

Newsletter June 2015

It's almost the end of the financial year and companies will be thinking about the task of preparing their remuneration reports, while also looking to arrangements for the year ahead.

New share scheme legislation will apply from 1 July after *the Tax and Superannuation Laws Amendment (Employee Share Schemes) Bill 2015* was passed. 1 July will also be the starting point of a new higher minimum wage.

Recently, we have been working with a number of smaller companies, reminding us of how different their remuneration arrangements can be to those in large organisations. This month we analyse bonus awards and disclosure for the smaller end of town.

Our continued work with IPOs has also highlighted the varied remuneration arrangements implemented by non-listed companies that can cause issues when benchmarking their reward with listed companies.



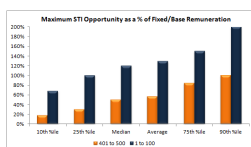
ESS Tax Changes Passed

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Independent Director Quota Announced for Super Boards

The government has released draft legislation that will require APRA-regulated superannuation Boards to be led by an independent Chairman and be comprised at a minimum of one third independent Directors.



Company Size Makes a World of Difference to Bonuses

CEOs of SMEs are by no means guaranteed an annual bonus and in fact, the CEO of most companies ranked 401 to 500 did not receive a bonus in the 2014 year.



When CEO Comparisons Mislead

Comparing executive remuneration is not as simple as it might seem.



Minimum Wage to Increase by 2.5% on 1 July 2015

The Fair Work Commission has awarded an increase to the minimum wage of 2.5%, or \$16 per week.

ESS Tax Changes Passed

The Australian Senate passed changes to the taxation of employee share schemes (ESS) on 25 June with no amendments.

The *Tax and Superannuation Laws Amendment (Employee Share Schemes) Bill 2015* will be effective for grants made from 1 July 2015 once the legislation receives royal assent.

For all companies, changes include:

- Rights (including options) that are eligible for deferred taxation will now be taxed at exercise rather than when a real risk of forfeiture is lifted. Cessation of employment remains a taxation point.
- The maximum tax deferral period rises from 7 to 15 years.
- The maximum interest (or rights to own interest) an employee can hold in an organisation and still participate in a deferred taxation scheme increases from 5% to 10%.
- New statutory valuation tables introduce lower valuations for options
- Refunds can now be obtained where an employee has paid tax on options but elects not to exercise them.
- The taxation treatment of equity deemed to have a nil value at grant has been clarified.

For start-ups, changes include:

- Eligible rights (including options) or shares will not be subject to tax on grant, vesting or exercise. Instead, they will be subject to capital gains tax, generally when the shares are sold. Shares can be issued at a discount of up to 15% to the market price, while options must have an exercise price of no less than the market price of shares at grant.
- The time employees hold options will be taken into account for capital gains tax purposes when the employee sells the shares upon exercise.

In order to be eligible for the start-up concession, employees must hold rights or shares for a minimum of three years and start-ups cannot be incorporated for more than ten years, be listed or have aggregate turnover higher than AU\$50 million.

The passing of the Bill follows a positive report from the Senate Economics Legislation committee. The Committee examined a number of issues raised by submissions on the legislation (summarised in our [recent article here](#)) and concluded that the reform constituted a significant improvement in the taxation of ESSs.

The changes may see an increase of the use of options in ESSs due to the lower valuations in the statutory tables and what may be considered a more favourable taxation point.



They may also lead to companies offering an exercise period on performance rights so that employees can elect when they exercise the rights and are therefore taxed.

There could potentially also be an increase in the use of performance rights as a component of fixed remuneration or annual bonus deferral.

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Independent Quota Announced for Super Boards

The government has released draft legislation today that will require APRA-regulated superannuation Boards to be led by an independent Chairman and be comprised at a minimum of one third independent Directors.

According to Assistant Treasurer Josh Frydenberg writing in the Australian Financial Review, the proposed definition of an independent director has been adapted from that specified in the ASX Corporate Governance Council principles that apply to listed companies.

“An independent director in the superannuation board context should be one that is not a substantial shareholder of the trustee, does not have a material relationship with the trustee and has not been, in the past three years, an executive or director of a body that has had a material relationship with the trustee,” he stated.



A three-year transition period from royal assent of the legislation will apply to accommodate the usual appointment period of superannuation Board Directors, but new funds established after 1 July 2016 will have to comply with the legislation from their commencement.

