Executive Remuneration Insights

July 2016

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Executive summary

KPMG is pleased to present our *Executive Remuneration Insights* publication.

The past year has seen the ongoing evolution, rather than revolution, of executive pay for listed companies in Australia.

There continues to be, in our view, a tendency for 'vanilla' approaches to executive remuneration designed not to raise the ire of proxy advisors and shareholders as the result of the two-strikes rule.

We hear from Non-Executive Directors that there is an unhealthy risk aversion amongst boards, created in part by regulation, lack of diverse thinking and public focus on those that stand out from the crowd.

You will see this conformity reflected in the analysis of remuneration data contained in this publication.

The real insight however is not in the data, but to challenge whether following best practice (which is likely to really be prevailing practice) will achieve the desired results and engagement from executives and drive long term increases in shareholder value.

How then does a board create a remuneration strategy that supports its unique business strategy, risks and opportunities when there is so much pressure to conform?

In our view this means focusing on a few critical questions:

- Are we focusing on the performance drivers that are relevant to our strategy, business cycle and the market conditions or are we using the same measures as everyone else?
- Have we explored all of the reward vehicles that can reinforce the short and long term focus for the business as well as encourage the right level of risk taking?
- Does the executive remuneration design reinforce and reward behaviour that is consistent with our culture, and is sustainable and ethical?
- And finally, if we do something different from everybody else, if it is well thought through and appropriate to our company, what is the worst that can happen?

To help Non-Executive Directors and management tackle these questions, the following pages cover the details of current executive remuneration practices and related topical issues in Australia and overseas. And, as always, we are ready to partner with you to ensure the right approach for your circumstances.

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KPMG have researched and reviewed information from a broad range of sources including:

- publicly available information on executive remuneration including Annual Report data
- investor expectations, views of proxy advisors and other shareholder representatives
- KPMG's national remuneration advisory experience and the firm's precedent material providing information relevant to executive remuneration
- KPMG Report: *ASX Corporate Governance Council Principles and Recommendations on Diversity*.

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The remuneration landscape 2016

What is on Directors' minds?

In our work for clients and ongoing dialogue with Non-Executive Directors (NED) and management, a number of key people and reward challenges emerge as being top of mind.

The following sections cover each of these themes in more detail.

_ Paying for performance

Ensuring that the appropriate level of reward is being delivered for the right performance continues to be a focus. While benchmarking the practice of comparable companies is a useful starting point, most Directors realise that this is just one input into determining the best mix of pay, potential reward and the performance metrics for their company.

The real investment is in identifying and articulating what is appropriate for the company, its business strategy and where it is in the business cycle.

_ Diversity

This is not simply an issue of representation but one that requires an examination of how decisions on selection, performance and pay are made.

Informed Directors are examining the underlying practices, attitudes and structures that may prevent, hamper or otherwise discourage diversity in all its forms within the company. In particular, slow progress on gender diversity shows that much work remains to be done.

_ Succession planning

One of the key responsibilities of the board is to ensure that there is a thoughtful succession plan in place that goes beyond the short-sighted 'what if they are hit by a bus' solution. While there are a number of recent examples of successful leadership transition in the market, there still continues to be situations of crisis when unexpected or unforeseen departures happen.

Directors have to deeply understand the talent in their company as well as have a real sense of the market place and the kind of leader they are looking for to contribute to the business.

_ Conduct and pay

Recent prominent examples of company misconduct have highlighted the importance of ensuring that the values espoused by the company are being reflected in how employees operate in reality. In many of these instances, remuneration and incentives have been identified as a contributing factor to inappropriate behaviour.

Boards need to recognise that having a clear view of pay systems, beyond Key Management Personnel (KMP), is a critical governance role in managing reputational risk.

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Paying for performance

Remuneration outcomes for CEO and CFO

In FY15 we have seen little real change in remuneration levels for CEOs and CFOs within the ASX 100. Fixed pay changes, where they occur, continue to be modest and generally in line with the overall salary movements in the market. Actual changes in fixed remuneration for CEOs is in part driven by new CEO appointments in the sample, particularly external hires. We note that most internally appointed CEOs are likely to earn less than their predecessor.

Movement in median Total Target Remuneration for CEOs has been around 14.5 percent, reflecting mainly increases in target short and long term incentives (STI and LTI respectively). In other words the mix of pay continues to shift more towards 'at-risk' or variable remuneration.

