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Current developments in Supervisory Board remuneration

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The role of Supervisory Board members, their legal mandate and their responsibility have changed significantly in the last decade. The tasks set for them are no longer confined to appointing the Management Board and monitoring their historical performance. The Supervisory Board must be included in all fundamental decisions from the start and agrees the strategic direction of the company with the Management Board. Due to this preventative consultancy and monitoring in important questions, for example for forward-looking investment and acquisition decisions, the Supervisory Board is developing into a strategic sparring partner for the Management Board. Connected with this change in function are increasing requirements in terms of their expert qualification and the Board members' time commitments. At the same time, their personal 'job risk' has increased markedly due to stricter legal liability regulations.

Current remuneration practice has reacted to this change in function in various ways to date. Whereas a majority of companies continue to ignore the necessity of growing professionalisation of Supervisory Board activities along with the remuneration policy consequences, the large listed companies in particular have meanwhile carried out a fundamental repositioning of their Supervisory Board payments.

Backlog for medium-sized enterprises

Especially in small and medium-sized companies, remuneration for Board members frequently remains on a level which corresponds to the traditional image of Supervisory Boards, i.e. more of an honorary office. As the latest empirical surveys show, today around half of all companies still pay their Supervisory Boards less than € 10,000 per person, and of these half again even less than € 5,000.

Since a horizontal market comparison with remuneration in companies of similar size and importance offers no reliable orientation, in particular for medium-sized enterprises, because of the wide-spread underpayment of Supervisory Board members, a pragmatic approach is recommended as an alternative for reviewing and redesigning Supervisory Board remuneration.

For Board members themselves, the low reward can become the standard for their personal commitment to the work – if it costs nothing, it's worth nothing. A better insight comes at the latest in the event of insolvency when the judge informs them of the requirements of their office and they first become fully aware of their liability risk.

For the companies, however, the low remuneration is already making the search for the necessary professional expertise in their Supervisory Board members difficult. A new orientation of remuneration policy is therefore urgently required, in the interests of both parties.

The starting point is a realistically calculated time budget in working days which Supervisory Board members, in the view of the equity owners, can be expected to devote annually to the company's business. The number of regular Supervisory Board and committee meetings, the time required to prepare for and to process after these, for participation in Annual General Meetings as well as other regular events should all be included in this. Any unscheduled time commitments between meetings are assessed based on past experience. These time budgets should be generated separately for the Chairman, his/her deputy, and for committee members respectively.

The operating days calculated in this way are valued with a rate which sufficiently takes into account the necessarily high qualifications and responsibility of Board members. If we take standard market rates for senior consultants in management consulting or for specialist solicitors, and additionally take into account the not insignificant liability risks of Board members today, as well as their constant availability, then daily rates of € 2,500 to € 3,500, depending on the complexity of their tasks should be considered appropriate for Supervisory Board members. The valuations determined in this way for individual office holders on the Supervisory Board can serve as a framework for determining their individual earnings.

Appropriate Supervisory Board remuneration
Framework calculation for offices/functions

Time Budget	x	Costs
Days worked		**……€ Daily Rate**
☐ Regular meetings/AGM (plenary/committee)		by complexity of task (e.g. daily fee for senior consultants, specialist solicitors: € 2.0–3.0 thousand)
☐ Unscheduled meetings (empirical value)		+ liability premium
☐ Preparation/processing (empirical value)		+ availability supplement
☐ Time commitment outside of meetings (empirical value)		**Days worked x day rate** **= appropriate remuneration**
☐ = total days		

Setting limits in large companies

Meanwhile, the remuneration situation in large listed companies is entirely different. With average annual earnings of € 340,000 for Chairmen and € 135,000 for the other members, DAX companies have indeed achieved an appropriate and attractive level of remuneration for their Supervisory Board members. The same applies to the MDAX with average earnings of € 160,000 and € 70,000 respectively, as well as to TECDAX and SDAX companies at € 85,000 and € 45,000 respectively. These average amounts however hide enormous spreads between companies. In the DAX there is now a danger that Supervisory Board remuneration in individual companies, due to their rapid development and enormous levels, can no longer be communicated to the public, so that in the coming years, Supervisory Board remuneration could become similarly socially unacceptable as Executive Board remuneration already is.

An example of this is the development at Volkswagen in the last 15 years. While Supervisory Board earnings in the DAX increased annually by an average of 7.5% since 1997, at VW it was no less than 21%. The average earnings of all DAX Supervisory Board members rose during this time three-fold, at VW, by contrast, 18-fold. If the Chairman received € 1.1 million in 2012, and an ordinary member was paid approx. € 300,000 for their certainly demanding, but nevertheless part-time work, an amount which exceeds that paid to the current Federal Chancellor, then the limits of social acceptability have clearly been overstepped. The Code Commission would therefore be well advised to preventatively demand earnings ceilings for Supervisory Board remuneration, as they do for Executive Board remuneration.

The latest lack of a binding recommendation for performance-oriented variable remuneration occurred not to meet an objective of limiting remuneration, but primarily as a reaction to the ongoing trend towards purely fixed remuneration.

This form of remuneration is however in no way appropriate. On the one hand, the transition usually happens at a point in time when the performance-dependent variable component is particularly high. In this way, companies conserve the success they have achieved and insure their Supervisory Board members against future risks of loss.

On the other, purely fixed remuneration does not correspond in any way to the legally defined range of tasks for Supervisory Boards. The argument given time and again at Annual General Meetings, that this form of remuneration is better suited to taking account of the Supervisory Board's control function, which is to be carried out independently of the company's success, is too one-sided. The Supervisory Board's role includes, alongside monitoring, also ongoing advisory for the Management Board. The joint responsibility for corporate planning and strategy makes them increasingly partners in the company. Appropriate remuneration design should also offer effective incentives to Supervisory Board members to sustainably engage with the long-term success of their company beyond their control function.

Long-term not short-term remuneration

For this, an annual bonus, such as 93% of total remuneration at Volkswagen in 2012 or even 98% at Südzucker, is not a suitable instrument. Here, in a critical economic situation which requires particular commitment from Supervisory Board members, a strong reduction in earnings will no doubt demotivate. Nevertheless, at least part of the earnings should be dependent on success and in accordance with the Supervisory Board function should be aligned with the long-term development of the company. The latest Code recommendation to relate any success-oriented remuneration primarily to long-term company success, at least goes in the right direction. To ensure appropriate remuneration even in company crises, fixed remuneration could be adjusted using the calculation scheme above, taking into account the various offices and committee activities. This fixed base would then be supplemented with a variable remuneration component to honour long-term success.

Meanwhile, nine DAX companies now offer their Supervisory Board members exclusively a long-term component as performance-related remuneration. Four of them emphasise explicitly that they intend to change over to purely fixed remuneration, but determine at the same time that 25% of earnings must be invested in shares with a lock-up period to the end of office.

This solution could become something of a model. After all, the sustainable, long-term increase in share price, despite the Supreme Federal Court´s fundamental concerns, represents a central corporate objective and is therefore entirely suitable as a target figure and performance standard for Supervisory Board activity.

The new Say on Pay – VorstKoG gives the AGM a say in questions of Executive Board remuneration

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Until now, the Management and the Supervisory Boards of listed companies were allowed, under § 120 (4) Aktiengesetz (Stock Corporation Law – AktG), to decide freely whether they wanted to bring about a General Meeting resolution to approve the remuneration system. Besides, the resolution had no legal effect – disapproval has an appeal function at most and should cause the Supervisory Board to review the remuneration system and alter it where applicable. This will be different in future.

The 'Act on Improving the Control of Executive Board Remuneration and Changing Further Company Law Regulations' (VorstKoG), which the Bundestag adopted on 27 June 2013, changes § 120 (4) AktG. In future, the Supervisory Board of a listed company must submit the system for the remuneration of Executive Board members to the General Meeting annually, disclosing the maximum achievable total remuneration in their submission. The differences to currently valid law consist not only in the "if", "when" and „how" of Say on Pay, but also in its effects: the General Meeting's vote is binding on the Supervisory Board. In the following, we will briefly present the new regulation, which due to its deliberately simple formulation raises numerous questions.[1]

Only listed companies

The regulations on Say on Pay apply only to listed companies, meaning AG, KGaA and SE, whose shares are admitted for trading in the regulated market at a German stock exchange, or with a comparable listing abroad. Open market securities and companies with a closed group of shareholders are not affected.