He expected some funds to oppose the change with the argument that the current equal representation model had delivered good returns to members, however stated there was no evidence the performance was due to the equal representation model.

He also noted that the Cooper Review into the Superannuation system and the Financial System Inquiry by David Murray had both recommended reform of the current governance model, with Cooper recommending Boards be comprised of one-third independent Directors and Murray recommending Boards have a majority of independent Directors including the chair.

Egan Associates will update this article with further detail after reading through the draft legislation.

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Company Size Makes a World of Difference to Bonuses

CEOs of SMEs are by no means guaranteed an annual bonus and in fact, the CEO of most companies ranked 401 to 500* did not receive a bonus in the 2014 year.

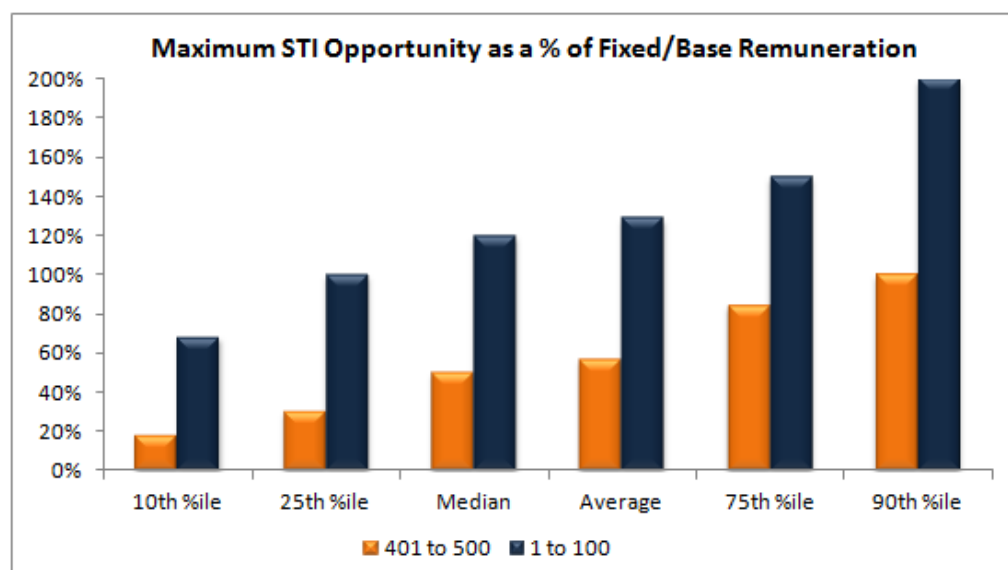
Following interest in our analysis last month of actual STI awards for CEOs of top 100 companies, we repeated the process for companies ranked 401 to 500.

In the top 100 companies, 96 companies were included in the analysis. the exclusions were companies that had undergone structural transitions complicating remuneration. For companies ranked 401 to 500, 88 were included in the analysis. The exclusions were companies that had recently listed via IPO/reverse takeover or had no CEO at year end.

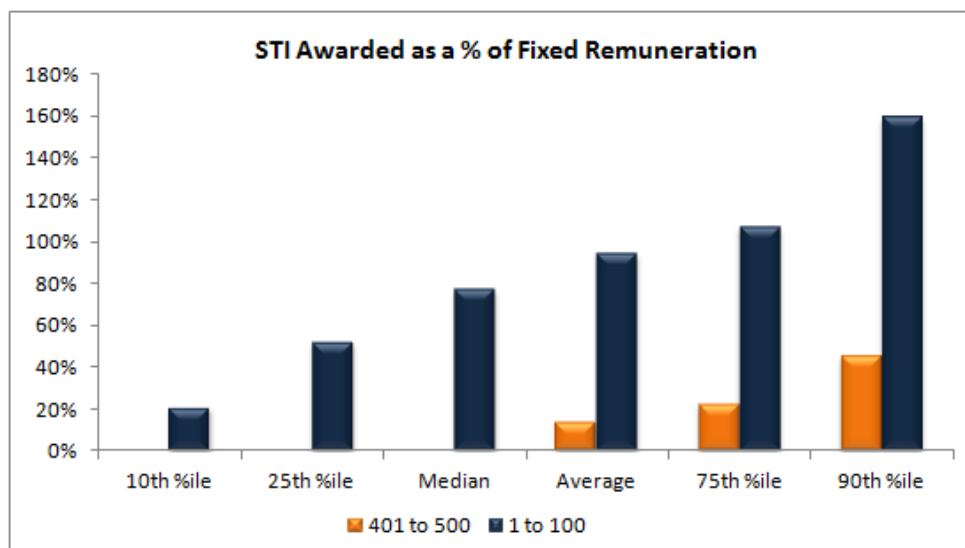
The results of the analysis were vastly different as can be seen in the table below:

