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AUDIT COMMITTEE INSTITUTE

Remuneration Committee : Time to Raise the Bar?

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Foreword

Mohamed Raslan Abdul Rahman
Managing Partner
KPMG in Malaysia

Remuneration invariably factors in the attraction and retention of top talent, particularly against the backdrop of a highly competitive global market environment. While it is desirable and in an organization's best interests to hire the "cream of the crop" to form its board, suitable directors come at a price. Companies need to value the contribution of directors in helping to drive their vision while recognizing the risk elements internally and externally.

Recent studies point towards a link between corporate failures in western countries and the remuneration package of board members and key management. Remuneration is key in the success and sustainability of a company, and the Remuneration Committee plays an increasingly critical role in the development of policies and establishing of sound compensation structures.

This article, ***Remuneration Committee: Time To Raise The Bar?*** is centered on the changing remuneration landscape of some developed economies, and provides much needed literature on this very current topic. As a firm committed to cutting through complexity for our clients, we wholly support this endeavor to equip boards with guidance on pertinent issues arising in this area. I commend the **Audit Committee Institute** for developing such an insightful piece of thought leadership.

Peter Ho
Chairman
Audit Committee Institute
Malaysia

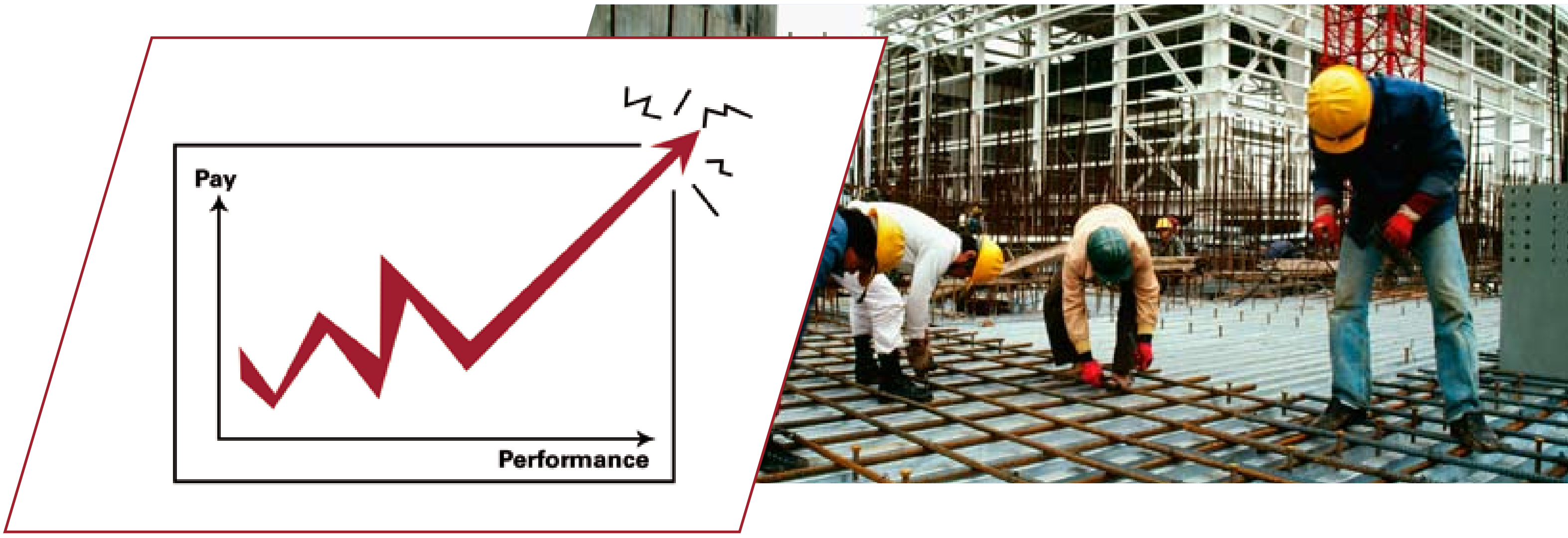
Recruiting the right candidates and then rewarding them appropriately requires careful deliberation. As a shareholder, you will want your directors and top management engaged, productive and able to bring out the best value in your organization. A right mix of the board will be able to add value, achieve compliance and, more importantly, discharge its oversight responsibilities more effectively.

As remuneration is the key driver in attracting talent, there is a need to get the right balance to avoid increasing excessive risk. An organization must have a clear objective and a set of quantitative and qualitative evaluation tools to support its long and short-term business strategies.