Annual vote

Under § 120 (4.1) AktG (new wording), the General Meeting must now decide annually on the remuneration system submitted by the Supervisory Board. "Annually" means within a period of twelve months, in line with the explanation for the Corporate Governance Code under § 161 (1.1) AktG. Unfortunately, the legislator did not follow the suggestion made during the legislative process to explicitly allocate Say on Pay to the Annual General Meeting's agenda. The law is silent on the legal consequences of overrunning the annual limit. However, we can assume that this would entail the contestability of the discharge of Management and Supervisory Boards, unless the time limit is exceeded to a slight extent or for an important reason. The new regulation takes effect for AGMs that are summoned after 1 January 2014, § 26f (4) Introductory Law to the Stock Corporation Act (new wording). Since the interim regulation does not differentiate between Annual and Extraordinary General Meetings, the resolution under § 120 (4) AktG (new wording) may also be the subject of an Extraordinary General Meeting taking place before the Annual General Meeting, if the latter is summoned after the deadline.

Presentation of the remuneration system

The Supervisory Board (and not the Executive Board) must prepare the presentation of the remuneration system (and formally resolve it) and submit it to the General Meeting.

In terms of content, the necessary presentation of the remuneration system in future exceeds the presentation of "Main Features of the Remuneration System" as required for the Management Report of a listed company under § 289 (2.5) Handelsgesetzbuch (Commercial Code – HGB). In accordance with the wording, not just main features need to be presented, but rather the whole remuneration system with all its details. According to the Parliamentary Legal Committee, on whose recommendation the new regulation is based, the remuneration system includes also any settlements, provided that contractual regulations exist about these, in compliance with the recommendation by the German Corporate Governance Code, as well as joining bonuses. In addition, disclosures must be made of the maximum achievable total amount receivable, shown for the Chairman of the Management Board, his/her deputy and an ordinary Member of the Management Board, § 120 (4.2) AktG (new wording). The additional disclosures mean that the General Meeting, in the final analysis, does not merely decide on the remuneration system as such, as it has done so far, but also on the level of remuneration.

The duty to disclose the maximum remuneration brings up the question of what should be disclosed if the variable remuneration has to date included neither explicit nor inherent ceilings. While KPI-based remuneration is usually capped (and has to be), this is often not the case with discretionary bonuses or share-based remuneration. The Legal Committee's Recommendation notes succinctly that the new regulation will prompt the Supervisory Board to introduce upper limits. However, this overlooks the fact that this requires contract alterations, to which the Executive Board members are not obliged.

[1] For further details, see e.g. Ziemons: 'Started out as a corporate law revision in 2012 and ended up VorstKoG – the new "Say on Pay" and other piecemeal developments in corporate law', in: GWR, 2013, p. 283 ff.

Beyond the law's wording, the Legal Committee also recommends disclosing the lowest achievable remuneration and the "probably resulting remuneration" (value of the median probability scenario).

Formalities

The presentation of the remuneration system as devised and signed off by the Supervisory Board must be published in the invitation to the General Meeting, in line with § 124 (2.2) AktG. The proposed resolution should be made in accordance with the general rules by the Management Board and Supervisory Board. It could be worded as follows: "The system of remuneration for Executive Board members submitted to the General Meeting and published in the invitation to the General Meeting is accepted." The General Meeting can only accept or reject the remuneration system submitted for approval. It may not resolve any alterations or make suggestions for changes to the Supervisory Board.

Approval by the General Meeting

If the Annual General Meeting approves the remuneration system, the Supervisory Board can make arrangements about remuneration with members of the Management Board on this basis, taking into account the guidelines under § 87 AktG, in the ensuing twelve months. If the remuneration system is changed in the subsequent period, then new contracts must be concluded subject to the condition precedent of the approval of the new remuneration system. The same applies if the amounts of the maximum possible remuneration as communicated to the General Meeting are changed.

Rejection of the remuneration system by the General Meeting

If the General Meeting does not approve the submitted remuneration system, then the Supervisory Board may not use the rejected remuneration system for future remuneration agreements. If it nevertheless does so, then it is in breach of its duties and may be liable for damages. But what are the consequences for the respective contract if it is agreed on the basis of a rejected system? This is currently unanswered. On the one hand, the Supervisory Board's representative powers are not limited and the resolution does not affect "the validity of remuneration contracts with the Management Board", § 120 (4.3.1) AktG (new wording). On the other hand, the Supervisory Board would exceed, in the internal relationship, the framework for action set by the General Meeting if it were to conclude contracts on the basis of the rejected system subsequently to the General Meeting.

Under the general rules, in particular the misuse of representative powers and collusion, these contracts ought to be void. If an accepted remuneration system is rejected in a subsequent year, this has no influence on the Management Board contracts based on it concluded previously. A rejection of the remuneration system also means as a rule that the Supervisory Board is obliged to modify it. Depending on the situation, this could necessitate a fundamental reworking, or only minor changes. If it became apparent in the course of the General Meeting that the rejection refers not to the system per se, but rather "only" to the level of remuneration, then it should be sufficient "only" to lower the amount of the maximum achievable remuneration. It may be different in particular situations, for example if the General Meeting's decision to reject is based on extraneous considerations and constitutes an abuse of rights. In that case, the usage prohibition applies, but the Supervisory Board is then free to submit the rejected system once again for approval. However, this would seem sensible only if the shareholder structure has changed in the meantime.

Before the first approval resolution

As already mentioned, the new regulation has no effect on Management Board contracts that were agreed before the VorstKoG comes into force. They remain valid even if the remuneration system they are based on is not accepted or if they are based on no remuneration system at all.

The question remains open as to what rules apply for agreeing and/or changing Management Board contracts in the period of time between the VorstKoG coming into force and the initial approval of the remuneration system by the General Meeting under the new law. Is the Supervisory Board permitted to agree contracts without impunity or only under the condition precedent of approval of the system by the General Meeting?

Conclusion

The new Say on Pay makes the Supervisory Board's remuneration decision even more complex. In practical application, there are numerous open questions which cannot be answered with legal certainty. It is therefore reassuring that the General Meeting's resolution cannot be contested by minority shareholders. The law still has to pass through the Upper House and is scheduled to be dealt with in its last session of the legislative period, which takes place on 20 September 2013.

The law failed in the mediation committee on 20 September. The discussion will however certainly be continued with the new Federal Government, therefore this articles remains worth reading.

New Code recommendations on disclosing Executive Board remuneration

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On 10 June 2013, the latest amendments to the Deutsche Corporate Governance Kodex (German Corporate Governance Code – DCGK) were announced in the Federal Gazette.[1] The focus of these adjustments was the improvement of the transparency and traceability of Executive Board remuneration, both with regard to shareholders and the (capital market) public, and also with regard to Supervisory Boards themselves. The Code now recommends the publication of additional disclosures in the remuneration report (clause 4.2.5) as well as the utilisation of model tables for the consistent representation of the required disclosures (Code Appendix).

In particular, the new recommendations stipulate that companies incorporate the following disclosures in the remuneration report for every Executive Board member:

1. The payments granted for the reporting year, including benefits supplemented, in the case of variable remuneration components by the maximum and minimum remuneration achievable
2. The inflow within and/or for the reporting year from fixed remuneration, short-term variable remuneration and long-term variable remuneration, differentiated by the relevant year to which they relate
3. For post-employment and other benefits, the benefit expense in and/or for the reporting year

The values in the model tables are in principle reported under IFRS.[2] Additional information, e.g. under IFRS, HGB, DRS or other legal regulations are published in the Notes to the financial statements, as before.

