

Risk Management Services

Fifth FTSE 350 **Corporate Governance Review 2006**

Highlighting trends in compliance

Grant Thornton 

Disclosure
Quantify Comply
BOILERPLATING: FACT OR FICTION?
Explain
Governance
OBJECTIVES
Business risks
CORPORATE SOCIAL RESPONSIBILITY
Progress
Disclos
Com

Contents

Introduction	1
Foreword	2
Executive summary	4
Corporate governance – general	8
Non-executive directors	10
Board and committees – general	12
Audit committee	16
Remuneration committee	20
Nomination committee	23
Turnbull compliance – internal control and risk management – revised Combined Code	24
Shareholder relations	29
Corporate responsibility	30
The future of governance	32
Grant Thornton Risk Management Services	33
About Grant Thornton	34

Introduction

Welcome to our fifth annual review of corporate governance disclosure by the FTSE 350. Three hundred and fourteen companies have been assessed against the terms of the Combined Code 2003 (the Code) and associated guidance in order to profile disclosure practices and trends. This year we have refreshed our approach by directly comparing individual companies' disclosures this year to last, in order to gauge whether they are truly updating and enhancing their explanatory narratives or merely rolling them forward, "boilerplate", year-on-year.

Overview

Our review confirms a continuing improvement in governance disclosure but also throws out a challenge to all UK plc directors to embrace the true spirit of the Code by resisting the temptation to merely repeat disclosures given in the previous years and furthermore to the non-executive directors to champion compliance by challenging any proposed departures as to whether they are truly in the interests of their stakeholders.



Simon Lowe, Head of Risk Management Services

Foreword

Landscape – UK

During the 12 months since our last review the corporate governance landscape has continued to evolve in the UK, throughout Europe and the rest of the world. In the UK, Douglas Flint's review focused on refreshing the Turnbull guidance on internal control, we saw some fine tuning of the Code as a result of a refresh exercise by the Financial Reporting Council (FRC) and there were a number of amendments to the Companies Act, notably the consideration around the Operating and Financial Review (OFR).

Landscape – Europe

In Europe, the fourth, seventh and eighth Directives are gradually being incorporated into corporate life. The Directives now formalise the need for companies to issue an annual corporate governance statement, to indicate whether or not they have complied with a code of governance, to formalise the need for disclosing information about the companies' control and risk management systems and to appoint an audit committee. In the UK, existing or draft legislation already reflects these, and directors will be very aware of the influence the Directives are having, for example in terms of their heightened responsibility to disclose all relevant information to the auditors.

This growing level of awareness and importance now being placed on corporate governance by a wide range of stakeholders is confirmed by the 2006 ISS Global Institutional Investor Study in which it was found that 78% of European institutional investors surveyed believe corporate governance will become "significantly or somewhat more important over the next three years" in Europe.

Message from America

In the US, there has been a growing clamour to apply a more risk-based approach to SOX partly driven by inflated implementation costs (particularly Section 404), but also due to growing concern at the flight of registrants away from the US exchanges. Conservative interpretation of the requirements of Section 404 and the available guidance, have driven additional cost into compliance regimes of many companies. This has, albeit somewhat belatedly, now been recognised by the regulators.

The US Securities and Exchange Commission (SEC) is currently looking to reduce the costs of assessing and auditing internal control, while still achieving the intended benefits. To that end, both the Public Company Accounting Oversight Board (PCAOB) and the SEC are devising revised guidelines to assist management and auditors in this regard.

A draft amended version of Auditing Standard 2 (AS2) for auditors and further guidance for companies to determine how to conduct an effective evaluation of internal controls, are due to be issued in December. However, if these fail to adequately address the issue of cost, it is highly likely that Congress will have to intervene to implement some level of exemption from Section 404. US vice president Dick Cheney, speaking recently about SOX, hinted at such a possibility. The imminent retirement of Senators Paul Sarbanes and Michael Oxley will perhaps provide the catalyst for change.

Scepticism abounds

Europe remains to be convinced as to the softening of SOX and its impact on European governance. The reaction of the UK government to NASDAQ's possible interest in the London Stock Exchange and the European reaction to NYSE's interest in Euronext confirms that scepticism abounds. In both instances the regulatory authorities are seeking to establish a right of veto (in one form or another) over any US corporate legislation crossing the Atlantic.

UK considerations

Concern re US legislative creep

Should UK directors be worried about the threat of legislative creep, or is it inevitable that the market will, over time, harmonise around a common, global approach to governance practice? After all, stakeholders want the same thing – consistent, reliable, honest, comparable accounting and reporting, coupled with low investment costs and easy access to capital.

Sight should not be lost of the governance principles the US Congress were seeking to embed into corporate practice through the introduction of SOX legislation, as they are not so dissimilar to Europe's. The US's reaction to corporate mismanagement is increasingly being seen as having given rise to something of an over reaction amongst those responsible for implementing it. Over time it seems inevitable that pressure, not least from those with vested interests in the capital markets, will lead to a more pragmatic approach to the application of the legislation.

The risk for UK plc is that it becomes complacent, choosing minimum disclosure rather than truly demonstrating its commitment to the principles to the Code, as such an approach could open the door to more prescriptive regulation.

Findings

Our 2006 review raises some interesting challenges for public company boards. It confirms the continued progress that has been made by the UK's larger plcs in complying with the Code.

However, looking more closely at those areas which allow for judgment and discretion as opposed to a straight yes or no, the picture is slightly different as the trend suggests a tailing off in those companies voluntarily giving additional, informative disclosure. For example, in the area of risk and internal controls, only 38 companies, a figure very similar to the previous year, have chosen to go the extra mile with their explanations. Furthermore, our review identified that only 31 companies provided enough disclosure to be considered fully compliant with the Code (see question 1), leaving some 90% falling short of full compliance. It is true that the majority of these companies provide explanations for their non-compliance, but this raises the question of whether companies are hiding behind the “comply or explain” option.

Spotlight on compliance

Common perception suggests that “comply or explain” are equal options. Whilst the Listing Rules do give the option, the emphasis of the Code is very much on compliance. With a large majority of companies feeling they can justify departure from the Code, perhaps choosing “departure” has become simply too easy.

The challenge

This year's review highlights both the improving trends and high standards of governance now practised by UK plc. But it also throws down a challenge to those charged with governance to truly embrace the spirit of the Code and so ensure the future of our principles based approach. Ultimately it is the degree to which UK plc chooses to apply the Code principles which will determine the future of our governance practices.

Executive summary

Taking time to “comply”?

Companies still need further time to adapt to the revisions made to the Code back in 2003.

With only 34% of the FTSE 350 claiming full compliance (an increase from 28% last year), the trend suggests that two more years will be required before the number of companies claiming full compliance reaches previous levels observed under the original version of the Code (54% of the FTSE 100 and 42% of the Mid 250 considered themselves fully compliant in our 2003 review).

But does “full compliance” really mean full? Our review could only identify 10% of FTSE 350 companies whose disclosure fully supported this claim. This either casts doubt on the rigour applied to the self-assessment of compliance, or suggests that key disclosure requirements have been omitted from their narratives. Companies should resist the temptation to simply “roll forward” their corporate governance statement and instead revisit the Code (in particular Schedule C), which lists out the specific disclosure requirements.

Comply or explain – a matter of convenience or better for the stakeholder?

Whilst specific reference is made to “comply or explain” in the Listing Rules, it is the Preamble, not the body of the Code, which refers to this option. And it is not a simple either/or, rather the emphasis is on “complying...most of the time” and departing only if it can be justified with considered explanations.

Given this emphasis it is surprising to find 66% of companies still choosing to depart from the Code’s provisions, in one regard or another.

Considered explanation or boilerplate

In this year’s review, we have seen further improvement in the degree to which companies are providing reasoning for areas of non-compliance, with 96% providing at least some explanation, up from 91% last year. However this disguises the true picture. This year we assessed whether companies actually update their disclosure year-on-year. Our aim was to draw out the prevalence of the so-called “boilerplate” disclosures which undermine the comply or explain approach. Of those companies who provide explanations of non-compliance, only 32% have made any significant change since the previous year and 57% made no change at all.

