

Across the board

A newsletter for Australian directors

AUSTRALIA

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National Chairman

Introduction

This year's financial system meltdown is the result of many factors including a less than rigorous approach to risk management.

Businesses and individuals traded in financial instruments without fully understanding the inherent risks involved, while investment decisions were made on asset prices that did not reflect the true risk-return equation. It is a timely lesson on the need to get back to the fundamentals of good business management.

In this issue of *Across the board*, we examine some of the key issues facing directors in the current volatile business environment. We also outline the business fundamentals directors should be focusing on in order to build strong and resilient organisations capable of surviving the tough times ahead.

Boards are now addressing multiple risks concurrently, dealing with issues such as catastrophic risk in the operating environment while stress testing capital adequacy to ensure it can withstand significant future downturns.

At the same time the issue of executive remuneration has become prevalent and pressing. We explore this issue in detail and suggest ways in which boards can regain control of this vexed issue.

While Australia is relatively well placed in global terms to withstand an economic downturn there is still a compelling case for government reforms to continue through measures such as infrastructure stimulus, tax reform and new industry incentives. In this edition we also update directors on the Australian Government's tax reform agenda, popularly known as the 'Henry Review'.

I trust you will find this edition of *Across the board* insightful and thought provoking.

Survival of the fittest: building your organisation's resilience

As the crisis in the world's capital markets runs its course, the fallout for the Australian economy is confronting boards with some unfamiliar and daunting challenges.



Peter Liddell
Partner
Business Performance Services



Paul Thomson
Partner
Restructuring Services

The world irrevocably changed in 2008.

This year's financial system meltdown is turning into the world's worst financial crisis since the 'Great Crash' of 1929. And while most economists believe it will not be followed by a 21st century equivalent of the Great Depression, the latest crisis is likely to result in long-term changes to the economic landscape.

As our government continues to assert, Australia is probably better placed than most to withstand the economic storms now building. Nevertheless business conditions are deteriorating across the economy.

Bank credit is becoming tight for all but the bluest of blue chip borrowers, most non-bank lenders are struggling to fund their existing loan books let alone expand their lending, and the corporate bond and commercial paper markets have largely shut down. Consumer demand is shrinking and much planned business investment is being curtailed, deferred or abandoned altogether. Asset values are eroding, potentially weakening many corporate balance sheets. Capital management strategies are emphasising recapitalisation and cash retention. Many commodity prices are falling as the balance of power shifts from sellers to buyers.

Longer term, governments individually and collectively will seek to fundamentally restructure the regulation and supervision of the world's banking systems and capital markets. It could mean big changes in how business typically funds its activities and in the level of returns considered 'normal' or 'acceptable'.

Whether or not Australia actually experiences a so-called technical

recession (two or more successive quarters in which economic output contracts), conditions in 2009 will feel like a recession for many businesses and households. How should company boards respond to this prospect?

Much depends, of course, on the circumstances of individual entities. However, KPMG considers that boards should take a measured approach to the current situation, looking first to the survival of the enterprise and then examining how adverse conditions might be leveraged to the benefit of the business. In particular, we feel independent directors need to assure themselves that management remains on top of a number of key areas likely to determine business survival and progress.

Cash

It always bears repeating — cash is king in a credit crunch. Has management adopted a sound and comprehensive approach to cash management that embraces actual cash disciplines across the entire organisation? Specific issues should include:

- improving the forecasting of cash requirements
- introducing measures to release cash (e.g. changes to trading terms)
- monitoring customers' and trading partners' ability to pay
- embedding appropriate systemic and cultural changes
- preserving surplus cash
- identifying business practices that unnecessarily inflate working capital requirements.

Costs

In times of strong business growth there is usually less emphasis on controlling and reducing costs. After all, cost control is hard and unglamorous work that involves saying 'no' to people. Yet costs that can be reduced or eliminated drop through to the bottom-line at the same time as they preserve vital cash. Boards should review management's performance in:

- entrenching a cost-conscious culture
- producing clarity of cost 'ownership'
- understanding the real drivers of cost
- rethinking and challenging the traditional business model
- reviewing existing vendor arrangements and contracts.