One of the key lessons learnt from the recent financial crisis in the West is that the remuneration policies of many overseas financial institutions led their key employees and directors to undertake excessive risk. In the absence of a proper balanced remuneration mechanism, individuals are often rewarded for their ability to deliver short term gains oblivious to the long term risks involved.

This article focuses on the changing remuneration landscape of certain developed jurisdictions and how such practices may impact the remuneration of Malaysian directors and top executives. We believe transparency in the remuneration framework will promote fairness and, at the same time, improve competitiveness in business.

Time to Raise the Bar?



In the past, corporations worldwide adopted remuneration philosophies skewed towards short term financial performance. These corporations failed to align their remuneration strategy to the best interests of their stakeholders. Certain business communities have suggested that the flawed remuneration strategies resulted in the recent global financial meltdown.

In adopting a balanced reward philosophy, an organization must achieve the right equilibrium between short versus long-term compensation and fixed versus performance-based remuneration.

It is essential that an organization sets out clearly its remuneration structure and highlights to its stakeholders how it is linked to the company performance.

In setting remuneration aligned to the strategies and objectives of the business, the **Remuneration Committee** must consider the following:

a) Performance Awards Must Tie to Shareholder Financial Objectives

The company has a financial responsibility to its shareholders. As a result, remuneration should be evaluated like any other investment.

b) Employ the Proper Mix of Remuneration Elements

One of the biggest challenges faced by growing companies is striking the right balance between short-term and long-term incentives.

c) Embrace Performance That Employees Can Impact

This equilibrium is achieved when an employee can say "I can see precisely how my performance aligns with my remuneration!"

d) Effective Communication and Reinforcement of Rewards

Reward programs become a covenant between employer and employees. It defines an area of stewardship, establishes expectation levels and provides incentives. "What gets measured, gets done".

Sound Principles of Remuneration

It is clear that remuneration plays a vital role in the success and sustainability of companies. Let us take a closer look at some of the principles and recommendations introduced in the West to address the issue of remuneration.

The High Pay Commission in the UK studied the remuneration landscape and made 12 recommendations in an article "**Cheques With Balances: why tackling high pay is in the national interest**". The recommendations were moulded around transparency, accountability and fairness.

Transparency

Greater transparency in remuneration policy, strategy and adequate disclosure of remuneration package would indirectly promote a higher standard of care and diligence in remuneration setting. This is especially true when the recommendation or decision is subject to scrutiny by the various stakeholders.

Accountability

Unraveling the board pay conundrum helps in promoting greater accountability and eventually reinstates the confidence of the stakeholders. Currently, no one is clearly accountable for the remuneration setting despite the fact that this should be the responsibility of the Remuneration Committee.

Fairness

Studies suggest that unfairness or inequality of the remuneration package will undermine the productivity of the company. Rewarding the directors and staff based on their respective contributions to the company is therefore important.

Dodd-Frank Wall Street Reform and Consumer Protection Act

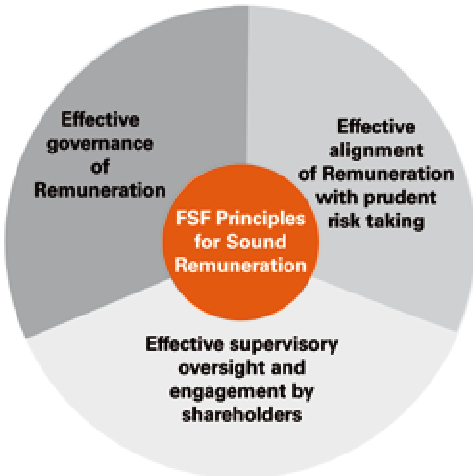
- Requires all members of the remuneration committee to be independent directors and have the sole discretion to appoint remuneration consultants.
- Requires disclosure on the correlation between executive compensation and financial performance of the company.
- Requires executive compensation to be approved by shareholders no less than once every 3 years and a right to a non-binding vote on golden parachutes paid to executives in relation to an M&A transaction.
- Requires public companies to set policies to recover executive compensation from past or present executives if it was based on inaccurate financial statements that do not comply with accounting standards.
- Requires the remuneration committee to consider the independence of the advisor, consultant or legal counsel and have the sole discretion to appoint remuneration consultants.

