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Inquiry into Executive Remuneration
Productivity Commission
Locked Bag 2, Collins Street East
Melbourne VIC 8003

Our ref 7716543_1

23 June 2009

Dear Commissioners

Executive Remuneration

We appreciate the opportunity to make this submission to the Productivity Commission's Inquiry into Executive Remuneration.

KPMG considers the work of the Commission on this subject is of the utmost importance to the effective operation of our markets and the role of human capital in those markets.

The Commission's Terms of Reference are wide ranging and many pages could be written in relation to each category. We have limited our submission to focus on the four most significant aspects of the current debate.

We have attached four appendices setting out our submission in each respect:

Appendix A: Effectiveness of regulatory arrangements

Appendix B: Alignment of shareholders, boards and executives

Appendix C: Impact of taxation on executive remuneration

Appendix D: Role of the remuneration advisor

We look forward to presenting on these and responding to your questions at the Productivity Commission hearing in Melbourne on 25 June 2009.

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In the meantime, if you have any queries please do not hesitate to call me on 03 9838 4600.

Yours sincerely

Martin Morrow
Partner, Equity Based Compensation

Appendix A

TOR: Effectiveness of regulatory arrangements

The Commission has been asked to consider the effectiveness of the existing framework for the oversight, accountability and transparency of remuneration practices in Australia. Some key questions that arise include:

- Are current disclosure requirements in the remuneration report too complex?
- How can we modify the disclosure requirements to help shareholders understand companies' Remuneration Reports better?

KPMG response

Background – current reporting requirements

For Australian Stock Exchange ("ASX")-listed companies, the disclosure of senior executive and director remuneration is governed by overlapping regulations, principally:

- Section 300A Corporations Act 2001; and
- Australian accounting standard AASB 124 Related Party Disclosures.

The ASX Corporate Governance Council has also published its own Corporate Governance Principles and Recommendations. Principle 8 in particular relates to executive remuneration. ASX Listing Rule 4.10.3 requires boards to disclose how their company is meeting the recommendations under principle 8, or to state "why not" if they choose not to follow certain of them.

Importantly these regulations and guidelines do not just require the disclosure of remuneration amounts, they also require explanation from the directors of how they see the link between the entity's executive pay practices and the entity's performance.

Professional bodies such as the Australian Institute of Company Directors ("AICD") have contributed further guidance for boards on how they should determine appropriate levels of executive remuneration.

It follows that listed companies' disclosure of executive remuneration is the product of boards' efforts to demonstrate compliance with the requirements of both regulators and community standards. However, we believe that these requirements combine to generate inefficiency and complexity in the reporting process which detract from the policy intention of providing information which investors can readily understand.

We have highlighted the most prominent issues below, together with our recommendations on how they might best be resolved.

Issue 1 - identifying whose remuneration the company should disclose

Subsection 300A(1)(c) Corporations Act 2001 ("the Act") requires a company to disclose the remuneration of key management personnel ("KMP") and of the five highest-paid executives ("group executives"). AASB 124 defines KMP as:

"those persons having authority and responsibility for planning, directing and controlling the activities of the entity......including any director.."

The Act defines a group executive as:

"a secretary or senior manager of the company.."

These definitions require a great deal of judgment from boards in terms of who should be included, and as a consequence boards often resort to legal advice. Companies incur time and expense in reaching a conclusion on which employees should be included in the disclosure, when the anecdotal evidence is that shareholders are overwhelmingly interested in the remuneration of only the directors (including the managing director / chief executive officer). In our view, the principal outcomes of the disclosure of remuneration of non-directors are:

- inflationary tendencies across a broader range of senior executive functions due to the ability to compare roles and relative pay levels based on public information;
- companies can experience difficulty in attracting suitably qualified individuals for certain roles whose remuneration is likely to be disclosable, on the grounds of concerns about personal security; and
- remuneration reports expand to include a large amount of detail about employees whose roles shareholders do not fully understand and, therefore, whose remuneration is of relatively little interest or usefulness when making decisions about investing in that entity.

Recommendation 1 - the company should only disclose the information that is important to shareholders

We recommend that disclosing entities should disclose the $ value of remuneration components (eg short-term, long-term, share-based payments) for the individual directors (including executive directors and the CEO) only.

