

The background of the cover is a blurred, blue-tinted photograph of three business professionals. On the left, a person is partially visible, gesturing with their hand. In the center, a woman is looking towards the right. On the right, a man in a suit and tie is looking towards the center. The overall tone is professional and corporate.

Deloitte.

Executive Remuneration
Best Practice Principles and Guide

November 2003

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Foreword

Few corporate governance issues raise as much publicity as the remuneration of directors and executives. Public debate and awareness has continued to increase along with a disturbing perception that many director and executive remuneration packages are overly generous and poorly constructed.

This has become particularly sensitive in cases where a company is on record as performing poorly or where increased shareholder value is in question.

For Boards, the challenge is to attract and motivate high quality executives yet maintain investor confidence in company executive remuneration strategies and policies. Investors of all types are closely monitoring the remuneration issue.

The use of best practice principles -v- legislative reform as tools for achieving compliance with good practice is an ongoing debate running within the broader corporate governance movement. In Australia, the Parliament's approach has been to use a blend of legislative requirements and best practice guidance to corporations.

Numerous documents providing guidance and sources of information on corporate governance and key aspects of executive remuneration have been released to the public or within industry and professional groups over the past three years by regulatory bodies, professional, industry and shareholder groups. There is, however, limited detailed guidance for companies which also incorporates broader executive remuneration issues including executive contracts, termination and related matters.

Deloitte has prepared this Guide for the Business Council of Australia as a set of global best practice guidelines on executive remuneration. The aim is to supplement existing regulatory and industry guidance. The guide draws on best practice from the US, Australia, Canada and the UK.

Deloitte encourages company boards to strive for best practice corporate governance when making decisions about executive remuneration - whether of an ongoing corporate policy nature or in determining specific levels of remuneration for executives upon their commencement or subsequent termination.

Michelle Narracott
Corporate Governance Partner

November 2003

The Focus of this Guide

What this publication is about

Deloitte have developed this Guide in consultation with Business Council of Australia members and the Chairmen's Panel with the aim of supplementing existing regulatory and industry guidance such as the ASX Corporate Governance Council's Principles of Good Corporate Governance and Best Practice Recommendations.

The key principles and related issues canvassed through this set of Practice Notes are as follows:

- Board scrutiny and risk oversight
- Building a strong remuneration philosophy and framework
- The Board Remuneration Committee
- Involving shareholders in executive remuneration
- Managing remuneration disclosure and transparency
- The value and composition of executive remuneration
- Executive remuneration contracts and managing termination risks
- External remuneration advisers.

Structure of the Guide

The Guide is published as a set of Practice Notes. Each Practice Note addresses specific executive remuneration issues of concern to Australian companies, board members, chief executives, management and corporate governance practitioners. The intention is to update these from time to time as both Australian and global corporate governance develops, and as better approaches emerge. The Guide reports on proposed reforms contained in the *CLERP (Audit Reform and Corporate Disclosure) Bill 2003*, released on 8 October 2003.

The clearly marked separate Practice Notes allow the reader, to quickly access the issue of concern.

A blend of principle and practice appears in each Practice Note. Checklists, although often criticised because of the tendency by users to adopt a tick and flick approach have been incorporated throughout the guide. Discerning use of these checklists by informed readers remains a very practical method of establishing your company's remuneration practices baseline.

Guiding Principles for Executive Remuneration

1 Board scrutiny and oversight

- The Board has ultimate oversight and responsibility for executive remuneration and this is widely understood and followed.
- The Board considers the risks arising from remuneration decisions including serious reputation risk and establishes appropriate controls.

2 A strong remuneration philosophy and framework

- The Board develops, implements and monitors remuneration policy and practice which will attract, retain and motivate executives to add value to the company but prevent the Board having to remunerate executives at levels which are not merited.

3 An effective Remuneration Committee or similar Board body

- The Board uses a Remuneration Committee or similar committee to develop, design and implement appropriate executive remuneration contracts and arrangements.

4 Shareholders concerns are managed by the Board

- The Board assists in eliminating or alleviating shareholder concern by disclosing information about the company's remuneration policies and the costs and benefits of those policies and core entitlements, to enable investors to understand the link between remuneration paid to directors and key executives and corporate performance.

5 Transparency is promoted and disclosure managed

- There is a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual executives. No executive should be involved in deciding his or her remuneration.

6 Performance is rewarded, not failure

- At the outset of an executive contract, the Board considers the potential total cost of the appointment and termination in monetary terms. The value and composition of executive remuneration must reward performance not failure.

7 Effective executive contracts are used

- Executives require some form of contractual protection. Contracts must be carefully evaluated by the Board.

8 Independent advisers are used by the Board as required

- If the Board or Remuneration Committee wishes to seek advice from outside consultants, the Board or Committee should itself choose and appoint the consultants. Committee members should have direct access to independent remuneration specialists and outside survey data.

Practice Note No. 1

Board scrutiny and risk oversight

Introduction

Shareholders, the market and the public are keenly interested in how well your Board scrutinises and oversees company executive remuneration.

The Board must have ultimate oversight of executive remuneration matters. Although the Board may authorise a specialist remuneration committee or other board committee to assist in this oversight role, Board members continue to carry a number of key responsibilities in relation to the company's executive remuneration policy, activity and management.

Box 1.1: Board responsibilities for executive remuneration

Executive Remuneration: A Board Responsibility

Irrespective of the governance structure chosen, the Board's specific responsibilities in relation to executive remuneration include:

- Establishing and overseeing your company's executive remuneration policy
- Determining the details of the CEO's remuneration package including all elements
- Reviewing, amending and approving CEO recommendations for remuneration of other executives
- Reviewing your company's performance targets for executive performance, assessing techniques for monitoring and measuring performance and determining when performance goals have been reached
- Determining company policy on disclosure of executive remuneration
- Meeting legal/regulatory obligations to disclose executive remuneration information to shareholders and stakeholders
- In the case of listed entities, ensuring ASX Corporate Governance Council Principles and Best Practice Recommendations (Principle 9) are considered and applied as appropriate, ensuring adherence is reported annually.

Turning risks into opportunities

The Board faces both risks and opportunities in making executive remuneration decisions. The Board's role is to oversee the remuneration plans for the company's top executives and provide the link between shareholders and management in determining the best interests of the company. Due to heightened public awareness and high profile examples of poor executive remuneration practices, shareholders, regulators and politicians have all placed pressure on Boards to meet this challenge.

To mitigate the risks and maximise the opportunities, the Board needs to be well-informed and diligent in reaching its decisions. The Board's diligence process also needs to be supported by a series of governance processes that ensure the Board has considered the key risks, determined the level of risk it is willing to carry in relation to executive remuneration (risk tolerance) and systematically minimised or removed the key risks according to the Board's risk tolerance.

Figure 1.1: Key Executive Remuneration Risks and Controls

The risks	Opportunities	Internal controls
Loss of shareholder and stakeholder respect and support for Board through lack of best practice remuneration approach	Shareholder support for Board and its actions and recommendations. Confidence and attractiveness to investors	The Company's Corporate Governance Charter, Code of Ethics and shareholder reporting processes support and promote best practice executive remuneration decisions. The role of shareholders is clearly established and observed.
Broader loss of reputation in the event of lack of best practice remuneration approach due to heightened public awareness of issue	Differentiation in market as leader in corporate governance best practice	There is transparency and ongoing disclosure of all aspects of remuneration practices and decisions
The company remuneration policy and plans fail to link pay with performance resulting in deficient or inappropriate executive behaviour	Optimal performance from the executive team	Remuneration policy, plans and agreements are constructed on a "no reward for failure nor unethical behaviour" principle and incorporate strong performance and ethical hurdles
Company fails to attract and retain a quality, ethical management team. Poor tone at the top has significant impact on corporate ethics and culture.	Competitive and attractive as an employer of choice	Remuneration plans are competitive with independent advice on this issue available to the Board and shareholders. Company conduct standards have been set and are observed.
Legal and regulatory exposure if corporate compliance responsibilities are not discharged in relation to executive remuneration	Minimisation of legal and regulatory exposure and reduction in non-productive time/resources allocation	Reasonable level of advice received by Board and Board understanding of consequences of proposed decisions and executive remuneration agreements
The executive remuneration risks and controls are not reviewed, updated and linked to corporate risk strategy and assurance program.	Regular monitoring of executive remuneration related risks and mitigations will result in improved performance and Board assurance.	Established process for reviewing remuneration risks and controls on a regular basis such as internal audit activity. Improvement opportunities continuously identified.