Debt and capital management

Debt levels that were 'comfortable' even 12 months ago might now be considered excessive. Do not assume that existing bank lines can be easily rolled over or renewed. What additional costs and conditions might be imposed if funding is to be retained? How vulnerable is the balance sheet to asset impairment? Might a restructure of the balance sheet be demanded? Boards should assure themselves that management is properly focused on:

- revisiting existing funding strategies and structures, including the maturity profile of debt and hedging instruments
- considering worst case scenarios, using sensitivity analysis and risk mitigation techniques
- reviewing investment plans for their effect on liquidity and their sensitivity to higher funding costs
- deferring or scaling back proposed capital outlays
- monitoring existing finance facilities and compliance with loan covenants
- allowing longer lead times for renegotiating funding arrangements
- maintaining and deepening key banking relationships

- managing cash aggressively to reduce reliance on short-term borrowing
- evaluating the consequences of necessary financial reporting disclosures
- revisiting gearing ratios, dividend policies and other capital management strategies.

Business performance

Slowing growth and rising costs threaten margins and profitability, allowing a smaller margin for error in decision-making. Boards should satisfy themselves that management is responding appropriately to these pressures by:

- forecasting and tracking performance and updating budgets to reflect changing conditions
- identifying particular instances of under-performance and acting quickly to deal with the problem
- assessing growth opportunities and their implications for cash flow and capital management
- divesting or closing down poorly performing or non-core assets.

Governance and risk

External risks have become more important in assessing the viability of most commercial organisations. Boards need to be confident that management is able to identify and quantify these risks as early as possible. Boards should be asking management to focus on:

- undertaking extensive and rigorous scenario analyses and stress testing to help identify and quantify existing and emerging risks
- reviewing derivative and related counterparty exposures
- considering the potential for fraud and for earnings and valuation manipulation
- asking if management truly understands the nature and extent of all of the company's financial and other exposures.

