

Business Risk Services

Sixth FTSE 350 **Corporate Governance Review 2007**

Highlighting trends in practice

Grant Thornton 

Disclosure  
Gover  
Boilerplate  
Transparency  
DISCLOSURE  
mittees  
The Higgs Effect  
COMPLIANCE OR COMPLACENCE  
RPLATE  
Role of  
Internal audit effectiveness  
Corporate resp

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## Introduction



Welcome to our sixth annual review of corporate governance practices by the UK's FTSE 350.

We now have the benefit of six years of information, highlighting trends and reflecting the impact of new and revised guidance. And for the second year running we have looked closely at the narrative to explore whether companies truly reflect their changing circumstances or merely repeat the same practice, year on year – “boilerplating”.

This year, 306 companies have been assessed against the terms of the Combined Code (the Code) and associated guidance, including the revised Turnbull Guidance (issued in 2006). As in previous years, we have excluded investment trusts due to the difference in their nature, structure, management and approach to corporate governance.

Grant Thornton International member firms publish governance reviews on listed companies for Hong Kong & China, Australia and Greece. These are available for download from the following websites:

- Hong Kong & China (Hang Seng Composite Index) – [www.gthk.com.hk](http://www.gthk.com.hk) (Second HSCI Corporate Governance Review 2007 review released December 2007)
- Australia (Australian Securities Exchange) – [www.grantthornton.com.au](http://www.grantthornton.com.au)
- Greece (Athens Stock Exchange) – [www.grant-thornton.gr](http://www.grant-thornton.gr)

## Foreword

In the last 18 months, 24 countries around the world have introduced or amended their corporate governance codes. Even the Securities Exchange Commission (SEC) has introduced a more risk-based approach to their 404 Sarbanes-Oxley assurance rules – possibly in recognition of the threat posed by the financial markets and their less prescriptive approach to governance.

**41%**  
claim full compliance.

The Financial Reporting Council (FRC) issued its review of the Combined Code (the Code) on corporate governance in November 2007, with the conclusion that the Code is working reasonably well and there is no need for a major change.

### Putting principles at risk

With such strong advocacy we in the UK might be forgiven for thinking that we have got our approach to governance just about right. Our guidelines – based around principles and pragmatism, supported by the option of explaining why non-compliance is appropriate – seem to offer the right solution: if you establish the principles and indicate what best practice looks like, responsible companies will follow.

So why would the lion's share of the UK's largest companies believe that, for one reason or another, explanation rather than compliance remains the best option for their shareholders and ultimately the wider population of stakeholders? Can so many companies really lay claim to special circumstances?

The FRC clearly believes the answer to be no, although their view is couched in terms of encouragement rather than confrontation. Their review concludes that with a couple of changes relating to the role of the chairman – to remove the restriction of individuals chairing more than one FTSE 100 company and allowing chairmen of sub-FTSE 350 (small) companies to be members of the audit committee when considered independent on appointment – the guidance is about right. Their challenge to UK plc is in the application of the principles.

Sir Christopher Hogg, chairman of the FRC, alluded to this when commenting on the FRC's findings in October. He said: "However there is no room for complacency. While respondents strongly endorse the flexible 'comply or explain approach', it is clear that it is not always applied as intended. All parties share responsibility for ensuring it remains an effective alternate to regulation - companies by providing robust explanations when they choose not to follow the code, and investors and their advisers by assessing each explanation on its merits rather than applying a rigid set of rules."

So the guidance is about right, the remaining challenge is around interpretation and implementation. And it is here that our findings perhaps shed some light on what is behind the FRC's comments.

The positive news is that the number of companies who claim full compliance continues to grow as do the number of companies who give more than the barest minimum of explanation as to why they chose "explanation over compliance".

However, on closer inspection, we were surprised to find that many claims of full compliance were not supported by appropriate disclosure. As to those choosing explanation over compliance, more often than not the content of the explanation left something to be desired and year on year, changes were frequently no more than superficial.

