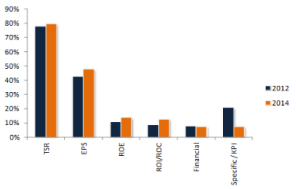
Newsletter January 2015

2015 is shaping up to be a big year. At the end of last month, the Productivity Commission released the terms of reference for its review of workplace relations. Representatives from the hospitality and retail industries are preparing for their submissions to the Fair Work Commission's review of penalty rates as part of the Commission's modern award review. Treasury has also just released its draft legislation amending the taxation provisions of employee share schemes.

In preparation for the coming year, we've put down our thoughts about what you can expect in 2015 in the areas of remuneration and governance.



Director and Executive Reward Trends

John Egan provides his thoughts on what's in store for the 2015 year.

Hallmarks of a Successful Board in 2015

Most Boards have a handle on the pressure points they'll be facing in 2015. Vince Murdoch relates what he thinks Boards will need to do to come out on top.

Draft Share Scheme Legislation Released for Consultation

Australia's Treasury has released draft legislation to implement proposed changes to the taxation provisions of employee share schemes that would see options taxed at the point of exercise instead of upfront.

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Director and Executive Reward Trends

John Egan

Egan Associates believes that fixed remuneration increases at all levels of staff in 2015 will be modest, with the majority of organisations making annual pay adjustments in the range of 2% to 3%, although we also expect greater variation by company and industry sector.

Board fees will be contained broadly in alignment with fixed remuneration adjustments, except where there have been minimal or no adjustments over the past three years to Board fee levels or where the demands on Directors have substantially increased due to organisation transformation or growth through acquisitive initiatives.

We believe there will continue to be churn at the level of CEO and senior management as Boards determine that their current leadership team, although suited to the last three to five years, does not have the relevant competencies to lead the organisation through the near-term challenges of the changing economic and technology environments. Board renewal will remain a constant focus, with some Boards reducing their number and others increasing their membership as demands on Directors change.

In our opinion, 2015 will be the beginning of more open discussion and debate around performance hurdles for long term incentive plans, particularly in the listed company environment. Bespoke performance criteria will gain acceptance in substitution of relative Total Shareholder Return and increasing pressure will be applied to shift timelines from the medium term three-year plan out to five years.

Where this occurs we believe there will be downwards pressure on the proportion and duration of short term incentive awards deferred. There will also be demands placed on Boards, particularly chairs of Remuneration Committees, to formulate policies and practice guidelines for exercising discretion relating to the vesting of equity to good leavers and the adjustment of performance hurdles for changing conditions.

In terms of IPOs and significant transactions, we believe the focus will remain on balancing reward arrangements to retain the leadership team that fostered the organisation pre-IPO, which will entail management maintaining a high level of skin in the game.

More detail on 2015 remuneration trends is provided in our KMP Report, separated into relevant factors that will impact on pay adjustments for staff, management and CEOs:

- economic setting and workforce planning;
- the organisation's business plans and challenges;
- the recent history of the organisation's pay adjustments;
- criticality of retention, recruitment and succession planning; and
- legislative/government policy settings.

Download the KMP report here.

Back to Title Page

Hallmarks of a Successful Board in 2015

Vince Murdoch

As we head into 2015, several international commentators have launched their predictions on what will occupy the attention of Boards this year. Notable among them are Richard Le Blanc, the Harvard Law School and the Australian Institute of Company Directors.

Looking at these prognostications, what challenges can we expect for Australian Boards in 2015? Most likely in my mind are:

1. ***Cyber security***

The 2014 year saw a number of high profile attacks across the globe. The consequences of these attacks were severe, both in their own right and due to the poor response of some of the organisations involved. The attacks will not stop coming in 2015. They will only become more frequent, and it's only a matter of time for many organisations before Directors' fears are realised and their company is tackled next. High priority targets would seem to be financial institutions and retailers and any other corporation where large amounts of sensitive consumer data is stored.

2. ***Sustainability***

More pressure will be placed on companies from stakeholders and investors on the viability of various business models given issues such as climate change, shifting demographics and social inequity. Boards can expect that investors and stakeholders will ask whether the business is sustainable given these factors, and make investments based on the answers to that question. Even sacred cows are no longer safe. For example, the concept that mining and oil companies are sitting on buried wealth is no longer considered to be certain given projected demand and pressure from activist investors.

