

Geoff Nunn &amp; Associates

Australia's Leading Independent Remuneration Specialists

# Remuneration Update

## Response to the Productivity Commission Report on Executive Remuneration



In this issue of Remuneration Update we will provide a summary and commentary on the Productivity Commission's draft report on Director and Executive Remuneration in Australia.

Specifically we will focus on this recommendations which do not relate to equity based remuneration (as this is not our primary area of expertise).

We will raise the issue that perhaps Remuneration Reports should be the subject of a broader level of professional scrutiny than currently exists.

Questions relating to executive remuneration will continue to cause concern for Boards beyond the Productivity Commission's final report and any subsequent Federal Government response. Designing the fixed and variable remuneration strategies for executives is complex. There are a range of possible approaches. And market practice may not always be a good guide. Each organisation's circumstances are different and require individualized approaches to the design of executive remuneration.

### September 2009 - Productivity Commission Releases Draft Report

On the 30th September, 2009 the Productivity Commission released its draft report into Director and Executive Remuneration in Australia.

The Commission has made a total of 15 recommendations which primarily target the area of corporate governance.

Specifically they focus on issues of:

- The mix of board skills required to effectively manage executive remuneration.
- A requirement that all members of the remuneration committee be non-executive directors (to remove any potential conflict of interest).
- Remuneration reports to con-

tain a clear statement of the organisations executive remuneration policies and the total shareholder of each executive and director.

- Where external advisors are engaged to provide executive remuneration advice they should report directly to the Board and the nature of their work disclosed in the remuneration report.
- Where the remuneration report receives a "no" vote of 25% or greater the Board should be required to report back to shareholders in the subsequent year on steps taken to address concerns. Should the succeeding remuneration report also receive a "No" vote (percentage

Unspecified) then elected members of the Board must offer themselves for re-election.

The recommendations do not seek to place any limits on executive remuneration. Rather they focus on the Board's role in ensuring that due processes are followed when setting executive remuneration levels. They seek to ensure that the design of performance based components is rigorous and that performance criteria are relevant and transparent.

In this Remuneration Update we provide a summary of the Commission's recommendations and offer some evaluative commentary. See Pages 2-4.

### Is There a Case for Greater External Scrutiny of Remuneration Reports?

Audit reports for listed companies usually contain a statement of compliance with Section 300A of the Corporations Act 2001.

We raise the issue of whether greater independent scrutiny is required to give shareholders some level of comfort that what is being proposed in the remuneration report is realistic given the company's size, market and general operating environment. For instance:

- Has a form of job evaluation been used to determine relative job size and, if so, what are the results?
- What market data

has been utilized to validate the rates proposed?

- What market position has been adopted (Percentile) and what is the justification for this?
- How has the balance of Fixed/STI/LTI been determined?
- What are the performance measures used to drive STIs and LTIs. Why have they been selected? How is their performance tracked and monitored

throughout the year?

Some commentators have suggested that there may be a need for more rigorous external review of the remuneration report. Compliance is important. Validity and reasonableness are different questions and worthy of consideration.

There may be the potential to strengthen the governance framework by requiring a full review of the remuneration report by a suitably qualified and experienced remuneration advisor (other than the one providing strategy advice to the Board).



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Independent Remuneration and Organisation Specialists

## Productivity Commission Draft Report on Director and Executive Remuneration in Australia - Preliminary Recommendations



In its draft report "Executive Remuneration in Australia" released on the 30th September, 2009 the Productivity Commission presents 15 preliminary recommendations aimed at improving the governance of executive remuneration in Australia. The draft recommendations are directed specifically toward entities covered by Section 300A the Corporations Act 2001.

The Commission did not recommend the imposition of salary caps on executive remuneration. Rather it focused on strengthening the already sound governance framework in Australia.

Generally the Report has received a favourable response from the corporate sector and industry associations. There has been criticism from the union movement with assertions that recommendations do not go far enough. Comment has been sought on the draft recommendations with the Commission's final report to be completed by 19th December, 2009.

In this article we will discuss a number of the recommendations and offer comment.

### The Right Skill Mix

The Commission's first draft recommendation is aimed at improving the skill mix available to Boards to enable more informed decision making on matters of executive remuneration. The report indicates that some submissions expressed concern that directors may be sourced from a "thin gene pool" of existing directors and known executives<sup>1</sup>. Women and some non-executive professionals are underrepresented on Boards across the ASX 200.

