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Independence and Conflict of Remuneration Advisers

When ASX listed companies seek independent counsel on remuneration issues, remuneration advisers can find themselves faced with numerous scenarios which can result in conflict with a departing executive, especially where the level of compensation as part of a separation or nominal resignation is being discussed.

Equal Pay for Work of Equal Value

Given the ongoing discussion and public comment in relation to the equality of pay, there is merit in addressing the challenge faced by employers in endeavouring to be fair in rewarding their workforce.

Short Term Incentive Risk Aversion in Boards

Boards, shareholders and proxy advisors are increasingly engaged in oversighting any company activity which fails to account for its exposure to risk, including short term incentive plans.

Lessons from the 2017 AGM Season

The Australian Securities & Investments Commission prepared a comprehensive report outlining the outcomes of the 2017 AGM reporting season.

The Agenda

'The Agenda' highlights current issues or matters that may be under review by Government or Boards.

Independence and Conflict of Remuneration Advisers

When ASX listed companies seek independent counsel on remuneration issues, remuneration advisers can find themselves faced with numerous scenarios which can result in conflict with a departing Executive, especially where the level of compensation as part of a separation or nominal resignation is being discussed.

Some typical scenarios include:

- options to exercise discretion in circumstances where a termination benefit was limited to 3 or 6 months;
- an option to enable equity incentives to vest when performance hurdles have not been met;
- challenges associated with negotiated separation arising in circumstances of under-performance (not constituting fraud or malpractice) revealing failure in leadership.

Boards often struggle in their efforts to manage separation to avoid incrimination, legal action or disputes, where either one or both parties have fallen short of effectively managing a situation. The role of the Remuneration Adviser needs to be wholly independent, providing advice which is accurate, defensible and which represents the most appropriate response under the circumstances.

Issues can arise in relation to incentive awards, particularly when there is a dispute in relation to an executive having the authority to change certain pre-existing agreed initiatives where there are contrary views of Board members, and/or where that tension has led to errors of judgement and/or poor execution of prior approved strategies and programs.

Another difficult situation can arise when an incoming executive discovers, within a relatively short period of time, that a number of business units are operating unprofitably and are poorly led. In these circumstances, shareholders and proxy advisers will often query separation arrangements where a retiring executive receives rights to considerable incentive benefits, though subsequent results reflect undisclosed under-performance.

Separation can also arise in circumstances where the primary reason is not apparent and settlement negotiations are contrary to company policy and market practice. In this situation, the Board's remuneration adviser needs to be fully appraised if called upon to attest to the reasonableness of the termination arrangements and their alignment with contractual entitlements.

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Equal Pay for Work of Equal Value

Given the ongoing discussion and public comment in relation to pay equality, there is merit in addressing the complexities faced by employers in endeavouring to be fair in rewarding their workforce.

Equitable reward is a matter considered by the Fair Work Commission, included in Enterprise Agreement negotiations and embraced in personal negotiations between employers and employees. It has regard to a considerable number of factors which incorporate the value of work itself which is often determined using a job evaluation methodology.

There is a difference between "work value" and the value of work. A perfect example, at the entry level of employment, would be the diversity of training provided to university graduates who have completed 3 or 4 years of training prior to entering the workforce. While job evaluation may suggest that the majority of workforce entry positions are equivalent in work value terms, the market would place a different value on those roles irrespective of gender or other factors.

Governments, for example, fund many positions with tax payers' dollars, so these roles are often less well rewarded than positions equivalent in work value in the private sector where young graduates can contribute to the almost immediate generation of profit.

Given the variety of careers sponsored by university education, the career paths and opportunities across the disciplines pursued will also vary. Similarly, within the first few years following graduation the roles which young graduates commence in the world of work will be vastly different. Their pay will also vary greatly and will be influenced by a multiplicity of factors. These include the graduate's level of experience and further specialisation in his or her field; whether the graduate's job is generating revenue or deemed as a "cost centre job"; the level, if any, of accountability for people management; whether the graduate is customer facing or in a back office job; job specific requirements such as overseeing multiple functions or operating across a diverse geographic span; the capacity for the employer/industry to reward their graduate(s), and the supply compared with market demand of a graduate's particular skills.

