

Human Resource Services


HR Quarterly

Sharing good practice*

October 2008



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From the editor

In our last issue we highlighted the fact that many companies were looking or should have been looking far more closely at their Executive Compensation models and in particular at their short and long-term incentive plans. Some hard questions were being asked. Have some of the Executives been paid too much? Has anything gone wrong with our reward practices?

We emphasised that shareholders were increasingly adding their voice to the calls for reform and no doubt major changes in this area were imminent. This was particularly true in the financial services industry where incentives were often above the median of the market.

Since then we have seen the financial services industry go into turmoil and the global markets being impacted negatively.

In the wake of the credit crisis, searching questions are once again been asked about whether compensation systems had a part in creating or fuelling the current situation.

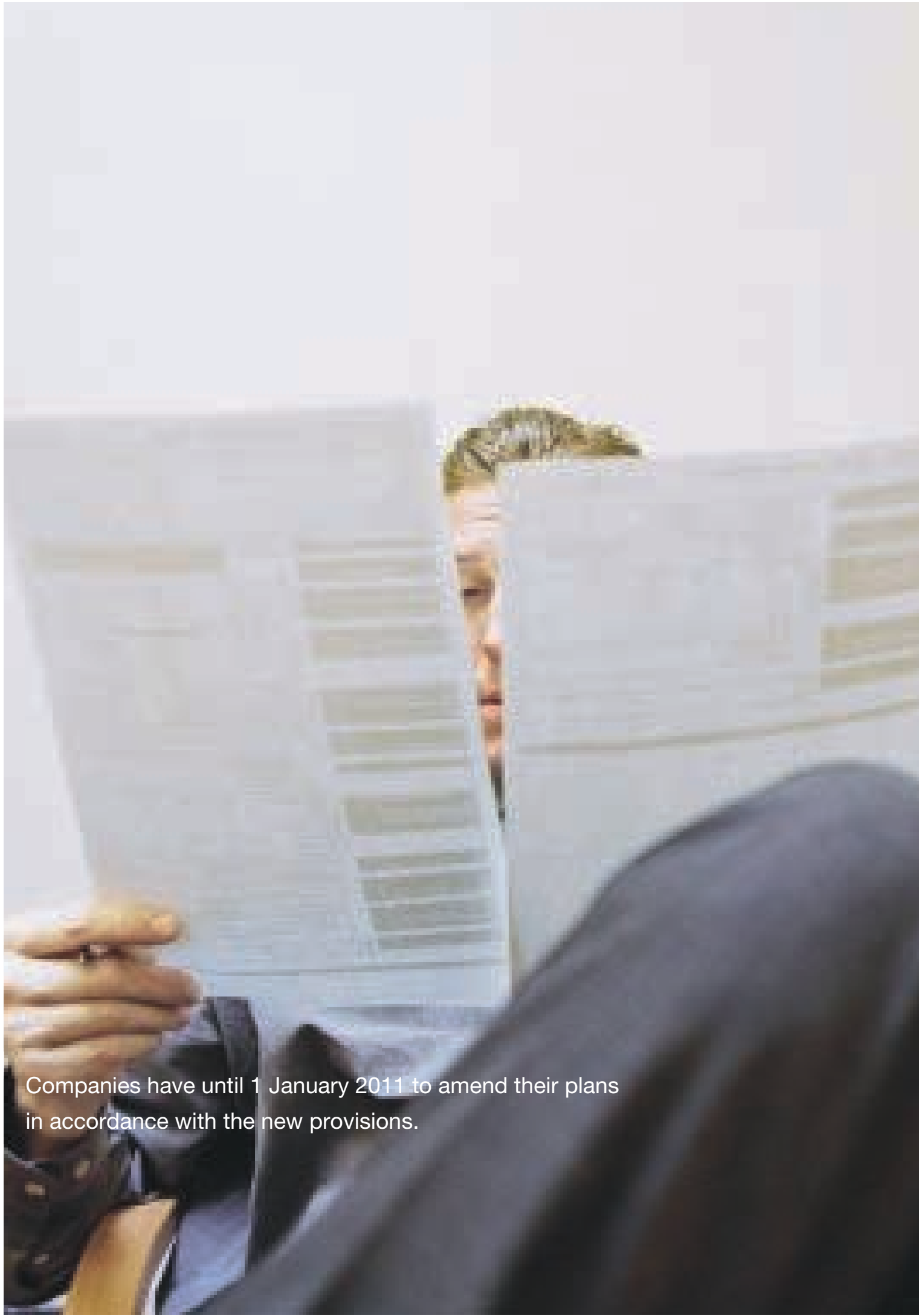
The politicians are interested: Prime Minister Gordon Brown is quoted as saying “I think there’s an element of the bonus system that is unacceptable. When you get bonuses and salaries based on short term deals that no relationship to long term performance then you have to look again at what the system is doing”; John McCain, Republican Presidential Candidate, is quoted as saying “The senior leaders of any firm that is bailed out should

not be making more than the highest paid government official” whereas Democratic Presidential Candidate, Barack Obama, is quoted as saying that “I tried to introduce legislation more than a year ago to give shareholders an advisory vote on determining the pay for corporate CEOs”.

