performance did not relate to changes in executive remuneration levels.
- Governance
  A direct relationship was found between company size and governance scores, noting that the larger companies had better governance policies in place.

However, the research was unable to find an alignment between Governance and total executive remuneration levels. Counter intuitively, good governance policies are associated with higher levels of remuneration.

Discussion of findings

There are significant differences in disclosure standards between the 172 companies examined for this paper. Examples include the disclosure of remuneration composition (categorisation of other benefits), options information and performance hurdles. In some instances executives were not employed for the full year making meaningful comparisons difficult.

Companies also reported information in different areas of the annual report, with some companies reporting in notes, while others reported in the directors' report. The inconsistency of remuneration disclosure is a significant issue for investment governance as it does not allow investors to readily understand remuneration governance.

Size and complexity were positively associated with executive remuneration levels. Although there is only limited evidence to suggest that company performance was associated with pay, the results did show a positive relationship between company size and governance.

1_Refer to Appendix 2 for further explanation these findings.
2_There is no evidence that previous year relative share market performance is linked to remuneration, and there is only a weak (10% level) relationship between CEO remuneration and previous year ROE.

Assessing whether executive remuneration practices are well governed is a significant challenge when corporate disclosure levels, as they stand, lack clarity. As long-term investors, we expect that the ASX Corporate Governance Council Principles will address current sub-optimal corporate disclosure levels. We do not however believe the principles are imposing a new obligation. Rather, they merely reinforce the reasonable expectations of shareowners.

Examples of poor disclosure during the 2002 reporting year include a significant number of companies (74%) not disclosing information on individual performance hurdles and their link to shareowner value. Of the 107 companies that reported issuing options 50 (47%) did not report on the value of those options.[1] Such behaviours invite further regulatory and community risk with the potential to adversely impact long-term shareowner interests.

We had anticipated that the better the governance policy, the more shareowner interest and executive remuneration packages would be aligned. Good corporate governance however does not, as indicated by this research, necessarily equate to higher or lower levels of remuneration. Company governance policies do not appear to align shareowner and executive interests.

Review

Our research suggests that the actual performance of the company — which is the primary concern of shareowners — does not appear to drive executive remuneration. The research found the statistical link between remuneration and company performance to be weak.

The research indicates that s300 and s300A of the Corporations Act 2001 are not having their intended effect. Remuneration disclosures, generally, do not discuss alignment with company performance. Options valuations in company disclosures are a strong candidate for improvement and have already attracted the attention of ASIC.[2]

The research findings help explain why community focus (including political) is on headline remuneration, not on alignment of reward. The information to enable an intelligent evaluation is difficult to obtain and in a significant number of cases, absent. Improving the nature of disclosure (remuneration quantum and the relationship to entity performance) will enable investors to better assess the reward practices of the companies in which they are owners. Improved alignment of reward is a desirable outcome for shareowners.

It is further recommended that improvements be made to specific options reward practices so that all options data is disclosed at issue date. Disclosure should incorporate the options exercise price(s), expiry date(s) and necessary performance hurdles.

Appendices

Appendix 1 — research metodology

Rem = f (size, complexity, risk, industry, performance, governance structure)

Data collection involved up to 20 remuneration factors collected for more than 2400 CEOs, Senior Executives and Directors in addition to more than 20 variables collected or scored for each company for financial years 2001 and 2002. All discussion is focussed on 2002 data. Automated data collections were augmented where inputs needed to be manually collected or individually scored (eg complexity). Unlike previous studies we directly estimated the initial value of options issued to executives using actual option details (number, strike price, maturity, issue date).

1_However there were companies that did report on other options data such as issue date, exercise price and number issued.
2_ASIC Press Release, 'Upgraded guidance on corporate governance', Thursday 1 August 2003.

This necessitated manual data collection as option details are not readily available in automated formats. In collecting the option data significant disparities in data quality disclosed by companies were noted. Whilst some companies provided all required information to calculate option values, and some even disclosed an option valuation amount, many companies fell well short of supplying sufficient details to accurately calculate option valuations.

In cases of missing data, assumptions were made to enable calculation of option values. These include:

1_Black Scholes model used for options valuation.
2_Using the exercise price of the option as the market price on date of issue where the date or market price were not disclosed.
3_Using the average term to maturity of all known option maturities for the 172 companies researched, when the maturity date was not disclosed.
4_Using Volatility Absolute as a volatility measure based upon the absolute value of stock returns as opposed to the usual squared function.

A number of manual crosschecks were conducted to ensure data veracity. A considerable number of potential data inconsistencies were identified and these were followed up manually via annual reports. Wherever possible we corrected potential obvious errors — eg extremely low remuneration. Low remuneration levels, often zero, could occur because of appointment or exit part way through the year (often this was difficult or impossible to determine, even after examining the annual report closely), or in the case of directors, due to their corporate connections (representing a major shareholder who pays their normal remuneration).

To minimise statistical bias, we excluded all executives who earned less than $10,000 during the year, and investigated CEOs/executives who earned less than $100,000. As a means of avoiding errors caused by termination during the year we eliminated all executives with termination payments from further analysis. One recommendation could be disclosure the effective annualised level of remuneration for executives not retained for the full year — as this would make it much easier for investors to evaluate true remuneration levels.

Appendix 2 — further discussions of findings

MD/CEOs

The predictive remuneration model developed for this paper explained approximately 50% of cross-sectional variation[1] in total MD/CEO remuneration across 172 S&P/ASX200 companies. Total remuneration (base, benefits, bonus and shares/options) is explained better than individual components (eg. base or bonus) suggesting that remuneration should be examined as a total package. For example, of the 107 companies (out of the 172 researched) that reported issuing executive options, 50 companies (47%) did not report the value of these options. There were no significant industry effects, suggesting that factors like company size and complexity appear to explain away any industry differences for CEOs.

The research also considered whether governance may be related to residual remuneration (remuneration levels not explained by our model minus the governance factor). Residual remuneration was regressed against the governance factor, and absolute residual remuneration against the governance factor. Absolute residual remuneration was considered as a measure because one might expect companies with poor remuneration policies to potentially pay too much or too little for executives.

1_Referring to the differences across companies.

Considering these factors, the research again found a weak negative relationship between governance and residual remuneration — companies with good governance policies tend to pay their CEOs more than expected under the model. However, there was no relationship between governance and absolute residual remuneration. Together this is somewhat interesting — why do companies with good governance policies tend to pay their CEOs more? This may simply be a spurious correlation, perhaps due to the fact that larger companies have better governance policies.

Chair

The research did not find strong relationships explaining Chair remuneration relative to CEO or senior executive remuneration. There are however fewer differences in Chair remuneration and factors such as size and complexity are much less significant in explaining these differences.

Senior executives

Senior executive results were similar to CEO findings, with approximately 50% of cross-sectional variation in remuneration explained by the research factors (size, complexity, risk, industry, performance and governance). Finance industry executives do seem to get paid more than other industries. The large banks in particular seem to pay their executives more than executives in other industries.

Risk was also found to be significant, suggesting executives in higher risk industries require a risk premium in their remuneration. It is surprising to note that this factor was not significant for CEOs, as previous research (Fleming and Stellios, 2002) has found this relationship to be significant.

For enquiries contact Amanda McCluskey (02) 9259 9301 or amanda.mccluskey@btfinancialgroup.com.

First published 19 October 2004.

BT6369sd Jul04