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Remuneration and bonus arrangements

Chartered Institute of Internal Auditors

This guide provides an insight into the risks associated with fixed and variable remuneration including real world examples. It provides tips for auditors plus practical thoughts on mitigating controls, how assurance can be provided and suggestions for audit tests.

Background

Remuneration and bonus packages should be sufficient to attract, recruit and retain staff working in an organisation. In recent years, there have been huge remuneration packages paid to senior executive directors in listed companies which have resulted in rebellion from shareholders over such payments. Along with remuneration policies which are considered to be unfair to the rest of the workforce. In addition, there have been increases in bonus and long-term incentive plan opportunities with little supporting rationale. For example, KPMG (Guide to Directors' Remuneration 2018) reported that approximately a third of executive directors in FTSE 350 companies received annual bonuses that was 80% of the maximum opportunity.

Remuneration policies can encourage excessive reward of senior executives at the expense of other staff in the workforce or where there has been significant drop in profits. Excessive or unfair remuneration can result in reputational damage and an inability to attract new investors.

A 2018 report by the Chartered Institute of Personnel Development on executive pay indicated payments from long-term incentive plans typically linked to shareholder returns rose from £213m in 2016 to £313m in 2017. Although it could be argued that this could be due to improved profits in the markets, questions exist around the extent to which an individual or small number of executives, could influence shareholder returns as opposed to other contributory factors, including the role played by the market, the wider workforce or the economic context.

A typical pay packet for a chief executive of a FTSE 100 firm in 2017 was £3.9m an 11% increase on 2016, according to the 2018 survey by the High Pay Centre and the Chartered Institute of Personnel and Development. It has been reported that between 2017 and 2018, there has been notable increase (of 2.5% to 12.5%) in the number of companies receiving a significant vote against their remuneration policy from shareholders.

There is significant focus on compensation packages from the public and the media. Adverse publicity on the compensation packages of employees could potentially lead to a financial impact, loss of market share or an investigation by regulatory bodies. Organisations with excessive remuneration packages could be seen as one that is remuneration focused and perceived as paying bonuses inappropriately. The issue of remuneration arrangements has considerable reputation risk for all organisations which do not have an ethical and equitable remuneration policy in place.

Examples

Below are some examples where unethical behaviour caused by an inadequate remuneration policy has led to financial loss and reputational damage:

AstraZeneca

Shareholders of the pharmaceutical firm AstraZeneca rebelled over the £9.4m pay package for the Chief Executive Pascal Soriot. This is despite the decrease from £14.3m a year earlier, when the company experienced votes against its pay policy and warnings from shareholder advisory groups over its bonus plans. It was reported that shares in AstraZeneca dropped following this, after it revealed a 46% drop in operating profits for the first quarter of 2018-19, with earnings falling to $896m, which was much worse than forecast by financial analysts.

Persimmon

Persimmon's CEO, Jeff Fairburn, the UK's highest paid chief executive as at November 2018, was asked to step down just four months after collecting a £75m bonus. He was originally granted a £100m bonus, but after a public backlash agreed to reduce that sum by 25 per cent. Although the bonus was awarded for 'outstanding performance' he was asked to leave at the request of the company because the controversy was having a negative impact on the reputation of Persimmon. The company was legally prevented from asking for him to return any of his bonus.

Wells Fargo

In 2016 it came to light that a sales incentive (variable remuneration) induced staff to fraudulently create client accounts because they were rewarded for reaching sales goals on newly created accounts. This led to 1.5 million unauthorised accounts being created without the clients' knowledge, a $185m fine, 5,100+ staff losing their job and board changes. Wells Fargo have said that they will not be using sales-based target incentive schemes in the future.

BT

BT announced in 2017 that it had discovered 'inappropriate behaviour' in its Italian subsidiary which cost BT £530m by the time the improper accounting practices had been investigated and this led to a fall of 20% of its stock market value. The improper accounting increased the bonus payments paid to senior staff and, therefore, BT propose to claw back bonus payments made to the senior management, which could amount to £75m. Similarly it has been reported that the Standard Chartered was considering clawing back bonus payments from current and former senior staff if they were found to be responsible for compliance and risk management breaches.

