

Fine-tuning your remuneration report

Communicating your “Pay for performance” story

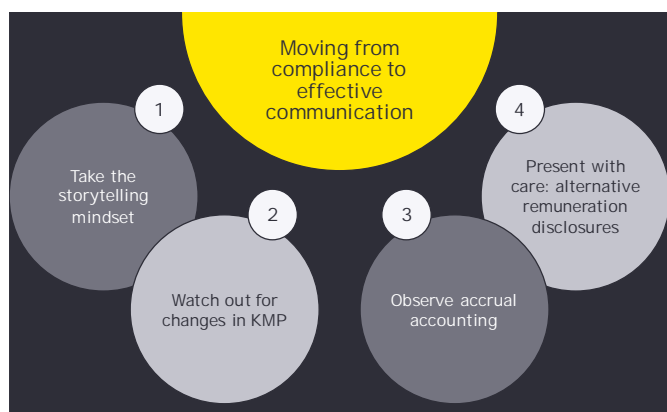
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Building a better working world

Key management personnel (KMP) remuneration is inherently a sensitive topic that attracts heightened scrutiny from investors, the KMP themselves and other stakeholders. Companies continue to be challenged on two fronts - motivating executives with an attractive reward scheme and explaining publicly its alignment with shareholder interests. Further raising its importance is the “two strikes rule” of the Corporations Act 2001 (Act) that triggers a board spill if the remuneration report receives 25% or more dissenting votes from shareholders for two consecutive years.

With these challenging backdrops, this publication seeks to focus on effective remuneration reporting.¹ We present some practical pointers in drafting a clear, transparent and understandable remuneration report, while also addressing some common misconceptions.



Take the storytelling mindset

Given the detailed disclosure requirements of the Act, we observe that many remuneration reports have been prepared with a checklist mindset. This approach however does not guarantee supportive votes from shareholders for the remuneration report since some reports apparently “ticking-all-the-boxes” nonetheless have received dissenting votes. While “no” votes could be driven by many reasons, preparers play a key role in managing the “two strikes” risk by drafting an effective remuneration report.

A storytelling mindset means carefully weaving a “pay-for-performance” narrative that helps shareholders understand the value received in exchange for the remuneration given to KMP. Therefore, key to writing an effective story is meeting the information needs of the users of the remuneration report. Insights about user needs may be drawn from information provided in the voting guidelines released by proxy advisors, feedback during discussions with institutional investors as well as ASIC’s focus areas.

An effective remuneration story presents qualitative and contextual information that complements the quantitative information within the report. This includes clear and concise disclosures on:

- ▶ The remuneration mix for the CEO and other KMP and why this is appropriate in the company’s circumstances, including the factors considered in determining the amounts of fixed, short term (STI) and long term (LTI) remuneration
- ▶ The performance targets (both financial and non-financial) selected to determine variable pay outcomes, and why they were selected
- ▶ How the performance measures are linked to the company’s circumstances, strategy and priorities (and if not, why not)
- ▶ The benchmarking process and comparators used when selecting peer groups and setting targets
- ▶ How and when performance is to be assessed against the targets, and by whom

¹ Our March 2021 publication, “Effective Financial Reporting” outlines practical insights on elevating financial reports into effective communication documents.

- ▶ The circumstances when discretion can apply – this is pivotal when applying discretion results in a greater entitlement, or when discretion was not applied but could have been
- ▶ Actual KMP performance assessed against each of the performance targets, especially for STIs, and
- ▶ When share-based payment (SBP) awards are modified - the conditions modified, those KMP affected and why the changes were made.

An effective story also requires consideration of how the information is presented, by exploring approaches such as:

- ▶ Including an executive summary that sets the theme for the report, and highlighting any major changes from the prior period, and
- ▶ Using illustrations and/or diagrams to simply convey complex information (eg the remuneration mix for the CEO and other executive KMP).



Clear communication in corporate disclosures and to stakeholder groups more broadly about the rationale for board decisions on executive variable pay outcomes is essential for maintaining investor confidence. This includes communication to the executive team and workforce more broadly to ensure buy-in internally.

ASIC Information Sheet 245 (INFO 245) reissued in March 2021.

Watch out for changes in KMP

The remuneration report captures all those meeting the definition of KMP, essentially those in charge of the governance of the reporting entity. KMP generally includes the directors of the parent entity of a consolidated group, as well as the CEO. It may also include direct reports to the CEO (if they meet the definition of KMP). If there is an executive committee, an assessment is made whether all or some of its members are KMP.

