10 minutes on....

Executive remuneration trends – a tweak and a tuck to get a tick

January 2013

What you need to know about remuneration trends in FY12

Brought to you by PwC, January 2013

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A tweak and a tuck to get a tick

Against a backdrop of ongoing global economic uncertainty, FY12 was a relatively uneventful year for executive remuneration.

We have reviewed the remuneration trends of the ASX 100 over FY12 and found minimal change to the structure and quantum of executive remuneration.

Instead there has been continued incremental tweaking of features, resulting in added complexity without the benefits of substantive change.

Remuneration committees have been kept very busy with this tweaking as they adjust to their extended oversight role, the continuing demand for stakeholder engagement, and the threat of the two strikes rule.

Highlights

- Minimal change to executive remuneration design and quantum between FY11 and FY12, despite growing evidence that the traditional and conformist model may not be effective.
- Fixed pay increased by 5% for CEOs and 4% for other executives (same incumbent), with many executives (approximately 20%) not receiving an increase.
- Total remuneration (actual) increased by 3% for CEOs and remained static for other executives (same incumbent).
- Only 30% of ASX 100 companies awarding at or above target STI.
- STI deferral and clawback provisions further increased in prevalence (51% of ASX 100 companies use STI deferral), in anticipation of revised legislation.
- LTI vesting outcomes were considerably varied, with 14% of ASX 25 companies having LTI vest every year in the past four years, 20% having no vesting at all and median vesting of approximately 70%.
- Some remuneration committees have questioned the basis of valuing LTIs and particularly whether the accounting value continues to be the most appropriate value to use when determining the number of LTI instruments to allocate.
- Further regulatory reform is due in 2013 with the proposed amendments to the Corporations Act requiring disclosure of past, present and future pay and clawback practices.
- Only three ASX 100 companies have received a strike against their remuneration reports in the FY12 AGM season to date, with no ASX 100 companies receiving a second strike.

Fixed pay and total remuneration increases

While fixed pay and total remuneration increases were modest, shareholders appear to be paying greater attention to overall remuneration quantum compared to previous years

For 'same incumbent' CEOs from FY11 to FY12, the median fixed pay increase was 5% and for other executives the median fixed pay increase was 4%. Approximately 20% of executives did not receive a fixed pay increase, which is lower than the period FY10 to FY11 (30%). This trend demonstrates a continued level of restraint by remuneration committees.

Despite the 'same incumbent' fixed pay increases mentioned above, the ASX 100 median for CEOs remained fairly consistent year on year (just 1% increase). This lesser increase compared to same incumbents is due to year on year changes of companies within the ASX 100 and incumbent CEOs changes, often with the successor earning less than their predecessors.

In FY12, 'same incumbent' CEOs and other executives actual total remuneration remained fairly consistent with FY11 (3% increase for CEOs and no change for other executives) reflecting slightly lower STI and LTI payments in FY12.

Shareholders and proxy advisors appeared more concerned in FY12 than in previous years about the absolute quantum of reward, particularly for CEOs. The historic continued year on year increases in fixed pay (albeit relatively low percentages) and the knock-on effects on total remuneration have raised the question of "how much is too much?"

Given the potential risks of shareholder angst over increases in fixed pay, even if relatively small, we anticipate some remuneration committees may, in future, question the need for an annual fixed pay review and instead consider less frequent reviews.

"Fixed pay increases for same incumbent CEOs and executives from FY11 to FY12 were around 5%"

Short-term incentives

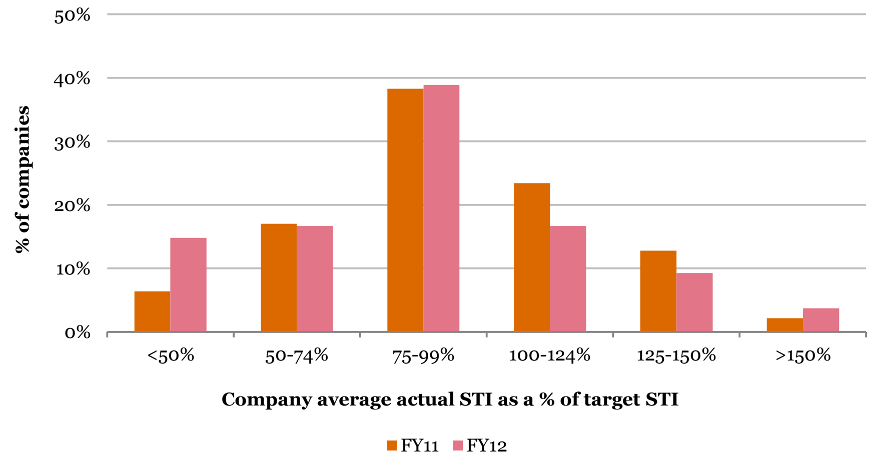
Greater complexity of design through deferral and clawback mechanisms

