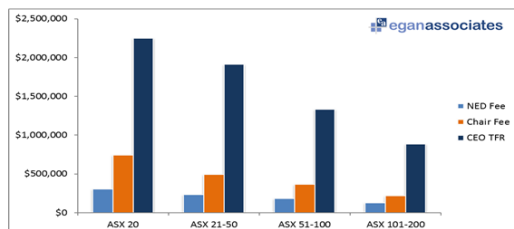


Newsletter August 2018

Figure 1: Median Chair, Director and CEO Fixed Remuneration (TFR) among the ASX 200



KMP Report: Cost and Complexity of Governance ASX Top 200

Our last research report dealing with the cost of governance was published in July 2014.



CEO Reward – Comment on Exceptions

Senior executive's fixed or come-to-work remuneration among Australia's leading companies has been in decline over the last decade.



CEO Pay in ASX 200 Companies

In recent weeks, the Australian Council of Superannuation Investors (ACSI) published their annual review of CEO pay in the ASX 200.



Executive Remuneration, Inequality and Productivity in the Spotlight

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KMP Report: Cost and Complexity of Governance ASX Top 200

Egan Associates has received many and varied requests from clients to advise on:

- the structure of Non-Executive Directors' (NEDs') fees;
- the level of fees paid to Chairmen and members of the Board and its committees; and
- the fee pools of companies regarded as comparable.

Our last research report dealing with the cost of governance was published in July 2014. Recent discussions arising from our advisory work and highlighted in Board responses from comments made by institutional investors and their advisers and issues recently arising in the Royal Commission into the financial services sector, have made several supplementary issues front and centre.

In addition to the above notations, emerging issues include:

- the attributes and skills essential for Directors serving on an ASX 200 Board
- the time commitment essential for Directors to meet their governance and stewardship accountabilities
- the Board diversity in relation to several attributes including industry & international experience, gender and age
- the nature of Board immersion in key governance issues including but not limited to:
 - adherence to corporate values & behaviours
 - ethical conduct, particularly in relation to the management of customers' affairs
 - depth of knowledge of Directors in relation to remuneration practices well below the KMP

Recent published information, in part arising from the Royal Commission, APRA and AUSTRAC, reveals that many Boards have not been aware of corporate practices in relation to the structure of remuneration, the criteria for the payment of incentives and the relationship between those practices and related research revealing positive customer engagement and employee engagement. Refer to our published article – [Governance: Front & Centre.](#)

Comment on and evidence being presented to the Royal Commission and observations and engagement with institutional investors and proxy advisers, further reveal that Boards have placed a significant level of trust in their KMP who prepare reports or make presentations to Directors outlining the integrity of organisation processes and the ethical conduct which is enforced throughout the organisation over which they have stewardship.

Boards have increasingly relied upon advice coming from management in response to questions arising or concern generally which has percolated into the community and increased awareness of shareholder expectations and, in part, the reliance in many organisations and therefore Directors on research undertaken by management's principal advisers.

These circumstances may well have highlighted the necessity in several major corporate entities for Boards to have a small cadre of highly skilled staff, independent of management and the KMP in the organisation, undertaking investigations on behalf of the Board. Such initiatives should ensure that there is no prejudice which either advantages or disadvantages KMP and senior management in relation to their reward and their continuing employment. This approach may not be entirely dissimilar to the intent of the support provided by Ministers' staff in government where they are not employees of the organisations or the Departments reporting through to the Minister and Cabinet/the Parliament, but rather undertake an independent assessment of matters of concern to the Cabinet.

As we reflect on discussions with a select number of major company Boards, 20 or more years prior, I recall both positive and negative feedback from management in relation to what I would have then described as deep hands engagement in the operation and stewardship of leading enterprises by Directors who wished to have a first-hand understanding of the organisation's contractual obligations, the nurturing and mentoring of talent in order to ensure succession and the oversight of either unintended or unidentified weaknesses in contracts entered into with third parties.

There appears to be emerging evidence that issues of this nature which have in part arisen from Board commitments to not interfere and therefore not engage in a forensic manner have led to concerns expressed by both customers and shareholders.

