Newsletter August 2015

Pay equality has been highlighted in the international arena this month after the British Prime Minister announced that companies will soon be required to reveal the difference in male and female earnings. Keeping with this theme, Egan Associates has presented a view on gender pay equivalence.

There have also been initiatives to disclose pay relativity in the US, with the SEC recently approving a rule which will require companies to disclose the ratio of pay of the CEO to the pay of the "*median*" employee.

With another financial year now well underway, we have provided some observations on how companies are structuring annual incentive deferral.

Concluding the newsletter is a summary of key points from the Productivity Commission's draft report on the workplace relations framework.

Gender Pay Equivalence

While equal reward for equal work represents a desirable social policy, measuring equality of both inputs (accountability and working conditions) and outputs (the value of experience, competencies and performance) adds complexity which must embrace acceptance of a limited differential favouring either gender.

Managing STI Deferral

Listed companies adopting deferral as an element of their annual incentive plan use varying equity instruments to match the deferral incentives.

SEC Approves Pay Ratio Disclosure Rule

Almost two years after the initial proposal, the United States Securities and Exchange Commission (SEC) has approved a rule that requires a public company to disclose the ratio of pay of the CEO to the median compensation of its employees.

Draft Report on Workplace Relations Framework Released

The Productivity Commission has released its draft report on the workplace relations framework, which contains a number of recommendations for improvement.

Gender Pay Equivalence

British Prime Minister, David Cameron, has announced that companies with over 250 employees will be required to publish the gap between average female earnings and average male earnings. It is proposed that, by increasing transparency and bringing pay discrepancies to the fore, the overall pay gap of 19.1% can be closed within a generation.

Some companies have already chosen to reveal this information. Deloitte's UK office has reported a 17.1% pay gap as part of its annual results for the year ended 31 May 2015. PricewaterhouseCoopers has also disclosed the gender pay gap in its UK practice, which was 15.1% last year.

In Australia, although there is no requirement to disclose or calculate a gender pay gap, companies with over 100 employees must provide certain remuneration information to the Workplace Gender Equality Agency (WGEA) under the *Workplace Equality Act*. Employers produce a workplace profile and report on a number of gender equality indicators, including steps taken toward encouraging equal pay between men and women. An example is whether or not the company conducts a gender remuneration analysis.

Employers also have an obligation to provide equal pay under the *Fair Work Act*. Section 302 of the Act empowers the Fair Work Commission (FWC) to make an equal remuneration order in circumstances where employees are not provided with equal remuneration for work of equal or comparable value. As such, the FWC has a significant degree of discretion in making remedial orders in the case of a successful application.

Despite legislative efforts at the federal level, the move toward mandatory pay gap reporting in the UK has some commentators questioning whether a similar system would minimise the perceived gender pay inequality in Australia. Australia's national gender pay gap, which is calculated by the WGEA, is currently 18.8%.

Egan Associates would caution, however, that publishing pay gap data on its own has the potential to mislead (this was also a point raised by the Confederation of British Industry) for a number of reasons, primarily:

- Broad comparisons that are not based on equivalence of accountability, for example, organisation wide or by reporting level can indicate a market prejudice which may not be present. Hence comparing the remuneration of a Head of Human Resources, where there are a number of highly effective and successful incumbents, with that of a Chief Financial Officer, which is predominantly a role dominated by males, is erroneous even though their reporting level is equivalent.
- Given the fact that there are typically fewer women in leadership positions, drawing conclusions about a pay gap may be flawed as the inclusion or exclusion of a particular female, for example Gail Kelly, could distort numbers.
- If gender is skewed, recent hire data will distort the statistics.

We note that a proportion of the comment on the pay differential has regard to access to particular occupations which might be high paying as distinct from those which are low paying. Helen Conway, Acting Director of the WGEA, cites a tendency for women to "gravitate to roles the market typically assesses as being of lower value" as the reason behind this. Ms Conway was commenting on new data released by the WGEA, which shows that the gender pay gap is highest for women in top management positions.