Key areas of improvement

Last year, the improvement story was audit committees. This year, it is board accountability, as evidenced by the strengthening of disclosures in respect of the authority and role of the non-executive directors. For example, 28% more companies are providing greater detail on the work of the nomination committee, including the processes it uses to evaluate appointments to the board. Encouragingly, the largest increase comes from the Mid 250 where a third more companies made this disclosure.

Nearly 20% more companies (70% overall) now provide a statement that the non-executive directors conduct an annual performance appraisal on the chairman. This is supplemented by the additional 6% of companies (now 89% overall) who provide at least some description of how the board, committees and individual directors are evaluated. Whilst this represents a marked improvement, the residual question and a current “hot topic” (although not possible to assess from disclosure alone), is the effectiveness or otherwise of these evaluations. Anecdotally, there is a consensus amongst chairmen and non-executive directors, that best practice has yet to emerge.

Interestingly, 24% more companies now make the terms and conditions of the appointment of non-executives available, but despite this improvement, this remains one of the most frequent areas of non-compliance.

Pushing full compliance

Almost full marks are now being achieved in the following areas:

- identification of key role holders on the boards and committees (99%)
- a statement of how the board operates (97%)
- disclosure of the number of meetings and attendance during the year (99%)
- disclosure of the steps taken to understand the views of shareholders (98%).

The cynic might suggest that the majority of improvements are either “quick wins” or “boilerplate” enabled as they don’t change year-on-year and no improvement in physical governance practice is required. However, this may be unfair as perhaps one of the greatest recent successes has been Sir Robert Smith’s work in raising the audit committee’s prominence, with 97% of companies now providing a separate report on the role and processes of that committee.

Directing the business – independence and accountability

For 23 of the companies reviewed, the chairman and chief executive are the same individual, and two-fifths of these were in the same position last year. For the small number of companies where the chief executive has become the chairman during the year under review, while the Code discourages this, around 80% disclosed that this was specifically discussed with shareholders, as required under the revised Code. Some further progress has been made in balancing the board with an appropriate independent non-executive element – 70%, up from 64% last year, all driven by increases in the Mid 250. However, that still leaves 94 companies with a majority of executive directors.

Role of the committees

In regard to the composition of committees, 88% of audit, 86% of remuneration and 92% of nomination committees are now in line with the Code, compared to 77%, 68% and 92% respectively last year.

Further progress has been made to ensure that the audit committee contains at least one member with recent and relevant financial experience. The FTSE 100 lead the way with 86% compliance, with the Mid 250 catching up, at 76%. Whilst there is no requirement to state who the individual is, it is encouraging to see the majority of these companies now being prepared to identify this key person.

Internal control reporting – the old...

Ninety eight percent of companies continue to provide a statement that a review of the effectiveness of the group's internal controls has been undertaken, and 82% now provide some form of summary as to how this assessment has been made. This is a significant increase from around two-thirds of companies last year. Progress was made by both the FTSE 100 and the Mid 250 in this respect. Within this statement, 85% of companies now explicitly state that their review covers a range of controls of an operational and compliance nature as well as financial – the highest level of disclosure during the five years of this review.

Conversely, this is also the area which continues to be one of the most challenging areas for compliance, as the principle requires companies to apply judgment as to the application of the Code, rather than giving a straight yes or no. An indication of such challenge is the fact that only a small number of companies, 38 (22 FTSE 100 and 16 Mid 250 companies), achieve what we consider to be “outstanding” levels of disclosure.

...and the new

We also looked for signs of early adoption of Douglas Flint's revisions. One of the key changes proposed by his review was the need for disclosure that necessary action has been (or is being) taken to remedy any significant failings or weaknesses identified in their systems of internal control.

Contrary to the US, the true incidence of significant weaknesses is difficult to ascertain, as companies are not explicit in admitting whether any significant weaknesses were actually identified. This may in part explain the low figures, as less than 20% of the FTSE 350 made appropriate disclosures, and the majority of these referred to the existence of a process rather than a specific event.

The business review and disclosing risks

The Chancellor withdrew the requirement for the OFR and with it the requirement to disclose principal business risks, in late 2005. However, amendments to the Companies Act relating to the “business review”, introduced to comply with European Directives, are now in force for companies with years ending after 31 March 2006. These require similar disclosures to the OFR, particularly in the respect of key business risk.

Annual reports within our review would not, in the main, have been required to apply the new “business review” protocols. However, the vast majority of companies, 80%, made valiant attempts to accord with the principles.

But whilst there is continued improvement in disclosures relating to the process of identifying risks, a sizeable percentage of companies, 23% of the FTSE 100 and 53% of the Mid 250, still do not give an indication as to what their principal business risks are.

Internal audit

A key element to any company's assurance framework is the operation of an internal audit function. But around 3% of the FTSE 100 and 20% of the Mid 250 still have no internal audit function, be it internal, or outsourced. Of those with such a function, only 45 companies went as far as disclosing who, whether internal or external, provided that assurance. While 80% of companies have stated that the audit committee "monitor and review the effectiveness" of internal audit activities, only around 14% appear to have initiated an external effectiveness review.

Corporate responsibility

Relatively large numbers of companies disclose the existence of processes dedicated to social responsibility reporting. They provide at least an overview of activities in the body of the annual report, and outline policies on responsible behaviour relating to their interaction with key stakeholders. Some improvement was noted in the provision of quantified results against corporate responsibility objectives, but a gulf remains between the FTSE 100 with 81% (2005 - 79%) and the Mid 250, 40% (2005 - 34%).

Independent verification of these results may become an increasing area of focus with corporate responsibility reporting moving from nice to do to having a hard commercial impact. The government is already indicating that as part of its procurement procedures demonstrable social responsibility performance is set to become a prequalification hurdle. So there is still a considerable amount of work to be done, as only 5% of the Mid 250 and 13% of the FTSE 100 were able to state that their activities had been independently verified.

Conclusion

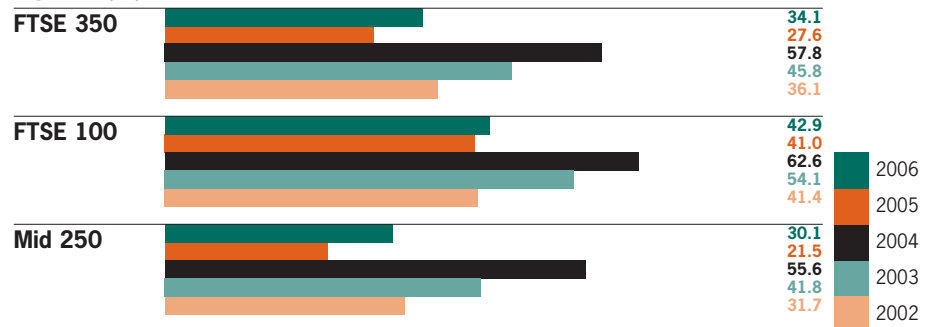
As governance practice continues to evolve around the world, the review identifies a number of welcome improvements but also picks up on a note of complacency, which the UK plc directors should ignore at their peril.

Corporate governance – general

Question 1: Do they claim full compliance with the Combined Code?

