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Report on the impact of the Directors' Remuneration Report Regulations

A report for the Department of Trade and Industry

November 2004

Audit. Tax. Consulting. Corporate Finance.

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1. Introduction and context



1.1 Introduction

This 'Report on the Directors' Remuneration Report Regulations 2002' ('Report'), describes research undertaken by Deloitte and Touche LLP ('Deloitte') on behalf of the Department of Trade & Industry ('DTI') and according to terms of reference agreed with the DTI.

The 'Directors' Remuneration Report Regulations' ('Regulations') apply to quoted companies with financial years ending on or after 31 December 2002. As stated by the DTI, the purpose of the legislation is to:

- enhance transparency in setting directors' pay;
- improve accountability to shareholders; and
- provide for a more effective performance linkage.

The Regulations require quoted companies to produce a detailed annual directors' remuneration report, and to hold a shareholder vote on that report. The first votes on the directors' remuneration report took place at AGMs between March 2003 and March 2004.

In addition to the legal requirements of the Regulations, the Association of British Insurers ('ABI') and the National Association of Pension Funds ('NAPF') issue guidelines on executive remuneration that act as a reference point both for shareholders in engaging with companies and making voting decisions, and for companies in the design of their remuneration policies. The Confederation of British Industry ('CBI') has also issued best practice guidelines on severance packages, and the Combined Code, responsibility for which now lies with the Financial Reporting Council, also provides guidance on best practice in the governance of directors' remuneration.

The purpose of this Report is to identify:

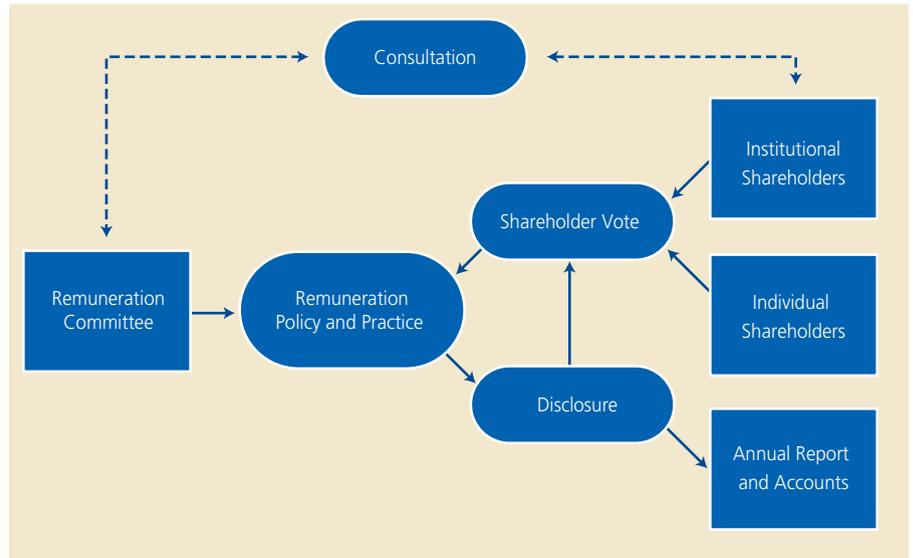
- the extent to which companies are complying with the Regulations;
- whether companies' remuneration policies and practices have changed in light of the Regulations; and
- any areas where disclosure requirements could be further improved.

The Report focuses on the effectiveness of the Regulations, but takes note where appropriate of additional relevant governance frameworks, such as those of the ABI, NAPF, CBI and Combined Code.

The recommendations set out in this Report are based upon the views expressed to Deloitte by shareholders and on Deloitte's analysis of the levels of disclosure in recently published remuneration reports.

1.2 Context

The inter-relationships between shareholders (for the purposes of this Report the term 'shareholders' refers to larger mainly UK based institutional shareholders, who own the majority of UK shares) and companies in respect of directors' remuneration policy matters are illustrated in the following diagram:



The Regulations provide a framework which assists shareholders to assess how well remuneration is governed. They are not and cannot be, in themselves, a substitute for governance.

The shareholder vote on a company's remuneration report, which includes the forward looking statement of policy, provides the Board and its remuneration committee with an annual signal as to how strongly its intended policy, and its actual practice in the past year, are supported by its shareholders.

Meeting the requirements of the Regulations does not necessarily mean that the disclosure of a company's remuneration policies and practices will be clear. Shareholders would like to see the rationale behind the policy explained in understandable terms. This is particularly the case in the context of large, complex, international and multi-faceted businesses.

As will be seen from the analysis of the current level of disclosure and the analysis of shareholder views later in this Report, most companies comply with most of the Regulations, and shareholders believe that the introduction of the Regulations has improved the level of disclosure. However, the analysis also shows that in many cases companies, while complying with the Regulations, rely on standardised language which may not be helpful. This suggests that regulation, in itself, does not necessarily lead to better explanations of either remuneration policy or practice.

The research in this Report seeks to distinguish between remuneration reports which comply with the minimum requirements of the Regulations, and those which go further and explain not only what the policy is, but why it is the way it is.

Recommendations arising from the research recognise that there are some specific disclosures that could be improved by increased clarity in the Regulations but in other areas regulation may not be the best way to effect this.

Across different companies executive directors' remuneration consists of various combinations of elements such as salary, performance-linked bonus, performance-linked shares or share options, and pensions. The design of the remuneration package and the balance of these elements will be influenced by the sector in which the company operates, the strategy and culture of the company, shareholder expectations, company and employment law, income tax rules and accounting standards.

It is not always easy to disclose and explain all of these elements in a straightforward and easily understood way. The range of different practices also means that it is impractical to codify all of the information that a shareholder may find helpful. The example below illustrates some of the communication complications in just two areas of remuneration.

Cash elements of remuneration

In order to explain the cash elements of remuneration it might be ideal to have details of performance targets for the year ahead and the potential cash bonuses that might arise. In practice, executive bonuses are very often largely earned in relation to the level of profit achieved within a comparatively narrow range. However, information on a prospective profit target for the year ahead may be both commercially and market sensitive. It may therefore not be appropriate to disclose the exact nature of the link between a future bonus payout and the performance required to achieve it. Companies may feel less constrained in disclosing retrospectively what targets had been set for the previous year and the results achieved in respect of these targets.

Shares and share options

It is particularly difficult to disclose the value of long-term awards made during the year. This is because the value will be dependent on whether performance targets have been met, as well as the share price at the time of vesting, which is likely to be at least three years from the date of award. Mathematical models such as the widely used 'Black Scholes' and 'Binomial' models may be used to estimate the values. However, the estimations that emerge from such models often deviate widely from the eventual actual values.

Communicating the gains made from previously awarded long-term incentives can also be problematic. An executive may have exercised¹ a share option in the past year and gained, for example, £100,000 in cash prior to income tax. However, that share option may have earned its value over a ten year period, during which time the executive will probably have contributed to the increase in share price. It could be argued that the executive has earned £100,000 from the sale of that option in the past year but it could be just as easily be argued that the £100,000 has been earned over a ten year period, which is roughly equivalent to £10,000 per year.

1 i.e. exercised the right to buy the shares at the market price when the option was first granted, typically selling some, or all, of them at the now higher market price to realise the gain.

The main conclusions and recommendations are set out in the next section.

2. Summary of findings, conclusions and recommendations



The DTI's terms of reference directed Deloitte to focus on the FTSE 350, i.e. the 350 largest companies by market capitalisation listed on the London Stock Exchange as at August 2004.

The context for that focus is that the Combined Code (Section A.3.2) defines for its purposes any company outside the top 350 as 'a smaller company'. Furthermore, the top 350 companies account for some 96% of all FTSE listed companies in financial terms, as measured by market capitalisation.

The top 350 companies are also referred to as the FTSE 100 (i.e. the largest 100 companies) and the FTSE 250 (i.e. the next largest 250 companies).

2.1 Overall compliance

- Most of the top 350 FTSE companies are now complying with the Regulations – they are disclosing what the Regulations require.
- Beyond the basic requirements of the Regulations, the analysis suggests that about half of the top 350 FTSE companies use the remuneration report to communicate their remuneration policies in an effective way.

2.2 Accountability

Are companies submitting their remuneration report to a vote at their Annual General Meeting, separately from votes on any other matters?

Analysis	Conclusion
Prior to the introduction of the Regulations, few companies put their remuneration report to a separate shareholder vote.	The Regulations have been complied with fully in this key respect.
Since the Regulations were introduced, all of the top 350 FTSE companies put their remuneration report to a separate shareholder vote in their last reporting year.	

2.3 Transparency of disclosure

Are companies correctly disclosing what the Regulations require in the remuneration report?

Analysis	Conclusion
<p>The research has addressed the specific disclosures required by the Regulations, focusing on 22 key areas, which are detailed in Section 4 'Research findings'. Currently disclosure standards of 90% or more are being achieved under 11 of the 22 headings for FTSE 100 companies and under 9 of the 22 headings for the FTSE 250 companies.</p> <p>The key areas where there is least compliance relate to:</p> <ul style="list-style-type: none"> • the reasons for choosing performance conditions for share options and other long-term incentive plans; • the methods used to assess whether performance conditions have been met; and • disclosure on the details of future possible termination payments. 	<p>The areas where compliance is less good mainly refer to places in the Regulations where it is more difficult to understand and interpret what they require.</p> <p>Compliance in these areas could be improved by a number of minor changes to the wording of the Regulations. Further details are provided at Section 8 'Improving the Regulations'.</p>

2.4 Performance linkage

Does the remuneration report enable shareholders to assess the effective linkage of remuneration to company performance?

Analysis	Conclusion
<p>Shareholders have indicated that the introduction of the Regulations together with guidelines published by, for example the ABI and NAPF, has improved the communication of the linkage between remuneration and performance. However shareholders are clear that they would like to see more detailed disclosure demonstrating this relationship.</p> <p>One area where shareholders have indicated that more information would be helpful relates to annual bonus plans which are not currently covered in the Regulations. Although most companies disclose some level of detail this often lacks transparency. This is particularly the case where a remuneration committee uses its discretion to award bonuses that appear to be outside normal policy.</p> <p>However it is recognised that a prescriptive requirement to state, say, formulae expressing the link between pay and performance, or a regulatory requirement to justify in detail the use of remuneration committee discretion, could lead to unintended and undesirable consequences. This level of disclosure could, for example, encourage companies to remove any element of judgement and use a mechanical formula to determine the level of award, which could result in awards which may not be considered reasonable in light of other circumstances. (cont)</p>	<p>While it is apparent that disclosure in relation to the explanation of the link between pay and performance could be improved, this is an area where it appears progress is being made and this process may be best encouraged through the further development and implementation of best practice guidelines, rather than by Regulation.</p> <p>This point is also evident in the key themes that emerge from the research of the views of shareholders, a large majority of whom:</p> <ul style="list-style-type: none"> • do not want more regulation; • would like better communication, but not necessarily more information – there is already a very material cost involved in the evaluation and analysis of remuneration reports for shareholders seeking to make informed voting decisions; • require more explanation of the reasons behind the policies, particularly in areas where a remuneration committee may use, or has used discretion; and • want a level and clarity of communication that provides them with confidence in both the people making the decisions and in the processes by which those decisions are made.

Analysis	Conclusion
<p>Few shareholders consider that the performance graph contributes to the understanding of the link between performance and remuneration. However, there is little consensus on what information would be more helpful. The most relevant information for individual companies is likely to vary considerably making it difficult to be prescriptive about what information should be presented and in what form. A number of companies include additional graphs, showing for example performance against a more relevant comparator group of companies, performance over a different time scale or graphs based on different performance measures.</p>	

2.5 Changes in policies and practices since the Regulations were introduced

Based on feedback from shareholders, the level of consultation between shareholders and companies has increased to a large extent as a result of the Regulations, and shareholders are also of the view that there has been significant improvement in the clarity of disclosure about directors' remuneration.

The rate of change in a number of areas of remuneration policy in the last two years suggests that the Regulations have had an impact. These include:

- a rapid and almost complete reduction in directors' notice periods to one year or less;
- a number of well publicised situations where remuneration committees have changed their policy or practice as a direct result of shareholder voting;
- insistence that performance conditions be taken into account in the vesting of share options and long-term incentive awards in the event of a change in control;
- more generally, scaling the vesting of awards so that only a proportion of any award will vest for a target level of performance, with full vesting requiring the achievement of more stretching performance; and
- the removal of the opportunity to re-test performance conditions in share option plans.

2.6 Improvements to the current Regulations

Although commentators have variously suggested that there is currently a degree of governance fatigue within the corporate sector which might be exacerbated by further regulation, the results of the analysis, and shareholder consultation, have identified areas currently not covered by the Regulations and ABI/NAPF/CBI guidelines where refinements to the current disclosure requirements could be considered.

Shareholders have indicated that the link between pay and performance is currently not sufficiently clear. However it is also apparent that shareholders' preference is for improvements to be made through the development of industry guidelines such as those published by the ABI and NAPF, rather than through further regulation. Although the rate at which companies are responding to new guidelines published by the ABI and NAPF would almost certainly speed up if further regulations were introduced, it may be more appropriate to assess this again in one or two years' time, in order to allow time for the Regulations and the guidelines to take full effect.

Additionally, the current wording of the Regulations could be improved in a number of places, in order to provide greater clarity as to what is required.

The next sections of this Report set out the detailed findings, conclusions and recommendations reflected in the above summary.

3. Approach and methodology

The research, findings and conclusions set out in this Report are based on two strands of work, as agreed with the DTI:

- detailed analysis of companies' latest annual reports undertaken by Deloitte; and
- a survey of the views of shareholders, institutional shareholders' representative bodies, the Confederation of British Industry and the Investment Management Association ('IMA'). The survey involved completion of a questionnaire and a meeting at which issues arising were discussed in further detail.

The research did not involve direct consultation with companies. It is recommended that further consultation be undertaken with companies and with professional bodies of those directly involved in preparing remuneration reports, including the Institute of Chartered Secretaries and Administrators (ICSA), the Chartered Institute of Personnel and Development (CIPD) and the accounting bodies.

Twenty four institutional shareholders, the ABI, NAPF, CBI and IMA assisted Deloitte's research through the provision of their views.

Appendix 1 'List of respondents to questionnaire' provides details.

Appendix 2 'Respondents' views on the Directors' Remuneration Report Regulations' provides details of the questions asked of the respondents, and summarises their responses.

