ON LINE *opinion* - Australia's e-journal of social and political debate

Heads I win: tails you lose

By John Shields

Posted Tuesday, 21 March 2006

The 100 chief executive officers (CEOs) who comprise the membership of the Business Council of Australia (BCA) represent the self-proclaimed elite of Australian business leadership. The CEOs who constitute the current BCA Board have day-to-day control of some of the most significant firms in the national economy, including Wesfarmers; IBM Australia; Qantas; Zinifex; ABN AMRO; Rio Tinto; and Boral - as well as the entity charged with the voluntary regulation of Australian-listed companies, the Australian Stock Exchange (ASX).

Individually and collectively they have also been in the forefront of the employer campaign for greater flexibility in Australian employment relations, as well as for increased labour productivity and labour cost competitiveness.

Since the election of the Howard Government in 1996, the BCA has enjoyed unparalleled access to the corridors of political power and past and serving members of the BCA board have been among the most outspoken critics of the “over-regulation” of Australia’s economy and labour markets.

The BCA has had a major influence on the Howard Government’s reform agenda, particularly the successive rounds of legislative change to the industrial relations system, the latest and by far the most radical instalment of which is the Work Choices legislation, which came into force late last year.

The BCA CEOs’ advocacy of more thoroughgoing reform of the Australian wages system inevitably invites consideration of their own remuneration as salaried employees and of how their pay has changed over time. In this regard, the long-term trend in the reported levels of CEO total cash remuneration in the 51 Australia Stock Exchange (ASX) listed companies whose CEOs are current BCA members is both instructive and disturbing.

There are four specific areas of concern - all of which, in my view, warrant more serious public debate, notwithstanding the more rigorous reporting and accountability provisions introduced by the 2004 “CLERP9” legislation.

BCA CEOs have enjoyed long-term cash earnings growth far in excess of that of ordinary Australian wage and salary earners.

Over the past 16 years, the reported average annual total cash earnings of ASX listed companies currently led by BCA CEOs has risen from just over half a million dollars to over $3.4 million. Over the same period, for private sector employees, average full-time adult total earnings has risen from $29,200 to $54,000. The rise in BCA CEO cash earnings equates to an average compound annual growth rate of 13.5 per cent (or 10.7 per cent in inflation-adjusted terms) compared to just 4.2 per cent (or approximately 1.4 per cent in real terms) for ordinary full-time wage and salary earners, while the gross cash earnings gap between the two groups has widened from 18:1 to 63:1.

This growth in CEO pay levels is difficult to reconcile with the BCA CEO’s persistent advocacy of a more competitive labour cost structure for the Australian economy. In relation to pay restraint, the stance of the executives and boards of BCA member firms is one of “doing as we say” rather than “doing as we do”.

The chief source of the surge in cash remuneration is cash “incentive plans”. Cash incentive payments have now overtaken fixed pay as the principal component of BCA CEO cash earnings, now accounting for 60 per cent of the total. Last year, BCA CEOs covered by cash incentive plans received average cash bonuses of $2.06 million, an increase of 55 per cent on the previous year’s average.

In truth, though, this reveals only part of the whole story, since these data relate only to the cash component of total CEO remuneration. Yet, we also know that since the early 1990s, equity-based “rewards”, including share grants, share options and associated share “rights” have assumed increasing importance in CEO’s total remuneration packages, to the point where equity now contributes between 40 and 50 per cent of the estimated total.

The remuneration consulting firm the HayGroup estimates that the contribution of “long-term incentives” (i.e. equity-based plans) to CEO remuneration in the largest listed Australia firms has risen progressively from 13 per cent in 1990 to 39 per cent in 2004. While the late 1990s surge in option grants and share shareholdings has evidently come to end, equity plans continue to overshadow cash as the major source of CEO wealth acquisition. In 2005-4, BCA CEOs held, on average, 2.6 million shares in their employing company, with a majority having from $10-$30 million in company equity.

What is clear is that traditional option plans have fallen from favour since 2000, with greater emphasis now being placed on most sophisticated instruments, such as share appreciation rights and zero exercise price options, which closely resemble restricted share grants. So the accumulation of executive wealth continues unabated, albeit via ever more complex equity plans.

On this basis, it is very clear that the increase in total CEO annual income and wealth acquisition significantly exceeds the 10.7 per cent real increase in reported cash earnings. My own preliminary estimate of the combined increase in cash plus equity indicate that since 1990 annual total (i.e. cash plus equity) CEO remuneration in the 51 sample BCA companies has risen from around $0.6 million to approximately $5 million, which translates to a non-inflation adjusted 15 year rise of 730 per cent, an annual compound increase of 15.2 per cent, and an inflation-adjusted annual increase of 12.4 per cent. To reiterate: over the same period, for ordinary wage and salary earners the real annual increase has been just 1.4 per cent.

In other words, in real terms, BCA CEOs have enjoyed a long-growth in total remuneration almost nine times greater than that of ordinary employees. The figure of $5 million also represents a current total income gap between these workers and BCA CEOs of around 100:1. So the income and wealth flowing the way of BCA executives has far outstripped that going to ordinary wage and salary earners - the very same individuals whom the BCA chiefs insist must lift their performance in the interests of national economic competitiveness.

Since 2000 changes in average CEO pay have become less sensitive to changes in total shareholder returns, not more so.

