10 Minutes on...

What you need to know this AGM season

October 2017

The headlines are once again being dominated by big dollar remuneration packages for executives - sometimes reflecting reality but often not. Trust in business continues to suffer and income inequality is painfully real for too many Australians, and so not surprisingly, executive remuneration is under scrutiny. There are a multitude of issues which can confuse the executive remuneration debate. In this AGM season, we believe there will be four prominent themes:

1. ***Accountability*** reinforced through pay outcomes
2. Reasonableness of ***quantum***
3. Remuneration models that are ***customised*** to the company and disclosures that are ***simple***
4. ***Alignment*** with shareholders

Companies that reinforce executive accountability through reward, have simple arrangements that are simply explained, demonstrate strong alignment between pay and shareholder outcomes, and are cognisant of fairness of pay quantum will come through this AGM season facing less controversy. Quality stakeholder engagement will continue to be critical to reduce scrutiny, particularly if changes to remuneration frameworks are being introduced.

What should companies be doing to prepare?

- Be able to articulate the full context regarding pay decisions. The correlation between remuneration and shareholder outcomes is only one factor to explain 'why' executives receive what they do. Remuneration arrangements and outcomes will be considered in light of the breadth of accountabilities that executives are responsible for - including financial, strategy, risk, safety, customer and company reputation.
- Demonstrate that sufficient consideration has been given to the 'reasonableness' of pay quantum. Familiarise yourself with local and international trends and regulatory developments and at least have considered how they may be relevant to your organisation, particularly as it relates to fairness of pay outcomes.
- Learn from the new emerging remuneration models and consider whether your arrangements, or your explanations of those arrangements, can be simpler. In doing so, ensure that your remuneration principles make sense for your particular company and context, and then are clearly reflected in your pay practices.
- Enter stakeholder engagement conversations with a well thought out strategy and talking points reflecting a conviction in the strength of your remuneration arrangements. This should include any rationale for changes, deep understanding of the design features and possible pay outcomes in both high and poor performing scenarios, and clear responses to anticipated questions, particularly those that have been raised previously by proxy advisors or investors.

Accountability should be reinforced through remuneration

We anticipate a strong theme during the AGM season will be around accountability, on two fronts:

a) ***executive accountability*** for sustainable company performance and reputation reinforced through remuneration outcomes; and
b) ***Board accountability*** demonstrated in the determination of incentive awards.

Executives are accountable - and paid - for the sustainable performance and reputation of the companies they lead. Therefore understandably, expectations are high. Shareholders continue to increase their scrutiny of how fixed pay increases and incentive payments correlate with shareholder outcomes, and are also questioning the connection to a broader set of outcomes including customer, safety, community, and reputation. So the expectation is for executive accountability to be reinforced in remuneration, both in terms of the 'what' - delivery of strategy and returns, and the 'how' - the reputation and culture of the company and executives' personal behaviours. There have been a number of public and recent examples of this, as shown to the right.

In Australia, the announced Banking Executive Accountability Regime (BEAR) looks to ensure Authorised Deposit-taking Institutions (ADIs) are appropriately reinforcing accountabilities partly through civil penalties, disqualification of individuals, and negative remuneration consequences. The proposals include specifying that 40% - 60% of variable remuneration (for large to medium ADIs) will be deferred - for a four year period - and will allow for reductions in variable remuneration if it is determined that the executive acted inconsistently with BEAR obligations. The proposals are proof that if companies don't fix the perception, or reality, of accountability and fairness in pay, the government will resort to regulation.

Where have companies sought to reinforce a comprehensive set of accountabilities through reward outcomes?