The world is equally getting increasingly angry. However, whilst we believe reward was not the cause of the credit crunch, it did add fuel to the fire. Consequently, change is now inevitable. Understandably, most companies would not want change forced on to them through regulation. The regulators will take a stance on this issue, so companies will need to be ready. In order to achieve this change and have a system that works, it is imperative that a collaborative approach between regulators and industry should be adopted.



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Companies have until 1 January 2011 to amend their plans in accordance with the new provisions.

New JSE requirements for listed companies operating share incentive plans

The recent changes to Schedule 14 of the JSE Listing Requirements, governing the operation of share incentive plans, makes it clear that the interests of shareholders of listed companies are taken to heart. Although executive remuneration is under the spotlight in South Africa, our counterparts in the UK remain subject to a greater degree of scrutiny when implementing new share plans.

These changes are effective for all listed companies that implement new share incentive plans after 15 October 2008. Companies that have plans adopted before this date will have until 1 January 2011 to amend their plans in accordance with the new provisions. Grants that have already been made under existing plans adopted before 15 October 2008 will remain unaffected by the changes. The new provisions are, however, silent on the transitional requirements in those cases where a company with an existing plan uses that plan to make new grants after the effective date. One would expect such new grants to be subject to the new provisions. PwC has approached the JSE to provide further guidance in this regard.

The provisions are not applicable to phantom plans and it therefore seems that companies that operate phantom plans can still implement plans that are not subject to the shareholder approval and the subsequent greater public scrutiny. Although phantom plans do not have a dilutive impact on shareholders, there is still a major cash impact as well as an impact on earnings as a result of the greater accounting charge. Although a number of

JSE-listed companies that implement phantom plans voluntarily comply with the JSE listing requirements, one would have expected that the JSE would have viewed phantom plans in a similar light as equity-settled share plans.

A summary of the major changes follows.

- Any new share incentive plan must be approved by 75% of the shareholders by way of an ordinary resolution, while the pre-October 2008 requirements only called for a 50% vote in favour of the plan. However, if the major or controlling shareholders are also participants under the plan, their votes are excluded and 75% of the remaining shareholders must vote in favour of the plan.

A major change revolves around the dilutive impact of share plans. The new requirements provide that shareholders must approve a fixed number of shares that can be utilised for the purpose of the plan. A fixed percentage over a period of time (e.g. 10% over a ten-year period) is no longer allowed. The 20% dilution limit that was referred to in the previous provisions has also been scrapped.

This implies that as long as a company has permission from its shareholders to grant a certain number of shares, there is no limit on the number of shares that can be utilised. New shareholder approval must be sought as soon as this limit has been reached. The dilution limit approved can, however, be adjusted where shares originally allocated to participants do not vest as a result of forfeiture for instance. Shares that are delivered can however not be excluded from the limit. It seems as if shares purchased in the market will, as in the past, not count towards the dilution limit.

In the event of a sub-division or consolidation of shares or the adjustment of the number of shares and the subsequent adjustment to the number of awards under the plan, such adjustment must give the participant the same rights as he previously had and Remuneration Committees should use best endeavours to provide meaningful disclosure that quantifies the aggregate payments arising on a change of control. This requirement implies that shareholders expect that the underlying financial performance of a company that is subject to a change of control should be a key

determinant of what share-based awards, if any, should vest for participants. Companies should therefore satisfy themselves that the performance criterion genuinely reflects a robust measure of underlying financial achievement over any shorter time period. This further implies that where share incentive awards vest early as a consequence of a change of control, awards should vest on a time pro-rata basis i.e. taking into account the vesting period that has elapsed at the time of change of control. This requirement is in line with standards in the UK for example.

Unless the plan explicitly provides for the purchase of shares in the market, no such purchases will be permitted. A number of companies have adopted this settlement method as an alternative to ensure that the cash cost is carried by the relevant operating entity in the group. It would therefore be important to ensure that approval from shareholders is specifically sought where shares will be purchased in the market to settle benefits under the scheme. In the UK, the Association of British Assurers

(ABI) acts as the watchdog of executive remuneration and the ABI Guidelines go even further to provide that there should be prudent and appropriate arrangements governing acquisition of shares, and financing thereof, to meet contingent obligations under share-based incentive plans.

