Australian Institute of Company Directors

BOARD

Directors' fees

It is becoming more important for boards to have a clear and transparent remuneration process due to heavy scrutiny from an organisation's shareholders, stakeholders and the media. Transparency encourages market confidence and allows comparisons between organisations.

In this director tool document, the following topics are covered:

- Directors' fees and executive remuneration
- Who determines the total amount of directors' fees?
- Who approves the total amount of directors' fees?
- How to allocate the total amount of directors' fees among the directors
- Remuneration committees
- Practical matters around director remuneration.

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This document largely deals with the remuneration of directors of companies under the *Corporations Act 2001* (Cth) (the Act). This covers all companies listed on the Australian Securities Exchange (ASX), the vast majority of for-profit organisations and those not-for-profit organisations which have the legal structure of a company limited by guarantee. It does not directly cover payments to directors/committee members for other not-for-profits such as incorporated associations, co-operatives and government boards. However, many of the principles discussed can be applied to other forms of organisation.

What is the difference between directors' fees and executive remuneration?

The wider community and the media often seem to be confused about directors' fees and executive remuneration. There are significant differences between the two. Directors may be classified as non-executive directors or executive directors. Executive directors are full-time employees of the company with day-to-day responsibilities.

Directors are not entitled to payment for services unless this is provided for in the constitution of the organisation or approved in a resolution of shareholders. The Act provides that "the directors of a company are to be paid the remuneration that the company determines by resolution" (s 202A (1), a replaceable rule). The company may also pay the directors' travelling and other expenses that they properly incur:

- in attending directors' meetings or any meetings of committees of directors
- in attending any general meetings of the company
- in connection with the company's business.

A person who is the single director and shareholder of a proprietary company is to be paid any remuneration for being a director that the company determines by resolution (s 202C).

It should be noted that s 202A (1) is a replaceable rule. This means that it can be varied in the company's constitution. Constitutions can set out that all directors may not be paid or alternatively, only non-executive directors can be paid for the role of director. Many constitutions state that directors may be paid and specify a process whereby either the total amount for the entire board or amounts for specific directors and governance roles may be approved. In short, companies have considerable flexibility in establishing if and how directors are to be paid.

Non-executive directors are remunerated for their role as directors of the company. This remuneration is paid for the time they spend on directorial duties, their experience, reputation and other skills they bring to the board, and for the risk they accept for being a director.

It is in shareholders' interests to remunerate appropriately in order to attract the best calibre of person to serve on the board. Remuneration should reward directors for the value they add to the organisation as well as reflecting their duties and the legal liability assumed on behalf of shareholders.

Executive remuneration refers to salaries and bonuses paid to executives as senior company employees and forms part of the executive's employment contract with the organisation. The board of directors determines executive remuneration and bonuses. Where senior executives are also legal directors (that is executive directors) they usually receive no extra fee for serving on the board.

Who determines the total amount of directors' fees?

There are three basic questions with respect to determining directors' fees. The first is who determines the total amount to be paid to the non-executive directors? The second is who approves the total amount to be paid to the non-executive directors? The third is, once the total amount is approved, how is this sum divided between various directors?

With respect to the first question, the determination of the total amount of directors' fees is normally made by the board, but in some instances may be made by the members (shareholders) directly.

For many companies which have large numbers of shareholders or members such as publically listed companies and not-for-profits with large numbers of members, it is not practical for shareholders to determine the total amount to be paid to the board, let alone the specific amounts to be paid to individual directors. Consequently, the board, often through a remuneration committee as discussed below, will make a recommendation concerning the total amount of remuneration.

The exception to this norm is where a company may have one or very few shareholders. For example, a company which is owned by very few individuals such as many family owned companies, a subsidiary of another company or a company which is owned by government. In this situation the owners may decide to set the level of remuneration directly. They may or may not consult with the board concerning the amount.

The board must be able to justify its directors' fees to members and shareholders. Suggested considerations include:

- Company-specific factors:
  - Size, nature and profitability of the company
  - Complexity of operations – lines of business, geographic spread of operations
  - Industry sector – some sectors are paid more than others
  - Structure and responsibilities of board including the number of board committees
  - Risks and challenges of the business
  - Any recent reputation damage for which the directors are held fully or partially accountable.
- Director-specific factors:
  - Qualifications and experience
  - Time commitment required
  - General performance and involvement in value-added decision making
  - Additional responsibilities, for example chair of a committee, other special duties such as at takeover time.
- External market factors:
  - Business and economic conditions.

