THE PAY MARKET IN 2004

Classified Salary Information Services Pty Limited

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FOREWORD

Around this time each year remuneration consultants are asked to give their forecasts as to the expected salary market conditions for the following year. Obtaining credible information can be quite a challenge, which is why **CSi** has developed a report to bring you the most up-to date and relevant information. Organisations may use this information as a guide, along with other material gathered, to incorporate into their management reports and forecasts for the next year.

The salary and wages bill is most often the highest expense on an organisation's balance sheet. A one percent over-estimation in guaranteed pay can be costly – particularly as the business environment tightens up. Therefore employers use predictive information to arbitrage the best outcome – one that is not too costly but should nevertheless cushion them from excessive staff attrition.

Performance based reward paid only after the achievement of performance hurdles will herald an era of self-funded pay increases.

CSi has sourced information in this report using trends from our various databases and the most recent general economic and market data available. Much of the trend analysis has been extracted from our November 2003 General/Combined Industries Salaries & Benefits Survey Database.

This report is designed as a preliminary document to provide organisations with an overview of the anticipated pay market in 2004. For further information contact **CSi**'s Client Services and Professional Services Divisions.

Peter Barton
Managing Director, **Classified Salary Information Services Pty Limited,** December 2003

EXECUTIVE SUMMARY

- Although currently flat, pay is set to take off again in 2004 in line with a budding economy so organisations should be planning ahead now to take advantage of the anticipated changes in the economy or employment market.
- Salaries are expected to rise next year – around 3.5 – 4.0% – to keep pay rates ahead of the prevailing CPI at the very least, but the CPI will no longer *drive* compensation reviews.
- The most notable strategy to drive motivation, performance and therefore organisational profitability is a shift towards increased variable pay as a proportion of total reward.
- Design pay programs that pay for themselves by linking the at-risk component of reward to individual objectives that contribute directly to organisational performance in an obvious and tangible manner.
- Commissions will remain a most effective form of self-funding short-term incentive for employees involved in sales. Commission schemes must be designed in a contingent fashion, but will generally incorporate more aggressive splits in the future.
- In the future, pay should also be considered in totality and incorporate more structure especially around the split between fixed and at-risk pay. This is particularly important in the realm of executive remuneration where more strict performance hurdles for reward achievement must be included.
- The most important factors affecting the structure of remuneration programs are company affordability, external market information, internal relativities and performance.
- Long-term incentives remain popular, but are only effective when they truly reflect the principles that provide the rationale for equity-based reward and incorporate performance hurdles.
- Where necessary, Australian organisations should be aware of global pressures impacting pay, but should be more concerned with local circumstances and relativities than be driven by the pressures of globalisation.
- Employers should concentrate on rewarding top performers who will continue to contribute to organisational profitability over the long term and using them as an example to which the 'average' employees should strive.

CONTENTS

INTRODUCTION

Currently, the Australian employment scene is thriving, despite the drought and numerous global concerns such as Iraq, SARS and weak global economic activity. Reasons for this include increasing business confidence, historically low interest rates, a voracious housing market and solid retail sales. However, the employment market can and should be split into select categories to identify a more localised and therefore accurate reflection of specific sectors. Two obvious broad categories are 'white-collar' workers (professionals and managers) and 'blue-collar' workers (consisting of tradespeople).

The pay market in Australia has remained fairly stagnant over the last 12 months – the 'employers' market' [See Appendix 1] continues in relation to 'white collar' positions which is unusual at a time when the level of national unemployment is the lowest it has been for 22 years at 5.7% (Trend). Employment prospects for professionals are set to benefit from positive wider economic fundamentals. The ramifications for overall pay movements will be determined by factors such as the cost of living, economic growth and supply of labour. However the key factor behind individuals' pay is supply and demand (market rates of pay), and increases determined by performance against set targets/objectives. Underpinning all this is company affordability. It is likely that the 'employers' market' will come to an end in the coming year although excessive wage increases are not expected as a result.

During the same period, employment prospects within the 'blue-collar' market are expected to slow after several years of frenetic growth spurred on by the housing and construction boom. The level of business activity and the supply of labour will govern pay issues within this sector. Skilled labour shortages are forecast for several key sectors including mining, utilities and construction. These shortages will see employers pay a premium to acquire the skills.

Given these circumstances, this is an opportunity for organisations to restructure their methods of operation and pay programs based on low growth in guaranteed pay over the long term with increasing emphasis on variable pay, particularly that which is self-funding. The first section of this report briefly describes the economic circumstances that have led to this market situation occurring. Next are some strategies to help HR professionals take advantage of the current and anticipated state of affairs – including the need to plan ahead, incorporate more structure into pay programs, reward the key employees and gear remuneration systems to pay for themselves by linking individual performance to organisational profitability. This section subsequently focuses on commissions and other variable pay options – how to get the most out of them during the current market situation and prepare for the future.

Executive remuneration is also discussed in detail, as it remains the most contentious compensation issue. The pressure for the "globalisation" of executive pay rates is likely to subside as the wisdom of adopting uncompetitive and unstructured packaging is questioned. New corporate governance and disclosure rules will monitor (and perhaps control) executive reward. High rates of pay for strategically responsible executives will remain but there will be ongoing pressures to relate and justify these pay rates according to performance hurdles and shareholder return.

No matter what the global outlook, salaries should rise next year – to keep pay rates ahead of the prevailing inflation rate (CPI) at the very least. As a rule of thumb, pay increases are generally 1.0%-2.0% ahead of the CPI rate, in effect ensuring that employees always have a "real" increase in their pay. However, it should be recognised that CPI movements are no longer a driver of pay increases, and that other factors such as company affordability and individual performance must be taken into account. This is especially true in regard to top executive pay, where the rate of inflation is often not considered at all. In Australia real wage increases are usually fairly moderate in comparison with other countries – a trend that is likely to continue next year.

ECONOMIC OVERVIEW

General Trends – The Economy In A Minute

Despite slowing in the second quarter the Australian economy looks well positioned to take advantage of the anticipated global upturn which should see growth return to levels we have become accustomed to in recent times. The following section includes data relating to economic growth, unemployment and inflation, which are key indicators of the state of the economy as a whole. This means, for example, that organisations can glean some information about their capacity to pay from the level of Gross Domestic Product (GDP). Unemployment is important in determining the demand for skills, while inflation indicates the level of prices in the economy – showing employers the minimum increases necessary for employees to retain their existing purchasing power.

GDP - Economic Growth

- Current Quarter: 2.5% Sept*
- Forecast: 2.8% Dec*
- 2004: 4.0%#

Comment:

Over the past year the Australian economy succumbed briefly to the seemingly relentless pressures it faced – including a weak global economy, SARs, terrorism, a rising currency and domestic drought – only to quickly regain momentum in the third quarter. Growth figures revealed the economy had slowed to just 1.9% (trend) over the year to June but had returned to strength in the September quarter increasing to 2.5% (trend).

Predictions place Australian economic growth between 3.0% - 3.5% by mid-2004. Importantly, the growth will be more broad-based and less reliant on a couple of select sectors for its growth as it has been in the past.

Unemployment

- Current Quarter: 5.6% Nov*
- Forecast: 5.6% Oct*
- 2004: 5.7%#

Comment:

Unemployment looks set to remain below 6.0% for some time, especially if the economy gains momentum as expected. Job advertisement indices, which measure the number of advertisements for jobs over a given period of time have risen recently, indicating that downward pressure on the unemployment rate exists. As conditions improve it is highly likely that more individuals will resume actively seeking employment, resulting in the participation rate rising. However, it is not perceived that this will place significant pressure on the unemployment rate and force it to edge higher. In fact, it is this additional labour that will restrain wages as the economy lifts and the supply of workers increases.