As a consequence, detailed oversight among Australia's ASX 200 and certainly the ASX 100, may involve the establishment of an Office of the Board (OTB) which is modest in scale though appropriately staffed by individuals with the relevant authority to

investigate matters on behalf of the Board and as a consequence shareholders, customers and suppliers in ensuring that a company's operations were being conducted in accordance with directions, in accordance with appropriate practice and absent of conflict of interest, particularly third party interests.

OTB staff would need to be highly skilled, independent of management and have the necessary authority to undertake any enquiry on behalf of the Board and to report to the Board independently of management, though in the spirit of transparency inform management of the outcome of their enquiries or investigations.

The cost of establishing an office of the Board would represent a cost of governance. Accordingly, in this report, rather than solely addressing the relationship of the remuneration payable to Directors as a proportion of the remuneration paid to a Chief Executive, we are also reporting on the total reward of a Chief Executive compared to Directors' costs highlighting what may represent an unanticipated and less widely published observation where six or more Directors, in aggregate, receive a modest proportion of the Chief Executive's annual reward.

This outcome, from a governance perspective and a reward management perspective, may well highlight matters which it is not intended to address in this research. This report does not address the number of Directors required to provide appropriate stewardship of organisations of varying size, of varying operational diversity/complexity including the number of regions of the world in which the company does business and deploys significant numbers of staff.

We do however comment briefly in our research on the way Boards are describing the skills and capabilities of their membership and comment on the appropriateness of Director attributes to the needs of the organisation in providing the necessary oversight of the enterprises operations on whose Board they serve in representing the interests of all stakeholders. Refer to our article- [Criticality of Board Capability](#).

You can download the report using this [link](#).

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CEO Reward – Comment on Exceptions

The heading of the article in the [Financial Review](#), written by Patrick Durkin on 2 July, in my view was appropriate. Senior executive's fixed or come-to-work remuneration among Australia's leading companies has been in decline over the last decade.

There are exceptions and the average does not provide information on the distribution of each of the executives whose fixed remuneration has been compiled. It is readily acknowledged that senior executives, in addition to their fixed remuneration, can receive awards under an annual incentive or bonus plan though not all do. A CEO's annual incentive can also exceed their fixed remuneration.

Many who have stewardship of a top ASX listed company, also participate in an annual equity-based incentive plan where securities are subject to a 3 year or longer period performance hurdle. Often being tied to a relative total shareholder return expectation and a compound earnings per share growth hurdle.

A proportion of CEOs, not insubstantial, do not always benefit from their participation in these plans as the performance set by the Board is not achieved over the defined period. Some however, do benefit in proportions well beyond which may have been envisaged by the Board at the time the award was determined, or of inappropriate valuation of the securities on offer.



There have been comments that **Alan Joyce** benefited beyond the markets expectations due to the improvements in the share price of **Qantas**. This was influenced by a practice which, while adopted by several organisations would not be well-regarded, in that the securities he received were discounted, using a fair value methodology and assuming the risk of forfeiture, well below the prevailing share price at the time of grant (indicatively \$1.345 allocated at \$0.785). This led to the allocation of 3,248 performance rights in lieu of around 1.9 million and a benefit, assuming a share price at the time of exercising those entitlements of around \$6.00, approximated \$19.5 million compared to \$11.5 million. The outcome of his award in the 2017 Financial Year reflected the unintended consequence of the valuation of securities at the time of grant.

It should, however, be acknowledged given this error in judgement, the Board changed the basis for the allocation of securities under Qantas's long-term incentive plan on the realisation of this unexpected outcome, to conform to more appropriate standards.

Reporting of executive remuneration reflects the cost of the provision of fixed remuneration, including superannuation and any other benefits. The actual payments made under an annual incentive plan and the statutory value, amortised over the vesting period, in relation to awards under a long-term equity-based incentive plan. The statutory valuations do not reflect the value realised, or not realised. These plans are subject to the prevailing share price at the time the awards vest and the proportion of the award which vests is subject to a performance hurdle.

In that context, the current disclosures of benefits arising under long term incentive plans provided to executives in leading public companies do not provide a mark-to-market view of the value of the award at the time of vesting.

Macquarie Bank have traditionally adjusted on a year-on-year basis, the underlying value of securities priced to market which operate under their deferred incentive program. This will both rise, and fall depending upon the company's success and share price growth.

