

Risk Management Services

Fourth FTSE 350 **Corporate Governance Review**

Highlighting trends in compliance

Grant Thornton 

55% of FTSE 350 do not identify a non-exec with relevant financial experience

Only 10% of companies do not comply or explain

Strongest set of results yet

106 companies do not describe their processes for reviewing the effectiveness of internal controls

Heightened profile for audit committees

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Introduction

Our fourth review consists of a detailed page-by-page study of 319 of the FTSE 350 companies' (we exclude investment trusts) compliance with the terms of the revised Combined Code on Corporate Governance. We consider that the annual report and accounts is the only regulated medium available to the investor and as such, if a company chooses to disclose only the barest minimum of information, then they must be considered to be dissenting from the principles of UK corporate governance.



Simon Lowe, Head of Risk Management Services

Foreword

The evolution of governance

The 2005 Corporate Governance Review is our most challenging and comprehensive study yet. It provides a detailed insight into attitudes and compliance trends.

Our review shows that UK companies are starting truly to embrace the principles enshrined in the UK's Combined Code on Corporate Governance, with the strongest set of results to date.

So, there can be no doubt that corporate governance is evolving. But what path will it take?

The American dream?

As the first round of Sarbanes-Oxley (SOX) compliance exercises draws to a close, Securities and Exchange Commission registrants are counting the cost. Will this type of regulation prevent another dramatic corporate collapse? Probably not, as it is very difficult for any set of rules to prevent fraud, especially complex deception. Does it reduce the risk? Quite possibly, as an iron grip on financial controls is now needed to comply with SEC listing rules.

But what about operational risks? The SOX philosophy only addresses part of The Committee of Sponsoring Organizations of the Treadway Commission (COSO) model. Although having tight financial controls is essential for market confidence, cultural and operational risks, if left unchecked, can just as effectively damage a business.

This is where the debate starts to take different paths; the US is insisting on management and auditor assertion on the financial control environment, whereas the UK is maintaining its focus on the wider control environment, but without the requirement for positive assertion.

But just as these differing paths became clear, the US regulator in May went on record saying that companies and auditors are applying too strict an interpretation of the intended approach, and taking a more risk-based judgement is to be encouraged. The anecdotal reaction of those who have to put the legislation into practice is one collective, frustrated shrug of cynical derision. One chief financial officer observed that it seemed to have a more political than practical audience in mind.

Turning theory into practice

So, can Europe provide the solution?

Is the development of a Europe-wide umbrella risk management framework in support of the harmonisation of financial markets and in pursuit of the transparency agenda a Holy Grail or a practical necessity? And if the latter, how will it be enforced?

Europe is fast approaching the point where the debate as to which way to develop the corporate governance framework must move from the esoteric to the practical. In the UK, a number of us are in the fortunate position of being able to consider the relative merits of the prescriptive approach under SOX as compared to our relatively mature principles approach.

The jury, in the guise of the Financial Reporting Council's recent Turnbull Review group led by Douglas Flint, clearly listened to all the stakeholders, including those institutional investors who manage in excess of £3,100 billion of funds, and voted firmly for a principles approach. But despite this clear message, the question surely still remains: will the needs of the global capital market lead inevitably to the evolution of one and only one approach to corporate governance?

If so, is the US capital market so influential as to make prescription inevitable or will the emerging markets' recent preference for UK listings (with all that infers in respect of corporate governance) stimulate the emergence of a workable compromise?

Competing paradigms

Should we look to Brussels for a workable solution? The cultural differences and legislative barriers to an effective European framework are apparent. If these barriers could be overcome, a framework might be designed to satisfy all market requirements. But its very flexibility could also be its weakness, as enforcement would be difficult, if not impossible.

One thing is certain, we cannot be complacent. In addition to the US's solution – SOX, closer to home the French have introduced the Loi de Sécurité Financière (LSF) which moves towards directors acknowledging their responsibility for having maintained a strong control environment (though they have yet to determine how it should be interpreted) and Ireland and Germany, among others, also have similar frameworks.

Pros and cons

By comparison, the UK approach, at least relatively, does not appear to incur excessive levels of cost. It gives the opportunity to provide clear and transparent disclosures, moves away from one single overall claim of compliance and covers a wider proportion of the COSO model. For now, it seems, while the debate continues in the global market, the UK market is happy with the existing approach. But is it really working in practice?

Executive summary

Revisions to the code

The impact of the revised Combined Code on Corporate Governance practices is very clear from our review. The number of companies claiming full compliance has halved since last year (28% down from 58% in 2004).

However, of these 231 companies that do not fully comply (representing 59% of FTSE 100 and 78% of the Mid 250), the majority give informative explanations of where and why they do not comply. Only just under 10% give no explanation. Despite the well publicised revision, it has clearly taken companies a while to implement the changes. It will be interesting to see next year how many of those once again regain full compliance.

Being held accountable

Particular areas of improvement this year relate to the information now given in respect of the roles and responsibilities of various committees and how the performance, both of those committees and individual directors, are appraised annually.

Again, those who are prepared to give more than the bare minimum (32%) shine through. But an overall increase in some form of disclosure of 77% over 2004 suggests a significant shift towards greater transparency and accountability. This trend is mirrored with much greater availability of committee terms of reference – 84% (2004:48%), although the disclosure regarding the work of the nomination committee has remained static at around 65%.

The impact of the 2003 report chaired by Sir Robert Smith – Audit Committees Combined Code Guidance (the Smith Report) – in raising the profile of the audit committee is clear to see. Information about how the committee reviews the auditor’s objectivity and independence, 91% (2004:64%); its responsibility for reviewing the effectiveness of internal audit, 82% (2004:69%); the dedication of a separate section in the annual report to describe its work, 93% (2004:81%) – all bear testimony to this heightened profile.

There is an ongoing debate among non-executive directors about the requirement for an individual to take on the mantle of “the financial expert”. Over half (55%) of companies do not identify a non-executive director with recent and relevant financial experience and 27% of audit committees make no mention of having even considered the matter.

On the issue of board composition, companies are struggling to achieve the balance required by the revised code. Over a third (115) of the companies do not have at least half of the board comprised of independent non-executive directors; and in just under a quarter (24%) of companies the chairman was previously the chief executive.

The spirit of Turnbull

It seems probable that two of the major areas of debate among the members of the recent Turnbull Review group would have been: should directors make a positive assertion as to the effectiveness of the controls; and, to what extent should the disclosure of information as to a company’s risks and controls be prescribed. In both cases, the Turnbull Review, reflecting strong institutional support, has opted to encourage greater voluntary disclosure.

Our review supports the findings that, over the past few years, UK Plc has taken great strides in the field of internal control, with effectively all (99%; 2004:93%) now acknowledging their responsibilities for reviewing the effectiveness of the systems of internal control. Those charged with governance could do worse now than turn to the appendix in the Turnbull Review for guidance on how, once again, to raise the bar on what constitutes good practice.

But how well placed is the Turnbull Review group’s faith that UK Plc will rise to the challenge set by Turnbull, namely, voluntary disclosure of additional information to assist the reader’s understanding?

Judging by their emphasis on encouraging greater disclosure, clearly they feel more can be done. It is encouraging to find that 70% of companies (Q35) give “good” or “excellent” additional disclosure in respect of risk and control processes. However, when it comes to explaining the process they have applied when reviewing the effectiveness of the systems of internal control (Q36) there is considerable room for improvement, as only 24% move away from boiler plating to give greater insight and 106 companies still give no disclosure at all.

What the Turnbull Review group are looking for, to justify the continuation of the UK approach, is further detail on how risk management operates and is embedded in an organisation.

The group’s faith may be further tested in the area of the disclosure and explanation of the principal business risks, where only 31% give any real clarity. The introduction of the Operating and Financial Review (OFR) for years commencing on or after 1 April 2005 may help to encourage greater disclosure in this area. However, it is too early to tell whether corporate sensitivity to retaining competitive advantage will prove to be too great a hurdle to overcome.

Are we responsible enough?

Corporate responsibility disclosure has seen a marked increase from last year in the majority of questions. More attention is being spent on providing quantified results and obtaining verification of disclosures. Forty eight percent of companies (2004: 42%) now provide quantified data to support this disclosure.

This year, we have determined whether corporate responsibility disclosure is formally verified, be it internally (by internal audit) or externally. A third of companies obtain assurance on their disclosures. Of these, nearly two thirds obtain some form of assurance from external sources – a promising sign that boards are taking corporate responsibility issues seriously.

Although the institutions play down the importance of corporate responsibility as a valuation driver, the wider stakeholder audience increasingly profess themselves to be concerned with corporate responsibility and accountability of management.

However, caution is required in interpreting such data. As only 21% of all companies submit their results for external verification, it may be some time before consistency and comparability can be assumed.

A limiting factor for any corporate responsibility review is the lack of corporate-wide metrics to aid comparability. Certain industries, eg oil and gas, are making headway, but cross industry sector metrics, other than the standard ones, may be some way over the horizon. Nevertheless, the findings from our review are encouraging.

