



**Shareholder Alignment, Company  
Performance and Executive Pay**  
Deloitte Executive Compensation Report

June 2017

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# Preface

Welcome to our inaugural executive compensation report. This report summarises a year of research which includes an analysis of 6 years' worth of executive remuneration and company performance data and a detailed review of the remuneration reports of the JSE Top 100 companies.

With the implementation of King IV taking place there will be an even greater spotlight than in the past on the design, implementation, documentation, communication and disclosure of executive pay, Deloitte is of the view that stakeholders in South Africa require an authoritative and balanced overview of the recent past in order to prepare for and inform the debate on the ensuing future.

There is a need to establish a benchmark of the past and to provide a road map for the future to all stakeholders in the executive remuneration debate, whether they be:

- the company executives and the managers, with both internal and external consultants that take instruction from them, or
- the Boards with Remuneration Committees, advised by external and independent consultants, who will have to increasingly take ownership of and direct remuneration policy, or
- the institutional shareholders who will be, now more so than ever, in the role of overseeing and influencing both policy and practice, both from their own perspective but increasingly from a societal perspective, or
- the media and other commentators who play the very necessary role of exposing the good, the bad and the ugly of executive pay, and will be ensuring that the spotlight never dims.

The intention of this report is to inform the debate and the ensuing dialogue between companies and shareholders and to identify the major issues that all parties will face in the future years. The outcome of this review focuses in the main on the disclosure and governance linkages of executive remuneration. Other than providing a review of current practice in the Top 100 JSE listed companies in order to help companies position themselves against informed benchmarks, we have chosen to establish the broad linkages between the growth in shareholder value creation and company performance, both in relation to the growth in executive pay over a six-year period.

Our analysis yielded a mixed bag of results across different sectors. Suffice to say that, when considering the general trend rather than the more visible and often disturbing incidences of seeming abuse, there was some alignment of executive pay and shareholder value creation, although the alignment with company performance, particularly in recent years, was not so discernible.

Over the next six months, we will be releasing further reports that cover in more detail the concepts that are discussed in this report. These include:

- Alignment of executive reward to company performance and shareholder value creation.
- Governance and shareholder views and disclosure.
- Guaranteed pay and performance variable pay concepts and disclosure.

Another exciting development is the release of our online director and executive pay portal which will be available towards the end of July 2017. The portal will allow users to interrogate all the quantitative aspects discussed in this report.

Executive pay continues to attract intense media scrutiny both locally and abroad, with headlines on executive pay appearing on a frequent basis. Much of the focus this year has been on the growing inequality between those at the top of the organisation and the general workforce. As much as this is of deep concern to all South Africans, as is the rate of unemployment, we are not alone in this, as the concern spreads far wider than just South Africa. In the United States the Securities and Exchange Commission has now adopted rules which require companies to disclose the median pay of the workforce with that of the CEO and similarly, the United Kingdom Government's Green Paper on Corporate Governance Reform also suggests pay-ratio disclosure.

On a more positive note, the King Committee published the King IV Report on Corporate Governance for South Africa (King IV) on 1 November 2016. King IV is effective in respect of financial years commencing on or after 1 April 2017. King IV replaces King III in its entirety. King IV is principles-based and follows an outcomes- rather than rules-based approach and emphasises ethical leadership characteristics of accountability and transparency. Our report attempts to highlight the issues, which in our opinion will lead to a more purposeful dialogue between Company Boards, shareholders and broader societal stakeholders. A key observation from our review is that remuneration governance and disclosure, bar some shining examples, still has a way to go to ensure that the dialogue is elevated from the acrimonious debate that seems to prevail at the moment.

Our analysis uncovered some key trends that, in our view, definitely provide vitriol to the debate, and are as yet not well addressed or defended in the disclosure within Remuneration Reports, which provide little or no explanation as to the cause or reason for these trends. Some of the key trends identified included:

- Guaranteed pay levels within our Top 100 sample:
  - Increases to CEO guaranteed pay over the last five increase periods exceeded inflation by a considerable margin on a compound annual growth rate basis.
  - There appears to be little correlation between CEO guaranteed pay and the size and complexity of the organisation they are charged to lead. This is particularly prevalent for organisations with a market capitalisation of between R5 billion and R50 billion.
- Annual cash incentives within our Top 100 sample:
  - Annual cash incentives paid to the CEO and CFO over the last six years are considerable in relation to guaranteed pay, but with little indication of the performance linkages.
  - In the case of the CEO, we only identified 15% of instances where an incentive was not paid over the last six years.
  - In the case of the CFO, we only identified 9% of instances where an incentive was not paid over the last six years.
  - Incentives appear to be “contingent” on performance rather than to “drive” performance.

King IV will engender increased levels of dialogue between companies and their shareholders and this in turn should have a positive impact overall both on the structure of remuneration policies and quality of disclosure in implementation policies. Remuneration Committees will have to continue to focus both on the target setting process to ensure targets are appropriately stretching and on the disclosure of these targets in relation to the payouts. We also expect to see greater vigilance around malus and clawback arrangements.

The derivation of simpler, more shareholder aligned and yet more societally oriented structures will be the challenge for the future with, perhaps, the establishment of minimum shareholding as one design goal for the future.

In short we expect to see increased scrutiny from shareholders around the effective implementation of King IV and its principles during the 2017 and 2018 AGM cycle.

**Leslie Yuill**

# 1. Introduction

The last few years have presented a difficult strategic and operating environment for companies. Executive pay, like many other business aspects, has challenged companies, particularly in their pursuit of:

- Balancing executive performance and reward.
- Effective design and implementation of pay delivery mechanisms.
- Ensuring acceptable disclosure to stakeholders.

The disparity in levels of top executive pay in relation to those of the lower paid workers is a societal concern worldwide. This is particularly the case in South Africa, with its additional transformational needs and high levels of unemployment, which contribute to a powder keg of potential dissent and disharmony.

Although this must be a concern to us all, and will be the subject of a later Deloitte commentary, this report confines itself to a qualitative and quantitative review of the nature and disclosure of executive compensation, without commenting on its relevance or impact on societal considerations.

The supplementary report, of which this is an abridged version, provides a detailed analysis of the relationship between top executive pay and company performance and shareholder value in top JSE listed companies, and a full review of company disclosure on remuneration policy and implementation. The following issues and constructs have been addressed:

- An analysis of pay and particularly performance variable pay in the context of company performance and shareholder value over the last six years.
- A broad overview of the current situation and emerging key trends in the governance associated with executive compensation, the views of shareholders and some of the technical and regulatory changes that have taken or are taking place.
- An analysis of the disclosure of guaranteed pay over the last six years with an examination of its relationship to company size and sectoral orientation.
- A commentary on shareholder concerns and company disclosure on executive remuneration policy, particularly in relation to the architecture and assembly of performance variable pay.
- A detailed analysis of the performance metrics and criteria governing the vesting of performance variable pay.

The analysis is based entirely on the information disclosed in the Annual / Integrated Reports and financial accounts of companies in the JSE top 100, as at September 2016, and so includes the 2015 pay disclosures for those companies that have December to mid-year year-ends.

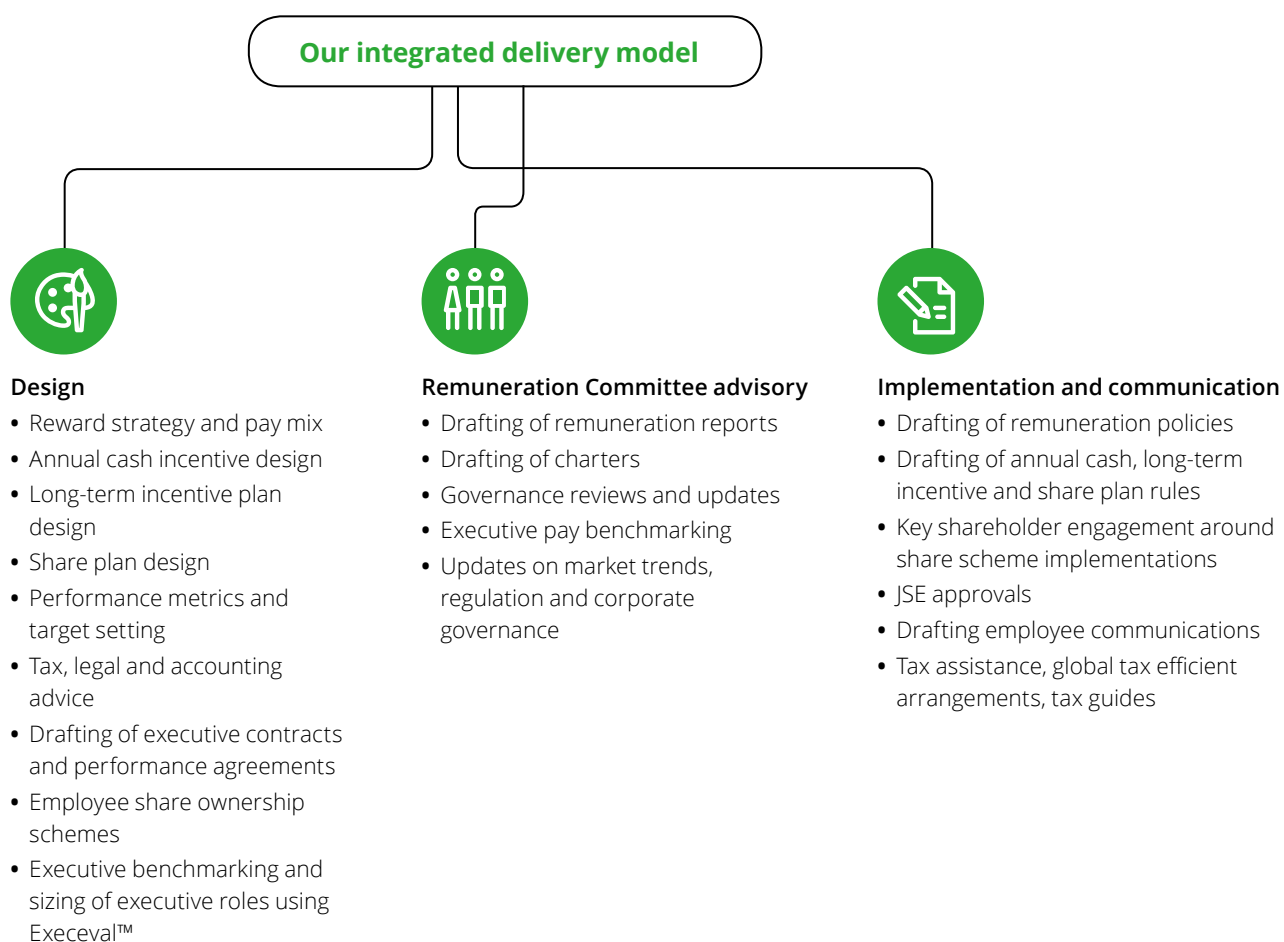
Although not specifically addressed as part of the analysis the following discussion points are also presented, as it is felt that no discussion as to the future of executive pay can be undertaken without their consideration:

- A discussion and summary analysis around the emerging debate around executive share ownership.
- A review of the seemingly complex accounting treatment of share based payments that influences and complicates share plan design and implementation.
- A review of the similarly complex tax treatment of share based offers and payments that influences and complicates share plan design and implementation, and which currently are subject to uncertainty.

## How we can help you

The Deloitte executive compensation team covers all aspects of executive remuneration and share scheme design and advisory services. Our team includes remuneration, share plan, tax and accounting specialists, governance experts and lawyers. We are able to provide advice on all aspects of executive remuneration with expertise in all areas including implementation, investor relations, corporate governance, accounting, legal and tax issues.

Our offering is built around an integrated model which links all these areas.



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## 2. Table of acronyms

A detailed analysis of pay and particularly performance variable pay in the context of company performance and shareholder value over the last six years

<b>ACI</b>	Annual Cash Incentive / Short-term Incentive
<b>AFS</b>	Annual Financial Statements
<b>ALSI</b>	A Market Cap weighted index of listed companies, as published by the JSE
<b>ALSI 40</b>	A Market Cap weighted index of the top 40 listed companies, as published by the JSE
<b>Base Salary or BS</b>	Monthly pensionable salary times 12
<b>CAGR</b>	Compounded annual growth rate
<b>CEO</b>	Chief Executive Officer or top executive director
<b>CFO</b>	Chief Financial Officer or financial director
<b>Company Return</b>	An Index which is used in this report to identify the summation of any metric addressing company performance
<b>CTT</b>	Deloitte derived broad sectoral grouping of commercial, technical and trading companies
<b>EBIT</b>	Earnings before interest and tax
<b>EBITDA</b>	Earnings before interest, tax, depreciation and amortisation
<b>EVA</b>	Economic Value Add, being the surplus in earnings after allocation of funds to the WACC
<b>FPI</b>	Deloitte derived broad sectoral grouping of financial and property investment holding companies
<b>Headline earnings, or HE</b>	Earnings after tax as declared in a company's AFS
<b>HEPS</b>	Headline earnings per share
<b>IAM</b>	Deloitte derived broad sectoral grouping of industrial and manufacturing companies
<b>IFRS</b>	International Financial Reporting Standards
<b>Index</b>	The aggregate summation of all data in a particular category as at any point in time
<b>JSE</b>	Johannesburg Stock Exchange
<b>JSE Top 100</b>	A selection of the 100 plus companies listed on the JSE



<b>King III</b>	The King Code of Governance Principles for South Africa 2009 (as amended)
<b>King IV</b>	The King IV Report on Corporate Governance for South Africa 2016
<b>Large Companies</b>	JSE listed companies falling in the Market cap range of R50bn to R300bn
<b>LTI</b>	Long-term incentive
<b>LTIP</b>	Long-term (share based) incentive plan
<b>Market Cap</b>	Market capitalisation, being the product of a company's issued shares and its share price at a point in time
<b>Mid-tier Companies</b>	JSE listed companies falling in the Market cap range of R5bn to R50bn
<b>MRC</b>	Deloitte derived broad sectoral grouping of mining & resources and construction companies
<b>Pay mix</b>	The proportionality between TGP & PVP, and within PVP between ACI & LTI
<b>PVP</b>	Performance variable pay (the sum of ACI and LTI)
<b>Remuneration Return</b>	An Index which is used in this report to identify the summation of any pay metric
<b>SARS</b>	South African Revenue Services
<b>Shareholder Return</b>	An Index which is used in this report to identify the summation of any metric addressing shareholder value
<b>SV</b>	Shareholder value, being the Indexed value of Market cap and dividends granted during the year
<b>TAC</b>	TGP plus ACI
<b>TGP</b>	BS plus allowance, perks and company contribution to medical and retirement funding
<b>Top 100</b>	Deloitte derived list of 100 or so companies, based on the premier 100 plus companies currently listed on the JSE
<b>Top Companies</b>	JSE listed companies with a Market cap in excess of R300bn
<b>TR</b>	Total remuneration, being TGP, ACI and any LTI accrual in a year
<b>TSR</b>	The growth in shareholder value over a period of time, being the growth in market value on the assumption that dividends are re-invested. Can be expressed as a percentage of the share price, or in Rands terms
<b>Turnover</b>	Revenue achieved from operations
<b>WACC</b>	Weighted average cost of capital (equity plus debt)

# 3. Headline findings

The following headline findings arise from this report:

## 3.1. Alignment of executive reward to company performance and shareholder value creation

The index of top executive pay over the last five years has generally tracked an index of shareholder value that has been sustained in Rand terms.

