

CAD-03229

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ON  
THE FINANCIAL ASPECTS  
OF CORPORATE GOVERNANCE

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4th June, 1992

Professor J. M. Samuels,  
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*Dear John,*

Thank you for your letter of 19th May and enclosure, which I have read with interest and copied to Sir Adrian Cadbury.

In case you have not seen it, I attach a copy of our draft report which was published last week. On directors' remuneration, you will see that, without getting into detail, it advocates complete transparency. It also contains various recommendations designed to establish a formal structure whereby directors' remuneration is recommended by a remuneration committee made up of independent non-executives who are selected through a formal process. We would argue that if these proposals are put into effect, shareholders and the public will have something against which they can exercise effective leverage.

There has been a good deal of forceful press comment to the effect that this is not enough, and that directors' pay needs to be brought under a much stronger framework of control and accountability to shareholders. I am not sure, therefore, that the issue can be resolved as easily as the final sentence of your paper suggests!

Thank you for your offer of a meeting. Given that our report sticks to principles rather than detail there are no specific points I would wish to raise on your paper, but if you are in London and would like a general discussion of the issues, and/or have any thoughts on how our proposals might be improved, I would be very pleased to meet you.

*Yours sincerely,*

*Nigel Peace*

Nigel Peace  
Secretary

*cc Sir Adrian ✓*

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19th May 1992

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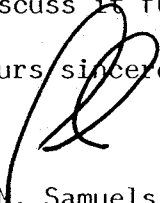
Dear Nigel,

It was good to meet you last night at the Arther Andersen dinner. There was one topic on the discussion paper that was circulated that we did not have time to discuss. This was on the question of shareholders being in a position to know what their directors are doing.

At the moment I am working on a research project, one aspect of which involves trying to value the total remuneration package of directors and this, of course, includes valuing share options. With a colleague, Michael Cranna, I have prepared a short paper which may be of interest to you and Sir Adrian's committee. It explains how impossible it is for the shareholders of a company to ascertain the total package.

If you are interested in this I would be very pleased to meet you and discuss it further.

Yours sincerely,

  
J.M. Samuels

## Directors' Remuneration and Corporate Governance

### INTRODUCTION

For some time now, there has been considerable publicity concerning the issue of disclosure of executive remuneration and how, in reporting this information, annual reports have become what one commentator has described as "...breathtaking masterpieces of failure."

The objective of this paper is to examine the difficulty shareholders have in accurately ascertaining the total financial rewards paid to their directors. This paper shall examine the various types of executive remuneration and the extent to which shareholders are able to establish actual levels of pays from the various documents and sources that supposedly record or analyse this information. Conclusions are drawn and recommendations made at the end of the paper.

During the course of the project with which we have been involved,<sup>1</sup> we have looked at the annual reports of over sixty companies dating back five years and in many cases, six. Our means of selecting these companies for the purposes of our study was to identify a sample which had been involved in three takeovers or more in the last five years, and another sample to match approximately to this as a control sample.<sup>2</sup>

With the increasing interest in corporate governance, a number of companies are disclosing the approach they adopt to decide upon the levels of remuneration of their executive directors. The companies have disclosed the personnel who sit on a remuneration committee which comprises the chairman of the board and the non-executive directors, who are there to act as checks to possible abuses of power or mismanagement by chief executives or chairmen.

This disclosure would appear to be designed to divert criticism from the levels of remuneration being paid, because the non-executive directors are all responsible members of the corporate community and the knowledge of their names is supposed to assure shareholders of fair play. However, the problem is that the non-executive directors of one company are almost invariably the executive directors of another. While an example of A sitting on B's remuneration committee and B on A's has not yet been found, it is not uncommon for A to sit in judgement on B's remuneration level, B on C's and C on A's. Thus any decision A makes on B's level of pay may indirectly affect his/her own.

While the existence of non-executives may appear to the shareholders of one particular company as a check on inflated

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<sup>1</sup> *The project is concerned with managerial motives for mergers and takeovers and the extent to which executive remuneration influences these motives.*

<sup>2</sup> *The control sample was matched along lines of approximate similarity in size and industry.*

pay rises, the total picture is somewhat more disconcerting, for this is a picture of an at least partly closed "club" or "network" whose interests are intrinsically tied up with those of the other members and which must therefore be questioned as an effective regulatory influence.

Indeed, research has shown that approximately 70% of non-executive appointments made are through personal links between the appointee and the board to which that non-executive is to be appointed.

How then, do these concerns translate into issues of directors' remuneration?

### ISSUES OF REMUNERATION

Rewards to Directors come in five forms;

- (i) Remuneration (Salary)
- (ii) Performance-Related Bonuses
- (iii) Executive Share Option Schemes
- (iv) Contributions to Pension Schemes
- (v) Cheap Loans<sup>3</sup>

The shareholder may assume it is possible to identify the total rewards from the following sources;

- (a) The annual accounts (in the Notes to the Accounts);
- (b) The directors' service contracts;
- (c) The Stock Exchange. (Official Weekly Intelligence Reports);<sup>4</sup>
- (d) Other organisations.

