8 Remuneration disclosure

Key points

- Remuneration disclosure makes boards more accountable and provides information about company prospects, and can thereby reassure investors. But benefits must be weighed against compliance costs and potential commercial disadvantage.
- Disclosure requirements have evolved over many years. Currently companies each year must publish their remuneration policy and pay details for key management personnel and the five highest-paid group and company executives.
- The usefulness of remuneration reports is diminished by their length, detail and complexity, as well as by 'boiler-plating' and some crucial omissions.
  - Plain English presentation would promote investor understanding of executive pay. Company efforts to improve the readability of reports would be bolstered by guidance on best practice, including a remuneration 'checklist'.
  - Reporting the pay actually realised by executives would be useful to investors, as would fuller reporting of performance hurdles, taking account of commercial sensitivities.
- Minimising compliance costs for businesses can complement efforts to improve the quality of disclosure for shareholders.
  - There is scope to rationalise the coverage of executives named in the report, and to streamline the regulatory framework.
- There will always be some tension between report readability and length, and the desire of investors and advisers for comprehensiveness.

8.1 Current remuneration disclosure

Remuneration disclosure is one mechanism for constraining the scope for company *directors* benefiting from their position by awarding themselves excessive pay, and also for providing reassurance to shareholders that they are not doing so. And while *executives* technically do not set their own pay, disclosure of executive remuneration can make the board more accountable and reassure investors that the board is negotiating with executives at 'arm's length'.

Disclosure of remuneration packages also provides information to investors about the incentives being set for executives. This could assist them to assess the company's prospects and risk profile, such that the share price more accurately signals the market's assessment of the stream of expected profits. Thus, through improving investor confidence and providing relevant information about company prospects, disclosure could enhance efficiency in equity markets. As the OECD observes:

> A strong disclosure regime that promotes real transparency is a pivotal feature of market-based monitoring of companies and is central to shareholders' ability to exercise their ownership rights on an informed basis … Shareholders and potential investors require access to regular, reliable and comparable information in sufficient detail for them to assess the stewardship of management, and make informed decisions about the valuation, ownership and voting of shares. (2004, p. 49)

However, *unlimited* disclosure would be unlikely to deliver net benefits — for instance, detailed revelation of a company's strategy could undermine its competitive advantage and long-term performance. Again, according to the OECD:

> Disclosure requirements are not expected to place unreasonable administrative or cost burdens on enterprises. Nor are companies expected to disclose information that may endanger their competitive position unless disclosure is necessary to fully inform the investment decision and to avoid misleading the investor. (2004, pp. 49–50)

In other words, the benefits of transparency need to be balanced against compliance costs and possible adverse consequences for a company's commercial position. Furthermore, although not usually a stated objective, remuneration disclosure also brings additional information about executive pay arrangements in the market into play in negotiations between boards and senior executives, which is likely to have promoted the rapidity of pay adjustments, if not growth in pay itself (chapter 4).

Australia's disclosure requirements have been progressively strengthened

As discussed in chapter 2 (box 2.5), listed companies have been required to disclose information about executive pay for many years, but requirements have been progressively increased. For example, prior to 1998, listed companies were required to disclose pay in 'bands' for executives earning over $100 000, but executives did not have to be individually identified.

From July 1998, as part of the Corporate Law Economic Reform Program, disclosure requirements were amended to cover the actual remuneration packages of individual directors and the five highest-paid executives. These changes were consistent with pressure from various stakeholder groups, including the then

Australian Investment Managers Association (now the Investment and Financial Services Association), to bring disclosure requirements into line with the more detailed requirements of the United States and the UK's best practice disclosure methods (Clarkson et al. 2005). In July 2004, disclosure was extended to key management personnel, together with the introduction of the requirement for a separate remuneration report to be incorporated into the company's annual report. This report was to be subject to a non-binding shareholder vote.

Disclosure requirements and common practice

Under section 300A of the *Corporations Act 2001* (Cwlth), listed companies are required to publish annually in a section of the directors' report for the financial year:

- a discussion of the policy for determining remuneration
- a discussion of the relationship between the policy and company performance
- if an element of remuneration is dependent on a performance condition, a summary of the performance condition and explanation of why it was chosen
- remuneration details for key management personnel, including the five group executives and five company executives who earn the highest remuneration.

More detail on disclosure requirements contained in the Act and the accompanying regulations are set out in box 8.1. International requirements for disclosure are presented in box 8.2.

Box 8.1 **Current disclosure requirements**

The Corporations Act 2001

Remuneration details for key management personnel, including the five highest paid company executives and the five highest paid group executives include:

- where remuneration is based on equity, and is not dependent on a performance condition, an explanation of why, and board policy in relation to hedging unvested entitlements
- an explanation of the proportion of remuneration that is related to performance
- the value of options granted and exercised during the year
- the value of options that lapsed due to a performance condition not being met
- the percentage of remuneration that consists of options
- if employed under a contract, its duration, notice period and termination payments.

(Continued next page)

Box 8.1 (continued)

The Corporations Regulations 2001

The Corporations Regulations prescribe additional disclosure requirements, including:

- short-term benefits, divided into: salary and fees; short-term profit sharing and other bonuses; non-monetary benefits; and other short-term benefits
- post-employment benefits (superannuation and pensions)
- long-term benefits, separately identifying amounts due to a long-term incentive plan
- termination benefits
- share-based payments, divided into: shares; options and rights; cash-settled share-based payments; and any other share-based payments
- for each grant of a bonus, the terms and conditions of the bonus, including:
  - the grant date and the nature of the remuneration
  - the performance criteria used
  - details of any alteration in the terms of the grant
  - the percentage of the bonus paid and percentage forfeited in the financial year
  - estimates of the maximum and minimum possible value of the grant
- if the terms of a share-based payment grant have been altered:
  - the terms of the grant immediately before alteration and the new terms
  - the difference between the value of the grant before and after the alteration
- for each grant of options or rights:
  - the number that have been granted and vested during the period
  - their terms and conditions, including fair value, and exercise price and date.

In meeting these detailed remuneration report requirements, companies typically:

- include an upfront, broad statement on remuneration policy (examples are contained in box 8.3). This is often supplemented with additional statements on specific remuneration types — for example base salary, short-term incentives and long-term incentives
- do not normally separately discuss the link between the remuneration policy and company performance. Instead, the remuneration policy will sometimes include reference to company performance, while discussion of short- and long-term incentives illustrates how remuneration is related to company performance. In addition, remuneration reports often include performance information (total shareholder returns), sometimes compared to long-term incentive arrangements

Box 8.2 **Remuneration disclosure — international approaches**

Germany — public limited companies must provide a breakdown of total earnings of each member of the management board. Companies can opt out where three quarters of shareholders vote to do so and only for a maximum of five consecutive years (Federal Ministry of Justice Germany 2009).

France — in 2008, French peak business bodies Medef and AFEP (2008) jointly released a standardised tabular format for executive remuneration disclosure which details:

- remuneration for each executive director for the current and previous year, both in terms of amount due and amount already paid
- shares and options awarded or exercised that year.

In March, the representative body of the French investment management industry recommended that remuneration disclosure should be provided as a three-year summary of remuneration packages for each director to enable shareholders to track changes more easily.

United Kingdom — the *Companies Act 2006* requires detailed disclosure on remuneration policy and a breakdown of total earnings for each director. In addition, explanations must be provided for any performance conditions and methods used to assess the fulfilment of these conditions. Where performance conditions are not attached to long-term incentive plans an explanation must be provided. A summary explanation of company policy on the duration of contracts with directors, and notice periods and termination payments under such contracts, is also required.

United States — executive and director remuneration disclosure has been required for some time in the United States, with the Securities and Exchange Commission releasing strengthened requirements in October 2006 (SEC 2006). These amendments provide investors with a clearer and more complete picture of remuneration to principal executive officers, principal financial officers, the other highest paid executive officers and directors through both tabular and narrative reporting.