The same index of top executive pay has generally tracked the index of company top-line performance (turnover), but outstripped that of bottom-line performance (headline earnings). Headline earnings growth over the last six years has further been exacerbated by a deterioration in the utilisation of invested capital.

## 3.2. Governance and shareholder views and disclosure

The dictates of corporate governance have placed an increasing emphasis on the nature and content of top executive pay, as well as its disclosure. The publication of King IV has further challenged executive pay stakeholders by providing a platform for enhanced shareholder vigilance and activism and more importantly, dialogue between the parties.

King IV, as with its predecessor, King III, is strong on principle, but offers little by way of guidelines to inform the executive pay debate or to identify the constructs of “best practice”. There is still a collective need to move away from an ill-informed “checklist” orientation towards a more principles based, holistic discourse and ultimate review of executive pay.

Although there are a few shining examples of well-written remuneration reports, in the vast majority, the essential elements of executive pay practice are still difficult to discern. The executive compensation industry has much to do in providing informed advice and commentary to all stakeholders, such that the executive pay controversy is translated into an informed debate towards a balanced and generally supported solution.

In order to inform this debate, Deloitte provides a comprehensive list of shareholder concerns which, if not addressed or disclosed appropriately may invoke criticism and / or trigger a negative vote.

## 3.3. Guaranteed pay and annual compensation concepts and disclosure

The very large, internationally footprinted, companies obviously pay more than their smaller counterparts do, however, amongst the mid-tier companies there is no apparent sense of top executive pay being linked to the size of the company or the complexity of the sector within which it operates.

Despite the increasing scrutiny on executive pay increases, in one way or another, executive guaranteed pay increases in general have well exceeded “inflation”.

As one would expect the differential of the CEO pay above that of the CFO is significant.

## 3.4. Performance variable pay concepts and disclosure

Almost without fail executive pay is made up of the three components of pay, guaranteed (monthly) pay, and performance variable pay, split into an annual cash bonus and a longer-term (typically share-based) incentive. There are only a few instances over a six-year period where a CEO or CFO has not earned a bonus. Although the occurrence of share-based payments is more sporadic, they are still a significant contributor to the total executive pay quantum.

An executive can expect to earn at least one times and as much as three times his base salary in performance variable pay, often when there is no discernible link to company performance or shareholder value. Although disclosure in remuneration reports on pay mix is incomplete, it would appear that there is an emerging consensus that the relationship between guaranteed pay and performance variable pay should be targeted at fifty-fifty and for maximum performance be one-third / two-thirds.

Practically, performance variable pay appears to be performance contingent pay, accruing under most circumstances other than the worst case of under-performance; and not performance driven pay resulting from out performance against targets set or in comparison to peer groups. It is almost as if executives are entitled to expect a reasonable performance bonus even when not warranted by performance.

In the selection of performance metrics governing the vesting of cash bonuses, financial metrics predominate with earnings (in one form or another) being the primary metric. Cash flow and return on capital metrics feature strongly. In the selection of performance metrics governing the vesting of share-based incentives, total shareholder return predominates, often accompanied by a headline earnings and / or return on capital metric. Typically, more than one metric is employed.

Non-financial metrics also feature to a minor extent in annual bonus metrics and to a lesser extent in share-based incentives, with their place in the scorecard determining performance being occupied / shared by operational measures, sustainability measures and / or individual measures.

The need to accommodate the requirements or expectations of an increasing number and variety of stakeholders has increased the complexity of the mechanisms of performance variable pay, and has contributed to the increasing suspicion and antipathy amongst those that debate executive pay.

### 3.5. Executive shareholding concepts and disclosure

In an attempt to engender increased shareholder alignment, an emerging trend is to orientate executive shareholding away from restricted shareholdings that provide for retention, to unrestricted share ownership that promotes shareholder alignment.

As yet only a few companies have joined this trend in practice, and it is not yet clear how companies can or will navigate to the desired state of unencumbered shareholdings equal to multiples of base salary, without adopting routes which further enhance executive reward on the way.

### 3.6. Regulatory, accounting and tax considerations

The complexity of addressing the demands of different stakeholder of executive pay is exacerbated in share plan design and implementation by the requirement to navigate through complex and often conflicting and moving demands from the regulatory, accounting and tax authorities.



# 4. Alignment of executive reward to company performance and shareholder value creation



**Remuneration Return:** *The indexed growth in aggregate executive remuneration over a period of years.*

**Shareholder Return:** *The indexed increase in aggregate shareholder value over a period of years.*

**Company Return:** *The indexed aggregate company financial growth in value over a period of years.*

This chapter addresses top executive pay and particularly performance-variable pay over the last six years, in the context of shareholder value and company performance.

The intent is to contrast the investment and performance of top executive pay (Remuneration Return) with the investment and performance of both shareholder value (Shareholder Return) and company value (Company Return).

Although the detailed analysis has spanned six years, well over one hundred listed companies, and the two top executive positions in each company, the aim is not to expose or comment on the outliers but rather provide an overall impression as to the relationships that have prevailed over recent years.

## 4.1. Methodology adopted

A full analysis has been undertaken, using an array of metrics, and the following paragraphs provide a comprehensive analysis and commentary.

**The following approach has been selected to explore the above relationships:**

- Notwithstanding the depth of analysis undertaken, rather than providing an overwhelming plethora of statistics, a decision was taken to adopt an indexed approach to ensure that the key trends were easily identifiable.
- For a chosen population of companies, the 2010 aggregate / overall position in terms of top executive remuneration, shareholder value and company value has been calculated, and this aggregate position has been plotted year by year to reach a final position as at 2015 / 16.
- Using this methodology, Remuneration Return can be contrasted with and compared to Shareholder Return and Company Return over the same period(s).
- This indexed approach, without delving into the detail by company, identifies both visually and arithmetically whether Remuneration Return has over-performed or under-performed Shareholder Return and / or Company Return.

- The detail of any one company's out-performance or under-performance in any one year is identifiable in the full analysis upon which the indices are based, but is not shown here.
- However, comparing the relative performances of the indices allows for a balanced and informed view of the overall, aggregate performance over time of top executives in adding value to shareholders and the companies they manage.
- The implication of this indexed approach is that the index excludes a company which has not been listed on the JSE for at least three years, or whose disclosure in regard to any one element has been materially incomplete.
- In any one index analysis, those companies excluded represent less than 3% of the potential population.

## 4.2. Choice of metrics to identify return

From a large number of potential metrics, the following have been selected as being most representative and illustrative (note all acronyms are defined in Chapter 2, but are also defined alongside for ease of reference):

- In establishing Remuneration Return:
  - TAC, rather than TGP, has been selected as the primary metric for top executive pay, as in the vast majority of instances over six years, cash bonuses have been paid, and therefore the investment that an executive makes and for which they expect a return is not only their guaranteed pay, but includes their expected cash bonus.
  - TR is also depicted, but is given less prominence as the share-based accruals are intermittent and therefore their timing can distort the sense of the index.

- In order to represent Shareholder Return in the analysis, Market Cap, TSR and HEPS have been analysed, Market Cap and TSR combining in a metric termed Shareholder Value (SV).
- In order to represent Company Return in the analysis, headline earning (HE), Turnover and EVA have been selected. EVA cannot be sensibly indexed so it is portrayed visually as the difference in total headline earnings and the total cost of capital utilised in generating earnings.

## 4.3. Shareholder value alignment: Remuneration return relative to shareholder return

During the period under review, share prices have grown steadily, although growth has stalled recently.

CEO TAC grew from an aggregate base of R973 million to R1 624 million, an increase in the index to 167%. During the same period, the index of Shareholder Value grew to 176%, while that of the JSE All Share Index (ALSI) grew to 155%. In contrast, TR grew to only 119%.

Thus, CEO annual pay in the Top 100 companies tracked but slightly underperformed shareholder value over the period, but both indices tracked and finally out-performed the ALSI.

CEO TR, perhaps coming off a relatively high base, initially declined, and then recovered to track the other indices and post a final index result well below the other metric indices, but still positive.

Overall, the tracking and final position of the Remuneration and Shareholder Returns indicate that the "investment" of executives in their pay has underperformed the investment made by shareholders, but not significantly so.



**TGP:** Total guaranteed pay = Base salary plus allowances & company medical and / or retirement funding.

**TAC:** Total annual compensation = TGP plus cash bonus.

**TR:** Total remuneration = TAC plus accrual value in year from any long-term (share based) incentive.

**Market Cap:** the total value of the issued share capital, calculated by multiplying the current company share price by the number of shares in issue.

**ALSI:** JSE All share index, a Market Cap. weighted index of all listed shares on the JSE.

**TSR:** Total shareholder return, calculated as the appreciation in value (Market Cap) of a portfolio of shares on the assumption that all dividends are reinvested in the portfolio.

**SV (Shareholder value):** calculated as Market Cap., plus the value of dividends accruing in preceding year.



**HE:** *Headline earnings.*

**HEPS:** *Headline earnings per share.*

**Turnover:** *Gross revenue from operations.*

**EVA (Economic value add):** *the surplus of earnings after a company has paid for its weighted average cost of capital (equity and debt).*

#### 4.4. Company value performance: Remuneration return relative to company return

During the period under review, company performances have been beset by a number of negative of economic, political and market forces.

The CEO TAC index of 167% contrasts with aggregate company turnover that grew to 163% and aggregate company headline earnings that grew steadily but then finally fell off to only 115%.

Thus, CEO annual pay in the Top 100 companies tracked and slightly out-performed company turnover over the period, but after an initial under-performance and then a subsequent tracking of company earnings, finally out-performed the index, when earnings dropped significantly in the last year.

#### 4.5. Economic value add

In the 2015 / 2016 reporting period it is apparent that the relatively lackluster earnings performance was achieved only by an increasing deterioration in economic

value add. It is apparent (although not shown here) that the major “culprits”, not surprisingly, were the financial institutions with their increasing capital adequacy requirements and the mining companies with their holding back of investment capital.

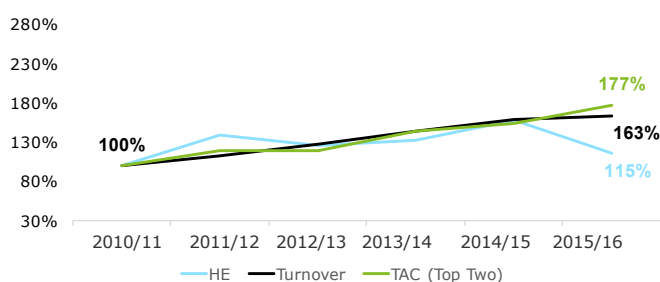
#### 4.6. Consolidated position

To give an overall combined view of value creation versus pay, TAC has been plotted against SV and HE.

The index of CEO pay has grown to 167%, slightly underperforming shareholder value but still well compensating executives despite the recent decline in earnings. It will be interesting to see the next year positioning, given the continuing economic stagnation.

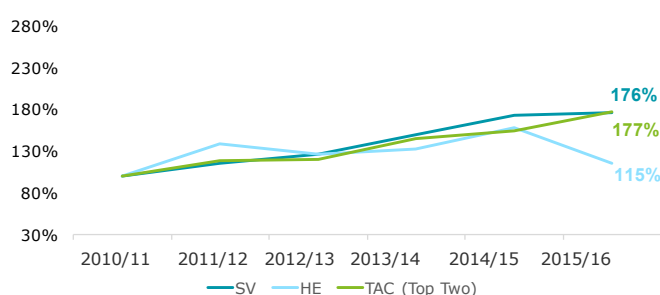
By comparison, the index of pay for the top two Executives (CEO plus CFO combined) has grown to 177%, indicating possibly that CFO's have been less penalised by the implications of the recent bear market and a declining growth in earnings. Graph 1 and 2 detail CEO and CFO pay against Turnover, HE and SV.