Deloitte's executive compensation research unit has studied in detail the disclosures of the top 350 companies regarding remuneration over a period of many years and has developed and utilised a five-level scale by which to rate the effectiveness of communication of a remuneration report. The perspective of this scale is from that of a reader who is reasonably informed and knowledgeable about the matters described in remuneration reports. It assesses the overall effectiveness of communication rather than strict legal compliance.

The Deloitte communications effectiveness analysis is explained in more detail later in this Report.



4. Research findings



4.1 Deloitte analysis – compliance and communication effectiveness

In a number of areas, in recognition of the wide variety of companies' remuneration policies and practices, the Regulations are not prescriptive and companies can choose how to interpret them. In these areas disclosures range from those which:

- address the Regulations in letter and spirit and provide readers with a genuinely comprehensible insight into most aspects of their executive remuneration policy and practice; to
- comply with the letter of the Regulations and/or use standardised language, or in some cases do not reach even these standards; it is not clear what their executive remuneration policy is aimed at achieving.

Remuneration reports consist of two sections. One section is subject to review and formal verification by the auditor. Included in this section are the quantified details of what has been paid to directors in the reporting year. The second section, which is not subject to audit, covers areas such as remuneration policy and performance linkage.

The audited section of a remuneration report requires relatively unambiguous statements of fact such as amounts of salary and fees paid, and details of share option and share awards made during the reporting year. In all the companies studied for this Report, these facts are by and large disclosed as required. The research has not attempted to assess the veracity of these facts.

The unaudited section of remuneration reports requires descriptions of, for example: the remuneration policy; performance conditions related to incentives; a performance graph; and details of service contracts. It is the unaudited section of remuneration reports that this research focuses on.

The following table summarises the extent to which companies' remuneration reports now comply with the minimum requirements of the Regulations.

The table sets out 22 compliance headings and shows that disclosure standards of 90% or more are being achieved under 11 of 22 headings for FTSE 100 companies, and under 9 of the 22 headings for the FTSE 250 companies.

The areas of material interest where least compliance is being achieved relate to:

- the reasons for choosing performance conditions for share options and other long-term incentive plans;
- the methods used to assess whether performance conditions have been met; and
- disclosure on the details of possible future termination payments.

Summary of compliance with the Directors' Remuneration Report Regulations

	Regulation	FTSE 100	FTSE 250
Resolution to approve the remuneration report	Companies Act 1985 S241A	100%	100%
Name each member of the remuneration committee	S234B S2(1)(a)	99%	99%
Disclose internal advisors to the committee	S234B S2(1)(b)	91%	81%
Disclose external advisors to the committee	S234B S2(1)(b)	99%	96%
Disclose nature of other services provided by the advisors	S234B S2(1)(c)(i)	89%	78%
Disclose whether the advisors are appointed by the committee ²	S234B S2(1)(c)(ii)	Unclear	Unclear
Summary of performance conditions used in share option and long-term plans	S234B S3(2)(a)	99%	94%
Reason for choosing these conditions	S234B S3(2)(b)	78%	65%
Summary of methods used to assess whether performance conditions are met	S234B S3(2)(c)	42%	41%
Disclose identity of comparator companies or index (where appropriate)	S234B S3(2)(d)	99%	95%
Companies failing to explain why there are no performance conditions attached to share options or long-term awards ³	S234B S3(2)(f)	4%	2%
Explanation of the relative importance of fixed and variable remuneration	S234B S3(3)	88%	74%
Policy on duration of service contracts	S234B S3(4)(a)	89%	70%
Policy on notice periods	S234B S3(4)(b)	89%	77%
Policy on termination payments ⁴	S234B S3(4)(b)	78%	80%
Include a compliant performance graph	S234B S4(1)(a)	99%	98%
Disclose name of index	S234B S4(1)(b)	100%	100%
Provide reasons for choosing the index	S234B S4(1)(b)	92%	94%
Disclose date of service contract for each individual director	S234B S5(1)(a)	92%	87%
Disclose notice period for individual director	S234B S5(1)(a)	95%	90%
Disclose provision for compensation payable on early termination ⁴	S234B S5(1)(b)	82%	70%
Disclose details to allow an estimate of the liability of the company ⁴	S234B S5(1)(c)	81%	82%

² The level of compliance with this regulation is difficult to assess. In many cases companies have not indicated specifically whether the advisors are appointed by the committee but may have indicated that the committee uses the services of, or is advised by them.

³ Companies where one or more directors appear to have outstanding awards (often granted many years ago) with no performance conditions and where this is not explained.

⁴ Disclosure of details of termination payments includes companies that have disclosed that they have no provision for termination payments, companies that have disclosed some details and companies that have disclosed full details of termination payment arrangements.

Although, as can be seen in the preceding table, the vast majority of companies are already complying with nearly all of the Regulations, a significant proportion are not going beyond the minimum in order to provide readers with a clear insight into their policies and practices. This is detailed in the Deloitte analysis set out in the following table and backed up by shareholders' views set out in Section 4.2 below.

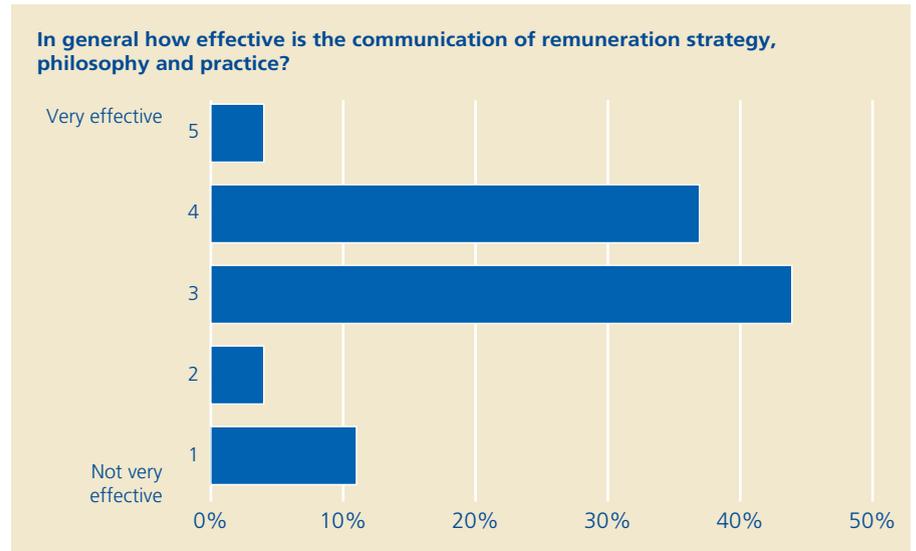
Communication effectiveness analysis

Rating	Description	FTSE 100	FTSE 250
Limited	Complies with some of the Regulations but several of the main requirements are not disclosed. Limited information on all aspects of the remuneration policy. Information difficult to find and often contained in footnotes.	6%	20%
Adequate	Complies with only the main elements of the Regulations. Policy information will be minimal with no additional contextual information.	10%	24%
Compliant	Will have complied with most of the Regulations. Basic details of policy provided with some brief additional contextual information.	31%	26%
Good	Complies with nearly all of the Regulations. Policy is fully described and the report is clearly written with information being easy to find. Contextual information is provided with relation to overall company philosophy. Also has a high level of compliance with other institutional guidelines.	41%	28%
Excellent	Fully complies with the Regulations. Provides a detailed, understandable description of remuneration policy. Uses tables and charts to illustrate the details. Also has a high level of compliance with other institutional guidelines. Provides context of how the executive remuneration policy fits in with overall company strategy and all-employee reward.	12%	2%

4.2 Shareholders' views

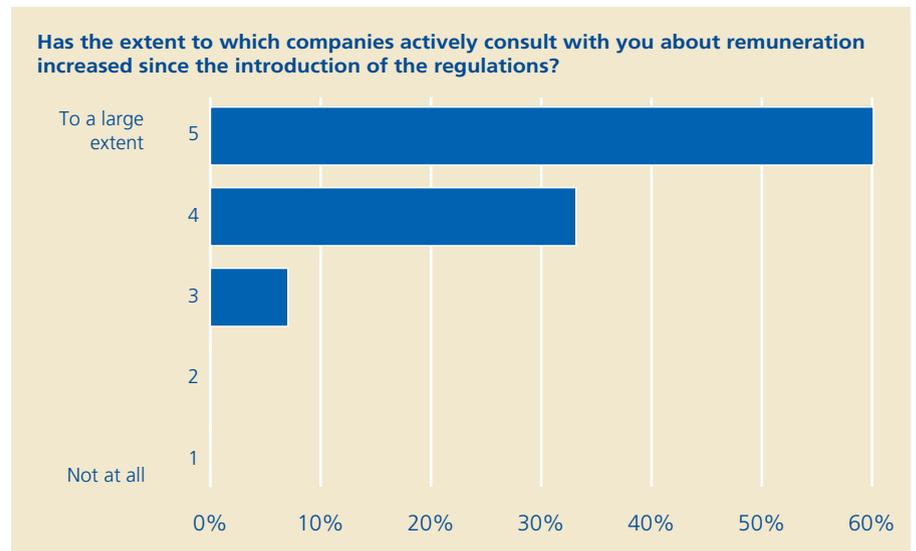
4.2.1 Communication effectiveness

The views of shareholders on the effectiveness of communication, shown in the following bar chart, complement the above findings.

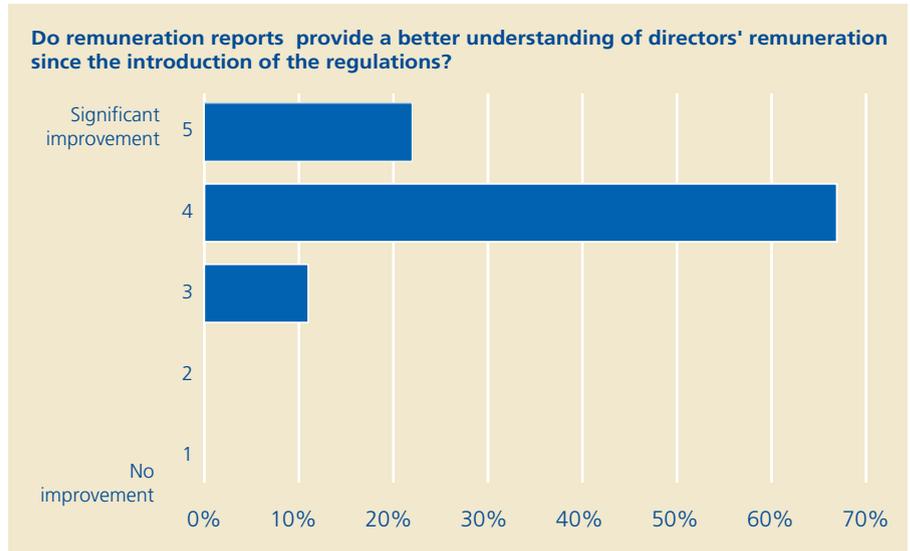


In discussions with shareholders, the consensus was that the best quality of disclosure and communication occurred when the remuneration report was clearly drafted and, where appropriate, there was a good level of consultation with shareholders.

Shareholders have stated that consultation about remuneration has substantially increased since the Regulations were put into effect. This is illustrated in the following chart:

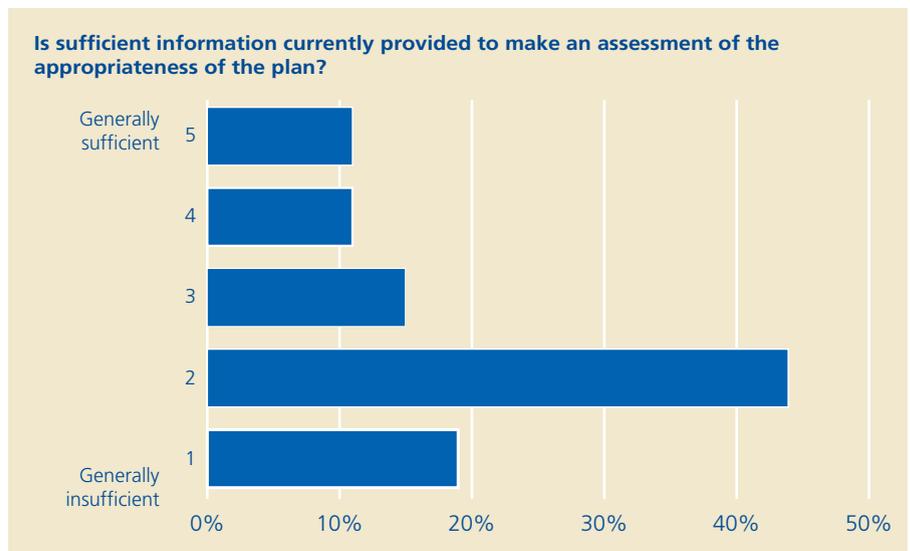


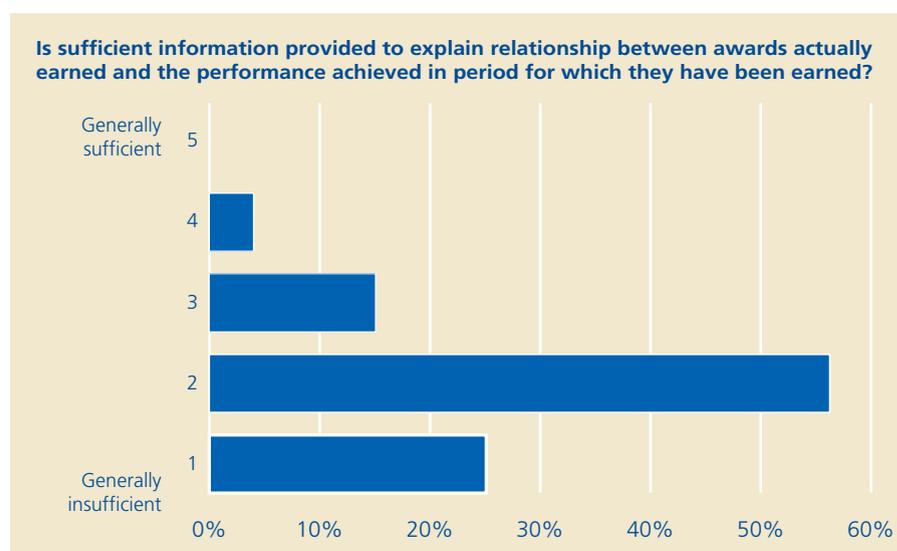
Shareholders have also commented that they have a significantly better understanding of companies' directors' remuneration since the introduction of the Regulations.