Figure 1: Median pay outcomes in ASX 100

ASX 100		2014 $AUD million	2015 $AUD million
CEO	Fixed Remuneration	1.50	1.60
	Total Target Remuneration	5.50	6.30
CFO	Fixed Remuneration	0.74	0.76
	Total Target Remuneration	1.83	2.10

Figure 2: Actual STI paid to CEO

Actual STI paid to CEO %	2014	2015
STI payment as a percentage of target (median)	102	94

In terms of outcomes, it is interesting to note that the median actual STI paid as a percentage of target for CEOs has dropped from 102 percent to 94 percent.

While this reflects prevailing economic conditions and business results, the outcome could be perceived as still relatively high leading to questions of whether STI plans are as challenging and truly variable as desired.

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Short term incentives

One of the key questions our clients have regarding STI is whether they should be using a deferral feature and, if so, how should it be designed. STI deferral is generally viewed favourably by proxy advisors and certain investors as it is used to promote longer term thinking by executives, align the executive with shareholders and allow for clawback in certain situations.

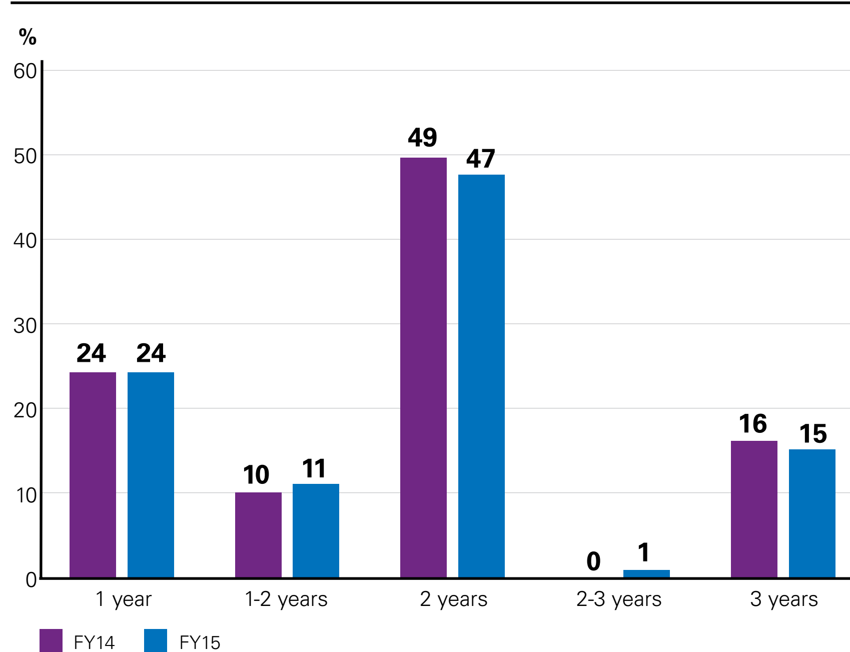
Figure 3: STI deferral instrument in the ASX 100

Year	Cash %	Equity %
FY14	12	88
FY15	8	92

The deferred portion is predominantly into equity (92 percent of those companies with STI deferral) with a slight increase in companies using this instrument, rather than cash, since 2014.

STI deferral is on the rise. 75 percent of the ASX 100 use an STI deferral feature (up 5 percent since 2014). Typically, 20 percent to 50 percent of STI is deferred.

Figure 4: Most common STI deferral period is 2 years



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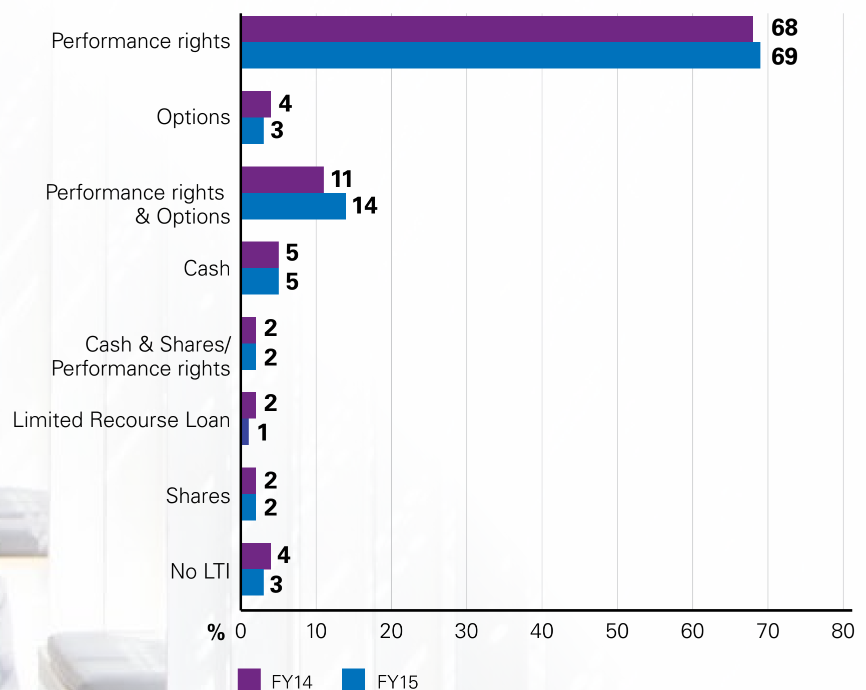
Long term incentives

