SECTION 1: BOARD LEADERSHIP AND COMPANY PURPOSE

An effective board is crucial to setting a positive company purpose, set of values and culture. The board should be diverse and committed to contributing to the long-term success of the company and the boardroom culture must enable each of the directors to contribute effectively and create a whole greater than the sum of its parts.

Company leadership, purpose and culture vary widely and investors should work with their advisers and managers to consider which issues are most likely to be material to value-generation. For instance, one company might have an issue with its supply chain and another an issue with staff retention.

The role of culture

Investors might underestimate the value of an organisation’s culture, but given its materiality to long-term corporate performance, schemes should consider and ensure they ask their managers to engage on this topic with investee companies.

An accurate assessment of a company’s culture is not an easy task but can provide vital insight into that company’s intrinsic value, as well as any emerging risks (and opportunities) the business faces currently or is likely to face in the future. Cultural failures can damage corporate reputation and substantially affect investment returns. The 2018 UK Corporate Governance Code more clearly highlighted the role of the board in particular in determining and assessing a company’s culture and values.

Culture is difficult to assess, but there are performance metrics available that can be helpful for raising questions. The PLSA has undertaken significant work on the value of an engaged, motivated and skilled workforce including a range of proxy metrics, tailored to specific sectors, for investors to use in assessing company culture through the use of different sources of information including their communications with employees, shareholders and wider stakeholders.

Evidence base

Shareholders will naturally look at financial results, as well as for wider evidence that the Chair and the board as a whole are adhering to the spirit of the Corporate Governance Code’s Principles. For instance, significant pay discrepancies between a company’s senior executives and the rest of the workforce, as well as gender or ethnicity pay gaps, can be signifiers of wider issues with a workplace’s culture and processes.

Clarity on company strategy, culture and the business model should flow through every part of the Annual Report. This should include information on a company’s employment model and working practices, given their materiality to a company’s long-term performance, and how this is linked to the firm’s culture and purpose.

The Annual Report should have clear information on workforce engagement and draw clear links between any employee survey findings, actions undertaken in response and the (expected) impact. Key metrics include employee turnover and employee survey follow-up.

28 Further information can be found in Understanding the Worth of the Workforce – a Stewardship Toolkit for Pension Funds (PLSA, 2016).
The Strategic Report should clearly articulate how the company’s key assets contribute to the generation of sustainable value creation. Clear connections should be apparently between chosen financial and non-financial priorities and KPIs selected by the company. Defined outcomes desirable for the company and its stakeholders should be measurable and incentivised by being integrated into remuneration arrangements that apply appropriate outcome measures over a reasonable time horizon.

Shareholders may want to undertake closer analysis of the narrative within company statements, noting the tenor and language used in describing the approach to the workforce and stakeholders and considering whether this bears out messaging from the Chairman and CEO statements about the aims and culture of the company. A feeling of alignment and consistency should be apparent throughout the document.

Leadership purpose and culture can be difficult to evaluate purely through reading company reports, however, and should be enhanced by shareholder engagement that has a central role to play in reviewing corporate behaviour and assessing performance on an ongoing basis.

The best indicators to use will depend on the situation, the context and the specific environment a company operates in. Investors should look for reliable and consistent sources of data, which allow comparison over time and with others in the sector.

What does good company behaviour look like?

- **Corporate purpose, culture and values are aligned with company strategy.** This alignment should continue through the recruitment, performance management and reward structures, all of which should be aimed at incentivising behaviour which is consistent with the company’s purpose and values.

- **There is a clear link between good performance, the effectiveness of the board and results delivered in a way which is consistent with the company’s stated strategy.** Any weakness in performance should be adequately explained and should not be as a result of imprudent management, poor judgement or weakness in corporate governance that are not being directly addressed. Any weakness in performance should rather owe to external factors over which the board has limited control.

- **Boards demonstrate awareness of their s.127 Duties under the 2006 Companies Act.** This is a requirement for Directors to have regard to other stakeholders, including workers, customers, suppliers and wider society and the environment. This should include evidence of a plan for engagement with stakeholders, as well as activities undertaken and consequent outcomes.

- **Boards demonstrate positive relationships with key stakeholder constituencies.** Boards should be able to communicate how stakeholder perspectives are fed into boardroom considerations. This should include shareholders – the quality of this dialogue is vital for assessing culture in particular.

- **The Annual Report as a whole offers a fair, balanced and understandable assessment of the company’s prospects and position.** It should cover both
financial and non-financial issues, and outline how the board has fulfilled its responsibilities.

- **Company statements refer to the workforce as a source of value, not a risk to be managed.** The 2018 Code explicitly clarified the company’s responsibilities to shareholders and stakeholders – including its workforce.²⁹

- **The Chair is engaged with the company’s shareholders on governance and culture.** Satisfactory engagement between company board members and investors is vital for a healthy UK corporate governance regime. The Chair should be accessible, accept legitimate shareholder requests for a meeting and convey relevant sentiments and dialogue back to the board as a whole.

**How investors should consider voting**

The most appropriate route for registering general concerns would be voting on the **Annual Report and Accounts**. Investors should consider voting against adoption of **Annual Report and Accounts** if:

- Key stakeholder relationships – including with shareholders and the workforce – are being neglected and the board is not adhering to the spirit of the Corporate Governance Code requirement to have concern for stakeholder constituencies

- Disclosure of the business model fails to convey how the company intends to generate and preserve long-term value

- The company fails to provide a fair and balanced explanation of the composition, stability, skills and capabilities and engagement levels of the company’s workforce.

More specific concerns related to the quality of the company’s interaction with shareholders could be addressed by voting against the re-election of the Chair i.e. if:

- The Chair has declined a legitimate shareholder request for a meeting without offering a valid reason, or has failed to find a mutually convenient time without undue delay

- The Chair has repeatedly failed to address investors’ concerns about the relationship with key stakeholders

- The Chair has had significant involvement, whether as an executive director or a non-executive director, in material failures of governance, stewardship or fiduciary responsibilities at a company or other entity.

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²⁹ Please see the PLSA’s *Hidden Talent II* report (April 2019) on workforce disclosure for further details of the latest regulatory developments in this space.

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SECTION 2: DIVISION OF RESPONSIBILITIES

Separation of the roles of Chair and Chief Executive

A key role for the board is to scrutinise the operations and strategy of a company, ensuring the firm is operated in a way which aligns with its mission, purpose and in the interests of stakeholders and holding company management – including the chief executive – to account.

Separation of the roles of Chair – who should be transparently independent – and Chief Executive is therefore a cornerstone of good corporate governance in the UK. The contravention of this tenet by (a) the combination of the roles; or (b) the designation of an executive chair, should cause significant concern.

There are very limited instances where a temporary combination of the roles may be justified, notably when a Chair “bridges the gap” between the departure of a CEO and the appointment of their successor. Investors must probe companies carefully in these instances, ensuring that this short-term fix is being well-managed and that it does not persist excessively.

The succession of the CEO to Chair is a significant issue and is very rarely acceptable. It must be made clear that external search consultants were engaged and that external candidates of at least equivalent stature had been actively and fully considered.

Director Commitment

The non-executive director role is an increasingly demanding one, particularly when chairing a key committee. It is crucial that directors have sufficient time and energy to fulfil their role properly.

Evidence base

Engagement with board directors, particularly with the Chair, gives investors the opportunity to assess the quality of the effectiveness of the board and its individual members.

The Annual Report should contain details of current appointments, including any changes over the previous year. Investors should be mindful of board directors’ concurrent directorships and take account of the size of the outside company, its complexity, its circumstances and other commitments that a director has in forming a view as to whether an individual director is over-committed.