In this context, a concern was raised that the model tables, due to the high degree of detail in them, could lead to significant additional effort for the companies, while simultaneously being detrimental to clarity for investors. This is all the more true since the Code's disclosure recommendations exist alongside the regulations on remuneration presentation under Deutsche Rechnungslegungs-Standard (German Financial Reporting Standard – DRS) 17, which have to be followed as well.

The new recommendations only come into force for financial years beginning after 31 December 2013, since in the view of the committee, compiling the information could require some effort initially. However, in their next Declaration of Conformity under § 161 (1) AktG, companies must communicate whether they will observe the new recommendations, and justify their intention not to comply, where applicable.

Payments granted for the reporting year

The payments granted for the reporting year should be presented as per model table 1 in the Code's Appendix.

For variable remuneration, column 'n' and 'n-1' (that is, the figures for the reporting year and previous year, respectively) contain not the actual amount of remuneration, but rather the target value resulting from the remuneration system for achieving 100% of objectives. The stated amount can therefore deviate from the actual payment amount, which is required in model table 2. If no such target value exists in the remuneration system, e.g. because the profit share is direct, a comparable value representing a 'median probability scenario' should be disclosed instead.

For multi-year variable remuneration, the payments should be broken down between the various plans, with a statement of the respective terms. In columns 'n' and 'n-1', according to the notes on the table the fair value at the point of granting should be reported for share-based remuneration. For plans which are granted in a regular multi-year rhythm, a pro rata value on an annual basis should be stated.

There are no further explanations in the Code (including the Appendix) on completing the n(Min) and n(Max) columns for one and multi-year variable remuneration. However, the required disclosures correspond to the likewise newly inserted recommendation in clause 4.2.3, under which remuneration in total and the variable remuneration component thereof is to be shown with its ceiling as an amount. As an example, share-based remuneration with an limitation only on the number of shares would therefore require the company to declare a deviation from this Code recommendation.

Under pensions benefits, the period of service expense under IAS 19 (revised 2011) should be stated, even if it does not refer to a newly granted payment in the strict sense.

[1] See also our report in the 2/2013 issue of the Corporate Governance Forum, page 17.
[2] According to explanations by the Committee at the press conference for the publication of Code changes on 14 May 2013.

Inflow within and/or for the reporting year

The payments granted in and for the reporting year should be presented as per model table 2 in the Code's Appendix.

According to the explanations for this model table, the disclosures on fixed remuneration, benefits and pension expense correspond to those in model table 1 (payments granted for the reporting year). With regard to the pension expense, it is explicitly stated that this does not represent a payment in the strict sense, but that it should be included anyway to make the overall remuneration clearer. The same can probably be assumed for particular benefits which are granted in the form of benefits in kind (e.g. private use of a company car), as well as components of the agreed fixed remuneration not paid out in the reporting year (e.g. due to deferred compensation agreements).

For one and multi-year variable remuneration, however, the amounts actually paid in the reporting year are specifically required to be stated. For subscription rights and other share-based remuneration which have been granted in actual shares, the time of payment and payment amount disclosed should be those applicable under German tax law. Remuneration reclamations (claw-backs) are included in the 'Other' line with a negative amount, with reference to earlier payments, and should be explained separately in the remuneration report, especially where former Board members are concerned.

Table 1

Payments granted	Name				Notes*
	Function				E.g. Chairman of the Board, CFO
	Date of joining/leaving				Only if joining/leaving occurred in the reporting year (n) or previous year (n-1)
	n-1	n	n(Min)	n(Max)	Reporting year, previous year, achievable minimum and maximum remuneration in the reporting year
Fixed remuneration					e.g. fixed salary, fixed annual one-off payments (n equals n(Min) and n(Max))
Benefits					e.g. benefits in kind and other benefits (n equals n(Min) and n(Max))
Total					
One-year variable remuneration					e.g. bonus, profit-sharing bonus, Short-Term Incentives (STI), profit-sharing
Multi-year variable remuneration					e.g. multi-year bonus, deferred portion from one-year variable remuneration, Long-Term Incentive (LTI), share options, other share-based remuneration
Plan description (plan term)					Multi-year variable remuneration, broken down by plan and stating their term
Plan description (plan term)					
Total					
Pensions expense					Period of service under IAS 19R under pensions commitments and other pensions benefits (n equals n(Min) and n(Max))
Total remuneration					

* according to the notes to the tables in the Code Appendix

Table 2

Payment	Name		Notes*
	Function		
	Date of joining/leaving		
	n-1	n	
Fixed remuneration			Amounts equal those given in the "Payments Granted" table
Benefits			Amounts equal those given in the "Payments Granted" table
Total			
One-year variable remuneration			Actual payment amount in the reporting year
Multi-year variable remuneration			
Plan description (plan term)			
Plan description (plan term)			
Other			e.g. remuneration repayments (Claw-backs)
Total			
Pensions expense			Amounts equal those given in the "Payments Granted" table
Total remuneration			

* according to the notes to the tables in the Code Appendix

Management Board remuneration – current developments in Germany

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With positive economic developments in the 2012 financial year and correspondingly good company key figures as well as a positive share price dynamic, remuneration for Management Boards is once again in the spotlight. The public debate is driven particularly by individual top salaries (among others at VW AG) as well as international developments (among others positive referendum in Switzerland). In this context, in recent years both legislators and the Deutscher Corporate Governance Kodex (German Corporate Governance Code – DCGK) have initiated new processes to regulate Management Board remuneration in Germany. At the centre of the DCGK amendment is an improvement in transparency and comparability for Board remuneration. On a legislative level, § 120 Aktiengesetz (Stock Corporation Law – AktG) was amended on 8 May 2013, a mandatory vote by the Annual General Meeting about the remuneration system (Say on Pay) introduced and guidelines for a minimum breakdown of Management Board pay defined.

Deloitte Remuneration Survey 2013

Our survey shows that in recent years, remuneration systems have gained more and more in complexity. Multi-year bonuses, deferred compensation models and a larger spectrum of bases for assessment used (KPIs) have driven these developments, just as the numerous new performance-based Long-Term Incentive (LTI) plans have. Admittedly, transparency is significantly greater than even a few years ago, thanks to individualised disclosures. However, the fact that there is no uniform yardstick for publication leads to a lack in comparability and makes it harder to understand. Differing accounting measurements of divergent remuneration plan types, uneven disclosure of actual payments and granting or target values for share-based LTI plans, missing descriptions and varying formats show some of the areas in which a need for improvement continues to exist.

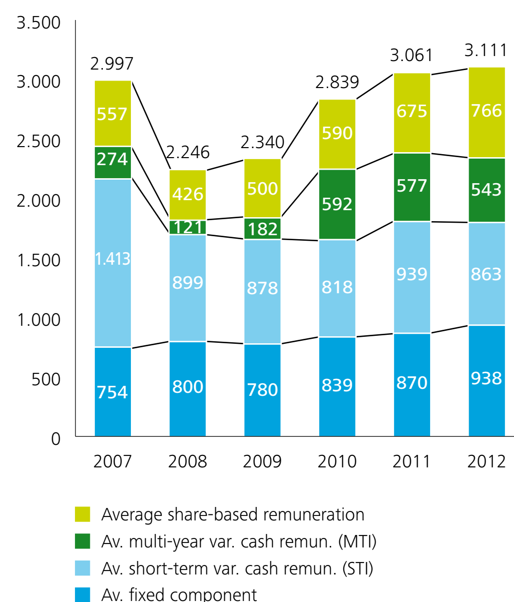
In terms of content, all of the indices surveyed show the following trends, which have not changed materially since the last great upheaval in 2009:

- Increasing number of independent Mid-Term Incentive (MTI) plans (multi-year variable cash remuneration)
- Deferred Compensation models for Short-Term Incentive (STI) (partial transfer to share-based plans and/or conversion into company shares with a corresponding lock-up period)
- Changeover from pure share option plans to performance-oriented LTI plans (Performance Share Units, Restricted Stock Units)
- Mandatory personal investment (using some of the variable remuneration and/or as part of Share-Ownership Guidelines)
- Stronger weighting of fixed amounts
- Introduction of qualitative assessment bases
- Definition of upper limits

A look at the indices shows that 2012, like 2011 before it, was a year of selective fine adjustments to existing plans. There were neither fundamental adjustments in the market nor was a greater dynamic visible regarding the level of remuneration.

