GRG **Remuneration Review**

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Prejudicial Articles on Executive Remuneration

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INTRODUCTION

It is that time of year when companies release their annual reports and notices of annual general meetings. The Media seems to be increasingly taking the opportunity to present prejudicial articles on executive remuneration. In the past the people who prepared articles were referred to as "reporters" but the in vogue term is "journalist". Perhaps this change reflects the fact that they have largely changed their roles from reporting facts to presenting points of view. It may be possible to mitigate this trend by improving communication in Remuneration Reports.

With the commencement of the two strikes rule (two successive 25% or more of negative votes on Remuneration Report resolutions means that a third resolution needs to be put to shareholders giving them the opportunity to spill board seats if 50% or more votes support the resolution) boards have become concerned to minimise the risk of receiving a strike against their Remuneration Report. However, it should be noted that a 25% negative vote may reflect dissatisfaction with some other activity and may be used by minority but significant shareholders or groups of shareholders to pressure the board on matters not directly related to the current year's Remuneration Report. A recent example is the Qantas pilots seeking to pressure the board to intervene in their pay rise negotiations by promoting a negative vote on the Remuneration Report.

BOARD RESPONSIBILITY

Many parties provide guidance to and/or criticism of boards on key management personnel (KMP) remuneration matters. Broadly, the KMP are the non-executive directors and top executives. These include: the ASX Corporate Governance Council, The Australian Council of Super Investors, proxy advisors such as CGI Glass Lewis and ISS, the Australian Shareholders Association and various journalists. Although boards may consider the opinions of these parties the responsibility for KMP remuneration rests squarely with the board.

Boards take this responsibility seriously and are increasingly seeking advice from external remuneration consultants who have extensive databases on market practices and detailed knowledge of the various laws, regulations and guidelines that need to be taken into account. Of course, KMP remuneration recommendations may only be received by non-executive directors - see www.godfreyremuneration.com for GRG Remuneration Report No 31 for more information on this aspect.

SOUND KMP REMUNERATION POLICIES AND PRACTICES

The starting point for maximising the acceptability of the Remuneration Report is for the company's KMP remuneration strategy to be soundly based. Typical remuneration profiles are composed of three elements being: Base Package (BP), short term incentive (STI) and long term incentive (LTI). Aspects to be considered in relation to a remuneration profiles include:

- Where in the market do our policies sit for BP and total remuneration package (TRP) at target and stretch performance levels?
- What are the relative weightings of STI and LTI at target performance?
- What are the key performance indicators (KPIs) and their weighting for the STI plan?
- Are there single or multiple KPIs for the STI and LTI plans?
- Do the STI and LTI KPIs focus on company performance and if so then are they measured by reference to profitability or returns to shareholders?
- What is the form of the LTI plan and what are the vesting conditions?
- What entitlements arise in the event of the various circumstances that can surround a termination of employment?
- What entitlements arise in the event of a takeover/change-in-control?
- What entitlements arise in the event of a distribution of capital, as opposed to normal operating profit, to shareholders?
- Has the board retained discretion to adjust entitlements should unforeseen circumstances give rise to inappropriate STI &/or LTI outcomes?
- Why are the policies in relation to the foregoing appropriate to the circumstances of the company?

IMPROVED COMMUNICATION

Most Remuneration Reports appear to have been written by lawyers or accountants with the primary objective of satisfying the disclosure requirements of 300A of the Corporations Act. While compliance with that provisions must be one of the objectives to be satisfied when drafting a Remuneration Report, other and perhaps more important objectives include to explain to shareholders and other interested stakeholders:

1. what is the current remuneration policy,
2. why was it adopted,
3. how past remuneration policies have worked, and
4. what improvements have been made in the light of experience.

The other major aspect of communication that needs to be addressed is with major shareholders who are more likely to understand the issues being faced by the board and appreciate the appropriateness of the remuneration strategy. Obtaining their early endorsement of the remuneration strategy will minimise any possibility of a strike for the Remuneration Report.

Aspects that may need to be covered in KMP remuneration communications include:

Element	Comment
Base Package	Increases in BP for KMP may be driven by many factors including: • market movement due to inflation etc., • job family movements due to supply and demand heightening or dampening the normal market movement for groups of employees, • job size growth which may be attributable to expansion of the business operated by the company due to mergers or acquisitions or internally stimulated growth or a response to external market growth. The first is likely to apply generally across the market from employees in moderately skilled roles to the KMP. The second and third points may produce growth in KMP BPs at a rate in excess of the rate of growth in wages of employees generally. The reverse is equally true in that when a company sells a division or business unit and distributes the proceeds to shareholders the resultant company will be smaller with smaller KMP roles and lower BPs. While some parts of the media suggest that something is amiss when executive BPs increase faster than "workers" wages this view shows a lack of understanding of the fact that the size of an executive's BPs tends to be related to the size of the role which tends to be more dynamic at the KMP level than at lower job levels. Job size is generally measured by reference to factors such as professional qualifications, ability to deal with complex problems and manage significant business operations.
STI	Some parts of the media seem to think that something is amiss when STI payouts are not either nil or substantially less than in the previous year if a company's share price has declined. This view shows a lack of understanding of how STI plans operate. STI plans tend to be structured around paying for delivery of annual business plans and targets. They also tend to have KPIs that relate to company performance, division or business unit performance and individual performance. Thus, depending upon the weighting applied to company performance there may not be a straightforward relationship between the total STI award (the reported amount of STI) and company profit performance this year compared to the prior year. A feature of STI plans that may give the impression that STI payout are almost guaranteed is that they tend to be paid close to the maximum each year when the target and maximum/stretch award opportunities are set at the same amount. Thus, if performance is in the range from good to outstanding the payouts will be about the same. A feature of STI plan design that seems to be absent from many plans is the concept of a "company performance gate", typically expressed as profit that needs to be exceeded otherwise no entitlements arise under the STI plan. The "company performance gate" ensures that in dire circumstances the company is not liable to make STI payments when they would be inappropriate and would attract strong criticism from shareholders and other stakeholders.

LTI	This is an area that needs better communication. LTIs are mainly in the form of grants of shares, right and options that vest when conditions are satisfied. What is disclosed as the value of the LTI is not the benefit derived from the grants but the value at grant date of the shares, rights and options which is then amortised over the vesting period. Thus, there will generally be little, if any correlation between the LTI value disclosed and either company performance or the benefit received by the participant.
	Consideration should be given to providing a detailed explanation of the LTI and disclosing for each KMP or perhaps for the CEO only as an example:
	• each live grant and perhaps the last one or two grants to vest,
	• an indication of the benefit derived at the vesting date and its relativity to:
	    o the threshold, target and stretch levels of benefit value (possibly indexed for the effects of inflation), and
	    o total shareholder return (TSR) over the same period, and
	• movement in accrued benefit values over the last few years.
	Consideration may also need to be given to reporting for each KMP the total of BP, STI and derived LTI benefit each year over the last few years and aligning it with changes in total shareholder value.
	While the LTI does align the interests of KMP with those of shareholders it seeks to do so over a longer period as the stock market is not, in the short term, a perfect accountant for reflecting future shareholder value creation.

GRG can assist companies in preparing KMP remuneration communication materials to be used in presentations to major shareholders and as part of Remuneration Reports.