Australian Council of Super Investors Inc.

CEO Pay in the Top 100 Companies: 2004

Research Paper
Prepared by ISS Proxy Australia

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EXECUTIVE SUMMARY

ISS Proxy Australia was commissioned by ACSI to conduct an empirical analysis of CEO pay in the Top 100 listed Australian companies for the 2004 financial year. This paper reports the findings of the study.

In several areas, the study revisits issues researched for ACSI by Institutional Analysis for the 2003, 2002 and 2001 financial years[1], and for the Conference of Major Superannuation Funds for the 2000 financial year[2]. Comparative statistics are provided.

KEY FINDINGS

CEO Pay in the Top 100 companies: aggregate statistics

This is covered in Section 3. The study looked at CEO pay in terms of its various components, and found that across the Top 100 companies:

- The average fixed remuneration increased by 9.1% between 2003 and 2004 (from $1.42 million to $1.55 million).
  - The median fixed remuneration was $1,376,798. This is a 21.0% increase on the 2003 median ($1,137,769), and a 50.6% increase on the 2002 median ($914,330).
  - The largest fixed remuneration was $11,731,875 in 2004, compared to $13,486,153 in 2003, $7,938,000 in 2002, $8,543,137 in 2001 and $7,205,688 in 2000.
  - The smallest fixed remuneration was $410,437 in 2004, compared to $345,056 in 2003, $50,575 in 2002, $52,055 in 2001 and $80,000 in 2000. (The small figures in 2002 and earlier years reflect CEOs who had been in office for less than a full financial year.)
- The average short-term incentive increased by 30.3% between 2003 and 2004 (from $1,283,330 to $1,671,608).
  - The median short-term incentive was $911,803. This is a 24% increase on the 2003 median ($735,129), and a 92% increase on the 2002 median ($475,000).
  - The largest short-term incentive was $17,980,437 in 2004, compared to $12,381,000 in 2003, $10,944,000 in 2002, $6,239,739 in 2001 and $13,808,000 in 2000.
  - 9.3% of CEOs did not receive a short-term incentive. Among those who did, the smallest short-term incentive was $126,000, compared to $88,000 in 2003, $50,000 in 2002, $73,000 in 2001 and $50,000 in 2000.
- The average total remuneration excluding long-term incentive (options and shares) increased by 28.7% between 2003 and 2004 (from $2.44 million to $3.15 million).
  - The median total remuneration (excluding long-term incentive) was $2.41 million. This is a 35.8% increase on the 2003 median ($1.77 million), and a 66.4% increase on the 2002 median ($1.45 million).

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[1] IA Research, *CEO Pay in the Top 100 Companies: 2003* (Research Paper prepared for ACSI, June 2004), Institutional Analysis, *CEO Pay in the Top 100 Companies: 2002* (Research Paper prepared for ACSI, May 2003); Institutional Analysis, *Board Composition and Pay in the Top 100 Companies: 2001* (Research Paper prepared for ACSI, January 2002), Section 9.

[2] Institutional Analysis, *Board Composition and Pay in the Top 100 Companies* (Paper presented to the Conference of Major Superannuation Funds, Gold Coast, March 2001), Sections 7 and 8.

- The largest remuneration package (excluding long-term incentive) was $29,712,312 in 2004, compared to $25,793,845 in 2003, $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 $410,437 compared to $387,472 in 2003, $50,575 in 2002, $166,457 in 2001 and $195,931 in 2000.

* The average total remuneration including long-term incentive increased by 23.7% between 2003 and 2004 (from $3.23 million to $3.91 million).
  - The median total remuneration (including long-term incentive) was $3.14 million. This is a 34.9% increase on the 2003 median ($2.33 million), and a 49.5% increase on the 2002 median ($2.1 million).
  - The largest remuneration package (including long-term incentive) was $29,712,312 in 2004, compared to $26,681,537 in 2003, $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 $410,437 compared to $387,472 in 2003, $50,575 in 2002, $166,457 in 2001 and $348,338 in 2000.
* The long-term incentive component of pay accounted for, on average, 19.7% of total pay for the Top 100 CEOs in 2004. This was down from 28% in 2001. This appears to have been driven partly 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 38.7% of total pay in 2004, up from 32.3% in 2003, 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 2004 was 58.4%. It was 55.1% in 2003, 57.2% in 2002, and 53.7% in 2001.

