

14 March 2013

General Manager
Corporations and Capital Markets Division
The Treasury
Langton Crescent
PARKES ACT 2600

Email: corporations.amendments@treasury.gov.au

Dear Sir/ Madam,

Exposure Draft Corporations Legislation Amendment (Remuneration Disclosures and Other Measures) Bill 2012

The Australian Institute of Company Directors welcomes the opportunity to comment on the Exposure Draft of the *Corporations Legislation Amendment (Remuneration Disclosure and Other Measures) Bill 2012* (Exposure Draft).

The Australian Institute of Company Directors (Company Directors) is the second largest member-based director association worldwide, with individual members from a wide range of corporations: publicly-listed companies, private companies, not-for-profit organisations, charities, and government and semi-government bodies. As the principal professional body representing a diverse membership of directors, we offer world class education services and provide a broad-based director perspective to current director issues in the policy debate.

1. Summary

In summary, Company Directors key comments are as follows:

- (a) We believe that paragraph 254T should be repealed and replaced with a well-formulated and express solvency test. The net asset test should be removed as it perpetuates the issues that were experienced under the original “profits” test. If Treasury fails to remove the net asset test, then the link to the accounting standards should be removed for all companies in determining the value of their assets and liabilities for the purposes of determining a dividend.
- (b) We agree with the proposed introduction of a requirement to include a description of a company’s remuneration governance framework in relation to key management personnel in the remuneration report, or for an appropriate cross-reference be included where this information is already included in the company’s annual report. However, as there is a possibility that a company will already include this description in its annual report in a section other than the financial report or the directors’ report (for example in the corporate governance statement), the proposed draft paragraph 300A(1)(aa)(ii) should be expanded to allow for the information to be included elsewhere in a company’s annual report.

- (c) The introduction of additional disclosures relating to remuneration outcomes will not add clarity. Rather, it will add an additional layer of complexity and is likely to further confuse readers of the remuneration report. In our view, the existing reporting requirements of remuneration outcomes should instead be amended to require the disclosure of a single set of remuneration figures that describe the actual remuneration outcomes for the reporting period (and, as is already the case, for the previous reporting period). This will enhance clarity and provide readers of the remuneration report with the information that is of most use to them by describing executive remuneration in “actual pay” terms as opposed to the disclosure of accounting values as is currently required.
- (d) The proposed additional disclosures relating to termination arrangements for key management personnel are unnecessary. Termination arrangements are already adequately disclosed under the existing requirements¹. If there is a need for these disclosures to be clarified, for example by requiring that they include specific payments or that they be broken down further, this could be more appropriately dealt with as an amendment to reg. 2M.3.03 of the *Corporations Regulations 2001 (Cth)* (Regulations).
- (e) While we agree with the less prescriptive approach towards clawbacks that has been taken in the proposed draft paragraph 300A(1)(i), we do not believe that legislative intervention is warranted in this area. Our strong preference is for this to instead be the subject of ASX Corporate Governance Council guidance.

These issues are discussed in more detail below.

2. General Comments

Company Directors remain concerned that the changes to the remuneration report set out in the Exposure Draft do not address the fundamental issues concerning the remuneration report. These reports are becoming longer and more detailed and consume a significant amount of time, particularly at the Board level. The remuneration report is not achieving the objectives for which it was originally introduced.

The remuneration reporting requirements, together with the two-strikes legislation and overly- restrictive limitations on termination benefits are placing an undue regulatory burden on Australian listed companies. As such, Company Directors believe that there is an urgent need to revisit all the requirements of section 300A to ensure that companies are able to report the remuneration outcomes of their key management personnel in a way that accurately reflect the company’s remuneration philosophies and the actual pay received by these individuals.

3. Proposed amendments to the dividends test in section 254T

Company Directors have continually advocated the need for a solvency based test for the payment of dividends. We do not believe the proposed amendments to the dividends test set out in paragraph 254T of the *Corporations Act 2001* improves the ability of a company to pay a dividend to its shareholders.

¹ In particular, s. 300A(1)(e)(vii) of the Corporations Act 2001 (Cth) and Items 7 and 9 of reg. 2M.3.03 of the Corporations Regulations 2001 (Cth)

In our previous submissions to Treasury about the dividends test², we have strongly advocated for an express solvency test and the removal of the consideration of the net asset position of the company when determining a dividend. The net asset test as set out in the Exposure Draft is still subject to measurement fluctuations under the International Financial Reporting Standards.

