Business Council of Australia

EXECUTIVE REMUNERATION

A Position Paper prepared by the Business Council of Australia

June 2004

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1. Introduction

Rarely a week goes by without some commentary on CEO pay. Debate inevitably focuses on excessive amounts and comparisons with the pay of average wage and salary earners.

Despite most objective data showing the performance of Australia's corporate sector is among the best in the world, underlined by a return to strong company profits and a strengthening share market, the debate continues to overshadow this.

The Business Council of Australia is extremely aware that this debate has damaged shareholder and general community confidence in corporate Australia. The BCA also acknowledges responsibility for this issue rests in part with corporations. Corporations collectively and individually have not done enough to explain the rationale for executive remuneration amounts and, in particular, how pay has been linked to performance. In some high-profile cases, the link between pay and performance has been conspicuously absent. In these cases public criticism and shareholder anger is fully justified.

There is growing evidence that corporate Australia has heeded the message. Company Boards are paying detailed attention to structuring pay packages in ways which are clearly linked to performance and are seen to be the case.[1]

At the same time, BCA believes there are issues beneath the surface of this debate which have not received proper attention. These include:

- The current executive pay debate in Australia focusses on a relatively small number of the 1,500 Australian companies that are publicly-listed.

  Australia's listed corporations need to provide pay levels that match those offered to executives of non-listed companies and other private sector organisations as well as competing companies overseas. A debate that inevitably focusses on applying regulations and restrictions on executive salaries for publicly-listed companies carries the risk these companies lose out to private firms and overseas corporations in recruiting the best executive talent;

- Australia's publicly-listed companies are already subject to some of the most stringent disclosure legislation on executive pay in the world.

  These laws have been added to by regulation and codes of conduct developed and adopted by publicly-listed businesses. These rules aim to promote greater rigour and transparency of executive pay structures – a transparency that the BCA supports; and

- Factors determining remuneration of senior executives are complex and do not lend themselves to one-size-fits-all regulation.

  Benchmarks for executive pay in Australia have become internationalised and reflect the increased complexity of business more broadly. Executive pay contracts are complex because they need to achieve a balance between risk, incentive and reward.

  The trend that has seen senior company decision makers subjected to greater regulatory pressures and higher performance expectations means the level of risk involved with these positions is greater. The consequences of this increased risk is higher pay.[2]

The BCA recognises that executive remuneration will always be a controversial issue, given the obvious gap between average earnings and executive pay.

However, the major theme of the paper is this – as Australia has increasingly become integrated with the global economy, executive pay has been increasingly influenced by global benchmarks. This reflects the fact that Australian corporations and the Australian economy require a wide range of skills and talent to successfully lead businesses in a global economy. This has implications for the quantum and rate of growth of executive pay as well as arguments that executive pay should be regulated at a level or rate below competitive global benchmarks.

1 EQUITY STRATEGIES SURVEY FOUND THAT 61 OF 71 EXECUTIVE SHARE PLANS FOR WHICH SHAREHOLDER APPROVAL WAS SOUGHT HAD PERFORMANCE HURDLES. EQUITY STRATEGIES PRINCIPAL EDWARD WRIGHT SAID THE SURVEY RESULTS SHOW THAT THE ALREADY MARKED MOVE AWAY FROM ALL OR NOTHING GRANTS CONTINUED LAST YEAR. 'EXECUTIVES PUT THROUGH HOOPS FOR PAY INCREASES' 2004, *AUSTRALIAN FINANCIAL REVIEW*, 11 MARCH.

2 AS AN EXAMPLE OF THIS TREND, REMUNERATION SPECIALISTS RPC FOUND REGULATORY PRESSURES WERE RESULTING IN HIGHER PAY FOR NON-EXECUTIVE DIRECTORS. 'REGULATION PRESSURE LIFTS EXECUTIVE PAY', 2004, *THE AGE*, 3 MAY.

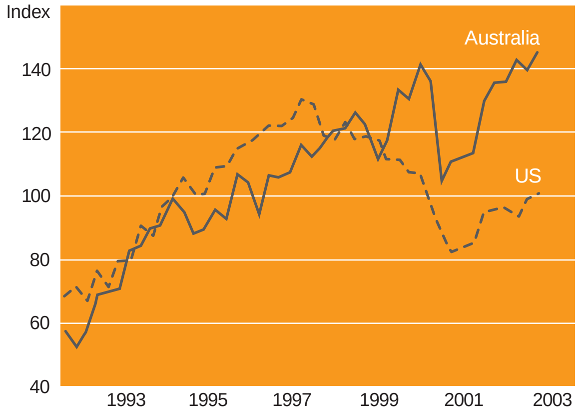
The same global forces that drive executive remuneration upwards have generated significant wealth creation for the Australian economy at both a macro and at an individual level. This spread of wealth has been helped by Australian corporates which have played a major role in forging linkages with Australia and world markets and have delivered consistently higher profits than overseas companies. Many in the Australian community – which represents the second biggest per capita shareholder society in the world – are direct investors in these companies.

Despite this investment relationship between corporations and ordinary Australians, BCA polling shows the complex, globalised environment in which the corporate sector operates is quite foreign to many shareholders. Knowledge of the dynamics and pressures involved with corporate wealth creation is limited, as is understanding of how the remuneration of senior business executives is arrived at, and why it is different from the way salaries are determined for the broader community.

The current angst about executive pay has in part been a failing of Australia's business community, particularly in the way it has communicated the rationale for, and structure of executive pay to shareholders and the broader community. It also represents a failure in other areas of leadership.