Despite anecdotal feedback that LTI plans are an area where many Directors wish to challenge the orthodoxy to get the right design for their company, the data suggests that most ASX 100 companies have a very homogenous design:

- performance rights;
- two measures, typically Relative Total Shareholder Return (RTSR) and one other (most often EPS); and
- 3 year vesting.

Performance rights are clearly the most common LTI instrument in the ASX 100. Figure 5 shows there was little or no movement between FY14 and FY15 in relation to LTI instruments.

Figure 5: Companies are yet to flock to options



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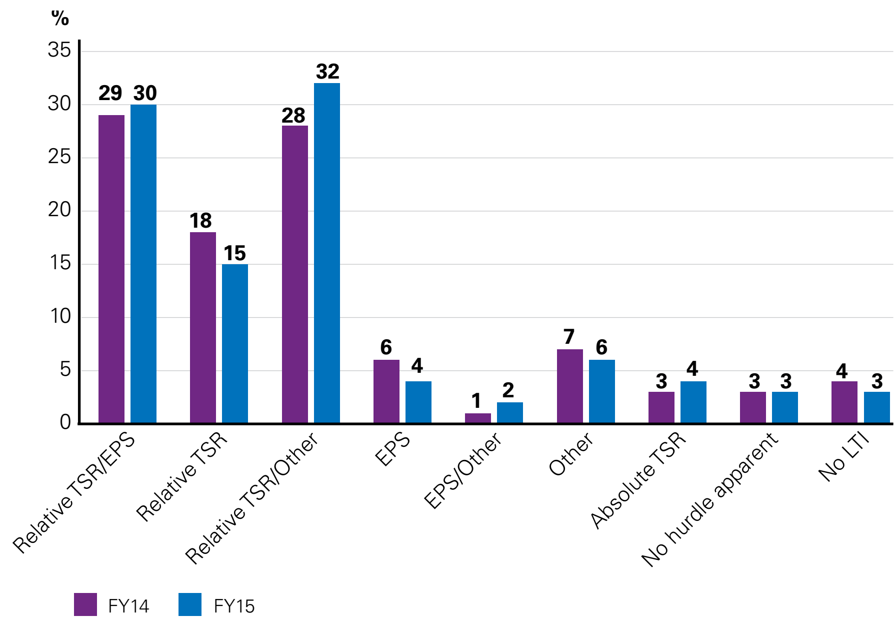
Relative TSR continues to be the most prevalent performance hurdle.

Figure 6: Number of LTI hurdles

LTI hurdles	FY14 %	FY15 %
1	22	20
2	64	65
3	7	9
4	1	1
No LTI	4	3

Figure 7: LTI hurdle combinations



Relative TSR continues to be the most prevalent performance hurdle (77 percent), however, there has been a slow but continuing increase in the number of companies combining this with a return based measure (such as ROIC or ROCE).

