

A decorative graphic on the left side of the page. It consists of a series of vertical lines of varying heights on the left, which converge towards a point. From this point, a large, solid yellow triangle extends diagonally upwards and to the right, filling a significant portion of the upper half of the page.

## Corporations Amendment (Improving Accountability on Termination Payments) Bill 2009

Submission by Ernst & Young

16 July 2009

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Our submission may be relied upon by the Senate Economics Legislation Committee pursuant to the scope of the Committee's Letter of Invitation only dated 1 July 2009. The submission represents our comments on the remuneration aspects of the Bill, Explanatory Memorandum and draft Regulations only. It does not address any related legal issues. We disclaim all responsibility to any other party for any loss or liability that the other party may suffer or incur arising from or relating to or in any way connected with the contents of our submission, the provision of our submission to the other party or the reliance upon our submission by the other party.

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# 1. Introduction

## 1.1 Background

Ernst & Young welcome the opportunity to provide this submission to the Senate Economics Legislation Committee ("the Committee"). Ernst & Young have reviewed the Government's "Corporations Amendment (Improving Accountability on Termination Payments) Bill 2009" ("the Bill") and related Explanatory Memorandum introduced into Parliament on 24 June 2009, and the accompanying draft Regulations released on 6 May 2009. This submission is a response to those documents.

In addition, we have provided a separate submission to the Productivity Commission as part of its review of executive and non-executive director remuneration. We note that the Productivity Commission will also be considering aspects discussed in this document as part of its review.

## 1.2 Overview of the contents of our submission

Ernst & Young have prepared this submission which discusses:

- ▶ The context of the draft legislation;
- ▶ Our perspective on the appropriate design of a cap for executive termination payments; and
- ▶ Based on our perspective of how the cap should be designed, our views on the draft legislation (including unintended consequences and areas for further consideration).

Please note that Ernst & Young does not provide legal advice. Accordingly, our submission represents our comments on the remuneration aspects of the draft legislation only. It does not address any related legal issues.

Please refer to Appendix A for an overview of the types of clients and services provided by Ernst & Young's Performance & Rewards practice.

## 2. Context of the draft legislation

### 2.1 Focus on executive remuneration

The financial crisis has brought executive remuneration back under scrutiny. Governments, media and shareholders alike have raised issues in relation to both a perceived general lack of alignment between performance and rewards and in many specific incidences in relation to termination payments that do not appear to be commensurate with an executive's performance.

Reforms have taken a number of approaches including global responses through the Financial Services Forum and the G20, and, closer to home, the Productivity Commission's review of executive and non-executive director remuneration.

As an early anticipatory action, the Government announced a change to the cap on executive termination payments. The Treasury formalised this statement in the form of an exposure draft on 5 May 2009. A consultation period followed and Ernst & Young provided a submission. Following from the consultation period, the Bill was introduced in Parliament on 24 June 2009, and was subsequently referred by the Senate to the Committee for inquiry. The Committee is undertaking a public consultation period and this document forms part of that consultation process.

### 2.2 Common confusion and misinterpretation of remuneration and termination payments

The values for executive remuneration quantum for individuals disclosed in companies' remuneration reports are based on *accounting standards* which prescribe complex rules and relate to the expense to the company. The disclosed remuneration for an individual does not therefore relate to the *cash value* received by the executive. This disconnect results in frequent misinterpretation by shareholders, media and the public, resulting in the sometimes false perception that an executive was over-paid. Similarly, an executive may receive significant remuneration value that is not immediately apparent from the disclosure.

We note that some companies have attempted to clarify this area of confusion by including additional voluntary disclosures regarding the cash value of remuneration components to executives. We support this practice as we believe it assists to facilitate understanding of executive remuneration.

The issue of understanding extends to the treatment of any "termination payments". Companies disclose the value of any "termination payments" in the individual executive remuneration table.

Two key areas of confusion arise:

- **Understanding the value of any equity component:** The remuneration table has a column(s) for share based payments (this is used to disclose the value of any long-term incentive being expensed in the year that is equity based or has some link to share price that determines its value).

