CEO Pay in the Top 100 Companies: 2003

Research Paper prepared by

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2 IA RESEARCH

IA Research is a Melbourne-based research firm, specialising in corporate governance, founded by Dr Geof Stapledon of the University of Melbourne.

IA Research analyses the corporate governance structures and processes of companies listed on the Australian Stock Exchange. It does this:

- For subscribers to the ACSI Voting Alert Service. This product is designed to assist superannuation funds in meeting their obligations as large shareholders.
- For clients in the superannuation and investment management sectors, who are interested in aspects of corporate governance in listed Australian companies.
- For government departments and multilateral agencies.

3 INTRODUCTION AND EXECUTIVE SUMMARY

IA Research was commissioned by ACSI to conduct an empirical analysis of CEO pay in the Top 100 listed Australian companies for the 2003 financial year. This paper reports the findings of the study.

In several areas, the study revisits issues researched for ACSI for the 2002 and 2001 financial years,[1] and for the Conference of Major Superannuation Funds for the 2000 financial year.[2] Comparative statistics are provided.

A companion paper ("The Incentive Components of Executive Pay") being prepared by IA Research for ACSI will analyse the current Australian guidelines on options and other long-term incentives for senior executives. It will assess those guidelines by way of comparison with guidelines in the United States, Canada and the United Kingdom, and by analysis of trends in long-term incentive plans used by S&P/ASX 200 companies.

Key findings reported in this paper are:

CEO pay in the Top 100 companies: aggregate statistics

This is covered in Section 4. The study looked at CEO pay in terms of its various components, and found that across the Top 100 companies:

- The average <u>fixed remuneration increased by 38.6%</u> between 2002 and 2003 (from $1.03 million to $1.42 million).
    - The median fixed remuneration was $1,137,769. This is a 24.4% increase on the 2002 median ($914,330), and a 45.5% increase on the 2001 median ($781,788).
    - The largest fixed remuneration was $13,486,153 in 2003, compared to $7,938,000 in 2002, $8,543,137 in 2001 and $7,205,688 in 2000.
    - The smallest fixed remuneration was $345,056 in 2003, compared to $50,575 in 2002, $52,055 in 2001 and $80,000 in 2000. (These small figures for earlier years reflect CEOs who had been in office for less than a full financial year.)
- The average <u>short-term incentive increased by 36.9%</u> between 2002 and 2003 (from $937,347 to $1,283,330).
    - The median short-term incentive was $735,129. This is a 54.7% increase on the 2002 median ($475,000), and a 90.1% increase on the 2001 median ($386,805).
    - The largest short-term incentive was $12,381,000 in 2003, compared to $10,944,000 in 2002, $6,239,739 in 2001 and $13,808,000 in 2000.
    - 20% of CEOs did not receive a short-term incentive. Among those who did, the smallest short-term incentive was $88,000 in 2003, compared to $50,000 in 2002, $73,000 in 2001 and $50,000 in 2000.
- The average <u>total remuneration **excluding** long-term incentive (options and shares) increased by 2.6%</u> between 2002 and 2003 (from $2.38 million to $2.44 million).

[1] Institutional Analysis, <u>CEO Pay in the Top 100 Companies: 2002</u> (Research Paper prepared by Institutional Analysis for ACSI, May 2003); Institutional Analysis, <u>Board Composition and Pay in the Top 100 Companies: 2001</u> (Research Paper prepared by Institutional Analysis for ACSI, January 2002), Section 9.
[2] Institutional Analysis, <u>Board Composition and Pay in the Top 100 Companies</u> (Paper presented to the Conference of Major Superannuation Funds, Gold Coast, March 2001), Sections 7 and 8.

- The median total remuneration (excluding long-term incentive) was $1.77 million. This is a 22.5% increase on the 2002 median ($1.45 million), and a 24.6% increase on the 2001 median ($1.42 million).
- The largest remuneration package (excluding long-term incentive) was $25,793,845 in 2003, compared to $16,294,620 in 2002, $14,858,424 in 2001 and $14,935,000 in 2000.
- The smallest remuneration package (excluding long-term incentive) was $387,472 in 2003, compared to $50,575 in 2002, $166,457 in 2001 and $195,931 in 2000.
- As mentioned above, average fixed remuneration increased by 38.6% and average short-term incentive increased by 36.9%. The reason the average total remuneration excluding long-term incentive increased by only 2.6% is that not all CEOs were paid a short-term incentive during the year (16 of the 78 CEOs did not receive a short-term incentive). If those CEOs who did not receive a cash bonus are excluded, average (mean) pay, excluding long-term incentive, increased by 3.6% between 2002 and 2003 (from $2.74 million to $2.84 million).

- The average <u>total remuneration **including** long-term incentive decreased by 2%</u> between 2002 and 2003 (from $3.23 million to $3.16 million).
  - The median total remuneration (including long-term incentive) was $2.33 million. This is a 10.8% increase on the 2002 median ($2.10 million), and a 9.7% increase on the 2001 median ($2.12 million)
  - The largest remuneration package (including long-term incentive) was $26,681,537 in 2003, compared to $16,294,620 in 2002, $14,858,823 in 2001 and $69,098,875 in 2000.
  - The smallest remuneration package (including long-term incentive) was $387,472 in 2003, compared to $50,575 in 2002, $166,457 in 2001 and $348,338 in 2000.
- The long-term incentive component of pay accounted for, on average, 22.8% of total pay for the Top 100 CEOs in 2003. This was down from 28.6% in 2002 and 23.6% in 2001. This appears to have been driven by the increasing significance of the short-term incentive as a proportion of total CEO pay. (The short-term incentive is typically an annual bonus paid in cash.) The short-term incentive accounted for 32.3% of total pay in 2003, up from 23.2% in 2002 and 25.7% in 2001.
  - Combining the short-term incentive and long-term incentive, the proportion of CEO pay that was “at risk” in 2003 was 55.1%. It was 57.2% in 2002, and 53.7% in 2001.
  - Australian CEOs are, on average, receiving a far smaller proportion of their total remuneration in the form of long-term incentives than their United States counterparts. The long-term incentive component of pay for the average U.S. CEO is nearly double that of the average Australian CEO. On the other hand, the average Australian CEO receives considerably more of her or his pay in the form of options and shares than the average British CEO. And the long-term incentive component of pay for Australian CEOs is now almost four times the level it was in the late 1980s.

Disclosure of options’ value

This is covered in Section 5. Every sample company which granted options to a director or top 5 executive in 2003 disclosed a value for those options. At first blush, this appears to show that ASIC's tough stance has led to 100% compliance with section 300A. However, one company, which issued options in February 2002 (i.e. in the previous financial year) did not allocate a portion of the value of those options in its 2003 annual report. This is inconsistent with the ASIC Guidelines. The same company also has a cash-based long-term incentive for senior executives. However, it did not disclose the amount that accrued under that plan for the CEO during the financial year.

Several companies use a loan-funded share plan as their long-term incentive. Invariably, these companies disclose either the "notional interest" that the company has foregone during the year (where the loan is interest-free), or details about the interest paid or payable (where the loan incurs interest). But is this really information about the *value* of the equity incentives being provided by the company? The ASIC Guidelines are not strictly relevant where a company has a loan-funded share plan rather than an options plan. However, going forward, for financial reporting purposes (rather than disclosure of pay purposes), these companies will need to recognise that Pending Accounting Standard AASB 2 "Share-based Payment" applies – as its title suggests – not only to options but also all other forms of equity incentives.

Top 10 case studies

This is covered in Section 6. We conducted 10 "pay-for-performance" case studies. We identified the 10 highest-paid CEOs for the year 2003, and then compared each CEO's pay for the five years 1999 to 2003 with his company's[3] financial performance over the period 1999 through 2003. This revealed that the pay of some CEOs has borne a relationship to the company's performance, but the pay of other CEOs has been large and increasing over a period of poor or at least uneven corporate performance.

[3] The 10 highest-paid CEOs were all men.

4 CEO Pay in the Top 100 Companies: Aggregate Statistics

This section considers the disclosed remuneration for the most senior executive officer in a sample of S&P/ASX 100 companies. The research involved extracting the components of income from the annual reports of the sample companies. This information has been disclosed by the companies under section 300A of the Corporations Act.

The sample consisted of 78 companies. Not all the S&P/ASX 100 constituents were included because some are trusts (or managed investment schemes) rather than companies, and some are companies incorporated in another country, which does not have remuneration-disclosure rules analogous to section 300A.

For simplicity, the report refers to "CEO pay". However, in relation to some companies the executive whose pay was analysed is not the person carrying the formal title "CEO". This could be, for example, because the company has an Executive Chairman and a separate Chief Executive Officer, and the Executive Chairman's remuneration is $2 million higher than that of the CEO.

In order to maintain consistency with the earlier studies, we used data from annual reports *published* in 2003. For the majority of companies, this means the annual report relating to the financial year ended 30 June 2003. For a small number of companies (all of which are banks), it means the annual report relating to the financial year ended 30 September 2003. But for those companies which have a 31 December financial year-end, it means the annual report relating to the financial year ended 31 December 2002 – which would typically have been published in early March 2003.

4.1 Breakdown of components and 2000-2003 change analysis

In this section the following elements of remuneration are considered:

- fixed pay – the non-variable element of the CEO's remuneration.
- short-term incentive – the annual bonus paid to the CEO in the financial year.
- total remuneration excluding long-term incentive.
- total remuneration including long-term incentive.

4.1.1 Fixed remuneration

Fixed remuneration comprises those components of a CEO's pay which do not vary with performance. This can include:

- Base (cash) salary
- Superannuation
- Motor vehicle allowance
- Fringe benefits

Of these, base salary is almost always the most significant component. In 2003, it made up 83% of total fixed remuneration for the average CEO.

Table 1 shows the fixed remuneration statistics for the period 2000 to 2003. Between 2002 and 2003, average (mean) fixed remuneration increased by 38.6% (from $1.03 million to $1.42 million). The average is skewed by the most highly paid CEOs, as indicated by the lower median figure: $1,137,769 in 2003. However, even the median was up considerably from earlier years. It was 24.4% higher than the 2002 median ($914,330) and 45.5% higher than the 2001 median ($781,788).