I doubt there would be any informed adviser on remuneration who would have endorsed the arrangements entered by the Board of CPA Australia. It would be my judgement that those circumstances and the termination arrangement which received significant publicity reflect that observation.

Remuneration planning is not a perfect science. A proportion of judgements made by Boards, or negotiated by senior executives, are not appropriate. The advice sought by Boards is reflective of the organisation's desired outcome rather than a completely independent view.

What is critical in this arena is that advisers to Boards are independent. What is equally important is to accept that the nature of the work of senior executives, the demands they are placed under, is totally different from the average worker. Where any error in judgement a worker makes is unlikely to become a national headline, rather absorbed by the workforce.

This is not universally the case and there are many blue-collar workers, including highly-skilled trades people, whom the community rely upon for meeting the highest standards. Particularly in the provision of electricity to homes, or wiring from the street, and plumbing. All other trades whether in the commercial, industrial, infrastructure or domestic market are subject to supervision and appropriate standards.

There are differences between the educational entry requirements for these positions and the educational demands in reaching accreditation, when compared to leaders of major corporations. This area of valuing differential capabilities applied across every occupation will always be a challenge and subject to varying community views.

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CEO Pay in ASX 200 Companies

In recent weeks, the **Australian Council of Superannuation Investors (ACSI)** published their annual review of [CEO pay in the ASX 200](#). Research is conducted on the organisation's behalf by Ownership Matters, an Australian governance advisory firm.

The report highlights differences between statutory disclosures and realised reward. It also reports remuneration in a manner which differs from the majority of consultants in that it provides information on the median and average levels of pay as well as the highest and lowest levels of pay for the ASX 100 and those organisations ranked between 101 and 200. In that context, it also provides information on percentage changes in realised reward over the relevant 12-month period. Its research covers all Financial Years ending in the 2017 calendar year.



Realised pay is an interesting construct though the primary variability between statutory disclosures and realised reward reflects the actual benefits a CEO receives on exercising their entitlements primarily under equity-based incentive plans. It would also include the benefits arising from deferred awards which were settled in the 2017 calendar year.

In recognising realised pay, the report does not annualise the benefit of reward which could cover a one, two, three, four or five-year period. By annualising such reward, the highest paid executives' reward outcomes in the majority of instances would be substantially reduced. It does however, in this context, reveal that disclosed remuneration, in a number of settings, is below realised remuneration. Statutory disclosure of long term equity-based incentives is amortised over a three to five-year period. Further, up to one third of CEOs fail to meet performance hurdles set under their longer-term incentive plans which traditionally require meeting a relative total shareholder return measure or an earnings per share measure or both.

In a relative total shareholder return construct, theoretically 50% of participants will not benefit as they will not achieve a median or better than median result. This circumstance is also influenced by the benchmark set for the company which might be an index, such as the ASX 100 or the ASX 200, it might be an industry or series of industry subsets of the ASX 200 or it might be a selected peer group which could include international comparators, particularly for large organisations with a global operating footprint.

In reporting on the top 10 highest rewarded CEOs (leading an ASX100 company) on a realised reward basis, there is a ratio between the top paid executive and the 10th highest paid executive of greater than 3:1. In the second ASX 100 the ratio is similar from the highest paid through to the 10th highest paid.

Due to movement in and out of the index and circumstances such as retirements, temporary incumbents in the CEO role or short tenure, the research provided information on 84 CEOs in the ASX 100 and 77 in the second 100, and on a year-to-year comparison basis the number of direct comparators were significantly less.

The report is available online using the following link – [ACSI CEO Pay in ASX 200 Companies](#).

In exploring the actual reward outcomes, the report does not consider the impact of alternate methodologies in determining the number of securities issued under a long-term incentive plan including Black Scholes, risk adjusted Black Scholes, Monte Carlo or binomial simulation valuations, or fair value in relation to rights. These methodologies for equity allocation have a significant impact in a number of circumstances on the actual outcome of reward realised in any one calendar year. Realisation is also influenced by the CEO's choice on whether to exercise their entitlements or defer them to a future year in anticipation of share price growth.

The research is thorough, retains its consistency and footnotes are comprehensive and clear. The report also highlights the variability between realised and reported pay from the 2016/2017 year and provides useful historic data in relation to the median and average reward arrangements from the 2017FY back to the 2011 Financial Year.