Ranking	1-100	401 to 500
No. companies where CEO received no bonus	6	49
No. companies disclosing target STI	70	7
Range of target STI as a % of base/fixed rem	22%-186%	25%-85%
No. companies disclosing maximum STI	86	24
Range of maximum STI as a % of base/fixed rem	See figure below	See figure below

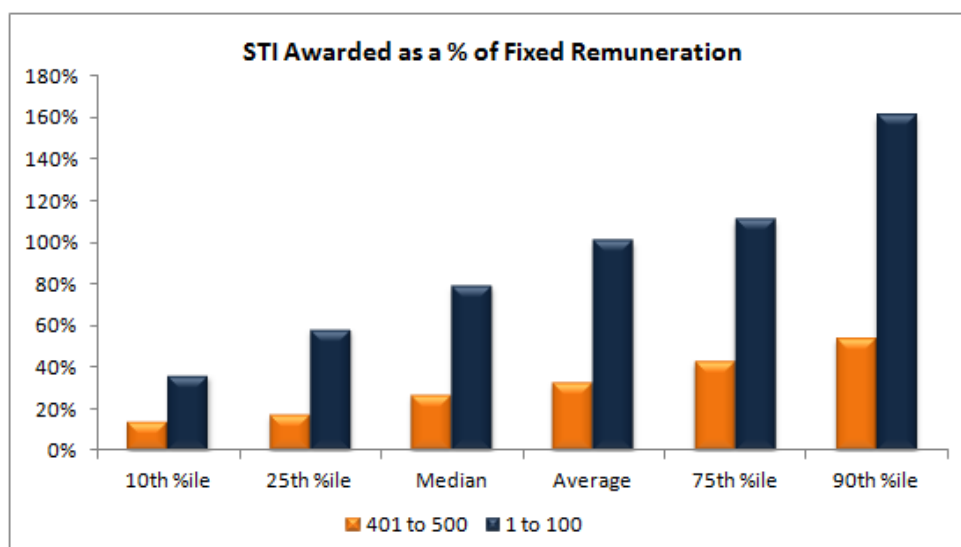
The distribution of maximum STI opportunity as a percentage of fixed or base remuneration for companies that provided comprehensive disclosure is depicted by the following figure:



The amount of STI actually paid as a percentage of fixed remuneration including zeros is shown in the figure below[#]:



The amount of STI actually paid as a percentage of fixed remuneration excluding zeros is shown in the figure below[#]:



There are four main observations that can be gained from these comparisons:

- Disclosure of remuneration targets and maxima is scant in the annual reports of low ranked companies.
- The award of a bonus is less frequent in lower ranked companies than in top companies.
- The proportion of remuneration that can be earned as an annual bonus in SMEs is much lower than that for larger enterprises.
- Once awarded, the proportion remuneration that comprises an annual bonus is also significantly reduced in lower ranked companies in comparison to the top 100 companies.

*Companies were ranked by market capitalisation as at 31 March 2015 using 22 day smoothing.

[#] The actual short term incentive of the CEO of Arowana International was excluded as an outlier due to the large nature of his award.

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When CEO Comparisons Mislead

Last month a number of publications [ran articles on Macquarie Group CEO Nicholas Moore's pay package](#), noting that he was now the second highest paid CEO of a listed Australian company, with his pay package only trumped by that of Nine CEO David Gyngell.

The comparison is based on the most recent remuneration data for both companies, which is the 2015 annual report to 31 March 2015 for Macquarie Bank and the 2014 annual report to 30 June 2014 for Nine Entertainment.

The article would make for interesting reading except that the comparison has very little meaning.

As most of our clients would be aware, the issue is the way long term incentives are presented in annual reports.



For accounting purposes, companies must report the cost of rewarding their executives and this must be expensed against the profit and loss statement. For remuneration that is paid in cash, this is simple enough. It gets trickier where pay is contingent on performance criteria or service.