Companies should inform shareholders about the extent to which the pay of other 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), but not the $ amount for each individual.

Issue 2 – determining how to disclose the value of non cash components of the remuneration package

The outcome of the disclosure requirements detailed above is often a remuneration report consisting of what can be 20 pages or more outlining every element 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 that the details of each remuneration element paid or payable for services rendered be detailed in the prescribed format. This means that the cash salary paid to the executive is often disclosed in the same table as the portion of the value of Long Term Incentive (“LTI”) granted to the executive in respect of the relevant year.

The actual value of salary and annual cash bonus is easy to determine, while the actual value of the LTI cannot be known with certainty until the instrument has vested (and if relevant, disposal restrictions have lapsed). The LTI value reported is the estimate of fair value that has been determined in line with the relevant accounting standards. Actual value derived by the executive can be potentially either higher or lower than the estimate and will not be known for some years.

As a result of these disclosure requirements, it is easy for this estimate of possible LTI value to be understood by retail investors as being the actual value that has been realised by the executive.

Example – value at grant, no actual value to date

In the year ended 30 September 2002, one of Australia’s leading banks granted 11,263,500 options to 751 senior employees. The Fair Value of these options as disclosed in the Financial Statements for the year was $71,861,130. The Fair Value was determined based on a numerical pricing method which took into account the probability of achieving the performance hurdles.

This value is disclosed in the table showing the senior executive emoluments in the Report of the Directors. To date, the executives have not received any benefit from this grant of options as to date none have, in fact, vested regardless of the fact that these options were shown as having a value of $6.38 each.

Further, none of the Long Term Incentives that have been granted by this bank since 2002 have vested. Nonetheless the bank's Remuneration Report for the year ended 30 September 2008 shows that an amount of $10,453,200 in respect of options and rights held at risk by Key Management Personnel was expensed in the year. This amount was determined in accordance with the relevant accounting standards and using appropriate valuation models. The relevant proportion of this amount is also included in the table showing the remuneration for the KMPs regardless of the fact that nothing has vested to date. An amount based on the accounting value is still listed as "remuneration" for each KMP.

Example – value at grant, real value at vesting?

A large Australian based manufacturing company granted 250,000 performance rights to a senior executive in the year ended 30 June 2004. The rights were valued at $1.60 at the time of grant and were subject to a 4 year performance period and a total shareholder return hurdle. At grant the share price of the company was approximately $2.70.

The total value of the rights on the basis of the accounting valuation was $400,000. The year ended 30 June 2004 was prior to the introduction of AASB 2 and accordingly the amount was not required to be expensed. However, had AASB 2 been in place at the time, $400,000 would have been expensed in the financial statements amortised over the vesting period (4 years), regardless of the number that actually vested.

On 1 July 2007, only 60% of the rights vested. The remaining 40% was forfeited. The value of the shares at the time of vest was $3.52.

Accordingly, at the time of vesting the value of the shares obtained was $528,000 (150,000 x $3.52).

In this case, the value at the time the rights vested was higher than the amount that had been disclosed as the value granted.

However, the shares acquired on the vesting of the performance rights are subject to a disposal restriction for 3 years from the date of vesting. Where the executive ceases employment the restriction period is 12 months from the date of termination.

While the 3 year disposal restriction has not lifted, the current share price is approximately $0.80. Accordingly, if this price is representative of the price at the time the disposal restriction lifts and the executive was able to realise the value of the shares, the value realised would be $120,000.

The point to note is the difference between the value ascribed to the rights ($400,000) and thus reported as remuneration of the executive during the vesting period (4 years) compared to the value that may be ultimately realised, in this case up to 7 years after grant (eg $120,000).

This point is only acknowledged in very small type within a note to the remuneration table. In the 2008 remuneration report, the company states:

"To the extent required by the Australian Accounting Standards, remuneration includes a proportion of the fair value of equity compensation granted or outstanding during the financial year….. The amount included as remuneration is not related to or indicative of the benefit (if any) that individual executives may ultimately realise should the equity instruments vest."