Remuneration risks and controls

Like all controls, the controls you place around managing executive remuneration can be circumvented deliberately: through fraudulent acts by individuals or by collusion between individuals associated with the company. Internal control can also be undermined inadvertently through poor judgement, carelessness, distraction, or other breakdowns of processes and procedures.

And internal control may be weakened or even eliminated by resource constraints or lack of understanding of their significance: the relative costs and benefits of internal control must be continually re-evaluated.

While internal controls can help to mitigate risks, it is unlikely that the risks will be eliminated altogether. Internal control can only provide reasonable - but not absolute - assurance that a company's objectives are met. Internal control is, after all, built on processes involving people, and, as such, is subject to all the limitations of human involvement.

The remainder of this Guide presents as a series of Practice Notes for governing your company's executive remuneration arrangements. Critical risk areas, the corresponding opportunities and range of internal control strategies available are discussed and marshalled into useful checklists where appropriate.

Managing Risk

Defining internal control

The most widely accepted definition of internal control was developed by the Committee of Sponsoring Organisations of the Treadway Commission (US):

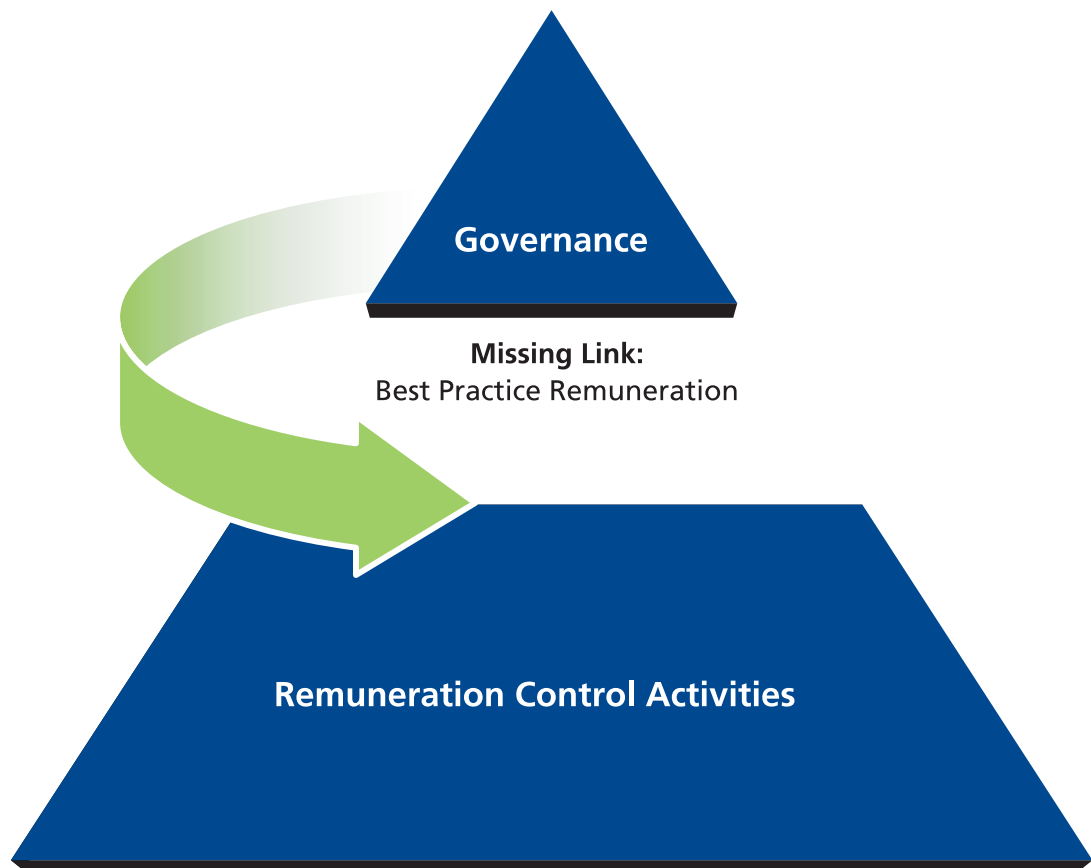
...a process effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- effectiveness and efficiency of operations
- reliability of financial reporting
- compliance with applicable laws and regulations

Like all internal controls, the controls you place around managing executive remuneration can be circumvented, weakened or eliminated deliberately or inadvertently: maybe through collusion between individuals associated with the company, poor judgement or resource constraints. The relative costs and benefits of internal control must be continually re-evaluated.

The Role of Internal Audit

Many companies already have an internal audit function, and in light of recent proposals by the ASX Corporate Governance Council, we expect that many more companies will establish the function. Internal audit can play an important role in a company's corporate governance activities by contributing knowledge of corporate risks, knowledge of processes and internal control, monitoring management's assessment activities and by serving as an important link to the Audit Committee and related committees of the Board.



An assessment should be conducted to monitor the effectiveness and alignment between corporate governance at the Board & executive level, and control activities at the operational level.

"The missing link" is an effective executive remuneration program to establish, manage and monitor alignment between the best practice governance principles which the Board need to display and company remuneration practices and controls

An effective remuneration program will tie together governance and control activities, thus eliminating the gap.

Practice Note No. 2

A strong executive remuneration framework

Introduction

Corporate governance frameworks around the world operate at a number of levels, and it is useful to keep in mind the key elements when determining your company's individual response to the management of executive remuneration. In Australia, as with the UK and Canada there are four key levels:

Mandatory requirements: There are some corporate governance issues where Parliament and the Australian Stock Exchange have taken the view that requirements should be imposed on companies through the Corporations Act 2001 and the ASX Listing Rules.

Principles-based regulation: In response to developments in Australia and globally, the ASX Corporate Governance Council has issued *Principles for Good Corporate Governance and Best Practice Recommendations*. Issued in March 2003, the Principles were released as guidance for listed companies, their investors, the wider market and Australian community. The success of this code of best practice is still to be determined.

Investor, professional and industry best practice guidance: There are, in addition, a number of investors' associations who have chosen to supplement existing information about corporate governance practices with their own best practice guidance. Examples include the IFSA Blue Book updated in 2002 and the Australian Council of Superannuation Investors Guide released in March 2003.

Individual company responses and frameworks: In the light of legal obligations, regulation and best practice guidance, individual company boards are determining their corporate governance response. There is a greater focus by Boards on executive remuneration issues as they drive for improved corporate performance, whilst balancing stakeholder and media/community concerns.

Company framework

The many elements of corporate governance call for an integrated framework governed by the Board and reliant on the strength of contribution from the Board, executive management, staff and shareholders. How can your company integrate solidly its oversight of executive remuneration into the company corporate governance framework? How well is remuneration already integrated?

Box 2.1: How critical is the company's executive remuneration framework?

Your company's remuneration framework: How critical?

How important is the framework to a company's executive remuneration program? Without a framework, external reporting and disclosure against the ASX Corporate Governance Principles will likely be difficult. If you do not have a clear framework featuring the Principles, it will be difficult to indicate best practice. Without best practice, it will be difficult for the market and stakeholders to establish that there are, in fact, sound processes in place. This will likely impact on investor and regulator confidence