However it would be overly simplistic to conclude that the Regulations alone have brought this about. Shareholders have indicated that the vote certainly has been important, but beyond that it is the combination of the Regulations, consultation, and guidelines published by the ABI and NAPF, which are now bringing about increasingly improved disclosure quality.

A main area which shareholders feel is still lacking focus is explanation about the link between bonus payout and performance. The following charts illustrate shareholders' views on this matter with regards to annual bonus plans:





Shareholders, during consultation about their views, also made it clear that they would wish to see more explanation about where remuneration committees use discretion outside of 'normal' policy to make awards of, for example, salary increases, bonuses, or other payments.

4.2.2 Overall shareholder views

The key themes that emerge from both the responses in the questionnaires and the subsequent discussions are that shareholders:

- do not want more regulation;
- would like better communication, but not necessarily more information – there is already a very material cost to shareholders involved in the evaluation and analysis of remuneration reports prior to reaching informed voting conclusions;
- require more explanation of the reasons behind the policies, particularly in areas where the remuneration committee may use, or has used discretion; and
- want a level and clarity of communication that provides them with confidence in both the people making the decisions and in the processes by which those decisions are made.

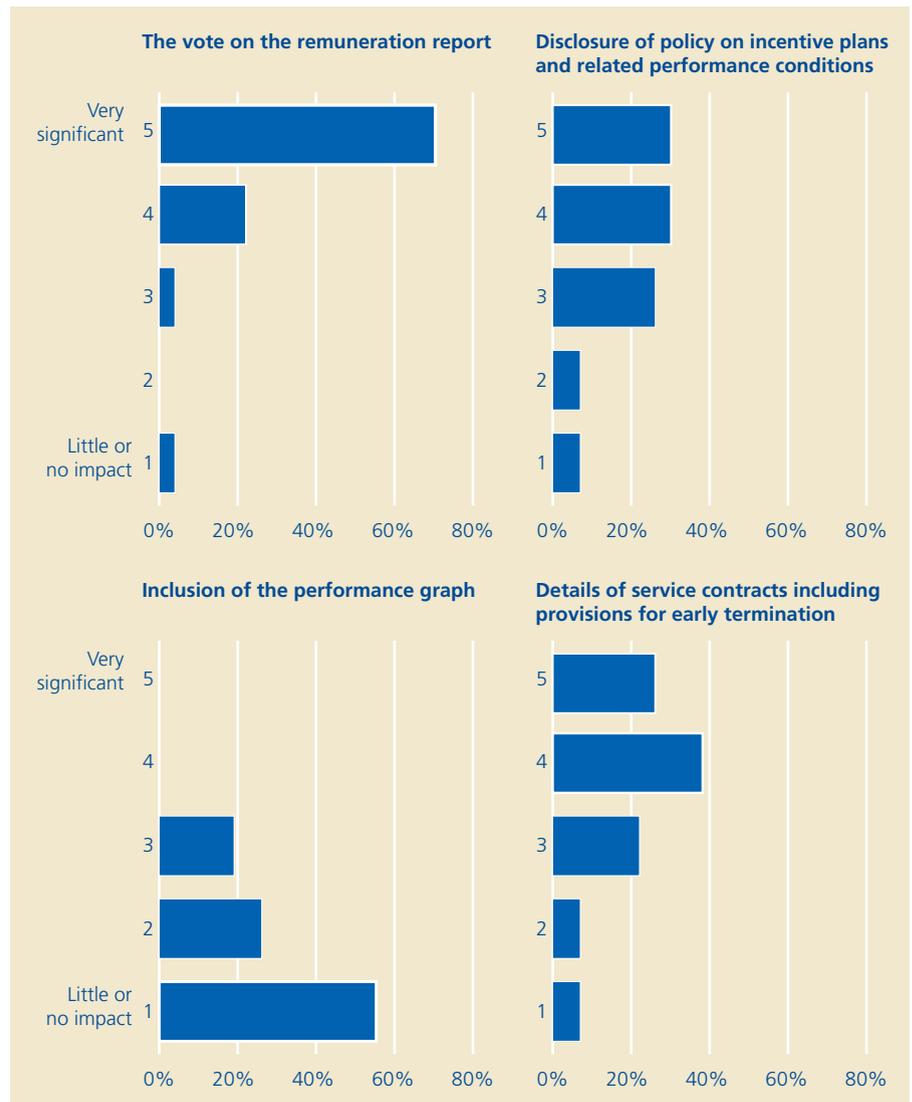
5. Accountability

All of the top 350 FTSE companies put their remuneration report to separate shareholder vote in their last financial reporting period.

When the Regulations were first introduced there were significant votes against a number of companies' remuneration reports. In a number of high profile cases it is clear that this did result in specific reconsideration of policy matters by the remuneration committees concerned.

In more recent months there have been fewer and less pronounced occasions where significant shareholder votes have been lodged against companies' remuneration policies which may be, at least in part, in response to increased consultation between companies and shareholders.

Which aspects of the Directors' Remuneration Report Regulations have had the most significant impact on attitudes and behaviours?



6. Performance linkage

This section focuses on the extent to which current disclosure demonstrates the link between performance and pay. Recommendations are made in a number of places, and these are drawn together and summarised in Section 8 'Improving the Regulations'.

It is clear from the analysis of shareholder views that the combination of Regulation and investor guidelines has improved the level of communication between companies and shareholders.

Shareholders have indicated that they have a better understanding of directors' remuneration since the introduction of the Regulations.

However it is also clear that there is still perceived to be a lack of clarity generally on the strategy, philosophy and practice of remuneration, and more specifically around the link between performance and remuneration.

Increased disclosure requirements do not directly lead to changes in policy but experience suggests that where disclosure is required it is likely to lead to a review of not only the underlying policies, but to some extent the processes by which the policies have been determined.

In effect, the process of having to disclose the information, and in many cases explain the reasoning behind the information, may highlight inconsistencies, or raise questions, which have previously not been apparent and which may prompt a reaction from shareholders.

That the increased level of disclosure and communication has been effective can be seen in Section 7 'Changes in policies and practices since the Regulations were introduced', which highlights the areas of remuneration policy where changes have taken place as a result of a combination of the Regulations and shareholder pressure. It is also clear that change has been accelerated in some areas, most notably policies on service contracts and notice periods, by the introduction of the Regulations.

One aspect which shareholders have suggested may provide more clarity on the link between performance and remuneration is providing retrospective information on the level of incentive payments, both short and long-term, and the level of performance that had been achieved to deliver that award.

Annual bonus

There is no requirement in the statement of companies' policy on directors' remuneration to disclose information relating to annual bonus policies. This is an area where shareholders have made it clear that they would like to see more disclosure.

Best practice guidelines – as shown in the extracts set out below – recommend disclosure on certain aspects of annual bonus plans, and many companies are meeting these requirements to a great extent.

Principles and Guidelines on Executive Remuneration December 2003 ABI

"The performance targets should generally be disclosed in the remuneration report subject to commercial confidentiality considerations. Shareholders understand that commercial confidence may prevent disclosure of specific short-term targets but they expect to be informed of the basic parameters adopted in the financial year being reported on. The maximum participation levels should be disclosed".

2004 Corporate Governance Policy
NAPF

"The components of an annual bonus should be clearly defined and the individual element for example, clearly separated from broader business goals and overall corporate performance".

"The annual bonus paid to each executive director in the financial year should be disclosed in the remuneration report. This information should be supported by a) a description of the performance targets that were achieved, b) an explanation of the relationship between the performance achieved and the value of the bonus paid, c) the maximum bonus award that would have been made had all the performance targets applying to the executive director been achieved".

Most companies disclose the maximum award and a good number disclose the performance measures used. Some go further and show a breakdown of the proportion linked to corporate and/or individual performance measures, or show the actual annual bonus paid relative to the maximum that may be earned.

Recommendations

Disclosure of details of the annual bonus plan has improved significantly over the past two to three years as a result of shareholder pressure and, with best practice guidelines now providing detailed provisions on what should be disclosed, this should continue to improve. It should be noted that the new NAPF guidelines were only introduced earlier this year.

As mentioned above, one of the key pieces of information shareholders would like to see is a retrospective indication of the level of bonus earned in the year and how this relates to the performance achieved. Examples of companies which have already begun to disclose this level of information, as a result of the above best practice guidelines, are included in Appendix 4 'Examples of disclosure'. While introducing additional regulations on this aspect of remuneration policy would almost certainly speed this process up a better option may be to allow the best practice guidelines more time to take effect and to review this area again in one or two years' time, with a view to introducing additional regulation if it is felt that companies have not sufficiently responded to these guidelines.

However the annual bonus is a significant element in the remuneration package and in 98% of FTSE 350 companies executive directors are eligible to participate in such a plan. Shareholders have indicated that they want to see some level of detail regarding the plan. It is generally accepted that it would be inappropriate for companies to be required to disclose the details of future performance conditions for reasons of commercial sensitivity. It is also worth bearing in mind that a requirement to disclose the detail of the plan could encourage companies to take a formulaic approach to the design so that there is no debate over the levels of award paid. This may not be in the interests of companies or shareholders.

It may therefore be sufficient to extend the Regulations to include disclosure on annual bonus plans along the following lines:

The policy statement shall:

- state whether a director is entitled to participate in an annual bonus plan; and
- summarise the key features of any such plan.

Extending the Regulations in this manner, in combination with the best practice guidelines which provide guidance on the level of detail shareholders would like to see, should encourage better disclosure⁵.

⁵ This would also align with the draft recommendations contained in Section II: Remuneration Policy, Article 4: Disclosure of the directors' remuneration policy, paragraph 2 of the European Commission on fostering an appropriate regime for the remuneration of directors. This is currently the only place where there is a significant difference between UK disclosure requirements and the European proposals.

Long-term incentive plans and share option plans

The details of long-term incentive and share option plans are usually well disclosed. Plans in which executive directors participate require prior and specific shareholder approval, and therefore it is usual for the full details to be included in shareholder communications. In the majority of companies, particularly the larger ones, these will be discussed with shareholders prior to the relevant AGM notice being released and shareholders will have had the opportunity to comment on, and, if appropriate, exert influence over, details of the plans.

Major changes are therefore not recommended to the disclosure requirements on the details of long-term incentive plans as existing requirements and best practice guidelines are generally sufficient. However there are some specific areas which could be improved.

Better explanation of performance conditions

There is no consensus among shareholders on whether the performance conditions used in long-term plans are adequately explained. This is borne out by the diversity of answers to questions detailed in section 4 of Appendix 2 'Respondents' views on the Directors' Remuneration Report Regulations'. These are matters which should continue to improve in response to best practice guidelines and increased communication with shareholders.

It is recommended that the explanation of performance conditions should be monitored over the next one to two years with a view to extending the Regulations at that time if it is apparent that not all companies are responding to the guidelines.

A requirement to disclose details of the performance period

Shareholders expect a long-term plan to measure performance over at least three years, and best practice guidelines suggest the period should, where appropriate, be longer.

NAPF guideline L.8 states "Performance periods for incentive plans involving the issuing of share options or shares or equivalent should be a minimum of three years. The NAPF considers that five years is generally the more appropriate performance period".

Many, if not most, companies already disclose this performance period, if not in the remuneration report, certainly in any shareholder communications regarding new plans. For completeness a relevant disclosure requirement could be added to Regulation 3(2)(a).

Assessment of the extent to which performance conditions have been met

As can be seen in the analysis of the current disclosure, this is one area where the level of disclosure has been variable suggesting that there is some uncertainty over what information is required. The Regulations could be made clearer on this point by including a requirement to disclose whether the assessment is independently verified and some information on the level of discretion the remuneration committee has in deciding what level of award will be made, and in what circumstances this would be used. This would provide shareholders with comfort that robust processes are in place for determining the level of awards being made.

In order to further address the issue of the linkage between performance and pay, shareholders have identified two other key areas for consideration.

Vesting schedule

It is helpful to have an indication of the vesting schedule for awards so the relationship between vesting and performance is clearer. Many companies already disclose this in the remuneration report, and most include relevant details of new plans circulated to shareholders for approval. Requiring companies to include full details of proposed new plans in the remuneration report could assist in this. However this is effectively covered in Regulation 3(2)(a) in so much as a 'detailed' summary of the performance conditions should include such information and in the majority of cases is certainly how this is being interpreted. Where this is not currently the case, there is no evidence to suggest that best practice guidelines and shareholder pressure will not continue to exert influence and it is likely that disclosure will continue to improve over the next one to two years. It is therefore not recommended that any further disclosure requirements are introduced in this area at this time.

Retrospective disclosure of awards vesting and performance achieved

As with the annual bonus, shareholders have indicated that they would like to see an explanation of levels of long-term incentive awards vesting and the performances achieved in the relevant performance periods. Again, there are examples of ways in which some companies are already disclosing this information included in Appendix 4 'Examples of disclosure'. However for the same reasons as outlined above for annual bonus it may be more appropriate to monitor progress over the next one to two years rather than introducing further regulation at this time.

Performance graph

Few shareholders consider that the performance graph contributes to the understanding of the link between performance and remuneration. However, there is little consensus on what information would be more helpful. The most relevant information for individual companies is likely to vary considerably making it difficult to be prescriptive about what information should be presented in the graph. A number of companies include additional graphs, showing for example performance against a more relevant comparator group of companies, performance over a different time scale or graphs based on different performance measures.

It is recommended that no further regulations are introduced with relation to the performance graph, leaving companies with the opportunity to include additional graphs where relevant. As best practice in this area emerges it is likely that more companies will provide additional and more relevant information.

7. Changes in policies and practices since the Regulations were introduced

Shareholders have reported that the Regulations' requirement to hold a vote on the remuneration report has had a very significant impact upon attitudes and behaviours towards and in respect of directors' remuneration. The improvement in the level of disclosure since their introduction has been critical in providing sufficient information to allow shareholders to make the decision on whether to approve the report. Shareholders also report that there has been significantly improved disclosure regarding incentive policies and service contracts since the Regulations have been put into effect.