The Annual Report should also clearly set out the ways in which the board has demonstrated its effectiveness and taken steps to address any areas for improvement. This should include insight into board-level training, assessment and outreach activities that have taken place.

30 The issue of combined chair-CEO roles is particularly key in France, Spain and the US. Combined chair-CEOs can be found on 47% of S&P 500 boards, 48% of Spain’s largest companies and more than half the CAC 40 companies in France (LGIM, 2020).
throughout the year. It should also include an assessment of the board’s diversity of skills, experience and backgrounds.

What does good company behaviour look like?

- **Different roles and individuals work together collectively and effectively.** The quality and mix of individuals should give investors reassurance as to the quality and openness of debate within the boardroom, the lack of dominance by any one individual and the avoidance of groupthink.

- **The roles of Chair and CEO are fulfilled by different individuals.** The two roles are distinctly different and should not, unless in exceptional circumstances, be held by the same person. Clear timescales for the persistence of this arrangement should be set out. Similarly, a company’s chief executive should not become chair of the company. We would expect significant levels of engagement with shareholders were this to be the case, setting out the reasons for doing so.

- **There is a transparently independent Chair and, upon new appointments, confirmation is provided to shareholders that the previous Chair was not involved in the appointment of their successor.** If the Chair is not independent on appointment, the company should consult its investors and provide a detailed explanation as to why it considers the appointment desirable. In assessing the new Chair’s suitability, shareholders must consider:
  - Their calibre, including skills, knowledge and experience
  - The balance of the board
  - The nature of the impediment to the proposed chair’s independence

- **The Nomination Committee anticipates change and ensures proper and timely succession planning.** This includes ensuring boards are equipped with a diversity of perspectives, skills and experience and that each member is able to devote the necessary time to carry out their responsibilities. Boards should endeavour, where feasible, to consult their long-term investors over sensitive board appointments.

- **Directors are able to commit appropriate time to the company.** Investors should assess the evidence for other demands on directors’ time as well as any significant developments which may have occurred since a director’s appointment.
  - This is particularly pertinent to the role of chair – and especially where a company is both complex and global in scale, or if it operates in a highly regulated sector such as financial services.

- **Clear mechanisms in place for shareholder communication.** This must include the appointment of a Senior Independent Director (SID) as a key contact for shareholders when the normal channels of the Chair, CEO, or CFO have failed to address concerns or are not the appropriate avenue.

- **Shareholders are given timely access online to terms and conditions on which directors are appointed.** It is clear that due consideration has been given by the board and each director to the time commitment required, particularly in the event of a crisis developing.
✓ No current or prior relationships exist between independent non-executives and the company, which could compromise directors’ ability to hold management to account. Shareholders should have a clear sense of any existing or pre-existing relationship between the independent non-executives and the company. The 2018 Code draws out more clearly its expectations regarding the independence and responsibilities of non-executive directors.

✓ There should be a clear mechanism in place for engagement with the wider workforce. Companies should be clear about linking their engagement with their workforce to their broader strategy, values and mission.

How investors should consider voting

We are aware that investors may feel uncomfortable voting against a combined Chief Executive/Chair given the pivotal role that a Chief Executive plays in a company (and the investment case). Some investors may therefore choose to vote against the Annual Report and Accounts to signal their concern, short of opposing the combined Chair/Chief Executive. However, we feel that this may not be a sufficiently effective response to what is a very serious issue. We therefore believe that investors should consider voting against the election of the Chair if:

× There is a combination of the role of Chair and Chief Executive without a convincing explanation, where an ‘interim’ period extends for more than one year, or where there is evidence of poor succession planning

× They judge that the arguments presented to justify succession of the CEO to Chair are insufficient – complexity of the business is unlikely to be sufficient in itself as an explanation

× The Chair is director of more than four companies and/or a chair of two or more global and highly complex companies – unless there is a compelling explanation as to why this will not impact their availability and commitment

× The situation persists and there remain serious concerns that the specific arrangements create unsolvable challenges for board oversight of executive management

× Material corporate governance failings under the chair’s watch are evident. This should include an inadequate response in addressing shareholder concerns

Investors should consider also voting against the election of the Director responsible for the appointment process (often the SID).
SECTION 3: COMPOSITION, SUCCESSION AND EVALUATION

Composition and Diversity

There is clear evidence that diverse boards make better decisions and avoid behavioural biases such as groupthink or herding, enhancing board effectiveness. Although progress in recent years towards meeting the Davies target of 33% of women on FTSE 100 boards has been positive, there is still considerable room for improvement in some cases. Progress also remains slow in terms of ethnic diversity on boards, as highlighted by the Parker Review of boards. Investors must continue to press companies to maintain momentum and assess company disclosures on diversity carefully.

Director (and Chair) Independence

This calls for a particularly thoughtful application of the “comply or explain” principle. Investors should consider the following factors in coming to their decision regarding independence:

- Overall corporate governance standards and history
- Evidence of independence in the director’s conduct, including holding management to account on particular issues
- Confirmation that independence (not just performance) was assessed in the board evaluation

Succession and Board Evaluation

Continuous and evolving Board refreshment and succession planning is vital. It is critical that appropriate and sufficiently flexible succession plans are in place for the CEO and Chair. An effective board evaluation process, which uses an independent external facilitator at least every three years, is an important part of a company’s governance processes.

Evidence base

While it is particularly difficult to get concrete metrics in this area, investors should look for progress over time and evidence that the company’s approach is changing for the better.

Company disclosures on succession planning in particular tend to be prone to the use of boilerplate reporting. Investors should look at the Annual Report with an eye to assessing how bespoke the narrative on succession planning is, including how well it is linked to the company’s overall strategy, values and mission.

Best practice disclosure on this issue includes:

- A board succession planning and nomination policy
- A rationale for re-election of each director

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Disclosure about the principles and process, including clearly defined parameters for and expectations of new appointments

A clear discussion of the outcome of the board effectiveness review, including how the findings impact upon broader company value.

What does good company behaviour look like?

- **The board has a clear vision about the optimal composition and a structured plan and times scales to achieve this.** This should include: the ideal mix of experience and skills; gender, ethnic and other forms of diversity; and the proportion of the board that should consist of NEDs.

- **Clear disclosure on succession plans.** While some allowance should be made for the confidential or sensitive nature of some succession planning issues, disclosures should cover as much material information as possible including:
  - Any identified skills shortages
  - A focus on the Chair and CEO
  - An approach which looks out over multiple years

- **Ownership of the succession planning approach by the company.** The board should – through the Nomination Committee – retain ownership over the succession planning and recruitment strategy for both the board and for the Senior Management Team (SMT). Although the company may use external consultants, the board should ensure it remains actively involved.

- **A well-balanced Nomination Committee.** This should include the non-executive chair of the board, given the vital role they play in director performance evaluation.

- **A clear and convincing rationale for Director re-election in the Annual Report.** Such a statement should present shareholders with a full picture of the relevant skills and experience that a director is bringing to the board. It should also include:
  - A statement of a director’s other directorships, trusteeships and responsibilities – including those outside the corporate sector
  - The contributions they have made or will likely make to the board
  - Confirmation that the director has recently been subject to formal performance evaluation in relation to the fulfilment of their s.172 duties

- **Detailed and considered explanations around Director independence.** This should include why the company considers that the director remains independent despite the existence of any factors which may impair independence. It should also include justification as to why the independent element is sufficiently strong to counter any imbalance that may arise from the presence of one (or more) non-independent non-executive directors.
✓ **A transparent and inclusive approach to the nomination process.** This should include engagement with key shareholders, or other stakeholders such as employees.

✓ **A consistent approach to board refreshment.** This should include appropriate director mandates in terms of duration, and a clear link between director performance and re-election.