- **CBA:** Reduced all senior executive bonuses to zero, and for some former executives cancelled deferred STI and reduced LTI vesting outcomes for "risk and reputation" matters. Sharing that accountability, the Board reduced its fees by 20% for FY18.
- **Seven West Media**: Disclosed that the CEO asked not to be considered for an STI award, and the Board determined that it would not be appropriate for the STI award to be made. While the specific rationale is not disclosed, it isn't difficult to consider that reputation may have had an influence in the outcome.
- **South32**: The STI has a specific 'business modifier' which is used to reflect discretion reserved for the Board to consider factors not included in the scorecard. In FY17 the CEO and an executive in Africa had a modifier applied to reflect a fatality, reputational outcomes and overall business performance.
- **Tabcorp:** Whilst financial results were significantly impacted by one-off costs (including a $68 million cost of anti-money laundering breaches) other key metrics related to strategic priorities and people & leadership were exceeded. Nevertheless, with profit results well below target, and an acknowledgement that risk and compliance issues had been "difficult and distracting", the CEO, CFO, and COO received no STI.
- **QBE:** CEO STI reduced by 20% or about $0.55m because "some personal decisions by the CEO have been inconsistent with the board's expectations" around the timely disclosure of a relationship.

What can you do to prepare?

- Clearly articulate the correlation between performance and shareholder outcomes and consider this explanation to be paramount
- Consider the appropriateness of, and be prepared to explain, pay outcomes in the context of other considerations that will impact on perceptions of 'fairness' such as public examples of poor customer outcomes, scandals that have led to reputational damage, mismanaged risks, poor safety outcomes and/or negative environmental impacts.
- Ensure that clawback and deferral policies do allow for a reduction in variable pay when the circumstances warrant it
- Be prepared to reduce variable pay outcomes in light of risk or compliance issues, even when financial performance is strong. Alternatively, be prepared to explain why a decision was made not to pass through any pay reductions if such issues existed during the year.

Pay quantum should be considered "fair"

The issue of pay quantum continues to be on the minds of government, regulators and the community.

For some time now, societal concern about levels of executive pay has been on the rise. And we expect commentary regarding executive remuneration "excess" to dominate the headlines again this AGM season. But how do companies or external stakeholders answer the question of whether pay quantum is fair? How much pay is reasonable? Such questions raise a complicated set of considerations and the definition of 'fair' is rapidly evolving and varies greatly by stakeholder. Nevertheless, companies increasingly need to be sensitive to the fact that executive pay has become a symbol for broader concerns about inequality.

The issue of fairness in pay quantum has been the backdrop to a number of recent elections and referenda across the developed world - with calls for pay ratio disclosures and better explanation for pay outcomes high on countries' political agendas. Australia is not immune to such views and debate, as evidenced by recent findings from The Governance Institute who report 77 per cent of respondents believe that a $3 million CEO pay package is unethical – even though this is close to the average pay packet for an ASX 300 company (Source: Governance Institute Ethics Index, July 2017). Furthermore, there has been much commentary this year by Australian media regarding stagnant wage growth in spite of CEO packages increasing.

Whilst pay ratios are not required to be disclosed in Australia - we do believe that companies that should understand and monitor pay ratios across their own organisation. In making decisions regarding pay increases, Board should also be aware that some external stakeholders have gone so far as to express an expectation that pay should be going down in an absolute sense. We are seeing this expectation play out for newly appointed CEOs in the ASX100 receiving on average 33% less fixed remuneration than their predecessors during the last financial year.

As seen in the table on the right, the focus on fairness of pay quantum is also occurring in other developed markets. Pressures to bring absolute pay levels down may indeed pose challenges for Australian Boards in terms of attracting executives from global markets, particularly if pay restraint in Australia occurs more substantially or at a faster rate.

Country	Evidence of scrutiny on pay quantum
United Kingdom	• UK government released a White Paper outlining its intentions on previous proposals and submissions on remuneration. • The government intends to introduce legislation to require listed companies to: 1) Report annually the ratio of CEO pay to the average pay of their UK workforce, as well as why the ratio changes year-on-year 2) Provide clearer explanation of the range of potential outcomes from share-based incentive schemes.
United States of America	• Disclosure of CEO pay ratios have been on the political agenda for some time. However, in June 2017, the House of Representatives voted to pass the Financial CHOICE Act, which would roll back a number of proposals from the Dodd-Frank legislation including: a) that publicly traded companies report their CEO to median-worker-pay ratio (which was planned to apply from next year) b) restrictions on incentive-based compensation in large FS institutions which encourage "inappropriate risks".
New Zealand	• Whilst there is currently uncertainty on which major party will form government in a coalition with NZ First, NZ First's public statements on the excess in disclosed remuneration packages indicate that the issue of pay quantum will increase in prominence in New Zealand's political and governmental arena.