Should the degree of complexity and the diversity of academic requirements for completing an undergraduate degree have an uplifting effect on a graduate position's work value and pay?

Not generally considered is the high school entry performance required to commence the degree program. This may vary from 65% to 95% of a perfect score, thus the input attributes of the candidate for graduation also vary because of the intellectual demand of the course and the competition from talented high school students to enter a particular discipline or field of study.

University data also reveals a sizable gender variation in the pursuit of certain careers. A similar assumption could be made in relation to those entering the world of TAFE while working part time. Again, across the trades there appear to be different choices between males and females and different rates of remuneration will be influenced by the factors nominated above for graduates.

Assuming all elements of the work environment and the education required to undertake the work are common, it is difficult to argue that pay should not be equivalent. Where variable hours are required, differentials should reflect that requirement. Where variable performance is evident, performance should be acknowledged and rewarded.

Factors which are generally not considered in determining equivalence of pay are, for example, the time and related costs for an employee to commute from their home to their place of work and an employee's domestic circumstance. These are factors which will influence an employee's capacity to contribute at work, the time they have available to meet the demands of their job, their ability to remain undistracted during their period of work and in many instances their opportunity to pursue higher levels of work and the demands of career progression. These are not universally gender specific factors.

Aspiring to equivalence of pay for all individuals undertaking a comparable role, offering different inputs, performing differently and working in organisations with variable capacities to pay, is a highly problematic goal. Adopting principles of equal pay for equal contributions in comparable work will always remain appropriate and should be a goal of every employer. The challenge is applying a universal pay level for a deemed standard job across all employers, in all locations, given variable individual capacities, the quality of their input and output of their training and their effectiveness on the job.

Egan Associates have, over many years, been actively engaged across all sectors in assisting organisations determine work value. More recently, we have developed online processes to enable organisations to evaluate positions and explore pay anomalies across their workforce.

For further details of these services, contact Alex Cass (acass@eganrem.com) or Zoe Lockyer in Sydney (zlockyer@eganrem.com) on (02) 9225 3225 or Peng Yang Long in Melbourne on pylong@eganrem.com or 0413 716 676.

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Short Term Incentive Risk Aversion in Boards

Boards, shareholders and proxy advisors are increasingly engaged in oversighting any company activity which fails to account for its exposure to risk, including short term incentive plans.

This is a direct result of the questionable behaviours which exposed organisations to potential risks and represented a significant contribution to the downfall of a number of high profile North American organisations, as well as the Global Financial Crisis of 2007.

This article examines the impact that short term incentives may have had in some of these significant cases and looks at considerations for organisations when developing both measures and assessment protocols for short term incentives.

1. **VA Healthcare**

   Veterans Health Administration is the US's largest integrated healthcare system providing care for Veterans across the country.

   In this tragic case, it emerged in 2014 that Department of Veterans Affairs officials falsified wait-list data in order to meet targets which were, in reality, not achievable due to the extreme high demand for services.

   A target of 14 days was set for seeing a patient after their initial request for an appointment. Achievement of this target was tied to annual performance reviews which were used to determine pay increases and incentives as well as other benefit entitlements.

   While the intention was to ensure veterans received healthcare as quickly as possible, the outcome of setting the targets and linking them to financial rewards led to the creation of falsified data to ensure financial rewards were paid. As a result, the real wait time (closer to 115 days on average) was kept a secret resulting in a number of veterans dying while on the wait list. It also led to highly stressed and overworked staff.

   In the aftermath of the scandal, US Congress and the White House took steps to reform the Department, including eliminating incentives for wait-time goals.

2. **Global Financial Crisis**

   

   The causes of the GFC are multiple and the crisis clearly cannot be attributed exclusively to short term incentives. In fact, Luci Ellis of the Reserve Bank of Australia articulated the broader causes here. However, short term incentives clearly played a critical role in creating the risk-taking behaviour which was inherent in the financial markets at the time.