In the DAX, the average Executive Board remuneration increased by approx. 2% to 3.11 million euros (2011: 3.06 million €). Measured against the rise in corporate profits and general salary developments, this is extremely moderate. The good performance of the DAX Index led to a situation where the proportion of share-based remuneration in the overall package of remuneration increased to 25% (22%). Following this trend, fixed remuneration increased further to 30% (28%) and short-term variable cash remuneration continued to diminish in importance at 25% (31%). A look at the years 2007 and 2008 illustrates the structural change with the introduction of the Act on the Appropriateness of Management Board Compensation (VorstAG). Particularly at the company level, individual adjustments took place. For

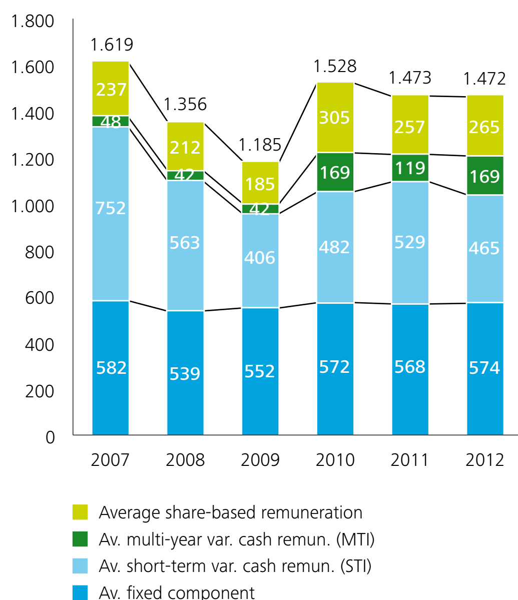
Fig. 1 – development of average Management Board remuneration in DAX since 2007 by components (in T€; n=30)



example, VW introduced an entry barrier for the MTI and defined a time-limited maximum amount. Commerzbank increased basic salaries significantly.

On the MDAX, the average remuneration for Management Board members remained static at 1.42 million euros. The proportion of the fixed amount stayed almost unchanged at 37.5% (37%), STI fell by 4.5 percentage points to 31.6% and the share-based component rose to 11.5% (8%). Some examples: Celesio transferred 30% of STI into company shares, Fraport introduced an upper limit (cap) for STI at 140% of target achieved and MAN swapped its share option programme for a multi-year bonus.

Fig. 2 – development of average Management Board remuneration in MDAX since 2007 by components (in T€; n=43)



For the first time, SDAX was also surveyed systematically. Compared to DAX and MDAX, the following significant differences appear. The average remuneration at € 780,000 corresponds to approx. 25% of the DAX level and 53% of the MDAX level. Structurally, there is also a clear difference. The fixed component as a proportion is 54%, STI at 35%, multi-year variable cash remuneration at 14% and share-based remuneration is 8%.

The rate of change in the post-VorstAG era was not as great as for DAX/MDAX. Many SDAX companies now follow the trends set by the large Top 80 companies in DAX/MDAX with a delay. Since 2011, Hornbach, Jungheinrich and Wacker Neuson, for example, have transferred their STI into a multi-year bonus. Nevertheless, there is still a great number of companies who do not have any multi-year variable remuneration component. There is a need for action here. Transparency and the quality of disclosures are worse overall. Many companies only publish the total remuneration or only separate it into fixed and variable remuneration, and around a third are exempted from the duty of individualised disclosure of Executive Board remuneration by a resolution at the Annual General Meeting (opting-out clause). The level of detail in the remuneration reports is very meagre in parts.

Conclusion and outlook

After years of great rates of changes, now, with altered economic conditions and further shifting regulatory requirements, a period of fine-tuning is taking place. We observe increasingly complex systems which are neither optimised with regard to the administrative effort (process view) nor based on mathematically well-founded scenario analyses. It is important to review the systems with suitable scenarios for all influencing factors, to check the scaling and take corrective action where necessary.

In line with the new requirements for disclosure, companies should report transparently and understandably for the new reporting season in order to avoid public criticism and to bring about a convincing vote from the Annual General Meeting. In particular, many SDAX companies will need to do some touching-up and to re-think their current policies. It is safe to assume that sooner or later, a standardised format for disclosure will become mandatory in Germany. Current changes in the DCGK provide an impulse here. In addition, pensions will increasingly become the focus of demands for improved transparency and require a critical review by the companies.

Management Board remuneration – international developments

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The international financial crisis led not just in Germany to a reconsideration in the area of Executive Board remuneration. A look at the major capital markets shows that increasing demands in terms of the transparency and sustainability of the systems are common concerns.

UK

The introduction of new disclosure duties as well as a mandatory vote on remuneration systems characterise the situation in the UK, too. For the first time it is no longer possible to make payments to Board members that are not covered by a strategy approved by the shareholders. These new regulations apply to financial years beginning on or after 1 October. In more than 80% of FTSE companies (compared with 61% in 2012), claw-back and malus clauses, conditions precedent for parts of the variable remuneration and formal personal investment obligations now apply. Almost two thirds of FTSE 100 companies require of their Management Board members that they hold shares to a value exceeding their annual salary (compared with 50% in 2012). We also observe – especially wherever new plans are being introduced – that companies are increasingly considering longer service periods and additional holding periods after the end of the lock-up period. There are signs of a tendency towards simpler remuneration structures consisting of an annual bonus and a long-term incentive plan. The utilisation of non-financial standards to calculate annual bonuses continues to increase.

France

France was in the news primarily because of tax increases at the highest income levels. In addition, however, there is also a trend towards expanded transparency requirements with 'Comply or Explain' rules.

Non-financial performance standards are increasingly wide-spread and more and more often share-based long-term incentives with (internal or external) performance conditions are being used. Basic Executive Board salaries increased by about 2.5% in 2012. For 2013, the same percentage increase is expected. Short-term incentives are on average 30-60% of basic Executive Board salaries, and a separation of the performance weighting is common (20% for personal performance, 80% for company performance). The long-term incentive systems used most often in France for Board members are based on Performance Shares (48%), share options (29%) and Restricted Stocks (13%). Due to a stronger alignment of monetary remuneration with the tax treatment of physical components, the resulting trend is towards simpler, exclusively financial remuneration.

Netherlands

After three years of steady decline, the average basic salary for Board members in the Netherlands increased by 6% to 512,000 euros, and the average total income by 7.5% to 1.15 million euros. Significant changes in the Netherlands which could spread due to public pressure are:

- The exclusion of bonuses for government-supported companies
- A 16% employer contribution on salaries deemed 'excessive' (i.e. more than 150,000 euros), which was planned originally as a one-off tax (for 2012), but will likely be charged in 2013 as well.

These laws currently only apply to the financial sector. However, there is an expectation that the measures will in future also apply to other (listed) companies in the Netherlands. Other regulations under which the variable remuneration component could be limited to 20% of the basic salary are currently under intense discussion.

USA

Basic salaries increased by about 3% in 2012. To increase the proportion of short- and long-term performance-related pay, the companies have refined the designs of their incentive plans further.

Share options continue to be on the decline (from 84% in 2008 to 71% in 2012); at the same time, 'Performance Shares' are in the limelight more and more (from 63% in 2008 to 75% in 2012). Key performance indicators continue to be strongly dominated by financial standards like yields and relative earnings per share; non-financial standards are in use by only 14% of companies. Non-binding regulations about votes on remuneration (Say on Pay) have led to significant changes in remuneration structures in recent times, since companies are aiming for positive results of the votes. Shareholders are highly supportive of these changes – 98% of Russel 3000 companies have introduced "Say on Pay"; overall, the average comes to 93%.

