Executive Remuneration
Fourth edition – 2010

Consulting

How do we rebuild shareholder trust on executive pay

What would you like to change?

PRICEWATERHOUSECOOPERS

Welcome to PwC's fourth annual Executive Remuneration publication

Executive remuneration has been through yet another period of turbulence. The global financial crisis acted as an impetus for intensified scrutiny and has precipitated action by a broader range of stakeholders. In Australia this has included legislative amendments, a Productivity Commission inquiry, greater regulation by APRA in the financial services sector, and a continued increase in "No" votes on remuneration reports.

While the global financial crisis may be finite, it has resulted in a permanent shift in the way remuneration is perceived. It has prompted fundamental questions about the links between the reward model and individual and company performance, as well as recognising the importance of risk in all aspects of reward.

The spotlight has turned to 'how' remuneration arrangements and processes are designed and governed, as well as evaluating the resulting outcomes against company performance.

In particular, roles and accountabilities are being re-examined for the board, the remuneration committee and management, and across the HR/reward, finance, risk and strategy functions.

This year our publication provides a perspective on the impact of this evolving environment, offers some alternative views to provoke discussion, and suggests ways to manage the often competing demands of multiple key stakeholders.

We believe that over the next five years we will see some very significant changes in executive remuneration, particularly in design, performance measurement and governance. So we suggest that now is the time to act to ensure you are well placed to meet those challenges.

We hope you will find this publication thought-provoking and an aid to your preparation.

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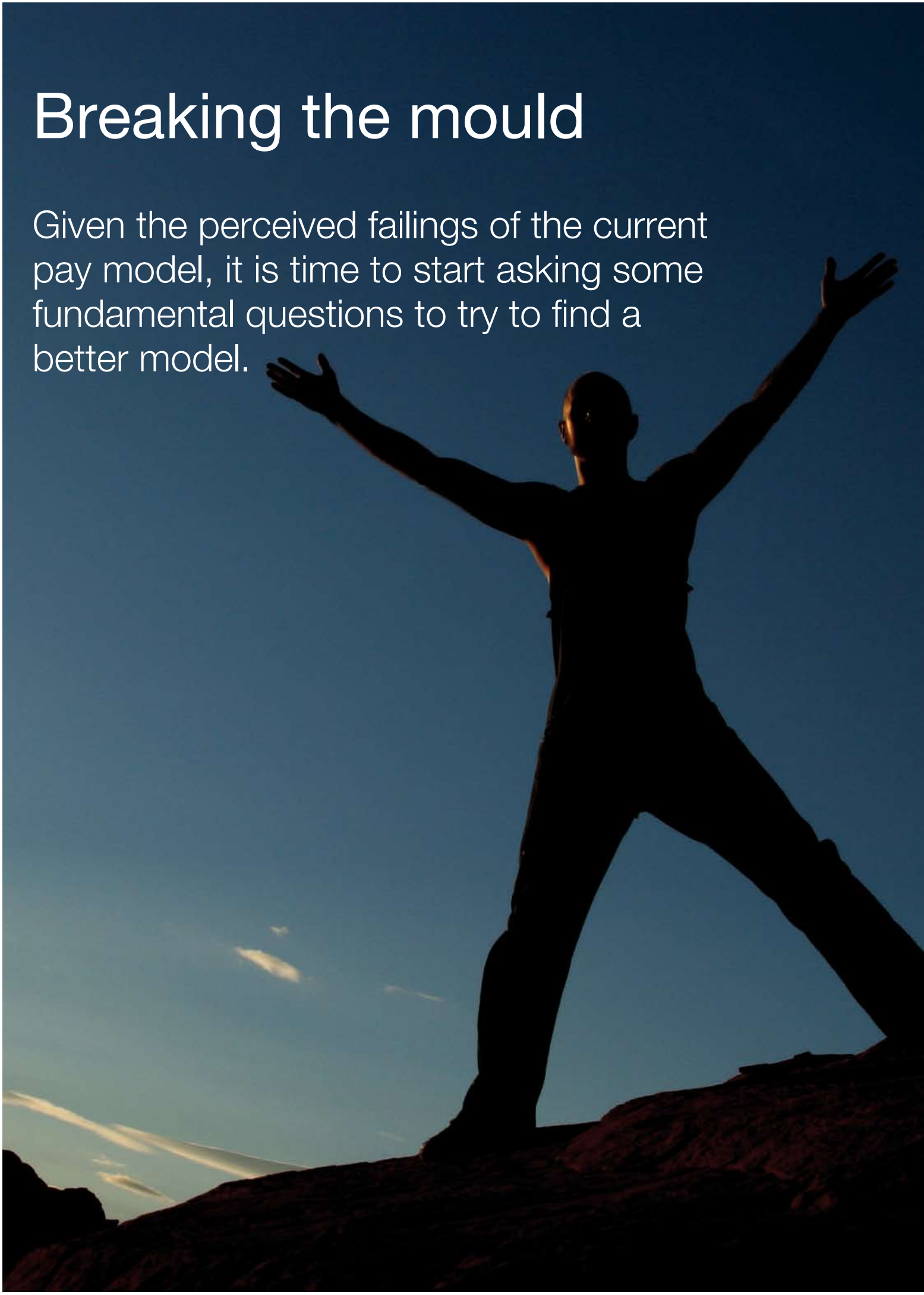
Breaking the mould

Given the perceived failings of the current pay model, it is time to start asking some fundamental questions to try to find a better model.



The increasingly complex nature of variable remuneration is an area where we would like to see change.

Over the last decade, executive remuneration in Australia has increased significantly. The increase has mainly been in the form of higher short- and long-term incentive awards, which are nearly always performance-related. This combination of higher remuneration outcomes and increased complexity has left almost everyone dissatisfied:

- Generally, management feels that incentives have become too complex and prescriptive, and are not aligned to the business strategy or within their control. As a result, they do not believe incentives drive performance or change behaviours, and many perceive them to be simply a lottery.
- Many institutional shareholders believe there is a tenuous link between remuneration and performance. The shareholder perception is that incentives ratchet up each year in line with annual benchmarking, while incentive design and performance measures chop-and-change depending on management's expectation of them paying out (or not). Underlying these perceptions is a feeling that remuneration committees are not being tough enough and when they do exercise discretion, it always favours executives.
- Remuneration committees are caught in a calibration hell, trying to design incentives that are durable and balance the expectations of executives and shareholders.
- Few really believe that complex long-term incentives retain executives; they just make it more expensive for a new employer to buy out the executive with golden hellos and guarantees.
- The public, particularly since the global financial crisis, sees executive remuneration as nothing other than a gravy train – pay regardless of performance, rather than pay for performance.

> "The World Economic Forum has consistently ranked Australia in the top three countries for corporate governance since 2002"
>
> *Source Productivity Commission Inquiry into Executive Remuneration 19 December 2009*

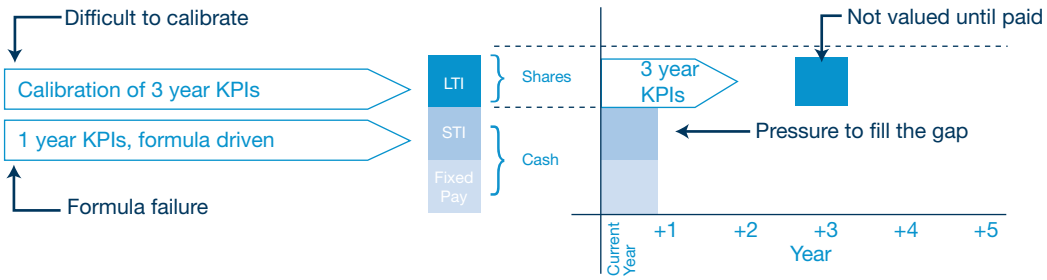
Generally, Australia is seen to be among the global leaders in terms of corporate governance and remuneration disclosure. We have one of the highest standards of disclosure, various best practice guidance, and healthy levels of shareholder engagement on executive remuneration compared with many other countries. However, many stakeholders would argue that this has not led to a particularly successful outcome; yet the danger is that any further prescription will result in more of the same, with calls for tougher performance conditions, tougher long-term incentives, greater disclosure and more governance.

What's the problem?

Figure 1 illustrates the problems with the current model:

- A formulaic approach to short-term incentives leads to excessive complexity and loss of control over outcomes.
- The attempt to set long-term incentive targets over a three-year timeframe leads to complicated calibration and intensive negotiation between remuneration committees, executives, and shareholders, none of whom can be certain how tough the targets will turn out to be.
- Long-term incentives can be considered too complex by executives, largely out of their control or unachievable almost as soon as they are granted. They therefore provide limited incentive or retention effect until the few months before they vest.

Figure 1: Problems with the current incentive model



- The outcomes from long-term incentives, because of calibration difficulties, rarely seem to be aligned with what the remuneration committee believes is a fair result (whether too high or too low).
- As a result the remuneration committee loses control over the total quantum of reward, and may have difficulty reaching the right total amount through the short-term incentive scheme.

In light of these problems, how can we change the way executives are remunerated? We offer below some alternatives for debate.

Model A: Simplified framework

Yes, you read it right. If there is any truth in the observations above, perhaps it is time to simplify incentives. Some in the media have already compared performance-related pay to the emperor's new clothes.

The alternative could be to significantly increase fixed pay but require the executive to purchase shares on a monthly basis with the increase. The executive keeps the shares regardless of whether they remain employed, but cannot sell the shares for five years. There would be no short-term incentive and no long-term incentive.

Consider the following example:

An ASX 100 CEO currently earns fixed pay of $1m a year. The CEO is eligible for a performance-related short-term incentive of up to 200% of fixed pay (with a target short-term incentive of 100% of fixed pay). The CEO also receives an annual award of shares with a face value of 200% of fixed pay under an LTI plan, again with a target value of 200%. The LTI plan vests subject to relative TSR over three years.

The theoretical range of package values is $1m to $5m, (or potentally higher spending on future share price) with a target value of $3m although in practice the short-term incentive pays out at or around target level. The long-term incentive tends to be feast or famine.

Under the alternative model, the CEO's fixed pay would be increased to $3m, of which $1m is paid in cash as normal salary and the balance used to buy shares on a monthly basis, which must be held for at least five years. There would be no short- or long-term incentive. Equally, the CEO could be paid $1m fixed pay with a $2m annual restricted share award.

Figure 2: Illustration of simplified framework

	Traditional	Model A
Fixed pay (cash)	$1m	$1m
Fixed pay (shares)		$2m
Short-term incentive	$0m - $2m	
Long-term incentive	$0m - $2m	
Total	$1m to $5m	$3m

Note: This illustration ignores the impact of changes in the value of the shares

Model A would deliver a similar target value to the current package, though it would be a lot simpler and more transparent. It would also potentially put an end to golden hellos and buy-outs, as the shares are not forfeited on leaving. However, under the model, the CEO would forgo the potential upside of the current package for the increased certainty under the alternative model.

"What about performance?" we hear you cry. Analysis conducted by our UK firm shows that over the long term, regular restricted share awards, without performance conditions, provide better alignment with shareholder returns than complex long-term incentives. The UK analysis looked at the average remuneration actually received by FTSE 100 CEOs over the period 2001 to 2006 compared to the absolute shareholder returns created over that period.

Their findings showed that, for all but the most outstanding performers, the link between pay and performance has been tenuous. However, the correlation between pay and performance was much better (although not perfect) if restricted shares and a high shareholding guideline were used instead of long-term incentive awards.

Under this proposed model, while the CEO remains employed they are paid the market rate, or above for high performance, but with a significant amount linked to the fortunes of their company (as viewed by the market). If they do not perform, it is left to the board and shareholders to take the obvious action.

In practice this may be a step too far for the current Australian environment. So let us consider some other alternatives.

Model B: Deferred STI model

The deferred short-term incentive model introduces more performance linkage. Instead of receiving long-term incentives subject to performance, executives simply receive an increased fixed pay package, partly paid in shares, and a short-term incentive, the majority of which is paid in shares, which vest over five years. In addition, the executive must build and maintain a significant shareholding in the company (eg 5x fixed pay as opposed to the typical 1x to 2x fixed pay).

So in our example, the executive receives fixed pay of $1.5m rather than $1m, of which $0.5m is paid in shares. In addition they get a short-term incentive of up to 200% of fixed pay each year:

Figure 3: Illustration of deferred STI model

	Traditional	Model A	Model B
Fixed pay (cash)	$1m	$1m	$1m
Fixed pay (shares)	-	$2m	$0.5m
Short-term incentive (cash)	$0m - $2m		$0m - $1m
Short-term incentive (shares)			$0m – $2m
Long-term incentive	$0m - $2m		
Total	$1m to $5m	$3m	$1.5m to $4.5m

Note: This illustration ignores the impact of changes in the value of the shares

The deferred STI model has some precedent, but has the weakness that the whole system becomes dependent on the short-term incentive paying out, and arguably creates an excessive focus on short-term performance.

> "The more deferral, the more pay is discounted in the eyes of executives"
>
> *John Schubert, Chairman of CBA – quoted in The Australian Financial Review, 14 January 2010*

Model C: Bonus banks

Last year, we reported that economic profit is experiencing a renaissance, particularly in the financial services sector where there has been much talk about risk-adjusted performance. This year, we have heard much talk from regulators and shareholders about the concepts of bonus clawback and the phasing of short-term incentives over a much longer timeframe. Like economic profit, bonus banking may be due a revival.

In its simplest form, bonus banking is the partial deferral of short-term incentives and aims to smooth out short-term incentive payments over time. Bonus banks accrue a reserve balance in good years which can be drawn down in years of poorer performance.

Figure 4: Illustration of bonus banking

Bank Balance	Year 1	2	3	4	etc.
Previous year balance		100	40	120	60
+ Awarded bonus	150	0	140	0	
– Awarded Performance Adjustment		-40		-30	
= Interim balance	150	60	180	90	
X Payout	33%	33%	33%	33%	
= Amount paid out	50	20	60	30	
Balance after payout	100	40	120	60	

The criticism of bonus banks is that they become overly complicated through complex mechanistic approaches. However, simpler approaches can be taken. The key insights of bonus banks are that:

- short-term incentives should be paid based on the cumulative / average performance over a number of years rather than just on one year
- years of poor performance can offset years of good performance to reduce the bonus bank, giving a stronger relationship between remuneration and performance over time.

The thinking is that this provides a balance between short-term measurement providing strong line of sight for management, and payments smoothed over time.

Model D: Multi-year incentive plan

Bonus banking, despite its many good qualities, is often discredited due to the complexity it can create. So is there another way of taking the good points of bonus banking and leaving behind the bad?

