NAPF

Securing the future of pensions

2014 AGM Season Report

September 2014

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Executive summary

This is the second annual report from the NAPF looking back at the AGM season just gone and in advance of updating its Corporate Governance Policy & Voting Guidelines for the subsequent year.

The NAPF is the voice of workplace pensions in the UK. We speak for over 1,300 pension schemes that provide pensions for over 17 million people and have more than £900 billion of assets. Our members are significant long-term owners (and creditors) of UK companies.

The NAPF, representing the interests of our pension fund members, has been involved in developing governance standards for over 25 years. We believe high standards of corporate governance lead to better-run companies, creating better outcomes for pension funds and their end beneficiaries.

In parallel, the Stewardship Code issued by the Financial Reporting Council (FRC) aims to promote the long term success of companies in such a way that the ultimate providers of capital – commonly pension funds – also prosper. The NAPF has been a vocal supporter of the Stewardship Code since its inception.

The success of the UK Corporate Governance and Stewardship Codes is predicated upon open and constructive communication between companies and their shareholders. In recent years there has been a marked increase in both the quantity and quality of this dialogue. As with last year however, this report draws particular attention to those companies at which shareholders have expressed significant dissent at successive AGMs, indicating that this dialogue has scope for improvement.

The fifth Principle of the Remuneration Principles for building and reinforcing long-term business success which the NAPF published in 2013 in conjunction with Hermes EOS, RPMI Railpen, BT Pension Scheme and USS Investment Management encourages companies and investors to have appropriately regular discussions on strategy and long-term performance. Fulfilling this Principle requires the best efforts of both parties. We encourage all companies to reflect upon the feedback from their shareholders and endeavour to respond as appropriate.

Regulatory changes mean that this AGM season has seen renewed focus on the issue of remuneration. The report thus also devotes significant coverage to this matter.

Away from the focus on the high profile territory of executive remuneration other changes to corporate reporting have exceeded expectations and brought to greater attention the vitally important area of audit. It seems possible that the audit firms will continue to innovate and evolve their audit reports in an effort to demonstrate their quality to investors – their ultimate clients. We are hopeful that a retreat to boiler plate reporting can be avoided and we encourage analysts to make use of these enhanced insights and investors to begin a new and fruitful conversation with both management and boards of investee companies.

The NAPF will continue to monitor developments and the application of its Corporate Governance Policy, seeking improvements from both companies and investors in the best interests of our pension fund members.

2014 reflections – a year of change and challenge

This year saw AGM turnout remain static at approx. 69% and similarly within the FTSE 350 shareholder support lingered at 97%[1]. Behind these headline statistics this year has been far busier and more eventful than most.

Companies and investors approached this year's AGM season with a mixture of trepidation and anticipation. Companies, auditors, investors and advisors have spent the preceding months grappling with a range of new corporate reporting regulations which were introduced for this year, including:

- The introduction of a new strategic report replacing the previous business review.
- Extensive changes to remuneration reporting.
- Enhanced auditor and audit committee reporting.

These extensive reforms to corporate reporting for 2014 resulted in more information than ever being made available by issuers for investors to analyse and make use of. Undeniably, the objectives which lay behind these new reporting requirements were positive. In some cases, the results, for example the new disclosures being produced by auditors, have exceeded expectations. In other cases however, such as with respect to the more extensive remuneration reporting the quantity has overshadowed quality.

Many companies have risen to the challenge of the new strategic report, providing clear articulations of the business model and the strategy. The best companies use this clarity of their direction to shape their overall reporting in order that it forms a single coherent whole.

The scale of the additional reporting burden has undoubtedly posed a challenge for companies. It has equally proven testing for investors to manage the deluge of expectant consultation requests, get themselves up to speed with the swathe of new information being sent their way and to navigate their way through to identify and subsequently engage upon the key issues of interest.

With every listed company this year required to submit a remuneration policy to a binding vote the understandable accompanying anxiety on the part of companies at times led to consultation overload. At times investors were concerned that these conversations, in many cases around insignificant policy changes, would crowd out the space for more strategic or important holistic conversations covering issues such as succession planning, corporate culture or corporate strategy.

It is in the interests of both directors and investors that meetings between both are informative and constructive. As we now move into a less hectic cycle, with the majority of remuneration policies envisaged as lasting for three years, one hopes that that many of the conversations – some which may have occurred for the first time this year – will now shift away from the period preceding the AGM season and become more holistic in nature. It is worth noting that investors have indicated that they will be concerned about companies whose remuneration policies do not last the full three years but which are altered year on year.

Away from the reporting on remuneration, investors are increasingly being equipped with more detailed, consistent and comparable information on the company's financial and extra-financial performance. In turn, a number of investors are progressively seeking to incorporate a wider assessment of corporate governance within the judgements which inform their exercising of voting rights. With more information being made available and investors often adopting different approaches to interpreting and making use of this new data it

[1] Source: The Manifest Voting Agency.

will be interesting to monitor in 2015 how firms continue to evolve their approach to utilising their enhanced voting rights.

