



Remuneration Review

Remuneration Reports Preparation

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INTRODUCTION

Although most companies have remuneration strategies they often have not been formalised into written policies and may not have been critically reviewed for some time, recent amendments to the Corporations Act require listed companies' Remuneration Reports to:

1. in effect, outline the Board's remuneration strategies for:
 - a. non-executive directors, and
 - b. executives (secretaries and senior managers), and
2. be submitted to shareholders for a non-binding vote (this will first apply to AGMs in relation to financial years commencing on or after 1 July 2004).

This **Remuneration Review** presents in plain English the components to be included in Remuneration Reports, comments upon them and then encourages boards to review their remuneration strategies, incentive plans and employment contracts. It is important that Remuneration Reports reflect positively on Boards and provide demonstrable evidence that they have adopted reasonable and responsible approaches in determining director and executive remuneration.

KEY POINTS

- ◆ Remuneration Reports will come under increased scrutiny due to the need for them to be submitted to a non-binding shareholders' vote at Annual General Meetings (AGMs).
- ◆ Remuneration Reports and the strategies they reflect are likely to become significant points of discussion and comment at AGMs and in the media.
- ◆ Remuneration strategies need to recognise the new s.300A of the Corporations Act requirements and facilitate efficient preparation of Remuneration Reports.
- ◆ Certain aspects need to be addressed in Remuneration Reports and they are identified and commented on in this **Remuneration Review**.
- ◆ To be prepared and well positioned, boards need to ensure that their remuneration strategies for directors and senior executives are market competitive, sound, reasonable and properly focussed on performance.
- ◆ Thus the reasons for reviewing remuneration strategies relate to ensuring that both conformance and performance objectives are being achieved.

GRG **Remuneration Reviews** are articles to assist directors and senior executives who have responsibilities in relation to Board and senior executive remuneration and other human resources issues. Their role varies between articles with some aimed at stimulating critical thinking, others updating information and others simply acting as a reminder of principles and approaches where awareness may need to be heightened.

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REMUNERATION REPORT COMPULSORY COMPONENTS

The following table outlines the compulsory components of Remuneration Reports and provides comments on each aspect.

Compulsory Component	Comments
<p>1. Discussion of the board policy for determining the nature and amount of remuneration of directors, secretaries and senior managers.</p>	<ul style="list-style-type: none"> ➤ To discuss the policies it will be necessary to outline the policies. ➤ The policies for non-executive directors and will be different from those applicable to senior managers and secretaries. Thus two policies or two sections of the same policy will be required to cover non-executive directors and executives. ➤ Discussion of the policies indicates that an explanation is required as to why the policy is appropriate in the circumstances of the Company and the senior managers and secretaries. ➤ Consistency between director and executive remuneration in relation to market benchmarking should be considered and a soundly based rationale developed in relation to the position that is adopted. ➤ The reference to “nature and amount” would seem to indicate that the policy aspects to be discussed relate to the broad issues rather than the details of the policy.
<p>2. Discussion of the relationship between such policy and the company’s performance.</p>	<ul style="list-style-type: none"> ➤ The policy for non-executive directors cannot include performance related remuneration as ASX Listing Rule 10.17.2 states that: “If a non-executive director is to be paid, he or she must be paid a fixed sum”. It is possible to seek an ASX waiver from compliance with this Listing Rule but it is rare for companies to do so. ➤ Thus in practice this provision will generally only relate to executives.
<p>3. The discussion of company performance must specifically deal with:</p> <ul style="list-style-type: none"> a. the company’s earnings, and b. the consequences of the company’s performance on shareholder wealth <p>in</p> <ul style="list-style-type: none"> c. the financial year to which the 	<ul style="list-style-type: none"> ➤ The first part of this provision seems to require some form of graphing of both earnings and total shareholder returns (TSR) over a five year period up to and including the year of the annual report. ➤ Although not required it would seem logical for the graph to include a benchmark such as one of the S&P ASX indexes or the cumulative return from