The requirement of disclosure of share-based payments in company's annual financial statement remains unchanged. However, the disclosure by South African companies is still a far cry from what global standards and what shareholders would expect to be informed about. To use the UK as an example, the ABI expects companies to use a comprehensive approach to the valuation and reporting of the valuation of share-based payments. The following information should be disclosed in order that shareholders can make a judgment about total cost:

The potential value of awards due to individual participants on full vesting. This should be expressed by reference to the face value of shares or shares under option at

point of grant, and expressed as a multiple of base salary;

The expected value of the award at the outset, bearing in mind the probability of achieving the stipulated performance criteria; and

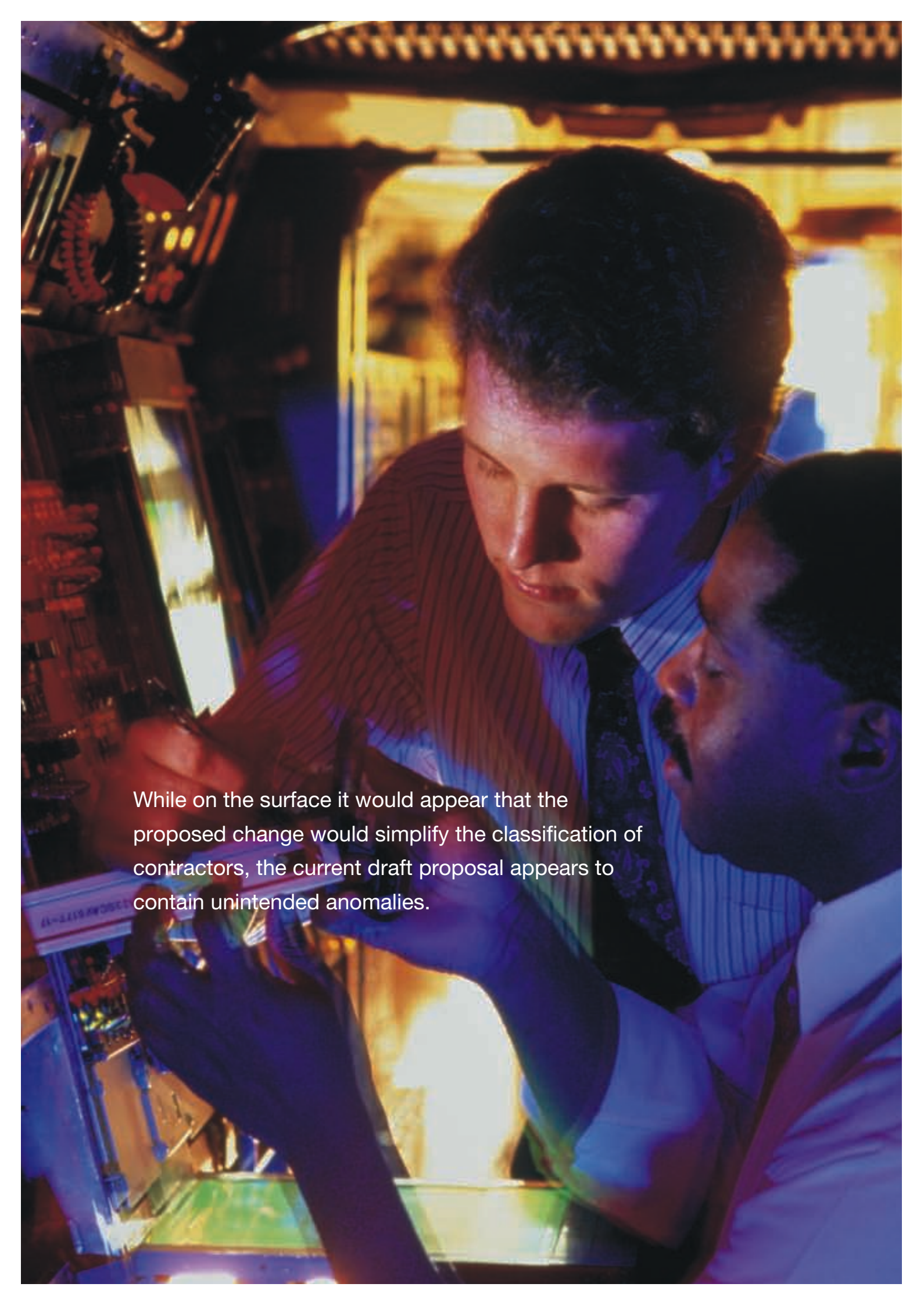
The maximum dilution which may arise through the issue of shares to satisfy entitlements.

The PwC Executive Reward team can assist companies with advice on any of the above matters and can also assist in re-drafting plan rules to comply with the new requirements. Please contact any of the following experts if you require assistance:

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A photograph showing two men in business attire (shirts and ties) looking intently at a document or screen in a control room. The man on the left is pointing at the document with a pen. The man on the right is looking at the document with a focused expression. The background is filled with various control panels, screens, and equipment, illuminated by warm, yellowish light. The overall atmosphere is professional and technical.

