24 March 2011

Clawback of executive remuneration
Corporations and Financial Services Division
The Treasury
Langton Crescent
PARKES ACT 2600
Email: clawback@treasury.gov.au

Dear Sir/Madam,

**Discussion paper – The clawback of executive remuneration where financial statements are materially misstated**

Thank you for the opportunity to comment on the Discussion paper – *The clawback of executive remuneration where financial statements are materially misstated*. CPA Australia, The Institute of Chartered Accountants (The Institute) and the National Institute of Accountants (NIA) (the Joint Accounting Bodies) have considered the Discussion Paper (DP) and our comments follow.

The Joint Accounting Bodies represent over 190,000 professional accountants in Australia. Our members work in diverse roles across public practice, commerce, industry, government and academia throughout Australia and internationally.

We understand the community concerns regarding excessive and inappropriate remuneration practices. As the Productivity Commission's (PC) final report concluded, Australia's corporate governance and remuneration frameworks are among the world's best. We do not consider that a reform to clawback director and executive remuneration when financial statements are materially misstated is needed to further enhance Australia's executive remuneration frameworks. We fail to see that the benefits of such a reform outweigh the compliance costs and the DP does not adequately demonstrate the case for introducing a clawback policy.

If the Government ultimately decides that it would like to pursue this policy, then use of the ASX Corporate Governance Principles would appear to be the most appropriate mechanism. This would enable companies to design a specific policy appropriate to their remuneration structure. Additionally, if there is overwhelming support for legislation, we recommend a requirement to disclose the existence of the clawback policy and key aspects of the policy in s300A of the Corporations Law. Our detailed comments on the DP are included in the attached Appendix and focus on the key issues and options as outlined in the DP.

If you have any questions regarding this submission, please do not hesitate to contact either John Purcell (CPA Australia) at john.purcell@cpaaustralia.com.au, Kerry Hicks (The Institute) at kerry.hicks@charteredaccountants.com.au or Tom Ravlic (NIA) at tom.ravlic@nia.org.au.

| Alex Malley | Graham Meyer | Andrew Conway |
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**Appendix: Detailed Comments**

**Key question – Do you believe that a reform to clawback director and executive remuneration when financial statements are materially misstated is needed to further enhance Australia's executive remuneration framework? Would the benefits of such a reform outweigh the compliance costs?**

We understand the community concerns regarding excessive and inappropriate remuneration practices. As the Productivity Commission's (PC) final report concluded, Australia's corporate governance and remuneration frameworks are among the world's best. The report did make some recommendations for strengthening the framework and these have been implemented by the government.

The PC's Inquiry was very thorough and wide-reaching and yet it did not make any recommendations relating to a claw back provision. We do not consider that a reform to clawback director and executive remuneration when financial statements are materially misstated is needed to further enhance Australia's executive remuneration frameworks. We fail to see that the benefits of such a reform outweigh the compliance costs. The DP does not adequately demonstrate the case for introducing a clawback policy.

The key benefit to shareholders for introducing the legislation appears to be saving them from having to go through costly legal proceedings to recover overpaid remuneration. However, the DP has not provided any information around the current number of cases, amount recovered, costs involved and the likelihood of beneficial result.

Paragraph 2.4 states that 'material misstatements in the financial statements are not an uncommon occurrence among listed companies in Australia'. However no information is provided on type of these misstatements. These may be due to the complex accounting standards and with nine new standards due soon, there is the potential to see an increase in misstatements as a result of the changes. The DP does not provide any information linking material misstatements in the financial statements to share price movements. This linkage is clearly important in demonstrating the impact to shareholders of material misstatements.

The DP refers to the definition of materiality as used in the Australian Accounting Standards. We note that paragraph 3.21 goes on to define a material misstatement as *an error in the financial statements that would be large enough to influence the economic decisions made by users on the basis of that information.* There are three instances in the current accounting standards (AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors)* where adjustments may be made in the financial statements to restate the prior year information. This includes changes to accounting policies, applying transitional arrangements when adopting new or revised accounting standards and prior period errors. . AASB 108 defines prior period errors as:
*omissions from, and misstatements in, the entity's financial statements for one or more prior periods arising from a failure to use, or misuse of, reliable information that:*

a) *was available when financial statements for those periods were authorised for issue; and*
b) *could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements.*

*Such errors include the effects of mathematical mistakes, mistakes in applying accounting policies, oversights or misinterpretations of facts, and fraud.*
We would expect the material misstatement terminology used in this DP to relate to prior period errors, as defined above. We consider if this term is to be used it is clearly defined. This is because users of the financial statements may not be able to distinguish between the three different types of prior year restatements as mentioned above, thereby causing confusion as to what changes impact the remuneration calculation.
If material misstatements are not uncommon, it is likely that, should this legislation be introduced, the policy could be applied in practice in many instances. This could have significant implications to business, including remuneration composition and making it more difficult to recruit the right people into roles. Incentive based pay is important as it links the interests of executives to shareholders. The worst case scenario as a result of the introduction of the clawback policy this as a may result in remuneration arrangements becoming more fixed in nature, thereby losing this important linkage provided by incentive based pay.

