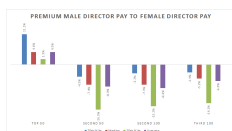


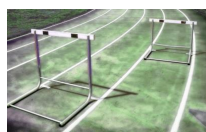
# Newsletter August 2016

The reporting season has started in earnest – a time of vindication or discomfort for Boards depending on how the numbers fall. Following interest in our KMP Report on 2015 Director Fees, we have conducted further research examining the differential in pay between female and male Directors, reaching a result that may surprise some. We also question whether Boards, shareholders and management are all on the same page about EPS hurdles and highlight some interesting developments overseas and at home.



## 2015 Director Fees: Women Earning More than Men

Female Board Directors from ASX companies ranked 50 to 300 earned more than their male counterparts in the 2015 year.



## Does EPS Market Practice Meet Board and Shareholder Experience

Egan Associates examines the pitfalls of a commonly utilised equation for earnings per share growth and questions whether shareholders understand their ramifications.



## Market Giants Agree on 'Commonsense' Corporate Governance Principles

A select group of high profile CEOs of US public companies, asset managers and pension funds have created a set of 'commonsense' corporate governance principles to foster economic growth and benefit shareholders.



## The Agenda

The Agenda is the must read summary of issues concerning Boards of Directors and Government.

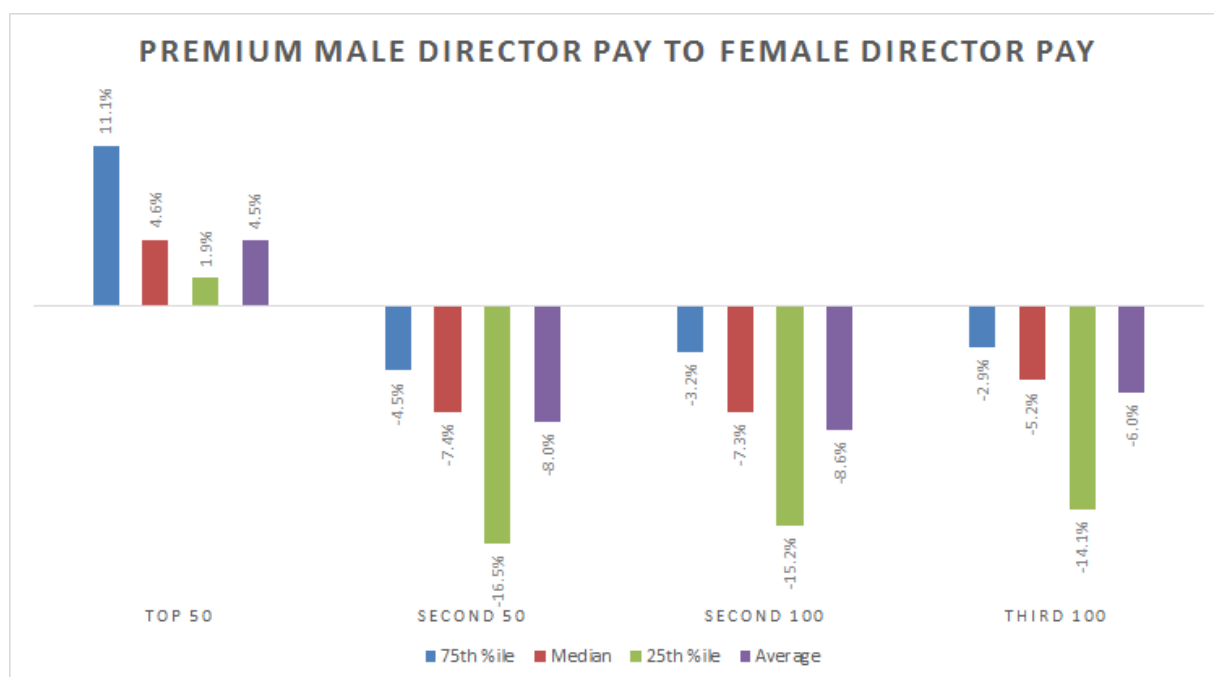
# 2015 Director fees: Women Earning More than Men

Female Board Directors from ASX companies ranked 50 to 300 earned more than their male counterparts in the 2015 year.