AIFM D requirements for executive remuneration structures

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The 2011/61/EU guideline (Alternative Investment Fund Manager Directive or AIFM D) was implemented in Germany on 22 July 2013 with the introduction of the Kapitalanlagegesetzbuch (Capital Investment Law – KAGB). This means that the previous unregulated sector of closed funds and/or alternative investment funds is now legally regulated. One area of focus is remuneration systems, since they are seen as a contributing factor to the financial crisis due to their unilateral incentive effect. The requirements of AIFM D apply to the remuneration of the Executive Board as well as risk-takers and employees with control functions.

The guidelines on the remuneration policy and system must have been introduced and implemented in order to apply for approval as an AIFM under § 22 KAGB, since on the one hand KAGB-compliant remuneration is a requisite of the approval application and on the other the remuneration practice has to be described in the approval application. This results in a deadline of 21 July 2014 for adjustments in the remuneration system. Implementation here extends not just to the introduction of a compliant remuneration system, but where necessary also to an adjustment in existing employment contracts.

The individual regulations in AIFM D on the remuneration structure and practice are adopted in KAGB completely and without changes. They make several requirements of the remuneration for the Executive Board, especially as regards the variable salary component.

All variable remuneration is to be made more sustainable, by (1) the underlying measurement displaying a broad basis with various and multi-year parameters, (2) deferring payment over at least three years, and (3) having correction mechanisms during this period which can also lower the bonus level depending on the performance of selected parameters (malus or claw-back regulations). These regulations are applicable to all forms of variable remuneration, including e.g. variable pension contributions. Likewise, guaranteed bonuses are categorically excluded, with the exception of the first year for new hires. Finally, variable remuneration must also take into account the company's financial situation and must be aligned with the service provided in case of a termination.

In the change-over phase, changes in existing incentive systems will necessitate corresponding adjustments in individual employment contracts as per the stipulations in AIFM D. This could lead to resistance from Executive Directors. The question whether employers may unilaterally alter the affected employment contract provisions in order to achieve compliance with AIFM D will need to be resolved in this context through employment law. Likewise, in companies with Workers Councils, the co-determination rights of the Workers Council must be taken into account where changes to works agreements are necessary.

By contrast, fewer difficulties present themselves in dealing with new hires, since it is possible to begin with AIFM D-compliant employment contracts from the start. Here, relevant model contracts can already be checked for compliance with AIFM D and adjusted where necessary.

In the ongoing business, AIFM D primarily means adjustments to performance management and bonus round processes. Overall, AIFM D regulations may lead to higher costs in the human resources department for many companies. For example, the correction mechanism for variable remuneration demands increased monitoring of the decisive parameters, regular value dates as well as respective communication to Executive Board and employees. Overall, we can therefore expect that the administrative costs of remuneration structures will go up.

Companies regulated by AIFM D are meanwhile beginning to prepare for the changes. A first step for many is a gap analysis, which will identify the changes required to the existing remuneration system. The complexity of upcoming modifications is assessed on this basis, so that the existing remuneration strategy can be re-evaluated and newly determined. From the remuneration strategy, as a next step they can derive the objective and consequential additional activities and processes as well as the necessary personnel capacity in regular operation. Many companies have meanwhile developed their schedule for the upcoming implementation in this way.

For many of the companies regulated by it, AIFM D involves significant changes in their remuneration structure, the complexity of which is frequently underestimated. However, these changes must be implemented in time for the approval application in July 2014. Therefore, it is recommended to start early with the conception and implementation.

Foresight in introducing long-term remuneration systems

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The use of long-term and share-based remuneration has increased significantly in importance in recent years. So-called Long-Term Incentive (LTI) plans are aimed at aligning the incentives in place for decision-makers with the long-term interests of the company and of the shareholders. The successful introduction and administration of LTI remuneration however presents a challenge to many companies, since alongside complicated plan rules, new compliance or financial reporting requirements for example, further increase the complexity of the plans further.

Deloitte's Total Rewards Team supports companies during the introduction of Long-Term Incentives and has identified several challenges and derived recommended action which should be taken into account in the introduction and usage of LTI plans.

Current trends in LTI remuneration

The development of long-term orientated remuneration in companies in recent years shows, also as a reaction to the economic and financial crisis, a clear trend to more long term elements and dependence on performance in the remuneration of Management Boards and upper management levels. An evaluation of DAX 30 company reports (2007–2012) shows that the remuneration structure for Management Boards has shifted towards more medium-term, but especially more long-term share-based remuneration elements.

Thus in 2012, Management Boards were remunerated at 25% on average with share-based remuneration elements, an increase of three percentage points compared to the previous year. While the proportion of short-term remuneration elements decreased, the fixed remuneration portion rose from 28% to 30%.

Within LTI remuneration, we also observe a clear trend away from share-based options to performance-based share plans. These strengthen the pay-for-performance principle in the long term, since the LTI plan is assessed and paid out at the end of its validity period (usually three years) based on performance indicators (e.g. EBIT). This performance appraisal is meanwhile often linked to multiple and relative performance indicators to reduce economic and accidental influences on the appraisal and to accurately reflect the shareholders' interests. Furthermore, we observe in the area of LTI remuneration that plan rules increasingly encompass claw-back and expiry regulations, which are intended to ensure a sustainable pay-out of the plans. Currently, dealing with insider trading is especially challenging for companies. Since upper management employees usually have access to insider information, particular processes have to be developed for plan pay-outs. Further, companies have developed complicated plans over time, which may even differ within a company depending on target group (e.g. High Potentials, middle and upper management).

The increasing complexity of LTI plans has an immediate influence on the complexity of introducing these plans as well. Based on our project experience, we have compiled an overview of the most important challenges with which companies are confronted in the introduction and utilisation of LTI plans.

Challenges in introducing LTI remuneration

The figure (see next page) shows an overview of the most important challenges in introducing and administrating LTI remuneration. These can be divided into four areas: plan design, compliance, stakeholder management and processes.

Alongside the more and more complex plan rules already mentioned, e.g. due to relative key performance indicators, companies usually need to define plan rules which apply across countries. In addition, complex plan rules also make it difficult to reliably project costs arising from the plan liabilities.

The second topic, compliance, is becoming more important for companies. Due to the changing regulatory requirements, not only in the banking sector, companies must meet the challenges of conformity in awarding, administering and disclosing remuneration (e.g. compliant taxation of share-based plans). The implementation of complex plan designs and new compliance requirements also necessitates an early and comprehensive integration of all relevant stakeholder groups in projects to introduce LTI plans.

Apart from the governance bodies, the Management Board and the Remuneration Committee, it is especially important to include stakeholders from the subsequent administration. Thus, the relevant experts from the areas of Treasury, Accounting, Controlling should be involved in the conception of the LTI plan design to counteract undesirable effects early on. Likewise, the tax department can make important contributions before the decision is made for a specific plan design as to which taxation issues could arise from administrating the plans across national borders.

The inclusion of relevant stakeholders cannot be seen independently of the processes mentioned above regarding the administration of LTI plans (see diagram, bottom left). Especially multinational companies need to manage their plans globally. For example, difficulties can arise for managers who move to a different country or switch to a different subsidiary during the lock-up period. In addition, companies often have established manual, historically grown and usually ineffective processes which prevent a comprehensive overview of the LTI remuneration and make working across interfaces difficult.

LTI plans are usually very capital-intensive and an inaccurate management of the plans can lead to high costs for the company. Therefore it is imperative to deal with the challenges early on. Meeting these challenges requires in our view a comprehensive consideration of the process from deciding to introduce an LTI plan through implementation to the issuing of shares or pay-out of cash to the plan participants in a globally active organisation. Only those who recognise early on what stumbling blocks could occur later and where problematic interfaces lie, can structure LTI plans in such a way that they can be managed efficiently.

Recommended actions

In summary, based on our consultancy experience, the following actions are recommended, which companies should bear in mind in the introduction of new LTI plans.