Recommendation 2 – the company should disclose the grant of equity instruments to employees in simple terms

The Remuneration Report could simply cease to include fair values for share based payments ("SBP"). Instead it could focus on the number of securities the entity has granted to 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 the SBP expense amount which would often have its basis in the grant date value.

Alternatively, we recommend that above the table disclosing the remuneration elements of the relevant individuals (refer Recommendation 1), the following is clearly noted in large format type:

> **"Important Note – The table shows details of remuneration provided to the relevant individuals.**
>
> **The short-term components consist of salary, allowances, fringe benefits and annual or short-term cash bonuses attributable to the financial period.**
>
> **Share-based payments ("SBP") represent the amount expensed in relation to the executive during the financial period, calculated in accordance with AASB 2 Share Based Payments.**
>
> **The disclosed SBP amount may differ from the benefit (if any) that relevant individuals ultimately realise, should the SBP instruments vest.**
>
> **Refer to Table xx for a summary of the number of shares (if any) transferred to the relevant individuals in relation to the financial period."**

Appendix B

TOR: Aligning interests: shareholders, board and executives

The Commission has been asked to consider trends in remuneration in Australia, and internationally, including, the types of remuneration being paid, including salary, short-term, long-term and equity-based payments and termination benefits and the relationship between remuneration packages and corporate performance.

Some key questions include:

- What types of remuneration structures and performance hurdles could be used to align the interests of executives and shareholders?
- What is the role of boards in developing and approving remuneration packages?

KPMG Response

The remuneration of executives should comprise an appropriate mix of fixed remuneration and variable remuneration so that an executive's remuneration is variable depending on the performance of the company and his or her own performance.

In this regard:

- fixed remuneration includes base salary, superannuation and benefits;
- short-term incentive ("STI") is paid for meeting specific performance targets (although mechanisms should be in place to ensure executives do not focus on short-term performance to the detriment of the long-tern performance of the company); and
- long-term incentive ("LTI") is tied to the long-term performance of the company.

Types of incentive arrangements

Short-term incentives

STI is the way in which boards can reward executives for meeting specific targets over a one year period. The key issues in respect of STI's include:

- it is appropriate for remuneration packages to include an STI - a remuneration package that includes an STI is preferable to providing an increased base salary as an executive should only be rewarded under an STI where performance meets specific targets;

- for the most senior of executives STI targets should be set by boards to align with the creation of sustained shareholder value with appropriate mechanisms to limit risk-taking by executives (such as the use of risk-adjusted returns rather than absolute measures);

- consideration should be given to compulsory deferral of a portion of STI into deferred equity (i.e. equity that cannot be sold for a period such as 1-2 years). In this manner the reward an executive receives is tied to the future performance of the company and is more closely aligned with shareholders. The proposed Budget changes may mean that this will not be feasible as an executive would be subject to tax on the deferred equity, notwithstanding it cannot be disposed of;

- bonuses should not be taxed differently to ordinary salary and wages, as an increased tax on bonuses would result in higher base salaries. In this event there would be a reduction in the alignment of executive pay with performance, as base salary is paid irrespective of performance;

- the quantum of STI should be determined by the board. The board should disclose the maximum level of payment that executives can receive under an STI (as a % of fixed remuneration) so that it can be voted on by shareholders as part of the non-binding shareholder vote on the Remuneration Report; and

- limits on the tax deductibility of bonuses for a company, or increased taxation for individuals, will undermine the ability of companies to attract and retain executives in a global economy. This will threaten the competitiveness of Australian companies against overseas companies that are not subject to the same regulation. More relevantly such artificial ways to influence market forces will lead to a distortion of compensation practices and the development of exotic instruments and reward mechanisms.

Long-term incentives

- LTI should be an essential component of an executive's remuneration package;

- boards should determine the features of the LTI including quantum, performance hurdles and performance period. This should continue to be subject to a non-binding shareholder vote;

- the LTI should be provided as a form of equity – this aligns the interests of executives with the interests of shareholders as the reward provided to executives is tied to movements in the company's share price;

- a cash LTI that is not linked to the movement in the share price of the company may not align the interests of an executive with those of shareholders as well as equity does;

- the performance period of an LTI should generally be at least 3 years;
- executives should not be able to hedge unvested LTI awards; and
- the LTI award should be taxed at the same rate as salary and wages – the appropriate taxing time is at the time the executive can dispose of the award.