Guidance: “The following additional items must be included in its annual report and accounts: ...a statement as to whether the listed company has complied throughout the accounting period with all relevant provisions set out in Section 1 of the Combined Code.” (Listing Rule 9.8.6(6)(a))

Figure 1 (%)



The main message:

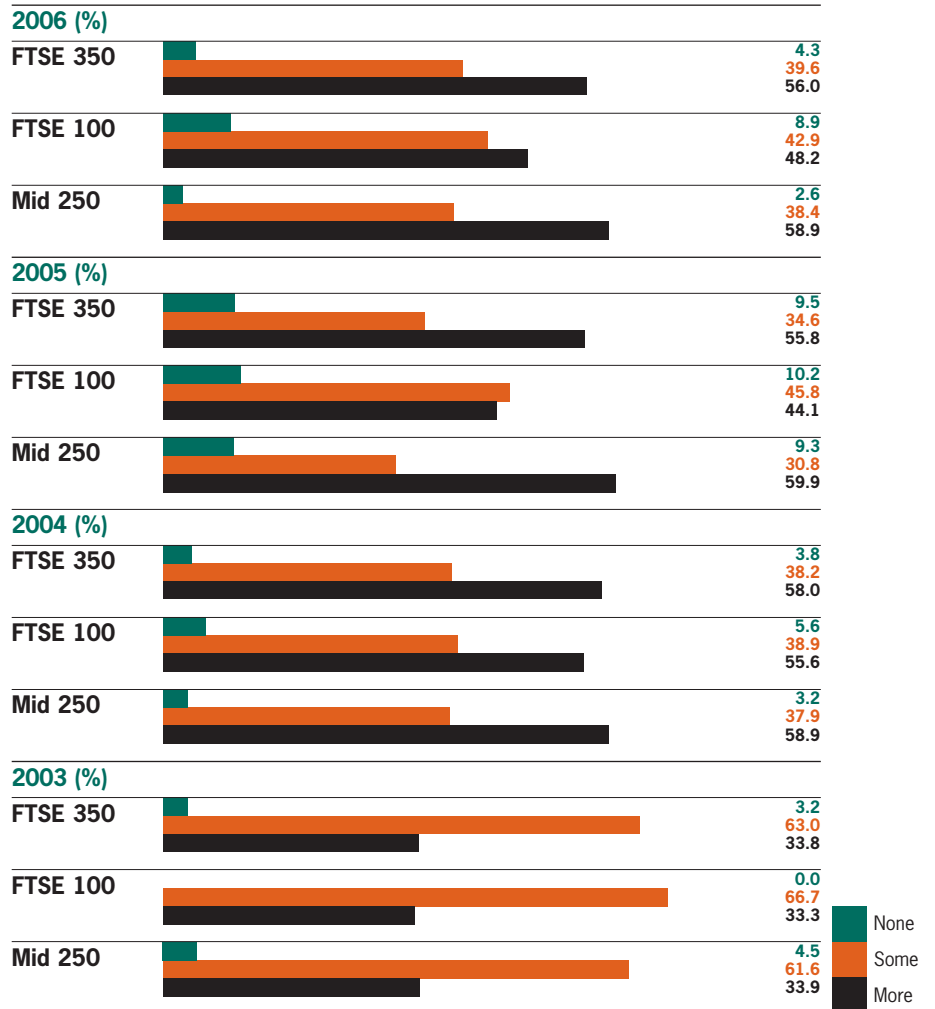
Companies appear to still be taking time to adapt to the revisions made to the Combined Code in 2003. The most common areas of non-compliance disclosed were A.4.4 (terms and conditions of appointment of non-executive directors), C.2.1 (internal control effectiveness) and C.3.1 (audit committee independence and financial experience).

Whilst a third of the FTSE 350 did claim full compliance, only around 10% of the FTSE 350 reviewed (31 companies) appeared to have made all of the disclosures that are expected by the Code to support this claim. Whilst companies simply may not be making disclosures on all relevant governance practices that they have in place, this does raise questions over what “full” compliance really means.

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 include in its annual report and accounts a statement setting out the company’s reasons for non-compliance.” (Listing Rule 9.8.6(6)(b)(iii))

Figure 2



The main message:

There has been an overall improvement in the level of explanation given by companies who do not fully comply with the Combined

Code. Now 96% of companies (previously 90%) provide at least some explanation as to the reasons for non-compliance.

Non-executive directors

Question 3: Is at least half of the board 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:

A steady increase for the Mid 250 where nearly two-thirds now have a balance of independent directors on the board. The FTSE 100 has remained at around

the same level as last year, but of the FTSE 100 that were also not compliant last year, half have failed to address the balance since.

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)

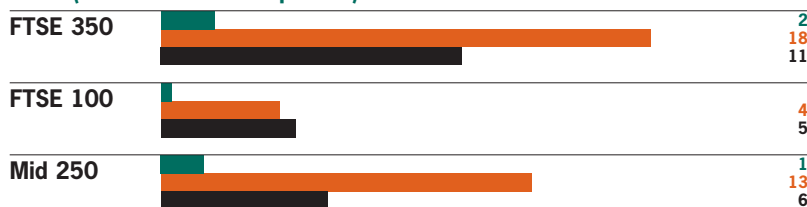
The main message:

An improvement in the level of detail for the FTSE 100, with the Mid 250 being consistent with last year. Whilst 20 companies still do not disclose any information to describe how they consider their non-executive directors as independent, if at all, one in ten companies demonstrated a noticeable improvement in the level of explanation given year-on-year.

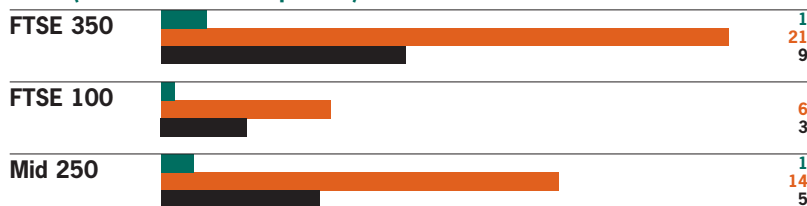
Example: The qualification for board membership includes a requirement that all our non-executive directors be free from any relationship with the executive management of the company that could materially interfere with the exercise of their independent judgement. In the board's view, all our non-executive directors fulfil this requirement. All have received overwhelming endorsement at successive AGMs, at which they are now subject to annual election. The integrity and independence of character of these directors are beyond doubt.

Figure 4

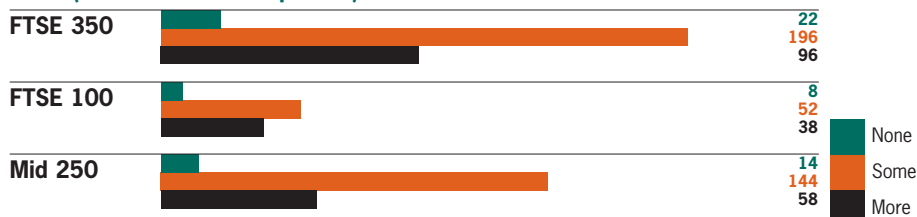
2006 (number of total responses)



2005 (number of total responses)



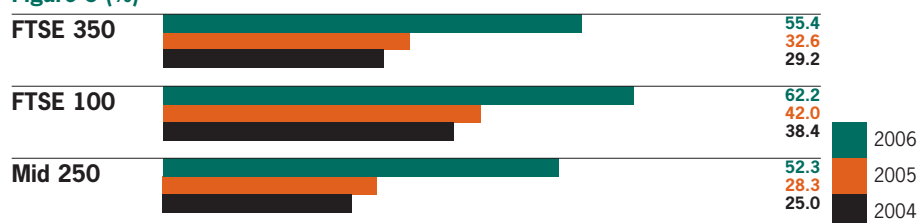
2004 (number of total responses)



Question 5: Is it disclosed that the terms and conditions of appointment of non-executive directors are 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:

Whilst companies appear to have taken heed to what was highlighted in last year’s review, (reflected in the big improvements in disclosure levels particularly in the Mid 250), this is still one of the weakest areas of compliance. 55% of companies now disclose that their terms and conditions of appointment of non-executive directors are available for inspection. In many cases the

terms and conditions appear to exist, but it was not disclosed that they are available for inspection. This simple disclosure will bring them in line with the Code. Whilst there is clear progress year-on-year, three years have passed and there is still some way to go. Even the FTSE 100 appear to have taken their time with this one.

Question 6: Led by the senior independent director, 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:

Strong growth in compliance for the second year running by both the FTSE 100 and Mid 250. However, 30% of companies overall still make no specific statement that the chairman’s performance is appraised by the non-executives on an annual basis. This demonstrates the learning curve experienced

in this area. The standard is set by a handful of companies that disclose a greater level of detail of the processes used, including performance questionnaires, formal performance appraisal processes, and consultation with executive directors and major shareholders.