Listening and learning?

As in 2013, the NAPF has looked at those companies which received more than 20% dissent last year on a remuneration related resolution (constituting votes against and abstentions) and looked to see how many received more than 15% dissent again this year. While clearly a very blunt approach, this filter simply seeks to highlight companies at which it may be valid to question whether the board has sufficiently sought to address shareholder dissatisfaction.

Of the 28 companies in the FTSE 350 at which investors expressed significant concerns last year on a remuneration related resolution, as of mid-August, eight had also received a further reprimand this year.

Successive years of dissent on remuneration resolutions

Company	2013 resolution	2013 dissent	2014 resolution	2014 dissent	Issues of concern
Capital & Counties Properties	Remuneration report	22.58%	Remuneration report	24.65%	Argued that 'exceptional performance' justified use of 'exceptional maximum' payout of 2013 bonuses.
easyJet	Remuneration Report	44.79%	Remuneration policy	45.21%	N/A*
FirstGroup	Remuneration report	29.96%	Remuneration policy	30.95%	High level of pay as compared to peers; inappropriate and un-stretching metrics/targets; low level of transparency.
Lonmin	Remuneration report	31.69%	Remuneration policy	17.39%	Policy allowed potential special payments to be made to departing executives. The LTIP also duplicated the performance measures of the annual bonus.
Mitie Group	Remuneration report	21.82%	Remuneration report	28.13%	The grant of an exceptional LTIP award to the CEO to ensure incentivisation and alignment despite already having a significant shareholding and increase in bonus in 2013.
Ocado Group	Remuneration report	24.20%	Remuneration report	20.00%	The level of disclosure was poor; in particular the targets for the annual bonus were not disclosed despite 90% vesting.
Ophir Energy	Remuneration report	32.25%	Remuneration report	32.89%	The executives were awarded generous salary increases and LTIP awards despite declining company performance.
SVG Capital	Remuneration report	33.32%	Remuneration report	35.60%	Ongoing opposition from Coller Capital, the trust's biggest shareholder, over remuneration and strategy.

Dissent is calculated as composing votes against + abstentions

* easyJet's proxy results are largely reflective of the votes cast by a single major shareholder.

In addition to the remuneration resolutions, a further nine companies in the FTSE 350 received significant dissent last year on a recurring resolution, and of these four did so again this year. These related either to the re-election of individual directors or to the disapplication of pre-emption rights.

Of the 11 companies in total which received successive years of dissent from their shareholders, both easyJet and Afren featured in 2013. easyJet however, continues to have a single dominant shareholder in the Haji-Ioannou family which controls approximately 35% of its shares and with whom relations remain strained. For Afren, having suffered a huge 81% rebellion against its remuneration report last year, it is pleasing that this year only 11% of shareholders voted against its remuneration report; however, shareholders did express again their concerns with respect to the re-elections of Egbert Imomoh and John St John as Directors.

Successive years of dissent – re-election of directors

Company	2013 resolution	2013 dissent	2014 resolution	2014 dissent	Issues of concern
Afren	Re-elect Egbert Imomoh	31.34%	Re-elect Egbert Imomoh	31.93%	Concerns that Afren's governance has deteriorated significantly.
	Re-elect John St John	31.87%	Re-elect John St John	16.20%	John attended just 70% of Board meetings during 2014 without any explanation.
AstraZeneca	Re-elect Jean-Philippe Courtois	24.17%	Re-elect Jean-Philippe Courtois	43.59%	Jean-Philippe attended less than 75% of board meetings for 2 years in a row without any explanation.
Jardine Lloyd Thompson Group	Re-elect Lord Leach of Fairford	24.31%	Re-elect Lord Leach of Fairford	25.70%	The company's board fails to contain a majority of independent directors. Lord Leach remains a member of the Remuneration Committee, which is expected to be wholly independent.
SVG Capital	Re-elect Lynn Fordham	31.83%	Re-elect Lynn Fordham	33.48%	Ongoing opposition from Coller Capital, the trust's biggest shareholder, over remuneration and strategy.

Dissent is calculated as composing votes against + abstentions

Both SVG Capital and easyJet also received successive years of dissent in relation to resolutions seeking to dis-apply pre-emption rights.

Sports Direct – a needless soap opera

On the topic of listening and responding to shareholder's concerns – or not as the case may be – then it would be significantly remiss not to pause for a moment to comment on Sports Direct.

On 2nd July this year, after two years of discussions and three rejected or withdrawn proposals, Sports Direct successfully passed a resolution which would permit the awarding of shares to Mike Ashley, its Executive Deputy-Chairman and majority owner holding approx. 58% of the company's shares. However, this was far from a successful episode. Indeed in the end Mike Ashley himself withdrew from participation in the scheme.