There have, however, been a number of initiatives by companies and business groups to address this historic imbalance. The Australian Institute of Company Directors (AICD), for example, works with Boards and utilises its networks and contacts in an effort to increase the number of females occupying directorships in major companies. As a result, the number of women in these positions has been steadily rising. Data released by Blackrock shows that from 2011 to 2014 the percentage of women on ASX200 Boards increased by 7.9% (from 14.4% to 22.3%).The AICD has reported that the figures were 15.4% and 19.3% in 2012 and 2014 respectively, and that the percentage of women on ASX200 Boards is 20.1% as at 31 July 2015.

Egan Associates' in-house data analysis shows a similar upward trend, although the average number of female executives has remained unchanged:

Average Percentage of Females in ASX200 Companies in 2012

Non-Executive Directors	Executive Directors	KMPs
15%	4%	10%

Average Percentage of Females in ASX200 Companies in 2014

Non-Executive Directors	Executive Directors	KMPs
19%	7%	10%

The AICD has stated that further improvement will come as a consequence of companies setting their own diversity targets rather than a mandated quota by government. It notes that many chairmen and chairwomen on S&P/ASX200 Boards have already committed to a 30% target for female directors by 2018.

An example of a recent strategy to increase the number of women in senior management ranks as well as on Boards is the partnering of universities with business whereby the participation of talented women is encouraged through MBA scholarships.

In terms of reward opportunity, Egan Associates hold the view that there should be no discrimination where position demands and performance are comparable. We observe that this applies widely in all sectors, particularly where there is no argument or view that roles are different.

In this context, Members of Parliament, irrespective of gender, are paid the same where their roles are comparable. Where academic members at university hold comparable appointments, be they Lecturer or Professor, Dean or Vice-Chancellor, it would be our observation that reward where positions are comparable is equivalent.

This is not a comment on access to those positions but rather comparability of pay where there are equivalent accountabilities and demands made in respect of a particular position. Among Australia's leading companies, while there are a majority of males serving on Boards, Directors are paid the same in respect of their Board role, independent of gender.

In the private sector and to some extent the public sector, in addition to receiving a defined level of fixed remuneration for occupying the position, many staff have access to performance pay where reward is determined on the basis of contribution and occasionally potential. These are clearly areas where the same principles of equal access, subject to equivalence of circumstance, should apply. We would endorse this view.

One of the key elements of difference in reward, holding work value or job content constant over time, has been differential performance ratings in part overlaid by automatic progression with tenure up to a midpoint or indicative pay level operating in a number of organisations.

While gender pay equivalence represents a worthy social justice policy focus, in our view it brings with it complexity which may not be well or widely understood. The gender pay equivalence challenge, while different, has many similarities to the challenge that management and HR face in defending pay differentials within their workforce among same gender participants.

Gender pay equivalence will bring with it similar challenges where the general workforce experiences pay differentials for jobs with common titles where the work is undertaken in different geographies or locations, under different working conditions including hours of work and time at which work is undertaken. Where organisations have policy and procedural mechanisms to address tenure or experience of an employee in a particular role, their performance and the extent to which relevant competencies are fully developed will also influence pay.

With all these variables at play there can readily be a pay differential of 10% which is absolutely consistent with the organisation's pay policies and practices. If this simple policy parameter were embraced then what may well have the appearance of substantial gender pay discrimination could be substantially less.

As noted above, where there is an equivalence of role clearly understood by the general public and shareholders, pay is identical irrespective of gender. Adopting gender pay equality as a social policy for all employees would be consistent with reward practices at the very top of the organisation.

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SEC Approves Pay Ratio Disclosure Rule

Almost two years after its initial proposal, the United States Securities and Exchange Commission (SEC) has approved a rule that requires a public company to disclose the ratio of pay of the CEO to the median compensation of its employees.

The pay ratio rule implements section 953(b) of the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (*Dodd-Frank Act*), which took effect on 21 July 2010. The SEC has stated that the rule will provide companies with flexibility in calculating the pay ratio, and helps inform shareholders when voting on the remuneration of executives.

Companies will be required to disclose the following:

- The median of the annual total compensation of all employees of the registrant (excluding the CEO) (amount a);
- The annual total compensation of the registrant's CEO (amount b); and
- The ratio of amount b to amount a.