3. ***Regulators***

Regulators will continue to introduce more compliance-based reforms that will either detract from Directors' attention on strategy or affect the functioning and performance of the Board. For example, any legislated change to the current composition of industry superannuation funds will cause disruption while Boards readjust their memberships. Likewise, continued pressure from APRA will cause Boards of financial institutions large and small to constantly ensure their focus remains on governance rather than management.

4. ***Activists and proxy advisors***

There will be increased scrutiny from external parties on Board actions. This will create pressure in some areas for Boards to act in ways that go against what is best for the company under their stewardship. The challenge of balancing long-term growth against short term returns is not new. What is coming to the fore is increasing pressure on Boards to ensure that they are focused on value-adding activities for the strategy and growth.

5. ***Economic setting***

The consensus appears to be that markets will be volatile, unemployment will be high, consumer confidence low, global growth low and the dollar down. Foreigners will find investments in Australia less attractive, dividends will come under pressure, some companies will face the threat of takeover (potentially hostile) and there will be more demands on Board time.

None of these challenges will be a surprise to anyone. What will be interesting is how Boards react.

A recent McKinsey article opines, rather provocatively, that "Boards aren't working" and are missing the boat in four vital areas:

- Electing the right people – Boards are seen as inadequately equipped to meet shareholder interests
- Spending quality time on strategy – Directors need to increase the number, quality and depth of strategic conversations
- Engaging with long-term investors – Boards are not conducting an open, ongoing dialogue with long-term investors to enable a longer-term outlook
- Pay – Directors need to think like investors by having more skin in the game, either via incentives or share holdings.

It's difficult to fault McKinsey's logic and it's unlikely the situation is significantly different in Australia than it is in the US.

If I were able to invoke the traditional genie's three wishes, it would be nice to look back in December 2015 and say that Boards have enjoyed success in the following:

1. ***Strategy***

Rather than reporting that they want to spend more time on strategy, my first wish is that Boards will have actually implemented specific activities to spend more time on strategy.

For example, during 2015 Boards will:

- Move beyond the one-off annual strategy event by creating a timetable that addresses corporate strategy regularly.
- Increase the time they devote to Board work.
- Table a strategy item as the first point on the agenda at each Board meeting when they are freshest. Encourage directors to discuss the high impact items that can add the most value.
- Require executive presentations to demonstrate explicitly where initiatives and projects contribute to the overall strategic plan.
- Invite external speakers/experts to provide industry insights, competitive analyses, and information on consumer demands that reinforce or challenge the corporate strategy.
- Become more active in the field, visit company locations, listen to customer panels, observe company operations – see with their own eyes what competitors are doing, what customers need, how their business could improve.
- Do more broad based scenario planning to consider a range of possible environments within which the organisation could be operating in the near and longer term future.

After implementing these activities, Boards will be more innovative and customer focused. In this data-rich decade, companies are able to know more about the customer than the customer does themselves. Using this information, Boards will drive strategy in the direction of tailored and innovative products and services that are what customers actually want and need, and reflect the changing world in which we all live.

2. ***Board performance, succession and composition***

A PWC survey of US Directors noted that 36% of respondents would like to see the exit of another Director on the Board, up from 31% the year before. The needs of Boards change as companies mature, grow, slow down, venture into new markets, withdraw from other markets, face new competitors and increased customer demands. Not surprisingly then Boards face an ongoing challenge in renewing Board capability, ensuring the right people are assembled around the table and are able to contribute where needed.

By the end of the year, my second wish is that many Australian Boards will have gone beyond the requirements of the new ASX corporate governance guidelines to invest significantly in identifying the contribution of individual directors. They will have articulated carefully the capabilities that are required at the Board level and will have assessed the capability of all Directors against the future needs of the organisation.

As a consequence, Boards will have put in place training and development for some Directors, removed others, and recruited new Directors. Boards will focus on leadership succession throughout the organisation based on the organisation's future strategy.

The focus on independence will shift to independence of thought rather than independence defined as how many years a Director has been on a Board and how many shares they own.

Although we will not see a 30-year old on the BHP or Commonwealth Bank Board, Boards will make use of advisory groups and special committees so that Boards can independently tap into the information they need.

3. ***Board dynamics***

My third wish is that Chairmen around the country will become more and more rigorous in bringing matters to agreed resolution and in rooting out dysfunctional behaviour. The leadership of the Chairman will encourage debate, ensure all views are expressed, and prohibit dysfunctional behaviour from disrupting the flow of debate and decision.