April 2014 – In April, despite the public support of Odey Asset Management, Sports Direct withdrew a plan unveiled in March to award Mike Ashley 8m shares (worth approaching £70m) after it became clear that there was insufficient support to pass the resolution. A week later Sports Direct's shares fell almost 10% after Mike Ashley sold £200m worth of shares. The Board at this juncture indicated that it would seek shareholder approval for a Bonus Share Scheme at the Group's AGM in September and indicated that such a scheme would include all eligible employees including Mike Ashley.

June 2014 - On 9th June Sports Direct set out a new plan to award £200m in shares to "all eligible employees" and posted a circular to shareholders convening an EGM on 2nd July for the purposes of seeking shareholder approval.

Given the significant lack of detail disclosed at this time with respect to the criteria for making awards, the allocations to individual directors or award limits, significant concerns were expressed by many institutional investors and representative bodies such as the ABI, IoD and NAPF. The proposal was nonetheless passed with 60% support of those independent shareholders voting.

July 2014 - On 16th July it was announced that Mike Ashley had informed the Board that he did not wish to be considered for participation in the Share Scheme [on the same day it was announced that Non-Executive director Charlie McCreevy would not stand for re-election at the Company's AGM in September].

September 2014 – Sports Direct received shareholder approval at their AGM for their remuneration policy which includes the 2015 Bonus Share Scheme and explicitly stipulates that Mike Ashley will not participate in the share scheme; the Policy did now include clear (very) stretching targets and maximum award limits. Although all resolutions passed, the company did receive 40% dissent from independent shareholders on their remuneration policy and approximately 20% of dissent with respect to the re-elections of the Chairman Keith Hellawell and Remuneration Committee Chairman Dave Singleton.

Ironically the final policy which was put to shareholders at the company's AGM in September had many commendable aspects. It is a shame that the process to get there was so unnecessarily fraught.

Pertinently Sports Direct remains an enormously successful company. Now residing as it does in the FTSE-100 It self-evidently remains on a governance learning curve. Investors hope that lessons are learnt from the events of early 2014 and strenuous efforts made to institute a much more harmonious and constructive relationship with minority shareholders.

A new dawn for executive remuneration

Under the new regulations introduced for this year's reporting season the remuneration report as it formerly was has been split into a policy report – subject to a binding vote at least every three years – and a remuneration report – subject to an annual advisory vote.

These new regulations provided shareholders with a further tool to equip (and encourage) them to question increasingly complex and generous pay packages. In addition to the rights already contained within the shareholders' toolbox investors are now well placed to influence, shape and approve director's remuneration arrangements in advance of awards actually being made.

For more than a decade now shareholders have had the right to have a "say on pay" by voting in an advisory capacity on directors' remuneration reports. The retrospective vote proved a useful tool for communicating concerns to the board. Most boards actively and effectively sought to respond to shareholder opposition, however, the retrospective nature of the vote of course meant it was often too little too late. Furthermore, the advisory vote became the proxy for expression of a broad range of concerns, commonly stretching beyond remuneration itself. For these reasons the NAPF welcomed the new binding vote and believe it has the capacity to further empower shareholders to press for remuneration structures which better align the long-term interests of management as well as providing greater coherence to dialogue.

The contents of these two new reports are substantially different from the previous requirements and for the first time explicitly provide information on:

- the company's policy on recruitment and loss of office
- the level of remuneration directors may receive under different scenarios
- a single figure of total remuneration for each director
- the link between pay and performance
- the relative importance of spend on pay
- how the conditions elsewhere in the company have been taken into account

As alluded to, the intention behind the new reporting requirements was to boost transparency; enabling investors to understand much more easily *what* a director is being paid, *how* and over what time frame the awards are being structured and importantly *why* both the amount and structure are appropriate for the strategy and position of the company and will drive sustainable performance.

Feedback to date would suggest that there is still much progress to be made. While it is easier now than before to grasp the *what* and the *how* it remains difficult in many cases to grasp the *why.* Perhaps understandably given the significant task companies have faced in getting up to speed with the new requirements, the new remuneration reports too often read as compliance documents as opposed to communication tools.

With the letter of the new regulations in most cases being well adhered to, it is hoped that companies will next year seek to more closely embrace the spirit of the new reforms and communicate more effectively.

The results are in

So, the reporting has improved, though not as yet as significantly as shareholders hoped. Have the new disclosures catalysed a second "shareholder spring"?

Well no they haven't, but this should not be viewed as a sign of failure. Indeed, positive trends of recent years have continued with relative restraint being exercised, companies simplifying their pay arrangements and shifting the alignment of awards towards a more appropriate longer-term time horizon.