A further discussion on specific key features of the STI and LTI is included below.

Role of the board

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 reward 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 STI and LTI;
- judge the performance of executives against the objectives set for them; and
- communicate the remuneration package to shareholders – including guidance on the quantum of reward that can be earned under a plan.

It is difficult to believe that an external organisation (such as a proxy adviser or investment manager) could 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 not appropriate.

However, it is appropriate for shareholders to vote on the Remuneration Report of a company. This provides feedback to boards and ensures that remuneration practices are monitored.

We do not consider that it is appropriate for the shareholder vote to be binding vote as:

- boards are elected to run a company on behalf of shareholders. The ability to remunerate key executives of the company is fundamental to attracting and motivating the key individuals the board considers are required to fulfil this primary obligation. Without the ability to remunerate executives, the board cannot fulfil its obligations;
- the information available to shareholders that may govern the decisions of the board is limited (and given commercial considerations as to the confidentiality of this information it

cannot be provided to shareholders). This means shareholders are not as well placed as the board to set the remuneration of executives; and

- shareholders can vote to elect (or not elect) the board of directors. This provides a direct opportunity for shareholders to remove directors they consider to be implementing inappropriate remuneration practices.

Type of performance hurdle

STI and LTI plans should include appropriate performance hurdles that seek to reward long-term creation of shareholder wealth. We consider that:

- boards are best-placed to determine the performance hurdles used in incentive plans. It is inappropriate to regulate the type of performance hurdles that can be used in plans as the key features, direction and drivers of each business are different. Regulation would undermine the ability of a company to reward executives for fulfilling the key outcomes considered to drive the creation of shareholder wealth for each specific business;

- the performance hurdles used in plans should be disclosed in the Remuneration Report – where a market-based hurdle such as total shareholder return ("TSR") is used, the comparator group and vesting schedule should be clearly articulated. Where an internal hurdle is used, a description and rationale for use of the hurdle should be outlined; and

- any discretion for a board to waive performance hurdles should be outlined in the Remuneration Report.

There has been continuing propensity for governance advisers and institutional investors to encourage boards to use total shareholder return measure against a peer group of companies ("relative TSR") as a key performance hurdle. This has led to companies using a relative TSR hurdle because:

- it is accepted practice;

- it is a concept familiar to shareholders and analysts;

- its measurement can be externally verified ; and

- it will get the 'tick' from governance advisers.

This is unfortunate because a relative TSR performance hurdle does not necessarily provide an accurate reflection of the company's performance unless the peer group is closely aligned with each other. In the Australian market it is difficult to find companies with a suitable number of direct competitors in the same industry with similar products and of similar size. The best

example in the Australian market of an appropriate peer group is the big 4 banks. Good peer group examples can also be found in different strata of the mining sector. However, outside of these examples it is not easy to find appropriate peer groups.

Yet, there is intense pressure on boards to use a relative TSR performance hurdle.

Recommendation – performance hurdles

It is submitted that the Productivity Commission should find that the ultimate determiner of 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.

Appendix C

TOR: Impact of taxation on executive remuneration

The Commission has been asked to consider any mechanism that would better align the interests of boards and executives with those of shareholders and the wider community. In doing so the Commissioner has been asked to:

- consider the role played by the tax treatment of equity based remuneration;
- to liaise with the Australian Future Tax System Review and the Australian Prudential Regulation Authority in relation to, respectively, any taxation and financial sector remuneration issues arising out of its review; and
- to make recommendations as to how the existing framework could be strengthened.

KPMG Response

Background – current taxation arrangements and proposed changes

Remuneration received by an executive in respect of services rendered by that executive is generally taxed as ordinary employment income at the executive's marginal rate of tax. This means that the value of compensation whether it be in the form of cash, property, shares or rights to acquire shares ("rights") would ordinarily be taxed at an individual's marginal rate of tax. An exception to this rule is the provision of fringe benefits. If a fringe benefit is provided to an executive the employer pays fringe benefits tax ("FBT").