The DP states that a claw back policy places 'a greater value on the accuracy of financial statements'. We consider that there is already a significant value placed on the accuracy of financial statements. This is through accounting standards, legally enforced auditing standards, corporations law and regulations, listing rules and corporate governance principles for listed entities. An additional legal requirement dealing with clawback is unnecessary. Nothing has come to our attention that would lead us to conclude that the current existing mix of standards, legislation, regulations and principles has proven to be inadequate. The DP also contains no evidence of systemic breaches of accounting standards in Australia. The Joint Accounting

Bodies would need to see evidence of widespread misstatements before the three bodies could entertain supporting further consideration of a clawback measure.

Paragraph 2.14 states '*the introduction of a clawback policy removes the incentive for executives to consider deliberately misstating company earnings in order to inflate their bonus figures.*' as a reason for introducing the legislation. However, paragraph 3.45 notes '*existing laws already deal with circumstances of deliberate misstatements of accounts and set out penalties for failing to comply with accounting standards or distributing misleading information.*' The messages in the DP are portraying deliberate misstatement as a reason for introducing the clawback policy and yet the DP later states that as existing laws adequately deal with deliberate misstatement, the clawback policy should cover all material misstatements. This appears to be contradictory.

The examples from overseas jurisdictions do not demonstrate the need for legislation in Australia. Only the United States has implemented legislation through the Dodd Frank Act and they have seen numerous examples of bonus payouts by companies who received government bailout funding. This situation has not occurred in Australia. The European Union (EU) and United Kingdom considered such proposals in 2009, however have not acted upon them as yet.

Australia should be cautious not to be overly reactive in its response to an issue which currently has great focus following the financial crisis. However it was not a cause of the crisis and the current focus could result in 'over' legislation which would not be in the best long term interests of the company and shareholders. As noted above, the impacts of such legislation on the remuneration policies of companies and the ability of companies to recruit and retain the best people in roles subject to clawback need to be seriously considered.

**We do not support the creation of clawback policy. However, if the government decides to proceed with such a policy following significant support from other interested parties, we have included details of the options we would prefer in these circumstances.**

**Issue A – how would the provision be implemented?**
We support Option A.3 – ASX Corporate Governance Council Principles.

We note that paragraph 3.13 deals specifically with the application of the 'if not, why not' approach to corporate governance practices, stating that this principle could apply such that "listed companies should clawback bonuses from their executives where based on financial information that turns out to be materially misstated", and further where "listed companies - - - fail to do so [they] would need to provide an explanation." This seems merely to address the mechanics of a clawback and an explanation of inaction. A more comprehensive approach would be to apply the 'if not, why not' principle to the inclusion of such a procedure within the companies constitution.

As noted in paragraph 3.14, this option would complement the self-regulation of companies who are voluntarily inserting clawback provisions into their constitutions. The DP includes a number of examples, particularly of UK companies, who have implemented their own company policies to deal with clawback of bonuses. Encouraging companies to self regulate their remuneration in this manner is significantly preferable to governance legislation. It would also give greater liberty in designing and implementing the policy to reflect their specific forms of incentive remuneration. The complexity of remuneration structures, which has arisen as a result of the need to link company performance and executive remuneration, would make it difficult to practically implement any form of legislation in this area. Companies could also include these provisions in their employment contracts, to enable them to legally enforce their repayment. This was noted in paragraph 3.15 as a downside to option A.3.

If there is significant support for legislation in this space, we recommend that the government consider including a requirement in s300A of the Corporations Law for companies to disclose the existence of a clawback policy and its key aspects in their remuneration report.

Specifically, there are significant risks in drafting such a policy into 'black letter' legislation, as noted below when considering some of the finer elements of the design, given the wide range of remuneration structures. The complexity of remuneration structures would make it practically difficult to implement any form of legislation in this area. Legislation could result in remuneration structures being designed to avoid the application of such a policy. This could potentially result in a greater amount of remuneration be attributed to fixed pay rather than incentive based pay.