The initial voting statistics suggest that the year-on-year level of expressed dissent remains fairly static. Figures from ISS indicated that on average 93% of votes were cast in favour of remuneration reports in 2013; early suggestions are that this year that figure will be very similar. For the remuneration report, ISS recommended against 13% of resolutions (up from 12% last year) and for the binding vote recommended against 10% of resolutions; shareholder support on both resolutions has been approximately 94% in favour with just one binding vote being defeated.

To judge from the above one could come to the view that it has been a quiet and uneventful season. Alternatively, a view could be reached that investors have given companies the benefit of the doubt as both adapt to the new reporting requirements.

The year-on-year statistics, however, mask a significant variation in the approaches adopted by different asset managers. It was notable that this year some firms voted against management in many more cases than they had previously. Fidelity Global Investors are perhaps the most notable this year, having issued an effective ultimatum to companies making clear that they would only support those that extended the holding periods for their long-term incentive awards for more than three years (and from next year extended holding periods to five years or more). Following this, Fidelity voted against FTSE 350 management on at least one remuneration proposal at 52% of AGMs. Similarly Newton Investments voted against management at 52% of company AGMs – up from 46% last year.

Of course that means that in order for the overall level of expressed dissent to remain static other firms adopted a very different approach. In part we would suggest that this variation occurred because dissent was often split across the two different votes, with investors often supporting one while opposing the other. This may well explain why this year there have been fewer resolutions receiving "significant" dissent (120) than in any of the previous five years[2].

The NAPF believes that the considered exercising of voting rights is a responsibility of institutional investors. There is a need for votes to be cast in an informed manner and where votes are cast against management these decisions should be made after engagement with the company, consideration of explanations and not be a result of a mechanistic approach. In this context there is no "right" approach. For that reason, as part of the regular provision of monthly topical questions for pension funds to utilise in their questioning of their investment managers' stewardship activities, one of the NAPF's questions in August picked up on the above theme and encouraged funds to ask:

- *Has the enhanced reporting brought to light more issues of concern; if so how have you sought to utilise your voting rights in a coherent fashion? Can you demonstrate how your voting activity is aligned with the aim of promoting the long-term success of investee companies?*

The year-on-year statistics also mask a more eventful year than is at first evident. Following the 2012 "Shareholder Spring" 2013 saw very few FTSE 100 companies ruffle their shareholder's feathers, instead investors' increased expectations of good practice were translated further down the market cap range. As a result, the percentage of companies receiving significant (defined as 20% plus) votes against their remuneration reports in the FTSE 100 last year was just 3%, whereas in the FTSE 250 this figure was 11%.

This year the disparity between the upper and lower ends of the market cap range appears to have diminished. Indeed, at least 11 companies in the FTSE 100 have received significant dissent against either their remuneration policy or remuneration report this year with Burberry receiving the highest vote against with more than 53% of shareholders voting against or abstaining on the advisory vote on their remuneration report.

2014 remuneration low points

While the average level of dissent this year on remuneration related resolutions has remained fairly consistent year-on-year, there have been a number of quite significant sized 'rebellions' at FTSE 350 companies. While no "Shareholder Spring", we list below the "top-10" rebellions.

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[2] "Source: The Manifest Voting Agency".

Company	2014 resolution	2014 dissent	Issues of concern
Kentz Corporation	Remuneration policy	**58.17%**	Remuneration Committee retained discretion to make emergency payments outside of the remuneration policy. Additionally, the annual bonus was to be paid in cash only and there are no shareholding guidelines.
	Remuneration report	**57.58%**	CEO received a one-off bonus following the announcement of the completion of the Class I transaction in acquiring Valerus Field Solutions; he also received a substantial increase (38%) in his basic salary.
Burberry	Remuneration report	52.99%	A generous pay package awarded to the new CEO Christopher Bailey despite a lack of previous ED experience and included a one-off award worth nearly £15m.
Reckitt Benckiser	Remuneration report	42.84%	Targets deemed insufficiently stretching to justify the level of awards granted.
Hiscox	Remuneration policy	42.16%	Significant flexibility allowed within the recruitment policy, in particular the absence of any cap on new executive director's pay.
Carnival	Remuneration report	41.60%	Annual bonus paid out despite poor corporate performance over the last three years. Additionally, generous recruitment arrangements provided for new CEO included guaranteed bonus.
Standard Chartered	Remuneration policy	41.05%	Generous remuneration package with a weighting towards short-term performance and the use of EBA discounting adding an undesired level of complexity.
AstraZeneca	Remuneration report	39.30%	A lack of (even retrospective) transparency around the targets for the metrics that would determine the vesting of the LTIP. Additionally, generous awards given to the departing CFO and an overly generous recruitment award given to incoming CFO.
Crest Nicholson Holdings	Remuneration report	38.74%	"Exceptional" LTIP awards granted during the year for retention purposes despite crystallisation of pre-IPO awards.
International Personal Finance	Remuneration report	38.60%	Significant salary increase for the CEO alongside share award at 'exceptional' level without sufficient rationale.