Are we really to believe that the majority of these companies are operating in a benign environment in which governance practices remain static? The FRC clearly think not.

# 42%

**recognise value in obtaining some form of external validation to support CR reporting.**

## **Corporate Responsibility reporting – a coming of age**

Corporate Responsibility (CR) reporting is moving into the mainstream. Previously we have seen a significant growth in companies providing narrative information to demonstrate their commitment to the cause of saving the planet, contributing to the local community and indeed setting the moral tone. This year practically all companies include reference to CR in their annual accounts.

For once we are seeing governance practice being led by market forces rather than driven by the regulators. This year there has been a marked increase in the number of companies seeking to support their claims by reference to some form of external assurance. While there are few metrics for inter-sector, or indeed intra-sector comparability, the more enlightened companies are beginning to recognise that being able to demonstrate accuracy, reliability and consistency of their CR key performance indicators (KPIs), year on year, increasingly has value. Whether the institutions yet value this information is a moot point, but certainly those companies believe their stakeholders increasingly do. And where market demand exists typically value creation follows.

## **Audit committees – heightened responsibility**

It is somewhat ironic that, in pursuit of the transparency agenda, the introduction of IFRS has achieved the opposite of what was intended, in the short term at least. Indeed, anecdotal evidence suggests that the growing complexity of the annual financial statements is a regular topic of conversation among directors, concerned that they – and in particular the audit committee – are now having to place increasing reliance on the finance director and the auditors to explain the IFRS accounts and to obtain the appropriate assurance.

Therefore, it is somewhat concerning that just over a fifth of all FTSE 350 audit committees, including 15% of the FTSE 100, still do not identify an individual as having recent and relevant financial experience, or even chose the default option of claiming collective experience.

### Non-executive directors – the Higgs Effect

The increasing importance of the role of the non-executive director in effecting good governance in practice is all too evident in recent corporate failures and frauds. There is a growing realisation among enlightened chairman, chief executives and nomination committee members that, with the exception of the charity sector, it is neither the title nor name alone, rather the individual's ability to introduce robust, informed challenge - or as one chief executive put it: "constructive tension" - that truly adds value to the board.

This recognition coupled with a change in the balance of the board, is what the Higgs review believed would underpin a permanent change in governance practices.

As an average, the goal of parity or non-executive majority, excluding the chairman, was finally achieved this year. Interestingly, the change was brought about as much by a decrease in the number of executive directors, as through the recruitment of new non-executive directors. Perhaps we are seeing a shift toward US style board structure where only the chief executive (who more often than not combines the role with that of chairman) and sometimes the finance director sit on the board so separating oversight and accountability from operational management.

### Risk – a growing confidence?

Historically, the arguments put forward by many of the FTSE 350 was that to disclose the principal risks of the organisation to any worthwhile degree would put them at a competitive disadvantage. The same was said of the use of KPIs, which will now be a mandatory part of the Enhanced Business Review (EBR) as required by the Companies Act 2006, itself resulting from the EC's transparency agenda. It is therefore encouraging to see, perhaps influenced in part by the Association of British Insurers in their guidelines on Responsible Investment Disclosure, that these concerns have now been overcome.

# 21%

**fail to highlight a member of the audit committee with recent and relevant financial experience.**

### In conclusion

Those who advocate market pressure as the most effective driver of governance will have been encouraged by the slight easing in the SEC's stance on prescription, as reflected in their newly issued guidance AS5. Even more recently, David Nason, the US Treasury assistant secretary, in commenting on the possible major overhaul of their regulatory regime, acknowledged the attractions of the flexibility afforded by the UK's principles-based approach. However, in the long running saga of principles versus prescription, UK plc cannot afford to be complacent. UK governance practice is rooted in the belief that best practice is an attitude of mind. Back in 1999, the Turnbull Report talked about embedding practices into an organisation's culture but with a significant number of the UK's leading companies not yet fully embracing this fundamental principle, the FRC is right to draw attention to this issue.