Top two pay versus company performance



Graph 1: Top two (CEO / CFO) pay versus Turnover and HE

Top two pay versus performance



Graph 2: Top two (CEO / CFO) pay versus SV and HE



#### 4.7. Contrast by sector

Table 1 below, and the graphs 3 - 6 delve into the detail by sector to establish whether the overall picture described above reflects a general trend or whether, at the relatively general approach, there are indications that certain sectors, to a greater or lesser extent, contribute to the phenomenon.

The following is immediately apparent:

- Whereas the other sectors have doubled or trebled shareholder value, the MRC sector has destroyed value, to the extent of approximately a third.
- In a similar vein, whereas the other sectors have grown company value approximately twofold, the MRC sector has more than halved company value.
- The reasons for this are not part of the scope of this report, but are well known, and are as much the result of the influence of exogenous factors than of executive performance.
- However the impact on MRC executive pay has not been dramatic, and shareholder and company misfortune has not correlated with executive pay.
- One could conclude from this that alignment of top executive pay to either shareholder value or company performance is not emphatic.
- In the other sectors, there appears to be more evidence that top executive pay has kept in line with or caught up with shareholder value and company performance.
- Whether or not alignment with shareholder value and company performance should be the ultimate or only determinant of reward is a moot point. However, it should no doubt prevail as a major influence on top executive pay.
- Through the last six years, collectively as a group, executive performance has perhaps satisfied, but not surpassed stakeholders requirements based on share and financial metrics.
- Whether or not the consistently large bonuses generally paid out have been warranted is however another matter for consideration.



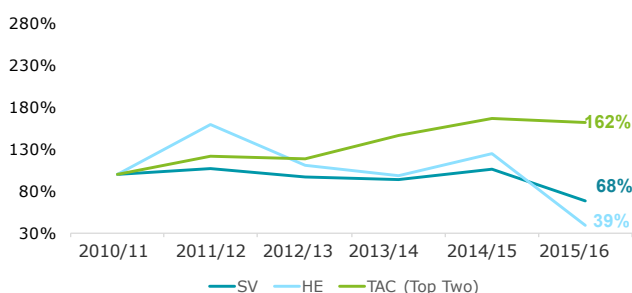
**MRC:** Mining, Construction and Resources.

**IAM:** Industrial and Manufacturing.

**CTT:** Commercial, trading and Technology.

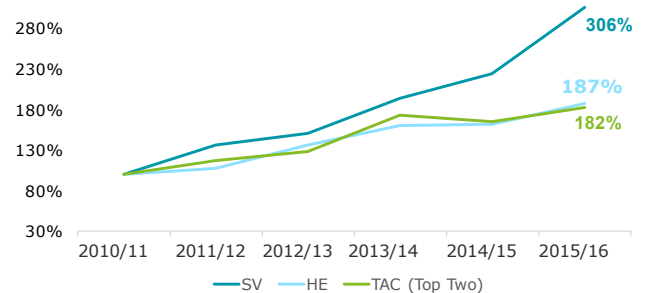
**FPI:** Financial, Property and Investment Services.

**MRC: Top two pay versus performance**



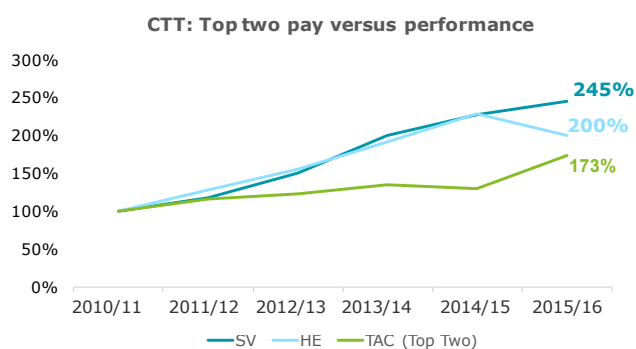
Graph 3: MRC TAC Top two pay vs. SV and HE

**IAM: Top two pay versus performance**

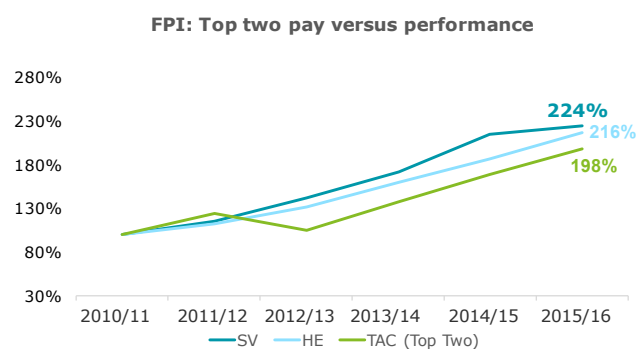


Graph 4: IAM Top two pay vs. SV and HE





Graph 5: CTT TAC Top two pay vs. SV and HE



Graph 6: FPI Top two pay vs. SV and HE

Indexed performance in terms of Remuneration Return, Shareholder Return and Company Return						
	Top Two TAC	Top Two TR	Shareholder Value	Market Cap	Turnover	Headline Earnings
Top 100	177%	140%	176%	178%	163%	115%
MRC	162%	196%	68%	69%	145%	39%
FPI	198%	196%	224%	236%	182%	216%
IAM	182%	202%	306%	307%	168%	187%
CTT	173%	87%	245%	247%	176%	200%

Table 1: Consolidated view of pay versus performance. Please note that all values marked in blue indicate growth rates below TAC growth

# 5. Summary of governance and shareholder views and disclosure

## 5.1. General commentary

Internationally and locally there is increasing scrutiny and involvement amongst institutional shareholders in the disclosure, the quantum and the delivery mechanisms of executive pay.

Where once shareholder and governance stakeholders were merely concerned with the adequacy and level of disclosure, and the quantum of delivered pay, the focus is now as much on its justifiability in terms of company performance and shareholder alignment.

In the last five years, and increasingly of late, there has been a great deal of media commentary on executive remuneration including specific coverage of the increasing number of companies receiving substantial votes against the remuneration report.

Advisory votes on Remuneration reports in the past may have seldom fallen below 50%, but the level of overall acceptance has certainly diminished, with many commentators and institutional shareholders vocal in their criticism, and votes in favour often sailing close to a 75% level.

Most recently, a Moneyweb analysis of the 100 largest JSE listed companies revealed "14 companies where more than 25% of shareholders who voted at their annual general meetings (AGMs), were not in favour".

In South Africa, the King IV Report on Corporate Governance for South Africa 2016 (King IV) has been published and, significantly, the previous approach of "apply **or** explain" in King III is now replaced with "apply **and** explain".

In general terms King IV requires that the application of all its principles is assumed and companies should explain the practices that have been implemented to give effect to each principle:

- Explanation should be provided in the form of a narrative account, with reference to practices that demonstrate application of the principle.
- The explanation should address which recommended or other practices have been implemented, and how these achieve or give effect to the principle.

More specifically, in line with international developments, remuneration has received far greater prominence in King IV. While King III required the remuneration policy to be tabled for a non-binding advisory vote of shareholders, King IV stipulates that both the remuneration policy and an implementation report (recording the various aspects of remuneration together with a link to performance) be tabled for a non-binding advisory vote.

The Board is tasked to ensure fair and responsible executive remuneration practices in light of overall employee remuneration. It should also provide for both pro-active and reactive engagement with shareholders to address their concerns.



*Where once shareholder and governance stakeholders were merely concerned with the adequacy and level of disclosure, and the quantum of delivered pay, the focus is now as much on its justifiability in terms of company performance and shareholder alignment.*

## 5.2. King IV: Remuneration policy implementation and disclosure

In line with international developments, remuneration is receiving far greater prominence in King IV, and it is clear that the responsibility for fair and equitable remuneration rests with the Board.

While King III required a company to have an approved remuneration policy that is voted on by shareholders in the form of a non-binding advisory vote, King IV takes this further by stipulating the minimum requirements of the remuneration policy.

The Code now requires the Board to oversee the implementation of a policy to:

- Attract, motivate, reward and retain human capital.
- Promote the achievement of strategic objectives within the organisation's risk appetite.
- Promote positive outcomes.
- Promote an ethical culture and responsible corporate citizenship.

The Board should also ensure that the policy results in fair and responsible executive remuneration practices in the context of overall employee remuneration.

King IV recommends that the Board oversees ongoing dialogue with the shareholder based on the mutual understanding of what performance and value creation constitutes for the purpose of evaluating the remuneration policy. In order to properly draft the policy the Board will be required to effectively articulate the link between strategy, sustainable value creation, performance and remuneration.

The policy and the implementation report will have to be approved by non-binding advisory vote by shareholders on a regular basis. Should there be a 25% or higher advisory vote against the adoption of the policy or implementation plan, the remuneration policy should set out the specific measures that the board commits to take to proactively attend to the underlying reasons for the vote. Such

measures should include an engagement process to ascertain the reasons for the dissenting votes, as well as measures to address the legitimate and reasonable objections and concerns raised by shareholders. These steps may result in amendments to the remuneration policy, or clarifying or adjusting remuneration governance or processes.

In the event that either the remuneration policy or the implementation report, or both were voted against by 25% or more of the voting rights exercised, the Board should make specific disclosures in the background statement of the remuneration report of the following year. These disclosures should indicate with whom the company engaged, and the manner and form of engagement to ascertain the reasons for dissenting votes, and the nature of steps taken to address legitimate and reasonable objections and concerns.

In addition and in accordance with the Companies Act, the fees of the non-executive director must be approved by special resolution by the shareholders within the previous two years.

King IV requires a three-part disclosure relating to remuneration including the remuneration background statement, policy and implementation:

- The background statement disclosure includes the context considerations and decisions as well as the opinion of the Remuneration Committee on whether the implementation of the policy achieved its stated objectives.
- The overview of the remuneration policy should include the elements and design of the remuneration system, the achievement of fairness and responsibility in the context of overall employee remuneration and the justification of benchmarks. Specific disclosures are required for executive directors to illustrate the application of the remuneration policy under different performance scenarios – these may include a description of the framework and performance measures used to

assess the achievement of strategic objectives and positive outcomes, including the relative weighting of each performance measure and the period of time over which it is measured. King IV recommends the use of performance measures that support positive outcomes across the triple context (financial, environmental, and social) in which the organisation operates, and / or all the capital that the organisation uses or affects. This is a departure from linking remuneration to financial performance only, and requires an account of the performance measures and targets used as a result of which awards of variable remuneration have been made.

- Remuneration implementation disclosure includes the remuneration paid to or accrued to executive directors and prescribed officers as well as to illustrate the link between remuneration and the contribution by directors and prescribed officers to the value created across the whole of the economic, social and environmental context within which the company operates.

The Remuneration Committee will have to take cognisance of the above as this will inform the effectiveness of the committee as a whole and will be considered in the performance assessment of the individual committee members as and when their re-election comes up for review.

The mandate of the committee has moved beyond the design of executive remuneration packages and now includes the justification of the link between remuneration, value creation and performance within the social, economic and environmental context. The Remuneration Committee will have to assist the Board with the dialogue with the shareholders to ensure they are comfortable with the correlation between directors' performance, their individual and collective contribution to value creation and associated remuneration.

### 5.3. Role of the shareholders in executive compensation

The role of shareholders in executive compensation has been widely debated in the United Kingdom and it is worth repeating the founding views of the Association of British Insurers (ABI) on this matter. In 2011 / 12, ABI provided executive remuneration guidelines for listed companies offering a principles based approach, which represented then a significant change from the previous guidelines in the United Kingdom and those still predominating in South Africa.

High-level principles were set out in five key areas, and were designed to encourage shareholders and companies to look at remuneration in a more holistic way and to avoid a potential 'box ticking' approach against a set of guidelines. They were also intended to encourage Remuneration Committees to focus on the key issues of concern to shareholders without being 'bogged down' in detail. The five principles were essentially:

1. The role of shareholders: responsible to ensure that the remuneration practices and policies of the companies they invest in are aligned with shareholder interests and promote sustainable value creation but not to micro-manage the remuneration policies of companies.
2. The role of the board and directors: appointed by shareholders to run companies and act in their interests including determining remuneration; also for non-executive directors to challenge and contribute to the process of determining and implementing strategy, ensuring robust risk management processes are in place, reviewing the performance of executive directors and overseeing executive remuneration.
3. The Remuneration Committee: responsible for ensuring that shareholder interests are protected in relation to the structure and quantum of remuneration. Remuneration should be set within the context of overall company performance, aligned with strategy and agreed risk profile, fairly reward success and avoid paying more than necessary. Executive remuneration should be considered in terms of the pay policy of the company as a whole, the pay and conditions across the group and the overall cost to shareholders.
4. Remuneration policies: should be clearly aligned with strategy and promote value creation. Excessive or undeserved remuneration may undermine the efficiency of the company, affect its reputation and is not aligned with shareholder interests. The Board must consider the impact of employee remuneration on the finances of the company, the investment and capital needs of the company and dividends to shareholders.
5. Remuneration structures: this principle clearly listed the key issues that were then of the most concern to shareholders. Remuneration structures should:
  - Not be unduly complex.
  - Focus on the long term.
  - Be efficient and cost-effective in delivering strategy.
  - Be determined in the context of the market environment, performance of the company and individuals, and the size and complexity of the business.
  - Seek to address the fact that executives and shareholders can have divergent interests, particularly in relation to time horizons and the consequences of failure or corporate underperformance.
  - Carefully balance the elements of fixed and variable to avoid payment for failure and promote a long-term focus.