In responding to a growing constituency of shareholders who are also voters, politicians have been prominent in reinforcing negative views of corporate Australia and devaluing the role and performance of Australia's business leadership and corporate sector more broadly.

REAL CORPORATE PROFITS*
September 1994 = 100



* Net of depreciation and interest
Sources: ABS, Bureau of Economic Analysis

The objective of the paper is to create a broader understanding of the following issues:

- the role of a public company and its CEO and senior managers in the context of Australia becoming both a shareholder society and closely connected to the global economy;
- factors that determine executive pay;
- requirements that are already in place to regulate executive pay in Australia and make sure pay arrangements are transparent; and
- some commonly-held views about executive pay and company performance.

2. Framing the debate

The executive pay debate is essentially about the remuneration paid to those CEOs and other senior managers who lead Australia's 1,500 publicly-listed companies. This is because only listed companies are legally required to report on the pay of their senior managers.

Given the relatively small size of the majority of these listed companies, scrutiny and debate actually focuses on a small number of executives employed by Australia's larger public companies.

As a result, the debate is skewed toward a small fraction of Australia's total executive population. It excludes the majority of Australia's company executives working for foreign companies operating in Australia and non-listed, private companies whose remuneration (and performance relative to remuneration) is relevant to establishing market conditions but outside the scrutiny of the broad investment community, media, politicians and the community in general.

The main implications of this are:

1. The different responsibilities of larger publicly-listed company CEOs frequently goes unacknowledged. The level of scrutiny and regulatory pressures associated with the position of senior manager of a listed company means the scope of the demands and expectations of the position often exceed that of private company managers;

2. The end result of shareholder pressure, political intervention or regulation may be to keep salaries of some listed company executives artificially low. The unintended consequence of political and regulatory responses to empower shareholders may be to attract or maintain a lesser quality of corporate leadership to manage shareholders' investment and;

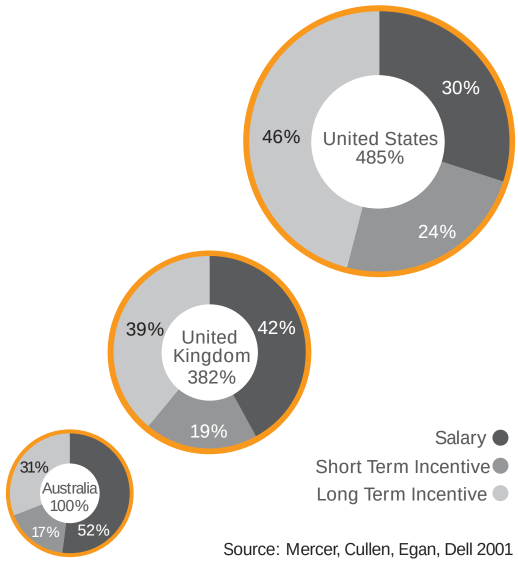
3. Restricting the level of pay to Chief Executives will flow to senior positions down the line. In the vast majority of companies, the CEO's pay sets the benchmark for other executive salaries within the company. Paying the CEO less means publicly-listed companies may not be able to pay the levels required to attract the most capable senior managers. It is frequently these managers who are the most vulnerable to change of jobs.

Naturally, the focus of the debate has been on a few examples where pay has clearly not been linked to performance. The intense level of investor, media and political scrutiny on these examples has been such that they have provided the benchmark for much of the debate.

Comparatively little attention has been paid to the value that CEOs and senior managers of Australia's larger publicly-listed companies have added to these enterprises and the Australian economy as a whole.

The debate does not always acknowledge that while the performance and competitiveness of Australian companies has been strong, the levels of remuneration paid to CEOs of Australian-based companies has been below that paid in other countries. The low valuation of the Australian dollar in recent years has helped to make local salaries comparatively more cost-effective. A study of executive remuneration levels between economies by leading executive recruitment experts during 2001 - the period most associated with the escalation of executive pay levels here and overseas - demonstrated Australia continued to be at the lower end of pay levels.[3] More recent comparative studies show that, in general, this trend is continuing.

COMPARISIONS BETWEEN EXECUTIVE SALARIES – US, UK AND AUSTRALIA



Source: Mercer, Cullen, Egan, Dell 2001

3 *CEO/SENIOR EXECUTIVE REWARD, PERFORMANCE AND BENEFITS: WHAT'S HAPPENING?* AUGUST 2001, MERCER CULLEN EGAN DELL.

3. The Role of a Public Company

What exactly is the role of a publicly-listed corporation and by extension its CEO and senior managers?

The listed company provides an effective mechanism to aggregate large amounts of capital for investment, to efficiently allocate and manage risk, accumulate expertise and knowledge and minimise the costs of doing business.[4]

All these attributes provide the foundation for a modern economy like Australia's. At the same time, changes have occurred in the last 20 years that have fundamentally altered the environment in which Australian corporations and their senior managers operate. These include financial deregulation, the end of government-sponsored protectionism through across-the-board tariff reductions, major tax reform and workplace relations changes.

These changes have all led to a global and more competitive business environment, as well as increasing complexity in the operations and demands on Australian corporations. In turn, this has lead to a rapid increase in responsibilities of and demands on the CEOs and senior management.

One of the more far-reaching changes during this time has been the significant increase in ownership (through direct shareholding) by ordinary Australians of publicly-listed companies.

