

Geoff Nunn & Associates
Australia's Leading Independent Remuneration Specialists

Remuneration Update

In this issue of Remuneration Update we continue our focus on issues of executive remuneration:

Key Topics:

- Executive Remuneration : A Time for Moderation.
- Managing Executive Remuneration Expectations.
- Executive Remunerations Strategy.
- The Role of the Board Remuneration Committee.

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Executive Remuneration: A Time for Moderation

There's been a lot of negative press over the last twelve months about matters relating to executive remuneration. Comment has mostly focused on the big end of town where seven figure packages have become the norm.

Many have argued that the fixed component of some executive's remuneration package is too high and that the linkage between variable reward and corporate performance is sometimes tenuous.

Others have commented that packages geared toward STI and LTI plans sometimes encourage excessive risk taking with potentially disastrous outcomes.

Generous sign-on bonuses, retention payments, and termination

provisions have also come in for a great deal of criticism.

The debate is going on at the moment over tightening of the regulatory environment on matters of executive remuneration, particularly termination payments. And a cap of twelve months package appears a likely (and reasonable) outcome.

Some Board's are currently arguing, that, if restrictions are placed on their capacity to pay, they will not be able to attract the best executive talent on the international market. The underlying assumption seems to be that we do not have suitably qualified and experienced home grown executives.

For some time we have been arguing for restraint in remuneration policy. Paying at the top of the market sets up an inflationary cycle. And sooner or later steps will be taken to bring outcomes back into perspective.

A few basic points:

- Check developments in your market sector.
- Link STI and LTI payments to integrated and strategic measures of performance.
- Limit termination payments to 12 months package.

See Page 2 for more extensive discussion.

Managing Executive Remuneration Expectations

In times of negative economic growth most Boards will be considering how to manage executive remuneration expectations. The Commonwealth Bank recently announced pay cuts for their top executive team and a pay freeze for all on a package of \$100,000 pa or more. Whilst this is a commendable move and may assist in avoiding redundancies it needs to be viewed in the light of managing realistic remuneration perceptions.

We propose a different and considered approach to managing executive pay. Start

by reviewing market alignment. This should be done annually. If your company has targeted Quartile 3 or above for executive remuneration consider whether retaining this policy is still prudent.

Check the job size and market rates for each executive role. Then compare what you are paying. You will then be in an informed position to make informed decisions and discuss them with the relevant executive.

Consider the organisation's corporate performance and that of each executive.

Hold one on one discussions with each executive (Chairman with the CEO, and CEO with each executive). Clearly communicate the organisation's policy position and how it might impact on each executive's own remuneration.

Don't forget to consider any contractual obligations. If market and review parameters are built into executive contracts they may need to be renegotiated to reflect current conditions.



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Independent Remuneration and Organisation Specialists

Executive Remuneration Strategies for 2009 and Beyond

The GFC has brought matters of executive remuneration into sharp relief. Moves to increase regulation have been met with outcries of excessive interference into what are essentially market driven outcomes.

In this article we explore some practical measures to ensure levels of executive remuneration remains competitive and yet avoids the excesses seen in some instances.

The following executive remuneration strategy initiatives may assist a return to stability in the remuneration market.

Executive remuneration strategy needs to be aligned to business objectives. Boards need to be conscious of the perspectives of all stakeholders. This includes shareholders, the executives themselves, other employees, regulators, customers, competitors, governments and even the public generally. Corporate social responsibility extends to effective management of executive remuneration.

Remuneration Strategy: Market Positioning

In the boom years many organisations targeted the third quartile of their respective market. They have argued that to attract the best executive talent rewards need to be highly competitive. The problem with this strategy is that, when applied "across the board", it creates upward pressures in the remuneration market. Paying at the upper end may only be appropriate in selected cases.

If, on the other hand, organisations were to take a more moderate perspective and target the median of their respective market, this would have effect of slowing inflationary pressures and assisting to keep the market in balance.

Short Term Incentives

In some recent press articles commentators have called for STI payments to be made via shares in the company (if listed). The suggestion here is for these shares not to vest for five and ten years in the future. Whilst this may be appealing in some circumstances from a practical point it is unworkable.

Short term incentive plans need to be designed to reward performance on an annual cycle. They should reward both financial and non-financial performance. Non-financial measures should be designed to strengthen and sustain the business. They should be relevant and may include measures of operational effectiveness, progress on strategic projects, research and development, environmental impact, people management processes, occupational health and safety and customer relations.

In the current market, ceilings should be conservative.

Long Term Incentives

The rhetoric about aligning the interest of shareholders and executives continues despite the GFC. At the end of the day most business owners and shareholders are concerned about maximizing financial returns. Usually as quickly as possible. Recent growth raised expectations of double annual digit returns.

Yet all of us rely on boards and executives to run the corporations and institutions which are a fundamental part of our society, in an ethical, responsible and sustainable manner. From this perspective our expectations of boards and executives differs from that of shareholders. Fair returns for shareholders is important. But so too are the interests of all stakeholder groups.



Equity based incentive plans are usually linked to measures of performance of financial performance and shareholder returns. They are generally not designed to recognise broader social contribution.

They also place potential earnings at risk via the vagaries of the share market. Many executives whose packages were biased towards equity based LTIs will now find their shares have diminished in value significantly. Options may currently be worthless. Yet these executives may have performed extraordinarily well in difficult circumstances and deserve to be rewarded for their efforts.