In conclusion

As evidenced by our 2005 review, we are seeing a year-on-year improvement in corporate governance disclosures.

Only 10% do not comply with the principle of comply or explain and, while less than a third of companies in the FTSE 350 claim full compliance, around a third of the others are only “not fully compliant” because of one provision, and around 80% only need to work on three key provisions or less.

Two years on from the release of the Smith Report, the role of the audit committee is far more evident, with greater disclosure about their composition, responsibilities and reviews undertaken.

Progress is now required in the field of additional disclosure, as promoted by Nigel Turnbull and now re-emphasised by the Turnbull Review group. The majority of companies are still hiding behind boiler plating when disclosing key business risks and the processes undertaken to assess the effectiveness of controls. Next year, the OFR may help to encourage greater disclosure, but a change in mindset will be needed before the goal of embedded risk management can become reality.

Our findings confirm that the trend of improving governance practice is well established and the Turnbull Review has confirmed the way forward for UK Plc.

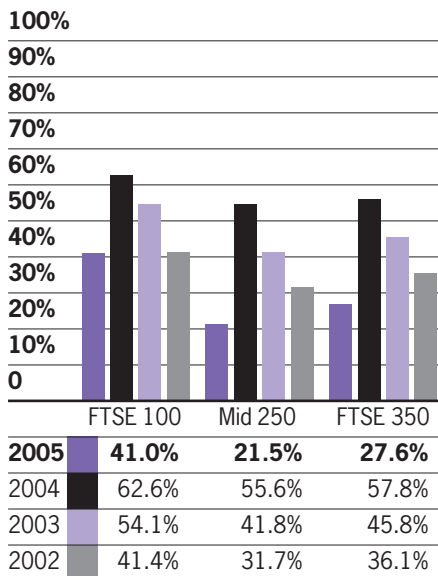
The message to the regulators has to be that the gap between the FTSE 100 and the Mid 250 is narrowing fast – so, leave well alone; guidance rather than regulation can be effective in bringing about lasting change; and, even though the change takes a little longer, in our experience it is more cost effective. The message to UK Plc has to be to forsake boiler plating in favour of giving greater insight into governance practice.

Corporate governance – general

Question 1: Do they claim full compliance with the revised code?

Guidance: “the following items must be included in its annual report and accounts: ... a statement as to whether or not it has complied with throughout the accounting period with the Code provisions set out in Section 1 of the Combined Code.” (Turnbull paragraph 5)

Figure 1



The main message:

While there is a significant drop in the percentage of companies claiming full compliance, this might have been expected when the goal posts have moved and the revised code has become more stringent in a number of areas.

Only next year will we see whether companies can continue to maintain the same rate of improvement in adoption of the revised code as in previous years. Furthermore, although over 80% of the annual reports reviewed related to companies with year-ends after 31 October 2004, the revised code will be applicable to all companies in next year's survey.

Corporate governance – general

Question 2: If not compliant, to what degree do they explain their reason for non-compliance?

Guidance: “A company that has not complied with the Code ... must ... give reasons for any non-compliance.” (Turnbull paragraph 5)

Figure 2 – 2005

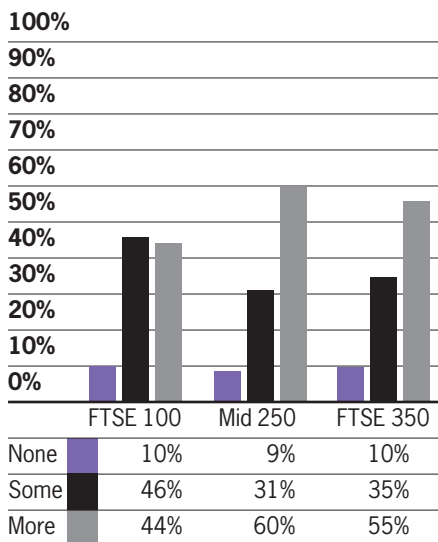


Figure 2 – 2004

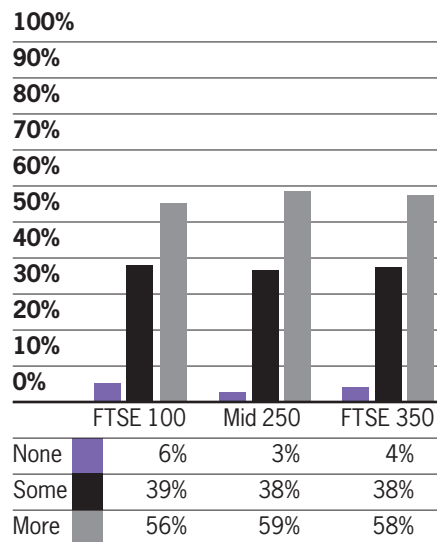
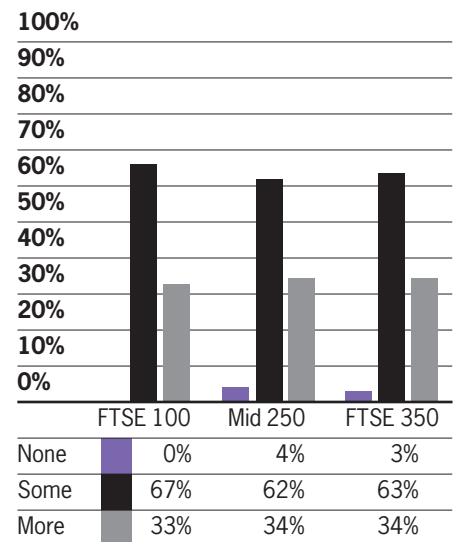


Figure 2 – 2003



The main message:

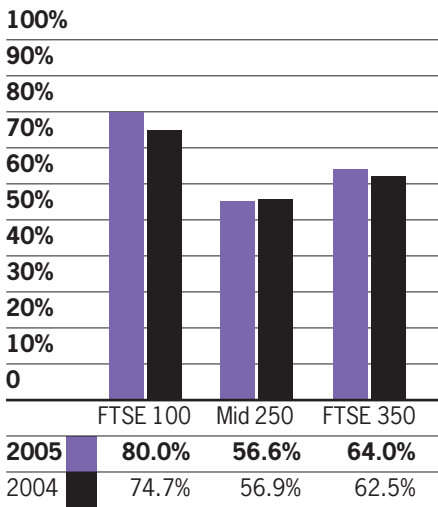
These absolute figures cannot be considered like-for-like. But, in percentage terms, they show similar levels of explanation as last year, perhaps as companies struggle to get to grips with the new principles and provisions contained in the revised code.

Non-executive directors

Question 3: Is at least half of the board (excluding the chairman) comprised of independent non-executive directors?

Guidance: "Except for smaller companies, at least half the board, excluding the chairman, should comprise non-executive directors determined by the board to be independent." (Combined Code, A.3.2)

Figure 3



The main message:

The FTSE 100 continues to lead the way in board composition and accounts for all of the slight increase in overall compliance year-on-year. But there are still 115 companies in the FTSE 350 who choose not to achieve the recommended balance.

Question 4: How well do companies describe the consideration of independence?

Guidance: "The board should identify in the annual report each non-executive director it considers to be independent." (Combined Code, A.3.1)

Figure 4 – 2005

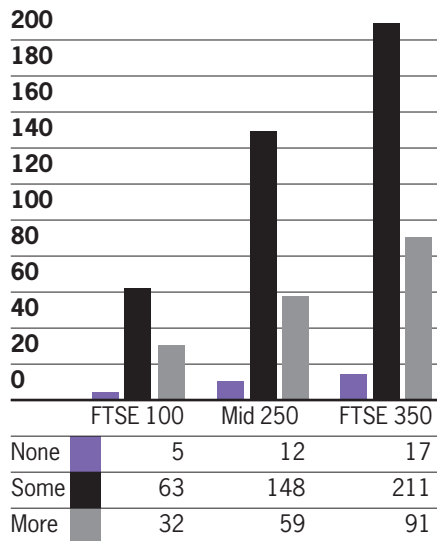
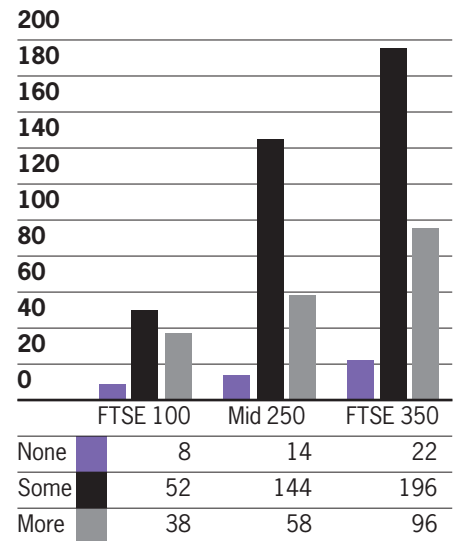


Figure 4 – 2004



The main message:

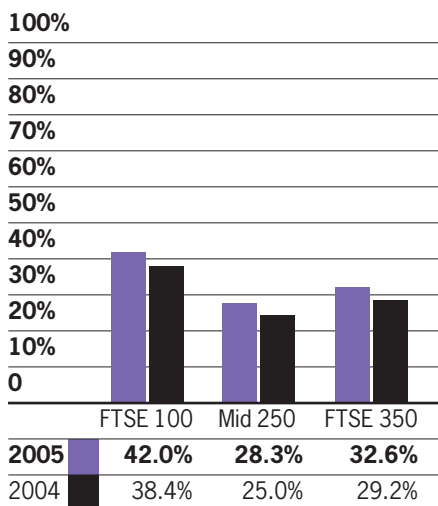
It seems surprising that there are companies in the FTSE 350 who still either have no independent director or do not disclose the information.