In fact it is possible with only a very few companies to ascertain the true position of directors.

#### A: Annual Reports and Accounts

From the annual reports of each company, we were interested in recording for each of the five years the following information on directors' remuneration;

- 1: Remuneration of the chairman, highest paid director and next highest paid director, and a breakdown of this remuneration into its elements of fees, salary, performance-based bonuses and pension contributions;

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<sup>3</sup> For the purposes of this paper we shall examine only the first four, given all details of loans to directors are supplied in the annual reports and they make up only a small part of the overall remuneration package.

<sup>4</sup> The Official Weekly Intelligence Report contains information solely on the share dealings of directors.

2: The number of ordinary shares and share options held by each director and at what price the options were granted;

3: The cash return to any director who exercised and then sold options during any of the five years;

4: The shareholding that the combined holdings of all the directors represented as a percentage of the company's total issued share capital.

Emoluments include the estimated money value of any benefits received by directors otherwise than in cash. The Companies Act (1985) requires full disclosure of the total emoluments received by directors. It therefore requires full disclosure relating to all types of remuneration paid to individual directors.

For almost 97% of the companies, emoluments were initially given as a figure for the Board as a whole, as were fees. Then, the remuneration figures for the chairman and highest paid director were given as one figure each, with no breakdown into flat salary, performance-related bonuses or other components. This was also the case with the salaries of all the other directors. In all the companies surveyed, none identified any other directors with their salaries. The information was provided in the form of salary bands, next to which were placed the number of directors within each of these bands. The form of this presentation varied, (for example the "width" of the salary bands) but the content remained quite consistent.

Perhaps five companies mentioned the pension contribution the chairman and highest paid director made (or was made by the company on their behalf), most gave this figure as a total for all directors, some included it in the total remuneration figure and some did not mention it at all. No companies identified the other directors with a pension contribution figure.

With regard to share and share options, the formula of presentation was almost identical for all but one of the companies. This was to give the *number* of options held by each director in one table and then in *another* table to give the *total* number of options granted under the scheme within a series of "grant price" bands. Neither table was thus of any use in calculating the value of option holdings, for the number of options held by each director and the price at which those options were granted were presented in isolation from each other. This method of separating the share option schemes from those participating in them has become established as the norm in seemingly all annual reports.<sup>5</sup> Only one company in

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<sup>5</sup> This approach may have been adopted merely with the intention of providing information on ownership, rather than providing the more detailed information required for issues of remuneration which have only recently become controversial.

our sample gave the number of options directors held and how many had been granted at each price in one table.<sup>6</sup>

It is difficult to determine the value of a share option. To grant a director an option is to give a potential benefit. The value is the premium a third party would be willing to pay for a call option on the company's shares. To calculate such a premium is difficult however, and depends on a number of assumptions.

Thus, of the four pieces of information we wanted to extract from the annual accounts, we were able to find only the last, and this aspect was connected with issues of ownership, not remuneration.

### B: Directors' Service Contracts

The Companies Act conferred on the Secretary of State certain powers to control the right of inspection of company documents; *The Companies (Inspection and Copying of Registers, Indices and Documents) Regulation 1991* requires companies to make available to inspection by members of the company directors' service contracts.

Unfortunately, the service contract only gives very general details of the directors' remuneration. While it mentions the flat salary figure, it does not provide specific details of directors' involvement in the executive share option scheme, pension arrangements or any performance-related bonus scheme. The reason given for this omission is that there is no *contractual relationship* with regard to these forms of emolument. Typically a remuneration sub-committee of the Board decides to make such rewards available. Nevertheless, it is difficult to believe that an executive director "head-hunted" from another company does not come with the expectation or even promise of benefiting from a share option or profit related bonus scheme.

### C: The Stock Exchange

The Stock Exchange's *Official Weekly Intelligence Report* that supposedly contains all directors' dealings in shares of their own companies is also lacking in consistently precise information in this area. Perhaps most importantly, on many occasions it does not give the price at which options being exercised and then sold were initially granted. Below is a sample of the types of entries commonly found in the Stock Exchange's report, and illustrates the substantial variation in disclosure. (Fig 1)

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<sup>6</sup> These were the accounts of *Glynwed International plc*, years 1987 - 90.

The level of disclosure that appears in the Stock Exchange reports again depends on the company, for the Report simply reproduces the information the company provides on the share dealings of its directors. There is no obligation on the part of the companies to provide specific information.