Compulsory Component	Comments
<p>report relates, and</p> <p>d. in the previous 4 financial years.</p> <p>The consequences of the company's performance on shareholder wealth in a financial year, need to have regard to:</p> <p>e. dividends paid by the company,</p> <p>f. changes in the company's share price between the beginning and end of the year,</p> <p>g. any return of capital to shareholders that involved</p> <p style="padding-left: 40px;">i. cancellation of shares, and</p> <p style="padding-left: 40px;">ii. payments to shareholders that exceeded the share price when the shares were cancelled.</p>	<p>investing in government bonds so as to indicate the relative performance of the company over the time period.</p> <p>➤ If benchmarking is to be used than it would seem logical for consistency to apply between</p> <p style="padding-left: 40px;">a. the performance conditions used in incentive plans, and</p> <p style="padding-left: 40px;">b. the performance benchmarks used to indicate the company's relative performance.</p>
<p>4. For remuneration elements that are dependent upon satisfaction of performance conditions there needs to be disclosed:</p> <p>a. detailed summary of the performance condition,</p> <p>b. explanation of why the performance condition was chosen,</p> <p>c. a summary of:</p> <p style="padding-left: 40px;">i. the methods used in assessing whether the performance condition is satisfied, and</p> <p style="padding-left: 40px;">ii. why those methods were chosen,</p> <p>d. if the performance condition involves a comparison with factors external to the company:</p> <p style="padding-left: 40px;">i. a summary of the factors to be used in making the comparisons, and</p> <p style="padding-left: 40px;">ii. if any of the factors relate to the performance of another company, of 2 or more other companies or of an index in which the securities of a company or companies are included –</p>	<p>➤ This requirement is not restricted to long term incentives (LTIs). Therefore, it relates to all incentives including short term incentives (STIs).</p> <p>➤ This is potentially an onerous requirement as STI plans typically use several performance conditions for senior managers.</p> <p>➤ For executives covered by this disclosure requirement, some companies may need to consider streamlining the measures used in their STI plans so that the company may more easily comply with this requirement.</p> <p>➤ For LTI plans the performance conditions are usually straight forward. Thus compliance should not be onerous.</p> <p>➤ Given the comments on benchmarking in the previous section there may be a need to review STI and LTI plans in relation to:</p> <p style="padding-left: 40px;">a. performance conditions used, and</p> <p style="padding-left: 40px;">b. time frames for measuring performance. Note that most plans would have a three year measurement period which is much shorter than the 5 years performance to be discussed in the Remuneration Report. Reasons for inconsistency</p>

Compulsory Component	Comments
<p>the identity of that company, of each of those companies or of the index.</p>	<p>between the reported period and the company's measurement period may need to be considered.</p>
<p>5. Individual remuneration details need to be disclosed in relation to:</p> <ul style="list-style-type: none"> a. non-executive directors, b. executive directors, and c. the 5 highest remunerated company executives (secretary or senior manager) who are not directors. 	<ul style="list-style-type: none"> ➤ This continues the practice that has been operating for several years except for the increased focus on management level instead of remuneration quantum only for executives.
<p>6. If an element of the remuneration of a person whose remuneration needs to be disclosed <u>consists of securities</u> and that element is <u>not dependent upon satisfaction of a performance condition</u> then an <u>explanation of why not</u>.</p>	<ul style="list-style-type: none"> ➤ Australian practice is to apply performance conditions for purposes of vesting securities. Thus, this provision would have limited application.
<p>7. For <u>each person</u> whose remuneration is reported: explanation of the relative proportions of remuneration that are:</p> <ul style="list-style-type: none"> a. performance related, and b. not performance related. 	<ul style="list-style-type: none"> ➤ Options need to be shown separately – see next section. ➤ Explanations are required, not just percentages added to the remuneration disclosure tables. ➤ LTI values are determined at the grant date and therefore have little if any relevance to performance. Therefore to report on disclosed values of remuneration would provide little if any information to shareholders. ➤ It seems that there will need to be some indication of the proportions of remuneration that will apply within a performance range from “poor” to “target” to “stretch” performance. ➤ Remuneration packages tend to be based on “cost to the company” and use LTI values at grant date. Thus there would need to be recognition that the benefit for the executive and real cost to the company can be greater or less than the values used for remuneration planning. For example an option may have been valued at say 20% of the share price at grant but the benefit for the executive and loss by the company of capital that could have been raised when the option is exercised, could be say 100% of the