Walker Review on Corporate Governance in UK Banks and other Financial Industry Entities

- Non-executive director remuneration should reflect the time commitment and not include share options or other performance related elements.
- Remuneration committees should seek advice from the board risk committee on an arm's-length basis on specific risk adjustments to be applied to performance objectives set in the context of incentive packages.
- Incentive payments should serve as the primary risk adjustment mechanism to align rewards with sustainable performance for executive board members and executives whose remuneration exceeds the median for executive board members.
- Short-term bonus awards should be paid over a three-year period with not more than one-third in the first year. Clawback should be used as the means to reclaim amounts in limited circumstances of misstatement and misconduct.

In the wake of the global financial crisis, the Financial Stability Board via its forum addressed how perverse remuneration incentives amplified excessive risk-taking that severely impacted the global financial system.

The Principles for Sound Remuneration were introduced and highlighted in 3 major principles which are summarized as follows :



Effective governance of remuneration

1. The board of directors must actively oversee the compensation system's design and operation.
2. The board must monitor and review the remuneration system to ensure the system operates as intended.
3. Staff engaged in financial and risk control must be independent.

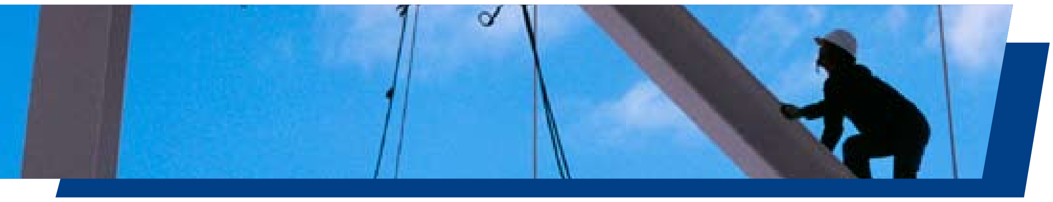
Effective alignment of remuneration with prudent risk taking

1. Remuneration must be adjusted for all types of risk.
2. Remuneration outcomes must be symmetric with risk outcomes.
3. Remuneration payout schedules must be sensitive to the time horizon of risks.
4. The mix of cash, equity and other forms of remuneration must be consistent with risk alignment.

Effective supervisory oversight and engagement by stakeholders

1. Supervisory review of remuneration practices must be rigorous and sustained, and deficiencies must be addressed promptly with supervisory action.
2. The company must disclose clear, comprehensive and timely information about their remuneration practices to facilitate constructive engagement by all stakeholders.

The Financial Stability Board was established to address vulnerabilities and develop and implement strong regulatory, supervisory and other policies in the interest of financial stability. Its members include the central banks of major countries such as the US, UK, China and Germany.



Final thoughts

The role of the Remuneration Committee is ever increasing in importance.
The pay package and remuneration structure can determine the success or failure of a company.
As highlighted in this publication, we believe it is imperative that Remuneration Committees focus on the things that matter the most.

1) Standardized remuneration report

Should the disclosure of directors' remuneration be more transparent, detailing the salaries, fees, benefits-in-kind and options, by each individual director at the group and company level?

Most public listed companies in Malaysia only disclose the remuneration of their directors in bands of RM50,000 and, at times, the disclosure is only limited to the company level. Certain top banks have, however, set higher standards by disclosing the full remuneration of each director.

We believe that over and above the remuneration packages, there should be standardized and comprehensive disclosures on the structure of the remuneration framework. The disclosures should cover objectives, strategies and policies of the remuneration framework, as well as the components and measurement used to align the remuneration to the business goals.

Reference could be made to the remuneration reports of Australian public listed entities. Such disclosures are governed by the Australia Corporations Act 2001.

2) Greater oversight on directors' remuneration by shareholders

Should shareholders be given full oversight over directors' remuneration? How?

In Malaysia, shareholders have to rely on the non–executive directors who form the majority of Remuneration Committee members to recommend Executive Directors' remuneration framework.

Certain countries have introduced new rules to the corporate governance framework. Under Malaysian legislation, directors' remuneration (with the exception of fees) is not subjected to shareholders' approval even though the amounts involved may be substantial. One needs to weigh the cost and benefit of such mechanism that allows shareholders to have full oversight and explore if this practice is suitable for Malaysia.

Under US Securities and Exchange Commission rules, issuers will be required, not less frequently than once every three years, to provide a separate shareholder advisory vote in proxy statements to approve the compensation of their executive officers.

3) Composition of Remuneration Committee

Should the Remuneration Committee be made up entirely of non-executive directors?

When the Remuneration Committee consists of both executive and non-executive directors, there is a genuine fear that the non-executive directors may find it hard to confront the executive directors on their remuneration and, hence, may not be able to act in the best interest of the company.