Non-executive directors

Question 5: Are the terms and conditions of appointment of non-executive directors available for inspection?

Guidance: "The terms and conditions of appointment of non-executive directors should be made available for inspection." (Combined Code, A.4.4)

Figure 5



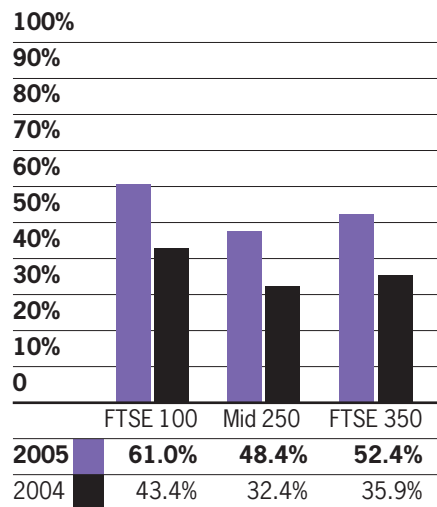
The main message:

The fact that there has only been a small improvement from last year is, perhaps, disappointing, since the vast majority of companies should be able to disclose the availability of these terms and conditions. There are several potential reasons for this: a) companies are happy to provide the information where requested, but do not disclose this fact; b) the documentation does not exist, or, c) companies are unwilling to share this information. We would hope it is more of the former than the latter. But it is up to companies to prove their position by a simple disclosure.

Question 6: Led by the senior independent, do the non-executive directors meet without the chairman at least annually to appraise the chairman's performance?

Guidance: "Led by the senior independent director, the non-executive directors should meet without the chairman present at least annually to appraise the chairman's performance." (Combined Code, A.1.3)

Figure 6



The main message:

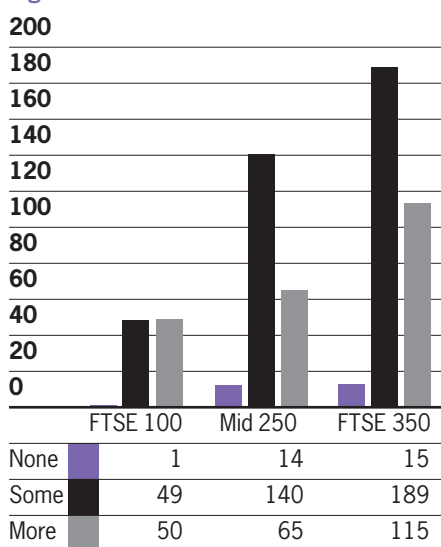
A strong increase in compliance is shown here, with significant increases by all of the FTSE 350, in particular the Mid 250, who improved slightly better in relative terms. Over half of all companies appraised the chairman's performance in this way.

Board and committees – general

Question 7: Is there a statement of how the board operates and how its duties are discharged effectively?

Guidance: “The annual report should include a statement of how the board operates, including a high level statement of which types of decisions are to be taken by the board and which are to be delegated to management.” (Combined Code, A.1.1)

Figure 7



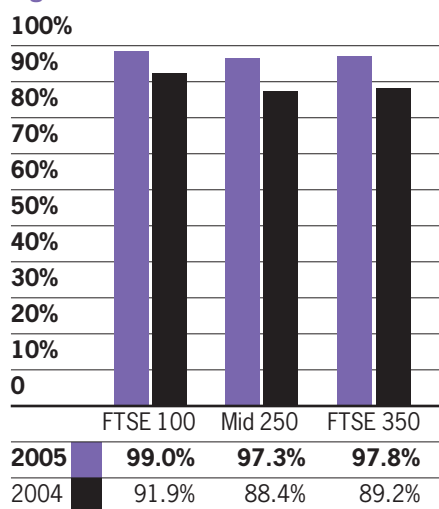
The main message:

Continued improvement year-on-year reinforces the observation that despite being a new element of the revised code, this additional disclosure requirement was not too hard for companies to add. Furthermore, just over a third of companies provided more than just a brief explanation in this respect. Next year, we expect this figure to increase further still.

Question 8: Does the report identify the chairman, chief executive, senior independent, members and chairs of the nomination, audit and remuneration committees?

Guidance: “The annual report should identify the chairman, the deputy chairman (where there is one), the chief executive, the senior independent director and the chairmen and members of the nomination, audit and remuneration committees.” (Combined Code, A.1.2)

Figure 8



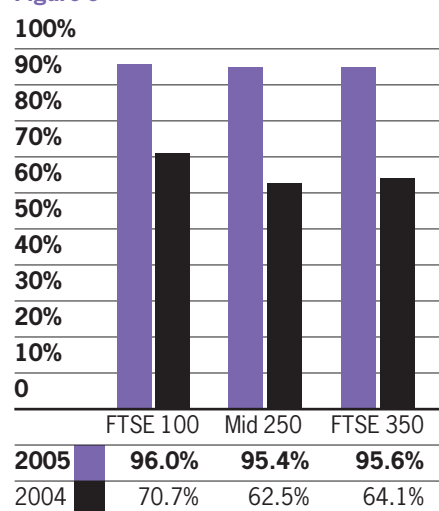
The main message:

Approaching full compliance.

Question 9: Is the number of meetings of the board and overall attendance disclosed?

Guidance: “[The board] should also set out the number of meetings of the board and those committees and individual attendance by directors.” (Combined Code, A.1.2)

Figure 9



The main message:

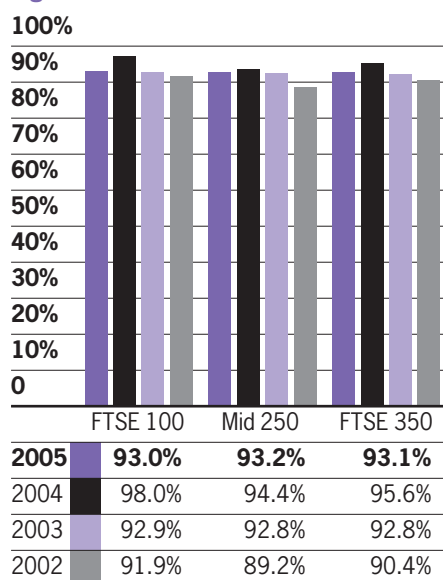
Last year was an indication of how this principal was likely to be addressed when the majority of companies were required to apply the revised code. However, now only around 4% of companies overall fail to disclose these figures and many companies have gone to reasonable lengths to present these in a simple, effective and transparent way through the use of tabular formats.

Board and committees – general

Question 10: Is there a clear division of responsibilities at the head of the company between running of the board (usually undertaken by the chairman) and the executive responsibility for the running of the company's business (usually undertaken by the chief executive)?

Guidance: "There should be a clear division of responsibilities at the head of the company between the running of the board and the executive responsibility for the running of the company's business." (Combined Code, A.2)

Figure 10



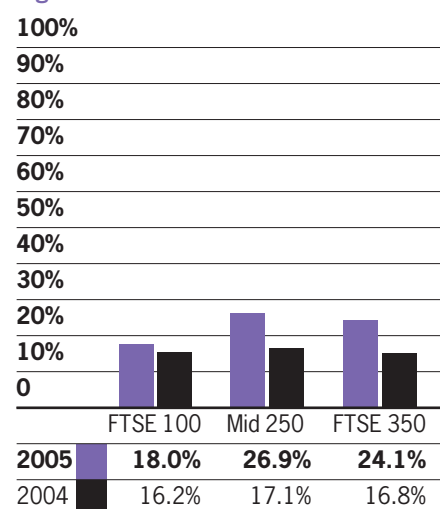
The main message:

This statistic is susceptible to both changes in the population set and changes in appointments at the head of the company, which perhaps explains the slight drop in compliance noted this year. If companies find it hard to recruit appropriate non-executives, replacing a chairman or chief executive, whether planned or unforeseen, is a further challenge still. In the interim, some companies have little choice but to have one person adopting both roles.

Question 11: Was the chairman previously the chief executive?