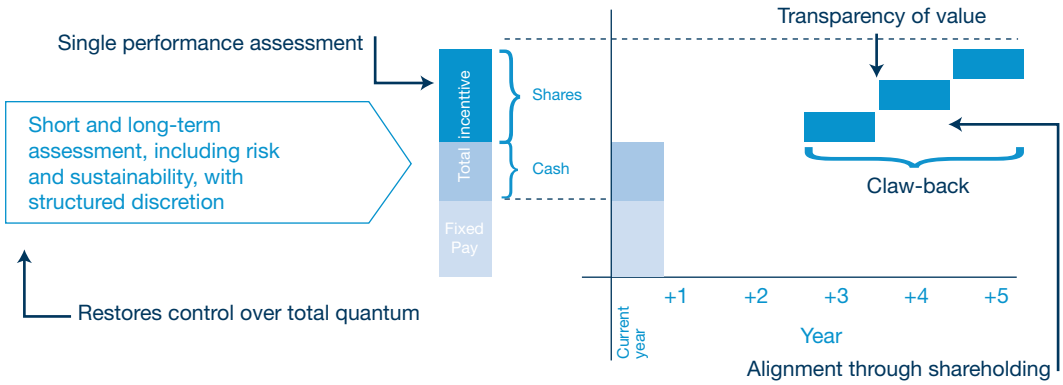
One approach is a multi-year incentive plan. Under this approach:

- the remuneration committee makes an annual assessment of performance against a balanced scorecard of objectives
- the performance assessment looks back over the previous three years, not just a single year, subject to an overriding remuneration committee discretion
- an incentive award is made partly in cash and partly in shares, with the share award vesting over a further three to five years to ensure sustainability of that performance
- once through a transition phase, this becomes the single incentive plan.

The key features of this approach are:

- a transparent single performance assessment each year, looking back over the previous three years, which enables a mature conversation with

Figure 5: Illustration of multi-year incentive plan



shareholders about performance, rather than the current discussions that focus on calibration of performance conditions

- transparency for executives: they know the domains in the balanced scorecard on which they are to be measured, and once the performance score is assessed the value of deferred shares they will receive is completely transparent
- performance based over the long term: with the average performance measured over three years and shares vesting over three to five years, the total measurement period is six to eight years
- a simplified incentive structure, with a strong focus on share ownership
- an enhanced role for remuneration committee discretion, assessing performance holistically, thus restoring control over remuneration quantum.

The approach is illustrated in Figure 5.

What can be done to break the mould?

The time has come for remuneration committees to ask some hard questions about their incentive programs, in particular long-term incentives:

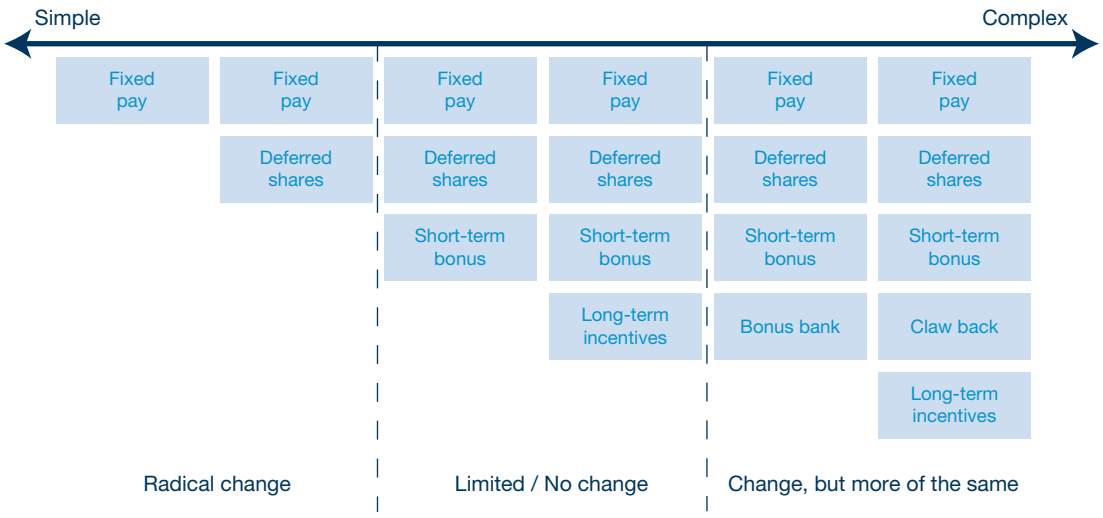
- What is their (LTIs') purpose within the package and are they achieving that purpose?
- Are the incentive programs motivating for executives and influencing behaviour?
- Are they achieving alignment with shareholders' expectations?

In many cases the answers will be uncertain or in the negative. So what is to be done?

We have set out some radical alternatives to the current incentive model to provoke some fresh thinking within companies and shareholder groups. However, while in quiet moments some shareholders and non-executive directors will admit the current model is broken, the appetite for radical change may be limited in the current environment. Companies and their boards seem reluctant to step away from the traditional fixed pay, STI and LTI model.

We hope that some remuneration committee chairs take a deep breath when considering what they would like to change, and instead of opting for complex solutions they try something radically different and simpler (see Figure 6).

Figure 6: Illustration of remuneration models



But in the meantime, what can be done within the existing short- and long-term incentive frameworks?

- First, wherever possible, try to develop relevant internal performance metrics for long-term incentives, rather than relying on the vagaries of relative TSR (other than for a top-slice element of the package).
- Second, consider ways in which greater discretion and broader measurement can be brought into incentives to avoid complex calibration and over-reliance on the formula.
- Third, turn executives into significant shareholders. Require very significant shareholdings in exchange for greater predictability and control in the incentive package.

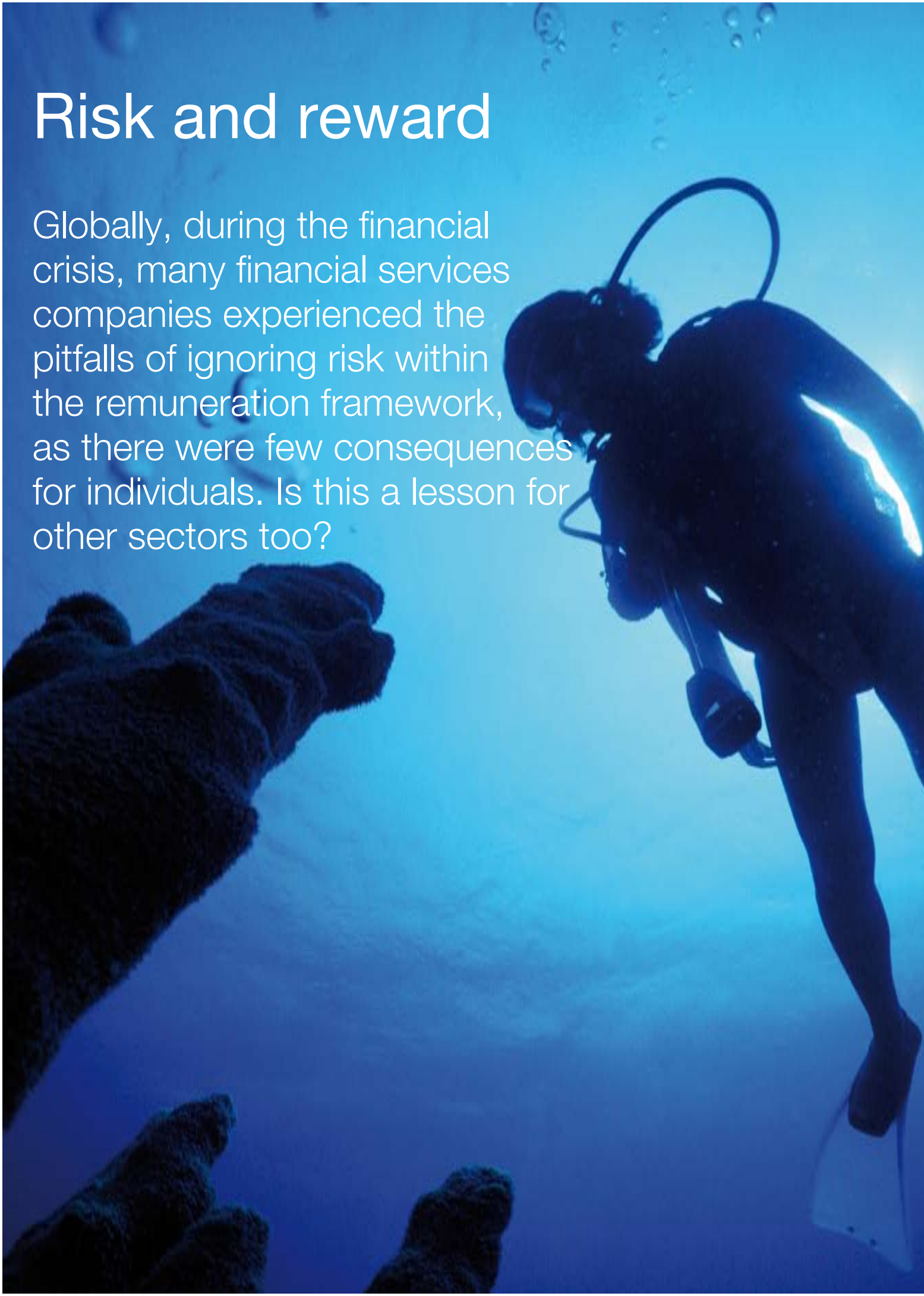
This requires trust between the remuneration committee and the company's shareholders and a willingness by all to change. This means greater openness and disclosure, and a more mature dialogue about the levels of performance achieved. The chair of the remuneration committee will need to actively engage with the company's shareholders if radical change is to be allowed.

There must be a simpler and better solution to designing executive remuneration than the current 'best practice' norm, and one that will better align pay with performance. Stakeholders with an interest in executive remuneration should be prepared to consider all possibilities. Otherwise the pain and frustration will only continue.

> "In all this debate we must ensure that our remuneration practices enable us to retain and attract great people. We can't allow mediocrity to become the way we do business."
>
> *Brian Schwartz – Director of Brambles, IAG and Westfield Group*

Risk and reward

Globally, during the financial crisis, many financial services companies experienced the pitfalls of ignoring risk within the remuneration framework, as there were few consequences for individuals. Is this a lesson for other sectors too?



Remuneration: cause or symptom of the global financial crisis (GFC)? While this question may be debated for years, regulators are acting now. Regulators are convinced that, at a minimum, remuneration arrangements that did not adequately recognise risk added fuel to the GFC fire.

In Australia and overseas, regulators now require many financial services companies to recognise risk in their remuneration arrangements. As a result, financial services regulated companies – including the banks and insurance companies – are being forced to revise their remuneration arrangements.

Is this an issue just for financial services, or do the principles and approaches being developed have wider application? After all, enterprise-wide risk management is an important topic across all sectors. However, how it plays out, outside of financial services varies enormously.

Case study: The resources sector

For a few years, up to 2008, the resources sector enjoyed a period of unparalleled buoyancy where commodity prices hit record highs as demand outstripped supply. Mining, and oil and gas extraction company revenues grew significantly with impressive margins.

Companies responded to this in different ways. Some were cautious, building high-quality asset portfolios and maintaining strong, unleveraged balance sheets. Others allowed costs to rise as they competed for scarce mining expertise and local labour. A number took advantage of cheap money to increase gearing and go on an acquisition spree.

As the commodity market rose, the cautious companies underperformed in the share market. However, when the market turned, the companies hit hardest were those that over-leveraged or had not paid attention to rising costs.

That is not to say that risk-taking is a bad thing – business is about taking risk. But it's about taking the right risks, risks within the company's risk appetite, risks that are understood and articulated, risks investors can choose to suit their risk-return profile.

As shown in financial services, companies can suffer if they do not align their incentives with their risk appetite. This lesson also applies to other sectors, as those that operate traditional remuneration programs share similar weaknesses:

- Short-term profit measures can encourage unsustainable growth
- During a market upswing, relative TSR measures reward companies that adopt the highest risk profile of the peer group
- Decisions made this year can have consequences way beyond the time-horizon of typical three-year incentives
- Simplistic financial measures can ignore the real drivers of long-term risk and value
- Formulas can have unintended consequences.

> "If you give people a chance to take risks to earn a truck-load of money, with the downside underwritten by a friendly bank or employer, why would they not have a go?"
>
> *Don Mercer – Chairman of Newcrest Limited and Air Liquide Australia Limited, and former Chairman of Orica Limited*

So what can be done?

Understand your risks

Risk management frameworks alone cannot make a difference. They can, however, become more powerful if the risk profile is linked to the remuneration framework. We therefore start by considering the material risks. In the resources sector case study, the material risks might be as follows:

Figure 7: Example of principal risks in a resources company

Principal risk	Example
Commodity price / exchange	Adverse commodity price or exchange rate movement
Financial resilience	Change in cost or availability of finance
Operational	Breakdown of key production facility
Depletion / asset quality	Failure to replace reserves
CAPEX execution	Major project over-run or failure
Political	Threat to ownership rights or cost structures
Reputation	Significant environmental or safety incident
Talent	Failure to develop robust succession plans

As each risk has a level of uncertainty, the challenge is in linking remuneration to something uncertain. Companies will therefore typically set out a number of parameters covering the different risks, for example:

- the earnings volatility they are prepared to sustain given typical movements in commodity prices and exchange rates
- the earnings exposure from a major accident in a single processing facility
- the percentage of earnings derived from territories categorised as high political risk.

The company will then aim to deliver performance within the parameters of their risk-appetite framework.

So far, so good (and nothing to do with remuneration). The trick is then to make the appropriate links, and bring the risk discussion into the remuneration committee.

Understand how the risks are reflected in your current remuneration plans

To understand how risk and remuneration link together, companies can map their principal risks against their existing executive remuneration arrangements. In the resources sector case study, a typical remuneration structure would be as follows:

Figure 8: Typical remuneration structure in a resources company

* Occupational health and safety

So how would a build up of risk be reflected in the remuneration elements outlined above?

Of these measures, EPS and relative TSR measures arguably encourage gearing during the upswing and may discourage companies from managing commodity and financial soundness risk. For the other measures and structures, there may be little risk recognition.

Of course, if companies take risks and the outcomes fall outside their risk appetite parameters, deferred STI should fall in value and LTIs may not vest.

But the GFC showed that the negative impact for executives was not necessarily proportionate to the damage caused by the collapse of a business. By itself, deferral will never be enough to influence behaviour. Incentive measures must reflect risk build-up as it occurs.

For many of the risks set out in Figure 9, relative TSR may be the only measure that reflects risk build-up. In a perfect world the market would reflect risk accurately. However, the reality is that in a boom the market gets it wrong as much as anyone else.

We must conclude that, even outside financial services, risk is sometimes inadequately priced or factored into remuneration models. Often good risk management happens in spite of, not because of, the incentive structures put in place.

So what should you do about it?

Link risk to remuneration

There are three main mechanisms for reflecting risk in remuneration:

- Use non-financial measures to encourage a forward-looking, sustainable focus on performance, and help mitigate risk build-up – potentially as part of a well-structured balanced scorecard (eg succession planning, capital projects)
- Use better risk-adjusted financial measures, linked to the business needs – not driven by the remuneration framework. For example, economic profit can account for more risks and costs than simple profit-based measures. Remuneration measures will be most relevant if they align with measures used in management reporting, decision-marking and investment appraisal processes
- Implement appropriate deferral mechanisms to allow companies to align business and remuneration outcomes if things go wrong. Despite calls for greater deferral by APRA, deferral should not be relied upon solely to change behaviour. The right measures upfront will be more effective than companies "holding back until we're sure", as deferral will not distinguish between good risk decisions that just happen to turn out bad, and bad decisions that were never within the company's risk appetite.