What does this mean for Australian companies?

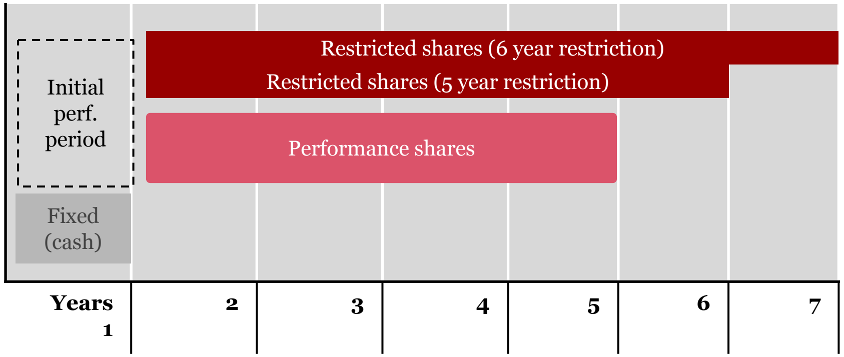
Any significant pay increases for existing incumbents, or new incumbent packages that approximate outgoing CEO pay levels, should be carefully explained in the context of strong shareholder outcomes, or as necessary to attract global talent. Boards may benefit from taking a moment to understand their own CEO to average worker pay ratio, and consider, and even communicate, how their organisation defines and manages fairness as it relates to pay. In doing so, Boards should seek to better understand the trends on both sides of their ratio i.e. CEO pay levels, and employee wage growth. Companies who can self regulate and clearly articulate a rationale for pay outcomes will help build trust in executive pay more broadly, and may help minimise further pay regulation, with potentially adverse outcomes, from occurring in Australia.

Customisation & shareholder alignment are driving the emergence of new remuneration models

When determining what is "fair" pay, the answer is likely to be different for each organisation and is often impacted by multiple factors. To this end, over the past few years, there has been increasing complexity in remuneration design to reflect varied views on how to align remuneration to strategy or "performance", differences in perspective on what "performance" really means, and how to incorporate risk (eg longer deferrals and clawback). The end result is remuneration arrangements that not only seem opaque to shareholders and the broader community, but they are often also not valued by executives. The 2017 annual reporting season has seen the emergence of a number of alternate simpler and/or highly customised remuneration models (ie. relevant to the specific organisation), that seek to enhance shareholder alignment via increased "skin in the game" (eg. shareholdings).

Wesfarmers

An in-year performance scorecard of financial and strategic goals determines incentive awards - delivered as equity[1]. The equity is split equally between restricted shares and performance shares. Performance shares are subject to measures relevant to the participant which may include a mix of divisional and corporate metrics (eg 80% divisional EBIT, 20% rTSR).



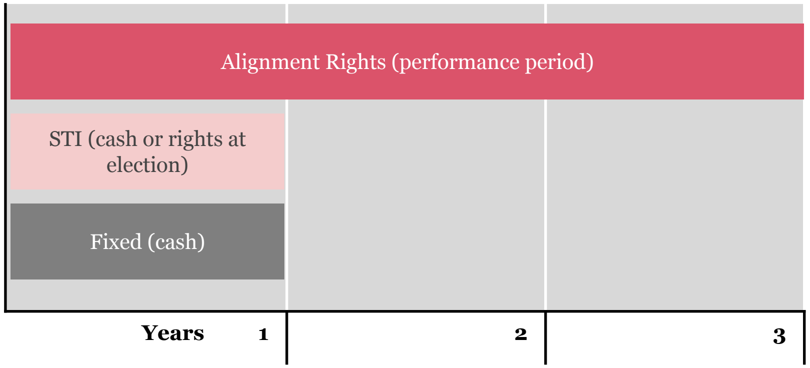
1. *During a transitional period, a cash component may be triggered. The cash component will gradually reduce to zero over the next four cycles.*

Why companies would consider this plan?