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

2006 (%)

FTSE 350		2.9 49.4 47.8
----------	--	---------------------

FTSE 100

FTSE 100		0.0 29.6 70.4
----------	--	---------------------

Mid 250

Mid 250		4.2 58.3 37.5
---------	--	---------------------

2005 (%)

FTSE 350		4.7 59.2 36.1
----------	--	---------------------

FTSE 100

FTSE 100		1.0 49.0 50.0
----------	---	---------------------

Mid 250

Mid 250		6.4 63.9 29.7
---------	--	---------------------

None
Some
More

The main message:

A strong increase in disclosure levels this year, particularly for the FTSE 100. Nearly half of all companies are now providing “more” than the bare minimum disclosure.

Example: To discharge its governance function in the most effective manner...the board has laid down rules for its own activities in a governance process policy.

The process policy covers:

- the conduct of members at meetings
- the cycle of board activities and the setting of agendas
- the provision of timely information to the board

- board officers and their roles
- board committees – their tasks and composition
- qualifications for board membership and the process of the nomination committee
- the evaluation and assessment of board performance
- the remuneration of non-executive directors
- the process for directors to obtain independent advice
- the appointment and role of the company secretary.

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:

All companies in the FTSE 100 clearly identify all the key members of their boards and committees. The Mid 250 are not far

behind, and have moved further towards 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:

Further steady improvements have been made this year. Companies appear not to have struggled to implement this additional

disclosure requirement introduced in 2003 and less than 1% of all companies in the FTSE 350 fail to provide this information.

Question 10: Are the roles of the chairman and chief executive divided and exercised by different individuals?

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:

The slight overall drop in compliance can be attributed to the new members of the FTSE 350, whilst a small improvement has been observed in the FTSE 100. Of the 23 companies that were non-compliant last year

however, 10 companies still have not split these roles. This suggests that companies are either finding it hard to attract the right candidate, or the chairman believes in the old adage “If I’m not broke don’t fix me !”

Question 11: For new chairmen that were appointed during the year...

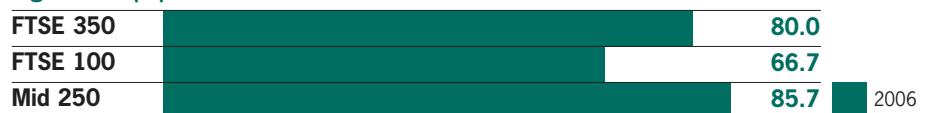
a) if they previously held the role of CEO, has his/her independence been assessed and fully disclosed?

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

b) if the chairman also chairs another FTSE 100 company, has there been consultation on the level of commitment needed and relevant disclosure made?

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

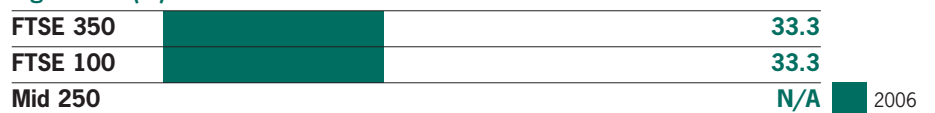
Figure 11a (%)



The main message:

Ten companies have appointed the CEO to chairman during the period subject to our review. Eight of these fully disclosed this fact.

Figure 11b (%)



The main message:

Three FTSE 100 companies have a newly appointed chairman that chairs another FTSE 100 company. Only one company fully

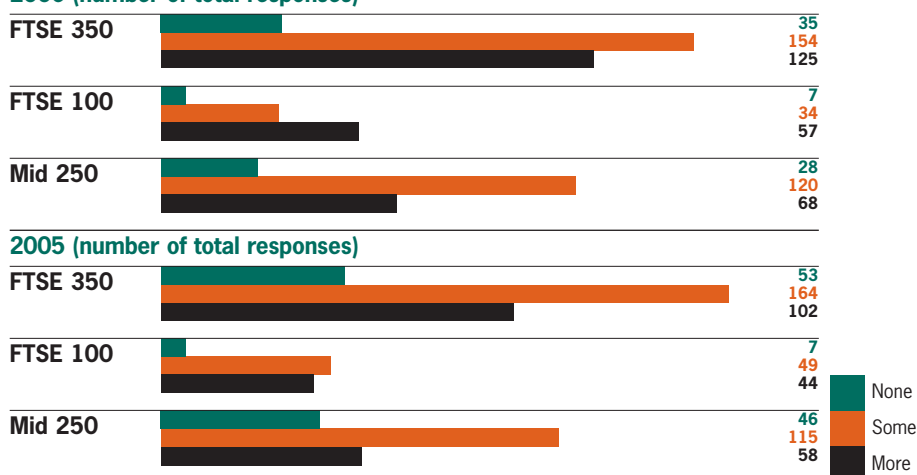
disclosed that they considered the time commitments required prior to appointment.

Question 12: How much explanation is there of how the board, committees and individual directors are annually evaluated formally 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 12

2006 (number of total responses)



The main message:

There has been an overall reduction in the number of companies who gave no disclosure at all on performance evaluation, and a greater number of companies (now 40% from 31% last year) provided “more” than minimal levels of explanation.

One in five companies appeared to have updated their disclosure from last year and 14% of companies showed improvement in the quality of disclosure provided.

Question 13: Is it disclosed that the terms of reference for the audit, remuneration and nomination committees is available for inspection?

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)

“The nomination committee should make available its terms of reference, explaining its role and the authority delegated to it by the board.” (Combined Code, A.4.1)

Figure 13 (%)



The main message:

Further steps have been made towards full compliance with good improvements made in both the FTSE 100 and Mid 250 disclosure and the majority of companies made reference to the availability of this information on their

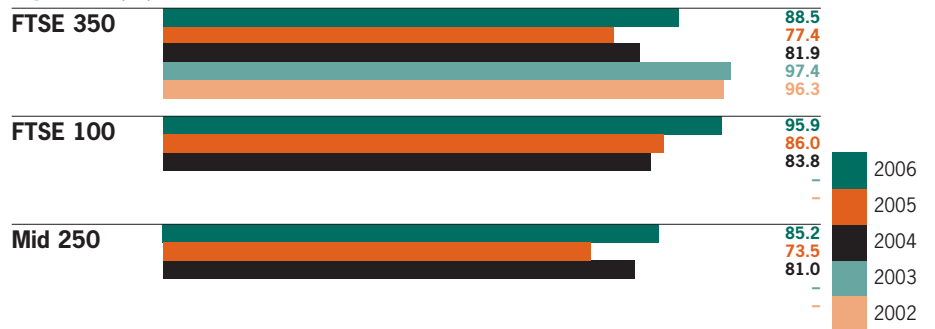
website. As with question 5, the terms of reference may be available, but still some companies fail to provide this simple disclosure.

Audit committee

Question 14: 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 14 (%)



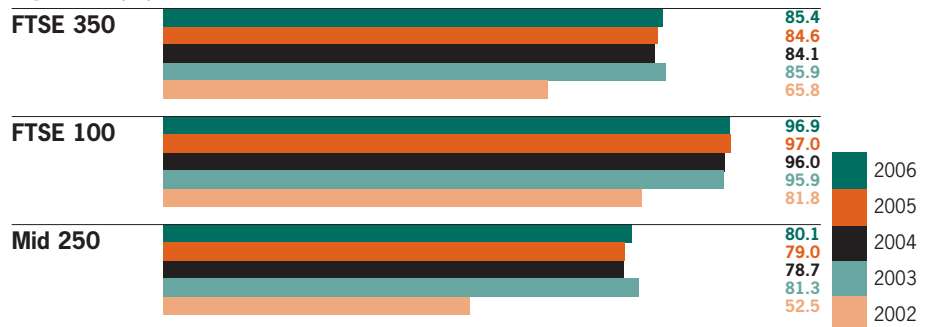
The main message:

This year witnesses strong improvement across the FTSE 350, indicating further evidence that the authority and influence of

the audit committee continues to grow. Surprisingly, four of the FTSE 100 and 32 of the Mid 250 still don't comply.

Question 15: Do they have an internal audit function or equivalent?