There has not been any similar overarching pronouncement from institutional shareholders in South Africa, and they appear to have in the past each gone their own way, and have not necessarily recognised the difference between "ensuring shareholder alignment and sustainable value creation" and "micro managing" the companies they are invested in.

On the subject of interaction between the "governing Body" (Board) and shareholders, the King IV opines in Clause 35 merely that it "should oversee that there is regular dialogue with shareholders, to create and maintain a mutual understanding of what performance and value creation means, in order to properly evaluate the remuneration policy".

### 5.4. Institutional guidelines and concerns

Shareholder guidelines exist in the United Kingdom as to the role of all stakeholders in formulating, disclosing and regulating executive pay. Although King IV will now provide the opportunity and platform for increased shareholder influence on pay, as yet there are no shareholder guidelines to enhance, the legal and governance dictates and to provide an agenda against which executive pay can be discussed and its disclosure examined and voted upon.

However, there is consensus in the United Kingdom, now emerging in South Africa, as to what are clearly unacceptable executive pay provisions, and so should be criticised and voted against by shareholders.

The majority of shares on the JSE are held and voted by institutional shareholders. With the current developments in the field of remuneration governance, and the need to address the views of their share / unit holders, institutional shareholders increasingly use guidelines (templates / checklists) in reviewing remuneration reports and approving share plans.



In the United Kingdom, the Association of Business Insurers (ABI) voting information service analyses annual reports and produces colour coded research reports for each company. One element of this is a detailed review of remuneration arrangements. Reports are coded blue if there are no particular areas of concern, amber if there are some areas of concern and red where there are serious areas of concern.

Institutional Shareholder Services (ISS), through its proxy voting service RREV, bases its voting recommendations on guidance which is consistent with the policy guidelines of the National Association of Pension Funds (NAPF), and already provides advice to a number of South African institutions.

Certain institutional shareholders in South Africa use their own checklists to a greater or lesser extent. In the recent past it appeared that in many cases, the lists were in need of updating to bring them in-line with contemporary issues. However, all tend now to follow and reflect the signals from the United Kingdom although

it is still apparent that their more informed application may be necessary.

Of concern is that they can be used somewhat arbitrarily and out of context. It is inappropriate to regard remuneration policy and governance as a series of scorecard elements (ticks and crosses), rather than seeing each element as part of a holistic and integrated whole.

### 5.5. Addressing shareholder views and concerns

In addressing shareholder views and concerns one has to recognise that shareholders are not all the same, a homogenous grouping. Their investment philosophies, and the “expectations” they have of executives, can differ considerably, as will their views on the performances that should be rewarded and the levels of such rewards.

For example is an individual shareholder a “blue chip investor” who is looking for dividend flow and long-term sustainable growth in share price, and particularly in the South African context a commitment to “corporate responsibility”. Or, in

contrast, does the shareholder have a “private equity” orientation and is looking for share price growth alone, this to be achieved over a relatively short period of time, and is not overly concerned with any major long term value concerns.

In the South African context, as in the United Kingdom, the shareholder population is predominantly made up of large institutional rather than individual shareholders. Although there are a number of individuals or smaller institutions that share the limelight of shareholder activism, it is the large institutional shareholders that are, and will increasingly become, the powerhouse behind the trends in shareholder scrutiny and influence.

- They collectively are the predominant investor and shareholder in the JSE.
- They have, and now increasingly use, their voting power.
- Many have taken upon themselves the role of and responsibility for providing guidance, scrutiny and sanction.

The guidelines or checklists that exist in support of shareholder scrutiny are at the moment many and varied. Individually they provide a guide to shareholders in their scrutiny of executive pay. Collectively they can also be used by companies wishing to establish or review or disclose their own remuneration policy.

They provide insight into those areas that shareholders are keen to have addressed, and are looking for acceptable disclosure, both that it has indeed been disclosed, and also the nature of what has been disclosed.

A negative view on any one remuneration policy element will not necessarily trigger a negative vote on the policy / report, particularly if the absence or deviation is motivated correctly. However, the evaluation of any one company's policy or implementation using such guidelines can provide an overall assessment of the company's positioning in terms of best practice.

Depending on the circumstances this assessment can be used for shareholder sanction against the company, or can be used by the company to review or adjust its policy or practice, and prepare for any pro-active debate with shareholders.

The most salient elements found in shareholder guidelines are captured below.

### **General shareholder concerns:**

- General lack of disclosure.
- Overall increases in total remuneration without acceptable justification.
- Over complexity of arrangements.
- Increases to base salary in excess of inflation.
- Base salary increases above the general increases in the company.
- Any increases at all where previous performance has been weak.

### **Shareholder concerns with respect to performance-variable pay:**

- Performance targeting that does not support the achievement of long-term growth.
- Incentive arrangements not including an overall cap, or the absence of individual limits for long-term and annual bonuses.
- The use of the same performance metrics in more than one plan.
- Any discretion applied to bonus payments or the vesting of share awards to allow a higher payout than would have otherwise been made.
- The absence of deferral and claw back provisions.
- Increases in potential reward due to, or in order to compensate for, the introduction of deferral and claw back.
- Increasing the potential bonus pay out and uncapped awards.
- Lowering of performance targets in either short-term or long-term incentives without a commensurate reduction in the bonus potential or size of the share award:
  - No disclosure on the extent to which performance targets have been met and the resultant level of vesting.
  - Any provision for retesting.

### **Shareholder concerns with respect to annual cash incentives:**

- Lack of a demonstrable link between performance and bonus pay-outs (and particularly when based on personal achievements when overall profit targets are not met):
  - Bonus targets which are not transparent.
  - Payouts not aligned with profit.
  - Lack of stretch in targets or insufficiently demanding performance targets.

- Non-disclosure of the extent to which performance targets were met in relation to bonuses paid and share awards that vest.

### **Shareholder concerns with respect to long-term (share-based incentives):**

- Insufficient disclosure on performance criteria / conditions attached to long-term share plans.
- Long-term share plans with performance periods of less than three years.
- High level of vesting at median performance.
- Significant weighting and / or lack of transparency of non-financial measures.
- Recruitment arrangements, particularly when awards have no performance conditions.
- One-off retention or transaction awards which have not been adequately justified.
- Provisions for early vesting of share awards where prorating for time and performance is not applied.
- Change in control provisions triggering earlier and / or larger payments and rewards.
- Termination arrangements, either exit payments made or policy on termination payments.
- Dividends paid on shares which subsequently lapse due to performance targets not having been met.
- Option grants to NEDs.
- Note the following are encouraged:
  - Further retention of vested shares.
  - Shareholding requirements of at least 100% of base salary.



# 6. Summary of guaranteed pay and annual compensation concepts and disclosure



**Remuneration Return:** *The indexed growth in aggregate executive remuneration over a period of years.*

**Shareholder Return:** *The indexed increase in aggregate shareholder value over a period of years.*

**Company Return:** *The indexed aggregate company financial growth in value over a period of years and shareholder alignment*

**TGP:** *Total guaranteed pay = Base salary plus allowances & company medical and / or retirement funding.*

**TAC:** *Total annual compensation = TGP plus cash bonus.*

**TR:** *Total remuneration = TAC plus accrual value in year from any long-term (share- based) incentive.*

## 6.1. Introduction

The management and disclosure of executive guaranteed pay and annual compensation can be, and has been in this report, extensively researched and analysed, as there are company law, JSE Listing, as well as a corporate governance requirements for full disclosure in annual reports / financial statements.

The analysis that follows has identified a number of trends and both confirmed and challenged a number of previously well-held notions, particularly as the analysis addresses a six-year view rather than an immediate past-year view.

The previous chapter on Remuneration Return, Shareholder Return and Company Return has identified that, whether one looks at the guaranteed pay (TGP) or the annual compensation (TAC) of top executives over a six-year period, it is apparent that in aggregate:

- In general terms the “performance” of top executive pay has not significantly outstripped the growth in shareholder value, other than in MRC.
- In general terms the “performance” of top executive pay has not far outstripped company financial performance, again with the exception of MRC.

However, there is no doubt that, across the board, growth in annual pay has far outstripped inflation, as this chapter will indicate.

For decades’ remuneration consultancies (many and varied) have surveyed the markets (many and varied) and have provided input and advice to companies on the levels of guaranteed pay (TGP) that reflect the “market”, and which should be used by companies to position (inter alia) executive pay vis-a-vis this market.

Conventional wisdom amongst consultants has been that companies should position themselves generally at or about the market median. They should further adopt a policy of paying key talent at the upper quartile, and “emerging talent” at the lower quartile, the former positioning in order to promote retention, the latter positioning in order to give the aspiring novice headroom for his advancement in pay towards full competency.

This may be true of policies addressing senior management positions but perhaps does not hold for executive positioning.

The problem in the past in terms of executive pay surveys has been the issue of sample size and composition. There are a large number of consultancies offering formal market surveys, whereas the population of top executives amongst the larger companies is relatively small.



Inevitably the sample size at executive level will be small, and the results (however they may be dressed up with a veneer of statistical sophistication) suffer from a lack of data, and particularly if and when significant participant companies migrate “to and fro” within market survey sample bases.

Executives will always be concerned about the comparability of their pay to that of their peers, and will mostly want to believe that they are at least as well paid as the others, and many will expect or demand to be placed in an advantageous position vis-a-vis their peers.

The executive placement (headhunting) industry has played a significant, albeit more informal, role in guaranteed pay determination as well. There has been considerable churn amongst executives in the last six years, with only a very few companies able to claim that they have had the same combination of CEO and CFO during the full period. Although many of the new appointments may result from an internal promotion within the company, a significant number of new appointees will have been recruited from outside. The “headhunting” market is a very aggressive market and it would not be out of order to suggest that their market reflects a 15% premium on the actual market.

## 6.2. Total guaranteed pay and total annual compensation levels

A complete survey of pay amongst the Top 100 plus JSE listed companies has been

undertaken, and although the sample is still small for any sophisticated statistical analysis it is deemed large enough to allow for authoritative commentary.

The tables and charts in this report examine high level guaranteed pay trends. A past notion supported by most commentators is that top executive pay should reflect the size and complexity of the executive role. As this report comments only on the CEO and CFO positions it is fair to assume that the size of the company and (perhaps) the operational / financial complexity of the sector in which it operates should be major determinants of pay levels for these two top roles.

The full report explores these concepts in considerable detail and supports the conclusions and commentary in this summary report. The following summary table illustrates the 2015 / 6 disclosed TGP and TAC statistics for the JSE Top 100, for all companies and then broken down into company size and sectoral groupings. The All Companies statistics do not really inform any debate or provide useful benchmarks as they represent top executive pay levels of companies with Market Caps ranging from R5 billion to R1 400 billion. In a similar vein the Market Caps of the 22 Top Companies range from R100 billion to R1 400 billion, and for the 22 Large Companies range from R20 billion to R100 billion. Even the Market Caps of the mid-tier companies range from R5 billion to R20 billion.



**Upper quartile:** middle value between the median and the highest value of the data set.

**Median:** value separating the higher half of a data sample from the lower half.

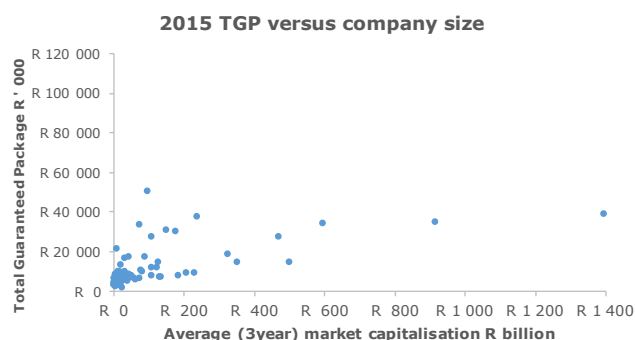
**Lower quartile:** middle value between the smallest number and the median of the data set.

**Average:** sum of a list of numbers divided by the number of numbers in the list.

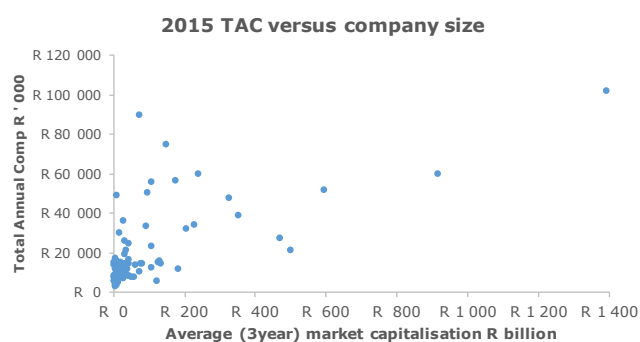
**Inter quartile range:** Lower quartile subtracted from the Upper quartile.