Table 1 also shows the range of fixed pay: from $345,769 to $13.5 million. Although the smallest fixed pay package ($345,056) is significantly higher than the minimum fixed pay for earlier years, this is driven by the fact that the small figures for earlier years were for CEOs who had been in office for less than a full financial year.

Figure 1 shows the distribution of CEO fixed remuneration component. Thirty of the 78 sample CEOs had a fixed component of less than $1 million. Thirty-nine CEOs had fixed remuneration between $1 million and $2 million. Seven CEOs had fixed remuneration between $2 million and $3 million. And then the there were the two outliers: $6.7 million and $13.5 million.

Yearly comparison	*2000*	*2001*	*2002*	*2003*
Average	$967,844	$1,008,012	$1,027,288	$1,424,285
Minimum	$80,000	$52,055	$50,575	$345,056
Maximum	$7,205,688	$8,543,137	$7,938,000	$13,486,153
Median		$781,788	$914,330	$1,137,769
Average Change…	*2000 to 2001*		*2001 to 2002*	*2002 to 2003*
for fixed pay…	+$40,168		+ $19,276	**+$396,997**

Table 1. Fixed remuneration: 2000-2003 comparison.

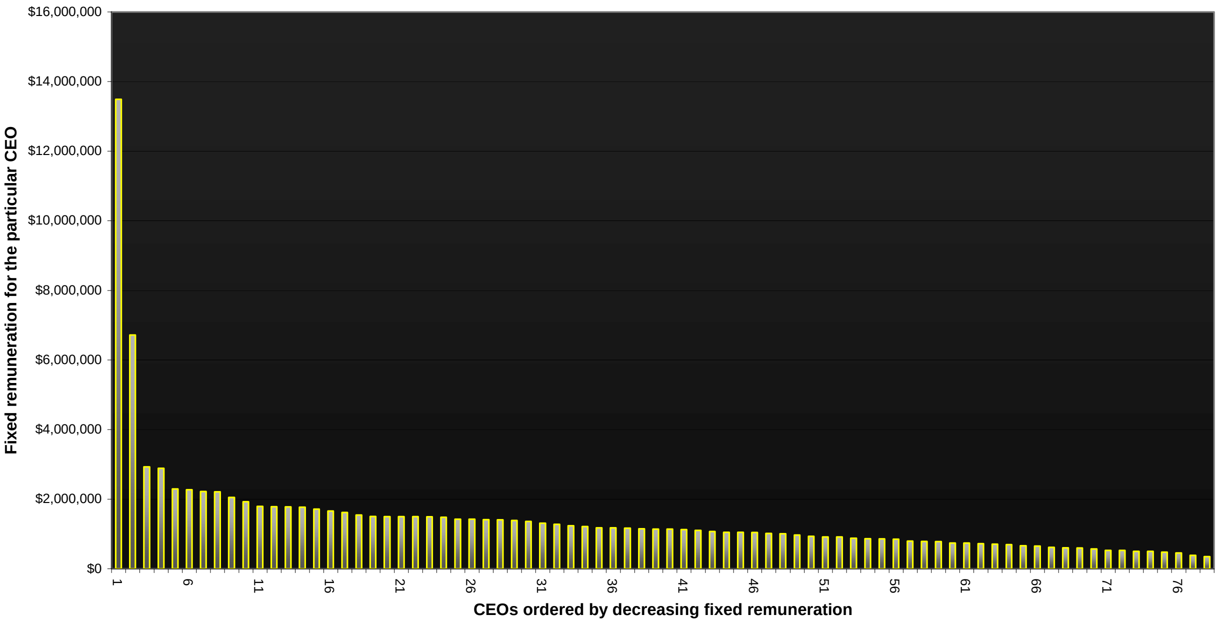


Figure 1. Distribution of fixed remuneration payments.

4.1.2 Short-term incentive

Most Top 100 companies have a short-term incentive plan (STIP) for their senior executives. Of the 78 sample companies in this study, 62 (79.5%) made a payment to their CEO under a STIP.

As the word "incentive" suggests, a STIP is (or at least in theory is) designed to reward the executive if certain performance measures are met. However, unlike a long-term incentive plan (LTIP), it is not common for a STIP's performance measures to relate to the company's share price. Rather, it is common for performance indicators to relate to company-wide accounting performance, business-division performance, successful completion of major projects, etc.

By far the most common type of short-term incentive is an annual cash bonus. Sixty of the 62 sample companies that made a short-term incentive payment in 2003 made the payment entirely as a cash bonus. One delivered the incentive partly as a cash bonus and partly in the form of shares (which were required to be held for a specified number of years: "deferred shares"), and the other delivered the incentive wholly as deferred shares.

Table 2 shows the short-term incentive figures for 2000 to 2003. Sixteen of the 78 CEOs did not receive a cash bonus in 2003. For those CEOs who did receive a cash bonus, the average bonus payment rose by 36.9% (from $937,347 in 2002 to $1,283,330 in 2003). The average is again skewed by the largest figures, as indicated by the lower median figure: $735,129 in 2003. However, as with the median for fixed pay, the median for short-term incentive was up considerably from earlier years. It was 54.7% higher than the 2002 median ($475,000) and 90.1% higher than the 2001 median ($386,805).

Table 2 also shows the range of short-term incentive payments: from $88,000 to $12.38 million.

Figure 2 shows the distribution of bonus payments. Twenty-one payments were of less than $500,000. Nineteen were between $500,000 and $1 million. Sixteen were between $1 million and $2 million. Four were between $2 million and $5 million. And the two outliers were $12.3 million and $12.4 million.

Yearly comparison	*2000*	*2001*	*2002*	*2003*
Average	$1,190,334	$871,389	$937,347	$1,283,330
Minimum	$50,000	$73,000	$50,000	$88,000
Maximum	$13,808,000	$6,239,739	$10,944,000	$12,381,000
Median		$386,805	$475,000	$735,129
Average Change…	*2000 to 2001*		*2001 to 2002*	*2002 to 2003*
for STI…	-318,945		+ $65,958	**+ $345,983**

Table 2. Short-term incentive: 2000-2003 comparison.

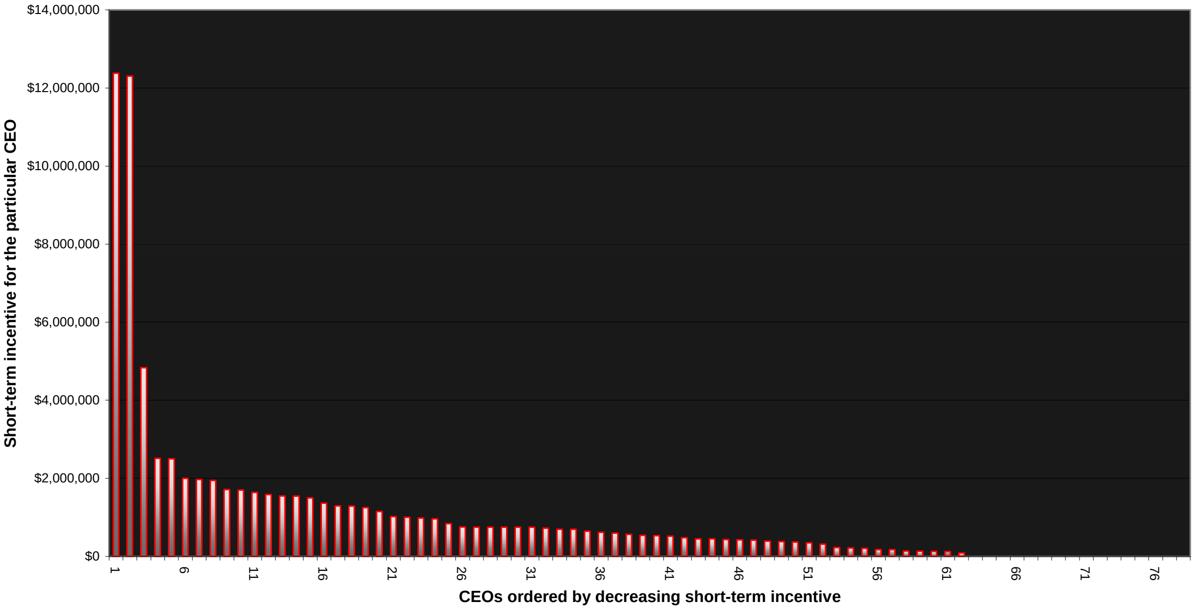


Figure 2. Distribution of short-term incentive payments.

4.1.3 Total remuneration excluding long-term incentive

Background

Historically it has been important to consider total pay both *including* and *excluding* the long-term incentive. This is because the way companies have traditionally made long-term incentive awards, and recorded the value of them in the annual report, has led to significant fluctuations in total pay from year to year:

- In recent years, it has not been uncommon for companies to make "lumpy" grants of options (or another incentive instrument) under the LTIP. That is, they grant options to an executive only once every three or four years. (However, some companies have in recent years moved towards making more regular (annual), smaller, awards of options.)
- Until recently, when an Australian company disclosed the value of executive share options granted, it would typically allocate the entire value as at the date of grant.

In combination, these two factors meant that a CEO's total remuneration *including* long-term incentive could fluctuate considerably. It would appear to be relatively high in those years when options were granted, and relatively low in those years when options were not granted.

However, in June 2003 the Australian Securities and Investments Commission (ASIC) issued Guidelines stating that, for executive remuneration disclosure purposes, the value of options granted during the financial year should be allocated equally over the period from grant date to vesting date.

> Assume a CEO was granted 1,000,000 options on 1 July 2003, and the minimum time before the options could vest is four years. A valuation of the options is carried out by the company's accountant and it is determined that each option's value is $2.00 (giving a total options package value of $2 million). In relation to this grant of options, the company should include $500,000 as "value of options" in the directors' and executives' remuneration section in each of the 2004, 2005, 2006 and 2007 annual reports.