Shareholders have for many years had the opportunity to review and vote upon the design of share option and share plans. However there are other areas of the remuneration policy where shareholders have not previously had the opportunity to have such a direct influence. A key issue for shareholders has been the length of notice period contained in directors' service contracts. Pressure has been applied over the past few years and practice has been slowly changing. However since the introduction of the Regulations the change has been dramatic:

% of executive directors with notice period of 24 months

	2001	2002	2003	2004
FTSE 100	32%	22%	14%	1%
FTSE 250	25%	16%	9%	5%

Further significant changes that have emerged with probable links to the Regulations and the requirement for an annual vote have been that:

- the level of consultation with shareholders about executive remuneration matters has increased (this is referred to in further detail elsewhere in this Report under the heading 'Shareholder Views'); and
- there have been a number of well-publicised situations where remuneration committees have changed their policy or practice as a direct result of shareholder disquiet and the possibility (or reality) of a substantial vote against.

Some of the key issues where shareholders have exerted pressure are:

Vesting of long-term awards in the event of a change in control

In 2000 over 40% of new share option plans introduced included provisions for all share options to vest in the event of a change in control regardless of whether performance conditions had been met. This was not so common in performance share plans but even in these plans, around 20% contained similar provisions. In the year to July 2004, of the new plans introduced only one includes automatic vesting in the event of a change in control, irrespective of performance. In a few plans vesting is at the discretion of the remuneration committee. In almost 90% of plans vesting is dependent on the performance conditions being met.

Re-testing

Another element of share option plans which has been under pressure from shareholders is that of re-testing of performance conditions. Old-style share option plans typically required performance conditions to be met over any consecutive three year period during the ten year life of the option. With the move towards annual grants of options (also brought about through shareholder pressure and now accepted as normal practice) shareholders persuaded companies to move towards measuring performance over the three years from grant. Initially it was accepted that one or two years' of re-testing, from the fixed base date, was appropriate. More recently, for new plans, shareholders have pushed towards no re-testing, with options lapsing after three years if the performance conditions are not met. Three years ago less than 10% of plans in FTSE 100 companies met this requirement; this has risen to 43% and in FTSE 250 companies has risen from around 25% of plans to 50%. Additionally, 37 FTSE 350 companies have removed the re-testing provision from existing plans in the last year and many more companies have, for their existing plans, reduced the number of years over which performance can be re-tested. Only four plans introduced in the past year include any form of re-testing, and this is over one year only. The inference can be drawn that over the next few years, as older-style plans continue to be phased out, re-testing will disappear completely.

Share option performance conditions

One further area which is changing rapidly is that of the level of performance required for share options to vest. Older-style plans typically required a one-off 'cliff vest' performance target to be met, at which point all the options would vest. Best practice guidelines have suggested, for the past few years, that a scale should be introduced whereby a proportion of the options would vest for a minimum level of performance, with full vesting requiring more stretching targets to be met. Three years ago 32% of FTSE 100 and 20% of FTSE 250 companies followed this approach. This has increased to 53% and 47% of companies respectively. Over 80% of share option plans introduced in the past year follow this guideline. Again, it could be inferred that within the next two to three years 'cliff vesting' will be a thing of the past.

Although it is not always possible to absolutely link the above evolutions of executive remuneration policy and practice to prior changes in ABI and NAPF best practice guidelines or to the introduction of the Regulations, there is little doubt that there is a strong link. As such, these statistics demonstrate the impact of the combination of Regulation, Combined Code and best practice guidelines. Clearly disclosure supports the types of changes described above in the sense that the requirement to disclose encourages companies to focus on the matters concerned. It is apparent that companies do make changes to policies as a result.

8. Improving the Regulations

This section summarises the recommended changes to the Regulations, incorporating those detailed in Section 6 'Performance linkage', other areas where the Regulations might be extended, and some possible minor changes which have arisen during Deloitte's research on compliance.

8.1 Areas where the Regulations could be extended

8.1.1 New appointments

Where a director has been appointed during the year compliance with the Regulations requires that the total amount of salary and fees paid to or receivable by the person in respect of qualifying services during that part-year is disclosed. This means that the full annualised remuneration package of a newly appointed director may not be known until the following year. It would be helpful to shareholders to have the full details of the package at the earliest opportunity. This could be effected through the listing rules or through the Regulations. The remuneration report could include a separate section with details of the package for a new appointment, including salary, pension arrangements, benefits, whether awards under annual bonus, share option and long-term incentive plans differ from normal policy and details of awards made specifically for recruitment purposes. Many companies already do this.

8.1.2 Total remuneration

This matter applies to the audited section of the remuneration report.

To satisfy shareholder concerns about the difficulties in understanding the total remuneration for a given director, it may be helpful to require all elements of the package to be disclosed in the same table. For example, the salary, fees, value of benefits, actual bonus received in the year, potential maximum bonus that could have been earned, face value of any option grant or long-term award. Examples are shown in Appendix 4 'Examples of disclosure'.

8.1.3 Explanation of additional payments/awards

This matter applies to the audited section of the remuneration report.

It may be helpful to include a specific requirement to explain discretionary awards under annual or long-term incentive plans. This is an area of concern for many shareholders and, although not common, typically where awards are made they are mentioned in the footnotes to the remuneration table and rarely adequately explained. In some cases they may not be referred to at all. We are only aware of 3% of FTSE 100 companies and 5% of FTSE 250 companies where discretionary awards appear to have been made in the past year or so and in many cases this will only be to one director. However, of these, only two have provided the detailed reasoning behind the awards.

8.1.4 Annual bonus

As referred to previously in Section 6 'Performance linkage', the annual bonus plan is an area on which shareholders wish to see further disclosure. However companies have concerns about commercial sensitivity.

The Regulations could be extended to include disclosure on annual bonus plans along the following lines:

The policy statement shall:

- state whether a director is entitled to participate in an annual bonus plan; and
- summarise the key features of any such plan.

8.1.5 Pensions

This matter applies to the audited section of the remuneration report.

It is clear from the comments of shareholders that the disclosure requirements on pensions could be improved. However there is a general lack of agreement on what information would be helpful. In light of the introduction of a substantially new tax regime for pensions, this is an area which it may be wise not to address at this time. Companies are likely to be reviewing pension policy over the next year. It will be some while before it is clear what the impact of the new tax legislation in this area is likely to be, and therefore it is difficult to identify what disclosure information is likely to be most helpful.

8.1.6 Dilution

This is an area where although there is agreement by shareholders that more information is required, there is a lack of agreement on what information should be disclosed. However best practice guidelines issued by the ABI and the NAPF now include guidance on the disclosure of dilution levels and it is recommended that these guidelines be allowed time to take effect before adding to the Regulations in this area.

8.2 Editing of current Regulations

The following section relates to relatively minor changes to the wording of the existing Regulations. The suggested new wording of the relevant paragraphs of the Regulations is detailed in bold in the boxes below.

Regulation 2(1)(b): Currently, where a company does not disclose any advisors, it is not clear whether this is non-compliance or whether the committee has not been materially assisted. More clarity could be provided by re-wording this Regulation along the lines shown in bold below.

2(1)(b) State whether **or not** any person provided advice, or services, that materially assisted the committee in their consideration of any such matter. **Where there was such a person**, state the name of that person.

Regulation 2(1)(c)(i): Where there is no disclosure on this point, it is not clear whether this is because no other services are provided or whether this is non-compliance. A change in the wording could again provide more clarity:

2(1)(c)(i) In the case of any person named under paragraph (b) who is not a director of the company state **whether or not** any other services have been provided to the company by that person during the relevant financial year and **where such services have been provided**, the nature of those services.

Regulation 2(1)(c)(ii): The wording here could be changed slightly to require disclosure of who appointed the advisor, rather than whether the appointment was made by the committee which would remove some ambiguity.

2(1)(c)(ii) In the case of any person named under paragraph (b) who is not a director of the company state **by whom** that person was appointed.

These are minor points but in light of suggestions that shareholders are likely to increasingly focus on the processes in place for determining directors' remuneration, clarity of disclosure is helpful. There may be an argument for including in the Regulations a requirement to disclose the process by which advisors are appointed. However this would appear to be adequately covered in the revised Combined Code provision B.2.1 and could be monitored over the next one to two years.

Regulation 3(1): The level of detail included in the 'general policy statement' varies greatly. This may suggest a lack of clarity around whether it is a requirement to include a general statement, as parts 2 – 5 of Regulation 3 go on to specify the detail of what should be included in the policy statement. However it may be unwise to be prescriptive about what should be included as a general statement and it may be more appropriate to leave this to the best practice guidelines of the ABI and NAPF, which already provide guidance.

Regulation 3(1) requires the report to “**contain a statement of the company’s policy on directors’ remuneration for the following financial year and for financial years subsequent to that**”.

The most common disclosure on this point is that the committee needs to retain the flexibility to adjust the policy to take account of the changing environment. The policy information included in most reports therefore relates primarily to the policy in place for the prior financial period, with some companies including any proposed changes to the existing policy for the following year. Requiring companies to disclose the current policy and to outline any proposed changes to this policy, where known, for the following financial year, with the reasons for these changes, may provide more clarity, resulting in more helpful disclosure. Changes to the policy could cover new incentive plans, the balance of the remuneration package, performance conditions, vesting schedules, comparator companies, notice periods and termination periods and pensions.

Possible wording changes to Regulation 3(1) might be:

3(1) The directors’ remuneration report shall contain a statement of the company’s current policy on directors’ remuneration and, if any changes are proposed for the following financial year, a summary of these changes, including the introduction of new incentive plans, changes to the balance of the package, changes to performance conditions, vesting schedules or comparator companies, changes to the policy on notice periods and termination payments and changes to pensions policy, together with an explanation for these proposed changes.

Regulation 3(2)(a)

- Typically the performance conditions in a long-term plan do not differ for individual directors. It may be helpful to change the Regulations to require disclosure of the generic performance conditions included in the plan, rather than for each individual, together with individual details if they differ.
- It may also be helpful to include a requirement to disclose details of the performance period. Shareholders expect a long-term plan to measure performance over at least three years, and best practice guidelines suggest the period should, where appropriate, be longer. Many, if not most, companies already disclose this information, if not in the remuneration report, certainly in any shareholder communications regarding new plans. For completeness, this could also be added to Regulation 3(2)(a).

3(2)(a) The policy statement shall include a detailed summary of any performance conditions in share option or long-term incentive plans under which a director has any entitlement, and the period over which such performance is measured. Where the performance conditions vary for individual directors this should be explained.

Regulation 3(2)(c): This regulation currently requires companies to disclose “**a summary of the methods to be used in assessing whether any such performance conditions are met and an explanation as to why those methods were chosen**”.

There is a general lack of disclosure on this point suggesting that there is some uncertainty over what information is required. This is often a complex and technical area which may be difficult to explain and could involve unhelpfully lengthy text. Current disclosure ranges from no detail at all to extensive descriptions of the calculations used to measure performance.

It may be more helpful to clarify the requirements of this regulation which could include, for example, a requirement to disclose whether the assessment is independently verified and some information on the level of discretion the remuneration committee has in deciding what level of award will be made, and in what circumstances this would be used. This would provide reassurance to shareholders that robust processes are in place for determining the level of award vesting.

3(2)(c) The policy statement shall include:

- i a statement of whether or not the assessment of the extent to which any such performance conditions have been met will be independently verified
- ii whether or not, when the assessment has been made, the remuneration committee has the discretion to materially change the level of award vesting
- iii details of the circumstances in which any such discretion would be used.

Regulation 3(2)(d): This regulation currently requires companies to disclose “if any such performance condition involves any comparison with factors external to the company – (i) a summary of the factors to be used in making each such comparison, and (ii) if any of the factors relates to the performance of another company, of two or more other companies, or of an index, on which the securities of a company, or companies, are listed, the identity of that company, or each of those companies, or of the index.”

The level of disclosure here is variable suggesting that again there is a lack of clarity. The Regulations could be modified perhaps to require the disclosure of the companies, or index, for only those awards made in the current financial year, with an explanation of any change from those used for previous awards, or, if known, any expected change for future awards. An explanation of the reasons for any change might also be required.

3(2)(d) The policy statement shall include, if any such performance condition relating to awards made under a long-term incentive scheme, in the relevant financial year, involves any comparison with factors external to the company:

- (i) a summary of the factors to be used in making each such comparison
- (ii) if any of the factors relates to the performance of another company, of two or more other companies or of an index on which the securities of a company or companies are listed, the identity of that company, of each of those companies or of the index
- (iii) if the details in (ii) have changed from those relating to awards made in the previous financial year, or are expected to change for awards to be made in the following financial year, a description of, and an explanation for, the changes.

Regulation 3(2)(e): This regulation currently requires disclosure of any significant changes to the terms and conditions of any entitlement of a director to share options or under a long-term incentive schemes, and an explanation of these changes. For the avoidance of doubt, the Regulations could be changed to require a statement to the effect that no such changes have been made during the relevant financial year, or where they have been made, or are proposed for the following financial year, a description and explanation of the changes to be disclosed.

3(2)(e) The policy statement shall include a statement that no significant changes have been made during the relevant financial year to the terms and conditions of any entitlement of a director to share options or under a long-term incentive scheme, or where significant amendments have been made during the relevant financial year, or are proposed for the following financial year, a description of, and an explanation for, these amendments.

Regulation 3(3): There is a wide variation in the level of information disclosed with respect to this Regulation which relates to the relative importance of those elements which are, and those which are not, related to performance. There are a number of ways in which the disclosure could potentially be improved:

- requiring a breakdown of the package to be disclosed and including the basis of the valuations – this is not an easy issue to resolve as there are a number of alternative possible valuation approaches which are all valid. This could be made more specific, whilst still leaving companies with the choice of exactly what basis to use, by requiring the breakdown to be shown for 'on-target' performance and for the maximum which may be earned;
- requiring details of the basis on which the calculation has been done;
- requiring companies to disclose how the make up of the package has changed since last year;
- requiring companies to explain why this balance is appropriate for the business; and
- requiring companies to explain any differences between directors.

However it is difficult to be prescriptive in this area without specifying the exact methodology to be used, which may not be appropriate in all cases. The quality of the information provided is likely to evolve as more companies provide detail and best practice will start to emerge. It is therefore recommended that the only change to this Regulation is to require companies to disclose and explain if, how and why this has materially changed since the previous year.