	All companies		Top Companies R100bn – R1 400bn		Large Companies R20bn – R100bn		Mid-Tier Companies R5bn – R20bn	
	TGP	TAC	TGP	TAC	TGP	TAC	TGP	TAC
Upper quartile	R9 322	R16 112	R30 153	R55 639	R9 322	R14 290	R6 795	R12 912
Median	R6 603	R11 625	R14 510	R32 744	R7 494	R13 169	R5 010	R10 012
Lower quartile	R4 831	R7 921	R9 041	R14 918	R5 881	R8 250	R3 836	R6 381
Average	R9 690	R17 972	R19 404	R38 327	R9 875	R14 545	R5 701	R11 020
Inter quartile	R4 491	R8 191	R21 112	R40 721	R3 441	R6 040	R2 959	R6 531

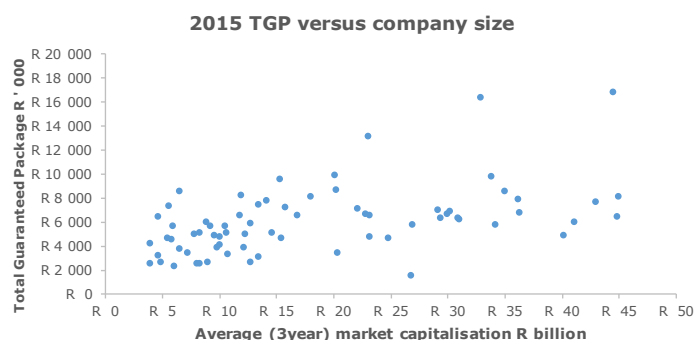
Table 2: CEO TGP and TAC by company size



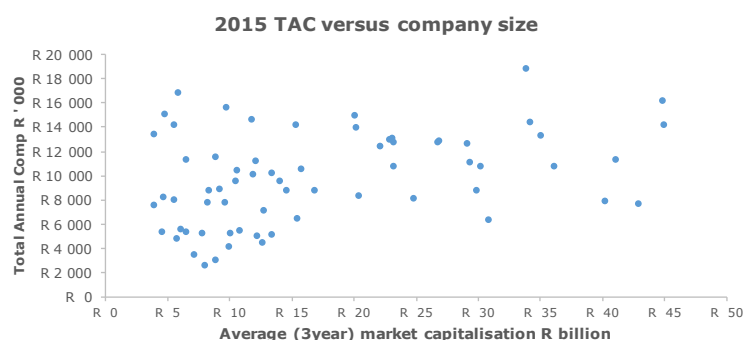
Graph 7: CEO TGP versus Market Cap



Graph 8: CEO TAC versus Market Cap



Graph 9: CEO TGP versus Market Cap (R 5b – R 50b)



Graph 10: CEO TAC versus Market Cap (R 5b – R 50b)

All that can be identified from **table 2** is that, as one would expect, very large companies pay their top executives more than the (much) smaller companies do.

Of note though is that the averages considerably exceed the medians, and in the case of the Large Companies, even the upper quartile. This phenomenon indicates that a number of significantly higher payers (outliers) exist amongst the population in each grouping: their impact influences the average statistic, without influencing the upper quartile statistic.

Also of note is that the inter quartile range is high. This indicates that there is considerable spread of data points either side of the median, and immediately brings into question whether the median of the population has any meaning or relevance as a benchmark.

These two phenomenon are illustrated visually in the graphs alongside and over, which are scatter charts illustrating the 2015 / 6 disclosed TGP and TAC levels for all the JSE Top 100 companies, plotted by company size (here indicated by taking the average of the last three year- end Market Caps).

**Graphs 7 and 8** illustrate TGP and TAC levels by company size. Of note they indicate that there are a number of smaller companies who pay as much as the very large companies.

In order to investigate this phenomenon in more detail as it pertains to the smaller companies, **graphs 9 and 10** are shown below, but only in the Market Cap range of R5 billion to R50 billion.

What is immediately obvious from the depiction alongside and over is that, if there is any trendline, its gradient is relatively flat, rather than one that emphatically recognises in pay the differentials in terms of company size.

This is further emphasised when one looks at the **graphs 11 and 12** with a vertical axis which shows pay levels only in the range zero to R20 billion a year.

Not only is there a very shallow gradient between relatively small companies and relatively large companies, but the variation above and below any such trendline is exceptional.

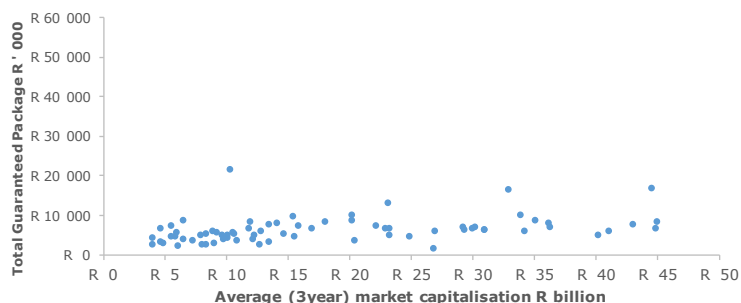
This provides a visual confirmation of the findings inferred from the median, quartile and average statistics summarised previously.

There is little evidence that company size influences top executive pay, or that statistics such as median and quartiles are either used or useful in setting benchmarks for executive pay in top JSE listed companies.

This then brings into question the assertion by most companies in the disclosure of their remuneration reports that pay levels are set in relation to benchmarks provided by market survey consultancies. If any such benchmarks truly exist and, if they have indeed been provided, there is no evidence that they have been in any way adhered to.

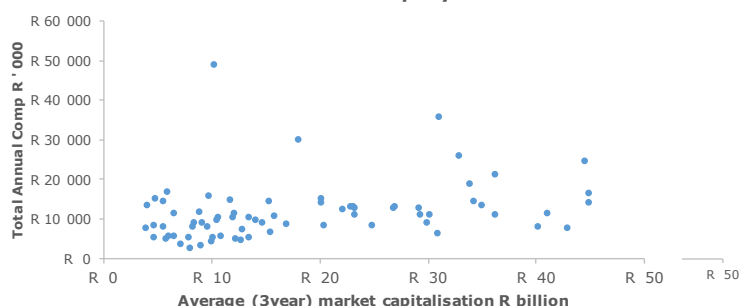
One wonders whether the setting and / or provision of “benchmarks” is driven more to address the needs of the executives demands, rather than the interests of shareholders, or indeed society at large.

**2015 TGP versus company size**



Graph 11: CEO TGP versus Market Cap (R5b – R 50bn)

**2015 TAC versus company size**



Graph 12: CEO TAC vs. Market Cap (R5b – R 50bn)



**MRC:** Mining, Construction and Resources.

**IAM:** Industrial and Manufacturing.

**CTT:** Commercial, Trading and Technology.

**FPI:** Financial, Property and Investment Services.

Over and above company size as a supposed determinant of executive pay, table 3 takes the previously represented overall statistics and then breaks them down by the four Deloitte derived sectors.

	All companies		MRC Companies		FPI Companies		IAM Companies		CTT Companies	
	TGP	TAC	TGP	TAC	TGP	TAC	TGP	TAC	TGP	TAC
Upper quartile	R9 322	R16 112	R15 437	R23 472	R9 093	R15 518	R8 689	R13 205	R7 691	R16 579
Median	R6 603	R11 625	R8 350	R13 093	R6 613	R13 488	R5 738	R8 513	R6 377	R11 644
Lower quartile	R4 831	R7 921	R5 816	R8 763	R3 823	R10 726	R4 351	R5 245	R5 140	R7 826
Average	R9 690	R17 972	R11 905	R19 951	R8 751	R19 941	R9 069	R17 233	R9 253	R16 126
Inter quartile	R4 491	R8 191	R9 621	R14 709	R5 270	R4 792	R4 338	R7 960	R2 551	R8 753

Table 3: CEO TGP and TAC by company sector

One can identify from **table 3** that the MRC Companies appear to be paying significantly more than the other three sectors, both in TGP and in TAC. However the MRC average is much higher in relation to the median than that of the other sectors. Also the inter- quartile range is relatively high. These two phenomenon in combination indicate that it is the large, internationally based, mining and resources companies that are influencing the statistics.



### 6.3. Annual pay increases

Chapter 4 identified annual pay growth as a form of Remuneration Return for executives and contrasted it with Shareholder Return and Company Return.

Moving away from the Index approach, we have analysed the 5 year and three year cagr to date of executive annual pay, and show the statistics below.

**Table 4** below depicts the growth in both TGP and TAC over the last five years and over the last three years.

	All companies				Top Companies R100bn – R1 400bn			
	Ave	UQ	Median	LQ	Ave	UQ	Median	LQ
CAGR in TGP over 5 years	10%	13%	9%	6%	14%	18%	13%	7%
CAGR in TAC over 5 years	11%	17%	9%	5%	13%	21%	12%	5%
CAGR in TGP over 3 years	11%	14%	8%	5%	16%	22%	13%	6%
CAGR in TAC over 3 years	11%	18%	7%	1%	20%	27%	14%	7%

	Large Companies R20bn – R100bn				Mid-Tier Companies R5bn – R20bn			
	Ave	UQ	Median	LQ	Ave	UQ	Median	LQ
CAGR in TGP over 5 years	8%	11%	8%	6%	10%	12%	9%	6%
CAGR in TAC over 5 years	8%	12%	8%	2%	11%	18%	10%	5%
CAGR in TGP over 3 years	8%	12%	8%	4%	10%	14%	8%	5%
CAGR in TAC over 3 years	3%	9%	6%	-6%	10%	15%	6%	1%

Table 4: Compound annual growth (CAGR) in CEO TGP and TAC over 3 and 5 years by Market Cap

The growths are shown for all companies and then separated for company size and then for broad sector. The following general assessment can be made with reference to compound annual TGP growth over three and five years respectively:

- At the lower quartile growth is in line with inflation.
- At the median growth exceeds inflation.
- At the upper quartile, growth is more than double inflation in most cases.

If one takes a broad sectoral view compound annual growth rates in TGP and TAC are similar across sectors as detailed in **table 5** below. It is apparent that the vast majority of companies over the last five / six years have not adhered to the oft-quoted norm of keeping executive pay increases in the range of inflation, and in most cases growths have exceeded the growth in pay that has been offered to lower paid workers.

	All companies				Top Companies R100bn – R1 400bn				FPI Companies			
	Ave	UQ	Median	LQ	Ave	UQ	Median	LQ	Ave	UQ	Median	LQ
CAGR in TGP over 5 years	10%	13%	9%	6%	9%	14%	8%	5%	12%	12%	9%	6%
CAGR in TAC over 5 years	11%	17%	9%	5%	8%	17%	8%	3%	13%	17%	10%	5%
CAGR in TGP over 3 years	11%	14%	8%	5%	10%	17%	8%	3%	14%	16%	8%	6%
CAGR in TAC over 3 years	11%	18%	7%	1%	7%	14%	7%	0%	19%	22%	11%	2%

	IAM Companies				CTT Companies			
	Ave	UQ	Median	LQ	Ave	UQ	Median	LQ
CAGR in TGP over 5 years	11%	15%	9%	7%	9%	11%	9%	6%
CAGR in TAC over 5 years	10%	18%	7%	5%	12%	18%	10%	5%
CAGR in TGP over 3 years	14%	18%	9%	3%	9%	12%	8%	6%
CAGR in TAC over 3 years	9%	12%	4%	0%	11%	15%	8%	2%

Table 5: Compound annual growth (CAGR) in CEO TGP and TAC over 3 and 5 years by sector

## 6.4. Guaranteed pay differentials

Not surprisingly, it is generally considered and practised that the pay of the CEO should be higher than that of the executives that report directly to him.

Table 6 below provides a summary statistical analysis of TGP differentials found in JSE Top 100 companies over the last six years between the CEO and CFO. The analysis looks at all companies and is then broken down by company size and by sector groupings.

	All	Top	Large	Mid-tier	MRC	FPI	IAM	CTT
Upper quartile	78%	71%	75%	80%	73%	75%	91%	78%
Median	63%	61%	57%	62%	58%	62%	65%	60%
Lower quartile	50%	24%	47%	49%	47%	26%	53%	43%

Table 6: TGP differentials between CEO and CFO

In the vast majority of companies over the last five years the guaranteed pay differentials between CEO and CFO have remained in the range of 50% to 80%, with a median of 63%. There does not appear to be a material change in this disposition whether one looks at companies by size or sector groupings.

## 6.5. Guaranteed pay practice in relation to policy

It would appear that the general strategies of all companies could be typified by the following:

- Although guaranteed pay levels are allegedly positioned commensurate to the size of the company, and therefore the relationship between guaranteed pay and company size should be relatively linear and graded by size, it is apparent that no such relationship exists.
- There is an indication for CEO pay that, at the mid to lower levels, there is considerable dispersion around the median, indicating perhaps that companies are paying as much for the incumbent as they are for the size of his role.
- Annual increases are generally much higher than annual inflation, although it would appear that major adjustments over the last five years may have often manifested themselves where companies have made new appointments or there has been material corporate activity or an organisational re-orientation.
- As one would expect, there is a significant premium to CEO pay in comparison to that of his direct reports, and this premium appears to be a consistent phenomenon across company size and across and within company sector.



# 7. Summary of performance variable pay concepts and disclosure

## 7.1. Introduction

Performance variable pay is the combination of annual cash incentives, deferred bonuses, and long-term (share-based) payments.

It is generally recognised that guaranteed pay should be set at the requisite level to attract and (in part) retain and develop the skills required of executive talent. However, performance variable pay, by its very nature and name, is to motivate and reward the performance of the individual / team over different time periods in striving for both company financial and operational performance and shareholder value enhancement.

Principally, performance variable pay could be distilled into two elements:

- Performance contingent pay, a portion that is expected and semi-guaranteed, to accrue under most circumstances other than the worst case of under-performance.
- Performance driven pay, a portion that results only under circumstances of out-performance; outperformance against targets set, or in comparison to peer groups.

Practically, it would appear that outperformance is handsomely rewarded but that, with a few exceptions, underperformance is not penalised. It is almost as if executives are entitled to expect a reasonable performance bonus even when not warranted by performance.

## 7.2. Pay mix

Pay mix can be defined as the targeted relationship between performance variable pay and guaranteed pay and within performance variable pay, the relationship between targeted short-term (annual) bonuses and the targeted / expected long term (three years plus) accruals from long-term (share-based) incentives.

In a philosophical context, as guaranteed pay increases with the increasing size and complexity of the role:

- The more senior the role, the more total expected pay should be oriented towards performance variable pay (the targeted / expected value from short- and long-term incentive pay).
- The more senior the role, the more performance variable pay should be oriented towards pay for long-term sustainable performance rather than pay for short-term operational performance.