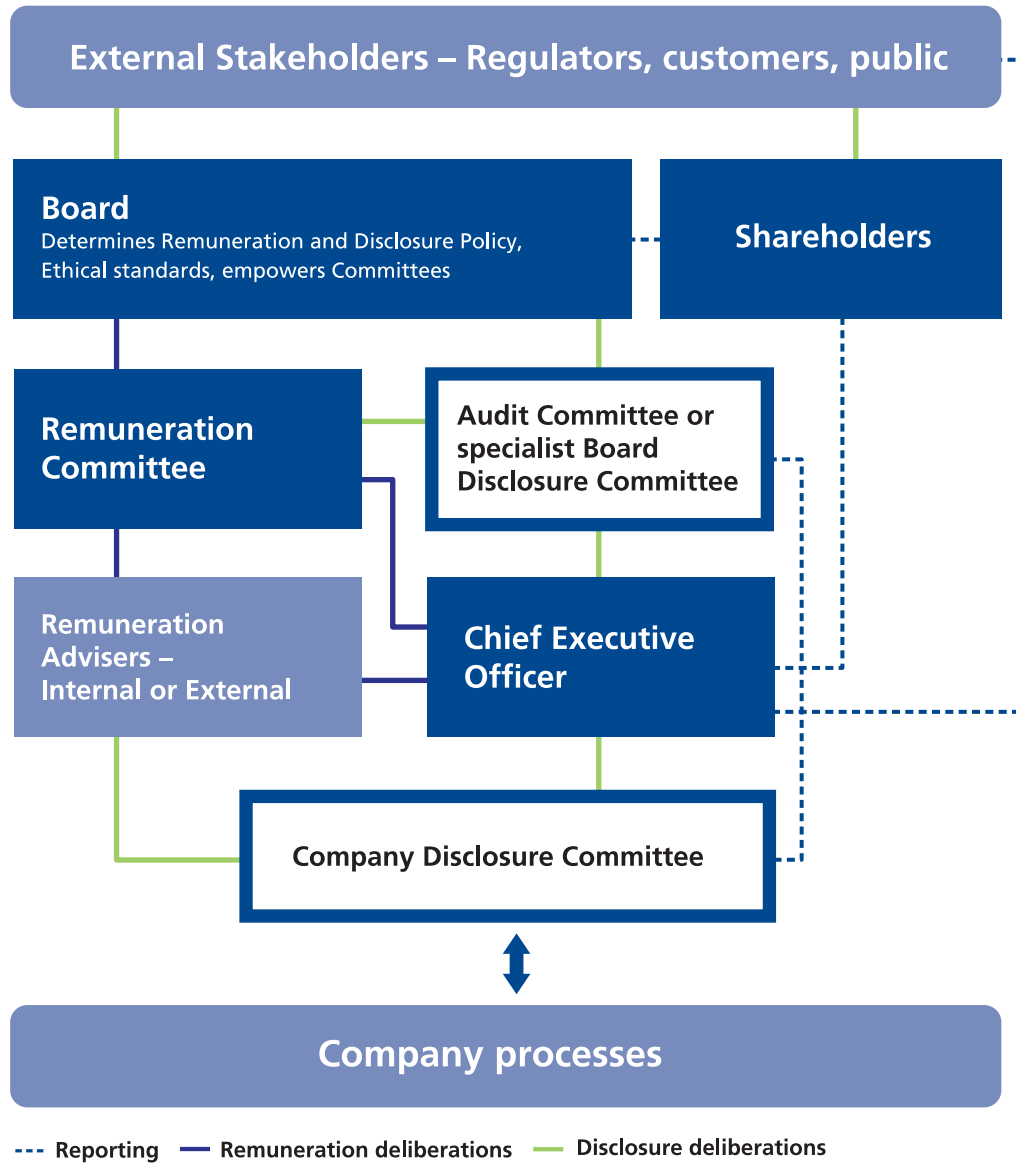
Or put it another way. You've got to indicate the set of rules that you play by and, if you don't have any rules, those you want to play with you will be cautious to do so, and those who are your referees will dedicate their and your valuable time to working out why you don't have any rules and whether this affects your ability to play.

Better practice framework elements are set out in Figure 2.1. The Board should be satisfied that these elements are in place or developing. Figure 2.2 presents a mature framework which integrates governance, disclosure, remuneration, assurance and corporate reporting.

Figure 2.1: The elements of a solid remuneration framework

✓	Details of Board Enquiry
	Do Company's Corporate Governance Charter, Code of Ethics and processes support and promote best practice executive remuneration decisions?
	Does everyone know and understand that it is the Board that has the responsibility for oversight of executive remuneration?
	Has the Board tasked a remuneration committee or other Board Committee to consider remuneration issues in more detail on behalf of the Board?
	Are there clear boundaries between the role of the Board and its committees and the role of management in developing and approving executive remuneration policies, practices, packages and schemes?
	Has the Board or remuneration committee developed a sustainable policy framework for remuneration issues, approved by the Board which addresses comparator groups, positioning, performance targets for short and long-term incentives, strategic alignment of pay and performance, quantification techniques for short and long term target values; and variable pay mix?
	The Board works actively with management to ensure an ethical, high performance culture exists within the company.
	Has the Board determined its approach to disclosure and transparency of executive remuneration issues? Is the company's remuneration policy disclosed to investors to assist their understanding of the costs and benefits of the policies and linkage between corporate performance and executive pay?
	Is executive remuneration disclosure integrated within your company's broader disclosure processes?
	Is company remuneration policy and practice the subject of regular monitoring and review by the Remuneration Committee, internal audit and the Board?

Figure 2.2: Mature, integrated remuneration framework



Remuneration philosophy and policy formulation

The best practice features of a company Executive Remuneration Policy are well-established globally. The policy should record the principles, objectives and design features of the policy and remuneration program. A clear relationship between corporate performance and individual reward needs to be drawn. Separation of executive and non-executive remuneration should also be evident. The company's approach to disclosure and transparency of remuneration should be established and clearly stated.

The Company's remuneration practices include development of components or elements of remuneration, performance conditions, fixed remuneration, variable remuneration, share scheme incentives, executive agreements, change in control arrangements and termination and severance.

Box 2.2: Example of Company Remuneration Policy Statement

Sample Remuneration Policy Statement

The key objectives of the company's remuneration programs are to attract, motivate and retain executives who will drive company success.

Company programs support these objectives by rewarding individuals for improving the performance of the company and by being culturally and ethically aligned to the company and aligning company interests with those of shareholders.

The programs are designed to:

- Provide competitive remuneration which is balanced between cash and shares and provides a significant portion of the total compensation at risk, tied both to annual and long-term financial performance of the Company as well as creation of shareholder value
- Reward performance, not failure so that the company's best performers receive highly competitive remuneration and poorer performers receive less
- Encourage executives to manage from the perspective of the shareholders by ensuring performance indicators are tied to achieving alignment of company and shareholder interests
- Separate executive and non-executive remuneration
- Promote transparency and disclosure of remuneration in accordance with all legal and regulatory requirements and global best practice guidance.

Practice Note No. 3

The board remuneration committee

Introduction

Best practice encourages your company to set up a remuneration committee of independent non-executive directors to assist the Board consider remuneration issues more efficiently and more fully. The Committee's role in relation to executive remuneration is to administer executive remuneration policies and practices, and periodically review them with management. The Committee reports regularly to the Board on its activities.

The Board Remuneration Committee has responsibility to the Board for the Chief Executive Officer's remuneration, including reviewing and approving corporate goals and objectives and evaluating how he or she performed against those goals and objectives. The Committee presents, for Board approval (excluding executive members,) all items of remuneration for the five highest paid executives.

The Board appoints independent non- executive directors of the company to the Remuneration Committee. Members are not eligible to participate in any of the plans or programs that the Committee administers.

If the Committee wishes to seek advice from outside consultants, the Committee is empowered by the Board to do so, and should itself choose and appoint the consultants. Remuneration Committee members have direct access to independent remuneration specialists and outside survey data, if required.

The ASX Corporate Governance Council

Recommendation 9.2 of the ASX Corporate Governance Council *Principles of Good Corporate Governance and Best Practice Recommendations* advises listed companies to establish a remuneration committee. The purpose, charter, composition and responsibilities of the Committee, are specified in the Recommendation. These reflect global best practice.

Committee best practice

As with all Board Committees, the Remuneration Committee presents the opportunity for the Board to ensure the Committee activities are conducted in line with Board Committee best practices.

Box 3.1: Elements of Board Committee Best Practice

✓	Elements of Board Committee Best Practice
	A strong and independently minded committee chairperson who manages agendas and establishes direct and regular contact with management and independent advisers.
	Timely dissemination of Committee materials in advance of scheduled meetings. Adviser availability to address Committee members' questions (one-on-one or collectively) in advance of the meeting.
	Regular "executive sessions" without any employees for open discussion among the committee members and independent advisers.
	Establishment of a regular Committee calendar, including meeting agendas and adequate time allocation.
	Interactions with other Board Committees (eg audit/finance/disclosure).
	Strong conflict of interest processes operate within the Committee preferably mirroring the Board's protocols. The Committee may seek input from individuals on remuneration policies, but no individual is directly involved in considering his/her own remuneration.
	Consideration of management proposals - including alternatives that were considered and rejected, by the Committee and rationale for rejection.
	Annual presentation of the company's trends in executive remuneration, and of broader trends, practices and legislative/regulatory developments.
	A formal education process for new members of the Committee.
	Holistic presentation and consideration of executive remuneration. There is consideration of total remuneration package rather than elements in isolation.
	Procedures to ensure that the entire Board has a reasonable understanding of executive remuneration.
	Report of all Committee actions to the Board and approval of Committee recommendations by the full Board. The Board is provided with sufficient information by the Committee to facilitate informed decision-making.

Sources: Deloitte Corporate Governance Better Practice Guide, The Canadian Institute of Chartered Accountants and ASX Corporate Governance Council.

