Practice Note

Should Company Executives Get Bonuses for Just Doing Their Job?

Janek Ratnatunga[1]

This article was written just after the first Presidential Debate of the 2016 American election season between Ms. Hillary Clinton and Mr. Donald Trump. In the early part of the debate, when asked about job creation, Ms. Clinton said that one of her plans to fix the American economy was to ensure that company profits are shared with all the workers in the company, i.e. giving not only senior executives bonuses; but also all those in the company that have toiled hard to achieve the bottom-line profit. Whilst it was not clearly articulated by Ms Clinton in the debate as to how such broad-based profit sharing would create jobs; I presume the logic is that when more people have more disposable income; they will buy more, thus stimulating the economy to produce more goods and services, which will in turn create more jobs.

Mr. Trump was disdainful of this plan, saying that the creation of these additional jobs will not be in the USA, but instead in China, Mexico and other low cost, low tax rate countries. His plan was the opposite of Ms Clinton's; i.e. to cut taxes so that the owners of the business had more of the earned profits in their hand to spur further investment in new businesses, and thus create more jobs. Mr. Trump also said that, reduced company tax rates will encourage more American companies to remain in the USA, rather than relocate their companies (and jobs) to low-tax or no-tax heaven countries. This will, he said, keep jobs in America. He also said he will renegotiate all unfair 'Trade Deals'; where American products are charged import duties in overseas markets; but products from those countries are duty-free in the USA. Mr. Trump said that if American companies still go offshore to take advantage of lower tax rates or cheaper labour rates; then those companies should be charged a countervailing tax (import duties) when they bring back their products and services to the USA for sale.

In their bare elements; Mr Trump's plan is one of 'protectionism' - the practice of shielding a country's domestic industries from foreign competition by taxing imports; whilst Ms. Clinton's plan is one taken straight out of the concept of 'socialism' – where all share equally in work and the fruits of their labour.

In modern companies, both white-collar and blue-collar workers are paid salaries or wages for doing their job. Ms. Clinton says that all should also get a share of the profits. Now many companies have employees profit sharing schemes where an employee receives a certain percentage of the annual profits, and a share of profit if business is sold; or an employee receives a percentage of the improvement in the company's profits and capital value above an agreed base. There are other minor perks such as time-sharing in holiday homes, free meals, child care. etc. However, there are many companies in which the very senior executives get 'bonuses' running into several million dollars; whilst ordinary workers get very little of the profit share; and that too *after* the big bonuses are paid out, and shareholder returns are quarantined.

On this point, Elizabeth Knight's article titled *"Companies turn bonuses into an art form"* in *The Age*, (on Saturday October 1, 2016, Business Day, p.7) struck a chord with the author.

She wrote that in 2013, the chief financial officer at one of Australia's largest companies, Rio Tinto, was paid a handsome bonus beyond his base pay for, among other things, engaging with

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shareholders and ratings agencies. The following year he was paid a bonus for making new appointments within his finance leadership team and for increasing his level of engagement with investors.

As chief financial officer, surely these duties should fall within his standard list of functions, asks Ms. Knight; because if he didn't hire staff and he didn't talk to shareholders, Rio Tinto couldn't function as a major listed company. Ms. Knight states that whilst the senior executive above is a highly capable chief financial officer - giving him a bonus *for just doing his job* properly looks disingenuous.

This is by no means an isolated example. Large listed companies have made bonuses an art form; by developing new and sometimes bizarre criteria for awarding senior executives money beyond their base pay - and all too often for them simply doing their jobs. Ms. Knight states that companies have made a farce of the notion of a performance bonus being a reward for achievements well beyond their peers, or the parameters of their jobs, either financially or in some other respect. Instead, it has become an 'entitlement'.

For example, the chief executive of Dexus Property Group in 2016 was awarded a bonus on the basis he was role model on *values, leadership behaviours, collaboration and inclusiveness.* This was because he was an "Active member of Property Male Champions of Change, a Property Council of Australia initiative to drive diversity in the property industry. (The) CEO is Chair of the Corporate Responsibility, Inclusion & Diversity Committee, which was involved in establishing five wellbeing communities across the Group".

Ms. Knight states that whilst this CEO's involvements above are laudable; being paid a bonus for being a was role model on values seems strange. I would tend to agree.

Meanwhile the chief executive of one of the big four banks was given a bonus for adhering to the company's risk appetite statement. One would think that would be a core part of his job - i.e. risk management, states Ms. Knight.

This year, the criteria boards use to measure management eligibility for bonuses is the issue in vogue. And it is no coincidence that this issue has reared its head in a year of lackluster corporate profit growth. With annual shareholder meeting season underway - which provides that once-in-a-year forum that affords shareholders the opportunity to have a say and a vote (non-binding as it is) on executive remuneration - the quantum of managers' pay packets and how they are calculated is back in focus.

And there is a view that boards are using performance-based bonuses to game the executive pay system - using any number of spurious measures to deliver a big packet to senior management using the guise of outstanding performance. Among the largest 100 companies, on average their top executives are getting only one third of their pay packet from their base pay, another third from short term bonus and the remainder from long term incentives.

The chief executives of these firms make on average around $2 million in base pay, but can triple what they pocket each year in pay from long term and short term incentive bonuses.
And of those incentives payments, around 30 to 60 per cent are non-financial awarded for non-financial outcomes.

There is plenty of cynicism around the fact that these benchmarks are difficult, or even impossible, to measure. But that is not necessarily the case. For example, the most popular criteria are health and safety - which is easily measurable, and customer satisfaction which is also clearly quantifiable.

"The problem is not so much that non-financial hurdles are soft, or that they sometimes reward executives simply for doing their jobs – the real problem is that at too many companies' executive bonuses, based on financial or non-financial criteria, are an entitlement and not a reward for performance" says Martin Lawrence from Proxy advisory group, Ownership Matters. His point is that boards need to be hard markers when it comes to assessing the performance of scores of executives, particularly given the non-measurable elements of a bonus relies on a board's discretion.

Ms. Knight concludes that “If receiving these bonuses is simply a default position for an executive that has done nothing more than *not screw up*, then they are tantamount to - as one commentator called it - base pay in drag”.

Therefore Ms. Clinton, your plan to create more jobs by profit sharing with all workers is not implementable in the current economic environment. Once the senior executives get their exorbitant bonuses as an ‘entitlement’ for just doing their job; there is not much profit left for the other more junior workers; as the shareholders also need to get their expected returns.