The Institute of
Chartered Accountants
in Australia

6 November 2009

Mr Gary Banks
Chairman
Productivity Commission
Locked Bag 2
Collins Street East
Melbourne VIC 8003

Executive Remuneration Inquiry

Dear Chairman,

It is with pleasure that the Institute of Chartered Accountants in Australia (the Institute) provides this submission in response to the Productivity Commission's draft report into executive remuneration issued on 30 September 2009.

As the Productivity Commission (the Commission) will be aware, the Institute represents over 50,000 chartered accountants in Australia. Our members work in diverse roles across public practice, commerce, industry, government, academia throughout Australia and internationally. The depth and diversity of our membership places the Institute is an ideal position to be able to provide the Commission with an independent view of the proposed reform options set out in the draft report.

The Institute response is limited to taxation matters, comments about remuneration committees, remuneration report disclosures and the determination as to whom the detailed disclosures should be applicable. We find that the majority of the other recommendations highly commendable and will leave it to other respondents to provide detailed comments. The majority of the draft recommendations put forward by the Commission would – if adopted as final recommendations and ultimately agreed to by the Federal Government – go some way to addressing both real and perceived shortcomings in the existing framework for the remuneration of executives in Australia.

Whilst fundamentally there appears to be agreement that there is not a compelling case for radical reform, targeted improvements geared towards enhancing the existing remuneration framework would be desirable as Australia (in-line with other G20 nations) seeks to promote a greater level of transparency in this important area.

Contained in an appendix to this submission, the Institute has made specific comment in respect of the following key issues:

1. Opportunities to better align tax policy with best practice corporate governance.
2. Consistency in messages regarding the composition of remuneration committees;
3. Ensuring disclosure requirements in the remuneration report do not impose a greater burden on preparers of financial reports; and
4. Ensuring that duplication between accounting standard requirements and law requirements are avoided.

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The Institute previously lodged a joint submission with other representatives of the Australian accounting profession as part of the consultation phase of the Commission's inquiry.

The Institute has framed its response in this submission in recognition of the need to ensure that future regulatory reform needs to strike the right balance between introducing appropriate safeguards to protect shareholders' interests whilst at the same time ensuring that those reforms do not unduly impede business entrepreneurship or impose significant additional compliance costs.

Finally, it is worth noting for record that the Institute is scheduled to give evidence at the Commission's public hearing in Sydney on 9 November 2009. Further discussion of the comments and recommendations contained in this second submission will undoubtedly take place during that forum.

In the interim, if the Commission has any questions in respect of this submission, please do not hesitate to contact the Institute's Tax Counsel, Mr Yasser El-Ansary, on 02 9290 5623.

Yours sincerely

Lee White
General Manager Leadership and Quality

TAXATION ISSUES

The Commission's draft report contains one specific tax recommendation that the current tax policy setting which seeks to trigger an employee share schemes deferred taxing point at the time of cessation of employment should be removed. In other words, that cessation of employment should not trigger a deferred taxing point event in the hands of the executive.

The Commission's recommendation that the Government consider moving away from that policy setting is welcomed and fully supported by the Institute. The Institute has indeed been in support of such a change for many years, as well as more recently during discussions and negotiations with the Federal Government in relation to changes to the taxation of employee share schemes.

The draft report also examines the arguments for and against introducing various forms of special tax rates in respect of bonus payments received by executives, as well as limiting the entitlement of corporate entities to claim tax deductions for certain types of remuneration payments. The Institute supports the conclusions reached by the Commission that such strategies would be unlikely to promote desirable behaviours amongst corporate entities, and in fact, may in some cases yield precisely the opposite outcome to that envisaged.

In the context of employee share schemes, the Institute believes that there remain two further tax policy settings that the Commission should further investigate as part of its final deliberations in this inquiry. The Institute is firmly of the view that these two important policy tax issues, if not addressed by the Federal Government, are likely to promote behaviours that are inconsistent with the broader objectives of aligning management and executive interests with those of their shareholders, and are likely to result in significant additional compliance costs for both corporate entities as well as executives.

Taxation of rights at time of vesting

As the Commission will be aware, draft legislation relating to the new employee share schemes tax laws was recently introduced into Parliament. The new legislation proposes to adopt a policy position that the deferred taxing point in respect of equity rights will be triggered at the time when the rights are no longer subject to a 'real risk of forfeiture', or a time based restriction which prevents the employee from being able to dispose of, or exercise, those rights.

Whilst this deferred taxing point test is consistent with the equivalent test proposed to apply to shares [with which we do not have any concerns], in our view the underlying differences between rights and shares do not appear to be adequately taken into account in proposing this policy position.

Fundamentally, rights held by employees are typically subject to either, or both, a real risk of forfeiture in relation to the employee and company's overall performance against pre-agreed key specific measurements (such as profitability or total shareholder return), or perhaps a time-based restriction. It would not usually be the case that an employee would subject to further real risk of forfeiture or time-based restrictions once the rights are able to be exercised over the underlying shares in the company.

