GRG Remuneration Insight 96

Remuneration Reports and Risk Management – Being Prepared

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Introduction

We are currently entering the season when Chairs of Remuneration Committees are putting their minds, and internal resources, to the drafting of Remuneration Reports. Remuneration Reports are compulsorily the subject of a vote at annual general meetings (AGMs) and if 25% or more of the cast votes are against the resolution then the company receives a strike. In addition, if two successive strikes are received then a resolution for a spill of the Board needs to be put to shareholders, unless a spill motion was put to shareholders at the previous AGM. This has made the resolution on the Remuneration Report one of the highest risks for governance, because few other matters have such a direct path to replacing the entire Board. As a result, it has become one of the highest focus areas for governance, transparency and in some ways is the "cutting edge" for the interaction between companies and external stakeholders. For this reason, the Remuneration Report resolution attracts activism, and not always because of remuneration issues. While some may view this as an abuse of the system, there are indications that this was actually intended by regulators.

Why it's Worth Preparing Even if Strike Risks are Low

Most boards are anxious to avoid strikes as they can cause reputational damage for the company, the board and the individual directors. When a strike is truly a reflection of a remuneration governance problem, then clearly improvements to governance, practices, policies, procedures and disclosure need urgent attention. But when a strike is really a "protest strike" and not about remuneration governance, there can be only one defence: having your Board's KMP remuneration governance systems, and disclosure in the Remuneration Report, in top condition. Considering this issue after a strike is received means the damage has already been done, and is too late. Sometimes the best defence, is preparation, good governance and transparency. Companies with high quality and appropriate remuneration governance and practices have received protests strikes in the past, but have not had high quality disclosure and therefore suffered from the appearance of low quality governance.

While the primary focus of the Remuneration Committee and the Board should be on KMP remuneration policies and practices that are reasonable and support the company's business objectives they need to also consider the views of stakeholder groups if strike risks are to be managed. External stakeholder groups have influence over the views and voting of shareholders, particularly institutions, and therefore should not be ignored. The main stakeholder groups include: proxy advisors, the Australian Shareholders Association, superannuation funds and funds managers, and their impact extends far beyond the ASX 300. This GRG Remuneration Insight identifies some of the aspects that should be considered when drafting Remuneration Reports in subsequent years.

Disclose Planned Improvements

Compliance with statutory Remuneration Report requirements may lead to a strike particularly when the practices of the year being reported upon have been reviewed and new practices will be implemented in the next reporting period. To minimise the possibility of a strike in these circumstances it is essential that proposed changes be clearly explained along with the rationale for them being adopted, as they are occurring and not simply after they become reportable. Too many Companies have received a strike for issues that they have already resolved, simply because they did not disclose the changes as the decisions were being made. Similarly, if a practice was adopted on a once-off basis to address a specific circumstance and it is not intended to be used again in the future then that should be clearly explained in the Remuneration Report. Accordingly, a well-constructed Remuneration Report will include a section dealing with changes since the last report, proposed future improvements, and key issues and context to consider particular to that business in relation to KMP remuneration.

Developing a Genuine Framework and Incorporating Policies by Reference

Many companies are concerned that Remuneration Reports are becoming too long and represent a disproportionate part of Annual Reports. Part of the reason for this is that in many cases, remuneration related resolutions now represent the majority of resolutions at the AGM, and are the biggest talking point in terms of governance. This has led the best companies to develop comprehensive Remuneration Governance Frameworks which are documented sets of not only policies but also procedures to underpin appropriate and consistent decision making as the Company evolves. Demonstrating this and outlining the policies in the Remuneration Report often adds significant length. One means of addressing this problem, that has been adopted by some companies, is to include as part of the company's website the various policies, procedures and charters that constitute the company's KMP Remuneration Governance Framework, maximising transparency, and seeking feedback. In these cases the KMP remuneration governance framework is included by reference in the Remuneration Report, leaving only a brief summary and those aspects that need to be highlighted to be presented.

It should be About Good Governance, Not Compliance

For those companies that are impacted by the views of proxy advisors, institutional investors and other groups, this will be no news: complying with the requirements of the Corporations Act (300A), associated regulations (2m.3.03) and accounting standards (most prominently AASB2) does not actually tell shareholders, and these groups, what they want to know. While the conversation about acceptable practices, good governance and transparency has moved on, the regulations largely have not.