Allocating the value across the vesting period will, in future, remove the lumpiness problem referred to above. However, for a transitional period of two years or so, a different problem will exist: ASIC's Guidelines state that no adjustments should be made to exclude amounts already disclosed in previous financial years. This means that, if a company made a grant of options to its CEO on 1 July 2002, with a four-year vesting period, and the company – under the previous practice – disclosed the full value in its annual report for the year ended 30 June 2003, the company will nevertheless need to include 25% of the options' value in the CEO's pay disclosure in the annual reports for years ending 30 June 2004, 2005 and 2006. So, some double-counting will occur for a transitional period due to ASIC's approach. However, ASIC's approach is consistent with that taken by the International Accounting Standards Board and the Australian Accounting Standards Board (see Pending Accounting Standard AASB 2 "Share-based Payment"), in relation to valuing options for the purposes of recognising an expense in the financial statements.

Results

Table 3 compares total remuneration (excluding long-term incentive) for the sample companies over the period 2000 to 2003. Average (mean) pay, excluding long-term incentive, increased by 2.6% between 2002 and 2003 (from $2.38 million to $2.44 million).

As mentioned on pages 9 and 11, during the year average fixed remuneration increased by 38.6% and average short-term incentive increased by 36.9%. The reason the average total remuneration excluding long-term incentive increased by only 2.6% is that not all CEOs were paid a short-term incentive during the year (16 of the 78 CEOs did not receive a short-term incentive). If those CEOs who did not receive a cash bonus are excluded, average (mean) pay, excluding long-term incentive, increased by 3.6% between 2002 and 2003 (from $2.74 million to $2.84 million).

The median figure ($1,773,180) was 22.5% higher than the 2002 median ($1,447,111) and 24.6% higher than the 2001 median ($1,422,662).

Table 3 also shows the range of total (non-LTIP) pay: from $387,472 to $25.8 million. The lowest figure is significantly higher than the minimum figure for earlier years, but again the small figures for earlier years refect CEOs who had been in office for less than a full financial year. The highest figure ($25.8 million) is noticeably higher than the highest figures recorded for 2000, 2001 and 2002.

Figure 3 shows the distribution of total (non-LTIP) pay. Seventeen of the 78 sample CEOs had a total package (excluding long-term incentive) of less than $1 million. Twenty-six CEOs had a package between $1 million and $2 million. Sixteen CEOs had a package between $2 million and $3 million. Fourteen CEOs had a package between $3 million and $4 million. The remaining packages were $4.2 million, $5.5 million, $8.3 million, $13.4 million and $25.8 million.

Yearly comparison	*2000*	*2001*	*2002*	*2003*
Average	$2,243,464	$2,018,190	$2,381,356	$2,444,368
Minimum	$195,931	$166,457	$50,575	$387,472
Maximum	$14,935,000	$14,858,824	$16,294,620	$25,793,845
Median		$1,422,662	$1,447,111	$1,773,180
Average Change…	***2000 to 2001***		***2001 to 2002***	***2002 to 2003***
for total remuneration (excl LTI)…	-$225,274		+$363,166	**+$63,012**

Table 3. Total remuneration excluding long-term incentive: 2000-2003 comparison.

Yearly comparison	*2000*	*2001*	*2002*	*2003*
Average	$2,243,464	$2,018,190	$2,734,769	$2,840,629
Minimum	$195,931	$166,457	$523,540	$553,056
Maximum	$14,935,000	$14,858,824	$16,294,620	$25,793,845
Median		$1,422,662	$1,466,345	$2,095,769
Average Change…	***2000 to 2001***		***2001 to 2002***	***2002 to 2003***
for total remuneration (excl LTI)…	-$225,274		+$716,579	**+$105,860**

Table 4a. Total remuneration excluding long-term incentive: 2000-2003 comparison.

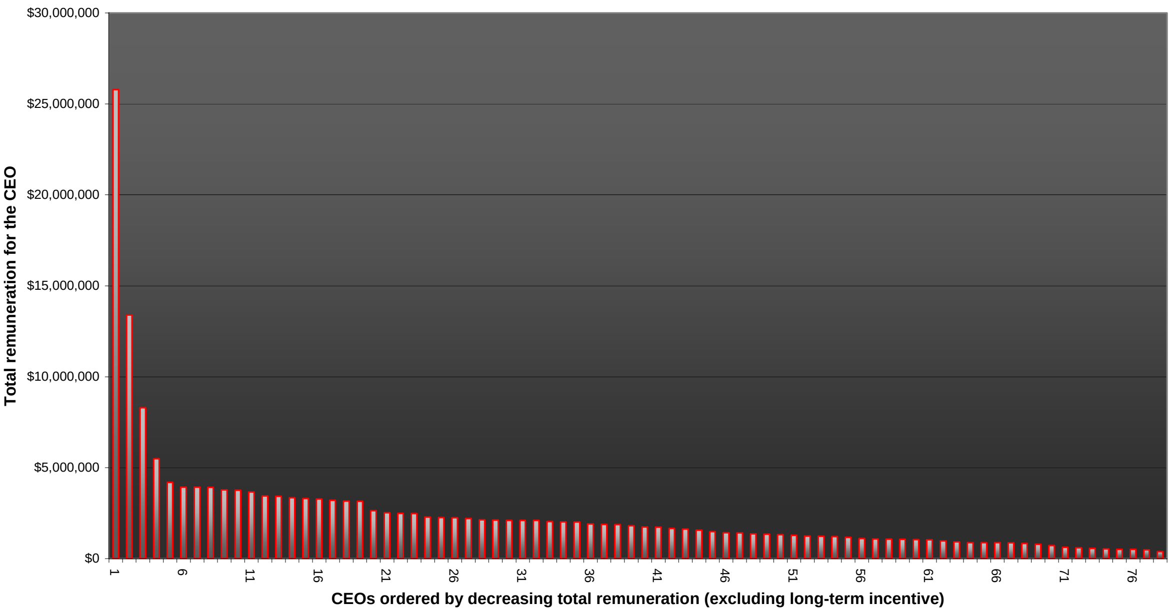


Figure 3. Distribution of total remuneration (excluding long-term incentive).

Figure 4 shows total remuneration (excluding long-term incentive) across industries. There are clear outliers in the Consumer Discretionary, Financials and Materials sectors. When these outliers are disregarded, the spread of pay packets between CEOs in particular sectors is broadly similar. For instance, 13 out of 17 CEOs in the Materials sector were paid more than $1 million during 2003, as were 16 out of 19 CEOs in the Financials sector.

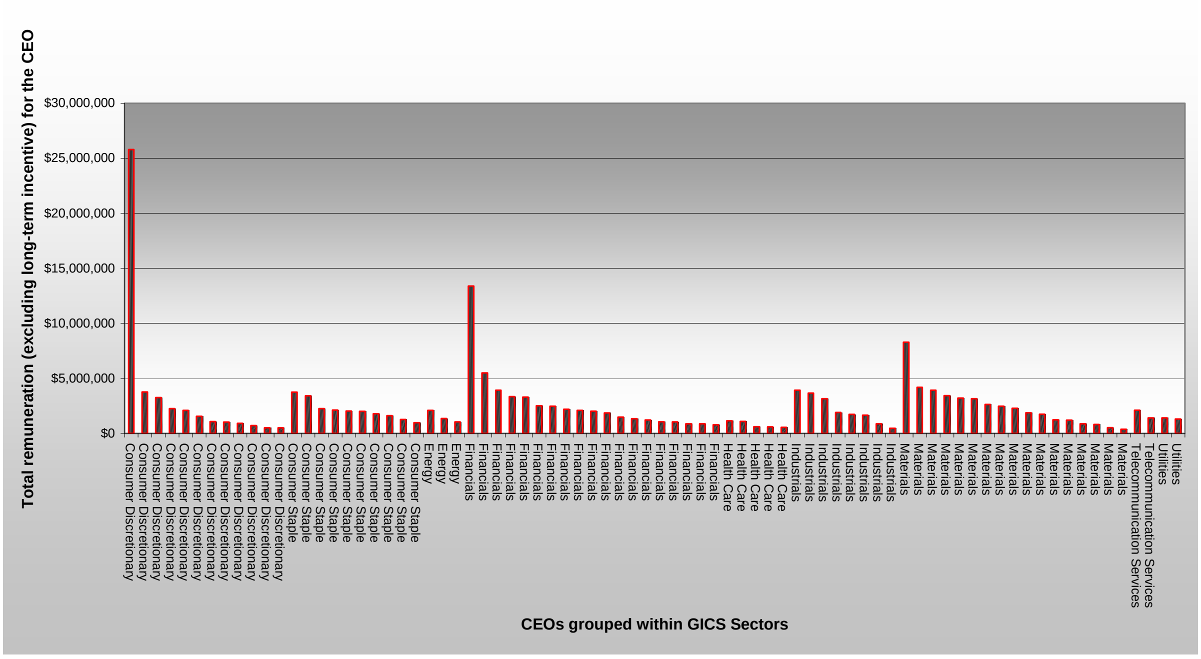


Figure 4. Total remuneration excluding long-term incentive, ordered by GICS sectors.

4.1.4 Total remuneration including long-term incentive

This section examines CEOs' total remuneration packages, including the value of long-term incentives.

Issues relating to the long-term incentive component of executive pay are explored in detail in:

- A companion paper that IA Research is currently preparing for ACSI: "The Incentive Components of Executive Pay".
- Section 4 of last year's Report: "CEO Pay in the Top 100 Companies: 2002" (May 2003).
- An earlier Briefing Paper prepared by IA Research for ACSI: "Executive Share Option Schemes in Australia's Largest Companies" (December 2001).

Table 4 compares total remuneration from 2000 to 2003. Average total pay, including long-term incentive, decreased by 2% between 2002 and 2003 (from $3.23 million to $3.16 million).

The median figure ($2,325,692) was 10.8% higher than the 2002 median ($2,098,601) and 9.7% higher than the 2001 median ($2,120,411).

Table 4 also shows the range of total pay: from $387,472 to $26.7 million.

Figure 5 shows the distribution of total pay. Ten of the 78 sample CEOs had a total package (including long-term incentive) of less than $1 million. Twenty-five CEOs had a package between $1 million and $2 million. Twelve CEOs had a package between $2 million and $3 million. Fourteen CEOs had a package between $3 million and $4 million. Six CEOs had a package between $4 million and $5 million. Six CEOs had a package between $5 million and $6 million. The remaining packages were $6.5 million, $7.8 million, $9.8 million, $13.4 million and $26.7 million.

