Executive Reward Systems
Time for Review

By Mary O'Hara, FCA

The remuneration of top executives has been a topic of public debate and media attention for some time now. But with the advent of the economic crisis, the political debate on remuneration systems has become increasingly heated. Even so, remuneration can hardly be blamed as the only cause of the economic crisis.

The controversy over executive compensation has added further fuel to the debate around inadequacies in strategy, risk management and corporate culture. The underlying problem for many companies lies in the interplay of a corporate culture encouraging excessive risk-taking, a lack of farsightedness, and weak corporate governance.

High investor expectations, excessive trust in economic and financial models, inadequate regulatory frameworks and the behaviour of some individuals provided the backdrop for these company-internal problems to spread so broadly.

Nonetheless it is acknowledged that executive remuneration systems are in need of significant reform. Regulatory bodies around the world are taking the opportunity to reassess both their own good practice guidelines and the role of the investor in challenging boards on their remuneration policies. Current practices, it is observed, are not only too short-term in their orientation, but have also largely failed to meet either of their key objectives: motivating executives and aligning their reward with shareholder outcomes.

Clearly, action needs to be taken to transform the governance and design of executive pay. However, making fundamental changes will be difficult, since in many cases the level of trust between companies and their shareholders in the area of remuneration is low.

Bringing about change will require an improvement in this trust. As a first step, improved consultation with shareholders ought to lead to greater support for the judgement of remuneration committees and more trust in executives to act responsibly.

Rewarding Long-Term Value Creation

There is a widely held perception that the short-termism inherent in incentive plans contributed substantially to the current credit crisis. In particular, there is concern that risk and compensation are not always closely aligned. For example, an executive might be able to take a bonus based on a mark-to-market profit in one year which becomes a loss in subsequent years.

Organisations need to ensure that remuneration models are tailored to business strategies, moving away from a follow-my-leader mentality. Simplification will be critical to success, with fewer complex incentives and a greater focus on long-term arrangements to achieve alignment.

There is a realisation that bonuses should be driven, not by an annual measure of performance, but rather on performance measured over a period that is closer to, if not beyond, the life of the activity in question. Incentives should not require or encourage executives to execute a quick 'flip' when the potential for the most value creation is over the longer term.

Linking Sustainable Performance & Reward

There is an obvious need for clarity and transparency around the area of 'pay for performance', with a focus on rewarding outputs, not effort. This requires a clear articulation of what constitutes performance, with skill and luck separately identifiable.

Total remuneration must support the business strategy and long-term value generation, and effective compensation systems tie managerial pay to performance. Of course, pay-for-performance is not a guarantee for better performance, but it is one factor in a best-practice total compensation strategy.

As shown in Figure 1, total remuneration comprises various elements, each of which influences different facets of executive

Figure 1:
Elements of total remuneration

Equity Programmes	Enables executives to participate in long-term sustainable value creation and aligns the interests of shareholders and management
Bonus	Uses short-term retrospective performance measurement, ideally based on both quantitative and qualitative objectives
Base Salary	Fixed compensation element, representing market value of function
Pension	Focuses on long-term wealth accumulation
Fringe Benefits	Usually tailored and at times driven by tax efficiency

behaviour. Typically, for top executives, the variable part of total compensation is significantly higher than the fixed part. It is, therefore, important to identify the right performance metrics and to set the goals appropriately, supporting the long-term business strategy.

How Might The New Model Look?

Already there are signs that organisations are taking steps to replace short-incentive payouts with long-term programmes featuring higher degrees of equity or deferral. Many are also considering making the eventual receipt of deferred bonuses subject to longer-term performance: so-called clawback.

The right reward system for a particular company depends directly on its business strategy and the environment in which it operates. There is no such thing as an ideal system to fit all companies – not even in a single industry. Therefore, tailoring the reward system in a 'best fit' approach is a key factor.

A Word About Pensions

Based on a recent survey of 290 Irish employers conducted by PricewaterhouseCoopers, it is clear that pension schemes are going through significant change, with nearly three quarters (73%) of defined benefit schemes having gone through or expecting to undertake some level of change.

Executive pension arrangements are seen as an important part of the reward package and were noted by survey respondents as becoming more important in the recruitment and retention of key talent. There is also an emerging trend towards tailored pension solutions, with companies beginning to talk about possible radical changes to modernise their pension provision to fit in appropriately with the overall wealth management opportunities for executives.

However, it is equally clear that while many organisations have staff affected by the €5 million cap on pension benefits, more than one third of these have yet to take any action even though the cap was introduced two years ago.

Employee Engagement And Motivation

Recent studies suggest that there should be a better balance between the financial management and motivational aspects of reward than was evident in the past. The non-cash rewards (benefits and pensions), as well as intangible rewards (career development opportunities, improving work climate, etc) cannot be ignored. Any perceived difficulty in assessing the competitiveness of the total reward packages must be overcome and, more importantly, the value of same communicated.

Many companies are also attempting to shift their cultures towards a more group-wide performance orientation. In particular, senior executives need a more group-based compensation plan to spur broader collaboration between business units.