Whilst the Commission has not sought to impose quotas its first recommendation does seek to reduce barriers to entry by removing the "no vacancy" rule which allows boards to set the maximum number of directors appointed at any one time. Draft Recommendation 1 states:

**The Corporations Act 2001 should specify that only a general meeting of shareholders can set the maximum number of directors who may hold office at any time (within the limits in a company's constitution).**

We support this recommendation although its

potential to increase the Board's level of expertise in matters of executive remuneration is limited.

### Reducing Conflicts of Interest

The Report quite rightly points out that there is a potential conflict of interest when executive directors sit on remuneration committees. There must be a clear separation of the role of executives as recipients of decision making and those charged with setting executive remuneration. Having said this, the CEO must provide input on fixed remuneration and performance measures for direct reports (level 2 executives).

Draft Recommendations 2 and 3 are as follows:

**A new ASX listing rule should specify that all ASX300 companies have a remuneration committee of at least three members, all of whom are non-executive directors, with the chair and a majority of members being independent.**

**The ASX Corporate Governance Council's current suggestion on the composition of remuneration committees should be elevated to a 'comply or explain' recommendation, which specifies that remuneration committees:**

- **have at least three members**
- **be comprised of a majority of independent directors**
- **be chaired by an independent director.**

These recommendations make sense and are current practice for a majority of organisations.

### Improving Disclosure

The Commission's report asserts that remuneration reports have tended to become generic in nature and are not readily understood by retail investors.

The report stresses three key elements:

- Remuneration reports should contain a "plain English" summary of the company's executive remuneration policy.
- The remuneration report should set out the 'realized remuneration of executives and

directors rather than theoretical remuneration based on accounting estimates of the value of shares and options.

- The remuneration report should disclose the total equity holdings of those named in the report.

Draft Recommendation 8 is as follows:

**Section 300A of the Corporations Act 2001 should be amended to specify that remuneration reports should additionally include:**

- **a plain English summary statement of companies' remuneration policies**
- **actual levels of remuneration received by executives**
- **total company shareholdings of the individuals named in the report.**

**Corporations should be permitted to only disclose fair valuation methodologies of equity rights for executives in the financial statements, while continuing to disclose the actual fair value for each executive in the remuneration report.**

We fully support this recommendation.

### Coverage of Management Personnel

The Commission quite rightly points out that the remuneration report should cover those individuals in the company who, by virtue of their roles, have the capacity to influence the performance of the company (and their own pay outcome). Restricting reporting to the top five may not add value.

Recommendation 9 is as follows:

**Section 300A of the Corporations Act 2001 should be amended to reflect that individual remuneration disclosures be confined to key management personnel. The additional requirement for the disclosure of the top five executives should be removed.**

(Continued on Page 3)

1. [Executive Remuneration in Australia](#). Productivity Commission. September 2009 pp 302.

## Productivity Commission Draft Report on Director and Executive Remuneration in Australia - Preliminary Recommendations (Continued)

### External Advice on Remuneration

The Commission's report specifically covers the role of external remuneration advisors in the process of setting executive remuneration. Specifically advisors may provide advice in the areas of:

- Market rates for specific board and executive roles.
- Remuneration strategies and policies.
- The structure of short and long term incentive plans.
- STI and LTI performance conditions.
- Remuneration contract provisions.

A potential conflict of interest is said to arise when the advisor is requested, by the executive, to provide advice to the Board in relation to executive roles. Another scenario is that the advisor may be directly engaged by the Board whilst also providing advice to management with regard to other areas of the organisation.

The conflict of interest arises when the advisor feels that ongoing broader work with the organisation may be compromised by conservative advice to the board on matters of executive remuneration.

Most advisors are well aware of this potential conflict and take steps to avoid it. It is not dissimilar to the conflict accounting firms face when providing audit services whilst similarly endeavouring to market other business services to the organisation. They generally endeavour to limit their activities to one reporting line or another. Either that or set up some form of Chinese wall such that different consultants work on the different level of assignments.

The specific productivity recommendations 10 and 11 are as follows:

**The ASX listing rules should require that, where an ASX300 company's remuneration committee (or board) makes use of expert advisers, those advisers be commissioned by, and their advice provided directly to, the remuneration committee or board, independent of management.**

**The ASX Corporate Governance Council should make a recommendation that companies disclose the expert advisers they have used in relation to remuneration matters, who appointed them, who they reported to and the nature of other work undertaken for the company by those advisers.**

We have no problems with either of these recommendations. However, there is almost always a need to ensure alignment (to use that word again) between executive remuneration strategy and remuneration strategy for managers and senior professionals in the organisation. Therefore internal human resources or corporate services executives need to ensure the appropriate linkages are maintained.