Yearly comparison	*2000*	*2001*	*2002*	*2003*
Average	$4,190,660	$2,644,393	$3,228,695	$3,163,769
Minimum	$348,338	$166,457	$50,575	$387,472
Maximum	$69,098,875	$14,858,823	$16,294,620	$26,681,537
Median	$2,168,289	$2,120,411	$2,098,601	$2,325,692
Average Change…	*2000 to 2001*		*2001 to 2002*	*2002 to 2003*
for total remuneration…	-$1,546,267		+ $584,302	**-$64,926**

Table 5. Total remuneration including long-term incentive: 2000-2003 comparison.

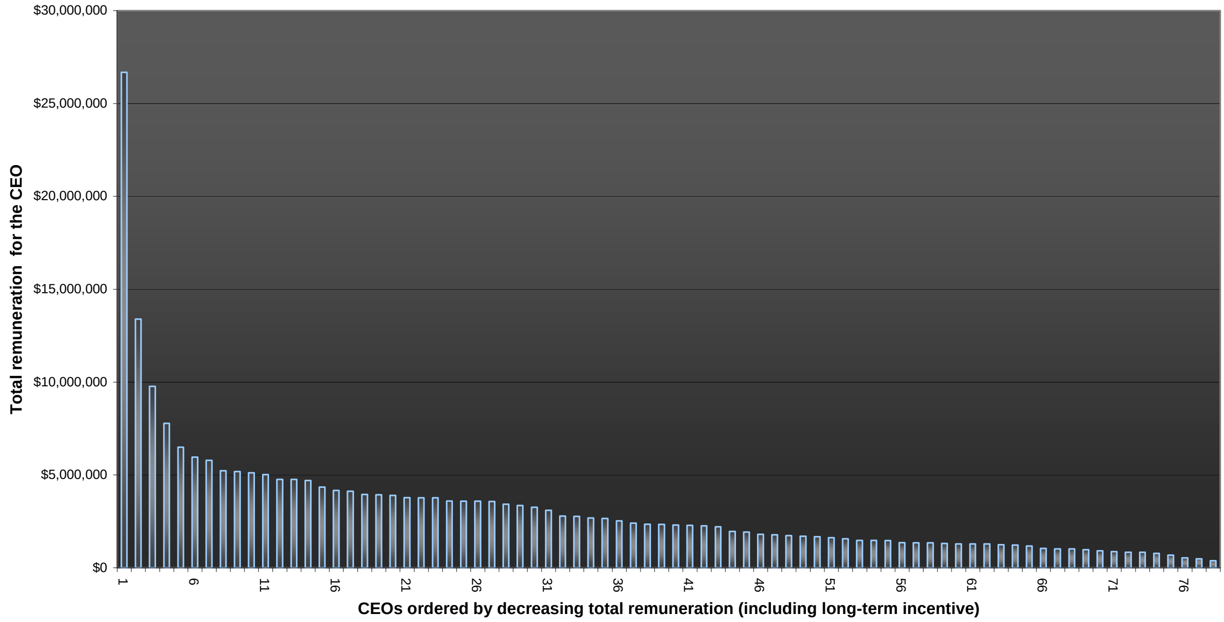


Figure 5. Distribution of total remuneration (including long-term incentive).

4.2 Remuneration components in detail

This section is designed to allow analysis of the relative significance of base salary, annual bonus (short-term incentive), options/shares (long-term incentive), and other components of CEO remuneration.

Companies have not adopted a standardised approach to disclosing the components of executive remuneration. Investors would benefit if a standardised approach were to be adopted, because this would allow for much easier comparison between companies. During the debate on the CLERP9 Bill, pressure has mounted for Australia to adopt the same approach as the United States – where SEC rules require companies to disclose the components of senior executives' compensation in standardised categories.

The problem is most pronounced in Australia in relation to amounts such as superannuation, value of use of a motor vehicle, and other fringe benefits. Some companies itemise these elements of remuneration, under their specific headings. But other companies use a general heading like "Non-cash Benefits" to disclose the total of all these elements.

> The new Accounting Standard AASB 1046 contains a pro-forma table that – if all listed companies elected to use it – would resolve the comparability problem. However, the table (contained in Appendix 3 to AASB 1046) is provided "for illustrative purposes only" and is specifically "not mandatory".

Some points to note about Table 6 are:

- For 2001 and 2002, the data on "Allowances", "Motor Vehicle" and "Retirement Benefits" was aggregated and included with "Other benefit" – for the reason outlined above. However, even though those three components of pay are itemised for 2003, the "Other benefit" figure will still include some motor vehicle allowances, retirement benefits and other allowances, even for 2003, because some companies continue not to provide separate figures. For the same reason, the "Other benefit" category also includes some superannuation for all three years.
- For 2003, the short-term incentive has been separated out as a cash bonus or a grant of shares. However, as the data shows, the annual cash bonus is still by far the most popular form of short-term incentive.
- For 2003, the manner in which shares were provided as a long-term incentive is separately itemised: as either "Performance Rights", "Deferred Shares", "Loan-Funded Share Scheme" or "Free Shares". Performance rights and deferred shares are both zero exercise price options (ZEPOs). An executive who receives ZEPOs, unlike an executive who receives traditional options, is not required to pay anything to the company at the time of vesting. The exercise price is zero – whereas the exercise price for traditional options is normally whatever the company's share price was back on the date the options were granted.
- The far-right column of Table 6 shows that the number of companies using performance rights and deferred shares was significantly higher in 2003 compared to 2001 and 2002. However, the value of those instruments awarded in 2003 does not appear to have been

significantly different to 2001 and 2002 (although, due to aggregation in the earlier years, it is not possible to say with precision).

- The long-term incentive component of pay is detailed in the final six rows of Table 6. The data in these rows reveals that long-term incentives accounted for 28% of the average CEO's total remuneration in 2001, 34% in 2002 and 22.8% in 2003. The dip in 2003 is interesting, given that the trend over the past two decades has been for long-term incentives to compose a greater proportion of total pay:
  - In 1987, on average long-term incentives accounted for 6.3% of total CEO pay.
  - In 1990, on average long-term incentives accounted for 13.3% of total CEO pay.
  - In 1995, on average long-term incentives accounted for 27.9% of total CEO pay.

An increase in the relative size of the *short-term* incentive (up from 23.2% in 2002 to 32.3% in 2003) appears to have driven the 2003 dip in comparative significance of the long-term incentive.

Table 5 shows that Australian CEOs are, on average, receiving a far smaller proportion of their total remuneration in the form of long-term incentives than their United States counterparts. The long-term incentive component of pay for the average U.S. CEO is nearly double that of the average Australian CEO.

But, as Table 5 illustrates, the average Australian CEO in 2003 was receiving considerably more of her or his pay in the form of options and shares than the average British CEO in 1997.

CEO of company in…	*Salary*	*Short-term incentive*	*Long-term incentive*
Australia	38%	32%	23%
United Kingdom	59%	18%	10%
United States	29%	17%	42%

Table 5. Components of total remuneration: Australian, UK and US CEOs.

Source for UK and US: Martin Conyon and Kevin Murphy, "The Prince and the Pauper? CEO Pay in the United States and the United Kingdom" (2000) 110 *Economic Journal* F640. UK and US figures are as at 1997.

	2001 Total Amount	2002 Total Amount	2003 Total Amount	2001 Proportion of total pay	2002 Proportion of total pay	2003 Proportion of total pay	2001 Number disclosing this component	2002 Number disclosing this component	2003 Number disclosing this component
Base salary	$64,512,799	$80,211,417	$92,421,433	38.1%	31.5%	37.5%	64	78	78
Bonus component (Cash)	$43,569,466	$59,128,151	$78,209362	25.7%	23.2%	31.7%	50	62	61
Bonus component (Shares)			$1,357,121			0.6%			2
Other benefit	$7,922,605	$22,810,308	$9,573,645	4.7%	9.0%	3.9%	48	56	51
Superannuation	$2,414,713	$5,869,570	$3,041,119	1.4%	2.3%	1.2%	32	45	40
Allowances			$841,986			0.3%			4
Motor Vehicle			$217,774			0.1%			4
Retirement Benefits			$4,998,265			2.0%			4
Cash long-term incentive payment	$7,458,969	$13,830,484	$10,870,061	4.4%	5.4%	4.4%	11	7	5
Options	$22,562,872	$50,642,948	$26,644,319	13.3%	19.9%	10.8%	19	39	36
Performance Rights	$17,514,110	$22,076,408	$10,488,984	10.3%	8.7%	4.3%	15	12	15
Deferred Shares			$6,143,166			2.5%			10
Loan-Funded Share Scheme			$1,966,764			0.8%			9
Free Shares			$0			0%			0
Total	**$169,241,163**	**$251,838,210**	**$246,773,999**	**100%**	**100%**	**100%**			

Table 6. Components of total remuneration.

5 DISCLOSURE OF OPTIONS' VALUE

Background

Section 300A of the Corporations Act requires listed companies to disclose, in the annual report, "details of the nature and amount of each element of the emolument of each director and each of the 5 named officers of the company receiving the highest emolument".

Until early 2003, a number of Australian companies had interpreted section 300A as not requiring them to disclose the value of share options granted to directors and senior executives.

However, in May 2003 ASIC announced – through a strongly worded Media Release and draft guidelines – that it interpreted section 300A as mandating disclosure of options value. In the final version of its "Guidelines to Valuing Options in Annual Directors' Reports", released in June 2003, ASIC warned that it would "consider taking action against the directors" if a company did not disclose the value of options granted to directors or executives.

Also, in January 2004 the Australian Accounting Standards Board released AASB 1046 "Director and Executive Disclosures by Disclosing Entities". This new Accounting Standard requires the value of options (and other equity incentives) to be disclosed for reporting periods ending on or after 30 June 2004. Because it is an Accounting Standard, it has the force of law under the Corporations Act (section 296). So there is now no more uncertainty about the legal position where a company chooses not to disclose (or neglects to disclose) the value of options granted to directors and executives. Because the Corporations Act requires listed companies to comply with all Accounting Standards, if a company does not disclose options' value for a reporting period ending on or after 30 June 2004, each of that company's directors will be subject to the civil penalty regime in the Act because the company's failure to comply with AASB 1046 will constitute a breach of section 296. That is, even if there is still some room for arguing about the meaning of section 300A, that will no longer be a valid basis on which not to disclose the value of options. AASB 1046 is a stand-alone disclosure requirement.