When Treasury first considered amending s254T to remove the “profits test” they stated in the accompanying Explanatory Memorandum to the draft *Corporations Amendment (Corporate Reporting Reform) Bill 2010* that they were moving away from the “profit test” because:

“The nature of the accounting principles for the calculation of profits has changed over time. Australian accounting standards, particularly following the adoption of International Financial Reporting Standards (IFRS), are increasingly linked to the fair value (whether realised or unrealised) impacting the profitability of the company. This makes the profitability of Australian companies increasingly volatile with a large number of non-cash expenses being included in the net result. In these circumstances a company may have sufficient cash to pay a dividend to shareholders but is unable to do so because the accounting profits of the company have been eliminated by non-cash expenses.”³

We believe that, by including a net asset test as part of the determination of a dividend, companies continue to be restricted in their ability to pay dividends. This is because those same non-cash accounting adjustments referred to above also affect the value of the assets and liabilities of the company. As such, companies that have sufficient and available cash resources may not be able to pay a dividend to their shareholders.

In our submission on 3 February 2010 in response to the draft *Corporations Amendment (Corporate Reporting Reform) Bill 2010*, we highlighted our concerns about the introduction of the net asset test and stated:

“... the proposed safeguard that the company’s assets exceed its liabilities and the excess is sufficient for the payment of the dividend, is an overly simplistic test:

- accounting practices, such as marking asset values to market, may unduly restrict the ability to pay dividends; and
- the net asset test ignores the timing of ingoing and outgoing cash flows (whereas insolvent trading does not).”⁴

Company Directors strongly encourages Treasury to remove the net asset test from the proposed paragraph 254T under the Exposure Draft and accompanying link to the accounting standards and replace it with a well-formulated and express solvency test.

We have previously raised concerns that companies wanting to pay a dividend under the existing paragraph 254T are required to prepare a balance sheet at the date of payment (or declaration as the case may be). This continues to be a concern under the proposed amendments. The Exposure Draft requires that a company consider the dividends test

² See our submission to Treasury in response to the Discussion Paper “Proposed Amendments to Corporations Act” (7 February 2012) and our submission to Treasury in response to Draft Legislation, “The Draft Corporations Amendment (Corporate Reporting Reform) Bill 2010” (3 February 2010)

³ The Explanatory Memorandum to the Corporations Amendment (Corporate Reporting Reform) Bill 2010, page 19

⁴ See our submission to Treasury in response to Draft Legislation, “The Draft Corporations Amendment (Corporate Reporting Reform) Bill 2010” (3 February 2010), page 7.

immediately prior to declaration or payment. In order to comply with the requirements in paragraph 254T, a company will be required to prepare an additional balance sheet at declaration or payment date. Given that a balance sheet is a representation of net assets at a specific point in time the value of assets and liabilities could be significantly different from the position at financial year end at another point in time (often due to external factors, such as currency movements or share price adjustments) and many IFRS valuation adjustments are only prepared as part of the year end procedures, companies are effectively required to prepare a balance sheet at the date of consideration of the dividend. This increases the compliance burden on a company.

The introduction of an express and well-formulated solvency test, would not require the company to prepare additional balance sheets, but the board of directors would be required to consider whether the entity would be solvent after the payment or declaration of the dividend.

While the changes proposed to paragraph 254T in the Exposure Draft with respect to dividends make it easier for those companies that are not required to prepare financial reports to consider the payment of dividends, this clarification would not be necessary if a solvency test was adopted for the determination of whether a company is able to pay a dividend.

4. Remuneration governance framework

The proposed paragraph 300A(1)(aa) would introduce a requirement that either a description of a company's remuneration governance framework be set out in the remuneration report or, where a description has been included elsewhere in the directors' report or in the financial report for the financial year, that the remuneration report include a cross-reference to the relevant section.

It is already widely regarded as good practice for listed companies to provide information on the structures governing remuneration of key management personnel. However, its inclusion in a company's annual report has not previously been expressly mandated⁵.