Dissent is calculated as composing votes against + abstentions

Encouragingly, many of the above have indicated that they have heard the concerns of shareholders and will be endeavouring to listen and learn over the coming year.

Kentz Corporation received the biggest shareholder revolt and became the first company to lose a binding vote. It has however, responded positively, stating: "Our shareholders have spoken and their message is clear." In turn: "We will consult further with them (shareholders) to make sure we fully understand their concerns and will revert with a new remuneration policy – taking full account of those concerns – in due course."

Similarly, Sir John Peace who Chairs both Burberry and Standard Chartered (and until recently Experian) acknowledged after the rebellion against Burberry's new Chief Executive Christopher Bailey's pay package that the board would have to "reflect on that and talk to shareholders". A spokesperson for Standard Chartered had voiced similar comments.

The NAPF remains ready to facilitate these conversations with pension fund investors and is hopeful that the concerns expressed this year will be appropriately considered and reflected in future policies or approaches.

The banks

While it was a year of change for executive pay generally, within the banking sector the change was even more significant following the introduction of CRD IV and in particular the infamous “bankers bonus cap”. Under the new regime all Material Risk Takers within banks have their variable pay capped at one times salary. This cap is able to be increased to two times salary with shareholder approval. Further still under complicated EBA guidance, up to a quarter of variable pay is able to be delivered in a "long-term form" which benefits from a discounted valuation for the purposes of the cap.

Unsurprisingly all the UK banks (with the exception of RBS) sought approval to the increase the cap for variable pay to two times salary. These resolutions were comfortably approved given the widespread belief that executives will be more aligned with shareholders if a larger proportion of pay is variable and linked to performance.

Standard Chartered was the only UK bank to make use of the EBA’s discounting and partly as a consequence their proposed remuneration package for executives was the most generous of the UK banks. This was associated by a feeling among institutions that their consultation process with shareholders was poor and it was no surprise that in turn they received such a significant vote against their remuneration policy.

The above is not to say that investors did not continue to have concerns about aspects of remuneration at the other major UK banks.

At Barclays, 34% of shareholders opposed or abstained on their remuneration report in frustration with the bank's decision to increase its 2013 bonus pool by 10% (13% increase in the investment bank) despite falling pre-tax profits and a bonus pool equating to more than 2.5 times the size of the dividend payout. Much of the frustration was tempered by announcements before the AGM that Barclays had appointed a new chair of its remuneration committee and a substantial review of its investment bank operations was underway. Despite this Standard Life Investments attended and voiced their ongoing concerns at the AGM itself which was met with an astonishing admonishment by outgoing remuneration committee chair Sir John Sunderland who observed that such remarks should have been raised privately.

HSBC too received more than 20% dissent against their remuneration policy and 17% against their remuneration report. Much of the ire in the case of HSBC focused on their proposal to award Executive Chairman Douglas Flint a bonus in shares of up to two times salary in light of the extra regulatory workload on the Chairman’s agenda. Many investors felt that this proposal represented a volte-face on commitments made in 2010 and considered that much of the regulatory agenda was already a core aspect of his duties for which he was already being paid. Following conversations with shareholders, concessions were made before the AGM with the potential award reduced and clarification provided that such an award would be a one-off.

Remuneration positives

The NAPF believes that remuneration should be proportionate and aligned with shareholder interests and long-term sustainable value creation. To that end, with a number of our larger members we published in 2013 the below "Remuneration Principles for building and reinforcing long-term business success".

1. Remuneration committees should expect executive management to make a material long-term investment in shares of the businesses they manage.

2. Pay should be aligned to long-term strategy and the desired corporate culture throughout the organisation.

3. Pay schemes should be clear, understandable for both investors and executives, and ensure that executive rewards reflect returns to long-term shareholders.

4. Remuneration committees should use the discretion afforded them by shareholders to ensure that awards properly reflect business performance.

5. Companies and investors should have appropriately regular discussions on strategy and long-term performance.

Our Principles emphasise that each company is unique and as such face different challenges and opportunities. While we are encouraged by some of the positive trends emerging we do encourage companies to assess whether their current remuneration practices are optimal for their unique circumstances in terms of incentivising their long-term success. We also encourage investors to give companies the space to do just this.

Many companies are moving aspects of remuneration in the right direction

1 We consider that the best form of alignment between executives and shareholders is the ownership of shares over the "long term" – three years generally not being long enough. The NAPF Corporate Governance Policy stipulates that companies should aim for a shareholding requirement of at least 2 x salary.

- In excess of a quarter of FTSE-100 companies have increased their shareholding requirements during the past year - the median shareholding requirement is now 200% of salary, up from 150% last year.