The Board Remuneration Committee

Box 3.2: Guidance on the role and operation of the Board Remuneration Committee

Board Remuneration Committee - Part 1 Setup

Introduction

Where your company size warrants allocation of tasks and functions in relation to executive remuneration to a specialist Board Committee such as a Remuneration Committee, that Committee will be expected by both the Board and stakeholders to meet certain standards of composition and operation. These standards stem from the Best Practice Recommendation 9.2 of the ASX Corporate Governance Council, and emerging corporate governance best practice principles relating to Board Committee and executive remuneration activity.

Value

In the case of listed companies, the ASX Corporate Governance Council Best Practice Recommendations advise establishing a Remuneration Committee to allow a sub committee of the Board to focus on this potentially controversial issue.

Composition

Effective Board Committees consist of Board members who are:

- in the majority are independent directors, with the Committee chaired by an independent director
- familiar with legal and regulatory disclosure requirements
- knowledgeable about the primary aspects of the company's business
- familiar with executive remuneration issues
- provided with ongoing opportunities to develop their knowledge and skills.

Charter or Written Authority

ASX Corporate Governance Council Best Practice Recommendation 9.2 encourages the use of a formal charter setting out the roles and responsibilities, composition, structure, membership and access to employees and external advisors of the Remuneration Committee. This is standard best practice for any Board Committee and is clearly a useful risk mitigation strategy. It provides the Board and the members with clarity as to their authority or remit from the Board and prevents Committees proceeding on unhelpful and sometimes damaging frolics of their own.

Key Functions

The Committee serves numerous valuable functions in relation to executive and director remuneration including:

- Developing and reviewing appropriate company remuneration policies
- Oversight of the process by which executive remuneration packages are established
- Oversight of application of company policy and procedures to recruitment, retention and termination
- Review of remuneration disclosure, identifying control deficiencies and determining Board remedial action.

Board Remuneration Committee - Part 2 Operations

Committee Tasks

The prominent task facing the Board Remuneration Committee will be to oversee and periodically review company remuneration activities, making sure Board approved policies and processes are in place and are applied. Where the Remuneration framework and policy has not been developed and approved by the Board, the Committee determines and agrees with the Board these important items.

The Committee works with the Board, other related Committees including the Nomination Committee, Disclosure Committee and Audit Committee and company management to minimise the risks associated with determining and managing executive remuneration and maximises the opportunities to attract, retain and motivate high quality executives.

Reporting to the Board on the outcomes of the Committee's oversight and review, and the contribution of sound recommendations for Board decision are important aspects of the Committee's role.

The Committee should among other items:

- Develop and review remuneration policies and practices which mitigate key risks and ensure that executive management are rewarded for performance and behaviour, and are provided with appropriate incentives to encourage enhanced performance
- Determine and review the policy for pensions, agreements for the executive, termination payments and compensation commitments
- Liaise with the Nomination Committee to ensure that the proposed remuneration and benefits of new executives is within the company's overall policy
- Within the agreed policy and with due regard to legal requirements, regulations and recommended best practice, determine the total individual remuneration package of each executive including bonuses, incentive payment and share options treatment
- Determine the targets for any performance related pay schemes operated by the company and where appropriate seek shareholder approvals for any arrangements
- Develop a strategy for shareholder and regulator communication as part of the company's broader disclosure and stakeholder engagement program ensuring requirements relating to disclosure of remuneration are fulfilled
- Remain aware of competitor company policies to ensure appropriateness of company remuneration packages
- Prepare briefings for Board, audit committee and other board committees
- In liaison with the Disclosure or Audit Committee, ensure there are disclosure practices supporting the posting of information on corporate/investor relations websites.

Interactions with the Board and other Board Committees

The Chair or a member of the Remuneration Committee may meet periodically with the Audit Committee and/or specialist Board Disclosure Committee to discuss the activities of the Remuneration Committee and issues of importance to the Audit Committee and/or Board Disclosure Committee including key risks and their mitigation, identified systemic issues.

Committee inquiries and gathering of additional information

The Committee needs the Board's authorisation to obtain information from employees in order to perform its duties. Similarly, the Committee should be empowered by the Board to select, set the terms of reference and appoint external advisors at the company's expense.

Practice Note No. 4

Involving shareholders in executive remuneration

Shareholders and investors show a keen interest in executive remuneration issues and, in the past year, have been willing to voice their concerns at general meeting. In managing shareholder expectations and concerns, clear and readily understandable communication on executive remuneration and the impact of the remuneration on the company is the best response.

A range of guidance and standards against which your listed company is being judged by the regulators, your shareholders, the market and investors now exists and is readily available to the market and the public. Your company should become familiar with the standards against which your company's remuneration policies and actions are being assessed by your regulators, but also by your shareholders, institutional investors and stakeholders.

Some of the key standards and best practice guidance on corporate governance issues including executive remuneration issues now available to the market are the ASX Corporate Governance Council *Principles of Good Corporate Governance and Best Practice Recommendations, Better Disclosure for Investors - Guidance Rules*, Australian Securities and Investments Commission, 2000, *Better Practice Guidelines for Communication between Listed entities and the Investment Community*, Australasian Investor Relations Association, August 2001 and *Guidance Note 8 - Continuous Disclosure: Listing Rule 3.1*, Australian Stock Exchange, January 2003.

The Australian Council of Superannuation Investors (ACSI) has developed corporate governance guidelines as a supplement to existing regulatory and industry standards with the ultimate aim of providing trustees of superannuation funds with a benchmark to assess corporate governance practices of listed invitee companies. Section 13 deals with remuneration issues and addresses:

- Use of remuneration reports
- Principles of remuneration schemes
- Termination payments
- Disclosure, valuation and expensing of remuneration
- Performance conditions
- Fixed remuneration
- Variable remuneration
- Share scheme incentives
- Option hedging
- Director remuneration and share ownership

The ACSI remuneration principles are well researched and written, and reflect best practice movements internationally.

Similarly, the IFSA Corporate Governance guidelines *Corporate Governance, A Guide for Fund Managers and Corporations - Blue Book, 2002* and *Executive Share and Option Scheme Guidelines - Guidance Note 12, 2000*, are issued for the information of investors and the information of companies in which they invest.

The IFSA Guidelines are designed to provide fund managers with a benchmark to assess the corporate governance of a particular company and engage the company to promote change. It also provides principles to assist fund managers in their decisions on voting on company resolutions. Guideline 7 outlines principles for the functioning of the Remuneration Committee and Guideline 11 address the equity participation of non-executive directors through use of a policy to encourage non-executive directors to invest their own capital in the company.

The Guidelines take a strong stance against non-executive participation in share and option schemes.

IFSA Guideline 13 recommends that the Board disclose in the annual report its policies on and quantum and components of remuneration for all directors and each of the five highest paid directors. A suggested format for disclosure is contained in the IFSA Guidelines at Appendix A. Share and option schemes are supported provided they have robust performance hurdles. The underlying principle is that companies develop incentive schemes appropriate to their company but which are aimed at driving superior executive performance.

ASX Corporate Governance Council Best Practice Recommendations

Principle 6 of the ASX Corporate Governance Council *Principles of Good Corporate Governance and Best Practice Recommendations* encourages each listed company to work to overcome potential sources of shareholder concerns about lack of information by:

- Communicating effectively with them
- Giving them ready access to balanced and understandable information about the company and corporate proposals
- Making it easy for them to participate in the general meeting.

In relation to managing executive remuneration issues, all Boards are encouraged under Recommendation 9.1 to assist in eliminating or alleviating shareholder concern by disclosing information about the company's remuneration policies, the costs and benefits of those policies and core entitlements, for example, the nature of the termination entitlements of the chief executive officer (or equivalent) when they are agreed. Disclosure to enable investors to understand the link between remuneration paid to directors and key executives and corporate performance is also advised.

Under ASX Listing Rule 4.10, listed companies are required to provide a statement in their annual report disclosing the extent to which the ASX Corporate Governance Council best practice recommendations have been followed. Where a company does not follow the recommendations, that company is required to identify in the annual report the recommendation not followed and the reason for not following it.

Obligations to disclose under Listing Rule 3.1 are not reduced by annual reporting requirements under Listing Rule 4.10.

CLERP 9 Proposals

The Australian Government's Corporate Law Economic Reform Program (CLERP) includes several proposals designed to increase disclosure of executive remuneration and to increase shareholder involvement in remuneration decisions by giving shareholders a non-binding vote on executive pay. The CLERP 9 exposure draft, *CLERP (Audit Reform and Corporate Disclosure) Bill 2003*, was released on 8 October 2003 and is available for public comment until 10 November 2003 at www.treasury.gov.au.

