Toward More Rational Executive Remuneration

July 3, 2006

There are several points in the remuneration planning process where ambiguity exists and a lack of understanding can lead to the establishment of inappropriate levels of executive pay. Awareness of these decision points will enable remuneration committees of boards of directors to exercise appropriate diligence in developing executive pay structures and levels that are motivational for executives and equitable for shareholders and employees as well. While executive remuneration comprises numerous components, this article addresses only issues associated with executive fixed pay, bonuses, and long-term remuneration.

Salaries: Job Value and Statistics

A multitude of factors are involved in determining job value. Most often, this process is referred to as job pricing. Typically, executive salaries are established using market surveys by reputable remuneration consulting firms, with the GuerdonData® on-line survey database of director and executive remuneration disclosures being among the best known in Australia.

However, the data provided by these consulting firms are presented in a number of different formats that can be interpreted in a variety of ways. For example, data for a specific executive position may be reported by industry, company revenue, company market capitalisation, or number of employees, to name a few. The fixed remuneration reported for each of these categories often exhibits a degree of disparity, leaving room for interpretation as to the value of the position. For example, for a “company secretary” the market salary may be reported as $170,000 when benchmarked by company revenue and $153,000 when benchmarked by market capitalisation.

Also, remuneration surveys typically report both “average” and “median” salaries for a position. There may be meaningful differences between these two figures. In general, medians are considered the more appropriate measures for valuation because averages are subject
to greater distortion from a few extremely high or low data points. Thus, when fixed remuneration is recommended to the remuneration committee by a remuneration consultant, the committee should inquire as to how that particular figure was arrived at. Then it will be up to the committee to determine if the remuneration proposed is the most appropriate indicator of the value of the position in question.

**Defining the Scope**

Another interpretative issue is the determination of the scope of the executive position itself. It is likely that the specific position under review by the remuneration committee may be larger or smaller than the one described and used in the survey. In this case, it is up to the committee to determine if, and how much, the remuneration survey data should be adjusted to reflect the realities of the job under consideration. For example, the “top human resources executive” position in one organization may include employee relations, risk management, payroll, environmental health and safety, and security. In another organization, the top human resources position may not include any of these functions, or some but not others. Thus, the remuneration committee should inquire about job scope and the entire range of job pricing practices when executive salaries are proposed.

**Bonuses: Targets, Ranges, and More**

Annual bonuses present a different set of interpretative issues. Typically, executive bonuses are determined by performance target plans based on the achievement of certain performance goals. In these types of systems, four major decisions must be made. The first is the selection of performance criteria. Here the committee must determine if the criteria recommended (e.g., cash flow, operating income) appropriately capture desired executive performance when compared to other available criteria. Essentially, this is an assessment of whether the measures reflect the key strategic objectives of the company.

The second decision involves the establishment of target performance levels for each criterion. This is a determination from which other bonus decisions will flow.

The committee must be sensitive to whether the target being proposed is a “lowball” that can be surpassed easily, a realistic target (but...
likely to be achieved without a great deal of effort based on the nature of the industry or past performance), or a true stretch target that ensures that higher bonus opportunities are related only to exceptional performance. The remuneration committee may rely on advice from the finance/audit committee regarding the appropriateness of the target, but only familiarity with industry and company financials can ensure that the committee aligns its remuneration recommendations with an appropriate target level of performance.

The third judgment is the range of company performance that will qualify for bonus consideration. For example, will executives be eligible for bonuses only for performance above target or will they also be eligible for some level of bonus at certain performance levels below target (e.g., bonus threshold at 80 percent of target)? The answer to this question will be determined partially by the committee’s assessment of the rigour of the target performance level. The more challenging the goal, the higher the level of risk the executive faces with regard to bonus remuneration. Therefore, for assuming higher degrees of risk, the committee may wish to establish some degree of award eligibility for performance below target.

A fourth decision is the range of individual bonus opportunity for which executives will be eligible at various performance levels. For example, should the maximum individual bonus opportunity for exceeding target performance be 150 or 200 percent of the executive’s individual target bonus level?

In addition to inquiring about market practices associated with these issues, the remuneration committee should consider what level of performance and bonus opportunity:

1. Is appropriate for the type of organisation in question;
2. Represents the degree of motivational incentive the committee wishes to establish for the executive cohort; and
3. Is consistent with the committee’s remuneration philosophy.

Another area of bonus consideration involves the weight attributed to financial vs. non-financial performance factors. Some CEOs may desire to “smooth” the amount of bonus awarded to executives annually by influencing the committee to give more weight to non-financial factors when financial performance is down and suggesting that non-
financial factors be downplayed when financial performance is exceptionally good. While this argument may have some merit in terms of creating greater income stability for executives, the committee should also recognise that this approach weakens the desired relationship between performance and reward. Many remuneration consultants believe that the weights applied to financial and non-financial factors should be applied regularly and predictably.

A consistent formulaic approach may work best.

**LTI: Levels and Valuation**

With regard to long-term incentives (LTI), the remuneration committee should review several decision points. First, a number of the considerations related to annual bonuses also apply to long-term incentive decisions (e.g., selecting appropriate performance criteria and targets). Second, the LTI target remuneration level must be determined. This can be done by determining the executive’s total remuneration target for the year and subtracting the fixed remuneration and targeted bonus recommendations. What remains is the LTI target for the year.

Similar to the development of fixed remuneration recommendations, the formulation of a total remuneration recommendation is also a market-based process. However, the process tends to be subject to greater variability than fixed remuneration or bonus assessments.

Therefore, it is important to ensure that the individuals included in the analysis are representative of the entire peer group and that the peer group is representative of the organization’s size and type of business. The remuneration committee should ask questions about why certain benchmark executives were included or excluded for the peer group analysis. Additionally, to ensure proper valuation, the composition of each benchmark’s executive’s LTI should be carefully scrutinised to determine if the data used in the analysis reflect typical remuneration levels or include unusual share and/or option exercises or awards. If share options are to be used to provide all or part of an executive’s LTI remuneration, it is also necessary to inquire how the options were valued to provide the targeted level of LTI remuneration.

Share option valuation is an imprecise process and, typically, is
based on a number of assumptions (e.g., average option term, stock price volatility). The remuneration committee should request an understanding of the share valuation methods. Is it based on a model that uses exactly the same assumptions? Or is valued using each survey companies’ AASB 2 interpretation?

Since undervaluing the price of a share option will result in a larger number of options being granted to achieve a specific remuneration target, it is important that the remuneration committee be comfortable with the option value that has been established.

Conclusion

Remuneration committees have a responsibility to determine the types and levels of executive remuneration that appropriately reward executives for their responsibilities and risks and are seen as equitable to shareholders and to the employees of the organisation. Hopefully, this article will aid remuneration committees and boards of directors in exercising due diligence in the design and evaluation of executive remuneration programs to achieve these multiple outcomes.