Disclosure of options’ value

This is covered in Section 4. Every sample company which granted options or performance rights to a director or top 5 executive in 2004 disclosed a value for those options.

However, as discussed below, there is a policy issue in relation to the value ascribed to shares granted under loan-funded share plans.

Top 10 case studies

This is covered in Section 5. We conducted 10 ‘pay-for-performance’ case studies. We identified the 10 highest-paid CEOs for the year 2004, and then compared each CEO’s pay for the five years 2000 to 2004 with their company’s financial performance over the period 2000 through 2004. This revealed a similar story to previous years. Namely, in some instances, CEO pay has moved in relative locks-step with company performance. However, in some cases CEO pay has been large and increasing over a period of poor or at least uneven corporate performance.

KEY OBSERVATIONS

Significant increases in base salary:

* Over the period from 2001 to 2004, median CEO fixed remuneration increased by 76%. This is many times greater than the level of inflation and the increase in average employee earnings over that period (15%). As base salary and other aspects of fixed remuneration are (by definition) not explicitly tied to the company’s performance, companies should disclose clearly the reason or reasons behind a significant increase in base salary. Investors can reasonably expect this disclosure regardless of whether the prior year’s performance was good, mediocre or poor.

Boom in short-term incentives:

- Over the period from 2001 to 2004, the median short-term incentive has increased by 136%. This is a very substantial increase, both in an absolute sense and also relative to wage increases in the general community.
- There would be at least three drivers of this large increase:
  1) One driver is the highly profitable period that 2002 to 2004 represented for many companies. Increasing earnings translates into bonus pay-outs because earnings per share is a widely used performance metric for the short-term incentive.
  2) Another driver is the large increase in fixed pay across the 2001 to 2004 period. This is relevant because virtually all companies tie the size of a short-term incentive payment to the size of the executive's fixed remuneration (e.g. maximum bonus = 100% of fixed remuneration).
  3) A third driver is the trend towards increasing the 'target' and 'maximum' short-term incentive, expressed as a percentage of fixed pay. For example, a CEO whose maximum annual bonus was previously set at 70% of fixed pay is now entitled to a bonus of up to 100% of fixed pay.
- The first driver is unlikely to be contentious for many shareholders.
- The second factor would probably be a concern. If a company increases its CEO's fixed pay by 21% (the median increase between 2003 and 2004), this has a knock-on effect when the short-term incentive is calculated. It will normally also have a knock-on effect when a grant of options is made under the long-term incentive plan — because the value of an options grant is usually also specified as a percentage of total fixed pay.
- The third factor would also concern many investors. It is being driven largely by remuneration comparisons across companies. It is an example of how pay can be 'ratcheted' upwards regardless of the circumstances of an individual company or an individual CEO. A company should not increase the maximum short-term incentive from (say) 70% of fixed remuneration to (say) 100% of fixed remuneration, unless it is prepared to disclose clearly the reason or reasons justifying the increase. Boilerplate justifications along the lines of 'following a review of market practices' are not adequate.

A re-think needed on valuation of loan-funded shares:

- Entities that use a loan-funded securities plan normally disclose interest foregone by the company (due to the loan being interest-free or having a concessional interest rate) as a component of the CEO's pay. The major policy issue that arises here, in relation to valuation, is: Is interest foregone an appropriate measure of value?
- Awarding shares to an executive under a loan-funded share plan is in some key respects analogous to a grant of traditional (market exercise price) options. If the share price on vesting is above the grant-date price, the executive captures the gain. This similarity to a grant of traditional options means a Black-Scholes (or similar) option valuation could be performed for an award of loan-funded shares. This may well result in a higher value than interest foregone.
- Relying on interest foregone as the value for the equity component of remuneration where loan-funded shares are used may well constitute a systematic understatement of the value of the equity component of pay.
- The relevant Accounting Standard (AASB 1046 — which is soon to be folded into AASB 124: Related Party Disclosures) should be amended to require loan-funded grants of shares (or stapled securities) to be valued in the same way as options. The International Financial Reporting Interpretations Committee concluded as much at its August 2005 meeting in London.