

Insights into Remuneration Reporting

Executive Summary for
Directors

June 2023

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Introduction

With shareholders, proxy advisors, institutional investors, the media, and other stakeholders increasing their focus on the remuneration of directors and Key Management Personnel (KMP), Remuneration Reports have never been more important. The Remuneration Report should tell the story of how the remuneration framework is structured, links to the organisation's strategies (including those related to ESG), the remuneration outcomes and how that aligns to the creation of long-term sustainable value, for both shareholders and other key stakeholders. It should be forward looking as well as reporting on what has happened in the current year. This all needs to be balanced against the privacy of the individuals captured in the report which is a challenging balancing act.

This Executive summary considers some of the main requirements of the *Corporations Act (2001)* (Act) and the *Corporations Regulations (2001)* (Regulations). It provides an overview to help you produce Remuneration Reports that are effective communication tools, aspiring to align with best practice, and which comply with the Act. For further information on any of the topics included and others please refer to the detailed version of [Insights into Remuneration Reporting](#).

Overview of Remuneration Reports

All Australian companies that are listed disclosing entities must prepare, and have audited, a Remuneration Report as part of their annual Directors' Report. There is no mandated layout for the Remuneration Report. However, it needs to clearly explain the remuneration strategy and link that to the organisation's performance. This might include the use of graphs and diagrams where they help to simplify the message to readers.

It has become best practice to include a brief cover letter from the Chair of the Remuneration (or equivalent) Committee, which outlines how the organisation has performed for the year and how this has been reflected in remuneration outcomes. The cover letter would also flag any changes made to the remuneration framework, and potentially any planned future changes. Where a malus or clawback clause was invoked during the year, the cover letter should acknowledge the circumstances leading to the exercise of the clause and discuss the consequences on remuneration. If the organisation had a first strike against its Remuneration Report, the letter should also address how the organisation has addressed the issues driving the strike.

Following the letter from the Chair, many organisations include a high-level snapshot of the remuneration framework and the different elements of remuneration including base salary, short-term and long-term incentives, and how this links back to the organisation's strategy. Typically, the statutory remuneration table and other statutory disclosures are included towards the back of the Remuneration Report.

The mandatory quantitative disclosures required in the Remuneration Report should reflect the requirements of relevant accounting standards. That is, the information in the Remuneration Report should align with the financial statements.

Some organisations also provide non-statutory remuneration information in the Remuneration Report to help explain the outcomes of KMP remuneration. Organisations often refer to this non-statutory remuneration information as 'realised pay,' 'take home pay' or other similar descriptions. This non-statutory remuneration information is used if organisations consider the amounts determined in accordance with the accounting standards are not fully reflective of what the individual received in the year and assists them in explaining their remuneration strategy and outcomes to readers. If organisations wish to include non-statutory remuneration information, in our view, the guidance in ASIC's Regulatory Guide 230: *Disclosing non-IFRS information* should be applied by analogy.

The audit of the Remuneration Report

The Remuneration Report is required to be audited under section 308(3C) of the Act. The audit covers both qualitative and quantitative disclosures and statements of policy or position. Auditors are required to report to members on whether, in the auditor's opinion, the Remuneration Report complies with section 300A of the Act.

The requirement to express a distinct opinion on the Remuneration Report is additional to the auditor's responsibility to express an opinion on the financial statements. While some of the content of the Remuneration Report, such as total KMP remuneration, is also in the financial statements, much of the detail and further statements of policy or position are incremental. Due to the sensitivity of the disclosures within the Remuneration Report, auditors will perform additional test work on the information disclosed and is likely to use a lower threshold of materiality to assess misstatements, than the financial statements as a whole.

An example opinion is:

In our opinion, the Remuneration Report of the Company for the year ended 30 June 20XX, complies with Section 300A of the Corporations Act 2001.

If the auditor is not of that opinion, the auditor's report must say why i.e. issue a modified opinion.

If material errors or misstatements in prior period Remuneration Reports are identified, consideration will need to be given as to how to highlight that amounts have been adjusted and additional footnotes might be added to explain the nature of the error and impact on previously disclosed amounts. Material prior year errors might also impact the audit opinion over the current year's Remuneration Report and possible notification to ASIC. We encourage early engagement by all parties.

Who is included in the Remuneration Report

The Act requires remuneration information to be disclosed for all individuals who are considered KMP under the accounting standards. This includes all persons who have the authority and responsibility for planning, directing, and controlling the activities of the organisation either directly or indirectly and includes any director (whether executive or otherwise) of that organisation.