Of interest in any debate on the balance between guaranteed pay the the elements of performance variable is the evidence from a number of motivational surveys that, whatever maybe targeted or expected from performance variable pay in relation to guaranteed pay, from a motivational point of view it is heavily discounted by executives, particularly if the time horizons are long into the future.

Deloitte South Africa has for a number of years offered a “House View” on pay mix, which is depicted in **table 7** below.

Reward component		Typical range	Suggested norm
Pensionable salary (PS), Total guaranteed package (TGP)		25th to 75th percentile of market benchmarks (similar size role, similar size company)	Median positioning (50th percentile for competent, 25th percentile for novice, 75th percentile for mastery)
Annual cash incentive on-target bonus for good stretch performance. 2 times on – target for exceptional performance	CEO	On target - 60% to 120% (of PS), 40% to 100% (of TGP)	50% of TGP as on target (stretch), 100% of TGP as maximum
	Executive team	On target - 35% to 100% (of PS), 35% to 80% (of TGP)	40% of TGP as on target (stretch), 80% of TGP as maximum
	Senior management	On target - 30% to 50% (of PS), 25% to 60% (of TGP)	30% of TGP as on target (stretch), 60% of TGP as maximum
Long-term (share based) incentive - "Expected value" (= PV of targeted future reward accrual"	CEO	Expected value - 70% to 170% (of PS), 50% to 140% (of TGP)	70% of TGP as annual expected value @ 15% 140% of TGP maximum
	Executive team	Expected value - 50% to 130% (of PS), 35% to 100% (of TGP)	50% of TGP as annual expected value @ 15% 100% of TGP maximum
	Senior management	Expected value - 30% to 75% (of PS), 25% to 60% (of TGP)	30% of TGP as annual expected value @ 15% 60% of TGP maximum
Pensionable salary (PS), total guaranteed package (TGP)			

Table 7: Deloitte “house view” on TGP and variable pay

If the above Deloitte House View were to be translated into the proportionality between guaranteed pay, targeted annual cash bonus, and targeted long-term accrual (and in parenthesis between guaranteed pay and performance variable pay);

For a target performance:

- 45% / 23% / 32% for a CEO  
(45% guaranteed pay / 55% performance variable pay).
- 53% / 21% / 26% for an executive  
(53% / 47%).
- 63% / 19% / 19% for a senior manager  
(63% / 37%).

In the unlikely hypothetical situation of a maximal performance, both annually and in the long-term, the figures would translate to:

- 29% / 29% / 41% for a CEO  
(29% / 71%).
- 36% / 29% / 36% for an executive  
(36% / 64%).
- 45% / 27% / 27% for a senior manager  
(45% / 55%).

Just over 50% of companies have disclosed their policy on the pay mix relationship, in one way or another. Of those companies:

- 30% provides an easily interpretable pie diagram or bar chart.
- In the others it is possible through interpretation of the written policy to identify the mix.

From the relatively limited sample the following general statements can be made:

- The proportion of guaranteed pay in the mix generally ranges from 25% to 50%, with an average of 40%.
- The proportion of annual targeted bonus pay in the mix generally ranges from 15% to 40%, with an average of 25%.
- The proportion of expected / targeted value in the long-term in the mix generally ranges from 25% to 60%, with an average of 35%.

The above pay mix percentages must be viewed with caution, however, as it not easy to establish whether the percentages of both the short-term and the long-term are in terms of on target or maximum targeted performances.

Of interest is not so much the policy on pay mix but how it turns out in practice.

**Table 8** below indicates for the full six year period, all Top 100 Companies, both CEO and CFO positions, the incidence of annual incentive payments by range. In only 12% of occurrences was no incentive paid at all in a year, and in a further 19% of occurrences was the bonus paid less than 25% of TGP. Of note also though is that bonuses in excess of 75% of TGP have occurred in only 3% of occurrences.

The CEO's appear to have fared less well than their CFO counterparts at the low end of bonus payouts but have fared better at the high end.

Percentage of occurrences when annual cash incentives were actually paid					
Cash incentive ranges (Incentive % of TGP in the year)					
In six years	No Bonus	<25%	>25%<50%	>50%<75%	>75%
Top two executives	12%	19%	45%	21%	3%
CEO	15%	15%	42%	23%	5%
CFO	9%	23%	48%	18%	2%

Table 8: Payment incidence of annual cash incentives

**Table 9** below attempts to capture the sense of pay mix both in design / disclosure and in practice for CEOs. Those in practice are the median statistics emanating from the full examination of executive pay disclosure over six years.

		In terms of TGP			Proportionality		
		TGP	ACI	LTI	TGP	ACI	LTI
Deloitte house view at on-target	CEO	100%	50%	70%	45%	23%	32%
	CFO	100%	40%	50%	53%	21%	26%
Deloitte house view at maximum	CEO	100%	100%	210%	29%	29%	41%
	CFO	100%	80%	150%	36%	29%	36%
Disclosure average	CEO / CFO	100%	63%	88%	40%	25%	25%
All companies	CEO	100%	65%	68%	43%	28%	29%
Top companies	CEO	100%	90%	120%	32%	29%	39%
Large companies	CEO	100%	60%	100%	38%	23%	38%
Mid-tier companies	CEO	100%	60%	40%	50%	30%	20%
MRC companies	CEO	100%	55%	28%	55%	30%	15%
FPI companies	CEO	100%	130%	80%	32%	42%	26%
IAM companies	CEO	100%	70%	80%	40%	28%	32%
CTT companies	CEO	100%	60%	45%	49%	29%	22%

Table 9: Pay mixes by market cap and sector

It would appear from the above table that there is relative consistency in practice at the median in terms of pay mix, and that the Deloitte house view on pay mix is not inappropriate as a design benchmark, even in its application to Top 100 Companies.

### 7.3. Performance variable pay architectures

- Commentary and analysis on performance variable pay can be assembled into the following broad plan architectural classifications:
- **Annual bonus plans:** predominantly cash settled plans which pay out an award based on the performance of the company over no more than a one year period, but which may incorporate a minor element of short- to medium-term deferral, usually in cash but sometimes in shares, but with no provision for any additional matching shares.
- **Deferred bonus plans:** annual bonus plans which incorporate a significant element of medium- to long-term deferral typically into shares and typically providing for additional matching shares which may or may not be based on performance over the deferred period. The deferral may be a requirement, or it may be at the request of the participant.
- **Co-investment plans:** plans which induce or assist participants to invest their own funds (either post tax bonus accruals or via loan finance) into shares in the company, typically introduced to encourage executive shareholding and to increase alignment with shareholder interests.



- **Appreciation plans:** include share option plans, phantom option plans and share appreciation rights plans, in which the value accruing to the participant is in the positive appreciation of the underlying share price. Settlement may be via shares or in cash. Vesting may or may not be governed by performance criteria.
- **Performance share plans:** take the form of a conditional offer of a right to a number of shares, part or all of which will vest at the end of the performance period depending on the performance of the company over this period. The value of the final award received will therefore depend both on the performance of the company and the performance of the share price over the performance period.

Each of the architectures described above have minor variations, particularly as to the factoring in of individual, company and share price performance. In addition, most companies in South Africa have more than one of such architecture in place at any time.

This variability and complexity is at odds with the increasing calls for more simplicity in performance variable pay that have been emanating recently from both shareholder and governance circles. However it is born out of the search for performance pay mechanisms that are a marriage of the different needs and requirements of various stakeholders.

Of note, a recent report from the Executive Remuneration Working Group in the UK has concluded that executive pay has become too complex and is no longer fulfilling its purpose.

#### 7.4. Current situation in performance variable pay

The most common incentive structure for executive directors in South African companies consists of an annual bonus plan, often now with a deferred bonus plan element, and a long-term incentive plan, the last mentioned typically one or other of or a combination of an appreciation plan, a co-investment plan and a performance share plan, conditional, forfeitable and or restricted.

There is little difference by company size although smaller companies appear more likely to operate a simple structure of an annual bonus and one long-term plan compared with larger companies, who usually have a number of long-term elements. These are often assembled piecemeal, but in many cases an integrated “hybrid” plan is designed and implement in one go.

There is some difference by industry sector with financial companies more likely to operate a simple structure of an annual bonus and one long-term plan compared with companies in the other sectors where most of the companies operate hybrid long-term share based incentives. The advantages of the hybrid approach is claimed to be that companies can adjust the mix between the elements from time to time in order to adjust to the evolving strategic environment, and the sometime re-ordering of the required balance between performance and reward and retention.

The following summarises the findings from a detailed study of the latest remuneration reports for the Top 100 Companies listed on the JSE:

- Participation in more than one incentive plan (including annual cash incentives, share option plans, performance share plans, co-investment plans, long-term cash plans, deferred bonus matching plans and one-off long-term plans) is found in most companies.
- Almost all companies surveyed operate some form of cash settled **annual bonus plan**, for achievement of short-term operational performance targets.
- Although there are a very few instances in which bonus payments have been curtailed, in almost all companies over the full six year period executive cash bonuses have been made, with no obvious correlation to company performance or shareholder value:
  - There is relative consistency in annual incentive architectures for executives, in which schemes are either funded by a primary performance indicator or scorecard, or driven by a shared scorecard of performance measures.
  - The primary performance metric is a profit one.
  - Scorecards may include a variety of profit indicators and can include operational (and sometimes sustainability oriented) performance metrics.
  - In most cases executive bonuses have a significant bonus portion semi-guaranteed based on individual performance.
- Approximately a quarter of the companies operate a form of **deferred bonus plan**:
  - Deferred bonus plans are funded from attendant annual cash incentive schemes, and are effectively a subsequent / delayed accrual of a bonus “earned” in a previous performance period.
  - Bonus deferrals are most often a matching of a bonus rather than an actual deferral to reduce the size of bonus.
- The previous practice of using deferral as a bonus smoothing approach, with deferrals for six months, a year and or two years is seldom seen at executive level.
- A three-year deferral is most common.
- In many cases the deferral can be an elective one with increased matching ratio.
- Matching / deferral value can be in cash but more often in restricted shares.
- Occasionally the deferral may be an elective one at the request of the participant.
- Sometimes the restricted shares are further matched with additional performance shares at the time of deferral, or further restricted shares if vesting shares are retained.
- In a number of cases **co-investment plans** operate, sometimes using a form or derivation of the above-mentioned elective deferral or, more often, plans which induce or assist participants to invest their own funds:
  - Either post tax bonus accruals.
  - Or via loan finance into shares in the company.
  - Typically introduced to encourage executive shareholding and to increase alignment with shareholder interests.
- **Long-term (share-based) incentive plans** in one form or another operate in almost all companies. In the discussion on architecture the distinction is made between:
  - Appreciation schemes in which the value accruing to the individual on exercise or settlement is that over and above the share price as at the time of offer (share option, share appreciation right, financed share purchase).
  - Full value schemes in which the value accruing to the individual on exercise or settlement is the full value of the share, on the basis that it is the performance of the company and / or the individual that warrants the settlement of a number of “free” / “nil cost” shares.
- Typically, company performance governs future vesting of the share (performance share, conditional share, forfeitable share).
- Typically, individual performance / worth dictates the offer of shares (deferred bonus, restricted share).
- A decade or so ago appreciation plans (share option plans, phantom option plans and share appreciation rights plans) predominated, now:
  - Only a small number of companies operate them in isolation as policy with regular offers to executives.
  - Some retain them for ad hoc purposes as once off offers to appointees.
  - A larger number retain them as part of a hybrid.
- By far the most popular form of share plan currently is a performance share plan in which the number or value of the final award received is dependent both on the performance of the company and the performance of the share price over the performance period. The performance criteria that govern the extent of vesting can be framed as:
  - Maximal, in which case the plan is typically referred to as forfeitable, and the number originally offered is reduced by lesser achievement, or
  - Targeted, in which case the plan is typically referred to as conditional, and the number originally offered is reduced by lesser achievement, but is also enhanced by over achievement.
- In most cases there is a threshold performance at which vesting commences.
- In some cases vesting commences from zero.
- In other cases vesting commences with a jump up to a certain level of vesting (step change):
  - In a large number of cases there is a “hidden” element of minimum vesting, which still occurs, even if threshold performance is not achieved, a form of restricted share but not offered for performance (not liked or appreciated by shareholders).



- In the forfeitable plan orientation, it is possible to document the scheme such a way that the shares (although not yet settled, and still restricted) are indeed owned, and therefore dividends are payable. This is currently under scrutiny from tax authorities.
- In both forfeitable and conditional orientations it is possible for the dividends not previously paid prior to vesting are then paid (in shares or cash) to reflect the value of dividends “paid” on the now vested / settled shares.

## 7.5. Performance metrics and criteria

Performance variable pay, by its very nature and name, is provided to motivate and reward the performance of the individual / team over different time periods and in both company financial and operational performance and shareholder value enhancement.

In the commentary the following definitions apply:

- Performance metric is defined as a metric that governs (usually in combination with other metrics) the extent of vesting in an annual cash bonus plan.
- Performance criteria is defined as that metric or combination of metrics that together govern the extent of vesting in a long-term (share based) incentive.

Performance metrics are found in all annual bonus plans and (other than in a number of legacy appreciation schemes, and a few deferred bonus schemes) and performance criteria in all forms of long-term incentives.

King III advised that companies should not duplicate metrics in different schemes, and for this reason and also because of a genuine commitment to recognise the diversity of performance, all companies employ anything from two to ten metrics either as primary drivers or in scorecards that govern the various forms of incentive plan that they operate.