Issue	CLERP 9 Draft Bill Proposal
Executive remuneration of listed entities	
Disclosure	<p>Presently the remuneration of the five most highly remunerated senior managers and all directors of the company must be disclosed. The draft bill proposes to extend this to include the top five senior managers in the consolidated entity.</p> <p>This disclosure is to be made in a new section of the Directors' Report to be called the Remuneration Section.</p>
Shareholder Involvement and Non-Binding vote	<p>At the AGM, the Chair must allow reasonable opportunity for shareholder discussion of the Remuneration Section of the Directors' Report and shareholders are to be given a "non-binding" vote on its adoption.</p>

Shareholder concerns

The Australian Shareholders Association (ASA) has published a list of all share and option schemes opposed by the ASA and detailed reasons for this opposition ranging from low, non-specific or undisclosed performance hurdles, shutting out of shareholder involvement, ASA opposition to immediately exercisable options which are not seen as encouraging medium to long term commitment and development, a blanket opposition to the issue of options to non-executive directors, buy back of declining shares and already generous remuneration .

Box 4.1: Recent Shareholder Opposition to Options

Issue	Basis for Shareholder Opposition
Share Options for executives and non-executive directors	<ul style="list-style-type: none"> ■ Inadequate or no explanation of performance hurdles in explanatory documents ■ Performance hurdles did not relate to earnings per share or return on equity ■ Opposed to the issue of options to non-executive directors ■ Length of Term for exercise of options did not align the executive with shareholder interests - three years minimum ■ Proposed terms of issue did not align with IFSA guidelines ■ Proposed recipients of options had retired and therefore unable to contribute to the enhancement of shareholder value. Already significantly rewarded ■ Resolution combined options for both executive and non-executives directors not allowing shareholders to address individual directors options

Managing remuneration disclosure and transparency

Introduction

Full and understandable disclosure of your company's management of executive remuneration has emerged as one of the most critical best practice aims. The aim is to achieve a more effective overall standard of dialogue between the company and investors. An immediate benefit will be to reduce the current level of high profile and disproportionate number of general meetings featuring executive remuneration issues and the subsequent media profiling.

This focus has raised a number of concerns within the director and executive management profession during recent public debate. There is a fear that detailed disclosure about individual remuneration plans may lead to increased levels of remuneration and that the unproductive rigidity in the relationship between companies and executives is also developing as evidenced by the growing use of detailed remuneration agreements or executive service agreements.

There is anecdotal evidence that the increasing use of regulatory disclosure has been a factor in increasing executive remuneration levels. The public interest response is that, on balance, such disclosure is needed to develop confidence amongst shareholders and the public that the company is not engaged in behaviour that will negatively impact shareholder value or allow advantage to be taken of inside information.

The latest round of the Federal Government's Corporate Law Economic Reform Program, CLERP 9, proposes several measures to provide disclosure on executive remuneration. The CLERP 9 exposure draft bill, *CLERP (Audit Reform and Corporate Disclosure) Bill 2003* released on 8 October 2003 for public comment includes several proposals designed to increase disclosure of executive remuneration and to increase shareholder involvement (refer Practice Note nos 4 & 6 for further information).

In Australia disclosure issues provide much of the impetus behind the Corporations Act 2001, the ASX Listing Rules and the ASX Corporate Governance Council's Principles of Good Corporate Governance and Best Practice Recommendations and require careful day-to-day management and control. In relation to managing executive remuneration issues, all Boards are encouraged under Recommendation 9.1 to assist in eliminating or alleviating shareholder concern by disclosing information about the company's remuneration policies, the costs and benefits of those policies and core entitlements, for example, the nature of the termination entitlements of the chief executive officer (or equivalent) when they are agreed.

Disclosure to enable investors to understand the link between remuneration paid to directors and key executives and corporate performance is also advised. Obligations to disclose under Listing Rule 3.1 are not reduced by annual reporting requirements against Recommendation 9.1 under Listing Rule 4.10.

The underlying principle guiding Boards in relation to remuneration disclosure is that there be as much transparency and ongoing disclosure of all aspects of remuneration policy, practices and decisions including individual executive remuneration agreements as the Board will endorse, subject to the need to protect the company's interests and to meet minimum legal and regulatory disclosure and reporting requirements.

Remuneration disclosure mechanisms

Timely and adequate disclosure is a cornerstone feature of Australia's corporate governance regulatory framework. The range of measures including disclosure of corporate governance practices under ASX Listing Rule 4.10, annual disclosure, continuous disclosure and web-based disclosure.

Box 5.1 Remuneration Disclosure Measures

Remuneration Disclosure Mechanisms in Australia

Disclosure of corporate governance practices

Under ASX Listing Rule 4.10, companies are required to provide a statement in their annual report disclosing the extent to which they have followed the best practice recommendations as set out in the ASX Corporate Governance Council's Good Governance Principles and Best Practice Recommendations.

This annual reporting does not reduce the obligation of companies to provide disclosure under ASX Listing Rule 3.1 (see below). As indicated in the ASX Principles, the following material should be included in the corporate governance section of the annual report:

- Disclosure of the company's remuneration policies
- The names of the members of the remuneration committee and their attendance any meeting of the committee
- The existence and terms of any schemes for retirement benefits, other than statutory superannuation, for no executives directors
- An explanation of any departures from the ASX best practice recommendations 9.1-9.5.

In addition, the ASX Corporate Governance Council's Good Governance Principles and Best Practice Recommendations provide specific guidance as to what disclosure the company is required or encouraged to make and when.

The corporate governance section of the Annual Report should contain appropriate website references, links or instructions to enable shareholders to readily access this information. Where a company does not have a website, this information is to be made publicly available by other means. For example, a company may provide the information on request by email, facsimile or post.

Annual Disclosure

The Corporations Act 2001 requires annual disclosure by a listed company. Section 300 requires all companies (other than small proprietary companies) to include details of any share options granted to directors (including a former director who was a director in the relevant year) and the five most highly remunerated officers of the company, in either the annual directors' report or the company's financial report for the financial year; and

Section 300A requires listed companies also to include a discussion of the board and senior executive remuneration policy of the company, a discussion of the relationship between this policy and the company's performance, and details of the nature and amount of each element including non-monetary components (such as options) of the remuneration of each director and each of the five named officers of the company receiving the highest salaries. Officer is defined in section 6 of the Act.

Remuneration Disclosure Mechanisms in Australia (cont.)

Continuous Disclosure

Certain executive remuneration actions may result in a need to disclose details to the market under the continuous disclosure requirements under ASX Listing Rule 3.1. Appropriate matters for disclosure are a matter of both regulatory requirement and judgement. Best practice recommends objective analysis by the company of matters for potential disclosure. A Disclosure Committee drawn from within senior management ranks may serve a valuable role in developing, managing and monitoring disclosure practices.

In the case of new employment agreements with key executives, or the crystallisation of obligations under these agreements, a summary of the main elements and terms of the agreement, including termination entitlements, should be disclosed.

Web-based Disclosure

The ASX Principles recommend the establishment of a clearly marked corporate governance section on the company's website containing more general company information about executive remuneration including the charter of the remuneration committee or a summary of the role, rights, responsibilities and membership requirements for that committee.

Where a company does not have a website, this information is to be made publicly available by other means. For example, a company may provide the information on request by email, facsimile or post.

Comparative measures in UK

There have been numerous developments in executive remuneration in the UK which are of considerable interest as they are likely to influence further development of remuneration disclosure practices in Australia. These include the release of:

1 *Rewards for Failure*

The UK Government's most recent public consultative document on executive remuneration reform is entitled "*Rewards for Failure Directors' Remuneration - Contracts, Performance and Severance*", June 2003. *Rewards for Failure* is the third consultative paper in four years issued by the UK Government on director remuneration. The first was issued in July 1999 and resulted in a strengthening of the corporate governance framework for directors' remuneration. The second paper issued in December 2001 resulted in the Directors Remuneration report Regulations 2002 requiring quoted companies to publish a report on directors' remuneration as part of the annual reporting cycle and a range of transparency measures.

The current paper seeks views on whether the issues surrounding the length of directors' contracts and compensation for payments on termination of contract should be addressed by either:

- *Use of Best practice guidance* - the paper leans towards addressing issues on length of contract etc using best practice solutions. At page 10 the paper states that "best practice is generally regarded as the most appropriate tool for achieving compliance with good practice in the drafting of director's contracts"; or
- *Possible legislative changes* - the paper cites difficulties with a legislative route as including drafting legislation so that severance payments reflect the business performance of the company; the extent to which it is appropriate or practical to override contracts of employment; the meaning of phrases such as fair and reasonable and success or failure of a the director and the comp any; and the fear that legislative restrictions on compensation may lead to increases in base salary or "golden Hello" payments.