- discuss and present detailed information on short- and long-term incentive remuneration. Given issues of commercial sensitivity, the level of disclosure and discussion around long-term incentives is greater than that for short-term incentives (chapter 7)
- provide detailed information on relevant individuals' remuneration (usually in tables). As they cover all forms of remuneration (for example: fixed, non-monetary benefits; short- and long-term incentives (including share and option schemes); post-employment benefits; and termination pay), these data and supporting commentary generally comprise the bulk of remuneration reports.

Box 8.3 Some remuneration policy statements

BHP Billiton's 2009 remuneration report comprises 11 pages of its annual report and includes principles to:

- provide competitive rewards to attract, motivate and retain highly-skilled executives willing to work around the world
- apply demanding key performance indicators, including financial and non-financial measures of performance
- link a large component of pay to our performance and the creation of value for our shareholders
- ensure remuneration arrangements are equitable and facilitate the deployment of people around our businesses
- limit severance payments on termination to pre-established contractual arrangements that do not commit us to making unjustified payments. (BHP Billiton 2009, p. 148)

AMP's 2008 20-page remuneration report includes the following statement:

> The AMP Board's approach to executive remuneration is to align remuneration with the creation of value for AMP shareholders. AMP's remuneration is market competitive and aims to attract, retain and motivate high calibre employees who contribute to the success of AMP's business. AMP pays for performance. All executives have a significant component of their remuneration at risk. (AMP 2008, p. 12)

The Commonwealth Bank's 2009 20-page remuneration report includes guiding principles to:

- motivate employees to work as a team to produce superior sustainable performance achieving the Group's vision
- be transparent and simple to understand, administer and communicate
- be market-competitive. (Commonwealth Bank 2009, p. 67)

Although remuneration reporting appears to have worked reasonably well thus far, both shareholders and companies (as well as proxy advisers, corporate governance experts and remuneration consultants) have indicated that there is scope for improvement. The concerns over current remuneration practices give rise to two related, but separable, questions:

- What do shareholders want to see in remuneration reports? (section 8.2)
- How can disclosure requirements best meet the needs of shareholders, while minimising compliance costs to businesses? (section 8.3)

8.2 Are remuneration reports clearly communicating what investors want to know?

As the requirement to provide a remuneration report is comparatively recent, companies continue to learn and to adapt their reports to best meet the requirements

of shareholders. There has been no guidance for companies about how best to communicate the required information (for example, via a template or best practice guide) and thus companies individually have determined how to meet the requirements of the Act and communicate the required information.

A major area of concern is the length and complexity of reports, with many investors stating they find them impenetrable (box 8.4). Reports are routinely 20 pages in length, and some are over 50 pages. Both their length and complexity reflect the breadth and complexity of remuneration arrangements. They also reflect what companies consider they must do to comply with the not insignificant statutory requirements. A number of participants described the approach commonly taken by companies as legalistic 'boiler-plating' — that is, they attempt to shield themselves by using standard terms to describe arrangements. Such terminology is not particularly illuminating for investors.

Box 8.4 **Participants' views on the length and complexity of remuneration reports**

Many participants expressed views on the length and complexity of remuneration reports. Comments included:

> It is not unusual for the statutory remuneration reports of large listed companies to run to 20 pages or more of detailed disclosures which can be largely impenetrable to the lay reader. (Chartered Secretaries Australia, sub. 57, p. 18)
>
> Remuneration reports have become lengthy and very detailed. Transparency and accountability could be increased if … requirements were simplified. (Macquarie Group, sub. 52, section 2, p. 6)
>
> … the desire for greater transparency has actually led to the reverse in that remuneration reports are now so complex that they are very difficult for a typical shareholder to understand. Transparency and accountability could be increased if the remuneration report requirements were simplified … (Australian Bankers' Association, sub. 70, p. 15)
>
> Woolworths' latest remuneration report is 19 pages long and includes 9 pages of remuneration tables. We believe, the important information that a shareholder wants to understand often gets lost in the detailed requirements. (Woolworths, sub. 91, p. 9)
>
> Complex reporting requirements reduce the impact of the information being disclosed and make it more difficult for shareholders to extract meaningful information from remuneration reports. (Freehills, sub. 46, p. 7)
>
> [Remuneration disclosure] has been corrupted by linking it to accounting and other standards so that what has to be disclosed is both highly complex and, hence, difficult for even sophisticated investors to grasp and, especially in the case of equity-based long-term incentives, totally fails to provide an accurate and meaningful disclosure of what the executive has actually received for the year under report. (Allens Arthur Robinson et al., sub. DD170, p. 4)

In addition to complaints that remuneration reports are neither succinct nor 'user friendly', there is widespread concern that some requirements are not being fully complied with, and that some relevant information is omitted from the disclosure regime. Specific criticisms include that:

- discussion of remuneration policy and the links between remuneration and performance is cursory at best
- pay as *actually realised* by executives is not required to be reported
- current *ex ante* valuations of equity-based pay are inadequate
- short-term performance hurdles are rarely adequately disclosed.

These concerns are discussed below, with options to address current weaknesses in disclosure requirements canvassed in chapter 11.

What would the 'ideal' remuneration report look like?

The adequacy of remuneration disclosure can be assessed against two benchmarks: transparency and simplicity. In many respects these two factors support each other. For example, a simple, 'user friendly' remuneration report can give shareholders a strong understanding of what a company is doing. However, the goals of transparency and simplicity can also come into conflict, particularly where complex arrangements are discussed — maximum 'transparency' (disclosing everything possible) may only confuse shareholders, while an emphasis on 'simplicity' could leave shareholders with too little access to detail. Hence, it is important to consider not just what remuneration reports should contain, but also how the content should be presented.

'Best practice' examples?

The Commission understands that a number of companies are making efforts to improve the readability and presentation of material in their remuneration reports. As an illustration, Caltex's 2007-08 report was cited by some institutional investors as approaching 'best practice'. The report's use of summary flowcharts helps to promote a clearer understanding of the links between company performance and remuneration outcomes, as well as the links between an individual's total incentive payment, individual performance and department performance, and Caltex's overall performance. The report explains that Caltex's overall performance determines incentive payments such that if the overall performance threshold is not met, no department performance payments are made. (However, a limited budget is available for the individual performance incentive.)

For the 2008-09 reporting season, some investors praised Boral's remuneration report. This may be at least partly attributable to the majority 'no' vote the company received on its remuneration report the previous year, which prompted the board to review its practices. Boral's remuneration report includes a two-page summary, outlining the results of its remuneration review and disclosing pay levels realised by senior executives (as opposed to only the accounting values). The report also discussed changes to the CEO's remuneration structure and relevant contract terms.

Nevertheless, trying to determine what is 'best practice' in designing remuneration reports is challenging. Different readers will seek different information from remuneration reports. In this regard, the style of disclosure will not only tend to vary with the company's own circumstances (for instance, the complexity of pay arrangements), but also with the composition of shareholders in any given company. Consequently, developing a 'template' for remuneration reports is unlikely to be appropriate. That said, there is a need to ensure consistent disclosure of information relevant to shareholders.

Key features for remuneration reports

Ernst and Young (sub. DD136) submitted that remuneration reports ideally should contain discussions on remuneration strategy, the use of short- and long-term incentives, the nature of contractual arrangements, and the link between pay and performance. Additionally, the report should provide data on remuneration outcomes, including 'actual' pay levels (that is, the amount realised by executives, rather than the accounting-based estimates currently disclosed). Ernst and Young also suggested that remuneration reports contain a descriptive, 'at a glance' summary, to identify the main features of the remuneration framework and highlight key changes made to remuneration practices and policies. (The details of this proposal are contained in the annexe to this chapter.)

In two joint submissions, Allens Arthur Robinson, Guerdon Associates, CGI Glass Lewis and Regnan (subs. DD168 and DD170) suggested that important factors to be discussed in remuneration reports included the link between pay and performance, how remuneration was benchmarked against comparator groups, whether the different parameters of incentive schemes had been adequately tested to account for 'extreme' outcomes, and the role of remuneration committees. Included in the submissions were tables proposing how 'realisable' pay (the value of payments at vesting), fair values (the estimated value of payments at grant date) and total executive shareholdings in the company could be reported. (Further details are contained in the annexe to this chapter.)

