

Annual KMP Remuneration Review

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Remuneration Review No 39, June 2012

Introduction

It is around this time of year that most Australian Securities Exchange (ASX) listed companies review the market competitiveness of remuneration for key management personnel (KMP) who are broadly the non-executive directors (NEDs) and top executives. Therefore, it may be timely to discuss recent developments and approaches that may be taken to the review process. Due to regulatory changes it is now essential that reviews of KMP remuneration be clearly separated from reviews of remuneration for other employees.

Recent Developments

Since July 2011 new provisions of the Corporations Act have significantly affected the processes that had previously been used by Remuneration Committees and Boards to review KMP remuneration.

One of the changes relates to the “two strikes” rule which has placed greater importance on KMP remuneration policies and practices being market competitive and appropriate to the company’s circumstances. It has also increased the need to demonstrate the link between reward and company performance.

Another change is that Boards must specify in their Remuneration Reports whether they are satisfied that any KMP remuneration recommendations provided by an external remuneration consultant (ERC) were free from undue influence of KMP and if so then why they have formed that view. This aspect will indicate to shareholders whether proper processes have been employed when reviewing KMP remuneration and may influence whether shareholders vote for or against the Remuneration Report.

Any amounts paid by the company to ERCs who provided KMP remuneration recommendations need to be disclosed along with amounts paid for other services. This aspect will help shareholders form a view on whether the ERC’s advice was likely to have been independent.

Other changes involve Board approval of ERCs and ERCs being restricted to providing KMP remuneration recommendations to non-executive directors only. These changes recognised that management may be conflicted when it sources market practice information and provides recommendations on KMP remuneration and that ERCs may also become conflicted when engaged or briefed by management.

Of course, independent information and advice from ERCs on KMP remuneration is an important input for Remuneration Committees and Boards. In essence the impact of the new Corporations Act provisions has been for Remuneration Committees to take greater involvement in reviewing KMP remuneration and engaging with ERCs. Provided that ERCs do not have linkages with management, they are uniquely placed to provide independent knowledgeable counsel to Remuneration Committees.

Approaches Available to Remuneration Committees

Given that ERCs may not provide KMP remuneration recommendations to anyone other than a non-executive director (or executive director if there are no non-executive directors) there are limited approaches that may be used by Remuneration Committees to obtaining the information and advice they need when reviewing KMP remuneration. The following table presents and comments on the three main approaches.

Approach	Comments
Market practice data, analysis and recommendations that the Remuneration Committee has sourced from an ERC and the Managing Director's recommendations in relation to remuneration of Direct Reports.	This is the optimal approach in that it ensures that legal requirements are fulfilled. By dividing the ERC's report on KMP remuneration into three reports (NEDs, MD and other executives) the Managing Director can be provided by the Remuneration Committee with the information and advice needed (other executives report) to assist in formulating recommendations on remuneration for Direct Reports.
Market practice data that has been sourced by management and management's recommendations.	This approach is legal but Remuneration Committees need to be vigilant to ensure that the information and advice provided by management is comprehensive and not biased.
Published market practice information and Guides.	This data can be useful as a guide to market practice particularly between more comprehensive reviews when ERCs may be involved.

Market KMP Remuneration Practice Information

There are five main approaches to obtaining information on market KMP remuneration practices.

Approach	Description	Comments
Tailored Report Using Disclosed KMP Remuneration Data	Comparator groups of companies can be selected with the aim of achieving as close a match to the client company as possible. Data is then extracted and analysed for all KMP roles (NB: remuneration for all KMP roles must be disclosed).	<p>Drawing on ASX listed companies the comparator group can consist of the most relevant companies rather than just those that have agreed to participate in a survey.</p> <p>Even when the entire market is available for inclusion in a sample it can at times be challenging to select a robust comparator group of companies of similar size and in the same industry sector – see discussion below.</p> <p>Multiple perspectives may be used to gain a better indication of market competitive remuneration. For example, for a business unit manager role the market data could be of:</p> <ul style="list-style-type: none"> • Business unit managers in companies of similar size to the client company, and/or • CEOs of smaller companies that are of comparable size to the business unit being run by the manager, and/or • Business unit managers running businesses of comparable size to the business unit being run by the manager (irrespective of the size of the companies in which they are located). <p>The Remuneration data extracted and analysed for these companies will only relate to KMP roles and therefore will not</p>