- Focus assessment of performance on divisional accountabilities where divisions are strongly autonomous and responsible for strategy execution, and on measures relevant to each participant
- To enhance long-term focus and "skin in the game" / shareholder alignment over 7 years via an incentive award solely delivered as equity with significant vesting periods
- Phased vesting of restricted shares over a significant deferral period drives retention

BlueScope Steel

A traditional LTI (rTSR and EPS) has been replaced with an annual grant of 'Alignment Rights', which vest subject to a number of underpinning performance conditions, accompanied by increased mandatory shareholding requirements. The STI opportunity has been reduced and executives can elect to receive their STI in cash and/or rights.



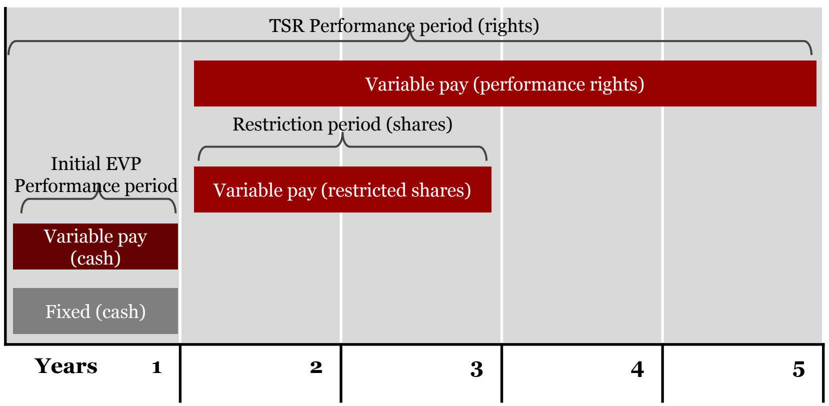
Why companies would consider this plan?

- Focus management on long-term alignment with shareholder outcomes ('behave like owners') and reduce volatility on reward outcomes from year to year
- Provide protection against perverse outcomes for alignment rights by ensuring that threshold performance is maintained over the performance period, together with malus provisions
- Opportunity to reduce the LTI quantum given the increased likelihood of payment and perceived value by participants

What's 'right' for the company is critical to any consideration of a new remuneration model

Telstra

A combined incentive plan with an initial performance measurement period of one year. A significant deferral of the incentive payment will be made into equity, the value of which will be impacted by long term share price performance, with a portion subject to a 5 year relative TSR condition.

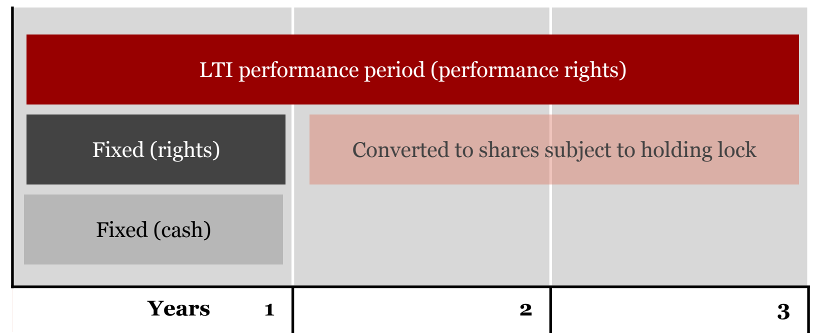


Why companies would consider this plan?

- Supports a focus on clearly articulated annual milestones that must translate into success over the long-term, whilst also providing flexibility to re-orient in a fast-paced and knowingly uncertain environment
- A significant equity deferral period and quantum aligns to long-term shareholders' interests and serves as a retention mechanism for executives
- Mitigates difficulty in setting meaningful long-term measures, but still ensures the realised incentive value is largely determined by share price movement over the longer term

Alumina

Under the new CEO's remuneration package for FY17, there is no STI. There is an annual grant of restricted share rights (as part of fixed pay) and also an annual grant of LTI subject to performance.



Why companies would consider this plan?

- Removal of the STI enhances simplicity and directs the CEO's focus on long-term sustainable performance rather than annual performance
- Places equity into the hands of participants early (and definitively as tied to fixed pay) via restricted rights that are not subject to further performance conditions, allowing participants to access real value and think like business owners

What does this mean for other companies?