While on the surface it would appear that the proposed change would simplify the classification of contractors, the current draft proposal appears to contain unintended anomalies.

Consolidation of deemed employee regime - simplified or more complicated?

After years of tweaking the legislation in respect of the employment status of employees, the South African Revenue Service (SARS), has proposed the consolidation of the deemed employee regime.

The tax legislation currently contains separate definitions for personal service companies (and trusts) (PSC) and labour brokers; each with its own set of regulating criteria.

The general aim is to create a deemed employment relationship between the payer and the service provider, so that consequently payments made to these deemed employees would fall foul of the employment tax net and would be subject to a payroll withholding.

While sharing a common goal, there are key differentiations between the two concepts. The labour broker provisions apply in the case of a natural person as well as to an incorporated entity, as opposed to those relating to a PSC, which only applies to incorporated entities and trusts.

A further distinguishing characteristic between the two concepts is that a service provider essentially agrees to render a 'deliverable' to the client, whereas a labour broker provides the 'productive capacity' of its employees to the client.

Generally speaking, labour broking services would be services where the service provider makes, at a cost to the client, the productive capacity of skilled persons available to such client. Providing services, on the other hand, would be characterised by the fact that the client pays for a predetermined deliverable from the company – regardless of who performs or renders the service.

Although the distinction may appear clear in its most basic form, it should be noted that both types of services could

be present in a single relationship with the client. As indicated by SARS, the current legislation recognises three different types of entities, which are in effect engaged in the same type of business. This places an administrative burden on employers to correctly classify contractors to ensure tax compliance. In addition the legislation was not conducive to a streamlined compliance and audit process.

In its draft Revenue Laws Amendment Bills, released on Friday, 1 August 2008, SARS has proposed that a single regime be introduced and that the current definitions of "labour broker", "personal service company" and "personal service trust" are to be replaced by the concept of a "personal service provider" (PSP). Furthermore, individuals rendering services as "independent contractors" will also be classified as employees under certain circumstances.

The proposed definition of a PSP follows the basic principles currently regulating a "personal service company". In reviewing the draft legislation, a few concerns spring to mind. Firstly, the explanatory memorandum issued in this regard suggests that the current concept of a "labour broker" will be included in the proposed new PSP definition; however, this is not clear in the current draft of the definition. Furthermore as indicated above, the defining distinction between a labour broker and a personal service company is that a personal service company provides service,s whereas a labour broker provides persons.

The new definition of a PSP does not adequately address the provision of persons. In fact, the only provision of persons contemplated in the new PSP definition seems to be where those persons are 'connected' to the PSP.

The above issue was specifically addressed in the PwC response to Parliament's Portfolio Committee on Finance, in which it was recommended that the PSP definition be reworded to expressly include the activity of providing persons, or to confirm that the provision of persons would fall within the ambit of the proposed new legislation.

The response from the said Portfolio Committee indicate that the proposed new "PSP" will only be applied to companies and trusts and that individuals will remain subject to the existing rules, including existing labour broker rules.

Once again this seems to be a direct contradiction of the initial draft legislation issued in August. While on the surface it would appear that the proposed change would simplify the classification of contractors, the current draft proposal appears to contain unintended anomalies, as does the official SARS response to these issues.

We all await the final legislation with bated breath. Watch this space for further information.

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Organisations need to develop consistent measurement tools as a key focus area in their expatriate management function going forward.

Return on investment – employer and expatriate considerations

How many organisations are aware of their annual expatriate programme cost in relation to overall business expenditure? Is this knowledge important to your organisation and if so should you be satisfied with a ballpark estimation or do you need to drill down to the actual costs related to each assignment on a host country and regional basis?

Are the total associated costs per expatriate reported at a global level and if so how should you be measuring a sustainable return on investment (“ROI”) to justify the investment in your expatriate programme? Are the ROI tools used to measure success aligned with normal employee assessments or have these tools been adjusted to the vagaries of the expatriate environment?

Due to the recent economic conditions affecting global companies and filtering steadily down into the South African market, the spotlight is shifting internally to justify the use of expatriates as opposed to local employees. This is exacerbated in industries considering retrenchment or down-sizing of the local workforce.

Business leaders are starting to focus on their international mobility population and demanding quantification of the total costs expended per expatriate assignment in comparison to the business strategies requiring an internationally mobile workforce.

Pressure is being exerted on expatriate programme owners and the end users within organisations,

who are requesting and using expatriate assignments, to justify defendable ROI against set measurable objectives. This process requires the identification and implementation of effective and sustainable ROI measurement criteria. This includes benchmarking of expatriate allowance and benefit policies to market best practice and driving global consistency and adherence to mobility policies and processes to enable ease of budgeting and facilitating equity amongst assignees.