If an individual is terminated, and the long-term incentive is allowed to partially or fully vest, this column is required to show the accelerated accounting expense. This disclosed value may differ significantly (negatively or positively depending on the original accounting value of the award and the prevailing share price) from the cash value the executive can receive if they sell their shares at that time.

If the individual is allowed to remain within the plan despite ceasing employment the accounting expense is not accelerated and therefore the remuneration disclosure in the final year for the executive will not reflect the full expense nor the eventual gain to the executive; and

- **Understanding what all the payments an individual has received represent:** The grouping together of termination payments often results in a lack of clarity regarding what the termination payment represents. In particular, there is often no clear distinction made between any amounts that relate *to past performance/service* (e.g. pro-rata short-term incentive or annual bonus (“STI”) for the period employed) vs. amounts that are an *ex-gratia termination payment* (e.g. payment in lieu of the notice period or as a result of accelerated vesting of future entitlements above a pro-rata amount).

## 3. Termination payments - Ernst & Young's perspective

### 3.1 Capping termination payments

Ernst & Young appreciates the need for the termination payment cap to be altered and supports the consultation process to ensure that the change achieves its objectives without adversely impacting the competitiveness of Australian companies. In particular, the legislation needs to balance the need for transparency and accountability with the commercial requirement of flexibility, speed in negotiating contracts and settlements on departure.

### 3.2 Design of the cap

The effective design of the cap on termination payments should include the following key features:

	Feature	Recommended approach and rationale
1	Scope	<p>Broadening of the legislation to apply to Key Management Personnel ("KMP") to ensure that termination payments are appropriately capped across all executives rather than simply executive directors (as per the general application of the current legislation).</p> <p>The legislation should only apply to contracts entered into from the date of Royal Assent and allow grandfathering of existing contracts, due to the legal and practical issues associated with having to negotiate and amend existing contracts.</p>
2	Definition of cap	<p>The cap for termination benefits should be based on a multiple of <i>fixed remuneration</i> (which includes base salary, fringe benefits, salary sacrifice benefits and superannuation) as most Australian companies remunerate executives using such an approach.</p>
3	Size of cap	<p>The appropriate cap multiple used for fixed remuneration will depend on the final definition of what is a "termination benefit".</p>
4	Definition of a termination benefit	<p>The definition of a termination benefit for the purposes of the cap should clearly differentiate between:</p> <ul style="list-style-type: none"><li>▶ Any payments for <i>past performance/service</i> (e.g.; accrued annual leave, long service leave, vesting of any deferred incentives, pro-rata short and long-term incentives to the date of termination); and</li><li>▶ The actual <i>termination payment</i> (e.g.; payment in lieu of notice period, short-term incentives for periods not yet worked, long-term incentive vesting above the pro-rata amount, any additional amounts).</li></ul> <p>The cap should only apply to the "termination payment" component. Additionally, we note that continued participation in an equity plan post-termination reflects a payment for past service, and continues to have performance conditions attached, and should not therefore be included in the definition of a termination payment.</p>

5	Valuing the equity elements of a termination benefit	The equity elements (which should include any share-based payments such as options, performance rights, performance shares and deferred shares) of a termination benefit should be valued at termination based on the benefit received by the individual at the date of cessation of employment (i.e.; the cash value they could receive if they sold their shares at that date). This value may vary significantly from the accounting value reported (negatively or positively).
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### 3.3 Complementing the cap with disclosure requirements

In order to facilitate shareholder understanding of any termination payments, make the approval process effective, and reduce the frequent misinterpretation of the termination benefit value, the disclosure requirements in relation to termination payments should be enhanced.