The challenge is now firmly in the hands of the UK's leading companies and their investors to step up a gear or face either the consequences of greater prescription or possibly a widened scope for the Financial Reporting Review Panel with the inevitable public exposure for those who are found wanting.

## Executive summary

This year's review confirms the continuation of a number of positive trends; for example an increasing number of companies aspiring to be fully compliant with the Code, the key committees consisting of the appropriate number of independent, non-executive directors and more information being provided around the effectiveness of the systems of internal control and risk management.

In the period we have seen our leading companies overcome their reticence to open up about their principal risks and have gained an insight into how long it takes for new guidelines (Smith and Higgs) to effect real change in practice.

We have seen CR reporting move into the mainstream and have the first response to change in Company Law introducing the Enhanced Business Review with its emphasis on non-financial as well as financial reporting. All these findings support the FRC's recent conclusion that the guidelines are fit for purpose.

But all is not perfect. Even when companies do seek fully to comply, they need to pay close attention to how they both evidence that compliance and explain their reasons for non-compliance.

### Compliance or complacency

The positive trend of companies aspiring to full compliance continues with 41% (2006: 34%) now making the claim. However, closer scrutiny suggests that many of these may need to revisit their disclosures as of the 125 companies claiming full compliance, in our view only 11 had fulfilled the disclosure requirements of the Code. Even more surprising, we identified another 16 companies who we considered to be making full disclosure, but who did not make the claim, taking the total to only 9% of the FTSE 350 who are fully compliant.

There is positive news in that of the 181 companies who do not claim full compliance, 110 have embraced the principle of "comply or explain" by providing robust explanations. However, the less encouraging observation is that 4% still give no explanation and 34% give only the barest minimum.

Of those companies who chose explanation over compliance, the quality of disclosure continues to improve with 62% (2006: 56%) of companies providing more than a basic explanation. However, look under the surface and you find that 46% of those who chose the explain option make no change to their explanation one year to the next and of the remainder, just under half were no more than cosmetic, leaving only 51 of the 181 having made any significant change to their explanation suggesting "boilerplating" is still in vogue.

### Board and committee performance

Disclosure has steadily improved since 2004 and by last year, only around 10% of companies did not provide any explanation on performance evaluation. We found that an encouraging 28% of companies have refreshed the information and over half of these have improved the quality of the disclosure provided. With regard to the review of the chairman's performance, further progress was demonstrated but you have to look to the FTSE 100 for an indication of what "good" practice looks like. It continued to adopt and develop its practice with 84% (2006: 76%) – confirming that they meet without the chairman, at least once a year, to appraise performance. Whereas among the Mid 250, this trend – which in previous years had grown from 48% to 68% – appears to have lost momentum.

Only **51** companies make significant changes to their explanations.

# 91%

disclose on principal risks.

### Getting the basics right

The positive news is that overall, the FTSE 350 now have, on average, a majority of non-executive directors (excluding the chairman). This does appear to have been achieved as much by a reduction in the number of executive directors (3.8, 2006: 4.6) as through the recruitment of non-executives (4.6, 2006: 4.4). And while the Mid 250 achieved a majority of 3.9:3.6 (2006: 3.6:4.2), a third of these companies remain underweight. Perhaps this is due to a scarcity of good candidates.

Some areas, such as disclosure that certain formal documents are available for inspection, have the potential for a quick win. So it is surprising to find that, for example, 42% of companies fail to disclose the availability of the terms and conditions of appointment for non-executive directors.

### Role of the committees

Since 2004, audit committees have had increasing prominence in the oversight of governance. This heightened responsibility has been reflected in them leading the way among the three principal committees, in achieving the desired composition of independent non-executives. And while the FTSE 100 were the first to achieve practically full compliance in this area (96%), this year the Mid 250 closed the gap (90%, 2006: 85%). The focus now needs to turn to the sensitive area of identifying that person considered to have the recent, relevant financial experience. This year, as last year, 21% of the companies failed to do so.

At a time when it is universally acknowledged that there is a need for technically informed input to audit committees, could this reticence be interpreted as increased risk by the investors?