✓ **Forward-looking and detailed succession and refreshment plans when proposing the re-election of long-serving members.** The UK Corporate Governance Code stipulates that a board should state its reasons if a director has more than nine years’ tenure\(^{32}\). This should not be considered to mark a limit on the value offered by an individual, but a detailed plan is particularly vital when the director chairs an important board committee, including the following:
  - There is evidence of a particularly rigorous review and evaluation process in the cases of long-serving members
  - There is particularly clear disclosure as to why a long-serving non-executive director remains independent

✓ **A clear link between implementation of the succession plan and company strategy.** This should include the board’s policy on diversity, including gender and ethnicity\(^ {33}\), including its diversity objectives and progress towards achieving them. There should also be clear information regarding the efforts to develop talent internally.

✓ **A clear description of the board’s policy on diversity – including professional, international, gender and ethnic diversity.** This should include any measurable objectives that it has set for implementing the policy, and its progress against these objectives. This should include the board’s policy not just on its own diversity, but also on the diversity of the Senior Management Team (SMT). There should be a consistency in the company’s strategy towards, and explanations of the contribution of, diversity (including cognitive diversity) and its link to corporate value over time.

✓ **External board evaluations are conducted by a truly independent organisation.** This is vital for any board effectiveness review to take an independent and rigorous approach. Companies should disclose details of the process – including the name of the firm or individual undertaking the board evaluation – and as far as possible the conclusions reached within the evaluation and subsequent actions taken. This should include details on the following:
  - When the review took place and when a subsequent review is planned;

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\(^{32}\) The 2018 Corporate Governance Code states that “the chair should not remain in post beyond nine years from the date of their first appointment to the board”. It also notes that this can be extended for a limited time, and alongside a clear explanation for doing so, to allow for effective succession planning and the development of a diverse board. Several investors currently consider that 12 years in post is a red line.

\(^{33}\) Diversity information should run through any key corporate disclosures on the board and workforce. This is particularly in the context of new (and forthcoming) disclosure requirements for the largest companies on gender pay and ethnicity pay and heightened investor focus on board diversity.
What was specifically reviewed (including the rationale for this decision);

- Who conducted the evaluation, whether they were internal or external; appointments and why they were selected;

- The nature of the process;

- Key findings and lessons learned, and whether any follow-up is required and if so, in what areas.

✓ **Disclosure of details of any controlling shareholders, including the relationship agreement.** Investors are increasingly concerned about controlling shareholders (defined by LR 6.1.2A) overriding the interests of minority shareholders. The relationship agreement must detail any entitlements to governance arrangements such as board appointments and be made available to investors – barring any commercially sensitive details.

**How investors should consider voting**

Holding individual directors accountable on this particular area is especially vital if schemes are particularly unhappy with the composition of a board of company, including the plans for succession and methods which have been used to ascertain how ‘fit for purpose’ an individual board member is.

Although voting against the entire board is usually the most powerful sanction an investor can apply, in this case, it is voting against specific individuals – alongside a clear and timely explanation from the investor as to why the vote is being cast – that can be most effective.

Investors should consider voting against the approval of the **Annual Report and Accounts** if:

- There is limited or boilerplate disclosure about the board evaluation and review of corporate governance arrangements

- A diversity statement is not disclosed, or is considered unsatisfactory

Investors should consider voting against the **re-election of the Chair** if:

- Practice does not improve or there is consistently no independent board evaluation conducted

Investors should consider voting against the **re-election of the Chair and the Chair of the Nominations Committee** if:

- There is no evaluation process

- There is no clear evidence that diversity is being sufficiently considered by the board

- There is a failure to disclose a reassuring succession plan, even after engagement with shareholders

- The board is consistently failing to move closer to the Davies Report target on female representation or the 2016 Parker report’s ethnic diversity target of no “all white boards” by 2021 (or other established targets for gender and other forms of diversity)
× There is a failure to move to annual director elections and an absence of an acceptable explanation

Investors should consider voting against the re-election of a Director (including re-election of the Chair) if:

× Previous legitimate investor concerns have not been sufficiently addressed

× The director has had significant involvement, whether as an executive director or non-executive director, in material failures of governance, stewardship or fiduciary responsibilities at another company or entity

× Engagement with a director has resulted in a judgement against their effectiveness and suitability, including with regards to conflict of interest

× There is no supporting statement from the board

× There is clear evidence of poor performance or poor attendance at meetings without provision of a satisfactory explanation

× There is concurrent tenure of a NED with an executive director for over nine years and no satisfactory explanation given as to why the director remains independent

× The composition of the key committees or the balance of the board has been compromised by the presence of one (or more) specific non-independent non-executive directors

× Where there is failure of a specific aspect of reporting or function (with investors voting against the Director responsible e.g. the Chair of the relevant Committee)
SECTION 4: AUDIT, RISK AND INTERNAL CONTROL

The primary client of a company’s auditor is the shareholder. Investors rely on a high-quality audit, where the auditors are fully independent and have exercised professional scepticism and judgement, to enable them to form a clear and accurate view of the financial health of the company.

Individual accountability here is key: if a named partner, or the Chair of an Audit Committee, has been involved in presiding over poor audit practices elsewhere, then investors should expect that the individual is not involved on an Audit Committee or involved in the audit at or of another firm.

Investors should note that the policy and regulatory framework for audit and investor engagement is likely to evolve rapidly over 2020 and 2021. This is in response to high-profile reports like the Brydon Review, which made a series of recommendations for engaging investors and enabling greater investor input, including:

- For the directors’ Risk Report to be published in good time for shareholders to comment, as well as for a formal invitation to be issued to shareholders to express any requests they have regarding where they would be particularly keen for auditor focus in the audit plan;
- A standing item to be added to AGM agendas for questions to the chair of the audit committee and to the auditor;
- The establishment of the Audit Users Review Board, comprising users of audit reports to review proposals from and give advice to ARGA as to the evolution of audit.

The external auditor

The role of the external auditor is to give an independent opinion on a set of financial statements and whether these show a true and fair value of the company. There should be regular refreshment and turnover in use of the external auditor to ensure that they remain impartial and able to exercise professional scepticism.

Risk and Internal Control

Risk management must be a prominent consideration at any company. Effective, robust and well-resourced internal audit has a central role to play in supporting boards to better manage and mitigate the risks the company faces. Firms should focus on risk in the context of the business strategy, the firm’s size and global footprint, as well as its assets, liabilities and the wider political and regulatory environment.

The role of the internal auditor is key. It is their task to provide an annual internal opinion on the state of the organisation’s arrangements in relation to risk management, governance and internal control. The internal audit function may also include an advisory or consultancy function, where they support management in improving systems and controls.

Evidence base
The key source of information on the auditor is the audit report. Investors should pay attention to the following information:

- Evidence of professional scepticism by the auditor;
- The critical accounting policies and principles used;
- The level of materiality adopted;
- Assumptions and judgements;
- The findings of any review undertaken by the FRC’s Audit Quality Review Team (and actions taken by the board in response to the findings).

Few investors are experts on audit assumptions and methodologies and there is an ongoing policy debate regarding to what extent investors can expect to be. The key determinant of a high-quality audit is professional scepticism and a willingness to challenge management.

Investors should be prepared to dig deeper and ask questions – via the Audit Committee or directly, if they have the necessary contact at the audit firms – including disclosure on areas where the auditor challenged management and the outcome, or even simply making a request – along the lines of the Brydon Review’s recommendations highlighted previously – that the auditor be present at the AGM to answer any questions and present their report.

On ESG metrics it is desirable that the sustainability metrics provided by companies be assured.

What does good company behaviour look like?