Egan Associates received a significant amount of interest in the KMP Report released last month on remuneration for Directors among Australia's top 300 companies, inspiring us to conduct further analysis. One question was whether the gender pay gap – which the Workplace Gender Equality Agency has identified as increasing as positions become more senior, appears at the Board level.

Filtering for gender, it appears that in most cases, for women serving on the Boards of Australia's top companies, the opposite was true.

Although women serving on Boards in the top 50 companies earned less than their male counterparts, those outside this group yet still within the top 300 companies actually earned more, as can be seen in the following figure of the premium male Directors earn over female Directors across company bands.



Generally, Director pay will be more uniform than that of executives, because the retainer and committee fees are fixed, with little room to acknowledge individual competence and achievement. Therefore, if a Director is to earn more, they must often serve on or chair more Board committees than other Directors.

Egan Associates examined the committee membership of the sample, finding that for those Directors in the top 50, the average number of committees on which the men served or chaired was higher than that for the females. For the other company bands, the opposite was true. Hence it can be surmised that it is additional committee memberships that is creating the difference in pay.

Egan Associates has observed that the qualifications, skills and training of women Directors is particularly high, providing them with the necessary prerequisites for participating meaningfully in Board committees. Therefore, although it may seem surprising to some that female Directors are actually earning a premium in some categories of the ASX, the fees have been well earned.

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# Does EPS Market Practice meet Board and Shareholder Expectations?

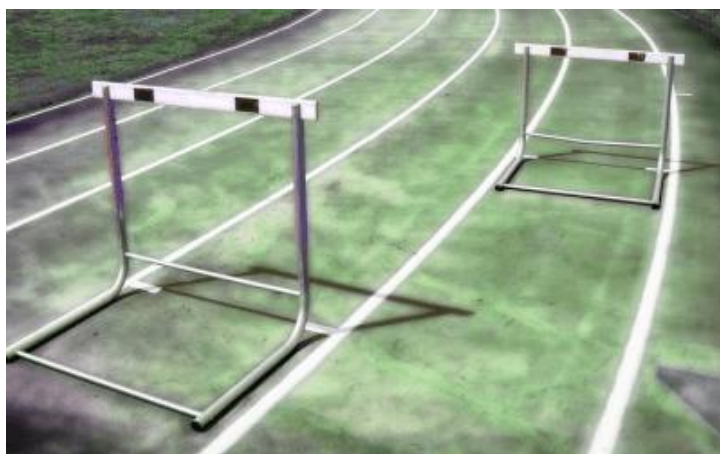
Generally, when measuring long term EPS performance, companies will calculate a compound annual growth rate using the formula below:

$$(EPS \text{ in the final performance year} / EPS \text{ in the base year})^{1/n} - 1$$

Where n is the number of years between the base year and the final year in the performance period.

An obvious issue with this is that if there is negative EPS performance in the base year, the equation is incalculable. This makes it unsuitable for companies that have made a loss or are likely to make a loss in the near future.

However, the formula also has another major pitfall that will affect even companies with stable earnings: it doesn't matter what occurs in the years between the base year and the final performance year in the performance period.



By excluding some years from affecting vesting, this formula provides incentives for executives to game the measure, for example by pushing costs into base years so that it is easier to achieve the necessary growth by the final year. It also means that a company could make a loss in an intermediate year and still be paid a long term incentive based on the EPS in the final year. In addition, we have observed one application of an EPS hurdle in a top 100 company which uses the point-to-point methodology and also provides for retesting. This adds another year that may have no impact on final vesting.

It is likely that many investors believe that EPS performance over the whole performance period is considered when calculating earnings performance. They may further believe that executives must achieve an EPS that is at least equal to that in the previous year plus a certain percentage uplift – that is, an annual growth rate compounding each year over the 3-year period.

For example, using the 2015 Financial Year as the base year and assuming 10c earnings per share, a 6% compounded rate of growth to reach threshold vesting would require earnings in the 2016 FY of 10.6c, earnings in the 2017 FY of 11.24c and in the 2018 FY 11.91c. Over the total performance period, earnings per share would amount to 33.75c (10.6c + 11.24c + 11.91c).