Proposals such as these identify that shareholders are not simply interested in the amounts paid to directors and executives (the 'what'), but also the framework under which such payments are made and the justification for the amounts being offered (the 'how' and 'why'). These qualitative factors are harder to prescribe, but are nevertheless critical to the clear communication of remuneration policies and practices to shareholders. Aspects worthy of discussion include:

- how remuneration is structured to align with the company's (and ultimately shareholders') interests, taking account of the company's growth plans, strategy and risk profile
- what roles fixed pay, and short- and long-term incentives play in the company's remuneration policy
- whether the company has sought to benchmark remuneration levels and structure against relevant peers
- to what extent sensitivity analysis has been undertaken to project potential remuneration outcomes, particularly in the light of extreme share price movements and in performance against selected metrics
- given the possibility of extreme share price movements or other unexpected performance outcomes, to what degree formula-based contractual obligations can be modified to guard against 'excessive' pay
- why specific remuneration instruments have been selected, and whether simpler alternatives were considered
- what contractual provisions apply in the case of termination, particularly with regard to poor performance
- how remuneration policies and practices are evaluated over time, taking account of pay outcomes, the relationship between pay and performance, and the results of sensitivity analysis.

Improved disclosure in these areas would give shareholders a more complete understanding of companies' approaches to remuneration. In many respects, they also mirror guidance on remuneration by the Australian Prudential Regulation Authority (APRA) for financial institutions (box 8.5). That said — and as some participants noted (Hay Group, sub. DD132; PricewaterhouseCoopers, sub. DD138) — greater discussion will add to, rather than subtract from, the length of remuneration reports. This effect may be mitigated by changes in other areas.

Box 8.5 **APRA's requirements for remuneration policies in the financial sector**

From April 2010, financial institutions regulated by APRA will be required to have a formal remuneration policy. While the contents of such a policy will vary between institutions (in particular, APRA acknowledges that larger, publicly-listed institutions will likely have more complex policies), factors that are expected to be discussed include:

- how remuneration is adjusted for risk
- how performance is measured (and how these outcomes are reviewed over time)
- the mix of fixed and incentive-based pay
- how 'extreme outcomes' are addressed — particularly where the financial soundness of the institution is threatened, but also in other circumstances (such as unexpected losses or reputational damage)
- the link between pay and performance, with specific regard to:
  - equity-based payments (and deferral of rewards)
  - executive lending and leveraging arrangements
  - sign-on bonuses and termination payments
  - hedging policies
  - perquisites.

Source: APRA (2009c).

Disclosure of remuneration policy and the link to performance

Various proposals have been made to reduce the length and complexity of remuneration reports, as well as to enhance their readability, including:

- streamlining existing reporting requirements (section 8.3)
- requiring a short-form report, additional to the existing report
- a plain English approach to describing remuneration policy and arrangements.

While a short-form report could enhance accessibility for investors, it would also impose an additional burden on companies. Production of the remuneration report already involves significant time and effort for companies and their boards (box 8.6). Moreover, in practice, if a short-form report simply replicated a subset of complex material from the full report or, at the other extreme, gave an overly simplistic and potentially misleading view of complex remuneration structures, it would not add value.

Box 8.6 The compliance burden

On the issues of cost and time to produce a remuneration report, Freehills made the following comments:

> The cost to the company associated with producing a remuneration report is substantial. These costs arise from the significant time and effort required from management to draft the remuneration report, the engagement of external consultants to assist with this specialised task, as well as the cost of obtaining appropriate legal and audit compliance checks.
>
> Simplifying the disclosure requirements … could reduce these compliance costs, and will have the corresponding advantage of encouraging companies to approach the remuneration report as a meaningful communication tool (as was intended by the legislature), rather than a 'compliance exercise'. (sub. 46, p. 7)

Charles Macek also commented on the time spent by non-executive directors on compliance issues such as the remuneration report, stating that 'directors are spending increasing amounts of their time on compliance to the detriment of oversight of strategic and business risk issues' (sub. 55, p. 13). He also noted that the workload of the remuneration committee chair is approaching and sometimes exceeding that of the audit committee chair, with 'the latter committee [having] oversight of all of the company's risks while the former is merely dealing with one set of contracts' (sub. 55, p. 13).

Enhanced accessibility might be better achieved, at lower cost, by clearer presentation of material, including the provision of a succinct overview or summary of remuneration policy and arrangements at the beginning of the report.

A summary of remuneration policy and arrangements?

A company's remuneration policy provides information on how remuneration of key management personnel is determined and the philosophy behind that approach. In addition, it can provide an indication of the company's broader approach to performance and strategy.

Section 300A of the Corporations Act does not prescribe what should be covered in the policy, simply stating the remuneration report should include discussion of board policy for determining the nature and amount of remuneration of key management personnel. Because of the wide range of companies to which the Act applies, non-prescription arguably is appropriate (box 8.3 includes examples of remuneration policies).

But given the length and complexity of remuneration reports, a summary presentation of company remuneration policy and arrangements could be helpful to investors.

As noted by the Australian Council of Super Investors (ACSI):

> ACSI recognises that … it is very challenging for a company to provide in 'plain English' a snapshot of its philosophy on remuneration and the implications this has on key management personnel … In particular, ACSI would support the listing rules and relevant legislation to encourage a brief summary of a company's approach in plain English … [on] the company's philosophy on remuneration, in particular the synergies with strategy and performance objectives … (sub. 71, p. 11)

Similarly, the Australian Bankers' Association stated:

> Transparency and accountability could be increased if the remuneration report requirements were simplified and focused on information that shareholders are really interested in, namely:
>
> - What is the company's remuneration policy and is there an appropriate level of remuneration governance? (sub. 70, p. 15)

Other submissions, including from ACSI (sub. DD156), Charles Macek (sub. 55), Chartered Secretaries Australia (sub. 57), CGI Glass Lewis and Guerdon Associates (sub. 80), Hay Group (sub. 84), Kym Sheehan (sub. DD137), PricewaterhouseCoopers (subs. 85 and DD138) and Ernst and Young (subs. 92 and DD136), also identified scope to improve clarity in the discussion of remuneration policy and arrangements.

Nonetheless, some inquiry participants expressed reservations about a plain English summary (for example, Australian Shareholders' Association, sub. DD121; Australian Securities Exchange (ASX), sub. DD142). KPMG observed:

> The inclusion of a plain-English summary of remuneration policies is unlikely to address the issues of complexity and ability to be readily understood by investors. Rather, it is likely to increase the overall length of the remuneration report, add to compliance costs and lead to unnecessary further debate where investors seek to reconcile points of detail in the statutory report with the general comments in the plain-English section. In addition, what is considered plain-English is subjective and likely to differ between readers. (sub. DD145, p. 2)

Other participants suggested that a summary be 'non-statutory' in nature (for example, Chartered Secretaries Australia, subs. 57 and DD147; National Australia Bank, sub. DD153). This suggestion arose from concerns that a summary of companies' remuneration policies, if it were prescribed by the Corporations Act, would be subject to the same legal requirements as the rest of the remuneration report. As such, its comprehensibility as a 'plain English' document would likely be compromised by legalistic language. Still, 'plain English' explanations have been mandated in other areas with some success (box 8.7), including in the United States with respect to remuneration disclosure (box 8.8).

Box 8.7 **Experiences with plain language**

Some participants expressed concern about mandating 'plain English' reporting. For example, The Business Council of Australia argued:

> Companies will most likely have to obtain legal advice to ensure that they have drafted a 'plain English' summary. It is difficult to see how the concept of 'plain English' can be appropriately defined in the law or how companies will comply with the requirement from a legal perspective. (sub. DD152, p. 13)

However, there are several examples from around the world where plain language has been legislated for.