Financial and operational, metrics and, increasingly, sustainability metrics are targeted in annual cash bonus plans, whereas selected financial and share based metrics tend to govern the vesting of long-term (share-based) plans.

It is outside the scope of this report to discuss in any definitive way the relative merits of the various metrics, and anyway each identified metric can by itself or in combination be entirely appropriate for any one company, whilst being inappropriate for another similar company.

However, there are a number of metrics that are generally held to be important in gauging company performance and shareholder enhancement, and these are spotlighted in the following review of current practice.

The review has been grouped for ease into the three categories of:

- Annual cash bonus plans.
- Appreciation plans.
- Full value (share based) plans.
- It is a qualitative summary of the results on a detailed quantitative examination of over a 100 Remuneration Reports, which will be reported on in more detail in the main report.

## Performance metrics in annual cash bonus plans

The major portion of companies use a scorecard of three or more metrics in their annual bonus plan, with the scorecard based wholly on financial measures in the majority of companies, although a significant number include non-financial measures and / or individual key performance areas.

Amongst the financial metrics adopted, some measure of profit is included in the scorecard, with the majority of plans adopting headline earnings as the main measure, with economic profit in one form or another often featuring.

Other financial measures such as cash flow, cost control and debt management are commonly found in cash bonus scorecards, but not so common are revenue and return on capital metrics.

Where non-financial measures are found in the scorecard, key company performance indicators, with company specific targets, “hard” measures such as operational efficiencies, new business development, and market share predominate.

“Soft” measures such as customer satisfaction and people management or employee satisfaction are used quite often, and increasingly now sustainability issues such as environment, safety and governance are influencing the scorecards.

Companies have largely disclosed the performance targets for the past year performance but have baulked at disclosing performance targets for the year ahead.



## Performance criteria in appreciation plans

There are a few (typically legacy) appreciation plans which are vanilla, i.e. with no performance criteria governing vesting, other than their allocation is only made if the company's or the individual's prior performance warrants it.

Where performance vesting is invoked it is typically based on a profit or share price measure handled in one of three ways:

- Out-performance of a hurdle rate that forms the base line for establishing the appreciation value on vesting / exercise.
- Out-performance of a hurdle rate that is a pre-requisite for vesting, notwithstanding the effluxion of time, but then once met does not influence the baseline for establishing the appreciation value on vesting / exercise.
- Performance vesting in which the extent (number) vesting is governed by performance but then the baseline for establishing the future value of appreciation on vesting / exercise is not influenced.

The hurdle rate when utilised is most often linked to inflation (CPI) and / or GDP, or in more extreme cases (typically oriented to private equity type arrangements) to the weighted average cost of capital or shareholder minimum return.

In the majority of plans the vesting patterns governed by continued employment are typically either phased over three year periods (with one third on 3rd, 4th and 5th anniversary being most common, although there are a number of plans in which 100% cliff vesting in the third year operates.

Typically, in appreciation plans individual participants may elect not to exercise on vesting but then the exercise horizon is typically set at six or seven years (where once it was ten years).

Where company performance additionally governs vesting it is measured over a fixed performance period, usually three years, with no opportunity to retest the performance conditions.

## Performance criteria in full value (share-based) plans

There are a significant number of full value plans which operate with no performance criteria governing vesting. These are usually restricted shares resulting from deferred bonus matching, or performance shares (supposedly), but with there being a minimum number that will still vest despite underperformance.

In the majority of plans a 100% cliff-vesting pattern (typically three years, occasionally four or five years) operates with performance criteria governing the extent of vesting, with no opportunity to retest the performance conditions.

The three most common performance metrics are Total Shareholder Return (TSR), Headlines Earnings per Share (HEPS) and (less often) Return on Capital, either Return on Invested Capital (ROIC) or Return on Capital Employed (ROCE). On rare occasions additional metrics are seen.

TSR features in a significant majority of performance share plans, either in a ranked TSR approach or in relation to an index or occasionally in relation to an absolute TSR target. In some cases, it is the one metric governing vesting, but is often found in weighted combination with (most commonly) HEPS or other earnings metric, or with a return on capital metric.

Plans based solely on HEPS are not common. Setting the HEPS target is a different process to TSR since this is an internal measure and therefore looking at general market practice is of less value compared with looking at past HEPS performance over a number of years and HEPS growth forecasts. HEPS growth has typically been measured relative to the consumer price index (CPIX) but there are instances in which HEPS is targeted relative to a risk free rate of return, relative to an index or relative to a comparator group, or relative to absolute growth targets set by the Board.

Return on capital metrics are usually targeted in terms of absolute growth targets (often linked to the cost of equity) or targets set in relation to the weighted average cost of capital (WACC).

## Performance vesting

Most companies require performance above upper quartile for full or maximum vesting, with typically a third or half vesting for a median, or on-target, performance. In this, there is little difference by industry or by company size although there is more likely to be larger maximal vesting in the Top Companies than in companies ranked below this level.

United Kingdom Investor guidelines state that the Remuneration Committee should satisfy itself that relative TSR performance genuinely reflects the company's underlying financial performance and therefore there is pressure to include an underpin relating to financial (typically earnings) performance.

There are a number of plans in South Africa which incorporate such a threshold level or 'hurdle' of performance, particularly where TSR is the sole performance measure, but this is not often found where TSR is used as only one of the main measures.

There are some instances of companies operating a share price or a TSR, or a return on capital, underpin where the main performance condition is a financial measure, such as HEPS, although this is less common.

As far as we are aware there are no performance share plans which provide the opportunity for performance to be retested over a further period where minimum performance targets are not met over the initial period.

### **Dividend and dividend equivalents**

A majority of full value share plans are termed forfeitable share plans, in which in theory and often in practice, executives can be deemed to be holders of the shares from the date of offer even if they may lose (forfeit) them subsequently for reasons of non-performance.

In a number of cases executives may receive dividends into the escrow account that is holding the shares. Currently there is a tax advantage to the individuals as dividends are taxed at a lower rate than income. This reading however is under scrutiny from the South African Revenues Service and may be countered or revoked.

United Kingdom guidelines state that where share awards are made there is a better alignment of interest with shareholders if the participant also receives the equivalent value of dividends accrued on vesting shares during the period from date of grant. Currently we are aware of a number of plans where provision is included in the plan rules that dividend equivalents will be paid on shares vesting.

The plan rules usually allow flexibility as to whether this will be a cash payment or an additional award of shares.

The ABI guidelines go on to state that Remuneration Committees should “also be mindful to ensure that the size of grants made on this basis takes into account reasonable expectations as to the value of the dividend stream on the company's shares over the period to vesting. Where the facility for rolled-up dividends is introduced a smaller initial grant size is required in order to target a similar level of value in the conditional share award.”

There is no evidence from current disclosures that the facility to award dividend equivalents is being taken into account in the level of awards made.



# 8. Summary of executive shareholding concepts and disclosure

## 8.1. Introduction

An increasing spotlight is being placed on the relationship between executive share ownership and its promotion of shareholder alignment. In the United Kingdom, it is now proposed that a section of the Remuneration Report focus on how policy has been implemented in the past year, companies will therefore be required to disclose:

- The company's share ownership requirements and whether they have been met.
- The total number of shares that each director owns outright.
- The total number of shares that are subject to deferral and are subject to performance conditions.

Investor guidelines suggest that executive directors and senior executives should build up significant shareholdings and unvested share awards should not count towards holdings.

Policies around shareholding, and practices to establish them, will need to differentiate between restricted share holdings that promote retention and unencumbered share holdings, which demonstrate shareholder alignment. Shareholding requirements are not a substitute for performance conditions in share-based plans.

This is an emerging trend in South Africa but as yet no best practice has been identified, but whether restricted or unencumbered, actual share holdings in South Africa appear well below those targeted in the United Kingdom.

## 8.2. Required shareholding

In the United Kingdom, the number of companies with an explicit shareholding requirement has increased significantly over the past five years. This trend is likely to continue as the pressure for a greater focus on long-term stewardship and a stronger alignment between directors and shareholders increases.

In South Africa there are no such formal stipulations yet, although for many years it has been a recognisable consideration for Remuneration Committees, and in the last few years' companies have been moving towards the United Kingdom practice.

Policies which require executive directors to build up and maintain shareholdings are now established in a number of companies, but as yet few companies have disclosed any explicit shareholding policy. Some companies are making use of deferred bonus plans, additional retention requirements on long-term plans or in some cases will require executive directors to hold shares vesting from long-term plans, or option plans, before further awards will be made, but the accent until recently has been more on placing vesting restrictions rather than encouraging unencumbered share ownership.

One of the issues facing companies is the tax treatment that may or may not prevail as and when an individual "takes on" a shareholding, and then subsequently disposes of any part of it. The uncertainty around this, described in more detail in the following Chapter.

In the United Kingdom, the shareholding requirement is usually expressed as a multiple of basic salary, although in some cases it may be a percentage of the total awards that may vest under long-term plans or may be expressed as a number of shares. Directors are usually given a period of time over which the shareholding is to be acquired. It is usual for directors to be required to hold a proportion of any shares vesting from long-term incentive plans until the shareholding guideline is attained.

In the JSE Top 100 Companies the informal targeted shareholding requirement has typically been one to two times guaranteed package however, it is often more in practice, with the shareholding requirement for the CEO likely to be higher than for other executive directors with often two to four times guaranteed package or more for the top full time executive.

# 9. JSE, accounting and tax considerations

## 9.1. Summary

Apart from the issues addressed above, executive pay design, documentation and disclosure is a veritable mine field, particularly in the field of share scheme design when one looks for an optimal solution amongst the sometimes conflicting requirements of the JSE, SARS and Treasury, and the dictates of the accounting standard, IFRS2.

These are summarised below under the two major headings, but what is apparent is that balanced design choices have to be made which inevitably result in a compromise, which reflects a company's current financial situation and, more importantly, its future performance and that of its share.

This is best illustrated in the points that follow:

- Schedule 14 of the JSE Listing requirements requires (inter alia) that the number of shares that may be utilised in the implementation of a share plan must be identified, and must be approved by shareholders in general meeting with a 75% binding majority.
- At the same time, however the JSE allows that the approved share limits need not include those shares that are purchased in the open market and transferred to participants in settlement, as long as the plan rules allow for such an approach.
- Company law prevents a company purchasing its own shares without first obtaining a 75% binding majority, unless it is in respect of previously approved share plan.
- SARS and Treasury stipulate that if an employer company issues shares in settlement it may not claim any deductibility as no expense was incurred by the company, and it is only the shareholders that are impacted, this by the dilution of their investment.
- Shareholders are now very concerned by their own dilution, but not necessarily so concerned if the company incurs an expense, as the potential dilution of their dividends as a result of the expenditure by the company is far more remote.
- The alternative to issuing shares in settlement is then for a company to incur an expenditure by buying shares in the open market and transferring them or by settling the value by way of a cash bonus.
- Many plan rules allow for settlement to be made in any of the three ways at the discretion of the Board:
  - Issue and allotment of shares (incurring shareholder dilution).
  - Acquisition and transfer of shares (incurring a company expense).
  - Provision of an equivalent value cash bonus (again incurring a company expense).
- However, before a company can make its choice on the means of settlement, up front it has to recognise the accounting implications of equity settlement versus cash settlement.
- IFRS2 requires that the fair value of any offer needs to be expensed over the vesting period (more detail below). If the offer is to be equity settled then the initial fair value is not to be adjusted other than for non-market related issues, however if the offer is to be cash-settled then each year a mark to market adjustment needs to be made to the fair value expense, going forward.
- Mark to market adjustments in the income statement can be significant particularly in times of share market volatility and can, rightly or wrongly, impact on shareholder views of earnings performance.
- So what should a company wishing to minimise its shareholder dilution, but at the same time also minimise the impact on its income statement, do to optimise its position, particularly when contemplating a volatile economic and market future?

The above bullet points are proffered to indicate there is a significant challenge for companies and their advisors in identifying an optimal solution, and there is no easy answer or simple product that can be offered.

Similarly, complex issues arise when a company has to address a solution also in the context of the individual tax consequences.

As the spotlight of shareholder scrutiny and activism, along with the vigilance of SARS and Treasury, and the concern of auditors and legal advisers, has increased, it is important that executive compensation in any organisation is a well-considered process.

Without in any way offering a formal opinion, a number of specific JSE, tax and accounting issues that need to be navigated in share scheme design, documentation and implementation, are summarised below under the accounting and tax headings.

## 9.2. Accounting treatment

### Introduction

IFRS 2 *Share-based Payment* requires an entity to recognise share-based payment transactions, such as, share options or share appreciation rights, in its financial statements, including transactions with employees. Specific requirements are included for equity-settled and cash-settled share-based payment transactions, as well as those for which the entity or the supplier has a choice of settlement by cash or equity instruments.

It is important to appreciate that IFRS 2 may be applicable even when the counterparty receives cash from the entity. This is because the scope of the Standard includes cash-settled share-based payment transactions.

The expense recognised under IFRS 2 is unaffected by whether the award is satisfied by an issue of new shares or by shares being purchased in the market.

IFRS 2 should be applied to any transaction in which an entity, receives goods or services or incurs an obligation to settle the transaction with the supplier and the arrangement entitles the other party to equity instruments or to cash or other assets of the entity for amounts that are based on the value of the equity instruments of the entity or another group entity. Additionally IFRS 2 is applicable when another group entity receives those goods or services and does not have the obligation to settle the share-based payment arrangement.

## Classification of share-based payments

Under IFRS 2, different accounting is required for different types of share-based payment transactions namely:

1. Equity-settled share-based payment transactions; and
2. Cash-settled share-based payment transactions.

These types of share-based payments are analysed below.