Inflation

- Current Quarter: 2.6% Sept*
- Forecast: 2.5% Dec*
- 2004: 2.6%#

Comment:

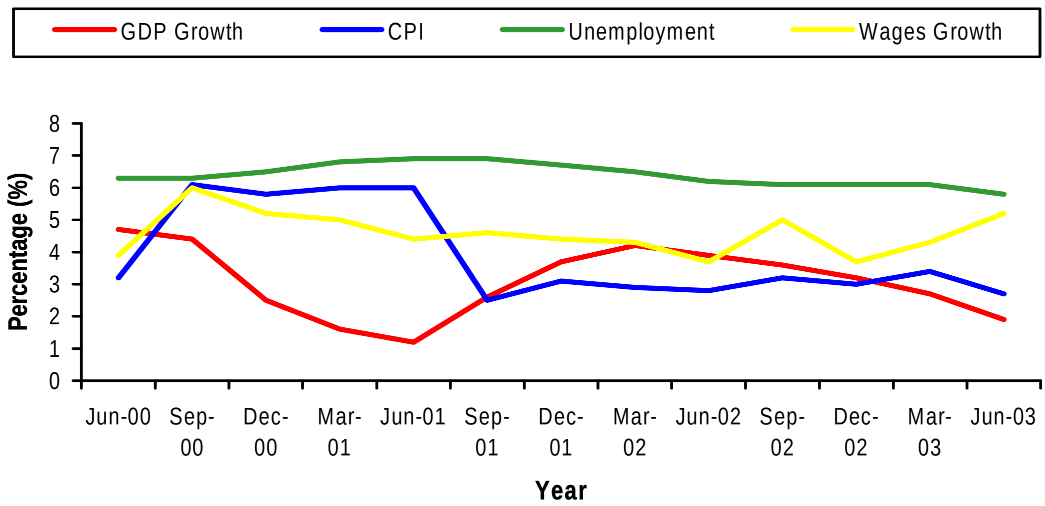
The September 2003 Consumer Price Index (CPI) revealed that annual inflation rose by 2.6%, placing it right in the middle of the target range put forward by the Reserve Bank of Australia (RBA). Looking ahead to the medium-term, restrained wages growth, a higher Australian dollar – which negatively affects our exports and strong productivity growth will most likely keep inflationary pressures low in 2004.

The question surrounding interest rates is no longer… "Will this be enough to prevent an increase?" The RBA has already answered this by increasing the official cash rate 25 basis points in both November and December. The question is now… "Will the RBA force another increase in response to continued positive economic news, both locally and internationally and the seemingly relentless consumption of Australians fuelled by debt?" Even they don't know the answer yet!

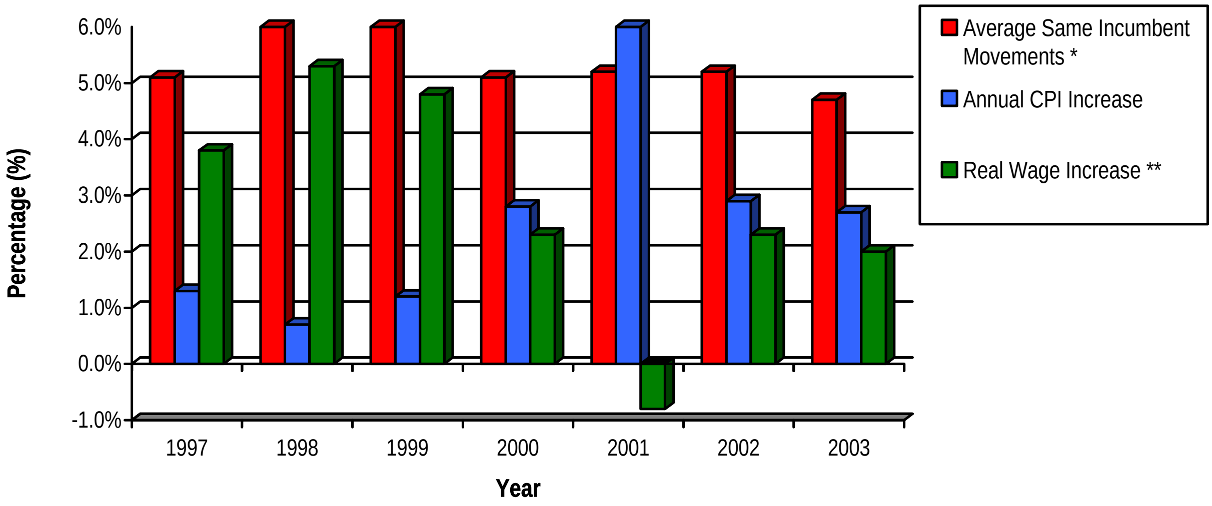
* Annualised Figures   # Calendar Year

A summary of these key economic indicators over the past three years can be seen in graphical format below:

Australian Economic Indicators June 2000 – June 2003



Real Wage Increases



* See Appendix 3 for definition

** Difference between Same Incumbent Movements and CPI

Real wage increases are defined as the difference between actual increases (average same incumbent moves) and CPI increases. These are important to employees as they represent a true increase in purchasing power. In short, this means people can afford to buy a greater amount of goods and services.

The graph above provides a summary of actual wage increases, the CPI increase and the Real Wage increase over the last 6 years. It can be seen that, apart from 2001, when inflation artificially grew as a result of the introduction of the GST the previous year, there have been real wage increases each year.

Anticipated Salary Increases for the Next Twelve Months

In order to equip management with an insight into salary increases for the next twelve months thereby aiding them in planning and budgeting, **CSi** conducted a Feature Survey on salary forecasts during the second half of 2003. The table below summarises contributor expectations for the next 12 months across a range of **CSi** surveys (as provided by respondents to the relevant Feature Survey question). In practice, **CSi** typically finds these forecasts are conservative estimates of actual increases.

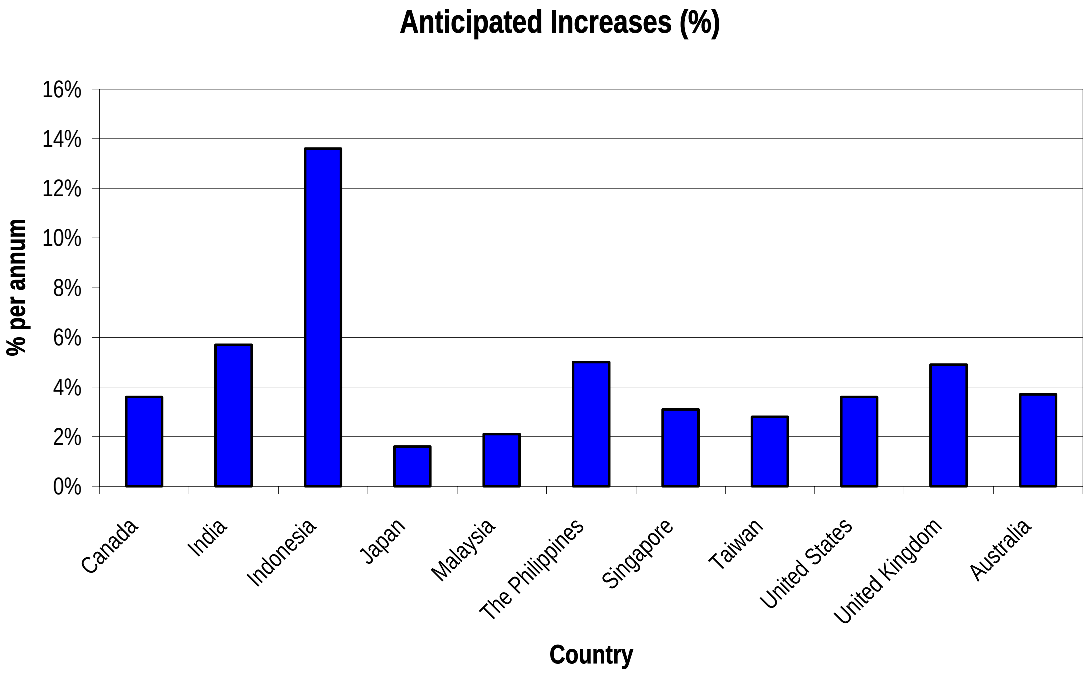
Survey	Average Increase	Median Increase
Australian Information Industry – AIIA	3.7%	3.5%
Australian Travel Industry	4.2%	4.0%
Australian Computer Specialists	3.8%	4.0%
Banking & Finance Industries	3.8%	4.0%
Business Equipment	3.6%	3.5%
Diagnostics, Medical Devices, Scientific Products & Equipment Industries	3.9%	4.0%
General Insurance Industry	4.3%	4.0%
Telecommunications Industry	3.2%	3.5%
New Zealand Computer Specialists	3.3%	3.0%
New Zealand IT & T Industries	3.3%	3.0%
Subscribers to General/Combined Industries Survey*	3.7%	4.0%

*Figures based on 1st cycle 2003.

CSi expects that salaries will increase by 3.2% - 4.5% in 2004 – a rate which will be 0.6 – 1.9% higher than the anticipated CPI and consistent with the trends predicted for the United States and United Kingdom. There will be certain industry sectors and job families that will see higher rates, but overall the market is likely to be flat. The WorldatWork 2003-04 Salary Budget Survey (a US-based publication) indicates that the salary increases in 2004 will be about 0.5% lower than what was projected last year, which is the same decreasing trend the survey revealed between 2001 and 2002.

Much will depend on economic conditions that in turn are affected by political and environmental uncertainty. An analysis of increases over the last 12 years illustrates greater restraint in pay increases in Australia in relation to most other larger economies. Lowered corporate profits have affected the capacity of Australian organisations to award solid increases. Australia's relatively low inflationary environment negates the inflationary pressure on wages experienced in other economies.