- In the **United States**, warranties have had to be produced in 'simple and readily understood language' since 1975. Some states have enacted laws mandating plain language be used in residential leases and consumer contracts. Another example is a requirement by the SEC for prospectuses to be 'clear, concise and understandable' and be drafted using 'plain English principles' (box 8.8). To assist in this process, the SEC has produced a 'plain English' handbook for US companies.
- Since 2000, **Canada** has required mutual prospectuses to be drafted in plain language. Additionally, many provinces require contracts to be drafted in 'plain', 'comprehensible' or 'intelligible' language.
- The **European Union** has enacted requirements for standard terms in consumer contracts to be expressed in 'plain, intelligible language'. Failure to comply can result in a contract term being ruled unfair.

Source: Asprey (2004).

Requiring plain English explanations might provide a useful signal even if it were impractical to enforce fully in practice. To help companies improve their reports, there could be merit in representative (including investor) bodies developing a best practice guide. (As noted in box 8.7, the Securities and Exchange Commission (SEC) produces a plain English handbook for companies in the United States.) In addition, or as an alternative, company reports that clearly convey information to investors could be identified and publicised as best practice.

Disclosure of 'actual' pay

Remuneration reports currently emphasise payments granted to an executive in a given financial period. Typically in the case of cash payments — base salary or annual cash bonuses — the executive realises the full benefit at granting. However, this is often not the case for equity-based remuneration, where an award granted today might not be paid out for years (consistent with promoting long-term performance). Rather than disclosing the value of equity the executive ultimately

receives, remuneration reports reveal only accounting costs — essentially the contingent liability for the company.

Box 8.8 **'Plain English' principles**

In 2006, the SEC announced amendments to the US remuneration disclosure regime. As part of the changes, the SEC required companies to adhere to 'plain English' principles in reporting director and executive remuneration. The SEC noted that companies should:

- present information in clear, concise sections, paragraphs and sentences
- use short sentences
- use definite, concrete, everyday words
- use the active voice
- avoid multiple negatives
- use descriptive headings and subheadings
- use a tabular presentation or bullet lists for complex material, wherever possible
- avoid legal jargon and highly technical business and other terminology
- avoid frequent reliance on glossaries or defined terms as the primary means of explaining information
- define terms in the glossary or other section of the document only if the meaning is unclear from the context
- use a glossary only if it facilitates understanding of the disclosure
- in designing the presentation of the information, include pictures, logos, charts, graphs, schedules, tables or other design elements so long as the design is not misleading and the required information is clear, understandable, consistent with applicable disclosure requirements and any other included information, drawn to scale and not misleading. (SEC 2006, p. 53 209)

Consistent with these, the SEC also advised companies to avoid:

- legalistic or overly complex presentations that make the substance of the disclosure difficult to understand
- vague 'boiler plate' explanations that are overly generic
- complex information copied directly from legal documents without any clear and concise explanation of the provision(s)
- disclosure repeated in different sections of the document that increases the size of the document but does not enhance the quality of the information. (SEC 2006, p. 53 209)

As discussed in chapter 7 and appendix E, under accounting standards, the cost to the company of equity-based payments must be calculated at the *grant* date, taking into account an estimate of when the option or right will be exercised and the probability that any vesting conditions will be met (such as performance hurdles). These estimates will also be discounted for effects of time where actual payments will occur some years in the future.

Many participants expressed concern that reported equity-based pay did not represent 'actual' remuneration and, moreover, that this was not well understood by shareholders and the broader community (box 8.9). Reporting long-term incentive remuneration inevitably involves a tradeoff between ensuring reasonable time proximity and reflecting what an executive has 'actually' received. Current reporting of accounting values provides close proximity (since values for incentive payments are reported in the year that they are granted) but limited indication of what the executive will eventually take home. By contrast, 'actual' pay might not become apparent for some years after the grant date, but will give a clear indication of the gains actually received by the executive. In this regard, reporting 'actual' pay would assist shareholders in understanding companies' remuneration practices, and provide greater clarity on the link between pay and performance.

Box 8.9 **Reported *vs* actual remuneration — views from submissions**

The Joint Accounting Bodies noted the difference between actual remuneration and the cost to the company (reported remuneration):

> It is important to note that [share-based payments] are valued at fair value at the grant date and then expensed (and disclosed) by the company over the vesting period. However, … the value of the [share-based payment] to the [key management personnel] at the vesting date is unlikely to reflect the amounts recognised through the profit or loss over the vesting period. We do not consider that this is an area fully understood by users … (sub. 77, p. 3)

CGI Glass Lewis and Guerdon Associates similarly stated:

> The value of equity based incentives is required to be amortised over the performance period, which may be up to five years … The resulting figure will have no correlation to the executive's level of remuneration in the year under report. (sub. 80, p. 70)

Freehills commented:

> … the numerous disclosure requirements in respect of equity grants are both time consuming and difficult for retail shareholders to understand … the disclosures in the remuneration report should be structured on the basis of the *actual* value derived by the executives … (sub. 46, p. 7)

Mercer stated that it was:

> … concerned that current disclosure requirements are not representative of the actual remuneration received by executives … (sub. 41, p. 9)

RiskMetrics noted that equity values reported are often far below realised value:

> RiskMetrics has observed that prior to August 2006, the fair value of equity incentives granted to CEOs of large companies was routinely far below the actual realised value. (sub. 58, p. 11)

It should be noted that there is no impediment to companies voluntarily disclosing actual equity remuneration. (Indeed, some have done so — for example, Boral and National Australia Bank in 2009.) It has been conjectured that the realised gains to executives have not been disclosed because in the boom years preceding the global financial crisis, accounting values may have been systematically lower than actual equity payments. However, as discussed in chapter 4, in the absence of full information there is no way of verifying this — there are examples of some executives receiving more than accounting values, some less. Moreover, realised amounts expressed in today's dollars always will be more than estimates at grant date simply because the latter are expressed in dollars from an earlier period.

What is 'actual' pay?

Determining what has been 'actually received' is not a straightforward exercise, given the complexities associated with equity-based pay instruments. Ernst and Young (sub. DD136) noted that inconsistent approaches in disclosure currently exist among companies that have voluntarily reported 'actual' pay levels. As with other aspects of remuneration disclosure, it is important that 'actual' pay be reported in a consistent manner.

'Actual' pay should, in principle, reflect the point at which an employee receives a benefit over which they can exercise control. This does not necessarily mean when a *cash* gain has been realised — for example, the point at which shares are sold. As Hay Group argued, 'the actual realised value at the point of selling the shares is not relevant for remuneration purposes, as the sale may be deferred for many years' (sub. DD132, p. 7). Moreover, any change between the share price at vesting and upon sale reflects a capital gain or loss for the executive rather than the employment-related income. (Indeed, such gains or losses would be taxable at the capital gains tax rate rather than under the income tax system.) At the other extreme, valuing equity-based payments at grant date is not consistent with 'actual' pay either. In the case of long-term incentives, there remains a risk that the executive will not actually receive a benefit (for example, due to a failure in meeting vesting conditions).

Many inquiry participants identified the vesting point as being appropriate for defining 'actual' pay (ASX, sub. DD142; Hay Group, sub. DD132; Macquarie Group, sub. DD157; Regnan, sub. DD159). At vesting, the executive takes receipt of shares from the company, which he or she is able to sell (although the shares may still be subject to holding locks, which restrict the holder from disposing of them). At the point where shares have been transferred from the company to the executive, the shares can be valued at the market-traded price.

Guerdon Associates suggested that actual remuneration be 'defined as the value of all remuneration that vests to the employee in the fiscal period. This would include cash, contributions to superannuation, fringe benefits, the market value of shares, and the realisable value of options' (sub. DD119, p. 5).

What is the 'actual' value of an option?

A separate concern arises with options, as vesting does not confer shares on the executive, but instead the right to acquire shares at an agreed price by a specified future time. It is when this right is exercised that a cost to the company is incurred, and the executive receives a pecuniary benefit (the difference between the market share price and the agreed 'exercise' price that the executive pays). This 'intrinsic value', reflects what the company has contributed to the executive's acquisition of equity. PricewaterhouseCoopers (sub. DD138) suggested that the exercise point would be suitable for reporting 'actual' pay in the case of options.