Figure 15 (%)



The main message:

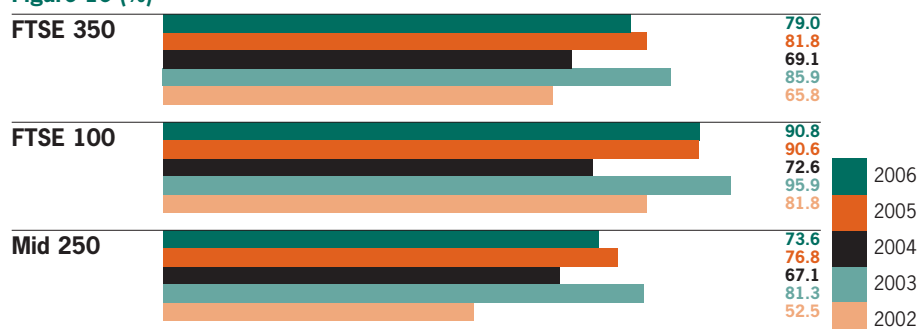
The number of companies in the FTSE 350 that have an internal audit function has remained steady for the third year running. Internal audit departments continue to be much more prevalent in the FTSE 100 than the Mid 250 and of those companies that have

such a function, 45 disclosed that they have at least a partially if not fully outsourced service to a third party. Of those companies that were non-compliant last year, a massive 88% still have not implemented such a function.

Question 16: 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 16 (%)



The main message:

Progress has stagnated this year in both the FTSE 100 and Mid 250. The Mid 250 are still lagging behind the FTSE 100, perhaps due to

a lack of resources to implement such a thorough effectiveness review (see also question 17 below).

Question 17: If the committee performs such a monitoring function, is there specific reference to an internal audit effectiveness review?

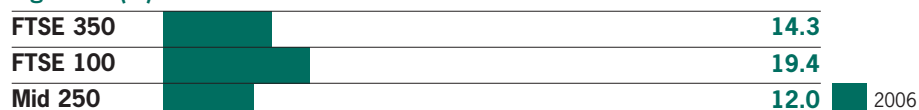
Guidance: “The main role and responsibilities of the audit committee... should include; to monitor and review the effectiveness of the company’s internal audit function.” (Combined Code C.3.2)

“Internal assessments should include: Ongoing reviews of the performance of the internal audit activity; and periodic reviews performed through self-assessment or by other persons within the organisation.”

(International Standards for the Professional Practice of Internal Auditing – 1311)

“External assessments should be conducted at least once every five years. The potential need for more frequent external assessments as well as the qualifications and independence of the external reviewer or review team, should be discussed with the board. Such discussions should also consider the size, complexity and industry of the organisation.” (International Standards for the Professional Practice of Internal Auditing – 1312)

Figure 17 (%)



The main message:

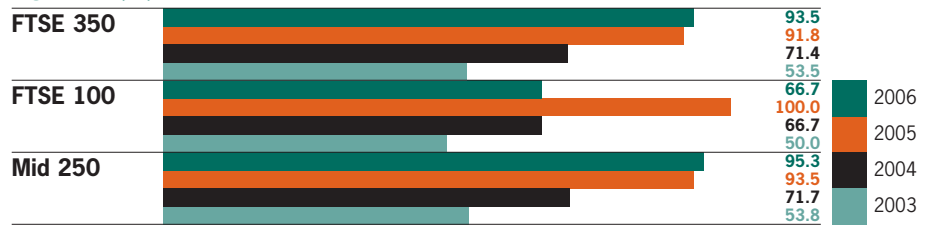
C.3.2 of the Code recommends that there should be an ongoing effectiveness review of the internal audit department, guidance brought in by the Smith report. This is further supported by the International Standards from the Institute of Internal Auditors, who state that at least every five years this assessment should be conducted by an external party.

The percentage of companies that disclose that a specific internal audit effectiveness review has been carried out during the year may appear low at first glance, but on average we perhaps might only expect one in five companies to have had an external review this year.

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:

Of the companies in the FTSE 350 that don't have an internal audit function, 43 out of 46 are in the Mid 250. However, the vast majority of these companies (41) do at least

provide an explanation as to why such a function has not been created, and that the board has reviewed the need for such a function 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:

Both the FTSE 100 and Mid 250 are embracing the Code guidelines in respect of non-audit services being provided by the auditor, with nearly all companies now providing a statement of how auditor objectivity and independence has been safeguarded. The Mid 250 have now caught up with the FTSE 100. This would further indicate the increasing seriousness with which

companies are taking the Code's guidelines on transparency and accountability for audit activities, despite a lack of mandate such as Sarbanes-Oxley.

Most companies also provide a brief statement on the policies or systems employed to ensure auditor objectivity and independence is not compromised.

Question 20: Does the audit committee state it has 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 FTSE 350 as a whole has seen positive movements in assigning this specific responsibility. The majority of companies reviewed not only make the statement but explicitly identify the member of the committee deemed to have the “recent and

relevant experience”. This is perhaps refreshing in this increasingly litigious age. However, 65 companies either fail to formally identify such an individual, or their audit committees appear to lack the requisite experience.

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:

A year-on-year improvement by both the FTSE 100 and the Mid 250 demonstrates the continual raising of profile of the audit committee, as the descriptions of the work of the audit committee are becoming more transparent and accessible to readers of the

accounts. Some companies that do not comply did describe the committee’s remit, but not within a separate section as required by the Code. However, only one in five companies reviewed have improved the quality of disclosure from last year.

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:

There is a significant increase in compliance levels this year, particularly in the Mid 250. This is mainly due to a large number of companies who have appeared to have recruited to the committee (and/or replaced

a member with) an independent non-executive in accordance with the Code, which is consistent with the increase in board balance (see question 14).

Question 23: If the chairman does sit on the committee, does he/she chair it?

Figure 23 – 2006 FTSE 350 (number of total responses)

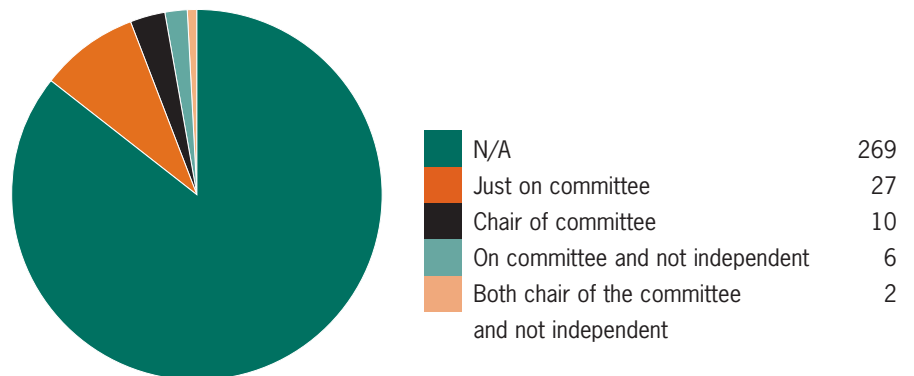
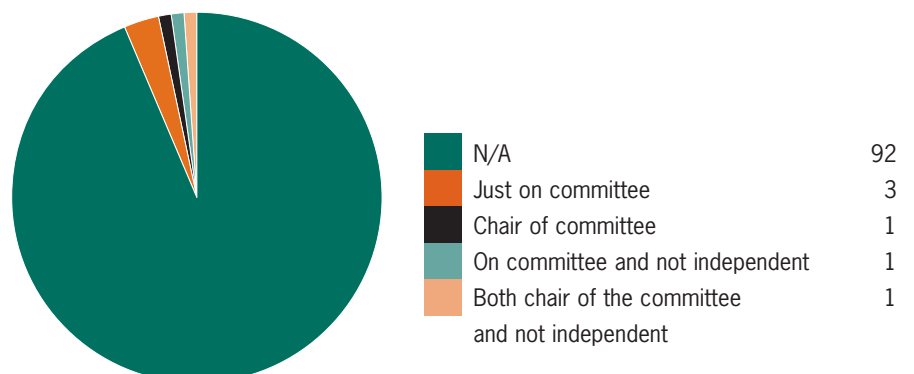
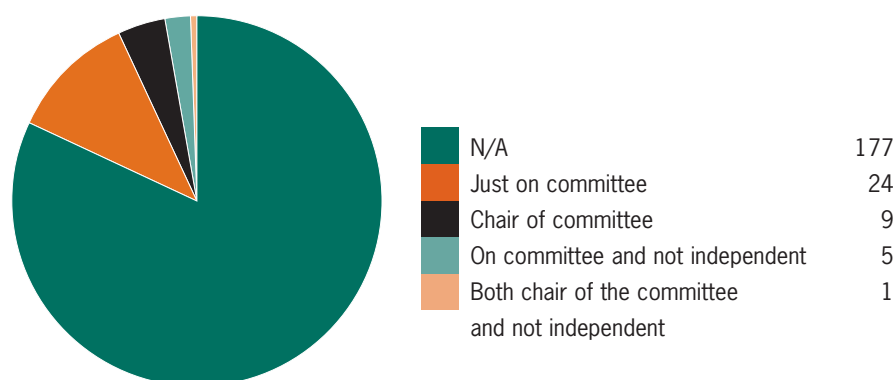


Figure 23 – 2006 FTSE 100 (number of total responses)



Question 23: If the chairman does sit on the committee, does he/she chair it?