> After the CLERP9 Act is passed, Treasury intends that a new Regulation (made under the Corporations Act) will prescribe the details that need to be disclosed under section 300A. The draft version of the proposed Regulation cross-refers to AASB 1046 in setting out what information must be disclosed.

This year's study provides the first evidence of options' disclosure since ASIC adopted its hard-line stance. AASB 1046 did not apply to 2003 annual reports, although its requirements had been flagged to the market through an Exposure Draft standard (ED 106, released in May 2002).

Results

Last year's study (based on 2002 annual reports) found that 75% of the sample companies disclosed the value of options or shares granted as at the grant date. This was a significantly higher incidence of disclosure than a year earlier, when only half the Top 100 companies disclosed this information.

Every sample company which granted options to a director or top 5 executive in 2003 disclosed a value for those options. At first blush, this appears to show that ASIC's tough stance has led to 100% compliance with section 300A. However, on closer inspection:

- One company, which issued options in February 2002 (i.e. in the previous financial year), that remained unvested as at 30 June 2003, did not allocate a portion of the value of those options in its 2003 annual report. This is inconsistent with the ASIC Guidelines, which state that "these guidelines do not provide any exclusion for options granted before 7 November 2002". (And, incidentally, the company had not disclosed any value for these options in its 2002 annual report.)
- The same company also has a cash-based long-term incentive for senior executives. However, it did not disclose the amount that accrued under that plan for the CEO during the financial year.
- Several companies use a loan-funded share plan as their long-term incentive. Invariably, these companies disclose either the "notional interest" that the company has foregone during the year (where the loan is interest-free), or details about the interest paid or payable (where the loan incurs interest). But is this really information about the *value* of the equity incentives being provided by the company? The ASIC Guidelines are not strictly relevant where a company has a loan-funded share plan rather than an options plan. However, going forward, for financial reporting purposes (rather than disclosure of pay purposes), these companies will need to recognise that Pending Accounting Standard AASB 2 "Share-based Payment" applies – as its title suggests – not only to options but also all other forms of equity incentives.
- For another company, it is not possible to judge whether it complied with section 300A, or even whether the company issued options or other equity incentives during 2003, because:
  - The company appears not to have filed its full-length annual report with the ASX (the ASX announcements page contains only a copy of the concise annual report); and
  - The company's website does not contain a copy of its full-length annual report. Again, there is only a copy of its concise annual report. The concise report does not contain the "Related Party" note to the financial statements.

6 Top 10 Case Studies

This section discusses 10 "pay-for-performance" case studies.

The 10 highest-paid CEOs were selected from the data discussed earlier in the report. (One of the top 10 CEOs works for a company that has been listed on ASX for less than two years. Because of the lack of historical pay and performance data in this case, this CEO was excluded and replaced by the 11th highest-paid CEO.)

The pay figure used to determine the ranking of CEOs was total pay *including* long-term incentive. Table 7 shows the remuneration for the CEOs selected.

Having identified the top 10 CEOs on that basis, we then gathered pay and corporate performance data for the period 1999 to 2003.

<u>Measures of performance used in the graphs</u>

Over the following pages graphs are shown comparing the CEO's remuneration over the last five years compared to three measures of corporate performance:

- Share price performance (SPP).
- Earnings before interest and tax over total assets (EBIT/Assets).
- Total shareholder return (TSR).

SPP captures the performance of the company's share price over several years.

EBIT/Assets is also referred to as "return on assets". It is an accounting measure of profitability. It captures the particular company's profit performance relative to that company's total assets.

TSR is a measure of the total financial return a shareholder would obtain from owning the company's shares for a period of time. TSR for one year takes into account the increase (or decrease) in the share price between the start and end of the year in question, and also the value of dividends paid by the company during the year (which are assumed to have been reinvested).

<u>How to compare pay and performance?</u>

In analysing the graphs, it is important in some respects to allow for a lag. For instance, one would expect the *short-term incentive* component of the CEO's pay in 2003 to reflect the company's performance in 2002 and possibly earlier years.

A qualification to this proposition is required. This is because the typical short-term incentive plan for an ASX-listed company includes performance conditions that relate to matters other than share price and dividends. The performance measures are often related to "internal" performance more than external measures like share price.

For example, in one short-term incentive plan, the performance measures relate to a series of quantitative measures (return on equity, cost management, total operating margins, value of new business) and qualitative measures (performance relative to competitors and market conditions, stakeholder perspectives, personal leadership, effective teamwork at senior management levels and strategic positioning).

So, when looking at the graphs below, the most appropriate measure of company performance against which to compare the short-term incentive is the accounting measure of performance: return on assets (i.e. the second graph in each case).

What about *fixed remuneration* (which is mostly made up of base salary)? Should it be expected that a CEO's base salary would be higher in 2002 than 2001 if the company performed well in 2001 (and, on the other hand, lower in 2002 than 2001 if the company performed poorly in 2001)? This might be expected as a matter of principle, but it should not be expected in practice. This is because the change in base salary from year to year is likely to be driven more by factors such as benchmarking against the base salary of CEOs of peer companies, rather than performance.

What about the *long-term incentive*? Until recently the generally accepted practice in Australia was that options (and performance rights, deferred shares, etc) were valued *in full* at the time they were granted – rather than the time the executive actually makes money out of them (i.e. when they vest). So, when examining the long-term incentive component of the bar charts in the graphs below, it should be borne in mind that this reflects options' / shares' value as at the grant date. In some cases (e.g. where subsequent company performance has been particularly poor), these options / shares will never have vested, and so the executive never actually derived a cash value from them.

Whether CEOs are paid for performance is of course currently a very topical issue in the corporate governance debate. The purpose of these 10 case studies is to provide some examples of the relationship between corporate performance and CEO remuneration in large Australian companies. These are case studies, and not a comprehensive statistical study.

CEO number in study	***2003 Remuneration***
CEO #1	$26,681,537
CEO #2	$13,393,275
CEO #3	$9,775,176
CEO #4	$7,774,626
CEO #5	$6,494,545
CEO #6	$5,963,661
CEO #7	$5,787,000
CEO #8	$5,224,039
CEO #9	$5,118,152
CEO #10	$5,020,880
Average remuneration	$9,123,289

Table 7. CEO case studies: 2003 remuneration breakdown.

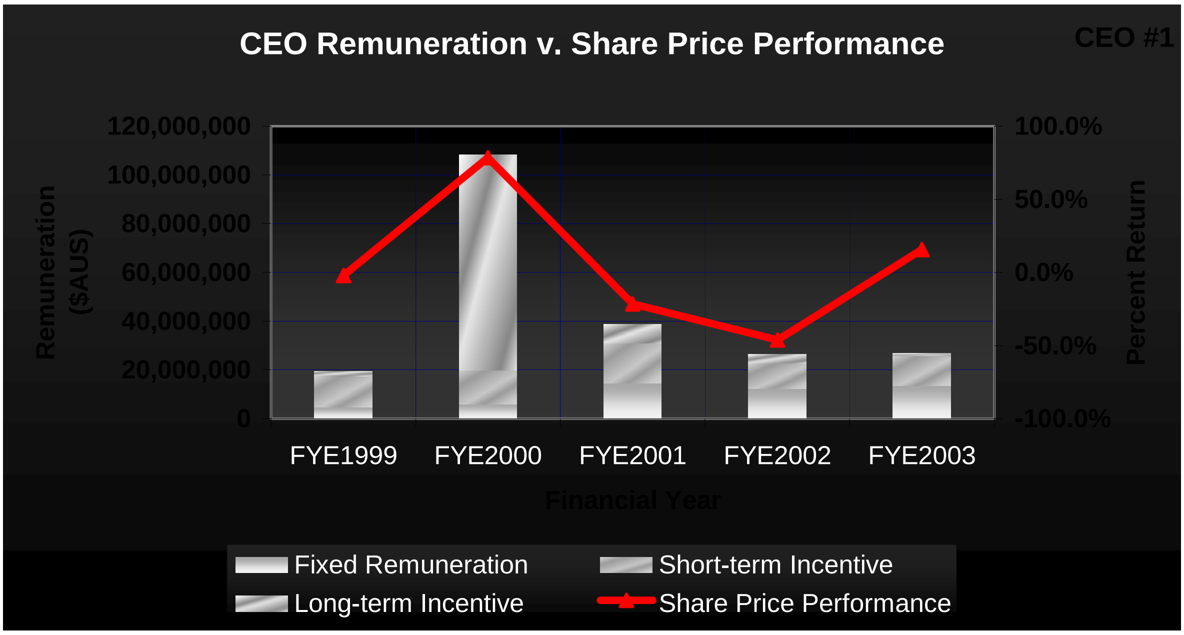


Figure 6. CEO #1: remuneration v share price performance.