3(3) The policy statement shall, in respect of each director's terms and conditions relating to remuneration, explain the relative importance of those elements which are, and those which are not, related to performance, and if this has changed significantly, during the relevant financial year, the reasons for that change.

A further related point not currently addressed in the Regulations, which shareholders have indicated is important, is information on the balance between short and long-term performance. For the same reasons as noted above it is believed that this particular point would be better addressed in best practice guidelines and not in Regulation.

Regulation 3(4) (termination payments)

It is clear that, while accepting that this is a difficult issue, shareholders want more clarity in this area and they have expressed the view that the current level of disclosure is insufficient. The problem is that in practice there are many variants to directors' employment contracts and that attempting to predict a precise termination payment value is virtually impossible – it would depend on matters such as timing, circumstances and lawyers' perspectives at that point. Rather than requiring companies to attempt to disclose the details of what the termination payment may include it may be more appropriate to require companies to outline the principles on which decisions will be made. Changing and extending the current disclosure requirements in the following ways may be helpful:

- combining the policy and individual director practice into one section. This could include a policy section with the requirement to detail any deviation from policy for individual directors;
- the disclosure requirement on policy should make it clear that this is the policy that would generally apply to new appointments going forward;
- a requirement to disclose the principles on which the determination of the termination payment would be based, how this would vary in the event of a change in control, and details of specific principles of mitigation, including phased payments etc; and
- a requirement to disclose the principles on which the determination of what would vest under long-term plans in the event of termination would be based could also be included.

9. Appendix 1 – list of respondents to questionnaire

The following list sets out details of the 24 institutional shareholders, and their representative bodies, the ABI and NAPF, who kindly responded to the Deloitte questionnaire. One of the institutions provided separate responses from its governance and investment departments:

Association of British Insurers	Aegon Asset Management
AXA Investment Managers Ltd	Baillie Gifford & Co
Brandes Investment Partners	Capital International Ltd
Co-operative Insurance Society	Deutsche Asset Management Ltd
Fidelity International Ltd	Gartmore Investments Management
Henderson Global Investors	Hermes Pension Management Ltd
HSBC Asset Management Europe	Insight Investment
Legal & General	ISIS Asset Management
M&G Investment Management Ltd	Merrill Lynch Investment Managers
National Association of Pension Funds	Morley Fund Management
Standard Life Investments	Newton Investment Management Ltd
Threadneedle Asset Management Ltd	SWIP Partnership
UBS Global Asset Management	T Rowe Price International

In addition to the institutions listed above, the Confederation of British Industry and the Investment Management Association also provided views.

10. Appendix 2 – respondents' views on the Directors' Remuneration Report Regulations

The following analysis is based on responses received from 27 questionnaires from 26 institutions and two associated letters.

Where the responses on the questionnaires are quantifiable, the results are summarised in tabular form showing the percentage responses in each category. For example, in the table immediately below, 8% of the respondents indicated that they monitored compliance at Level 1 'Broad assessment', whilst 31% of the respondents indicated that they monitored compliance at Level 5 'Detailed assessment'.

A number of questions elicited written responses which are not quantifiable. In these cases the analysis distinguishes points with similarities made relatively frequently by different respondents from those points which were made by only one or a few respondents.

1. General

Do you monitor compliance (by the companies in which you invest) with the Directors' Remuneration Report Regulations?

Broad assessment			Detailed assessment	
1	2	3	4	5
8%	4%	15%	42%	31%

Do remuneration reports provide a better understanding of directors' remuneration since the introduction of the Regulations?

No improvement			Significant improvement	
1	2	3	4	5
0%	0%	11%	67%	22%

On the occasions on which you have voted against, or abstained from voting on, a company's remuneration report please indicate the principal reasons for doing so.

A total of 27 respondents provided written views and commentary in response to the above question. The more frequent points that were commented upon in respect of their principal reasons for voting against, or abstaining from voting on, a company's remuneration report were as follows:

- length of service contracts – the granting of greater than 12 month service contracts; additional concerns regarding service contracts include: compensation paid for reduction in service contract length; change of control conditions exceeding 12 months; unreasonable severance/termination provisions – 'rewards for failure';
- performance conditions – insufficiently challenging or inappropriate performance conditions;

- poor disclosure – insufficient disclosure to enable shareholders to take an informed view;
- quantum – excessive levels of salary and awards with one respondent commenting that disclosure does not prevent excessive pay;
- retesting provisions;
- weak performance linkage – weak or no linkage between performance and reward;
- special arrangements – ex gratia payments and irregular bonus awards; and
- lack of alignment with shareholder interests.

Other comments included – ineffective consultation with shareholders; terms of scheme in breach of proxy voting guidelines; dilution – amount allowable; remuneration committee independence and composition; policy not conforming to current practice; repricing of share options; pension issues and failure to justify level of bonus awards.

How important would it be to have information on employees below board level (e.g. the five highest paid employees/officers)?

Not very important				Critical
1	2	3	4	5
3%	8%	23%	62%	4%

2. Company policy on directors' remuneration

Fixed and variable remuneration

How important is disclosure of the policy on the balance of fixed and variable remuneration?

Not very important				Critical
1	2	3	4	5
0%	0%	12%	42%	46%

Is sufficient information currently provided to assess the appropriateness of this balance?

Generally insufficient			Generally sufficient	
1	2	3	4	5
0%	27%	27%	31%	15%

Short and long-term performance

How important is disclosure of the policy on the balance between short and long-term performance?

Not very important				Critical
1	2	3	4	5
0%	0%	4%	38%	58%

Is sufficient information currently provided to assess the appropriateness of this balance?

Generally insufficient			Generally sufficient	
1	2	3	4	5
8%	19%	27%	31%	15%

3. Annual bonus plans

In order to assess the appropriateness of the annual bonus plan how important is the disclosure of design features such as:

	Not very important			Critical	
	1	2	3	4	5
Performance measures	0%	0%	15%	11%	74%
Level of performance required to achieve the maximum award	0%	0%	11%	30%	59%
The maximum award that may be earned by each director	0%	0%	11%	26%	63%
The relationship between awards made in the year and performance over the period	0%	0%	4%	7%	89%

Is sufficient information currently provided to make an assessment of the appropriateness of the plan?

Generally insufficient			Generally sufficient	
1	2	3	4	5
19%	44%	15%	11%	11%

Is sufficient information provided to explain the relationship between awards actually earned and the performance achieved in the period for which they have been earned?

Generally insufficient			Generally sufficient	
1	2	3	4	5
25%	56%	15%	4%	0%

What further information would be helpful?

21 respondents provided commentary of what further information would be helpful:

- disclosure of performance targets – considered ambiguous, however commercial sensitivity of performance targets recognised; historical and detailed assessment of criteria required;
- detailed explanation of how plans operate – context and rationale for awards made;
- more retrospective information regarding targets set and performance achieved against them; and
- rationale for remuneration committee discretion.

Other comments included: proportion of awards based on group versus personal/other metrics.

4. Long-term incentive and share option plans

In order to assess the appropriateness of long-term incentive plans, how important is the disclosure of design features such as:

	Not very important			Critical	
	1	2	3	4	5
Performance measures	0%	3%	0%	4%	93%
The annual maximum award that may be made to a director	0%	3%	0%	19%	78%
The rationale behind the actual award in any given year	0%	4%	4%	22%	70%
The level of vesting at various levels of performance	0%	4%	0%	22%	74%
The relationship between awards vesting in the year and performance over the period to which the vesting relates	0%	4%	11%	11%	74%

Is sufficient information currently provided to make an assessment of the appropriateness of the plan?

Generally insufficient			Generally sufficient	
1	2	3	4	5
11%	7%	38%	33%	11%

Is sufficient information provided to explain the relationship between awards actually earned and the performance achieved in the period for which they have been earned?

Generally insufficient			Generally sufficient	
1	2	3	4	5
19%	22%	15%	33%	11%

What further information would be helpful?

19 respondents provided commentary of what further information would be helpful:

- quantification of awards potentially realised with details of assumptions and awards actually realised by each director;
- performance linkage – general disclosure on relationship between actual rewards received and performance; and
- clarification/explanation of circumstances where discretion is exercised by remuneration committees i.e. what constitutes exceptional circumstances.

Other comments included: specific graphs of TSR performance versus peer group for specific performance periods of awards which have vested; vesting conditions on change of control; rationale behind choice of plan and level of award; lack of remuneration committee response and explanation regarding anomalous awards; and retesting provisions.

5. Service contracts

In order to understand what payments would be made in the event of termination, how important is the disclosure of information such as:

	Not very important			Critical	
	1	2	3	4	5
The notice period for each director	0%	0%	4%	19%	77%
What would be payable in the event of termination of a directors' contract?	0%	0%	4%	11%	85%

Is sufficient information generally provided on what would be payable in the event of termination?

Generally insufficient			Generally sufficient	
1	2	3	4	5
19%	22%	33%	19%	7%

If not generally sufficient, what further information would be helpful?

23 respondents provided commentary of what further information would be helpful:

- greater detail of termination provisions e.g. bonus, long-term incentives, pensions, other benefits;
- extent to which options/performance shares would vest on termination ;
- statement as to whether mitigation is applied at termination; and
- greater clarity regarding change of control provisions.

Other comments included: disparities between expected and actual payments; early retirement pension provision; extent of remuneration committee discretion; and the need for an explanation of non-conformity with best practice guidelines.

Is sufficient explanation given of any termination payments made in the year?

Generally insufficient			Generally sufficient	
1	2	3	4	5
19%	19%	30%	26%	6%

If not generally sufficient, what further information would be helpful?

17 respondents provided commentary of what further information would be helpful:

- more explicit breakdown of how the payment on termination is calculated;
- description of mitigation policy and whether it is being applied; and
- description of rationale for when discretion is exercised by the remuneration committee.

Other comments included: justification of payments made; announcement at time of payment rather than in remuneration report; explanation of payment made outside stated policy.

6. Performance graph

How important is the performance graph in understanding the relationship between performance and reward?

Not very important				Critical
1	2	3	4	5
33%	26%	34%	0%	7%

Does the performance graph provide sufficient information to allow you to understand this relationship?

Generally insufficient			Generally sufficient	
1	2	3	4	5
37%	26%	33%	0%	4%

If not generally sufficient, what further information would be helpful?

20 respondents provided commentary of what further information would be helpful:

- comparison of how the company has performed relative to performance targets for long-term incentive and share option plans;
- performance shown versus the comparator or peer group; and
- demonstration of performance over a 1, 3, and 5 year period rather than just over 5 years.

Other comments included: explanation of the relationship between performance and actual vesting; rationale for remuneration committee discretion and rationale for exceptionally large awards.

7. Pension arrangements

How important is it to understand the pension arrangements in place for directors?

Not very important				Critical
1	2	3	4	5
0%	0%	11%	33%	56%

Is sufficient information generally provided on the pension arrangements?

Generally insufficient			Generally sufficient	
1	2	3	4	5
11%	26%	15%	33%	15%

If not generally sufficient, what further information would be helpful?

15 respondents provided commentary of what further information would be helpful:

- a clearer, standardised format, possibly disclosed in a separate section;
- greater clarification/explanation where large enhancements in pensions are made i.e. outside of normal practice; and
- disclosure of pension costs to the company.

Other comments included: detail of early retirement provisions; comparisons with all employee arrangements; explanation of basis for special arrangements; the basis of funding; the basis on which the level of contributions has been determined and disclosure of full pension entitlement.

8. Dilution

How important is the disclosure of information relating to dilution such as:

	Not very important			Critical	
	1	2	3	4	5
The dilution limits included in share plans	0%	0%	8%	12%	80%
The level of current dilution	0%	0%	12%	35%	53%

If information on current levels of dilution is important to you, please indicate what information would be helpful in addition to the following best practice guidelines:

- total number of shares committed at the start of the Financial year;
- total number of additional shares committed in the year;
- total number of shares committed at the end of the year; and
- proportion of shares committed at the end of the year compared to the 5% and 10% ceilings.

18 respondents provided commentary of what further information would be helpful:

- explanation of basis for any breach of dilution guidelines and how the breaches will be handled;
- inner flow rate policy;
- dilution per annum that is permitted;
- details of constraints on headroom and year end position;
- disclosure where recently the slate has been wiped clean regarding dilution;
- details of annual shares awarded and annual lapse rates; and
- details of the split between market purchase and newly issued shares used to satisfy share award.

9. Amount of directors' emoluments

How important is it that you can easily identify the overall quantum that may be earned by directors in a year?

Not very important				Critical	
1	2	3	4	5	
0%	0%	12%	44%	44%	

In general is sufficient information disclosed and presented in a clear way to allow this?

Generally insufficient			Generally sufficient	
1	2	3	4	5
7%	22%	42%	22%	7%

If not generally sufficient, what further information would be helpful?

15 respondents provided commentary of what further information would be helpful:

- potential/actual gains in the current year for all outstanding plans;
- consistent method required for valuing share based schemes and pensions;
- year-on-year comparisons;

- comparisons of all remuneration components versus peer group median;
- greater transparency of disclosure i.e. all components shown in one place; and
- differentials between executive and average employee pay or below board pay.

Please rank the following methods of valuing long-term incentive awards from 1 to 4, 1 being the most useful:

- face value of awards;
- projected value for on-target performance on the basis of share price growth assumptions;
- projected maximum value on the basis of share price growth assumptions; and
- expected value using an option pricing model (such as Black Scholes or Binomial).

26 respondents answered this question, with 9 attributing joint rankings to some of the options. Whilst no clear conclusion can be drawn from the responses, there are some general observations:

'Face value' versus 'Expected value'. These tended to be ranked either as 1 or 4 on a fairly even divide, demonstrating highly diverse shareholder preference as to their usefulness.

Projected value based on share price growth assumptions – 'on target performance' versus 'maximum'. These were very evenly rated against each other, and were often placed at ranking 2 or 3. Where joint rankings were provided by respondents it was mostly with regards to these two options. Overall a slight preference for 'on target performance' was indicated.

Other comments provided by respondents: all four are significant and all share price assumptions can vary and distort clarity.

10. Overall effectiveness of disclosure

Which aspects of the Directors' Remuneration Report Regulations have had the most significant impact on attitudes and behaviours?