A number of commercial organisations provide data on current levels of directors' fees broken down by factors such as company size, industry and so on. Some boards also commission remuneration consultants to make recommendations as to directors' fees based on industry benchmarks and accepted methodologies.

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Who approves the total amount of directors' fees?

The answer to who has the final right of approval of the total amount of directors' fees depends on the type of company, and possibly the company's constitution.

As noted above, director remuneration generally is dealt with under s 202 of the Act. Section 202A (1), which determines whether directors can be paid, was discussed above.

Section 202B (1), which is not a replaceable rule and hence applies to all companies, allows for members (shareholders) to obtain information about payments to directors. Specifically:

> *A company must disclose the remuneration paid to each director of the company or a subsidiary (if any) by the company or by an entity controlled by the company if the company is directed to disclose the information by:*
>
> *(a) members with at least 5% of the votes that may be cast at a general meeting of the company; or*
>
> *(b) at least 100 members who are entitled to vote at a general meeting of the company.*

As a general principle, the board presents what they think is an appropriate pool of fees for the board as a whole to shareholders at a general meeting. The fees, if approved, represent the upper limit that can be paid to the board. The board then decides how the pool is split between individual directors. This is the amount paid to non-executive directors. Shareholders only have to be approached when the board wants to increase the pool – it is not an annual requirement, rather increases in directors' fees will generally occur every few years. Of course, as noted below, publicly listed companies must disclose the amounts paid to each director each year.

Below is discussed the specific situation for listed companies, non-listed for-profit companies, companies which are regulated by the Australian Prudential Regulation Authority (APRA) and not-for-profit companies

Listed companies

Shareholders of public companies generally approve an upper limit or pool of fees for the board as a whole in general meeting. The board then determines how this is distributed to individual directors. Many companies obtain by resolution an upper limit to the total amount to be paid on an ongoing basis and then infrequently seek to have this increased. Usually companies do not allocate this total amount. A listed company will need to have sound reasons for seeking an increase to this amount.

Listed companies must account annually for directors' fees as well as the remuneration paid to senior management under s 300A of the Act. Listed companies must present a remuneration report to shareholders at every annual general meeting showing the board's policies for determining the nature and amount of remuneration paid to key management personnel (which includes any director), the relationship between the policies and company performance, an explanation of performance hurdles and actual remuneration paid to key management personnel.

The *Corporations Act 2001* was amended from 1 July 2011 to provide for the *two strikes rule* in relation to the remuneration report. At the annual general meeting, the shareholders must vote approval or otherwise of the remuneration report. The first strike is when a company's remuneration report receives a no vote of 25 per cent or more. Where this occurs, the company's subsequent remuneration report must explain whether shareholders' concerns have been taken into account, and either how they have been taken into account or why they have not been taken into account.

The second strike occurs where the company's subsequent remuneration report receives a no vote of 25 per cent or more. Where this occurs, shareholders will vote at the same annual general meeting to determine whether the directors will need to stand for re-election within 90 days. If this resolution passes with 50 per cent or more of eligible votes cast, then the spill meeting will take place within 90 days. At the spill meeting, those individuals who were directors when the report was considered at the most recent annual general meeting will be required to stand for re-election (other than the managing director, who is permitted to continue to run the company).

Non-listed for-profit companies

For a non-listed for-profit company, be that company a public or a private company, the constitution should set out the mechanisms for the approval and reporting of directors' remuneration. If the replaceable rule 202A (1) has been followed, the total amount to be paid to directors should be approved at a general meeting of the shareholders. Constitutions may contain more specificity concerning the approval and reporting mechanisms.

APRA-regulated financial institutions

There are a number of special requirements for financial institutions (for example, banks, building societies, insurance companies) regulated by the Australian Prudential Regulation Authority (APRA). For example, Prudential Standard CPS 510 *Governance* (effective 1 July 2019) requires a regulated institution to have a remuneration policy. That remuneration policy covers executive directors, among others, and must provide that the performance-based components of remuneration is to be designed to align remuneration with prudent risk-taking and must incorporate adjustments to reflect:

- the outcomes of business activities;
- the risks related to the business activities taking account, where relevant, of the cost of the associated capital; and
- the time necessary for the outcomes of those business activities to be reliably measured.

