

1. INTRODUCTION

- 1.1 One of the distinguishing features of UK companies' legislation and Stock Exchange Regulations is the emphasis placed on transparency in the setting and reporting of directors' remuneration. The roots of this lie in the privatisation programme of the 1980's and the "fat cats" pay outcries that followed in the mid-1990's which prompted the Greenbury Report and subsequent introduction of the directors' remuneration report. There is a continued sense among UK investors that there should be a clear link between directors' remuneration and the creation of long-term value for shareholders which in turn has translated into both legislation and institutional shareholder codes.
- 1.2 UK companies' legislation and the London Stock Exchange Listing Rules therefore require quoted companies to prepare a directors' remuneration report each year as part of their annual report. The directors' remuneration report is required to be tabled at the annual general meeting for shareholders approval albeit the vote is advisory rather than mandatory. In reality, such is the strength of sentiment on this subject, any sizable minority vote against a directors' remuneration report will usually be taken seriously by the members of the remuneration committee concerned. Consequently, the directors' remuneration report and the underlying policies and procedures reported within it will be closely scrutinised and commented on.

2 SUMMARY OF THE REQUIREMENTS

- 2.1 The requirement for Main Market quoted companies to present their directors' remuneration report is set out in the Companies Acts. Legislative direction has been given to the content of the directors' remuneration report over the past few years, the latest being Schedule 8 of the Large and Medium-Sized Companies and Groups (Accounts and Reports) Regulations 2008 which applies to reporting periods commencing after 6 April 2008 (this having replaced Schedule 7A of the Companies Act 1985).
- 2.2 Further guidance as to the content of a directors' remuneration report is provided by the Listing Rules (paragraph 9.8.8) and the Combined Code on Corporate Governance (particularly Section B and, in respect of performance-related remuneration, Appendix A).
- 2.3 Factual information about directors' remuneration during the year needs to be included in the report and audited. This has resulted in most reports being split into two parts – a largely narrative section which is unaudited and a largely numerical section that is audited.
- 2.4 The following information is normally set out in the unaudited section:
- Details of members to the remuneration committee and advisers to that committee;
 - A forward-looking statement concerning the remuneration policy of the company;
 - Details of share options and long-term incentive arrangements;
 - A performance graph showing the company's total shareholder return compared with a broad equity market index chosen by the company.

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- The date, notice period and unexpired term of contract of each individual contract along with any provisions for compensation payable upon early termination of the contract;
- An explanation of any significant awards made to past directors during the year;
- A statement is required as to whether the director will retain those earnings and if so what remuneration was paid when a company releases an executive director to serve as a non executive director for another company; and
- The aggregate amount of consideration paid to or recoverable by third parties for making available the services for each director serving during the year.

2.5 The audited section usually consists of a table setting out the following information for each director during the current and previous years:

- Basic salary and fees.
- Estimated money value of benefits-in-kind.
- Bonuses.
- Total expense allowances that would be chargeable to UK income tax.
- Compensation for loss of office/payments for breach of contract/other termination payments.
- Total remuneration for each director for the current and corresponding accounting period.

2.6 In addition significant information about defined benefit pension schemes will need to be included in the audited sections.

2.7 It is the board of directors who are responsible for issuing the directors' remuneration report to shareholders although this responsibility will invariably be delegated to the remuneration committee. It is usual for the chairman of the remuneration committee to sign the report on behalf of the board.

2.8 The board should ensure that an ordinary resolution for the approval of the remuneration report is included in the notice convening the annual general meeting. The chairman of the remuneration committee is expected to be available at the annual general meeting to answer any questions that shareholders attending the meeting may have about the remuneration report.

3. MARKET EXPECTATIONS

3.1 The main representative organisations on behalf of the major institutional investors (ABI, NAPF and PIRC) each produce their own guidelines on executive remuneration reporting and make recommendations to their institutional shareholder members on voting.