In FY12, there was increased shareholder scrutiny on the size of STI awards and the relationship to company performance. Only 30% of companies paid at or above target STI (based on the average of all STI awards as a percentage of target provided to executives). This is a reduction from previous years' practice where approximately 38% of ASX 100 companies paid STI awards at or above target (see figure 1).

There were also some high profile reports of CEOs electing to forego their STI payments. However, it is difficult to determine how much influence remuneration committees had on these decisions. While these actions may have been viewed by some as positive, others may view the need for such interventions as a consequence of poor STI plan design or worse, poor decision making by the remuneration committee.

We expect companies will continue to face pressure to justify STI payments in FY13 and possibly to introduce minimum company financial performance gateways. Currently, only 21% of companies have a financial performance gateway to STI.

Figure 1: ASX 100 average actual STI as a percentage of target STI



"There were also some high profile reports of CEOs electing to forego their STI payments"

Short-term incentives (continued)

STI deferral and clawback

There has been a further increase in compulsory STI deferral since FY11, with 51% of companies requiring a portion of STI payments to be deferred (up from 43%). The median deferral period is two years, and the most common amount deferred is 50% of the award (see figure 2).

Clawback provisions have also increased in prevalence, with 25% of ASX 100 companies having or proposing to incorporate such provisions in their STI plans. Most typically, clawback is applied at Board discretion with some guidelines on circumstances when it would be appropriate. We anticipate clawback will become more common in FY13 given the Corporations Legislation Amendment (Remuneration Disclosure and Other Measures) Bill 2012.

While the benefits to regulators and companies of deferral and clawback are well reported, it should be recognised that, if adopted, the difference between short and long-term incentives will become less distinct and executives are likely to significantly discount the value of the reward due to the impact of deferral and the complex and ambiguous clawback arrangements. PwC's study, "Psychology of incentives", undertaken in conjunction with the London School of Economics, proved that executives significantly discount deferred pay to immediate pay, and discount complex or ambiguous schemes compared to simple ones. Deferred bonuses are discounted by executives by around 50% over three years. This is surely a sign that the obsession of regulators with deferral may be counterproductive. We therefore question the impact these STI design tweaks may have on executive motivation and perceived value of these rewards.

Figure 2: ASX 100 deferral periods and quantum*

		ASX 100 deferral period					
		1 year	**1.5 years**	**1-2 years**	**2 years**	**3 years**	**Other period**
ASX deferral quantum	**20% - 33%**	2%	2%	7%	16%	7%	
	34% - 50%	7%		7%	23%	7%	2%
	Other amounts	2%		7%	2%	2%	
	Not disclosed					5%	

** Of those companies that had STI deferral in FY12*

Long-term incentives

Three year performance rights assessed against a relative TSR performance hurdle, in conjunction with another hurdle, continues to be the most common LTI design

There has been very little change or creativity in LTI plan design in FY12. Consistent with previous years, relative TSR (total shareholder return) continues to be the most commonly used performance hurdle (76% of companies). Most often TSR is combined with a second hurdle and the use of TSR as a sole hurdle has reduced by 8% in FY12 to 23% of ASX 100 companies. The most common performance period is still three years (75% of companies). *

This convergence and standardisation of LTI design has generally resulted in proxy advisor and shareholder approval. However, we are beginning to see limited examples of institutional investors, such as BlackRock Investment Management #, encouraging companies to break away from the conformity and rethink executive incentive programs. BlackRock has urged remuneration committees to consider alternative incentive structures that reflect the company's uniqueness. Whether such a view will be more widely accepted by shareholders generally has yet to be fully tested.

