

18 June 2009

Executive Remuneration Inquiry  
Productivity Commission  
Locked Bag 2, Collins St. East  
Melbourne VIC 8003

Dear Sirs

## Review of Director and Executive Remuneration in Australia: Ernst & Young submission

Ernst & Young are pleased to provide this submission to the Productivity Commission. Ernst & Young have reviewed the Terms of Reference and the Productivity Commission's Issues Paper "Regulation of Director and Executive Remuneration in Australia" (April 2009). This submission provides a summary of our key responses.

A separate extended submission (marked in confidence) has also been provided that includes specific answers to the majority of the questions within each Term of Reference.

This letter focuses on the following topics:

1. **Overarching considerations:** Factors for the Productivity Commission to consider before recommending reform to any aspects of director and executive remuneration;
2. **Regulatory effectiveness:** The effectiveness of the existing framework for the oversight, accountability and transparency of remuneration practices, and areas for improvement;
3. **Governance considerations:** Suggested enhancements to the Australian governance framework in relation to remuneration; and
4. **Shareholder influence:** Whether there is a need to increase the influence provided to shareholders.

This submission does not make reference to the treatment of termination payments or the tax treatment of share plans, as we have provided separate submissions to Treasury on these matters.

### 1. Overarching considerations

The Productivity Commission should give due consideration to the following, prior to developing recommendations:

- ▶ **Australian competitiveness and the community interest:** The wider community interest is not served by imposing significantly more stringent requirements in Australia compared to overseas. The outcome may be to discourage companies from listing or operating in Australia. This would

reduce the available investment opportunities for Australian investors, reduce employment opportunities for Australian workers and reduce revenue for the Government (if companies go offshore).

Additionally, minimising companies' administrative burden, protecting commercially sensitive company information and allowing companies to adopt effective remuneration structures (or at least not discouraging them) are all important for the efficient operation of companies and their competitiveness, which is in the interests of shareholders and the broader economy.

- ▶ **Executive vs. Non-Executive Director ("NED") remuneration:** In reviewing remuneration approaches, there needs to be a clear distinction between executive and NED remuneration. The roles of executives and NEDs are inherently different and therefore are associated with distinct remuneration structures. The differences must be taken into account when drafting any new regulation.
- ▶ **Ensuring understanding of disclosed remuneration:** The remuneration details disclosed in annual reports are based on complex accounting disclosures. Consequently, the details are frequently misinterpreted by shareholders and the general public, who may not fully understand the accounting rules. Misinterpretation may be the cause of some of the public unrest regarding director and executive remuneration. As such, enhancing shareholder and public understanding of remuneration practices should be a key objective of any recommended changes.
- ▶ **Listed vs. non-listed companies:** Increased regulation of remuneration for listed companies versus non-listed companies (and/or differing tax treatment) may make employment at listed companies less attractive, without improved alignment to shareholder interests.

## 2. Regulatory effectiveness

The current regulation in Australia (through the Corporations Act, ASX Listing Rules and various governance guidelines) is broadly appropriate and does not require overhaul.

It is critical that companies are able to tailor executive remuneration to meet their specific needs. A "one size fits all" approach to remuneration is not in the best interest of shareholders. Different remuneration mechanisms will promote alignment for different companies. It is the Board's role to oversee the development of a suitable framework, and communicate the commercial rationale of the framework to shareholders.

Key enhancements that could be made to Australian regulations are:

### a) Amendments to the disclosure requirements

There are some relatively minor amendments that could be made to disclosure requirements to increase shareholder understanding and promote good remuneration governance:

- ▶ **Disclosure of the STI amounts payable for target performance:** This would encourage companies to communicate STI outcomes in relation to the achievement of budgets / targets.

- ▶ **Disclosure of the pre-tax gains from equity awards:** The following disclosures would facilitate understanding regarding the actual value of equity from the participant's perspective and remove the common misinterpretations that result from the accounting standards that currently dictate remuneration disclosures:
  - ▶ The pre-tax gain to executives in relation to equity awards that vested during the year (i.e., the cash gain to the executive, before tax, net of any exercise price, if they were to have sold the equity at the time it vested); and,
  - ▶ The hypothetical pre-tax gain for unvested equity awards at the time of disclosure.
- ▶ **Removed disclosure of the "five highest paid" executives:** Current disclosure requirements require the details of Key Management Personnel ("KMP") and the five highest paid executives to be disclosed. The Remuneration Report is intended to focus on the executive team, who should all be captured under the definition of KMP. The "five highest paid" are typically included within the KMP population, so, in most cases, would be disclosed.