A 2011 paper by Chesney, Stromberg and Wagner cited the review of incentive compensation practices by the Board of Governors of the Federal Reserve System which stated that, *"risk-taking incentives provided by incentive compensation arrangements in the financial services industry were a contributing factor to the financial crisis that began in 2007"*.

In an **article in The New York Times referring to financial incentives**, Nassim Taleb commented that, *"the greater problem is that it provides an incentive to take risks. The asymmetric nature of the bonus (an incentive for success without a corresponding disincentive for failure) causes hidden risks to accumulate in the financial system and become a catalyst for disaster".*

Clearly traders were taking significant trading risks to meet financial targets and adopting unethical behaviour due to the 'carrot' of a large financial bonus. The end result sought by the traders, whatever the means, was to achieve that bonus. The end result for the rest of the world was the GFC.

3. Wells Fargo

A **1998 Fortune magazine article** interviewed Dick Kovacevich (then CEO of Wells Fargo) who likened bank instruments such as ATM cards, cheque accounts, and mortgages to regular consumer products like screwdrivers in a hardware store.

This attitude underpinned the scandal that was to emerge at Wells Fargo when it launched its *"Going for Gr-eight"* initiative.

The concept was to encourage branch workers - or, as they were more aptly regarded, '*sales people'* - and branch managers to ensure each customer had eight of the bank's products through cross-selling.

This was based on the notion that customers with a variety of bank products were typically far more profitable for their bank than those who had, for example, just one cheque account.

Sales targets were strongly reinforced by Wells Fargo management and resulted in branch staff creating accounts for customers without the customers' knowledge.

The policy and resultant malpractice continued for years. In fact, according to Bethany McLean writing in **Vanity Fair**, *"Wells Fargo's own analysis found that between 2011 and 2015 its employees had opened more than 1.5 million deposit accounts and more than 565,000 credit-card accounts that may not have been authorised.*

Some customers were charged fees on accounts they didn't know they had, and some customers had collection agencies calling them due to unpaid fees on accounts they didn't know existed".

In the case of Wells Fargo, both compensation and performance ratings were associated with sales goals and this, along with the culture and pressure to achieve goals directly, led to unethical and fraudulent behaviour.

4. **Green Giant**
   The Green Giant label has been iconic in US produce for close to a century.

   In this relatively light-hearted example, Green Giant suffered significant brand damage a few years ago when they discovered remnants of insects in their products. With the best intentions of eliminating the incidence of contamination, the company introduced an incentive plan which rewarded employees with a bonus for finding insect "parts". A number of employees responded by bringing in remnants of insects from home to "plant", only to "find" these remnants later, thereby qualifying to claim their bonus. A well-intentioned, but flawed, incentive plan.

There are countless other examples where poor incentive design has resulted in behaviour which is fraudulent or unethical. Arising from circumstances of this nature, Boards today are more highly focused on the company's exposure to reputational risk and are monitoring assessment processes which trigger the payment of incentives.

To manage risk within a short term incentive design, there are several factors to consider, including:

1. When performance targets are created, what behaviours are being driven? Are there any potential negative impacts of those behaviours? If so, is the measure appropriate and/or are there safeguards (such as deferrals, caps, discretionary components and pricing control) in place to alleviate the potential negative impacts?
2. Are standards included which relate to values and ethics (which can be measured through colleague and customer feedback) which can be linked to clearly articulated clawbacks in case of failure?
3. Are operational controls in place to prevent manipulation of results?
4. How is performance validated?
5. What is the level of engagement of the Audit and Risk or Remuneration Committees (in listed organisations) in approving performance measures and outcomes?

If these factors are taken into consideration during the development of performance measures, the associated risks can be minimised and managed to win the approval of shareholders, proxy advisors and Boards.