Figure 23 – 2006 Mid 250 (number of total responses)



The main message:

The revised Code proposes that the chair of the board may only be a member of the remuneration committee if he or she was considered independent on appointment, and should not chair the committee.

There are a number of companies, of whom the vast majority are in the Mid 250, that do not comply with this revised guidance. Whilst these changes to the

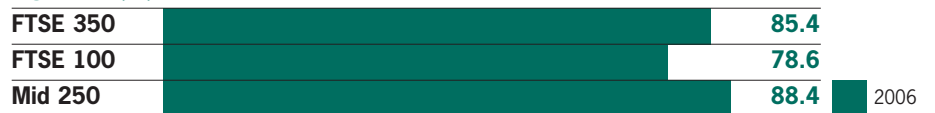
Code were not expected to be applicable to any of the companies in this year's review, it is interesting to note the existing position on a much debated area.

It seems at first glance that the extent of the issue and the resultant change in the Code is not supported, however, many companies may have improved their governance prior to the subsequent relaxation. This will be interesting to monitor again next year.

Question 24: Does the company state the potential maximum remuneration available including performance related elements?

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:

Approximately 15% of the FTSE 350 do not disclose an upper limit on the potential maximum remuneration for directors. This may be attributable to companies having a

“variable bonus pool” from which to draw performance related elements, depending on the level of the firm’s success in the year.

Question 25: Is it stated that the board (or shareholders where required) sets 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 25 (%)



The main message:

A decrease in relevant disclosure in the Mid 250 has led to a drop in the overall compliance from last year. A higher proportion of new entrants to the FTSE 350

are in the Mid 250 rather than the FTSE 100 and these companies may not yet have adapted to the guidance on performance related pay and corresponding disclosure.

Nomination committee

Question 26: Are the majority of members non-executive directors and is the chairman either chairman of the board or a 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 26 (%)



The main message:

A similar level of compliance to last year. Many chairmen sit as the chair of the nomination committee, showing a keenness

to remain influential in the selection of board members.

Question 27: 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 27 (%)



The main message:

There has been a large increase in the number of companies who are becoming compliant in this area of the Code, particularly in the Mid 250. The inclusion of details of the appointment process, as well as ensuring there is a separate section for the nomination committee within the report has helped to increase the compliance levels in this area.

In years where there have been no appointments to the board, companies tend to omit a statement confirming that there is a

formal procedure in place for when appointments are made.

The amount of detail given in the description of the work of the nomination committee is higher for FTSE 100 than Mid 250. Around a third of the Mid 250 give the bare minimum amount of detail, whilst a quarter of all the FTSE 350 set the standard by providing more. The gap between the levels of compliance in the two groups has closed considerably in the year.

Turnbull compliance – internal control and risk management – revised Combined Code

Question 28: 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 28 (%)

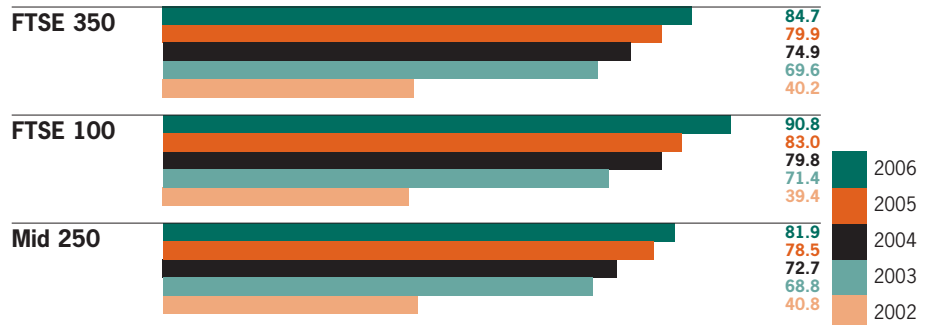


The main message:

Although the disclosure level is still close to full compliance, overall there has been a slight drop from last year, which again can be attributed to the turnover of companies entering the FTSE 350 this year.

Question 29: Is there a statement that this review covers all material controls including financial, operational and compliance controls and 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 29 (%)



The main message:

The number of companies that state that the review of the effectiveness of the internal controls includes all types of controls, has increased in this year’s review. A steady increase in compliance year-on-year suggests that companies are demonstrating greater acknowledgment of the consideration of other control types during internal control reviews, beyond purely financial. Companies therefore appear to be getting the message, but there is still some way to go, suggesting a need for further education, particularly for the Mid 250, or simply better disclosure on existing processes.

Question 30: 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 in 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 30 (%)



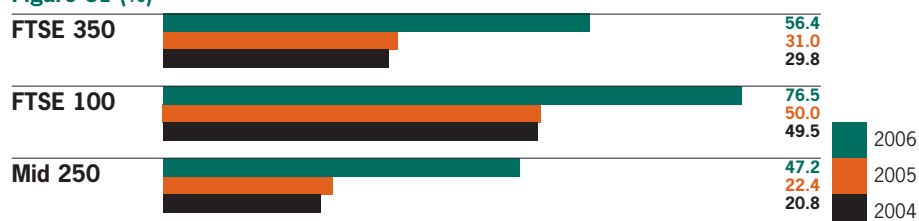
The main message:

The principle of this question is that the internal controls of a company should evolve and be kept continuously under review to adapt to the changing nature

of risks. The results of this year’s review suggest that the vast majority of companies have fully adopted the Turnbull principles in this respect.

Question 31: Do they give an indication of what their principal business risks are?

Figure 31 (%)



The main message:

The number of companies that give an indication of their principal business risks has increased further this year. Despite the OFR requirements being dropped, there is still a requirement for this disclosure under amendments to the Companies Act, although

these would have only applied to a minority of companies in this year’s sample (those with year-ends on or after 31 March 06). The Mid 250 appear to be more sensitive to the potential impact on competitive advantage that this disclosure may have.

Question 32: Is there an apparent consideration of risks relating to other key stakeholder matters?

Figure 32 (%)



The main message:

The consideration of other key stakeholder matters within the identified business risks

has remained at the same level as last year. It is the FTSE 100 who continue to lead the way.

Question 33: Is there information to assist the understanding of the company's main features of its risk management and internal control process?

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)

Figure 33

2006 (number of total responses)

FTSE 350	None	6
	Some	88
	More	182
	Outstanding	38

FTSE 100	None	1
	Some	10
	More	65
	Outstanding	22

Mid 250	None	5
	Some	78
	More	117
	Outstanding	16

2005 (number of total responses)

FTSE 350	None	7
	Some	89
	More	189
	Outstanding	34

FTSE 100	None	2
	Some	12
	More	66
	Outstanding	20

Mid 250	None	5
	Some	77
	More	123
	Outstanding	14

2004 (number of total responses)

FTSE 350	None	13
	Some	90
	More	211
	Outstanding	-

FTSE 100	None	6
	Some	15
	More	77
	Outstanding	-

Mid 250	None	7
	Some	75
	More	134
	Outstanding	-

2003 (number of total responses)

FTSE 350	None	43
	Some	116
	More	147
	Outstanding	-

FTSE 100	None	10
	Some	31
	More	57
	Outstanding	-

Mid 250	None	33
	Some	85
	More	90
	Outstanding	-

2002 (number of total responses)

FTSE 350	None	97
	Some	58
	More	64
	Outstanding	-

FTSE 100	None	2
	Some	8
	More	89
	Outstanding	-

Mid 250	None	35
	Some	57
	More	28
	Outstanding	-

None
Some
More
Outstanding

The main message:

A marginal improvement in results from last year, with the standard still being set by just less than 40 companies that are deemed as

“outstanding” for their level of useful additional information provided.