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		<p>be polluted by data for non-KMP roles.</p> <p>By selecting companies with similar dimensions to the client there is no need to separately evaluate the size of the roles as most of the size differences between KMP roles is driven by differences in company size. Other size differences between KMP roles can be accounted for by judgements about internal relativities which may utilise tool such as the Elliott Jacques method.</p> <p>Companies in the comparator group can be contained within a reasonable spread of the size of the client company thereby ensuring that the 25th and 75th percentiles are not skewed by having too wide a spread of company sizes.</p> <p>As data relates to specific financial years it may be indexed with confidence to project it to the year when reviewed remuneration will be paid.</p> <p>All elements of remuneration (Base Package, STI & LTI) are disclosed.</p> <p>Remuneration policies and the design details of STI and LTI plans may be accessed and analysed.</p>
Tailored Report Using Survey Data	Data is extracted and analysed for jobs often of a specific size.	<p>Samples can be too small or contaminated by data for non-KMP roles.</p> <p>Quality of data may vary depending upon who provides the input to the survey.</p> <p>Companies that are reviewing remuneration tend to receive data based on practices prior to the reviews which therefore reflects prior year practices and data is typically not indexed.</p>
Guides to Market Practice	These provide KMP remuneration data for a sample of ASX listed companies.	<p>These can be comprehensive and include over 800 companies if all ASX listed companies with market capitalisations of more than \$25 million are included.</p> <p>Cuts of data tend to be broad in terms of size and industry groupings making them useful for broad guidance but not ideal for determining specific remuneration packages for KMP in a specific company.</p>
Club Survey	A group of companies with a common interest agree to participate in a survey.	<p>These surveys tend to focus on specific industry sectors and can be useful for non-KMP roles. However for KMP roles they are less useful because industry sector based surveys tend to be composed of a diverse group of companies in terms of size. Thus samples of truly comparable KMP jobs tend to be too small.</p>
Broad Survey	Broad industry surveys in terms of types of companies and roles surveyed.	<p>Can be useful for non-KMP roles particularly if job size is taken into account.</p> <p>Despite these surveys often appearing to have a significant number of participants they tend to have difficulty in accessing sufficient remuneration data for KMP roles in specific comparable companies. This is because they have a small representation of ASX listed companies and KMP remuneration details are often not provided by unlisted companies.</p>

Comparator Group Selection

When selecting comparator groups it is usual practice to look for companies of similar size to the client. Size may be measured in several ways including: market capitalisation, revenue, profit, employees or enterprise value. While the most relevant size measure can vary from company to company the most frequently used tends to be market capitalisation followed by revenue. As a guide the companies in a comparator group should fall within a range of 50% to 200% of the company's size metric.

Industry sector can be problematic as most industry sectors contain a reasonable number of companies but of greatly varying sizes as will be seen from the following matrix of the top 839 ASX listed companies. Other factors may also need to be taken into account such as geographic spread, business complexity and stage of evolution e.g. minerals explorer or producer.

Industry Sector	Market Capitalisation Range at End of June 2011									Totals
	>\$10b	\$5b - <\$10b	\$2b - <\$5b	\$1b - <\$2b	\$500m - <\$1b	\$250m - <\$500m	\$100m - <\$250m	\$50m - <\$100m	\$25m - <\$50m	
Resources - Total	7	4	9	17	21	39	70	89	110	366
Base Metals	2	1	2	2	4	9	11	13	23	67
Diversified	1	1	2	3	5	12	23	22	43	112
Other Energy	1	1	4	3	3	2	5	15	10	44
Gold	1	0	1	5	7	12	15	18	18	77
Oil & Gas	2	1	0	4	2	4	16	21	16	66
Industrial & Services - Total	5	10	28	32	33	49	76	54	89	376
Healthcare	1	0	3	2	2	4	9	11	13	45
Consumer	2	3	15	15	13	18	24	9	25	124
Services	1	1	0	1	3	9	16	12	28	71
Industrial	1	6	10	14	15	18	27	22	23	136
Financial Services	9	6	8	5	6	10	25	11	17	97
Totals	21	20	45	54	60	98	171	154	216	839