

Director and Executive Remuneration Inquiry
Productivity Commission
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By email: exec_remuneration@pc.gov.au

Dear Sir/Madam,

Productivity Commission Issues Paper – *Regulation of Director and Executive Remuneration in Australia*

Thank you for the opportunity to comment on the Productivity Commission Issues Paper – *Regulation of Director and Executive Remuneration in Australia* (Paper). CPA Australia, The Institute of Chartered Accountants and the National Institute of Accountants (the Joint Accounting Bodies) have considered the above Paper and our comments follow.

The Joint Accounting Bodies represent over 180,000 professional accountants in Australia. Our members work in diverse roles across public practice, commerce, industry, government, academia throughout Australia and internationally.

We support the Productivity Commission's inquiry into executive remuneration and encourage the Commission to consult widely on this issue before looking at proposing changes to legislation. We would be happy to meet with the Commission if there are matters within our submission that the Commission wish to discuss further. Our detailed comments and recommendations on the paper are included in Appendix 1.

If you require further information on any of our views, please contact Kerry Hicks, the Institute via email kerry.hicks@charteredaccountants.com.au John Purcell, CPA Australia via email John.Purcell@cpaaustralia.com.au, or Tom Ravlic via email tom.ravlic@nia.org.au.

Yours sincerely

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Representatives of the Australian Accounting Profession

Appendix 1

Scope

We note that the Paper looks to identify the scope for the review as well as for the remuneration report. We agree that the scope of the review should be for disclosing entities that are corporations and cover those directors and executives already covered by s 300A (1c) of the *Corporations Act 2001* (the Act).

Definitions

We note that the Act includes the definitions of a company executive s 300A (1Ba) and group executive s 300A (1Bb) and s9. The Act also defines key management personnel (KMP) as having the same meaning as in the accounting standards. The Australian accounting standard definition is the same as that in the International Accounting Standard Board's International Financial Reporting Standards (IFRS). We are aware that currently some confusion may exist between the different definitions. Australian accounting standard setting operates under the policy directive of ensuring that the requirements of Australian Accounting Standards are the same as those of IFRS. Accordingly the accounting standard definition will need to be retained.

Definitions provided in the relevant regulations are included in Appendix 2 of this letter for your reference. S 300A (1c) of the Act currently requires the disclosure of remuneration relating to each member of the KMP (as required under Accounting Standard *AASB 124 related party disclosures*) and also the five and company executives who receive the highest remuneration for that year.

We recommend the Productivity Commission re-consider defining which executives should be included in the remuneration report. The Commission should acknowledge that the disclosure of the remuneration of KMP is already required by the accounting standards and it would seem appropriate for the Act to be similarly defined. Therefore we consider the disclosure of the remuneration of KMP within the remuneration report is sufficient and the inclusion of the five highest paid group and company executives is unnecessary.

We also note that the paper and the Act use the term share options or stock options. We recommend the Productivity Commission revise this terminology to refer to the broader 'share based payment arrangements'. This term encompasses share options but also other alternative arrangements such as performance rights. A definition of a share-based payment arrangement is included in Appendix A of the Australian Accounting Standards Board (AASB) 2 *Share-based Payment*. Refer to Appendix 2 of this letter.

Relationship between remuneration policy and company performance

Section 300A of the Act requires directors in their report to provide discussion of the relationship between remuneration policy and the company's performance (s 300A(1)(b)) with particular emphasis on the consequences for shareholder wealth (s 300A(1AA)(b)). Sub-section 1AA states the following:

[Specific requirements] Without limiting paragraph (1)(b), the discussion under that paragraph of the company's performance must specifically deal with:

- (a) the company's earnings; and
 - (b) the consequences of the company's performance on shareholder wealth;
- in the financial year to which the report relates and in the previous 4 financial years.

These largely qualitative disclosures, we believe, should be considered in the context of the Commission's reference in the Paper to suggestions that the structure of remuneration can, in some instances, encourages a short-term approach to decision making and undue risk-taking.

As we note in Appendix 3 to this letter, there has been some research and discussion to indicate that there is not a strong link between remuneration and company performance. Stemming from concerns that remuneration practices may have been an element contributing to the current economic situation, much of the foreshadowed guidance, such as that announced by the

Australian Prudential Regulation Authority¹, is directed at structuring salaries to encourage a longer term orientation. This notion of a longer term view of the company's and its shareholders' interests is widely accepted in many aspects of corporate law. As such, the wording in s 300A(1AA) does not reflect the wider scope of directors' general duties against which a director's obligations to the company are governed.