A general perception persisted in the market that certain organisations did not quantify the actual total costs of expatriate assignments, as this would require justification of the expenditure against clearly defined and accountable factors. Organisations can no longer afford to overlook ROI issues and need to develop consistent measurement tools as a key focus area in their expatriate management function going forward.

Measuring ROI for expatriate assignments is traditionally very challenging due to the extensive ancillary costs of assignments, including home and host country compliance costs, and also the lack

of measurable objectives, which differ amongst organisations based on variable operating environments and internal culture.

A significant issue is cost allocation between expenditure incurred for specific project deliverables and overall programme expenditure supporting talent management and strategic objectives within the expatriate programme.

Should all of the assignment costs be passed along to the receiving host country and compared against specific project objectives or should certain costs be assessed and allocated to sponsoring business units at a regional or global level and compared against expenditure incurred in developing an internationally experienced workforce?

In examining ROI issues for clients, PwC focuses on both employer and expatriate considerations, as it is vital to ensure that an organisation is competitive in its respective markets, while balancing and achieving the objectives of both the business and expatriate population. Understanding the differences between ROI considerations for the employer and

expatriate is crucial to developing measurement tools and enhancing satisfaction with the overall programme.

Employers need to consider the following main issues when assessing ROI for their expatriate population:

Assignment objectives met within budget and timeline

This emphasises the need for a well defined assignment initiation phase to ensure that a suitably skilled candidate is selected and a comprehensive project plan agreed between the three main stakeholders (Home Country, Host Country and Expatriate) defining the project scope, timeline and expected outcomes with scheduled reviews to measure success.

Detailed pre-assignment cost estimations and defined approval processes are key to this measurement factor.

Total assignment costs vs. Assignment deliverable value

Organisations need to assess the value achieved in the host location through the completion of the project deliverables against the overall project costs. The overall employer and expatriate goals (talent management, new skills, global experience etc) must also be

incorporated to assess the total value of the assignment to the organisation as a whole.

Knowledge transfer

A key deliverable of any expatriate assignment is to up-skill the local employees in the host country. The skills gap in the host country that necessitated the assignment must be filled by a local employee to remove the need for a subsequent expatriate assignment.

Measuring continuous or extended expatriate assignments serves to highlight whether ROI is actually being achieved in the respective location.

Retention

Assignees need to return to a home environment facilitating and supporting the implementation of new skills and international experience to ensure employee engagement.

Organisations do not want to be grooming their top performers for external competitors and mentoring programmes need to be implemented during the assignment to continue attachment with home office networks. Failure in this area might lead to you having to absorb the costs of the assignment while trying to match increased offers from

competitors, which is not cost effective in the current climate.

Measuring expatriate attrition on an annual basis compared to acceptable attrition rates within your particular industry is an important ROI tool.

Corporate capital

Expatriate strategy needs to be aligned to your overall business strategies of developing and retaining a highly skilled international workforce. Implementing a sustainable assignment strategy and measuring the skills in your existing expatriate talent pool aligned to company culture and overall strategy generates greater value than merely linking ROI to specific project objectives.

The temptation is always to only measure ROI from an employer's perspective but ensuring that your expatriates derive value from seeking and accepting international assignments contributes to the overall success of the programme.

Expatriate considerations are fundamental to this process and incorporate both financial and non financial indicators including the following:

Financial rewards and overall assignment support

Expatriates associate international assignments with financial reward based on increased compensation during the assignment and the perception of home country savings. The financial package promised and delivered during the assignment is critical but the importance of logistical support on the ground must not be overlooked in favour of financial incentives.

Immigration and tax compliance support and providing cultural awareness training to facilitate a successful integration into the host country environment are crucial to enable expatriates to focus on the project deliverables rather than external distractions and also to ensure expatriate satisfaction with the programme.

Expatriates measure ROI based on the actual assignment delivery versus pre-assignment promises.

New skills

A main driver for employees to accept or seek international assignments is the development of

new skills to accelerate career advancement within the organisation and to increase their marketability to external employers. Employees are performing a personal career risk/benefit assessment prior to joining the expatriate workforce and new skill development provides a measurable barometer to assess the ROI derived from an international assignment.

Reintegration

Organisations need to direct measured support towards the successful repatriation of the expatriate to the home office to ensure a successful reintegration into an environment where the employee has an opportunity to immediately implement new skills and participate in challenging projects.

It is often extremely challenging for an expatriate to adjust into the old home office role and employers need to establish post-assignment goals aligned with career progression. Expatriates represent the high performers in your organisation and an effective talent management programme for your expatriates is vital for retention of skills.

The expatriate is able to measure ROI derived from participating in an international assignment through speed of career progression.

Career capital

Expatriates want to expand their skill sets, broaden cultural and business awareness and develop internal and external networks to ensure that they derive value from participating in the expatriate programme. These personal goals and post-assignment assessment are a main consideration of ROI from an expatriate perspective.