Exercise complicates the assessment of remuneration, as this amount is partly dependent on when the executive makes a choice (that is, when he or she chooses to exercise the options). If an executive chose never to exercise an 'in the money' option (one where the share price exceeds the exercise price), he would be voluntarily forgoing part of his pay. In this case, it would seem unreasonable to disclose as 'actual' pay what the executive never received (and a cost that the company never incurred). A similar principle would apply if an executive held an option that was previously 'in the money', but which had fallen 'out of the money' (that is, the share price fell below the exercise price, rendering the option intrinsically worthless) before the option expired. In this case, had the executive exercised the option earlier (when it was 'in the money') and immediately sold the shares, he would have received a benefit. That the executive had not exercised early to claim that benefit is a function of his own judgment about timing — an issue that is more closely related to capital gains and losses than employment-related income.

In contrast, Guerdon Associates (sub. DD119) and Regnan (sub. DD159) argued that options should only be calculated at their intrinsic value at the vesting date. This 'realisable' pay reflects the benefit executives would receive if they exercised their options at the first possible opportunity. This approach would strip away the effect of gains and losses stemming from executives' own decisions on when they exercised their options. However, reporting realisable pay would also mean that an option that was 'out of the money' at vesting would be disclosed as providing no 'actual' pay to the executive (since the intrinsic value would be zero), even if the option later turned 'in the money' and was consequently exercised — with the

company incurring a remuneration-related cost that would not be revealed in the remuneration report.

An alternative to the intrinsic value approach to realisable pay is to recalculate the option's fair value at vesting. As such, an option that was 'out of the money' at vesting could still be reported as having a positive value, reflecting the potential for that option to be 'in the money' before expiration. (This approach is broadly consistent with the assessment of options for income tax purposes, although there are separate issues about option valuation in this context — see chapter 10.) An obvious drawback is that — as with grant date fair values — the actual value eventually realised by the executive might bear little resemblance to the estimate. (That said, a fair value calculated at vesting will tend to be more accurate than one calculated at grant date, since the additional time provides further information about the share price path, which in turn narrows the range of expected possible outcomes at exercise or expiry.)

In short, neither the exercise nor vesting points are ideal measures for the 'actual' value of options. Valuing at exercise will provide the best information on the cost to the company, while adopting realisable pay at vesting will give a clearer indication of the executive's remuneration income (removing the effect of capital gains or losses). However, as discussed below, valuation at vesting may have compliance cost advantages, because this is the basis for income tax assessments.

Disclosure of fair value estimates

Current valuation of long-term incentive payments relies on estimates calculated at grant date — a value that will likely differ from the true cost the company will face at exercise (if the instrument is exercised at all). As a pecuniary cost has not yet actually been incurred (rather, it is an expected future cost), valuation techniques must be used to provide an appropriate value for the company's accounts (see appendix E). This is the principle of 'fair value' accounting.

Guerdon Associates commented that 'fair value' is not currently disclosed in remuneration reports. Instead, it is used as an input to an 'accounting value'. It explained the distinction between these two terms:

> Fair value is an arm's length objective assessment of the potential market price of a compensation item in the year of grant. Accounting value includes the fair value of compensation, but amortises it over the period of service to which that item of compensation pertains. (sub. DD119, p. 6)

Box 8.10 provides an illustrative example of this difference.

Guerdon Associates (sub. DD119) and Regnan (sub. DD159) both suggested that fair value be covered in remuneration reports rather than the accounting value(which would instead be contained in the financial statements). They argued that this would give a clearer indication to investors of how much executives are granted in any given year. In the context of the earlier example, the executive's long-term incentive remuneration in year three would not be reported as including amortised amounts from his first and second years at the company, but instead the (non-amortised) entirety of the amount as valued in his third year.

Box 8.10 **Fair value versus accounting value — an illustrative example**

The following example illustrates the difference between fair value and accounting value for an equity-based instrument that vests over three years:

	Year 1	*Year 2*	*Year 3*
Grant date fair value	$X	$Y	$Z
Reported accounting value	$X/3	$X/3	$X/3
		$Y/3	$Y/3
			$Z/3

In year 3, the fair value of equity to be awarded to an executive is $Z. However, the reported accounting value includes only a portion of that amount, combined with portions of grants from the previous two periods.

Disclosure of grant date fair value (rather than accounting values) was adopted by Canada in 2009, and the United States is also considering this approach (Lang Michener 2009; Willkie Farr and Gallagher 2009, p. 1). In Canadian practice, and in US proposals, accounting values are retained for the financial statements. There may be merit in considering this approach for Australian disclosure requirements as well, although the benefits should be weighed against the costs for companies (producing up to three sets of numbers — the accounting value for the financial statements, the grant date fair value, and 'actual' pay — to describe the same payment), as well as for shareholders (changing how accounting-based estimates of pay are reported may provoke further confusion, at least in the short term).

‘Actual’ pay, accounting-based estimates, or both?

Some participants felt that only ‘actual’ remuneration (however defined) is of interest to shareholders, while others considered that both estimated and actual outcomes were relevant. Retail investors and the general community are likely to be more interested in actual remuneration received by the executive. Others, such as proxy advisers, governance groups and institutional investors, are likely also to be interested in the accounting valuation of equity, to gain a more complete understanding of a company’s remuneration policies, the incentives being provided to executives, and their potential financial impact on the company.

A compromise suggestion made by the Joint Accounting Bodies (comprising CPA Australia, the Institute of Chartered Accountants and the National Institute of Accountants) was to include actual remuneration in the remuneration report, while reporting the accounting values and methodologies only in the financial statements (where they are also currently reported):

> These [accounting] estimates on day one are based on models and different proven valuation methodologies. So to be showing people what’s going through the accounting records, and they often are the numbers that get picked up by the media and strewn through papers, it’s not necessarily reflecting the true position. We think that to cut the confusion there is scope to look more at the type of information the shareholders really want and put it in a context that is reflecting the value to the executive at the date where the executive is able to do something with those options or to do something with those shares. (trans., p. 258)

While this suggestion has some appeal, the financial statements do not break down the estimates by individual executive. This would tend to limit the usefulness of the disclosure, particularly where the remuneration mix and the performance hurdles vary by executive.

An alternative would be to present in the financial statements the detail of the equity valuation methodology (thereby removing some technical detail from the remuneration report), while presenting estimates and actual remuneration by individual executive in the remuneration report. This approach may help to ensure that disclosure is comprehensible, without making it less comprehensive. In particular, technical material is likely to contribute to the confusion of ordinary shareholders, but may still be highly useful for proxy advisers and other remuneration specialists. Ensuring such details are still disclosed, but separating them from the remuneration report specifically, can help balance the needs of different readers.

'Actual' pay is not a perfect measure

Disclosure of actual payments to executives could promote more accurate reporting of executive remuneration, particularly as it would distinguish remuneration from capital gains (or losses). However, misunderstandings about discounting for time, the difference between real and nominal amounts, as well as reasons for differences between an estimate based on probabilities of the executive's performance level and share prices, and the realised outcome, would likely persist.

Some participants expressed reservations about requiring 'actual' pay to be reported. For example, although Hay Group supported calculation of actual levels of remuneration at vesting, it also observed that this 'actual' pay value would:

> … be objective but [have] limitations for remuneration purposes. The value cannot be shown until well after the [long-term incentive] has been granted and approved, if necessary, by shareholders. This will then involve the Board justifying the outcome of decisions made in good faith three years ago. Potentially those decisions were made in different circumstances by a differently constituted Board. They will now be judged by commentators enjoying the benefits of hindsight. (sub. DD132, p. 7)

Specifying a precise definition of 'actual' pay may have limited benefits, while adding new disclosure requirements will add to businesses' compliance costs. CPA Australia (sub. DD148) and the Institute of Chartered Accountants (sub. DD146) observed that companies already had to calculate an 'actual' amount of pay for income tax purposes, and suggested that this could be reported with little additional compliance cost to businesses. This approach would define remuneration at the point when an individual is assessed to have received payment for income tax purposes and would, in principle, be consistent with reflecting an executive's realisation of benefits. That said, problems could emerge in the case of options, with the effect of performance hurdles excluded from the valuation of options for tax purposes (chapter 10). However, the Board of Taxation is currently conducting a review of the option valuation rules, an outcome of which may be to resolve this issue. Were this matter to be adequately addressed, remuneration as assessed for income tax purposes could be a workable definition of 'actual' pay.