Guidance: "A chief executive should not go on to be chairman of the same company." (Combined Code, A.2.2)

Figure 11



The main message:

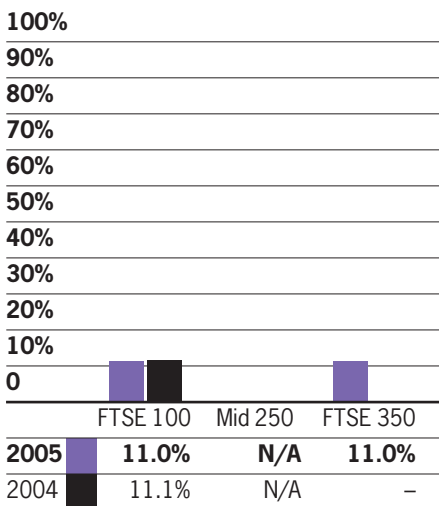
In a large proportion of the new entrants, to both the FTSE 100 and Mid 250 populations, the chairman was previously the chief executive, which accounts for these increases.

Board and committees – general

Question 12: Does the chairman chair more than one FTSE 100 company?

Guidance: “No individual should be appointed to a second chairmanship of a FTSE 100 company.” (Combined Code, A.4.3)

Figure 12



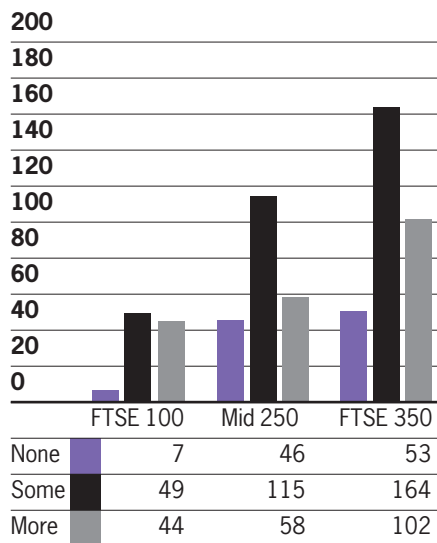
The main message:

The same number as last year.

Question 13: How much explanation is there of how the board, committees and individual directors are annually formally evaluated for their performance?

Guidance: “The board should state in the annual report how performance evaluation of the board, its committees and its individual directors has been conducted.” (Combined Code A.6.1)

Figure 13



The main message:

Similarly to Q6 above, this is another principle introduced by the revised code relating to performance evaluation, and another significant improvement shown by the FTSE 350.

This year, we took a more detailed look at the level of disclosure applied, and can conclude that around a third of companies are providing more detail than the bare minimum required by the revised code. Of course, a considerable number could still say more. Perhaps companies will be more comfortable in making disclosures once they are clearer on the process they have adopted. Next year, it will be interesting to note how many companies use the services of an “external third party” as Higgs’ 2003 guidance on non-executive directors suggests.

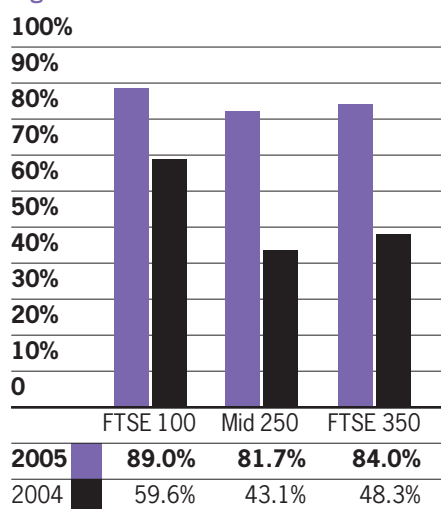
Board and committees – general

Question 14: Are terms of reference available for the audit, remuneration and nomination committees?

Guidance: “The terms of reference of the audit committee, including its role and the authority delegated to it by the board, should be made available.” (Combined Code, C.3.3)

“The remuneration committee should make available its terms of reference, explaining its role and the authority delegated to it by the board.” (Combined Code, B.2.1)

Figure 15



The main message:

The nomination committee should make available its terms of reference, explaining its role and the authority delegated to it by the board.

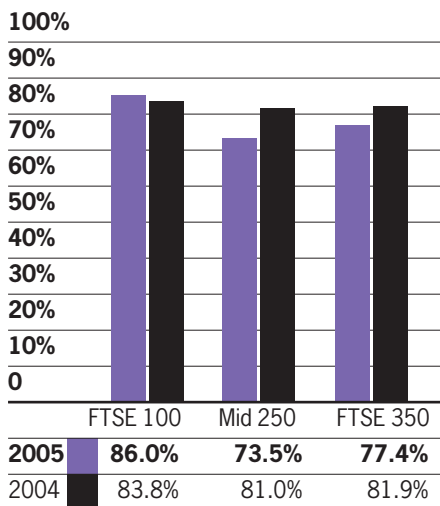
Unlike Q5 above, only 16% overall fail to comply. For the sake of a simple disclosure directing the stakeholder to the website or a point of contact, there must be scope for attaining near full compliance.

Audit committee

Question 15: Are all the members independent non-executive directors?

Guidance: "The board should establish an audit committee of at least three ... members, who should all be independent non-executive directors." (Combined Code, C.3.1)

Figure 15

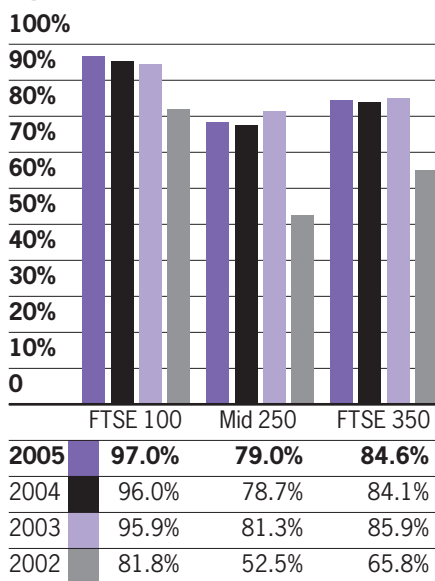


The main message:

While there is a slight improvement by the FTSE 100 in the independence of the audit committee membership, the overall figure for the FTSE 350 shows a slight decrease in levels of compliance. This can be attributed to the new companies that have entered our population who have yet to bring the audit committee's composition in line with the revised code.

Question 16: Do they have an internal audit function or equivalent?

Figure 16



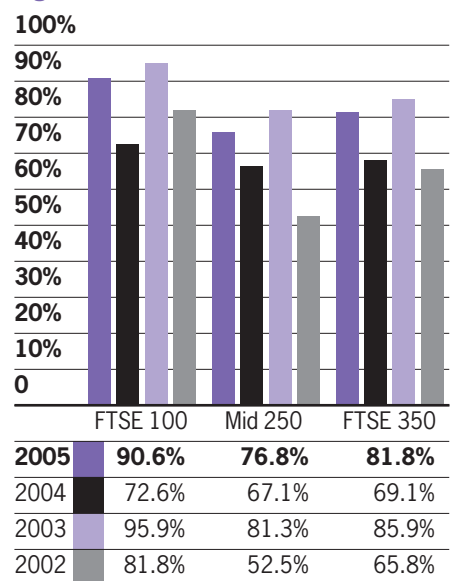
The main message:

For the second successive year, there is no significant change in the numbers of companies who have disclosed the existence of an internal audit function.

Question 17: Does the audit committee monitor and review the effectiveness of internal audit activities?

Guidance: "The main role and responsibilities of the audit committee should ... include ... to monitor and review the effectiveness of the company's internal audit function." (Combined Code, C.3.2)

Figure 17



The main message:

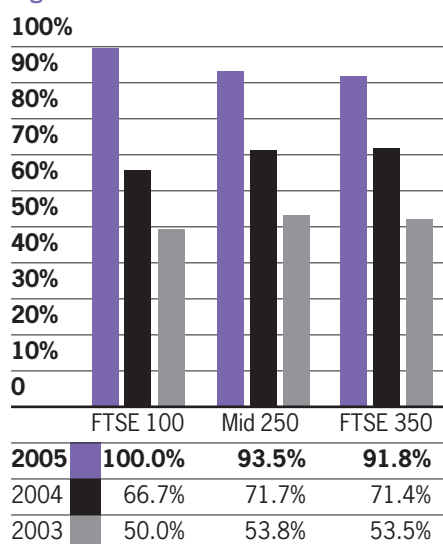
In order to discharge its duty to review the effectiveness of the internal audit department, we believe that the audit committee should play an active part in both setting the scope and reviewing the results. The percentage of company disclosures in accordance with these practices has increased from last year, with the FTSE 100 leading the way both in terms of overall adherence and relative improvement.

Audit committee

Question 18: If there is currently no internal audit function, is the absence of the function explained and is there disclosure that a review of the need for one has been carried out during the year and a recommendation been made to the board?