Compulsory Component	Comments
	share price at grant if the share has doubled in value.
<p>8. For <u>each person</u> whose remuneration is reported:</p> <ul style="list-style-type: none"> a. If options were granted, as part of remuneration, to the person during the year, then the value of those options at the time of grant worked out in accordance with applicable accounting standards, b. If remuneration options were exercised during the year, then the value of the options at the time of them being exercised, c. If remuneration options lapsed during the year then the value of the options at the time they lapsed, d. The aggregate of the values in a, b and c above. e. The percentage of the person's remuneration that consisted of options. 	<ul style="list-style-type: none"> ➤ The onerous reporting requirements in relation to options could be viewed as discouraging their use as similar provisions do not apply to other equity based forms of incentive. ➤ Presumably all options that lapse have a nil value so the need to disclose this is difficult to understand. Presumably some clarification will be forthcoming. ➤ Options that accrue to executives, not as part of remuneration should not be included in the Remuneration Report, but may be included as part of directors' equity holdings.
<p>9. For <u>each person</u> whose remuneration is reported and who is employed under a contract:</p> <ul style="list-style-type: none"> a. the duration of the contract, b. the notice periods, c. the termination payments provided for under the contract. 	<ul style="list-style-type: none"> ➤ The termination payment provisions will need careful explanation as they will generally vary with the nature of the termination which may include: death, disablement, dismissal, resignation, company initiated for other than cause, etc. ➤ Contract provisions may need review to ensure that pro-rata entitlements under STI and LTI plans are covered in the plan rules rather than in the employment contract.

ACTION REQUIRED

All ASX listed companies need to review their remuneration strategies so as to ensure that they will have evidenced that the Board has properly fulfilled its responsibilities in relation to Board and top executive remuneration. Aspects to focus on include:

1. What is the mix of remuneration elements between those that are fixed and those that are performance related?
2. What are the performance conditions that are used for purposes of the incentive components of remuneration? This includes both short and long term incentives.

3. Why are those performance conditions appropriate for the company?
4. Are those performance conditions connected to earnings and/or TSR?
5. What performance benchmark will the company use for indicating the company's relative performance in relation to earnings and TSR?
6. Do the measurement periods for the incentives align with the 5 years of company performance that needs to be discussed in the Remuneration Report?
7. What is the relationship between company performance (earnings and TSR) and the remuneration policies for the directors and senior executives?
8. Are the notice periods and termination payments in the employment contracts appropriate to the various termination circumstances that may arise?
9. Are share options (including zero exercise price options) still being used and is the board prepared to undertake and report on the option valuations now required?
10. Do the STI and LTI plan rules adequately cover termination of employment so that the contract termination payments are not inflated to deal with aspects that ought to be covered outside the employment contract?
11. Has the Board received independent advice confirming that the remuneration strategies, incentive plans and employment contracts are appropriate to the company's circumstances.

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GRG Contacts

GRG is well positioned to assist boards in reviewing their company's remuneration strategies, incentive plans and employment contract terms. Many of the top Australian listed companies among our growing number of clients.

GRG maintains data bases on director and executive remuneration particularly those affected by S300A of the Corporations Act. We will be capturing all the aspects required to be covered in Remuneration Reports and therefore will provide an authoritative source of advice in relation to market practices and emerging trends.

Please feel free to call any of the following consultants.

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