Figure 8: RTSR remains the most prevalent LTI hurdle

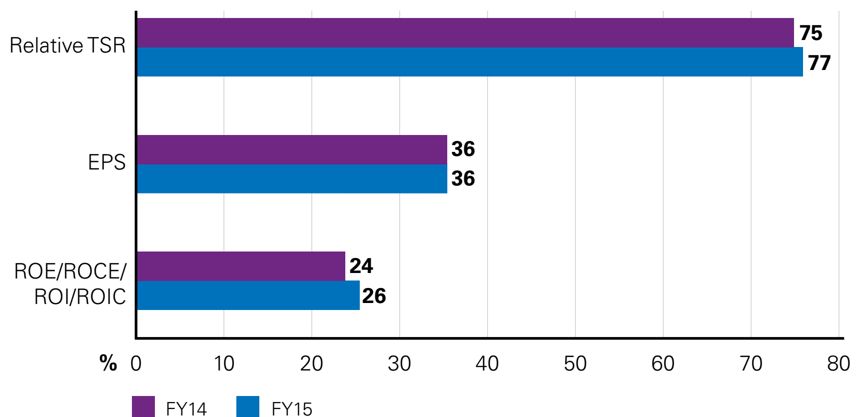


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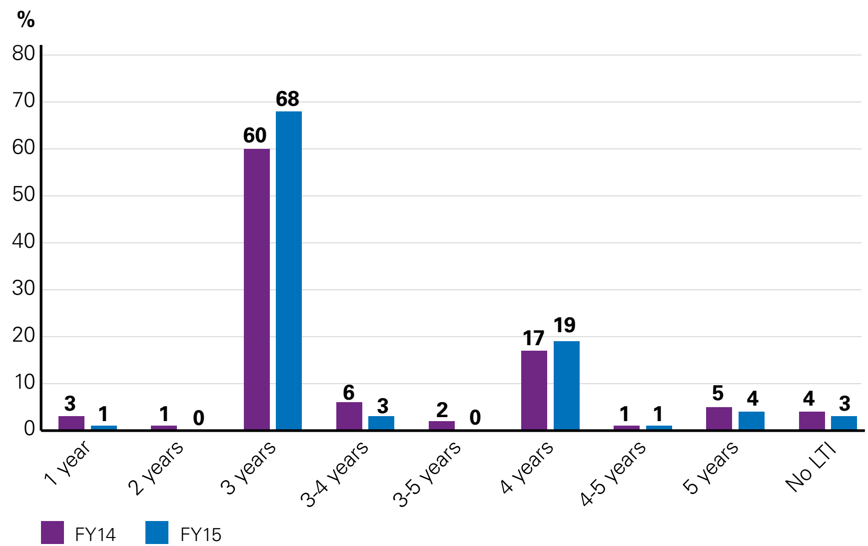
Figure 9: 3 year performance period remains most common



An increasing majority of ASX 100 companies use a performance period of 3 years (refer to Figure 9).

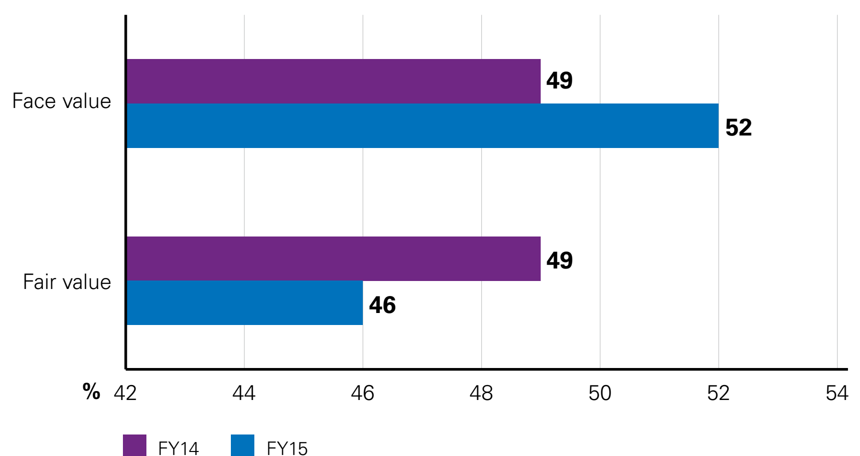
There is no statutory or regulatory basis by which the number of LTI instruments to be granted is determined.

Long term incentive allocation methodology

There has been significant focus on the manner in which companies determine the number of LTI instruments to grant to executives for a given remuneration value.

There is no statutory or regulatory basis by which the number of LTI instruments to be granted is determined. However, a number of major investors and analysts (e.g. CGI Glass Lewis, Australian Super, Credit Suisse) have expressed a preference for companies to communicate LTI opportunity in face value terms to enhance transparency and allow like-for-like comparability between companies. Perhaps for this reason, we have seen a slight increase in the number of ASX 50 companies adopting the face value approach (refer to Figure 10).