The disclosures should cover the following aspects:

- ▶ **Components of all payments received at termination:** All payments on termination should be disclosed, differentiating between:
  - The payments for *past performance/service* (e.g. pro-rata STI for the year, pro-rata vesting of any long-term incentives, early vesting of any earned deferred STI payments, annual leave, long-service leave); and
  - The *termination benefit* itself (e.g. payment in lieu of notice period, any ex-gratia payments, vesting of equity awards over and above the pro-rata amount, any additional STI payments for periods not yet worked).
- ▶ **Overview of performance assessment:** An overview of the company's and the executive's performance (over the period of the executive's employment) should be provided to enable shareholders to understand the rationale behind the payment of any performance-related remuneration components on termination.
- ▶ **Value attributed to vested equity awards at termination:** The value disclosed (in the components breakdown above) for equity awards on termination that have vested should be the pre-tax value to executives (i.e.; the benefit that can be derived by selling the shares at the time of cessation of employment). As discussed, the accounting expense can vary significantly from the benefit received by the executive.
- ▶ **Value attributed to equity awards that continue in the plan post-termination:** As noted earlier, these awards will continue to be expensed. To provide shareholders with an indication of the potential value of these awards, the potential gain to the executive should be disclosed based on the share price at termination and the anticipated level of vesting (based on performance to the date of termination). Importantly, it should be noted to shareholders that the eventual gain to the executives will vary based on the share price at vesting and the portion that vests based on the relevant performance hurdles.
- ▶ **Location of the disclosure:** Details of the termination benefit and accompanying commentary should be disclosed in the Remuneration Report in the year following cessation of employment, regardless of whether it has exceeded the cap. If the termination benefit has exceeded the cap, and is therefore presented to shareholders at the Annual General Meeting for approval, the relevant disclosures should also be included in the explanatory memorandum that accompanies the Notice of Meeting.

## 4. Views on the draft legislation

### 4.1 Alignment of the draft legislation with Ernst & Young's view on appropriate cap

Given our view on the preferred approach outlined in Section 3, the draft legislation requires significant further consideration by the Committee. The draft legislation goes some way to addressing public and shareholders' concern on executive termination packages. However, the draft legislation has potential unintended consequences for businesses and remuneration practices which should be reviewed by the Committee before it reports to the Senate (see Section 4.2). There are also specific aspects of the legislation that require further consideration and clarification (see Section 4.3).

### 4.2 Potential unintended consequences

The table below summarises our comments on the potential unintended consequences of the draft legislation.

	Potential consequence	Comments
1	Many payments requiring approval despite being predominantly payments for past performance/service	<ul style="list-style-type: none"><li>► <b>Potential issue:</b> The definition for a termination benefit does not appear to distinguish between payments for <i>past performance/service</i> paid at termination, and any <i>ex-gratia payment</i> made in respect of termination.  Examples of payments for past performance/service include:<ul style="list-style-type: none"><li>a. Equity awards that have already vested;</li><li>b. Mandated holding of bonuses/equity awards subject to trading restrictions (but not forfeited on termination);</li><li>c. Pro-rated incentive awards for the period up until the termination date; and</li><li>d. Payment of accrued annual leave and long service leave entitlements.</li></ul></li><li>► <b>Consequence:</b> Termination payments may require shareholder approval despite consisting largely of payments for past performance/service. As discussed in Section 3, we believe payments for past performance and service paid at termination should not be considered as termination benefits as they have been earned by the executive whilst in employment.</li></ul>