At the start of the 1990s, around 10 per cent of Australians were direct or indirect share owners. Australian Stock Exchange figures[5] show that the proportion of adults owning shares has grown to around 40 percent, one of the highest in the world. Since 1991, the number of Australians owning shares has increased from 1.1 million to 5.7 million, due largely to a series of major floats, privatisations and demutualisations.

Collectively, Australia's 1,500 listed companies, and by extension their senior management, are responsible for the management and growth of nearly $1,000 billion in shareholder and investment wealth.

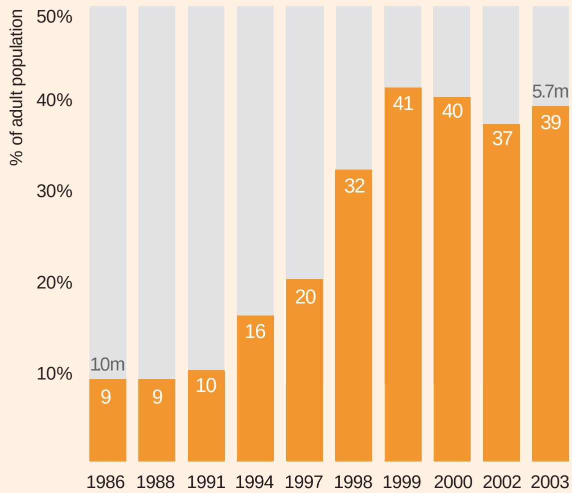
As an indication of the contribution of Australia's listed companies to wealth creation, this amount has grown since 1993 when their total capitalisation was $443 billion.

This growth in direct shareholding has created a strong link between the Australian community and private wealth creation and growth. The link has been strengthened by the Commonwealth's transfer of responsibility for retirement/pension costs to private fund managers and investors in the form of superannuation capital. A large proportion of the $500 billion of compulsory superannuation funds is tied to the performance of Australia's publicly listed companies. Most Australians now have a direct and/or indirect interest in the performance of listed companies.

The number of direct and indirect shareholders has created a powerful constituency which is able to demand from politicians and regulators greater control and regulation of companies in which they have investments. The debate over executive pay of listed company executives makes it an obvious target for more regulation.

The market for executive management works as a total market, yet the increased regulatory demands and expectations on public companies risk creating restraints and distortions on the workings of one part of the market for senior executives (ie in listed companies) while allowing a significant part of the market (ie for non-listed companies) to operate in a relatively unfettered and a non-transparent way.

INCREASE IN NUMBER OF AUSTRALIAN SHAREHOLDERS



Source: ASX

4 MICKELTHWAIT, JOHN & WOOLDRIDGE, ADRIAN 2003, *THE COMPANY: A SHORT HISTORY OF A REVOLUTIONARY IDEA*, RANDOM HOUSE, NEW YORK.

5 *SHARE OWNERSHIP STUDY* 2003, AUSTRALIAN STOCK EXCHANGE.

4. The Role of the Listed Company CEO

At its most fundamental level, the role of a listed company CEO involves leading a team, responsible through the Board to the shareholders, to safeguard and grow shareholders' capital within the regulatory, statutory and ethical requirements of the markets and communities in which the corporation operates.

In order to manage shareholder capital and deliver competitive returns, the typical CEO has four sets of accountabilities, namely:

- those that relate directly to achieving the commercial and financial objectives of the company;
- those that relate to the internal structure and organisational capability required to meet these objectives;
- those that define the professional, regulatory and ethical relationships required to protect and grow company value; and
- those that influence its relationship and standing within the wider community.

The defining characteristic of the CEO position is that the scope and size of the role and its accountabilities require significant personal latitude, discretion and responsibility. Over the past 20 years, as Australia has internationalised its economy, the structure and role of major corporations has changed markedly. So has the complexity, expectations of and risks associated with the role of the CEO and senior managers.

The opening of the Australian economy to international markets has provided many companies and their shareholders with additional sources of revenue and profit. At the same time, it has exposed Australian firms to an unprecedented level of competition and risk.

CEOs of Australian-listed companies with overseas operations must manage the political, social, regulatory and market risks in each market, and their implications for the company's business strategy.

Examples of Growth of Major Publicly-Listed Companies

In 1993/94 total passengers carried by Qantas were 13 million. In 2002/03, despite the outbreak of SARS and security concerns, Qantas carried a total of 28.9 million passengers.

In 1994/95 Woolworths Limited operated a total of 991 stores. By 2002/03 Woolworths was operating 1,597 stores, a 61 per cent increase in outlets.

Total assets of the Commonwealth Bank in 1992/93 amounted to $91 billion. In 2002/03 the Commonwealth Bank's total assets had risen to $265 billion.

As a result of the demands, skills and expectations involved with managing large companies in a global economy, executive salaries have become increasingly aligned with international benchmarks.

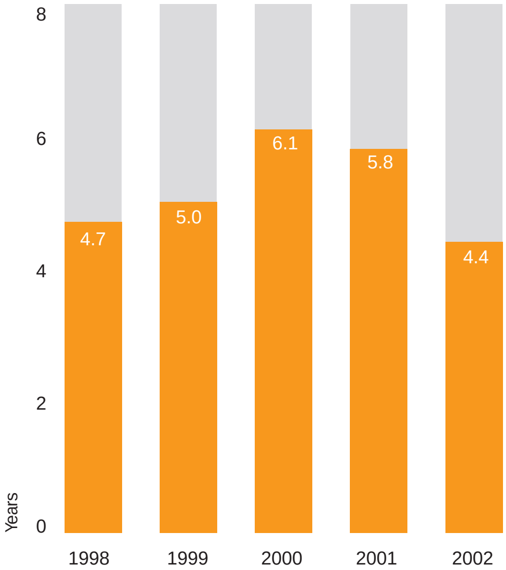
This is an appropriate development given CEOs and senior managers of Australian-based companies are expected to and have been generally successful in recognising and developing investment opportunities and growth in overseas (and domestic) markets with global competitors.