Following the amendments to the Code in 2006, the chairman can now sit on the remuneration committee provided that he/she was considered independent on appointment. Companies have clearly taken advantage of this relaxation, with more than double the number of chairmen (67, 2006: 27) sitting on the remuneration committee. Strong improvements by the FTSE 100 in disclosing the potential maximum remuneration available (91%, 2006: 79%) has brought it in line with the Mid 250 who previously was stronger in this area.

More companies are at least providing a minimum level of disclosure around the work of the nomination committee with only 15% not providing anything (2006: 27%).

### External audit and internal audit

We looked at the extent to which companies are disclosing a policy for audit tendering and switching. Although only 17% of the FTSE 350 make disclosure in this area, this is significantly more than the companies who actually changed auditors during the year (3%) and none of these were in the FTSE 100. Where the auditor also provides non-audit services, 98% of companies provide a breakdown of these services into value and type. There was a slight drop overall in the number of companies that disclose how the auditor's objectivity and independence is safeguarded to 94% (2006: 97%). The number of companies referencing a specific internal audit effectiveness review is increasing, with 22% of the FTSE 350 now making such a reference (2006: 14%). It is unclear however, how many of these reviews were undertaken by an external party, as suggested by the Smith guidance.

### Internal controls

After years of continuous improvement, effectively all companies (98%) now disclose that all categories of control and risk management systems have been considered for effectiveness. As in previous years, the Turnbull beacon is being carried forward by a small but growing number of companies (43, 2006: 38) who, of their own volition, give “outstanding” information to enable the reader to fully understand the main features of their risk management and internal control processes.

In addition, 28% of companies provide “more” detail when summarising the process they undertake to review the effectiveness of their internal control system.

It was encouraging to see that 47% of companies have anticipated the requirements of the 4th EC Company Law Directive, which comes into effect in 2008, by making specific reference to their financial reporting processes and associated controls.

# 44%

refer to a review of internal audit effectiveness.

### Corporate Responsibility reporting

Three quarters of the FTSE 350 now disclose risks relating to other stakeholders (2006: 45%) and 94% (2006: 85%) of companies now disclose their position on Corporate Responsibility (CR) issues. Only 17 companies within the sample do not mention CR in their annual reports. Sixty-one companies lead the way by providing a separate CR report, with 40 of these being in the FTSE 100.

A growing number of companies support their quantified results by reference to some form of external assurance, with 42% (2006:8%) recognising the value of some form of external validation. Although the nature of the validation varies, this does hint at what we believe will be a growing trend – as companies aim to assure the reader of the accuracy, reliability and consistency of their chosen key performance indicators (KPIs) in the field of CR.

### The Business Review

All companies are providing at least some information that is in line with the Business Review requirements of the Companies Act but it is often fractured across other sections of the annual report (Chairman’s Statement, Chief Executive’s Statement, Directors’ Report, etc).

The arguments from some corners, regarding competition disadvantages for disclosing key business risks, seem to have faded: there is a large increase in disclosure within the FTSE 350, with nearly 91% (2006: 79%) providing disclosure on their principal business risks.

There is also a strong level of disclosure for financial KPIs across the FTSE 350, with a third of companies providing a good level of detail and description for each KPI used. However, despite the generally positive trend, there still remains almost a third of the Mid 250 who make no reference to KPIs as part of their performance measurement.

There is clearly further to go when it comes to measuring performance in the non-financial areas, where nearly half of the companies give no information at all. The quality of disclosure for non-financial KPIs is also of poorer quality to the more traditional financial measures, with only 18% of companies providing “more” detail.