- In over a quarter of FTSE-100 companies share plan participants do not receive any of the shares vesting from the plan for at least five years.

    - **ITV –** Increased their minimum shareholding requirements for Executive Directors, for the CEO this increased to 400% (from 200%). Additionally, LTIP awards are now subject to an additional two year holding period.

    - **Royal Dutch Shell –** Substantially increased shareholding requirements for the CEO to 700% (from 300%) and for the CFO to 400% (from 200%).

2 We encourage remuneration committees to design rewards that encourage the specific behaviours required to drive long-term strategic success.

- There is a continuing increase in the use of measures other than TSR and EPS in pay structures – three quarters of FTSE-100 companies now include some other measures and more are including non-financial business-specific strategic measures.

- **National Grid** – Have moved away from using TSR and EPS as their LTIP performance conditions and instead now focus on two measures: a value growth metric and Return on Equity in order to better reflect the way in which the business is managed.

- **Hammerson –** Retrospective disclosure of performance against both financial and non-financial annual bonus targets is comprehensive with a clear link to the drivers of business success. Additionally, the LTIP performance period is set to reflect the capital intensive and cyclical nature of Hammerson's business.

3 The NAPF Policy encourages firms to avoid operating multiple long-term incentive schemes as we do not believe that a multiplicity of awards, with varying performance conditions, helps to motivate executives. Additionally, we have suggested that in some circumstances it may be better to have a single bonus scheme – with no long-term incentive plan.

➢ This year 13 FTSE-100 companies removed bonus matching plans from their pay arrangements. In turn, the number operating multiple long term incentive plans has reduced to 29% (from 46%).

➢ A few companies have replaced annual and long term incentive plans with a single plan based on pre-grant performance conditions, usually over one year (sometimes over a longer period) with the majority of awards coming in the form of shares released over a significant period (at least five years).

- **London Stock Exchange** – As with others, LSE have simplified their pay arrangements by removing their voluntary matching element and providing one LTIP in future award cycles.

- **Hikma Pharmaceuticals** – The renewed Executive Incentive Plan is the sole incentive arrangement and allows for the setting of annual targets based on the strategic objectives at that time coupled with detailed annual disclosure and significant deferral of shares.

4 Remuneration committees should, exercise their judgement about the overall performance of the company when determining awards. In particular, the committee should consider *how* the results have been achieved, not just *what* was achieved.

➢ In the past year the remuneration committees of eleven FTSE-100 companies used their discretion to reduce the level of bonus payout better to reflect company performance.

- **Meggit –** The Committee took into account the supply from a vendor of non-conforming raw material in 2012 which was discovered during the year and which impacted on customers; in turn downward discretion was used to reduce the vesting of incentive awards.

- **Capita** – Bonus targets were met in full but the Committee scaled back awards due to the partial sale of the insurance distribution business and closure of the SIP business.

Audit reports just got interesting

It is rare for a newly introduced regulation to keep investors and companies happy and for the results thereof to exceed expectations, but it seems as if the new enhanced auditor reporting may have managed just this.

The audit report is the auditor's primary means of communication with the audited entity's shareholders who are in effect the client of the audit. Historically while investors have taken comfort from knowing that financial information has been through the audit process they have generally taken little of value from the report itself. Essentially, the reports presented what were in effect a pass or fail mark. Because a "fail" (a qualified audit report) can be highly damaging to a company, great steps are taken to avoid this.

This year, however, audit reports have just got that bit more interesting. Auditors are now required to provide more company-specific colour within their reports; the new information includes the materiality of the audit, the scope of the audit, and the work done on key areas of audit focus – i.e. key risks.

As always with anything new, the results have spanned a broad spectrum. Reports have varied in length from two to seven pages and the quality has ranged from boilerplate comments to genuinely informative.

Rolls Royce Auditor's Report (produced by KPMG)

It has been widely acknowledged that the external audit report produced by KPMG for Rolls Royce deserves recognition. The Rolls-Royce auditor's report comments not only on key risks and the work done to assess them by the auditor, but also seeks to answer the important "so what" question by providing the auditor's view on whether the company's estimates are cautious or optimistic.

Examples of the auditor's views providing insightful 'colour' included comments such as:

- The auditor identified "weaknesses in the design and operation of controls".
- However, the auditor believes that the assumptions and estimates "resulted in mildly cautious profit recognition".
- With respect to the valuation of a put option relating to a company jointly held by Rolls-Royce and Daimler AG the auditor found Rolls Royce's estimate of the liability to be "acceptable but mildly optimistic".

The sort of language and opinion provided by KPMG within the Rolls Royce audit report provides analysts with new information and insight and investors hooks with which to engage with the audit process and in particular to have useful conversations with management and the Board.