BP

BP's Chief Executive, Bob Dudley, has had his pay cut by £5m after a shareholder revolt in 2016. Dudley had been awarded a pay rise despite BP's falling profits and job cuts.

Importance of policies

Organisations should ensure that their remuneration and bonus policies are in line with good practices. This is vital because even when there has been no evidence of wrong doing, a remuneration package can still be seen by the shareholders as being excessive – and they can take action! So, remuneration packages should be able to withstand scrutiny by shareholders and legal challenge.

There are also advantages to having a good remuneration policy in place. An organisation needs to be able to attract and retain talented employees to be successful and meet their objectives; a good remuneration policy helps an organisation to achieve this. This is the case for all levels of employees, not just senior executives.

Therefore, it is important to have a policy that allows remuneration packages to be set which achieve sufficient levels of recruitment and provides recognition and rewards for existing employees. Many organisations benchmark their remuneration against similar sectors/organisations to achieve the level of remuneration which meets their needs, affordability and in line with the long-term vision of the organisation.

Top tips for auditors

1. Consider the audit approach

Who should carry out the audit? Is the information of top executive’s remuneration sensitive and does the internal audit team have staff with the right skills and competencies to conduct the audit?

Who should see the testing results? They may be very sensitive and need to be kept confidential from those not involved in the audit.

How would the audit data be sent to the audit team? Will there be a need to use a secured memory stick (iron key), encrypted e-mail, secure documenting sharing system eg Egress for the transfer of data or will the data be reviewed on site?

Does the audit team have a policy for handling sensitive data, and how are GDPR requirements being complied with?

Where should the working papers be filed? Confidentiality should be a priority, even perhaps preventing other internal auditors, not involved in the review, from seeing them. Is there a restricted folder that can only be accessed by internal auditors involved in the audit?

With whom are the audit findings going to be discussed/escalated? The findings may relate to top management and perhaps, you wouldn’t want to widely discuss them. Is the internal auditor suitably skilled to present the audit findings and have difficult conversation with senior executives? Is there a need to meet with the audit sponsor/client to provide regular feedback as the audit progresses? Who should be the audit sponsor/client? The chair, senior non-executive director (NED), chair of the remuneration committee, chief executive officer (CEO)? Who is going to be the recipient of the draft and final reports? Is the human resource director senior enough, should it go to the CEO, or even the chair of the remunerations committee and ultimately chair of the board?

2. Legislation and regulation

The 2018 UK Corporate Governance Code contains important changes to the remuneration for the senior management of listed companies. This good practice guidance sets out the principles that should be followed to determine remuneration. Find out if your industry/sector has legislation/regulation covering remuneration that you need to comply with.

The pay ratio regulations introduced in January 2019 brings new transparency measures that require listed companies with more than 250 employees to justify how much they pay their bosses and how their salaries relate to employees. Companies will need to start reporting in 2020 to cover CEO and employee pay awards in 2019. Additionally, as well as reporting of pay ratios, the new law also requires all large companies to report on how their directors take employee and other stakeholder interests into account. It also requires large private companies to report this as part of their corporate governance arrangements/statement in the annual report and accounts.

3. Governance arrangements

Every organisation should align remuneration to its organisational purpose and values, linked to the successful delivery of the long-term strategy and objectives.

The 2018 UK Corporate Governance Code and Wates Principles for Large Private Companies 2018 set out the principles and supporting guidance that should be followed around remuneration arrangements for senior executives. This good practice states that remuneration policies and practices should be devised to support strategy and foster the long-term sustainable success. In addition, executive remuneration should be aligned to an organisation's purpose, values and long-term strategy. Guidance for charities is also available from the National Council for Voluntary Organisations.

The 2018 UK Corporate Governance Code, section 5, page 13 states that there should be a remuneration committee delegated with responsibility to determine policy for the remuneration of senior management including the chair and entire workforce. The committee should consist of three (or two, for small companies) independent non-executive directors; their terms of reference should include approving the remuneration policy, setting, or recommending, executive remuneration and approving amounts available for fixed and variable remuneration.

The remit of the committee also includes review of the workforce remuneration, incentives and reward scheme culture to ensure these are in line with the culture of the organisation and remuneration packages are reflective of this.