Another exception to the general rule is the provision of shares or rights to an employee. Since December 1995 Division 13A of the *Income Tax Assessment Act 1936* (the "ITAA 1936") has prescribed the way in which an individual should be taxed when they are granted shares or rights in respect of their employment.

Division 13A levies tax on an employee in the year in which shares or rights are granted to the employee, unless they are qualifying shares or rights. Qualifying shares and rights are taxed at the *cessation time*. It is not necessary for present purposes to describe the conditions under which shares or rights will be qualifying but suffice it to say that the majority of employee share plans are designed to be qualifying.

The cessation time is, broadly, the earlier of:

- the time when the share or right is disposed of (other than by exercise in the case of a right);

- the time when any restriction preventing sale of the share lifts, or in the case of the right the time when any restriction preventing the sale of the share acquired by exercise of the right lifts;
- termination of employment; and
- ten years.

In general terms, the individual is taxed at their marginal rate on the market value of the share at that time reduced by any amount paid to acquire the share. This is commonly referred to as deferral of taxation because the individual pays tax when they are able to realise any gain on the shares or rights, rather than paying tax at the time the shares or rights were granted to them.

This approach to the taxation of employee share scheme income is common throughout the world.

Division 13A of the ITAA 1936 allows an employee to choose an alternative method of taxation.

An employee can elect to pay tax in the year in which the shares or rights are granted. In this event, the value of the shares or rights is taxed at the employee's marginal rate of tax and the employee is then treated as holding the shares or rights as capital assets. As such, the employee's next taxing point is when they dispose of the share or right, or share acquired by the exercise of the right.

Division 13A of the ITAA operates to prescribe a statutory value, in particular, for unlisted rights. This value is broadly based on an adjusted Black-Scholles option pricing model. The taxation value of unlisted rights under the statutory formula is determined by reference to a table and is a percentage of the value of the underlying share.

It is this latter election in the legislation that has created an element of controversy and debate. There have been media comments and various statements made that executives are able to pay tax at a rate of 26% (sic) on the shares and rights granted to them. Such claims are incorrect and are misleading.

If an employee is granted a performance right (i.e. a right to acquire a share for no consideration) and elects to pay tax at grant, the employee will pay tax on the market value of the share on the day of grant. The employee will then next pay tax at the time of disposal of the share. Taxation at that time will be determined under the capital gains tax provisions. This is a correct reflection of the law as the employee would have acquired the share from after tax salary by virtue of the fact that they paid tax at grant.

Similarly, if the employee was granted a right to acquire a share for an exercise price equal to the market value of the share on the day of grant and the right expired at the end of five years,

the employee will pay tax on 11.6% of the exercise price if he or she elects to pay tax in the year of grant. The employee would then pay tax on the disposal of the share that was acquired by exercise of the right. That transaction would be subject to the capital gains tax provisions of the legislation and if the employee held the share for more than 12 months after acquiring it by exercising the right, any gain would be subject to the capital gains tax discount rules. That is, 50% of the capital gain would be included in the employee's assessable income. It is important to recognise that the capital gains tax discount is only available if the employee holds the share for more than 12 months.

The Government's proposed rules

Since the 2009 Budget, the Government has undertaken a series of consultations and on 5 June 2009 released a Consultation Paper indicating its proposals to revise the employee share scheme rules. The Consultation Paper proposes a number of wide ranging reforms but, for the purposes of this submission, the most relevant are the following:

- there will no longer be an election available to the employee to choose to pay tax at grant or on a deferred basis. The design of the employee share scheme will determine whether the employee is taxed at the time of grant or at a later time;
- if the employee share scheme meets certain conditions including a primary condition that the employee has a real risk of forfeiting the shares or rights, the taxing point will be the earlier of:
  - the time when the employee disposes of the share or the right,
  - the time when the employee no longer has a real risk of forfeiture,
  - termination of employment, and
  - seven years.

The Government has advised in its Consultation Paper that it will continue to review the valuation rules as presently prescribed in Division 13A. It will be referring the valuation rules to the Board of Taxation for further consideration as the Government is concerned that they may undervalue the taxable value of unlisted rights.