Challenges in introducing LTI remuneration

Plan Design	Compliance
• Complex plan design (e.g. due to relative performance assessment, long lock-up periods, claw-back plans, etc.) • Multitude of differently designed plans • Globally applicable plans (in multinational companies) • Reliable projection of plan costs	• Dynamic tax law framework • Compliant regional taxation • Accurate public reporting • Dealing with insider trading issues
Stakeholder	**Processes**
Comprehensive inclusion of: • HR (Business Partner, salary calculation) • Organs & Governance (Supervisory Board, Executive, Remuneration Committee) • Finance (Treasury, Accounting, Controlling) • Tax and legal departments • Administration/SSC (internal/external)	• Cross-border processes • Multitude of cross-function and external interfaces • Historically grown and sometimes inefficient processes • Unclear process ownership

Design processes

The overall process of introducing a new LTI plan should be designed early on. Subsequently the focus can move to success-critical partial processes (e.g. pay-out) to understand future sharing of responsibility and become aware of design problems.

Stakeholder analysis

When introducing LTI plans, it is imperative to gain an overview of all stakeholders who participate in the management of the LTI plan, e.g. finance department with regard to complex hedging and provision issues.

Document process and ownership

After the introduction of a new LTI plan, processes and responsibilities should be clearly established and documented. This is the only way to ensure that fast and accurate action can be taken in the area of LTI remuneration, which frequently also implies the treatment of individual cases.

Business practice shows that these days, complex LTI plans are being developed without dealing with their operational handling from the start.

Including a comprehensive overall view in the introduction of a new LTI plan can contribute significantly to reviewing plans for practical issues even before they are introduced. The proposal submitted to the Supervisory Board can therefore include statements about the subsequent management of the plans in order to achieve a target-oriented and in particular efficient design of capital-intensive LTI plans.

Federal Supreme Court: corporate bodies may not act against the company's purpose

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In a decision dated 15 January 2013 (file II ZR 90/11), the Federal Supreme Court (Bundesgerichtshof – BGH) clarified that any action by boards of directors in a stock corporation (Aktiengesellschaft – AG) alien to the object of the company is a breach of duty and can lead to their liability for any damages arising.

Facts of the case

In the case on which this decision was based, the plaintiff AG had recourse to two former Board members jointly and severally for the payment of damages. The AG's Articles of Association stated that the object of the AG was operating a mortgage bank. Over a long period of time, the mortgage bank carried out various interest-rate derivatives transactions, at the instigation of the defendant Board members. The volume of the usual mortgage bank transactions was exceeded many times over by doing so. The AG suffered losses totalling millions from these transactions.

Decision

In this decision (see also BGH dated 5 October 1992 (file II ZR 172/91)), the BGH further clarifies the core principles of Management Board responsibility, personal liability of individual Board members and the distribution of the burden of proof in D&O liability suits.

Fundamentally, the BGH affirms a claim for compensation due to breach of duty under § 93 (2.1) Aktiengesetz (Stock Corporation Law – AktG). It sees the reason for this in the fact that the interest-rate derivatives transactions were no longer covered by the object of the company.

In principle, the company bringing the suit must show and prove that it has suffered damage through the action of a Board member (§ 93 (2.1) AktG). In turn, the Board is required to show and prove that it has not breached its sphere of obligation and/or has acted blamelessly in any case (§ 93 (2.2) AktG). Further, the Board may also allege that damages would have occurred even from lawful alternative action. This could also include evidence that the management discretionary power, which is generally to be interpreted broadly, had been adhered to as part of the 'Business Judgement Rule' (see § 93 (1.2) AktG). In these cases, the damages for compensation should be calculated based on the balance method, i.e. by a comparison of the financial status due to the event giving rise to the liability with that which would have occurred without such an event. The company should therefore be placed in a position as if the transaction breaching duty had not been carried out.

Recommended action for Board members

This ruling has a significance extending well beyond the area of mortgage banks as addressed by the topic, since especially with regard to the complex distribution of the burden of proof and evidence in D&O liability suits it further specifies the conditions of Management Board liability. In practice, the proof of lacking culpability could be difficult due to the complex requirements of the Management Board's responsibility. In order to deliver this proof, the Management Board is well advised to work in a conscientious way with appropriate precautions in the area of documentation and internal monitoring to limit risks. In addition, further individual liability risks for Management Board members should be excluded: as events causing liability for Management Board members, not only does a breach of duty as a result of their own actions or due to collegiate decisions come into question, but even if they suggest actions in breach of duty to other Board members or employees or in dereliction of their duty do not prevent these.

However, caution is advised here. Especially against a background of entrepreneurial action, carrying the risk of failure by its nature, as well as with regard to the legally designated distribution of the burden of proof and evidence for actions in breach of duty and/or omission and bearing in mind the restrictive ruling by the BGH, Management Boards are urgently advised to document the process of making decisions cleanly and to obtain external advice where necessary.

Implications for Supervisory Boards

The strategic control of Management Board activity by the Supervisory Board itself encompasses entrepreneurial decision-making. The Supervisory Board should in general believe the reports submitted by the Management Board and is not required per se to carry out investigations. The Supervisory Board's information duties increase however with its inclusion in the decision-making process (e.g. through approval requirements). Where a plausibility check results in doubt, the Supervisory Board is obliged to carry out further investigations. The line can be somewhat fluid. In this sense, prudent application of the liability standards is advised so as not to hinder entrepreneurial decisions.

Federal Supreme Court news on the treatment of incorrectly elected Supervisory Board members

The Federal Supreme Court (Bundesgerichtshof – BGH) has provisionally brought an end to the previously intense debate about the treatment of incorrectly elected Supervisory Board members (see BGH decision dated 19 February 2013 – II ZR 56/12). In the case referred to here, the BGH decided that a Supervisory Board member whose election is declared void from the beginning or in retrospect must be treated as a non-member with regard to casting votes and passing resolutions. This fundamental decision has far-reaching consequences in practice, since it follows that resolutions passed by incorrectly constituted Supervisory Boards could potentially also be viewed as void, at least in cases where the quorum or the passing of a resolution depended on the participation and/or the assent of the incorrectly elected Supervisory Board member.

BGH decision

In the case decided by the BGH, a shareholder had contested the re-election of several Supervisory Board members as well as the new election of other Supervisory Board members. Within a few months of filing the action for annulment, all persons who had been re-elected or newly elected to the Supervisory Board resigned their positions. Against this background, the procedural issue as to whether the plaintiff's legitimate interest in the proceedings thus ceased to exist arose.

In the legal literature, it has until now been disputed whether a person who had accepted an appointment as a Supervisory Board member and had actually carried out the role, regardless of any nullity or contestability of the appointment, should be treated as an effectively appointed Supervisory Board member, at least until revocation of the appointment or resignation from the office. Pointing to the serious consequences of a retroactive invalidity of the appointment to the Supervisory Board, a strong group held the opinion that a person incorrectly appointed to the Supervisory Board should be treated as a correctly appointed Supervisory Board member (doctrine on incorrectly appointed bodies). On the basis of this opinion, the plaintiff's legitimate legal interest would not apply in the case discussed here, since an annulment by the Court would not make any difference to the legal relationships between the parties.

The BGH has now contradicted this approach and has clarified that a person elected to the Supervisory Board whose appointment is void or subsequently declared void should be treated in principle as a non-member with regard to passing resolutions. With regard to the case decided by the BGH, the direct consequence is that the plaintiff's legitimate legal interest should be assumed in any case if the Supervisory Board resolution would not have been passed without the participation of the person incorrectly appointed to the Supervisory Board. To this extent there must be a causal relationship between the non-member's vote and the passing of the Supervisory Board resolution.

At the same time, the BGH recognised that in some cases the retrospective annulment of resolutions passed by the Supervisory Board would not lead to results in accordance with the interests of the parties. Therefore, a subsequent annulment of the election of persons to the Supervisory Board is deemed not relevant to the proposals submitted during the relevant period by the Supervisory Board to the Annual General Meeting for resolution. Furthermore, third parties who enter into legal transactions with the company should be able to rely on the correct appointment of the Supervisory Board. Likewise, an Executive Board member should be allowed to retain his or her remuneration entitlements under employment contracts agreed in error on these grounds. By contrast, the BGH left it open whether the incorrect appointment of the Supervisory Board leads to a conclusion of defective participation by the Supervisory Board in the adoption of the financial statements.