	Little or no impact					Very significant				
	1	2	3	4	5	1	2	3	4	5
The vote on the remuneration report	4%	0%	4%	22%	70%					
Disclosure of policy on incentive plans and related performance conditions	7%	7%	26%	30%	30%					
Inclusion of the performance graph	55%	26%	19%	0%	0%					
Details of service contracts including provisions for early termination	7%	7%	22%	38%	26%					

In general how effective is the communication of remuneration strategy, philosophy and practice?

Not very effective					Very effective				
1	2	3	4	5	1	2	3	4	5
11%	4%	44%	37%	4%					

Has the extent to which companies actively consult with you about remuneration increased since the introduction of the Regulations?

Not at all					To a large extent				
1	2	3	4	5	1	2	3	4	5
0%	0%	7%	33%	60%					

Is the level of engagement sufficient?

Generally insufficient			Generally sufficient	
1	2	3	4	5
4%	0%	19%	47%	30%

Is the level of disclosure required by the Regulations sufficient to identify where rewards are inadequately linked to performance?

Generally insufficient			Generally sufficient	
1	2	3	4	5
7%	7%	37%	37%	12%

What further disclosure would be helpful and how might this best be encouraged?
17 respondents provided commentary on further disclosure:

- shared understanding of best practice rather than Regulation;
- greater transparency of performance targets and awards for annual bonuses; and
- disclosure of policy/approach on below board and/or all employee pay.

Other comments included: disclosure of overall quantum with assumptions; vesting-related disclosure should be encouraged; details of remuneration consultants' mandates and any conflicts of interest; details of payments made before the year end and publication of report, with reasons.

General comments on Directors' Remuneration Report Regulations

- greater explanation of performance linkage to reward and company objectives;
- greater clarity in structure and layout of information; and
- variation of quality and extent of disclosure between companies.

11. Appendix 3 – details of Deloitte's compliance analysis

This research is based on a Deloitte analysis of companies' annual report and accounts.

The compliance review contains an analysis of the disclosure in FTSE 350 companies from their latest remuneration report in relation to the Directors' Remuneration Report Regulations. The companies reviewed in the FTSE 350, excluding Investment Trusts, total 319 of which three are newly listed and have not yet published a remuneration report. The analysis is therefore based on 99 FTSE 100 companies and 217 FTSE 250 companies.

In order to provide context, this section provides quotes of relevant extracts from the Regulations. These extracts, and their paragraph numbers as stated in the Regulations, are shown in bold to distinguish them from the main text of the Report.

Members' approval of directors' remuneration report

The company must, prior to the meeting, give to the members of the company entitled to be sent notice of the meeting notice of the intention to move at the meeting, as an ordinary resolution, a resolution approving the directors' remuneration report for the financial year.

Although in the first year of reporting under the new Regulations there were a number of companies who bundled the resolution to approve the remuneration report with the resolution to receive and adopt the report and accounts, in the second year of reporting these instances have all been rectified and all companies have included a separate resolution to approve the remuneration report.

Part 2 Information not subject to audit

Consideration of matters relating to directors' remuneration

2(1)(a) name each director who was a member of the committee at any time when the committee was considering any such matter

All but one of the FTSE 100 companies has disclosed the names of the remuneration committee members.

All but one of the FTSE 250 companies has disclosed the names of the remuneration committee members.

The two that have not disclosed the names did not have any non-executive directors and therefore did not have a remuneration committee at the time the latest annual report was printed.

Typically disclosure of members of the board and committees is good in annual reports. Many companies indicate membership/chairmanship of committees in the section on board members and biographies. It is also likely to be in the corporate governance statement as well as in the remuneration report itself. Companies also indicate changes to the composition of the committee during the year.

The requirement in the Combined Code to disclose attendance at meetings will further strengthen this area.

2(1)(b) name any person who provided to the committee advice, or services, that materially assisted the committee in their consideration of any such matter

Compliance with this Regulation is not clear cut; however most companies have disclosed both external and internal advisors to the committee.

Internal advisors

91% of FTSE 100 companies and 81% of FTSE 250 companies have disclosed the internal advisors to the company. In some cases the names of the individuals have been given but in most cases the job title(s) are provided. Where companies have been silent on this matter it is not clear if this is a lack of compliance, or if there have been no internal advisors to the committee. Only one FTSE 250 company has stated that the committee has access to internal advice but has not disclosed who from.

External advisors

Some companies have stated that the committee has taken no external advice. Only a very small number have not disclosed this information. However, as above, where companies have been silent on this matter it is not clear if this is a lack of compliance, or if the committee has not taken external advice.

The following table shows the level of disclosure regarding external advisors.

	FTSE 100	FTSE 250
Disclose the external advisors	94%	87%
Disclose sources of information	2%	1%
Disclose that no external advice has been taken	3%	8%
Do not disclose advisors	1%	4%

For the avoidance of doubt, this Regulation could be tightened up to require companies to disclose where no advice, internal or external, has been taken.

2(1)(c)(i) in the case of any person named under paragraph (b) who is not a director of the company state the nature of any other services that that person has provided to the company during the relevant financial year

89% of FTSE 100 companies and 78% of FTSE 250 companies disclose the other services provided to the company by the external advisors. Again, it is not clear whether non-disclosure is because no other services are provided or whether this is non-compliance.

However it is worth noting that in seven companies (one of these a FTSE 100 company) one of the named advisors is the company's auditor and this has not been disclosed.

The Regulation could be tightened to require disclosure of whether any other services have been provided, and if so, what these are.

2(1)(c)(ii) in the case of any person named under paragraph (b) who is not a director of the company state whether that person was appointed by the committee

The majority of companies have disclosed whether the advisors are appointed by the company or the remuneration committee. However the disclosures in this area are not straightforward as in some cases this does not appear to be a formal appointment and in these cases a statement may be included to the effect that the committee has taken advice from, or has consulted with, but not appointed, the advisor. In some cases the advisor might be appointed by the company at the request of the committee. In other cases one advisor may be appointed by the committee and another by the company.

The Regulation could be made clearer by requiring disclosure of who appointed the advisor, rather than whether the appointment was made by the committee. For more transparency it may be helpful for companies to disclose the process by which advisors are appointed.

Summary

There is a high level of compliance with the disclosure requirements in Section 2. Where there appears to be non-compliance this may be, in many cases, because the particular issue does not apply rather than non-disclosure. Minor changes to the wording of the Regulations would provide more clarity in these areas.

Statement of company's policy on directors' remuneration

3(1) The directors' remuneration report should contain a statement of the company's policy on directors' remuneration for the following financial year and for financial years subsequent to that.

All reports include a statement of policy. The level of detail included in the policy statement varies greatly. The policy for subsequent years is not generally disclosed and where this is acknowledged it is justified on the basis that the remuneration committee needs to retain flexibility to adjust the policy to take account of the changing environment.

The elements to be disclosed in the policy statement are listed but it is unclear whether it is intended that a general overview of policy should be included in addition to these. Many remuneration reports already include one or more of the following:

- the key factors influencing the remuneration policy;
- the markets in which the company competes for talent;
- how the remuneration package is benchmarked against other companies, and which companies are used;
- explanation of the level of salary increases; and
- the wider context of all employee reward.

Some examples of best practice starting to emerge in some of these areas are included in Appendix 4. Extending the Regulations to require some or all of these issues to be disclosed is not likely to be helpful in that the nature of relevant information will vary between companies and it is difficult to be prescriptive about what should be included. Current best practice guidelines, particularly those of the ABI and the NAPF, provide guidance on what information is helpful and this may be a more appropriate place for such guidance.

However changing Regulation 3(1) to specifically require companies to disclose the current policy and to outline any proposed changes to this policy for the following financial year, with the reasons for these changes, may provide more clarity, resulting in more helpful disclosure. Changes to the policy could include the introduction of new incentive plans, any shift in the balance of the remuneration package, changes to performance conditions, vesting schedules or comparator companies, changes to service contracts and notice periods and pensions policy.

3(2)(a) the policy statement shall include for each director, a detailed summary of any performance conditions to which any entitlement of the director to share options, or under a long-term incentive scheme, is subject

The level of detail disclosed relating to performance conditions in long-term plans is generally very good. It is also worth noting that there is also a high level of detail provided in shareholder circulars when plans are put forward for approval.

Of the 99 FTSE 100 companies, one does not have any share option or long-term plans in place for executive directors. Of the 217 FTSE 250 companies, two do not operate share option or long-term plans.

Of the remainder only one FTSE 100 company does not include a description of the performance conditions included in these plans. 6% of FTSE 250 companies do not include a description.

It should be noted that it is quite unusual for the performance conditions to differ for individual directors participating in a long-term plan. Therefore, companies typically disclose the performance conditions included in the plan, and not for individual directors.

It may therefore be helpful to change the Regulations to require disclosure of the performance conditions included in the plan with any differences applicable to individual directors clearly identified.

3(2)(b) the policy statement shall include an explanation as to why such performance conditions were chosen

78% of FTSE 100 companies and 65% of FTSE 250 companies disclose why the performance conditions were chosen. However the level of explanation is variable. In most cases the explanation consists of a broad statement such as 'total shareholder return was chosen as this aligns the interests of directors with shareholders'. Few companies have made any real attempt to explain the rationale behind the choice of one or more performance conditions and how they interact. The following table shows the level of disclosure relating to this Regulation:

	FTSE 100	FTSE 250
No explanation or inadequate explanation	22%	35%
Broad statement only	49%	43%
Some details	10%	11%
Good level of detail	19%	11%

It is difficult to be prescriptive about the level of detail required to adequately explain why the performance conditions were chosen. There is detailed guidance in relation to the use and disclosure of performance conditions in the best practice guidelines issued by the ABI and the NAPF and therefore it may be more appropriate to monitor this issue over the next one to two years with a view to extending the Regulations at that time if it is apparent that companies are not responding sufficiently to the guidelines.

3(2)(c) the policy statement shall include a summary of the methods to be used in assessing whether any such performance conditions are met and an explanation as to why those methods were chosen

The level of disclosure in relation to this part of the Regulations suggests a lack of clarity as to what should be disclosed. Only 42% of FTSE 100 and 41% of FTSE 250 companies have included a summary of the methods to be used in assessing whether the performance conditions are met. This usually takes the form of a statement that the calculations of TSR will be undertaken by an independent external source, or that the method of calculating EPS is a recognised standard. Where EPS, or other financial measures have been used, there may be some detail as to what is included/excluded in this calculation. There will also often be a statement that the remuneration committee have some discretion over the level of vesting. There is rarely any explanation of why the methods have been chosen.

This Regulation could be made clearer by including a requirement to disclose whether the assessment is independently verified and whether, and in what circumstances, the remuneration committee has discretion in deciding the level of award that will be made.

3(2)(d) the policy statement shall include – if any such performance condition involves any comparison with factors external to the company – (i) a summary of the factors to be used in making each such comparison and (ii) if any of the factors relates to the performance of another company, of two or more other companies or of an index on which the securities of a company or companies are listed, the identity of that company, of each of those companies or of the index

Where companies compare performance against a comparator group or an index this is usually identified. Only 1% of FTSE 100 companies and 5% of FTSE 250 companies have failed to do so.

However there is wide variation in the level of detail in respect of historical, current and future awards. Some companies list all the companies for each outstanding award, some list the companies currently being used, some list the companies and highlight any variations for previous and future awards. The Regulations could be tightened up here, perhaps to require the disclosure of the companies, or index, for awards made in the financial year, with an explanation of any change from those used for previous awards, or expected change for future awards.

There is no requirement to explain changes to comparator companies although some companies choose to include an explanation. While this could be addressed in Regulation we believe that where this raises unanswered questions this will prompt communication between shareholders and companies and will over time lead to better disclosure in this area.

3(2)(e) the policy statement shall include a description of, and an explanation for, any significant amendment proposed to be made to the terms and conditions of any entitlement of a director to share options or under a long-term incentive scheme

It is not common for the terms and conditions of an existing entitlement to be changed; few remuneration reports include any such disclosure and it is not possible to say whether this is because there has been no such amendment or whether the company has failed to disclose any such amendment. However our experience suggests that this information would typically be disclosed. For the avoidance of doubt, the Regulations could be changed to require a statement to the effect that no such changes have been made, or where they have been made a description and explanation of the changes to be disclosed.

3(2)(f) the policy statement shall include if any entitlement of a director to share options, or under a long-term incentive scheme, is not subject to performance conditions an explanation as to why that is the case

There are very few companies in the FTSE 350 where executive directors are eligible to participate in plans currently being operated which have no performance conditions. There may be outstanding options with no performance conditions and where this is the case it is usually explained, and is usually a result of options granted under old plans at a time when it was not common market practice to incorporate performance conditions, or where options have been granted to a new incumbent to compensate for loss of earnings at a previous employer, or where options were granted prior to becoming a director. As far as we are aware there are four FTSE 100 companies and seven FTSE 250 companies where options have been granted recently with no performance conditions and where this has not been explained.

There is therefore a high level of compliance with this Regulation.

Summary to Section 3(2) of the Regulations

There is a high level of compliance with this part of the Regulations apart from the requirement to disclose the methods used in assessing whether performance conditions have been met and an explanation of why this method was chosen.

A better explanation of why the performance conditions have been chosen would be helpful but this is an area which is improving and will continue to improve as a result of shareholder pressure.

It is also helpful to have an indication of the vesting schedule for awards so that it can clearly be seen what level of award will be earned for what level of performance. Many companies already do this in the remuneration report, and most include this in details of new plans circulated to shareholders for approval. Requiring companies to include full details of proposed new plans in the remuneration report would assist in this. This is another area that is likely to continue to improve over the next year.

On the point of assessing how the performance conditions have been met there could be more clarity in the Regulations. This might include a requirement to disclose whether the assessment is carried out by an independent external source and some information on the level of discretion the remuneration committee has in deciding what level of award will be made, and in what circumstances this would be used.

3(3) The policy statement shall, in respect of each director's terms and conditions relating to remuneration, explain the relative importance of those elements which are, and those which are not, related to performance

Compliance with this Regulation is variable suggesting that there is some confusion about what level of detail is required. The following table shows the level of disclosure.

	FTSE 100	FTSE 250
No details	12%	26%
Broad statement only	27%	49%
A breakdown of the proportion of the package that is related to performance	61%	25%

Where companies have included a broad statement, this will typically state that a significant proportion of remuneration is linked to performance, or that an appropriate balance is struck between fixed and performance related remuneration.