Here, the company must amortise the expense of the deferred payment over a period of time, discounted for the possibility that the company will never have to make the payment – for example if the performance criteria are not met, or the employee leaves the company and forfeits the payment. It is this value that is disclosed in the statutory remuneration table.

If the line ran had been that Macquarie Group has expensed the second highest cost of CEO reward of other listed companies it would have been more correct – but made less of a story.

Although the accounting value recorded in the statutory table is a good estimate of the cost to the company of remuneration, it says very little about how much an executive is actually paid.

There are a number of reasons for this:

1. Large one off payments, for example retention and sign-on payments, or in David Gyngell's case a one-off payment linked to his performance prior to the IPO of the Nine Entertainment Company, inflate the figure expensed. This is despite the fact that such awards are not indicative of remuneration paid by listed companies in the normal course of their business.

In the case of IPOs, executives have often been working with a company for many years while it was in private ownership and have holdings under an incentive scheme or prior entitlements relating to services rendered. When listing occurs, such holdings can be dealt with in a variety of ways, but often result in the issuing of equity in the newly listed company to account for work over prior years. This equity must be expensed over the time of vesting or restriction – but does not reflect remuneration going forward, rather efforts over prior periods. In addition to his other awards, Gyngell received an award of \$10m worth of shares relating to longstanding prior contractual agreements with Nine, of which he had been the CEO for a number of years

prior to listing. Interpretation is further complicated by escrow provisions attached to the award, which was restricted for disposal until three years after completion of the IPO.

Other examples from 2014 where distortions were created due to one-off grants of equity during the IPO process include:

- Veda Group's Nerida Caesar – Caesar was listed as number 15 in the [Australian Financial Review's 2014 executive pay survey](#) due partly to a high disclosed long term incentive value reflecting a retention grant of 25,000,000 options that vested at IPO but could not be disposed of or dealt with unless Board approval was obtained.
- Recall Group's Doug Pertz – Pertz was listed as number 41 on the Australian Financial Review's 2014 list due partly to a high disclosed long term incentive value that reflects rights granted around listing worth \$6 million to compensate him for foregone Amcor incentives. These rights were restricted for four years.

Maverick Drilling and Exploration's Michael Yaeger was a non-IPO example. He was number six on the AFR list due to a grant of shares and rights made in return for his accepting employment terms when he started at the company on 15 October 2013. Without this sign-on grant, his total remuneration would have been between \$1 million and \$2 million rather than over \$11 million.

2. The figure displayed aggregates the expense booked for multiple incentives granted over a number of years – Therefore, it is not what the executive "received" in the financial year, what the executive was granted in the financial year or what the executive would benefit from in the financial year.
3. In some cases where the equity instrument used for short term incentive deferral is the same as that used for the long term incentive, the figure displayed mixes the expense booked for short and long-term incentives.
4. Even if the grants were disclosed individually, the amount expensed may not bear any resemblance to an executive's take home pay packet. For example:
 - If none of the long term incentive vests, the amount expensed will overstate the final value of the grant to the executive, because the amount the executive receives at the end of the performance or service period is zero.
 - If all of the long term incentive vests, the amount expensed will either under or overstate the final value of the grant to the executive depending on the market value of the shares at grant.
5. Changed conditions and assumptions, the failure to meet performance conditions or executive movements can lead to negative values being expensed, which intuitively have little meaning in a remuneration sense.

Therefore, if an article looks at Gyngell and Moore and says the former received more than the latter in a given year based on their total remuneration, where total remuneration includes an accounting value of the long term incentive, the statement means nothing at all.

The significant number of new listings over the recent year could cause further distortion in comparative analysis driven by cash or shares paid to acknowledge an extended period of

performance or to fulfil prior contractual commitments. Some executives may receive equity holdings to a value of \$20 million that become available over the calendar years following IPO.

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Minimum Wage to Increase by 2.5%

The Fair Work Commission has awarded an increase to the minimum wage of 2.5%, or \$16 per week, bringing the minimum wage to \$656.90 per week. The changed minimum wage, which affects 1.86 million Australian employees who are award reliant, will apply from 1 July 2015.



The Commission decided to also increase modern award minimum wages by 2.5%, stating that the 2014 flat dollar increases had compressed award relativities and reduced the gains from skill acquisition, reducing the ratio of the higher award classifications relative to market rates and average earnings.