The use of the phrase 'shareholder wealth' in this regard may suggest a short time horizon of assessing performance. Former champions of the 'shareholder values [wealth]' movement have more recently condemned share price focus as a strategy.² Moreover it is noteworthy that s 181³ of the Act uses the phrase 'best interests of the company', which has long been interpreted as meaning not "the sectional interests of some, or a majority, or even all the present members, but of present and future members; a long-term view should be balanced against the short-term interests of present members."⁴ We recommend therefore that the Commission consider amending of the wording of s 300A(1AA) to reflect the acknowledged broader scope of directors' duties against which an individual's performance should be measured.

Remuneration disclosure

We recommend that the Commission considers firstly the purpose of the remuneration report and the information required by users. The current remuneration report disclosures have generally been adopted in a checklist style approach by companies. This has not necessarily led to better information for the users of the financial statements. We recommend that the Commission reconsider what information users require from the remuneration report, such as who should be disclosed (refer to our points above on KMPs), how they are remunerated, how performance is measured, how much they received for their performance during the year and how much has been deferred based on future performance.

We consider the Commission should be aware of how executive remuneration is currently determined for disclosure within the remuneration report. This, as noted earlier, influences the users of the financial statements and therefore should form part of the review.

Confusion seems to exist in the area of disclosure of share-based payments (SBP). The disclosure is based around the measurement and recognition requirements of the relevant accounting standard AASB 2 *Share-based Payment*. It is important to note that SBPs are valued at fair value at the grant date and then expensed (and disclosed) by the company over the vesting period. However, importantly, the value of the SBP to the KMP 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, particularly since the value attributed to the KMP at the vesting date is not disclosed.

We recommend the Commission consider what information should be included in the remuneration report based on the needs of the users of financial statements. These considerations could be further informed via liaison with the Australian Accounting Standards Board (AASB). Understanding the cost of the SBPs to the company is important to the users of financial statements. Additionally, as highlighted by the need for the review, it is important for the users to understand the economic value of the benefits received by the KMPs each year. There needs to be clear distinction between what is actually received by the KMP in the financial period (split between current and historical performance), what has been awarded or granted to the KMP in the financial period (relating current performance and future performance) and the timing of when KMPs will receive remuneration that has been awarded in current or previous financial periods.

¹ http://www.apra.gov.au/Policy/upload/AI_DP_PEGR_052009_ex_R.pdf <http://www.apra.gov.au/Policy/upload/Draft-PPG-511-Remuneration.pdf>

² Financial Times 12 March 2009 'Jack Welch condemns share price focus'.

³ Good faith - civil obligations

⁴ J D Heydon, 'Directors' Duties and the Company's Interests' in P D Finn (Ed), *Equity and Commercial Relationships* (1987), LBC, Sydney p 120.

Tax implications of executive remuneration

We recommend that the commission work with the Review into Australia's Future Tax System (chaired by Dr Ken Henry) when considering the tax implications of executive remuneration. Our comments on specific issues relating to the taxation of executive remuneration should be considered in the context of this wider review.

We don't consider that tax arrangements currently have significant influence on the structure of executive remuneration, however if changed they have the potential to influence future structures. The taxation of share-based payments currently includes a deferral of tax mechanism, which delays the need to pay tax until shares are disposed of (or 10 years, whichever occurs earlier). This encourages the inclusion of equity based long-term incentives within the executive remuneration structure. This benefits shareholders as it aligns their interests to those of the KMPs.

We support extending compliance obligations to require businesses to disclose the issuing of shares and options to the Australian Tax Office. Improved disclosure and reporting could be achieved by implementing a reporting system under which benefits awarded (and realised) through employee shares are linked to the PAYG Payment Summary reporting system currently in place for taxpayers. This would help the ATO monitor the grant, vesting and issue of share based payments to all employees, including executives, to enable them to monitor the taxpayer's compliance in disclosing taxable income arising from the sale of the shares.

We consider that bonuses should continue to be an allowable tax deduction for an organisation and taxed at the standard rate for both organisations and the individuals. Bonuses are an important aspect of remuneration for all employees to reward excellent performance, normally in the shorter term. The taxation treatment of bonuses should remain the same for all employees.