A substantial proportion of FTSE 100 companies have included a breakdown of the package, either generally or for each individual director. 21% of FTSE 100 companies and 10% of FTSE 250 companies have illustrated this with charts, or in a table. However in order to provide a breakdown of the remuneration package, it is necessary to place a value on the long-term elements of the plan, or alternatively to show what was actually earned in the year, and what vested under long-term plans in the year. Companies have chosen a variety of ways to do this, and so any comparison between companies is problematic. Companies rarely include the benefits, or the pension in these calculations.

It is perhaps unclear what 'explain' in this context means. The broad statement often included is not very illuminating. A breakdown is helpful to a point as long as the company explains the basis of the calculation. What is typically missing is any indication as to why this balance is appropriate in the particular circumstances of the company, and if it changes over time, the reasons for this.

There are a number of ways in which the Regulations could be tightened in this area :

- requiring a breakdown of the package to be disclosed and including the basis on which the calculation should be shown – this is not an easy issue to resolve as there are a number of alternatives which are all valid. This could be made more specific, whilst still leaving companies with the choice of exactly what basis to use, by requiring the breakdown to be shown for 'on-target' performance, or for the maximum which may be earned;
- requiring details of the basis on which the calculation has been done;
- requiring companies to disclose how the make up of the package has changed over time;
- requiring companies to explain why this balance is appropriate for the business; and
- requiring companies to explain any differences between directors.

Recommendations on this point are summarised in Section 8.

3(4) The policy statement shall summarise, and explain, the company's policy on – (a) the duration of contracts with directors, and (b) notice periods, and termination payments, under such contracts

There appears to be some confusion between Section 3(4) which asks for details of the company policy and Section 5 of the Regulations which asks for similar details for each individual director. In some companies where there have been no recent board appointments policy and practice may in effect be the same thing and where companies have disclosed the individual details this may be considered sufficient.

Generally speaking there is a high level of disclosure on the length of service contracts and notice periods for each individual director (see Section 5 below). Many companies provide this in tabular form for clarity. The approach to disclosure of company policy is not so consistent, with 89% of FTSE 100 companies and 70% of FTSE 250 companies disclosing information on the duration of contracts. 89% of FTSE 100 companies and 77% of FTSE 250 companies also disclose the policy on notice periods.

Disclosure of termination payments is variable. The following table shows the level of disclosure on termination payments.

	FTSE 100	FTSE 250
No provision for payment in the event of early termination	21%	26%
No details	23%	20%
Some details of what would be included in the payment	34%	41%
Full details of what would be included in the payment	23%	13%

It should be noted that although the Regulations do not specifically require it, many companies include details of any specific provisions in the event of termination following a change in control. Historically it has been relatively common for the notice period to increase in these circumstances and this has been an area which has come under much pressure from shareholders.

Many companies (52% of FTSE 100 companies and 42% of FTSE 250 companies) also disclose the policy with regard to mitigation, or disclose details of policies such as phased payments.

It is also worth noting that whereas most companies provide an explanation as to why current policy and/or practice for individual directors does not comply with best practice guidelines, in 9% of FTSE 100 and FTSE 250 companies where this is the case there is no explanation given.

Summary to Section 3(4) of the Regulations

The level of disclosure in the information disclosed on service contracts, notice periods and termination payments is variable. Possible changes to the Regulations include:

- combining the policy and individual director practice into one section. This could include a policy section with the requirement to detail any deviation from policy for individual directors;
- the disclosure requirement on policy should make it clear that this is the policy that would apply to new appointments going forward;
- a requirement to disclose the principles on which the determination of the termination payment would be based, how this would vary in the event of a change in control, and details of specific principles of mitigation, including phased payments etc; and
- a requirement to disclose the principles on which the determination of what would vest under long-term plans in the event of termination would be based could also be included.

Performance graph

4(1)(a) The directors' remuneration report shall contain a line graph that shows for each of (i) a holding of shares of that class of the company's equity share capital whose listing, or admission to dealing, has resulted in the company falling within the definition of "quoted company" and (ii) a hypothetical holding of shares made up of shares of the same kinds and number as those by reference to which a broad equity market index is calculated, a line drawn by joining up points plotted to represent, for each of the financial years in the relevant period, the total shareholder return on that holding

All FTSE 100 and all but three FTSE 250 companies include a graph. The three that do not are recently floated companies for which there is less than a year of data to compare.

One FTSE 100 company and one FTSE 250 company has not complied strictly with the Regulations as the graph is not in the remuneration report but is contained in the general review of company performance. One FTSE 250 company has not included a broad index as the comparator but only the specific company comparator group. Apart from this all companies include a compliant graph.

4(1)(b) The directors' remuneration report shall state the name of the index selected for the purpose of the graph and set out the reasons for selecting that index.

All companies show the name of the index chosen. 8% of FTSE 100 companies and 6% of FTSE 250 companies do not provide the reason for choosing the index. The reasons for choosing the index are generally broad statements such as 'a broad index of which the company is a constituent'. Whilst compliant this is not helpful in understanding why a company has chosen a particular index.

The following table shows, for interest, which companies have chosen to show which indices:

	FTSE 100	FTSE 250
Comparator group	0%	1%
FTSE 100	54%	3%
FTSE 100 and comparator group	8%	0%
FTSE 100 and FTSE 250	2%	1%
FTSE 100 and FTSE 350	1%	0%
FTSE 100 and international index	4%	0%
FTSE 100 and sector	7%	0%
FTSE 100, FTSE 250 and sector	1%	0%
FTSE 100, international index and comparator group	3%	0%
FTSE 100, international index and sector	1%	0%
FTSE 250	2%	33%
FTSE 250 and All Share	0%	1%
FTSE 250 and comparator group	0%	1%
FTSE 250 and sector	0%	9%
FTSE 250, sector and comparator group	1%	1%
FTSE 350	2%	6%
FTSE 350 and comparator group	0%	1%
FTSE 350 and sector	0%	3%
FTSE 350 sector	0%	4%
FTSE All Share	4%	5%
FTSE All Share and comparator group	0%	1%
FTSE All Share and FTSE 350 sector	1%	1%
FTSE All Share and sector	2%	1%
FTSE Fledgling	0%	1%
FTSE Small Cap	0%	2%
FTSE Techmark	0%	1%
FTSE sector	7%	23%
Sector and comparator group	0%	1%

However despite the lack of detail in the explanation statements, we do not believe additional regulation in this area is necessary; from the shareholder perspective, the graph has limited value in addressing the linkage between performance and remuneration.

Service Contracts

5(1)(a) The directors' remuneration report shall contain, in respect of the contract of service or contract for service for each person who has served as a director of the company at any time during the relevant financial year, the date of the contract, the unexpired term and the details of any notice period

5(1)(b) The directors' remuneration report shall contain, in respect of the contract of service or contract for service for each person who has served as a director of the company at any time during the relevant financial year, any provision for compensation payable upon early termination of the contract

5(1)(c) The directors' remuneration report shall contain, in respect of the contract of service or contract for service for each person who has served as a director of the company at any time during the relevant financial year, such details of other provisions in the contract as are necessary to enable members of the company to estimate the liability of the company in the event of early termination of the contract

It appears that many companies have had difficulty in distinguishing clearly between the disclosures required by 5(1)(b) and 5(1)(c).

As noted above the disclosure on individual details of service contracts and notice periods is generally of a high level. 92% of FTSE 100 companies and 87% of FTSE 250 companies disclose the date of individual contracts and 95% of FTSE 100 companies and 90% of FTSE 250 companies disclose the notice period for each individual director.

Combining this disclosure with the policy information and requiring companies to disclose where individual details vary from company policy may provide more clarity in this disclosure.

As with the policy information, there is less information provided on the provisions for payments in the event of early termination and on the requirement to disclose details to allow the liability of the company to be estimated. The following table shows the level of disclosure in these two areas:

	FTSE 100	FTSE 250
5(1)(b)		
No provision for payment in the event of early termination	16%	20%
No details	18%	20%
Some details of what would be included in the payment	38%	40%
Full details of what would be included in the payment	28%	20%
5(1)(c)		
No provision for payment in the event of early termination	15%	20%
No details	19%	18%
Some details	39%	42%
Full details	27%	20%

Recommendations on what could be changed in order to improve the disclosure on service contracts, notice periods and termination payments are given in Section 8.2.

Part 3 Information subject to audit

There do not appear to be any major issues with compliance with this part of the Regulations. There is one FTSE 100 company where the pension details are in the notes to the accounts and not in the remuneration report and three FTSE 250 companies where all of the audited information is in the notes to the accounts and not in the remuneration report, although it should be noted that the location of this information is referenced in the remuneration report.

There are a number of observations that relate to the audited information:

New appointments

Where a director has been appointed during the year compliance with the Regulation requires that the total amount of salary and fees paid to or receivable by the person in respect of qualifying services is disclosed. This means that the package of a newly appointed director is not known until the following year. It may be helpful to require separate disclosure regarding the details of the package for a new appointment, including awards under long-term plans, both those made for recruitment purposes and those made as part of the normal policy. Many companies already do this.

Total remuneration

To satisfy shareholder concerns about the difficulties in understanding the total remuneration for a given director, it may be helpful to require all elements of the package to be disclosed in the same table. For example, the salary, fees, value of benefits, actual bonus received in the year, potential maximum bonus that could have been earned and face value of any option grant or long-term award.

Discretionary awards

It may be helpful to include a specific requirement to explain discretionary awards under annual or long-term incentive plans. This is an area of concern for many shareholders and, although not common, typically where awards are made they are mentioned in the footnotes to the remuneration table and rarely adequately explained. In some cases they may not be referred to at all. We are only aware of 3% of FTSE 100 companies and 5% of FTSE 250 companies where discretionary awards appear to have been made and in many cases this will only be to one director. However of these, only two have, in our view, adequately explained the reasoning behind the awards.

Pension

The level of detail on pension plans has actually decreased since the introduction of the Regulations since there is no requirement to disclose the policies in place and previously many companies had chosen to include this information. Although some companies still do so, many do not. One particular area which shareholders have indicated would be helpful is an understanding of how the pension provisions in place for executive directors differ from those in place for other employees.

However in light of the introduction of the new tax regime for pensions it is recommended that this is an area which is not addressed at this time. Companies are likely to be reviewing pension policy over the next year and it will be some while before it is clear what the impact of the new legislation in this area is likely to be and therefore it is difficult to identify what information is likely to be most helpful.

12. Appendix 4 – examples of disclosure

This section provides examples of where companies have provided information in a clear and helpful manner and ways in which companies have disclosed information above and beyond that currently required by the Regulations.

Context of the wider employee population

Level	Number of employees	Salary range	Bonus opportunity (% of salary)	
			Target	Maximum
1	32,750	£10,700 – £16,000	10% – 12%	20% – 30%
2	11,500	£16,100 – £24,100	10% – 12%	20% – 30%
3	9,250	£22,900 – £34,300	10% – 12%	20% – 30%
4	4,500	£31,700 – £47,500	10% – 12%	20% – 30%
5	1,750	£44,700 – £67,000	17.5%	35%
6	600	£59,700 – £89,500	25%	50%
7	100	£97,800 – £146,700	30%	45%

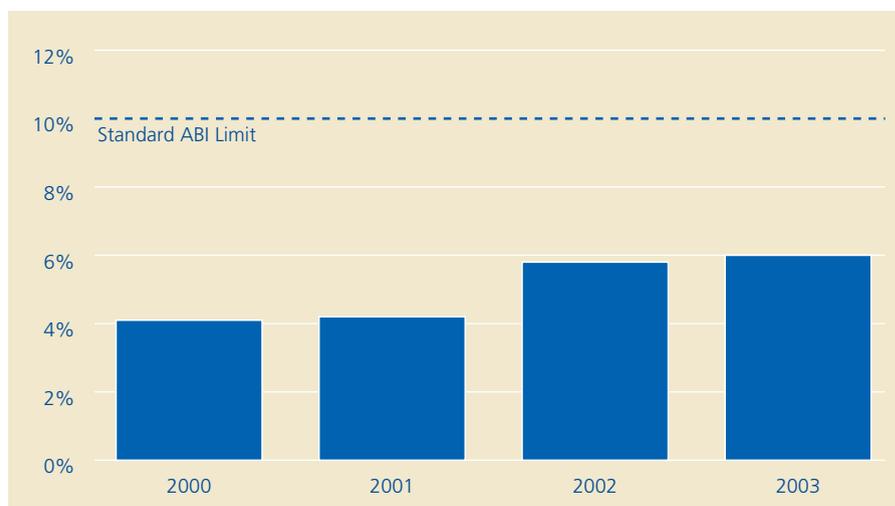
Summary of executive directors' remuneration and share interests

	CEO	FD
Year of appointment to the Board	1999	1993
Annual salary		
1 April 2003	£495,000	£295,000
31 March 2004	£495,000	£295,000
Annual incentive plan		
2003/2004 payment	£175,000	£105,000
% of salary paid	35%	36%
2004/2005 maximum % of salary	60%	60%
Equity investment plan 2000/2005		
Investment shares held as % of salary	150%	100%
Number of shares	45,034	28,465
Maximum matching multiple – 1st place out of 16	3	3
Minimum matching multiple – 8th place out of 16	1	1
Executive share options		
Year in which first options granted	1987	1996
Total options awarded to date	460,544	189,464
Total options exercised/lapsed to date	(220,768)	–
Options to be exercised	203,669	189,464
Value of options to be exercised	£407,456	£301,545
Gains on options exercised during year	nil	nil
SAYE share options		
Total options outstanding	1,416	1,245
Value of options to be exercised	£2,543	£2,176
Gains on options exercised during year	nil	£3,556
Shares beneficially owned		
1 April 2003	176,786	34,877
31 March 2004	276,454	50,987

Example of summary of executive remuneration policy

	Element	Objective	Performance period	Performance conditions
Annual	Base salary	Maintain package competitiveness at all levels with the Group.	Not applicable	Not applicable but salary levels are determined taking a number of relevant factors into account, including individual and business unit performance, level of experience, scope of responsibility and the competitiveness of total remuneration.
	Performance bonus	Incentivised delivery of value at all levels of the Group. A deferral opportunity provides further alignment with share owner interests.	1 year	Achievement of challenging performance goals (financial and non-financial) at the individual and operating company level and independent of an executive's position within the Group.
Long-term	Executive share option plan	Aimed at high performers in operating companies to develop a stronger employee ownership culture. Currently not offered to parent company executive directors.	3 years	Achievement of various stretching TSR and EPS conditions.
	LTIP	Aimed at key executives in Group operating companies to align reward with achievement of targeted performance measures.	3 years	Achievement of specific operating company performance measures such as: <ul style="list-style-type: none"> • Improvement in operating profit. • Improvement in operating margin.
	PSP	Aimed at all executive directors and other key parent company executives to incentivise long-term performance against key comparators.	3 years	Relative TSR performance against a group of key comparator companies, subject to the recorded TSR, in the committee's view, being consistent with the achievement of underlying financial measures.
	Co-investment plan	Participation only offered to parent company executive directors and key operating company executives who transcend their day to day role. Incentivises long-term performance against key comparators and maximises alignment with share owner interests through high level of personal financial commitment.	5 years	Relative TSR performance against a group of key comparator companies, subject to the recorded TSR, in the committee's view, being consistent with the achievement of underlying financial measures.