While the roles of listed and non-listed company CEOs share many common responsibilities, some performance-driven responsibilities for listed corporations have greater emphasis.

They include:

- expectations that publicly-listed companies play a role in financial security for many Australians – particularly retirees. High rates of share ownership means greater public awareness and interest in issues related to corporate performance and governance, which in turn are tied to perceptions of the performance of the CEO.
- these performance expectations have been a major driver of greater employment risk for CEOs. A recent BCA/Booz Allen Hamilton 'Study on CEO Turnover' in Australia[6] shows the average tenure for CEOs of Australian listed companies has fallen from 5.8 years in 2001 to 4.4 years in 2002. CEOs seen as not meeting Board expectations last only an average 3.6 years in the role. Globally, the number of CEOs sacked in 2002 increased by 70 percent. These results underscore the growing influence of investors, and the willingness of Directors to exercise their power in the interests of shareholders; and
- increasing focus on short-term results at the expense of longer-term strategy has conditioned market expectations and puts significant pressure on CEOs of listed companies to deliver – and be seen to deliver – results within shorter timeframes. It also places pressure on Boards to act against CEOs who do not have the market's confidence. Short-termism naturally makes it harder for many ordinary investors to recognise longer-term wealth creation, and the executive skills required to achieve and sustain it.

MEAN TENURE OF DEPARTED CEOs IN AUSTRALIA



Source: BCA/Booz Allen Hamilton 2003

What determines CEO pay?

CEO pay is generally viewed as out of step with community views of fairness and equity. Aside from the quantum of executive pay compared to average earnings, this is based on a belief that no job is worth the amount paid to company executives[7]. One proposal put forward is that CEO pay should be limited to a multiple of average earnings, with 25 being a common multiple nominated. Implicit in this approach is the assumption that the role and responsibilities of a CEO can be accurately fixed at 25 times that of the average worker.

This proposal, however, does not reflect how the labour market for executives operate, nor the differences between this market and the general labour market. Executive remuneration is structured differently from the pay structures of average workers because the executive market which:

- draws on an extremely small pool of potential applicants that have the skills and track-record to manage the scope and complexity of tasks involved in leading a major firm, employing thousands of people in an international environment;
- places a significant and very public link between the performance of the individual to the broad performance of the enterprise; and
- lacks specific protections from dismissals, with a forced exit usually highly public and career-ending.

5.1 The Role of the Board

Selecting a suitable CEO and decisions about executive pay are the responsibilities of the Company Board, which is elected by shareholders to manage their investment and provide strategic guidance and oversight of executive management.

Given the requirements of a CEO vary dramatically from company to company, Boards and their remuneration committees increasingly seek independent information and advice on available executive talent.

Data provided by remuneration specialists allow some form of comparison with firms from the same industry and size (eg capitalisation, revenue, employee numbers). Data used to measure the position provides a greater level of accuracy in comparing one CEO role to another. But ultimately Boards must decide how much to pay a CEO based on a wide range of considerations that are linked to size, complexity, operations and objectives of an individual company.

Over and above complying with legislation and regulatory requirements, there are powerful incentives for Boards not to pay company executives more than they need to. They include reputational issues and increased transparency and accountability. Given the microscopic scrutiny and levels of disclosure that now operate, Boards which award excessive amounts of remuneration to management risk market and public criticism, resulting in damage to personal and company reputations. There are also competitive issues, which view remuneration as a cost input into the business process. Competitive forces require Boards to examine all costs carefully. While pay to senior managers may account for around one per cent of a large company's total cost, excessive remuneration, or remuneration which rewards under-performance represents a potentially highly public, uncompetitive cost structure.

5.2 Other Board Considerations in Determining Pay

While market data is used by Boards as a reference point of CEO's remuneration for similar roles, there are other areas that individual Boards consider in deciding the level and structure of CEO pay. They are the specific skills and competencies required to undertake the role of a CEO and succeed in corporate leadership. The available supply of people with the required high-level skills to perform consistently under pressure and scrutiny is very limited.

This has two implications for a Board in the process of selecting a CEO. First, not only is the available candidate pool small, but different business situations require particular capabilities and experience. For example, different leadership characteristics and styles are required for

7 SEE PAGE 13.

companies in growth, turnaround or divestiture stages. It is important therefore to match CEO recruitment to the specific business context and strategy.

The second issue relates to the individual market value of a CEO, or prospective candidate. While it may not be 100 percent accurate, previous performance is probably the most critical factor in the decision to retain or appoint (and therefore what to pay) a CEO.

The Board will form a view on what value a specific individual brings to the role. So too will the candidate; and importantly, other Boards that may be in the market for a new leader. Clearly, executives who demonstrate a history of solid performance will attract an individual premium based on their past record of success.