Question 34: 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 in 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:

We see a general improvement of the detail of disclosure from last year. Of particular note is the FTSE 100 where only one in ten companies have no summary of the review process, dropping from approximately a quarter last year.

Of the 30 companies that are new to our sample this year, 27 are new to the Mid 250. Three-quarters of these have given no detail of the review of effectiveness. This illustrates a possible need for better quality advice on following the Turnbull guidance to smaller cap companies, prior to entering the FTSE 350.

For the other companies in the Mid 250, it would appear that 32 companies have moved from giving no summary to providing some disclosure in this regard.

Overall however, the figures for the FTSE 350 who provide neither are still perhaps disappointing (18%) and only 27% appear to really "think Turnbull".

Figure 34

2006 (number of total responses)



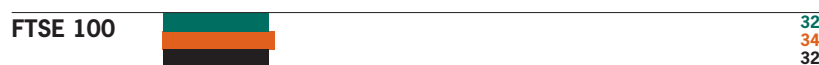
2005 (number of total responses)



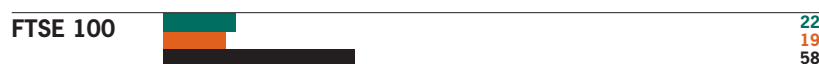
2004 (number of total responses)



2003 (number of total responses)



2002 (number of total responses)



None
Some
More

Question 35: Does the company disclose that any necessary actions have been or are being taken to remedy any significant failings or weaknesses?

Guidance: “In relation to Code provision C.2.1, the board should summarise the process it has applied in reviewing the effectiveness of the system of internal control and confirm that necessary actions have been or are being taken to remedy any significant failings or weaknesses identified from that review.” (Revised Turnbull guidance, paragraph 36)

Figure 35 (%)

FTSE 350		18.8
FTSE 100		18.4
Mid 250		19.0

2006

The main message:

Companies may not be confident in disclosing negative comments and would prefer not to mention this in their reports. However, this goes against the nature of the “comply or explain” policy of which the Code and associated guidance relies upon to hold

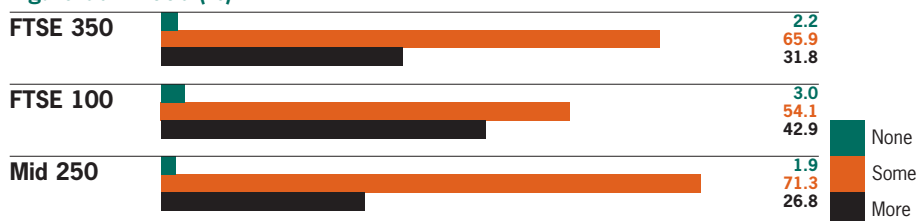
credibility with investors and other stakeholders. Companies that disclose weaknesses or areas of improvement give assurance that their effectiveness reviews are working well.

Shareholder relations

Question 36: Does the board demonstrate the steps taken to understand 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 36 – 2006 (%)



The main message:

More than 97% of companies are providing at least some information in this area (last year 98%). On average the FTSE 100 gives more detail than the Mid 250, which perhaps again demonstrates the greater resources available for investor relations and the greater degree of consultation given by companies with larger market capitalisation.

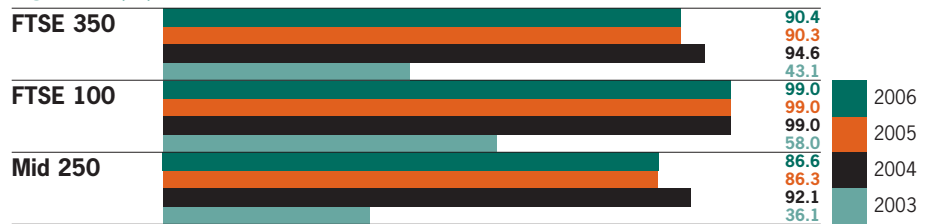
Whilst companies are relatively good at communicating their views on the company to the shareholders, they are generally weaker at providing specific information on how the views of shareholders have been understood.

Example: The company has a programme of communication with its shareholders. As well as share price information, news releases and annual reports, the website includes speeches from the AGM, presentations to the investment community and a section for shareholder services. The board believes that the AGM presents an important opportunity for dialogue with private shareholders, many of whom are also our customers. Representatives from across the Group are available and all shareholders have the opportunity to cast their votes. Shareholders can register...the company.

Corporate responsibility

Question 37: 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 37 (%)



The main message:

Nearly 100% of the FTSE 100 and 90% of all companies reviewed have some structure in place for the direction and monitoring of corporate responsibility matters, in keeping with previous years.

Question 38: 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 38 (%)

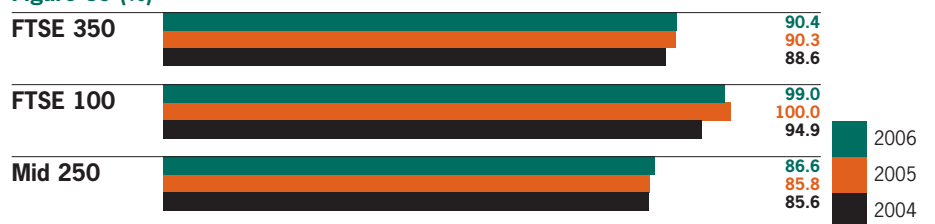


The main message:

The FTSE 100 continue to approach full disclosure in this area, with an improvement of over 10% on last year. Many companies have separate corporate social responsibility reports available on their websites. Within the annual reports there are reduced versions, with references to the full reports. This has been considered acceptable disclosure. In contrast, the Mid 250 companies have performed slightly worse in comparison with last year. This again could be explained by the level of company turnover on the index where new companies may take time to be able to report the wealth of information that many of the FTSE 350 currently provide.

Question 39: Is there a statement of company policy regarding issues such as energy/natural resource consumption, employment, recycling, carbon emissions etc?

Figure 39 (%)

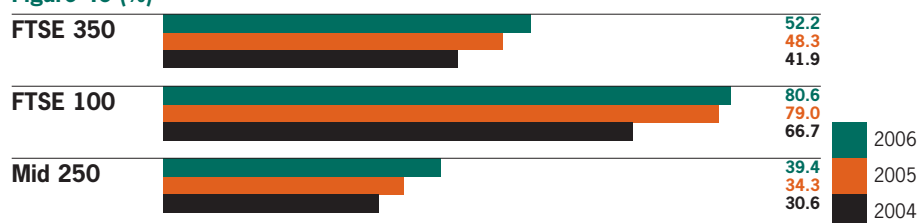


The main message:

FTSE 100 companies continue to give more detail of company policy, and targets for socially responsible actions.

Question 40: Are such policy objectives stated with quantified results?

Figure 40 (%)



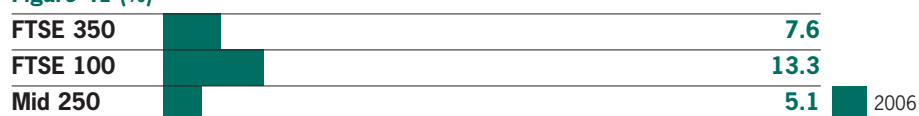
The main message:

While the FTSE 100 results have remained consistent with the previous year, the Mid 250 has seen a slight increase in disclosure. Given that nearly 90% companies in the FTSE 350 have specific policies on corporate

responsibility matters, it is disappointing that so many in the FTSE 350 fail to support these with some disclosure on quantified progress against policy objectives.

Question 41: Are disclosures verified by an independent (external) third party?

Figure 41 (%)



The main message:

Proportionally more FTSE 100 than Mid 250 companies are having their corporate responsibility disclosures independently reviewed. This figure may be set to rise as

more industries follow the government's lead on pre-qualification based upon corporate responsibility factors.