Audit

- **The audited accounts represent a “true and fair” view of the state of affairs of the business.** This should include its assets, liabilities, financial position and profit or loss – all of which should be prudently assessed to avoid overstating capital.

- **The Audit Committee obtains a high-quality audit in the interests of shareholders, allowing for proper accountability between the audit company and the investors.** The Committee has arguably the most complex brief of any of the board committees as objective and prudent accounts sit at the heart of an effective accountability regime.

- **The Audit Committee demonstrates sufficient independence from company management.** The Committee should be staffed solely by independent directors (both from the executive, but also taking into account independence from the external auditor) and enjoy sufficient relevant experience to carry out its responsibilities to a high standard.

- **The Audit Committee Report provides ‘colour’ and detail.** This should not simply mirror the auditor’s report. It should include the right quality and amount of information to give investors an insight into the audit process, including:
  - Explicit details of the criteria used for auditor selection and evaluation, including any contractual obligations to appoint audit firms;
- Details of the audit tender process, including when the audit was last tendered\(^{34}\) and how the company ensures independence is safeguarded

- How the Audit Committee satisfied itself that it got the highest quality audit possible

- Any changes to the process and plan of the audit (and reasons for these changes), including any changes to the audit partner and the process carried out by the audit committee to agree this appointment

\(\checkmark\) The Audit tendering process is in line with EU Regulations and has been rigorous. Any tendering process should enable the audit committee to compare the quality and effectiveness of the services provided by the incumbent audit with other audit firms – including those outside the Big Four. The intention to tender the audit contract should be disclosed in advance within the report and accounts and the process should focus on audit quality – not costs – including the auditors’ independence and processes to ensure professional scepticism.

\(\checkmark\) The Audit Committee fully discloses any members’ connections with the current or potential auditor. Committee members should also have recent and relevant financial experience related to audit, accountancy or investor practitioner expertise.

\(\checkmark\) Additional disclosures clearly cover any the reasons for any auditor resignation and fully detail all non-audit fees and policy on non-audit work. Where the auditors supply non-audit services to the company, the audit committee should keep the nature and extent of such services under regular and closer review, to ensure objectivity is not compromised. Disclosure of non-audit fees should include:

- Clear break-down between the types of services received;
- Tax compliance services are differentiated from tax advisory services;
- Non-statutory acquisition-related services are separated from statutory services;

\(\checkmark\) Appropriate use is made of third parties for non-audit services (including outside the Big Four). Where the company also uses its auditors for non-audit work, the rationale for doing so much be clearly explained. No more than 50% of the audit fee should be spent on non-audit services.

\(\checkmark\) The AGM includes a presentation from the auditor. This happens increasingly rarely but the PLSA would be keen for this to take place more frequently. An appearance by the auditor at the Annual General Meeting would give investors the opportunity to directly ask questions and hopefully raise the profile of audit issues.

\(^{34}\) Rules require tenders to be undertaken at least every ten years, with audit firms being replaced at least every 20 years.
Risk and Internal Control

✓ **The Annual Report covers the key elements of the business.** It should explain how the company generates value from its key tangible and intangible assets. It should set out the board’s view of the key strategic and operating risks facing the business – including environmental, social, governance and reputational risks.

✓ **The Annual Report covers emerging risks, demonstrating a dynamic approach to risk assessment**. This could include risks from climate and cybersecurity, or tax management (and the potential impact on reputation and brand value). Companies should be communicating what changes have occurred in relation to their risks over the previous year, how it has chosen to respond and the impact so far – including likely impact on the overall business strategy and model.

✓ **Directors state whether they expect the company to meet its liabilities as they fall due over the period of their assessment.** This should include drawing attention to any qualifications or assumptions as necessary. This should be as part of an articulation as to whether they have a reasonable expectations that the company will remain a viable and sustainable enterprise for the foreseeable future.

✓ **Directors articulate their reasons for choosing a specific time-frame.** This should follow the FRC’s guidance that the length of the period should take account of the board’s stewardship responsibilities, previous statements they have made, especially in raising capital, the nature of the business and its stage of development.

How investors should consider voting

Investors should note that in most cases, but not always, there are separate resolutions which cover the appointment of external auditors and the setting or authorisation of the board to set auditors’ fees. This is important because investors may have concerns about the balance between audit and non-audit fees which need to be considered separately to the appointment of the auditor alone.

There is a range of resolutions that investors might use as a vehicle to express concerns regarding audit process or outcomes. These include: the vote to (re-)appoint the auditor; the vote to give directors power to agree the auditor’s fee; the vote to approve the Report and Accounts; or the election of the chair (or other members) of the audit committee.

Investors should consider voting against the Report and Accounts and perhaps also the auditor and/or audit committee chair if there are ongoing concerns in relation to:

× The audited accounts fail to provide a true and fair view of profit or loss, assets or liabilities e.g. they overstate profit or assets, or understate likely liabilities (e.g. pension liabilities, climate-related liabilities) **please note: if the auditor is seen to have helped reveal this issue then their re-election, all other things being equal, should be strongly supported**

× There is ongoing use of alternative performance measures to report on business performance and their use is not transparent and fully justified, or where the

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35 The PLSA would encourage investors to use the FRC’s Guidance on Risk Management, Internal Control and Related Financial and Business Reporting and Guidance on Audit Committees.
reconciliation to the GAAP accounting numbers if unclear, or where the calculations change regularly in ways that appear to flatter management delivery

× There is poor disclosure of the strategy and risk exposures or a lack of disclosed review of the company’s risk management and internal control systems

× There is either no viability statement which looks out over multiple years, or one which does not evidently consider a full range of risk factors

× The climate change assumptions that underlie calculations of relevant and publicly stated asset valuations or business profits are not sufficiently transparent or appear to be inconsistent with science and expert opinions on climate change

Investors should consider voting against the re-election of the Chair of the Audit Committee and reappointment of the auditor if:

× The tenure of an external auditor extends beyond ten years and there has not been a recent tender process and where no plans to put the audit service out to tender are disclosed

× The auditor has been in place for more than 20 years

× If the non-audit fees exceed 50% of the audit fee in consecutive years without an adequate explanation being provided

× There are major concerns regarding the audit process and quality of accounts – particularly a failure to provide a true and fair view, or good visibility over payment of dividends and these are not resolved satisfactorily by the board

Investors should consider voting against authorisation of auditors’ remuneration (or the reappointment of the auditor if these resolutions are bundled if:

× The auditor’s report fails to address a key issue or is otherwise unsatisfactory

× Audit fees have been either increased or reduced by a significant proportion (e.g. more than 20%) in a given year without a clear justification

Investors should consider voting against the re-election of the Chair if:

× There are extreme concerns or persistently poor disclosure

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36 Investors should make sure they are clear on whether this is simply because the auditor is more efficient or whether this fall is in fact accompanied by an inappropriate reduction in audit scope or increase in the materiality threshold, i.e. explicitly a reduction in audit quality. Additional scrutiny should be expected if a significant reduction in fees follows an audit tender.
SECTION 5: REMUNERATION

Remuneration is seen by many investors as a litmus test for wider corporate governance practices; it encompasses board effectiveness and leadership, challenge and oversight, as well as strategy and risk management.

Investors must continue to evaluate all aspects of a company’s remuneration policies critically, with a view to ensuring that they are closely aligned with their interests and are driving long-term strategic success.

Investors should be aware that there is a significant and growing reputational risk from the issue of poorly managed executive remuneration – including for investors themselves and how well they are holding companies to account on this issue.

Significant pay discrepancies between a company’s senior executives and the rest of the workforce, as well as those based on gender or ethnicity, can be a signifier of wider issues with a workplace’s culture and processes.