Perhaps the clearest example is the way that statutory remuneration tables require disclosure of the long term incentive (LTI) that was recorded in the Company's accounts, under AASB2. While this makes sense from the perspective of impact on the P&L, it actually doesn't say anything about what the value of the LTI was that was intended to be offered, whether there is an appropriate range of outcomes and rewards around thresholds, targets and stretch, how target is set, or even how much LTI was realised/earned. These are all matters that require additional disclosure to be understood, and many would say are not technically required to be disclosed, and many companies now present multiple remuneration tables to fill the gaps left by the statutory requirements. This example demonstrates how a compliance focused report can quickly lead you down the path towards a misunderstanding between the Board and shareholders, and ultimately increases the risk of a strike.

Scope of the Report and Who it Covers

Key management personnel (KMP) is defined as follows:

> *"**Key management personnel** are those persons having authority and responsibility for planning, directing, and controlling the activities of the entity, directly or indirectly, including any directors (whether executive or otherwise) of the entity. (IAS 24.9)"*

GRG's observation of Remuneration Report disclosures for FY16 clearly indicate that many companies have been adopting a minimalist compliance approach to classifying executives as KMP. When the lists of senior executives classified as KMP in Remuneration Reports are compared to the lists of senior executives on company websites there is a substantial difference between the two lists with the KMP Remuneration Report list being much shorter than the website list despite the website list containing roles that appear to warrant classification as KMP. For some reason, the advisors of some Boards are not recognising that all members of the executive/senior leadership team fulfil the definition of KMP by virtue of their participation in and active contribution to, such a group.

GRG also understands that ASIC considers Managers of Business Units that represent a significant component of the company's operations to be KMP, even if they do not make decisions that impact other business units directly. ASIC also encourages companies to take a broader rather than a narrower interpretation of the definition of KMP as this is consistent with the spirit of the relevant Accounting Standards (which is where the definition is maintained) and the Corporations Act.

Unless companies commence to adopt the spirit of the definition and the Corporations Act, then they risk the prospect of more onerous disclosure requirements being regulated. The current trend towards minimalism is not going un-noticed by external stakeholders and regulators.

Disclose Actual Compared to Target to Allow Assessment of Alignment and Strategy

In addition to statutory tables of remuneration it is constructive to the purpose of building support for remuneration practices, to provide detailed incentive assessment and outcome tables which compare actual awards flowing from incentives, with intended policy levels, actual targets and actual performance outcomes. For this purpose it is the face value of LTI at grant that needs to be used otherwise the comparison with policy will be distorted by market movements in the share price.

Commentary confirming that the policy is working as intended or has produced unexpected results which have led to a review being undertaken can be useful information for shareholders. Even when results are not aligned with policy the fact that it has been noticed and is being acted upon will be useful information for shareholders who will be assured that the Remuneration Committee is fulfilling its duties diligently, and will generally reduce the strike risk. Drawing the links between appropriate performance and reward is often of key importance.

The lack of disclosure around detailed performance ranges, particularly targets, actual performance outcomes, and associated award calculation for each KPI is perhaps the most common, and most hotly contended issue observed in proxy reports. While proxy advisors generally accept that the provision of forecasts cannot be expected to be disclosed in respect of future incentives, most expect that retrospective performance ranges around which incentives were set, and outcomes determined, are not considered commercially sensitive and will be disclosed. GRG's interpretation of the Corporations Act is that this is in fact required. Defining Threshold, Target and Stretch in the context of incentives, is critical.

Disclose Actual Earnings to Inform Stakeholders

Currently discussion is taking place among various stakeholders with a view to reaching agreement as to a standard for disclosing actual/realised remuneration. The purpose seems to be to provide interested parties with data on how much executives actually earned from their remuneration particularly from participation in incentive plans. While such information may be of interest to shareholders it will undoubtedly be used by journalists as a source for sensational stories about what they consider to be excessive remuneration, usually only because it is high with performance being ignored.

This is an area that can be complex; for example, in the case of LTI, vesting does not necessarily mean that an executive may sell shares to realise the accrued benefit, and more commonly vested equity is subject to disposal restrictions meaning that the "Realised/taxable" value of the LTI may be much different from the value at vesting, when finally accessible. Arguably LTI has not actually been realised until it is actually sold. There are big differences between benefits that are accrued, realisable or realised. Of these, the concept that seems to be most consistent with the purpose is realisable. It is also the value that needs to be disclosed to the Australian Taxation Office in respect of LTI benefits (i.e. taxable value, generally arising when disposal restrictions cease to apply). Thus, the additional work involved in preparing this table would be minimised if companies could use the values that are already being calculated for individual executives.