Another important factor is risk. The recent BCA/BAH survey of CEO turnover highlighted how firing poorly performing CEOs more than doubled globally from 1995 to 2001. Comment has been made that points to the relative size of the Australian market as a factor behind Australia exhibiting higher rates of CEO turnover than the rest of the world. Our CEOs are highly visible, they figure prominently in their companies' overseas operations, and the perceptions of investors and their demands for short-term performance. These factors combine to generate "behaviour that exaggerates market rewards for superior (short-term) performance – and market punishment for perceived poor performance."[8]

While Boards need to consider how risk will be reflected in the level and structure of remuneration, similar considerations will be made by the CEO. For example, there is significant risk for a CEO accepting a role as turnaround leader for a poorly performing company. The challenge is considerable under any circumstance, but at the individual level can jeopardise a successful and established career as a senior executive. Assessments like these form part of subsequent negotiations between the parties.

5.3 Pay structure and performance

The quantum of remuneration is an outcome of negotiations between the Board and the CEO, based on the factors outlined above. Apart from the actual amount, agreement needs to be reached on the structure of the package. Executive pay is designed around four components:

- fixed pay – made up from salary plus the cost of any benefits and superannuation;
- short-term incentive – usually an annual cash amount paid if specific performance hurdles are met;
- long-term incentives – involving shares or options linked to sustained shareholder return; and
- termination conditions – detailing agreed periods of notice, any entitlements to cash payments and/or share allocations.

As with any commercially-based contract, the amount of remuneration agreed and its structure will reflect the risk-return relationship – the greater the risk, the higher the pay. Within this context, the Board has to decide four key issues:

- how will the total package be divided between the fixed and performance-based aspects of pay?;
- within the performance pay, what will be the percentage split between short and long-term incentives?;
- what type of performance hurdles should be made part of the package?; and
- what are the payout costs and conditions of involuntary termination?

Over the past 15 years, a significant shift has occurred in executive pay structures for CEOs, globally and in Australia. In 1990, the fixed component of pay for Australian executives represented over 80 percent of the average CEO package; by 2002 fixed pay represented 43 percent of the package, annual incentive payments 15 percent and long-term incentives 43 percent.

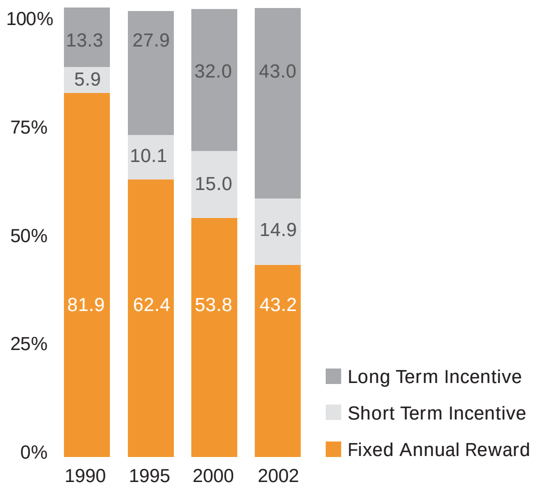
8 'HERE'S YOUR BRIEF CHIEF – YOU'VE GOT 3.6 YEARS TO MAKE GOOD' 2003, *THE AGE*, SEPTEMBER 18.

This provides some context to comment about the high amounts of performance-based payments made to CEOs and senior managers compared to their base salary. The concept that performance payments, such as multi-million dollar bonuses and option schemes, can far exceed base salary is quite foreign to most Australians. This difference is driven by the unique characteristics of the executive labour market. The level of 'at risk' pay has increased as the risks and the complexity associated with executive management operating in a world economy has grown.

At the same time, Boards have increasingly put in place specific structures to measure CEO performance. These take the form of specific review and performance tracking mechanisms, establishing Board remuneration committees and the use of outside consultants to advise on executive contracts and pay. Through a combination of regulatory and self-regulatory measures related to executive pay, these processes have become highly transparent.

Yet, criticism remains of the relationship between company performance and CEO pay. There is an assumption that the complex link between pay and performance is going to be found in a common metric across all firms.

CHANGING STRUCTURE
OF CEO PAY IN AUSTRALIA



Source: The Hay Group 2003

Correlations are often made between financial indices such as profit, earnings before interest and taxation and return on equity, or with shareholder measures such as total shareholder returns. Each company has their own strategy and operating objectives, and they will differ considerably in these and where they are on the business cycle.

Qualitative measures (eg talent and succession planning, strategic milestones, culture management) also figure prominently in a Board determining if a CEO has performed well. Performance-based components of CEO pay often provide recognition of achievement of milestone events towards longer-term objectives that do not yet yield a measurable result.

The BCA acknowledges that some contracts have been without doubt poorly structured so that performance relative to pay are weak or non-existent. Yet some CEO contracts that appear to be rewarding underperformance are not. The timing of performance pay relative to company performance can be an important factor. There are frequent lags between when 'at risk' payments are made and reported and the period to which they relate. Performance payments such as bonuses occur in arrears, as long as a year and sometimes longer - in other words, well after this performance has been recorded. As a result, performance – based pay in the form of bonuses or options, may only be realised after changes to the business cycle.

For most of the bull market, a majority of sectors experienced a period of increased profitability and performance. In those circumstances, the performance component paid to many individual executives increased. Given the lag in the payment of the performance element of executive packages, they were paid well after this increased profitability was recorded.