The Board might require the management team to at least meet each of the annual targets in order for any of the incentive to vest, or could state that if the target was missed in the first year, as long as the shortfall is made up in the following years and the cumulative EPS total of 33.75c is reached, the threshold number of incentives will vest.

In contrast, if the CAGR formula above is used, the company could have negative EPS in FY 2016 and FY 2017 and it would not affect vesting as long as the EPS reaches a minimum of 11.91c in FY 2018.

If this were the case, it is clear that the model incorporating EPS results from all three years within the performance period will deliver a superior level of performance than the traditional CAGR formula. The base year is still important, but management teams must improve the aggregate EPS result in order for their incentives to vest.

Egan Associates has had discussions with Boards about this performance condition where it became clear that this is what the Boards wanted to achieve when they nominated an EPS hurdle.

If Boards do want to diverge from EPS market practice to achieve a better performance outcome (whether through the above suggestion or any other alternate calculation), they must make the methodology for calculating EPS growth clear in the share plan rules/and or the offer letter for grants. The methodology and reasoning behind the methodology must also be clear in the annual report so that shareholders also understand the true difficulty of the performance condition.

Only by being completely transparent will Boards both reduce the likelihood of disputes over whether performance conditions have been met and ensure shareholders are kept abreast of the Board's incentive strategy.

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# Market Giants Agree on 'Commonsense' Corporate Governance Principles

A select group of high profile CEOs of US public companies, asset managers and pension funds have created a set of 'commonsense' corporate governance principles to foster economic growth and benefit shareholders.

The group, including Berkshire Hathaway Executive Chairman Warren Buffet, BlackRock CEO Larry Fink, Vanguard Executive Chairman Bill McNabb as well as GE, Verizon, GM, and JPMorgan Chase CEOs Jeffrey Immelt, Lowell McAdam, Mary Barra and Jamie Dimon, believe that while corporate governance has been intensely debated of late, the "debate has generated more heat than light", with little agreement on what exactly corporate governance actually means.



The hope is that the principles will form a common ground to promote further conversation, resulting in public companies taking "a long-term approach to the management and governance of their business (the sort of approach you'd take if you owned 100% of a company)".

Significant points from the principles are summarised under the following headings. The open letter from the group and their complete set of principles can be found [here](#).

## Board Composition

The group appeared concerned about the potential for Boards to become beholden to the CEO or management. The principles stressed the need for Directors to be "strong and steadfast" and "independent of mind", be "business savvy, shareholder oriented and have a genuine passion for their company".

Other principles included that: The Board should be as small as practicable; the majority of the Board should be independent as defined by the New York Stock Exchange rules or similar standards; a subset of Directors should have professional experience directly related to the company's business; Directors should be drawn from a rigorously diverse pool; and consideration should be given to Directors' service on other Boards as well as external commitments.

The principles did not specify limitations on tenure, merely noting that Boards should explain their approach to tenure limits and that Board refreshment should always be considered to ensure perspectives and skills remain current and broad. One succinct yet powerful statement was "The Board should have the fortitude to replace ineffective Directors."

## Board Agenda

One of the most important jobs of the Board was making sure the company has the right CEO, according to the group. Accordingly, the consideration of CEO and executive performance and succession was one of the items the group believed should be taking up most of the Board's time.

Others included:

- "A robust, forward-looking discussion of the business" and "creation of shareholder value, with a focus on the long term".
- Major strategic issues such as mergers, acquisitions and capital commitments and consideration of operational and financial plans, quantitative and qualitative key performance indicators and assessments of organic and inorganic growth.
- Significant risks.
- Determining and assessing standards of performance and maintaining the company's culture and values.
- Corporate responsibility matters.
- Shareholder proposals.
- The best approach to executive remuneration.
- Informing and educating Directors, via outside experts and advisors where necessary.
- Financial statements, including consideration of whether they would be prepared or disclosed differently if the external auditor were solely responsible for their preparation.

## Remuneration

It was interesting that the principles contained the same sentence regarding Director and executive remuneration: "Companies should consider paying a substantial portion (e.g., for some companies as much as 50% or more) of Director/[senior management] compensation in stock, performance stock, units or similar equity-like instruments."

