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 AMP, much anger and frustration was directed at highly paid executives, and specifically at the sheer size of their remuneration.

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Roy Morgan qualitative research reports comments such as, "Payouts have been exorbitant", "Executives get paid and [are] not accountable" and "How can a CEO who gets paid so much make so many bad decisions?"

Today, the media is full of debate about CEO and senior executives' salaries. Like a good movie or popular series, the CEO salary debate is self-nourishing - it has "goodies" (those who create wealth for 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 "humbug" being used in conjunction with business chiefs and salaries or by Senator Stephen Conroy calling directors dinosaurs with their "snouts 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. 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 Coles 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 held 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 two groups must also be added to the list of those potentially responsible.

And what of the exiting 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 Buffet challenges directors to go back to the drawing board - when it comes to CEO or senior executive recruitment and remuneration, the board can do it differently.

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In selecting and employing a CEO, a board must look for value. It can look at alternatives - would two smaller jobs be better than one large one or would some kind of virtual office be relevant?

Would a well-planned team of five people each on 30 per cent of the CEO's salary be better than a CEO plus four people on 20 per cent of his or her salary? The first solution represents not only a 30 per cent saving, but also a break with tradition. 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.

Rotating CEOs may actually achieve the kind of rejuvenation that is thought to be needed every four years or so. Rotations happen in legal partnerships - many law firms are both large and extremely profitable - it happens with heads of department at universities, and has been used in situations where, for example, advertising agencies have retained existing management structures after acquisition.

Alternatively, rather than a forced rotation, the choice of CEO could rely on the strategic direction of the company at a particular time. So if a board decides that corporate direction for the next three years will be on growth through sales and commercialisation of existing products, a marketing-focused board member would be the obvious choice.

The task and transparency

A CEO is in many ways like any other investment, whether it be in a building, a company or a new computer system. The strategy and tactics involved in these three examples are not dissimilar to those involved in finding and employing the right CEO at the right price. These transactions are open to scrutiny.

Choosing a CEO could most closely be likened to buying a company, or conducting a merger where issues of price, cultural fit and future earnings are all important.

I have never seen a deal where the recently acquired company was subject to a special arrangement, so that if the cultures did not fit the company would be given back and compensated for the experience.

The right to know but not to decide

Today, advertisers use the Worm to measure how people respond to an advertising campaign. For companies, the share price is the Worm'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 should 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-à-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? ■