We agree that there is merit in introducing an explicit requirement for the remuneration report to address this. However, a company may determine that the appropriate place to include a description of its remuneration governance structure is not in either of the directors' report or its financial report, and that it is instead more appropriate to include this information elsewhere in its annual report, such as in its corporate governance statement⁶.

As such, draft paragraph 300A(1)(aa)(ii) should be amended to allow companies to cross-refer to another section of the annual report where the description of the remuneration governance framework is set out, without limiting the location of this description to the directors' report or financial report.

⁵ See our Position Paper 15 Remuneration Reports, page 12.

⁶ All listed companies are currently required to include in their annual report "a statement disclosing the extent to which the entity has followed the recommendations set by the ASX Corporate Governance Council during the reporting period". This statement, usually called the "corporate governance statement" is included in the annual report for the listed entity in a stand-alone section and does not form part of the directors' report or the financial report. One of the areas of corporate governance that must be addressed in this statement relates to remuneration (Principle 8 - Remunerate fairly and responsibly, ASX Corporate Governance Council's Corporate Governance Principles and Recommendations 2nd edition)

5. Disclosure of total remuneration

One of the key concerns raised by both preparers and users of remuneration reports is that the value of remuneration calculated in accordance with IFRS and included in a company's financial statements often does not reflect the remuneration actually received by key management personnel during the period.

In our view, the remuneration report should not be required to include theoretical accounting values relating to various parts of remuneration packages (as is currently the case). Rather, it should be a shareholder-friendly overview of the key elements and outcomes of a company's remuneration arrangements. We do not think that the additional disclosures proposed under draft paragraph 300A(1)(ca) will achieve this and, in fact, will serve only to increase complexity and confusion by introducing additional "values" of remuneration without providing any clarity as to what the key management personnel have actually earned during the reporting period.

The proposed categories of remuneration values a company would need to disclose for each member of its key management personnel under draft paragraph 300A(1)(ca) are:

1. the total amount of remuneration granted in a prior reporting period but paid during the reporting period;
2. the total amount of remuneration granted and paid during the reporting period; and
3. the total amount of remuneration granted in the reporting period but to be paid in a future reporting period.

The disclosure of the above amounts are proposed to be in addition to the accounting figures that are already required to be disclosed in the remuneration report under Items 6 – 11 of reg. 2M.3.03 of the Regulations. It is important to clarify to users that the three values that would be calculated above, should not be added together as these are three independent values and do not represent a "total" of all remuneration earned during the period.

In the Explanatory Memorandum for the Exposure Draft, the rationale behind the requirement to disclose these three amounts is to "assist shareholders to clearly distinguish between present pay, future pay and pay that has been received due to past pay being crystallised". This, the Explanatory Memorandum contends, will mean that companies will be disclosing the "realised pay" for each member of the key management personnel.

In our view, the proposed amendments will not achieve these objectives for the following reasons:

- Where an incentive does not vest in the same year that it is granted (which will be the case with all long-term incentives and for most short-term incentives), the value of that incentive will need be disclosed both in the remuneration report for the year that it is granted (in the first of the three categories of disclosure) and again in the remuneration report for the year that it finally vests (in the third of the three categories of disclosure). This is likely to create confusion for readers of the remuneration report as it suggests that executives will receive value from the one incentive twice – once in the year that it was granted and again in the year that the value of the incentive crystallises.
- The proposed categories of disclosure do not provide a single figure that represents the total amount of remuneration received by the key management

personnel during the reporting period. Because of this, it will still be unclear to readers of the remuneration report what actual remuneration was paid to the company's executives in the relevant reporting period.

- If the new proposed disclosures are required in addition to the figures currently required under Items 6 – 11 of reg. 2M.3.03 of the Regulations, this will mean that there will be two sets of numbers provided in the remuneration report – both of which purport to provide the “total remuneration” received by key management personnel. This again will raise questions with readers of the remuneration report as to which of these numbers are correct – ie which set shows the actual remuneration that was received by the key management personnel during the reporting period? It will also no doubt lead to criticisms of companies and boards for overly complicating these disclosures or potentially even being accused of trying to mislead shareholders.
- There is no guidance with respect to what amounts would be included within “total amount of remuneration”. Different companies would include differing amounts in their “total amount of remuneration” and this would result in a lack of comparability between companies and sectors.
- There is also no guidance as to what would constitute “paid” for the purposes of this section. For example, is a long-term equity incentive “paid” when the entitlement is granted, when it vests, or when all restrictions on dealing are removed?
- Also, by requiring these new figures to be disclosed in addition to the existing disclosure requirements, the proposed amendments will add to the length and complexity of the remuneration report without providing any real benefits to readers (such as enhanced clarity). This is contrary to the intention of the Exposure Draft, which is to introduce measures that enhance disclosure of executive remuneration in Australia.