These three mechanisms can help to bring greater risk sensitivity to remuneration outcomes. However, the fallacy of risk-adjustment is that simply implementing such mechanisms is a silver bullet; it is not.

Use your judgement

A constant danger with incentives is the temptation to take an excessively mechanistic approach. Introducing risk-adjustment gives ample opportunity to succumb to this temptation. Yet introducing ever more complex metrics into the incentive formula may create unintended consequences. Our view is that the best way to start reflecting risk in incentives is to give the remuneration committee the tools to apply their discretion in a sensible way. What this means in practice is set out on the following page.

Figure 9: Example mapping of risks to remuneration elements

		Commodity	Financial	Operational	Depletion	CAPEX	Political	Reputation	Talent
Measures	EBIT		≈✓	≈✓					
	OH&S							✓	
	Environment							✓	
	EPS	✓	✓						
	TSR	✓	✓	≈✓	✓	✓	✓	✓	≈✓
Structures	Deferred STI	In principle provides some alignment, but short period and blunt instrument							
	LTI	In principle provides some alignment, but period shorter than commodity cycle							

1. Understand the company's material risks, and articulate the relevant risk appetite (this can be, at least, partially achieved through closer liaison and/or cross-membership between the remuneration and risk committees).
2. Understand the potential weak areas of the remuneration system, and map risk against the remuneration elements. How and where are risks picked up? Are risks reflected in remuneration when the risks turn bad, or is there sensitivity to the build-up of risk over time?
3. If necessary, introduce a small number of new or amended metrics to better reflect risk.
4. Provide existing collected risk information to the remuneration committee when it is determining incentive outcomes.

The remuneration committee should then judge performance against targets in light of the risk information provided. If the committee judges that excessive risk has been taken during the period to generate the performance, then performance outcomes should be scaled back or a greater amount of remuneration should be deferred for a sufficient period of time to allow the risks to play out.

For example, two companies may make the same profit of $1bn, but it doesn't mean they should get the same STI. Stress tests and probability modelling may show one company's profits to be much more vulnerable to changes in commodity prices, exchange rates or operational risks. If this is so, the remuneration committee may judge that company's performance to be less sustainable and as a result decide to either pay less or defer more.

This requires much better information about risk to be provided to remuneration committees. But remuneration should not drive risk management. If risk management information is being created just for the purposes of remuneration plans, either there is something wrong with how the company is being run, or the information being gathered is irrelevant. Remuneration frameworks will never be a substitute for good risk management.

Finance or risk functions should work with HR to produce a report for the remuneration committee identifying key risks, outcomes for the year's profit under identified stress tests, and problem areas identified through the year. This information should be segmented (eg by division) in a way that matches up with the information the remuneration committee is reviewing on incentives. Getting the right information, presented in the right way, in the right place, and at the right time for the remuneration committee, is essential to informing discretionary judgement.

Remuneration committees may be reluctant to take on this role. But business life is complex. It is rarely possible for performance to be encapsulated in one or two simple metrics.

Aligning reward to performance is an old idea… or is it?

Why has alignment between pay and long-term sustainable performance been so elusive? How can we get this right?

Remuneration issues dominated the world's business press in 2009 – for all the wrong reasons. Globally, there are many examples of companies that have failed to properly align remuneration with business performance, as evidenced by exorbitant bonuses or sizeable golden parachutes when business performance hasn't warranted them.

Challenging and rapidly shifting economic conditions, followed by a regulatory focus on remuneration, have exposed the disconnect between remuneration outcomes and performance, especially longer-term sustainable performance. Aligning performance and reward is not a new aspiration. However, the key question is: "Why didn't we get it right?" Clearly there is a great opportunity for companies to do this much better in the future. Closer alignment should help reinforce management accountabilities, derive greater value from performance and reward programs, and restore shareholder confidence.

Reward structures and quantum have dominated the debate so far but a broader debate is now needed to address the performance side of the reward-performance equation. That is, how can companies better define and measure performance that supports the achievement of strategic objectives?

How can we get the performance-reward equation right?

Making strong connections between strategy and performance management is a multi-faceted, complex process. Given the backlash company have faced over their remuneration policies, many have sought to understand why performance and reward alignment has been so elusive. In our opinion, there have been several barriers (see Figure 10).

Figure 10: Barriers to performance and reward alignment

Barrier	Description
Strategy is written in a way that is not actionable	• Strategy is not necessarily developed with the end goal of clear and measurable individual KPIs. • Strategy is often not translated into meaningful individual actions and targets.
Strategy is not effectively cascaded	• Significant effort is devoted to articulating organisational-level strategy, with less effort dedicated to its succinct disaggregation and cascading it throughout the organisation. • An intuitive, ie dynamic, articulation is important, to ensure there are no gaps or duplication in accountabilities across the management team.
Business units determine KPIs within silos	• As well as determining how each business unit will contribute individually to the organisation's strategic imperatives, business units need to think about how they can work together to achieve strategic goals. • This is particularly pertinent for companies hoping to realise strategic objectives through collaborative efforts and cross-selling.
There is minimal collaboration between functions	• Performance management is still seen as an HR responsibility. • There is rarely an integrated effort between the strategy, risk, finance and HR functions to truly link strategic objectives to reward outcomes.
The 'complacency' trap	• Organisations and employees can fall into the trap of believing that if they continue to do what they've always done, they will achieve the same positive results and outcomes.
There is no catalyst for change	• Strong economic conditions and growth over the past decade meant that companies typically exceeded performance targets. • Increasing the rigour behind performance management, or its links to strategy, was not considered a key priority. • Disconnects were revealed following the financial crisis, as few had bothered to look 'under the bonnet' given company performance was sufficient and, frequently, impressive.

So will we see real change?

These barriers must be overcome – shareholders, employees and regulators are demanding change. There needs to be a clear understanding among executives and management about their individual accountability for achieving strategic imperatives, as well as any shared accountabilities.

Performance can no longer be judged on fiscal achievements alone. Key strategic imperatives will need to be embedded in employee scorecards and KPIs. Systems need to be established to monitor on an ongoing basis non-financial outcomes and behaviours that help determine the long-term sustainability of a business, such as whether an individual's behaviour is in line with the organisation's values and risk management framework. Finally, if targets are not met there should be remuneration consequences for executives and other employees, in the same way shareholders face the consequences when a business does not meet its targets.

In summary, we expect that the old world of performance and reward will look very different to the new world (see Figure 11).

How will pay and performance be aligned in the new world?

The transition to the new world of performance and reward has already begun. While some industries appear to be more advanced than others, partly due to regulatory requirements (for example financial services), many companies are recognising that traditional approaches are not driving optimal alignment of strategic objectives and remuneration outcomes. Businesses that succeed in better aligning strategy, performance management and remuneration will do so by ensuring:

- strategy is defined in a way that is clear, actionable and helps drive individual accountability
- there is a focus on developing an end-to-end performance and reward process, from strategy development right through to reward outcomes
- there are collaborative efforts across the HR, finance, strategy and risk functions and across business units, with clear roles and accountabilities
- performance metrics and targets are aligned to strategic objectives and assessment is based on rigorous and objective data

Figure 11: Comparing the old and new world

Old world	New world
• Strategy development as an input.	• Strategy development as a driver.
• Independent and discrete management of each part of the system; eg strategy development vs individual scorecard development vs ongoing performance management vs remuneration outcomes.	• Highly collaborative efforts between HR, risk, strategy, and finance to define and manage the end-to-end process.
• Metrics determined within teams/business units.	• Metrics determined within and across teams/business units.
• Metrics and KPIs being pretty consistent year-on-year.	• Metrics and KPIs changing year-on-year as the strategic imperatives change.
• Targets based on individual negotiation.	• Financial targets based on objective, analytical data; non-quantitative targets based on clear and pre-determined success criteria.
• A focus on financial outcomes, on the 'what' rather than the 'how', and one year performance rather than consistent longer-term achievements.	• A focus on a more rounded view of performance including financial and non-financial metrics, the 'what' and the 'how', short- and long-term outcomes.
• Boards focused on remuneration levels of the executive team.	• Greater role of the board in overseeing the remuneration policy, governance of remuneration frameworks, and alignment to the performance management system.

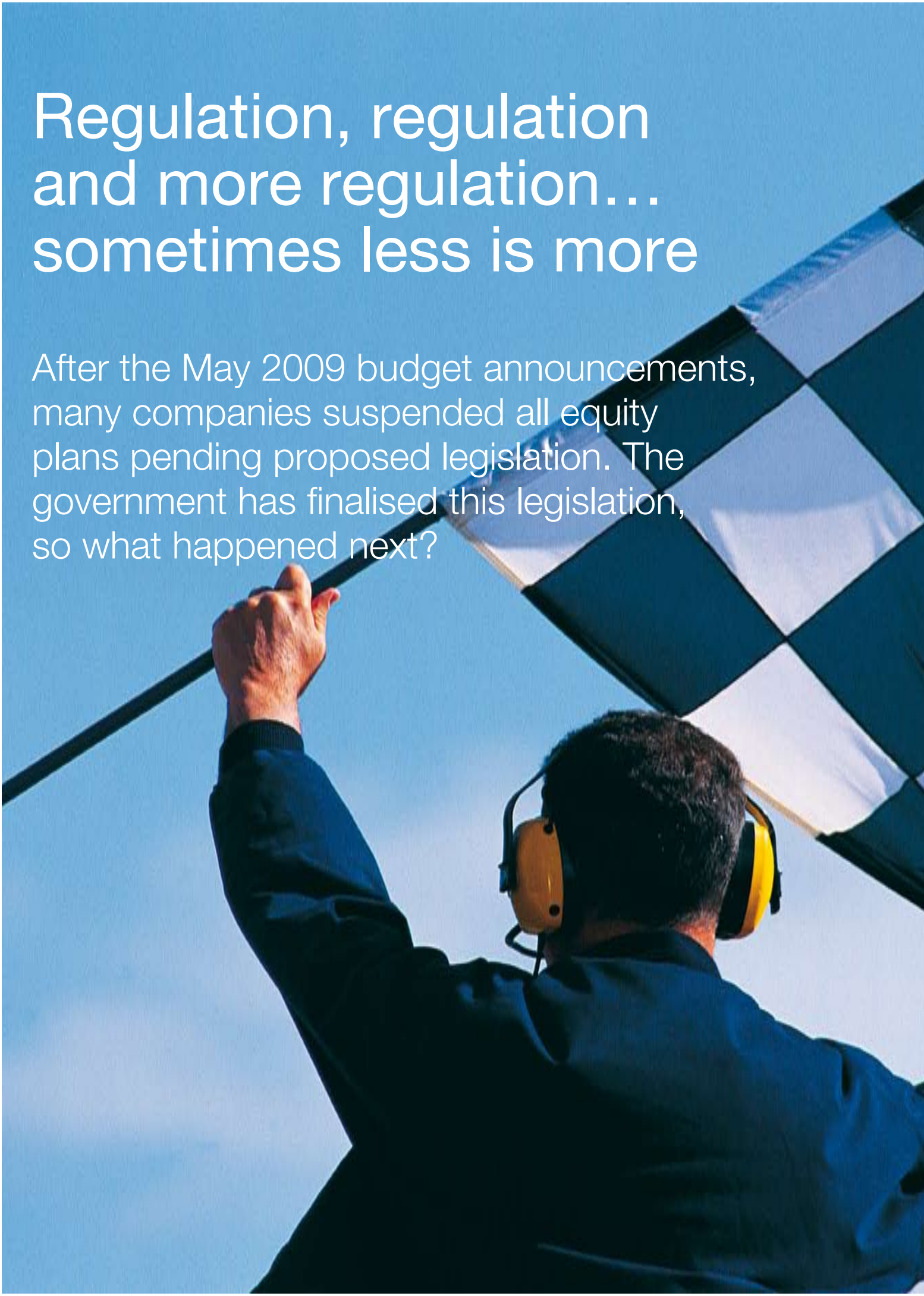
- remuneration and performance frameworks that generate outcomes are highly differentiated (ie bonuses become truly variable in nature)
- remuneration committees play a critical role in governance and approve appropriate alignment between performance and reward
- totally formulaic approaches to incentive design are avoided, and discretion, in some form, is considered appropriate, allowing remuneration committees to take into account unexpected internal or external events that would have affected the company's or executive's performance.

And finally, it is apparent that businesses that are more successful at performance alignment are those that don't treat it as a one-off event. An evaluation process should occur regularly, but particularly when the organisation faces a significant event such as a change of CEO, a restructure, when new strategic initiatives arise, and when market guidance changes.

Achieving the right alignment is not an easy process but those who get it right will reap the reward of more effective strategy execution, more engaged employees, a culture of accountability, increased shareholder trust, and sustainable business performance.

Regulation, regulation and more regulation… sometimes less is more

After the May 2009 budget announcements, many companies suspended all equity plans pending proposed legislation. The government has finalised this legislation, so what happened next?



It is fair to say that the last 12 months has seen an unprecedented amount of uncertainty and change in executive remuneration, largely driven by regulatory intervention.

And as with any significant period of change, we will see some positive and some less positive effects. Whether we end up with a better system, only time will tell.

The Australian Government's interventions in executive remuneration have manifested themselves not only in a Productivity Commission inquiry and the release of revised APRA Prudential Standards requiring increased remuneration governance for regulated financial service entities, but also in legislative amendments to employee share schemes and termination payments to key senior executives.

But first, what do the tax reforms mean?

For most qualifying schemes, employees used to be able to choose to pay income tax in the year of grant based on the market value of the grant, and to later pay tax on any subsequent capital gain, with careful planning, at the 50% discounted rate. The tax reforms mean that this choice no longer exists. Provided there is a real risk of forfeiture, the tax payable on a grant made under an employee share scheme will now automatically be deferred until the year the grant vests, or in some circumstances, to a later year if there is a continuing disposal restriction on the grant. There are also new reporting restrictions imposed on employers.

Who is covered by the new rules?

The new share scheme tax rules became law in December 2009 and apply to employee share scheme interests acquired on or after 1 July 2009[1].

Shares[2] acquired under an employee share scheme for an amount less than market value are subject to immediate taxation (ie no deferral of tax), unless the shares:

- are subject to a real risk of forfeiture; or
- are acquired under a salary sacrifice arrangement (to a maximum of $5,000 in an income year).

Typical long-term incentive plans with TSR, EPS or other company-related performance hurdles will generally fall within these requirements, as will plans with a minimum employment condition in order for a grant to vest. But companies offering voluntary salary sacrifice plans (with the only restrictions being on disposal) to help build an equity ownership culture will have to review these plans carefully, because plans which allow employees to sacrifice in excess of the $5,000 cap will not qualify for tax concessions. Non-executive director fee sacrifice share plans are likely to disappear altogether.