Definitions

- The term "registrant" refers to companies that are required to provide executive compensation disclosure under Item 402(c) of Regulation S-K. As a result, the disclosure requirement does not apply to emerging growth companies, smaller reporting companies, or foreign private issuers.
- "Total annual compensation" has the same meaning that it is given in Item 402(c)(2)(x) in Regulation S-K.
- Employees are defined as:
  - Full-time, part-time, seasonal, and temporary workers employed by the registrant or any of its consolidated subsidiaries; and
  - Individuals employed as of the last day of the registrant's last completed financial year.
- The rule does not extend to independent contractors and "leased" workers who are employed by, and whose compensation is determined by, an unaffiliated third party.
- There are no prescribed methodologies for calculating the median employee. Registrants can choose a method that is appropriate to the size, structure, and compensation practices of their business.

Modification to Proposed Rule

The SEC acknowledges that the final rule is generally consistent with the proposed rule, however, it has made a number of revisions in an effort to minimise the expected costs and unintended consequences of the disclosure. The final rule has been modified as follows:

- There are now exclusions for non-U.S. employees in circumstances where foreign data privacy laws make registrants unable to comply with the rule or where these employees account for 5% or less of total employees.
- Previously, the definition of "employee" applied on an enterprise-wide basis. It has since been narrowed to include only employees of the registrant and its consolidated subsidiaries.
- In relation to identifying the median employee:
  - Registrants can use any date within three months prior to the last day of their completed fiscal year to identify the median employee.
  - The median employee only needs to be identified every three years unless there has been a change in the employee population or employee compensation arrangements.

- The registrant can use another employee in subsequent years if the median employee's circumstances have changed. However, this is only permitted where there has been no change in employee population or compensation arrangements.
- Cost-of-living adjustments for employees in other jurisdictions are permitted.

- In circumstances where a CEO is replaced within a fiscal year, the registrant may use either:
  - The total compensation provided to each person and combine the figures; or
  - The annualised compensation of the CEO serving on the date that the registrant uses to determine its median employee.

Compliance

Registrants must comply with the rule for the first fiscal year beginning on or after 1 January 2017. There are, however, transition periods for new companies, companies engaging in business combinations or acquisitions, and companies that cease to be small reporting companies or emerging growth companies.

The information is to be provided in annual reports, proxy and information statements, and registration statements that require executive compensation disclosure under Item 402 of Regulation S-K.

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Managing STI Deferral

With an increasing number of listed public companies introducing an element of deferral in relation to their annual incentive plans, we have observed variable practice in relation to:

- The period of deferral;
- The equity instruments used for deferral;
- The valuation of those equity instruments for the purpose of allocating value; and
- Adjustment to deferred equity awards at the time when vesting takes place.

Period of Deferral

The dominant period of deferral is twelve months following the determination of the incentive award. The twelve month period of deferral is split between the beginning of the financial year following the performance period or twelve months from the date on which the annual incentive award has been determined.

There are an emerging number of companies that are deferring the award in two tranches of equal value over two years and a small minority with a three year deferral.

A number of organisations philosophically, particularly those with relatively aggressive annual incentive plans, see deferral as a key element of retention.

Instruments of Deferral

It is Egan Associates' observation that the majority of annual incentive plan deferrals are in the form of a restricted share or share right, with a number using restricted shares and a small minority using cash, that cash being either unadjusted or adjusted by a factor such as the CPI or the weighted average cost of capital of the company.

Value of Deferred Incentive

Where cash is deferred the value of the deferred incentive is equivalent to the proportion of the award deferred. Where restricted shares represent the instrument of deferral the number of shares issued is represented by a nominal VWAP, either at the time of the determination of the award and the deferral amount or on the basis of VWAP either side of the date on which the financial year concludes.

In relation to rights, if they are the instrument of deferral they would normally follow the principles adopted for restricted shares. We have, however, noted that some companies are allocating rights adopting a fair value methodology which discounts the prevailing share price for the purpose of allocation by up to 50% at the time of award, adopting a grant value methodology in parallel with that which a minority of companies apply when issuing rights under a long term incentive plan. It is not our view that this is appropriate nor clearly understood by the majority of shareholders.

