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Mr John Kluver
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Our ref Admin_13853561_1.DOC

23 August 2010

Dear John

Executive Remuneration

We appreciate the opportunity to make this submission to the Corporations and Markets Advisory Committee ("CAMAC") regarding the Executive Remuneration issues referred to CAMAC.

Specifically, CAMAC has been requested to:

- examine the existing reporting requirements contained in section 300A of the Corporations Act and related regulations and identify areas where the legislation could be revised in order to reduce its complexity and more effectively meet the needs of shareholders and companies;

- examine where the existing remuneration setting framework could be revised in order to provide advice on simplifying the incentive components of executive remuneration arrangements; and

- make recommendations on how best to revise the legislative architecture to reduce the complexity of remuneration reports and simplify the incentive components of executive remuneration arrangements.

We have set out our submission in the attached two appendices by making several recommendations in respect of:

Appendix A:	Remuneration arrangements
Appendix B:	Remuneration reporting

If you have any queries, please feel free to contact me on 03 9838 4600 or Andy Hutt on 02 9335 8655.

Yours sincerely

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Equity Based Compensation & Executive Remuneration

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Appendix A

Remuneration arrangements

The Committee has been asked to examine where the existing remuneration setting framework could be revised to enable it to provide advice on simplifying the incentive components of executive remuneration arrangements.

KPMG considers the current remuneration setting framework should not be revised as it is appropriately structured.

The taxation of employee share scheme should, however, be revised to remove some of the complexity and inequity that arises under those arrangements. Such measures would work to simplify the incentive components of executive remuneration arrangements.

We have set out our reasons for these recommendations below.

Role of the Board

The ultimate decision on remuneration structure and performance hurdles for the organisation should be left in the hands of the Board. It is the Board that is in the best position to determine what is appropriate in the company's circumstances, and it is the Board that should be, and will be held accountable over time.

Boards have the responsibility of setting the strategic direction of a company and are privy to significant confidential information about the company, its future direction and specific key milestones that need to be achieved. Equally relevant is that the Board is required to know and deal with the company's most senior executives and to compensate them for the performance of their employment duties. This means that it is, and should be the Board's responsibility to:

- determine the composition and quantum of remuneration packages;
- set the performance hurdles and vesting period of short-term incentives ("STI") and long-term incentives ("LTI");
- assess the performance of executives against the objectives set for them; and
- communicate the remuneration package to shareholders – including guidance on the quantum of compensation that can be earned.

It is the directors of the Board who are in the best position to have a sufficient knowledge of the company's business strategies, objectives, its people and the markets in which it operates to conclude that the performance hurdles, for example, are appropriate.

Importantly, the Board should also be accountable for appropriately weighing up the company's risk horizons and setting the vesting period for variable pay accordingly. To prescribe that companies operating complex businesses should "simplify" their executive remuneration arrangements would be directly at odds with the standards for risk-adjusted variable pay that regulators such as APRA now require.

Both internal and external remuneration advisors seek to understand the requirements of the relevant position, the requirements of the organisation and the responsibilities of the employee to determine the most appropriate way in which to compensate the employee.

It is the responsibility of Board Remuneration Committees to understand the remuneration structure that is appropriate for their organisation. To achieve the necessary level of understanding, directors will seek to understand the merits of different structures that are used by other organisations.

Through this knowledge and experience, it is the directors of the Board who can best determine the appropriate and the most suitable mix of fixed remuneration, short term incentive and long term incentive.

It would not be appropriate to regulate the type of performance hurdles that can be used in remuneration arrangements as the key features, direction and drivers of each business are different. Regulation in this regard would undermine the ability of a company to compensate executives for achieving the key outcomes considered to drive the creation of shareholder wealth for each specific business, something that cannot be regulated. Regulation would limit the ability of the Board to recruit and retain the executive(s) who it considers is the best person to drive performance that will ultimately reward shareholders. If the Board fails in this responsibility, the shareholders have the ability to hold the directors accountable.

Difficulty and risk in simplification

The diversity and varying circumstances of companies and executives are such that it would not be appropriate to simplify and standardise incentive components. As companies grow and increase in complexity in all aspects, so too do the incentive components of their executive remuneration arrangements. As the global economy is developing at a fast pace and is increasing in complexity, it would be unsuitable to simplify executive remuneration in this environment. Institutional investors in complex businesses recognise that there will be some difficulty in determining whether a Board has set the correct and most appropriate amounts, forms and types of executive remuneration.

At the same time, Boards are seeking to better inform retail investors of the way in which they have structured the company's remuneration arrangements and their reasons for doing so.

There is no one right, or wrong way in which to compensate employees. It is necessary to have regard to all aspects of an employee's role to properly compensate them. While there continues to be calls for remuneration to be simplified it is the experience of many organisations that over-simplified remuneration arrangements lead to poor outcomes and inequities between employees. Simple remuneration arrangements will not necessarily align executive compensation with shareholder interests.