Figure 12: Comparison of the old world to the new

	Pre-1 July 2009 grants	On or after 1 July 2009 grants
Tax deferral possible?	Yes – to "cessation time" if disposal restriction OR forfeiture condition	Yes – if there is real risk of forfeiture
Maximum deferral	10 years	7 years
Elect to tax at grant?	Yes	No
Employer reporting?	No – unless the deferred taxing point after 1 July 2009	Yes
Employer withholding?	No	Yes – but only where "No TFN/ABN"
Refund of tax paid upfront on forfeited awards?	Rights only	Rights and shares
Upfront $1,000 exemption	No income restriction	New $180,000 adjusted taxable income test
Limit on automatic deferral for salary sacrifice plans	No	Yes – only applies to share plans, with concession capped at $5,000 per employee per income year

1. The rules also capture interests acquired by employees before 1 July 2009 but which have not reached the deferred taxing point under the old rules. Transitional provisions allow the old tax treatment to apply, but only if those interests are reported by the employer to the ATO when the interests reach the deferred taxing point.

2. Including rights to shares.

Another share scheme commonly used to promote equity ownership is a $1,000 tax-exempt plan, typically offered to at least 75% of employees (in order to achieve eligibility for the $1,000 exemption). These tax-exempt plans are likely to continue to operate as they always have, with some minor changes, because the exemption is only available to employees with a maximum adjusted taxable income of $180,000. Companies will need to make sure their communications regarding these plans are clear about the consequences of an employee failing the income test.

Options, or rights, or shares, or something else?

Elections to be taxed at grant are now gone. As tax is now applied at vesting (unless there are continuing restrictions), different considerations may influence how a long-term incentive is delivered. While the tax treatment of equity is not (and should not be) the only consideration in determining incentive instrument selection, it is clearly something that companies cannot overlook.

Options were historically attractive, with tax usually payable on exercise. Now that options may be taxable on vesting, there is greater risk, as even 'underwater' options are subject to tax. Certain changes to plan designs can be made to mitigate this risk (eg modifying the lapsing conditions, shortening option life in certain events and changing the way vesting conditions apply).

We are already seeing evidence of option expiry dates shortening, because an option's taxable value decreases the shorter the option life. Alternatively, companies may impose a genuine disposal restriction on any shares acquired on exercise of the option, in which case the taxing point will normally be deferred until the disposal restriction lifts.

The performance rights plan continues its surge in popularity. We expect that over the coming years this type of plan will probably be the LTI plan of choice. This is helped by the fact that options can no longer be taxed at grant on a concessionary value:

- it is easier to align taxing point (at vesting) to the exercise – ie automatic conversion into shares on vesting
- tax deferral can be extended beyond vesting through use of disposal restrictions on shares acquired on exercise of rights, without the employee needing to fund any exercise price during any restriction period (ie nil exercise price)
- they cannot go 'underwater' (ie nil exercise price) so reduced risk of paying tax on a benefit which is never realised.

Performance shares have historically been the instrument of choice for some companies as they were seen to be a much more tangible reward, with the additional dividend yield benefit on top of any share price growth.

Unfortunately the new tax rules may expose company trusts that manage employee shares to a CGT liability when legal ownership of the shares is passed on to employees. This is a radical change, introduced at the very last minute, and will require some schemes to be redesigned.

The continued viability of share plans may require moving towards a more hybrid structure where the award is partly structured as a performance right at the time of grant, which then converts into a share subject to additional vesting conditions.

Thinking outside the box – a possible new plan

So do you still like options? A new plan structure may provide many of the benefits of these plans while providing more certainty on the tax outcomes – a share appreciation rights (SAR) plan.

A SAR is an entitlement which on vesting entitles an employee to a payment equal to the difference between the share price at exercise and the share price at grant, with the economic value able to be settled in cash or equity at the company's discretion (see Figure 13).

Regardless of which path a company chooses, the Government's intervention will result in companies reconsidering all of their equity plans. Whether the tax reform will result in a better system is still to be seen. However, as a catalyst for companies to review their equity plans, it may be that companies will have programs that are both more tax-effective and more reward-effective.

Terminating termination payments?

In targeting executive remuneration, the Australian Government has also focused on an issue which has raised the interest and ire of stakeholders in recent years: termination payments to key senior executives.

As a result of amendments to the Corporations Act, shareholder approval is required for termination payments to directors and key management personnel, where termination benefits exceed one year's "base salary" (a defined term). At first glance, it appears little more than a minor change limiting a payment on termination to 12 months' base salary. However, given the legislation's broad description of 'benefit', which includes payments in lieu of notice and the value of accelerated or automatically vested share-based payments at or as a result of termination, this has a much greater impact than may be first appreciated.

What does it actually mean?

In short, the legislation means that less can be paid to directors and key management personnel on termination, unless shareholder approval is gained first. Where there is a perceived reduction in the value of termination benefits being offered, there may be pressure for compensation by way of higher fixed pay. As a result, greater detail may need to be included in employment contracts or plan rules as to how and whether there will be accelerated or pro-rata vesting of STI and LTI plans on termination. Some companies may seek AGM approval for these contractual terms.

Figure 13: Advantages and disadvantages of SAR plans

Advantages	Disadvantages
• Simplicity • Shares (or a cash equivalent) are not required to be delivered until vesting conditions are met • The company can use either on-market or new issue shares or choose to settle in cash • Provides a higher degree of leverage in a high share-price-growth environment than available under a standard performance rights plan • Easier to align the taxing point to the time it is exercised, as it is not until exercise that the taxable value can be quantified • No exercise price funding requirements for the employees (who receive the spread value in the SAR) • Less dilution than options, resulting in less impact on EPS	• Where share price growth is flat or nil, will deliver limited or no reward, similar to an option plan • Given this is an innovative approach, may require a tax ruling before being implemented, to confirm likely tax treatment • Careful consideration needs to be given to securities law issues

While redesigning plans or the inclusion of greater detail may help to manage the issues in the future, a critical issue now is how the new laws apply to existing employment contracts. The new rules will not apply to existing contracts unless a relevant senior executive:

- enters into a new employment contract on or after 24 November 2009
- extends or renews their contract on or after that date; or
- has a variation of a condition of their existing contract which takes place on or after that date.

Given the broad definition of variation as "changes that affect an essential term, including any term relating to remuneration", the new laws could operate in a number of ways:

- It will not apply to existing contracts where changes to remuneration terms are already provided for in the existing contract – this could arise (although it would be unusual) where the terms of the contract provide for the executive's salary to increase by a specific percentage or figure (eg CPI increase)
- It will apply to existing contracts where changes to remuneration levels are made as a consequence of a mechanism in the contract – this could arise where the terms of an existing contract provide for the executive's salary to be reviewed and potentially increased, such as depending on the outcome of an annual performance review. Based on the guidance released, this appears to constitute a variation of a condition in the contract
- It will apply to existing contracts where changes to remuneration levels are made without any contractual mechanism – this could arise where there is simply a salary increase as a result of a salary/performance review, even though there is no specific mechanism in the contract. Once again, based on the guidance released, this appears to constitute a variation of a condition in the contract.

The last two points are not definitive and we recognise that there is some difference in opinion in the market. It is hoped that ASIC will provide some guidance on these issues at some point.

We strongly suggest that prior to any remuneration and/or contractual changes, you seek specific legal advice.

The bottom line

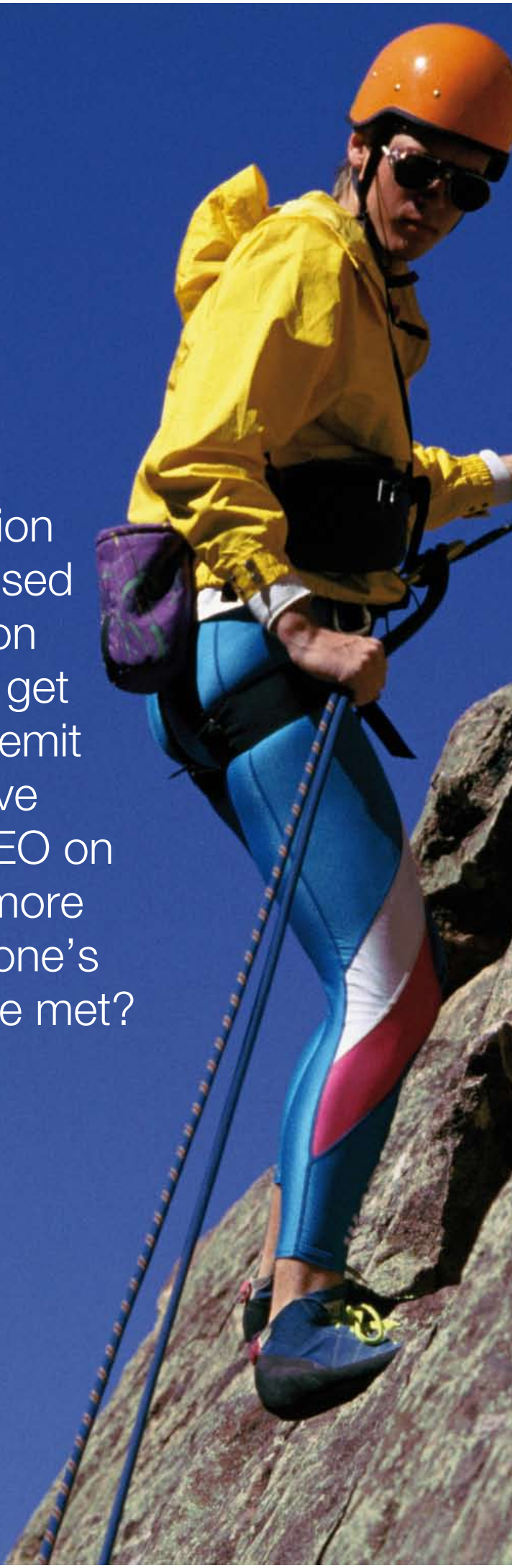
The upshot is that companies cannot discount the impact these legislative changes will have on equity and termination arrangements. Companies would be well advised to review their equity and termination arrangements to ensure that they operate as intended under the new legislation. At the same time, as tax and legal issues should not drive the primary purpose of any equity or termination arrangement, this may be an opportune time to review those arrangements to ensure that they continue to serve your desired objectives.

> "The unfortunate consequence of the new tax and termination pay legislation is that boards will struggle to find remuneration structures that encourage long-term initiatives that extend past the CEO's tenure. Similarly, it will be difficult to use pay to motivate successful succession. Many companies would like to hold back some executive pay for several years after a CEO leaves to foster good succession handover and good longer-term decisions. The new legislation effectively eliminates that possibility."

Diane Grady – Director of BlueScope Steel, Woolworths Limited, Goodman Group and Wattyl Limited and Senior Advisor to McKinsey & Co.

Who wants to be the chair of a remuneration committee?

Being chair of the remuneration committee is already recognised as one of the toughest jobs on the board – and it's going to get harder. As the committee's remit expands beyond the executive team, divergence with the CEO on responsibilities will become more common. So how can everyone's expectations pragmatically be met?



Change is coming

The global financial crisis has turned the spotlight on remuneration governance and on the role of the remuneration committee. For many external stakeholders, it's not just the impact on remuneration that is important. They feel that how well a company governs its reward system is a clear signal of how its governance operates more widely.

We expect changes to remuneration governance to be profound. Pressure is building because:

- there is a perceived triangle of mistrust between shareholders, boards/remuneration committees and management, which demands a more transparent and effective governance framework
- many of the Productivity Commission's recommendations are effectively focused on remuneration governance (see Appendix 1 for our summary)
- APRA has now mandated increased governance requirements for APRA-regulated institutions (see Appendix 2 for our summary)
- executives and HR teams are confused by the shifting sands of remuneration governance – they want greater clarity about who is responsible for what.

In APRA-regulated institutions, we have already seen significant changes or, at a minimum, formalisation of existing ad hoc processes. If these changes are not implemented, being the chair of the remuneration committee could become a full-time job. Even outside regulated institutions, shareholders' expectations of remuneration committees are increasing on issues such as:

- ensuring that performance and remuneration outcomes align and the remuneration arrangements do not encourage excessive risk-taking[1]
- the need for boards to exercise judgement – both for and against the benefit of executives
- the need for clear governance processes to maintain actual and perceived independence in decision-making
- greater transparency and proactive engagement with stakeholders.

Using judgement when exercising discretion

To date, the remuneration committee's use of discretion has been perceived somewhat negatively. Generally, shareholders have tended to suspect that the remuneration committee might use their discretion to pay high bonuses regardless of the formulaic inputs into the incentive plan. In other words, the sceptical view is that discretion is virtually always used in favour of the executives. So a 'good' incentive plan was one that minimised the use of discretion, while a 'bad' incentive plan was one where the remuneration committee had significant discretion to adjust bonus levels based on the overall performance of the company and the executive.

However, boards, shareholders and executives alike are now becoming aware that the strict application of formulas do not necessarily produce the fairest or most appropriate outcomes. Experience during the global financial crisis has proved that, in many instances, metrics set at the beginning of a performance year are often not valid by the end of the year.

Bodies such as APRA are now taking the view that, together with clear key performance measures, board judgement is a critical element in good incentive design. Specifically, the APRA standard requires remuneration policies to provide the board with discretion to adjust performance-based pay downwards (including to nil) if necessary to protect the financial soundness of the institution or to respond to significant unexpected or unintended consequences.

There is no doubt that the nature of the discretion held by remuneration committees, and the resulting expert judgement required, will become more complex. The use of risk-adjusted measures and the increased importance of deferral (and the decision about whether, and in what circumstances, to forfeit) mean that judgements made without substantiation are even more likely to be seen as arbitrary, inconsistent, or capricious – and therefore a source of legal risk.

In our view, the basis for determining bonuses will need to become more transparent, and with that will come the need for clear controls and processes to ensure that proper and defendable decisions are made.

1. These issues are covered in our articles "Risk and reward" and "Aligning reward to performance is an old idea … or is it?"

And that does not just mean adherence to general principles. It means:

- robust and documented evidence of how and why individual bonus decisions are made
- a culture in which adherence to those controls and processes is embraced
- more rigorous performance assessment. Documentation and scrutiny will be more detailed, from the individual bonus determination to the paperwork supporting the final decisions of the remuneration committee.

Remuneration governance

The remuneration committee's traditional role has been to provide oversight of senior executive remuneration, with reporting accountability to shareholders through the remuneration report. This remit has typically involved oversight of broader remuneration policy, but in practice this declines rapidly below the executive level.

It is interesting to consider APRA's approach to the remuneration committee's responsibilities, as it is potentially an indicator of the committee's expanding role in all sectors (not just financial services).

Under the APRA standard, the board and the remuneration committee's remit have increased substantially. The board is now required to review and approve the remuneration committee's recommendations regarding:

- the **remuneration policy**, which must cover at a minimum the remuneration structure for Responsible Persons[2], Risk and Financial Control Personnel[3] and all other people for whom a significant portion of total remuneration is based on performance and whose activities, individually or collectively, may affect the financial soundness of the institution
- the **annual remuneration structure** for the above people
- **individual remuneration arrangements** for the CEO, direct reports to the CEO, other people whose activities may, in the remuneration committee's opinion, affect the financial soundness of the institution, and any other person specified by APRA.