4) Disclosure of remuneration packages of top executives who are not board members

Should the remuneration of the top paid executives be disclosed alongside that of the directors? Should there be an analysis on the remuneration of these top executives against the performance of the business and the median remuneration of the employees?

In Singapore, public-listed entities are required to disclose the remuneration of the top 5 executives who are not part of the board of directors.

The call for additional disclosure may be justified as the greater transparency will promote accountability. On top of that, it may, to a certain extent, reduce the inequality or disparity in remuneration.

In the UK, the High Pay Commission recommended a distribution statement that covers the distribution of total staff costs, company reinvestment, shareholder dividends, executive team total remuneration package and tax paid that is presented on the front page of the annual report.[1]

The High Pay Commission is an independent inquiry into high pay and boardroom pay across the public and private sectors in the UK.

5) Governance structure for remuneration experts

Should there be a governance structure in place for the remuneration experts?

Remuneration setting is extremely sensitive and vital to a company in view of its potential impact over the performance of the directors as well as top executives.

Certain remuneration committees may draw advice from remuneration experts. However, the independence of the experts and the potential conflict of interests must be addressed prior to engaging their services.

Should we adopt the same approach or governance structure implemented elsewhere?

In the US, the Securities and Exchange Commission has decreed that a company whose board retains a remuneration expert to advise its Remuneration Committee on executive remuneration (including those of directors) must disclose all fees paid to this expert if the same firm provides the company with other services.

6) The Malaysian Code on Corporate Governance 2012 ("MCCG 2012")

Released in March 2012, the MCCG 2012 supersedes the 2007 version. Interestingly, the new Code has removed as one of its recommendations for listed issuers to form a Remuneration Committee (previously such a Committee was included as a best practice with the scope of work set out in the old Code). In the absence of this Committee, the board is expected to oversee the remuneration framework and ultimately, the pay out.

It will be interesting to see how the new Code which takes effect immediately upon its release would pan out amongst listed issuers, especially those which already have in place a Remuneration Committee. Will this committee be removed and the board takes over?

1. Extracted from "Cheques With Balances: why tackling high pay is in the national interest" issued by the High Pay Commission.

Contact us

Should you have any feedback on this article, or wish to obtain a complimentary copy, please drop us a note at **info@kpmg.com.my**

For further information, please contact:

Peter Ho
Chairman
Audit Committee Institute Malaysia
Phone: (603) 7721 3388, ext 3006
E-mail: peterho@kpmg.com.my

Mohamad Khaidzir
Partner, KPMG in Malaysia
Audit Committee Institute Malaysia
Phone: (603) 7721 3388, ext 7093
E-mail: mshahari@kpmg.com.my

Johan Idris
Partner, KPMG in Malaysia
Audit Committee Institute Malaysia
Phone: (603) 7721 3388, ext 3018
E-mail: jidris@kpmg.com.my

To learn more about the Audit Committee Institute Malaysia or to access our resources, please visit our website (www.kpmg.com.my/aci) or contact us by e-mail (info@kpmg.com.my).

About ACI Malaysia

In recognizing the importance of audit committees, the Audit Committee Institute (ACI) Malaysia was created to assist audit committee members adapt to their changing role.

Sponsored by KPMG in Malaysia, the Institute's primary mission is to communicate with audit committee members to enhance their awareness of, commitment to, and ability to implement effective audit committee processes.

ACI Malaysia engages in a variety of initiatives to assist audit committee members by providing a range of resources through its website, publications and roundtables all designed to facilitate the exchange of views and insights on audit committee best practices and processes, and other topics of interest.

The Institute has developed a range of tools to assist audit committee members in meeting their oversight role. These tools include:

- Audit Committee Guide – a comprehensive reference for audit committee members. It captures KPMG's insights into what makes a best practice audit committee and provides practical tools to help improve audit committee processes.
- Regular updates – ACI Malaysia will publish regular newsletters to provide audit committee members with timely updates on significant reporting and regulatory changes, and emerging issues.
- Website (www.kpmg.com.my/aci) – Designed to provide audit committee members, board members, senior executives and other interested parties with timely access to a wide range of useful resources. ACI Malaysia's website provides access to updates on current and emerging issues related to governance, risk management, internal and external auditing, accounting, financial reporting and a library of reference materials.
- ACI Roundtables – ACI Malaysia facilitates interactive roundtable forums which provide a platform for the exchange of views and insights on topics of interest to board members, audit committees members and senior executives.