This removal would also reduce some of the disclosure requirements' complexity. Currently, remuneration policy and actual remuneration must be disclosed for KMP, whereas only the latter must be disclosed for the five highest paid executives.

#### b) Encouraging focus on usefulness vs. compliance

Compliance alone is not sufficient. The disclosures must also be useful for, and understandable by, shareholders. Specific areas of focus should be:

- ▶ **Commercial rationale:** Many Remuneration Reports lack insight into how the remuneration approach supports the business strategy and ensures alignment with shareholder interests. Companies should be encouraged to focus on the "why" rather than just the "what or how" in relation to their remuneration approach.
- ▶ **Not relying on mandatory disclosures to ensure relevance:** A specific area of disclosure that is often approached from a compliance perspective, rather than a "usefulness" perspective, is the requirement to "discuss the link between performance and reward". The disclosures presented in this section of the Remuneration Report, in many cases, apply the literal application of the legislation, by specifying earnings, share price and dividend performance rather than clearly explaining the link between performance and reward at the company.

In order to explain the company-specific link between performance and reward, the company may have to disclose financial performance against different metrics from those specified in the legislation. Companies should provide more useful explanations of the link between actual performance and reward received based on the performance metrics focused on in their business strategy and incentive plans, but without revealing commercial sensitive information.

We caution against over-regulating remuneration in Australia. A regulation-based approach is appropriate for *disclosure*, because it enhances shareholder understanding through consistent and detailed provision of information.

Regulation should not dictate remuneration *structures* or *quantum* as this would reduce each company's ability to use remuneration to meet their specific business needs. Voluntary guidelines can have a significant influence on remuneration, as illustrated in the UK by companies' careful consideration of the Association of British Insurers ("ABI") Guidelines when designing executive remuneration.

Further, we caution against applying differentiated regulations to the financial sector. Differences between the financial sector and other sectors have been widely recognised and are reflected through the Financial Services Forum Principles (of which Australian Prudential Regulation Authority ("APRA") is a signatory). APRA is currently developing its governance framework through the introduction of new Prudential Standards.

### **NEDs**

There is less need for increased regulation of NED remuneration, as the remuneration approaches adopted for NEDs are significantly different and less complex, and rightly so, from executive remuneration. NEDs typically do not have any variable remuneration. The ASX Corporate Governance Council Guidelines specifically state that NEDs should "not normally participate in schemes designed for the remuneration of executives" and "should not receive options or bonus payments". We believe these guidelines, the existing disclosure requirements, plus the need for the NED fee pool to be approved, provides sufficient regulation and guidance.

### **3. Governance considerations**

In relation to the remuneration governance framework, the Australian framework is relatively robust. We support the continued focus on not imposing a "one size fits all" approach and ensuring that Boards have the flexibility to adopt approaches that best suit their company's circumstances.

There are two key issues that require consideration: a) ensuring that Remuneration Committees are effective; and b) the perceived independence issue regarding external remuneration advisors.

#### **a) Ensuring Remuneration Committees are effective**

To ensure effectiveness, we recommend that the following good remuneration governance practices be incorporated / emphasised in corporate governance guidelines:

- ▶ **Minimum required level of remuneration and risk knowledge:** A key driver of Remuneration Committee effectiveness tends to be the experience and remuneration knowledge of the Committee members. NEDs on Remuneration Committees, and particularly new members, should be encouraged to obtain a level of both remuneration and risk knowledge (similar to the ASX Corporate Governance Council Guidelines in relation to Audit Committee membership). An understanding of risk is important in the current climate, particularly in financial services companies.

- ▶ **Provision of stress testing analyses:** Boards have often been presented with insufficient stress testing of remuneration proposals and thus have not been fully informed regarding the potential outcomes of incentive plans. Provision of analysis of the potential outcomes of plans would assist Boards to ensure the outcomes are aligned with shareholder interests.
- ▶ **Evaluating incentive outcomes:** Companies should be encouraged to apply an informed evaluation of the outcomes generated by their incentive plans to ensure they operate as intended and generate appropriate outcomes for the company and individuals. An example of this in practice is for Boards to apply their discretion to increase or decrease incentive payments due to consideration of other factors, such as impact of externalities.
- ▶ **Access to external advice:** Decision making is timelier, and outcomes are generally more effective, when Remuneration Committees and management have access to the same information and insights. However, we believe that, while the Remuneration Committee should have access to any information and advice provided to management, the Remuneration Committee should be able to seek independent advice if required.