### Well Conceived Remuneration Policies

Whilst acknowledging complexity does not necessarily equate to effectiveness the Commission has taken the view that one size does not fit all when it comes to matters of executive remuneration. Rather that strategies need to be devised based upon individual company circumstances, strategic goals and operating environment. However the report does propose a draft check list for Boards to consider when formulating executive remuneration strategy:

*"Remuneration structures are company and context-specific and a matter for boards to resolve rather than being amenable to prescriptive direction. That said, there are some key dimensions that often warrant being explained clearly to shareholders and, where appropriate, could usefully be addressed in companies' treatment of their remuneration policies in the remuneration report:*

- *how the remuneration policy aligns with the company's strategic directions, its desired risk profile and with 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 and metrics were selected*
- *how incentive pay arrangements were subjected to sensitivity analysis to determine the impact of unexpected changes (for example, in the share price)*

- *whether any 'incentive-compatible' constraints or caps to guard against extreme outcomes from formula-based contractual obligations apply*
- *whether alternatives to incentives linked to complex hurdles have been considered (for example, short-term incentives delivered as equity subject to holding locks)*
- *whether employment contracts have been designed to the degree allowable by law, to inoculate against the possibility of having to 'buy out' poorly performing executives in order 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.*"<sup>2</sup>



Whilst not yet canvassed in the Report the notion of an "Executive Remuneration Review" may have some merit whereby an independent external advisor (other than the advisors used to establish policy) conducts an annual review of executive remuneration strategy and provides a report to the Board. (See Page 1)

### A "No" Vote on the Remuneration Report

Perhaps the most controversial of the Commission's recommendations is the "Two Strikes and Your Out" proposal for Boards in relation to a "no" vote on the remuneration report.

The report mounts a very well constructed argument around the notion that the non-binding vote on the company's remuneration report by shareholders is a clear indicator to shareholder support for the company's remuneration policy. A no vote signals that shareholders do not believe the board is managing executive remuneration policy effectively.

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2. Executive Remuneration in Australia. Productivity Commission. September 2009 pp 318.

The challenge in interpreting the no vote is to assess the degree to which shareholders are able to evaluate the effectiveness and market relevance of remuneration policy (based on the remuneration report).

Two factors impact here:

- The Remuneration Report is a summary only of the Company's executive remuneration policies and their outcomes for any given year. In many instances the full detail and rationale is not disclosed.
- Many shareholders, particularly retail investors, are not well versed in matters of executive remuneration strategy. Therefore the shareholder vote may not be a true reflection of the soundness of the company's policies.

As a result we may well find a sound company with well thought out and relevant remuneration policies receiving a no vote on the remuneration report.

Recommendation 15 is as follows:

*The Corporations Act 2001 should be amended to require that where a company's remuneration report receives a 'no' vote of 25 per cent or higher, the board be required to report back to shareholders in the subsequent remuneration report explaining how shareholder concerns were addressed and, if they have not been addressed, the reasons why.*

*If the company's subsequent remuneration report receives a 'no' vote above a prescribed threshold, all elected board members be required to submit for re-election (a 'two strikes' test) at either:*

- *an extraordinary general meeting or*
- *the next annual general meeting.*

In their latest Boardroom Report (Volume 7, Issue 19, 7 October, 2009) the Australian Institute of Company Directors, whilst generally supportive of the Commission's report, questions the efficacy of making the full board submit to re-election when the remuneration report has up to (potentially) 75% support. They are concerned that the vote could become vehicle for expression of other interests by minority shareholder groups.

#### Overall Comments

The Commission's report provides an excellent analysis of the factors impacting on executive remuneration for listed companies in Australia. The recommendations, by and large, seek to strengthen an already sound framework of corporate governance in this critical area. The next stage is further consultation prior to the final report to government on the 19th December, 2009.

In our view most of the recommendations will proceed in the current form. The exception is likely to be Recommendation 15 (Two Strikes) which clearly requires some further thought and refinement prior to submission to government.

#### **About Geoff Nunn and Associates:**

Geoff Nunn & Associates was established in Melbourne, Australia in 1993. Since then, the Company has established a reputation for professionalism and quality service. Projects have been completed in over 950 organisations across Australia.

#### Our Services

- **Remuneration Strategy Development.**
- **Job Evaluation.**
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