Non-binding vote

Under the Commission's second term of reference, views are sought on the effectiveness of the existing balance of regulatory arrangements governing director and executive remuneration. The non-binding resolution of shareholders for the adoption of the remuneration report (s 250R(3) of the Act) is intended to operate in a manner complementary to the s 300A directors' disclosure of remuneration policy and detail. The value of the non-binding vote has been called into question through the occurrence, in a limited number of high profile instances, of board inaction in response to member non-adoption of the remuneration report. The non-binding resolution is consistent with a number of aspects of corporate law and we support its retention in its current form.

The Paper points out (page 5) that a distinction is typically drawn between the remuneration of directors and the remuneration of executives. This distinction and the underlying responsibility of directors to appoint and determine the remuneration of key executives is reflected in the CLERP 9 commentary which accompanied the 2003 Audit Reform & Disclosure Bill (Bill). The Bill, amongst a raft of matters, introduced s 250R(3) as an accompanying provision to s 300A. There it is stated:

"The Bill recognises that it is generally the function of members to approve the remuneration of directors and the function of directors to determine the remuneration of executives."⁵

And further;

"While the resolution will not be binding, the process provides an avenue for shareholders to actively express any views they may have regarding decisions taken in relation to remuneration."⁶

The intent, and in turn effectiveness, of the s 250R(3) non-binding vote on executive pay as complementary to the enhanced remuneration disclosures contained in s 300A, reflects traditional legal doctrine concerning the division of corporate powers.⁷

⁵ Chapter 5: Remuneration of directors and executives. Para. 407 p 101.

⁶ Ibid at para. 429 p 105.

⁷ The *CCH Australian Corporations Commentary* on s 250R(3) states: "Traditional legal doctrine provides that the business of the company is managed by or under the direction of the board of directors, not shareholders. The determination of which persons comprise

A binding vote would directly challenging 'traditional legal doctrine' and could potentially lead to a blurring of the roles of directors and the role of members in annual general meetings. Further, we consider any move to enhance the shareholders' power under s 250R(3), beyond its current advisory and non-binding nature, would present the following difficulties:

- > Such formality potentially disregards the wider context of remuneration disclosure as a basis for bringing to bear less interventionist or informal approaches to modify corporate behaviour in response to shareholder and indeed wider community expectations.⁸
- > Any suggested amendment of s 300A, along with associated trend towards shareholder democracy under the guise of an expanded s 250R(3), needs to be cognizant of the recent Exposure Draft (ED) issued by Treasury on Improving Accountability on Termination Payments. This ED outlines the Government's intention to increase the range of benefits and lower the threshold at which termination payments are subject to explicit shareholder approval (ss 200A to 200J).
- > It is not immediately apparent how such power might be drafted in statute to take into account the fact that the disclosure itself covers cumulative past transactions, nor is it clear how the actions that would need to ensue once the remuneration report is voted could be described in statute.
- > It is unclear how shareholders could be sufficiently conversant with the details of the disclosures and the underlying remuneration policy so as to form a fully informed view about a matter directly related to the allocation of company financial resources.⁹

We recommend a modest approach to possible reform of executive remuneration disclosures, driven by ideas of enhancing shareholder understanding with the use of the non-binding vote as a mechanism, along with other market mechanisms, to achieve over time a greater accord between remuneration policy and the interests of shareholders.

We suggest that the future effectiveness of the non-binding vote needs to be considered in the context of trends in executive remuneration in the aftermath of the current global economic downturn, and in terms of other foreshadowed reforms, such as those arising out of the APRA's consideration of potential means of better aligning executive remuneration with the avoidance of inappropriate risk-taking.

Non-recourse loans

The use of non-recourse loans is discussed in the Paper under the first term of reference and questions of the adequacy of current regulation posed under the fourth term of reference. We note that Treasury in March 2008 canvassed views on the adequacy or otherwise of regulations governing the use and disclosure of non-recourse loans as part of executive remuneration. Treasury, in its background paper, noted the existence of a range of governance concerns relating to this practice, particularly around the encouragement of short-termism and the erosion of shareholder value. The background paper presented three regulatory options; the status quo whereby companies are free to determine the use of non-recourse loans though subject to disclosure requirements, enabling greater shareholder oversight and outright banning of the use of non-recourse loans as part of executive remuneration packages. Treasury also noted the wider use of this practice as part of funding employee share purchases.

the executive management team and the composition of the remuneration packages, has traditionally been thought of as being within the sphere of the board's discretionary powers. A binding vote would erode this traditional doctrine; a non-binding vote clearly does not go this far, but leans in the same direction."

