

Executive Remuneration Reporting

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Introduction

Forbes / Economics & Finance

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FINANCIAL REVIEW

NEWS WEBSITE OF THE YEAR

Updated Aug 30 2017 at 12:00 AM

Executive pay needs to come down, here's how to do it

“Too much disclosure

Directors singled out three issues. First, the remuneration disclosure regime, which reveals the incomes of senior executives and so provides ammunition for others to 'match' them. Second, the varying remuneration structuring preferences of major shareholders and their proxy advisers; and third, poor independent advice, focused on chasing market 'benchmarks'.”

Introduction

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AGM unrest as CEO pay confuses investors

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Qube CEO Maurice James' total remuneration has increased from \$3.7 million to \$4.2 million, of which 70 per cent is linked to performance. **Louie Douvis**

“There was confusion all round about Qube's executive remuneration policy, which was highlighted by the fact that one proxy firm significantly miscalculated James' total remuneration.”

Problems with current requirements

- Majority of these requirements are contained in S300A of *Corporations Act 2001* and associated regulations, with some additional and overlapping requirements in:
 - *ASX Corporate Governance Principles and Recommendations*,
 - *AASB 2 Accounting for Share-based Payments*, and
 - *AASB 124 Related Party Disclosures*.
- Requirement for disclosure attracted much disagreement as there are concerns that the detailed statutory requirements have resulted in overly complex remuneration reports ([PwC, 2017b](#)).

Objectives

- Pilot study to investigate aspects of the following questions:
 - Considering listed companies' current disclosure practices, what information is most useful for investors?
 - What company attributes are associated with high-quality disclosures?
 - How might disclosures be streamlined?

Approach

- Review executive remuneration literature
- Compare disclosures with mandatory requirements
- Compile checklist
- Score sample from ASX 200

Literature review

- Focus on literature around incentives
 - Description of remuneration incentives
 - How managers have reacted to incentives
 - Areas of abuse / concern

Remuneration philosophy and strategy

- Link to performance
- Mix match strategy
 - Long term
 - Short term
 - Product differentiation vs Cost leadership
- Australian packages homogenous

How does remuneration link to strategy?
How do you determine overall remuneration levels?

Remuneration design

- Right balance between risk-taking and risk avoidance
 - Camouflage pension benefits
 - Higher shareholdings, higher bond spread
 - Higher pensions, lower bond spread



Remuneration mix

- Mix match firm characteristics
 - Accuracy
 - Sensitivity
 - Non-GAAP earnings
 - Remuneration leverage match firm leverage



Remuneration and firm characteristics

- Remuneration inconsistent with firm characteristics leads to lower performance
 - Firm size
 - Complexity
 - MTB ratio
 - Historical share performance
 - CEO share ownership
 - Large outside block shareholders

What is remuneration mix and why?

Share-based payments

- Most direct link between shareholder value and remuneration
- Should use relative performance

What is comparator group and why?

Performance metrics

- Link to strategy
- Too many metrics leads to averaging effect
- Robust and transparent measurement



Who gives better disclosure

- Bigger firms
- Lower paid CEOs
- More independent BOD (mixed findings)
- Less family members on BOD
- Government shareholder

- More is not always better

Checklist (Table 2)

Overall remuneration philosophy and link to strategy

1. The remuneration committee's processes to determine appropriate level of overall remuneration (e.g., external compensation specialists, industry practices and salary levels).
2. Is executive director compensation linked to company performance?
3. Is compensation linked to the individual executive's performance?
4. What is the comparator group?
5. *How is remuneration mix and duration linked to strategic objectives?*
6. *Do the performance measures used reflect the particular characteristics of the firm and the industry (precision and sensitivity)?*
7. *How is comparator group chosen?*

Checklist (Table 2) Cont'd

Remuneration design

1. Terms and conditions of all performance-based benefits (performance targets, incentive amounts at various target levels)?
2. Duration of executives contracts and applicable notice periods.
3. Details on any removal clauses, retrenchment or termination payouts in directors contracts.
4. *How was the duration (mix of long and short term) of incentives determined?*
5. *How was the type (mix of cash, shares, share options) of incentives determined?*
6. *How were the performance measures determined?*
7. *Disclosure of policy on mandatory shareholding.*
8. *How is compensation of non-executive directors linked to their level of contribution and responsibilities, and time spent and effort?*