Disclosure of performance hurdles

As incentive payments are forming an increasing proportion of executive remuneration packages, disclosure of performance conditions is important for investors to determine the appropriateness and risks of remuneration structures. Yet as shown in chapter 7 (tables 7.4–7.7), in 2007-08, only one of the top 20 companies disclosed the actual performance hurdle for payment of (some)

short-term incentives. In contrast, a majority provided specific information about long-term incentive hurdles.

Section 300A(1)(ba) of the Corporations Act states:

> If an element of the remuneration of a member of the key management personnel … is dependent on the satisfaction of a performance condition:
>
> (i) a detailed summary of the performance condition; and
>
> (ii) an explanation of why the performance condition was chosen; and
>
> (iii) a summary of the methods used in assessing whether the performance condition is satisfied and an explanation of why those methods were chosen …

As outlined in box 8.11, a number of participants considered companies were not complying with these requirements, and that the regulator, the Australian Securities and Investments Commission, was not taking remedial action. Nonetheless, the Corporations Act requires a '*detailed summary* of the performance condition' to be disclosed, not the actual condition. Thus, in providing information about the nature of performance hurdles, but not the levels of performance required to obtain the incentive payment, companies may be complying with the letter of the law. However, Guerdon Associates countered that:

> Regulation 2M.3.03 [of the Corporations Regulations] is very specific, and requires disclosure of sufficient detail to provide an understanding of 'how the amount of compensation in the current reporting period was determined'. Judging from the submissions made to the Commission to date, current disclosure practice has clearly not met this objective. (sub. DD119, p. 5)

Requiring companies to disclose full details of all performance hurdles would likely reveal commercially-sensitive information to competitors. In particular, short-term hurdles typically involve both financial and non-financial metrics that are more likely to be company specific, compared with long-term hurdles related to publicly-available indicators of company performance against general market indicators. Even where a performance hurdle has been met and incentive payments made, disclosure of the performance hurdle may, on some occasions, still not be in the company's best interests. For example, a bonus related to a performance hurdle to improve occupational health and safety outcomes, such as the number of fatalities, while worthy, could appear simply mercenary.

Freehills commented:

> … increased disclosure of short-term performance measures should be resisted, as disclosure of this information may impair companies' ability to keep commercial information in confidence. Companies may still voluntarily disclose such measures in retrospect, if appropriate … (sub. 46, p. 7)

Box 8.11 **Compliance with disclosure of performance conditions — views from submissions**

In regard to meeting disclosure requirements on performance conditions, CGI Glass Lewis and Guerdon Associates stated:

> … fewer than 20 per cent of listed ASX300 companies comply with this requirement … The main area of non-compliance is in the full reporting of performance requirements, mainly for the annual [short-term incentive] payment. (sub. 80, p. 68)

Similarly, RiskMetrics stated:

> Non-compliance with [section 300A(1)(ba) of the Corporations Act] is routine, especially in relation to annual cash bonuses, and is apparently not policed. RiskMetrics is aware of only a handful of listed companies … that disclose the actual performance conditions that had to be satisfied in order for bonuses to be paid for the prior year … the relevant government agency, the Australian Securities and Investments Commission, [should] more stringently police disclosure in this area … (sub. 58, p. 12)

Guerdon Associates acknowledged that commercial sensitivity may be a valid reason for non-disclosure in some instances, however it believed that requiring companies to seek exemptions from the Australian Securities and Investments Commission would be a better approach than (in its view) not enforcing the law. This would be consistent with the US, where exemptions are allowed, but are:

> … actively monitored and usually disallowed by that country's SEC. It would be difficult for a company to argue that such information is commercial in confidence as it pertains to a past fiscal period. (sub. DD119, p. 5)

ACSI submitted:

> There are companies that do not disclose the performance conditions attached to short-term incentives … ACSI is aware of the commercial sensitivities that arise in the disclosure of specific internal Key Performance Indicators or budget related information that is linked to annual bonuses. However ACSI believes that this can be overcome by an appropriate narrative on these issues. (sub. 71, pp. 8–9)

In view of such considerations, current legal requirements might not be appropriate. Indeed, mandated disclosure of actual hurdles could lead perversely to the adoption of hurdles that are less closely aligned with improving company performance, or even a reduction in the use of incentive pay. Nevertheless, companies should be encouraged to disclose as much relevant information as possible by including, as ACSI suggests (sub. 71), a narrative about commercially-sensitive hurdles and, where feasible, by disclosing them after the event.

8.3 Can disclosure requirements be rationalised?

Without a reduction in the range of information currently required to be disclosed, and given the inherent complexity of remuneration structures, remuneration reports

will remain long and complex. Accordingly, a number of participants raised the possibility of streamlining current disclosure requirements with a view to focusing on core aspects of remuneration important for investors (including the Australian Institute of Company Directors, sub. DD149; the Australian Bankers' Association, sub. 70; the Joint Accounting Bodies, sub. 77; CGI Glass Lewis and Guerdon Associates, sub. 80; Chartered Secretaries Australia, sub. 57; Hay Group, sub. 85; the Law Council of Australia, sub. DD150; Mercer, sub. DD139, Woolworths, sub. 91; and KPMG, sub. 95).

For example, CGI Glass Lewis and Guerdon Associates suggested that:

> … some of the current disclosure requirements of section 300A of the Corporations Act provide nonsensical and irrelevant requirements for disclosure of many aspects of executive remuneration.
>
> A good example of such a requirement is section 300A(1)(e)(iv) of the Corporations Act which requires the disclosure of the value of options that have already lapsed … (sub. 80, p. 70)

Another requirement that might fall into this category is section 300A(1AA)(b), which requires discussion of the consequences of company performance for shareholder wealth. While obviously important for shareholders, it is not clear why this should be included in the remuneration report.

Potentially more wide-reaching areas for reducing the compliance costs associated with remuneration reports include:

- limiting the number of individuals whose pay is to be reported
- streamlining the regulatory framework.

Is the remuneration report covering the right people?

Given the twin objectives of disclosure of minimising conflicts of interest and providing information relevant to company risks and prospects, the appropriate focus of disclosure should be on individuals who can influence their own pay (that is, where there could be a conflict of interest) and on those whose behaviour could materially affect the performance of the company.

The Corporations Act (section 300A) requires disclosure of remuneration details for both key management personnel (as defined by accounting standards — see box 8.12) *and* the five highest-paid group and company executives. In practice, there tends to be a high degree of overlap between the two classifications.

Box 8.12 Accounting standards: key management personnel

AASB 124 requires remuneration disclosures for key management personnel, defined as 'those persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity' (AASB 124, p. 10). It is up to each company to determine which employees fit within this definition.

BHP Billiton (sub. 45), the Joint Accounting Bodies (sub. 77) and CGI Glass Lewis and Guerdon Associates (sub. 80) questioned the need for inclusion of the five highest paid group and company executives as well as key management personnel. BHP Billiton suggested that the Corporations Act be aligned with the Australian Accounting Standards Board (AASB) standard AASB 124:

> We believe there is no sound basis for section 300A continuing to refer to the 5 highest-paid executives of the group and of the company. This aspect of section 300A derives from its introduction more than a decade ago, at which time there was no coherent interaction between section 300A and accounting standards. That is no longer the case … we believe section 300A should be aligned with AASB 124 and require disclosure only in relation to the key management personnel. (sub. 45, p. 2)

Pushing in the opposite direction, however, are calls in response to the global financial crisis to expand remuneration monitoring and disclosure of individuals responsible for risk-taking, such as traders in investment banks. In Australia, remuneration of such individuals will be captured by APRA's remuneration policy for financial services businesses. Given the special nature of the financial sector and APRA's supervision of it, it would not seem appropriate to additionally require public disclosure of remuneration of the subset of such individuals who work for such financial entities. Moreover, for non-financial companies, it is unlikely that any personnel other than key management personnel are routinely able to make unsupervised decisions that expose the company (or the broader community) to significant risks.