Dilution chart



Dilution table

Example 1

	2004
Total issued share capital as at 31 March 2004	256.6m
All schemes	
10% in any consecutive 10 years	25.6m
Remaining headroom	15.8m
Executive schemes	
5% in any consecutive 10 years	12.8m
Remaining headroom	6.9m

Example 2

Ordinary shares			838,269,490	
5% limit			41,913,475	
10% limit			83,826,949	
		Total awards		Headroom
		No of shares		% of capital
			No of shares	% of capital
Executive share option plan	23,927,967	2.85		
Performance share plan	6,887,365	0.82		
Total under discretionary plans	30,815,332	3.68	11,098,142	1.32
Savings related share option plan	8,405,627	1.00		
Employee stock purchase plan	1,650,577	0.20		
Total under all plans	40,871,536	4.88	42,955,413	5.12

Performance review

The following table summarises the TSR for the last five years of ABC plc's ranking relative to the comparator group.

TSR	1999 %	2000 %	2001 %	2002 %	2003 %
Upper quartile	80	22	29	1	51
Median	30	7	4	-15	35
Lower quartile	-1	-10	-12	-32	15
ABC plc	-4	26	13	23	32
ABC's ranking (of 49)	37th	11th	19th	3rd	26th

General policy statement

Example 1

The company's objective is to attract, retain and motivate high quality directors and managers to perform at the highest levels over the short, medium and long-term. In fulfilling this objective the company fully embraces and complies with the principles of the Combined Code on directors' remuneration as outlined below.

In order to ensure continuing market competitiveness, the ongoing level of executive directors' remuneration is reviewed against median practice in a comparator group of companies as well as constituents of the FTSE 100. For 2004/05 onwards, the comparator group has been reviewed and changes made to ensure that the balance of companies in each of the sectors appropriately reflects the company's business. Changes have also been made to this group to replace companies that are no longer constituents of the FTSE 100.

The comparator group is formed of 30 companies from sectors which reflect different aspects of the company's business. The comparator companies are primarily constituents of the FTSE 100 index reflecting the company's size in terms of market capitalisation.

This comparator group will be used as a basis to benchmark remuneration levels for executive directors and other senior executives as well as to determine the company's relative performance under the proposed new long-term incentive plan which is outlined below.

Remuneration benchmarking is also undertaken against other appropriate organisations as well as the wider FTSE 100 on the advice of the advisers to the remuneration committee.

The membership of the comparator group for 2004/05 onwards is.....

Executive directors are rewarded on the basis of individual responsibility, competence and contribution, and salary increases also take into account pay awards made elsewhere in the Group. Performance-related elements form a substantial part of the total remuneration package and are designed to align the interests of directors with those of shareholders. Performance is measured on the basis of a 'balanced scorecard', which reflects the company's core objectives.

During 2003, the remuneration committee undertook a review of the company's remuneration arrangements for its executive directors and other senior executives to ensure that they remain appropriate in the light of the company's business needs and future strategy, are market competitive and take account of external developments in executive pay.

Following the review, the Committee made a number of adjustments to senior executive remuneration arrangements within the context of the existing remuneration strategy.

The changes, which are detailed in the report below, will ensure that the remuneration arrangements continue to be in line with best practice and the interest of shareholders, and that executive packages remain broadly at median levels, reflecting a market competitive position when measured against the comparator FTSE 100 companies. The changes will take effect in the year ending March 2005.

No change is proposed to base pay policy and, as a result, a greater proportion of the total package will be performance-related. Reward levels will remain dependent on the achievement of demanding corporate and individual performance targets, ensuring continued close alignment between executive reward and enhanced shareholder value.

Example 2

The company needs to be able to employ and retain international employees of the highest calibre with the necessary skills, capabilities and experience to execute its business strategy and thereby deliver strong growth. The catchment area for recruitment is increasingly outside the UK and the required talent is scarce.

The overriding principles of our remuneration policy are:

- to enable the recruitment and retention of this limited resource; and
- to reinforce our strong performance ethic.

Accordingly, the central premise of the policy is that, while reward arrangements should be market competitive, employees should look to performance related incentives rather than base salaries to achieve above average reward. Performance related incentive schemes form a significant proportion of the total reward package for executives and are designed to align executives' interests with those of shareholders and establish a clear link between pay and performance.

To implement our policy, we have a well-developed, company-wide performance management system and we operate three complementary performance related incentive schemes for directors. The three schemes are the annual incentive scheme (AIS), the long-term incentive scheme (LTIS) and the Company share option scheme (CSOS). The AIS is designed to focus executives on the business priorities for the financial year and to reinforce our individual performance culture. The aim of the LTIS is to motivate participants to maximise total shareholder return as measured against a comparator group of companies over a period of three years. The CSOS aims to drive real earnings growth over the long-term. The mechanism used for measuring this is the growth in earnings per share relative to the growth in the retail price index, excluding mortgage interest repayments. Further details of the AIS, LTIS and CSOS can be found below.

The varying performance periods and performance conditions of the three schemes combine and complement each other to enable the measurement and reward of both short and long-term performance and of absolute (AIS), sustained (CSOS) and comparative (LTIS) financial performance.

The Committee reviews the remuneration policy on a regular basis and recommends changes as and when appropriate. No changes are proposed to the policy this year in so far as it applies to Directors' remuneration. However, the Company plans to review the use of the CSOS as the primary share based incentive vehicle for the broader employee population below senior management level.

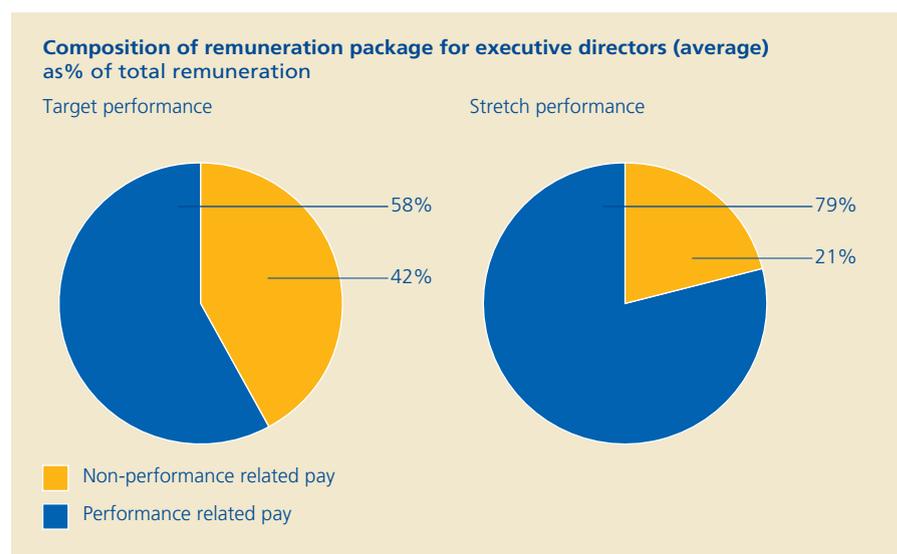
In defining the remuneration policy the remuneration committee takes into account advice received from external consultants and also best practice guidelines set by institutional shareholder bodies, including the revised principles and guidelines on executive remuneration issued by the Association of British Insurers (ABI).

Composition of remuneration package

Example 1

The proportion of each Executive Director's total remuneration that is performance related is significant even for target (which is based on budget) performance. For stretch (significantly above budget) performance, the total amount of remuneration payable is higher, as is the proportion of that total which is performance related.

In determining the relative importance of those elements of remuneration which are, and those which are not, performance related as required by the Regulations, we have, as last year, made a number of assumptions on the Company's share price growth and TSR, relative to the Company's comparator group, over the next three years.



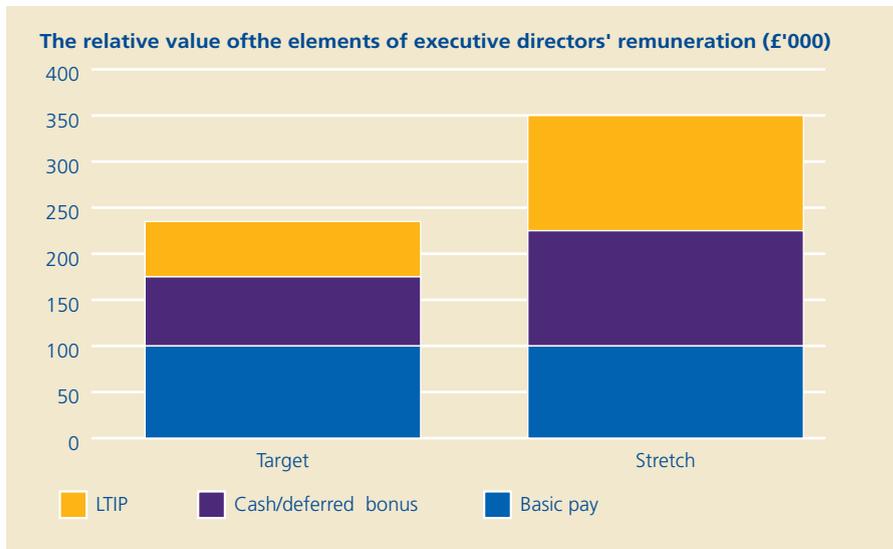
Example 2

The balance of these elements is such that, for directors achieving 'Target' performance, basic salary represents approximately 40% of the potential total remuneration package, with the annual bonus/deferred bonus plan representing 35% and the long-term incentive plan 25%. At 'Stretch' performance, basic pay represents approximately 28% of the potential total remuneration package, with the annual bonus/deferred bonus plan representing 36% and the long-term incentive plan 36%. 'Stretch' performance would represent the achievement of business significantly better than the business plan target.

For the purposes of the diagram, the following assumptions have been made:

At 'Target' performance – the annual bonus is 35% of basic pay and the executive director chooses to defer the whole of his bonus, which is matched. The Return on Capital Employed (ROCE) performance condition on the long-term incentive plan is met in full and the Company's total shareholder return (TSR) position is median resulting in the vesting of 50% of the shares awarded. The share price growth assumption during the three year performance period/deferral period averages 5% per year.

At 'Stretch' performance – the annual bonus is the maximum 50% of basic pay and the executive director chooses to defer the whole of his bonus, which is matched. The ROCE performance condition on the long-term incentive plan is met in full and the Company's TSR position is upper decile resulting in the vesting of 100% of the shares awarded. The share price growth assumption during the three year performance period/deferral period averages 10% per year.



Service Contracts

Example 1

Service contracts agreed with each executive director incorporate their terms and conditions of employment. Executive directors have rolling service contracts which came into effect from 1 June 2000 and which can be terminated by the Company giving 12 months' notice' and by the director giving 6 months' notice.

In respect of early termination of a service contract, the Company would, depending upon the circumstances, either seek to make a payment in respect of damages less an amount for appropriate mitigation, or would invoke a provision in the service contract allowing it to terminate the contract by making a payment of one year's basic salary in lieu of notice.

Under the Company's discretionary redundancy arrangements, which apply to United Kingdom based employees, an executive director may, depending on his length of service, receive an ex gratia payment of up to one year's basic salary should he leave employment on the grounds of redundancy. No special arrangements would apply should there be a change in control of the Company.

During the year, the Committee reviewed the terms of the service contracts and except in a few areas, the current contracts comply with much of what has come to be regarded as best practice. In respect of appointments made following the review, the contracts include provision to allow the Company to phase any termination payments over a 12 month period and include a specific requirement for employees to mitigate their losses. It is the Company's policy to notify to the market the terms offered to executive directors upon appointment.

Example 2

For newly appointed Executive Directors, the Committee has agreed a policy that termination payments, including compensation paid during any notice period, should not exceed 12 months' pay. Service contracts should be rolling and terminable on six months' notice. Contacts should also provide liquidated damages of six months' base salary, plus an amount equal to one time the average bonus paid (if any) in the two years up to termination.

In agreeing this policy, the Committee decided that any bonus earned should be included in the termination payment, on the basis that a high proportion of pay is related to Company results and that, in the event of termination for unacceptable business performance, it is unlikely that any bonus will have been paid. Liquidated damages also provide clarity for shareholders and executives, and are usual among the Company's peer group.

In 2003 the existing Executive Directors, agreed to changes in their service contracts to align them with this policy.

	Date of service contract	Date of amendment	Unexpired term	Notice period	Compensation for early termination
Chief Executive	3 December 1999	19 November 2003	n/a	6 months	0.5 x base salary + 1 x average bonus (if earned) in previous two years
Finance Director	21 July 2000	9 December 2003	n/a	6 months	0.5 x base salary + 1 x average bonus (if earned) in previous two years

Annual bonus

Example 1

	Target bonus (as a % of salary)	Maximum bonus (as a % of salary)	Weighting of target bonus objectives	
			Group	Personal
CEO	55%	100%	80%	20%
Executive directors	50%	75%	60%	40%

Example 2

	PBT target max bonus % salary	Individual financial performance target max bonus % salary	Personal objective max bonus % salary	Max total bonus % salary
CEO	30	20	20	70
Executive director 1	20	15	15	50
Executive director 2	20	25	5	50

Example 3

	Group profit targets % salary	Operational milestones % salary	Share price appreciation targets % salary	Total % salary
CEO				
Maximum bonus	70%	20%	10%	100%
Bonus payable	0%	5%	10%	15%
Finance Director				
Maximum bonus	60%	30%	10%	100%
Bonus payable	0%	10%	10%	20%

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