Just Rewards or Corporate Excess?

Executive Remuneration in Australia – It's Time for a New Model

by Geoff Nunn FAHRI, GAICD

Abstract

"At Risk" rewards, driven by financial KPIs have emerged as a key factor in problematic corporate behaviour. It's time to for a new approach. One which better balances the competing interests of different stakeholder groups. Board Advisor and Corporate Governance Specialist, Geoff Nunn, takes a critical look at the structure of Executive Remuneration in our larger listed and private companies.

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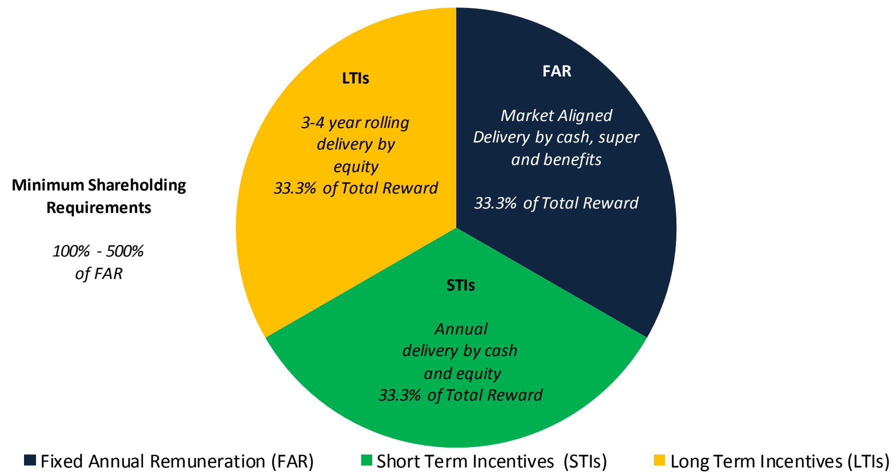
The current model of executive remuneration, in our major corporates, is designed to reward profitably and shareholder returns. There is a strong case that the high "at risk" component, based primarily on financial performance, is implicated in the instances of negative corporate behaviour.

The 2018 Edelman Barometer ranked Australia 8th lowest of 28 countries surveyed when it came to the population's trust in our institutions. This is a shocking result given the developed state of Australia's economy. The Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, the Prudential Inquiry into the Commonwealth Bank of Australia, prepared for APRA, and various other inquiries have uncovered serious failings of corporate governance.

Reported transgressions represent the iceberg as various inquiries probe into what has become a pervasive norm in corporate culture. That is, the pursuit of sales and profit without due regard to the impact on various stakeholder groups. A culture where the standard of business ethics appears to have sunk to an all-time low. Corporate credibility is in tatters.

The Structure of Executive Remuneration

The larger the company the greater the 'At Risk' component in the executive's remuneration package. For major corporates this is basically one third fixed, one third short term variable and one third long term variable as follows[1]:



The Key Performance Indicators (KPIs) which drive Short Term Incentives (STIs) and Long Term Incentive (LTIs) are aimed at 'aligning' the interests of executives and shareholders. Shareholders are focused on returns. There is a strong emphasis on measures like Net Profit After Tax and Total Shareholder Returns. Sections 180-184 *Corporations Act 2001 (Cth)* enshrine in legislation that directors act in the interests of the corporation (meaning shareholders).

This doesn't preclude directors from considering the interests of other stakeholders. Most organisations have statements in their annual reports and on websites emphasising the importance of these groups and outlining their credentials as corporate citizens. However, the lived experience of customers, suppliers and employees is often vastly different from the promise made in these carefully crafted messages.

Various inquiries have held that the current wording of the *Corporations Act 2001* is adequate to enable directors to consider the interests of all stakeholder groups. However, this will again be cast into doubt by the findings of the Royal Commission.

[1] STIs are delivered annually either in cash or a combination of cash and equity. LTIs vest after a 3-4 years and are almost always delivered with equity in the employing organisation.

Corporate KPIs Driving Executive STI and LTI Plans

Executive STI and LTI Plans are weighted toward financial performance:

Typical STI measures include:

- Earnings Before Interest and Tax (EBIT)
- Net Profit After Tax (NPAT)
- Gross Revenue/Turnover

Many companies include non-financial KPIs in their STI Plans although their relative weighting is low

LTI measures include:

- Total Shareholder Return (TSR)
- Return on Equity (ROE)
- Compound Annual Growth Rate (CAGR)

Non-financial KPIs are seldom used to drive LTI Plans.