While increases in CEO cash remuneration correlated quite closely with growth in total returns (i.e. dividends plus share price appreciation) to ordinary shareholders during the 1990s (as measured by the S&P/ASX200 accumulation index), over the past five years CEOs have enjoyed earnings increases disproportionate to those of investors in their own and other "top cap" companies. Despite the return to a bull market, the gap that opened between CEO pay and returns to shareholders during the recession of 2001-2 shows no sign of being corrected.

How can this be, especially when we are assured repeatedly by defenders of current executive pay practice that the application of executive "performance hurdles" guarantees "alignment" between "shareholder value" and executive rewards?

Notwithstanding the greater application of performance hurdles to CEO incentive payments, the evidence suggests that the earlier coupling between CEO pay and "shareholder value" during the 1990s boom is, if anything, breaking down. Performance hurdles, it would seem, are not all that they purport to be. Indeed, it is possible that their chief effect is to disguise additional wealth transfer.

Performance targets are open to considerable manipulation. As is well recognised, carefully timed announcements of staff cut-backs can also serve as a powerful share price stimulant and it appears to be far from coincidental that past and present BCA CEOs with the most to gain from share options and rights have also been among the most committed practitioners of workforce downsizing. Accounting-based hurdles are also open to manipulation. For instance, with profit-based targets, the executive may artificially inflate paper profits by postponing infrastructure investment or cutting back on research and development.

Hurdles based on peer company benchmarking may also still provide rewards for mediocre performance, especially where the pay-out target is set only at the 50th percentile (i.e. the median) of comparator company performance. By the same token, the use of more onerous hurdles, say a pay-out set at the 75th percentile of peer group performance, may also encourage executives to demand and receive a much higher potential reward. Of course the use of relative performance measures of this type may also result in a substantial payout to the CEO in circumstances where company performance is actually declining, albeit at a lower rate than that of comparator firms.

One outcome of the hurdle malleability and manipulation would be a tendency for incentive payments to outstrip performance and shareholder returns. As noted above, this is precisely what has occurred since the late 1990s in firms in the BCA sample.

Despite the public and media outcry against high payouts to departing CEOs, boards seem incapable of controlling their own largesse in this regard.

While it may be the case, as the BCA has repeatedly claimed, that the tenure of the typical Australian top cap CEO is - at around five years - relatively short, the pain of separation is certainly salved by non-superannuation-related severance payments - or “golden handshakes” - that generally amount to the equivalent of one-two years’ salary - and sometimes a great deal more.

Over the past five years reported termination payments made to departing BCA CEOs averaged $3.3 million, up from $2.3 million in the 1990s. Such payments are further indication of the continuing bargaining power of incoming and incumbent CEOs relative to their notional employers, the board of directors. Like the more recent practice of the “golden hello” and the “long-service bonus”, such payments, which are generally additional to standard superannuation benefits, amount to a form of disguised income supplementation.

The BCA’s aggressive support for the gutting of unfair dismissal laws makes a mockery of its contention that multi-million dollar termination payments are justified on the grounds that CEOs lack specific protections from early dismissal. Here, as in other aspects of the debate on pay, the highly paid employees who comprise the BCA have elevated the policy double standard to something of an art form.

Many company boards behave more like executive accomplices than as independent guardians of shareholder interest.

It is still the case, as Berle and Means noted back in 1932, that the separation of ownership and control in the modern public corporation fundamentally advantages the salaried executive over ordinary shareholders and their notional representatives on the company board. Whatever the advances in recent voluntary and mandatory corporate governance requirements, it is still the case that many non-executive directors hold their positions at the behest of the incumbent CEO. Indeed, many are themselves ex-CEOs.

Despite the appearance of board independence and the existence of “independent” remuneration committees, the balance of day-to-day boardroom power clearly continues to reside with the CEO. In this respect, it is particularly significant that the BCA itself is comprised of CEOs rather than, say, board chairpersons (with the exception of executive chairs, of course).

According to US law professors Lucian Bebchuk and Jesse Fried, far from acting in shareholders’ interests, and far from executive pay being determined by arms-length bargaining, executives use the power of their positions to extract an “economic rent” above and beyond what could be achieved by means of “optimal contracting”.

The issue here is one of “asymmetric information” - the “agent” has greater knowledge, and hence power, than does the “principal”. Using recent US evidence, Bebchuk and Fried argue that, despite closer scrutiny and new reporting requirements, CEOs have managed to maximise their personal returns by uncoupling pay from performance, persuading or forcing boards to renegotiate or soften performance hurdles, reprice out-of-the-money options, and offer access to disguised income in the form of generous sign-on payments (or “golden hellos”), special retirement benefits, retention and long-service bonuses, no-interest company loans, special zero-cost share rights, post-termination consulting fees and the like.

As such, executive incentive plans that purport to advance shareholders' interests may be little more than devices to camouflage economically unwarranted levels of income and wealth appropriation.

The evidence to date indicates that such “rent extraction” practices are alive and well in corporate Australia - all of which goes to show that unchecked growth in CEO remuneration is merely the symptom; the underlying problem is that of boardroom timidity and complicity.

The full version of the evidence and findings on which this piece is based is available here. (pdf file 125KB)

Dr John Shields teaches human resource management and has a special interest in the fields of performance and reward management at the School of Business, Work and Organisational Studies, University of Sydney.