In addition to commenting on realised total reward, there is also a similar perspective offered in relation to median and fixed remuneration over a 12-year period dating back to the 2005 Financial Year, which for that period indicates a relatively flat adjustment to CEO fixed remuneration, having regard to inflation and average weekly earnings over that period.

The report further highlights the degree of variability in incentive or bonus payments over the last 10 years and provides interesting insights into termination payments over the same extended period.

For Directors and senior executives interested in trends it is a research document worthy of a read.

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Executive Remuneration, Inequality and Productivity in the Spotlight

Following the recent decision of the Fair Work Commission in relation to minimum earnings, there has been a considerable amount of press comment and research data reflecting on the rate of growth in CEO reward.



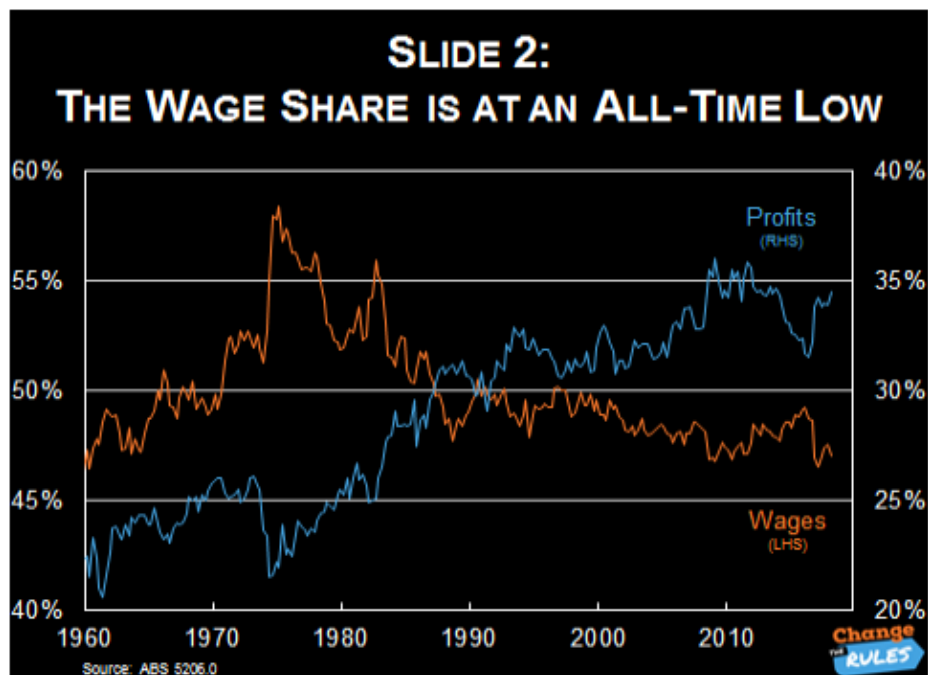
In our June/July Newsletter, we published an article highlighting the movement in fixed remuneration over the past decade, transitioning from the period prior to the Global Financial Crisis to the current period where a degree of economic growth is in evidence.

At the ACTU Congress on 18 July 2018, President Elect of the Federal Labor Party and member for Lilley, Wayne Swan, described as hypocrisy and wage theft the earnings gap of “several hundred times” between Australia’s highest paid CEO and the average employee.

In his speech, “[Trickle-down Economics & Inequality in Australia](#)”, Mr Swan, stated that Australians,

“are crying out for leadership to end trickle-down and deliver some economic justice and fairness to our nation...In theory, trickle-down economics is fundamentally about redistributing resources to the already wealthy or advantaged ... in practice, trickle-down economics is a recipe for rampant income and wealth inequality. Its reality is tax cuts for the rich, deregulation for the powerful, the destruction of social safety nets, the end of universal health and education programs and wage suppression for working people. Trickle-down gives the most to those who need it least and the least to those who need it most.”

Mr Swan went on to state that recent tax cuts provide the top 20% of earners with the greatest benefit in aggregate and that wage share is at an all-time low.



*Source: ABS 5206.0

In that context, Mr Swan stated that the trickle-down agenda is seen in penalty rate cuts, the stacking of the Fair Work Commission, the dissemination of public sector workforces and the outrageous behaviour of employers in enterprise bargaining.