These KPIs provide useful measures of financial performance. Informed shareholders will be keen to follow their performance in relation to their portfolio. However their heavy weighting in executive STI and LTI Plans is a concern from a Core Purpose and Corporate Social Responsibility (CSR) perspective.

Some listed corporations have "minimum executive shareholding requirements". The executive is required to hold a minimum level of equity in their employing organisation. For the Westpac CEO this equates to 500% of FAR or approximately $13.5m. This is another device to align the interests of executives with those of shareholders. But tying up a significant portion of an executive's personal wealth with the employing organisation creates the potential for self-serving behaviour, if not a conflict of interest for independent decision making.

Boards and Remuneration Committees need to take a serious look at their executive remuneration strategy and consider the following issues:

1. The heavy weighting attached to financial metrics in executive STI and LTI Plans might be driving corporate behaviour in a way that negatively impacts on some stakeholders.

2. The current strategy might not be appropriately aligned to the organisation's Core Purpose.

3. The current model is complex. If it takes a 25 page Remuneration Report to explain it, it's too complex and needs to be simplified.

Internationally renowned author and researcher, Dan Pink argues that setting focused performance measures attached to substantial reward may have adverse effects on certain aspects of performance:

"Like all extrinsic motivators, goals narrow our focus. That's one reason they're effective; they concentrate the mind. For complex or conceptual tasks offering a reward can blinker the wide-ranging thinking necessary to come up with an innovative solution. Likewise, when an extrinsic goal is paramount – particularly a short term measurable one whose achievement delivers a big payoff – its presence can restrict our view of the broader dimensions of our behaviour. "[2]

A Fresh Perspective

It's time to move to a simpler model that focuses primarily on Fixed Annual Remuneration and discontinue or substantially reduce the 'at risk' component. A model that includes corporate and individual performance in the annual review process.

Discontinuing or reducing the potential value of STIs and LTIs does not mean that financial and non-financial performance targets are no longer important. It simply means less remuneration attaches to them.

[2] Drive. Daniel H. Pink, Canongate *2009.* P 50.

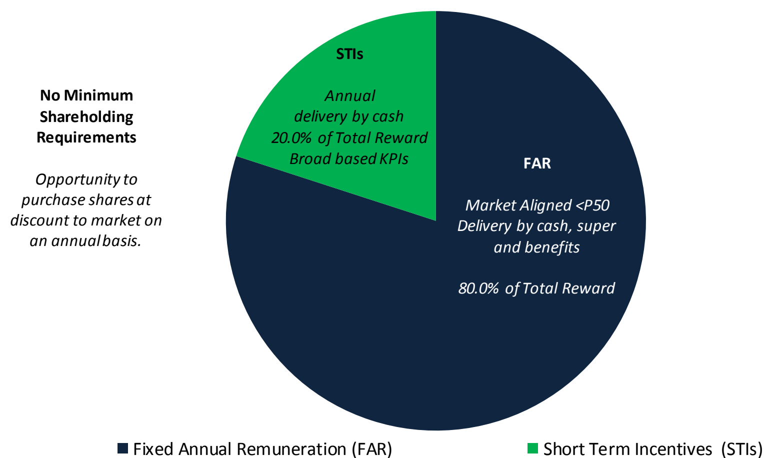
We propose that boards and remuneration committees undertake a full review of their executive remuneration practices and:

1. Base their strategy primarily around **Fixed Annual Remuneration**.

2. Consider the continuance of annual incentives or STIs, and if employed at all, ensure they are kept to a moderate level of, say, 20% of FAR.

3. Abolish equity based LTIs altogether.

To make these changes will require "cashing out" a percentage of STI and LTI opportunity. The revised model could look like this:



Depending up the amount cashed out a reduction of the overall quantum of executive remuneration may result. This will be seen by many stakeholders as a desirable outcome.

This fundamentally challenges the executive remuneration orthodoxy in the corporate sector. The focus for boards and remuneration committees must be to find a more balanced approach. Not one that encourages corporate excess in the pursuit of profit.

About the Author: *Geoff Nunn manages an independent governance and board advisory practice. He has worked extensively with private sector and government organisations in corporate governance, board strategic advice, board renewal, board structuring, board and executive remuneration strategy.*

Geoff has lodged a Submission to the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry in Australia, arguing for a return to a more balanced approach to executive remuneration.