Checklist (Table 2) Cont'd

Remuneration outcomes

1. Separate disclosure of remuneration to individual directors.
2. Separate disclosure of remuneration to other executives that are not directors.
3. Disclosure of the remuneration mix (fixed salary, bonus, share options, share rights, fringe benefits, retirement benefits, etc.).
4. Annual entitlement to all post-employment / retirement benefits.
5. Termination payments made during the year.
6. Number and value of shares or share options granted during the year.
7. Details of directors' interest in shares or share options (amount held, sold, purchased, granted, exercised during the year).
8. How total remuneration outcomes reflect company performance.
9. *Actual remuneration outcomes (vested pay).*

Pilot Study

- 20 companies from the ASX200 index as at 30 June 2017.
 - Companies in the index were partitioned into deciles based on the market capitalisation of the companies
 - Ten companies were randomly selected each from the top and bottom deciles
- Two researchers coded the first four remuneration reports individually and refined the checklist so that the coding was consistent across the four remuneration reports.
 - The checklist was then used to code the other 16 companies in the sample.

Sample (Table 3)

Company Name	Market Value (millions)	Industry	Annual Report Pages	Rem Report Pages
Panel A: Firms randomly selected from top decile ranked by market value of equity				
CBA*	143,250	Financials	218	18
ANZ	84,323	Financials	173	25
NAB	79,166	Financials	162	25
CSL*	62,639	HealthCare	132	20
Wesfarmers	45,490	Consumer Services	157	20
Woolworths Group	33,059	Consumer Services	128	18
Macquarie Group	30,122	Financials	212	29
Amcor	18,773	Industrials	125	14
AGL Energy*	16,728	Utilities	77	25
Fortescue Metals Gp.	16,254	BasicMaterials	145	32
Panel B: Firms randomly selected from bottom decile ranked by market value of equity				
Estia Health	795	Health Care	118	18
Nanosonics	756	Basic Materials	108	27
Aconex	742	Technology	96	11
Orocobre	731	Basic Materials	148	26
Greencross	703	Consumer Services	168	19
Infigen Energy	694	Utilities	137	15
Myer Holdings	686	Consumer Services	117	20
Gateway Lifestyle Group	584	Financials	93	10
Western Areas	575	Basic Materials	112	11
Lynas	386	Basic Materials	104	11

Results (Table 4)

		Panel A: Top Decile (n = 10)		Panel B: Bottom Decile (n = 10)	
	Max Score	Mean	Prop*	Mean	Prop*
Total Score	24	17.9	0.746	15.7	0.654
Mandatory	15	13.1	0.873	12.7	0.847
Voluntary	9	4.8	0.533	3.0	0.333
Overall remuneration philosophy and link to strategy	7	4.6	0.657	3.6	0.514
Mandatory	4	3.2	0.800	3.0	0.750
Voluntary	3	1.4	0.467	0.6	0.200
Remuneration design	8	5.6	0.700	5.0	0.625
Mandatory	3	2.8	0.933	2.9	0.967
Voluntary	5	2.8	0.560	2.1	0.420
Remuneration outcomes	9	7.7	0.856	7.1	0.789
Mandatory	8	7.1	0.888	6.8	0.850
Voluntary	1	0.6	0.600	0.3	0.300

Examples from remuneration reports (WES)