2 Updates to the UK Combined Code on Corporate Governance

The Combined Code was first issued in 1998 by the Hampel Committee on Corporate Governance. The Code's 'comply or explain' approach was the model for the ASX Corporate Governance Council's approach to corporate governance reporting. The Listing Rules require listed companies to make a disclosure statement in two parts in relation to the Code. The company reports on how it applies the *main* and *supporting principles* in the Code in whatever manner it chooses. The company then provides a statement as to whether it complies with the Code's *provisions* - or where it does not, and if so, provides a considered explanation.

Section 1B *Remuneration* of the revised Code establishes two main principles for remuneration of executive directors, non-executive directors and senior management. Each principle is supported by secondary principles and numerous Code provisions. The key principles are:

- Levels of remuneration should be sufficient to attract, retain and motivate directors of the quality required to run the company successfully, but a company should avoid paying more than is necessary for this purpose. A significant proportion of executive directors' remuneration should be structured so as to link rewards to corporate and individual performance
- There should be a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual directors. No director should be involved in deciding his or her remuneration

3 The release of Best Practice on Executive Contracts and Severance - A Joint Statement by the Association of British Insurers and the National Association of Pension Funds

The Best Practice Statement identifies six key principles:

- Executives must be rewarded for performance not failure
- Executives will require some form of contractual protection
- Boards have a duty to develop and implement policy which will prevent Boards having to make payments where not merited
- At the outset of an executive contract, Boards must consider the potential total cost of the appointment and termination in monetary terms
- Boards should consider the risks arising from remuneration decisions including serious reputation risk; and
- Boards should use Remuneration Committees to develop, design and implement appropriate executive remuneration contracts and arrangements

4 Directors Remuneration Report Regulations 2002

Under the *Directors Remuneration Report Regulations 2002*, all quoted companies are required to:

- Publish a report on directors' remuneration as part of the company's annual reporting cycle;
- Disclose within the UK report the details of:
 - Individual director's remuneration packages
 - Remuneration policy
 - The remuneration committee (where one exists) and its advisors
 - Policy on the duration of directors contracts, and notice periods and termination payments under such contracts; and
 - Payments made in respect of loss of office, and an explanation for any such payments;
- Display a line graph showing company performance; and
- Put an annual resolution to shareholders on the remuneration report.

Directors' Remuneration Report Regulations 2002: UK Transparency Measures

Introduction

In August 2002, the UK introduced the Directors Remuneration Report Regulations 2002 requiring directors of UK incorporated companies whose share capital is listed on the London Stock Exchange, the NYSE or NASDAQ exchanges or in a member state of the European Economic Area, to publish a detailed director's remuneration report as part of the company's annual report. The remuneration report must be put to a vote of the shareholders.

Matters to be included in the remuneration report

The following matters must be included in the remuneration report but are not subject to audit:

- Details of the remuneration committee, including the name of any person who provided the committee with advice which materially assisted it in its deliberations
- A forward-looking statement of the company's policy on directors remuneration for the following year and subsequent years, including a detailed summary of any performance condition to which the directors' share awards or options are subject and the company's policy on the duration of directors service contracts, including the notice periods and termination payments under such contracts
- A performance graph comparing over a five year period the total shareholder return on the company's shares with a hypothetical holding of shares of the same kinds and numbers as those by reference to which a broad equity market index is calculated
- Details of directors service contracts

The following matters must be included and are subject to audit:

- The amount of the directors emoluments and compensation in the relevant financial year
- Details of share portions and interests in the long term incentive plans held by directors
- Details of directors pension rights and excess retirement benefits
- Details of compensation paid to past directors
- Details of sums paid to third parties in respect of a director services; and greater level of detail to be provided as well as explanation in some cases of the reasons behind actions taken such as why particular performance conditions were chosen.

Using Company Disclosure Committees

One of the most important controls that a company can implement on a day-to-day basis at the management level to ensure that its disclosures are fair, accurate, timely and complete is the formation of a Company's Disclosure Committee. The Committee operates as a management committee operating at the company level, closely linked to the Board Committee with responsibility for disclosure issues. This may be the Board Audit Committee or a specialist committee. Practice varies from Board to Board.

Box 5.3 Company Disclosure Committees

Company Disclosure Committees - Part 1

Introduction

The Company Disclosure Committee is a management committee operating at the company level, closely linked to the Board Committee with responsibility for disclosure issues.

Disclosure issues provide much of the impetus behind the Corporations Act 2001, the ASX Listing Rules and the ASX Corporate Governance Council's Principles of Good Corporate Governance and Best Practice Recommendations and require careful day-to-day management and control.

Composition

Effective Company Disclosure Committees consist of individuals who:

- are familiar with legal and regulatory disclosure requirements
- are knowledgeable about the primary aspects of the company's business
- are familiar with the disclosure practices of peer companies
- have sufficient stature within the company to initiate action when appropriate

The size of your company will, in part, determine the makeup of your disclosure committee. Larger companies may have a full complement of personnel with the roles listed below. Smaller companies may have individuals whose job description spans several titles.

Some possible members of the Disclosure Committee include:

- Principal accounting officer or controller
- General counsel or another senior legal officer responsible for advising on company disclosure and other corporate compliance issues who reports to the general counsel
- Principal risk management adviser
- Chief Investor relations officer
- Chief Operations officer
- Other officers or employees (including business unit representatives), as company deems appropriate. Some of these individual might be heads of key business units, heads of geographic regions, a business development representative or a human resources representative

Company Disclosure Committees - Part 2

Key functions

The Disclosure Committee serves numerous functions, including:

- Determining the appropriateness of disclosures in all publicly disseminated information
- Overseeing the process by which disclosures are created and reviewed
- Identifying what constitutes a transaction or event requiring disclosure
- Ensuring both CEO and CFO are aware of information that could affect disclosures
- Reviewing disclosure control deficiencies with the CEO and CFO to determine remedial action.

Committee tasks

The prominent task facing the Disclosure Committee will be making sure processes are in place to gather and analyse information to determine whether proper disclosure is occurring

The Committee should review among other items:

- All press releases providing financial information, guidance, information about material acquisitions or dispositions or other events material to the company
- Correspondence broadly disseminated to shareholders
- All presentations to investor conferences or analysts
- All presentations to rating agencies and lenders
- Internal audit reports in relation to disclosure practices
- Briefings for management in relation to disclosure practices
- Briefings for Board, audit committee and other board committees as appropriate
- The company's disclosure policies for information included on its corporate/investor relations websites.

Interactions with the Board

Although the Disclosure Committee is accountable to the CEO and CFO, a member of the Disclosure Committee may meet periodically with the Audit Committee or specialist Board Disclosure Committee to discuss:

- The activities of the Management Disclosure Committee
- The quality of disclosures
- Disagreements with the CEO and CFO
- Disagreements with external experts such as legal counsel or independent auditors.

The Audit Committee can also take a role in resolving significant disagreements. For example, if the Company Disclosure Committee recommends disclosure of particular information but the CEO or CFO disagree, the Audit Committee could be called upon to assist in determining the final decision.

Practice Note No. 6

The composition & value of remuneration

Introduction

Globally, new accounting standards, the introduction of tighter corporate governance practices and pressure from investors are prompting a reconsideration of the composition and value of executive remuneration. Boards are facing increasing scrutiny from regulators and shareholders alike as they consider remuneration proposals.

Reflecting recent developments in the UK and the US, the Australian government's exposure draft bill, *CLERP (Audit Reform and Corporate Disclosure) Bill 2003*, released on 8 October 2003 for public comment, includes several proposals designed to focus on the value and composition of executive remuneration and to increase shareholder involvement in remuneration decisions.

In addition, the Australian Securities and Investments Commission (ASIC) recent requirements on the valuation and disclosure of options in directors' reports and the International Financial Reporting Standards (IFRS) impending requirements on expense options, both leave little doubt that companies need to be in a position to respond to emerging pressures to effectively structure and value executive remuneration.

When assessing remuneration proposals, Boards need to consider the total value of the remuneration including cash components, equity-based remuneration and termination payments in monetary terms and be satisfied as to its reasonableness, both at the time of appointment and at regular review intervals. Secondly, the Board must be satisfied that the proposal will result in reward for the executive's performance not failure, both in the short term and long term. A visible and effective link between remuneration and performance is vital to the credibility of the remuneration decision.