The Banking Executive Accountability Regime (BEAR), which is set out in Part IIAA of the *Banking Act 1959* (Cth) establishes accountability obligations for authorised deposit-taking institutions (ADIs) and their directors and senior executives, who are considered 'accountable persons'. With respect to remuneration, BEAR requires ADIs to have robust remuneration policies, including the ability to reduce variable remuneration of an accountable person where they have not met their obligations.

Not-for-profit organisations

Not-for-profit organisations may or may not pay directors. This is sometimes covered by regulations. For example, non-government schools in NSW are not allowed to pay directors, no matter what the legal structure of the school. Some not-for-profits take the view that directors should see their contribution as service to the community and hence receive no remuneration outside of reasonably occurred expenses. Other, usually larger, not-for-profits take the view that they expect a considerable workload from directors and are seeking directors with high levels of skills. Hence it is appropriate to pay in these circumstances and as a recent study has revealed, there is a growing trend to remunerating directors in not-for-profit companies with reported remuneration rising from 13 per cent in 2015 to 18 per cent in 2018.[1]

As noted above, when a not-for-profit company is a company limited by guarantee, the provisions of s 202 also apply. However, the Australian Charities and Not-for-profits Commission (ACNC) Governance Standards must also be considered. While not specifically mentioning payment to directors, Governance Standard 2 is relevant:

> *A charity's members are its 'owners' and form an important part of any charity. Members are entitled to know how a charity is acting and using its resources (finances and any assets) on their behalf.*
>
> *This standard helps a charity's members to understand the charity's operations and also to raise any questions or concerns they may have about the way it is run.*[2]

Under this Governance Standard it can be expected that the charity will seek members approval of the total amount of the proposed directors' remuneration and provide details, usually as part of the annual report, as to what payments were made to directors. In short, although not legally required, it is recommended that not-for-profits which pay directors adopt many of the practices concerning approval and reporting as apply to listed companies.

Some not-for-profits take the view that directors should see their contribution as service to the community and hence receive no remuneration outside of reasonably occurred expenses.

How to allocate the total amount of directors' fees among the directors

There is no one best way of structuring directors' fees. Each organisation's system must be tailored to their specific circumstances. However, there are some general guidelines set out in the ASX Corporate Governance Council's *Corporate Governance Principles and Recommendations* (ASX Principles).[3] Firstly, Recommendation 8.2 states that companies should separately disclose the structure of non-executive directors' remuneration from that of executive directors and senior executives.

1. Australian Institute of Company Directors, 2019, *Not-for-Profit Governance and Performance Study*, July, **https://aicd.companydirectors.com.au/-/media/cd2/resources/advocacy/research/2019/pdf/07277-adv-nfp-governance-performance-study-2019-a4-68pp-web-2.ashx**, (accessed 7 August 2019).
2. Australian Charities and Not-for-profits Commission, Governance Standard 2: Accountability to Members, [website], **https://www.acnc.gov.au/for-charities/manage-your-charity/governance-standards/2-accountability-members**, (accessed 7 August 2019).
3. ASX Corporate Governance Council, 2019, *Corporate Governance Principles and Recommendations*, 4th Edition, February, **https://www.asx.com.au/documents/asx-compliance/cgc-principles-and-recommendations-fourth-edn.pdf**, (accessed 7 August 2019).

The ASX Principles state that companies may find it useful to consider the following in relation to non-executive directors:

- Non-executive directors should normally be remunerated by way of fees, in the form of cash, non-cash benefits, superannuation contributions or salary sacrifice into equity – they should not normally participate in schemes designed for the remuneration of executives.
- Non-executive directors should not receive options or bonus payments.
- Non-executive directors should not be provided with retirement benefits other than superannuation.

It is broadly accepted that holding equity in a company can align non-executive directors' interests with shareholders (by giving them 'skin in the game'). The ASX Principles state that it is generally acceptable for non-executive directors to receive securities as part of their remuneration to align their interests with the interests of shareholders (although non-executive directors generally should not receive options with performance hurdles attached or performance rights as part of their remuneration as it may lead to bias in their decision making and compromise their objectivity). Many companies now have non-executive director shareholding policies in place that encourage (or require) their directors to build a shareholding in the company over a certain period of time, in order to promote director and investor alignment.

