CHARTERED SECRETARIES
AUSTRALIA

Leaders in governance

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General Manager
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Dear Treasury

Corporations Legislation Amendment (Remuneration and Other Measures) Bill 2012

Chartered Secretaries Australia (CSA) is the peak body for over 7,000 governance and risk professionals in Australia. It is the leading independent authority on best practice in board and organisational governance and risk management.

Our members have primary responsibility to develop and implement governance frameworks in public listed and unlisted and private companies, and not-for-profit and public sector organisations. A key responsibility of our members is the management of the annual report and the remuneration report to ensure that directors can report to shareholders. Our members are therefore uniquely positioned to provide independent, expert commentary on the legislative framework governing the remuneration report, and the manner in which directors report to shareholders on the remuneration framework they have implemented to align executive remuneration with company performance.

CSA welcomes the opportunity to comment on the Corporations Legislation Amendment (Remuneration and Other Measures) Bill 2012. CSA Members have commented on many of the issues dealt with in the bill in previous consultations. CSA is of the strong view that, in terms of remuneration reporting, a fresh approach to content, built around real consensus, is desperately needed.

Our detailed comments are set out in the following pages. We would be more than happy to meet with you to discuss our comments.

Yours sincerely

Tim Sheehy
CHIEF EXECUTIVE

1 Dividends test amendments

CSA welcomes the clarification of various areas of concern as to the application of the test for payment of dividends from capital. However, we still have concerns with some aspects of the proposed amendments, which do not address some ongoing issues with the current legislation.

Declare or determine a dividend

CSA welcomes the proposed amendment in the exposure draft allowing companies to either declare or determine a dividend.

Prior to the introduction of the *Corporations Amendment (Corporate Reporting Reform) Act 2010*, which amended the test for payment of dividends under the Corporations Act, most company constitutions provided for the board to 'determine' that dividends are payable rather than to declare a dividend. As we have noted in previous submissions, the issue with the current provision is that once the dividend is 'declared' by the directors of a company, it becomes a debt owing to shareholders by the company at the time it is declared rather than at the payment date (s 254V). In practice, this means that under the current legislation, at the time of payment of the dividend, a contingent liability is in place even if the directors decide not to proceed with the payment due to changed circumstances, as the liability arises when the dividend is declared. This heralded a return to the capital maintenance doctrine, yet the repeal of the 'profits test' in the Corporations Act was expressly designed to move away from this doctrine.

CSA notes that some companies amended their constitutions to use the word 'declared' (replacing the use of the word 'determine') to respond to the *Corporations Amendment (Corporate Reporting Reform) Act 2010*. By retaining the capacity to use the word 'declare' in the Act, as proposed in the bill, it ensures that such companies need not return to shareholders for further constitutional amendment to unravel earlier changes, which would be difficult to explain. CSA supports the flexibility in the proposed amendments for companies to either 'determine' or 'declare' a dividend.

We note that the proposed amendment provides that, where a company declares a dividend, the dividends test will apply immediately before declaration, and where a company determines and later pays a dividend without having declared it earlier, the dividends test will apply immediately before payment.

CSA supports this amendment, given that:

- most group accounts are prepared on a month-end basis, and
- directors are therefore presented with the latest set of accounts that may at a minimum be weeks out-of-date, and
- with the test requiring assets to exceed liabilities, the test can only apply 'immediately' before the dividend is paid, not at the time of declaration for such companies.

Calculate assets and liabilities based on existing reporting requirements

CSA also welcomes the proposed amendment that the calculation of assets and liabilities will be based on the existing reporting arrangements of the specific entity concerned.

CSA has previously expressed its concern that, by tying the calculation of assets and liabilities to the International Financial Reporting Standards (IFRS), the current Act requires companies that are not currently obliged to prepare their financial statements in accordance with IFRS to consider and apply IFRS before paying a dividend. As we have noted in various submissions, this created a new and unreasonable compliance and cost burden for a great many companies (many of which are small businesses), and such a cost impost was of overwhelming economic detriment to a great many small proprietary companies and of no legitimate probative value to the spirit and intent of the policy.