Notwithstanding, he acknowledged that this trend exists globally across developed economies.

[Wayne Swan's speech](#) put significant emphasis on a redistribution of economic wealth and offered Labor's alternative of "inclusive prosperity". To achieve this, Australia needs to invest in its human and physical infrastructure to lift productivity, to build a more progressive and growth-friendly tax system thereby providing incentives for work and investment and reduce the "political clout" of the wealthy elite.

Mr Swan identified four pillars of what he describes as 'Laborism':

- Full employment
- Stronger worker voice
- Taming corporate excess
- Progressive tax

In his concluding remarks Mr Swan stated that if company Boards can't impose pay restraint on executive salaries, it is time for shareholders to take matters into their own hands and agitate for a binding vote to cap CEO pay.

While any presentation intended to be persuasive draws upon significant outliers for the purpose of illustration, the paper highlights key areas which are clearly on the agenda of Federal Labor. These broad initiatives need to embrace the interleaving of population growth, purchasing power, planning and productivity.

Employers need to plan thoroughly and in alignment with expected outcomes and related profits; they need to secure suitably qualified and trained talent to fulfil both existing and future roles which are increasingly technology-focused.

Productivity should not be expected to result from employees working longer hours, but rather accomplishing more in each hour of work.

Australia's population growth has provided an increased workforce capacity leading to increased consumption, however wages have paused. This is due in part from under-employment of those seeking work and from labour productivity not increasing at a rate which counter-balances lower wages in economies able to supply consumables to meet Australian demand.

It is in this context that Boards should seek to identify key factors to improving labour productivity and therefore profitability arising from those improvements. Such measures should initiate a trickle-down mandatory performance objective from the CEO to the "shop floor", acting as either a source of reward or a gateway denying reward. Employers who are not focusing on improving productivity and enhancing the welfare of all stakeholders will be increasingly challenged, while those who develop reward programs which share productivity aligned profit improvement with their workforce will become employers of choice.

In a recent article by Professor Steven Bell from the University of Queensland entitled, "[How Rising Inequality is Stalling Economies by Crippling Demand](#)", Professor Bell comments on the rate of growth in executive reward compared to ordinary wage growth.

While he has taken a global view, Professor Bell's analysis reflects on issues raised by the Fair Work Commission, other academics and economists. Referring to a book which he wrote with Michael Keating entitled, "", Professor Bell argues that rising inequality in wages share is weakening economic growth across economies by reducing aggregate demand. Professor Bell acknowledges that this view differs from mainstream economists who argue that growth stems mainly from the supply side of the economy.

Professor Bell's research considers the periods both prior to and post-GFC, where top income earners' share of wage increases had outstripped those in the lower deciles of earnings across many advanced economies. His thesis in a broad conceptual context is that competing economic claims can potentially deliver various combinations of inflation, wage stagnation, growing inequality, weak demand and slower economic growth.

The central proposition of his thesis is that a "fairer share" links income distribution to economic growth. In that context growth is substantially dependent on a more balanced distribution of income.

Considering Australia's recent economic progress, Professor Bell observes that reforms over recent decades to improve market flexibility have underpinned one of the longest expansions in capitalist history. He also observes that wage share in Australia in 2015 was similar that of 1990 and only marginally higher than that of 1960.

Professor Bell's research indicates that income inequality has risen less in Australia than in many overseas countries and although this is evident, there are clear signs that wages are stagnating, and household debt levels are high.

While acknowledging the desire to improve the balance of income distribution, Professor Bell references the criticality of wage-supporting measures to ensure our workforce is equipped to adapt to the rapidly changing workplace and notes the importance of a “new agenda” which supports economic growth and transformation based on innovation and technological change.

Professor Bell acknowledges the role of government in promoting demand as well as supply. Demands on the training and education sector and the commitment of employers to embrace innovation and drive productivity through improved supervision and on-the-job training will increase. While not specifically focusing on labour productivity, it is evident in Professor Bell’s thesis that productivity will be an important ingredient in reducing perceived income inequality.

As an adjunct to improving workforce productivity, the role of innovation and the adoption of emerging technologies is critical. Economic prosperity will require increased employee accountability, an increasing relevance of employee on the job training, and the preparedness of employers to retrain and re-equip their employees.

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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.



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