The future of governance

Question 42: Does it appear that the company has provided a separate business review in the directors' report in accordance with Section 234ZZB of the Companies Act?

Figure 42 (%)

FTSE 350	79.3
FTSE 100	85.7
Mid 250	76.4

2006

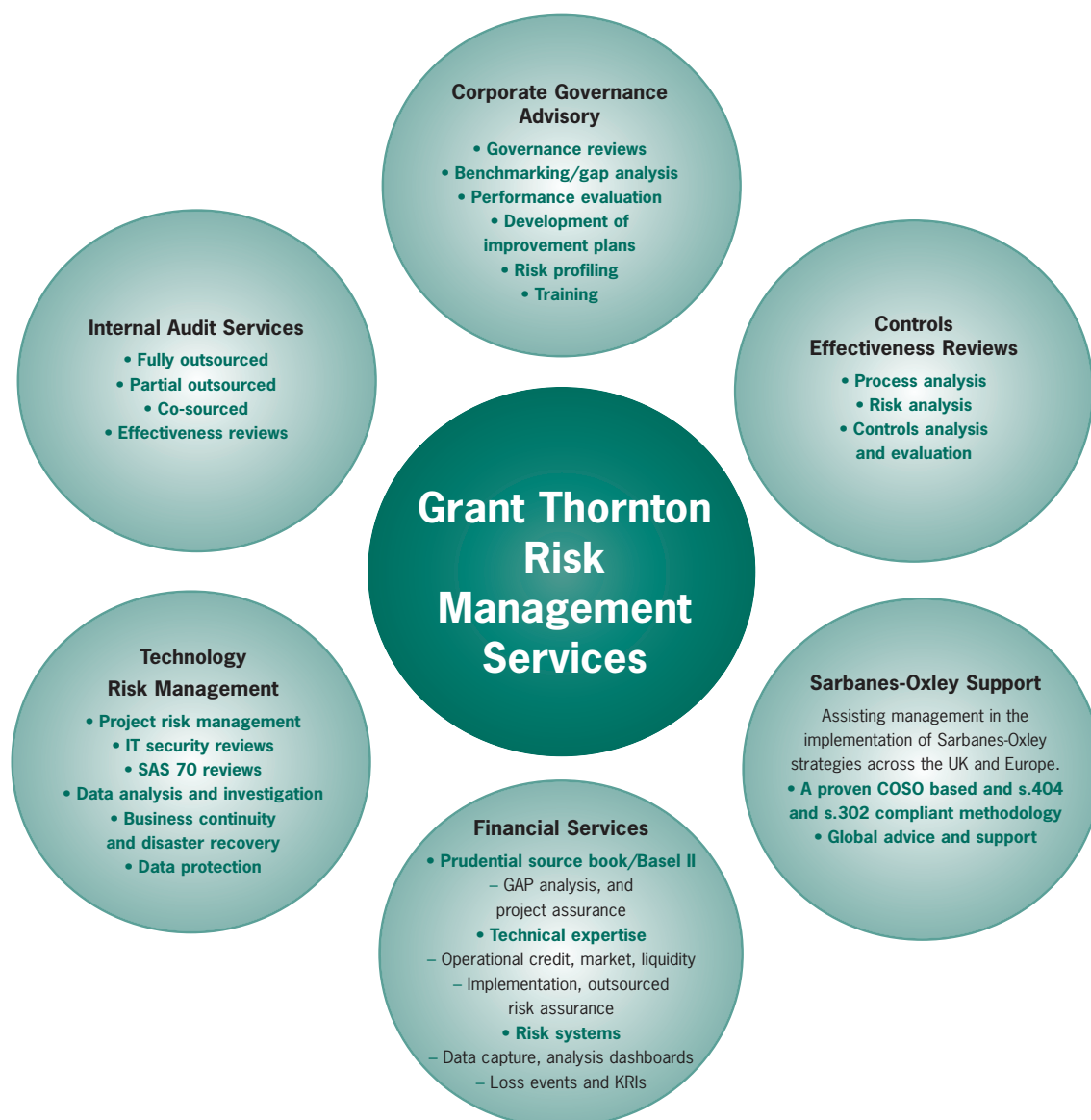
The main message:

As the amendment to the Companies Act requires a business review, it would appear companies are pre-empting any potential penalties by drafting business reviews/OFRs within the annual report as a matter of priority.

Note:

For the first time, companies listed on the Hong Kong Stock Exchange are having to comply with a code of governance which largely mirrors the UK Code. Grant Thornton Hong Kong has reviewed the disclosure practices of some 200 major companies in the Hang Seng Composite Index (HSCI) and the published results provide for an interesting comparison between Hong Kong's performance and the mature practices of the UK (www.gthk.com.hk).

Grant Thornton Risk Management Services



For more information

To find out how Grant Thornton may be of assistance to you and your business, please contact:

London

Simon Lowe

Head of Risk Management Services

T 0870 991 2451

E simon.j.lowe@gtuk.com

Philip Keown

Partner – Risk Management Services

T 0870 991 2394

E philip.r.keown@gtuk.com

Martin Gardner

Partner – Risk Management Services

T 0870 991 2847

E martin.n.gardner@gtuk.com

Midlands

Eddie Best

Partner – Risk Management Services

T 0870 991 2849

E eddie.j.best@gtuk.com

North

Barrie Senior

Partner – Risk Management Services

T 0870 991 2135

E barrie.senior@gtuk.com

About Grant Thornton

We are the UK member of Grant Thornton International, one of the world's leading international organisations of independently owned and managed accounting and consulting firms. These firms provide a comprehensive range of business advisory services from around 520 offices in over 110 countries worldwide. Although Grant Thornton International is not a worldwide partnership, the firms share a commitment to providing the same high quality service to their clients wherever they do business.

Notes

Notes

For further information contact your nearest Grant Thornton office or visit our website at www.grant-thornton.co.uk

Belfast

T 028 9031 5500
Trevor Blayney

Birmingham

T 0121 212 4000
Steve Line

Brighton

T 0870 381 7001
Ellen Walsh

Bristol

T 0117 926 8901
Mark Aldridge

Bury St. Edmunds

T 01284 701271
Mike Burrows

Cambridge

T 01223 225600
John Corbishley

Cardiff

T 029 2023 5591
Louise Evans

Cheltenham

T 0845 026 1250
Mark Aldridge

Edinburgh

T 0131 229 9181
Robert Hannah

Farnham

T 01252 734 345
Robin Rowe

Gatwick

T 0870 381 7000
Ellen Walsh

Glasgow

T 0141 223 0000
Robert Hannah

Ipswich

T 01473 221491
James Brown

Kettering

T 01536 310000
Steve Robinson

Leeds

T 0113 245 5514
Andrew Moore

Leicester

T 0116 247 1234
Garry Meakin

Liverpool (Mersey)

T 0151 224 7200
Howard Hackney

London

T 020 7383 5100
Mark Henshaw

London Thames Valley

T 0870 733 6700
Jim Rogers

Manchester

T 0161 834 5414
Graeme Whittaker

Milton Keynes

T 01908 660666
Phil Barrett

Newcastle

T 0191 261 2631
Andrew Moore

Northampton

T 01604 623800
Steve Robinson

Norwich

T 01603 620481
James Brown

Nottingham

T 0115 948 3483
Garry Meakin

Oxford

(Oxfordshire)
T 01865 799899
Tracey James

Poole

T 01202 308000
Stephen Mills

Reading

T 0870 733 6700
Paul Etherington

Sheffield

T 0114 255 3371
Garry Meakin

Southampton City

T 02380 221 231
Stephen Mills

Southampton

Segensworth
T 01489 864200
Stephen Mills

Grant Thornton 

Advisers to the independently minded

© 2006 Grant Thornton UK LLP. All rights reserved.

“Grant Thornton” means Grant Thornton UK LLP,
a limited liability partnership.

UK member of Grant Thornton International, a leading
international organisation of independently owned and
managed accounting and consulting firms.
Grant Thornton International is not a worldwide partnership.

This publication has been prepared only as a guide.
No responsibility can be accepted by us for loss occasioned
to any person acting or refraining from acting as a result of
any material in this publication.

www.grant-thornton.co.uk

Grant Thornton
thinking