It is little surprise that scrutiny and public attention occurred only well after the start of the bear market in Australia in 2001, and helped foster a belief that many executives were being rewarded for under performance.[9]

9 THE INCREASE IN MEDIA STORIES HIGHLIGHTING SHAREHOLDER OR PUBLIC CRITICISM OF EXECUTIVE REMUNERATION OCCURRED IN 2002 WHEN THE MARKET WAS INTO ITS SECOND YEAR OF NO OR NEGATIVE GROWTH. THE NUMBER OF PRINT MEDIA STORIES ON EXECUTIVE REMUNERATION TOTALLED AROUND 400 DURING THE OCTOBER-NOVEMBER REPORTING SEASON OF 2002 COMPARED TO AROUND 140 THE PREVIOUS YEAR.

5.4 Termination Payouts

The most controversial aspect of the executive pay debate is why 'failed' CEOs receive large payouts. The trend toward firing CEOs of listed companies is increasing. The BCA/BAH study on CEO tenure noted that the market is defining performance of listed company CEOs in increasingly strict terms. On a global basis, CEOs who were dismissed in 2002 generated shareholder returns only 6.2 per cent lower than Chief Executives who retired voluntarily. In 1998, it took an 11.9 percentage point difference to prompt a firing.

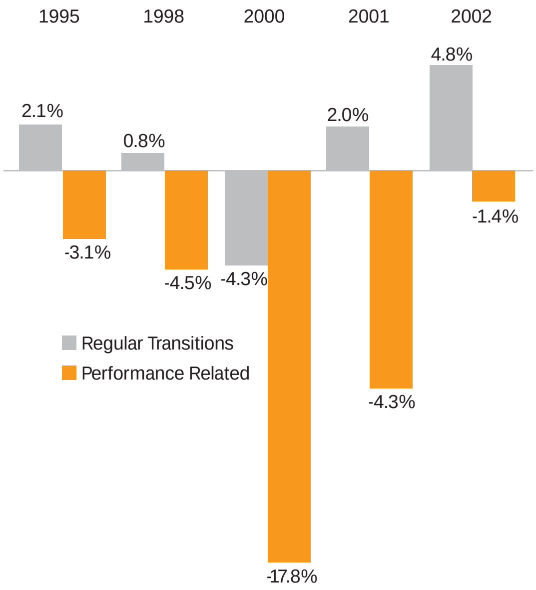
As a result, the likelihood that CEOs are seen to have failed to deliver the level of company performance investors expect is greater than ever before.

For most employees, industrial and common law has established specific dismissal processes that must be followed to sack an employee for poor performance. These involve formal performance warnings, together with establishment of specific short-term performance goals and documented consequences of failure to improve.

Yet, employment agreements for CEOs, as with other senior executives, typically provide for termination with very little notice. When a Board decides the CEO is not delivering acceptable results, it would not be acting in the best interests of shareholders if it embarked on an extended poor performance review process. Significant damage can be done to the business, its share price and employee morale in that period. The best approach is to encourage the CEO, through mutual agreement, to leave sooner rather than later.

This means compensation for the risk of early termination is a priority issue in contract negotiations for any incoming CEO – a reasonable position given the increasing trend toward CEO firings and the limited employment opportunities for exiting CEOs that are seen to have been 'pushed' by their Boards.

MEDIAN ANNUAL RELATIVE SHAREHOLDER RETURN DURING FULL CEO TENURE



Source: Booz Allen Hamilton 2003

6. Existing Regulation of Executive Pay

The issues outlined previously provide some reference points and issues that Company Boards take into account when they decide the structure of executive pay contracts.

But there are also explicit statutory requirements and guidelines that provide a clear framework for Board decision-making, disclosure, and governance over executive pay. These requirements and guidelines demonstrate there is a robust structure already in place setting out a framework for regulating executive pay. At the same time, they provide Boards with scope to structure executive pay according to their company's needs.

6.1 Corporations Act 2001

The Corporations Act has two sections that relate directly to the Board's accountability for executive pay. Section 211 requires that remuneration paid to an employee of a public company must be deemed 'reasonable'.

The following are examples of circumstances that may be considered within the meaning of this section:

- using overseas competitors as a reference to set pay for the CEO of an Australian-based company with a significant international revenue and operations base;
- providing a highly competitive remuneration package to attract a successful CEO to an ailing and poor performing company; and
- negotiating a long-term service contract to retain a CEO.

Section 300A of the Act requires that the Annual Directors' Report include an explanation of the Board's policy for determining the "nature and amount " of pay to Directors and executives.

The Board is also required to show the relationship between this policy and the company's performance and to provide details of pay for each Board Director and each of the named five highest paid executives.

While disclosures promote openness about the rationale and structure of executive pay within any public company, it comes at a cost. It provides an open and visible public scoreboard against which each CEO can see his or her relative remuneration ranking. Inevitably this contributes to an upward spiral of overall pay levels by providing CEOs and senior managers more detailed information on which to negotiate.[10]

6.2 ASX Best Practice Recommendations

In March 2003 the Australian Stock Exchange Corporate Governance Council released its Principles of Good Corporate Governance and Best Practice Recommendations for listed companies.[11] The Principles require a company's Annual Report to comment on how it has applied each principle or provide a statement explaining why any given principle has not been adopted in the reporting year.

Principle 9, headed 'Remunerate fairly and responsibly', is meant to ensure that executive pay has a defined relationship to individual and company performance. Best practice

10 PAUL RIGGS, HEAD OF EXECUTIVE REMUNERATION AT MERCER SAID THERE IS SOME DANGER THAT FULL DISCLOSURE WILL CAUSE PAY TO MOVE UP RATHER THAN DOWN, AS EXECUTIVES WILL BE ABLE TO SEE WHAT THEIR CONTEMPORARIES ARE BEING PAID AND IMMEDIATELY DEMAND INCREASES IF THEY ARE BEHIND. 'EXECUTIVES PUT THROUGH HOOPS FOR PAY INCREASES' 2004, *AUSTRALIAN FINANCIAL REVIEW*, 11 MARCH.