Introducing a broader percentage of pay based on group performance may seem simple enough. But in practice, there is likely to be considerable resistance. For example, executives whose actions and commitment are delivering strong returns will likely resent seeing their compensation diminished by loss-producing business units.

The Role Of Governance

Rewards most certainly need to guard against excessive risk taking, but equally, compensation systems need a means of discouraging the taking of insufficient risks. Striking the correct balance may be difficult, and no system is likely to be perfect, but it is essential that organisations begin to do a better job of linking risk to performance.

Being a member of a remuneration committee is – and should be – a tough role

Good corporate governance directly depends on a strong board of directors that assumes its oversight role of the company by ultimately driving the culture and setting the standards for behaviour throughout the organisation. Being a remuneration committee member is, and should be, a tough role. There is a need for committees to be more informed and questioning, to exercise more discretion while at the same time avoiding divisiveness over pay.

Executive pay should reflect the nature of supply as well as the demand for talent. For average performers this will mean that pay will come down, but for the best performers, it will continue to grow, as individuals are differentiated based on the value they add to the enterprise. Pay is part of the equation that can assist in supporting skilled executives to perform to the best of their abilities. High potential pay for performance, responsibly governed, is a force for good. In the wake of the economic turmoil over the past 12 months and the calls for stronger governance, this fundamental message needs to be remembered, emphasised and communicated.

In summary

Compensation systems are a mirror of corporate culture and governance and have to be specific to individual organisations. Every organisation has to consider the challenge of finding the right personnel: managers who are able to implement strategy; people who do not just have the right professional qualifications, but who also set the right tone at the top. Drawing up compensation systems should be at the very core of the responsibilities of the remuneration committee, acting on behalf of and in close consultation with the full board of directors.

Undoubtedly, there is a need for balanced compensation systems which offer long-term incentives, as well as alignment between strategic business objectives and sustainable performance, together with an appropriate adjustment for risk. Remuneration committees will need to be better informed and more challenging around the question of pay, but without losing sight of the key role which reward plays in the retention and motivation of key talent.

Recent events have removed the luxury of a long timeframe to fix remuneration models – change is required now. Achieving change will be an immense task for all involved, particularly remuneration committees. But we all need to rise to the challenge. If we do not, then there is a risk that we will lose the freedom to use pay as a force for good, motivating executives by rewarding success.

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FRC Publishes Revised Guidance For Directors On Going Concern Assessments And Disclosures

The Financial Reporting Council (FRC), the United Kingdom's independent regulator, has published updated guidance for directors of UK companies to help with assessing going concern. The guidance is based on three principles covering the process which directors should follow, the period covered by the assessment, and the disclosures on going concern and liquidity risk. It emphasises the importance of balanced, proportionate and clear disclosures about going concern issues and the key assumptions being made in one place in an annual report.

Feedback received from market participants in response to a series of documents published by the FRC in the last twelve months is also taken into account. Commentators expressed strong support for both the principles-based approach and the implementation date of 31 December 2009.

The guidance is designed to be relevant to the annual going concern assessment that must be carried out by directors of all UK companies including those that apply the *Financial Reporting Standard for Smaller Entities*. For companies that are admitted to trading on a regulated market, it will apply to both their annual and half-yearly financial statements.

Paul Boyle, Chief Executive of the FRC, remarked: "We are grateful for the support for our efforts relating to going concern, both in the UK and further afield. The updated guidance should be helpful to directors of all sizes of UK companies in the current difficult economic conditions and in more settled times."

A number of commentators on the Exposure Draft remarked on continuing inconsistencies between the going concern requirements of IFRS, UK GAAP and Auditing Standards and on the need for IFRS to contain more guidance on going concern.

Ian Wright, Director of Corporate Reporting of the FRC, said: "The guidance reduces significantly inconsistencies between UK practice and IFRS, but some differences remain. The FRC has written to the International Accounting Standards Board to encourage them to incorporate the new principles and guidance into IAS 1: *Presentation of Financial Statements* when it is next reviewed."

IAASB Staff Practice Alert Helps Auditors Plan More Effective Use Of External Confirmations

The International Auditing and Assurance Standards Board (IAASB) has released a new audit practice alert to raise awareness of potential issues and to help auditors use external confirmation procedures more effectively. Entitled *Emerging Practice Issues Regarding the Use of External Confirmations in an Audit of Financial Statements*, the alert highlights areas within the International Standards on Auditing (ISAs) that are particularly relevant when deciding to request external confirmations, designing and carrying out confirmation procedures, and evaluating responses received.

The alert also raises awareness of potential issues that may surface from the increasing use of technology in the confirmation process and the use of restrictive language by respondents.

James Gunn, IAASB Technical Director, explains: "Requesting external confirmations is a commonly used audit procedure in an audit of financial statements. Today's environment, however, reinforces the need for professional scepticism and professional judgment in all aspects of an audit, including the use of confirmations. The alert reminds auditors of the need to maintain control over the confirmation process, and to remain alert to circumstances that may undermine its effectiveness."