Comparison with the market

As the company's leaders in corporate governance, the Board needs to ensure that the total remuneration is reasonable, appropriate and defensible by considering how the remuneration, in total and by each element, compares to the competitive market. A well-articulated remuneration policy and a set of historical corporate remuneration data that establish and monitor the company's philosophy on competitive positioning against the market for total remuneration as well as each compensation element and the mix of compensation will provide the right framework for making sustainable decisions. A comparison with similar peer group companies is recommended.

Performance - linked remuneration

It is likely that effective company remuneration policy will already require linkages between remuneration, performance of the executive and the overall performance of the company in the short and long term. However, it is important to ensure that these linkages are visible and strong in relation to each remuneration proposal before the Board.

The executive's remuneration should be designed to motivate the executive to achieve superior performance for the company by rewarding strong performance and be measurable against the key corporate performance indicators. These should include financial indicators such as earnings per share, total shareholder returns and returns on equity as well as non-financial indicators such as long-term strategic positioning; market share/growth; customer satisfaction; employee retention; employee safety; corporate social responsibility and environmental performance; and credit rating.

Practice Note no7 *Executive remuneration contracts* provides a series of enquiries for Boards when considering proposed executive remuneration arrangements. The enquiries are designed to draw out:

- The linkage between performance and remuneration, the process of setting performance goals and objectives for the executive and the evaluation of performance relative to corporate goals both financial and non-financial
- Complete information on the total value and reasonableness of each component of the proposed remuneration package including share based incentives and options

Valuation of remuneration

The correct valuation of executive options provides a solid foundation for the implementation of future accounting standards; it demonstrates to investors a transparent and accountable approach to executive remuneration; it will give investors a much greater comfort level.

Option valuation methodologies should of course be founded on consistency. ASIC has reinforced that need by requiring valuation models to factor in six sets of circumstances, all of which are embraced by the Black Scholes option valuation model. But, in most cases, that is only a starting point; modifications and adjustments will be necessary.

Beyond Black-Scholes

In June 2003, ASIC expressed its requirements for companies to tell investors what executive options are really worth by issuing guidelines on the valuation and disclosure of options in directors reports. Listed companies, when releasing their 30 June 2003 annual reports, will have already complied with their legal obligations under s300A (1)(c) of the Corporations Act by valuing and disclosing the value of executive options according to those guidelines.

In mandating what features an option model must include, many companies have interpreted the guidelines as an endorsement of the famous *Black-Scholes* option pricing model. Indeed, recent research has indicated that 77% of top Australian companies use the *Black-Scholes* (or the very similar *binormal*) option pricing model to value their options. The model addresses the following six factors:

- The option's exercise price
- The option's expected life
- The current price of the underlying securities
- The expected volatility of the share price
- The dividends expected on the shares
- The risk-free interest rate for the life of the option

While ASIC has not explicitly indicated what monitoring will be performed on these guidelines, and whether the application of *Black-Scholes* is adequate to meet these requirements, good corporate governance and disclosure practice goes beyond this. In all but the simplest cases, i.e. where an option has virtually no conditions attached, various modifications and adjustments should be applied to *Black-Scholes* and any other model used.

Some types of performance hurdles require more sophisticated modelling. For example, a common hurdle condition may state the company's stock price must exceed a certain price level for a minimum number of days before the option is triggered. Specialised option models are available that accommodate this condition. Simply discounting the option by factoring in the probability of exceeding the barrier price understates option value; it does not account for the fact that the range of possible stock prices is skewed upwards when the option is alive.

There are many other types of options where specialised models should be used. Given increasing demands by shareholders that performance hurdles be tailored to match specific business requirements of the company, the prevalence of options within complex hurdles will only increase. Shareholders will also expect that the true impact of these hurdles on option value will be disclosed. Given the current level of awareness about executive options, shareholders are more likely to react favourably to a proposal if they know the option grants have been properly valued using the best available pricing models.

Box 6.1 Valuation of Options

Valuing options for directors and executives: New ASIC Guidelines

ASIC has issued final guidelines on the method for including values of options in the disclosure of directors and officers emoluments in their annual directors' reports for the years ending on or after 30 June 2003.

Director's reports must disclose the value of remuneration relating to options granted to each director and each of the five highest remunerated executive officers and the methodology and assumptions used to value options. Companies are not relieved of their statutory obligations because they regard calculation or disclosure too onerous or difficult.

The guidelines are designed to help companies fulfil their statutory disclosure requirements and inform shareholders of the full value of the remuneration of directors and executive officers.

The ASIC guidelines require the options to be valued at the time they are granted and then to have that value apportioned over the period from grant date to vesting date. The options must be valued in a manner consistent with the requirements of the International Accounting Standards Board's Exposure Draft ED2 Share based payment and the Australian Accounting Standards Board Australian exposure draft ED 108.

Although the guidelines are intended to deal only with the treatment of options for the purpose of disclosing emoluments in the directors report of Australian listed companies, ASIC encourages entities preparing financial reports under the Corporations Act 2001 to apply the guidelines in determining the amount of directors and executive remuneration disclosed in the notes to the financial statements under Accounting Standards AASB 1017 'Related Party Disclosures' and AASB 1034 'Financial Reports Presentation and Disclosures'.

For further information see www.asic.gov.au and Deloitte Touche Tohmatsu Accounting Alert *ASIC Issues Final Guidance on Valuing Options for Directors and Executives*, July 2003

International Financial Reporting Standards

The impending introduction of the International Financial Reporting Standards (IFRS), previously known as International Accounting Standards (IAS), *Share-Based Payments* provides further impetus for listed companies to ensure that disclosure around option schemes is in order. The standard encompasses all forms of share-based remuneration - including restricted stock, share appreciation rights and other alternatives to share options.

It now appears that the standard will require executive (and other employee) options to be treated as expenses, resulting in an impact on the bottom line. The size of this expense will be commensurate with the value of the options. Shareholders are not the only group of people seeking the true value of options; company auditors also need assurance that valuations have been correctly performed.

Practice Note No. 7

Executive remuneration contracts

Introduction

Your Board, under a better practice model, has ultimate oversight of executive remuneration matters. In these circumstances, Board members have specific responsibilities in relation to determining the details of the Chief Executive Officer's remuneration package including salary, bonuses, share options, other long term incentives, pensions, benefits, and termination compensation. In addition, the Board will review, amend and have sign off on recommendations for remuneration of other company executives.

The Board faces the need to balance the reward and motivation of superior executive performance with legitimate shareholder concerns about remuneration levels, total packages and transparency of arrangements. Figure 7.1 guides Board members when considering proposed remuneration arrangements for individual executives.

Suggested Board enquiries

Figure 7.1: Board Enquiries when considering proposed executive remuneration contracts

Control	Recommended Board Enquiries
Executive Contracts	Has the proposed executive contract been reviewed by the Remuneration Committee in consultation with the Nomination Committee, or otherwise checked to determine if it meets company policy and is reasonable and fair?
	Has the contract been professionally reviewed by legal and remuneration advisers?
	The terms and conditions of the contract are tightly and clearly framed with termination payouts minimised wherever performance is poor.
	Is the length of term reasonable in all the circumstances?
	How does the level of remuneration compare, in total and by element, to the competitive market?
	What is the total opportunity being delivered to executives and how does this correlate with the increased value being realised by shareholders?
	Is remuneration linked to clearly specified, transparent performance targets and benchmarks designed to enhance company value? Will performance objectives be made public? Is failure rewarded?
	Is any equity-based remuneration designed to remove "short termism"? Are there clear provisions governing how and when options may be exercised and/or acquired shares can be sold, share ownership and share-related transactions?
	Are the performance measures and standards appropriate? Is adherence to company behaviours a performance requirement?
	Is it understood and clearly stated how subjectivity and/or discretion are to be applied in determining the ultimate award and in what circumstances the awards are available?
	Does the full range of possible payouts make sense relative to the applicable performance levels and total compensation? Can it reasonably be said that the executive, if unsuccessful, will receive compensation for failure?

Control	Recommended Board Enquiries (cont.)
	Does the Board understand and is the Board comfortable with the termination, pension and post-retirement benefits the executive is entitled to over time?
	Does the Board understand and is the Board comfortable with compensation that may be payable in special circumstances such as change-of-control?
Disclosure	Have disclosure requirements been determined in relation to this contract and what is the specific strategy for disclosure of the Board's decision on this contract and shareholder engagement?

Managing Termination Risks

One of the most sensitive issues in Australian corporate governance is that of remuneration levels for company executives especially the concern that executives are being rewarded for failure. The risks generated by poor termination arrangements including serious reputation and financial risk, call for strong controls on development, recording and independent approval of the executive's total termination benefits.