3.2 The main provisions of the ABI guidelines include the principle that boards are responsible for adopting remuneration policies and practices that promote the success of companies in creating value for shareholders over the longer term. The policies and practices should be demonstrably aligned with the corporate objectives and business strategy and reviewed regularly. According to the ABI, remuneration committees are responsible for ensuring that the mix of incentives reflects the company's needs, establishes an appropriate balance between fixed and variable

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remuneration, and is based on targets that are stretching, verifiable and relevant. The ABI also emphasises that executive remuneration should be linked to individual and corporate performance through graduated targets that align the interest of executives with those of shareholders. A further key principle is that the resulting arrangements should be clear and readily understandable. Increasingly the ABI are seeking evidence that directors' remuneration is linked to corporate performance on environmental, social and governance matters.

- 3.3 The guidelines from these organisations carry significant weight with institutional shareholders. Although the approval of the remuneration report by shareholders is only advisory, if they are dissatisfied with the levels or structures of executive remuneration or disclosure, institutional shareholders will often be advised to vote against the re-election of members of the remuneration committee as well as vote against the remuneration report.
- 3.4 Representatives of major shareholders or groups like the ABI and NAPF will often raise issues with the company direct once the annual report has been published.
- 3.5 The financial crisis and associated collapses in share price performance during 2008 has resulted in the emphasis shifting in favour of remuneration that incentivises prudent management.

4 GOOD PRACTICE

- 4.1 The content and structure of a good directors' remuneration report will often be due to a well organised and proactive remuneration committee. At the heart of the report will be a remuneration policy which is balanced in dealing with short-term and long-term remuneration and incentives. Meetings of the remuneration committee should be timed to ensure that key elements of remuneration and incentivisation are reviewed and approved in a timely manner.
- 4.2 Where practical, best practice guidance from the institutional investor bodies such as the NAPF and PIRC should be reviewed at an early stage in order for the remuneration committee to consider that guidance in time to respond before the directors' remuneration report is written. It may be appropriate for the remuneration committee to consider feedback received from investors during the period between the annual report being published and the annual general meeting being held. In any event such feedback should be captured at the time it is received and referred to when preparing the following year's report.
- 4.3 It is appropriate for the remuneration committee to ensure that the following steps are taken in good time before the year-end:
- Review its policy statement regularly;
 - Ascertain how the data for the audited section of the report will be collected and verified;
 - Ensure all contracts and executive remuneration arrangements are documented and up to date; and
 - Consider the details of current year bonuses for the current year as well as salary and KPI's for the following year are reviewed and approved within a sensible timescale.

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- 4.4 The Combined Code on Corporate Governance anticipates that shareholders will be consulted over the introduction of performance based incentive schemes. Dialogue with shareholders during the year is an important component in ensuring that the directors' remuneration report is received well and supported by shareholders.

5 PRISM PERSPECTIVE

- 5.1 The directors' remuneration report is now a well-established element of the annual report for UK quoted companies and one of the more scrutinised parts of the annual report. Nevertheless, the directors' remuneration report has tended to be treated as a stand-alone report. We believe that this may begin to change.
- 5.2 The growing emphasis on non-financial reporting as a result of Section 417 of the Companies Act 2006 and its link to the performance of duties by directors is mirrored in the requirements of the ABI and others on executive remuneration being linked to environmental, social and governance performance indicators. This is a trend which looks set to continue and it will be increasingly expected that there will be consistency between the performance targets that are set for directors and performance indicators set out in the Business Review.
- 5.3 It is possible that the emphasis of remuneration reports will move away from the incentivisation of executive directors based on delivery of financial growth towards incentives for a broader range of objectives including sound stewardship and effective management of risk.

6. USEFUL LINKS AND SOURCES

ICSA Guidance on Directors Remuneration Reports

<http://www.icsa.org.uk/assets/files/pdfs/081103%20Directors'%20Remuneration%20Report.pdf>

ABI Guidelines on Executive Remuneration

<http://www.ivis.co.uk/ExecutiveRemuneration.aspx>

NAPF Corporate Governance Policy and Voting Guidelines

http://www.napf.co.uk/DocumentArchive/Policy/Corporate%20Governance/20071126_Corporate%20Governance%20Policy%20and%20Voting%20Guidelines%20-%20November%202007.pdf

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