As indicated in box 2.5, the requirement for disclosure of remuneration of the five most highly-paid executives was introduced in 1998, with the addition of 'key management personnel' in 2004 in the context of the introduction of the remuneration report and non-binding shareholder vote. Given the objective of remuneration disclosure, it would seem that a focus on key management personnel would be appropriate. Such rationalisation would also make the Corporations Act provisions consistent with accounting standards.

In practice, confining disclosure to key management personnel is likely to have a negligible impact on disclosure by larger companies because their five highest-paid

group and company executives typically are subsumed by the definition of key management personnel. Smaller companies are more likely to have fewer than five key management personnel, resulting in a reduction in their reporting requirement. Nonetheless, by definition, executives removed from the remuneration report would not have responsibility for managing or controlling the activities of the entity. (For example, one company has reported remuneration of its graphic designer.) Consequently, for these companies, confining obligatory reporting to key management personnel would reduce the compliance burden and the complexity of the remuneration report, without losing relevant information for shareholders.

Some participants questioned whether disclosure for all key management personnel was appropriate. KPMG considered that disclosure had created difficulties in recruiting to some positions due to privacy and security concerns (trans., p. 387 and sub. 95, p. 4). Privacy issues were also raised by CGI Glass Lewis and Guerdon Associates (sub. 80, p. 23). Moreover, it was suggested that shareholders were not interested in remuneration disclosure other than for individual directors and the CEO. According to KPMG:

> … the anecdotal evidence is that shareholders are overwhelmingly interested in the remuneration of only the directors (including the managing director/chief executive officer) … We recommend that disclosing entities should disclose the dollar value of remuneration components (eg short-term, long-term, share-based payments) for the individual directors (including executive directors and the CEO) only. (sub. 95, p. 4)

Such an approach would reduce the amount of detail in remuneration reports while still providing broad information about key management personnel other than the CEO and executive directors. Detailed reporting would only be required for those executives for whom there was scope for conflicts of interest (because of their board positions).

Further consideration and recommendations on the range of individuals to be covered by the remuneration report, and the reporting requirements for them, are presented in chapter 11.

Compliance with disclosure requirements

It is unlikely that removal of one or two items from remuneration reports would significantly reduce their length or the compliance burden associated with producing them. Any more substantial paring back of requirements would likely reduce the usefulness of the report to some investors and consultants, particularly proxy advisers whose comparative advantage is in interpreting and on-selling such detail. In other words, the usefulness of reports is likely better advanced through

improvements in presentation and clarity of exposition than a reduction in reporting requirements.

That said, compliance costs might still be reduced by rationalising the regulatory framework for remuneration disclosure. Companies are currently required to comply with reporting requirements contained in a variety of sources — chiefly the Corporations Act, but also other 'black letter' instruments (such as the accounting standards) and 'soft law' (for example, the ASX Corporate Governance Council's guidelines). These regimes risk unnecessary duplication in reporting requirements.

The Corporations Act and Corporations Regulations

The Corporations Act and Corporations Regulations concurrently detail the requirements for remuneration disclosure (box 8.1). Allens Arthur Robinson, Guerdon Associates, CGI Glass Lewis and Regnan (subs. DD168 and DD170) submitted that many requirements currently contained in the Act could be transferred to the Regulations.

Under the proposal outlined in the joint submissions (and detailed in the annexe to this chapter), section 300A of the Corporations Act would give only a high level indication of what disclosure is necessary, with the specific reporting requirements referred to Regulations. This 'back to basics' approach would be designed to give effect to the original purpose of section 300A — to 'improve the capacity of shareowners to carry out their governance role by providing them with better tools to do so' (sub. DD170, p. 3).

Containing the details in one location has some appeal from a streamlining perspective. A further benefit cited by Allens Arthur Robinson et al. is that further amendments could be easier to undertake, which would provide greater flexibility to adjust to changing circumstances than would amending the Act. However, this could easily become a drawback as well — particularly if new complexities were introduced into the Regulations. (Recognising this, Allens Arthur Robinson et al. suggested an expert panel be constituted to monitor the ongoing operation of the relevant sections of both the Act and the Regulations.)

There is invariably a balance between provisions being contained in an Act of Parliament (the primary legislation) and the supporting Regulations (the administrative guidance on how legislation is applied). Determining what should be placed in an Act and what may be left to Regulations will depend on a multitude of factors, including the level of scrutiny that is warranted.

Accounting standards

Some inquiry participants identified potential benefits from consolidating disclosure requirements contained in accounting standards with the Corporations Act (Australian Institute of Company Directors, sub. DD149; Chartered Secretaries Australia, sub. DD147; CPA Australia, sub. DD148; Institute of Chartered Accountants, sub. DD146). While Australia's accounting standards are principally derived from international agreements, the standards sometimes include Australian-specific provisions. This occurs in the case of remuneration disclosure requirements, under AASB 124, with the requirement to disclose equity holdings being just one example (box 8.13).

Box 8.13 **Total company shareholdings**

While much of the focus of disclosure is on annual remuneration, numerous studies (for example, Gayle and Miller 2008) have shown that a more relevant indicator of the alignment between executives' actions and company performance is the proportion of their total wealth that is linked to company performance. Changes in wealth, and the potential for such changes, can significantly affect an executive's behaviour. For example, equity holdings can motivate an executive to improve company performance in order to increase shareholder value.

The appropriate equity portfolio will depend on the ability of executives to increase the share price, their risk aversion and time horizon — in other words, it tends to be specific to the company and executive. On the other hand, a very large equity holding in a company could in some circumstances influence a chief executive officer to adopt less risky strategies in order to maintain share value in the short term (for example, to preserve wealth as retirement approaches). This might suit investors with a similar consumption time profile, but might not be in the long-term interests of the company.

As equity holdings are not remuneration as such, the remuneration report is not required to include information on total company shareholdings for individuals named in the report. (Some companies do so of their own accord.) However, under requirements imposed by the AASB the notes to the financial statements must report for equity, the number granted, held at the start and end of the period, and received on exercise of options or rights. Further, section 300(11) of the Corporations Act requires similar information for directors as part of the annual directors' report. Having this information summarised in the remuneration report (rather than detailed in the financial statements) would provide a more complete picture of the extent to which executives incentives were aligned with the interests of the company and shareholders. Again, however, this would add to, rather than subtract from, the length of remuneration reports.

The Institute of Chartered Accountants suggested:

> In order to reduce the potential for duplication, the Institute would encourage the Commission to consider making a recommendation for the removal of all the Australian-specific paragraphs in this accounting standard (applying to companies and disclosing entities). If these disclosures are determined necessary by law, they could perhaps be included in the remuneration report or another relevant section within the Corporations Act. (sub. DD146, p. 5)

Further, the Institute of Chartered Accountants conjectured:

> … that if the accounting standard board was approached that they would be very happy to wipe all of those [Australian-specific] paragraphs and it is just a matter of the lawmakers working with the [AASB] in order to get the right result which is, 'Let us make it not complex, not complicated, let us remove duplication and simplify it.' (DD trans., pp. 78–9)

In principle, this approach appears attractive. There does not appear to be a clear reason why remuneration disclosure matters should be addressed by accounting standards rather than the Corporations Act. While sound accounting principles are critical for preparation of a company's financial statements, shareholder disclosure is not of itself an accounting exercise. Transferring requirements currently contained in the accounting standards to the Corporations Act or Regulations could streamline requirements without compromising the quality of disclosure currently maintained.

A code of practice?

Consolidation might also occur between some of guidelines issued by investor groups. One approach to this, advocated by the Australian Human Resources Institute, could be to adopt a code of practice for company remuneration policies (see box 9.6 in chapter 9).

While potentially improving the presentation of a company's remuneration policy, the code as proposed would also include specific requirements and/or boundaries on remuneration policy (and actual remuneration). Further, a code would provide more detail and generally be 'stronger' than existing 'soft law' requirements and non-regulatory guidelines.