By including a reference within the ASX Corporate Governance Principles requiring companies to have a clawback policy or explain why not, would demonstrate to all organisations that this is considered best practice. Many organisations other than listed entities use the Corporate Governance Principles as best

practice and adopt them on a voluntary basis. This would widen the potential application of such a policy to entities that are not listed, such as large private companies.

**As noted above, our preference is for the companies to create their own policy for dealing with the claw back of executives. They would determine the most appropriate options to select for the following issues as appropriate to their specific remuneration structures.**

**Issue B – Who would the provision apply to?**
We support Option B.1 – Current CEO and CFO only
The policy focus of the Discussion Paper is on who is harmed or wronged, or alternatively expressed, whose rights are it that are infringed – that is, the company and its shareholders, and who in turn benefits from the making of restoration – again, the company. It could be seen as appropriate therefore that a wider reach under the clawback should apply. Further paragraph 3.18 notes that if it does not apply to former executives, the current executive may feel pressure to resign.

On the matter of the CEO's and CFO's direct responsibility for the accuracy of financial statements, it should be noted that a narrower approach may be consistent with the listed company declarations set out in s 295A, although more widely the solvency declaration (s 295(4)(c)) and the declarations as to compliance with accounting standards and a 'true and fair view' (s 295(4)(d)(i) and (ii)) apply to the wider body of the directors. However, the DP is focused on executive remuneration, rather than broader remuneration of all directors.

We note that the CEO and CFO are ultimately responsible for the accuracy of the financial statements and already are required to sign a statement to that effect. Therefore, in the balance we suggest that they are the only ones who should be covered by this policy. We note the concern that this could be a disincentive for qualified persons to take on the role and this supports our overall position for no legislation.

We also raise the following question, regarding the treatment of parties to whom the recipient is related – will they also be exposed to making restoration? We note that closely related parties to key management personnel have been defined in the recent *Corporations Amendments (Improving Accountability on Director and Executive remuneration) Bill 2011.*

However we also believe government need to ensure that, whether affected through the Act or contained within the corporate constitution, there must be a sound and rational basis for depriving the recipient of their own property. Consideration must be given of what would be considered a reasonable basis of a defence, for example related to an innocent change of position.

**Issue C – How would the clawback event be triggered?**
We support Option C.2 – Release of the recast financial statements by the company.
Drawing on the rationale of the continuous disclosure regime and the interests of those parties who may form an opinion or make an economic assessment based on financial information, it would seem appropriate to tie the timing to the public announcement. However, the clawback amount needs to be accurately determined and the policy enacted to recover the funds. We would recommend that the trigger for the start of the repayment period to be the release of the recast financial statements. This would enable time for the misstatement to be adequately assessed and its size to be properly determined, with the financial statements audited.

**Issue D Calculation of the clawback amount?**
We do not consider we can make a recommendation here. As noted under issue A, we believe that if a clawback policy is required, the company should design it themselves. This would enable the company to select the appropriate option for their specific remuneration structure.

If certain methods for determination are included in rules or regulations, remuneration structures may change to work around the requirements. These changes may not be in the best interests of shareholders as they could result in more fixed remuneration, losing the important link to performance and hence shareholders interests, ie share price. As noted in the paper, determining what impact a misstatement has on a share price is extremely difficult. We recommend that if Treasury intend to proceed with this policy, that research is performed on this link to determine whether there is a material impact.

**Issue E – A clawback from total remuneration**
As noted under issue A, we believe that if a clawback policy is required, the company should design it themselves. This would enable the company the select the appropriate options for their specific remuneration structure. However, if this option is not pursued, then we support Option E.2 – The clawback from performance based pay only.

If the full amount was subject to clawback, this would obviously impact on the ability of companies to attract the necessary talent to sit on boards and would also wipe out what is commonly called base or fixed pay. It would make more sense to have the performance related remuneration subject to the clawback.
We also note the further complication of whether the clawback and process of disgorgement should be extended to any gain which the receipt has derived through use of the incentive payment? Were such a fiduciary or restitution approach to be applied, such amounts might be seen as being held on constructive trust for the benefit of the company.

**Issue F – an underpayment in the executive's bonus caused by a material misstatement**

As noted under issue A, we believe that if a clawback policy is required, the company should design it themselves. This would enable the company the select the appropriate options for their specific remuneration structure. However, if this option is not pursued, then we support Option F.1 – Allow the company to pay the executive the extra bonus.