4. Remuneration policy

Fixed remuneration: is the process transparent and fair across grades, geographical location, diversity etc.?

Does the policy include variable remuneration: such as bonuses, commissions etc.? Moreover, does it encourage unacceptable levels of risk taking, eg high sales targets?

Are bonuses based on organisational goals? ie is this profit sharing or an incentive plan? Is this a productive measure instead of profitability? Does the policy specifically included who should be awarded bonus or be in remuneration schemes?

Who will be responsible for monitoring compliance with the remuneration policy? How often will this be monitored? Does the policy specifically include actions that should be taken when non-compliance has been identified?

Does the policy include evaluation of the effectiveness of the remuneration and bonus arrangements ie around making the organisation an employer of choice?

Is the policy clear and easy to understand? Does it include clear mitigating strategies covering risks associated with excessive rewards and behavioral risks? Is the policy proportionate in terms of links between individual awards and organisational performance?

Risks and controls

1. Staff compensation is not in line with share values and earnings and or not sustainable over the long-term resulting in business objectives not being achieved.

Potential impact

- staff dissatisfaction
- loss of key employees and potential skills gap in the organisation
- reduced revenues
- possible industrial action.

Potential control

- organisations should balance earnings with staff compensation costs (reasonable pay ratios)
- approved remuneration policy and procedures which supports retention of employees.

2. Inappropriate payments of rewards which are not in line with profit threshold or poorly defined remuneration policies.

Potential impact

- reputational damage
- inability to attract new investors.

Potential control

- remuneration policy endorsed by the remuneration committee, which is fair and applicable to stakeholders
- remuneration packages should only be awarded if a profit threshold has been approved or a bonus threshold agreed ie the CEO at Persimmon Homes.

3. Ineffective processes in place for monitoring compliance with the remuneration and bonus policies.

Potential impact

- financial loss
- low staff morale due to payment of unauthorised or inappropriate remuneration packages.

Potential control

- remuneration packages should be linked to performance appraisal process for all staff alongside the achievement of the organisations goals and objectives

- remuneration policy should include approval processes and a nominated member of staff should be responsible for checking compliance with the policy
- internal audit assurance over the remuneration and bonus arrangements.

4. Reputational damage due to adverse publicity on the compensation packages of employees.

Potential impact
- financial loss
- loss of market share
- investigation by regulatory bodies.

Potential control
- a remuneration committee with a minimum of three (two in small companies) non-executive directors who should be responsible for setting the remuneration of all executives and non-executive directors and approving of the remuneration policy.

5. Excessive remuneration and bonus payments.

Potential impact
- significant reputational damage
- key stakeholders see the organisation as remuneration focused and paying bonuses inappropriately.

Potential control
- periodic benchmark of remuneration payments to the industry.

Assurance considerations

Remuneration committee assurance
The 2018 UK Corporate Governance code requires that there is a remuneration committee. If there is not a remuneration committee, why not and who approves the remuneration arrangements?

Who chairs the committee? Confirm that this is not the chair of the board.

If there is a remuneration committee are the members non-executive directors? Who are the attendees eg CEO? Does this comprise of a minimum of three members (two in smaller companies) who are independent non-executive directors?

Does the remuneration committee have delegated responsibility for determining the policy for executive directors and senior management?

Does the remuneration committee review workforce remuneration and related policies and the alignment of incentives and rewards with culture? Are these taken into account when setting the policy for executive directors' remuneration?

If a new chair of the remuneration committee has been appointed, has the appointee served on a remuneration committee for at least 12 months, before this appointment?

Is there an annual report from the remuneration committee in the annual report?

Remuneration policy assurance

Is there a remuneration policy covering all employees, including senior executives?

Are there conflicts of interest in the remuneration approval process? Are there ‘toxic pairs’ where a committee chair and members sit on more than one committee and can approve each other’s remuneration?

Is anybody able to decide their own variable remuneration? Are there compensatory controls built into the system that mitigates this risk and is this effective?

Does the policy allow discretion to be applied to remuneration and bonuses? If so, is there criteria that must be met and does the policy specify that reasons should be provided if such discretion is applied to remuneration or bonus payments?