In Australia, although it is considered desirable that Directors have skin in the game, too much skin in the game can jeopardise a Director's independence, and the ASX Corporate Governance Principles and Recommendations state that "it is generally acceptable for non-executive directors to receive securities as part of their remuneration to align their interests with the interests of other security holders. However, non-executive directors generally should not receive options with performance hurdles attached or performance rights as part of their remuneration as it may lead to bias in their decision-making and compromise their objectivity."

The US Principles also recommend that companies consider requiring Directors to retain a significant portion of their equity-based remuneration for the duration of their tenure to "further Directors' alignment with the long term performance of the company."

On executive remuneration, the group recommended that even as they evolve, remuneration plans should maintain continuity over multiple years. It also suggested that remuneration not be entirely formula-based.

"Companies should retain discretion (appropriately disclosed) to consider qualitative factors such as integrity, work ethic, effectiveness, openness, etc. Those matters are essential to a company's long-term health," the principles state.

## Reporting

The group believed financial markets had become “too obsessed with quarterly earnings forecasts”, stating that companies should not feel obligated to provide guidance and that they should frame their required quarterly reporting in the broader context of their strategy. They also echoed widely-held concerns about the use of non-GAAP (Generally Accepted Accounting Principles) results, stating that while it might be acceptable to use non-GAAP results in certain circumstances these results should not obscure the GAAP results.

## Asset Managers

The principles did not only focus on the corporate governance obligations of public companies, but also those of asset managers. The principles in this section appeared focused on ensuring a two-way conversation where both parties receive Board/senior level access and endeavour to the best of their ability to understand the others’ point of view.

The principles stated that “Asset managers should devote sufficient time and resources to evaluate matters presented for shareholder vote in the context of long term value creation. Asset managers should actively engage, as appropriate, based on the issues, with the management and/or Board of the company, both to convey the asset manager’s point of view and to understand the company’s perspective.”

The group also requested that governance activities receive appropriate senior level oversight by the asset manager and that asset managers raise critical issues to companies as early as possible in a “constructive and proactive” way. The proxy voting process and voting guidelines should be made public and there should be clear engagement protocols and procedures.

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# The Agenda

## Prominent UK leaders Release Executive Remuneration Recommendations

A group comprising leading representatives of UK listed companies, investment management and asset owners, has [released its final report](#), making ten recommendations to improve the effectiveness of executive remuneration:

1. Remuneration committees should have more flexibility to choose a remuneration structure that is tailored to the company's strategy. This is particularly the case for the long term incentive, which the group believes has become too formulaic.
2. Non-Executive Directors should serve on the remuneration committee for a year before becoming Chairman of the committee.
3. Boards should be engaged in setting remuneration, not just the remuneration committee.
4. Remuneration committees need to be less reliant on remuneration consultants and should put remuneration advice out to tender.
5. Shareholder engagement should focus on the strategic rationale for remuneration structures.
6. Companies should focus engagement on the material issues for consultation.
7. Remuneration committees should disclose the process for setting bonus targets and retrospectively disclose performance ranges.
8. The use of discretion should be clearly disclosed including what impact the discretion had on remuneration outcomes.
9. The Board should explain why the maximum remuneration level is appropriate for the company using external and internal relativities.
10. Remuneration committees and consultants should be aware of the potential inflationary impact of market data on their remuneration decisions.

## NZ Director Pay

The NZ Institute of Directors has released the results of its [annual Director remuneration survey](#).

The median increase in non-executive directors' fees was 3%. For non-executive directors the median rose from \$41,610 in 2015 to \$42,994 in 2016. For non-executive Chairman the median fees increased from \$52,500 to \$54,000, with the gap between male and female non-executive directors being 10%, a drop from 21% in 2015.

The Institute of Directors also commented that New Zealand Directors are [remunerated far less generously](#) than their counterparts overseas, expressing the concern that this could be having an effect on the quality of governance in the country. Egan Associates has previously made similar comments in our annual [KMP reports](#) on Australian and New Zealand Director remuneration.

The NZ Institute of Director survey includes a much broader set of companies than Egan Associates' research on the remuneration of the top 50 NZ companies, which can be found [here](#). Our work on the differences in Director pay by gender [here](#).