<p>2 May increase the challenge of attracting executives from other jurisdictions, or in retaining executives in Australia</p>	<ul style="list-style-type: none"> <li>▶ <b>Potential issue:</b> Australia will be one of the first jurisdictions to introduce rigid regulations on termination benefits, except where governments have included similar measures in circumstances where companies have been bailed out.</li> <li>▶ <b>Consequence:</b> Reducing the cap on termination benefits may increase the difficulty and/or costs involved in attracting executives from other jurisdictions with less stringent regulations on termination benefits, or in retaining executives in Australia. This may create pressure on companies to compensate executives with other types of remuneration (such as sign-on bonuses) which may not necessarily align with shareholder expectations.</li> </ul>
<p>3 May impact the competitiveness of remuneration packages offered to overseas-based executives</p>	<ul style="list-style-type: none"> <li>▶ <b>Potential issue:</b> Remuneration market practices vary by jurisdiction. Imposing the termination payment cap on all KMP (including overseas-based executives) may result in companies not being able to provide remuneration packages/approaches that are competitive in the respective local market.</li> <li>▶ <b>Consequence:</b> Australian companies may lose competitiveness in some local hiring markets.</li> </ul>
<p>4 May conflict with laws of other jurisdictions</p>	<ul style="list-style-type: none"> <li>▶ <b>Potential issue:</b> Where an overseas-based executive falls within the terms of the legislation, this may result in a conflict between the laws of the two jurisdictions. For example; in some jurisdictions there may be a legal right to a termination payment in excess of 12 months' base salary.</li> <li>▶ <b>Consequence:</b> If termination payments to individuals in these jurisdictions were to be limited to 12 months' base salary, this may give rise to a claim against the employer under local employment law.</li> </ul>
<p>5 Pressure to change remuneration mix</p>	<ul style="list-style-type: none"> <li>▶ <b>Potential issue:</b> Reducing the cap on termination benefits and deriving the cap using base salary may create pressure from executives to increase fixed remuneration (through an increase in base salary) and reduce performance-based remuneration.</li> <li>▶ <b>Consequence:</b> Less performance-based remuneration (through a shift towards base pay) means that remuneration will be less aligned with company objectives/performance and shareholder interests.</li> </ul>

### 4.3 Detailed areas requiring further consideration

The table below summarises our comments on aspects of the draft legislation, which we believe require further clarification or consideration.

