Deloitte Australia
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A&A Accounting Technical

Clarity in financial reporting

Remuneration Reporting in the Annual Report

Talking Points

- Globally remuneration of key management personnel is a highly emotive and increasingly ethical issue.
- A company's remuneration committee has the unenviable task of balancing the shareholder value proposition with fair compensation to those employees and management who deliver that value.
- As a result of many media reports about "boardroom fat cats" and the increasing margin between a company's highest and lowest earners, the remuneration report makes up the few pages of the annual report that are guaranteed to be subject to intense public scrutiny.
- The "two strikes" rule introduced in Australia in 2011 increases the stakes for Australian reporters, because if the remuneration report receives 25 per cent or more dissenting votes for two consecutive years it will trigger a board spill.
- A clear and easy to understand remuneration report that reflects a reasonable and justifiable remuneration policy is likely to reduce the risk of shareholders casting dissenting votes.

While the regulatory requirements of remuneration reporting are extensive, companies should view the remuneration report as a means of telling the remuneration story rather than as a laborious tick box exercise. The International Accounting Standards Board (IASB) has chosen 'better communication in financial reporting' as its theme for future projects and the Australian regulator's (ASIC) surveillance program supports this initiative and efforts to reduce unnecessary clutter. As a result, companies have already moved or will be under increasing pressure to use the annual report as an effective means of telling their story rather than as a pure compliance exercise.

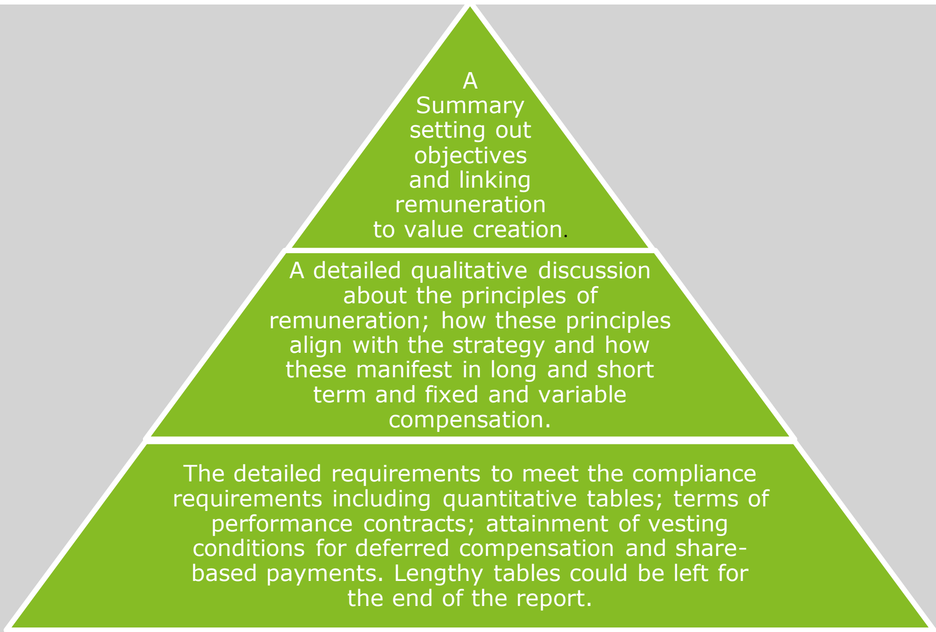
Ultimately, shareholders want to understand what value they are getting in return for the compensation received by management and employees. In turn management and employees are entitled to fair compensation for the value which they have added. The remuneration policy of the company is the link between the shareholder and employee objectives. The remuneration report is in turn the communication link between what the company's strategic objectives are; how those have been delivered and how the people who executed the delivery have been compensated.

This conversation can't begin in the remuneration report, remuneration is a part of the story that flows throughout the annual report. Typically the Chairman's statement would set out the strategic framework for the company; the CEO and CFO reports would articulate how the company has delivered shareholder value against that strategic framework. Once that scene is set then the task of the remuneration report is to articulate the principles around how management and employees are compensated for delivering against the strategic framework.

There are a few key aspects about remuneration that are particularly important to users of financial statements and should be set out as concisely as possible in the remuneration report, bearing in mind that sometimes a well thought out picture can be worth 1000 words:

- The principles and application of the principles around guaranteed pay and variable pay and how those align employee and shareholder objectives;
- The proportion of pay that is performance based and a description of the performance targets, why they are appropriate and whether they have been met or not and the consequence of that on the remuneration;
- The split between short-term and long-term incentives and how these encourage long term thinking by management and employees;
- Share ownership plans and the associated dilution risk which exists for shareholders;
- Benchmarking exercises that are performed to ensure that the employees are fairly compensated for the market and industry in which the company operates. As much as paying too much is a risk, the risk of key staff leaving because they can earn more elsewhere also has to be considered; and
- The principles for remunerating different functions within the organisation, for example one would expect the principles applied to remunerating management and risk takers would differ to that applied to non-executives.