Dysfunctional behaviour will be called out in Board rooms with no glossing over problems, so we won't hear that:

- Debates become bogged down in irrelevant detail
- Directors regularly discuss matters or lobby each other outside the main session
- Directors are hostile to management and interrogate them based on a personal agenda
- Directors are out of touch with the company
- Directors bring items to meetings that are not on the agenda

Such markers of poor Board dynamics will be noted and the problematic behaviour changed, or the Director/s will be asked to leave. There will be more and more awareness on how Board dynamics (the interaction of different Director skill sets and behaviours and the extent to which Boards tolerate poor performance) affects what the Board does.

In the same way that Boards will put a process in to identify capabilities they require and facilitate Board renewal, the management of boardroom dynamics will have become a repeatable process that is conducted regularly.

If all of this can come to pass in 2015, we can all look forward to McKinsey NOT publishing an article leading off with the sentence "Boards aren't working" at the end of the year.

Back to Title Page

Draft Share Scheme Legislation Released for Consultation

Australia's Treasury has released draft legislation to implement proposed changes to the taxation provisions of employee share schemes that would see options taxed at the point of exercise instead of upfront.

The government wished to reverse changes made by the former Labor Government, noting that the new rules were reducing the competitiveness of Australian start-up companies and hampering their ability to attract and retain high quality employees.

These proposed changes apply to all companies; however, the government has also introduced a further taxation concession for employees of certain small start-up companies.

Changes applying to all companies

As foreshadowed when the changes were first announced, the new legislation will:

Allow schemes offering rights (including options) that do not contain a real risk of forfeiture to access tax deferred treatment, as long as the scheme rules state that tax deferred treatment applies and the scheme genuinely restricts an employee from immediately disposing of the right. Taxation can be deferred until the disposal restriction on the rights and the underlying shares is lifted.

Change the taxation point of rights from the point at which a right "can" be exercised to the point at which it "is" exercised.

The legislation has also increased the maximum deferral period for shares and rights from seven years to 15 years (unless the employee ceases employment).

Employee share schemes must still meet general eligibility conditions, although the ownership condition – where employees could not participate in schemes if they owned more than a 5% interest (or rights to own interest) in the company – has been extended to 10%.

Employees can also now reclaim tax paid on rights they decide not to exercise, for example in the case that an option is underwater. This does not apply where the scheme protects the employee from market risk.

As proposed, Treasury has released revised tables for the valuation of rights granted in employee share schemes, using updated assumptions to reflect current market conditions. Commentary from taxation experts such as KPMG notes that the new tables generally reflect lower values than the existing tables.

In addition, the Taxation Commissioner will receive new powers to approve different valuation methodologies. If the taxpayer uses the approved methodology, they can rely on that method as reflecting the market value of the asset or non-cash benefit being valued.

Changes applying to selected start-ups

Some start-ups will be eligible for additional concessions where:

- Shares can be issued at a discount up to 15% of market value; and
- Rights can be issued with exercise price equal to or above the market value of an ordinary share,

with taxation to be deferred until the shares are sold, when they will be subject to capital gains tax with a cost base reset at market value for shares and the employee's cost of acquiring the right for rights.

To qualify, the general eligibility conditions for all ESS concessions must be met and the scheme must mandate a three-year holding period for the interests issued under the share scheme unless employment with the company is ended earlier.

In order to be eligible to offer the tax concession the companies must:

- Not be listed on any stock exchange when the share or right is acquired
- Have incorporated under Australian or foreign law less than ten years before the acquisition of the share or right (the incorporation rule also applies for the company's subsidiaries, holding companies and subsidiaries of the holding company)
- Have aggregated turnover of no more than $50 million in the year before the income year in which the employee acquires the share or right
- Be an Australian resident taxpayer at the time the employee acquires the right.

The closing date for written submissions is 6 February 2015. The proposed legislation is to be valid for shares or rights acquired under employee schemes on or after 1 July 2015.

Disclaimer: This article has regards to legislation that is yet to pass into law. This material does not constitute tax, legal or accounting advice.

Back to Title Page

Workplace Relations Reform: 3 Key Points Boards Can't Afford to Ignore

The Federal Government released the terms of reference for the Productivity Commission's review into Australia's workplace relations framework in late December 2014. The terms of reference are broad, with some commentators noting that "everything is up for grabs".

The initial reaction when such reviews are announced is to dismiss them as irrelevant to executive remuneration, aside from how the results of the reviews affect company performance when it comes to managing staff resourcing and costs.

This is not the case.