Component	FIXED ANNUAL REMUNERATION (FAR)	ANNUAL INCENTIVE ¹	WESFARMERS LONG-TERM INCENTIVE PLAN (WLTIP)
	Salary and other benefits (including statutory superannuation).	Cash for target performance. Restricted shares for performance above target. Voluntary deferral (of portion of cash award into shares).	Performance rights.
Performance measure	Key result areas for the role: As outlined in the individual's position description.	For the Group Managing Director and the Group Chief Financial Officer: 70% of the annual incentive comprises Group financial measures: Group NPAT and ROE. 30% of the annual incentive comprises Group strategic measures: Including strategy execution, succession, gender balance, talent management, safety and agreed key objectives.	Total Shareholder Return (TSR), relative to ASX 50 Index (100% weighting). Measured over a four-year performance period.
Opportunity	Total remuneration levels are set at competitive levels to attract, retain and engage key talent, with FAR set at a level that is appropriate given the Group's focus on long-term performance.	100-120% of FAR for the Group Managing Director and the Group Chief Financial Officer.	100-200% of FAR for the Group Managing Director and 80-160% for the Group Chief Financial Officer.
Strategic objective/ performance link	Considerations: <ul style="list-style-type: none"> Role and responsibility. Business and individual performance. Internal and external relativities. Contribution, competencies and capabilities. 	<ul style="list-style-type: none"> Rewards performance at Group level. The financial performance measures were chosen principally because Group NPAT and ROE should drive dividends and share price growth over time. Drives leadership performance and behaviours consistent with achieving the Group's long-term objectives in areas including safety, gender balance, succession planning and talent management. Aligns to the Group's material business risks, including strategy execution (earnings delivery) and loss of key management personnel (succession planning). 	<ul style="list-style-type: none"> Provides a link with the creation of shareholder value. TSR was chosen because it provides a relative, external market performance measure having regard to Wesfarmers' ASX 50 peers. While the Board and management are committed to managing the generation of acceptable levels of ROE, it was not felt appropriate to use ROE given the impairment charges taken against Target and Curragh and the material effect these had in the 2016 financial year ROE (which would be the starting point from when performance would be measured).

Examples from remuneration reports (CSL)

Business Performance

Measure:

Shared objectives aligned to the CSL strategy and categories include:

- R&D investment and achievement of key research milestones; and
- Operational targets representing key outcomes supporting achievement of CSL's long-term strategy.

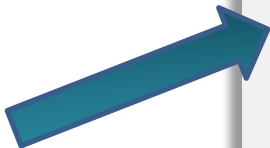
Rationale:

- Using the same high level financial KPIs for all KMP encourages teamwork; and
- R&D and operational efficiency are fundamental to CSL's success.

Weighting:

CEO 30%

Executive KMP 20% (excl. G Naylor)

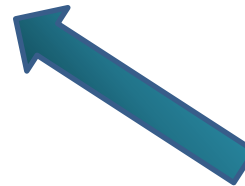
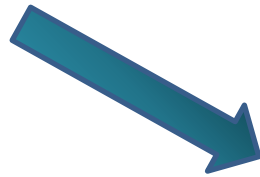


Examples from remuneration reports (FMG)

Relative Total Shareholder Return (RTSR)

RTSR is a measure of the performance of the Company's shares over a three year period against the ASX 100 Resources Index (noted below). It combines share price appreciation and dividends paid to show the total return to the shareholder expressed as a percentage.

Relative TSR hurdles are valuable because the Company needs to outperform a peer group of participants to receive any reward and therefore, is aligned to relative market performance. The ASX 100 Resources Index has been chosen as the comparator group because this is a transparent market indicator, includes Fortescue's ASX Listed commodity market peers and represents the peer group that Fortescue competes with for investment.



The Company used absolute return on equity (AROE) as the sole performance measure for the FY15 LTIP assessed over the three year performance period.

AROE was selected in 2015 as the performance measure for the FY15 LTIP for the following reasons:

- AROE is one of the most important value metrics reflecting profit earned relative to shareholders equity (the amount of capital invested by shareholders)
- AROE performance in excess of the Company's cost of equity capital will deliver shareholder value

Key themes from first strikes

- Remuneration not aligned with shareholders' interests
- What is overall approach to setting remuneration
- Outcomes are out of line with company performance
- The remuneration report is complex, lacks transparency and is difficult to read.

For consideration by AASB

- How is remuneration determined?
 - Level
 - Mix
 - Metrics
 - Comparator group
- Streamlining

Areas for future research

- Characteristics of companies
- Smaller companies
- Not-for-profit entities
- Which elements do users actually read
- Responses to a first strike

Remaining aspects still to be addressed

- Descriptive evidence on application of reporting requirements
- Costs vs Benefits
- Effects of changes in reporting rules
- Not-for-profit entities

Conclusion

- Current requirements well supported
- Some areas emphasised by literature not done well
- Additional requirements targeted at strategy and performance
- Avoid clutter