11 ASX GUIDELINES CAN BE FOUND AT HTTP://WWW.ASX.COM.AU

requirements include: guidelines for annual reporting and continuous disclosure; the purpose, composition, charter and responsibilities for the Board's Remuneration Committee; and guidelines for the structure of executive remuneration packages, including termination payments, and non-executive Director remuneration.

A recent study[12] of the top 100 Australian companies listed by Business Review Weekly shows that 75 firms have a separate committee to oversight remuneration issues on behalf of the full Board. This is either through a dedicated remuneration committee (58 companies) or through a combined committee (17). Of the remaining firms, 15 had less than 500 employees and presumably considered that their size did not warrant a separate committee. An independent, non-executive Director, as recommended by the ASX guidelines, chaired all of these committees. Furthermore, 70 percent of remuneration committees consisted only of non-executive Directors, also complying with the guidelines.

The ASX guidelines were released in March 2003, and apply to the first financial year commencing after 1 January 2003.

6.3 BCA/Deloitte Executive Remuneration Guidelines

In November last year, the BCA together with Deloitte released governance Guidelines for CEO and Executive Remuneration.[13] The Guidelines were developed to draw upon best practice both within Australia and globally to assist Boards of publicly-listed companies to develop appropriate structures for executive remuneration. The Guidelines include:

- a strong remuneration philosophy and framework;
- an effective Remuneration Committee or similar Board body;
- processes to ensure shareholders' concerns are effectively responded to by the Board;
- transparency is promoted and disclosure managed; and
- performance not failure is rewarded.

The Guidelines are self-regulatory and recognise that the market for executive talent is a global one and the varying requirements in CEO pay arrangements for different companies.

12 COLVIN, J, PRITCHETT K & JACKSON, A 2002, 'CORPORATE GOVERNANCE AND THE BOARD REMUNERATION COMMITTEE: AN ANALYSIS OF THE CURRENT PRACTICE,FREEHILLS.

13 *EXECUTIVE REMUNERATION – BEST PRACTICE PRINCIPLES AND GUIDE* NOVEMBER 2003, BCA/DELOITTE TOUCHE TOHMATSU.

7. The Community's View

Much of the push for a political and regulatory response to executive pay has come from investors and the general community. The high level of public and media interest in executive pay in recent times has been a function of several factors. They include:

- high-profile examples in which executive pay has clearly not been linked to performance, particularly in the area of termination payouts;
- the recent bear market in which expectations of high performance and returns conditioned by a prolonged bull market were not met; and
- the growing expectation that company behaviour should be increasingly regulated to reduce risk.
- the significant number of Australians who have invested directly into publicly-listed companies in the past decade;

Underlying these particular issues are broader values relating to social and economic equity. These values are not tolerant of large differences between executive remuneration and average earnings (even though the two markets are vastly different). Nor is it likely that termination payouts resulting from company underperformance will be viewed as anything other than reward for failure.

Recent public opinion polling conducted on behalf of the BCA which examined community opinions of executive pay found that most Australians believed that company executives were overpaid for the role they performed. At the same time, the polling found that the drivers of executive pay were not readily understood.

Despite Australia having one of the highest proportions of direct shareholders in the world, the concept of 'wealth creation' is neither well understood nor valued by the general public.

This has meant a level of public ambivalence about contributors to wealth creation, including the role and function of large business and the executive resources required to run them.

As one respondent commented: "A lot of CEOs seem to be rewarding themselves for doing some huge super human task. Yes, it may be difficult but it's still a routine job."

The BCA polling found that most people associate corporations with generating employment but little in terms of value and wealth creation. As a result, value and wealth creation is typically viewed as a one-way exchange, with the beneficiaries being large companies and their senior managers which extract value from workers and shareholders.

Based on the polling, the following diagram outlines the disconnect between corporations, wealth creation and public opinion.

WEALTH CREATION AND LARGE BUSINESS: COMMUNITY PERCEPTIONS

* Actual quotes from BCA polling focus groups
Source: BCA

A recent survey of its Member Companies by the BCA sought to address this misconception by quantifying the value and contribution that large companies make to the Australian economy, shareholders and the broader community.

The Community of Business survey[14] found that:

- those BCA Member Companies that are publicly-listed in Australia returned $18.4 billion in dividends to shareholders;
- Member Companies employed more than 900,000 Australians, including 250,000 in regional and rural areas;
- Member Companies exported goods and services to overseas markets valued at $47 billion, or 31 percent of Australia's total export effort.
- BCA Companies pay a third of all corporate taxes and collect a third of all Government GST receipts. They pay a further $13 billion in other taxes, royalties and duties to Federal and State Governments;
- BCA Companies spend $16 billion in new business investment annually; and
- the number of staff hours contributed to social and community projects by BCA Companies totalled 219,000 a year, with a further 425,000 staff hours contributed to environmental projects.

Levels of executive pay is seen by most of the public as an excessive amount to pay for services which are seen as having limited value. These views still represent very powerful influences for Boards and CEOs to take into account when deciding executive pay levels.