By way of example, if the deferred incentive amounted to $50,000 then the cash deferral would be $50,000, the restricted shares would have a market value on the basis of VWAP of $50,000 and rights would have a similar value and allocation number. It would be our view that where a substantial discount is applied for the purpose of allocating equity instruments as an element of deferral and the value is up to twice the deferred incentive this is an appropriate practice.

We have observed over recent years that companies which have introduced deferral under their annual incentive plan have often increased the maximum potential award under that plan in recognition of the deferral.

Adjustments to Awards Under Deferral

In relation to the deferral of restricted shares, dividends on those shares are either passed through to the executive during the period of deferral or reinvested. Where rights are the instrument of deferral they are either unadjusted for dividends or additional rights are granted equivalent to the gross value of the dividend paid during the period of restriction. Where cash is deferred the deferred cash is either passed through to the executive or adjusted by some other factor such as the CPI or the weighted average cost of capital of the company.

Forfeiture

Our observation is that the annual incentive plan rules indicate that deferred incentives would be forfeited where the executive chooses to leave the company and the deferred component would not be paid. Many organisations have plan rules which provide the Board with discretion whereby deferred incentives are paid in a number of instances which would be similar to rights and entitlements under a long term incentive plan.

Where STI is deferred as an equity instrument and the employee is terminated other than for cause or is made redundant the equity instrument is either released at the time of separation or held but available to the executive when the deferral conditions are met. This latter strategy is often adopted where the employment agreement includes restraint of future employment for a period after separation.

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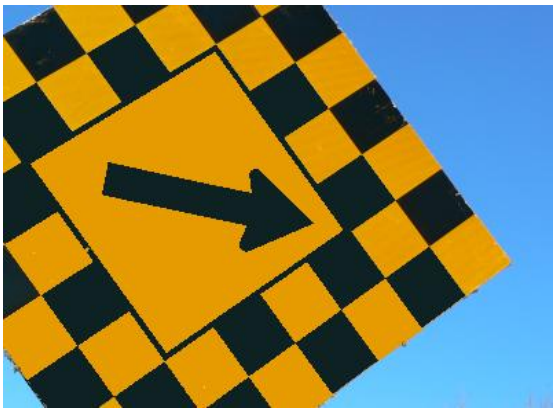
Draft Report on Workplace Relations Framework Released

The Productivity Commission has released its draft report on the workplace relations framework, which contains a number of recommendations for improvement.



The terms of reference for the inquiry were released in December 2014, five years after the commencement of the *Fair Work Act*. The government believed the inquiry was a timely assessment of the operation of the Fair Work system, and a means of ensuring that the laws are meeting their desired objectives. In particular, it was requested that the Productivity Commission focus on social and economic indicators important to the well-being, productivity and competitiveness of Australia and its people.

Initial submissions, which were due by March 2015, revealed conflicting views on the future of the workplace relations environment. You can read a summary of those arguments in our recent article here.

In its draft report the Productivity Commission found that, despite some significant issues, the workplace relations framework should be finetuned rather than replaced. It notes that the challenge is developing a system that provides balanced bargaining power between parties, encourages employment, and enhances economic efficiency.

Key Recommendations

Unfair Dismissal Protections

The Productivity Commission has proposed that moderate and incremental reforms can address the current problems with unfair dismissal protections:

- Compensation should be given to employees only when they are dismissed without reasonable evidence of persistent underperformance or serious misconduct;
- Procedural errors alone should not result in reinstatement or compensation;
- There should be more upfront filters that focus on the merits of claims as well as higher lodgement fees;
- The emphasis on reinstatement should be removed as a primary goal of the unfair dismissal provisions in the *Fair Work Act*; and
- Subject to the implementation of other recommended changes, the (partial) reliance on the Small Business Fair Dismissal Code in the *Fair Work Act* should be removed.

General Protections

It is suggested that the following reforms to the general protections provisions will reduce unnecessary contention caused by the complicated structure of the provisions and absence of active guidance on defences and coverage:

- Compensation should be capped;

- The right to make a complaint or inquiry needs to be better defined;
- There should be exclusions for complaints that are frivolous or vexatious; and
- The Fair Work Commission (FWC) should be required to report more information about general protection matters.

The Productivity Commission acknowledges complaints that the reverse onus of proof for adverse action claims can be problematic, however, it notes that many superior courts have taken significant steps to curtail discovery which has reduced costs and timelines.