Organisations need to develop and review their internal ROI success factors and create an environment conducive to meeting both employer and expatriate drivers to build a highly skilled and sustainable expatriate workforce to support business goals.

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Gaining an understanding of IFRS is essential for the HR function because of the impact it will have on the company's retirement, medical and other employee benefits, equity-based compensation and overall compensation arrangements, and the measurement of cost for these plans.

IFRS – the impact on employee benefits and compensation

The IFRS conversion process is labour intensive, time consuming and can present significant challenges for companies. Whilst many may think of IFRS as an accounting/reporting issue, one quickly realises that the conversion is an enterprise-wide, business transformation project impacting on many operations, including the HR function. Soon HR will have to answer the question, “What should we be doing about IFRS?” given the impact on retirement, medical and other employee benefits, equity-based compensation and overall compensation arrangements.

What does this change in accounting framework mean for HR?

The conversion to IFRS involves a fundamental change in the framework of how companies measure pre-tax income and the principles governing accounting for benefit and compensation plans. Gaining an understanding of IFRS is therefore essential for the HR function because of the impact it will have on the company’s retirement, medical and other employee benefits, equity-based compensation and overall compensation arrangements, and the measurement of cost for these programs/plans.

HR will need to maintain detailed records supporting IFRS accounting and will be responsible for ensuring that costs are measured properly. HR will therefore need to:

- understand the IFRS rules as they apply to company’s benefits and compensation packages;
- consider appropriate changes to HR systems, recordkeeping and internal controls;

measure obligations and expenses under the new rules;

assess whether plan design or funding should change in light of IFRS adoption; and

formally implement the changes and develop communications to stakeholders.

IFRS for retirement and other employee benefits

The HR function must be involved to address how the IFRS conversion will affect employer-provided benefits, retirement plans, medical benefits and other post-retirement benefits. Some examples to consider include:

- recognition of actuarial gains and losses;
- determination of expected returns on plan assets;
- treatment of ‘special events’ such as settlements; and
- definition and accounting for defined contribution and multi-employer plans.

IFRS for equity-based compensation

There are many accounting differences that will affect pre-tax accounting, including:

- expense attribution for awards with graded vesting;
- definition of grant date;
- accounting when there is a choice of settlement methods;
- treatment of equity-based payments to non-employees; and
- measurement and recognition related to payroll taxes and social charges.

Where IFRS is required or permitted for local statutory purposes, the adoption of IFRS could impact local tax deductions in the respective tax jurisdictions.

Action plan for HR Management

It is essential that HR is involved in the process as early on as is possible. The HR and Finance functions will need to work together through all facets of the IFRS conversion. Some key actions steps are as follows.

Assess the impact of IFRS on financial statements for:

pensions, medical and other benefits; and

equity-based compensation.

Conduct complete global inventory of benefit plans and determine classification of benefit types.

Develop roadmap to embed IFRS in HR reporting function.

Complete formal valuations and conversion to IFRS.

Review business impact such as impact on financial performance indicators.

Prepare initial IFRS financial statements and reconciliations.

Provide training to HR and Finance on specific accounting standards e.g. IFRS2.

Assess the potential impact on HR processes and systems. Identify areas for improvement and recordkeeping.

Develop communications to convey IFRS changes to relevant stakeholders.