The introduction of different and customised models is a welcome sign of companies taking a considered view of how remuneration can support their own specific needs. While we expect simpler models to increase in prevalence, we note that many external stakeholders are still somewhat resistant to change. Whilst we don't believe that any particular model is the 'right' model for all organisations, it is an opportune time to assess whether further customisation of a company's existing remuneration framework can enhance the return on total remuneration spend by both shareholders and executives.

Stakeholder consultation - two-way expectation of engagement

Engaging with external stakeholders on remuneration design

Continuing the trend from prior years, early consultation with investors, shareholders and proxy advisors to articulate the rationale for reward design and outcomes is part of a good governance approach for many companies.

Engagement becomes particularly important when sharing how customised remuneration frameworks or reward outcomes align to the particular circumstances of the company. Lessons include:

1. Be transparent on the rationale for change – have a detailed set of talking points, outlining the company's specific context and rationale for change, "why now", why your company, what it means for shareholders, and what are the "risk-mitigants".
2. Be knowledgeable on the detailed design features, including any change in quantum, calibration of pay and performance, metrics, stretch goals and discretion.
3. Anticipate questions / concerns across different stakeholder groups and be prepared to alleviate such concerns.
4. Allow time for iterative conversations as some external stakeholders will take time to comprehensively digest the change.

Proxies under pressure…

Concerns have been raised both in Australia and globally on the influence of major proxy advisors on remuneration, and whether this is in the best interests of shareholders and the organisation.

In Australia, listed company chairs and chief financial officers have called for ASIC to introduce a compulsory code of conduct for proxy advisors. ASIC has responded by issuing a letter to key stakeholders that they will be engaging with proxy advisors on their engagement practices, including when an "against" recommendation is proposed. This is particularly to address concerns from organisations that some proxy advisors' engagement approach fails to:

- adequately allow for two-way engagement
- provide time to clarify misinterpretations
- update for inaccuracies.

In Australia, ISS has introduced a new 'pay for performance' model as a further input to determining their voting recommendation. While it is used as one input, companies should note:

- The range for determining comparator companies is very broad - at the low end can include companies that are ¼ the size of the company or at the high end 4 times the size of the company on either revenue or market capitalisation, ie significantly different.
- When comparing pay and performance, ISS utilises 'granted' value of LTI to determine pay. This disregards the fact that granted LTI is not determined on the basis of performance, and the ultimate value may be zero, or multiples of the grant value dependent on performance
- Historical TSR performance compared to current CEO pay may not sufficiently take into account changes in CEOs during that period and resultant impact.

In both the UK and the US, concerns have also been raised on the influence of the proxy advisors on remuneration. In the US, a bill was drafted in June 2016 to require proxy advisory firms to register with the Securities Exchange Commission (SEC). Such registration would require proxy firms to provide annual financial reporting, disclose conflicts of interest, codes of ethics, methodology for the formulation of voting recommendations, and provision of adequate opportunity to respond to draft recommendations (with an ombudsman to mediate any issues raised by companies). Proxy firms and the investment community are strongly opposed to such measures in the draft bill.

What does this mean for Australian companies?

Each of the developments overseas and in Australia speak to greater desire to increase the quality of conversations between stakeholders on remuneration.

For companies, having a well thought out strategy for proxy advisor and shareholder consultation, including rationale for change, good knowledge of the design features, and making sure you know your audience, is always desirable.

And with increasing criticism of proxy advisors, be cognisant of the advice that proxy advisors are putting out to your investors, and be prepared to rebut if required.

How can PwC help?

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

Sydney

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

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

Cassandra Fung
Director
Ph: (02) 8266 2183
Email: cassandra.fung@pwc.com

Katie Williams
Senior Manager
Ph: (02) 8266 0273
Email: katie.williams@pwc.com

Melbourne

Andrew Curcio
Partner
Ph: (03) 8603 1685
Email: andrew.curcio@pwc.com

James Orr
Senior Manager
Ph:(03) 8603 0018
Email: james.orr@pwc.com

Michael Bierwirth
Senior Manager
Ph:(03) 8603 4835
Email: michael.bierwirth@pwc.com

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