An international perspective of expected salary increases for 2004



Source: WorldAtWork Salary Budget Survey 2003-04

A global perspective on pay is becoming increasingly important as larger numbers of Australian (and international) organisations are locating operations offshore. Pay rates in overseas business locations are crucial in order to appropriately remunerate employees who may be located there. The anticipated increases shown in the graph above also provide some indication as to the state of the economy and business confidence more generally. Organisations must be wary of potential flow-on effects from these countries on a broader regional basis. Some other observations that are relevant here include:

- Most economies around the world are affected by uncertainty in the global economic environment, but to differing degrees.
- Despite many countries experiencing slower growth, wage increases still exceed CPI increases – making for 'real' wage increases in most countries.
- Developing countries such as Indonesia and the Philippines are anticipating the largest increases, but starting from a lower base, and also in line with their high forecast inflationary growth.

STRATEGIES TO TAKE ADVANTAGE OF THE CURRENT MARKET SITUATION

What to do in the Current (Employers') Market:

The three primary objectives of an effective reward plan remain to attract, retain and motivate employees to achieve competitive advantage. The use of particular compensation techniques should thus be seen as contributing to a wider performance-management strategy. In a typical performance-management system, an employee's salary increase is determined by his or her individual performance. The intent is to differentiate between individuals' contribution to the success of the organisation. At a time of economic slowdowns and uncertainty, a pay program such as pay-for-performance is particularly appealing and increasingly popular, especially in order to keep employees motivated and focussed.

The emphasis of strategic remuneration considerations in the near future should thus be variable pay – linking compensation directly to performance, with the explicit purposes of motivation and retention. Some of the key strategies that organisations should adopt in an employer's market are noted below, with greater detail in the following discussion of commissions, long-term incentives and executive remuneration.

1. Plan ahead

Though times may be tough, employers should start planning now for the change – there are already those predicting a take off in pay (and the economy) in two to three years time. Since the pay market is flat, employers have the power and opportunity to do what is in the best interests of the organisation. Though growth in wages remains conservative, if the economy picks up higher rates of growth are expected, so "get your house in order now". The focus should be on retaining top performers who will be able to capitalise on an improving economic situation in the future. Also consider the loyalty benefits to be derived from long-term rather than short-term incentives.

2. (Executive) pay needs to be more structured

Countless exposés of executive pay in recent times have highlighted the need to make pay more rigorous and structured. It is no longer acceptable for pay packages to be designed in an ad-hoc, 'laissez-faire' fashion. Instead, pay rates should be determined using external market information, internal relativities, company affordability and both individual and organisational performance.

Also be wary of 'globalisation talk' – though a global perspective on remuneration is useful, do not let international evaluations become *US-only* comparisons. The United States (US) may be a driving force in the world economy, but domestic circumstances must also be taken into consideration. Particularly in an employers' market, when there is little pressure for retention, Australia need not follow the trends of the US for fear of losing staff to overseas markets.

Lessons learned in the executive realm should give rise to sound principles that can then be applied to all levels of the organisation. Indeed, the success of any remuneration program depends on a clear linkage between its objectives and corporate-level organisational strategy in order to integrate all business units and support organisational direction. The structure should also seek to reflect the culture of the organisation and may be used to drive organisational change in some circumstances.

3. Employers must stop rewarding mediocre performance!

All too often in the past we have seen cases where even sub-standard performance still gets rewarded. Organisations simply cannot afford to do this during tighter economic times. Instead, organisations should be concentrating on 'star' performers – set them challenging goals, and reward them accordingly (with monetary incentives and other tangible and intangible benefits) when the targets are met. For consistently 'good' employees, who form the core of the workforce, invest in training and development in order to bring them up to the 'excellent' level. A focus on generously rewarding the top performers can also help to support a high-performance culture for the organisation – one that values excellence and performance. Such a culture should have clear direction, stated values, continual feedback, performance criteria and standards accepted by all.

4. Design remuneration systems that are self-funding

Regardless of conditions in the pay market, employers should be looking to design remuneration packages that focus on variable pay. Gear up pay programs that are designed to pay for themselves by linking individual performance to organisational profitability. In this way, the better employees perform, the more profitable the organisation and therefore the greater the ability to pay the 'at risk', performance-related reward. The pressure in the future will be to ensure this fundamental rule is being applied. There is a perception prevailing in the current environment that under-performing employees at all organisational levels have been rewarded strong increases regardless of performance, resulting in scepticism. It is also important for organisations to maintain the cost of remuneration programs as a ratio of organisational profitability to guard against excessive payouts.

Generally accepted principles of any pay-for-performance program:

- Success depends on the willingness of individual managers to make objective assessments of employees.
- Managers must be willing to differentiate between performers that meet expectations and those that exceed – or fall short – of expectations.
- Competency-based systems should measure an employee's performance against a set of core behaviours that have a proven impact on business.
- Payouts should be made quarterly or at least more often than annually. There must be follow-up evaluations.
- The plan must be communicated clearly, frequently, and simply.
- Success depends on training, reinforcement, and company-wide commitment.

Commissions

Commissions are an important element of pay for those involved directly in selling products and services. They remain popular as an objective measure of performance that can be linked directly to financial results/targets. Commissions can and should provide a basis for distinguishing levels of performance and rewarding accordingly. From an HR or Remuneration and Benefits specialist perspective, the main aim should be to participate in getting the commission structure right.

☑ HR should be involved in plan design

Do you know whether your commission plan is working?

Commissions are typically an element of reward which either overlaps with or falls within the domain of the Sales Division – especially its budget. Sales people typically do not like to surrender an element of control over their territory especially their budgets, however lack of input by the HR team can result in an ineffective use of organisational resources. It is important for the HR professional to be involved in the design phase of any commission scheme in order to get the structure right and also to create internal alignment between sales and other business units.

☑ There is no one perfect commission plan

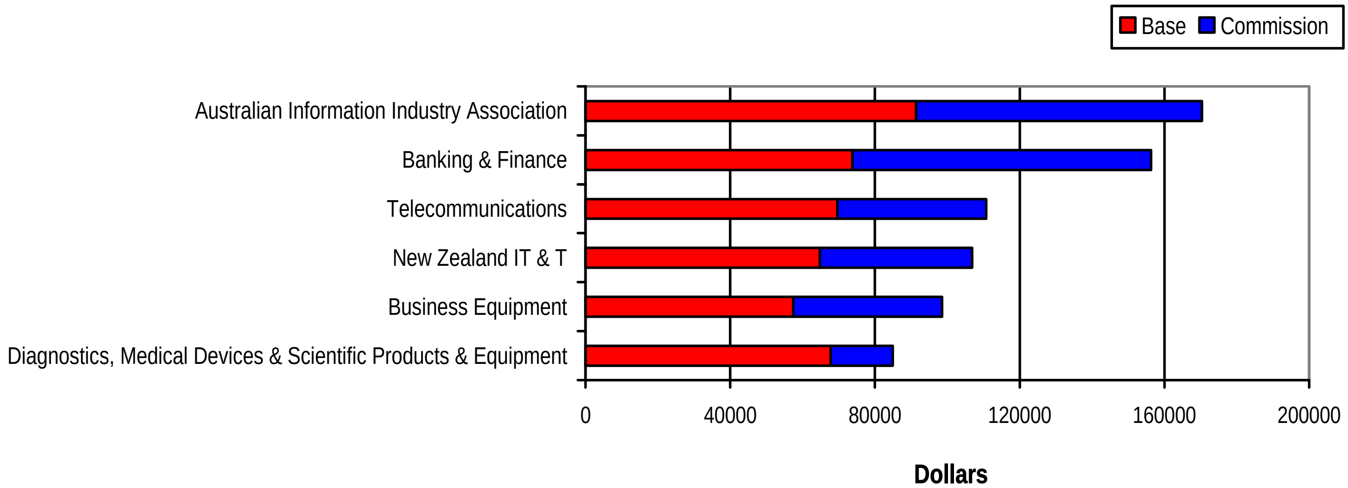
Is your commission plan right for your organisation?

There is no perfect commission plan. Most organisations will require more than one type or level of scheme to reward different levels of performance and different sales positions. It will be important for HR professionals to consult with both divisional managers and the sales team to design the most effective plans that integrate all business units and support corporate-level organisational strategy.

☑ Remember industry differentiation

What are the trends in the industry you are operating in?

It is clear from the chart below that different industries pay differing commission rates. Obviously those at the ends of the spectrum should review their policies if they find them to be either too expensive or ineffective.