Evidence base

There will be several pages dedicated to executive remuneration in the Annual Report. However, it is vital that companies and shareholders also have appropriately regular discussions on strategy and long-term performance. Investors must use these engagements as an opportunity to encourage firms to directly link remuneration and corporate performance objectives.

Remuneration metrics should be considered in the context of the sector in which the company operates and what similar companies are doing in terms of their pay arrangements. There should be evidence of a range of long-term remuneration structures considered, with a convincing rationale as to why a particular approach – such as a Long Term Incentive Plan (LTIP) – was chosen over other approaches such as deferred stock options.

Investors should also ensure that there is a discussion of the remuneration quantum and not just the approach, bearing in mind the increased scrutiny from public and policymakers regarding big pay packages in an era where we are likely to face greater economic and market uncertainty.

What does good company behaviour look like?

✓ Remuneration structures cascade down to all employees. Remuneration structures and incentives for executive directors should in some form cascade down to all employees in order to allow employees to also share in the success of the business. For example, companies should seek to offer employees share awards in the most cost effective and simple manner. This should also include executive pension contributions – rates for executive directors should be in line with those available to the workforce. This should be the case for both new directors and investors should engage as much as possible to ensure that this is the case for existing directors too.
  
  • Maximum pay-outs must remain in line with the expectations of shareholders and other stakeholders, including workers and wider society.
- The pay policy should not enable any pay award larger than that necessary to successfully execute the company’s wider strategy, and to incentivise and reward.

- There are clear time frames for bringing executive pension contribution rates for existing directors into line with those of the wider workforce. No compensation should be awarded for this change.

- New executive directors or any director changing role are appointed at the same level of pension contribution as for the overall workforce.

- **The remuneration policy is clearly linked to incentivising behaviours which are consistent with the company’s purpose and values.** This should include performance on E and S issues and should demonstrate some recognition of wider societal expectations, the general economic environment and the returns to long-term shareholders.

  - Remuneration Committees should take as a starting point the company’s strategic plan and KPIs and ensure there is a strong read across from the company’s strategy to the drivers of executive remuneration.

  - This should include an aspiration in the near-term, if not already undertaken, to tie remuneration to company performance on relevant and material E and S metrics. Please note that this should be done in a way which does not incentivise the pursuit of sustainability at any cost and should be appropriate to the company context.

  - Where LTIPs are used, these should be linked to several different performance metrics, perhaps including a combination of growth, earnings and a mix of top-line and bottom-line contributions, in order to avoid incentivising short-term behaviour by executives.

- **Pay schemes are clear, understandable for both investors and executives.** Firms should not be operating multiple long-term schemes – a multiplicity of awards, with varying performance conditions is rarely successful in motivating company executives.

- **The Remuneration Committee designs rewards that drive long-term success.** Remuneration committees should take ownership of, and be accountable for, both the remuneration policy and its outcomes. Companies should consider how they might align pay more closely with the interests and expectations of their long-term owners in order to position themselves best for future success.

- **The Remuneration Committee exercises its judgement, taking a critical and challenging approach to pay increases.** Shareholders allow Remuneration Committees significant discretion and room to exercise judgement about the overall performance of the company when determining awards.

  - Even when Remuneration Committees are thinking about making executive salary increases that are in line with the average employee increase,
consideration should be made to how competitive pay is already and to the extent to which this will increase all other areas of remuneration (typically already at high multiples of salary and much higher than that available for employees).

- Remuneration Committees should demonstrate that they are prepared to exert downward pressure on executive pay where necessary and that they have used their discretion to ensure that awards properly reflect business performance. This should include a willingness to scale back in light of wider factors relating to the company, its conduct, reputation and relationship with key stakeholders.

- Where Remuneration Committees have used their discretion in an upwards direction, they should explain appropriately.

- Remuneration Committees should consider how the results have been achieved, not just what was achieved including the creation of meaningful value and not just temporary stock price increases.

✓ Executive management makes a material long-term investment in shares of the businesses they manage. Senior executives should have significant “skin in the game” of the companies they manage. Importantly, this should not just arise owing to share awards, but be as a result of active purchase of shares by executives in the open market.

  - The bulk of variable rewards should flow over time from the benefits of being an equity owner.

  - Companies should also consider ensuring that executives are exposed to some tail risk for an appropriate length of time once they leave a company.

✓ There is a cap on variable pay and clear Remuneration Committee consideration of the overall quantum. There is no need for there to be a cap on fixed pay but Remuneration Committees should ensure there are set limits for variable pay (typically as a percentage of salary). They should also consider whether an overall pay cap (i.e. value of awards actually paid) may be appropriate in certain circumstances i.e. to ensure executives are not benefiting from windfall gains, particularly as a result of external factors which are outside of management’s control.

✓ There is a clear narrative to support the gender pay gap figures. This should include a well-targeted action plan for any improvement, including anticipated outcomes and how it links back to both the company’s strategy. The best companies will also be disclosing – in advance of likely future mandatory reporting requirements – their ethnicity pay gap and any supporting narrative.

✓ The company initiates appropriately regular discussions with investors on strategy and long-term performance. Any discussions on remuneration should be initiated at a sufficiently early stage in the process and include long-term investors who are committed to stewardship.

How investors should consider voting.
It is important that investors note the difference between a remuneration policy and a remuneration report when it comes to choosing the right resolution on which to express a view. While one does impact the other, a vote for or against one does not necessarily require a vote for or against the other. Shareholders should view the separate resolutions independently.

On the Remuneration Report resolution specifically: given that this is advisory and that many companies remain too slow to heed the message on remuneration, the PLSA believes it is more appropriate for investors to vote against any remuneration report that they feel unable to support, rather than abstain.

Investors should consider voting against the Remuneration Policy if:

- The company’s remuneration policy fails to meet the standards outlined above
- Pay policies may result in pay awards that could bring the company into public disrepute or foster internal resentment
- The pay policy awards ‘sign-on’ bonuses without the inclusion of any conditionality, or allows for the payment of awards not already vested at the previous employer
- The process of engagement prior to the AGM vote fails to produce a remuneration policy that shareholders can support – this represents a serious failure on the part of the Chair of the remuneration committee in what is the most fundamental aspect of their role
- There is no provision to enable the company to claw back sums paid or scale back unvested awards – such provisions should not be restricted solely to material misstatements of the financial statements
- The pension payments or payments in lieu of pension (as a percentage of salary) for new appointments are not in line with the proportion paid to the rest of the workforce
- There is no plan to bring pension payments to incumbent directors in line with the proportion paid to the rest of the workforce over the next few years
- There is an excessive amount of flexibility being provided for ‘exceptional circumstances’
- The recruitment policy is vague and unlimited or substantial headroom which is not then accompanied by substantial additional hurdles
- There are guaranteed pensionable, discretionary or ‘one-off’ annual bonuses or termination payments
- There is any for re-testing of performance conditions
- New share award schemes are layered on top of existing schemes

Investors should consider voting against the Remuneration report if:
× There is insufficient evidence of alignment with shareholders’ interests and company long-term strategy. This could include, but is not limited to, a shareholding requirement for which the level is set at less than 2x salary

× The metrics used are inappropriate or there are insufficiently stretching targets for annual bonus or LTIP

× There are annual pay increases in excess of those awarded to the rest of the workforce and an absence of a convincing rationale

× Pension payments to incumbent directors (as a percentage of salary) are higher than the rest of the workforce and there is no evidence that payments have been introduced or any plans to reduce

× The pension payments or payments in lieu of pension (as a percentage of salary) for new appointments are not in line with the proportion paid to the rest of the workforce

× There is failure to disclose or retrospective disclosure of variable pay performance conditions for annual bonuses, or ex-gratia and other non-contractual payments

× There is a change in control provisions which trigger earlier and/or larger payments and rewards and an absence of service contracts for executive directors

× The process of engagement prior to the AGM vote fails to produce a remuneration policy that shareholders can support – this represents a serious failure on the part of the Chair of the remuneration committee in what is the most fundamental aspect of their role

Investors should consider voting against the Remuneration Committee Chair (Director’s election) if they have been in post for more than one year and:

× The company has repeatedly failed to take investors’ concerns into account and respond in what investors consider to be an appropriate fashion

× The process of engagement pre-AGM has failed to result in a remuneration policy that shareholders can support, or shareholders feel that the Chair has failed to take on board their concerns about the remuneration report.