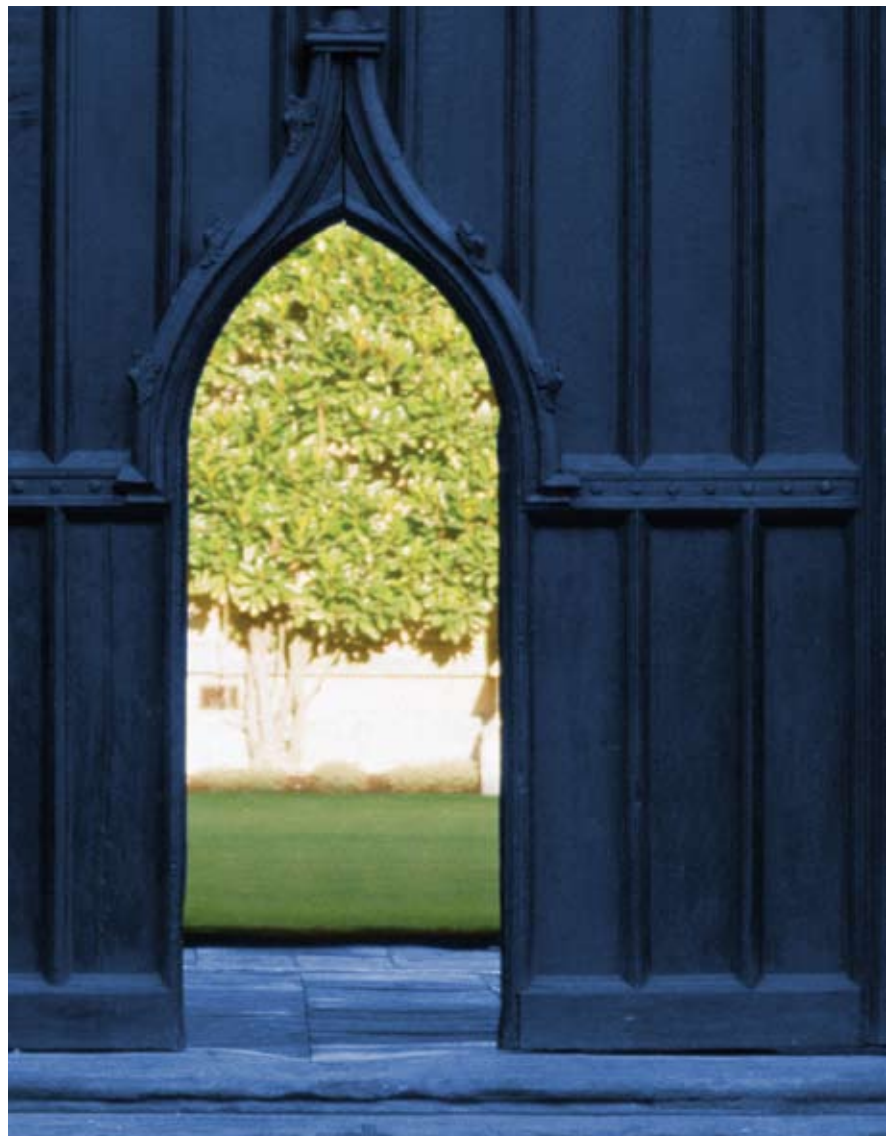
Stakeholder management

In the present climate, complex and opaque business structures and processes invite market scepticism. Misunderstandings and confusion over a company's financial position can quickly erode confidence. Shareholders, financiers and analysts are looking for reassurance about how the changing business landscape will affect the business's profitability and its intrinsic viability. Boards are being expected to take proper control of executive performance and remuneration. Boards should be:

- taking a proactive approach to managing stakeholder expectations
- ensuring clear, transparent and relevant external financial reporting
- responding to continuous disclosure requirements in a timely manner

- formulating a clear policy on disclosure to banks and other lenders
- reviewing executive remuneration arrangements and clearly understanding the link between pay and performance.

It would be a mistake to plan for an early return to 'business as usual'. No one knows how deep the current downturn will go, or for how long it will last. However, it is important that boards take a balanced approach. They will obviously be looking for management to secure credit lines, conserve cash, cut costs and allow for declining asset values. At the same time, boards need to maintain flexibility to deal with changing circumstances and take advantage of the lucrative opportunities that will emerge as conditions eventually turn for the better.



Executive pay: balancing investor and executive expectations

Investor and public concern over executive remuneration is putting many company boards on the spot. We consider how they should respond.



Martin Morrow
Partner
Equity Based Compensation

In the present market environment it can be difficult to obtain an objective and informed discussion of executive remuneration issues. As scrutiny of corporate pay levels increases, boards are discovering a renewed importance to effectively managing investor and executive expectations when they make decisions about executive remuneration.

There has been some highly publicised examples of controversial executive incentives and rewards. Claims of excessive pay are increasing as the performance of companies decreases, amidst the global financial meltdown.

Legislators are either intervening in the pay-setting process or seeking to influence it; shareholders are voting down board-sanctioned remuneration reports; investors are marking down companies perceived to have poor remuneration practices. France has legislated to restrict payments for failure and Germany is proposing to cap executive pay. The Financial Services Authority in the United Kingdom has advised financial institutions what it considers to be good and bad remuneration practices and the review action it proposes. In the United States, the *Emergency Economic Stability Act* is being used to limit excessive executive remuneration. Even the Swiss are considering whether they should try to control management rewards.

Here the Australian Government has asked the Australian Prudential Regulation Authority (APRA) to review the executive remuneration practices of banks and other regulated financial institutions. The Chairman of APRA, John Laker, has said that his objective is to address agency risk where "executive remuneration arrangements encourage management to focus on a shorter term horizon than the

long term approach that would also be in the depositors', policyholders' or fund members best interests". Laker's main concern is the structure of remuneration packages, rather than the quantum.

Boards typically respond to concerns about the issue by pointing out that talented executives are a scarce resource. Successful managers enhance shareholder value. Attracting and retaining these professionals is a matter of meeting 'market rates' of remuneration and offering appropriate incentives for superior performance.

One of the main issues is aligning the interests of executives with a company's owners i.e. its shareholders. The shareholders do not want to see executives receiving all of their 'at risk' pay when their own returns have diminished.

Most remuneration packages now contain incentive elements that should be designed to increase reward in line with improved company performance. Critics point out that many remuneration schemes actually end up rewarding poor performance, and even outright failure. For example, cash based incentives or performance shares with easily achieved hurdles have aggravated shareholders. Many remuneration practices are also thought to encourage excessive risk-taking, a short-term focus and other inappropriate behaviour by managers. For their part, many executives point out that their rewards are typically linked to such things as the company's share price, which are largely influenced by external factors outside of management control.

As many boards will testify, designing remuneration and incentive systems that consistently align management behaviour with shareholder interests is difficult.

KPMG has advised many boards and board remuneration committees on formulating executive pay packages and policies. Given the complexity and uncertainty of the task, boards might want to consider the following issues when formulating their responses to the legitimate concerns of their executives and those of investors and other stakeholders in the enterprise.

