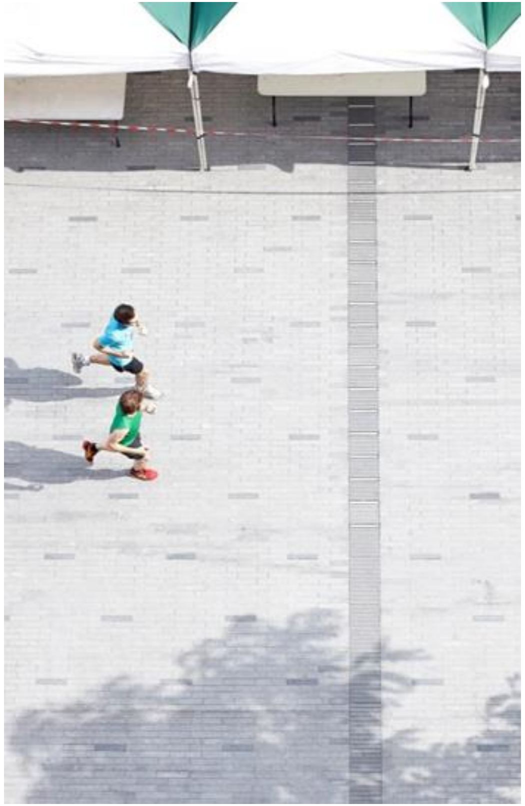
10 minutes on...

Annual General Meeting season – Remuneration report voting outcomes 2015



Are companies finding it more difficult to get a yes vote?

Media coverage would suggest that the Annual General Meeting (AGM) season has been a bruising one. Deeper analysis shows that there has been a increase in the proportion of votes cast against companies remuneration reports almost a third of the ASX200 compared to last year. However, almost half of companies received a vote within 1% of their prior year vote, and a further quarter decreased the proportion of votes cast against their remuneration reports. This does not suggest widespread dissatifaction with current approaches. Rather shareholders are highlighting the need for continuous improvement of the fundamentals, supported by transparent disclosures and effective communication.

Highlights:

- Seven companies in the ASX200 received strikes on their annual remuneration report
- To date, none of the companies within the ASX200 have recorded a second strike this season.
- The median percentage of votes cast against the remuneration report across the ASX200 is 2.8% compared to 2.4% in 2014 (on a like-for-like basis).

The modest increase in the proportion of votes made against remuneration reports is, partially, a result of shareholders showing an increased willingness to make up their own minds on remuneration voting outcomes rather than merely deferring to proxy advisors[1]. This appears to have resulted in a more 'active' voting season. The areas of focus for continuous improvement being highlighted in voting outcomes include:

- Poor disclosure of short-term incentives (STIs)
- Inadequate long-term incentive (LTI) performance hurdles
- Addressing the link between pay and performance

Results also indicate that shareholders are rewarding companies with yes votes for clarity and consistency in their approach and disclosures.

International reporting observations

In the UK, companies are required to put their remuneration policy to shareholders at least once every three years, and more frequently if there is a change. If the remuneration policy gets voted down (>50%), the company must revert back to the previously approved policy. The UK FTSE100 experience was similar to Australia:

- Median proportion of vote cast in favour for remuneration policies put to shareholders was 96%
- Common reasons where lower support was provided for companies include significant fixed remuneration increases, large incentive payouts (STI and LTI) not warranted by performance and inadequate disclosure around STI.

Notable reporting developments include:

- Improved quality of retrospective disclosure of STIs
- Increase in LTI measures (more than 50% now have three measures), and the increase in post vesting holding locks (approximately 50% of companies operate a period of five years between grant date and release of awards).

In the US, where the 'say on pay' also requires votes at least once every three years, the SEC in 2015 adopted an additional rule requiring disclosure of the CEO's annual total compensation compared to the median annual total compensation of all employees. While the reporting requirement is less likely to have regulatory ramifications for Australia, it could calls from shareholders for additional disclosures and factors to consider in voting for or against a company's remuneration.

Local development: APRA looks to further influence executive pay

- Australian Prudential Regulator Authority (APRA) has indicated its intent to influence executive remuneration, forming a dedicated team to target the issue.
- APRA are proposing empowering Board Chairs to strike out bonus payments if they are not justified.

1 *Funds flex their muscles – The Australian (30/03/2015).*

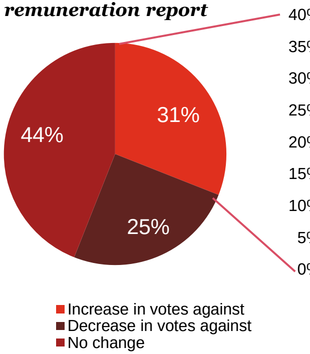
Whilst only seven ASX200 companies received their first strike, 31% of companies experienced increases in their no vote…

First strikes in 2015

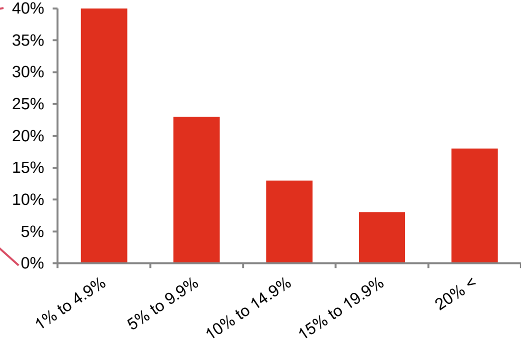
Compared to this time last year, there has been one more ASX200 company receiving a strike[2] (where more than 25% of shareholders vote against the annual remuneration report). Companies receiving a strike in 2015 include:

- AusNet (41%)
- Ansell (33%)
- ALS (27%)
- Downer EDI (27%)
- Liquefied Natural Gas (34%)
- Premier Investments (34%)
- Village Roadshow (32%)

Change in proportion of votes for the remuneration report



Scale of decrease in votes for the remuneration report (compared to 2014)



Second strikes

A strike at successive Annual General Meetings (second strike) triggers a vote on a Board spill where all Board members may be replaced. A spill resolution is passed if 50% (or more) shareholders vote in favour.