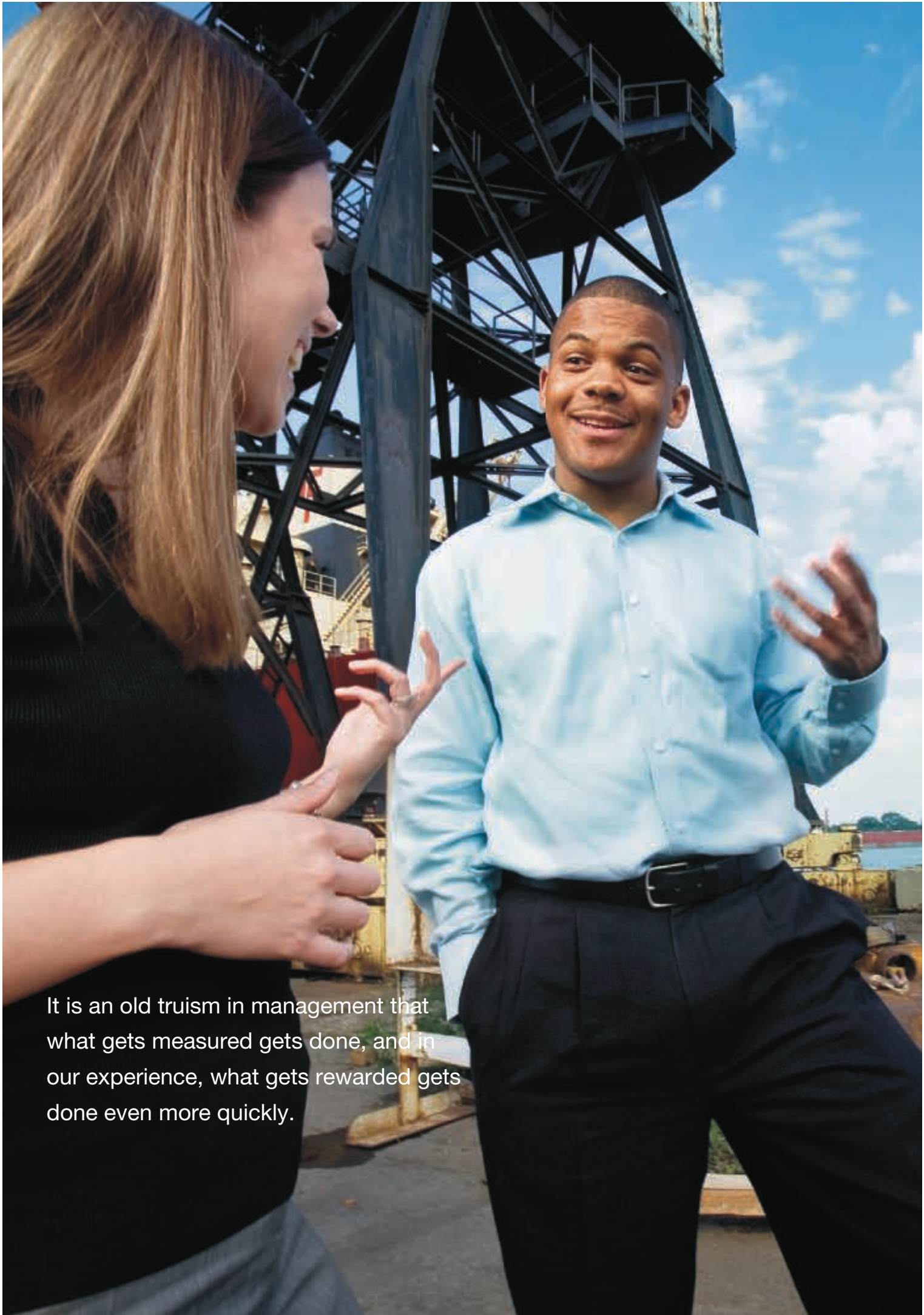
Develop business case and IFRS HR strategy/rollout with training.

[Article adapted from HRS Insight Newsletter – August 2008]

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It is an old truism in management that what gets measured gets done, and in our experience, what gets rewarded gets done even more quickly.

Financial and non-financial measures in incentive plans

Non-financial measures

There is little doubt that incorporating non-financial measures into bonus plans can deliver benefits, including:

- improved understanding of the business strategy and the organisation's areas of focus;
- increased relevance of bonus measures to individual's actions, enhancing motivation;
- greater focus on the longer-term strategic building blocks of success and reduced obsession with current-year budgets; and
- a change in culture and renewed understanding of what is important to the company.

However, as always with reward, it can seem easier to get it wrong than right and the use of non-financial measures is no exception. Risks to be managed include:

- a loss of clarity and focus in objective-setting through the use of too many targets;
- budget discussions and gaming could simply be multiplied across the non-financial as well as financial measures;
- a lack of historic patterns of performance on some of these newer measures could make forecasting and target-setting difficult;
- the effects of uncontrollable factors on performance are tough to predict; and
- the law of unintended consequences could mean that non-financial targets are somehow met, but through dysfunctional and unanticipated routes.

Based on our experience, the following steps could help to maximise the benefits and minimise the risks of changing the annual bonus plan:

Don't just rely on the bonus plan: a considerable body of research shows that the effectiveness of incentive plans is highly dependent on related areas such as the quality of performance management, reporting and communications.

Only use measures where you have a reliable track record: when introducing totally new measures, use them for performance reporting and management purposes until they are reliable and understood and only then link bonus payments to them.

Retain some discretion to provide protection against the law of unintended consequences.

Invest in training and communication about the new incentive approach on an ongoing basis with regular reporting and discussion regarding non-financial measures, what affects them and how they can be improved.

Start simply: begin by using the most obvious and reliable measures, for example customer satisfaction. Use them with a low weighting, initially alongside traditional financial measures, increasing the weighting over time as confidence in the measures builds.

It is now widely accepted that ignoring non-financial measures in business is like driving looking backwards. A

consensus seems to be emerging that such measures should also be used in bonus plans.

It is an old truism in management that what gets measured gets done, and in our experience, what gets rewarded gets done even more quickly. With the shift to reflect a broader stakeholder and corporate social responsibility agenda in corporate boardrooms, it is to be expected that bonus plans are reflecting performance goals and achievements in these non-financial domains. But is it desirable?