### 1. Equity-Settled share-based payments

IFRS 2 defines an equity-settled share-based payment transaction as “a share-based payment transaction in which the entity:

- Receives goods or services as consideration for its own equity instruments including shares or share options; or
- Receives goods or services but has no obligation to settle the transaction with the supplier”.

The goods or services received or acquired in an equity-settled share-based payment transaction are recognised as the goods are obtained or the services are received, with a corresponding increase in equity. Services are typically consumed immediately, in which case an expense is recognised as the counterparty renders service.

In some circumstances the entity may include a condition that determines whether the entity receives the services that entitle the counterparty to receive cash, other assets or equity instruments of the entity, this is referred to as a vesting condition. A vesting condition is either a service or performance condition. Additionally, an entity may include a market condition as a performance condition, this includes, attaining a specified share price or a specified amount of intrinsic value of a share option.

If the equity instruments granted do not vest immediately as they contain a vesting condition such as, the counterparty must complete a specified period of service before they are granted shares, it is presumed that the service period equals the vesting period. The services are accounted for as an expense as they are rendered by the counterparty during the vesting period, with a corresponding increase in equity.

For equity-settled share-based payment transactions, the goods or services received and the corresponding increase in equity are measured directly at the fair value of the goods or services received, unless that fair value cannot be estimated reliably.

Service conditions and performance conditions, other than market conditions are not included in the fair value at grant date. Instead, vesting conditions, other than market conditions are taken into account by adjusting the number of equity instruments included in the measurement of the transaction so that, ultimately, the amount recognised for goods or services received is based on the number of equity instruments that eventually vest.

Market conditions, such as a target share price upon which vesting is conditional, are taken into account when estimating the fair value of the equity instruments granted.

If it is not possible to estimate reliably the fair value of the goods or services received, the fair value of the equity instruments granted is used as a proxy. A limited exception to this requirement applies in rare circumstances when the entity is unable to estimate reliably the fair value of the equity instruments granted at the measurement date.





## 2. Cash-settled share-based payments

Cash-settled share-based payments apply to transactions in which the entity acquires goods or services by incurring a liability to transfer cash or other assets for amounts based on the price (or value) of the shares or other equity instruments of the entity or of another group entity. The most common examples of such arrangements are cash-settled Share Appreciation Rights (SARs).

For cash-settled share-based payment transactions, the goods or services acquired and the liability incurred are measured at the fair value of the liability. The liability is re-measured at fair value, at the end of each reporting period and the settlement date. Any changes in fair value are recognised in profit or loss for the period. Fair value should be determined in accordance with the guidance in IFRS 2, not IFRS 13 *Fair Value Measurement*.

Vesting conditions other than market conditions are not taken into account when estimating the fair value of the cash-settled share-based payment at the measurement date. Instead, they are taken into account by adjusting the number of awards included in the measurement of the liability arising from the transaction.

Market conditions (e.g. a target share price upon which vesting is conditional), as well as non-vesting conditions, are taken into account when estimating the fair value of the cash-settled share-based payment granted and when re-measuring the fair value at the end of each reporting period and at the date of settlement.

### 9.3. Tax drivers affecting executive compensation

Over the last 10 years, tax structuring opportunities have slowly been eroded through incremental changes to the tax legislation. Although pockets of exceptionally aggressive structuring are still constructed, it is generally not supported by listed companies whose shareholders are generally at arm's length.

Tax and reward professionals are closely scrutinising the continuing changes to legislation and the plethora of views of SARS and National Treasury, as these are often indicative of changes to come to the tax regime in South Africa.

The debate on increases to executive pay is in part driven by the impact that the changing tax landscape is having on take home pay for executives, and there are a number of tax associated factors having an influence on its quantum.

- Firstly, few (if any) tax breaks are available to executives based on current pay models.
- Executives have seen the highest marginal tax rate increase from 40% in 2014 / 2015 to 45% in 2017 / 2018.
- Capital gains tax has moved from an effective 10% rate to 18% in the 6-year period under review.
- The overarching view by SARS and National Treasury is that differing forms of remuneration should not have differing tax outcomes.
- According to the SARS official rates, in January 2010, the Rand was at R7.4527 to the US Dollar; by January 2017 it had moved to R13.5629. This represents an 82% deterioration over the 6-year period under review.

The comments in this section are not intended to be comprehensive but to give a high level flavour of the tax considerations affecting the executive compensation landscape. As mentioned in the preface and introduction, we do not seek to remedy disparity in pay but to provide some insight and provoke discussion on the relevant taxation laws.

## Tax rate increases

Executives have faced a 5% increase in the maximum income tax rate. In addition, the effective Capital Gains Tax rate has increased by 8%, which, while not impacting on remuneration, will be a consideration in the disposal of shares acquired and retained as part of any *minimum shareholding* requirement.

While the income tax rate may be seen to impact all executives equally at first glance, one needs to consider that their peers do not only consist of local South African executives. Many of the executives are globally employable and therefore the peer group not only includes local South African executives, but also foreign executives whom companies would look to entice to enhance their global skillset.

## SARS and National Treasury's ad hoc changes to share plan legislation

Since the introduction of section 8C of the Income Tax Act in 2004, numerous amendments have been made to the legislation. These changes have been made on an ad hoc basis, to counter perceived abuse or avoidance, rather than as a result from any overall review.

Although, in some areas scepticism by the authorities could be well founded (and therefore the ad hoc changes have been necessary), interest bodies have been calling for some time for a review of the taxation laws pertaining to share plans, as the legislation (both the tax legislation and the corresponding employers' withholding obligations), as it stands, are creating confusion and uncertainty.

Companies wanting to set up share plans (or manage existing ones) often struggle to plan for unpredictable tax changes, when awards may have a lifespan up to 10 years from grant.

For the executive, this uncertainty reduces the perceived value of any offer, particularly with the prospect of increased taxes by the time the tax event arises.

Added to the tax rate and continuous law changes, a pending change that could radically complicate the executive pay debate is the Budget announcement by the Minister of Finance to adjust the section 10(1)(o)(ii) exemption so that foreign employment income (which will include shares) will only be exempt if it is subject to tax in the foreign country.

## Different forms of remuneration – same tax treatment

SARS and National Treasury believe that a non-cash benefit should have the same final result as if it was cash and should therefore have the same tax treatment. For example, whether shares or cash are provided as a long-term incentive, the tax treatment should not favour / disadvantage one or the other.

Although it may be reasonable to tax cash and shares in the same manner, after all the employee effectively gets the same value, there are reasons why SARS and National Treasury should consider incentivising, through tax relief, the settlement of long-term incentives in shares:

- Providing shares to individuals can result in a diversified shareholding of the company, particularly for employees below executive level – a challenge faced by South Africa based on historical wealth creation for certain demographics.

- Promoting share ownership will help with the establishment of the minimum shareholding requirement concept for executives.

Delivering shares is complex. Although it is easier to deliver cash, companies do tend to settle in awards with shares. This indicates that delivery of shares under a share plan is not solely driven by tax efficiencies but by a reward strategy through a conscious election by an employer.

Over the years, cash settling was common practice amongst many foreign companies operating in South Africa due to exchange control regulations. However this is changing and there are many foreign companies who are settling awards in shares in South Africa<sup>1</sup>. This has meant that local companies have needed to look to share settled to remain competitive for top talent.

## Dividends

In a forfeitable share plan, shares are awarded up front and placed into an escrow account. The final number of shares that the participant receives is determined by the extent to which performance measures are met. These shares (even shares that were eventually forfeited) can earn dividends, which are exempt from income tax.

This is in contrast to a conditional share plan where an amount equivalent to the dividends paid over the vesting period is paid to the participants on receipt of the shares at vesting. This income however is treated as employment income and subject to income tax at marginal tax rates.

1. It should be noted that SARS has recently introduced changes to the information required when submitting a tax directive for each taxable event that arises for each participant. This antiquated system should be scrapped, as it has no advantage to SARS, employers or taxpayers other than the argument that garnishee orders can be issued against share gains. This argument is irrelevant as SARS can: at any point, request a company to withhold higher amounts from salary; shares are not cash and therefore there are many instances where the additional withholding (under a garnishee order) cannot be operated against the shares as there is no cash element; cash bonuses are used more widely than share based income yet a directive is not required.



SARS and National Treasury's latest argument is that any dividends received with a causal link to employment should be treated as employment income. This may have been an overreaction to some private companies "dividend stripping" to obtain a tax benefit. Besides the introduction of a policy that would have an immediate impact on existing plans and therefore the pockets of all levels of employees, it was shown to SARS and National Treasury that it would be commercially and practically near impossible to remain compliant as it would be very difficult to determine whether dividends were being paid to an individual subject to dividends withholding tax or income tax as the individuals may hold the shares in their own right or because they were an employee. Practically this would be onerous to govern which meant SARS and National Treasury had to go back to the drawing board. This has resulted in some new anti-avoidance rules.

The point here is that there is a mass of uncertainty on the policy of long-term incentives from a tax perspective, therefore resulting in executives likely pushing for higher incentive pay as the perception of long-term incentives is that the tax policy is a moving goalpost.

### Minimum shareholding requirements

SARS or National Treasury has not provided either guidance or legislative updates in relation to the implementation of some globally trending practices, such as *minimum shareholding*. The question that is posed frequently is whether the imposition of a *minimum shareholding* requirement would be seen as a restriction on the shares or not. If it is a restriction, it would have income tax consequences (i.e. 45% tax rate) on the growth over the holding period, or if not, it would likely be subject to CGT on disposal at 18%.

The relevance of the CGT rate increase mentioned earlier is that the executive will consider the CGT impact of the forced investment (related to their employment) and that the CGT rate could go up significantly during the executive's tenure. It has already increased effectively by 8%.

The introduction of *minimum shareholding* has also meant that some companies feel obligated to assist executives reach their holdings through various share plans. This therefore can result in inflated awards as the perceived risk of an income tax charge is conceivable. Although not obliged to, it would be progressive of SARS and National Treasury to provide their view or a framework to deal with these trending reward practices.

We believe that through careful drafting, the shares held under a company's *minimum shareholding* policy will not be subject to income tax but rather capital gains tax.

In terms of shareholder and executive alignment, it is interesting to contemplate the tax differential between the two from a tax perspective. Executives are facing a 45% income tax charge on share gains, whereas investors usually look to capital gains tax at effective rate up to 18%. Executives may receive dividend equivalents, which are taxed as revenue up to 45% versus tax free dividends received by shareholders. Executives have an increased risk as their portfolio is not diverse - not only are they working for the company, their investments are also in the company.

### International tax considerations – share plans

One factor which is encountered often is the one-jurisdictional view of tax with respect to share plan design. Companies, in their methodology for design, often do not consider the tax impact of the plan design for other countries in which they operate.

Often, a plan is designed for South African executives of a South African company and the plans are put in place with a 10-year lifespan. Companies need to consider their global expansion strategy when designing a plan.

Looking at Deloitte's latest Global Share Plan survey, it is clear that the design of plans for multinationals has become rather standardised and simplified. This is due to the requirements that the plans should be as compliant and as easy to implement and operate in as many countries as possible / necessary without increasing the costs significantly.

For this reason, we find that many companies are no longer looking for minor tax advantages in individual countries, as exceptions:

- Are difficult to manage and therefore become costly.
- Can create inequalities between participants in different countries.
- Increase the risk of non-compliance.

The tax implications across borders can be the fine line between success and failure of a plan. Failure of a plan can be a costly exercise as some countries such as France, US, Canada, UK, China to name a few have strict and punitive legislation to combat, in their view, inappropriately designed plans.

The risk of reputational damage, not only with the tax authorities but also with the participants' themselves has seen companies really evaluate any deviations from standardised plans.



On a number of occasions where assistance has been provided from a tax perspective, the amendments that have been suggested to ensure compliance in other countries have been imperative. However, if a global tax review is done after a plan has been implemented, it can result in unnecessary administration and sometimes costly changes for the client and to individuals. This sometimes results in the companies having to settle unnecessary / unplanned taxes, again resulting in increased cost of executive pay.

### **Double tax situations**

Amongst the issues that National Treasury and SARS could be addressing are the challenges faced by individuals and especially executives who travel a lot.

Although section 10(1)(o)(ii) assists a lot of residents by providing relief from paying double taxes in multiple jurisdictions, one prerequisite is that the individual needs to remain out of the country for more than 60 continuous days. This is often an impossible task for an executive who has to travel to multiple jurisdictions on a frequent basis especially back to South Africa for unavoidable meetings.

The taxpayer may therefore rely on the legislation that permits a credit for foreign taxes paid. However, this cannot be taken into account at payroll level by default, although this is permitted in some countries. Challenges arise in that the individual can be severely out of pocket whilst awaiting a refund of over withholding and may take years to be settled.

Similarly, the existence of double tax agreements (DTAs), designed to assist with double tax situations, are, in reality, not always helpful. There are instances where countries follow a different interpretation of the DTA. The result is that although an executive's income looks high, the net take home is significantly reduced through double tax.

SARS has taken the position that before they will intervene in instances where a DTA is not offering the relief it should, all local remedies should be exhausted. Many companies conducting business in a foreign jurisdiction may not wish to take court action against the government of that country due to the cost of

litigation or company profiling. Therefore, it may make financial sense to the company to rather cover the double tax hardship by increasing pay to the individuals. Unfortunately, although companies try to plan affairs appropriately, it is not always easy to predict due the impact of specific personal circumstances of the individuals.

In summary, overseas duties can have a negative personal impact on net take home pay, which cannot easily be evaluated from the outset and this may not be clear in the Annual Financial Statements of the company.





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