Is there is a process in place to apply the remuneration policy?

Evaluate and form an opinion as to whether the policy is transparent and fair across grades, geographical location, diversity etc. and it is consistently being applied.

Check that remuneration is linked to the performance appraisal process.

Are there appropriate checks and balances in the performance appraisal process? This is particularly important to ensure that senior executives are not excessively remunerated or not seen to be rewarded for under performance.

Is the remuneration policy sufficient to attract, recruit and retain talented employees?

Do remuneration schemes promote long term share holdings by executive directors that support alignment with long term shareholder interests?

Is any form of benchmarking carried out is appropriate which informs the remuneration process?

Remuneration governance assurance

Are there conflicts of interest in the remuneration approval process?

Is anybody able to decide their own variable remuneration? Are there compensatory controls built in to the system that mitigates this risk and is this effective and operating as intended?

Is the remuneration of non-executive directors in accordance with the Articles of Association, or alternatively by the board? Confirm that remuneration for all non-executive directors does not include share options or other performance related elements.

Compare the organisation’s remuneration policy with the 2018 UK Corporate Governance Code – are there differences between the two?

Assurance on exceptional arrangements

Have trade union/staff council agreements been included into the process, including mandatory rises for inflation? Consider whether there may be 'hidden' elements in top executives' compensation, such as school fees, car hire etc., think about how you can identify these. Consider whether the policy clearly specifies who should get hidden elements on top of remuneration; and circumstances when this should be awarded.

Is there a start and end date for payment of remuneration that are hidden and whether prompt actions are taken when payment comes to an end for Directors close to retirement? The review of payment dates of remuneration packages will ensure that payments are not open ended to minimise the risk of overpayments in remuneration packages.

Audit test considerations

- test for evidence of intentional or unintentional (conscious/unconscious) bias, eg women awarded lower bonuses, older workers not awarded pay rises etc.
- if remuneration is linked to company/divisional performance or a 'balanced scorecard', check that the reported results can be verified
- for variable remuneration: such as bonuses, commissions etc. ensure that the calculation process is formalised, transparent, rigorously applied, includes start and end dates
- is a proportion of the variable remuneration required to be non-cash and retained for a period before vesting? Is there a process to prevent inappropriate release or claw back released amounts? Check if this is consistently being applied and operating as intended
- is benchmarking carried out to set compensation levels? Evaluate the result and form an opinion as to whether this is appropriate and informs the remuneration process
- check if there is a process map for payment of bonus and remuneration payments
- check that amounts paid can be reconciled to the amounts agreed and that the payments are shown in financial reports
- track the bonus and remuneration payments to source documentation including personal files, payroll an audit trail is maintained to support all remuneration and bonuses paid
- ensure that regulatory requirements are met, eg bonus caps are applied or remuneration is published in annual reports and accounts, and that compliance is monitored
- check if the board reviews the effectiveness of the bonus and remuneration policies
- check that trade union/staff council agreements have been included into the process, including mandatory rises for inflation etc.
- is the treatment of pay rises for staff on the maximum of their pay scales correctly treated? Check to ensure that any such increase is non-consolidated and therefore not pensionable
- check that there are no 'hidden' elements in top executives' compensation, such as school fees,

car hire etc. Where these are being paid, this is in line with the policy timescales for payments are included in the policy

- check if appropriate that the remuneration for all non-executive directors does not include share options or other performance-related elements
- is a proportion of the variable remuneration required to be non-cash and retained for a period before vesting? Is there a process to prevent inappropriate release or claw back of released amounts? Check if this is consistently being applied and operating as intended
- check whether the remuneration policy of the organisation you are auditing is being complied with.

Additional reading

Supplemental guidance

Auditing Executive Compensation and Benefits

Guidance

Reward and recognition

External resources

Financial Reporting Council - UK Corporate Governance Code

Financial Conduct Authority – Remuneration

Gov.uk - listed companies will legally be required to annually publish and justify pay difference between chief executives and their staff

Chartered Institute of Personnel and Development – Executive pay: review of ftse 100 executive pay

KPMG – Guide to Directors’ Remuneration 2018