The term KMP refers to a function, rather than a specific title. Therefore, identification of KMPs will require judgement and different organisations may reach different conclusions for the same job titles. For example, for many organisations the Chief Financial Officer (CFO) is considered a KMP role. However, a small organisation with an outsourced CFO function with limited responsibilities may conclude the CFO role is not a KMP role for their organisation.

In addition, careful analysis may be required of any interim appointments (e.g. acting CEO etc.). If an interim CEO or CFO (or any other interim role) meets the definition of a KMP, then they must be included in the Remuneration Report from the date of their commencement in the role. However, an interim appointment may have limited responsibilities and authorities and therefore might not be considered a KMP.

Changes in KMPs

When an individual becomes a KMP during the year, they are included in the Remuneration Report from the date they were appointed to that KMP role. The remuneration disclosed should reflect all amounts attributed to the period they are a KMP, including any payments made to the person before they started to hold the position as part of the consideration for holding that position. Where an individual continues to earn share-based payments awards or bonuses granted while they were not a KMP, these components should be apportioned between the periods before and after the individual becomes a KMP. The Remuneration Report disclosures will then only include the amounts attributable to the period they are KMP.

When an individual ceases to be a KMP, the remuneration disclosed in the Remuneration Report should similarly reflect the amounts attributed to the period they were a KMP.

Complexities may arise when an individual steps away from a KMP role and enters into a separate arrangement with the organisation to provide future consulting or other services. Careful consideration of all the facts and circumstances will be required to determine if the payment relates to their KMP role or to the separate arrangement for consulting services. If the amount paid or to be paid relates to the individuals' services as a KMP or is for no substantive future services, this will be disclosed as part of KMP remuneration in the current year.

When a KMP departs, only amounts that arise due to them ceasing employment are disclosed as termination benefits in the statutory remuneration table. Other amounts paid out such as their annual leave and long service leave entitlements or amount relating to share-based payments awards which may remain on foot, would not be disclosed as termination benefits, and would continue to be presented in their respective categories. Payments may be made subject to the KMP providing active service during a notice period. Such payments would be disclosed as salaries and not as termination benefits.

The Act contains restrictions in relation to termination payments, including requirements for shareholder approval where the value of termination benefits exceeds the termination benefits cap. 'Termination benefits cap' is defined in the Act as opposed to accounting standards. As a result, termination payments for the purposes of this restriction may not align with the termination benefits disclosed in the statutory remuneration table.

Variable awards

The Regulations require specific details about variable awards to be provided. It is not sufficient to only provide a high-level overview of the awards. Disclosures should include details of any relevant features such as change in control, Board discretion or other terms which may impact the remuneration the KMP will be entitled to. Such details provide readers a better understanding of the risks and potential payments the KMPs are exposed to.

A clear story of the variable remuneration plans, both cash and equity-based plans is necessary to assist readers in understanding the effectiveness of the organisation's remuneration strategy. It is important to present this information in a manner that allows readers to understand that the performance hurdles were suitably challenging, and that the outcomes were appropriate in the circumstances. This will include:

1. *Identify performance hurdles*

First, clearly articulate the performance hurdles - both financial (e.g. Earnings Before Interest and Tax (EBIT), revenue growth) and non-financial (e.g. work safety measures, climate targets) - that the KMP is required to meet. Where the measure is a non-statutory measure (e.g. underlying profit), provide an explanation of what adjustments might be made to the relevant statutory measure to assess the KMP's performance and why the adjustments are considered appropriate.

2. *Explain why the hurdles represent value for the organisation*
Discuss why the hurdles represent an appropriate measure of performance for the KMP and how they align with shareholder interests and the organisation's strategic priorities.
3. *Explain how the KMP has performed against the hurdles*
Whilst not explicitly required, we recommend disclosing how the KMP performed against each of the hurdles in the award. This provides linkage between the hurdle and the level of award achieved and can be part of the explanation of how the award links to the organisation's performance.
4. *Explain the level of award achieved, including where in the range of outcomes if relevant*
Where the award had a maximum outcome, disclose the percentage attained because the hurdle was achieved, and percentage forfeited as the hurdle was not achieved. Where an award had a range of potential outcomes, disclose where in the range the achievement sits.

ESG measures

ESG measures are becoming more common as organisations strive to reduce carbon impacts. ESG measures are variable awards that will require specific disclosure by the Regulation, similar to the approach discussed above. Start by outlining how the ESG measure selected aligns to the organisations long-term strategic plans and business activities. By doing this, the organisation will be able to articulate why the measure is important to the creation of long-term value for shareholders.