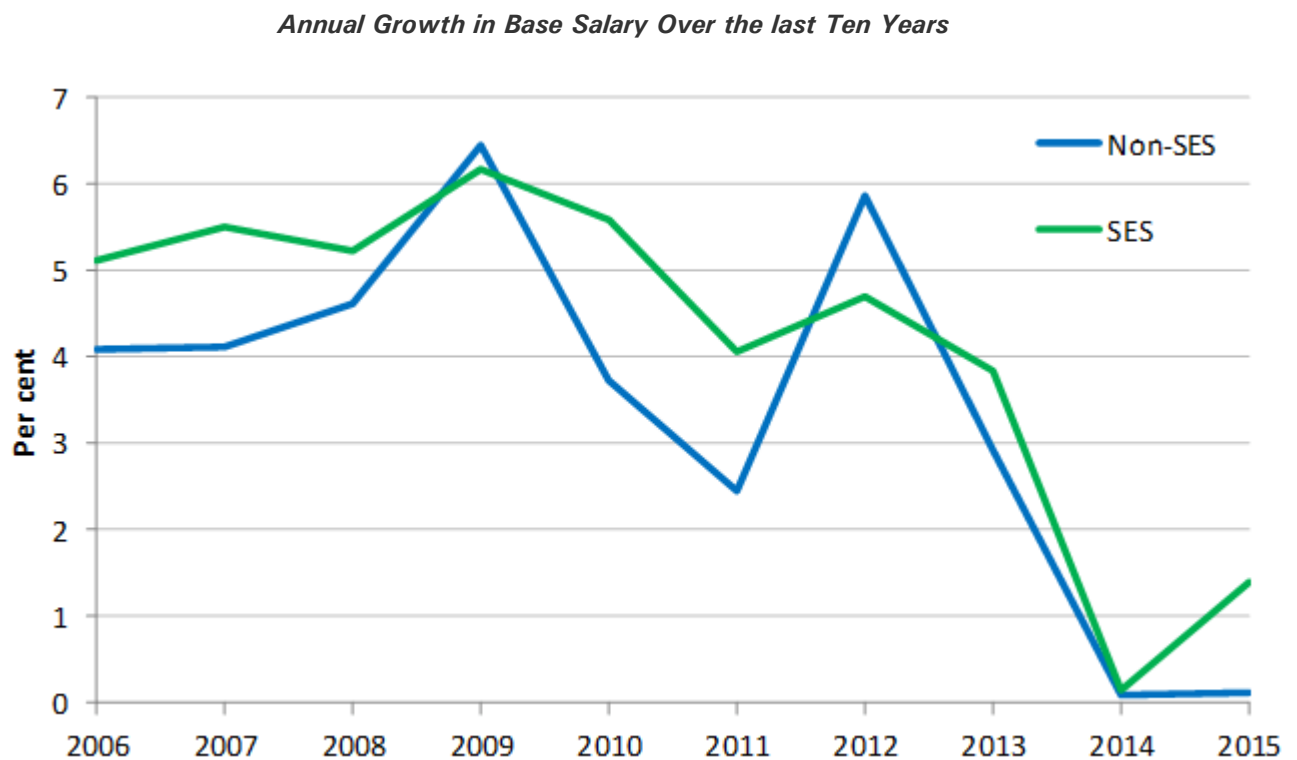
## APS Remuneration Report 2015

The Australian Public Service has released its [2015 Remuneration Report](#), which shows that the median base salary for senior executives has increased by 1.4% while the median base salary for non-senior executive service employees has only increased by 0.1%. The latest wage growth data

recorded by the movement in the Wage Price Index to June 2016 reveals that wages increased 2.1% in the year, seasonally adjusted, with the private sector increasing 2.0% and the public sector increasing 2.4%.

**Hiring of employees increased by over 100% from 2014 to 2015, as did promotions.** This affects the statistics because new hires and promotions **tend start at the bottom of their salary scale**: as employees' tenure increases, they will progress to higher levels of pay. The slow progress of enterprise bargaining has also had an effect. Although 24 new agreements were signed, they were concluded late in the year and would not yet have changed remuneration levels.