Figure 10: LTI allocation method in ASX 50



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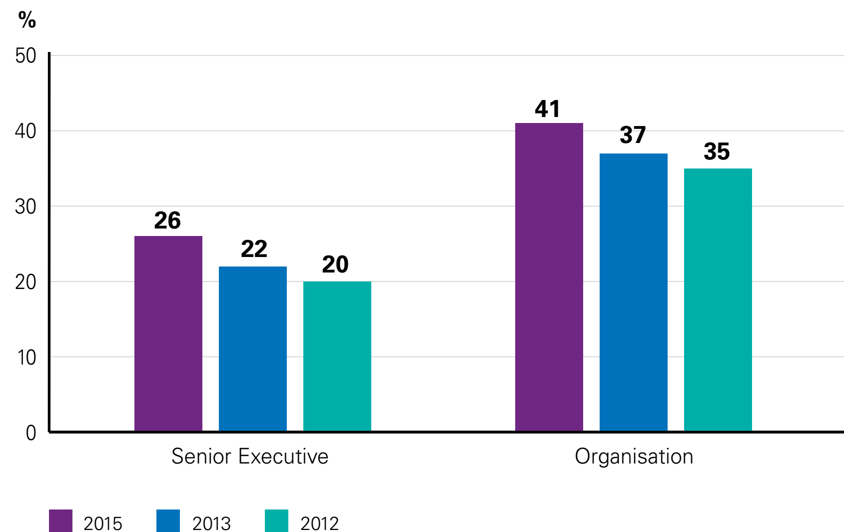
Diversity

Female representation in the ASX 200 has increased at all levels.

Diversity, including a mix of skills, expertise, background, age, ethnicity and gender, is recognised as important to ensure that companies have a stronger connection with customers, employees and other stakeholders.

Currently, in the S&P/ASX 200, the proportion of female NEDs is 26 percent. The proportion of women at senior executive level is also 26 percent.[1] As illustrated in Figure 11, female representation in the ASX 200 has increased at all levels, however the rate of change has been slow.

Figure 11: Female representation in the ASX 200



Few female NEDs hold chairman roles and each female NED on average holds a greater number of board roles (1.42) in the S&P/ASX 100 than their male counterparts (1.15)

At senior executive level, improvements are concentrated to certain roles such as HR (64 percent), legal (39 percent) and marketing (33 percent)

There was notable improvement in female representation in CIO roles (29 percent in 2015, up from 19 percent in 2011)

Women remain a minority in finance and business unit head roles i.e. those roles from which CEO succession typically occurs

As a result, female representation at CEO level has remained flat at 5 percent – with no change since 2011

1 *ASX Corporate Governance Council Principles and Recommendations on Diversity: Analysis of disclosures for financial years ended between 1 January 2015 and 31 December 2015.* Published by KPMG 2016.

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Changes since 2010 which have reshaped gender diversity include:

- the ASX Corporate Governance Principles on gender diversity
- the Male Champions of Change initiative by Sex Discrimination Commissioner, Elizabeth Broderick
- changes to Workplace Gender Equality Act (WGEA) reporting requirements

What gets measured, gets done

While many companies disclose initiatives or processes to support gender diversity[2], few disclose specific quantifiable targets or time frames to achieve them.

KPMG research indicates a correlation between the disclosure of measurable objectives and improvements in gender diversity suggesting what gets measured, gets done.

A minority of companies are going a step further by adopting the *Male Champions of Change* approach to setting 'Targets with Teeth'. This involves linking executive incentive payments to achievement of quantitative diversity targets placing the onus squarely on the shoulders of the organisation's leaders.

Beyond gender

As gender diversity initiatives are becoming increasingly embedded in organisational culture, many companies are taking the next step to achieving diversity and inclusion by looking 'beyond gender'.

At this stage, few companies have put in place specific quantifiable objectives to address 'beyond gender' diversity but many are starting to consider age and ethnicity through the use of specific initiatives. As many of the initiatives designed to address gender diversity may be easily adapted to other areas, we hope for a shorter lead-in time to seeing real improvements in these beyond gender areas.

2 In accordance with the *ASX Corporate Governance Principles*.

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Succession planning

Succession planning needs to go beyond the short-sighted 'what if they are hit by a bus' solution.

CEO succession is a key concern of boards and the consequences of succession events are amplified in Australia with its relatively high CEO turnover and shorter than average tenure.

Succession planning needs to go beyond the short-sighted 'what if they are hit by a bus' solution. However, announcements of CEO departures are frequently accompanied by external searches to find a replacement indicating legitimate succession readiness is still absent in many companies.