☑ Identify appropriate commission splits

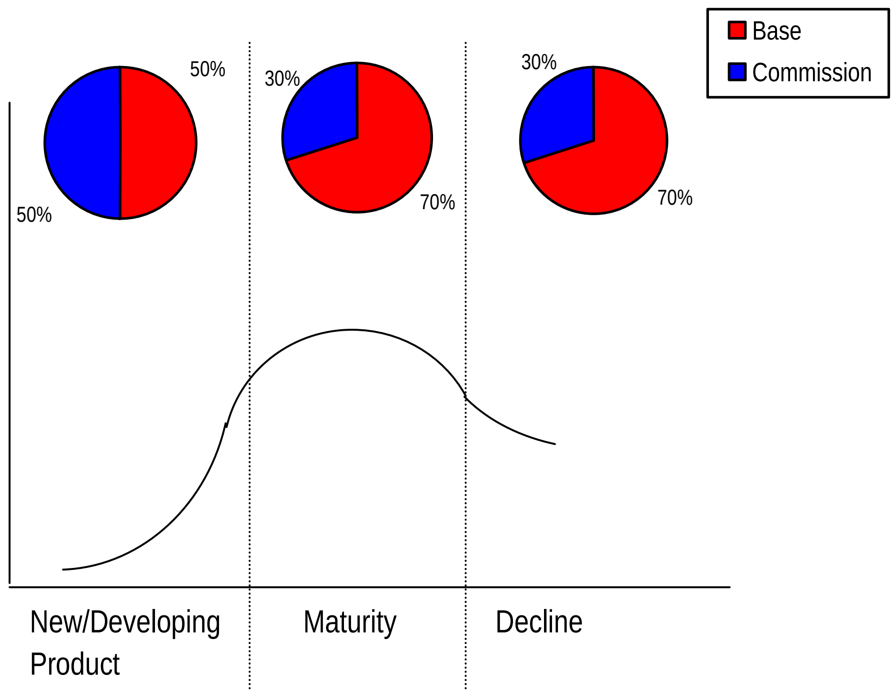
How aggressive are the splits in your commission schemes?

A commission split is the proportion of variable pay, i.e. commission, compared to fixed remuneration. Commission splits are important as they set the strategy for the plan. During an employers' market, organisations should be looking to extract greater productivity from employees and at the same time gear remuneration systems to pay for themselves. More aggressive splits – tying a greater proportion of reward to performance – can enhance this. Splits can range from ultra aggressive 100% of Total Cash reward 'at risk' to the very passive (motivationally ineffective) 0% 'at risk'. Most organisations choose their splits based on either their product/service mix or position in their product life cycle.

☑ Tie commission schemes to the sales cycle

What stage of the product life cycle is your product/service in?

The appropriate structure of reward (commission split) and the rules of a commission plan depend on the maturity of the product life cycle for each of the organisation's products. A company launching its range of products/services will most likely recruit 'hunters' and be willing to reward them with highly leveraged commission plans eg a 50/50 split where 50% of the Total Remuneration is guaranteed and the other 50% is 'at risk'. As the product/service cycle matures, so the split may become less aggressive, say 70/30, which is better for rewarding the 'farmers' who generate additional business from the existing client base. During the decline phase, splits should remain at this level as new sales become very difficult, and the level of total remuneration should decrease. This is illustrated in the chart below.



Product Life Cycle

☑ Consider product/service differentiation

What kind of margins are involved in the selling of the product?

A marginal cost is the extra cost associated with producing each extra unit of the product/service. The marginal return on a product/service is the additional profit derived from each extra unit sold. When determining the fixed/'at risk' split in the commission scheme, take into consideration the differing marginal costs of products or services being sold. Increasing marginal returns (i.e. low marginal costs) should be reflected in the employees' remuneration packages in terms of more aggressive splits in their total package. For example, a highly leveraged split (50/50) exists for those selling packaged software – marginal costs are low but there are greater returns once the product development cost is recovered. Thus it is appropriate to have a higher proportion of total pay at risk because the organisation must encourage performance at least at the on-target (100%) level. Below this, the marginal returns make any commission payments largely unviable. Moreover, performance at an above-target level can and should be promoted via the use of 'accelerators'. [See below for more information on accelerators.]

Conversely the split is different for selling professional services where the marginal returns are lower. In this situation, it is more common for organisations to impose a limit or cap on the commission that sales employees can receive when they achieve over and above their set targets within a pre-set period. Another example is in the Business Equipment Industry (eg. Copiers, printers, fax machines) where sales are now inclined to be in the area of Total Business Solutions rather than individual products and the spilt for selling this more sophisticated product is more likely to be a less aggressive 70/30.

☑ Reward true performers

Who are the extraordinary performers – your key sales people?

Of the reasonably successful sellers only one or two will be outstanding sales people. These are the key people who should be able to earn sufficient commission to be able to afford a boat on the harbour or a Porsche! They set the example for the others. These people can be rewarded most effectively using targeted accelerators where appropriate – to encourage extremely high levels of performance (over and above the expected standard/target). Some examples of the accelerators being used by respondents to **CSi**'s Feature Survey on sales commissions include:

- Between 100-120% of target, every 1% increase in performance = 1% increase in incentive; >120 = 2%, >140 = 4% etc. (uncapped).
- 100-150% = 300% multiplier, >150% = 450%
- 207% commission paid at 150% of quota; 340% at 200% of quota
- 110% of target - 130% paid, 120% of target - 160% paid, 130% of target - 190% paid
- >100% of target commission achieved then 1% of booked revenue (above target) and 5% of earned revenue is paid
- 100-150% = 4 times accelerator and for >150% = 2 times accelerator

  [Note that this last policy obviously focuses performance at the 100-150% level, but 'discourages' achievement beyond this.]

Other Short-Term Incentives

During tighter economic times, the use of ad-hoc payments unrelated to performance (i.e. bonuses) in remuneration packages is largely unjustified. Nevertheless, incentives are essential in order to keep top performers satisfied with their total compensation packages. So, for employees involved in facets of the business other than sales, short-term incentives (i.e. those covering a period of 12 months or less) remain a popular alternative to commission plans. This is largely due to the fact that they are flexible because targets can be set at any level – depending on the organisational and job design structure. These incentives need not be expensive in order to be effective. Evidence suggests that there is a strong link between non-cash rewards/incentives and improved job performance. Providing that they are linked explicitly to performance targets, alternative awards such as team dinners or activities, Christmas hampers, mufti day, or massages can just as successfully maintain employee motivation and commitment as cash. These can be good substitutes for monetary rewards within a constrained remuneration budget. It will be the star performers who will play key future roles in nurturing new growth and rebuilding a company that is 'on a slide' in a soft economy, so adequately rewarding and motivating these employees is crucial to retention.

Unfortunately, the application of short-term incentives can lead to 'short-termism' amongst employees – meaning that some objectives or outcomes may be blindly pursued at the expense of longer-term issues such as customer relationships and loyalty. In order to avoid such a problem, both short and long-term incentives should be designed and delivered within a complete and balanced compensation strategy.

Long-term Incentives

Long-term incentives plans reward performance over a period of more than one year, and typically at least three years. Australia still has a relatively low incidence of pay being based on long-term results – reflecting the short-term focus traditionally associated with the United States and other individualistic cultures. However long-term incentives (LTIs) have been used more extensively over the past couple of years than ever before, especially in executive remuneration, and this trend is likely to continue. Long-term incentive rewards can be delivered using a variety of vehicles, stock options being one of the most common. Despite the apparent advantages of linking remuneration directly to long-term (as opposed to short-term) targets relating to shareholder value, the use of stock options has been largely overrated. Nevertheless, stock options continue to be far and away the most common instrument used for delivering long-term incentives in both the US and Australia. HR professionals face major challenges in successfully structuring this compensation and retention strategy. One answer may be to look at alternative types of stock/equity-based remuneration including performance shares, phantom and restricted stocks. Other ideas to assist in the design of an adequate and effective LTI program are given below.

The practice of paying long-term incentives in Australia is still considered as an add-on component to total remuneration. Due to this, there are vast variations in the value of long-term incentives provided, particularly at the general staff level, where standard amounts are often set for all employees.

See Appendix 4 for information regarding the valuation of long-term incentives.

☑ Link goals and structure with the business plan

The time frame built-in to the incentive scheme should reflect that of the overall business plan. In the near future, people involved in the (re-)design of LTI programs should be most concerned with developing a strategically oriented plan that is directly linked to the goals of the organisation, as well as performance. This may involve lengthening the vesting period of stocks to engender a more long-term focus.

☑ Match rhetoric with reality: Be true to rationalisation principles

The key goals of a long-term incentive program are said to be employee motivation and performance, employee retention, wealth creation, and alignment of individual and organisational interests. In the past, plans may have typically been utilised as a tax-effective, less transparent 'cheap' form of reward (because they were not 'expensed' to the business) for executives while being couched in this type of rhetoric. If organisations are to be true to the principles that rationalise this form of reward, they must link the return to performance hurdles – both in absolute and relative terms (i.e. vis-à-vis their peers).