Guidance: “Where there is no internal audit function, the audit committee should consider annually whether there is a need for an internal audit function and make a recommendation to the board, and the reasons for the absence of such a function should be explained in the relevant section of the annual report.” (Combined Code, C.3.5)

Figure 18



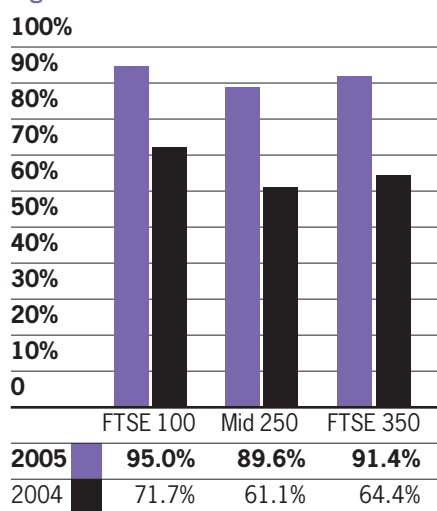
The main message:

Overall, 30% more companies made this disclosure compared to last year. Only around 8% (of the 50 or so companies who don't appear to have an internal audit function), have not explained why and whether they have reviewed the need for one during the year.

Question 19: If the auditor provides non-audit services, is there a statement as to how the auditor's objectivity and independence is safeguarded?

Guidance: “The annual report should explain to shareholders how, if the auditor provides non-audit services, auditor objectivity and independence is safeguarded.” (Combined Code, C.3.7)

Figure 19



The main message:

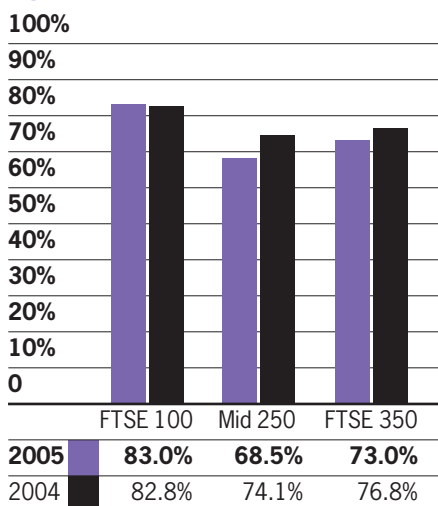
While this is not a new area of good governance practice, the need to make a specific statement on how auditor objectivity and independence has been considered has raised the bar for disclosure in the annual reports. Both the FTSE 100 and the Mid 250 (which has closed the gap) have responded to this challenge. It will be interesting to note how a potential change in the traditional relationship with auditors will affect the audit fees. Statements like the following were typical: “...the board has determined policies as to what non-audit services can be provided by the company's external auditors and the approval process related to them. Under those policies work of a consultancy nature will not be offered to the external auditors unless there are clear efficiencies and value added benefits to the company.”

Audit committee

Question 20: Does the audit committee appear to have at least one member with recent and relevant financial experience?

Guidance: “The board should satisfy itself that at least one member of the audit committee has recent and relevant financial experience.” (Combined Code, C.3.1)

Figure 20



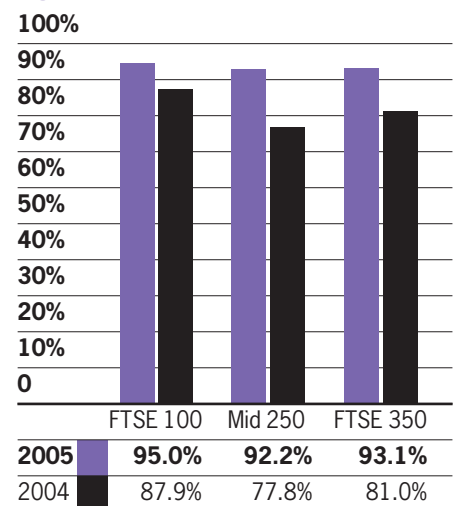
The main message:

The revised code states that the board simply needs to satisfy itself that the audit committee has the requisite experience. We believe, however, that further disclosure is necessary to truly embrace the comply or explain approach. Last year, we investigated whether committees appeared to have “recent” and “relevant” financial experience. This year we looked for specific disclosure on who was identified in this respect. That 55% of companies do not identify a specific individual may be due to the unwillingness of individuals to be held accountable in this increasingly litigious age. The response is often a statement that the company believes that the committee collectively have the required experience. But, 27% of companies do not even do that.

Question 21: Is there a separate section of the annual report which describes the work of the committee?

Guidance: “A separate section of the annual report should describe the work of the committee in discharging those responsibilities.” (Combined Code, C.3.3)

Figure 21



The main message:

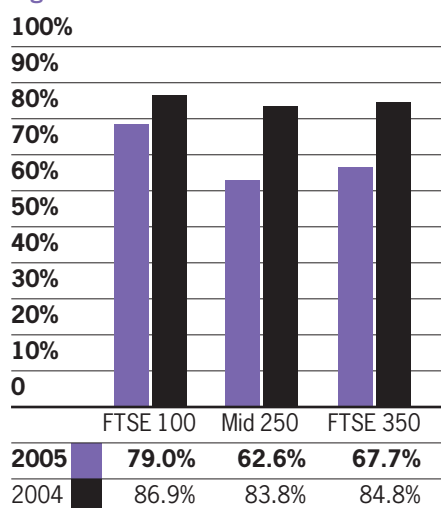
These results support the overall improvement in revised code disclosure with both the FTSE 100 and FTSE 350 making significant improvements in this respect.

Remuneration committee

Question 22: Are there at least three members, all of whom are independent non-executive directors?

Guidance: “The board should establish a remuneration committee of at least three, ... members, who should all be independent non-executive directors.” (Combined Code, B.2.1)

Figure 22

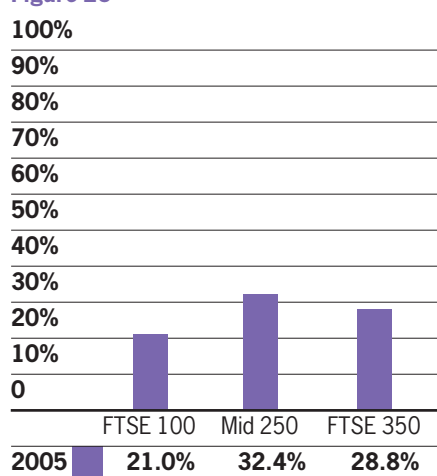


The main message:

This year, we have considered the chairman not to be independent, for the purposes of the remuneration committee membership. Therefore, this question is not directly comparable with last year's results. Q23 indicates that this decrease is explained, in the main, by this re-classification.

Question 23: Does the chairman sit on the committee?

Figure 23



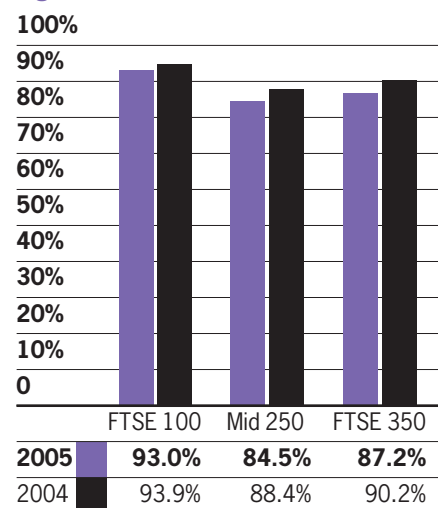
The main message:

We have added this question in order to provide some quantification for the debate over the appropriateness of the chairman sitting on the remuneration committee. Over a quarter of all remuneration committees include the chairman within their membership. This is, of course, more of a governance issue where the chairman is not considered independent, but in line with the Smith Report, can the remuneration committee be truly independent with a chairman among its members?

Question 24: Does the performance related element of director's remuneration appear significant?

Guidance: “The performance-related elements of remuneration should form a significant proportion of the total remuneration package of executive directors ...” (Combined Code, B.1.1)

Figure 24



The main message:

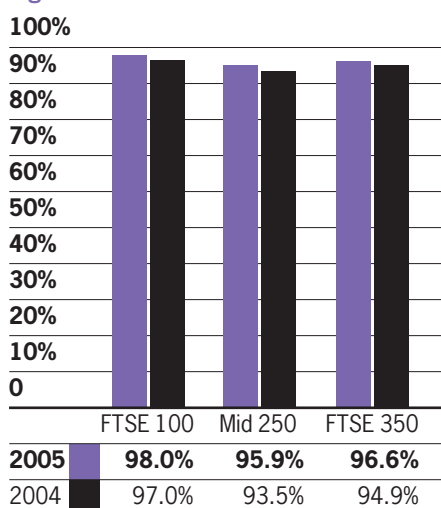
There is of course no definition of “significant” and the extent of any potential performance bonus is sometimes not clear from the annual report. The slight drop in figures for this year may also be attributed to the number of companies that have capped the bonuses to 50% of base salary. Under our definition of “significant” (more than 50%), these would not count. Overall, however, the level of compliance with this principle is still relatively high.

Remuneration committee

Question 25: Are notice (or contract) periods set at one year or less?