As noted previously, remuneration consultants may be able to assist with the structuring and size of a remuneration package for directors but smaller organisations may find the cost to be prohibitive. Listed companies are required to disclose details relating to the use of remuneration consultants. In addition, for listed companies, remuneration consultants are required to be engaged by non-executive directors, and must report to non-executive directors or the remuneration committee, rather than company executives.

There are many different mechanisms that determine how much individual directors are paid. Common practices are:

- The chair will normally be paid more than other directors. The ratio of chair to non-executive director remuneration is normally dictated by relative workload and the role expectations of the chair. It is common for this loading to be two to three times more than the payment to other directors.
- Chairs of board committees may receive an additional loading.
- Directors sitting on board committees may also receive a loading, in recognition of their extra workloads.

Additional fees should not be construed as meaning that these directors carry responsibilities above those of other directors on the board.[4] The chief reason for appointing a chair and subcommittees is to obtain efficiencies in getting the board's work done. The board as a whole retains collective responsibility for decisions on recommendations made by committees.

What is the role of a remuneration committee?

The main purpose of a remuneration committee is to develop policies and practices for the remuneration of directors, the CEO and senior executives, to disclose this to the market (s 300A of the Act) and to review the remuneration and benefits paid. The responsibilities of the committee are captured in a charter approved by the full board. The charter should state that the committee does not have any authority for decision making delegated to it by the board. The full board retains responsibility for decision making.

In relation to directors' fees, the committee makes recommendations to the board on an appropriate level and structure of fees. The entire board then collectively decides what is put to shareholders for approval.

4. This is a matter for legal debate. For more information, refer to AICD, 2016, *The Greaves Case and Responsibilities and Liabilities of a Chairman*, AICD Policy Position Paper – 2006-01, February, **http://www.companydirectors.com.au/-/media/resources/director-resource-centre/policy-on-director-issues/2006/200601-greaves-case--responsibilities--liabilities-of-chairman.ashx**, (accessed 7 August 2019).

Recommendation 8.1 of the ASX Principles states that boards should establish a remuneration committee. Under ASX Listing Rule 4.10.3, if a listed company does not follow an ASX Corporate Governance Council recommendation it must explain why not. Recommendation 8.1 further states that the committee should be comprised of a majority of independent directors with an independent chair and have at least three members. The commentary to Recommendation 8.1 recognises that having a remuneration committee may not be practical for all listed companies, so instead suggests that these companies have processes in place which allow the full board to consider the same issues as the remuneration committee would.

ASX Listing Rule 12.8 states that a listed entity which was included in the S&P/ASX300 Index at the beginning of its financial year must have a remuneration committee comprised solely of non-executive directors.

Many larger non-listed companies, including not-for-profits will also have a remuneration committee although they are not legally obliged to have one.

Practical matters around director remuneration

When are directors paid?

Every organisation will operate differently. In general, directors can expect to be given an annual amount of fees. It is not recommended that fees be calculated using an hourly rate as this may promote time-wasting behaviours. The organisation will decide how frequently this will be paid: for example, monthly, quarterly. Directors' fees are paid for services rendered, hence they would normally be paid in arrears. It is not recommended that payments be made in advance. It can cause problems in cases where a director resigns, dies or is disqualified from acting as a director.

Does longer tenure entitle a director to more pay?

Many factors contribute to how much a director is paid. As discussed above, these factors include the size and complexity of the organisation, time commitment, additional responsibilities such as sitting on a board subcommittee, etc. Length of time served on a board should not be used to determine a director's fees as it is not a true indicator of the value that an individual adds to the board.

Are directors entitled to higher fees when their workload increases significantly?

Instances of when a director's workload may increase significantly include during times of a merger, takeover or acquisition.

When the board recommends a pool of fees to shareholders for approval, it might request an amount higher than their needs at that point of time. In times of higher workloads, this may give some leeway for additional payments above normal fees but within the approved upper limit. Experience has shown that it can be difficult for directors to ask for additional payments due to unexpected workloads after the event.

Can a director's personal company be paid instead of paying the director directly? How is the income taxed?

The rules regarding the taxation of directors' fees are very complex. General advice was sought from the Australian Taxation Office (ATO) on these questions and the response received from the ATO confirms this complexity – the answers depend on numerous factors, which makes it almost impossible to give a simple answer to either question.

Directors are encouraged to seek their own advice from a tax lawyer or tax accountant tailored to their particular situation.

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