Non-financial performance hurdles

The Australian Prudential Regulation Authority ("APRA") executive remuneration standards and guidelines have gone a long way in regulating non-financial measures as part of performance-based remuneration. APRA requires financial institutions to have regard for such non-financial measures as management of staff and adherence to corporate values and displaying acceptable corporate citizenship.

As these requirements are part of a multitude of requirements companies must comply with, it will become even more difficult to regulate non-numeric/financial components of executive remuneration schemes.

Implications of deferred components

While we support the use of equity and deferred components of variable short-term and long-term incentives, we do not support a requirement or regulation for rules determining the percentages that variable pay should consist of these components.

Although the notion that prescribed amounts or percentages may assist with simplicity of incentive components, there is not one particular amount which can be applied fairly across all industries and all companies and will work effectively in Australia.

The European Union now requires that at regulated financial institutions, set percentages of an executive's variable remuneration be paid as deferred compensation. Such regulations should not be necessary in Australia, as Australia already has sound corporate governance principles and a robust regulatory framework. Australia does not need strict provisions in an attempt to discourage excessive risk-taking.

The risk with increasing the component of variable compensation that is deferred, and concurrently extending deferral periods, is that employees do not place any value on the deferred compensation. It therefore ceases to influence their behaviour, and can also give them more incentive to negotiate a higher fixed base remuneration. This will weaken the correlation between the interests of company executives and the interests of its shareholders.

As well as there not being a need for strict percentage requirements, such a move would undermine the power and influence the shareholders currently have in relation to remunerating their Board and executives. All remuneration increases for key management personnel must be voted on by shareholders and there is no evidence to suggest that this is a practice Australia should be moving away from.

Taxation

A contributing factor to the complexity of executive remuneration requirements comes in relation to the taxation of incentive components of variable remuneration.

Australia is the only country that taxes rights to acquire shares (or options) at the time of vesting rather than at the time of exercise of the rights. This has created many issues for start-up as well as larger companies that seek to construct the most appropriate equity compensation arrangements for the organisation.

Similarly, Australia is unique in taxing unvested equity awards at the time of termination of employment rather than on exercise or vesting at the end of the performance period.

These two aspects alone mean companies need to create arrangements that do not result in individuals being adversely and inequitably taxed. In this respect, taxation rules are leading to remuneration arrangements that are not reflective of good governance practices.

Recommendations

- **The remuneration setting framework should not be revised as a company's Board is best placed to appropriately determine remuneration levels and structures.**
- **There should be no regulation or legislation to simplify the incentive components of executive compensation arrangements. To do so would hamper Boards in setting arrangements that were suitably aligned to business performance and risks.**
- **The taxation of employee share schemes should be revised so that:**
    - **rights to acquire shares are taxed at the time they are exercised, and not at vesting;**
    - **termination of employment is not a taxing point.**

Appendix B

Remuneration reporting

We consider the most effective way to improve the readability of the remuneration report is to consolidate the multitude of statutory, regulatory and other requirements that must currently be taken into account by Boards in the preparation of the report.

Reporting entities in Australia that are compiling remuneration reports are required to prepare their remuneration reports in accordance with:

- the statutory requirements of the *Corporations Act 2001*; and
- Australian Accounting Standards set by the Australian Accounting Standards Board ("AASB") which follow from, and add to, International Financial Reporting Standards ("IFRS") set by the International Accounting Standards Board ("IASB").

The ASX Corporate Governance Principles, various investor association guidelines, proxy advisor guidelines and similar are neither statutory nor obligatory but, nevertheless, are sought to be followed by reporting entities.

KPMG considers that CAMAC should recommend there should only be one statutory set of requirements governing remuneration reports. The AASB should also be directed to remove any specific remuneration disclosures from Australian accounting standards, as this type of disclosure should be a public policy decision.

Current status of section 300A of the Corporations Act

KPMG considers that CAMAC should initiate a complete re-write of section 300A of the *Corporations Act 2001*. The disclosure requirement should be principles-based, with the objective of disclosing to shareholders the principles and policies followed by the entity in setting remuneration for key management personnel, and the nature and extent of remuneration transactions that have occurred in the reporting period.

The starting point for such a re-write should be the principles in AASB 124 and should involve the input of Treasury, the ASX Corporate Governance Council and investor associations. This would enable there to be one comprehensive set of requirements that fulfil the information needs of users so they can make appropriate investment decisions.

This would ensure that the myriad of overlapping recommendations and requirements directors must have regard for when preparing remuneration reports are distilled into a clear and concise set of principles-based requirements. This is likely to make remuneration reports more concise and more useful for the end user, as well as reduce the administrative effort of producing the report.