Guidance: "Notice or contract periods should be set at one year or less. If it is necessary to offer longer notice or contract periods to new directors recruited from outside, such periods should reduce to one year or less after the initial period." (Combined Code, B.2.1)

Figure 25



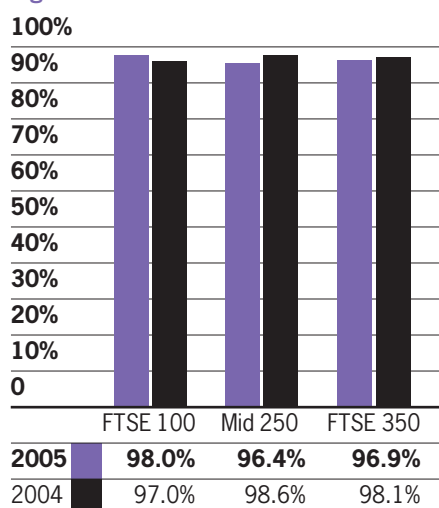
The main message:

Only 4% of companies still have individual employment contracts with notice periods that exceed 12 months. Most of these relate to where an offer of an initial two-year notice period has been made in order to attract new directors to the company. This practice is acceptable under the revised code, provided the notice period is subsequently reduced to 12 months after an initial period. The small improvement in the figures may be a direct result of this reversion in practice.

Question 26: Does the remuneration committee set remuneration for all execs and chairman, and have power to monitor and recommend remuneration of senior management?

Guidance: "The remuneration committee should have delegated responsibility for setting remuneration for all executive directors and the chairman [and] should also recommend and monitor the level and structure of remuneration for senior management." (Combined Code, B.2.2)

Figure 26



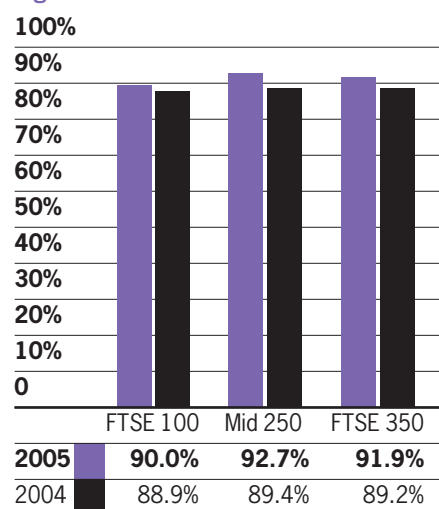
The main message:

The figures remain close to full compliance, despite the small drop within the FTSE 350 overall. This, again, can be attributable to the turnover of companies in our population.

Question 27: Do the board (or shareholders where required) set the remuneration for the non-executive directors?

Guidance: "The board itself or, where required by the Articles of Association, the shareholders should determine the remuneration of the non-executive directors." (Combined Code, B.2.3)

Figure 27



The main message:

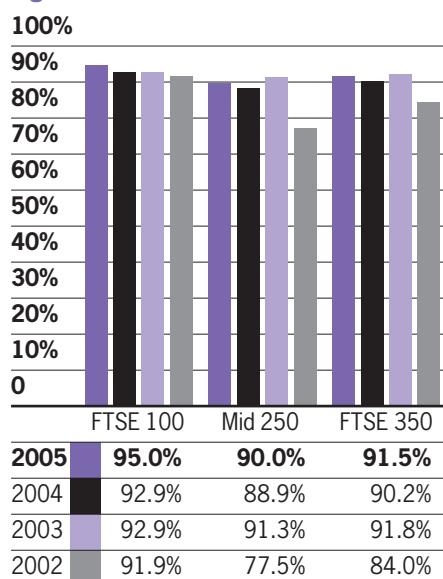
A very slight improvement on last year. But, in 8% of companies, there is either a failure to provide a simple disclosure of applied practice or the members of the committee are effectively deciding their own remuneration. The latter seems most improbable, as it is a strict contravention of one of the revised code's main principles.

Nomination committee

Question 28: Are the majority of members independent non-executive directors and is the chairman either chairman of the board or an independent non-executive director?

Guidance: "A majority of members of the nomination committee should be independent non-executive directors. The chairman or an independent non-executive director should chair the committee" (Combined Code, A.4.1)

Figure 28



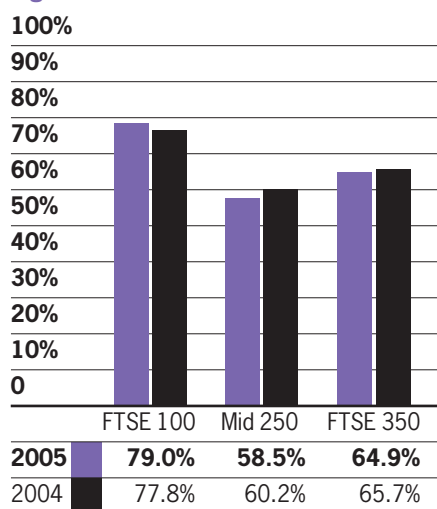
The main message:

A marginal improvement in nomination committee composition is mainly led by the FTSE 100, as companies continue to edge nearer to being fully compliant.

Question 29: Is there a description of the work of the nomination committee, including the process it has used in relation to board appointments?

Guidance: "A separate section of the annual report should describe the work of the nomination committee, including the process it has used in relation to board appointments." (Combined Code, A.4.6)

Figure 29



The main message:

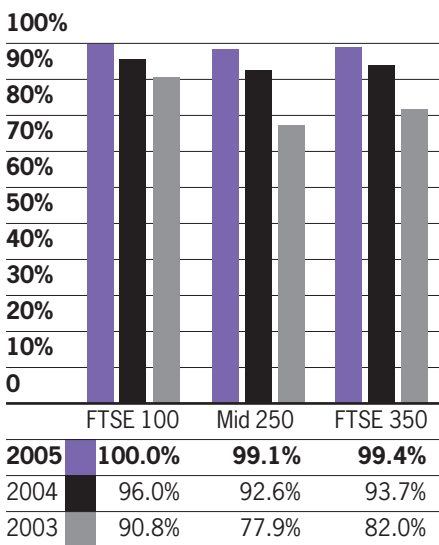
While disclosure on the work of the audit committee has shown significant improvement, the corresponding level of disclosure for the nomination committee remains surprisingly static year-on-year.

Turnbull compliance – internal control and risk management

Question 30: Is there a statement that a review of the effectiveness of the group’s internal controls has been undertaken at least annually?

Guidance: “The board should, at least annually, conduct a review of the effectiveness of the group’s system of internal control and should report to shareholders that they have done so.” (Combined Code, C.2.1)

Figure 30



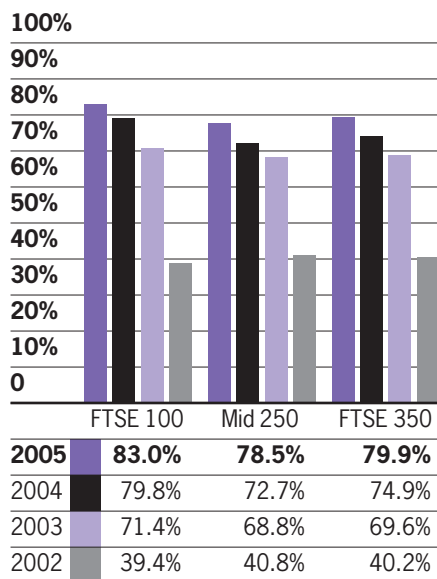
The main message:

Finally, companies have, at least formally, acknowledged the need to review the effectiveness of their internal controls. But what does this actually mean and how do they actually do it? The focus should now turn to what companies do to satisfy themselves on their controls’ effectiveness (see Q36). This need not go to the lengths of a SOX approach, but the question remains whether simply reviewing and noting a report prepared by management goes far enough?

Question 31: This review should cover all material controls including financial, operational and compliance controls risk management systems?

Guidance: “The review [of the effectiveness of the group’s system of internal control] should cover all controls, including financial, operational and compliance controls and risk management.” (Combined Code, C.2.1)

Figure 31



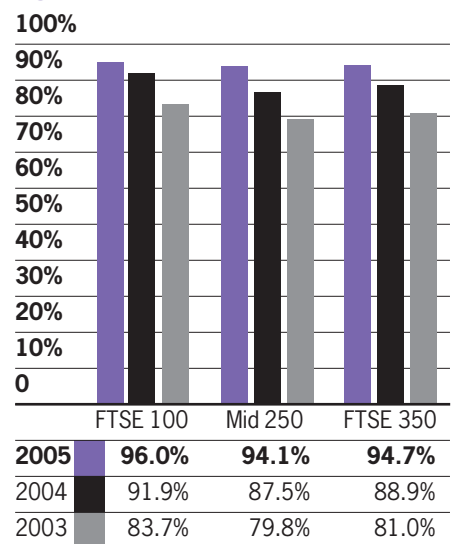
The main message:

Unlike the approach taken to comply with SOX, where the focus is purely financial, the consideration of all types of control and risk management is a better practice, which some companies (around 20%) do not claim to undertake. Steady, but slightly slowed, growth in disclosure demonstrates that the scope of consideration appears to be increasing still.

Question 32: Is there a statement that there is an ongoing process for identifying, evaluating and managing the significant risks faced by the company?