Many submissions have been made to the Government on its proposed rules. There is a broad theme in those submissions that the Government's proposal to tax employees at the earlier time when an employee no longer has a real risk of forfeiture will give rise to inequitable outcomes for the individual. The argument by many people, organisations and companies making submissions is that the individual should not be taxed until they are first able to deal in the shares or rights without any restriction preventing them from so dealing.

The APRA Discussion Paper

It is also relevant to recognise that the Australian Prudential Regulation Authority ("APRA") released its Discussion Paper and included therein a recommendation that executives and employees throughout the organisation should be remunerated in shares and or rights so that their compensation is linked to shareholders. Further, and importantly, APRA recommends that such compensation be deferred for a number of years until such time as the performance on which it was given is able to be fully assessed and it can be determined that no part of the compensation should be forfeited for subsequent underperformance. In this regard, APRA, along with others, considers it important that executives be rewarded with compensation that does not vest at the time of termination of employment. Notwithstanding that an employee may voluntarily resign, APRA and others have called for the employee's equity compensation to remain unvested until the performance has been fully tested.

APRA recognises in its Paper that taxation liabilities might arise on termination of employment and indicates that it would be acceptable for employers to release sufficient number of shares to enable the employee to meet their taxation liability.

Issue 1 – the appropriate basis on which to tax executive compensation

The Government's Consultation Paper indicates that its starting principle is to tax employee share income at grant but provide deferral of taxation under limited circumstances. In both cases the employee will be taxed at their marginal rate of tax. Those principles are appropriate.

This equally means that if an executive is taxed at the time they are granted share or rights, any subsequent gain will be taxed on capital account. This is also appropriate.

Issue 2 – should the executive be taxed when there is no longer a risk of forfeiture

The proposal by the Government to tax an employee when they no longer have a real risk of forfeiture can lead to inequitable outcomes for the employee.

The Commission should recognise that arrangements under which full entitlement to shares or rights does not vest in the executive until the performance of the individual and the company has been fully tested is appropriate. Further, it is important that executives be required to hold minimum shareholdings so that their interests are aligned with those of the shareholders. It is also necessary to recognise that, even when an executive's or employee's shares or rights may be fully vested, there will be many occasions when they will not be entitled to deal in those shares or rights because of trading windows or because they hold sensitive inside information.

If the Government's proposal to tax the employee at a time when they no longer have a real risk of forfeiture is ultimately legislated, there will be inequitable outcomes from the employee being taxed at a time when they are unable to deal in the shares or rights. These outcomes would include employees having tax liabilities when they are unable to sell the relevant shares (or even other fully rested shares) to fund the liability. In any event, the value on which the executive is taxed is unlikely to reflect the value ultimately realised by the employee.

It is submitted that the Commission should recognise in its final report that the appropriate time at which an executive should be taxed should be no sooner than the time that the executive is first able to deal in the shares or rights, rather than the time when they no longer have a real risk of forfeiture.

Issue 3 – taxation on termination of employment

Governance advisers, shareholder groups, APRA and many others recognise, and have called for equity compensation arrangements to continue past the time of an executive's termination of employment.

It is not an appropriate governance measure when APRA is forced to recognise that an employee can have a tax liability at the time of termination of employment without the ability to realise the value of the relevant equity holdings. APRA acknowledges that, because of this, it would be acceptable for a company to release sufficient of the equity holdings to enable the employee to meet that tax liability. This is inappropriate governance because taxation policy is driving compensation design and behaviour, rather than compensation design being determined by appropriate governance policy.

It is submitted that the Productivity Commission's final report should include a recommendation to the Government that termination of employment should not be a taxing point.

Appendix D

TOR: Role of the remuneration consultant

The Commission has been asked to consider the role of remuneration consultants including any possible conflicts of interest in executive remuneration.

Some of the key questions this raises include:

- What is the role of remuneration consultants and what has been their influence on remuneration practices including levels, growth and structures of remuneration?
- Do any conflicts of interest exist?
- Should Government have a greater role in regulating remuneration?

KPMG response

Background

There has been media discussion and commentary that remuneration advisors have played a significant role in the determination of amounts and types of executive remuneration. There have been claims that remuneration advisors have a conflict of interest in the role they fulfil.