- The composition of the executives' total remuneration should be properly structured with a fixed component of an amount that is sufficient to meet the financial needs of the executive and is competitive with the market. The short term and long term components should then be structured to provide a competitive and appropriate part of the total salary at-risk.
- There should be an appropriate mix of cash and equity in the at-risk component of the structure. The equity can be restricted shares, performance rights, and/or options with at least a market value exercise price.
- Consideration should be given to deferring a proportion of the short term incentive (STI). Once the STI has been earned, shareholders want to see sustainable performance and continued employment. Consideration should be given to the forfeiture of the deferred bonus if performance is not sustained. Deferment of a proportion of the STI should be for at least one year and potentially longer.
- Performance hurdles linked only to revenue or profits with no link to the risk undertaken in generating those profits is unlikely to be accepted going forward. Companies should consider adopting performance hurdles which seek to assess, calculate and expense or set-off risk. Such hurdles can include economic profit based on economic capital allocations or risk adjusted return on capital.

- Boards will need to separately consider the remuneration packages of executives and managers involved in managing the company's risk and compliance. There will be an even greater need to consider the performance hurdles of executives in companies with diverse business portfolios.
- Remuneration committees will be expected to be even more hands-on in future, taking greater control of the remuneration process. This can mean seeking their own advice while management is separately advised.
- There will be an even greater need to have clarity in the remuneration report both in the disclosure of reward granted and pay realised and the link between the performance of the organisation and executive pay. There is often complexity and confusion around what has been disclosed as granted to an executive and what is ultimately received.

There is a natural tension between the interests and motivations of executives on the one hand, and those of investors on the other, when it comes to executive remuneration. This tension should always exist and not unduly favour either party. However, it is exacerbated in the current environment where the only constant is change. Boards play a key role in the balancing and reconciling of these differences.

What boards need to know about the current tax reform agenda

Decisions arising from the Australian Government's present tax review could affect business for decades to come.



Rick Asquini
Partner
Tax

In May, the Australian Government announced a comprehensive review of Australia's tax and income transfer (welfare) system known as *Australia's Future Tax System Review*, or more popularly dubbed the 'Henry Review' after the chairman of the review panel, the Secretary of the Treasury, Dr Ken Henry. It is designed to create a new tax structure for Australia to withstand the social, environmental and economic challenges of the 21st century.

The Government intends to use the review to reduce the enormous complexity of the Australian Tax System, which is currently a burden to the economy in itself.

By any measure the tax review is an important development. Comprehensive reviews of the tax system offer a rare opportunity for organisations and the community to influence future tax policy. In the fallout from the global financial crisis and the ensuing sharp downturn in economic conditions, corporate Australia is actively seeking reform and improvement, there is hardly a more important issue.

Although the review is genuinely comprehensive, there are at least two important carve-outs from the potential reform agenda: changes to the GST rate and base will not be considered and neither will any changes to existing tax-free superannuation payouts. Apart from such exclusions, the terms of reference still leave ample scope for meaningful change.

Current turmoil in the capital markets gives an extra edge to the review. As the review panel's initial discussion paper, *Architecture of Australia's Tax and Transfer System* explains, Australia's current tax system is biased towards the taxation of capital. The paper notes that it is "a surprising result in a globalising world with increasingly mobile capital flows for a small open economy to have the highest weight given to the taxation of capital income".

The Australian corporate tax rate is only the 21st lowest in the OECD, equal with New Zealand and Spain. Furthermore, compared with all OECD countries, Australia derives a lower share of revenue from taxes on labour. On the other hand, we derive the highest share from capital taxes, including company tax, taxes on individual capital income (interest, dividends, capital gains and some business income), resource rental taxes and property taxes.

In a post-financial turmoil world, the ability to compete internationally for scarce capital is likely to become a pressing consideration. Tax will be a vital factor in this regard.

Certain other government initiatives will also interact with the tax review. These include reviews of the administration of GST and international corporate tax being undertaken by the Board of Tax as well as the National Innovation Review that is examining, among other things, the R&D tax concession scheme. Then, of course, there are the potentially wide-ranging tax implications of an Australian emissions' trading scheme, currently scheduled for introduction in 2010.

The Government intends these initiatives to help develop long-term

environmental sustainability and competitive advantage for the Australian economy despite a background of difficult and uncertain economic conditions.

