CEO Pay in the Top 100 Companies: 2002

Research Paper
Prepared by Institutional Analysis

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INTRODUCTION AND EXECUTIVE SUMMARY

ACSI commissioned Institutional Analysis to conduct an empirical analysis of CEO pay in the Top 100 listed Australian companies for the 2002 financial year. This paper reports the findings of the study.

In several areas, the study revisits issues researched for the 2001 financial year,[1] and the 2000 financial year.[2] Comparative statistics are provided. The paper can be summarised as follows:

The pay for performance dilemma

The report aims to highlight some of the reasons why, in Australia, there is no strong link between CEO pay and corporate performance across the Top 100 companies overall. Some of these reasons include:

- In some cases the long-term incentive plan (e.g. executive options plan) has no performance hurdles. This is so for only a small minority of Top 100 companies, but it is a little more common among non-Top 100 companies.

- In some cases the long-term incentive plan's performance hurdles do not relate directly to share price or dividends. For example, some plans have performance hurdles relating to accounting measures of financial performance, and it is possible for these performance hurdles to be achieved without any significant improvement in the company's share price and without any increase in dividends.

- In an increasing number of cases, the long-term incentive plan has "relative" rather than "absolute" performance hurdles. With relative hurdles, the company's performance is compared against that of other companies. The hurdle may be satisfied even if the company's share price and dividends have fallen – provided that in a relative sense the company has fared well compared to its peers.

- In an increasing number of cases, the long-term incentive plan allows a significant proportion of options / shares to vest when company performance is at the median.

- In some cases the long-term incentive plan allows performance to be tested on multiple dates. Sometimes the degree of latitude involved is so great that the company's performance would need to meet the required benchmark for only a short period of time in order for the options / shares to vest.

- In an increasing number of cases, the long-term incentive plan uses zero exercise price options (ZEPOs) rather than traditional options. The company usually describes the ZEPOs as "performance rights", "performance shares", "allocation rights", "deferred shares" or something similar. The key point is that the executive pays nothing to the company when exercising ZEPOs, whereas with traditional options the executive pays the "exercise price" to the company – and the exercise price is typically the market price of the company's shares at the time the options were granted (say, three years earlier).

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[1] Institutional Analysis, Board Composition and Pay in the Top 100 Companies: 2001 (Research Paper prepared by Institutional Analysis 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.

- In some cases the long-term incentive plan is not really "long-term" at all. For example, if options vest after only one year, it is not really a long-term incentive scheme.

- It is quite common for executives to be granted options (or performance rights, etc) only once every three years or so. And the generally accepted practice in Australia is that options are valued at the time they are granted (rather than the time the executive actually makes money out of them – when they vest). Taken together, these two common practices mean that a pay-for-performance study which looked at the CEO of Company A during the year in which the CEO was granted 500,000 options will report a significantly larger annual remuneration for that CEO than if the study looked at the CEO in the following year – when no options were granted.

- In the vast majority of cases the <u>short-term</u> incentive plan's performance hurdles do not relate directly to share price or dividends. Most of the Top 100 companies use performance measures other than share price and dividends in determining the short-term bonus for the CEO. The performance measures are often related to "internal" performance more than external measures like share price. This is not necessarily problematic at all from a corporate governance perspective (provided that the measures adopted are rigorous and defensible). But it needs to be borne in mind that a sizeable annual bonus could be paid under a short-term incentive scheme even if the company's share price has fallen during the year in question.

- Most large companies use external remuneration consultants to assist in setting the CEO's pay. The consultants rely partly on benchmarking techniques. That is, they produce league tables indicating how much (and in what form) the CEOs of other companies (of comparable size and in comparable sectors) are paid. This can partly explain (but not justify!) why a CEO's base salary increases despite poor company performance.

- Some pay-for-performance studies which have appeared in Australia recently do not use a sufficiently rigorous approach. Therefore, their findings on a link (or lack of a link) between CEO pay and company performance should be qualified and treated cautiously.

CEO pay in the Top 100 companies: aggregate statistics

The study looked at CEO pay in terms of its various components, and found that across the Top 100 companies:

- The average <u>base salary increased by 1.9%</u> between 2001 and 2002 (from $1.01 million to $1.03 million).

  - The median base salary was $914,000.

  - The largest base salary was $7,938,000 in 2002 compared to $8,543,137 in 2001 and $7,205,688 in 2000.

  - The smallest base salary was $50,575 in 2002 compared to $52,055 in 2001 and $80,000 in 2000.

- The average <u>cash bonus increased by 7.6%</u> between 2001 and 2002 (from $871,000 to $937,000).

  - The median cash bonus was $475,000.

  - The largest cash bonus was $10,944,000 in 2002 compared to $6,239,739 in 2001 and $13,808,000 in 2000.

  - Several CEOs did not receive a cash bonus. Among those who did, the smallest cash bonus was $50,000 in 2002 compared to $73,000 in 2001 and $ 50,000 in 2000.

- The average total remuneration excluding options and shares increased by 18% between 2001 and 2002 (from $2.02 million to $2.38 million).
  - The median total remuneration (excluding options and shares) was $1.45 million.
  - The largest remuneration package, excluding options / shares was $16,294,620 in 2002 compared to $14,858,424 in 2001 and $14,935,000 in 2000.
  - The smallest remuneration package, excluding options / shares was $50,575 in 2002 compared to $166,457 in 2001 and $ 195,931 in 2000.
- The average total remuneration including options and shares increased by 22% between 2001 and 2002 (from $2.64 million to $3.23 million).
  - The median total remuneration (including options and shares) was $2.1 million, which was $22,000 lower than in 2001.
  - The largest remuneration package, including options / shares was $16,294,620 in 2002 compared to $14,858,823 in 2001 and $69,098,875 in 2000.
  - The smallest remuneration package, including options / shares was $50,575 in 2002 compared to $166,457 in 2001 and $348,338 in 2000. Several CEOs were not granted any options or shares in 2002.
- Options and shares accounted for, on average, 23.6% of total pay for the Top 100 CEOs in 2001. This increased to 28.6% in 2002, with corresponding declines in the relative significance of base salary and cash bonus. Therefore, at least to the extent that grants of options and shares have demanding performance hurdles attached to them, a greater proportion of CEO pay was "at risk" in 2002 compared to 2001.

Disclosure of options' value

Only 72 of the 80 sample companies used options and/or shares as part of their executives' pay. Of these 72 companies, 54 companies (or 75%) disclosed the options value as at the date options were granted. This is a significant increase on 2001, when approximately half the Top 100 companies disclosed options' value as at date of grant, and half did not. Some of the companies that did not disclose a value at the time of grant chose instead to provide a value as at the time the executive actually makes money out of them – when they vest.

Among those companies which *did* disclose the value of options at grant date, the disclosure ranged from excellent to poor.

Top 10 case studies

10 "pay-for-performance" case studies were conducted. The 10 highest-paid CEOs were identified for the year 2002, and then compared each CEO's pay for the four years 1999 to 2002 with his company's[3] financial performance over the period 1999 through 2002. This revealed that the pay of some CEOs has borne a relationship to the company's performance, but the pay of other CEOs has been large and increasing over a period of poor or at least uneven corporate performance.

[3] The 10 highest-paid CEOs were all men.