Concluding Comments

Getting the balance right in executive remuneration strategy is now more critical than ever. Have a careful look at your market segment before making policy decisions. Recent calls for pay cuts or freezes may be appropriate in some cases. But should not signal a slash and burn approach.

"Boards should do more to recalibrate remuneration packages - as well as CEO and senior management expectations of these - to ensure that they are appropriate and properly linked to sustainable organisational performance."¹

1. The Boardroom Report Vol. 7, Issue 7, 22 April, 2009. Australian Institute of Company Directors.

Board Remuneration Committees: Challenges in Managing Executive Remuneration

Board Remuneration Committees, in organisations of all types, are under increasing pressure to ensure appropriate corporate governance standards are followed when setting executive remuneration levels. Most of the recent press coverage has focused on listed companies, primarily the ASX Top 100. Yet organisations of all sizes and ownership structure face similar challenges. In this article we offer some guidance and comment which may assist remuneration committees.

The ideal structure of executive reward may vary between organisations based on a number of parameters:

- Industry Sector
- Revenue/Asset Base
- Market Diversity
- Ownership (Listed, Private, Govt.)

The structure of the remuneration package for a CFO working in a listed retail company may be different to that for a similar role in a government owned energy utility for example.

In determining the most appropriate structure of an executive remuneration package the Board should take advice as to proportions of Fixed Annual Remuneration/Short Term Incentives/Long Term Incentives. These may also differ between the CEO and next executive level.

The balance should reflect not only that of your immediate competitors and market comparators, but also your business model.

Setting Fixed Annual Remuneration

There are two ways to set Fixed Annual Remuneration using market data from professional sources:

- The position match approach.
- The job evaluated approach.

The position match approach involves matching the job to a similar job in published executive remuneration surveys and then refining data based on organisation parameters mentioned earlier.

Your target market position should reflect performance and capacity to pay. Err on the conservative side in the current market. As mentioned in the previous article targeting above the median in current conditions may be unwise.

This approach to determining fixed remuneration is relatively blunt. It does not take into account variations between roles of a similar title. Nor does it factor in all of the relevant organizational parameters in a single comparison.

The job evaluated approach offers a better alternative. Most proprietary job evaluation systems factor in organisational parameters. They require a detailed analysis of the job based upon ten or twelve factors. The overall result is a points score which is linked to market formulae and enables precise market remuneration rates to be determined for each executive role.

We suggest organisations use the job evaluated approach wherever possible. A number of advisors provide this service.

Short Term Incentives

The Remuneration Committee has a number of roles in relation to short term incentives:

- To set the performance measures against which the CEO will be assessed for STI purposed.
- To overview the performance measures set by the CEO for the executive team and ensure they are in alignment with those set for the CEO.



- To ensure appropriate measurement mechanisms are in place to facilitate accurate evaluation of performance results.
- To determine the STI payment for the CEO and overview the CEOs recommendations with respect to other members of the executive team.

In setting and overseeing performance measures ensure that all key performance areas are covered. All stakeholders are concerned to see sustainable performance, growth in capability and contribution. Make sure stretch is required to achieve incentive ceilings.

Long Term Incentives

Take advice on the structure of LTI Plans and ensure that there are appropriate strategic measures in place. Don't rely solely on financial and market based measures. Consider achievement against long term goals embedded in business plans. With current market volatility consider non-equity based models as an alternative to the traditional share and option plans

On Contracts and Communication.

The structure of the package must always be set out in the executive contract. But circumstances change and the Board must retain the flexibility to vary arrangements should there be a valid reason to do so.

A couple of points to consider:

- Its best not to quote specific market percentiles in an executive contract. Rather indicate that review decisions will be made with reference to market rates. The organisation needs to retain the flexibility to vary market positioning should circumstances dictate.
- With any Short or Long Term Incentive Plan always insert a clause that allows the organisation to vary the structure of plans at its absolute discretion. Circumstances change and there may well be a need for a new approach to STIs or LTIs.

In listed companies the terms of executive remuneration packages and contracts are the subject of disclosure and reporting requirements. This looks set to increase with current government reviews underway. Therefore the structure of any arrangements entered into now must anticipate the need for increased scrutiny.

A Further Word on Communication

Executive remuneration is an emotive issue. At least to some degree the executive's sense of self esteem and personal worth is reflected in the package. The Board needs to ensure that all executives remain focused on the achievement of sustainable performance. This emphasises the need for tact and sensitivity during the annual executive performance and remuneration review discussion.

Here are some comments which may assist:

- Have all the facts on hand. There's nothing that undermines a sensitive discussion more than having to shuffle papers to find the right performance report or set of market figures.
- Choose a neutral setting for the discussion.
- When meeting with the CEO the Chairman may seek to involve the Chair of Remuneration Committee and other committee members as appropriate (particularly if the Chairman is not also Chair of the Remuneration Committee).
- If the CEO is new to the role or needs support in discussing performance and remuneration with members of the executive team a Remuneration Committee member may offer this support either directly or indirectly.

Discussions should be documented and agreed outcomes and action plans recorded.

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 900 organisations across Australia.

Our Services

- **Remuneration Strategy Development.**
- **Job Evaluation.**
- **Market Remuneration Advice.**
- **Board and Executive Remuneration.**
- **Performance Based Incentives.**
- **Balanced Scorecard Performance System.**
- **Organisation Structuring and Design.**
- **Board Advisory.**

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