- There have been no second strikes in the ASX200, this reporting season
- UGL, which is positioned outside the ASX200 received its second strike but avoided a Board spill.

[2] *Based on disclosed information (14/12/2015).*

But increases are considered moderate

Observations from the AGM season so far have indicated that almost 1/3 of companies have experienced an increase in votes (>1%) cast against the remuneration report relative to last year.

The scale of the shift is considered moderate. Of the organisations that experienced an increase in no votes, almost 40% registered a vote against the remuneration report of less than 5% and almost two thirds registered a vote against of less than 10%. The net effect is that the median vote against remuneration reports is 2.73%.

Shareholders are looking for continuous improvement…

Area of focus	Examples	Concern(s)	Suggestions for improvement
STI disclosures	Ansell - concern over the quality of disclosure relating to the STI	Concerns relating to STI disclosure include: • Disclosure of previous year's STI, rather than current year actual or accrual (where the incentive has not yet been paid) • Limited or no disclosure relating to performance measures, weightings, thresholds, targets and multipliers.	To ensure greater understanding of the STI, provide detail about: • Performance measures and weightings (not necessarily actual targets) • Relative threshold and maximum levels, rather than absolute levels (ie threshold = 90% of profit target) • How formulaic the STI is, and under what circumstances discretion is applied • Retrospective bonus targets.
Performance hurdles	ALS (strike) – concern over the degree of difficulty in the EPS hurdle Echo (increase in no vote) – concern that LTI EPS targets were not disclosed suficiently to enable shareholder assessment of appropriateness	Concerns relating to performance hurdles cover: • Lack of performance hurdles • Alignment between performance hurdles and business objectives • Evidence of reasonableness/stretch in performance hurdles.	To ensure greater rigour around performance hurdles: • Consider whether the performance targets are appropriate for your business • Consider applying holding locks beyond vesting date in line with UK developments.
Pay and performance relationship	Westpac (significant increase in no votes) – concern raised over adjustment to cash earnings based on software write down Downer (strike) – concern over retention payment	Shareholders have been particularly unforgiving against: • Large fixed pay increases- viewed as inappropriate within a climate of moderation • Retention payments – generally viewed as inappropriate at executive level due to lack of performance criterial • Adjustments and discretion – viewed as inappropriate where it generates an outcome for the executive which is different to that of the shareholder.	To navigate difficult remuneration decisions, and eliminate perceptions of inappropriate outcomes, clearly define performance. • Develop consensus between management and shareholders regarding performance • Ensure definition goes below surface-level descriptions such as 'linking results to profit' • Capture how this is applied eg difference between statutory and non-statutory results.
Streamlining and simplicity in remuneration reports	Wesfarmers – specific recognition for simplicity in remuneration report disclosures	Simplicity of remuneration reporting is still a key focus: • ASX 100 companies have continued to streamline their remuneration report,	To enable shareholders to quickly digest information • Provide illustrations / graphics where possible • Avoid duplication and use of jargon • Obtain formatting advice • Reorganise existing information to make it more readable

...and vote 'yes' where there is clarity and consistency in approach

Rewarding for good behaviour

For those companies that showed a significant improvement in the voting for their remuneration reports, there were mixed reasons. Key themes included:

- **A sensible approach to remuneration quantum:** companies who improved their remuneration report votes generally showed restraint in fixed pay increases with clearly articulated rationale where this was applied (or in the case of Federation Centres significantly reducing the potential STI opportunity for the CEO from 375% of fixed pay to 200% of fixed pay).
- **Structural changes to align to a longer-term focus and market norms:** For companies that had received a strike in the previous year, various structural changes were introduced including STI clawback and deferral, mandatory holding locks, and eliminating or clarity of discretionary measures of performance. This generally had a positive impact on voting.
- **Improved disclosures showing how reward aligns to performance:** Similarly, companies responding to a strike or significant increase in no votes focused on improving disclosure of their remuneration strategy and structure, and in particular the STI plan e.g. Magellan Financial Group were able to decrease their votes against the remuneration report from approximately 15% to less than 1%.

The results show a consistent trend from prior years: that the fundamentals are critical.

But is that enough given the remuneration report contributes to setting t the tone of the relationship between a company and its shareholders?

Basic building blocks for the relationship with your shareholders

- **"So what?"**- Does your disclosure really answer the "so what" question? You've disclosed to your readers that you believe performance is linked to reward and that you think reward outcomes reflect performance during the year. But so what? Consider what this meant for executives. How did this impact their reward outcomes. More than ever, simplistic statements that don't equip shareholders with the information to come to their own decisions, are not sufficient.
- **"Why... ? If not, why not?"** Have you answered the biggest "why" questions? "Why was performance set at X level?" "Why were outcomes made at Y level?" And if not, consider "why not?" Consider if there really is a good reason for not disclosing this information. Building shareholder confidence in performance targets and outcomes is possible without revealing commercially sensitive targets, for example to provide evidence of how performance targets are calibrated.
- **"What is possible?"** How many companies think of writing the remuneration report as a legislative requirement? Or think that if last year was ok, it's "good enough" to do it again in exactly the same way. Consider how improved transparency in reporting can strengthen your relationship with shareholders.

How can PwC help?

To have a deeper discussion about these issues, please contact

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