These claims are simplistic and do not recognise that companies, executives and boards need to seek advice and inform themselves.

Remuneration advice is provided to executives as well as boards by both internal and external advisors. Many of the largest ASX listed companies have significant internal resources to design appropriate remuneration structures based on data that they have gathered themselves or have acquired from external sources. However, there are many companies that do not have sufficient internal resources nor resources with sufficient expertise to fully inform the board on the details of appropriate remuneration structures.

Both boards of directors and executives require independent expert advice for the following reasons:

- Companies need to competitively reward their employees or risk losing them. It is a core activity of the human resources function of a company to continually obtain independent data of remuneration across all levels of the organisation so that it maintains the right level of remuneration. It is not surprising that in the current economic climate, companies are finding that the remuneration levels are frozen, or in some circumstances, reducing. Human resources functions need market data in order to validate their annual remuneration reviews.

- There is no one right, or wrong way in which to reward 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 simpler it is the experience of many organisations that over-simplified remuneration arrangements lead to poor outcomes and inequities between employees. 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 reward the employee. It is the role 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.

- Remuneration can, in its simplest form, be provided as cash or otherwise in property or shares or rights to acquire shares. In all forms there are accounting, taxation, valuation, legal, and behavioural implications of the way in which it is provided. Human resource groups, executives and boards of directors seek the advice of remuneration advisors to help them understand the interaction and implications of each of these aspects on the way in which employees and executives are to be rewarded. An organisation can build its own expertise in house across each of these areas and seek to limit the extent to which it obtains external advice from remuneration advisors. However, such organisations put themselves at risk of falling behind the market, the internal group becoming subject to the same conflicts as external groups, and the same pressures. In any event, the cost of building and maintaining that specialised expertise within an organisation can be prohibitive.

- There can clearly be occasions when conflicts of interest can arise for remuneration advisors. This is the case in any number of circumstances for an organisation. It is appropriate that the organisation have controls and systems in place that address conflicts of interest. The most recent and best example of this is the arrangements put in place by companies seeking to address conflicts of interest and independence issues with their auditors. Both auditors and their clients have built systems and controls to enable them to address the potential for conflicts of interest arising.

  The same should be in place in relation to remuneration advisors. It is necessary to recognise that governance advisors, companies, shareholder groups, APRA and others have all recommended that the board of directors take a greater involvement in determining the remuneration structure of an organisation. It is important and relevant therefore that boards and executives have access to, and be encouraged to use remuneration advisors.

Issue 1 – using remuneration advisors

It is submitted that the Commission should find in its final report that the board should be responsible for appointing the company's remuneration advisor and dictating the terms of reference.

Further, the Productivity Commission should recommend that companies have clearly defined systems and procedures in place to address the potential for any conflicts of interest.

Issue 2 – should remuneration advisors be named

There is a case for remuneration advisors to be named in the remuneration report for the benefit of shareholders. However, it is important to recognise that the nature of remuneration advice, like that of any other advice provided to a company, is simply that – it is advice which may or not be followed by the company.

It is not unusual for a remuneration advisor to provide detailed recommendations and analysis to the board of directors only to find that the company has followed a different course in determining its final remuneration structure and quantum. This is not to say either the advice or the company's ultimate position was incorrect. Rather, the advice often informs the board and enables them to reach their ultimate decision.

There can be occasions when a remuneration advisor will advise a board against using a particular structure and arrangements. Nevertheless the board may, for its own reasons decide to use such structures. If those arrangements are considered inappropriate by shareholders the remuneration advisor would be concerned about being disclosed in the remuneration report as having provided advice to the company.

The disclosure of the name of the remuneration advisor raises the question whether all advisors to the company should be disclosed. For example, should the engineering advisor be disclosed and the extent to which their advice was followed; should the legal advisors be disclosed and the nature of their advice and whether it was followed; and it goes on.

It is submitted that the Productivity Commission should find that it is unnecessary and potentially misleading to require the disclosure of the remuneration advisor. However, it should nevertheless be recommended that companies and remuneration advisors should consider and agree the extent to which disclosure may be made.