In our view, the ability to understand the disclosures made in remuneration reports is likely to only be improved if the number and complexity of the specific disclosures required to be included in the remuneration report is significantly reduced. Rather than adding additional disclosures (with no real purpose), we believe that readers of remuneration reports would be better served if the current disclosure requirements were amended to provide more succinct and meaningful information with respect to executive remuneration.

Instead of introducing the proposed additional disclosures, we recommend that the existing disclosure requirements under Items 6 – 11 of reg. 2M.3.03 of the Regulations be amended so that the figures disclosed in the remuneration report describe the remuneration outcomes for the reporting period and the previous reporting period (for the purpose of comparison) in “actual pay” terms.

In our view “actual pay” should be based on when the remuneration vests. In other words, when the right an employee has to the remuneration in question crystallises⁸. Given that, under our proposed approach, companies would be required to report on this basis both in the current and previous reporting period, and given the fact that current entitlements to future remuneration are already required to be disclosed under

⁸ For example, a long-term incentive (cash or equity) that vests in Year 3, after three successive years of meeting performance hurdles, will be recorded as “actual” remuneration in Year 3, and not apportioned or split across the three years. In Years 1 and 2 the contingent payments would be described in a separate section of the remuneration report that sets out details of bonuses that were made during the reporting period in compliance with Item 12 of reg.2M.3.03 the Corporations Regulations 2001 (Cth).

Item 12 of reg. 2M.3.03 of the Regulations, this will provide readers of the remuneration report greater clarity with respect to:

1. what key management personnel actually received as remuneration during the relevant reporting period;
2. how this amount compared with the remuneration that they received in the previous reporting period; and
3. what entitlements to receive remuneration in future reporting periods have been granted to key management personnel during the current reporting period.

This approach to reporting on executive remuneration would be similar to the approach that is now being taken in the UK following recent reforms. The key difference would be that, unlike the UK approach which focuses on remuneration that relates to performance during the reporting year, the approach that we propose would focus on remuneration that has crystallised during the reporting period.

To ensure consistency in reporting between different companies, how the “actual” value of a vested equity incentive is calculated should be specified in the Regulations. For example, by reference to the market value of the underlying shares on the date of vesting/ exercise (as appropriate) less the exercise price (if any).

To address any confusion between the figures reported in the remuneration report and those that companies are required to disclose in the financial statements and notes, we recommend that companies be required to include a statement in the remuneration report that informs readers that the remuneration figures disclosed in the remuneration report are described in “actual pay” terms and will not necessarily be the same as the accounting valuations included in the financial statements and the notes.

6. Benefits on termination

Currently, companies must include in the remuneration report certain details of any contract of employment that is in place between the company and its key management personnel. These details include any termination payments that are provided for under those contracts⁹. Additionally, where a member of the company’s key management personnel received a termination payment in the reporting period, this must be disclosed together with the details of all other remuneration that they received during that period¹⁰.

In our view, these disclosures already provide adequate information on the termination arrangements for key management personnel. The additional disclosures proposed by draft paragraph 300A(1)(ea) are not warranted and will only add a further level of complexity to the remuneration report. Also, there are already extensive and more than adequate checks and balances on the payment of termination benefits to key management personnel in place under the Corporations Act¹¹.

The Explanatory Memorandum for the Exposure Draft suggests that there are questions as to the adequacy of the current level of disclosure of termination benefits in remuneration reports. In particular, it suggests that the current legislation does not currently cover non-contractual payments that are made on termination, such as discretionary payments, gratuitous bonuses, settlement payments that are paid in

⁹ In particular, under s. 300A(1)(e)(vii) of the *Corporations Act 2001 (Cth)*

¹⁰ Item 9 of reg. 2M.3.03 of the *Corporations Regulations 2001 (Cth)*

¹¹ Namely, the limit that is placed on a company’s ability to make payments to key management personnel in connection with their termination under ss. 200A – J of the *Corporations Act 2001 (Cth)*

connection with the termination of a member of the key management personnel, nor does it cover arrangements entered into with a departing director or executive to provide consultancy services to the company following their termination.