The answer is yes, but with qualifications. A bonus plan by itself will never achieve the desired result. But, if aligned with other initiatives in reporting, communication and performance management, it can be a powerful agent for change.

Two centuries years ago, Scottish mill owner Robert Owen proclaimed that 'philanthropy goes hand in hand with economic advantage'. Today, even more than in Robert Owen's time, it seems good companies really are just that: good to their shareholders, customers, employees and community. Whether this is real philanthropy or simply enlightened self-interest is of academic interest – we need more good companies, and good companies need good bonus plans.

Financial and non-financial measures in incentive plans (cont)

Financial measures

One of the easiest ways of kicking-off the conversation at a dinner for Executive or Non-Executive Directors is to ask what they think about TSR as performance measure. This issue seems to create a lot of heat. The major consultancies have picked up on this. Several have published studies over the last year or so identifying a particular flaw in this particular measurement approach.

Our own research last year showed that relative TSR (at least as commonly used in the UK) is surprisingly bad at aligning reward with performance over long periods, as it rewards volatility rather than sustained, above-average performance.

The other weaknesses of TSR are well known, including:

- difficulties with selecting an appropriate peer group;
- the influence that apparently random events such as takeovers have on vesting; and
- sensitivity to precise grant date and average period.

These issues all add up, in executive's minds, to a measure whose outcomes have very little connection to their performance, leading to frustration and demotivation.

The result has been a significant move away from relative TSR as the sole measure on long-term incentive plans.

Although TSR remains the single most common measure on performance share plans, it is now most commonly used in conjunction

with another measure, such as earnings per share. It is felt that this improves the balance in long-term incentive plans by providing a portion of the award based on measures that are within management's control. Some companies have gone further, moving away from TSR altogether in their long-term incentive plans.

As with the overflow of any once-proud institution there comes a point where the glee of revolution gives way to sympathy and even regret. We find ourselves approaching that point – is relative TSR really so bad?

After all, at some point, over long enough periods, all debates about what constitutes value must fall away: surely TSR is ultimately what it is all about. You will not find many private equity investors being delighted at great earnings performance if they cannot exit their investment at a significant return to the purchase price. In our view, the problems with TSR have arisen from two sources:

- Too much has been expected of it; and
- It has been generally poorly implemented as a measure.

To illustrate this point, we analysed the performance of the FTSE 100 over the last ten years, segmenting the companies into four quartiles of performance over the entire ten-year period.

Having segmented companies into each quartile over ten years, we have then tracked where the companies spent their time over intervening rolling three-year periods (the typical performance period over a long-term incentive plan).

A number of features come out of the analysis:

Companies that are upper quartile over ten years were rarely below median (fewer than one period in five) over intervening three-year periods.

Companies that are upper quartile over ten years spent the majority of intervening three-year periods also in the upper quartile.

Companies ending up below median were very rarely in the upper quartile.

So far so good. But the issue arises when we look at companies ending up between median and upper quartile over ten years. This is strong

performance, but such companies spent nearly half (43%) of intervening three-year periods below median.

This would have resulted in zero pay-out, even though performance over longer periods was strong. This is at the root of the demotivating impact of TSR measures.

Of course, companies that end up above median spend significantly more time in the upper quartile than their lower performing counterparts. But one of the major drivers of the perceived relevance and motivational impact of a plan is how often at least something is delivered. With these statistics, it is not surprising that relative TSR plans are viewed as demotivating in many companies.

This analysis supports our conclusions from last year. TSR plans with a requirement for at least median performance before vesting occurs will never successfully differentiate companies on between the second and third quartiles of performance over long periods.

As highlighted last year, one approach would be to allow vesting down to lower quartile. Extending the range of differentiation would take much of the emotional heat out of the debate and would actually improve the alignment between reward and performance. There are international precedents: vesting below median is

not uncommon in plans in the Netherlands, Germany, South Africa and US.

So does this mean that we should ditch TSR altogether? Not necessarily. Instead, we should recognise that if median performance is imposed as a minimum requirement, then TSR no longer works as a good differentiator of performance across the entire performance range.

However, relative TSR remains excellent at picking out the truly outstanding performers. Relative TSR plans should be focused as ‘top-slice’ plans, designed to reward upper quartile and upper decile performance with truly outstanding payments. This may mean stretching the vesting scale up beyond the upper quartile (with correspondingly higher maximum rewards) and avoiding large cliffs in payment at median performance. As a result TSR will have a lower expected value, providing just the upside in the package.

The rest of the package must adjust in response. With no vesting below median, relative TSR is not the way to provide graduated rewards for average to good performance – this must be the role of internal financial measures such as earnings per share, return on capital or cashflow.

The trend towards TSR being used in conjunction with another measure is a therefore a good one.

[Extracted from PwC’s third edition of “Executive Compensation”, FTSE 100, Review of the year 2007.]

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