The Effective Board

INDEPENDENT AUDIT
BOARD REVIEW

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Avoiding the pitfalls

Back in the May edition we looked at what to consider in looking at how well your Remuneration Committee is working. We promised a follow-up on what needs to work well when it comes to the Committee designing packages and evaluating the outcomes. As all members of Remuneration Committees know, it's darned complex: it combines dealing with people and their behaviours with, measurement, communication and strategy – a potent mix. So we can't cover all the angles. But here is a good smattering to help you get it right – avoiding some of the traps.

REMCO SEEKS A BETTER UNDERSTANDING OF WHAT MOTIVATES THE CEO

Good practices to consider...	Things to avoid...
Start the process of designing any new policy or assessing the likely outcomes of existing arrangements at an early stage. All too often the RemCo's work gets squeezed into a month or two at year end. It might be inevitable that the timing of the results means a lot has to be done then – but some forward thinking and anticipation can smooth the discussions with executives and analysts.	Simply sticking to the previous year's timetable. That might work – but if the issues are different from last time round, or the need to discuss outcomes with investors suggest a trickier set of discussions, different timing might be needed, and possibly more time. And if it's time for policy approval, that certainly will be the case.
Keep in mind the full range of important stakeholders. Whether shaping policy or looking at outcomes, the response of regulators, the wider workforce and broader society (as reflected in the media and political noise) are increasingly becoming important factors. It's not that you have to – or can – respond to everybody's concerns or interests. But weighing them up and considering the possible implications can help manage reputation risks and the possible impact on the organisational culture. Forewarned is forearmed.	Slipping into thinking that it's just about the reaction of the executives and the shareholders. There are a lot of other vocal groups out there, with a media mindset that will jump on perceived social unfairness or suggestions of corporate greed. Whether you think them fair or not is largely irrelevant: it's going to be the perceptions that do the damage.
Have somebody play the role of the cynic – most effectively a member of the RemCo. Get them to think through – and then vocally set out – what the reaction of other stakeholders outside the business and the Board might be. And have them apply the "moral test": how will this award go down in outsiders' eyes?	Supposing that just because the award is in line with policy, everything will be OK. Societal reaction might be damaging even if the policy is what it is and gives a certain unavoidable result. There can come a time when a litmus test of stakeholder opinion can help avoid a lot of aggravation and reputation damage.

Good practices to consider…	Things to avoid…
Aim for simplicity and avoid unnecessary complexity. If it's only the committee chairman and the consultants (and probably the highly-motivated CEO) who understand it, it's too complex. A scheme that can't be explained or understood is probably not going to achieve its objectives.	Ending up with a policy and structure that is quite simply too difficult for all of those covered by the scheme (and the analysts) to understand. And certainly too difficult to see how it will drive the target strategic outcomes.
Think strategy first – and then compliance. It's about the impact you want to have in increasing the chances of strategic success, not about fitting policy into a straight jacket of expectations.	Losing sight of the strategic goal. Yes, recruiting or retaining the right CEO is important of course. But is there clarity over the linkage between strategic objectives and remuneration targets and measures? Sometimes the LTIP measures are just too broad to make that link to strategy visible – especially when market movements or commodity prices obscure the picture.
Do some scenario thinking from a strategic, not just numerical, perspective. If all goes to plan (or much better) what might we find ourselves paying out – or wanting to pay out? And in the flip side scenario, how much embarrassment and how many "wrong" messages to staff and the outside world might take flight?	Being too focused on modelling the numbers: the advisors or HR may well have presented some outcomes, but that will often just reflect some representation of KPIs. That's not the same as envisaging scenarios and the strategic and reputational implications.
Consider how far you want the committee to maintain discretion – upwards or downwards. Even though the policy will be reviewed every three years, the environment and circumstances can change a lot more quickly with the result that the outcome just doesn't seem right.	Getting locked in to an automatic result regardless of the circumstances, the real corporate performance or the likely reaction. And, in particular, getting locked into a situation where widespread executive dissatisfaction arises because genuine hard work and progress can't be recognised.
Look at the package as a whole: salary, bonus, LTIP, pension and benefits. And in particular make sure there's enough time spent on understanding the pension angle.	Taking each part separately and in isolation. You can be sure the executives will look at the total deal – and increasingly investors are doing the same.
Apply a good dose of healthy scepticism and caution when looking at benchmarking data.	Failing to take into account the performance aspects of comparators as well as the pay levels.
Think how the remuneration policy and targets fit with the "people strategy", whether that's about the desired culture or how you want to develop, motivate and retain "stars". And think risk: what attitudes do you want to nurture through reward? A less conservative attitude – or reining in unhelpful aggression?	Focusing too much on the task of rewarding the top executives. What happens at the top gives messages to those below: culture, expectations, morale, positivity versus cynicism, risk-taking… Often RemCos just don't stop to think about the wider implications.
Consider how best to go about understanding the psychological angle and how key executives might respond. If it might be complicated, it could be worth getting some professional advice if the risks are high – or simply seeing this as part of the induction training for RemCo members so they can factor in considerations in general.	Assuming they will think as you do. We all can hear different things, interpret messages in different ways – and then respond in unanticipated ways. But whilst RemCos might often try to think about this, most will be doing so from the standpoint of well-intentioned amateurs.

Good practices to consider…	Things to avoid…
Have a clear communications plan – for the executives and for the investor community. That means thinking through early notice, face-to-face meetings, who's doing what, allowing people time to think and respond – and allowing the Committee time to think through differing responses (as the messages coming from investors will differ almost for sure).	Going with the flow and taking things as they come without a well-thought-through and timely plan. That might work well when things are straightforward. But when it gets messy – whether with individual executives or with vociferous investor bodies – time and planning are of the essence.
Make sure targets are known and communicated before you get into the period they cover.	Allowing slippage: as can happen with the annual budget, performance targets too often seem to slip – possibly because they in turn are waiting on a delayed budget approval but sometimes because the RemCo still hasn't met.

As well as undertaking reviews of the full board, Independent Audit has specialist expertise in remuneration and the work of Remuneration Committees. So if you are considering a "deep dive" into the work of the RemCo – whether as a focused approach to your annual board review or as a special assessment, we would be pleased to discuss our approach.

INDEPENDENT AUDIT

Independent Audit are leading specialists in governance, risk and assurance. We help clients understand and improve the effectiveness of their governance, including the board and its committees, internal and external audit, and risk governance.

If you have any questions on the issues covered here, please contact Richard Sheath at richard.sheath@independentaudit.com

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