☑ Consider all the available alternatives

Previously, the most common and preferred type of equity/stock based compensation programs has been stock options. However given the ups and downs of Wall Street, stock options have lost much of their motivational lustre. Consequently, the credibility of alternatives such as phantom or restricted stocks, loans and performance shares is increasing as they become more widespread, familiar and supported by results. The most effective method will of course depend on what the organisation is trying to achieve/deliver. Performance shares may be a superior alternative to stock options for a number of reasons:

- They can be traded-off for salary more easily than options;
- The associated dividends continue to reinforce the reward, making it more current and immediate;
- Performance linkages can be much better targeted;
- The deferral concession encourages long-term ownership, but has more limited tax-effectiveness.
- Applicable under all economic conditions, i.e. can reward/retain even in a bear market.

Executive Remuneration

It is evident that executive remuneration remains the most high profile area of the pay market. The most pertinent topics to be addressed in regard to executive pay include the need for structure, pressures of globalisation, an assessment of all relativities and the concept of 'total pay'.

There are going to be many changes in 2004 as corporate governance regulations emphasise accountability in reward programs at this level. As with sales commissions which are often outside the usual reward programs, senior executive pay is likewise. It falls within the gambit of the Remuneration Committee, which in turn is a subset of an organisation's Board of Directors. These directors (executive and non executive) are rarely appointed to Boards for their level of expertise in the field of remuneration management. There have been sufficient exposés in the media to illustrate this point – executive pay over recent years has been a free for all, where anything goes. Communities, shareholders and governments around the world have put in place new rules to try and prevent these problems from recurring. From an internal company perspective there are some basic steps to follow:

☑ **Build some structure into executive pay systems**

It is clear from the intense public scrutiny surrounding executive pay in recent times that an ad-hoc approach is no longer acceptable. With tougher corporate governance regulations, policies and procedures are necessarily becoming more transparent and remuneration committees being held accountable for the packages they design. This is an important step in incorporating some structure into executive pay. To assist with this process, remuneration training should be provided to those involved in the determination of top executive pay either via a one-on-one session or a course – Eg. **CSi**'s *Rem101 Training*.

The disproportionately large packages recently received by some executives are viewed as exorbitant and unjustified, particularly in relation to their organisations' performance. Both performance hurdles and stringent, defensible management of top executive pay must be applied. Certainly the role of Executive Search Consultants in relation to top executive pay has to be discounted. There is a considerable conflict of interest, since these consultants are often motivated by their own commission interests – particularly to adopt 'global' pay rates.

☑ **Be wary of globalisation**

There are advantages to be derived from applying a global framework to pay and benefits programs, particularly for multinational organisations, because it can help to standardise remuneration systems. However it is important to make this a truly global perspective, not one centred on the US. Though Australia has tended to follow the US in the past in terms of remuneration practices, organisations should not feel obliged to continue this approach. Given the prevailing employers' market, relatively optimistic domestic market conditions, and the recent disparagement of US top executive pay in particular, employers are under little pressure to adopt pay rates equivalent to those in the US. Consider that the biggest economic 'threats' in the near future may be from developing countries – such countries should also be included in a 'global' outlook in pay trends. For example, China sits in Australia's geographic sphere and is typically part of Asia/Pacific with Australia. More regional roles are increasingly based in Shanghai in particular.

☑ Assess all relativities

Though a global framework is useful for multinational organisations, pay and benefit programs also need to be tailored at a more local level. Pay should be determined using a combination of company affordability, external market information, internal relativities and performance.

1. Company affordability – organisations must take into consideration the budget available for remuneration and stick to it. This can be achieved by capping potential incentive payouts, or by making targets more challenging. Capacity to pay should be the primary concern that underpins other compensation issues.
2. Market competitiveness – there should be some compatibility between the pay rates for company executives and those in similar positions in similar companies. While there may be some influence by 'global market pressures', these should not be the determining factor.
3. Internal relativities – there should be some link between top executive pay and that of other employees in a company. Theory says that the difference between the highest and lowest paid in an organisation should be no more than 1:20, but in practice the ratio can be much greater. Also, in theory, CEO pay should be no more than 40% higher than that of the next highest pay package. Consider that successful management is a group effort and whilst it is accepted that there is an exponential relationship that has to be taken into account when determining the pay of the CEO, there are many others in the executive team who are fundamentally responsible for the success of the organisation.
4. Performance – this aspect of executive remuneration packages has seemingly been overlooked by many organisations in the past. Cases where top executives have received large increases and inflated severance payouts despite only average organisational performance are not uncommon. This must change immediately – organisations must build more challenging performance hurdles into executive packages, and link a far greater proportion of total remuneration to performance. Also, organisational performance must be measured relative to competitors – both financially and in the stock market. Further scrutiny of proposed severance arrangements is necessary to avoid paying for under-performance.

☑ Use the concept of 'Total Pay'

Top executive packages should be based on the concept of Total Pay – where *all* benefits are taken into consideration in the calculation of total remuneration. This should include allowances, long-term incentives and other company perks, which have typically been considered as add-ons to remuneration. Consequently, the value of executive packages is often understated.

CONCLUSION

On reviewing the predicted economic and related remuneration trends for the coming twelve months, it is clear that while an employers' market situation currently prevails, conditions are likely to change in the near future. Employers should be planning for the long-term – 'getting the house in order' now to capitalise on the opportunities when they arise. The economic environment on a global scale is inherently more dynamic and uncertain than in the past. To cope with these conditions, a remuneration strategy should focus on flexibility to be in a position to embrace change as it happens and sustain competitive advantage. Despite the rapidly changing environment there is a need to ensure our short-term successes are not at the expense of long-term viability. There is a big gap between current and desired practice here in Australia that is likely to be remedied as organisations increasingly investigate the potential benefits to be derived from the use of long-term incentive programs.

The most noticeable trend of the immediate future though will be the shift towards variable, performance-related pay as a far greater proportion of total reward. Organisations should concentrate more on effectively linking the variable pay components to organisational goals and strategy – making the links between individual performance and organisational objectives more direct, relevant and obvious. Over the next twelve months, we expect to see more aggressive splits in remuneration packages, with more pay being 'at risk' rather than guaranteed. In a soft economy, there may not be enough extra cash for bonus plans, especially in smaller companies, giving rise to the need to investigate non-cash benefits and recognition programs. Linking a greater proportion of incentives to company performance can facilitate financial flexibility for the organisation as remuneration systems become self-funding.

Also, pay packages must be considered in totality and incorporate more structure, rather than being designed in an ad-hoc fashion. The structure should ideally take account of company affordability, external market information, internal company relativities and performance. This is particularly relevant to executive pay, where the latter two have conventionally been overlooked according to recent scandals brought to light in the media. Pay that properly relates to performance is likely to be the next, and most volatile frontier in shareholder activism. Australian executives are among the most modestly paid in the western world, and we should not be forced into thinking that we must catch-up to the US, despite the pressures of globalisation. Executive compensation programs, like those for more general employees, should increasingly be geared towards performance-related pay. A successful executive compensation program will have both short-term and long-term incentives in order to balance the interests of major stakeholders. In this way, executive remuneration can be adequately justified using traditional rhetoric.

APPENDIX 1: EMPLOYMENT MARKET SITUATIONS

What Is An Employees' Market?

An employees' market is one where an individual's bargaining power is strong – the "pay me more or I will leave" mentality prevails. There is a low risk factor from the employee's perspective because there are so many other employment opportunities available, often at higher rates of pay. Staff attrition rates tend to be relatively high (>20%pa) despite many varied attempts by employers to reduce them. "Just in time" staff loyalty prevails. Unemployment should be low and falling in this environment. The years of the late 90's including the year 2000 were times when an employees' market prevailed.

What is an Employers' Market?