However, we are of the view that these amounts are already required to be disclosed. In particular, where a payment is made to an executive in connection with his or her termination or retirement, companies are already required to disclose these amounts in their remuneration report pursuant to Item 9 of reg. 2M.3.03 of the Regulations.

If there is a concern that the required disclosure of these payments does not currently include a requirement that the company breaks this figure down into particular categories of payments, for example into accrued statutory entitlements and other, non-statutory payments (such as a payment in lieu of notice in accordance with the terms of an executive's employment contract or a non-contractual, discretionary bonus payment that is made in connection with the executive's termination), we believe that this could more appropriately be dealt with by amending the existing requirement under Item 9 of reg. 2M.3.03 of the Regulations to require such a break down.

With respect to the disclosure of consultancy arrangements that may be entered into with a departing director or executive, we are strongly of the view that legislative intervention is not required. If these arrangements relate to the provision of services following their termination or retirement, they are unlikely to confer benefits that are given in connection with their retirement or termination. Rather, the arrangements relate to services provided by the director or executive after they have ceased to be a member of the key management personnel. Mandating disclosure of these arrangements in a company's remuneration report, which is primarily concerned with remuneration that is paid to a company's key management personnel, would have the effect of unnecessarily extending the scope of the existing remuneration disclosure regime. No reasons have been provided in the Explanatory Memorandum to the Exposure Draft that would suggest that this significant expansion in scope is warranted.

7. Clawback of remuneration

As we have stated in our previous submission relating to the clawback of remuneration¹², we do not believe that the introduction of a mandated remuneration clawback provision related to material misstatements in financial statements is desirable nor is it needed to enhance Australia's executive remuneration framework. We are of the view that there is no evidence to justify a prescriptive, heavy-handed approach to clawbacks and that numerous checks and balances already exist to effectively protect against the remote possibility of executives manipulating earnings with a view to securing greater remuneration¹³.

We consider that, instead of mandating clawback arrangements, the Federal Government should remove impediments to companies putting in place long-term performance-based incentives with executives, for example by adopting the recommendation of the Productivity Commission to remove the cessation of employment as a taxation trigger point for incentive arrangements.

¹² See our Submission to Treasury in response to Discussion Paper, "The clawback of executive remuneration where financial statements are materially misstated" (30 March 2011)

¹³ Such checks and balances include the existing Corporations Act (eg remuneration report disclosure, non-binding vote, two-strikes rule etc), the Board, Human Resources Committees, Remuneration Committees, internal auditors, external auditors and intense shareholder and media scrutiny

That said, the proposed draft paragraph 300A(1)(i) is, in our view, an improvement from the approaches that had previously been explored in Treasury's Discussion Paper on this issue¹⁴ which were even more heavy-handed and overly prescriptive. Subject to our previous comments, we agree that if there is to be any prescription, the less prescriptive approach that is being proposed would leave the methods for implementing a clawback on remuneration, and circumstances in which it would be invoked, largely with the company.

We do not agree, however, that this area should be regulated through legislative intervention. Our strong preference would be for the implementation of the proposed draft paragraph 300A(1)(i) to instead be introduced as ASX Corporate Governance Council guidance (as opposed to a "Principle" or a "Recommendation"). As we have previously submitted¹⁵, we believe that this is more appropriate because the desirability and optimal design of a clawback provision will depend on the circumstances and will vary from company to company and executive to executive.

If you would like to discuss any aspect of our views please contact me or Nicola Steele on (02) 8248 6600.

Yours sincerely,



John H C Colvin
Chief Executive Officer &
Managing Director

¹⁴ Discussion Paper, *"The clawback of executive remuneration where financial statements are materially misstated"* released by the Federal Government on 20 December 2010

¹⁵ See our submission to Treasury in response to Discussion Paper, *"The clawback of executive remuneration where financial statements are materially misstated"* (30 March 2011)