KPMG’s survey of Directors’ compensation analyses the latest trends in FTSE 350 directors’ pay. It covers base pay and incentives, both short and long-term. We also look at non-executive directors’ fees. The picture is not complete without also looking at the package in its totality, so to put the various components in context, we start by analysing total remuneration.

Key Findings

By the standard set in earlier years, 2008 has been another quiet year for executive remuneration. There have been few public controversies surrounding new incentive plans. At the same time, the number of new and amended plans taken to shareholders has dropped dramatically. As at the end of July 2008, 44 FTSE 350 companies had put 65 new or amended plans to shareholder vote.

This compares with 72 and 100 respectively in the course of 2007 and continues a three year trend of decline in the number of FTSE 350 companies introducing new plans. We believe that this reduction is a result of the streamlining of plan structures and the relative saturation in common plan types among FTSE 350 companies and that the trend will continue into next year.

The key findings of this year’s survey are as follows:

- **Base salary** – the median rates of salary increases are six to eight percent. It should be noted that for many companies the pay increases reported here pre-date the economic downturn. Rates of salary increases might therefore be expected to decline further.

- **Annual bonuses** – while bonus policy amounts stayed at about the same maximum levels as last year, actual payouts have declined as a percentage of potential payout, particularly among FTSE 100 companies.

- **Deferred annual bonus plans** – these are now an established component of pay, with over half of FTSE 350 companies operating a deferred annual bonus plan. Typically new and live plans include a matching element, linked to three year total shareholder return (TSR) or earnings per share (EPS) performance.

- **Performance share plans** – last year we observed that actual awards had increased and that for many companies they were near maximum limits. This year we observe an increase in the maximum plan limits. However, crucially, the levels of expected value of actual awards have generally declined. The main reason for this seems to be that performance conditions have become more stretching, with many companies pushing the full vesting threshold upwards, for example from upper quartile to upper decile relative TSR performance.
In other words, this is a reflection of a trend of higher potential payouts in return for more stretching levels of performance. This trend is currently much stronger in FTSE 100 companies than in FTSE 250 companies, in which maximum payouts remain considerably lower but in which many fewer plans require performance above the upper quartile point for full vesting.

- **Share options** – last year we noted that companies appeared to be using their share option plans more selectively. There has been an increase in the maximum grant policy over the past year, particularly among FTSE 100 companies, but generally the levels of actual grants made as a percentage of salary have decreased in FTSE 100 companies from last year and they have remained broadly the same in FTSE 250 companies.

- **One-off plans** – with over ten such arrangements put to shareholders this year – and likely more special one-off awards that did not require a shareholder vote – one-off plans have become a significant exception to the general trend of more standardised incentive arrangements. Investors can be sceptical about these plans but accept that special circumstances will sometimes exist to justify a departure from ongoing remuneration strategy, for example the introduction of a new management team as part of a business turn-around plan.

- **Non-executive directors’ pay** – the rates of increases in annual fees are similar to last year, indeed in some cases higher. This is likely to be a response to the perception that the level of risk, and time commitment, associated with a non-executive directorship of a listed company has grown steadily over the last few years.

**Outlook for 2009**

- **Annual bonuses** – we think that, in current market conditions, some companies will find that focusing on earnings and profitability – traditionally the most common corporate measures for annual bonus plans – is less appropriate than highlighting alternative performance targets such as margin, market share, cash flow and other strategically important, sometimes non-financial, measures. Investors are expected to continue to focus on both policy changes and actual payouts.

- **Performance measures** – the importance of ensuring that performance measures are appropriate is not limited to annual bonus plans. On the contrary, it seems likely that company boards and shareholders will in some cases conclude that the company’s long-term incentive plans are not delivering value which properly reflects the true performance of the business. This can work both ways. On the one hand, some plans will stop paying out, even though management might be doing a particularly good job in difficult circumstances. On the other, there will be plans which will pay out even though shareholder value is being destroyed. The hope might be that such considerations will stimulate more innovation in this area, long identified as overly shaped by convention. Investors can be expected to scrutinise proposed changes to performance measures to ensure that they do not simply represent a relaxation of performance targets.
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- **One-off plans** – we think it likely that a similar, if not an increased, number of one-off plans will be brought to shareholders next year as companies bring in new directors and management teams ahead of an anticipated upturn in economic fortunes.

- **Salary increases** – it will come as no surprise to companies that investors are expected to continue to scrutinise salary increases closely, one of a number of factors making significant base salary increases unlikely. The market capitalisation of many companies has decreased significantly over the last year and base salaries in some companies may, as a result, look high for the size of the company. While, to some extent, market capitalisations have decreased across the board, investors may scrutinise the level of potential payouts under incentive plans (which are set by reference to base salary) more closely in the case of companies whose market capitalisation has decreased most sharply.
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