As stated by the Australian Human Resources Institute:

> The code of remuneration practice should really have some bite. It should go into the real drivers, how the decision to set somebody's pay is referenced by the value of their job, where they sit in the market, the value of that person, the value they're expected to drive, and then the process by which it is put through some appropriate review filters one or two levels away. You don't find that in the codes I've seen. (trans., p. 139)

The risks of a compulsory code are that it would become overly prescriptive and inflexible. An alternative is to encourage boards to provide more informative explanations of the objectives and design of remuneration packages, including key parameters and assumptions about how the package will work, and how risks have been taken into account. This could give investors some comfort that all contingencies have been considered, such that the risks of the pay structure delivering excessively costly outcomes for the company have been minimised.

Consolidation under a single 'umbrella'?

KPMG proposed broader consolidation still, recommending that disclosure requirements be placed:

> … under the one umbrella, rather than having accounting standards, corporate governance principles, investor association guidelines and, even further, a plain English summary. … There [should] actually be a recommendation by the Commission to the government to rewrite the Corporations Act, specifically section 300A, with a view to picking up any principles that are in all of these other guidelines. (DD trans., pp. 39–40)

While companies face a range of obligations, it would be hard to contain all remuneration disclosure principles solely in the Corporations Act. For instance, the ASX Corporate Governance Council's system of 'if not, why not' disclosure is deliberately a non prescriptive regime, recognising the diverse nature of companies. This would be ill-suited to a 'black letter' framework. Similarly, it would be difficult to synthesise the various guidelines promoted by individual investor groups into the Corporations Act, given that such organisations might seek to emphasise different areas of remuneration in different (and potentially conflicting) ways.

It is unlikely that all disclosure-related requirements and guidelines can be located in a single set of rules. Nevertheless, some degree of streamlining appears possible — particularly the accounting standards, as discussed above. Options for consolidating disclosure requirements are discussed further in chapter 11.

Allens Arthur Robinson, Guerdon Associates, CGI Glass Lewis and Regnan (sub. DD170) suggested that some reforms to the Corporations Act since 1998 (when section 300A was introduced) have made remuneration disclosure more complex than was initially intended. This view, at least in part, drives their proposal to redraft section 300A (see annexe). It also contributes to their recommendation that an 'expert panel' be established to monitor the operation of section 300A of the Corporations Act and the relevant regulations.

Given the potential for unnecessary duplication, which can impose undue compliance costs on companies and undermine the readability and usefulness of remuneration reports, an ‘expert panel’ that draws upon the perspectives and experiences of companies, advisers, investor groups and regulators might help ensure that the architecture for disclosure is streamlined, such that appropriate information is clearly conveyed to shareholders at least cost to companies.

Annexe: Specific proposals from inquiry participants

In response to questions raised in the Discussion Draft, some participants offered detailed suggestions on how remuneration reports should be designed and on how disclosure requirements could be streamlined.

Remuneration report design

Ernst and Young (sub. DD136) provided the framework for what they considered an 'ideal' remuneration report. The structure for remuneration of executives would be:

- Overview/summary — a description of the remuneration framework, key details of approaches to incentive payments and any additional one-off payments, as well as details of any expected reviews or changes to future remuneration.
- Remuneration strategy — including a discussion of objectives, quantum and the mix of remuneration components (fixed pay, short- and long-term incentives).
- Short-term incentives — a description of the plan, including discussion of performance metrics (as they operate) and details of any equity grants.
- Long-term incentives — a description of the plan(s), including discussion of performance metrics (as they operate), vesting schedules and details of equity grants.
- Contractual arrangements — such as notice periods, sign-on arrangements, termination entitlements (including those paid out in the current year) and details of any guaranteed payments.
- Remuneration outcomes — 'actual' pay data for current and previous years.
- Performance and reward link — including rationale for the selection of performance hurdles, current short- and long-term incentive payments relative to maximum opportunity and rationale, historical short- and long-term incentive payments relative to key financial measures and rationale, and changes in executives' shareholdings in the company.

For non-executive directors:

- Non-executive director policy and outcomes — a description of the remuneration framework (including base directors' fees, committee fees and fee sacrifice schemes), noting any changes to the framework. This section would also include 'actual' pay data for current and previous years.

Under the Ernst and Young proposal, other details would be moved to the financial report — for example, the accounting values of remuneration for key management

personnel (which would be aggregated, rather than individually reported as now), and a description of the methodology used to value equity-based payments. A key appeal of this approach is that 'the removal of complex accounting disclosures would make it easier to use plain English throughout the [remuneration] report' (Ernst and Young, sub. DD136, p. 2).

Ernst and Young notes that mandating the structure of remuneration reports would likely be impractical. Instead, it suggests changes to the Corporations Act and Corporations Regulations to remove unnecessary disclosure requirements, modify potentially beneficial requirements, and to add new requirements (table 8.1).

Redrafting section 300A of the Corporations Act

Allens Arthur Robinson, Guerdon Associates, CGI Glass Lewis and Regnan proposed a 'simplification' of section 300A of the Corporations Act (subs. DD168 and DD170). Under their proposed redrafting of section 300A, the Corporations Act would require that remuneration reports contain a plain English summary of remuneration policies and the remuneration for each member of the key management personnel. The details of these arrangements would be transferred to regulation 2M.3.03 of the Corporations Regulations.

Table 8.1 **Proposed changes to disclosure requirements**

	Suggested change
Remove	• methods used to assess performance conditions • minimum and maximum values of bonuses and share-based awards in future periods • accounting disclosures regarding options (value of options exercised during the year, value of awards lapsed during the year, percentage of remuneration consisting of options) • description of long-term incentive plans that do not relate to current year grants • individual disclosures for the five highest paid executives if they are not key management personnel.
Modify	• description of performance and remuneration link • vesting percentages of bonuses and share-based payments • remuneration mix discussion • presentation of prior year individual remuneration data • share option and right disclosures.
Add	• actual remuneration outcomes • rationale for remuneration policy and mix • details of comparator groups and mechanisms to guard against 'extreme' incentive payments • termination payments disclosure.

Source: Ernst and Young (sub. DD136).

Under regulation 2M.3.03, the plain English summary would be designed to inform shareholders about:

- the use of fixed remuneration, short- and long-term incentives, and how they relate to the company's performance
- the use of comparator groups for benchmarking remuneration
- whether incentive schemes had been subject to any sensitivity analysis (measuring under what circumstances 'excessive' pay levels might emerge)
- how remuneration levels might be tempered in the event of 'extreme outcomes' resulting from formula-based contractual obligations (that is, how 'excessive' pay levels might be restrained should unexpected outcomes emerge)
- who is responsible for setting and implementing remuneration policies
- how the policies are evaluated, and against what criteria
- how aligned the policies are with the company's risk profile.

Disclosure of remuneration levels would cover:

- 'realisable' remuneration during the reporting period, including:
  - what proportion of the 'realisable' remuneration resulted from fixed pay, vested incentives or termination benefits
  - a description of any performance hurdles or other vesting conditions
- payments granted (reported fair value at grant date), including:
  - a description of any performance hurdles or other vesting conditions
- total shareholdings.

Remuneration levels would continue to be reported in tables, for which Allens Arthur Robinson, Guerdon Associates, CGI Glass Lewis and Regnan proposed standardised formats (box 8.14).

Arguing that section 300A of the Corporations Act had been 'corrupted' since it was introduced in 1998, Allens Arthur Robinson, Guerdon Associates, CGI Glass Lewis and Regnan also proposed that an expert panel be established to monitor the ongoing operation of, and advise on any future amendments to, both section 300A and regulation 2M.3.03.

Box 8.14 **Presentation of remuneration**

Allens Arthur Robinson, Guerdon Associates, CGI Glass Lewis and Regnan suggested how tables should be used to present remuneration levels (sub. DD168, pp. 4–5).

'Realisable' remuneration

Name	*Position*	*Total amount of realisable remuneration*
…	…	…

Grant date fair value

Name	*Position*	*Fixed rem.*	*Short-term incentives*	*Long-term incentives*	*Termination benefits*	*Other benefits*	*Total rem.*
…	…	…	…	…	…	…	…

Total shareholdings

Name	*Position*	*Total shareholding*
…	…	…