



Executive pay

THE ISSUE

Public trust in capital markets has been damaged by corporate wrongdoing and heightened awareness and scrutiny of companies has given rise to debates about how executive pay is determined. Many cases have been highlighted where executive rewards are unrelated to the economic performance of the company or the risks they take.

THE BACKGROUND

The differential between the pay of those running the UK's largest listed companies and the average pay of their employees continues to widen. Since 1998, the average chief executive officer's (CEO) total remuneration has risen by 208%. In the same period, average earnings have increased by just 33% and retail prices by 15%, while the FTSE 100 index fell 13%.

In 2004, in companies with a turnover of over £1bn¹, CEOs were paid 65 times more than their average employees and, in the same year, CEO total remuneration rose 17% compared with 2003.

In 2003 the Secretary of State for Trade and Industry² noted the high level of public debate and concern over the granting of generous compensation packages, particularly in cases where companies had performed poorly.

THE CASE FOR ACTION

Although the numbers of directors receiving excessive rewards for failure is small, such payments reflect an inappropriate culture at the top of organisations and can have a strong influence in wider society, making the issue one in the public interest.

Recent legislative changes have assisted active shareholders in limiting the most excessive attempts at self-enrichment, but show no prospect of slowing the general upward trend. The present market mechanism, in which the pay of CEOs is decided by remuneration committees, seems to perpetuate the trend. It has been argued that as members of remuneration committees tend to be executives from other large companies, they share a common financial interest in increasing levels of executive pay.

ACCA'S RECOMMENDATIONS

ACCA calls for better initial disclosure of contract terms, greater emphasis on empowering smaller shareholders and increased transparency.

Disclosure: There should be a clear link between the remuneration report, company objectives and achievements reported in the Operating and Financial Review and the statement on board and director evaluation.

Enhance communication with shareholders: At present, only large (normally institutional) shareholders communicate with directors. Other shareholders can only communicate through the company general meeting. Individual shareholders often hold their shares through a nominee and so lack the opportunity to attend an AGM. To give individual shareholders a voice, companies should, for example, establish a web based discussion forum for shareholders, which encourages companies to respond to issues raised and allows shareholders to vote on issues they propose.

Increase accountability of institutional shareholders: As institutional shareholders hold their investments on behalf of others, and the managers of these bodies are themselves well remunerated, they may lack sufficient incentive to curb all but the worst excesses. Government efforts should be focused on ensuring that institutional investors are genuinely accountable to the people whose money they look after.

Pay for Performance: Directors should be required to demonstrate to shareholders that their pay is reasonable in relation to their individual performance, company performance and employee pay. To help ensure that boards remain sensitive to the issue of compensation, a standard measure should be used to track the relationship of board pay to average employee pay and to appropriate measures of company profitability.

Employment terms: Previous debate has focussed on whether compensation reflects performance at the point when directors' contracts are terminated, but 'rewards for failure' potentially arise at the time they come into employment. If directors' original terms and conditions are seen to be fair and reasonable then problem issues on termination should be dealt with transparently and, hopefully, to the satisfaction of all concerned.

REFERENCES

¹ *Executive Directors Total Remuneration Survey 2005* by executive pay consultancy, Independent Remuneration Solutions (IRS) and Manifest.

² *"Rewards for Failure" Directors' Remuneration – Contracts, Performance and Severance A Consultative Document* by the DTI. 2003