Regulation and market pressures

As with diversity, the regulatory environment is focussing boards' attention on succession planning. The *ASX Corporate Governance Principles and Recommendations* explicitly state that boards should be accountable for 'ensuring there are plans in place to manage the succession of the CEO and other senior executives'.[3] This reinforces the view that succession extends beyond the CEO.

However, while few boards view CEO-level succession simply as a 'tick the box' governance requirement, many are still being caught out when CEOs unexpectedly step down.

Pressure is also mounting with institutional investors signalling that succession is an important consideration in their overall assessment of a company and the management team.

Talent development

Encouragingly, boards, CEOs and HR Directors (HRD) are increasingly future-focused in developing executive talent to support succession readiness. This includes investing more time to understand the landscape into which their organisations are moving and the capabilities of leadership required in the future. However, most organisations still have a long way to go.

Event versus eventuality

The mindsets of boards and organisations considering CEO and senior executive succession fall into two camps – succession as an event and succession as an eventuality. The key differences are outlined in Figure 12.

3 Recommendation 2.1 of the *ASX Corporate Governance Principles and Recommendations* (3rd edition) which came into effect on 1 July 2014.

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Figure 12: Event versus eventuality differences

Succession as an *event*

- Plans in place for emergency replacement and a conceptual framework for longer-term succession needs
- Limited internal talent available
- Limited focus and time invested by the board on CEO and senior executive succession readiness
- Limited investment in senior executive development that specifically targets succession readiness
- Limited scope of dialogue on succession between the board, CEO and HRD

Succession as an *eventuality*

- Multi-year time horizons with senior executive development programs specifically targeting succession readiness
- Multiple succession candidates are developed
- Structured, regular focus by the board and continuous dialogue between the board, CEO and HRD
- Succession considered a trigger for a number of positional changes rather than a single person event

In summary, viewing succession as an eventuality rather than an event is vital. This shift in mindset leads to a more active approach to ensure there is a clear succession pathway for all leadership positions that are critical to the organisation.

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Conduct and pay

The intense focus of the media and public on recent cases of corporate misconduct and the negative impact on stakeholders (customers, employees, suppliers, the community and shareholders), has put remuneration at the centre of the discussion on how boards can prevent conduct risk in companies. Remuneration and incentives have been seen as drivers of bad behaviour in many of these instances.

The issue is cast as a failure to reconcile in remuneration designs the conflict between growing profits of the company and acting in the interests of other stakeholders.

Boards have typically focused their remuneration governance and decision-making almost exclusively on the top of the house, or KMP. Management is entrusted with the design and administration of pay for the rest of the organisation.

While this delegation is understandable given the sheer number of below KMP employees in many companies, the reputational risk of misconduct poses a real challenge for how the board can practically ensure that remuneration systems are aligned with the values of the company and the interests of all stakeholders.

Policies, processes and procedures may well be in place to establish how remuneration below KMP is governed. However, the board must go further to assure itself that incentives aren't driving the wrong outcomes.

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Understand who is involved in designing remuneration plans

The design of incentives shouldn't be left to the business units (e.g. sales functions) on their own, rather it should include the expertise of those from the human resources, finance, compliance and risk functions. This will ensure multiple perspectives on the operation of the plan and how it will best operate.

Educate yourself on how the major remuneration plans work

It is a poor defence to say 'you didn't know this was going on' should a misconduct event occur and pay systems are part of the problem.

Ensure there is appropriate sign off on final incentive designs

Again multiple levels and cross functional approval should be required for remuneration plans to become operational.

Ask if the mix of pay exposes employees to ethical pressures

Having an outsize portion of pay at risk can influence employees to make poor or self interested choices.

Understand what is being measured and rewarded

If a balance between financial results and other objectives isn't reflected in the remuneration plan then there is a real risk that undesired outcomes will result.

At the end of the day, most companies spend far more on the pay of the broad employee population than they do on KMP. However, this is not reflected in the time spent by the board on these issues.

Given the external focus on conduct and pay, boards must take clear steps to ensure that remuneration plans are not creating unacceptable risks for their organisation. Taking the practical steps outlined above will provide a greater level of assurance for boards over this key risk.

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US developments

The most significant change to the US executive compensation landscape is the pending introduction of the pay ratio disclosure requirements.

While disclosures will not be due until the beginning of 2018, boards globally will keep a close eye on reaction to the rules, as other jurisdictions may consider adopting similar approaches.