Given this increased remit and accountabilities, boards at APRA-regulated institutions are now considering whether the current governance framework is sufficient.

Let's consider what APRA is trying to change (or, at least, formalise) in financial services and whether there are similarities outside that sector. Broadly, APRA's focus is on:

- requiring the board to determine who in the organisation has a material impact on the long-term sustainability of the business
- ensuring the board (not just the remuneration committee) understands, and clearly articulates through a remuneration policy, the remuneration structures (mix of remuneration, key performance measures, appropriate recognition of risk and eventual outcomes) for those people[4]
- encouraging more frequent and regular review and monitoring of remuneration outcomes to ensure the remuneration policy is operating as intended, and is adjusted/amended as required.

Those key focus areas could (and many would argue should) apply outside the financial services sector.

With this increased role, will chairs of remuneration committees be expected to work full-time to meet all these expectations? This is unlikely. So how will it work in practice?

> "It is good practice for all remuneration committees (whether they be financial services companies or not) to have general oversight of all incentive plans across the company – the Committee should not be solely focused on the senior executives"
>
> *Graham Bradley – President, Business Council of Australia, Chairman, HSBC Bank Australia, Stockland Corporation, Angle American Australia Limited, Po Valley Energy Limited, Boart Longyear Limited, Director, Singapore Telecommunications Limited*

2. Responsible Persons is defined in APS 520 and excludes responsible auditors and non-executive directors.
3. Risk and Financial Control Personnel includes those whose primary role is risk management, compliance, internal audit or financial control.
4. In practice, many APRA-regulated institutions have chosen to implement a remuneration policy which covers all employees with specific reference to APRA's nominated groups as required.

A practical model for governance

A formal – yet pragmatic and workable – governance structure should be adopted to provide appropriate oversight, from the board to the remuneration committee down into the divisions. This structure should encompass an explicit role for the control functions, particularly HR and risk (and particularly in financial services), and should enable the remuneration committee to demonstrate appropriate oversight of the remuneration process.

For the remuneration committee to be able to demonstrate appropriate oversight, there must also be formal, rigorous oversight below the remuneration committee. This covers both the oversight of divisional decision-making and also the appropriate involvement of the control functions.

In our experience, the risk function has rarely been involved in the remuneration process; even the finance function's involvement has been somewhat limited. Too often the responsibility for the process is disproportionately borne by HR. Yet the complexity of modern businesses, and the requirement for a deep understanding of the financial and risk implications of remuneration arrangements, means that this arrangement is no longer viable. It is now necessary for the control functions' involvement in remuneration to be formalised.

A number of models may be appropriate, depending on the particular business structure and issues. Any such model should meet the following criteria:

- creates a direct line of oversight to the remuneration committee
- defines an explicit role for the control functions (eg HR, risk, finance)
- minimises disruption to business-as-usual through the line management structure
- enables the remuneration committee to provide assurance to the board, shareholders and regulators (as required)
- ensures appropriate flows of information in a timely manner
- provides appropriate checks and balances to manage conflicts of interest.

In practice, in large organisations this is going to require supporting structures such as a management remuneration committee (consisting of group control functions and, potentially, the CEO) and divisional remuneration committees (consisting of divisional control functions). Establishing the remit and membership of these committees is not trivial, and requires careful planning. In our experience, this is an area where a large number of firms will have to undertake significant changes.

A word of caution as remuneration committees find themselves delving into remuneration arrangements below the 'top team'. Traditionally, it has been the domain of the CEO and HR to design and implement these remuneration arrangements, with limited or no involvement from the board. We are seeing confusion among, and even conflicts between, the board and the CEO about who is responsible for what.

This confusion is avoidable. But this requires a clear governance framework which meets the criteria outlined above and, more importantly, engagement and involvement from the CEO and HR in the design and implementation of that framework.

Proactive engagement with stakeholders

A company's interaction with the outside world on remuneration matters has largely been via the remuneration report to shareholders. However, in our experience, too often this document is driven by compliance rather than by communication considerations. For remuneration reporting to be based on a premise of communication, companies need to establish a proactive program of interaction that takes into account the needs of multiple stakeholders.

Effective remuneration reporting as communication will have the following characteristics:

- consistency of message in the submissions going to different stakeholders
- explanation and justification of policies, rather than just a presentation of bare facts
- clarity of expression, avoiding remuneration jargon. This is supported by the Productivity Commission's recommendation that remuneration reports should include a summary, in plain English, of the company's remuneration policies
- a focus on simplicity and transparency rather than volumes of information that are difficult to understand.

For larger companies, the chair of the remuneration committee should be prepared to meet face-to-face regularly with key shareholders. Their time commitment is likely to increase as a result of this new role as spokesperson and advocate for the firm on remuneration matters. The boundary between remuneration reporting and public relations will blur.

In our view, companies will need to make their case on remuneration in a much more compelling, sensitive and thoughtful way than in the past. This will be valued by stakeholders. Those companies that succeed in getting their message across will have much greater freedom of action.

> "Whilst there is a certain inevitability of complex remuneration design, we need to minimise that complexity and focus on clearly and simply explaining the executive remuneration strategy and practices to our stakeholders. Improved communication will go a long way to rebuilding trust"
>
> *Brian Schwartz – Director of Brambles, IAG, Westfield Group*

Stakeholder engagement – what does it achieve?

As greater scrutiny is applied to companies' remuneration governance, it is easy to forget that the existing governance system has not failed completely. After all, shareholders remain generally supportive of the remuneration arrangements in Australian companies. Even this year, more than 83% of companies received the support of over 80% of shareholders for their remuneration report (see Figure 14). This is surely indicative that the problem is not widespread.

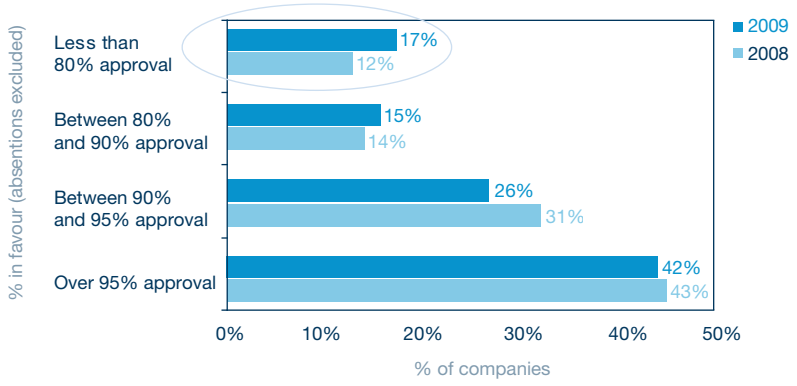
Rather, the issue has been the minority of situations where shareholders are showing greater opposition. These cases generate a profile out of all proportion to their frequency, and give rise to the impression of a wider problem.

Summing up

The burden on remuneration committees is about to increase, particularly in financial services companies. Delivering change in governance processes will take time. However, the greater scrutiny and interest in remuneration outcomes and remuneration governance is not going to abate.

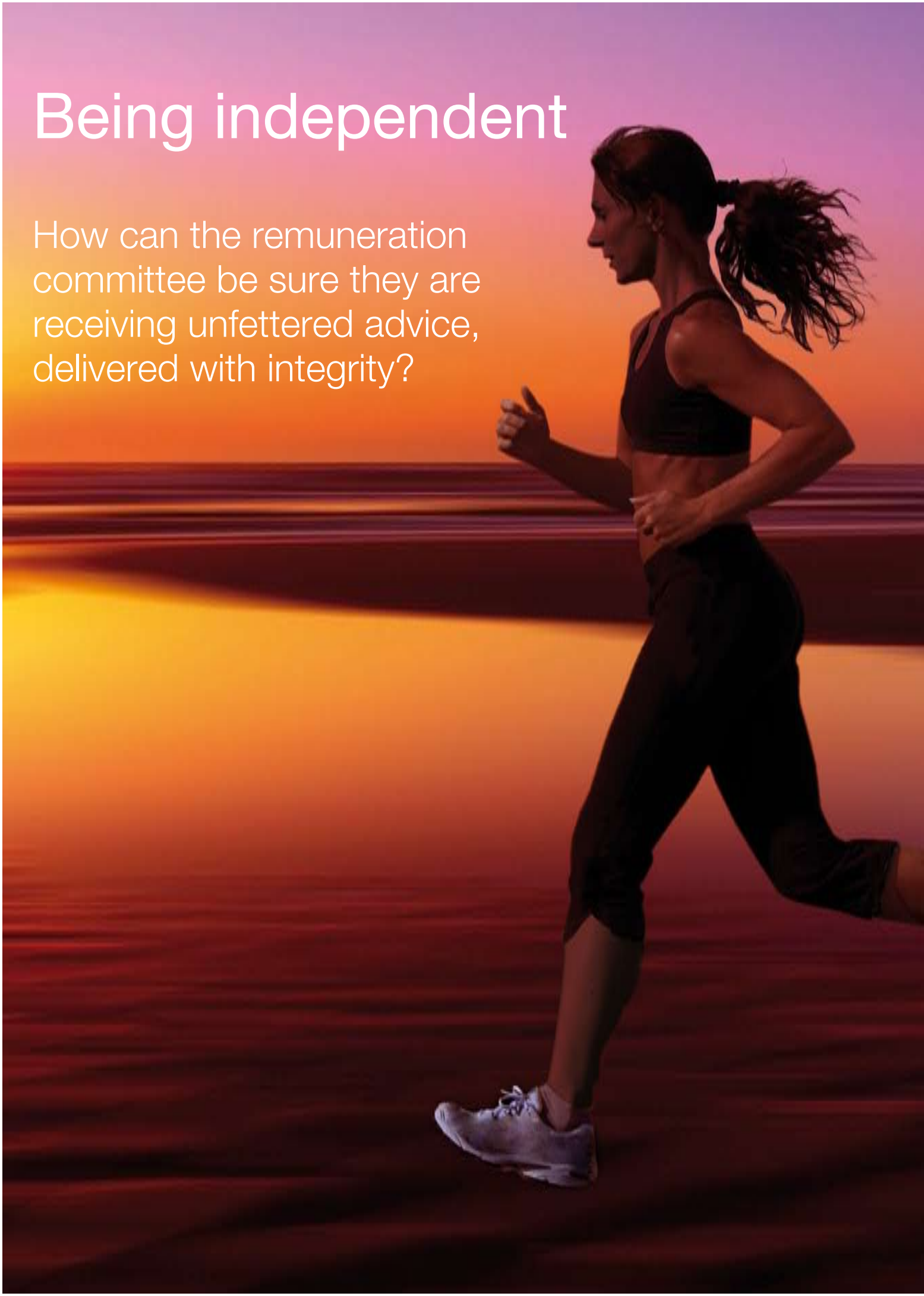
As companies prepare for this new world of remuneration, it is valuable to remember that all of the stakeholders have the same goal – to increase value that results in shareholders getting a good return on investment, and a fair sharing of the gains by those who directly contributed to it. And the tools to achieve this? Performance alignment. Discretion. Governance. Engagement. And greater understanding by all.

Figure 14: ASX 100 remuneration report voting outcomes



Being independent

How can the remuneration committee be sure they are receiving unfettered advice, delivered with integrity?



The perception and the reality

Remuneration committees and their consultants have both been charged with lacking independence from management in the setting of executive remuneration. The accusation goes further: that this leads to an unjustified inflationary spiral. We believe that, to the extent that there is a problem, it is not because of the formal governance rules, which in our view have been perfectly adequate. Rather, the focus needs to be on behaviour, and how the various parties including consultants work together within the 'new' boardroom.

Advice in whose interest?

Remuneration consultants are being increasingly blamed for having an inflationary impact on executive pay. The accusation is that they get hired by convincing the CEO he or she is underpaid. They then persuade remuneration committees to accept unjustified remuneration packages, before forcing them on unwilling shareholders. Worse still, they use their skills in achieving high remuneration levels for the executives to win other lucrative contracts with the company. Some parties propose that the only way to reduce this potential conflict is for external remuneration advisers to work solely for the remuneration committee and to do no work for management.

This analysis would have some validity if remuneration were set purely on the basis of a consultant's recommendations, using data to which only the consultant was privy, and without checks and balances. But this is not the reality. With full disclosure of remuneration for key management personnel, a remuneration committee can see the remuneration of comparators on a company-by-company basis. Many large companies also disclose their remuneration structure for the following year. False predictions about remuneration trends will therefore become obvious within a short space of time.

The important point is that the remuneration consultant is not giving an opinion on which others must rely without access to the underlying evidence. Instead they are providing data and ideas to be used as the basis for remuneration committee's judgement and decision-making. The results of those decisions are then made fully public to shareholders, who analyse and decide whether or not to support them. Serious failures of independence by a remuneration consultant would very quickly become public, resulting in the destruction of that consultant's reputation and business.

Be careful what you wish for

But given the importance of rebuilding public trust in executive remuneration, surely it is better to avoid even the perception of a conflict, and to mandate the use of entirely independent advisers (such as the route implied within APRA's latest Prudential Practice Guide)? We think not, for two reasons:

- Focus on this issue would distract from the areas of executive remuneration where change is genuinely required
- The unintended consequences of the change in rules could be worse than the problem it is trying to solve.

More on the first point later. What of the unintended consequences?

There are practical constraints. Remuneration advice is becoming increasingly complex. It requires firms with access to international networks of remuneration advisers; technical skills covering tax, accounting, legal and valuations; risk and performance measurement expertise; stakeholder communication skills; and so on.

Firms with the scale to support the required investment in learning, skills, and infrastructure are unlikely to submit themselves to the constraint of only being able to provide advice to the remuneration committee. This would drive remuneration committee advice into a boutique business area, with the inevitable consequence that management would then need to appoint its own adviser in order to access the depth and breadth of skills required to achieve a rounded remuneration solution.

This dual adviser model has the risk of institutionalising conflict where none need exist. An advocacy model can arise, with one adviser batting for management and the opposing adviser batting for the remuneration committee. Not only does this duplicate costs (which would be particularly onerous for smaller companies), it also reduces the incentive to achieve a balanced outcome.

As is often the case with changes to governance rules, the danger is that the only beneficiaries are the professional advisers for whom additional fees are generated.

Focus should be on behaviours

The key issue is not whether the adviser also works for management, but how their inputs are used by the remuneration committee.

Executive remuneration advisers often provide market data on remuneration levels. This is meant to be only one of many inputs into remuneration decisions, however more and more remuneration committees are becoming dependent on it. Why this is the case? As ever, there is a mix of reasons, some good some bad.

It is a core function of remuneration committees to ensure they have policies that attract and retain talented executives. Ensuring they are appropriately competitive against the packages offered by other companies is an important part of this.