For business the tax review presents both risks and opportunities.

As the review covers personal income tax as well as corporate tax together with the interaction of the tax and social security systems, business will be but one interest group seeking to shape the review's final recommendations and Government's response to them. There is a real risk that the voice of business will be drowned out by a multitude of other, highly vocal interest groups. Others will likely try to frame the tax debate in terms of the threats posed by global warming.

The current review is an opportunity to help rebuild an increasingly fragmented tax system characterised by high levels of complexity, uncertainty, ambiguity and compliance costs. Current conditions will help business to demonstrate the critical role of the tax system in encouraging/discouraging capital formation and in influencing investment decisions and consumption patterns.

The closing date for initial submissions on tax reform was in October. There should be further opportunities to make submissions and engage in consultation before the review process is complete.

KPMG urges companies to embrace tax reform. Boards should seek regular reports on the review's progress from their internal or external tax advisers. They should support the work of appropriate industry and business organisations in promoting the case for reform. Boards and individual directors should tap into their political networks to argue the case for change. The overriding message should be the potential of well directed tax reform to drive the renewal of Australia's economic prosperity, increasing our capacity to meet the daunting social and environmental challenges facing us.

Visit taxreform.kpmg.com.au for more information about the tax review and related developments.

Key financial reporting implications

It is timely to reflect on the key financial reporting issues we have seen during the past reporting season. We expect market volatility to continue in the foreseeable future and therefore many of the issues outlined here will continue to impact financial statement preparedness.



Patricia Stebbens
Partner
Audit

Write-down of assets

Several major listed companies recognised significant impairment write-downs during the last reporting season.

Given underlying volatility in the variables and assumptions used in impairment testing such as interest (discount) rates, exchange rates, commodity prices (including crude oil) and growth projections the assessment of impairment of non-financial assets will continue to be a challenge.

Note: *AASB 136 Impairment of Assets* — requires Australian entities to consider if the value of any non-financial assets has become impaired. At its simplest, this means that the value attributed (carrying amount) in the financial statements of a non-financial asset, such as goodwill, should not exceed the asset's recoverable value. When the carrying amount exceeds the recoverable amount, the asset concerned is 'impaired' and its value should be written-down to the lesser (recoverable) amount.

Financial risks

There were some key issues arising out of the unprecedented volatility in capital markets. Under the accounting standard *AASB 139 Financial Instruments*, equity investments have to be fair valued (except in rare circumstances where fair value cannot be reliably measured). Where the assets are not held for trading purposes, the change in fair value is recognised in equity unless the asset is considered to be impaired or sold, at which point in time, the amount recognised in equity will be transferred to the income statement. Hence, one of the key issues is assessing whether

an entity's investment portfolio is impaired. This is a significant matter for a number of entities including not-for-profits who tend to have sizeable investment portfolios.

The less obvious but equally significant issue is counterparty risk. Entities had to review their exposure to counterparty risk, especially for long-term derivatives. For example:

- Who is the counterparty?
- If it is the local subsidiary of an international financial institution, is it still been supported by the parent or has it been acquired by another entity?
- Has the credit rating of the counterparty been downgraded?

Funding requirements

In a time of tight credit, one of the most important issues for many entities was reviewing their funding requirements. Some of the main questions included:

- What measures are in place to deal with actual or potential funding shortfalls?
- What is the company's reliance on short-term financing?
- Are credit lines secured?
- Is the company at risk of default on debt covenants?

A number of entities provided detailed information about their expected future sources of funding, including the potential sales of significant assets. An in-depth analysis of an entities on-going viability, based on their dependence on some of these funding arrangements, was also provided.

Another common reporting matter arising out of funding reviews was the classification of loans payable. Loans should be classified as current where, for example, the lender can call on the loan at any time due to a breach of covenants or if the loan is contractually due within 12 months after the reporting date notwithstanding that there has been a history of rolling the settlement of the loan.

Fair value measurement

There has been considerable discussion about fair value. From a financial reporting perspective, the issues have been around the reliability in estimating fair value under current market conditions especially for those assets where the inputs are no longer observable in an active market. Refer also to the section of this article titled *International Financial Reporting Standards* for more detail and international developments.