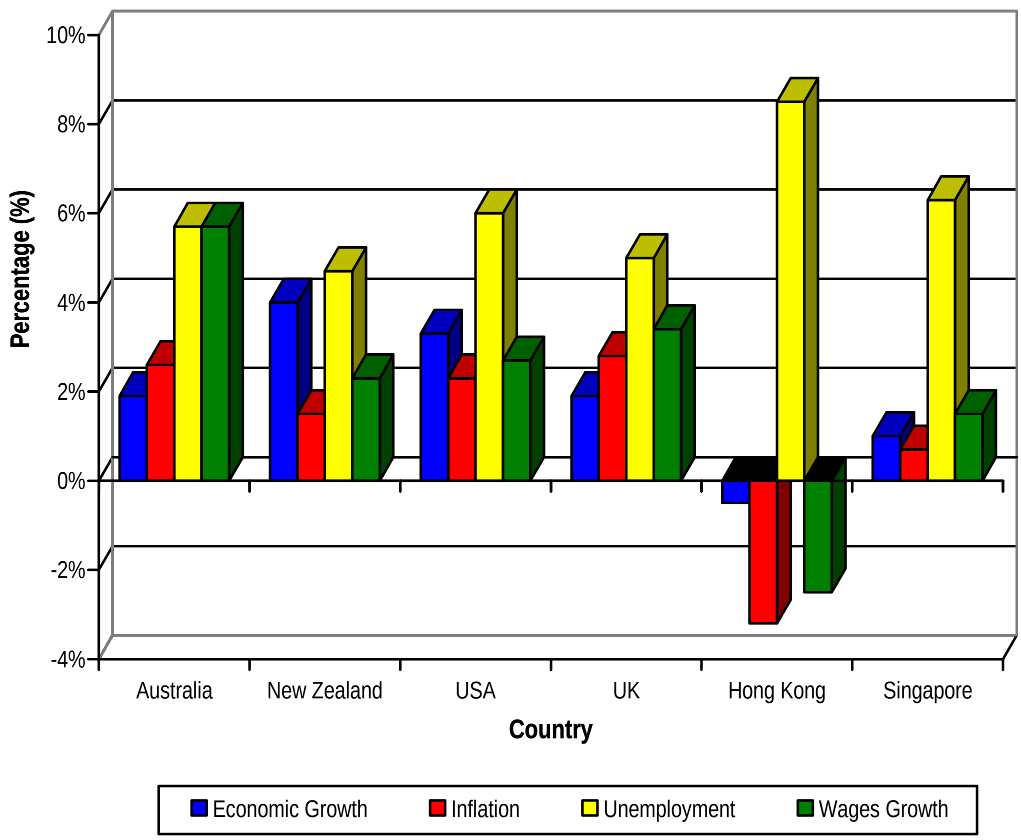
An employers' market is one where the employer holds the relative advantage over employees in the employment relationship and can therefore keep pay rates in check. Staff attrition is generally lower (in the 5 – 15% range) and unemployment tends to be rising. An employers' market may be identified as that operating in the current climate and that of the early 90's.

APPENDIX 2: FURTHER ECONOMIC INFORMATION

International Comparisons
General Economic Trends (Data current as at November 2003)

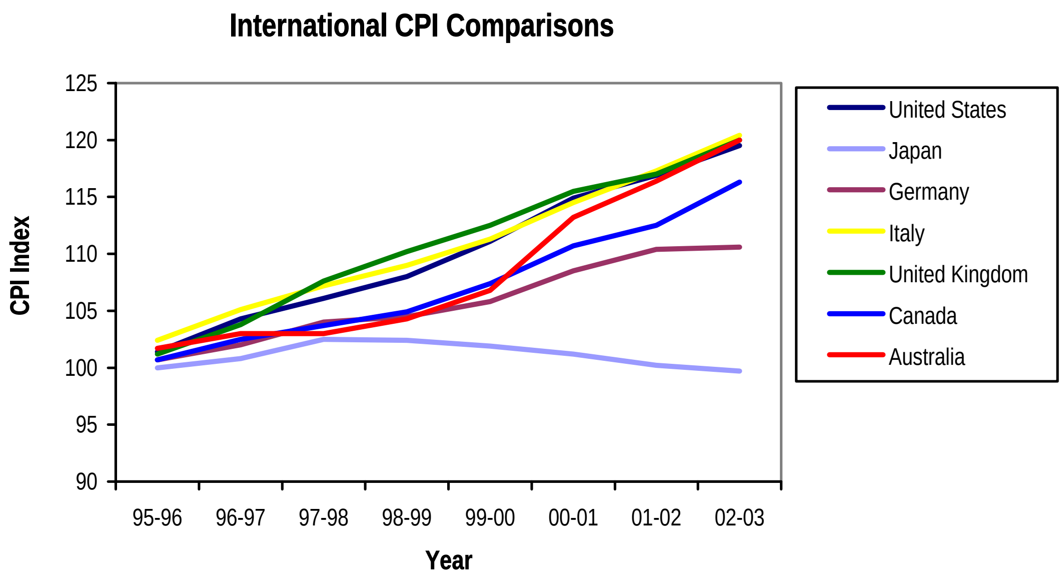
Indicator	Australia	New Zealand	USA	UK	Hong Kong	Singapore
Economic Growth	2.5% (Sep)	4.0% (Jun)	3.3% (Sep)	1.9% (Sep)	-0.5% (Jun)	1.0% (Sep)
Inflation	2.6% (Sep)	1.5% (Sep)	2.3% (Sep)	2.8% (Sep)	-3.2% (Sep)	0.7% (Sep)
Unemployment	5.6% (Nov)	4.7% (Jun)	6.0% (Sep)	5.0% (Sep)	8.5% (Sep)	6.3% (Sep)
Wages Growth	5.7% (Aug)	2.3% (Sep)	2.7% (Sep)	3.4% (Aug)	-2.5% (Jun)	1.5% (Jun)

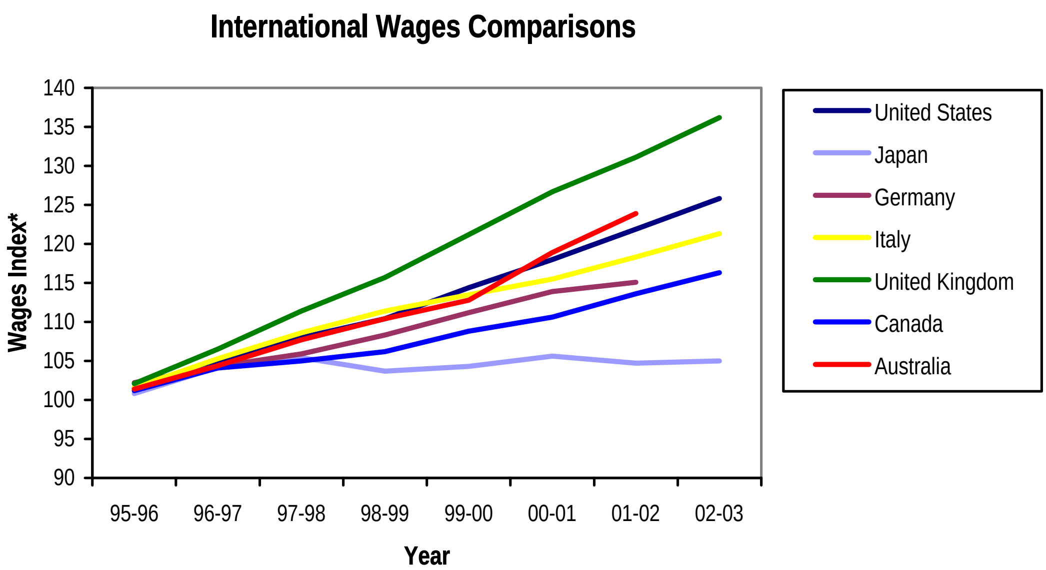
Source: ABS, Statistics NZ, US Dept of Labour, HK Census & Statistics Dept, Statistics Singapore & UK National Statistics



CPI and Wages Trends

The graphs below show a comparison between seven countries for CPI index movements and wages over the past seven years.