Problems arise, however, when the remuneration committee uses the market data as a silver bullet: when they are afraid to deviate from market practice because it is safer to be part of the pack and to 'do what everyone else is doing'. Being an outlier is an uncomfortable, exposed place to be. In addition, data provides a helpful way to side-step difficult discussions. Relying on a median figure to set the remuneration package of a CEO avoids the need for difficult and emotionally charged discussions in the boardroom about performance and pay.

It is the responsibility of remuneration committees to be independent, and to organise their advisory relationships to ensure this. A focus on consultants avoids the core issue: how their advice is used. No amount of governance will bring about change if this core issue remains unaltered.

If appropriate protocols are established upfront, it is our view that executive remuneration advisers should be able to work with both the board and management on different remuneration engagements. Difficulties can obviously arise where the adviser is placed in a position where they are effectively acting on behalf of both the board and management on the same remuneration matter.

How to be independent in matters of pay

The remuneration committee should satisfy itself that the advice is delivered with integrity and is unfiltered. There is no single model for achieving this, and committees will meet this responsibility in different ways.

Where there is a single adviser, it should be crystal clear that in their task of developing an executive remuneration strategy, the remuneration consultant is accountable to the remuneration committee as the delegated sub-committee of the board. This makes clear their responsibility to produce the optimal outcome rather than acting as a management advocate.

This can be reinforced by creating a direct line of communication between the remuneration committee chair and the adviser, setting up clear protocols for flow of information and advice, and providing regular opportunities for the whole remuneration committee to question the adviser without management present.

But it is not all about the relationship between the remuneration committee and its advisers. More important is how independently the committee behaves, and behaviour is different from process.

In business, as in life, conflicts cannot be avoided – they must be managed. As we have stated elsewhere, there is plenty that is not working in executive remuneration. Our view is that the current governance rules for executive remuneration provide all the tools required to provide a mutually satisfactory outcome for shareholders and executives, while rebuilding the trust of wider stakeholders. It is now up to all of us involved in the process, including remuneration consultants, to raise our game to prove it to be so.

> "Remuneration committees need to become much more independent. Traditionally, committees have 'reacted' to proposals put to them by management. In the future, remuneration committees need to be proactive in determining remuneration structure and principles for senior executives. For many companies this will require non-executive directors to have significantly greater involvement in policy setting than in the past, and far greater understanding of remuneration complexities."

Diane Grady – Director of BlueScope Steel, Woolworths Limited, Goodman Group and Wattyl Limited and Senior Advisor to McKinsey & Co.

Choppy waters

We are in a period of unprecedented complexity for remuneration committees. What should be the priorities for 2010?

It is clear from the previous articles in this publication that remuneration committees are facing a lot of work in 2010 and beyond. Figure 15 shows a proposed 2010 work cycle for most remuneration committees.

When working through the cycle, although committees are likely to encounter some unique company-specific issues, they will almost certainly need to consider the following common challenges, related to the segments.

1. Adapt your approach to reflect the regulatory changes

For those companies within the financial services sector, the road map is a bit clearer – the APRA Prudential Standard covers a whole range of items for the remuneration committee to consider during 2010 and beyond.

For those in other sectors, remuneration committees need to review their internal and external environment and consider how well their approach to remuneration is aligned.

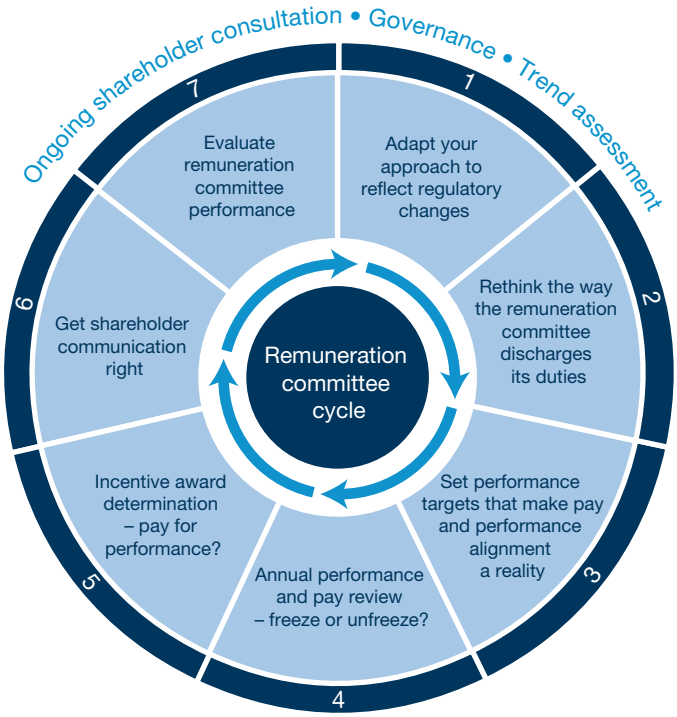
At first glance this might appear to be a simple exercise that could be dealt with via a simple compliance checklist. However, those who have attempted it in practice have found that it is much more complicated, with many different views being voiced. Serious issues are raised that require consideration by the remuneration committee at subsequent meetings. Comprehensive planning of the committee's annual work program will therefore be essential.

2. Rethink the way the remuneration committee discharges its duties

The remuneration committee's remit is being extended and the way in which it discharges its responsibilities is also changing. In reviewing how it discharges its duties, the remuneration committee will face some challenging issues.

For example, how will the committee deal with the oversight of all incentive arrangements within the company? At what point will it engage external advisers? How will it ensure risk is appropriately balanced and the duties appropriately discharged between the risk and remuneration committees? How will it deal with two consecutive high shareholder votes against the remuneration report?

Figure 15: 2010 remuneration committees' work cycle



These are not easy issues and they require considerable thought before any changes are made. A balance needs to be struck between oversight and governance on the one hand, and, on the other, the freedom of management to use remuneration as a strategic tool to support enhanced performance.

During 2010, remuneration committees should be considering at a minimum the potential impact of new guidelines and evolving practices on their role, charter and method of operating.

3. Set performance targets that make pay and performance alignment a reality

The value derived from linking business strategy, performance management and remuneration strategy, as outlined in the chapter "Aligning reward to performance is an old idea – or is it?", warrants serious consideration.

We suggest that now is the time for remuneration and performance management models to be truly tailored to business strategy. The benefits of such an approach will likely be more important than ever in the challenging times ahead.

4. Annual performance and pay review – freeze or unfreeze?

Fixed pay reviews will be a tricky area in 2010. Last year approximately one third of ASX 100 companies froze executive salaries, and others made only modest increases. It is likely that executives are expecting a fixed pay review this year, on the basis that it is de-motivating to freeze salaries two years running.

Looking forward, there will also be significant tensions with shareholders, who are not all of the view that one year of pay restraint is sufficient given the severity of the downturn and the impact on profits and share price.

Issues to be aware of in the fixed pay debate:

- Evolving shareholder attitudes and guidance – how strongly will they push for a continued pay freeze?
- The economy – indications of a double-dip recession could change sentiment on pay increases very quickly.
- Politics – recent evidence of government intervention in new legislation and regulation has shown how hard it is for politicians to resist public pressure in the executive remuneration area. How much further will politicians push this issue?

These are matters on which remuneration committees need to keep a close eye, and ideally defer decisions until as late as possible.

5. Incentive award determination – pay for performance?

Another major focus for 2010 will be the appropriateness of performance measures and targets in respect of short- and long-term incentive plans.

Many remuneration committees have spent considerable time debating and mapping out potential changes to performance measures, in respect of both the measures themselves, and also – more importantly – the absolute targets. We have seen a number of companies reducing performance targets in long-term incentive plans. This requires not only careful calibration and scenario testing, but also real craftsmanship in respect of how such changes are communicated to shareholders.

Committees will need to take seriously the institutional shareholder view that if performance targets are reduced from historic levels, the incentive opportunity should be correspondingly lower. This approach needs to be balanced against the requirement to motivate executive teams through an extremely difficult period. Committees will need to be prepared to explain how they addressed this issue and, in the remuneration disclosures, exactly how they reached their conclusions.

The handling of bonus outcomes for 2009/10 will also require care. Bonuses were reduced in 2009, on average by about 20% from the previous year. This can be explained by the fact that the recession hit many businesses in the last half of FY2009, and so did not affect the full year results too badly. However, the recession did hit early enough for companies to reset their incentive targets for 2010.

Many remuneration committees were sensitive to the lower profit outlook and set targets for FY2010 that were tougher, relative to budget, than would previously have been the case. In a number of cases, this resetting may mean that bonus payments rise while profits continue to fall. The communication of this issue needs to be handled carefully. It could be one of the biggest sources of dispute in the 2010 AGM season. Remuneration committees should therefore be sensitive to this when considering applying discretion in determining bonus outcomes.

6. Get shareholder communication right

The remuneration report is one of the key tools of effective shareholder communication, but not the only one. Proactive engagement with all key stakeholders will be tangibly valued, and those companies that do so will benefit from a much greater freedom of action.

The process for effectively managing the AGM and remuneration-related resolutions needs to be elevated on the remuneration committee's agenda, particularly if the Productivity Commission's for the 'two strikes test' proposal is adopted in legislation.

The two strikes test proposal recommends that where a company receives a 25% or higher against vote against its remuneration report for two years running, a resolution be put to shareholders that the elected directors who signed the directors' report stand for re-election at an extraordinary general meeting (EGM). If this resolution is carried by more than 50% of eligible votes, the EGM would have to be held within 90 days.

We therefore anticipate that in future the remuneration committee will spend a great deal more time on disclosure, shareholder consultation and preparation for the AGM.

7. Evaluate remuneration committee performance

It will be a busy year for remuneration committees in all sectors. More regular or longer meetings may be required than in previous years to cover all the relevant items in an appropriate manner. There will be a need for education about trends. Remuneration committees should consider holding sessions without the goal of formal decision-making, purely with the aim of reviewing trends, their possible impact on the strategic landscape, and their impact on the committee's agenda.

Given the increased requirements on the remuneration committee, its performance will need to be assessed annually, with the outcome of that assessment reviewed by the board.

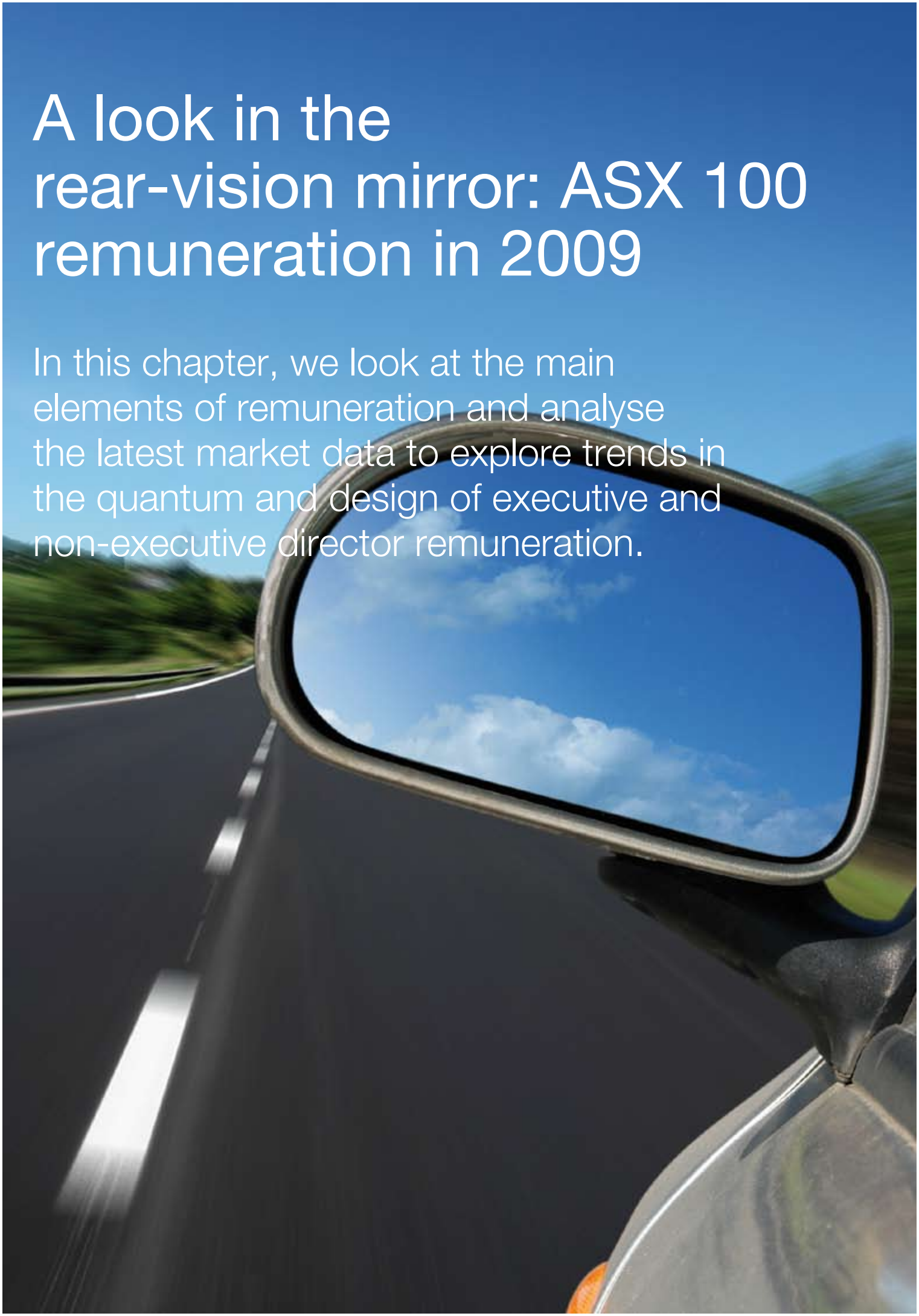
> "On the 'two strikes rule', this will actually reduce the number of 'no' votes on remuneration reports as shareholders will be concerned about the possible implications of a high no vote. The proposal is not justified by the scale of the problem and is generally bad governance practice. I hope it is rejected by the Government".
>
> *Graham Bradley – President, Business Council of Australia, Chairman, HSBC Bank Australia, Stockland Corporation, Angle American Australia Limited, Po Valley Energy Limited, Boart Longyear Limited, Director, Singapore Telecommunications Limited*

Wrapping up

We believe that 2010 will continue to present many challenges for remuneration committees. Now is the time for remuneration committees to act to ensure they are well placed to meet these challenges.

A look in the rear-vision mirror: ASX 100 remuneration in 2009

In this chapter, we look at the main elements of remuneration and analyse the latest market data to explore trends in the quantum and design of executive and non-executive director remuneration.



Total remuneration and mix

The total remuneration levels (see Figure 16) of CEOs, CFOs and other disclosed executives within ASX 100 companies have not changed dramatically at the median in the last year, with a slight decrease in total remuneration for CEOs, and no change for CFOs and other executives.

Breaking total remuneration into the various components shows an interesting picture. Fixed pay at the median of the ASX 100 for CEOs, CFOs and other executives increased slightly, but the median short-term incentives paid decreased significantly as the impact of the GFC set in. Long-term incentives valued at grant increased for CFOs and other executives, but decreased slightly for CEOs. This may have been due to an increase in scrutiny of CEO remuneration practices by various stakeholders.