The following graph shows the effects of these trends:



*(Source: APS Remuneration Report 2015)*

While base salary increased for senior executive employees, **the proportion of employees receiving a performance bonus has declined** (continuing a trend that has been occurring for the last few years – 2015 bonus participant numbers were a quarter of those in 2011), as have those receiving motor vehicle allowances.

This has led to the increase in the median total reward (including benefits such as motor vehicle and performance bonus) being 0.7% for senior executives and -0.2% for non-senior executive employees.

### **Australia's leadership not a true representation of its population**

The Australian Human Resources Commission has [released a report](#) investigating exactly how many of Australia's leaders come from culturally diverse backgrounds. The research examined whether leaders came from Anglo-Celtic, European, Non-European or Indigenous backgrounds, focussing on ASX 200 CEOs, Federal Parliament MPs and Senators, Federal Ministers and Assistant Ministers,

Federal and State Public Service Secretaries and Heads of Departments and Vice Chancellors of Universities.

In all of the above categories, more than three quarters of leaders were Anglo-Celtic, while less than 5% were Non-European, with little to no Indigenous representation. Given that only 32% of the Australian population has an Anglo-Celtic background, the Commission suggests that organisations consider sending signals on cultural diversity: making a leadership commitment, collecting more comprehensive data, setting leadership targets, introducing better accountability, and enhancing professional development.

It is Egan Associates' observation that were this analysis to be carried out for ASX200 boards, the proportion of non-European Directors would likely be much higher than the numbers in the Commission's report.

## Amendments to AASB2

The AASB has issued [AASB 2016-5 Amendments to Australian Accounting Standards – Classification and Measurement of Share-based Payment Transactions](#), to address:

- accounting for the effects of vesting and non-vesting conditions on the measurement of cash-settled share-based payments;
- classification of share-based payment transactions with a net settlement feature for withholding tax obligations; and
- accounting for a modification to the terms and conditions of a share-based payment that changes the classification of the transaction from cash-settled to equity-settled.

The amendments apply to annual periods beginning on or after 1 January 2018.

## MSCI claims pay for performance mismatch. Others disagree.

MSCI has [released a research report](#) claiming that US companies which pay their CEOs more achieved lower levels of 10-year performance over the period from 2006 to 2015. The company proposed a hypothesis that those who grant larger share awards will better incentivise performance. Yet it found that of 429 large-cap U.S. companies observed, companies with total pay below the sector median outperformed companies with pay above the sector median by as much as 39%. In this case total pay included the value of grants made during the year. Total shareholder return was used as a measure of performance.

Executive remuneration specialists Pay Governance, on the other hand, [conducted a review](#) of the report, concluding "we believe [the MSCI] study is based upon an incorrect premise of executive motivation and an improper measurement of CEO pay".

Pay Governance's concern with the study centres around the choice of measurement "CEO pay", which includes the accounting value of stock awards at grant date, with MSCI's hypothesis being that the higher opportunities represented by large grants would motivate more than lower opportunities represented by smaller grants.

Pay Governance points out that the majority of companies target the value of share grants to the median of their peer group, and therefore it would be expected that there is a weak correlation between pay opportunity and total shareholder return. It is the change in value of the equity after the grant that motivates, Pay Governance continued, not the size of the opportunity at grant. If realised pay or realisable pay ([see definitions here](#)) are used to analyse the effectiveness of pay for performance, there is a strong correlation with TSR, it stated.

## Most employees don't disapprove of CEO pay levels

Data provider PayScale [surveyed over 22,000 US workers](#), asking if they knew what their CEO was paid, whether they thought this was appropriate and whether knowing the level of CEO pay negatively impacts their view of their employer.

More than half of employees didn't know what their CEO was paid, but of those who did, only 21% thought the CEO's pay was excessive and of those who disapproved, almost half said it didn't negatively affect their view of their employer.

As might be expected, the more an employee earns or the more senior the role they hold, the less likely they are to disapprove of how much their CEO is paid. Interestingly, 16% of Director level employees disapproved of CEO pay.

In terms of generations, more Millennials than Baby Boomers or Gen X stated that the level of their CEO's pay negatively affected their view of their employer.

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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 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](http://www.thebraesgarden.com) – and he served as a Trustee of the Sydney Royal Botanic Gardens & Domain Trust from May 2010 to June 2014.