× Any revised policy continues, on a repeat basis, to fail to meet the principles outlined above
SECTION 6: CLIMATE CHANGE AND SUSTAINABILITY

Amongst sustainability issues, climate change has gained particular prominence, with UK MPs declaring an environmental and climate emergency in May 2019 and pension schemes explicitly incorporating climate change concerns into their SIPs. Climate change is a corporate governance issue as well as a matter of environmental and social policy, and one that often touches on core company strategy. Boards should be expected to provide effective monitoring, assessment and oversight of the company’s approach to managing risks including those arising from climate change.

Companies should also disclose relevant material business issues and their strategic approach to addressing these, for instance their role in public policy and advocacy on related issues, as well as their membership of trade associations conducting similar activities.

The PLSA believes that climate change – or, rather, the climate emergency - is a systemic issue affecting nearly every industry and nearly every firm. Although the risks and opportunities arising as a result of climate change will impact some sectors more than others, most companies will need to assess the impact of climate change on their strategy and business model in the coming years if they are not already doing so.

While the issue of climate change is currently receiving significant focus, other sustainability issues – such as waste, deforestation, water usage/scarcity and biodiversity are also high on many investors’ agendas. Investors should be careful not to ignore non-climate sustainability issues and consider carefully which sustainability issues are most material to holdings in their portfolio and prioritise allocation of stewardship resources appropriately.

Please note: smaller and medium sized companies should be allowed some discretion and flexibility regarding their choice of framework, approach and timescales.

Evidence base

Listed companies will be required to report against the Taskforce on Climate Related Financial Disclosures (TCFD) recommendations37 by 2022. The TCFD’s major step forward is to emphasise climate as a strategic issue that must be considered in the boardroom. The recommendations are split across different categories: governance, strategy, risk management, and metrics and targets and have been endorsed by investors representing trillions of dollars-worth of assets under management.

The largest companies are already reporting using TCFD: either separately, in their Sustainability Report or – as investors prefer – in their Annual Report. Investors may wish to consider making allowances for smaller firms in their use of third-party frameworks. However, the PLSA supports the TCFD approach and would expect to see evidence that companies are at least broadly considering their approach to climate risk in terms of

37 This was announced in the government’s Summer 2019 Green Finance Strategy, which also committed to setting a parallel “expectation” that “large asset owners” will also report in line with the TCFD framework by 2022. The PLSA is part of the Pensions Climate Risk Industry Group (PCRIG) which is producing guidance for asset owners on TCFD reporting. The expectation is that the final guidance will be produced late Q3 or early Q4 2020.
governance, strategy and risk management, while making use of appropriate metrics and scenario analysis.

It is mandatory for listed companies to measure and report on the greenhouse gas emissions they are responsible for producing. However, although this information is vital for investors when assessing how exposed their portfolio is to climate risk, it is not sufficient in itself and should be accompanied by a clear narrative surrounding the approach the company is taking to ensuring it manages this risk through its governance, processes and internal control arrangements.

Investors may prefer that companies take a joined-up approach in their discussions on climate change and other sustainability issues, both environmental and social. Due to the interrelated nature of climate change impacts, system-wide approaches and discussions – rather than single-issue responses – may yield more insights.

Given the systemic nature of the risk the climate emergency poses to companies, there could also be implications for capital structure and allocation. Investors should also carefully scrutinise disclosures regarding any planned capital expenditure on climate change related research and development, or whether any relevant merger and acquisition activity has been planned.

**What does good company behaviour look like?**

- **Climate change is discussed in terms of strategic, financial and operational factors.** The potential impact of different scenarios – including reactions from policymakers and regulators – on value creation in the long-term should be clearly discussed. There should also be a clear link to risk management at the executive level and risk oversight at the board level. The impact of climate risk and opportunities on the firm’s strategy over the short-, medium- and long-term should be clearly outlined.

- **There are clear climate-related governance and oversight structures and processes.** This includes climate change expertise at board level, identification of which Director is accountable for climate issues and management’s role in assessing and managing climate-related risks and opportunities. Every Director should demonstrate an understanding and awareness of the potential range of impacts which climate change may have on the company.\(^{38}\)

- **A proactive approach both to identifying and managing climate risks (and opportunities) and providing sufficient disclosures on climate change.** Although at this stage this does not need to include reporting using the TCFD framework, there should already be evidence that companies are considering the issue of climate change across the high-level TCFD areas of governance, risk management, strategy, metrics and targets, and scenario analysis.

\(^{38}\) We acknowledge that this understanding may change owing to developments in the available data as well as technological, regulatory and scientific developments.
The potential consequences of both expected physical impacts of climate change and transition impacts are actively considered and discussed in reporting. In terms of physical impacts of climate change, the resilience of assets and supply chains in the face of, for example, changing weather patterns and rising sea levels should be considered as relevant. Companies also need to demonstrate consideration of the potential impact of changes in public policy and regulation around the transition to a low carbon economy.

Clear reference in the Annual Report and Accounts to, and use of, credible industry climate reporting metrics. This should include reference to the Taskforce on Climate-Related Financial Disclosures, SASB (Sustainability Accounting Standards Board) CDSB (Climate Disclosures Standards Board), or other established third party frameworks. Companies should provide explanations as to the rationale for their choice of framework and the extent to which, if at all, relevant metrics have been “blended” with others. Please note: smaller and medium sized companies should be allowed some discretion and flexibility regarding their choice of framework and timescales.

Disclosures refer to the Paris Agreement and mention Net Zero. Companies should disclose whether or not they have assessed whether their business model is compatible with commitments to mitigate global temperature increases (at either 2 or 1.5 degrees) and, where they do not feel this is currently the case, have outlined a process – complete with relevant timescales – under which they hope to achieve compatibility.

- This should include a discussion of the metrics which the company has chosen to assess climate-related risks and opportunities in line with its strategy and risk management. These metrics could include Scope 1, 2 or (where relevant) Scope 3 greenhouse gas (GHG) emissions.

Financial disclosures include transparency on the underlying assumptions used to calculate balance sheet valuations and earnings. Many key valuation and profit measures disclosed by companies depend on assumptions about future returns. Investors may wish to challenge the calculations and/or substitute alternative assumptions in their own financial analysis should there be concern that these may rely on the Paris Agreement not being delivered in practice. In order to be open to such discussion, companies should be transparent on the assumptions underlying their calculations.

A company’s political donations and membership of trade associations are aligned with their stance on climate change. Investors have become increasingly concerned about corporate support for organisations and individuals whose lobbying activities and objectives are considered to frustrate climate change mitigation. Such support may take the form of political donations, trade association
membership, or the establishment of charitable or educational trusts that undertake lobbying against progressive climate legislation.