Solvency test

CSA also welcomes the proposed amendment clarifying that the dividend test is a straightforward solvency test. That is, the directors must reasonably believe that the company will be solvent immediately after the dividend is declared or paid.

Our support for the repeal of the 'profits test' was always based on it being replaced by a basic solvency test, so that a company could pay a dividend provided it did not affect its ability to pay its debts as and when they become due.

CSA also welcomes the removal of the requirement that a dividend be 'fair and reasonable to the company's shareholders as a whole'. As noted in previous submissions, proprietary company directors can decide to pay differential dividends and some companies have constitutions that provide for special dividend rights for the holders of different classes of securities that they may issue. The current legislation therefore compromises the ability of such companies to pay differential dividends.

CSA supports the removal of the fair and reasonable requirement and the clarification that the dividend test is a solvency test.

Application of the net assets test to group companies

However, CSA is of the view that the proposed legislative amendment still does not clarify its application to group companies.

In many corporate groups a deed or deeds of cross-guarantee may be in place, effectively providing comfort that the group as a whole will meet the debts of each company in the group.

Where dividends are being 'streamed up' to the ultimate holding company in a corporate group, each company within the stream must meet the net assets test.

However, a wholly owned subsidiary in the group may not necessarily meet the net assets test, even though the group as a whole does. For example, a parent company may have a very profitable wholly owned subsidiary which is held through an intermediate wholly owned holding company. If there is a deficiency of assets in the intermediate holding company, the parent company may not be able to access the dividends from the profitable subsidiary to permit the parent company to pay dividends to its shareholders.

Under the current provisions and the proposed amendments, although the group is solvent and can meet the net assets test on a consolidated basis, the position of an intermediate entity which is deficient in terms of meeting the test can prevent a dividend payment being 'streamed up' through the group. Such a prohibition will not affect the ability of the group to pay its debts, but might prevent the parent company in the group paying dividends to its shareholders.

CSA recommends that the legislation clarify that for wholly owned subsidiaries in corporate groups the solvency test is the only test that would be applied to payments of dividends, subject to the consolidated group being solvent and a deed of cross guarantee being in place.

Reduction of share capital

We note that the Explanatory Memorandum states that 'The new dividends test does not displace the existing requirements in relation to conducting share capital reductions and share buy-backs under Part 2J of the Corporations Act. These provisions will continue to apply under the new dividends test'.

However, CSA Members note that the proposed new s 254T in the Exposure Draft is not explicit on this issue. Moreover, in terms of policy intent, we note that the discussion paper and the explanatory materials that introduced the current s 254T into the Act suggested that s 254T was intended to operate as an exception to the capital maintenance rule and that it may not be necessary for an authorised dividend payment that includes an amount of share capital to also satisfy the requirements of Chapter 2J of the Act.

CSA Members are of the view, therefore, that it remains unclear as to how the test for paying dividends interacts with the capital maintenance requirements in the Act. It also remains unclear as to whether a dividend paid under the new provision can be an authorised reduction of share capital that does not have to satisfy the requirements of Chapter 2J of the Act.

A further complication is that Australian Taxation Office Taxation Ruling TR 2012/5 sets out that, for the purposes of the Act and company accounting, dividends can only be paid from profits. The Commissioner’s view expressed in that ruling was based on legal advice received from counsel.

If s 254T is amended as proposed and the provisions in Chapter 2J are required to be complied with upon payment of a dividend that includes an amount of share capital (which would seem in line with the comments in the Explanatory Memorandum), then it would nonetheless appear that the test for paying dividends will effectively return to a ‘profits-based’ test but with additional restrictions on the ability to pay dividends that were not present before s 254T was amended in June 2010.

This is reinforced by the statement in the Explanatory Memorandum that:

> The new dividends test is not designed to change taxation arrangements for dividends. A central feature of the income tax law is that, to the extent that a company makes a distribution out of profits, that distribution is generally taxed as a dividend and may have franking credits attached to it. Otherwise, it is generally treated as a tax-deferred return of capital, and cannot have franking credits attached to it. A number of integrity provisions in the income tax law reinforce this principle.

An amendment to the Tax Assessment Act 1936 was made, following the amendments to s 254T in 2010, in order to provide that a dividend paid out of an amount other than profits would, in normal circumstances, be capable of being franked.