We believe that the overlapping and sometimes conflicting requirements of regulators and current legislation combine to generate inefficiency and complexity in the reporting process. This detracts from the policy intention of providing information which investors can readily understand. Having uniform, prescriptive rule-based requirements will not reduce the reporting complexity but, rather, lead to a potentially misleading view of remuneration structures.

Increasing the current requirement to satisfy the various ASX Corporate Governance Principles, *Corporations Act 2001* obligations and the Australian Accounting Standards along with the new APRA guidelines and the addition of the Productivity Commission recommendations will increase the length and complexity of the remuneration report, add to the cost of producing the report, and yet probably detract from its ability to be readily understood by investors. This would not occur if all information was consolidated and reported in simple terms.

Reporting in simple terms

We recommend that reporting entities should disclose the monetary value of remuneration components (eg fixed base, short-term, long-term and share-based payments) only for the individual directors (including executive directors and the CEO). Disclosing the monetary value does not necessarily mean that only actual values, or only amortised values should be disclosed, but just the values in simple terms that are relevant for shareholders.

Companies should inform shareholders about the extent to which the pay of senior executives is fixed or variable based on short-term or long-term performance. The company should be required to disclose the make-up of these individuals' pay by describing the percentage that is fixed, short-term variable or long-term variable (including the performance criteria that apply to variable pay elements).

How to disclose the value of incentive components

The outcome of attempting to satisfy all of the myriad of principles governing disclosure is often a remuneration report consisting of what can be 20 pages or more detailing all components of the remuneration framework of the company. This information can be difficult to interpret and in many cases seems repetitive.

What further complicates matters is the value ascribed to the non-cash elements of remuneration detailed in the remuneration report.

Section 300A of the Act requires the details of each remuneration element paid or payable for services rendered be discussed in the prescribed format. This means that the cash salary paid to the executive is often disclosed in the same table as the proportion of the value of LTI previously granted to the executive but attributable to the relevant year. The actual value of salary and annual cash bonus is easy to determine, while the actual value of the STI and LTI often cannot be known with certainty until the instrument has vested (and if relevant, disposal restrictions have lapsed). This detail is neither useful nor necessary for the shareholder.

As a result of these existing disclosure requirements, it is common for this estimate of LTI value to be misunderstood by investors and commentators as being the actual value received by the executive. These arduous and strict provisions do not make remuneration reports easier or simpler for shareholders to read and interpret.

The issues around disclosing "actual" pay

Many commentators have suggested that remuneration reports would be easier to understand if they disclosed *"actual"* pay, or pay that was *"realised"* during the year. While this may appear to give a clearer picture than annual amortisation of deferred values, it will become increasingly the case that the pay *realised* during a year is the product of service and performance over varying periods covering more than just that particular year. Such *'actual'* disclosure may, therefore, be equally prone to misinterpretation.

The Remuneration Report could instead simply cease to include values for share based payments because such values rarely represent what, if anything, is ultimately received by the executive. Rather, the Remuneration Report could disclose the number of securities the entity has granted and subsequently allowed to vest for each relevant individual, and a description of the performance hurdles governing them. Investors and analysts could then form their own view of the potential value of the instruments from time to time during the performance period, without the distraction of either the accounting expense for the share-based payment which would often have its basis in the grant date value, or of the share value at vesting which would not be reflective of factors that were known at the time of the grant.

KPMG supports the principle of having Remuneration Reports that are readily understood by investors and clearly articulate the policies applied by a Board in determining how to remunerate, and the nature and extent of remuneration provided to executives.

Non-binding shareholder vote on the Remuneration Report

The Productivity Commission has recommended that the accountability of the Board to shareholders on executive pay matters can become stronger where there is a mandatory vote on directors being required to stand for re-election if there is a significant vote against the Remuneration Report in consecutive years.

If the Federal Government acts on this recommendation, it will become very important for Remuneration Reports to clearly identify those elements of remuneration that are the result of decisions that the Board has made during or immediately after the reporting period.

It is these elements that shareholders should focus on when considering whether they should vote in favour of the report. Other disclosed elements of compensation (such as actual payment of deferred bonuses, or amortisation thereof) are the result of decisions that the Board has made in previous years, *and which the shareholders have already had the opportunity to vote on.*

It would not be a correct reflection of the Productivity Commission's recommendations if shareholders were to vote on the content of a Remuneration Report that contains the deferred elements of pay that was granted two years earlier and voted on by the shareholders at that time.

Recommendations

- **There should be one unified statutory set of requirements (in s 300A of the Corporations Act) governing remuneration reports.**
- **These requirements should not be so prescriptive as to dictate exactly what amounts should be included, other than mandating reporting in simple terms for the benefit of the shareholders.**
- **There should be a requirement for the Board's pay decisions taken during or immediately after the reporting period to be identified separately from elements of disclosed pay that are a consequence of deferred or multi-year remuneration granted in previous years, and on which the shareholders have already had the opportunity to vote at the time of grant.**