It is for this reason that the proposed policy position of triggering a deferred taxing point at the time that the rights are vested will likely result in situations whereby many employees, in order to generate sufficient cash funds to be able to meet their triggered tax liability, will effectively be compelled to either:

- dispose of the rights for cash consideration; or
- exercise the rights and immediately dispose of the acquired shares.

An implicit compulsion on employees to dispose of the rights or exercise the rights and dispose of the underlying shares is not considered to be an appropriate reflection of sound corporate governance as it allows taxation policy outcomes to unduly influence the behaviour of executives to take decisions that are not necessarily in the best interests of either themselves or their employer company.

Where an executive does not elect to dispose of the rights, or exercise the rights and dispose of the underlying shares, the outcome will be that executives will be required to pay tax at a point well before they have the means with which to fund their liability. As a fundamental principle, individuals should not be required to pay tax a point in time before they have realised the cash gain which may be generated from disposal of the rights and/or underlying shares.

In our view, it would seem appropriate for the Commission to consider the merits of this policy principle and determine whether such an approach is warranted in the context of attempting to foster a best practice corporate governance framework where the executive's interests are aligned to the long-term interests of shareholders.

It is the Institute's view that this tax policy setting should be changed such that the deferred taxing point in respect of options would be triggered at the time the options are exercised. Making this change would remove the undue influence that the proposed tax policy position may have on undesirably influencing employee decision making in a way that does not demonstrate a genuine alignment between employee, the company and its shareholders' interests.

Salary sacrifice schemes

Many Australian companies offer their executives and non-executive directors access to share ownership through the use of salary sacrifice arrangements. Under these types of plans, executives and non-executive directors are provided the opportunity to direct a portion of their pre-tax income towards the acquisition of shares in their employer company. It is also commonplace for specific management and executive-level employees to be required in some cases to direct a portion of their short-term bonus incentives towards the acquisition of shares in their employer company; this approach is attractive in that it has the effect of converting some of an employee's short-term remuneration into longer-term incentives.

The Institute believes that the current policy position of the Government of proposing to impose a uniform $5,000 per annum deferred taxing point maximum threshold in respect of salary sacrifice share schemes is inadequate.

The introduction of a threshold at this relatively low level in the context of executive level employees will, in practice, be considered too low to encourage executives and non-executive directors to voluntarily participate in employee share schemes. It is appropriate to conclude that for management and executive-level staff, a threshold limit of $5,000 per annum will only represent a relatively small proportion of their, on-average, higher salaries.

It would therefore be appropriate in our view for the Commission to examine the merits of recommending a change to the proposed $5,000 threshold limit for salary sacrifice arrangements. It may be more reasonable to consider either significantly increasing the threshold limit for senior-level employees, or perhaps removing the cap all together. Prior to the new taxation laws proposed by the Government over recent months, no salary sacrifice limit was imposed in respect of participation in such schemes.

REMUNERATION COMMITTEES

The Institute supports recommendation three in the Commission's draft report to elevate the ASX Corporate Governance Council's current suggestion on the composition of remuneration committees to a 'recommendation' within the Principles.

However, the Institute considers that recommendation two should be consistent with recommendation three regarding composition of remuneration committees and should not place an unnecessary burden on companies when they become part of the ASX 300. Furthermore, in many circumstances the involvement of the chief executive officer or managing director on the remuneration committee is valuable as this committee will typically look at many other areas of remuneration other than only the CEO or MD's salary. Therefore, the Institute believes that the words 'all of whom are non-executive directors' should be removed from recommendation two.

REMUNERATION REPORT DISCLOSURES

The Institute supports the disclosure of 'actual' or 'realised' levels of remuneration as part of recommendation eight. The Institute is of the view that this approach should however be limited only to equity rights (as this is the only area of confusion), and that it should be defined in a manner that utilises existing and accepted methodologies.

As an approach that could be considered by the Commission, the value assessed to taxation in the hands of the executive could be an appropriate methodology to determine 'actual' or 'realised' levels of remuneration. This methodology may be appropriate as it is encapsulated within the current Australian income taxation law and therefore would not likely create any significant additional compliance burden on corporate entities.

The Institute agrees that the remuneration report is an appropriate place to disclose equity holdings by individual key management personnel. However, it is worth noting that this would essentially duplicate the disclosures required by AASB 124 *Related Party Disclosures* in the financial statements. In order to reduce the potential for duplication, the Institute would encourage the Commission to consider making a recommendation for the removal of all the Australian-specific paragraphs in this accounting standard (applying to companies and disclosing entities). If these disclosures are determined necessary by law, they could perhaps be included in the remuneration report or another relevant section within the Corporations Act.

DETERMINING WHO SHOULD HAVE DETAILED REMUNERATION DISCLOSURES

The Institute supports the removal of the top five executive disclosures in order to focus disclosure of detailed information on individual 'key management personnel' as defined by AASB 124. However, the Institute cautions against confining detailed individual disclosures to only the chief executive officer and 'top key management personnel'. This approach will, in the Institute's view, create additional complexity and confusion in respect of determining the precise make-up of 'top key management personnel' versus 'normal key management personnel' as compared with 'key management personnel'.