Industrial Action and Right of Entry

The Productivity Commission stated that industrial action is at low levels and only minor tweaks are required, which include:

- Limiting the grant of protected action ballot orders to circumstances where enterprise bargaining has already commenced;
- Empowering the FWC to suspend or terminate industrial action where it is causing, or threatening to cause, significant economic harm to the employer or the employees covered by the agreement (as opposed to both parties);
- Introducing more graduated options for retaliatory industrial action;
- Restricting the right of entry of unions that do not have members employed in the workplace and are not covered by (or currently negotiating) an agreement to two occasions every 90 days;
- Allowing employers to stand down relevant employees without pay where employers have engaged in a reasonable contingency response to an aborted industrial action; and
- Increasing the maximum ceiling of penalties for unlawful industrial action.

Wages and Conditions

Recommendations for penalty rates and minimum requirements are as follows:

- Sunday rates in the hospitality, entertainment, retailing, restaurants and cafe industries should be brought into line with Saturday rates; and
- Employers should not be required to pay for leave or additional penalty rates for any newly designated state and territory public holidays.

Individual Flexibility Arrangements

For individual flexibility agreements, the Productivity Commission recommends a minimum termination period of 13 weeks, but with the capacity of employers and employees to agree at the formation of the agreement to a one year period.

Minimum Wage

The Productivity Commission stated that the contention that existing minimum wage levels are prejudicial to employment is not well founded, however, significant increases in the minimum wage pose a risk for employment.

It recommends that the FWC should be able to make temporary variations in awards in exceptional circumstances after the completion of an annual wage review.

Enterprise Bargaining

The Productivity Commission noted that enterprise bargaining works well, however:

- The Fair Work Commission (FWC) should have the discretion to overlook a procedural defect in deciding whether to approve or reject agreements;
- There should be a requirement that a non-union party can only act as a bargaining representative if they have the support of a reasonable proportion of the workforce;
- Clauses that regulate the use of contractors and labour hire should be limited;
- In the case of greenfields agreements, goodfaith bargaining requirements should be introduced as well as a limited menu of bargaining options in circumstances where negotiations are at a standstill; and
- Introducing an 'enterprise contract' would offer many of the advantages of enterprise agreements without the complexities, making them particularly suitable for smaller businesses.

The Better off Overall Test (BOOT)

In order to reduce uncertainty during the bargaining process, the Productivity Commission proposes that the **better off overall test** be replaced with a **no-disadvantage test**. In particular, it states that this would overcome the issue of how to trade off non-monetary benefits against other benefits of an award.

Response

Unions have responded with concerns that the Productivity Commission has fallen short of protecting the rights and entitlements of employees. The Australian Council of Trade Unions (ACTU) claims that the report is an attack on penalty rates, the minimum wage and rights at work, and this view was endorsed by the Community and Public Sector Union (CPSU) and Unions Tasmania in their respective statements.

The ACTU has stated that:

- There is no evidence to show that cutting penalty rates increases employment or productivity and is a "raid on people's wages";
- The minimum wage recommendations will cause the minimum wage to stagnate and will not take into account the rising costs of living; and
- The recommendation to expand individual contracts which sit outside the award system will undermine rights at work, particularly those of the most vulnerable.

The BCA congratulated the Productivity Commission on recognising the flaws in the system; however its Chief Executive Officer, Jennifer Westacott, has since stated that the recommendations are insufficient to address problems with awards and the enterprise bargaining process.

Ms Westacott said that the Commission has not grappled with complexities that can arise due to the many and varied clauses in enterprise agreements, which encourage risk aversion. She also dismissed the notion that companies should have to reorient their business models in order to work around difficulties in the system.

While agreeing with the Productivity Commission's stance that awards should be repaired rather than replaced, she has recommended that they be "stripped back to the essentials". Accordingly, she believes that there should be economy-wide rates for casual, overtime, penalty and shift work and these should be part of the Minimum Wage Order rather than contained in awards. She also suggested that businesses should be able to add a premium rate for employees working on weekends.

Interested individuals and organisations are invited to examine the report and make submissions by Friday 18 September. The final report will be provided to the government in November 2015.

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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.