Questions directors should ask before ASIC does

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The Director’s Dilemma

Great CEOs don’t come cheap, but shareholders are becoming increasingly concerned about CEOs’ salary levels. The board’s involvement is essential in determining both remuneration policy and the role of the CEO.

This country has a history of company owners – albeit mostly from private or privately controlled public companies – rewarding executives who have contributed to the wealth of the company in unusual ways. These include no (or very low) interest loans to assist them in creating capital to buy out parts of the business at a value much below market worth. Indeed, immediately after WWII there were examples of senior executives running their own businesses while working in public companies.

These were informal ways of recognising that if a particular person had the capacity to generate great wealth and that if that capacity had to be harnessed for the good of the company, rewards could not necessarily be limited to what the company could afford to pay in a salary.

Such devices are not possible today given fringe benefit tax and greater transparency in relation to the disposal of company assets and inter-company transactions. Today that’s just not on as a means of rewarding senior executives.

Beyond the legalities, the system was far from perfect – being very much at the whim of the owner or controlling shareholder so that nepotism was rife. Executive remuneration is much more structured today, and at the top end is generally much higher.

Following the collapse of HIH and the decline in value of the highly regarded AMF, much anger and frustration was directed at many and “baddies” (those who plunder companies and walk away unscathed and it draws upon and then feeds on Australian values of equity and fair play).

Of course, things are not helped by words like “obscene” and “burbog” being used in conjunction with business chiefs and salaries or by Senator Stephen Conroy calling directors dinosaurs with their “stouts fairly in the trough”.

Is it fair that some earn more than others, or have more, even much more, than others? Along with many Australians, I have real difficulty with this philosophical question. But equity is not the real issue here, and not all CEOs get huge salaries and huge payouts.

The worldwide problem is that there are significantly fewer good CEOs than there are companies to run. So the best CEOs have many choices.

Much has been written about CEO salaries, but less attention has been directed to the role of the board, either as the problem (or part thereof), or as the solution.

They can run their own business, run someone else’s business, enter politics, retire, enter academia or engage in community or charity work.

The fatal flaw in market logic

Although CEOs need rewards to convince them to join a company, there is a very real problem – double inflation, even triple inflation in the making.

Salaries are generally determined by competitive benchmarking – what the average CEO in a similar sized company...
in a similar industry would expect - plus a bit (premium), because no one wants an average CEO.

The reduced length of time CEOs are spending in their jobs means the inflationary "plus a bit" occurs with ever-increasing frequency. This is not dissimilar to the impact that would occur out of compounding interest monthly then weekly then daily.

Moreover, if CEO salaries must be market competitive at all times, and increased to keep in line with the market regardless of contract (as was the explanation for Cokes Myer CEO John Fletcher's proposed salary increase), then potential exists for tertiary inflation.

Concern has also been expressed that transparency will boost salaries as people both in the organisation and outside make comparisons and seek increases. Head-hunters, for example, hold market information on salaries and can use this to "bid up".

Where does responsibility lie?

Typically, responsibility would have been felt to lie with the board, the CEO, or management. But recent proposals to have government and shareholder involvement in the remuneration decision process means that these groups must also be added to the list of those potentially responsible.

And what of the existing CEO - who is responsible for his pay? A CEO exiting early and getting a big payout when a company is not performing tends to create a reaction.

Is the CEO responsible because he or she did not perform? Or is the board responsible because they hired the wrong person or did not provide the right environment, support, or direction? Much has been written about CEO salaries, but less attention has been directed to the role of the board, either as the problem (or part thereof), or as the solution.

Abrogation of responsibility to head-hunters

Australians don't want figureheads as directors of their companies. Yet many businesses leave the crucial process of CEO selection and remuneration to head-hunters.

Not many head-hunters have been valued members of boards of major companies going through dramatic change or have been CEOs who have successfully turned around a failing company.

Back to the drawing board

Warren Buffett challenges directors to go back to the drawing board - when it comes

Companies profess a belief in teamwork, seek team players and a "partnership of equals" at board level, but cling to the notion of a sole CEO sitting godlike at the top.

The right to know but not to decide

Today, advertisers use the Wards to measure how people respond to an advertising campaign. For companies, the share price is the Ward's equivalent. It should respond, not dictate.

Encouraging shareholders to vote on executives' salaries must not be allowed to go too far. Shareholders are not a quasi-Senate, and the ramifications they take on that role would be far-reaching. There would not only be a fundamental shift of power, but also a fundamental shift in responsibility.

Today, debate rages on the proposed reforms to the Senate - whether the Senate is a legitimate check on the Government of the day, or whether the Government of the day has a right to govern without obstruction.

Prima-facie there is a strong parallel with the role of boards vis-a-vis shareholders. However, there is a fundamental difference - shareholders can sell at any time. The share price is a real measure of confidence in the company and the board, one which translates immediately into dollars.

The role of company directors in this executive remuneration debate is essentially one of opening the channels of communication. The questions are Are you as board members communicating with your shareholders in such a way that they can understand what you are doing? Have you put your strategies into a broader context for your shareholders and stakeholders? Have you involved them? Have you been transparent about the complexities? Are you communicating honestly, intelligently and with wisdom, or just giving the company line?