Consequences in practice

The possibility of the retrospective removal of a person as a member of the Supervisory Board leads to significant legal uncertainty, which extends to the effectiveness of resolutions already passed, not least because the BGH left a series of questions unanswered in its decision. The Supervisory Board can defuse the resulting dangers in particular by exercising greater care in documenting the passing of resolutions and e.g. recording the votes in favour or against by name. Often there will be a lack of evidence of a causal relationship between the participation of a non-member and the passing of a resolution.

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Financial reporting on share-based remuneration

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The Supervisory Board has a special responsibility for setting total remuneration for each member of the Executive Board. Total remuneration includes in particular incentive-based remuneration promises, such as share options (§ 87 (1) Aktiengesetz (Stock Corporation Law – AktG)). Since it is not only one of the core tasks of the Supervisory Board to ensure that total remuneration is set correctly, but also to review the annual and consolidated financial statements as per § 171 (1) AktG, stock options (or more generally: share-based remuneration) always need the particular attention of the members of the Supervisory Board, as accounting issues too.

Financial accounting pitfalls

Representing such remuneration in external financial reporting holds a plethora of accountancy pitfalls. This fact is not only due to the multitude of arrangements found in practice, but also has causes originating in financial accounting itself. While the International Financial Reporting Standards developed in the meanwhile have a very extensive and sophisticated set of rules in IFRS 2, which in its practical application inevitably requires thorough familiarisation, the financial accounting issues in preparing accounts in accordance with the Handelsgesetzbuch (Commercial Code - HGB) are due (also) to the fact that, to date, there are no explicit regulations which allow unequivocal accountancy instructions to be derived. Both IFRS and HGB accounting therefore require – if for different reasons – detailed examination by the members of supervisory bodies as to the question whether the company has represented its remuneration plans adequately in its external financial reporting. This requires first of all a fundamental understanding of accounting for share-based remuneration, and needs to be deepened subsequently on the basis of specific circumstances in the reporting entity (where applicable with the help of explanatory notes by the auditor or other experts).

IFRS

IFRS 2 distinguishes between two types of plans:

- Plans which lead to an actual issuing of company shares (stocks) (equity-settled share-based payment transactions), and
- Plans in which share-based values are paid out in cash (cash-settled share-based payment transactions).

The particular feature of the former is that for the purposes of financial reporting and regarding the conditions for the vesting period of the option rights, IFRS differentiates strictly between the value and the volume components. The value component is determined by the total value (fair value) of the option on the date of granting; this is only calculated once and remains unchanged thereafter. Terms (market conditions) which also affect the value of the option rights in any case (e.g. reaching a particular share price) are only taken into account once as part of the value component. By contrast, the volume component refers to the number of vesting option rights. This number can naturally change across periods in consequence of further (other) conditions which are linked to the vesting of the entitlement (non-market conditions or service conditions). Examples of these conditions would be reaching particular turnover targets or serving a particular minimum period of service. The total amount calculated by multiplying the value and volume components must be recognised pro rata over the earning period (vesting period). Changes in the value calculated this way compared to the balance sheet date in the previous year affect profit. The contra entry is in equity.

Cash-settled share-based payment transactions must be valued at every balance sheet date with their pro rata total option value. Unlike equity-settled share-based payment transactions, however, the current total option value at the balance sheet date must always be used here. The (estimated) liability calculated this way represents a debt. A change in the level of the recognised debt compared with the previous year affects profit (personnel costs).

HGB

The treatment of share-based remuneration belongs to one of those areas, interestingly, in which despite years of intensive and controversial debate, no uniform or binding approach has crystallised in all aspects. In particular, neither the Institut Deutscher Wirtschaftsprüfer (Institute of Public Auditors in Germany – IDW) nor the Deutsche Rechnungslegungs Standards Committee (German Accounting Standards Committee – DRSC) has so far developed final views on this.

This may initially create a hope for practice that there is de facto a choice in specific individual cases between various options for financial accounting. In actual fact, however, it means a significant responsibility for companies and their Supervisory Boards, since the details of financial reporting must be worked out anew in each case, and technical reasons and documentation must be provided. There is consensus about the fact that for financial accounting in accordance with accepted commercial accounting principles, a distinction must be

made over how the beneficiaries' shares were serviced. A significant design option consists of creating new (young) shares by way of a conditional capital increase, which are then issued when employees exercise their option rights. The equivalent when applying IFRS 2 would then be equity-settled share-based payments. It would also be possible for example that entitled employees could receive a cash settlement instead of shares. This would then be a cash-settled share-based payment under IFRS 2.

Capital increase

In this case the different approaches clash especially freshly. The main views in this difference of opinion are as follows: on the basis of a more traditional understanding of accounting principles, the apparently prevailing view concludes that employers have nothing to record during the validity period of the option. This is based on the conviction that this process takes place – in the final analysis - outside the company sphere. This view has also been taken by the Federal Fiscal Court. Under the influence of international financial reporting, however, a significant minority holds the view that personnel costs must be recognised in capital reserves during the retention period on a pro rata temporis basis (as per § 272 (2.2) HGB). The value of the option rights used as a basis for this calculation is determined once at the point of issue. This does not alter equity capital in toto, however this transaction of course changes the annual result and those reserves limited to particular uses (in a stock corporation under § 150 (3) and (4) Aktiengesetz (Stock Corporation Law – AktG)).

Cash settlement

If employees receive a financial settlement instead of actual shares, then a deferred liability must be created on the balance sheet date after granting the option. Here, the view is becoming predominant that the reserve must be valued at each balance sheet date with a pro rata total option value. The (distribution) period relevant here depends on the remuneration period, which usually corresponds to the contractual retention period. This process requires a new calculation of the total option value at each balance sheet date. However, there is also a view that that reserve should be increased at the level of the respective intrinsic value of the option. This opinion is based on a (problematic) fiction that options are exercised on the balance sheet date. The intrinsic value also has to be determined anew for each balance sheet date. This approach can lead to significant variations in profit when there are variations in share prices between periods.

Option price determination

In financial accounting under both IFRS and HGB, it is usually necessary to calculate the total option value using a valuation model. In practice, the use of a model based on considerations by Black/Scholes is widespread. However this model is not mandatory. In this sense, the selection of a valuation model and any modifications or adjustments carried out should be viewed critically. Regardless of which model is used for the valuation, the specific parameters for the selected valuation model (e.g. interest rate, volatility of the share price) need to be set accurately.

Conclusion

In the selection and execution of share-based remuneration, from a legal point of view the regulations under corporate law (§ 193 (2.4) AktG) and consequences for reporting procedures in the Notes to the financial statements and Management Report must be considered. This is generally known.

Less awareness exists however for the fact that share-based remuneration also requires a more in-depth understanding of the balance sheet effects. Due to the complexity of structural options, and especially because of the financial accounting rules which are only rudimentary in part or apply only to standard cases, Supervisory Boards are required to gain extensive information on the specific financial accounting carried out in actuality by the Executive. Exactly because there are either extensive guidelines (IFRS) or conversely only very vague and still debatable ones (HGB) on this topic, there are pitfalls which Supervisory Boards should meet with sufficiently well-founded knowledge of the subject matter. Sufficiently well-founded knowledge can be assumed to exist if the Supervisory Board is able to ask critical questions regarding the financial accounting.

The interest rate melt-down and the valuation of pension provisions

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Developments in discount rates

Under § 253 (2.1) Handelsgesetzbuch (Commercial Code - HGB), provisions with a remaining term of more than one year must be discounted. For the valuation of post-employment benefit obligations or comparable obligations due in the long term, § 253 (2.2) HGB permits a simplified, flat-rate discount of the average seven-year market interest rate to be used that results from an assumed remaining term of 15 years. The discount rate is set every month by the German Federal Bank in accordance with the Regulation on the Discounting of Provisions (RückAbzinsV – § 253 (2.4) and (2.5) HGB). Since 2009, the discount rates have fallen continuously.