CEO-to-worker Pay Disclosure Ratio

The SEC has adopted a final rule mandated by the *Dodd Frank Act* that amends existing executive compensation disclosure rules to require companies to disclose:

- the *median* of the *annual total compensation* of *all of its employees*, except the CEO (refer to page 21 for further information);
- the annual total compensation of its CEO; and
- the ratio of these two amounts.

Key facts:

The pay ratio disclosure will appear in registration, proxy and information statements, and annual reports that require executive compensation disclosure.

Companies must disclose the methodology, assumptions, and estimates used in determining median employee annual total compensation. However, they are permitted, but not required, to disclose other information, such as other ratios or narrative explanations.

The SEC believes the pay ratio disclosure should allow shareholders to better understand and assess a particular company's compensation practices rather than facilitating comparison with other companies.

The pay ratio disclosure is required for fiscal years beginning on or after January 1, 2017. The rule does not apply to smaller reporting companies, emerging growth companies, foreign private issuers, Multijurisdictional Disclosure System (MJDS) filers, or registered investment companies.

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SEC listed companies will be required to disclose:

How do we define 'all employees'?

The calculation will need to consider domestic and international employees, and those of consolidated subsidiaries, including full-time, part-time, seasonal, and temporary employees.

Exclusions from the definition include; employees in foreign jurisdictions where obtaining information would violate data privacy laws; non-US employees (if they account for 5 percent or less of total employees, with certain limitations); independent contractors; and employees of third-party contractors.

How do we define the 'median employee'?

- Companies may determine the median employee on any date within 3 months of the fiscal year.
- The pool from which this is identified includes all employees as of that date.
- May use a methodology that is reasonable based on specific facts and circumstances e.g. from full population of employees or statistically representative sample.
- Company must identify actual employee and determine their total compensation, without using any personally identifiable information.
- May use total compensation, as defined by SEC executive compensation rules, or other consistently applied compensation measures e.g. payroll or tax records.
- Permitted, but not required, to annualise total compensation of permanent full-time and part-time employees as of the testing date, adjusting for portion of year that employee did not work. Rule prohibits adjustments to compensation of seasonal or temporary employees, or adjustments to treat part-time employees as full-time equivalents.
- Permitted, but not required, to adjust employee compensation for cost-of-living differences between where the CEO lives and the median employee's residence. Adjustments must be consistently applied to all employees of a jurisdiction where any adjustment is made.

Note: Based on client discussions, we believe most organisations will use statistical sampling to identify annual compensation of the median employee.

How do we calculate 'total compensation'?

Total compensation is the sum of an employee's salary, bonus, stock and option awards, non-equity incentive plan compensation, change in the actuarial present value of the accumulated benefit under all defined benefit and actuarial pension plans, non-qualified deferred compensation earnings, and all other compensation (Regulation S-K, Item 402(c)(2)(x)).

Reasonable estimates may be used in determining annual total compensation of the median employee. In particular, it would be appropriate to estimate the change in value of an employee's defined benefit pension plan if the actuarial information is not available on an individual basis.

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Is executive pay genuinely tracking performance of the underlying corporate?

UK developments

There has been a resurgence in shareholder activism in the UK driven off one key issue – **is executive pay genuinely tracking performance of the underlying corporate?** There is a concern that incentive plans are not responsive enough to fluctuations in performance. As a result there is growing pressure to engage on whether the system is broken and to what extent there is a burning platform to consider 'Plan B'. *The Interim Report* released by the Executive Remuneration Working Group in April 2016, has been a catalyst for such thinking, and is a significant discussion point in the UK.

Trends in fixed and variable remuneration

- Minimal movement in fixed remuneration over the last 12 months. Negative feedback often received when executive pay is lifted by an amount greater than the increase offered elsewhere within the organisation.
- One in four executive directors in the FTSE 350 received no salary increase, which is the highest level of pay freezes in the last 4 years. Where increases were provided, the median ranged between 2 percent to 3 percent.
- Short term pay remains remarkably resilient to the vagaries of company performance. More than one third of FTSE 350 companies paid their executive directors bonuses of over 80 percent of the maximum opportunity.
- Conversely, long term pay is reasonably matched with the creation of shareholder wealth given the frequency of total shareholder return (TSR) measures used in these plans.
- In the midst of the highest level of base salary freezes in recent years, the level of total earnings for both the FTSE 100 and FTSE 250 CEOs has increased compared to last year, primarily driven by payouts under long term incentive awards.