In FY12, a key area of interest for some remuneration committees was the level of historic LTI vesting, that is the value that executives actually receive from past awards. Detailed disclosure of LTI vesting is often limited. However, we have analysed the practices of a sample of 21 ASX 25 companies over the period 2009 to 2012. The key findings indicate that only three companies in the sample of 21 (14%) had LTI awards vest in full (100%) every year over the period. Nineteen percent (four companies) had no LTI awards vest over the period and median vesting was typically around 65% - 75% of the annual LTI award.

"We are beginning to see limited examples of institutional investors…encouraging companies to break away from the conformity and rethink executive incentive programs"

** Includes companies that have scaled multi-year vesting periods*
 # BlackRock Investment Management- Time to rethink executive incentive programs 2012

Long-term incentives (continued)

Going forward, remuneration committees will seek to better understand how much LTIs are really worth to executives, partly in anticipation of the proposed Corporations Legislation amendments requiring companies to disclose the value of LTIs when they vest (past pay) but also to demystify some of the complex assumptions of accounting valuation and help determine the right level of future awards.

When determining how many LTI instruments to allocate on an annual basis, companies use either a face value (market value of a share) or some form of valuation per instrument, often a fair value. In FY12 approximately 75% of ASX 100 (that disclose) used a fair value. The difference in the two values is often significant, for example, amongst ASX 100 companies granting performance rights with a TSR hurdle in FY12, the fair value ranged from 53% to 73% of face value (i.e. effectively 37% to 89% more instruments allocated if using a fair value approach).

As shown in figure 3, the median discount to face value applied to LTIs for allocation purposes was 37%.

In FY12, some proxy advisors indicated a lack of confidence in the use of fair value as an LTI allocation methodology and suggested that in some cases the size of LTI grants appeared excessive. In response to these views, and the anticipated changes to disclosure, some companies are considering moving to a face value allocation. Going forward, we anticipate this is likely to become a greater issue. However, both sides of the argument need careful consideration before simply adopting such a change.

Figure 3: ASX 100 face to fair value discount *

	Fair value as a % of face value	**Face value discount**
25th Percentile	53%	47%
Median	63%	37%
75th Percentile	73%	27%

** Of those companies that made a grant of performance rights with a TSR hurdle in FY12.*

Shareholder acceptance and outlook for FY13

Shareholders strike against only three ASX 100 company remuneration reports

The second Annual General Meeting (AGM) season following the introduction of the 'two strikes rule' is nearly complete and the number of ASX 100 companies receiving votes against their remuneration report remains low. As was the case in FY11, only three companies in the ASX 100 received a strike against their FY12 remuneration report (in other words, a vote against of greater than 25%). No ASX 100 companies have received a 'second strike' in FY12.

Those companies that received a first strike in FY11 addressed the concerns raised by shareholders by: freezing fixed pay or non-executive director fees, reducing or deferring bonuses, redesigning their LTI plans or providing better disclosures. The concerns raised by shareholders in relation to companies who received a strike in FY12 were slightly different to FY11. For at least two of the companies, shareholders had issues with the valuation of LTIs (either being valued at a significant discount to the market share price at grant or significantly more instruments than historically being granted).

Outlook for FY13

There is a growing body of evidence that implicit acceptance of the conformist approach to remuneration design, that has required constant tweaking, could be challenged in FY13. Remuneration committees will continue to strive for simplified arrangements, that shareholders accept and executives view as motivational, while accommodating new legislative requirements. As remuneration committees consider these challenges ahead, maybe for the first time in a number of years, we will see some seriously consider more wholesale change, rather than just tweaks.

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How PwC can help

To have a deeper discussion about these issues, please contact:

Sydney

Debra Eckersley
Partner
Ph: (02) 8266 9034
Email: debra.eckersley@au.pwc.com

Emma Grogan
Partner
Ph: (02) 8266 2420
Email: emma.grogan@au.pwc.com

Alena Mackie
Director
Ph: (02) 8266 0696
Email: alena.mackie@au.pwc.com

Melbourne

Della Conroy
Partner
Ph: (03) 8603 2999
Email: della.conroy@au.pwc.com

Daryl O'Callaghan
Principal
Ph: (03) 8603 2841
Email: daryl.ocallaghan@au.pwc.com

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