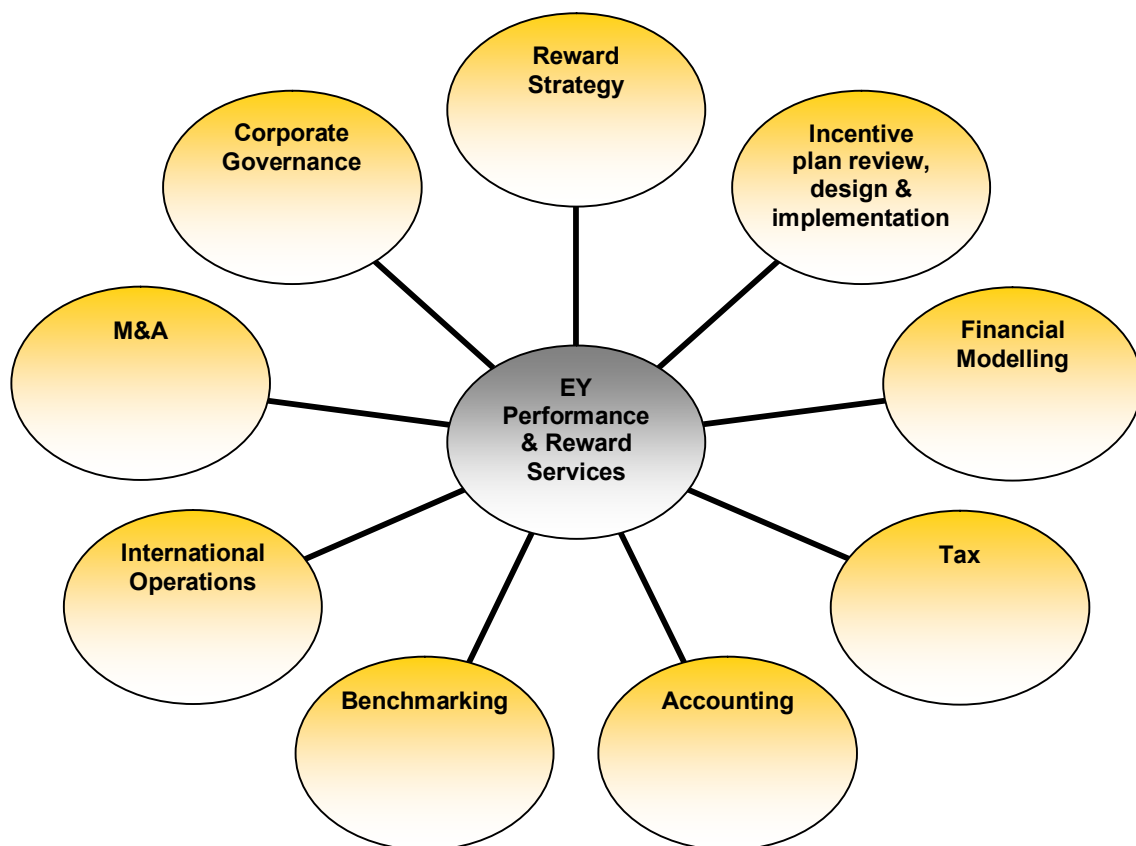
	Aspect	Considerations
1	Scope	<ul style="list-style-type: none"> <li>▶ We support the broadening of the legislation to cover all Key Management Personnel (i.e. typically the executive team).</li> <li>▶ However, we recommend not applying the cap to the “5 highest paid executives” as this group may vary year on year and practically may be difficult for companies to implement.</li> <li>▶ Overseas-based KMP should also be excluded as the cap may result in remuneration arrangements being uncompetitive in the applicable local market, and may conflict with local employment laws.</li> </ul>
2	Base salary approach	<ul style="list-style-type: none"> <li>▶ Given that most Australian companies now remunerate executives using a fixed remuneration approach (which includes salary sacrifice benefits and superannuation), the cap should be based on the value of fixed remuneration (instead of base salary).</li> </ul>
3	Performance-based payments other than options	<ul style="list-style-type: none"> <li>▶ Clarification is required in the legislation as to whether performance-based payments other than options (e.g. performance shares, performance rights etc.), are included within the meaning of a “termination benefit”.</li> <li>▶ Further, as discussed earlier, we do not believe that pro-rata incentive payments that vest on termination should be included as “termination payments”, as these payments are for past performance.</li> </ul>
4	Valuation of automatic or early vesting of options	<ul style="list-style-type: none"> <li>▶ The legislation needs to specify how equity remuneration will be valued at termination.</li> <li>▶ The value should be based on the actual value received by the individual (i.e.; the pre-tax cash value that could be obtained if the executive sold the shares at the date of termination), as the accounting value can often vary significantly from this amount.</li> </ul>
5	Vesting of equity post cessation of employment	<ul style="list-style-type: none"> <li>▶ Continued participation in an equity plan post-termination reflects a payment for past service, and continues to have performance conditions attached, and should not therefore be included in the definition of a termination payment.</li> </ul>
6	Accrued annual leave and long service leave	<ul style="list-style-type: none"> <li>▶ Clarity is required as to whether payments for any accrued annual leave or long service leave are included within the definition of the termination payment. As these payments relate to past service, we do not believe they should be included.</li> </ul>
7	Existing contracts with changes to any remuneration-related terms	<ul style="list-style-type: none"> <li>▶ Clarity is required as to what types of changes to remuneration-related terms in contracts will be considered as a “variation to condition”. There are concerns that changes such as an increase to fixed remuneration will result in contracts becoming captured under the revised termination payments cap.</li> <li>▶ The legislation should only apply to contracts entered into from the date of Royal Assent and allow grandfathering of existing contracts, due to the legal and practical issues associated with having to negotiate and amend existing contracts.</li> </ul>

## Appendix A

# Ernst & Young's Performance & Rewards practice

Ernst & Young's Performance & Reward team provide remuneration-related advice to Boards and management, both in Australia and overseas. We have a fully integrated advisory offering and can provide remuneration, tax, accounting, valuation, financial modelling and corporate governance advice.

The Australian team has provided advice to 75% of the ASX 50, 66% of the ASX 100, and 50% of the ASX 200, over the last 18 months on executive remuneration issues.



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