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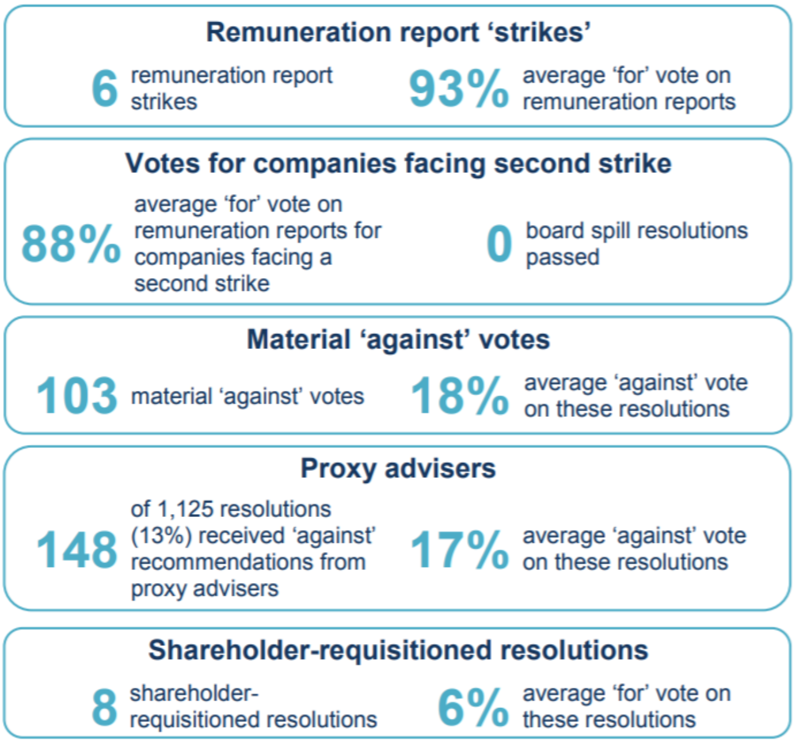
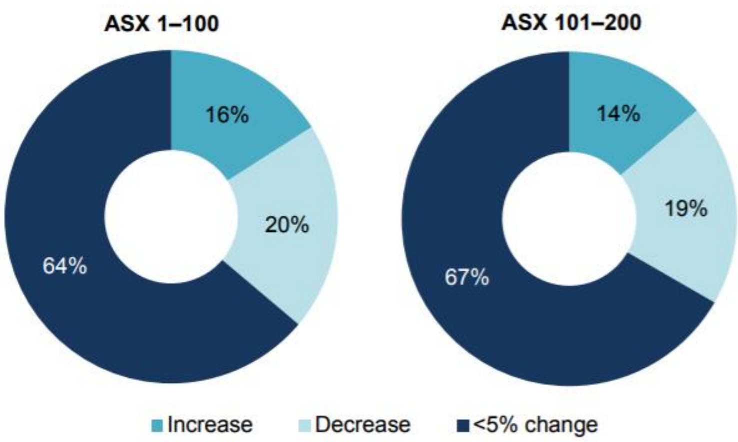
Lessons from the 2017 AGM Season

The Australian Securities & Investments Commission issued [Report 564] in January this year. The Report provides a comprehensive insight into the outcomes of the 2017 AGM reporting season and is a useful overview of the key trends observed across the ASX 200 during the recent reporting period.



ASIC observed a significant decline in the number of first strikes on the Remuneration Report, from 11 in 2016 to 5 in 2017. Only one company received its second strike. The pie charts below highlight ASIC's research.

Change in 'for' votes on remuneration reports from 2016 to 2017 (ASX1-100 and ASX 101-200)



ASIC's report encourages all companies to:

- adopt incentive structures designed to achieve long term company value, which may involve the use of non-financial targets;
- ensure remuneration structures are sufficiently transparent to allow objective measurement of performance;
- avoid unnecessary complexity in the design of the incentive structures and in the disclosure made in remuneration reports. This should assist shareholders to understand the bases on which performance-based payments are to be made (or have been made), including whether these payments are (or were) actually at risk.

The Report acknowledges the increasing influence of proxy advisers, including their influence on Director election, with more than 13% of Director resolutions not being supported by proxy advisers and more than 16% of resolutions in relation to KMP remuneration in the remuneration report having a negative vote from proxy advisers.

In the context of the increasing influence of proxy advisers, ASIC encourages companies to:

- understand the engagement practices of proxy advisers;
- engage early and proactively with proxy advisers as an extension of a company's ongoing active engagement with their shareholders;
- release notices of meeting to the market early and ensure disclosure to the market is clear and not overly complex.