The Commission is required to investigate how the framework affects:

- unemployment, underemployment and job creation
- fair and equitable pay and conditions for employees, including the maintenance of a relevant safety net
- small businesses
- productivity, competitiveness and business investment
- the ability of business and the labour market to respond appropriately to changing economic conditions
- patterns of engagement in the labour market
- the ability for employers to flexibly manage and engage with their employees
- barriers to bargaining
- red tape and the compliance burden for employers
- industrial conflict and days lost due to industrial action
- appropriate scope for independent contracting

and suggest improvements to the framework. The final report is scheduled for delivery to government in November 2015. Any changes will go to the next election.

Three of the above items are of particular interest for executives: "fair and equitable pay", "productivity, competitiveness and the business environment" and "the ability of business and the labour market to respond appropriately to changing economic conditions".

1. Fair and equitable pay

We have previously noted the rising interest around the globe in ratios between CEO and median worker pay. The amount of research on the topic of pay inequality, including Thomas Piketty's *Capital in the 21st Century*, is vast.

In Australia, wage growth has slowed. The wage price index increased 2.5% over the year to September 2014. Full-time adult average weekly ordinary time earnings increased 2.4% over the

year to May 2014. This is only just higher than the CPI increase to September 2014 of 2.3%. Since the ABS's Wage Price Index data series began in 1997, the year-on-year change had consistently been over 3% until September 2013.

It is no coincidence that recent and forecast increases in the fixed remuneration of executives have also been modest. Executive pay does not exist in a vacuum. Shareholders expect that while wages are depressed across the economy, growth in executive pay will be restrained if it occurs at all.

2. Productivity, competitiveness and the business environment

Multiple commentators, including ourselves (see our productivity discussion paper), have noted in the past that wage increases can only come from improvements in productivity.

In prior years, rising terms of trade have bolstered lacklustre productivity performance in Australia. However, as above trend growth ends, the free wage ride also ceases.

As we have previously argued, executives are not free from the obligation to increase productivity. Total productivity, or multifactor productivity, is made up of labour productivity and capital productivity. Unlike the average worker, executives have the opportunity to lift capital productivity as well as labour productivity.

Though still low in historical terms, the labour productivity over the last three years has been considerably better than the preceding seven, according to ABS data. Capital productivity on the other hand has declined year-on-year over the last decade.

Much of this has been blamed on the capital intensive investment stage of the mining boom. Now that this is phasing out, the onus will be on executives to exert the discipline necessary to increase the productivity of all inputs.

It may be difficult to argue that growth in wages should be based on productivity for the workforce if executives do not face similar hurdles. Incentive measures that take return on total capital employed into account are becoming increasingly popular – moves to link wages to productivity could see this trend become stronger.

3. The ability of business and the labour market to respond appropriately to changing economic conditions

Employers are increasingly calling for flexibility in workforce deployment so they can adjust employee numbers and hours as business requirements vary. Where employers demand flexibility, it behoves them to behave consistently across all levels of employment.

Although executives are hired by individual agreement, their remuneration structure is not always responsive to changing economic conditions. For example, while organisations are often prepared to increase remuneration as their fortunes are on the rise, where organisations encounter tough conditions, they find it difficult to reduce remuneration.

When difficulties are of short duration this is not a major issue; when performance issues are protracted on the other hand, shareholders can become concerned. Workers can also become

disengaged – especially if they are subjected to a workplace relations environment where flexibility is expected.

The reduction of fixed remuneration is a difficult proposition, especially for executives facing long hours to implement challenging transformation initiatives. The easiest avenue to introduce flexibility is via adjustment to incentive plans, backed up when necessary by the exercise of Board discretion. Careful design of sign-on and termination payments is another avenue to increase flexibility and manage unplanned costs.

Back to Title Page

An Executive View of Penalty Rates

Whether or not they are paid a premium for it, working at unsociable hours has become a reality for many Australians and indeed employees around the world.

In a 2014 survey of 571 executives around the world, BlueSteps executive search service found that the modern lifestyle (including globalisation and mobile technology) had decreased the leisure or personal time of 64% of its respondents.

53% of respondents said they always stayed connected to their office (via phone, email and social media) while they were on vacation. An additional 44% said they sometimes did, with only 3% saying they were never contactable on vacation.

Executive respondents worked an average of 58.5 hours a week, compared to the average full-time Australian worker, who worked for just under 40 hours a week according to ABS data for November 2014.

Yet 52% of executives are satisfied or extremely satisfied with their work-life balance. This contrasted to 45% four years ago. Executives appear to have come to grips with the new work reality with the help of flexible work schedules and telecommuting.