It should be noted that deferred short term incentives (STI) are increasingly vested on grant, and subject to disposal restrictions rather than service conditions, so this issue is going to become increasingly critical. When STI deferral applies, it also makes sense to show the change in the value of equity during the deferral period so that the impact of deferral can be demonstrated (in-line with its purpose).

While the regulations and accounting standards require disclosure of amounts paid during the reporting period, this often leads to the STI paid in respect of the previous financial year being disclosed in statutory tables (STI is usually paid after the end of the reporting period, and LTI similarly vests following the completion of the financial year i.e. not technically during it). This breaks the link between performance and reward being disclosed. Some companies appear to be applying an interpretation of the regulations such that they disclose the STI earned during the reporting period, and paid just after the end of the year following audit completion, in the statutory table (and some auditors appear to be accepting this approach). However this still leaves the STI being mixed with an AASB2 LTI value, which produces an obfuscated view of remuneration and the link between performance and reward.

To GRG, it seems much cleaner to leave the statutory tables as a discrete section in the report, fully compliant with the regulations, and to instead present tables that more clearly communicate what shareholders want to know. This, again, is also key to outlining the clear links between performance and reward.

Consensus Forecasts

For purposes of both STI and LTI plans it is common practice for companies to use metrics related to company profitability. When this occurs the proxy advisors seem to be increasingly assessing the appropriateness of the performance standards by reference to consensus forecasts of stock analysts. For example, if a company used an EPS compound annual growth rate (CAGR) range of 8% for 25% vesting to 12% for 100% vesting and the consensus analyst forecasts fell around 11% CAGR then the vesting scale would be seen as soft.

Accordingly, Boards should take into account consensus forecasts before settling on vesting scales and if they decide on a scale that is not consistent with the consensus forecast then they should explain the reasons why they selected the vesting scale including why it is appropriate for the relevant measurement period. Despite the fact that some companies have limited analyst coverage, and there are sometimes problems with that coverage including a lack of apparent consensus, this data is ignored at the Board's peril. Of course links to historical outcomes also need to be considered, particularly when forecasts are not available.

LTI Grant Calculations

Proxy advisors and other stakeholders seem to have become fixated on using stretch/maximum LTI award opportunities and the share price (usually a VWAP) as the only two factors to be used in calculating the number of equity units to be granted for long term incentive (LTI) purposes. They usually express the calculation as LTI award opportunity divided by face value, ignoring when conditions are binary (no scale) and whether a Target is really a target, or is instead a threshold or a stretch (or when maximum is really a target, with no stretch opportunity). This is leading to significant problems and encourages Boards to make maximum/stretch LTI outcomes easier to achieve, which would appear to be counter to the interests of these external stakeholder groups.

When they say "face value" they mean share price, ignoring vesting conditions and dividend loss. Shares have not had par or face values for many years in Australia, so their incorrect use of this term can be confusing. If companies wish to adopt this approach so as to manage criticism from proxy advisors, then care needs to be taken in determining the stretch/maximum LTI value. The fact that rights or options (not shares) are being granted means that they have values which are less than the value of a share. Accordingly, this fact needs to be taken into account. The nature of the vesting scales that apply to the grant also need to be taken into account. For example a grant which has service only as the vesting condition would have a different stretch/maximum value to a comparable grant subject to performance vesting conditions. Also a grant subject to performance vesting conditions would have a different stretch/maximum values if the target vesting percentage were say 33.3% for one and 50% for another.

If these aspects are not correctly addressed then executives may receive LTI grants that deliver less opportunity than was intended by the company e.g. when Target LTI is divided by the face value instead of a maximum/stretch LTI being divided by face value. Many Boards are not actually clear whether the policy level of LTI is a Target level, associated with a challenging but reasonable expectation of full achievement, or a stretch, associated with an unlikely outcome and similarly unlikely reward, or a threshold, very unlikely to be missed. As a result of the lack of clarity prevalent amongst all stakeholders, this issue should be a top priority for Boards to consider as a matter of both policy, and disclosure.

Conclusion

Writing remuneration reports for compliance will take your Board down the wrong path, and if a strike is ever received, it will be too late to resolve. Applying a lens of good governance and transparency is much more likely to produce positive outcomes for the Company, executives, and for shareholders; really all stakeholders.

GRG has a proven track record of writing remuneration reports that improve voting patterns on the resolution to adopt the Remuneration Report at AGMs. We also undertake reviews and provide advisory reports regarding how to write the best Remuneration Reports, appropriate to your circumstances. Please do not hesitate to contact us for further information.