A look at the remuneration mix at the median of the ASX 100 further confirms the reduction in STI value as percentage of the total remuneration mix (see Figure 17).

The level of total remuneration continues to have a high correlation with market capitalisation, even with significant swings in company share prices over the past 12 months (see Figure 18).

Figure 16: ASX 100 CEO, CFO and Executive total remuneration levels

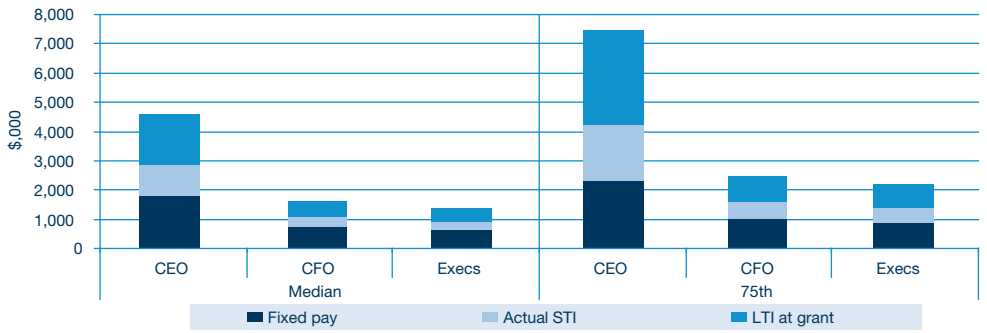


Figure 17: ASX 100 CEO, CFO and Executive remuneration mix – 2008 and 2009

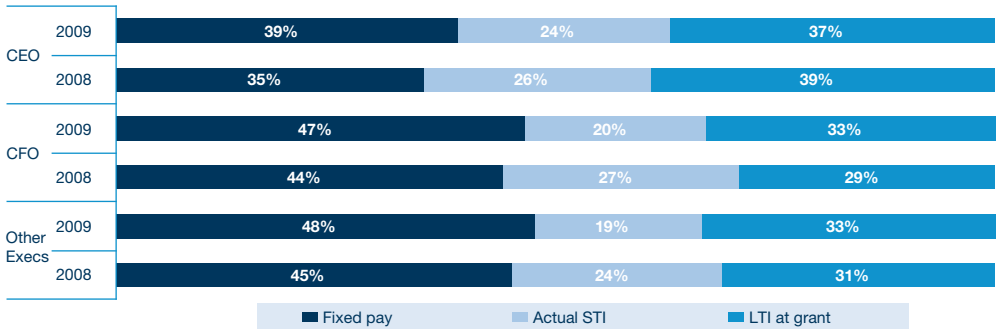
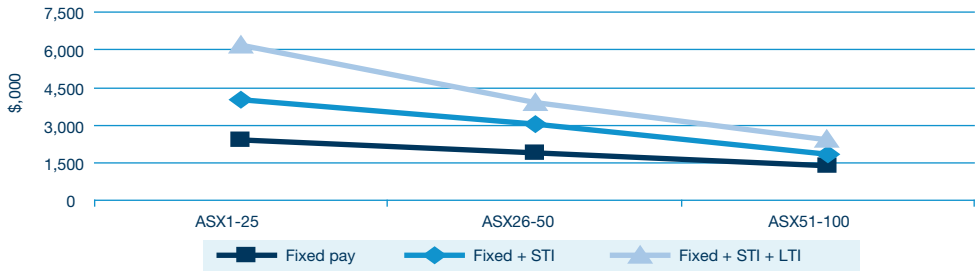


Figure 18: ASX 100 CEO median remuneration levels by company size (market capitalisation)



Fixed pay

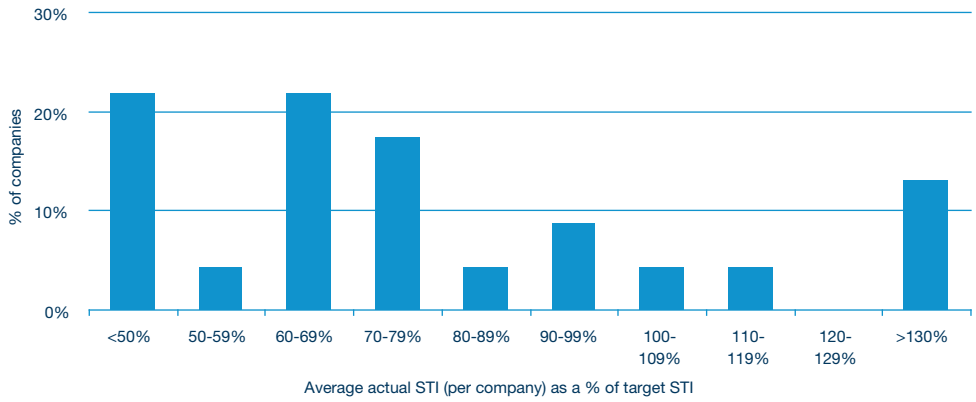
Over one-third of companies announced that fixed pay would be frozen for the 2009/10 pay review, with only a few announcing that they would reduce executive fixed pay. The remaining companies either made no announcement on the topic, or announced that existing policies would continue to apply.

Short-term incentives

The impact of the GFC was felt by executives in 2009, with the largest decreases in their total remuneration being attributable to reductions in STI. This is particularly evident in the substantial drop in the amount of STI actually paid compared to target STI (see Figure 19). Approximately 21% of ASX 100 companies paid an STI that was at or above the target STI amount in 2009, compared to 45% in 2008. Significantly, 13% of companies paid at least 130% or more of their target STI amount. This is only slightly below 16% for the same achievement in 2008, suggesting top performing companies continue to pay above-target incentives even in tough economic conditions.

At the other end of the scale, approximately 22% of companies in the ASX 100 paid actual STI at 50% or less of their target STI, not surprisingly a significant increase compared to the 6% in 2008.

Figure 19: ASX 100 average actual STI (per company) as a percentage of target STI



Deferred short-term incentive plans

Approximately 32% of ASX 100 companies now operate a deferred STI plan with compulsary deferral. We expect the percentage of companies with compulsory deferral plans to increase, particularly given APRA requirements within the regulated financial services sector.

It is likely that voluntary deferral plans will largely become redundant as a result of the Federal Government's tax rule changes.

Approximately two-thirds of companies operating deferred STI plans use shares as the instrument of deferral, with the remainder simply deferring cash.

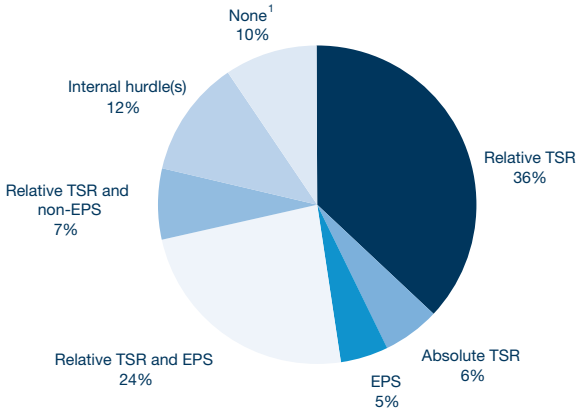
Levels of compulsory deferral range between 33% and 50% of the actual STI payment. Of the companies where deferral is compulsory, the time period for deferral typically ranges from one to three years.

Long-term incentives

Relative TSR as a sole hurdle remains the most common LTI performance hurdle and now accounts for 36% (26% in 2008) of the LTI plans of companies in the ASX 100 (see Figure 20).

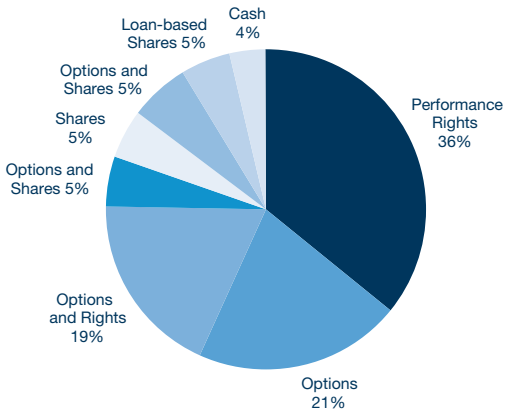
With respect to LTI instruments, performance rights continue to be the most commonly used instrument, followed by options. There are also a large number of companies that offer both options and rights to their executives (see Figure 21). With 2009 performance leaving some option grants 'under water', and the changes to share plan tax rules, we expect to see a greater shift towards the use of performance rights as the sole instrument.

Figure 20: ASX 100 LTI performance hurdles



1. 'None' is made up of plans with time based vesting only, and most are option plans

Figure 21: ASX 100 LTI instruments



Non-executive director fees

Fee levels for NEDs at the median of the ASX 100 (see Figure 22) have slightly increased over the last year, despite a small number of companies announcing a NED fee cut, and approximately a quarter announcing a NED fee freeze in 2009.

Committee fees, for being either the chair or a member of a committee, have also increased, with the exception of remuneration committee members, where no increase was observed. There was a significant increase for audit committee chair fees, likely reflecting the increased work load in risk assessment through the GFC.

Figure 22: ASX 100 median NED fees

Role	Median fees ($)
Chairman total fee	391,000
Non-executive director base fee	145,000
Committee fees	
Chair – Audit Committee	36,000
Member – Audit Committee	16,000
Chair – Remuneration Committee	21,000
Member – Remuneration Committee	12,000

Methodology

Item	Explanation
Fixed pay	• Base pay includes salary, superannuation, non-monetary benefits and leave accruals. • Where disclosed, any amounts relating to expatriate benefits, termination payments and one-off retention amounts have been excluded.
Short-term incentive (STI)	• STI market data refers to the actual STI received, not the target STI opportunity. It includes the value of any deferred equity or deferred cash that is awarded as part of the STI plan. • STI data excludes nil bonuses.
Long-term incentive (LTI)	• The LTI amount has been determined by using a Black Scholes valuation. • LTI data excludes nil LTI amounts.
ASX 100	• ASX 100 companies were selected on the basis of three-month average market capitalisation to 1 December 2009. • Trusts, infrastructure groups, and companies not domiciled in Australia have been excluded.
Data sources	• Data is based on most recently released company annual reports from 31 December 2008 to 30 September 2009.

Appendix 1: Productivity Commission final report on executive remuneration

The Productivity Commission's final report on executive remuneration was released on 4 January 2010. This report is now being reviewed by the Australian Government and a response is expected during the first quarter of 2010.

The Productivity Commission's final recommendations are largely pragmatic and acknowledge that the current system is fundamentally sound but could benefit from some strengthening of the governance framework.

The report's recommendations acknowledge that remuneration practices are context specific and should therefore be structured according to a company's individual needs as opposed to a 'one size fits all' approach.

The Commission has taken a holistic view, by attempting to bring together the various regulations, principles and guidelines on executive remuneration.

One of the more material recommendations is the "two strikes test". Where a company receives a "no" vote of 25% or higher on their remuneration report for two years running, a resolution is required to be put to shareholders that the elected directors who signed the directors' report stand for re-election at an Extraordinary General Meeting (EGM). If this resolution is carried by more than 50% of eligible votes cast, the board would be required to hold this EGM within 90 days.

The 17 recommendations and 2 findings aim to strengthen governance and remuneration practices – however many organisations have already adopted some of these practices voluntarily. Accordingly, some of the proposed changes will not be a substantial additional burden for companies.

Productivity Commission recommendations	What this means / PwC view
1. Any declaration of "no vacancy" at AGM to be agreed by shareholders – Where the board seeks to declare no vacancies and the number of directors is less than the constitutional maximum, shareholder approval should be sought – Boards to retain their powers to appoint directors and fill or leave vacant casual vacancies throughout the year.	• Greater shareholder input on board size and composition.
2. Ensure remuneration committee independence – "if not, why not" – The ASX Corporate Governance Council should specify that all remuneration committees: – have at least 3 members and be comprised of NEDs, with the majority of the NEDs and the chair being independent – have a charter setting out procedures for non-committee members attending meetings.	• No major impact as the ASX Corporate Governance Council already specifies that this is good practice and many companies already meet the independence requirement. • Some companies may need to revisit their charters to ensure they have appropriate procedures for non-committee member attendance. This should involve a period of time in the Remuneration Committee meeting that is set aside for just committee members.
3. Ensure remuneration committee independence - ASX Listing Rule – A new ASX listing rule should specify that all ASX 300 companies have a remuneration committee and that it should be comprised solely of NEDs.	• No major impact as many ASX 300 companies already meet this requirement.

Productivity Commission recommendations	What this means / PwC view
4. Prohibit key management personnel (KMP) (includes directors) voting on remuneration reports – Amend Corporations Act to prevent KMP from voting their shares on remuneration reports and any resolutions related to those reports.	• Mainly impacts organisations for companies where the KMP have significant shareholdings. Where the KMP own the majority of shares, the situation could arise where remuneration policies are being determined by the minority of shareholders which PwC does not believe is appropriate. • PwC believe this recommendation is better incorporated into the ASX Guidelines rather than being incorporated into the Corporations Act. This sends the message that it is best practice for KMP not to vote their shares on remuneration reports, however it also gives companies the flexibility not to comply with this requirement if they believe it is not appropriate for their circumstances.
5. Prohibit executives hedging equity – Amend the Corporations Act to prohibit executives hedging unvested equity or vested equity subject to holding locks.	• The prohibition of hedging unvested equity should not be a major issue for most companies as many already prohibit this practice. • The prohibition of hedging vested equity subject to holding locks should also not be a major issue, however PwC's view is that executives should be able to hedge this equity if they wish to do so. This is because once the equity has vested, the executive is absolutely entitled to it and, subject to trading restrictions and company policy, it is similar to other personal investments.
6. Prohibit KMP (including directors) voting undirected proxies on remuneration reports – Amend the Corporations Act and relevant ASX listing rules to prohibit KMP from voting undirected proxies on remuneration reports and any resolutions related to those reports.	• Implementation will likely prove challenging; undirected proxies could represent a large number of potential votes on remuneration-related issues.
7. The Corporations Act should be amended to require proxy holders to cast all of their directed proxies on remuneration reports and any resolutions related to those reports.	• Implementation may prove challenging.
8. Improve information content of remuneration reports to include: – a plain English summary statement of companies' remuneration policies; – actual levels of remuneration received by the individuals named in the report – total company shareholdings of the individuals named in the report. The Australian Government should establish an expert panel under the auspices of the Australian Securities and Investment Commission to advise it on how best to revise the architecture of section 300A of the Corporations Act 2001 and the relevant regulations to support these changes.	• Many companies already spend considerable time trying to make their remuneration reports as readable as possible. The challenges come from trying to comply with the Corporations Act and Accounting Standards mandated disclosures while attempting to present information shareholders would like to see. • Actual realised levels of reward will require careful definition to ensure disclosures have been made using similar principles. There are also real challenges in relation to the timing of the valuation – eg is it at the earliest vesting point, when the holding lock is released or when the shares are sold? • Revising the Corporations Act and regulations to improve the information content of remuneration reports is complex. This is due to the multitude of stakeholders, their different information needs and the desire to keep remuneration reports as simplistic and easy to understand as possible. PwC therefore agrees with the Productivity Commission that an expert panel should be established to consider these issues.