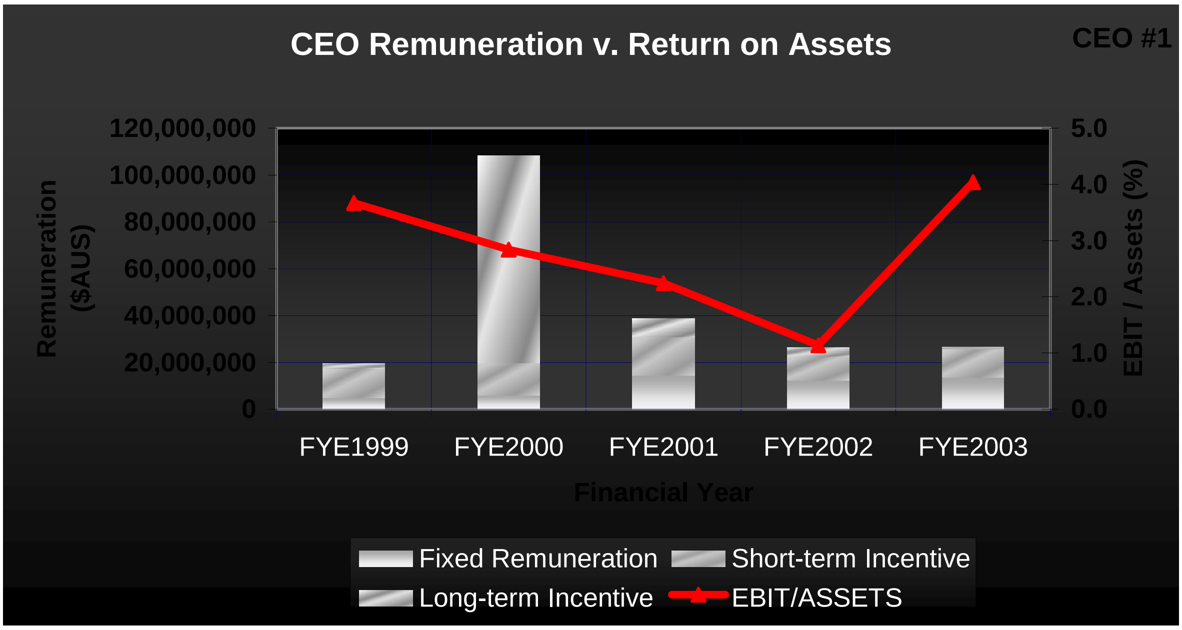
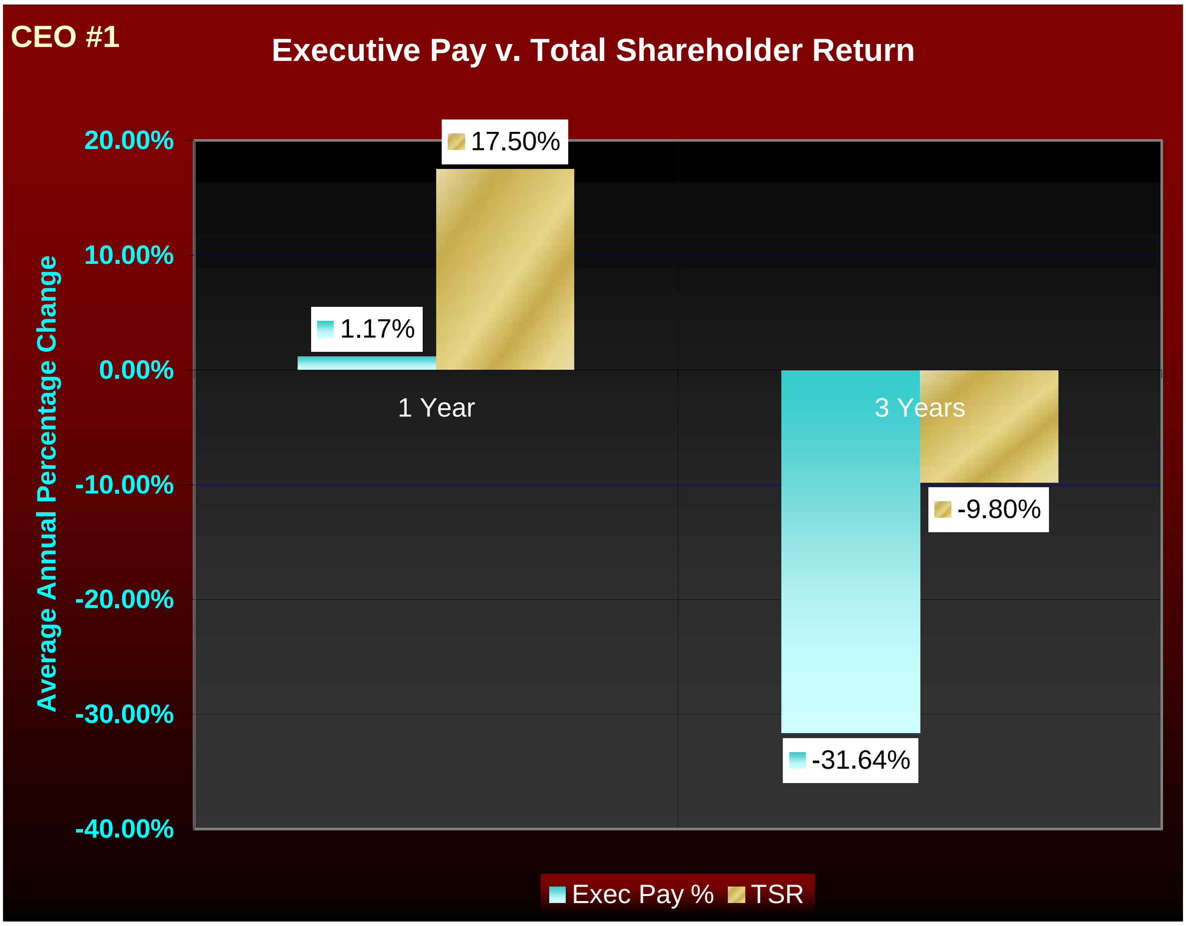


Figure 7. CEO #1: remuneration v earnings before interest and tax over total assets.



Performance: For CEO #1, the company's share price fell 2% in the 1999 financial year, before increasing 78% in the 2000 financial year. It then fell 22% across the 2001 financial year, and a further 46% in the 2002 year. It increased 16% from 1 July 2002 to 30 June 2003.

This company's return on assets was 3.7% in 1999, 2.8% in 2000, 2.2% in 2001, 1.1% in 2002 and 4% in 2003.

Pay: Remuneration received in the 2000 financial year was 453% higher than in 1999.

> This was mainly due to a large grant of options in 2000. Two points should be borne in mind here: First, as discussed earlier in this report, it is customary to value options at the date of grant – even though they may never vest due to (e.g.) performance hurdles not being met, or the company's share price. Second, until recently, 100% of options' value was attributed to executive's pay in the year of grant. The new practice is to allocate the value proportionately over the options' vesting period (which is often three years). In the case of CEO #1 (and indeed, all the CEOs), option grants in 1999 through 2002 have been valued under the old method – so 100% of value appears in the year of grant.

Remuneration fell 64% between 2000 and 2001, and a further 32% between 2001 and 2002. It was then 1% higher in 2003 compared to 2002.

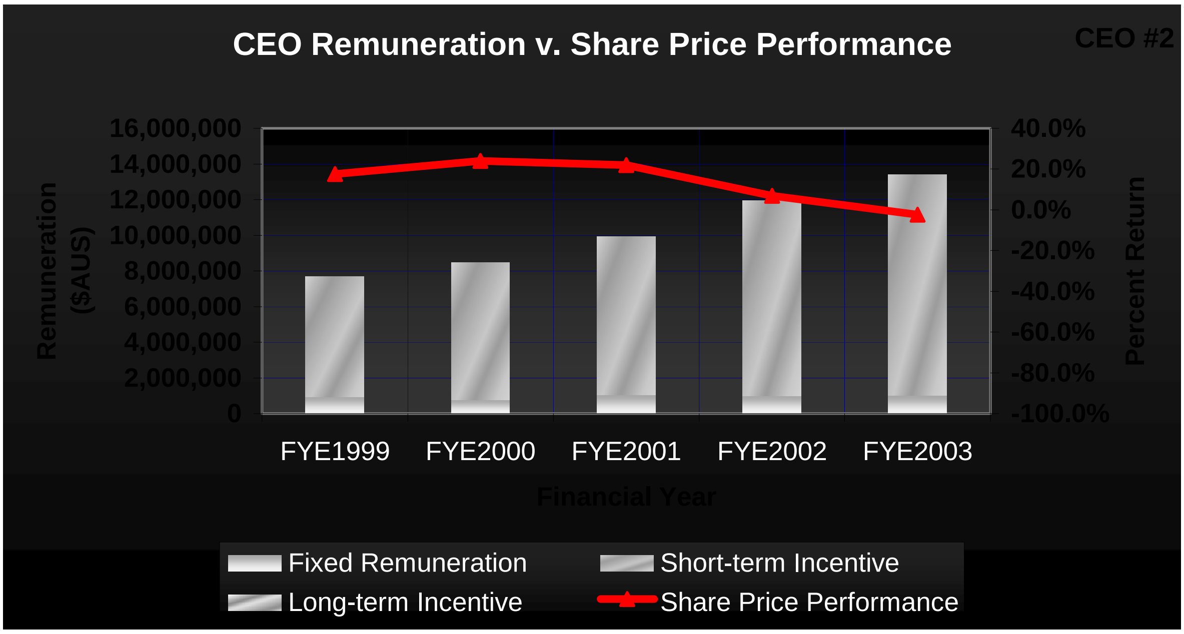


Figure 8. CEO #2: remuneration v share price performance.