ASIC's report is comprehensive. The total report is available online through ASIC - Report 564 - 2017 AGM Season.

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The Agenda

Productivity Needs to be a Priority at Australian Universities

Danny Samson, a Professor of Management at Melbourne University, believes universities in Australian can significantly improve on their productivity, including that of their physical assets.

Professor Samson believes that the current 24-week university teaching year results in as many as 10,000 tutorial rooms and 100 lecture halls across Australia being used for only *"half their working lives*". He suggests that productivity could be increased by 50% and the time taken for a student to complete a degree could be reduced by up to one third if universities were to adopt a trimester system and extended teaching times.

Professor Samson also sees the current rigidity of University Enterprise Bargaining Agreements as a source of diminished academic productivity, as they prescribe adherence by the academic to a structure of 40% research, 40% teaching and 20% administration, thereby overlooking individual differences in competencies and performance.

"In many other industries people specialise in what they are best at. But we expect everybody to be a competent and active researcher, teacher and engaged with admin. We could increase our research productivity and teaching effectiveness if we redesigned our EBAs", Professor Samson said *(**Australian Financial Review, 27 February 2018**).*

Ruthven Inspires Boards with Hopes to Achieve a 20% Return

After more than fifty years as an advisor and data provider to the corporate sector, businessman Phil Ruthven believes that businesses in Australia should avoid being too diversified and focused on hard assets.

Having founded IBIS World in 1971, a global business gathering data on business and industries, Mr Ruthven is now establishing the Ruthven Institute whose objective it is to advise public companies how they can achieve a 20 percent return on shareholders' funds.

No mean feat, according to Ruthven, who says on average Australia's top 1,000 companies struggle to make 8 percent return on total equity (ROE).

This level of *"woeful"* performance *"was considered acceptable in the 1960s. These days you can earn 8 percent from passive assets"*, Ruthven told the Financial Review *(**Australian Financial Review, 1 March 2018**).*

Through his Institute, Ruthven hopes to *"double the number of companies that achieve a 20 percent ROE [and] to reach 50 times the number of clients IBS reaches".*

Australian Universities Twice as Efficient as US Counterparts

U.S. universities have an academic to administrative staff average ratio of 1:2.5, while Australian universities have a ratio of 1:1, according Melbourne University Vice-Chancellor, Glyn Davis *(**Australian Financial Review, 27.2.2018**).*

Professor Davis was commenting in response to suggestions that Australian universities had failed to lift productivity, particularly where opportunities exist to better utilise physical assets such as lecture and teaching venues *(**Australian Financial Review, 27 February 2018**)*.

Margaret Gardner, the Vice Chancellor at Monash University and Chairman of Universities Australia, acknowledged during an address to the National Press Club that there was room for more efficiency within Universities, but that *"a lot of this would be driven by technology and new buildings which required investment"* **(Australian Financial Review, 28 February 2018)**.

Professor Gardner cited a number of steps that had been taken within Australian Universities to improve, including the creation of shared spaces in place of individual offices and automated student selection and enrolment processes.

Professor Gardner also noted that salary increases have reduced from previous awards.

Vice Chancellor at Deakin University, Professor Jane den Hollander, believes University EBAs are not over generous in how they pay their academic staff.

Professor Hollander asserts that a typical professor paid $180,000 reflects the fifteen or so years he or she has taken to reach that point and the fact that Australian universities must compete within a global market to attract high quality academic staff.

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About Egan Associates

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.
- **Workforce & Governance**: *Define and evaluate positions and analyse pay the easy way!* Our new cloud-based software captures more than 30 years' knowledge, learning and experience in organisation analysis and remuneration in a suite of products which operate either as powerful, stand-alone modules or as an integrated combination. Access more than 1,000 role templates and over 13,000 accountability statements or easily create your own PDs from scratch. Organisation charts are generated automatically. Powerful analytics give you pay and workforce insights in one click. And our intuitive, user-friendly job evaluation module is designed to bring your JE process into the 21st century. And because *Workforce is* designed and hosted in Australia by Egan Associates, you know you're in great hands!

Egan Associates Phone 02-9225 3225