In submissions to the Commission before the decision, the stakeholders had presented the following positions:

- The Unions proposed a \$27.00 wage increase per week.
- The Australian Industry Group (Ai Group) submitted that the increase should be 1.6% (\$10.25 a week).
- The Australian Government, the Australian Chamber of Commerce and Industry (ACCI), and the Australian Business Industrial (ABI) urged the Panel to adopt a cautious approach.
- The ABI proposed a “modest sustainable increase” while the ACCI and the Australian Retailers Association recommended an increase of no more than \$5.70 per week.

Our summary of submissions to the review from various parties can be found [here](#).

The most significant economic factor in the Commission’s decision was the fall in inflation and wages growth, with most recent annual growth rates of 1.3% for the consumer price index, 2.3% for the wage price index and 2.8% for average weekly earnings. This growth was a reduction on already modest growth the prior year. The growth in average annualised wage increases, which reflects bargaining outcomes, was also relatively low at 3.4%. Meanwhile, the unemployment rate has increased from 4.9% in March 2011 to 6.1% in April 2015.

The Commission raised concerns on delays to Australia’s return to trend growth, with business investment yet to pick up the slack from lower mining investment. Yet the Commission also noted that there were no real signs of corporate distress, with low bankruptcy rates, a higher number of business entries than exits and an absence of cost pressures from the labour market.

These factors led the Commission to recommend the 2.5% increase in minimum wages, which was lower than last year's 3% increase. The net effect of such increases after tax ranges from a 1.9% to 2.2% uplift depending on applicable tax rates, including the Medicare Levy, excluding any offsets and disregarding dependents. If high income earners (for example \$100,000 to \$500,000) also received a 2.5% increase, the percentage increases in net income would be similar if they do not claim deductions and offsets.

The ACTU was not satisfied with the increase, stating that the decision will bring the national minimum wage to 43.3% of average weekly ordinary time earnings, the lowest on record. The union highlighted that the increase was lower than the latest rise in average weekly earnings.

"This decision won't relieve the stress on low income households in the face of increasing healthcare, education and childcare costs," ACTU Secretary Dave Oliver said.

"It's not good enough when profits are up, productivity is high, executive salaries are up and the Abbott Government delivered a small business bonanza in the budget – but once again workers are left with the scraps."

On the other side, the Australian Chamber of Commerce and Industry stated that the above inflation increase will work against the government's budget measures to encourage small business investment and growth, especially when the effect on superannuation is taken into account.

Jenny Lambert, ACCI's Director of Employment, Education and Training, said: "We hold concerns that this increase is too high against the backdrop of softening labour market conditions and an economy undergoing structural adjustment.

"Most small businesses run on lean margins, operate in a price-sensitive environment and are unable to pass these costs on to consumers. So there is a real prospect it will lead to firms reducing staff numbers or the hours offered."

The Australian Retailers Association (ARA) called the increase "unmanageable".

"Many small to medium enterprise retailers are reliant on a minimum wage workforce, and the announcement today to increase wages during this time of low consumer confidence and low growth will sadly result in further job losses and business closures – a very distressing truth for retailers," Executive Director Russell Zimmerman said.

"The minimum wage increase, coupled with weak trade figures and penalty rates, will only cause further damage to retailers who are struggling to keep their heads above water as it is. While interest rates are currently at a record low (with the Reserve Bank of Australia [in its June decision] deciding to keep rates on hold at 2.0%) and there is support from the recently released Federal Budget, the retail industry cannot simply keep up with excessive wage increases."

Egan Associates understands that in depressed industries and enterprises, award exempt staff are accepting zero pay increases and in some cases pay reductions. Senior staff up to the executive ranks are placing more value on keeping their job than on pay increases.

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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 CEOs, executives, senior management and professional positions, including specialist roles
- **Annual incentive plan structures:** advice on performance criteria, target and maximum payment levels as well as deferral and clawback provisions
- **Long term incentive plan structures:** advice on participation, performance hurdles, equity instruments, valuation and allocation, as well as provision of performance monitoring services
- **Corporate transactions / IPOs:** assistance transitioning pre-IPO reward arrangements into the listed company environment (or any other corporate transformation) considering issues including escrow provisions
- **Government pay reviews:** assistance at federal, state and local level in administrative, policy and corporatised environments on reward for senior executives, professional and administrative staff, and governing Boards
- **Board fee reviews:** benchmarking Board fee levels, including Chairman and Director retainer fees, Committee Chairman and member fees and fees for adhoc engagements.
- **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.