How investors should consider voting

Investors should consider voting against the Report and Accounts if:

- There is insufficient disclosure (both level and quality) on how a company intends to monitor and manage the risks and opportunities brought about by climate change
- The business has operations which are *highly carbon intensive* and there has been no disclosure of the climate-related assumptions which underlie their financial calculations, or where those assumptions are not consistent with the Paris Agreement
- The business has operations which are *highly carbon intensive* and there is no commitment to disclose memberships and involvement in trade associations that engage on climate-related issues

Investors should consider voting against the Remuneration Policy if:

- There are no plans to align senior executive remuneration to performance against relevant sustainability metrics within a reasonable timeframe
- The business has operations which are *highly carbon intensive* and has not included at least one climate-related metric in the calculation of executive incentives. The metrics also should not be contradictory.

Investors should consider voting against the re-election of the responsible Director or the re-election of the Chair if:

- Shareholders have attempted to engage on the issue and yet companies have still failed to demonstrate effective Board ownership, for example providing a detailed risk assessment and response to the effect of climate change on the business, or incorporating appropriate expertise on the board
- The business is *large* and it is not already moving towards disclosures consistent with TCFD, CDP, SASB or another established third party framework, and smaller businesses are not readying themselves at a pace proportional to the resources available
- The business has operations which are *highly carbon intensive* and has not made sufficient progress in providing the market with investment relevant climate disclosures including committing to publish science-based targets
- The company has not listened to investor concerns about any direct or indirect corporate lobbying activity whose objectives are considered to frustrate climate change mitigation

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39 We encourage investors to consider the recommendations from the Institutional Investors Group on Climate Change (IIGCC) on *European Investor Expectations on Corporate Lobbying on Climate Change* (2018) which outlines what positive company engagement with public policymakers on the transition to an orderly transition to a low carbon economy might look like.

40 For instance, if there is a target in terms of percentage reduction in GHGs but there is also a production target so the latter neutralises the effects of the former.
× The company has not responded appropriately to the result of a climate change related resolution, whether binding or not, and whether it was actually passed or not

Investors should also consider voting in favour of relevant climate-related or similar resolutions.

### CLIMATE CHANGE RESOLUTIONS: WHAT SHOULD INVESTORS LOOK FOR?

Though they still remain rare, the last few years have seen a growth in the number of climate-related resolutions being tabled at AGMs⁴¹. Organisations can use these for awareness-raising and as part of a public campaign as well as to effect change.

If an investor judges that climate risk is particularly material to a holding in their portfolio, then they should strongly consider supporting resolutions tabled by others – or tabling a resolution themselves if they have sufficient resources – which ask or require companies to either disclose what they are doing to mitigate climate risk or take concrete action to achieve specific climate-related targets where this is in the broader shareholder interest.

**Questions which investors should be asking when deciding whether to support a given resolution**

- Does it conflict with other climate resolutions? If so, which one will be most effective in achieving aims in line with the impact on the portfolio?
- Has it been supported by management?⁴²
- Does it focus on disclosure of activities and action – i.e. taking a behavioural approach which is trying to nudge companies into particular behaviours – or on the substance?
- If the resolution covers issues applicable across a sector, have similar requests been made of other companies in the industry, or is there a justifiable reason why the company has been singled out for attention?
- Does it clearly link to internationally agreed targets and agreements such as the Paris Agreement?
- Is the resolution binding? If so, is the request proportionate? Is there a good understanding of its likely impact on all relevant stakeholders, if passed? Would it impact the ability of target company to make strategic decisions without seeking further shareholder approval in the future? Or does it offer some flexibility?
- If the resolution is non-binding (sometimes known as “precatory”), is the aspiration sought appropriate and consistent with the business’ long-term success? What

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⁴¹ Our *AGM Voting Review 2019* (January 2020) gives further details of some of the key developments on climate-related resolutions. Resolutions can be withdrawn before the AGM if the company has demonstrated sufficient progress or made commitments which are satisfactory to shareholders.

⁴² As has happened with some of the Climate Action 100+ shareholder resolutions.
actions would be appropriate for the company to take in response to the resolution? If those actions were not taken, how concerned would the investor be?

- Would voting against resolutions on political donations, re-election of the responsible director or the Annual Report and Accounts better reflect specific concerns on a particular area i.e. lobbying?
SECTION 7: CAPITAL STRUCTURE AND ALLOCATION

Capital structure and allocation is the process of distributing a company’s financial resources to enhance the firm’s long-term financial stability and protect capital value. It can appear unexciting – and so often receives little attention from investors – but a mis-judged approach can contribute to corporate collapse and failure.

Capital allocation practices include re-payment of debt, repurchasing shares, paying final or interim dividends to shareholders and investment either in organic growth or in M&A activity. There are several stakeholders whose interests need to be balanced in any capital allocation decision, including the DB pension scheme, shareholders, employers and customers and the appropriate ratios between profitability and dividend payments must be maintained.

Although some of the issues highlighted below can seem technical or of low priority, investors should be alert for the signs of patterns of behaviour which suggest that the company continues to fail to honour shareholder rights. In 2016 BHS went into administration following several corporate governance failures including payment of illegal dividends. The total dividends paid by BHS Ltd between 2002 and 2004 were £414 million, almost double the after-tax profits of the company of £208 million. For its part, Carillion paid out £376m over a five-year time period while generating £159m of net cash from operations. Carillion also paid an interim and final dividend every year from 2010.

Dividends

Information on dividend structure, including both policy and practice will be of interest both to equity investors who are looking for income or growth potential, and bond investors who are considering a company’s long-term credit-worthiness.

New shares

In company law, companies must secure shareholder approval to be able to issue new shares. Resolutions that allow the company to issue new shares are normally of two types: ‘Section 551’ and ‘Section 570’ Authorities. These should be separated into two resolutions.

RESOLUTION TYPES: ISSUANCE OF NEW SHARES

- **Section 551 Authorities** allow companies to allot new shares. Any amount in excess of one-third of existing issued shares should only be applied to fully pre-emptive rights issues in order to protect against shareholder dilution.

- **Section 570 Authorities** allow companies to issue shares for cash *without the application of pre-emption rights*. The Pre-Emption Principles are equivalent to 5% of the issued share capital at the time of the Authority. An additional 5% is acceptable provided that the company confirms in its AGM circular that it intends to use this only in connection with an acquisition or specific capital investment which is

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43 The EU Prospectus Regulation (which came into force in July 2017) increased the threshold for the exemption from the obligation up to 20% however the Pre-emption Group which publishes the Principles has noted that it will not relax its requirements. This is a move with the PLSA – which sits on the Pre-Emption Group – supports.
announced at the same time as the issue, or which has taken place in the preceding six-month period. A multi-year limit also applies to the issuance of shares for cash otherwise than in connection with an acquisition of specific capital investment (typically a maximum of 7.5% shares to be issued over three years without the application of pre-emption rights).

Share buybacks

Rule 9 waivers are usually sought where a company proposes to institute a share buyback programme in which a large investor or concert party intends not to participate. This brings with it the risk of creeping control – which is a clear issue of concern to shareholders.

Resolutions on dividends, share buybacks or issuance and debt constraints in articles need to be set within a considered capital structure framework. This framework should balance the need for shareholder returns with the long-term viability of the business.

Evidence base

Dividend information can be found in several different corporate communications, including the annual report, interim accounts, press releases and preliminary announcements. It should be noted that companies often fail to clearly articulate the story of the dividend, from policy development – including the rationale for its approach – to declaration and payment. Although there should also be a justifying statement around the dividend, this does not always happen.

The Viability Statement should also provide a basis for an annual assessment and debate on capital structure. However, these rarely provide as much useful and high-quality information as they could do – it is notable that the Brydon Review recommended the production of a Resilience Statement to perform a similar function.

Key metrics for investors to pay attention to should include the “payout ratio” where dividends are set as a percentage of a defined metric (this could be earnings or free cash flow). Where this is used – and particularly when the ratio is not based on a defined IFRS metric such as earnings of cashflow – the rationale for the selection of metrics should be justified.