Guidance: “In its narrative statement of how the company has applied Code principal D.2 [C.2.1 the revised code], the board should, as a minimum, disclose that there is an ongoing process for identifying, evaluating and managing the significant risks faced by the company, that it has been in place for the year under review and up to the date of the approval of the annual report and account.” (Turnbull, paragraph 35)

Figure 32



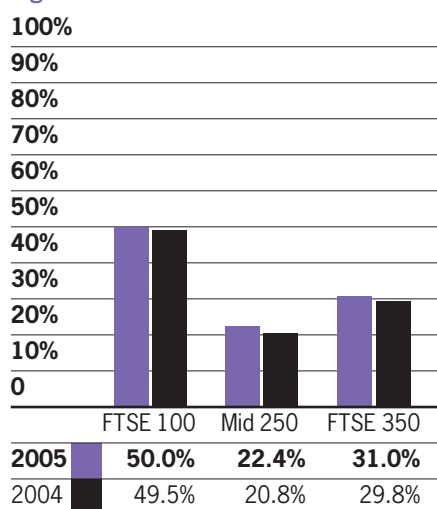
Turnbull compliance – internal control and risk management

The main message:

A clear improvement with relatively strong year-on-year growth reflects the fact that the Turnbull guidance is now widely recognised and, more importantly, is used by companies as guidance in managing their risk. We must now turn to how disclosure develops with the introduction of the OFR and moves away from the boilerplating that is often the case under Turnbull.

Question 33: Do they identify what their principle business risks are?

Figure 33

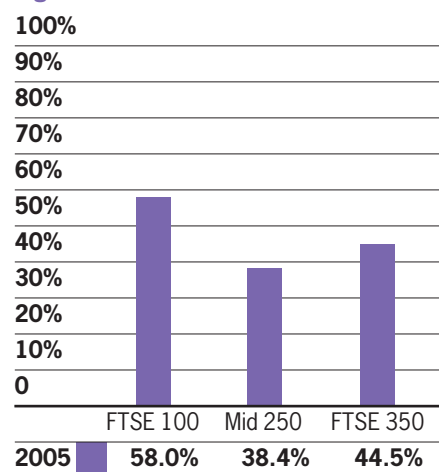


The main message:

There has been little progress from last year and only a third of companies give an indication of their principle risks. There is, however, still perhaps a trade off between disclosing information that is valuable to the investor and of value to a competitor. However, in the coming years, we would expect the level of compliance for this question to increase due to the changes brought in with the OFR. As it stands presently, the transparency of principle business risks is low, and is not immediately obvious to the reader of the accounts.

Question 34: Is there an apparent consideration of risks relating to corporate responsibility matters?

Figure 34



The main message:

There has always been less concern over the commercial sensitivity of information on corporate responsibility, eg how companies interface with the environment, employees and the local community. The FTSE 100 leads the way with 58% disclosing risks such as lack of public trust, employee engagement and motivation and environmental liabilities.

Turnbull compliance – internal control and risk management

Question 35: Is there any additional information to assist understanding of the risk management and internal control process as a whole?

Guidance: “The board may wish to provide additional information in the annual report and accounts to assist understanding of the company’s risk management processes and system of internal control.” (Turnbull, paragraph 36)

The main message:

There is some improvement on last year. But it appears the standard is still being set by around 30 or so companies who are in a class of their own and really give the reader an insight into the companies system of internal control and how they manage their risk. This includes detail on: risk governance structures outlining roles and responsibilities; authority levels and segregation of duties; policies and procedures; internal control representations; confirmation of compliance or self-assessments; and the use of risk registers and post-investment reviews.

Figure 35 – 2005

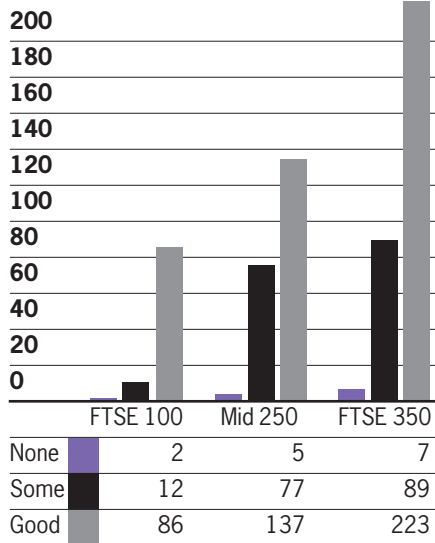


Figure 35 – 2003

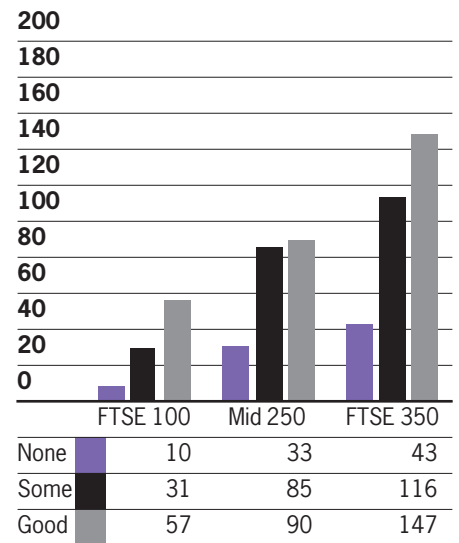


Figure 35 – 2004

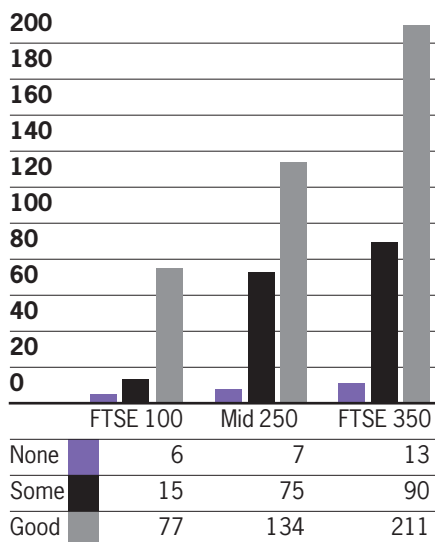
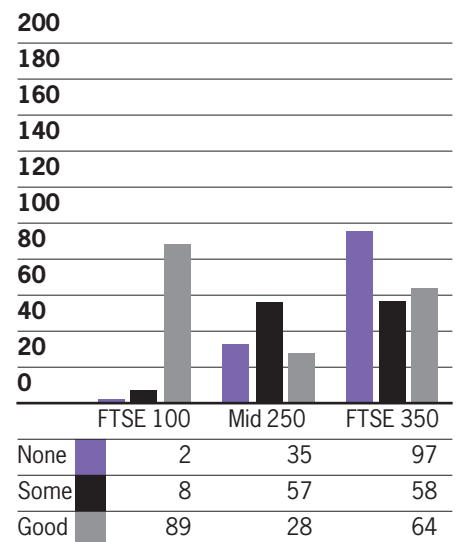


Figure 35 – 2002



Turnbull compliance – internal control and risk management

Question 36: Is there a summary of the process the board/committees have applied in reviewing the effectiveness of the internal control system?

Guidance: “In relation to Code provision D.2.1 [C.2.1 the revised code], the board should summarise the process it (where applicable, through its committees) has applied in reviewing the effectiveness of the system of control.” (Turnbull, paragraph 38)

The main message:

While the quality of disclosure continues to improve, around a third of all companies still provide no summary of the process at all. If this is the case, how can the reader be sure that companies are not simply paying lip service to this practice? Companies need to embrace the comply or explain approach while they still can.