Key regulatory requirements on the horizon

- The next wave of financial services regulation, *Solvency II*, came into force on January 1, 2016. The legislation requires executives, material risk takers, and select others, to have a substantial portion of their variable remuneration deferred for a minimum of 3 years. There is currently some concern among some non-financial services businesses that the insurance industry (as a key institutional investor) will begin to push for *Solvency II* to be applied more broadly. Such a move would significantly impact executive remuneration in the UK.
- Pressure is mounting to regulate remuneration consultants or, at least disclose all fees paid to a firm for remuneration consulting, or otherwise.

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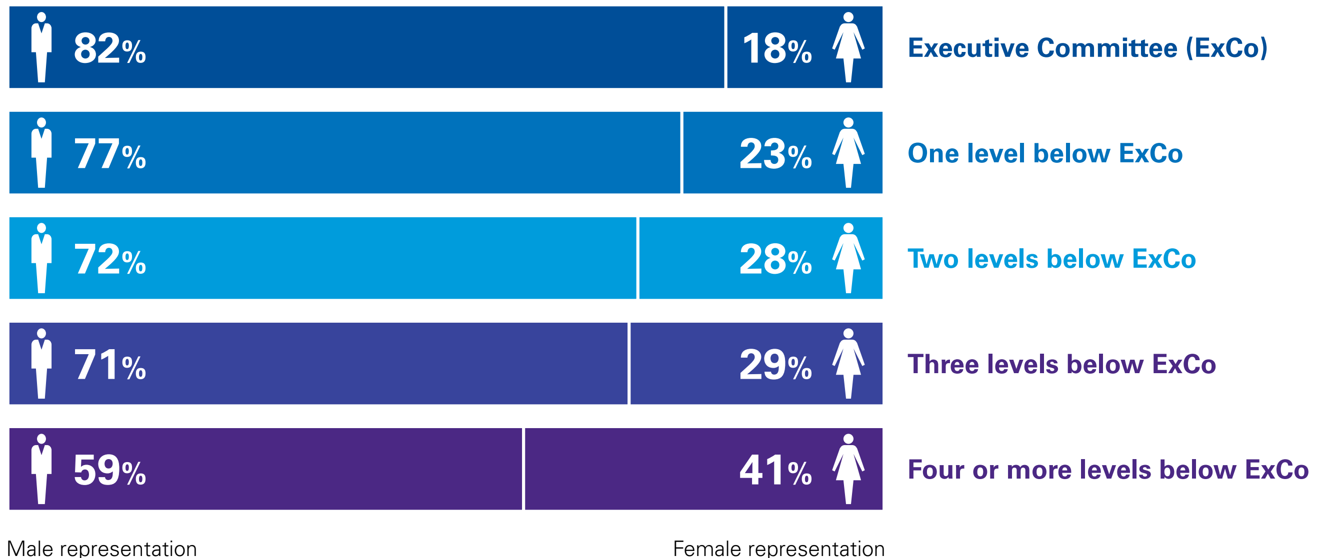
Diversity

Like their Australian counterparts, gender diversity is a key issue for boards in the UK. The internal pipeline of executive female talent currently feeding into board positions is not strong. The 30% Club, launched in the UK in 2010, with the aim of boards having at least 30 percent female representation on FTSE-350 boards by 2020 currently relies on appointing more female Non-Executive Directors.



For more information regarding UK remuneration practices, refer to:

- **KPMG's Guide to Directors' Remuneration 2015**
  https://home.kpmg.com/uk/en/home/insights/2015/09/kpmgs-guide-to-directors-remuneration-2015.html
- **Cracking the Code. A paper summarising some of the key issues surrounding gender diversity in the UK**
  http://www.kpmg.com/uk/en/issuesandinsights/articlespublications/documents/pdf/about/cracking%20the%20code.pdf

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In KPMG Performance & Reward we work with clients to help align business strategy with performance and reward design. Our capabilities include:

- reward strategy
- benchmarking
- short and long term incentive plan design
- implementation of remuneration plans
- remuneration report review and drafting
- proxy advisor engagement
- IPO and transaction services
- LTI valuations and accounting treatment
- legal and tax advice.

Our broader People Advisory practice advises clients on how to implement change successfully, identify and develop talent, align organisation design with business strategies, optimise workforce costs, and transform the HR function with improved processes and enabling technologies.

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KPMG has capabilities in other jurisdictions such as the UK and the US, and all initial enquiries should be addressed to the KPMG Australia contacts.

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