A number of approaches have been recommended for managing this issue. Prevention and discouragement of certain forms of termination arrangement has received greater favour than proposals to improve the ability of the Board to recover termination payments after they have already been made to the executive.

Executive contracts need to be designed so as to minimise the risk of paying for failure upon termination of the executive. This Practice Note and appendix 1 provide the Board with a set of enquiries to make when determining executive contracts. The total value, absolute linkage of reward to performance and the level of Board discretion in determining termination payments are key issues for the Board to consider in establishing whether the proposed package is reasonable and fair.

In Australia the ASX Corporate Governance Council best practice recommendations advise that termination payments for chief executive officers be agreed in advance and include detailed provisions in the case of early termination, except for removal for misconduct. Agreements should include a clear articulation of performance expectations and give consideration to the consequences of the appointment not working including costs and other impacts. (Recommendation 9.2, Box 9.2)

Measures

The control framework outlined in this series of practice notes is designed to reduce or remove a range of risks associated with executive remuneration. The ability to manage termination risks will be dependent on whether broader measures have been put in place ranging from:

- Board oversight
- Board's recognition of the need to manage executive remuneration risks
- Strong remuneration policies which are designed to prevent or reduce the termination risks
- Use of external advisers as required
- Shareholder and regulator disclosure and communication.

In addition, depending on the Board's appetite for more closely controlling executive remuneration and managing stakeholder concerns, there are a range of more specific measures which can be used to manage the risks to the company arising from termination of key executives. These include:

- *Shorter contract and notice periods:* The use by Boards of terms of one year or less for executives to control termination payments in the event of severance
- *The use of phased payments:* Avoiding the use of lump sum payments on termination and substituting phased payments such as on a monthly basis ceasing when the executive commences fresh employment.
- *Liquidated damages:* At the time of entering into the executive's contract, calculating and negotiating the amount that will be paid to the executive in the event of termination. This provides clarity from the commencement of the contract but carries the disadvantage that the amount cannot be reduced in the light of subsequent poor performance. A variation to overcome this disadvantage is the addition of an arbitration clause to cover that, in the event of event of termination, the parties will go to arbitration to determine the final termination payment.
- *Disclosure:* Careful assessment of the benefits of disclosing details of executive contracts to obtain shareholder and stakeholder support.

Practice Note No. 8

Using expert advice

External remuneration advisers are a feature of many company executive remuneration processes because of the specialist nature of the field. Your company may engage such advisers at the company management level, or you may encounter advisors when recruiting executives, advising the executive on appropriate conditions and packages.

It is important that the Board considers:

- the circumstances in which external remuneration advisers or consultants will be used;
- the purpose for obtaining their advice;
- the need for the advice to be independent of management; and
- how independence will be ascertained and conflicts avoided.

Some circumstances will dictate using independent advisers, for example, where there is any concern about the potential for management self-dealing, where there is conflict or an adversarial relationship between management and the Board, or perhaps, where the Board is concerned about the diligence or independence of the Remuneration Committee.

Potentially, independent advisers are in a position to provide the Remuneration Committee and the Board with broader, and more objective data and perspectives. The ability of the Committee or the Board in the absence of a Remuneration Committee to engage and terminate outside remuneration consultants reinforces the independence from company management on executive remuneration issues. It also puts the Committee or Board in firm control of executive remuneration policy and proposals, and reduces the potential for conflict of interests between advisers and management.

Figure 8.1: Board Enquiries to manage use of external remuneration advisers

Recommended Board Enquiry	Further Details
Has the Board determined, in principle, when external remuneration advisers will be used, what the purpose of their advice will be and what level of independence is required?	The Board should determine the circumstances in which independent advice is required, and how best it can be obtained.
Is the Board Remuneration Committee empowered to obtain advice direct from remuneration consultants?	Emerging best practice recommends empowering the Board Remuneration Committee to obtain advice direct from external advisers as required.
How is independence of remuneration consultants managed and potential conflicts of interest avoided when developing and considering executive remuneration issues?	Is the consultant's independence regularly checked and provision for the consultant to disclose other business relationships at each engagement to ensure that their independence is not marred by other relationships.
Is the role of the Consultant understood? Have reports tabled at the Board or Committee been carefully checked?	Are remuneration consultant reports to the Board clearly presented to clarify whether it is the consultant, management or Committee making the recommendation. Clarify who is recommending change.

Appendix 1

Board Assurance Enquiries

Box 3.1: Elements of Board Committee Best Practice

✓	Control	Details of Board Enquiry	See page #
	Board oversight	Do Board members understand that the Board has oversight of executive remuneration?	4
		Are Board members knowledgeable about best practice executive remuneration principles?	
		Are there clear boundaries between the role of the Board and its committees and the role of management in developing and approving executive remuneration policies, practices, packages and schemes?	
		Are company remuneration policy and practices the subject of regular monitoring and review by the Remuneration Committee, internal audit and the Board?	
	Remuneration policy	Are remuneration policies structured to encourage executives to acquire a meaningful equity position in the company on a long term basis?	8
		Are executives required to give public advance notice of their intention to sell company shares?	
		Are remuneration policies tailored to the company?	
	Remuneration Committee	Has the Board established a Remuneration Committee or allocated this role to an existing board committee?	12
		Is the Remuneration Committee's charter, boundaries and powers clearly set out in a charter document?	
		Is the Remuneration Charter published on the company website and readily accessible?	
	Shareholder involvement	Is there a clear, transparent policy on shareholder involvement on remuneration issues? Are share plans and material modifications to existing arrangements, including share options repricing subject to shareholder approval?	16
		Is there plain English disclosure of the effects of equity based remuneration plans and the extent to which future value will be transferred to executives and employees, including the overhang of outstanding options?	

✓	Control	Details of Board Enquiry	See page #
		Is there disclosure of new executive employment agreements?	
		Is there clear disclosure of the dilution and cash costs associated with maintenance of the company's equity programs?	
	Competitive remuneration	Is there competitive executive remuneration which is balanced between cash and shares and provides a significant portion of the total compensation at risk, tied both to annual and long-term financial performance of the Company as well as creation of shareholder value?	26
	Rewarding Performance & Behaviour	Does the policy reward performance, not failure so that the company's best performers receive a highly competitive remuneration and poorer performers receive less?	26
		Is executive remuneration tied to the company's agreed ethical corporate behaviour standards?	
		Are there performance-based goals set for executives which support and reinforce the company's long term strategic goals?	
		Are there clawback provisions to prevent executives benefiting from their own wrongdoing?	
	Executive Contracts	Has the proposed executive contract been reviewed by the Remuneration Committee in consultation with the Nomination Committee, or otherwise checked to determine if it meets company policy and is reasonable and fair?	29
		Has the contract been professionally reviewed by legal and remuneration advisers?	
		The terms and conditions of the contract are tightly and clearly framed with termination payouts minimised wherever performance is poor.	
		Is the length of term reasonable in all the circumstances?	
		How does the level of remuneration compare, in total and by element, to the competitive market?	
		What is the total opportunity being delivered to executives and how does this correlate with the increased value being realised by shareholders?	

✓	Control	Details of Board Enquiry	See page #
	Remuneration Disclosure	What is the total opportunity being delivered to executives and how does this correlate with the increased value being realised by shareholders?	19
		Is remuneration linked to clearly specified, transparent performance targets and benchmarks designed to enhance company value? Will performance objectives be made public? Is failure rewarded?	
		Is any equity-based remuneration designed to remove "short termism"? Are there clear provisions governing how and when options may be exercised and/or acquired shares can be sold, share ownership and share-related transactions?	
		Are the performance measures and standards appropriate? Is adherence to company behaviours a performance requirement?	
		Is it understood and clearly stated how subjectivity and/or discretion are to be applied in determining the ultimate award and in what circumstances the awards are available?	
		Does the full range of possible payouts make sense relative to the applicable performance levels and total compensation? Can it reasonably be said that the executive, if unsuccessful, will receive compensation for failure?	
	Use of remuneration advisers	Does the Remuneration Committee have the right to seek advice from remuneration experts?	33
		Is there a process for avoiding potential conflicts of interest when developing and considering executive remuneration issues?	

"*The Board's Guide to Executive Remuneration Issues*" is a publication of Deloitte designed to help you clearly understand the fast-evolving requirements of the new corporate governance environment, while keeping your response aligned with your broader corporate goals and strategies. This publication is part of Deloitte's corporate governance services. These services focus on four specific areas - board roles and responsibilities, ethics and corporate compliance, risk management and controls and transparency and disclosure.

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