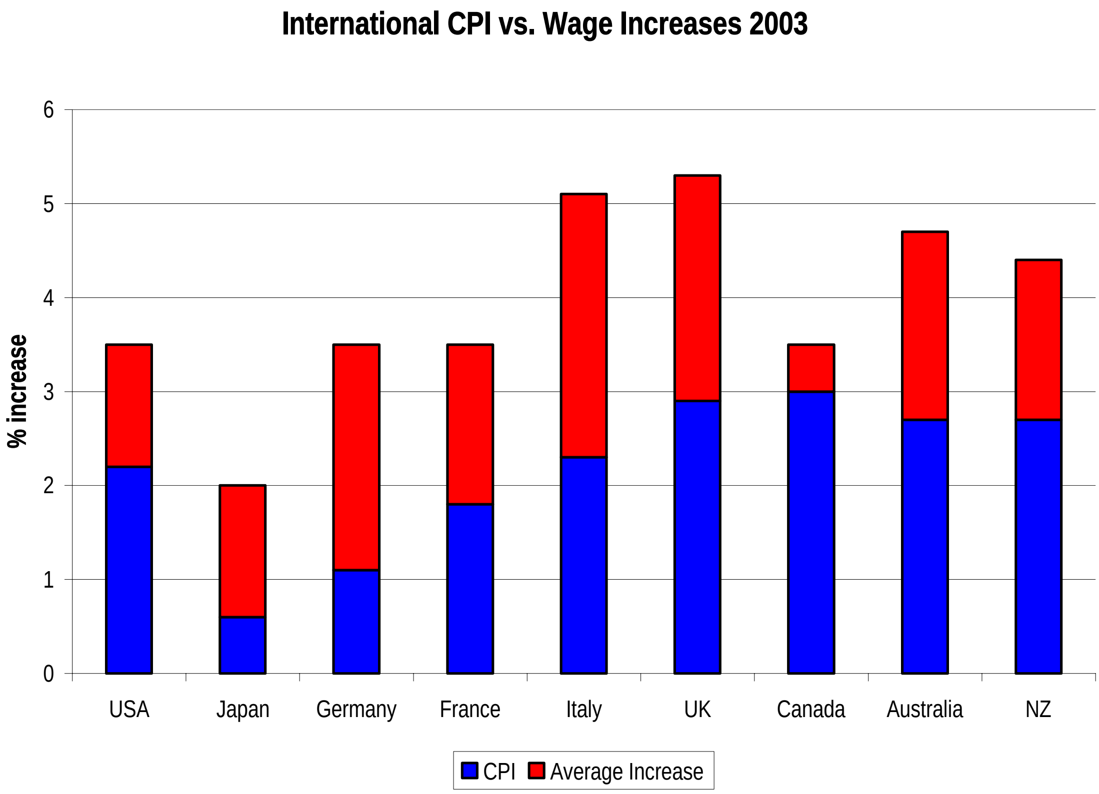


*Data represents hourly wages rates in the manufacturing industry, except for the United Kingdom (weekly earnings), Japan (monthly earnings), Italy and Australia (all industries)

Source: *ABS*

‘Real’ wage increases for 2003

The graph below shows an international comparison of wage and CPI (percentage) growth – demonstrating that average wage increases have outstripped the CPI in most countries over the past year. The difference between the two measures indicates the extent to which a ‘real’ wage increase has occurred, despite actual increases appearing minimal in these slower economic times.



APPENDIX 3: INDICATORS OF SALARIES AND WAGES

Average Weekly Ordinary Time Earnings (AWOTE)

This includes only full time employees working standard hours - excludes overtime.

Figures on average weekly ordinary time earnings (AWOTE) for full time adults increased in trend terms, so that wages for this group of workers were up 1.5% (trend) in the three months to August 2003, and 6.1% in the year to August 2003.

Public Sector (AWOTE)

Public sector workers secured a 1.2% average increase in the three months to August 2003 and 4.6% for the year to August 2003 (trend). On average, full-time adults in the public sector earned ordinary time wages of $53,113 per annum. When including overtime payments this figure increases to $54,756.

Private Sector (AWOTE)

Average weekly ordinary time earnings for full-time adult workers in the private sector rose 0.4% in the three months to August 2003 and 5.9% in the year (trend). Full-time adults in the private sector earned an average of $46,846. When including overtime payments this figure increases to $49,353.

Private sector salaries and wages are typically more sensitive to the state of the economy, rising faster during booms and more slowly during downturns. As a result, the Reserve Bank pays more attention to private sector wage growth because it has a more direct impact on inflation.

Average Weekly Earnings (AWE)

A broader measure which covers weekly wages of all employees, both full-time and part- time.

The national average weekly total earnings of all employees rose by 1.3% (trend) in the three months to August 2003 and rose by 5.4% in the year to August 2003.

Salary Market Movements

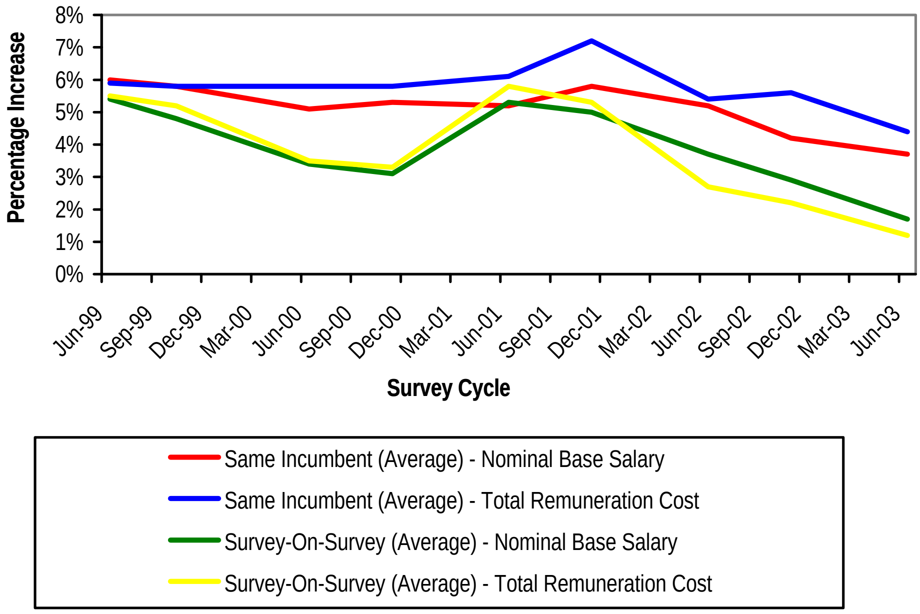
CSi reports on two movements in its surveys – that which reflects increases where they have been given to individual staff members, and the other which reflects changes in market rates for the positions surveyed. The two are quite different as illustrated :

The Same Incumbent (SI) Movement: reflects the overall average and median movements in various remuneration aggregates as reported by contributors in their data submission – i.e. where they input salaries for the same incumbents in the same position this year and last. **CSi**'s program calculates the overall increases in the reported salaries.

Survey-on-Survey (SOS) Movement: is simply a calculation of the annual movement in Nominal Base Salary, Total Remuneration Cost and Total Fixed Remuneration rates as reported in the annual cycle within this survey.

History of Salary Movements

The following graph shows the percentage increase in Same Incumbent and Survey On Survey movements over the past four years for both Nominal Base Salary and Total Remuneration Cost. The graph indicates that of late, same incumbent and survey-on-survey movements have been following similar trends, but are different in absolute terms as a reflection of the current employers' market. Also, the fact that total remuneration packages are increasing at a similar or lesser rate than nominal base salaries reflects the fact that employers tend to reduce variable pay in tougher economic times.



Why the figures differ

For many years **CSi** has been tracking survey movements across a variety of industry sectors, in times when demand for labour is thriving and in times when it is in decline. Throughout these periods, **CSi** has been able to plot the resulting effects on the survey movements. The following represents an overview of the observations **CSi** has made in relation to these differing labour conditions:

In a high demand labour market (for the relevant industry), **CSi** expects the Same Incumbent Movements and the Survey-on-Survey Movements to be relatively similar (especially in large established databases). Typically, in this environment the demand for labour results in higher rates for new incumbents than those currently being paid to existing incumbents. As a result, pay ranges move consistently in line with market demand thus maintaining a fairly equal relationship between the Same Incumbent and Survey-on-Survey Movements.

Conversely, in very flat labour markets where demand is stifled (for the relevant industry), **CSi** expects the Same Incumbent Movements and the Survey-on-Survey Movements to be quite different. Typically the Same Incumbent Movement stays at a relatively consistent level (as experienced in previous years) whilst the Survey-on-Survey Movement decreases. This represents the market's response to an economy in which employers need to retain their best employees whilst rationalising head count. Not all employees will receive increases in tight economic conditions, which will have a dampening effect on the SOS move. Another factor of this market is that new employees are typically recruited in at a lower point in the salary range. Again, the forces of supply and demand (in this instance there is an over-supply of potential candidates) help to suppress new employee increases thus fuelling lower Survey-on-Survey Movements.

Which movement should I use?

CSi recommends that the Same Incumbent Movement be viewed as the most reliable measure of remuneration movements in the market – but please remember it is a retrospective movement.

In a very buoyant labour market both the Same Incumbent and the Survey-on-Survey Movements should be fairly similar and can be viewed in harmony as an indicator of remuneration movements. In depressed markets, please view the Same Incumbent Movement as your preferred indicator of remuneration movements of key individuals, whilst the Survey-on-Survey movement will provide an important indicator of market hiring movements.

As a word of caution, in less stable economies **CSi** typically experiences greater fluctuation in the contributor base thus potentially affecting the Survey-on-Survey movements. This is one of the reasons why **CSi** views the Same Incumbent movements as a more consistent measure of market rates for those individuals in the same job.

History of Average Salary Increases

The following table shows the history of average salary increases over the last eight years as reported in **CSi**'s General/Combined Industries Survey.