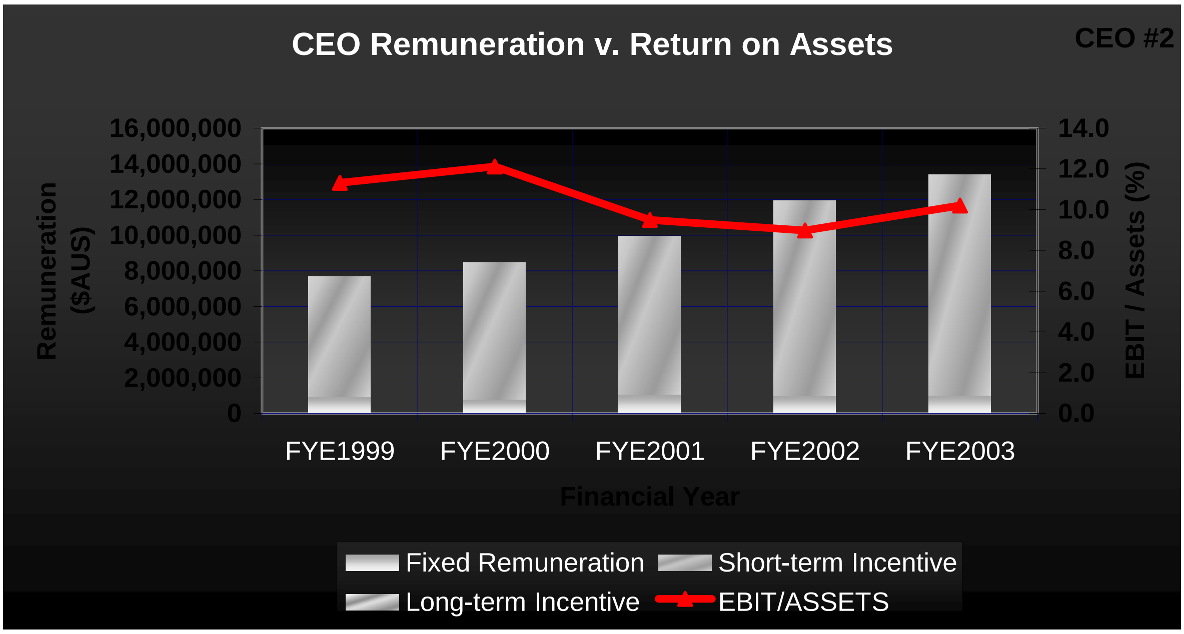
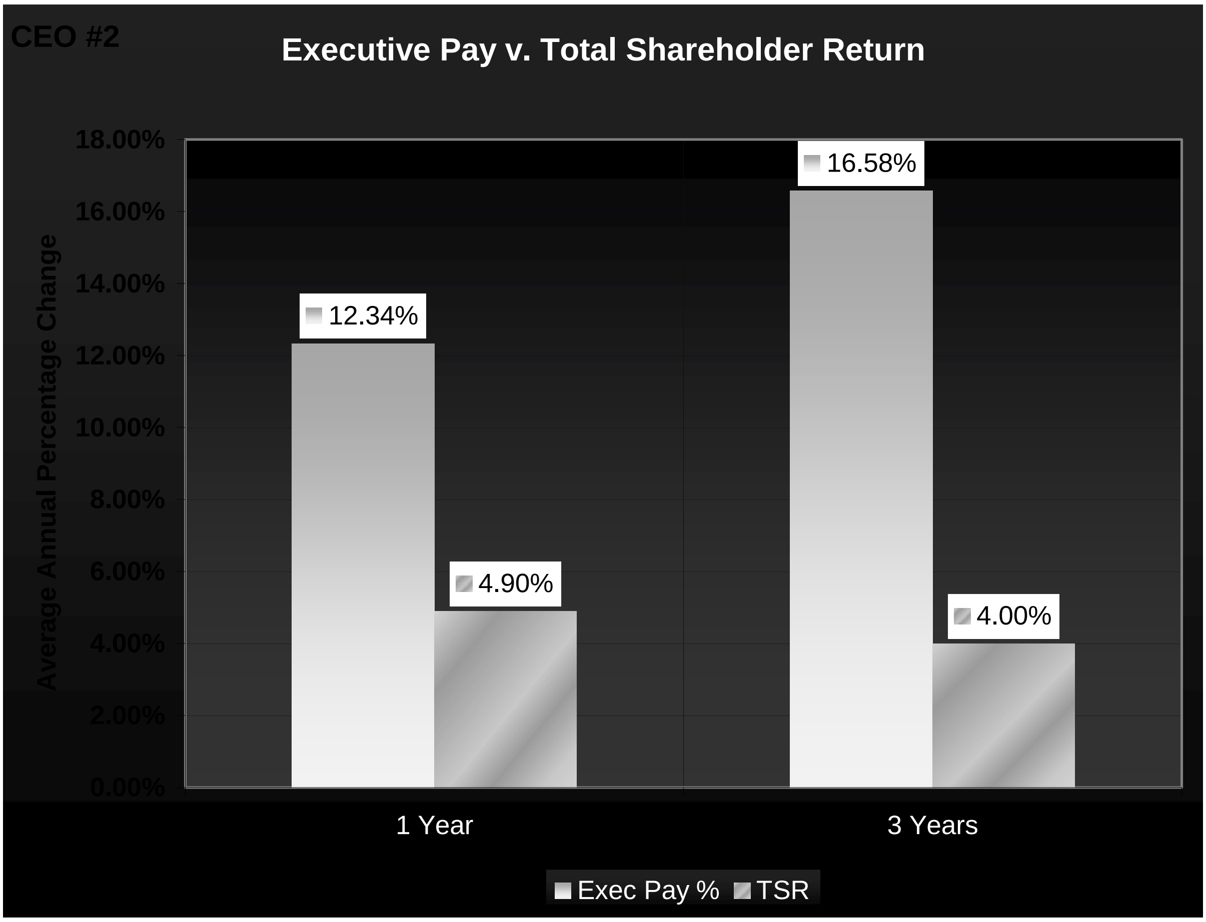


Figure 9. CEO #2: remuneration v earnings before interest and tax over total assets.



Performance: For CEO #2, the company's share price increased 18% in the 1999 financial year, 24% in 2000, 22% in 2001, and 7% in 2002. It then fell 2% across the 2003 financial year.

This company's return on assets was 11.3% in 1999, 12.1% in 2000, 9.5% in 2001, 9% in 2002 and 10.2% in 2003.

Pay: Remuneration received in the 2000 financial year was 10% higher than in 1999. Remuneration was 17% higher in 2001, 20% higher in 2002, and 12% higher in 2003. The bulk of this CEO's remuneration in each of these years was an annual, multi-million dollar, cash bonus.

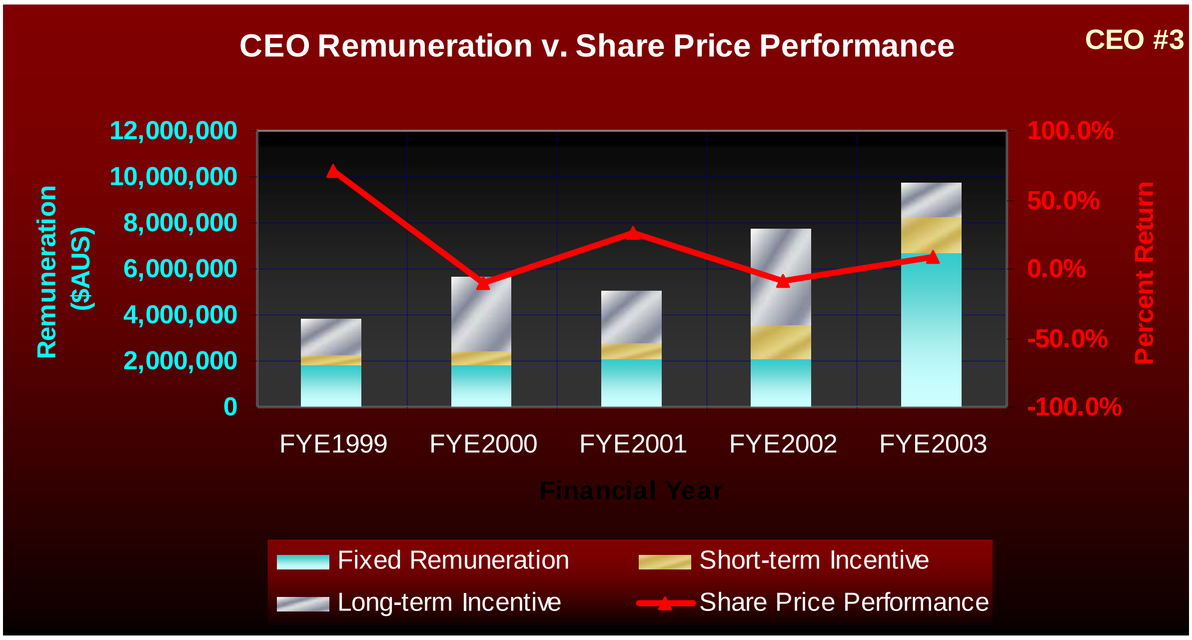


Figure 10. CEO #3: remuneration v share price performance.

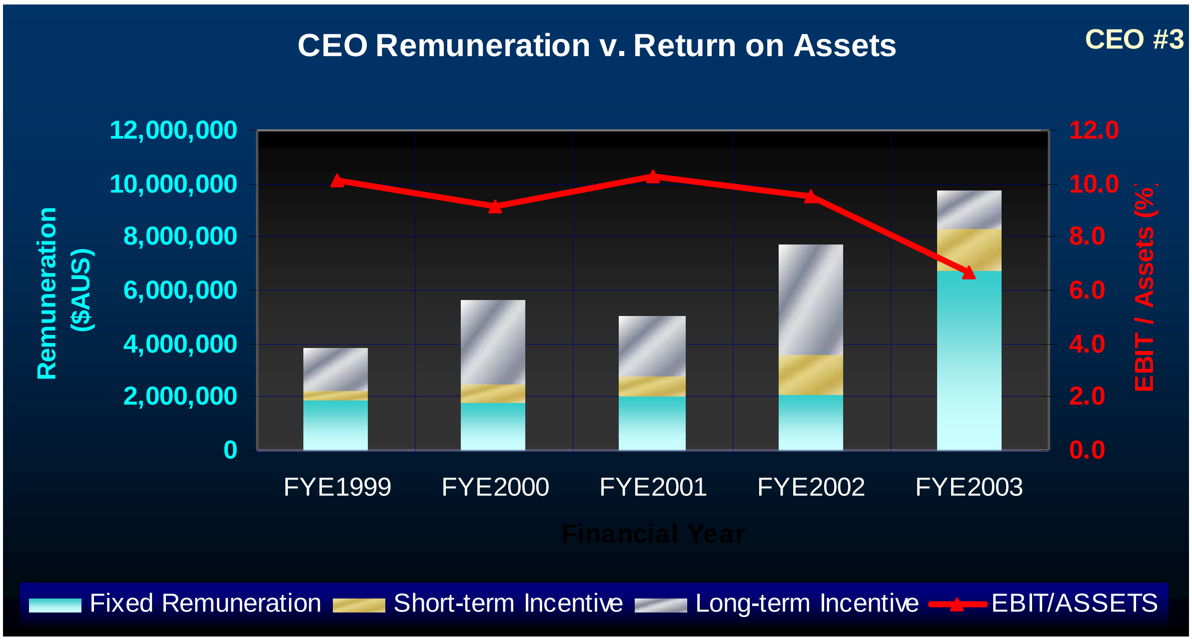


Figure 11. CEO #3: remuneration v earnings before interest and tax over total assets.