However, CSA Members are of the view that the legislation provides that Australian Taxation Office (ATO) can disallow the franking benefit to dividends paid other than out of realised profits (such as reserves) and that any such disallowance operates against the policy objectives of the repeal of the ‘profits test’, which was not intended to interfere with the current imputation rules.

CSA recommends that the government clarify in the proposed amendments to the Act that the dividends test operates as an exception to the requirements in Chapter 2J of the Act (for example, that paying a dividend will be an ‘otherwise authorised’ method of reducing share capital for the purposes of section 256B(1) of the Act).

CSA recommends that the government clarify that any dividends paid other than out of realised profits (such as reserves) also attract the franking benefit.

2 Improving disclosure requirements in the remuneration report

Listed disclosing companies to include in the remuneration report a general description of their remuneration governance framework

CSA supports this amendment.

The vast majority of listed disclosing companies already provide a description of their remuneration governance framework. Such a description will cover the matters set out in the Explanatory Memorandum, as well as other matters such as the use of remuneration consultants. It is a good governance outcome for any listed entities that do not currently report on their remuneration governance framework to provide such disclosures, and to implement the necessary processes to ensure that remuneration decisions are free from undue influence by the key management personnel (KMP) to which they relate.

Listed disclosing entities to disclose in the remuneration report the number of lapsed options and the year in which the lapsed options were granted

CSA supports this amendment.

The current requirement to report the value of lapsed options as if they had not lapsed causes confusion for readers of the remuneration report. The amendment will remove this confusion.

Listed disclosing companies to include in the remuneration report the details of all payments made to KMP upon their retirement from the company

CSA supports this amendment.

The *Corporations Amendment (Improving Accountability on Termination Payments) Act 2009* was introduced to address shareholder disquiet about termination benefits, particularly in instances of poor company performance, by lowering the threshold at which termination benefits must be approved by shareholders. The proposed amendment ensures full transparency to shareholders as to any payments made to KMP upon their retirement from the company.

Listed disclosing companies to disclose for each KMP:

- ***the amount that was granted before the financial year and paid to the person during the financial year***
- ***the amount that was granted and paid during the financial year; and***
- ***the amount that was granted but not yet paid during the financial year.***

Concerns with the proposed amendments
CSA has serious concerns with this proposed amendment, as we do not believe it will simplify remuneration reporting at all. Rather we are strongly of the view that it will serve to further confuse the target audience of remuneration reports.

That is, the proposed new requirements will supplement, rather than replace, the existing remuneration disclosure requirements.

The proposed disclosure requirement will see three additional numbers reported. Australian companies will have to disclose two differently calculated pay numbers for each executive. This is not simplification of remuneration reporting, but an additional convolution that will not provide investors with the clarity on remuneration that they seek. Rather, it will be ambiguous and confusing for shareholders and other stakeholders, as they try to ascertain which number is the correct one.

Moreover, the bill lacks details on matters such as the measurement of the pay components, which means that there is a high probability of Australian companies adopting different interpretations. This will defeat any possibility of comparability, which is a critical requirement for shareholders and stakeholders.

The proposed disclosure requirement will also see double-counting of remuneration, as the same figures will be reported in successive years. This too will add to the complexity and confusion of remuneration reporting. The proposals are counter to any policy objective to make remuneration information accessible to and understandable by shareholders and other stakeholders.

Anyone involved in both the preparation and reading of remuneration reports knows that there are serious problems with remuneration reporting under the current regulatory approach. A fresh approach to content, built around real consensus, is desperately needed. The current proposals do not meet this criterion.

Simplification should be the core principle of any further amendments to remuneration reporting

CSA supports the principle that any new piece of legislation concerning remuneration reporting should not add further complexity to these already convoluted disclosures by imposing additional reporting requirements.

CSA is of the view that there is an urgent need for an approach to legislative requirements concerning remuneration reporting that aims to simplify reporting, rather than adding layers of complexity, in order to provide investors with the clarity they seek.