Non-GAAP disclosures

There is a trend for companies to refer to non-GAAP earnings when describing the performance of the company. Examples of non-GAAP earnings include profit after tax and before special items, and normalised earnings. Non-GAAP earnings are statutory earnings (that is earnings determined in accordance with accounting standards) adjusted for certain transactions that are considered to be significant one-off transactions including fair value adjustments. It is not surprising that there is a trend towards communicating non-GAAP earnings given the increase in significant one-off write down of non-financial assets or fair value losses from financial assets.

Concerns have been expressed by the Australian Shareholders Association about the increasing use of non-GAAP measures by boards and management when reviewing the entity's performance. The Financial Services Institute of Australasia and Australian Institute of Company Directors have issued a Discussion Paper *Underlying profit* in August 2008. One of the recommendations of the paper is that non-GAAP profit must always be reconciled back to the statutory profit figure. This is consistent with the draft guide *Disclosing pro forma financial information* issued by the Australian Securities & Investments Commission in July 2005.

Changes on the horizon

In addition to the impact of current economic conditions on financial reporting, entities should also be keeping abreast of regulatory changes which may have an impact on future financial reports.

Carbon Pollution Reduction Scheme

The Australian Government has issued a Green Paper on the *Carbon Pollution Reduction Scheme* (CPRS). It is expected that a white paper will be issued in December 2008.

In addition to entities having to establish appropriate systems which will enable them to comply with the requirements, they also need to start considering the impact of the scheme on the assessment of the recoverability of their assets.

An additional factor is whether the introduction of such a scheme would have an impact on the market's assessment of the credit worthiness of, for example, heavy polluters. Would this impact the assessment of an entity's ability to meet its financial obligations?

International Financial Reporting Standards

Boards and management should also be aware of other key changes to International Financial Reporting Standards (IFRS) that have been made recently or are being considered by the International Accounting Standards Board (IASB).

The use of fair value is an ongoing debate. There have been significant asset write-downs as a result of measuring trading assets and derivatives at fair value. This has subsequently resulted in many financial institutions needing to raise additional capital, putting pressure on liquidity ratios. Hence there are directors, regulators, and other key stakeholders with the view that fair value has contributed to the current financial volatility. They also argue that current fair value does not reflect the 'true' economic value of these assets.

The counter-argument is that fair value provides transparency that is necessary for efficient markets, that is, fair value accounting has not caused the current financial crisis, it has just made the financial position of companies more transparent. In some

cases the market has acted to penalise company's making disclosures but this may say more about the state of the market than the accounting standards. However, it must be acknowledged that it is difficult to estimate the fair value of financial instruments (and other assets) in the current environment given the level of market volatility and the illiquidity in many markets.

The debate on fair value escalated to such a level globally that the IASB issued an amendment to IAS 39, in October 2008, without its normal due process. The amendment allowed entities, in limited circumstances, to reclassify assets that were fair value – to be measured at amortised cost. The amendments were effective immediately. The objective of the amendment was to align IFRS with US GAAP.

There continues to be ongoing discussion amongst global regulators about the use of fair value and a number of other requirements in the accounting of financial instruments.

For example, the US SEC is presently holding roundtable discussion on mark to market accounting. This discussion is congressionally mandated. The European Commission has written to the IASB to further allow an entity to change the measurement basis for other financial instruments that are currently measured at fair value and to reassess the existing impairment requirements for financial assets. The leaders of G-20 nations met in November 2008 to discuss the current global economic crisis and reforms to financial markets. One of the key actions identified (to be addressed before 31 March 2009) is guidance on the valuation of complex, illiquid

products, especially during times of stress. This will further strengthen the transparency and accountability of financial reporting

There are other key changes being considered by IASB.

For example, companies that have issued preference shares or hybrids as equity may find themselves in a precarious situation if the US recommended approach to the reporting of debt and equity is adopted by the IASB.

Under the US Financial Accounting Standards Board (FASB) recommended approach all of these instruments would appear as liabilities on a company's balance sheet which could significantly skew a company's debt/equity ratio and trigger a breach of loan covenants.

Action before December 2008 reporting

Not only do boards need to focus on business issues that have been exacerbated by the current market conditions, they also have to consider the reporting consequences.

Boards can take the following basic steps to keep up with the various accounting and key regulatory changes:

- request regular updates from their external audit provider
- ensure their organisation is prepared for any changes in reporting standards
- where appropriate, ensure management is providing feedback to the IASB on proposed changes to ensure they adequately reflect commercial considerations.





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