Performance: For CEO #3, the company's share price increased 70% in the 1999 financial year, and then fell 10% in 2000. It increased 27% in 2001, and then fell 9% in 2002 before increasing 9% across the 2003 financial year.

This company's return on assets was 10.1% in 1999, 9.2% in 2000, 10.3% in 2001, 9.5% in 2002 and 6.7% in 2003.

Pay: Remuneration received in the 2000 financial year was 46% higher than in 1999. Remuneration fell 10% in 2001, and was then 53% higher in 2002, and rose a further 27% in 2003. For each year except 2003, the long-term incentive accounted for a large percentage of this CEO's remuneration. The large increase in fixed remuneration in 2003 is due to a change in accounting rules where this company is domiciled – which necessitated disclosing the "transfer value" of the increase in retirement benefit that accrued during the financial year.

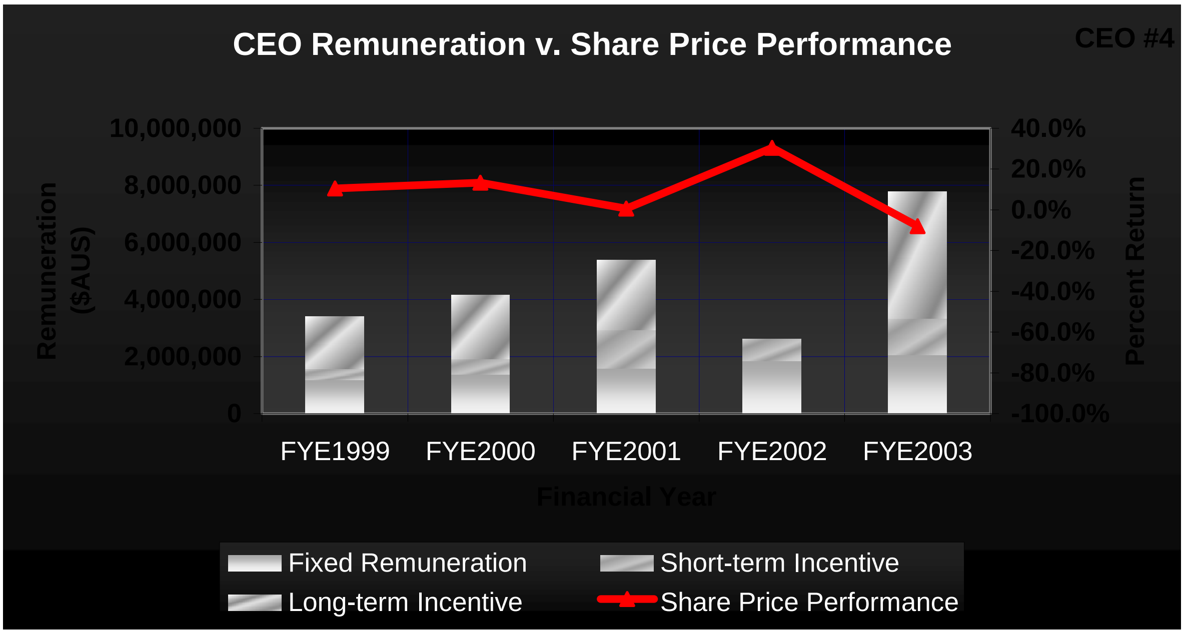


Figure 12. CEO #4: remuneration v share price performance.

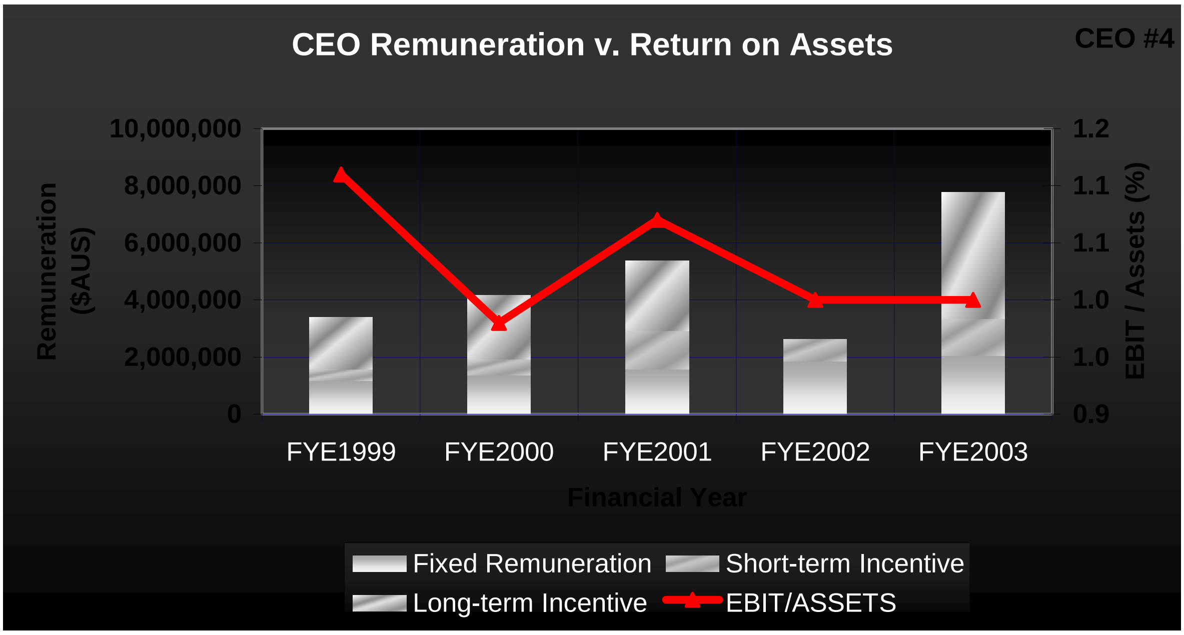
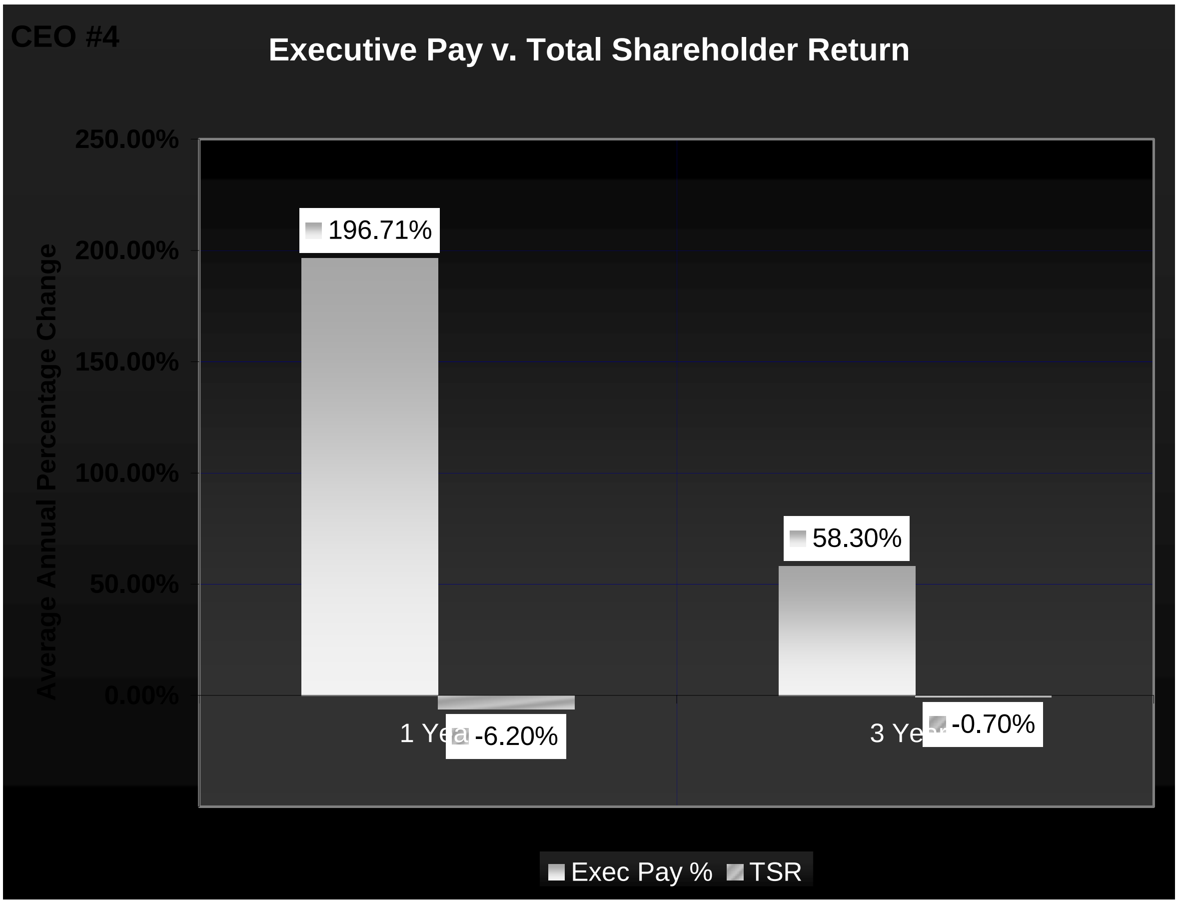


Figure 13. CEO #4: remuneration v earnings before interest and tax over total assets.



Performance: For CEO #4, the company's share price increased 11% in the 1999 financial year, 13% in 2000, 1% in 2001, and 30% in 2003, before decreasing 8% across the 2003 financial year.

This company's return on assets was 1.11% in 1999, 0.98% in 2000, 1.07% in 2001, 1.0% in 2002 and 1.0% in 2003.

Pay: Remuneration received in the 2000 financial year was 22% higher than in 1999. Remuneration rose 29% in 2001, and then fell 51% in 2002, before increasing 197% in 2003. The drop in pay in 2002 was due mainly to no options or performance rights being granted that year. And therefore 2002 served as a comparatively low base when calculating the increase in pay (197%) between 2002 and 2003. The other reason 2003 is such a stark contrast to 2002 for this CEO is that options and performance rights were awarded in 2003, together with the company reporting the accrued value of a deferred long-term cash payment.