Many companies have put considerable effort into drafting their remuneration reports as clearly and simply as possible over the past few years, but due to the interaction with the accounting standards the outcome has not been as effective as hoped. This is compounded by the addition of new pieces of legislation over time, which further complicate remuneration reporting, making it extremely difficult for investors to gain a clear picture of how remuneration decisions are made and applied in entities, or to gain transparency as to how much KMP are paid and how it is calculated.

The UK approach

CSA has examined the UK approach to remuneration reporting with interest. The UK approach was aimed at the simplification of remuneration reporting, as it identified the issue of multiple figures being disclosed for each executive and how this added to the complexity and confusion, rather than providing clarity to shareholders.

In order to achieve accessibility and clarity, it was recognised by the UK Government that:

- existing legislation needed to be repealed in order to implement a new approach
- shareholders, in discussion with investor bodies, companies and remuneration experts, were better placed than public servants to develop an approach to remuneration reporting that met investor needs
- the new requirements developed by shareholders were to replace the existing requirements.

Accordingly, in January 2012, the Secretary of State for Business in the UK announced a series of proposals relating to executive pay and its disclosure. These proposals addressed four areas of focus, one being ‘greater transparency so that what people are paid is clear and easily understood’.

The UK Department of Business Innovation and Skills (BIS) set out more detail on the proposed disclosure requirements in mid-2012, one of which was for ‘one single figure for total remuneration of each director’. (In Australia, non-executive directors’ remuneration is not subject to performance hurdles and nor do they receive retirement benefits or options or bonus payments. The first edition of the ASX Corporate Governance Council’s *Corporate Governance Principles and Recommendations* in 2003 provided guidelines on non-executive director

remuneration, which ensured that non-executive directors did not participate in schemes designed for the remuneration of executives. Therefore, in Australia, executive and non-executive remuneration are properly contained. It provides clarity to the market generally to differentiate between non-executive and executive directors' remuneration.)

As there was no agreed basis for calculating this 'single figure', at the request of BIS, the Financial Reporting Lab agreed to undertake a short-term project to obtain the views from the investment community on how a 'single figure' might be measured and presented, with the objective that the output would be made available to help inform BIS's thinking in developing this disclosure requirement. The group that was formed consisted of shareholders, investor bodies, companies and remuneration experts. Importantly, the main driver was to develop remuneration reporting requirements that met investor needs — the principles of comparability and clarity underpinned the work of the group.

The Financial Reporting Lab recommended to the UK Government — and the government adopted the recommendation — a method that focuses on share awards with a link to current year performance. The new rules specify in detail how the components of pay are to be calculated and reported, which means they are comparable across companies.

The overall project to arrive at a new approach to remuneration reporting in the UK was subject to nine months' detailed consultation. By the time the single figure was announced, all parties had had ample time to participate in the consultation process and provide their input and feedback.

CSA Members do not recommend that Australia should simply import a concept from the UK, given that the UK concept had been designed to meet the needs of a particular jurisdiction. However, we note that:

- the consensus approach provided for frank and robust discussion of investor needs and how best to meet them
- the final approach to the development of a single figure has been greeted with approval by shareholders, investor bodies, companies and remuneration experts
- there is agreement that the single figure provides greater transparency to investors so that what people are paid is clear and easily understood.

In considering the 'single figure' approach, it is important to note that the draft UK regulations require all the components — base salary, benefits, pension/superannuation, STI and LTI — to be disclosed in a table that will look very similar to the current Australian statutory table. The single figure will be the total of these components. The single figure will include all the components of what is referred to in the bill as 'past' and 'present' pay — the only differences between the UK and Australian approaches are that the UK regulations define very precisely how to measure and report each component, whereas the Australian bill lacks specificity. The UK regulations specify the inclusion of STI and LTI share awards that are more closely tied to current year performance and also require disclosure of what is referred to in the Australian bill as 'future' pay.

The UK regulations also require many other disclosures, for example, on pay versus performance; additional pension disclosures; loss of office payments; future pay policy; service contracts; pay scenarios; etc. But the ones highlighted above are those that demonstrate that the single figure is neither a lessening of disclosure standards nor a diminution of the amount of information provided relative to the current regime (either in the UK or Australia). It is for these reasons that CSA is of the view that the UK approach is worthy of consideration.