The Annual Report should disclose Related Party Transactions which are significant, whether by virtue of their significance to the business, the individuals involved or the perception of potential conflicts.

What does good company behaviour look like?

- Companies take capital structure decisions which balance the financing needs of the firm with the interests of broader stakeholders. This includes striking the right balance between dividend payments to shareholders and paying Deficit Repair Contributions (DRCs) to any Defined Benefit (DB) pension scheme, and undertaking share buybacks only when doing so is the best way of achieving long-term value. Dividend resolutions should not simply be approved as a matter of

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44 This refers to Rule 9 of the Takeover Code.
45 The Brydon Review also proposed that directors should make a statement that the dividend would not threaten the existence of the company for two years, so we may see further change in the mechanisms and communications to investors on this issue.
course, and moves that weaken a company’s balance sheet – and so its long-term stability – are not in long-term shareholders’ interests.

**Dividends**

- **Companies have clear dividend policies.** These should set out the circumstances for distributing dividends and returning capital to shareholders. There should be evidence that the financial position (especially distributable reserves), maturity and strategy of the business – including the necessary level of Deficit Repair Contributions to any DB scheme – have been appropriately considered and reflected. Investors should pay attention to the possibility of companies taking on more leverage to cover dividends to shareholders.

- **Dividend policy disclosure is specific.** The information given should be at a sufficiently granular level so that investors can understand what the policy means in practice, including the basis for deriving the proposed level of dividend and the specifics of how it is determined. It should describe: the governance process over the policy decision, the risks and constraints associated with the policy and the timeframe over which the policy is expected to operate.

- **There is a prudent level of interim dividends issued.** Such dividends are usually decided solely by directors without the need for shareholder approval. There is a growing trend for companies to pay only interim dividends which is detrimental to the role of investor oversight on this issue. Where a scrip dividend or equivalent is issued, there should be a cash dividend also available.

- **Shareholder approval is sought for the approval of the financial dividend.** Should this not be the case, investors should strongly consider submitting a shareholder resolution or voting against the company’s report and accounts, except where companies can compellingly demonstrate that changing their practice to seek shareholder approval of the dividend would significantly delay payment and do so to the material disadvantage of shareholders.

**Share buyback**

- **There is a clear rationale – one that aligns with the interests of long-term shareholders – for any share buybacks undertaken.** Share buybacks can on occasion be a useful tool for companies to manage their capital structure and most investors will support these repurchases provided local market regulations and relevant shareholder guidance are met. However, share buybacks can be manipulated by managers whose pay is aligned with earnings per share and in a way which comes at the expense of long-term investors or the company’s long-term success. Metrics and disclosure provided should cover:

  - The weighted average cost of shares bought
- Total cost
- Impact on key metrics for buybacks undertaken during the previous year
- Clear explanation of the process used to identify when buyback is appropriate
- The maximum price the company is willing to pay and the hurdle rate in respect of the buyback, linking to the overall capital management framework of the company.

Issuance of new shares

 ✓ The company recognises that pre-emption rights are important for the protection of stakeholder interests. Companies should seek to abide by the recommendations of the Pre-Emption Group UK Statement of Principles except where they can make a clear case for these not being applied in the context of the best interest of all of the owners of the company concerned. To protect the rights of existing shareholders and reinforce the accountability of management to the company’s owners, companies should avoid the creation of “poison pill” provisions except in exceptional circumstances.

 ✓ Any non pre-emptive issue is clearly signalled at the earliest opportunity. Companies should also seek to establish a dialogue with investors at this stage. They must keep shareholders informed of issues related to an application to disapply their pre-emption rights. The Pre-Emption Group Principles should be followed.

Related Party Transactions

 ✓ There is a robust and independent process for reviewing, approving and monitoring related party transactions (RPTs). This should include both individual transactions and in aggregate and include appropriate procedures to identify and manage conflicts of interest.

 ✓ A committee of independent directors, with the ability to take independent advice, reviews significant RPTs and the board confirms that all RPTs have been reviewed and met with its approval. The Committee’s review should include aggregate levels of RPTs to determine whether they are necessary, appropriate and in the best interests of the company and of shareholders.

How investors should consider voting

There are several different resolutions pertinent to various capital allocation issues, including approval of final dividend; issuance of new shares; market purchase of shares; and Related Party Transactions.

Investors should consider voting against approval of the final dividend if:

 × The dividend does not seem sustainable and appropriate, when considered in the context of the financial position, maturity and business strategy, or where issues such as Deficit Repair Contributions are not appropriately reflected.
× There is no cash dividend available as an option to a scrip dividend or equivalent
× They have concerns regarding the accounting standards and assumptions used in the metrics provided

Investors should consider voting against a resolution on issuance of new shares if:
× Section 551 and Section 570 Resolutions are bundled together, or with any other issue
× The issuance is not consistent with Pre-Emption Principles without a satisfactory explanation

Investors should consider voting against a resolution on market purchase of shares if:
× The resolution proposes a waiver of Rule 9 of the Takeover Code
× The buy-back is not deemed a prudent use of the company’s cash resources, are not supported by cash flows of the underlying business and introduces excessive and unsustainable leverage

Investors should consider voting against a resolution on related party transactions if:
× An RPT has not been subject to proper oversight by the board and regular review (through the audit or shareholder approval)
× The RPT is not: clearly justified or beneficial to the company; undertaken in the normal course of business; on fully commercial terms; in line with best practice; or in the interests of all stakeholders.

Investors should consider voting against a resolution on re-election of the Chair if:
× There is an unsustainable level of interim dividends issued and they have reason to believe that this is being done to avoid shareholder scrutiny. Please note: this is a serious issue and if investors have particular concerns in this space, they could accompany this with a vote against the Annual Report and Accounts
× Shares are issued outside of the Pre-Emption Group Principles
SECTION 8: TAKING A HOLISTIC APPROACH

It is important for investors to do a stock-take after they have worked with their advisers and managers to consider their approach to voting on any company issues and to think about their views of the board as a whole. Voting decisions should be made in the context of a company’s overall governance arrangements and should include consideration of the progress made – progress is always dynamic.

Investors should also consider the level of responsiveness of the board to investor concerns. Although it is mandatory for companies to address significant dissent votes and explain how the board will address the concerns that have led to the dissent, directors should be responsive to investor concerns throughout the course of the year and not just on a one-off basis, in specific circumstances.

The level of disclosure

Investors need detailed and meaningful disclosures about a company’s board and governance practices. Without this, it is very difficult to arrive at an informed opinion. Investors should reflect on whether the Annual Report adequately informs investors on the company’s strategy, vision and business model.

If investors are unhappy with the level of disclosure overall or in key areas, this should be a significant factor in their holistic assessment of how to vote.

Accumulation of minor issues

Although certain minor corporate governance issues would not generally trigger voting consequences, an accumulation of minor issues may be indicative of poor corporate governance and more deep-rooted issues at a company itself. This is particularly the case if there fails to be meaningful progress – despite expressions of concern and engagement from investors – and it appears that the company management does not prioritise shareholder concerns.

How investors should consider voting.

Investors should consider voting against the Annual Report and Accounts if:

× They feel this has not fulfilled its purpose of giving insight into the company’s strategy, vision and business model

Investors should consider voting against the Chair or against the Senior Independent Director if:

× They have particularly serious concerns about the company’s business model, plan or implementation of its plan for engagement with long-term shareholders

× The company seems unwilling to change its approach in light of significant investor concerns

Please note: where investors may wish to take the extremely significant step of voting against the whole board, they should be able to clearly articulate an alternative proposition for the board’s approach.