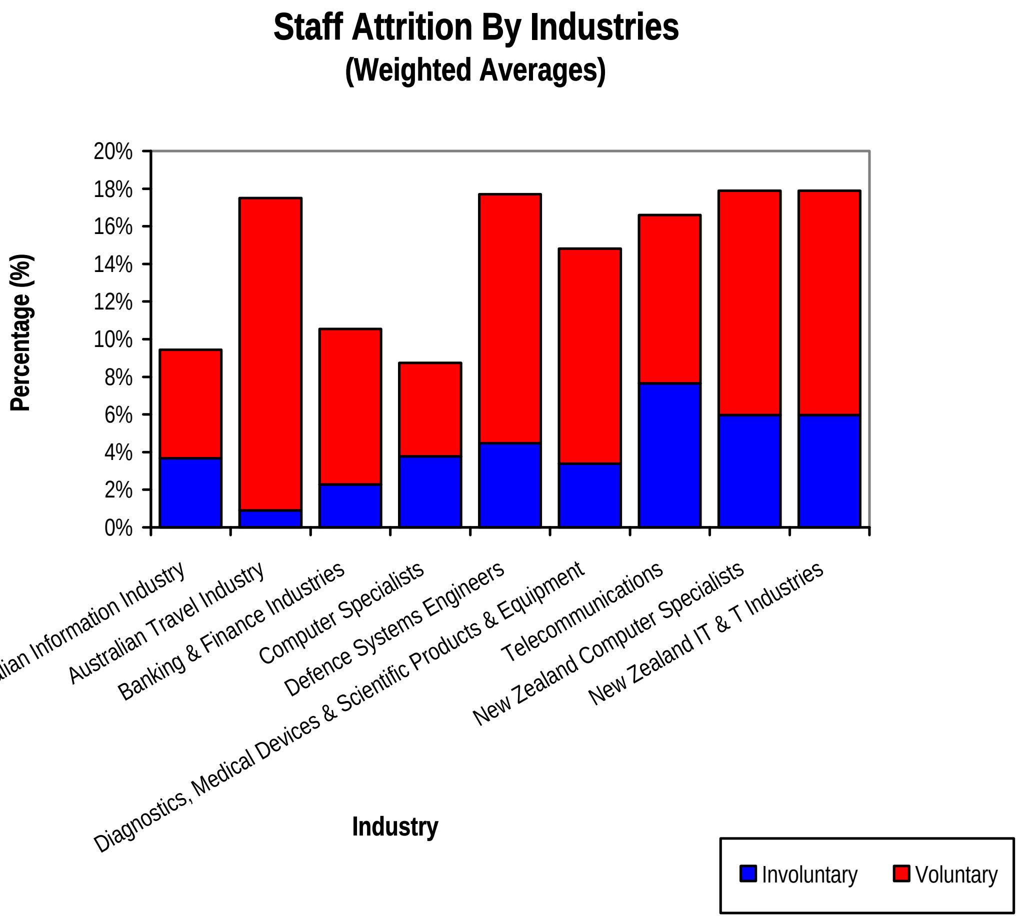
CYCLE	SAME INCUMBENT (AVERAGE)		SURVEY-ON-SURVEY (AVERAGE)	
	Nominal Base Salary	Total Remuneration Cost	Nominal Base Salary	Total Remuneration Cost
June 1996	4.8%	3.4%*	3.4%	5.0%*
November 1996	5.2%	5.0%*	3.4%	5.0%*
June 1997	5.1%	5.2%*	4.3%	4.1%*
November 1997	4.6%	4.8%*	4.7%	3.8%*
June 1998	6.1%	5.8%*	3.8%	3.6%*
October 1998	6.0%	5.7%*	5.2%	5.3%*
June 1999	6.0%	5.9%*	5.4%	5.5%*
October 1999	5.8%	5.8%*	4.8%	5.2%*
June 2000	5.1%	5.8%	3.4%	3.5%
November 2000	5.3%	5.8%	3.1%	3.3%
June 2001	5.2%	6.1%	5.3%	5.8%
November 2001	5.8%	7.2%	5.0%	5.3%
June 2002	5.2%	5.4%	3.7%	2.7%
November 2002	4.2%	5.6%	2.9%	2.2%
June 2003	3.7%	4.4%	1.7%	1.2%
November 2003	4.3%	4.1%	2.6%	1.6%

*Total Package rather than Total Remuneration Cost

Despite the healthy state of employment and economic growth in the Australian economy, new incumbent movements remain lower than same incumbent movements. This suggests a 'lag' effect from recent redundancies and emphasises the fact that the supply of external candidates will ensure recruitment salaries remain steady in the short term.

Staff Attrition by Industries

The graph below shows a comparison between voluntary and involuntary turnover (using weighted averages) across a number of industries. The subsequent discussion of formulae illustrates the difference between simple and weighted averages, followed by a table that presents all of the voluntary and involuntary staff attrition data across all of **CSi**'s survey databases this year *(Simple and Weighted Averages)*.



Formulae

CSi employs the following formula when calculating Staff Attrition/Turnover:

$$\frac{\text{Total Staff Turnover}}{\text{Average No. Of Employees for the Year (for the previous 12 month period)}} \times 100\%$$

Simple Average: is calculated by applying the above formula to each organisation's data and taking the average of these calculated figures.

Weighted Average: is calculated by taking the sum of the Total Staff Turnover for all organisations and dividing by the sum of the average number of employees for the year for all organisations.

Survey	Voluntary Staff Attrition		Involuntary Staff Attrition	
	Simple Average	Weighted Average*	Simple Average	Weighted Average*
Australian Information Industry (August 2003)	9.0%	5.8%	9.0%	3.7%
Australian Travel Industry (April 2003)	17.3%	16.7%	0.8%	0.9%
Australian Computer Specialists (November 2003)	8.6%	5.0%	6.8%	3.8%
Banking & Finance Industries (October 2003)	15.5%	8.3%	3.2%	2.3%
Business Equipment (September 2003)	10.8%	8.4%	4.2%	2.7%
Defence Systems Engineers (November 2002)	10.9%	10.3%	5.6%	5.2%
Diagnostics, Medical Devices & Scientific Products & Equipment (October 2003)	12.3%	11.5%	3.7%	3.4%
General Insurance Industry (June 2003)	18.7%	18.5%	8.2%	11.0%
Telecommunications (August 2003)	8.3%	9.0%	8.9%	7.7%
New Zealand Computer Specialists (September 2003)	12.7%	12.0%	5.8%	6.0%
New Zealand IT & T Industries (August 2003)	12.7%	12.0%	5.8%	6.0%

APPENDIX 4: VALUING LONG-TERM INCENTIVES

Where contributors have provided details of a share scheme to one of **CSi**'s surveys, a valuation model has been developed to allow us to report the anticipated reward it will deliver to an incumbent in an annualised form. The model's main variables are the number of shares and the market price of these shares at the time of issue. **CSi** then apply approximations of what the expected rate of return on the instrument will be over its lifetime, and discount this back to present day terms. An approximation of the 'risk' involved in achieving these outcomes is also included, which covers both the volatility of share prices and the imposition of performance hurdles.

Share options are far and away the most common instrument used for delivering long-term incentives amongst companies surveyed. Following are valuations we have applied by industry category.

Industry	Valuation Factor
Banking & Finance	10.8%
Computer & High Technology	11.8%
Manufacturing	9.0%
Energy & Primary Industry	9.5%
Wholesale, Retail & Service	8.4%
Average	9.9%

Companies wishing to apply their own valuation to share options may do so by dividing the amount specified on the table as "Long Term Incentive" by the average valuation factor above.

Example:

The average annualised long-term incentive for a particular role in the Computer & High Technology Industry is $100,000.

Divide this figure by 10.8%.

This returns a value of $925,925.92, which is the average 'face value' of stock options granted.

This amount can then be fed into an alternative valuation model for determining an appropriate grant size.

CSi accepts that this is a very simplified model. It has been developed as an initial mechanism to encourage the provision of long-term incentive data by survey participants. At present many subsidiaries of foreign companies do not administer nor have access to details of these plans. In addition, the large number of variables which apply to each stock grant present a significant logistical hurdle to participants when supplying data.

It is envisaged that, as equity based long-term incentives become a better understood remuneration tool, this model will grow in sophistication to match.

Further reading on the valuation of long-term incentives:

CSi recommends the following sources as good background reading on this topic. These provide an overview of the various issues and approaches to valuing share options. It is worth considering when reading these articles the different uses the valuations will go to. Be aware of the situation the author is discussing (eg. conducting a salary survey, preparing statutory filings, communicating the value of the incentive to employees) because this can impact on how they value the various factors which go into the valuation model.

Buyinski, T & Silver, D., "Determining the Compensation Value of Stock Options",

ACA Journal First Quarter 2000, Vol. 9, Number 1.

Nevinsky.M., "Stock Options for Undiversified Executives",

http://papers.nber.org/papers/W8052

JT Reserch LLC

http://www.jtresearch.com/resources/bibliographies/options.html