The rationale for not paying the additional amounts is set out in paragraph 3.38 in terms that "management should not be rewarded for a material misstatement in the financial statements, which may have caused shareholders to trade on incorrect information." This rationale may be hard to support on a number of fronts, particularly given its possible characterisation as a deterrent to intentional misstatement noted earlier.
It is possible that a prohibition may cut-across fundamental contractual and equitable principles around certainty and reliance. Further, the idea that shareholders may have traded on incorrect information may be causally remote and indeterminate. This could be countered by argument that the shareholders will benefit from a higher market capitalisation and dividend pool. Finally, if a nexus is drawn between the financial statement's restatement and the quantum of the clawback, this should not be undermined by denying a "reward" where the conditions are in the reverse.

**Issue G – When would the clawback amount need to be repaid?**
As noted under issue A, we believe that if a clawback policy is required, the company should design it themselves. This would enable the company the select the appropriate options for their specific remuneration structure. However, if this option is not pursued, then we support Option G.2 – an executive must repay the remuneration following a specified time period. This would allow sufficient time for the executive to realise any assets as needed and arrange for payment. However, we consider this area to be fraught with practical difficulties, for example the executive may have already incurred and paid tax on the remuneration received. Repayment of the clawback amount would then also require the tax to be repaid by the ATO to the executive. It is likely to be difficult to unwind the transaction in these circumstances. This form of policy impacting personal income tax is unprecedented in Australia and would be complicated and costly to administer.

**Issue H – A deliberate intention to mislead or act of misconduct?**
We support Option H.1 – intention element necessary for the clawback provision to be invoked. However, as noted in our response to the key question and included in the DP, 'existing laws already deal with circumstances of deliberate misstatements of accounts'. If the clawback provision is applied to all misstatements, it is likely that companies will design remuneration structures to protect their executive's incentive payments.

We note in the examples provided from overseas, the new Dodd Frank Act in the United States deals with all misstatements. However, we note that the DP states that the EU '*believes that it is for companies and their shareholders to determine what pay structure and levels are appropriate for their directors in light of their particularly circumstances, and that general best practices should be followed'*. They go on to say that one such best practice relates to clawback in the event of significant misstatements because of '*wrongdoing or malpractice'*. Therefore the EU is specifically looking at situations of intentional misstatement rather than all significant misstatement.

As per our recommendation under issue A, if companies are allowed to design their own clawback policies, they can allow a delay in confirming the bonus as they see appropriate. In many instances, incentive payments are not confirmed until after the financial statements are audited and released. Additionally, some incentive payments may be paid over a period of time and hence companies can stop or reduce later payments in the instance of financial misstatement as they deem relevant.

**Issue I - re-issue of financial statements due to subsequent events?**
We support Option I.1 – a subsequent externally-based event should exempt executive from the clawback provision. As noted above, we support Option H.1 - intention element necessary for the clawback provision to be invoked and therefore there is no intention in externally-based events. We refer to our comments under Issue H which note that companies can design appropriate policies themselves which would deal with the circumstances as they consider appropriate.

The options provided refer to 'an externally-based event' however this is not defined and could prove to be very difficult to define for these purposes. The Accounting Standard AASB 110 *Events after the Balance Sheet Date* includes definitions and information to identify events occurring after the balance sheet date and whether they are adjusting or non-adjusting events.

We are also concerned that the example provided in the DP from the Auditing Standard has been taken out of context. There is insufficient detail in the example provided to determine whether it is an adjusting event or a non-adjusting event. However, it is important to note that both the Auditing and Accounting Standard's deal principally with situations between the balance date and the signing of the annual report. Further AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors* defines prior period errors and deals with the circumstances when they can be adjusted in prior periods.

**Issue J – How far back should the clawback provision apply?**
We support Option J.1 – the 12-month period preceding the 'material misstatement' event. This would be appropriate if implementing a policy for material misstatement. As noted earlier, in the instance of a deliberate intention to mislead or an act of misconduct, existing laws already deal with these circumstances and the penalties are defined.

**Issue K – Who is responsible for applying the clawback of bonuses?**
We support Option K.1 – place to onus on the company to reconcile the bonuses of executives if there are discrepancies as a result of the financial statements. The company would have designed the remuneration scheme and paid the bonuses so they are best placed to handle any clawback. This aligns to allowing the company to design their own policy and implement it as appropriate.

In the case of deliberate intention to mislead or an act of misconduct, this would be a matter dealt with ASIC and the courts and hence repayment would form part of any proceedings against the officer.

We note also in passing that shareholders are not without rights and powers in relation to the conduct of the companies of which they are members. Chapter 2F of the Act provides targeted scope to seek the court's regulation or direction of the conduct of a company's affairs. Such avenues may potentially be used to compel action where the directors are otherwise recalcitrant in relation to recoveries of erroneously paid remuneration. We raise this point largely to highlight the added complexity that would arise particularly were a legislated approach to remuneration clawbacks taken.