Changes during the year in the composition of the KMP can sometimes create confusion about the individuals or amounts to include in the remuneration report. The following are some basic principles to keep in mind:

- ▶ KMPs should be re-assessed each period due to changes in role descriptions, appointments and resignations including those triggered by restructures, acquisitions and disposals. Changes should be explained with appropriate disclosure
- ▶ Remuneration earned by an individual in a role elsewhere in the organisation prior to them becoming a KMP is excluded from the remuneration report. For example, a bonus arrangement in place for the full year is allocated and KMP remuneration only includes that portion attributable to the period while a KMP
- ▶ No comparative information is required for the prior period when an individual becomes a KMP in the current period

- ▶ If a person ceases to be a KMP (including may have resigned employment) in the current period, only amounts earned while a KMP are to be included in the report. For example, if an individual changed roles during the period, then the KMP remuneration captures only the period they were a KMP, and
- ▶ Comparative information is still required for the prior period when an individual was a KMP in the prior period, but is no longer a KMP for the current period.

Observe accrual accounting

There is a misconception that certain information presented in the remuneration report is to be prepared on a cash-basis. However, the Act is clear that amounts disclosed for each element of KMP remuneration (ie fixed remuneration, non-monetary benefits, STI, LTI, SBP etc) is to be based on the accounting expense for the period. Areas where oversights are common include:

- ▶ Cash bonuses for which relevant performance hurdles have been met for the period, but still require board approval, should be recognised as a provision and expense for the period. Use a reliable estimate of the amount that is expected to be approved subsequent to year end
- ▶ When a SBP award is communicated to a KMP but requires approval at the AGM, a provisional measurement of the grant date fair value is to be made and an expense recognised for the period, based on the service provided to date. The provisional fair value is then finalised in the subsequent period that approval is obtained and a true-up of the expense made at that time
- ▶ When a SBP award is forfeited due to resignation, a negative amount is to be reflected for the reversal of the cumulative expense previously recognised
- ▶ A component of STI that is deferred and to be settled in equity is still to be expensed over the vesting period and presented in the remuneration report as share-based payments
- ▶ When an employee resigns but discretion is exercised to allow a SBP award to vest conditional on future performance hurdles, any grant date unamortised fair value is recognised immediately as an expense
- ▶ The payment of previously accrued leave benefits is not disclosed as remuneration, since the expense is recognised (and disclosed) as and when it was accrued, and
- ▶ Any redundancy / termination benefits are recognised as termination benefits once the decision is communicated – it is not delayed until the end of a notice or gardening period.

The requirements of AASB 2 *Share-Based Payments* and AASB 119 *Employee Benefits* are to be observed when presenting the quantitative disclosures in the Remuneration Report.

Present with care: alternative remuneration disclosures (ARD)

Quantitative information presented in the remuneration report is often criticised for being difficult to understand since it requires knowledge of often complex accounting rules. In response, there is increasing use of ARD to enhance a reader's understanding of remuneration. ARDs are sometimes presented on a "cash" or "realised" basis whereby disclosures cover actual cash payments received by the KMP for salary and STI, and the value of SBP awards that vested during the year.

The following table is an illustration of a typical ARD:

FY 2021	KMP A	KMP B
Salary and fees	xxx	xxx
Short term incentives/bonus*	xxx	xxx
Non-monetary benefits	xxx	xxx
Superannuation benefits	xxx	xxx
Shares**	xxx	xxx
Performance rights***	xxx	xxx
Total "realised remuneration"	xxx	xxx

* STI earned in FY 20 but paid in FY21

**Value of shares that became unrestricted in FY21, based on the share price when they became unrestricted

*** Value of performance rights that vested in FY21, based on the share price at its vesting date

When presenting ARD however, care must be taken that it is not presented with more prominence to the statutory information. In addition, to maximise its usefulness, ARD should, inter alia:

- ▶ Include the basis of measuring each element disclosed (e.g. for options vested during the period, the amounts may have been based on an intrinsic value at vesting date)
- ▶ Be calculated consistently each period, and
- ▶ Explain why the selected ARD is useful and how it provides relevant information to the readers.²

Overall, an effective remuneration report is one that provides a narrative story on how the company pays for performance and obtains value for its shareholders. Like any good story, it does not suffice that the information is complete and correct. Hence, preparers accepting the challenge to weave the remuneration report with consistency, clarity and transparency, will help users assess whether the remuneration is appropriate and consistent with the company's circumstances, strategy and priorities.

To discuss further, please contact your local EY adviser.

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² RG 230 Disclosing non-IFRS information provides guidance when presenting information that is not in accordance with accounting standards.