25 November 2011

Our ref: ICAEW Rep 111/11

Executive Pay Discussion Paper
Business Environment
Department of Business, Innovation and Skills
1 Victoria Street
London
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By email: executivepaydiscussionpaper@bis.gsi.gov.uk

Dear Sirs

Executive Remuneration Discussion Paper

ICAEW welcomes the opportunity to comment on the discussion paper *Executive Remuneration* published by the Department for Business Innovation & Skills (BIS) on 19 September 2011, a copy of which is available from this link.

ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter which obliges us to work in the public interest. ICAEW's regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council. We provide leadership and practical support to over 136,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.

ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.

This response reflects consultation with the ICAEW Corporate Governance Committee which includes representatives from the business and investment communities. The Committee is responsible for ICAEW policy on corporate governance issues and related submissions to regulators and other external bodies.

Some of the ground covered in this discussion paper was covered in the call for evidence *A Long-Term Focus for Corporate Britain* published by BIS in October 2010. A copy of our response to that call for evidence, ICAEW Rep 07/11, is available from this link.

Although the UK has an existing system of governance relating to executive pay which has been built up over several decades this appears not to have led to effective alignment of pay with performance in the largest of our listed companies. While this is deeply worrying in governance terms we believe that it is essential to support positions taken in any discussion paper with sufficient factual and research-based material to ensure that any new initiatives in this area are built on firm foundations.

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As executives operate in a global market it is difficult to view this as simply a UK issue that can be tackled by increasing UK regulation or making changes to existing UK governance frameworks.

We have set out observations in more detail in the appendix to this letter.

Yours sincerely

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APPENDIX

The growth in pay

1. We agree that the growth in pay cannot be linked to definitive causes and that increasing trends in executive remuneration are likely to result from a combination of factors, some local and some global, none of which appears to be dominant. We found it revealing that none of the graphs included in the discussion paper sought to demonstrate a link between pay and the rise and fall of profits in companies. This may need to be addressed in order to close any gaps in the existing evidence base before policy decisions are taken.

2. Reduced tenure and changing practices over terms and conditions of employment and pensions, including shorter notice periods for directors, may be factors in driving increases in basic and incentive remuneration. There is scope for research in looking into these areas in more detail to establish their effects on remuneration.

Improving transparency

3. It is important that companies provide clear and accessible information about remuneration to enable shareholders to scrutinise and challenge where appropriate. However, many commentators believe that greater pay disclosure has ‘ratcheted up’ directors’ pay and that increasing disclosure below director level may simply extend the existing problem of escalating pay levels. There is scope for research to help establish whether the benefits of increased disclosure in terms of improved performance have outweighed potential ratchet and other effects on costs.

4. The Directors’ Remuneration Report Regulations introduced in 2002 and subsequently amended have undoubtedly provided a useful framework which assists users of annual reports but regulation is not and cannot be, in isolation, a substitute for good governance and best practice reporting. The link between pay and performance is still not sufficiently clear and companies and their advisors still have improvements to make in reporting on how pay is linked to absolute, rather than relative, performance.

5. Remuneration reports are already complex documents which are hard, even for those experienced in remuneration, to understand and compare. We support the disclosure of a total value for individual directors’ remuneration provided that it is clear what is to be disclosed and the basis to be used for valuation.

6. The proposal for companies to disclose expected remuneration in differing performance scenarios has the merit of encouraging remuneration committees to consider all potential outcomes which can only be a good innovation. The reality is that remuneration committees already consider differing performance scenarios but disclosure of these would be helpful.

7. We support the suggestion that companies should be required to disclose fees paid to remuneration consultants and include full disclosure of the services provided to both the remuneration committee and to management by the remuneration consultants as well as confirmation that no conflicts of interest exist.

Role of shareholders

8. We are not convinced that shareholders actually are seeking any more than an advisory vote on the remuneration report and we see no evidence that they are actively seeking direct representation on board committees. We believe that shareholders already have sufficient mechanisms to change company behaviour on pay and with an annual vote on director re-election believe that a binding vote on the whole of the remuneration report is a step too far. Shareholders already have the ability to vote down any remuneration report or intended share plans that they do

not agree with. Existing shareholder powers coupled with the Companies Act 2006, which already requires company directors to act in the long-term interests of shareholders, should be sufficient.

9. In practical terms any binding shareholder vote on prior remuneration committee determinations would be difficult to implement because of the contractual obligations already incurred and the difficulties of unwinding contractual commitments already in place.

Role of remuneration committees

10. We acknowledge that in some respects remuneration committees appear not to be working correctly and that there needs to be better debate at remuneration committees. Perhaps this can be achieved through greater diversity of thinking.

11. We do not however believe that simply widening remuneration committee membership would have a significant effect on the dynamic of setting remuneration. We feel that appointing employee representatives is not the route to adopt in the UK because they would suffer from information asymmetry that would put them at an immediate disadvantage in the committee room. If the employee representative was one lone voice they may find themselves regularly outvoted and it is hard to see how they could operate being the only member of the remuneration committee not on the board. Further, would the employee representative be expected to be independent of mind and to exercise their own judgement or would their role be to reflect employee opinion? Remuneration committees could have professional members similar to some pension scheme trusts but even so it is hard to see how they could operate without understanding the context of the board's activities as a whole.

12. We do however believe that greater scrutiny of the activities of remuneration consultants and how they interact with the remuneration committee could have a significant effect on practices. This could be achieved by building on the work already done in this area by the Remuneration Consultants Group.

Structure of remuneration and promoting good practice

13. Simplification of executive pay has to be the way to overcome the apparent lack of transparency in this area and prevent bad publicity. There is merit in simplicity over complexity when it comes to remuneration.

14. If the disclosure of directors' pay arrangements in annual reports was expected to be clear, this would focus the attention of boards and consultants on effective communication and the need to avoid overly complex arrangements that are impossible to communicate clearly. It might then be possible to require detailed disclosures to be made elsewhere, for example on the company's website, to meet the need for transparency.

Conclusion

15. There needs to be fresh and innovative thinking when reviewing the ways in which market participants seek to incentivise boards, managers and each other to act in the interests of those that they are meant to serve. Fundamental areas that could usefully be researched are:

    - Why certain incentives have failed and are failing and how people can be incentivised to achieve longer term strategic objectives.
    - Why new mechanisms are needed to link pay to value creation.
    - How pay fits into broader issues of human capital governance.

16. There is a real need to obtain accurate and clear research in a cost-effective way. The academic community is the most obvious source for such research.