Figure 36 – 2005

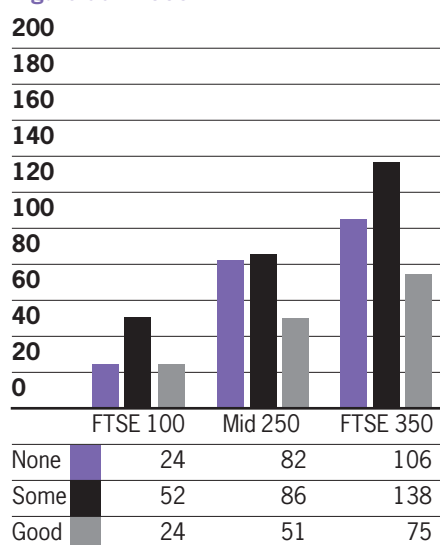


Figure 36 – 2003

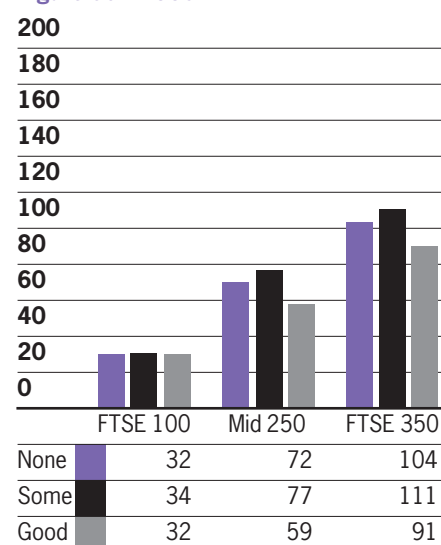


Figure 36 – 2004

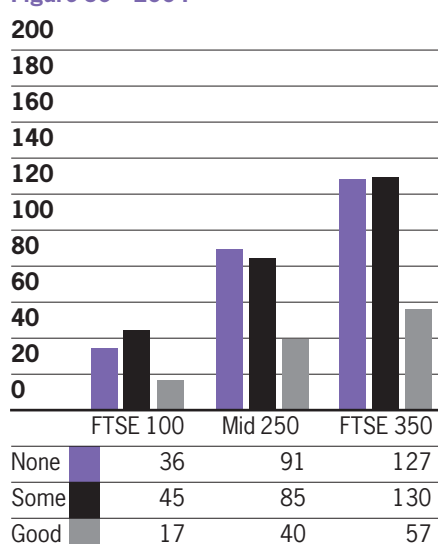
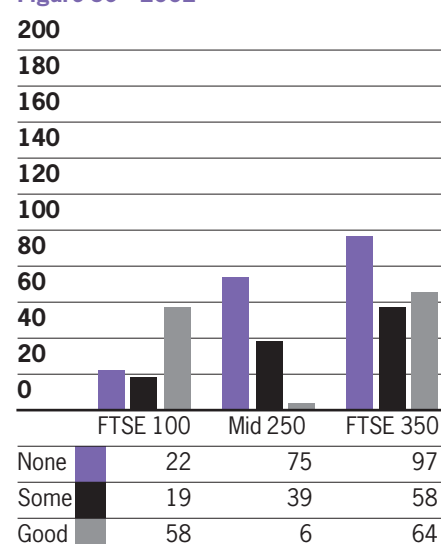


Figure 36 – 2002



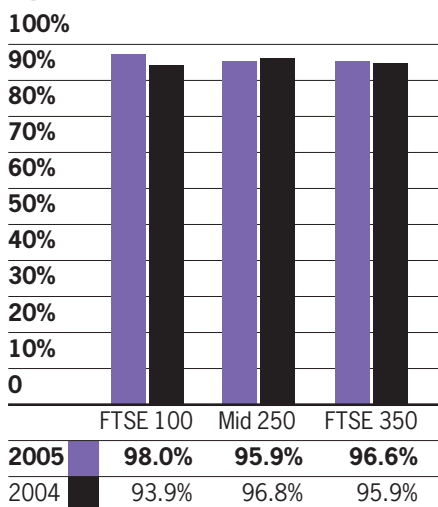
Relations with shareholders

Question 37: Is there a statement of the steps taken by the board to develop an understanding of the views of major shareholders?

Guidance: “The board should state in the annual report the steps they have taken to ensure that the members of the board, and in particular the non-executive directors, develop an understanding of the views of major shareholders about their company ...”

(Combined Code, D.1.2)

Figure 37



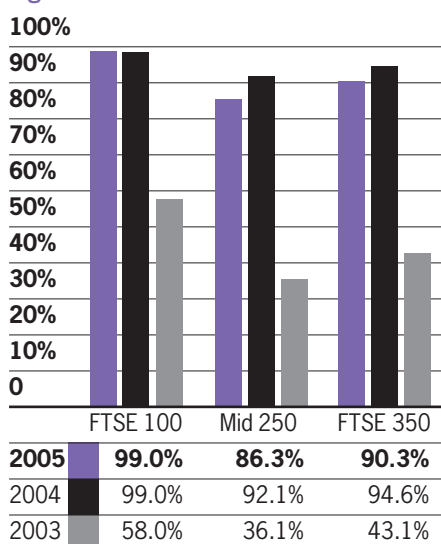
The main message:

Further steps towards full compliance are shown here. For the remaining 3.5% of companies, surely it is likely to be a lack of disclosure, rather than a lack of communication?

Corporate responsibility matters

Question 38: Have they established dedicated structures and processes to direct and regularly monitor the company's wider social environment and ethical performance and report to the board?

Figure 38



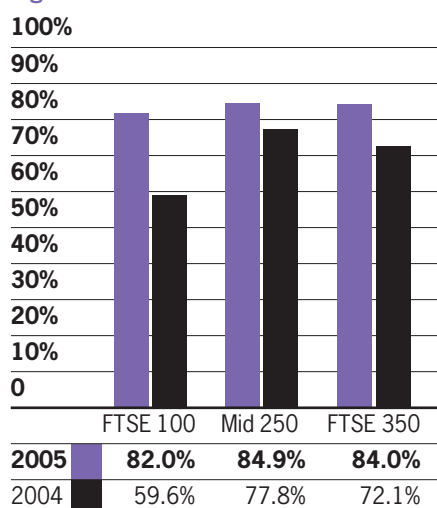
The main message:

The major shift towards implementing corporate responsibility structures has already been seen between 2003 and 2004. The decrease shown in the Mid 250 may be explained by the growth in smaller cap companies without the commensurate growth in governance practices in this respect.

Question 39: Is the disclosure within the annual report?

Guidance: "The guidelines take the form of disclosures, which institutions would expect to see included in the annual report of listed companies." (Association of British Insurers (ABI) – Guidelines on Socially Responsible Investment, section 2)

Figure 39

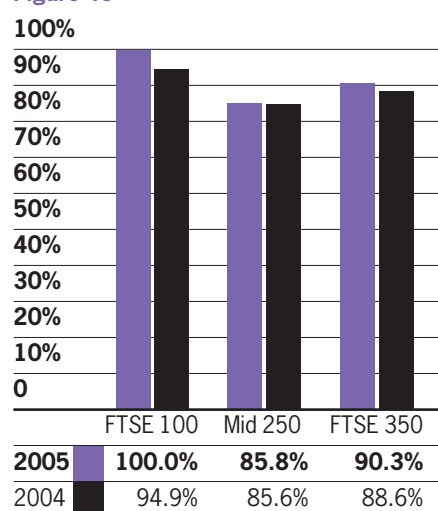


The main message:

Companies have clearly heeded to best practice, despite the obvious effect on the volume of the annual report. We still believe, in line with the ABI guidance, that it is preferable for all necessary information required for an investor to make his/her decision should be contained in one place – the annual report and accounts.

Question 40: Is there a statement of company policy regarding issues such as energy consumption, employment, recycling, carbon emissions, water/electricity consumption, etc?

Figure 40



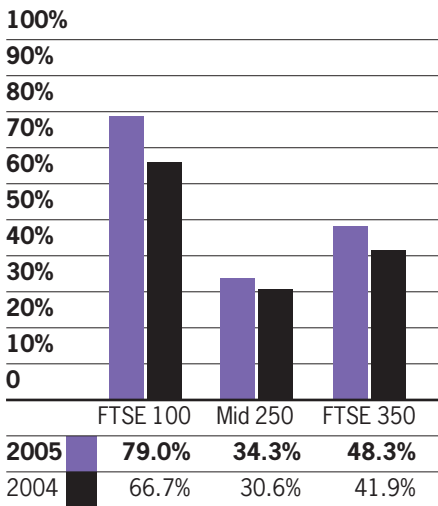
The main message:

The majority of companies now make a statement. But the production of comparable reliable data is more difficult.

Corporate responsibility matters

Question 41: Are such policy objectives stated with quantified results?

Figure 41

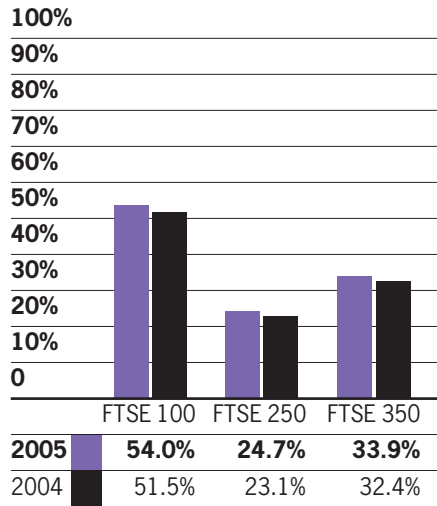


The main message:

The Mid 250 have something to learn from the FTSE 100 in this respect. However, the ability to collate and compare information against a high-level policy objective, such as the aim to reduce emissions or increase levels of recycling, is perhaps easier for a larger company with greater resources and infrastructure.

Question 42: Are disclosures verified independently either internally (internal audit) or externally?

Figure 42



The main message:

We have only witnessed a small increase in disclosure here. This year, we have been quite specific in looking for actual verification statements situated within the statements on corporate responsibility. Although only a third of companies have disclosed that they get their data verified, it may be worth also considering membership of such bodies as the FTSE4Good index, which uses an independent body to match a company's corporate responsibility policy against set criteria before membership is granted. Many companies make no reference to this in their reports, but this may be because it is not a key differentiator within the FTSE 350, as a large proportion appear to be constituents of this index.

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