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When executive remuneration counts

Boards should adopt a more flexible approach to executive remuneration to reward staff without incentivising behaviour that counters the company's long term goals, writes JULIE GARLAND McLELLAN.

Executive remuneration has been a hot issue for boards since the rise of the "star CEO" and its influence in linking salary to performance. As the collective tide rose over the last decade, the staggering salaries earned by some executives in the financial services sector often required the board chair on occasions to explain the rationale to shareholders.

With the current financial crisis lowering the tide considerably, fund managers, super fund trustees, and financial planning directors are under renewed pressure to justify their model of remuneration.

In response, a number of boards are producing remuneration reports for shareholder approval, which involves balancing transparency while protecting confidentiality, as well as careful wording so that competitors can't gain the clarity they need to target an organisation's best staff.

The treatment of executive remuneration is one of the key indicators of a board's ability to understand its business because remuneration methods should have the flexibility to change with the changing needs of the organisation.

One of the key elements of a performance strategy is to ensure that the delivery and achievement of certain tasks are not taken to an excessive point, in which the future of the company is in peril.

In other words, if a company's leaders design an incentive to achieve a level of performance that reinforces the wrong behaviour, clearly the organisation is going to get a negative result.

The grey area in this equation is when an employee's incentivised behaviour goes from being a positive for the organisation's performance to suddenly being a negative that if left unchecked can have disastrous consequences.

This is why it is important for boards to understand the dynamics driving the business. This allows them to help manage risk in consultation with management.

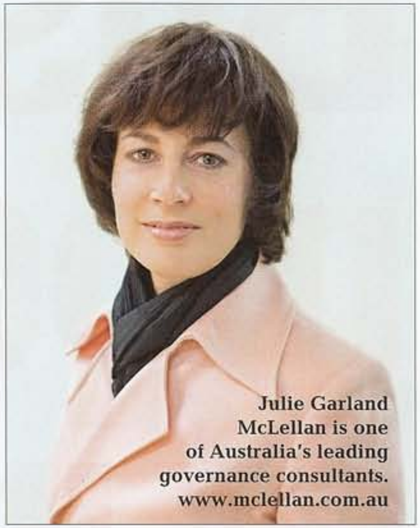
One way to avert the shift of an incentivised behaviour becoming a negative to the company's long-term business is that, after a certain level of performance is achieved, the performance agreement is recalibrated and bonuses are attached to a new form of behaviour.

In addition, as the knowledge and understanding of how businesses and the people that work in them continues to grow, it is possible for the board to be more clinical in its approach to remuneration, which must include using the right strategy for the moment.

It's about recognising that simple is not always good. For example, investors have long criticised how bonuses are tied to share performance because it incentivises management to increase short term profit and decrease long term sustainability.

There was a similar sentiment ten years ago where bonuses based on manufacturing and production were found to be wrong because management would sell at a loss in order to move product, or not be concerned if they were producing the wrong product.

One option certain boards have adopted is remuneration that supports a combination of positive behaviours. For example, the securing of a 20 per cent bonus by a chief executive could be broken into four key measures: 5 per cent based on share price, 5 per cent on successfully opening an office in a new territory, 5 per cent if key staff are maintained, and 5 per cent if customer satisfaction is maintained at a certain level.



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By breaking down the reward based on these four measures, the board has selected activities that will help the company in the short and long term and choose outcomes that can be measured.

It is apparent in the current crisis that many boards have not understood the impact the remuneration strategy has had on the culture of their organisation. With boards now having to deal with the prospect of governments becoming major shareholders, the critical role of the new remuneration strategy will be to support the long term financial health of the business. ●