While it is noted that KPMG have set a new benchmark in the standard of reporting expected by auditors this year it is perhaps PwC which has been the laggard of the group. The PwC reports commonly disclosed two standard "areas of audit focus" usually described in standard language resulting in confusion as to whether the risks disclosed are really the most important or were simply included automatically. Additionally, it was common within PwC's audit reports to identify the materiality number but to not explain how this number was derived nor to provide helpful additional context on materiality. That said, investors accept that this year has been a learning exercise for audit partners in understanding the expectations of investors and there have been valiant efforts made by all of the big audit firms to respond to the new challenges.

The response from the audit profession to the first year of these new reporting requirements has been encouraging. We are hopeful that further innovation and evolution of these reports next year will build on this positive start and foster more transparency and dialogue between auditors, companies and shareholders. Shareholders hope and expect that the more transparent forms of audit report will provide the model for the future, not those that fallen into the traps of boilerplate.

Audit competition

A core focus of both the UK Competition Commission's statutory audit services market investigation and the recent EU audit market reforms has been on the level of competition within the audit market and whether this has a detrimental impact upon audit quality.

New reforms are set to further build upon the enhanced reporting, for example including greater transparency of the findings of the Audit Quality Review Team. As such there will continue to be more scope provided for shareholders to ask questions of the audit firms as well as of Directors, in particular the audit committee, on the fundamental issue of audit quality.

As identified by the UK Competition Commission within its recent analysis of the market, all of the audit firms have in some form the strategic objective of increasing their market share and revenue. Unsurprisingly, and as discussed in this report in 2013, companies have been quick to respond to shifting sentiment (and ahead of compulsion) as evidenced by an increase in audit tenders and indications of audit tenders to come.

A number of big companies have followed in the path of those identified last year by giving a clear indication within their report and accounts that they intend to submit their audit contract to tender in the coming years – Johnson Matthey for example will put its audit out to tender in 2017 bringing to an end a 20+ year relationship with KPMG.

The 'competition' thus far, stimulated by the FRC's Code change (requiring tendering every ten years) and the pending European rules, has seen companies rotating their audit contract between the constituents of the Big Four – PwC, Deloitte, KPMG and EY. Interserve are rare in bucking this trend, having announced this year it will replace its Big Four auditor Deloitte with Grant Thornton.

The "second tier" firms – including Grant Thornton and BDO – have it seems had some traction within the FTSE All-Share and AIM markets, however, for the time being it appears that the FTSE 350 market remains as it was; dominated by the Big Four (97% of audit contracts are with Big Four firms). A paper published by the Institutional Investor Committee earlier this year emphasised that investors are keen to see a vibrant audit market. As such investors do expect that in most cases a wide range of audit firms would be invited to tender for audit contracts including those from outside the Big Four, with a genuine prospect that they may win the work.

With the rate of tendering continuing apace and the level of information available to shareholders similarly increasing it will be interesting to monitor how the market alters in the coming years and whether competition begins to stretch beyond the Big Four and crucially whether it is driven by judgements about the quality of audit provision provided. Shareholders remain clear that companies should actively consider hiring non-Big Four firms as their auditors.

NAPF keeping it topical

The NAPF publish (via its Stewardship Central website – www.napf.co.uk/stewardship) on a monthly basis two topical questions to aid pension fund trustees in questioning the effectiveness of their managers' stewardship activities. A number of the issues highlighted within these topical questions were prominent in the lead up to or during the AGM season itself. Others provided pension funds with a hook on which to question how fund managers and in turn companies are approaching governance in a holistic fashion and how these judgements inform their voting decisions on AGM resolutions.

The NAPF encourages pension funds to utilise these questions during their regular manager reviews in an effort to gain a greater understanding of their investment managers' approach and activity and to ensure that they are adhering to the funds' own stewardship policy. Below is snapshot of 2014's questions to date:

January's topical questions for your manager:

- In light of the announcement this month from Experian about the succession of its CEO to Chairman, how do you assess the independence and effectiveness of company directors?

February's topical questions for your manager

- Reports suggest that British companies are lagging behind their peers in addressing cyber security risks and the SEC has noted a recent spate of cyber-attacks on asset managers. What policies do you have in place to prevent, detect and respond to cyber-attacks internally and ensure boards of investee companies are addressing the issue?

March's topical questions for your manager:

- Corporates reporting in 2014 have new requirements for enhanced auditor reports which aim to open up the black box of audit to discuss the assessment of risks and materiality and how these are addressed by the auditor. A number of these new more revealing reports have now been published - how are your fund managers making use of this additional information?

April's topical questions for your manager:

- At Barclays AGM next week (24th April) many investors are expected to express their frustrations with the bank's decision to increase its 2013 bonus pool by 10% (13% increase in the investment bank) despite falling pre-tax profits and a bonus pool equating to more than 2.5 times the size of the dividend payout to shareholders. Barclays have since appointed a new chair of its remuneration committee for 2014 and a substantial review of its investment bank operations will report in the summer. Given recent announcements and assurances, have you voted against Barclays remuneration report or are you giving the board the benefit of the doubt that effective changes are being made?