A major in debate in 2015 will be whether other workers should also be adjusting their mindset to embrace the modern working reality. As part of its four-yearly review of modern awards, the Fair Work Commission is examining penalty rates for retail and hospitality awards.

Employers argue that in today's 24/7 environment, penalty rates have become an outdated concept and one that leads to reduced productivity and profitability, shorter opening hours and lower employment in their industries. The rates are too high for businesses to viably open during certain periods, they claim.

Although employer groups are still gathering evidence and consulting as to what exact changes they will seek to penalty rates in the relevant awards, the complete abolition of penalty rates is not on

the agenda for most. Rather they seek a rate reduction and recognition that for most Australians, Sunday is no longer any different to Saturday.

Unions respond that major events are still held mainly on weekends and that children are home on weekends and evenings – therefore recognition of unsociable hours must continue. They also draw attention to the fact that retail and hospitality workers often earn minimum wage, or close to it, such that penalty rates may represent the only way employees can make ends meet.

Research conducted in 2014 by the University of South Australia across 2,690 employees covering a range of occupations revealed that of those employees who received penalty rates for working unsocial hours, over half reported that they would cease working non-standard hours if penalty rates or additional pay were not offered. Exceptions to the rule were workers aged 18 to 24 years and those with combined annual household incomes of $90,000.

Executives also value the premium they receive for additional work (which in many cases will be conducted at unsocial hours). Although over half of the respondents to the BlueSteps survey said that work-life balance was just as important to them as pay, only 37% said they would work a lower number of working hours for a proportional drop in pay.

The question for either group of employees is "Is the premium paid for unsociable hours reasonable?"

For executives this is complex, as it is not always clear how much of their (admittedly higher) remuneration is for expertise and financial accountability, how much for their unsociable work hours and how much for their exposure to excessive travel. Yet there is a certain level of flexibility and simplicity in executive arrangements as they are negotiated on an individual "whole of job" basis.

The discussion of penalty rates in an award is a different matter. It must consider a broad variety of employees of different age, background, culture and religious persuasion, who may be prepared to work at different times in the day and different days of the week to suit their personal domestic circumstance and be paid variable casual (hourly, daily (shift)) rates, overtime rates, allowances and leave entitlements (or lack of in the case of casual employees).

In addition, while the world of work has gradually changed over time, the review will occur at a single point of change and likely recommend a step change. In this sense, it becomes a pay revolution rather than the pay evolution created by multiple changes to individual executive contracts.

Revolutions are seldom as peaceful as evolutions.

Back to Title Page

About us

For more than 25 years, Egan Associates has advised leading organisations and emerging enterprises in Australia and New Zealand on the remuneration of Board Directors, executives and key staff members, as well as performance management, corporate governance and Board effectiveness.

Our Services include:

- **Remuneration reviews and benchmarking** for Boards, CEOs, executives, senior management and professional positions, including specialist roles
- **Corporate transactions / IPOs**: assistance transitioning pre-IPO reward arrangements into the listed company environment with considerations including escrow provisions
- Advice on **annual incentive plan structures**, performance criteria, target and maximum payment levels including deferral and clawback provisions
- Advice on **long term incentive plan structures**, participation, performance hurdles, equity instruments, valuation and allocation, as well as monitoring
- **Government pay reviews**: assistance at both Federal, State and local level in administrative, policy and corporatised environments on reward for senior executives, professional and administrative staff and governing Boards
- **Online human capital solutions:** online resources to assist organisations manage position documentation, work value, internal relativity, market competitiveness and performance.
- **Board effectiveness:** assistance with Board reviews, Board skills matrices, scenario planning and Board documentation.

John Egan

John's early career was with Cullen Egan Dell (now Mercer Human Capital), which he chaired from 1983 to 1989, when he formed Egan Associates. John has been an advisor to Boards and senior executives on organisation, governance and reward issues over many years. He has assisted a significant majority of Australia's top 200 companies as well as a myriad of entrepreneurial organisations and government entities across a wide range of industries.

John has been actively involved with Universities, chairing Sydney University's Board of Advice for its Faculty of Economics & Business (2001 – 2010). John is an Honorary Fellow of the University and an Adjunct Professor in the School of Business.

His personal interests are in cool climate gardens – www.thebraesgarden.com – and he served as a Trustee of the Sydney Royal Botanic Gardens & Domain Trust from May 2010 to June 2014.