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Conflict of Interest in the Commercial and Corporate Law Environment – Lessons from the Conference: An Outlook

(The associated publication will be entitled: 'Conflict of Interest in Profit-Based Remuneration Rules')

Prof Dr Lukas Handschin, Professor for Commercial and Corporate Law, Faculty of Law, University of Basel; Attorney-at-law, Baur Hürlimann; Board Member, Basel Institute on Governance (Switzerland)

The correct determination of the remuneration of the top management leads to conflict of interest – issues, since the decision-makers are as receivers of these remunerations specifically concerned. In many companies systems are in place which try to reduce the conflict of interest – risk by fixing objective criteria to determine the remuneration. Such objective criteria link the remuneration for example to dividend payments, company profits or other financial figures which describe the financial success of the company. At first glance, such remuneration-systems which link the payments to the top management to objectively measurable financial figures, such as profits, seem to reduce the risk of conflict of interests.

The profit of a company is also the result of the application of accounting and valuation rules. True and fair based accounting rules give a large amount of discretion to the top management when it comes to the valuation of the assets of the company. True and fair based rules allow, for example, the revaluation of fixed assets to the real value, even if the real value is higher than the production or purchase value. Furthermore, true and fair asset valuation is often based on capitalized income value or cash flow and not on its substance value or production cost. True and fair rules assess the value of an asset by looking into the future, in particular by estimating the future income the asset can generate. Prudent valuation of assets reduces the company profit; aggressive valuation of assets increases the company profit.

The choice of the applied valuation rules rests with the top management of the company. The top-management has to decide in the best interest of the company on how to assess the future potential of each group of assets as the basis for its valuation. This decision is of crucial importance for the company. If the assets are valued at a value which is too high, the company shows high profits and will be tempted to distribute a part of this profit as dividends to the shareholders. There is a risk that such (unjustified) dividend-payments



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withdraw necessary liquidity from the company and put the company at risk if the economic situation worsens. The decisions by the top management regarding the valuation of assets should occur unbiased and in the best interest of the company. To link the remuneration of the top management to the company profit leads to a conflict of interest situation.

The consequences are that the remuneration system has to be defined in such a way that a conflict of interest can be ruled out when the top-management decides on how to value assets. This can be achieved by respective corporate structures and by linking the remuneration of the top management not to the company profit (or other figures which require valuation decision by the management) but rather to objective figures such as cash flows or other company specific figures which can be measured objectively.