On this basis, CSA is of the view that Australia should explore the UK approach, which is a 'single number' concept, and how and whether it could be applied in Australia. This could be effected through roundtables involving shareholders, investor bodies, companies, remuneration experts and bodies such as CSA representing those involved in preparing disclosures, to tease out the issues and robustly test any suggested approaches to remuneration reporting.

CSA strongly recommends that, rather than adding three more concepts requiring listed disclosing companies to disclose past, present and future pay — which apply in addition to existing reporting requirements — as set out in the bill, any changes to Australian remuneration reporting should be proceeding on the basis of:

- developing a consensus approach between shareholders and companies to ensure any recommendations to the government on remuneration reporting meet investor needs
- repealing existing legislation in order to implement the consensus approach
- introducing the new requirements to replace the existing requirements.

3 Clawback of remuneration

CSA is on record as having recommended in various submissions both to the Productivity Commission in response to its inquiry into the regulation of director and executive remuneration and to Treasury in its consultation on approaches to clawback that the company should reserve the right, at the discretion of non-executive directors to:

- reclaim performance-linked remuneration elements which were paid to or vested on executive directors on the basis of results that afterwards were found to have been significantly misstated because of wrongdoing or malpractice (a 'clawback' provision), and
- not make such payments if the results are found to be manipulated.

We strongly support mechanisms to facilitate the recovery of amounts paid to executives based on financial statements subsequently found to be materially misleading as being in the best interests of shareholders. It is appropriate commercial practice for a company to negotiate such an outcome and reflects good corporate governance.

We appreciate that the bill contains a clawback provision that is significantly less prescriptive than the one set out in the original discussion paper. The bill amends the Corporations Act by requiring listed disclosing companies whose financial statements have been materially misstated to disclose whether any overpaid remuneration to KMP has been 'clawed-back', and if not, to provide an explanation.

While we recognise that the bill leaves the choice to claw back remuneration with the board, which we support, CSA remains of the view that the clawback of executive remuneration is best dealt with in the ASX Corporate Governance Council's *Corporate Governance Principles and Recommendations* (the guidelines), which provide a mechanism for the review by investors of decisions taken by directors. Our view is also based on the clawback requirements in the draft bill being couched as an 'if not, why not' disclosure requirement, which is the cornerstone of the accountability mechanism provided in the guidelines.

Remuneration is structured differently in individual companies. Designing and implementing provisions in employment contracts to recover erroneously awarded remuneration could expand to include unjust enrichment other than misstatements of financial statements, should that be appropriate to the company. That is, boards would need to decide when formulating their policy on clawback provisions if they intend it to apply to beyond a material misstatement of the financial statements, or if it is intended to apply regardless of fault. The board may decide that the clawback policy is not intended to penalise any employee unfairly, or that it is intended that the company not pay more remuneration than it should regardless of fault.

The choice as to how to recover the unjust enrichment is a matter for the company. An expanded clawback policy would result in an employment contract freely entered into by an executive that provides for a company to reclaim performance-linked remuneration elements which were paid to or vested on executive directors in alignment with the company policy. Under contract law, the company would have the capacity to take legal action against any employee under the terms of their employment contract. This flexibility is in shareholders' favour.

Including a disclosure obligation in the guidelines ensures that the board must explain to its shareholders its decision making on this issue. Such a disclosure obligation provides clarity to shareholders as to whether the companies in which they invest have entered into contractual arrangements that provide for the company to be reimbursed where there has been unjust enrichment.

CSA continues to recommend that clawback be dealt with through the introduction of new reporting recommendation in the ASX Corporate Governance Council's *Corporate Governance Principles and Recommendations* as follows, setting out that boards should:

- develop and disclose a policy or summary of the policy on the clawback of equity remuneration
- put in place a framework for managing the clawback of equity remuneration
- disclose a summary of the CEO's contract and any clawback provision in it and report on the framework for managing the clawback of equity remuneration.

Should the government decide to progress the legislative approach to clawback, CSA has no comment on the proposed amendments set out in the bill.

4 Relieving public companies from the obligation to appoint auditors if audits are not required

CSA supports this amendment.

5 Remuneration setting for certain statutory office holders

CSA supports this amendment.