***b) Perceived independence of remuneration advisors***

The main remuneration consultants advising in Australia have appropriate independence, quality and risk management procedures in place to ensure that conflicts of interest do not arise. However, we note that the public perception could be otherwise. Consequently, we support increased disclosure of the remuneration consultants used and the nature of their advice. If this is mandated, we caution that it is important that it is mandated that the consultants' specific roles (and the extent to which companies have relied / used the advice) is also disclosed, to avoid misinterpretation of the consultant's role or services.

*Proposals/recommendations to separate management and Board advisers*

The Australian Institute of Company Directors ("AICD") recommends that Boards obtain expert remuneration advice. In order for this advice to be independent, they recommend that the advice be commissioned by (and provided directly to) the Board, with the Board and management preferably engaging different advisers.

Our experience indicates that the company objectives for which remuneration consultants are engaged can be achieved most efficiently and effectively when the consultant reports to the Board, with a mandate to work with management. In cases where there have been separate consultants to each of the Board and management, we have found that the project's time and expense increases, with no enhanced outcome.

In addition, Australia is a small market, with few remuneration advisers. Thus, it is not always feasible for the Board and management to engage separate advisers with the necessary experience to meet the company's needs.

Ernst & Young's Performance & Reward practice has stringent review protocols and independence requirements in place to ensure appropriate advice is provided to Boards. We are often engaged by the Board to work with management and prepare proposals for the Board. We ensure that the advice

submitted to the Board is robust and appropriate through our rigorous review process, which includes second partner review and, in some cases, independent second partner review.

If there needs to be separate consultants for Board advice versus management advice, it may be better to define roles up front (e.g., the second consultant provides a 'sense check' rather than a re-design of remuneration arrangements).

#### *Advice provided to audit clients*

Ernst & Young are restricted in the advice that we can provide audit clients. Our assistance cannot include acting as management (e.g., making decisions) or seconding individuals to the client. The other "Big 4" accounting firms have similar independence policies.

#### *Distinction between remuneration consultants and recruitment consultants*

In particular, there needs to be a clear distinction made between the role of a remuneration consultant and that of a recruitment consultant. While recruitment consultant fees are often a proportion of the recommended remuneration, creating a conflict of interest, remuneration consultants do not receive any commission-based fees, thus removing any incentive to recommend higher remuneration.

## 4. Shareholder influence

### *a) Remuneration Report*

The current level of influence (via the non-binding vote on the Remuneration Report) is having an impact on company actions. For instance, many organisations who have received significant "no votes" do indeed review - and in many cases amend (where commercially appropriate) - their remuneration practices in response to shareholder feedback.

We support continued shareholder influence through the current non-binding vote. We do not support making this vote binding for the following reasons:

- ▶ **Unclear implication of the voting outcome:** The Remuneration Report sets out past remuneration payments and current/ongoing policy. The implications of a "no vote" would therefore be unclear (e.g., past payments could not be changed, whereas policy can, but not immediately).
- ▶ **Bluntness of the vote:** Shareholders would have to reject the whole report to express dissatisfaction with specific elements of remuneration. There would be uncertainty as to which aspects of remuneration are contrary to which shareholder's views and require amendment.

### *b) Remuneration quantum*

We do not support providing shareholders a vote (binding or otherwise) on remuneration quantum. Individuals' quantum should be the responsibility of the Board. The factors that the Board considers in determining remuneration quantum are complex. Remuneration quantum should be set having

consideration for the incumbent's role, history, criticality to the business, future potential, as well as individual and company performance and market competitiveness. Shareholders are not privy to such information, nor do they have an expert understanding (in most cases) of market practices and trends.

**c) Voting on grants of equity**

To the extent that the Productivity Commission deem a binding vote to be necessary, seeking approval on executive equity plans would provide an opportunity for shareholder input and influence on practice. If introduced, we recommend that this vote replace the existing voting on individual grants to directors (which includes consideration of quantum).

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As noted earlier, this letter summarises our key views in relation to the Productivity Commission's review. The separate extended submission (marked *in confidence*) elaborates further on our views and provides more detail in response to the specific questions within each Term of Reference.

If there are any areas of this submission (or the extended submission) that you would like us to expand upon further, we would be pleased to discuss these with you. We look forward to continuing to engage with the Productivity Commission under the consultation process.

Yours sincerely,



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