As a result of the fact that there is still a minimum compliance aspect to the remuneration report preparers often struggle with determining the optimum structure and length of the report. While there is no one size fits all solution we have found that length and quality of the report are not necessarily directly correlated. The structure alongside could work well in setting out the key messages early on in the report and keeping the detailed quantitative compliance in tables at end.



Companies would hardly consider using a generic template for the Chairman's statement or simply rolling forward a CEO report year on year. However, as a result of the compliance nature of the remuneration report and the extent of quantitative disclosures required, the report does lend itself to the use of templates and roll-forwards. We encourage companies who do make use of templates and roll-forwards to be particularly careful that the narrative is still relevant to the story of the company that the rest of the annual report tells. There shouldn't be any contradictions between the strategic objectives and the delivery against those objectives as set out elsewhere in the annual report and the remuneration report. Also boiler plate disclosures are not useful to the shareholders in understanding how compensation links to value creation.

Ultimately preparers should bear in mind that the objective of remuneration reporting is to articulate the remuneration principles and policies of the company for the period under review. Overly complex schemes that don't link to the strategic objectives of the company make for overly complex reporting. Also the task of the remuneration report is made much easier when the rest of the annual report supports the remuneration report and policy – if all the other parts of the annual report set the scene appropriately it becomes a lot easier to articulate the link between the delivery of shareholder value and compensation for that delivery.

Appendix

The table below sets out some of the technical requirements that we find preparers most often struggle with interpreting.

<table>
<tr><td colspan="2">Which Key Management Personnel (“KMP”) to include in the disclosures</td></tr>
<tr><td colspan="2">Changes to the remuneration report several years ago removed the original requirement to name the Top 5 paid individuals and the Company Secretary. This means that the remuneration report should not name or provide details of the remuneration of these individuals unless they are a KMP.

However section 300(1)(d) of the Corporations Act, 2001 (“the Act”) requires that in the directors’ report, disclosure is made of options granted to the Top 5 paid individuals and the Company Secretary as part of their remuneration.</td></tr>
<tr><td colspan="2">Disclosure required in respect of share schemes</td></tr>
<tr><td>Lapsed options</td><td>The only requirements in respect of lapsed options are:
• the number of options that have lapsed in the financial year; and
• the year in which the lapsed options were granted.</td></tr>
<tr><td>Reconciliation between the remuneration report and the share-based payments note</td><td>The information about share-based payments for KMP included in the remuneration report should be prepared on the same basis as that in the notes to the financial statements, i.e. in accordance with AASB 2 Share-based Payment. Information such as grant date, exercise price and fair value for a particular scheme should reconcile between the remuneration report and the notes to the financial statements.</td></tr>
<tr><td colspan="2">Disclosure related to short term employee benefits</td></tr>
<tr><td>Reporting accruals and negative remuneration</td><td>A common oversight by preparers is the belief that the remuneration report is prepared on a cash basis. In actual fact, the manner in which it is prepared is consistent with the manner in which the company accounts for these items, which will be on an accruals basis. While some companies may choose to provide additional cash disclosures in a remuneration report, it is important to note that the cash disclosures are considered non-IFRS information and in ASIC’s view (as documented in ASIC RG 230), the cash disclosures should be less prominent than the remuneration tables required by the Act.

Common areas to note include:

• Bonuses should be disclosed in the period in which they are accrued, not when they are paid.
• Annual leave and long service leave should be disclosed in the period in which they are accrued, not when they are paid.
• Reversals of share-based payments and unvested leave should be reflected as a negative amount in the remuneration report, often such reversals are omitted.</td></tr>
<tr><td>Salary sacrificing is still salary that requires disclosure</td><td>When key management personnel decide to salary sacrifice a part of their salary, this shall still be reported as a component of their individual cash salary. This is also the case where the salary sacrifice is for something that is non-monetary, such as a car.</td></tr>
<tr><td>Non-recourse loans to KMP</td><td>The remuneration report requires the disclosure of loans made to individual KMPs. This does not, however, include loans provided to KMPs in transactions that are in-substance options, including non-recourse loans.

Where such loan arrangements exist and are excluded from the loan table, the following disclosure is recommended: ‘These balances do not include loans that are in-substance options and are non-recourse to the Group.’</td></tr>
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