⁸ In this regard the *CCH Australian Corporations Commentary* cites UK experience where adverse media and ratings agency response has had a modifying influence concluding that:

"Requiring the Remuneration Report to be put to the non-binding vote of shareholders effectively compels the board to cease viewing the disclosure of remuneration policy as merely a compliance exercise for the purposes of satisfying the disclosure requirements of the annual directors' report."

⁹ This issues of the differential in access to, and complexity of, remuneration information is examined in what is to date one of the more comprehensive analyses of the governance impacts of s 250R(3): L Chapple & B Christensen, 'The non-binding vote on executive pay: A review of the CLERP 9 reform' (2005) 18 AJCL 263.

We acknowledge that the use of non-recourse loans does not represent best practice with the current market and economic circumstances as outlined in the Paper highlighting the potential risks and perverse incentives arising from the practice. This said, the option of outright banning of the practice is excessive. Development of alternative approaches whereby shareholders are granted greater oversight would need to be cognizant of the general position that the setting of remuneration falls correctly within the domain of the directors'. Similarly, restraint on non-recourse loans, whilst valid, should not unduly impact upon employees who, unlike executives, do not have a significant management role directly affecting shareholder and corporate value.

Appendix 2 - Definitions

AASB 124 Related Party Disclosures (9)

Key management personnel - Are 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.

Corporations Act 2001

S9

group executives for a consolidated entity means:

- (a) the directors of the companies or bodies within the consolidated entity; and
- (b) the secretaries of the companies or bodies within the consolidated entity; and
- (c) the senior managers of any corporation within the consolidated entity; and
- (d) the partners, and senior managers, of any partnership within the consolidated entity; and
- (e) the trustees, and senior managers, of any trusts within the consolidated entity; and
- (f) the senior managers of any joint venture within the consolidated entity.

S300A (1c)

(c) the prescribed details in relation to the remuneration of:

- (i) if consolidated financial statements are required—each member of the key management personnel for the consolidated entity; and
- (ii) if consolidated financial statements are not required— each member of the key management personnel for the company; and
- (iii) if consolidated financial statements are required—each of the 5 named relevant group executives who receive the highest remuneration for that year; and
- (iv) in any case—each of the 5 named company executives who receive the highest remuneration for that year;

S300A

(1AAA) For the purposes of subsection (1), **key management personnel** has the same meaning as in the accounting standards.

(1B) For the purposes of paragraph (1)(c):

- (a) a person is a **company executive** of the company if the person is a secretary or senior manager of the company; and
- (b) a person is a **relevant group executive** of the company if the person:
 - (i) is a group executive of the consolidated entity; and
 - (ii) is not a director of the company.

AASB2 Share based payment arrangement

Share based payment arrangement

An agreement between the entity and another party (including an employee) to enter into a share-based payment transaction, which thereby entitles the other party to receive cash or other assets of the entity for amounts that are based on the price of the entity's shares or other equity instruments of the entity, or to receive equity instruments of the entity, provided the specified vesting conditions, if any, are met.

Appendix 3 – CCH Commentary on s 300A

CCH in its *Australian Corporations Commentary* makes the following remarks about the objective of s 300A:

Best practice corporate governance practice requires that there should be a clear link between executive remuneration policy and the company's performance (such as return on equity or return on assets).

The OECD Principles of Corporate Governance (January 2004) state:

"In particular, it is important for shareholders to know the specific link between remuneration and company performance when they assess the capability of the board and the qualities they should seek in nominees for the board."

These sentiments are echoed in the UK Combined Code of Corporate Governance (July 2003):

"... the performance-elements of remuneration should form a significant proportion of the total remuneration package of executive directors and should be designed to align their interests with those of shareholders and to give these directors keen incentives to perform at the highest levels."

Best practice does not always accord with actual practice. Some independent research indicates that executive remuneration is more strongly correlated with the size and complexity of the company, rather than linked to company performance: *Position Paper — Executive Remuneration*, BT Governance Advisory Service (2003). The research report said:

"Our research suggests that the actual performance of the company — which is the primary concern of shareholders — does not appear to drive executive remuneration. The research found the statistical link between remuneration and company performance to be weak.

The research indicates that s [300](#) and s [300A](#) of the Corporations Act are not having their intended effect. Remuneration disclosures, generally, do not discuss alignment with company performance.""