The discount rates follow corporate bonds denominated in euros with a rating in the AA category (zero coupon euro swaps plus an appropriate mark-up). Determining these is relatively complex. If we compare the seven-year average of the annual yield for iBoxx € Corporates AA 10+ Index (the reference index for determining the interest rate for the measurement of pension liabilities as per IFRS (IAS 19)) with the discount rate published in the past by the German Federal Bank, then the two interest rates are very close to each other.

In order to simulate the discount rates from June 2013 onwards, we have therefore assumed that the currently low interest rate will continue in future and that therefore the Annual Yield of iBoxx € Corporates AA 1010+ Index continues with the same interest rate from 30 June 2013 to December 2019 (interest rate 3.02%). This allows us to determine the 7-year average of the Annual Yield of iBoxx € Corporates AA 10+ Index for the years 2013 to 2019. Since in the past, the 7-year average of the Annual Yield of iBoxx € Corporates AA 10+ Index did not correspond exactly to the discount rate published by the German Federal Bank, we have extrapolated a mark-up from the known differences in the past.

Fig. 1 – Simulation of the discount rate

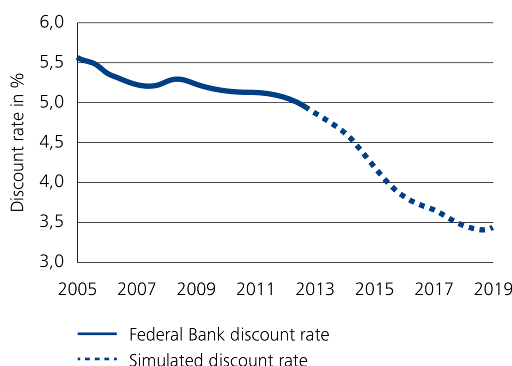

Figure 1 shows that, assuming a sustained low interest rate level, the development will continue to follow this trend in the coming years. The interest rate will fall from 4.94% at the end of June 2013 to 4.84% at the end of December 2013 and to 3.42% by the end of 2019.

Pressure on future profits through decrease in interest rates

On the basis of this predicted discount rate, we have simulated the development of pension provisions for a mixed test portfolio of around 150 pension beneficiaries (50% active, 50% non-active). We calculated the pension provisions on the basis of the Klaus Heubeck 2005G mortality tables, taking into account a 2% index-linking of vesting rights and pensions. The portfolio ages over the period from 2012 to 2019. There is no staff turnover, however active employees switch to the pensioner group when they reach retirement age. The full settlement amount, i.e. not offset or spread, is recognised as a liability.

Fig. 2 – Pension provision as at 31 December

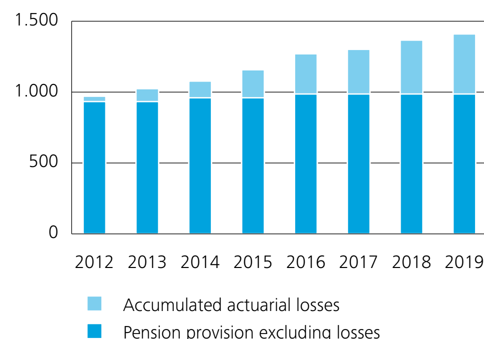

Figure 2 shows that the pension provisions increase by approx. 30% from 2012 to 2019. Because of the balanced portfolio structure, this increase is due primarily to actuarial losses, which arise from the decline in the interest rate. Companies which are dependent on the satisfaction of distribution and payment requirements made of them should therefore prepare in good time for a significant interest-induced pressure on profits.

Supervisory Board members should ask in this context what level of interest rate-induced profit pressure is to be expected and how this could affect profit distribution.

IFRS at a glance: new proposals on accounting for leases

On 16 May 2013, the IASB published the revised exposure draft of its new standard on accounting for leases. The comment period ran until September 2013. The IASB has not yet specified the point in time from which retroactive application will take place. However, it can be assumed that the initial application obligation will not fall before the year 2017. The basis for the proposal is the 'right of use' methodology. The outcome of the regulation is that almost all lease contracts will have to be recognised in the lessee's balance sheet. The introduction of this new standard could lead to significant additional work and completely altered key financial figures for both lessees and lessors.

Lessee accounting

Regardless of the type of leasing relationship, lessees are required to recognise a right of use asset and a corresponding lease liability for the leased asset. Depending on the classification of the lease contract into Type A or Type B, subsequent accounting differs, in particular the recognition of an expense in the income statement. Type A is used primarily for lease contracts for equipment, and Type B mainly for those regarding property. Type A lease contracts result in degressive expenditure over the term of the lease. This is contingent on a decreasing rate of interest being paid over time from the continuation of the lease liability as well as a generally linear amortisation of the right of use. By contrast, a Type B lease is characterised by a constant lease expenditure. Given a likewise decreasing interest payment, this results from the progressive amortisation of the right of use, which is determined as a residual value. For Type A leases, interest paid and amortisation should be recognised as such in the income statement. In the case of Type B leases, however, these are recognised as lease cost on one line of the income statement.

Lessor accounting

Lessors also distinguish between Type A and Type B lease relationships. Type B leases, i.e. the majority of lease relationships regarding property, continue to be shown in earnings as operating leases are currently. The leased asset continues to be recognised by the lessor. For Type A lease contracts, by contrast, the asset is derecognised and the lease receivable as well as a residual asset value are recognised. The latter represents the use potential of the leased asset at the end of the contract.

Effects on financial data

For the lessee, key financial figures alter through the recognition of rights of use and the recognition of the lease liabilities. Total assets rise. At the same time, the equity ratio falls, while the debt level increases. In the income statement, compared to the current recognition of operating lease relationships, Type A lease contracts relieve EBIT by the amount of the interest paid and EBITDA by the amount of the total lease expenditure.

For lessors there are changes insofar as contracts currently treated as operating lease relationships will be reclassified as Type A leases in future. The balance sheet structure changes, as the leased assets are derecognised and financial assets are added in the form of lease receivables. The income statement reports only interest earned during the term of the lease contract. At the same time there is no amortisation of the derecognised leased asset.

Multitude of implications

If these changes are implemented, then they will have to be explained, for example, to analysts, rating agencies and banks. Adherence to financial covenants must be ensured. Within the company, acquiring the necessary information about lease contracts can be expensive in both time and money. In addition, adjustments to IT systems may be required in order to process the data. A number of other specialist departments should be included, such as the tax department, since deferred taxes arise. Controlling should be informed, provided it uses IFRS data. If variable remuneration for employees is linked to IFRS figures, then the Human Resources department has to be consulted. The lessee's purchasing department and lessor's sales department must be involved. Processes and controls need to be reviewed.

For Supervisory Board members, there are therefore four starting points for questions to the Executive, such as the effects on the balance sheet structure, on key operating profit figures and on financial covenants, as well as the influence on remuneration agreements.

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Events

- Deloitte Executive Dinner with Winfried Kretschmann, Prime Minister of the State of Baden-Württemberg, Stuttgart, 18 November 2013

Publications and further information

- Plendl/Kompenhans/Buhleier (editors): The Audit Committee in the Stock Corporation - Practical Guideline for Supervisory Boards
- Deloitte Global Center for Corporate Governance: Women in the boardroom: A global perspective
- Global Economic Outlook Q3 2013
- Self-evaluation of the Supervisory Board: Support for the efficiency check, 2nd edition
- Self-evaluation of the Audit Committee: Support for the efficiency check, 2nd edition
- Self-evaluation of the Audit Committee: Support for the efficiency check, 2nd edition
- Enforcing financial reporting – DPR guideline for Executive and Supervisory Boards
- Finance & Accounting Forum, issue 2/2013
- CFO Survey 1/2013 – Companies back on the starting blocks
- Manufacturing for Growth – Interviews and discussions with twelve CEOs of top German companies on Germany's competitiveness
- Top Management Reporting – Survey from twelve countries on the importance of Top Management Reporting

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