DIVIDENDS PAID BY ASX-LISTED
BCA COMPANIES BY INDUSTRY

* INCLUDES THOSE INDUSTRIES WITH ONE OR TWO COMPANIES
Source: BCA

14 *THE COMMUNITY OF BUSINESS – THE ROLE OF THE CORPORATION IN AUSTRALIA* 2004, BUSINESS COUNCIL OF AUSTRALIA.

8. The Political Response

RECENT QUOTES ON AUSTRALIA'S CORPORATE PERFORMANCE FROM SENIOR POLITICIANS

For years now, the corporate bureaucrats running our public companies have been busy savaging their workers on the one hand while riding high on the hog on the other.

Australians no longer trust companies to look after their employees and their shareholders … it's time to take the corporate snouts out of the trough.

They have sat on their hands, risking the eruption of a culture of greed and corruption in Australia as it has in the US.

Unfortunately too many Directors have had their hands in the till. They have shown they can't be trusted.

A factor in reinforcing community views had been the various political responses to executive pay and corporate performance generally. The rise of the shareholder society has created a major constituency of direct shareholders able and willing to exert significant influence on politicians and regulators.

This influence has taken the form of advocacy for greater regulation of poor corporate behaviour. The political response on executive pay is expressed through proposals to regulate excesses as well as highlighting exceptional cases of excess to justify across-the-board regulation. Broadly, proposals for greater regulation fall into two categories:

- giving shareholders executive pay decision making powers (through either binding or non-binding voting on executive pay packages); and
- 'restraints' on particular components of remuneration, such as options and termination payments.

The BCA has and continues to argue that laws providing shareholders direct input in decision processes they have already delegated to Board Members they have elected is flawed. On the one hand, it undermines a fundamental cornerstone of listed companies, that Boards are directly elected by shareholders as their agent to manage the company. The proposal to give shareholders a non-binding vote on executive pay has been compared to legislation recently enacted in the UK. It is different in that the UK model applies only to senior management who are represented on the Company Board and therefore are directly accountable through their Board membership to shareholders. Second, it assumes that shareholders generally have a detailed understanding of the complex role, function and value of executive management, as well as the detail associated with the global market for executive talent and how suitable candidates for specific positions might be rewarded.

The Australian Shareholders Association[15] recently acknowledged that small shareholders may not have a sufficient understanding of the complexities involved with determining executive pay. The ASA argued this was the main reason it was opposed to giving shareholders a binding vote over executive pay decisions by Boards.

Proposals such as capping the quantum and value of options and removing tax deductibility of termination payouts seek to address the issue-of-the-day in terms of a particular component of executive remuneration, but does not recognise that one-size-fits-all regulation – motivated by isolated examples of excess – is not appropriate to a highly flexible, selective executive labour market that needs to be benchmarked against global standards.

Regulation applied to one part of the executive pay market risks creating distortions in other parts. Regulation applied only to publicly-listed companies risks creating distortions in this market by restricting the best management talent from seeking positions with listed enterprises. Ultimately, the unintended consequences of inappropriate regulations will be to the detriment of shareholders whose interests these regulations are designed to promote.

The business community acknowledges that politicians will be continually subject to pressures to influence executive pay in ways that are short-term and voter-friendly. At the same time politicians have access to the big picture in a way that many Australians do not. The challenge for politicians and law-makers is to successfully manage the demands of an internationalised economy, rather than distorting the market for what is a major factor in successfully managing Australia's largest companies.

15 AUSTRALIAN SHAREHOLDERS ASSOCIATION CHIEF STUART WILSON SAID THAT SHAREHOLDERS SHOULD NOT BE GIVEN THE RESPONSIBILITY TO DETERMINE EXECUTIVE PAY BECAUSE THEY WERE REMOVED FROM THE COMPANY, WERE NOT LEGALLY REQUIRED TO ACT IN SHAREHOLDERS' BEST INTERESTS, AND WERE NOT PARTICULARLY SOPHISTICATED. WWW.APH.GOV.AU, *OFFICIAL COMMITTEE HANSARD, JOINT COMMITTEE ON CORPORATIONS AND FINANCIAL SERVICES*, 9 MARCH 2004, PAGE 28.

9. Conclusion

The issue of executive pay goes to the heart of the credibility and integrity of corporate Australia. Executive pay decisions are closely examined and subject to significant public debate both in Australia and overseas. As a result, there is little doubt that the debate itself has conditioned the thoughts and actions of nearly every large company Board and Chief Executive.

The BCA welcomes the debate, as well as outcomes that have led to greater transparency and responsiveness by Boards who are elected by shareholders to manage their investment.

However, there is a risk that additional regulation aimed at promoting accountability and the interests of shareholders may have the opposite impact. Excessive regulation may inhibit the ability of Australia’s major listed companies to attract and retain high-calibre senior executives, which in turn may impact on the economy’s longer-term performance.

For smaller public companies, the one-size-fits-all regulatory approach has created problems – a fact acknowledged by the recent decision to exclude many smaller listed companies from new regulatory requirements.

The fact that Australia’s economy has been one of the best performing in the global market for a number of years is due to a number of factors, including a reform agenda conducive to business competitiveness, relatively stable interest rates and a mostly favourable global environment. Yet the strong performance of Australia's corporate sector has also been due to the overall quality of its leadership at both a Board and executive level.

Despite views that executive resources have a limited role in the success of corporations and the economy generally, companies do not run themselves, nor do they stumble upon success. Corporate executives are paid significant amounts compared to ordinary Australians, but the evidence demonstrates that collectively, and in the vast majority of cases individually, they have delivered significant value in return.

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