Productivity Commission recommendations	What this means / PwC view
9. Remove superfluous disclosure – The Corporations Act should be amended such that only KMP remuneration levels are required to be individually disclosed – The requirement to also disclose the top 5 highest paid executives should be removed.	• Positive simplification of remuneration disclosure.
10. Disclosure of remuneration advisers – The ASX Corporate Governance Council should recommend that companies disclose their remuneration advisers, who appointed them, who they reported to, and the nature of other work undertaken for the company by those advisers.	• Greater remuneration disclosures. • PwC is supportive of the recommendation for companies to disclose their remuneration advisers, however we believe that further guidance should be provided to companies in respect of how they should meet this recommendation. For example, often remuneration advisers may advise the board or management on specific remuneration arrangements rather than the company's entire remuneration strategy. If remuneration advisers are named, the broad nature of the advice requested should also be disclosed. PwC also believe that this recommendation should only apply if the board or remuneration committee acted upon the advice of the remuneration consultant as otherwise the disclosures will be misleading. • PwC does not believe it is necessary for the company to be required to disclose the nature of other work undertaken for the company by the remuneration adviser. This is because firms can legitimately provide other services to companies, such as tax, accounting, legal or other consulting advice provided that appropriate protocols are in place.
11. Require ASX 300 remuneration advisers to be independent of management – The ASX listing rules should require that where an ASX 300 company's remuneration committee (or board) uses remuneration advisers in respect of KMP remuneration that these advisers be commissioned by, and their advice provided directly to, the remuneration committee or board, independent of management. – Confirmation of this arrangement should be disclosed in the company's remuneration report.	• This recommendation will be familiar to APRA-regulated institutions as this is similar to the APRA Prudential Standard on Governance. • Management will still be able to engage a remuneration adviser and this adviser can still be the same as the adviser to the remuneration committee / board. This requirement is about ensuring that where the remuneration committee / board uses advisers that they will need to be commissioned by, and report directly to, the remuneration committee / board.
12. Institutional investors should disclose their voting on remuneration reports and other remuneration related issues – Initially this should be progressed on a voluntary basis by institutions in collaboration with their industry organisations.	• It is likely to become more difficult for companies to forecast how institutional investors will vote their shares on remuneration-related resolutions. This is because the disclosure of institutional investor voting may change their voting patterns. • Implementing this practice on a voluntary basis in collaboration with industry organisations is likely to result in different outcomes.
13. Remove termination of employment as a taxing point under the employee share scheme income tax rules for equity that qualifies for tax deferral and is subject to risk of forfeiture.	• Companies will be able to align executive remuneration to long-term company performance even after the executive has terminated employment. • Aligning executive pay to long-term company performance has been emphasised internationally by the Financial Stability Board and the G20 and locally by APRA.

Productivity Commission recommendations	What this means / PwC view
14. ASIC should confirm that electronic voting is legally permissible without the need for constitutional amendments.	• No material impact.
15. The Corporations Act should be amended such that: – where a company's remuneration report receives a "no" vote of 25% or more, the board should be required to explain in its subsequent report how shareholder concerns were addressed and, if they have not been, the reasons why – where the subsequent remuneration report receives a "no" vote of 25% or more, a resolution be put that the elected directors who signed the directors report for that meeting stand for re-election at an EGM. Notice of the re-election resolution would be contained in the meeting papers for that AGM. If this resolution is carried by more than 50% of eligible votes, the board would be required to hold an EGM within 90 days.	• This is one of the more material recommendations and is likely to discourage companies from adopting innovative and company-specific remuneration plans that deviate from traditional remuneration plans for fear of a high "no" vote. • The importance of shareholder engagement will increase as companies will need to understand what aspects of their remuneration practices are being voted down which is not clear by a "no" vote on the entire remuneration report. These issues may also differ from investor to investor. • The re-election resolution has the potential to cause substantial instability and may discourage investors from voting "no" on the remuneration report. In addition, shareholders that submit their votes prior to the AGM are placed in a difficult position because they need to vote on the re-election resolution not knowing whether this resolution will be activated and, if it was activated, the extent of the "no" vote. • PwC does not believe that there is any reason for change in this area. This is because the non-binding vote on remuneration reports is already working effectively as seen by the fact that the vast majority of companies who receive a significant "no" vote address any issues the following year. In addition, shareholders elect directors to act on their behalf in terms of determining the company's strategy, which includes the remuneration strategy. If shareholders are not comfortable that the directors are acting in their best interests, there is already a mechanism in place not to re-elect that director when they present themselves for re-election which occurs every three years. • That said, PwC is supportive of the first part of the Productivity Commission's recommendation as this promotes greater shareholder engagement and consultation. • PwC is not supportive of the second part of the recommendation for the reasons noted above.
16. If the ASX does not give effect to recommendations 3 or 11 and / or the ASX Corporate Governance Council does not give effect to recommendations 2 or 10, the Australian Government should give consideration to putting into effect the intent of those recommendations through legislative means.	• Requirements will be more stringent as they will be legislated as opposed to some of the recommendations that have currently been put forward on an "if not, why not" basis.
17. There should be a review of the corporate governance arrangements that emanate from the Australian Government's response to this report. This should be conducted no later than five years from the introduction of the new arrangements.	• PwC supports the review process.

Findings	What this means / PwC view
Finding 1: Gender diversity - this is a new finding in the Productivity Commission's report and is aligned with the amended ASX Guidelines which will take effect from the financial year commencing 1 July 2010. The Productivity Commission strongly endorses the initiatives by the ASX Corporate Governance Council: • to require companies to adopt and disclose, on an "if not, why not" basis, their progress against gender objectives set by their boards • to encourage nomination committees to review the proportion of women at all levels in the company and disclose annually the skills and diversity criteria used for board appointments. Outcomes should be reviewed three years after the measures have been introduced.	• If not already doing so, boards should consider diversity objectives and plan to report progress.
Finding 2: Remuneration "check list" for boards • Remuneration practices and disclosure could be enhanced by considering: – how the remuneration policy aligns with the company's strategy, its desired risk profile and shareholder interests – how the mix of base pay and incentives relates to the remuneration policy – how comparator groups for benchmarking executive remuneration and setting performance hurdles / metrics were selected and how such benchmarks have been applied – how incentive pay arrangements were subjected to sensitivity analysis to determine the impact of unexpected changes (eg in the share price) and how any deferral principles and forfeiture conditions would operate – whether any "incentive-compatible" constraints or caps apply to guard against extreme outcomes applies from formula-based contractual obligations; – whether alternatives to incentives linked to complex hurdles have been considered – whether employment contracts have been designed to the degree allowed by law to inoculate against the possibility of having to "buy-out" poorly performing executives to avoid litigation – whether post-remuneration evaluations have been conducted to assess outcomes, their relationship to the remuneration policy and the integrity of any initial sensitivity analysis.	• This could be a useful checklist for boards when assessing their remuneration practices. However, if incorporated into disclosures, this will add further complexity and length to remuneration reports.

Appendix 2: The APRA remuneration and governance standard

On 30 November 2009 APRA released the final versions of the amended Prudential Standards APS 510, GPS 510 and LPS 510, which cover increased remuneration and governance requirements for APRA-regulated institutions. The revised governance standards will come into effect on 1 April 2010.

APRA has stated that its supervisory focus in respect of its remuneration requirements will be on genuine board involvement and engagement, demonstrating independence from management, gauging the adequacy and appropriateness of the remuneration policy (especially in its linkage to risk) and actively monitoring the implementation of the policy.

In the first six to twelve months, APRA will be seeking information on the implementation of its remuneration requirements (particularly from larger institutions) and will assess peer institutions together. Where APRA judges that the remuneration arrangements of a regulated institution are likely to encourage excessive risk-taking, it has several supervisory options, including the power to impose additional capital requirements on the institution.

By 1 April 2010 the board remuneration committee, with appropriate composition and charter, will need to be established and a written remuneration policy that is largely compliant with the governance standards will need to be in place. Regulated institutions must ensure that contracts in force as at 1 April 2010 are fully compliant at the first reasonable opportunity for renegotiation, and in any event by 31 March 2013.

In addition, it is APRA's expectation that regulated institutions negotiating or renegotiating contracts between the release of the revised governance standards (1 December 2009) and their commencement date will be fully cognisant of APRA's requirements and will begin the transition during this period for existing arrangements that would not meet the revised standards.

Prudential Standard summary	What this means / PwC view
• The board must establish and maintain a written remuneration policy. This policy must: – outline the remuneration objectives and the structure of the remuneration arrangements, including performance-based pay – encourage behaviour that supports long-term financial soundness and the risk management framework	• Ensure that your company's remuneration policies not only reward long-term sustainable value creation, but that they also appropriately incorporate risk.
– reflect: a) the outcomes of business activities b) the risks related to the business activities taking account, where relevant, of the cost of the associated capital c) the time necessary for the outcomes of those business activities to be reliably measured	• Understand how long it takes to reliably measure performance and assess the applicable risks at a business activity level. There may be challenges in both obtaining a granular understanding of the risks which exist in relevant businesses and also what metrics to use to assess such risks. • Determine whether one deferral period is still appropriate across the various business activities or if there needs to be different deferral periods for different activities. Maintain the focus on simplicity where possible.
– provide the board with discretion to adjust performance-based components of remuneration downwards, to zero if appropriate, if such adjustments are necessary to (a) protect the financial soundness of the regulated institution; or (b) respond to significant unexpected or unintended consequences that were not foreseen by the board remuneration committee	• Consider how to incorporate such discretion into the incentive plans.

Prudential Standard summary	What this means / PwC view
• The remuneration policy must: – cover the following persons: • each responsible person[1], excluding responsible auditors and non-executive directors • persons whose primary role is risk management, compliance, internal audit or financial control ("risk and financial control personnel") • all other persons for whom a significant portion of total remuneration is based on performance and whose activities, individually or collectively, may affect the financial soundness of the institution.	• Companies need to identify which employees fall into the relevant employee categories. This is often not a straight-forward task, particularly in relation to identifying risk and financial control personnel and determining what should constitute "significant portion of total remuneration".
– cover a service contract between a regulated institution and an entity that is not a related body corporate of the regulated institution if either of the following conditions apply: • the primary role of the entity is to provide risk management, compliance, internal audit or financial control services to the regulated institution • the services provided by the entity, either individually or collectively with like services provided by other entities, may affect the financial soundness of the regulated institution and, under the services contract with the regulated institution, a significant portion of the total payment to the entity is based on performance. However, the remuneration policy need not cover a service contract with such an entity if both of the following conditions apply: • the regulated institution's risk management framework explicitly addresses the structure of payments to entities of the relevant kind and the rise that payment incentives can give risk to inappropriate behaviour • oversight of this risk has been delegated to a board committee.	• Determine whether applicable service contracts should be dealt with within the remuneration policy or as part of the risk management framework. Typically the structuring of service contracts is seen to be a business risk and is dealt with outside of the remuneration framework.
– ensure that the structure of the remuneration of risk and financial control personnel does not compromise their independence in carrying out their functions	• Determine how remuneration and performance management should be structured for risk and financial control personnel to ensure their independence is not compromised. Relevant factors to consider may include the remuneration mix and the nature of KPIs.
– prohibit responsible persons from hedging their equity-based remuneration until it is fully vested and specify the actions to be taken where a person is found to have breached this requirement	• Review your hedging policies to ensure compliance.
– form part of the risk management system	• HR personnel will need to work more closely with risk personnel to determine how best to embed the remuneration policy into the risk management system.
– be provided to APRA on request.	• Establish a process of consultation with APRA.

1. A responsible person includes (i) a director of the regulated institution, (ii) a senior manager of the regulated institution or (iii) a person who performs activities for a subsidiary of the regulated institution where those activities may materially affect the whole, or a substantial part, of the business of the regulated institution or its financial standing, either directly or indirectly.

Prudential Standard summary	What this means / PwC view
• Board remuneration committees must: – have at least three members and consist entirely of non-executive directors, with the majority being independent. The chair also needs to be independent	• Review your remuneration committee composition.
– have a written charter outlining the committee's roles, responsibilities and terms of operation. These responsibilities must include conducting regular reviews of the remuneration policy, including an assessment of its application, effectiveness and compliance with the requirements in the Prudential Standard	• Review and make any necessary amendments to the remuneration committee charter.
– make annual recommendations to the board on the remuneration in respect of the CEO, direct reports of the CEO, and other persons whose activities may in the board remuneration committee's opinion affect the financial soundness of the institution, and any other person specified by APRA	• The role and accountabilities of the board and remuneration committee is likely to increase, resulting in a heavier workload. Supporting governance structures may need to be put in place to support the board and remuneration committee in fulfilling their increased remit.
– make annual recommendations to the board on the remuneration of the categories of persons covered by the remuneration policy where individual remuneration recommendations are not required (see above)	• As above.
– have the power to engage third-party experts in a manner that ensures that the engagement, including any advice received, is independent	• Determine processes for the board, management and external consultants to work together that avoid conflicts of interest. Amend the process for engaging external consultants if required.
– have free and unfettered access to risk and financial control personnel and other parties (internal and external) in carrying out its duties. The committee must also be available to meet with APRA upon request.	• Review and update the remuneration committee charter if necessary. We note that remuneration committees already practically have access to both internal personnel and external consultants on an as-needs basis.

Our Team

Our People and Change team works with business leaders and their HR teams to:

- align and enable the organisation and its people
- maximise the organisation's productivity and effectiveness
- make change stick.
- We work with our clients on:
- Change management
- HR transformation
- Reward & performance
- Workforce effectiveness.

PwC's reward specialists work with many of Australia's leading companies in relation to:

- Reward strategy
- Reward and performance alignment
- Incentive plans – executive, broad-based and sales plans
- Employee equity schemes
- Advice to remuneration committees.

We use a multi-disciplinary, integrated approach to enable us to take a fresh perspective, think differently and develop and implement new and value-adding solutions.

For further information on how we can help you with your reward challenges please contact:

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Debra leads PwC's Australian People and Change practice. She focuses on the management and delivery of a wide range of human resources assignments to help clients enable their people to be a sustainable source of competitive advantage.

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Della leads the Melbourne Reward and Performance practice. She is a specialist in the design and implementation of executive and non-executive remuneration programs, the application of corporate governance principles and design of sales incentive and commission practices.

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Emma is a Director, specialising in identifying opportunities for improving the productivity of employees through the assessment, development and execution of effective and market competitive incentive plans.

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Daryl is a Director and is a leader in the field of employee share plans. He has deep expertise in the area of reward strategy design and implementation for executives and key talent.

He helps companies of all sizes and across all industries to design and implement employee reward and performance management systems that align with the culture and business strategy, and ensure the reward system is a positive influencer/driver of employee behaviours.

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