#### NOTIFICATIONS

<u>Company</u>	<u>Holder</u>	<u>Class</u>	<u>Nominal Amt</u> <u>(Sale)</u>	<u>%</u>	<u>Price per</u> <u>share</u>	<u>Total</u> %	<u>Date of</u> <u>Bargain</u>	<u>Date</u> <u>Co. informed</u>
AAH Holdings	Exercise of Options W.M Pybus (D)	ord	10,000	-	85p	- -	16 Dec	-
Fisher (Albert) Group	Exercise of Options D.G. Pearse (D)	ord	100,000	-	-	633,333 -	-	-
Greycoat Group	Exercise of Options G.A Wilson (D)	ord	207,881 (207,881)	- -	- -	- -	25 Mar 25 Mar	- -
Hanson Trust	Exercise of Options Lord Hanson (D)	ord	799,498	-	26.7p	- -	25 Mar	-
		ord	323,898	-	53.3p	- -	25 Mar	-
		ord	(799,498)	-	163.0p	- -	25 Mar	-
		ord	(323,898)	-	163.0p	8,666,666-	25 Mar	-
SPP plc	Options Granted P.J Andrews (D)	ord	71,420	-	143.0p	140,000-	5 Mar	-
Berisford S&W	Options Granted D.J. Allen (D)	ord	470,455	-	-	- -	-	-
ASDA MFI Group	Exercise of Options E.G Bosfield (D)	ord	(50,000)	-	155.0p	439,784-	-	-
BTR plc	Exercise of Options H.W Laughland (D)	ord	45,000	-	160.0p	- -	-	-
		ord	(45,000)	-	322.0p	6,180 -	-	-
		ord	( 2,500)	-	-	7,500 -	-	-

(Fig 1)

## D: Other Organisations

Preliminary investigations have revealed one other principal source that deals in this area, Incomes Data Services (IDS). This organisation collects surveys carried out by various consultancies, and publishes them in a monthly review. Perhaps one of their most interesting tables was published in March of this year and revealed the top and bottom twenty five profit on share options earning companies, based on their directors' exercising of options.<sup>7</sup> While this gave no information pertaining to specific directors' holdings, it gave an overall picture of how well boards were doing out of their options. However, the figures IDS regularly publishes are normally limited to general increases in directors' salaries across particular industries and would be of no use to a shareholder interested in a particular company.

Of the consultancies, Datastream has compiled figures on the highest and lowest salaries paid to directors, and PA Consulting Group has researched how non-executives were appointed.<sup>8</sup> There are many other consultancy groups who have done research in this area, but of course only produce this work on demand for particular clients, such as newspapers. Other sources have in fact included most of the broadsheet papers. For example, *The Guardian* has recently run a detailed two part report, and addressed some of the issues we have been discussing. As one commentator stated, under the existing regime, there is a greater likelihood that a journalist will have more information on a company's remuneration policy than a shareholder will ever be able to obtain.

## CONCLUSION AND RECOMMENDATIONS

Of the sixty companies we examined, only one contained all the information we required in its annual reports, and even in this case had only done so for the last four years.<sup>9</sup>

With the exception of company loans, it is obvious it is difficult, and in most cases impossible, for shareholders to obtain any accurate information on the levels of remuneration of their directors. Any determined shareholder would find it a time-consuming, costly and probably fruitless business.

<sup>7</sup> Typical entries were thus:

<u>Company</u>	<u>No. of shares</u>	<u>Length (months)</u>	<u>Profit (£)</u>	<u>Profit (%)</u>
Shanks & McEwan	90,000	84	155,700	788.6
Glaxo Holdings	336,000	70	2,046,240	294.2

<sup>8</sup> For the results of these studies see *The Independent on Sunday*, 24 November 1991, pg 8.

<sup>9</sup> However, since that stage of our project was completed, several companies in our sample have, in their latest reports, improved their standard of disclosure.



In the first instance, in accordance with the intention of the Companies Act, total remuneration to directors should be specified in the annual report. It should not be necessary for shareholders to have to seek this type of information from other sources. This is not information that could be considered commercially sensitive, nor are the figures in question difficult to calculate and from within the company are easily obtainable. Total emolument figures should be broken down into their components, specifically performance-related bonuses and pension contributions and for each director. The way in which performance-related bonuses are calculated, while often very complicated, should also be given.

Even if the company cannot estimate the value of the share options it grants its directors, it should at least disclose sufficient information to enable shareholders to ascertain for themselves the possible benefits of the options to each director. If the "grant price" and number of options at each "grant price" were presented in one table next to the name of each director, shareholders would be able to compare the "grant price" to the current share price and thus be able to calculate each board member's potential earnings from this source.

The Association of British Insurer's Institutional Shareholders' Committee's guidelines in this area are unspecific. In its document *The Role and Duties of Directors - A Statement of Best Practice*, under the section on emoluments it states; "A summary of the details of any performance-linked remuneration schemes and of all types of share option and other incentive and profit sharing and bonus schemes should be disclosed in the annual report." While this goes further than previously, as we have seen, "...a summary of the details..." of a share option scheme can be designed to give no information at all. "Benefits or potential benefits accruing from these schemes" would be more appropriate.

Finally, The Stock Exchange should be more rigorous in its requirements for information on directors' share dealings in their own companies. While its current parameters are sufficient to monitor issues of ownership, issues of remuneration remain largely unanswered. Specifically, it should require the price at which options were granted.

These recommendations are not complex, nor are they controversial. They are not restrictive, but elucidatory. With a few, specific changes in the ways in which companies present information pertaining to directors' remuneration and the regulatory authorities monitor that information, the issue of directors' remuneration and corporate governance could be quickly and efficiently resolved.

Professor John Samuels  
Michael Cranna MA  
May 1992