

# Board Obligations

## Addressing Pay Reasonableness and Independence

by John Egan

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*The present crisis in financial and capital markets highlights issues which have been raised in the Australian, US, UK and European parliaments regarding the independence of external advisors and their level of engagement in the provision of professional services to corporations.*

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### Independent Advice

Remuneration Committees and boards increasingly need expertise in risk management, accounting and tax, audit, remuneration plan design and governance, compliance and legal, and that expertise is certainly not available in its entirety from remuneration advisors.

A question which arises is the role of directors and their level of engagement. Is the role of directors to take advice or to ensure that they are fully informed on all the relevant issues and once informed, as a collegiate group, make determinations which with their intimate understanding of the organisation and its shareholders result in appropriate programs? Our experience is that there is no panacea.

The best programs are tailored to an organisation's circumstance and are reviewed regularly.

The main thrust at present for the taking of independent advice comes from the legislative requirements set out in section 211 of the Corporations Act 2001. The section states that, for the remuneration of related parties to be validly paid without the approval of the members (in public companies only) it must be reasonable considering the circumstances of the company and of the recipient.

However, a prudent board may well consider that, given the complexity of contemporary remuneration, the emotional nature of reward, its hierarchical implications and the sensitivity of shareholders to some groups of expenses such as remuneration, independent advice on reasonableness of remuneration is essential quite apart from the legislative imperatives.

Such a decision raises two concerns:

- the appropriate skill sets needed by both directors and their advisors, and
- the independence of the advisor.

### The Appropriate Skill Sets

It is vital that auditors attest to the validity of reporting of the structure and quantum of executive remuneration. On the other hand, it is unfair to accountants and auditors to expect them to accumulate the information and judgement to attest to the reasonableness of remuneration in the context of a company's circumstances. Many remuneration consultants have access to sophisticated analysis of market and sector practice and history and are aware of market expectations of performance to earn the remuneration paid. They are the appropriate arbiters of structure and quantum.

### Independent Advisors

It is important to separate the questions of the judgments to be made in advising a company on accounting for the remuneration quantum and the judgments to be given in attesting to the reasonableness of that remuneration. That is not to say that legal and accounting advice on structures and the reporting of quantum does not require strict conformity to reasonableness but rather that the organisation attesting to reasonableness must be able to demonstrate competence in understanding the design and remuneration outcomes of the reward structures in place, as well as ensure that the intent of disclosed reward is appropriately reflected in employment contracts and/or service agreements.

Consultants are more often asked whether the incentive and remuneration structures are "reasonable". While some of the issues may be answered from a legal or accounting point of view, or considered in light of general market practice, it could be argued that the foundations and outcomes of these plans need to be addressed by an ethicist or a moral philosopher.

A remuneration consultant can advise on market practice and on how well a particular incentive plan reflects performance. However, in view of the complexity of the investment instruments and the wide range of risks being managed, it may be useful to have a consultant who is totally independent of the design and documentation of a company's incentive plans to attest to their reasonableness. This structure of consultation and advice might well see different advisors for the board from those consulted by executives.

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- INCENTIVE PLAN DESIGN
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## Engagement of Directors

Given the Rudd Government initiated enquiry by the Productivity Commission, where boards have not sought independent guidance in relation to the reasonableness of senior executive employment arrangements they may well find themselves needing to address the appropriateness of prevailing contractual commitments. Including the validity of current practice in relation to contractual commitments or the stated application of those commitments or company policy in remuneration reports.

While most service agreements would indicate that the company would not be obliged to make any payments which do not comply with Corporations Law, documents will often set out a ritual of entitlements in the event of termination other than for cause.

It is our experience that if an executive is promoted internally to a senior role, particularly one reporting to a Chief Executive, or an internally promoted executive to the position of Chief Executive it is appropriate at that time to substantially refresh and/or substitute a new contract, with all parties agreeing to the ensuing documentation.

It is our judgement that in the prevailing climate and one which has been emerging over recent years that the level of involvement of a remuneration or equivalent committee of a board needs to reflect an intimate understanding of corporate policies and programs. Familiarity with contractual entitlements of named executives, the refreshing of those arrangements as appropriate, incorporating both changes in an organisation's structure, changes in an individual executive's accountability or place of domicile, should not simply be done through a series of attachments or schedules to a long established contract of employment.

An era may emerge where members of such a board committee will need to sign-off at the end of each financial year and in respect of each remuneration report. This sign off would reflect that their review has entailed a series of defined steps and that the company has not entered into any agreements, any payment plans or termination arrangements with which they have not familiarised themselves and signed-off on having regard to their appropriateness and having obtained independent advice.

## Ensuring Quality Advice

Directors who believe they need to seek an independent source of advice should choose that advisor carefully, ensuring they have the experience and skills to provide the advice sought. The quality of advice received is dependent upon the thoroughness of the briefing, which includes the organisational context or challenges which sponsored the need for advice.

Directors themselves need to adopt an independent perspective and form their own view on the basis of advice received, not simply accept it without review. They also need to ensure that the advice received answers the questions asked and if qualified, probe the reasons for such qualification.

If on the basis of the advice received Directors are not satisfied that the questions asked have been fully comprehended or understood, a further opinion will often assist in enabling directors to resolve what in many instances are complex issues. In the case of CEO appointments or CEO and senior executive termination, matters which do not regularly confront them, a further opinion is often valuable.

From an advisor's perspective the most difficult position which is faced is one where the Board or briefing Director provides an inadequate or incomplete brief because of a sense of refrain, embarrassment or sensitivity to confidentiality. Seasoned advisors will offer fearless and independent counsel of the highest quality when their briefing reflects similar respect and level of engagement.