A clear description of the ESG measure(s) and the targets that are expected to be achieved for vesting should be provided, as well as the weighting of the ESG measure.

Disclosure in the Remuneration Report should also include how performance against the measure will be addressed, including how data will be captured.

As ESG measures evolve and mature, it may be the case that initially these measures are more discretionary in nature (rather than clearly quantifiable), with the Board or Remuneration Committee determining whether vesting has occurred. Where this is the case, the factors considered by the Board in determining whether vesting has occurred should be clearly disclosed and, in case of a long-term incentive measure, annual updates on how the organisation is tracking should be provided to support the final vesting outcomes.

Modifying share-based payment awards

Modifications are any changes to terms and conditions of share-based payments transactions granted to a KMP. This may include changes to the number of instruments granted, the exercise price of an option, the service period or performance hurdles that the KMP must achieve before they can vest in the award, or even how it will be settled, for example from equity to cash.

Modifications may also include situations where organisations make changes to ‘underlying profit’ or other non-IFRS measures used as performance hurdles in share-based payments. Where organisations make “new” adjustments to what they include in their underlying profit for the purposes of assessing performance, this may be considered a modification if the KMP did not have an expectation that these new adjustments might be made to the performance hurdle.

Modifications are only accounted for, and the fair value of the award updated, if the modification is beneficial to the employee (e.g. increase in number of instruments granted, shorter service period etc). Any incremental fair value at the date of the modification will be recognised as an additional expense over the remaining vesting period. The Regulations require specific disclosures about the details and impacts of the modification. Modifications can sometimes result in significant additional expense recognised and disclosed as additional remuneration for the KMP. A well communicated explanation for why the modification was considered appropriate, how it relates to the broader remuneration strategy, linkage to the organisation’s performance and the factors driving the increase in the fair value (and additional remuneration) will encourage stakeholder support for the modification.

Malus and clawback clauses

Often seen in share-based payments and sometimes in cash awards, malus clauses provide the organisation with discretion to adjust an award downwards during its vesting period, if matters arise that in the organisation’s opinion indicates the award previously granted is no longer appropriate. Clawback clauses are similar but typically apply once an award is fully vested but is still subject to trading restrictions.

The existence of these clauses demonstrates good governance and as such should be disclosed as part of the organisation’s remuneration policy and the terms and conditions of KMP awards. Due to the significant nature of the events triggering the exercise of the clauses, it is in the organisation’s interest to be upfront about the enactment of these clauses, and the consequential impact on remuneration. This demonstrates to readers that the organisation is dealing with the misconduct, and that there are penalties to the KMPs in question.

While enactment of malus and clawback clauses typically arise from historical events that come to light sometime later, this does not mean the accounting for the award and the remuneration disclosed in previous Remuneration Reports is inappropriate and required to be restated¹. Instead the impact should be reflected in the current year.

The enactment of a malus clause in a cash bonus will be a downward estimate and result in a reduced or possibly even negative remuneration in the current year cash bonus. For a share-based payment, the enactment of a malus clause would be considered a forfeiture of the award and the previously recognised remuneration is reversed. As clawback clauses are usually enacted after the SBP has vested, and all amounts have been expensed, there is no impact on the quantum of remuneration recognised or disclosed in the Remuneration Report¹.

¹ Further assessment may be required if the event resulting in the clawback being enacted is a restatement of prior period financial statements.

'Two strike' rule

At each AGM, shareholders cast a non-binding vote on the adoption of the Remuneration Report. If more than 25 percent of the votes cast in the non-binding vote are against the adoption of the Remuneration Report, the organisation has a 'first strike'. The Remuneration Report that is presented the year following the first strike must provide an explanation of the organisation's proposed action in response to the first strike, or, if they do not propose any action, the reasons for inaction.

The organisation will need to understand the reasons behind the 'no vote.' Engagement with the relevant shareholders, investor groups and/or proxy advisors will be critical in gaining this understanding. The organisation can then consider the concerns raised and either:

- Adjust the remuneration framework to address shareholder concerns and explain the adjustments, with supporting rationale, or
- Communicate why they consider the chosen framework to be appropriate.

Organisations in such a situation may wish to seek advice from their KPMG Advisor when responding to a strike.

For more information on any of these and other topics, please refer to our publication [Insights into Remuneration Reporting](#) or speak to your KPMG Advisor.

Contact us

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