May's topical questions for your manager:

- This week Centrica informed shareholders it had begun planning to replace chief executive Sam Laidlaw and BG group have recently begun searching for a new Chief Executive after Chief Executive Chris Finlayson abruptly resigned a little more than a year into the post. With many other large companies wrestling with the challenge of succession planning, not least where there is a long-serving

CEO, what steps are you taking to ensure that investee companies are adequately managing succession issues in both short and long-term scenarios?

- As M&A activity continues to boom this year, the protagonists in the current most high profile potential deal, the Chief Executives of both Pfizer and Astra Zeneca, faced the scrutiny of a Parliamentary Select Committees this week. What engagement have you had with the two companies and how are assessing the merits of any further formal bid?

June's topical questions for your manager

- With the government committed to legislating against modern slavery and companies increasingly being encouraged to consider and report on supply chain risks, one study this week linked the investments of UK institutional investors, including pension funds, to firms either known or alleged to be involved in cases of so called land grabbing, and another news story identified slavery as an integral part of the supply chain of prawns provided to many global supermarkets. As companies become ever more global, what assessment have you made of the potential risks which may be embedded in vast corporate supply chains and which have significant financial and/or reputational consequences? How have you encouraged investee companies to report more fully on these supply chain risks and to manage them over time?

- Trinity Mirror's annual report identified the financial and reputational impact associated with historical legal issues related to phone hacking as one of the Group's four principal risks. With news this week that twenty individuals have initiated legal actions against the Group what engagement have you had to date to assess the appropriateness of management action to mitigate the risk, including the level of provisioning made? More broadly, what is your assessment of the implications of the debate around ethical standards in news-gathering on the investability of our listed media companies?

July's topical questions for your manager

- Last week, at the fourth attempt and in the face of widespread opposition, Sports Direct achieved assent from a majority of shareholders to award £180m of shares to 3,000 permanent staff including 58% owner Executive Deputy Chairman Mike Ashley. How did you vote? If you supported management, what persuaded you that this proposal was more appropriate and in the interests of shareholders than those proposed and withdrawn previously? If you did not support the resolution, what further engagement will you undertake with respect to the overall quality and independence of the governance arrangements at Sports Direct?

August's topical questions for your manager

- We are nearing the end of the first AGM season in which shareholders have had at their disposal the enhanced voting rights introduced by the Government last year. Has the enhanced reporting brought to light more issues of concern; if so how have you sought to utilise your voting rights in a coherent fashion? Can you demonstrate how your voting activity is aligned with the aim of promoting the long-term success of investee companies?

Conclusion

As we reflect back on the 2014 AGM season, more than anything else companies and investors will be pleased to have simply got through an exceptionally busy year during which there was an unprecedented amount of change to company reporting. The magnitude of the changes posed serious resource challenges to both companies and their investors and both will be hoping that 2015 brings a return to a more steady state.

That said there was much of positive to note and in general both the quantity and quality of engagement between companies and their shareholders continues to improve.

The introduction of the new binding vote on remuneration policy alongside a retrospective advisory vote has brought more coherence to the exercising of votes on pay and new disclosures have brought greater attention to previously opaque areas of remuneration policy. The new information and rights have been utilised in different ways by different asset management firms. One continuing tendency, however, remains a reticence on the part of investors to personalise their dissent and to escalate voting sanctions to individuals.

Most importantly, the conversations between companies and shareholders, the better ones at least, are proving more constructive, with discussions more commonly focusing on how the proposed pay structure would drive sustainable business success.

That said, a relatively small proportion of companies continue to have a less than harmonious relationship with their shareholder base. Most commonly, the cause of frustration is unsurprisingly pay arrangements. We urge these companies in particular, along with all those which have received significant dissent this year, to reflect upon the concerns expressed by their owners and respond accordingly.

Looking ahead to 2015, it is hoped that governance discussions will continue to become more integrated and holistic in nature, incorporating discussions on remuneration and audit within conversations about strategy and risk. It will continue to be a challenge for investors to communicate their concerns coherently through exercising their shareholder rights when their engagement has not proven successful; it will prove at least equally challenging for companies to endeavour to untangle and interpret the messages they receive. In this context, effective ongoing communication between both parties is as essential as ever.

Both the actual and anecdotal evidence suggests that the attention being given to the stewardship activities of their agents by pension fund clients is also growing. As activity continues to increase, expectations do also. It is becoming more important for asset managers to be able to demonstrate how they have sought to utilise voting rights in a coherent fashion and how their activities are aligned with the aim of promoting the long-term success of investee companies.

The NAPF will continue to assess how companies are matching up against its corporate governance policy, monitor developments in good practice and seek improvements from both companies and investment managers in the best interests of our pension fund members.