### One final thought

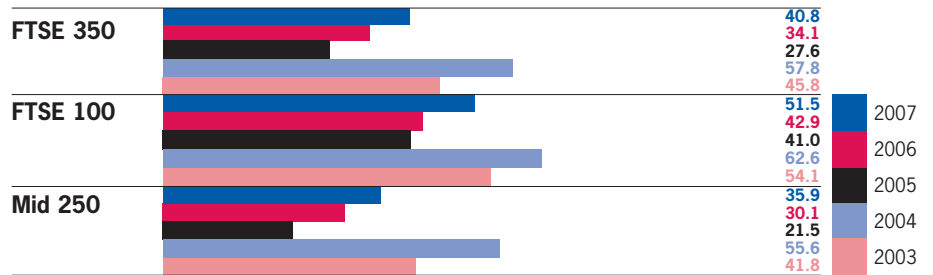
In light of our findings and with the growing importance of the narrative part of the accounts, perhaps now is the time for companies, encouraged by their investors, voluntarily to seek greater independent assurance over the information contained in the front end of the annual reports.

## 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 financial report: 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:

After the revisions to the Combined Code (the Code) in 2003 we witnessed an overall drop in the number of companies who claimed full compliance. Since then we have seen a gradual improvement, although at the current rate it looks like it will be at least another two years before we will see compliance levels exceeding those seen against the original 1998 Code.

However, as with last year, only a very small number of companies (9%) actually appear to fulfil the full level of expected disclosure requirements as indicated by the Code. This continues to cast doubt over the interpretation of the word “full”, and suggests that companies need to revisit their existing disclosures.

**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 financial report a statement setting out the company’s reasons for non-compliance.” (Listing Rule 9.8.6(6)(b)(iii))

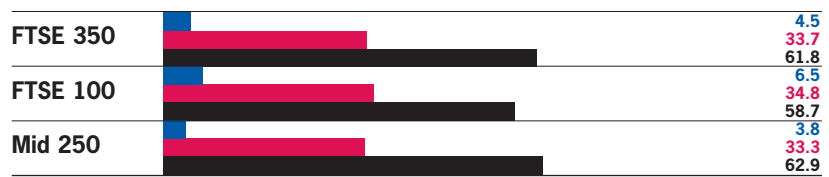
**The main message:**

We noted increased levels of disclosure this year with over 60% of companies providing “more” than “some” level of detail to explain why they are non-compliant with the Code. It is these companies that are truly embracing the “comply or explain” spirit of the Code.

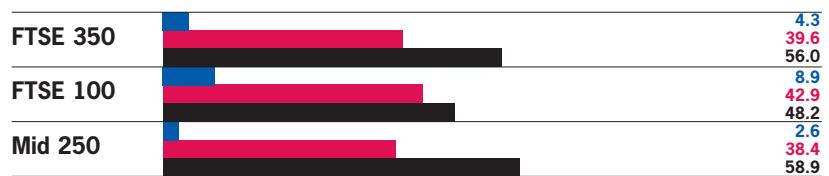
In response to any claims of lip service and “boilerplating”, it is refreshing to see companies updating their disclosures year-on-year with 42% (128 companies) doing so in this area. Of these 128 companies, 70 seemed to reflect an improvement in disclosure on the previous year.

**Figure 2**

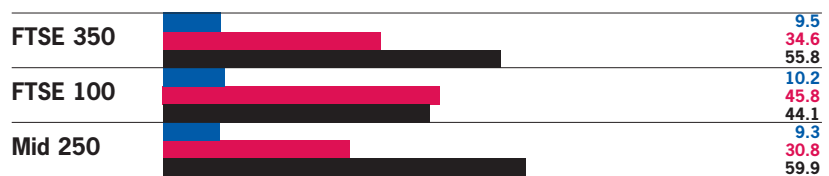
**2007 (%)**



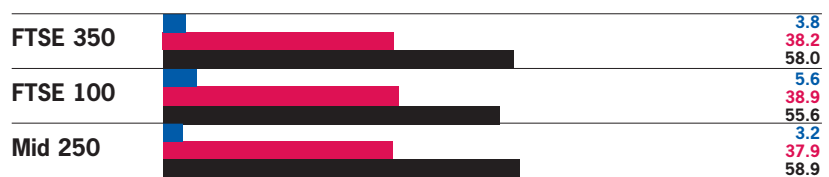
**2006 (%)**



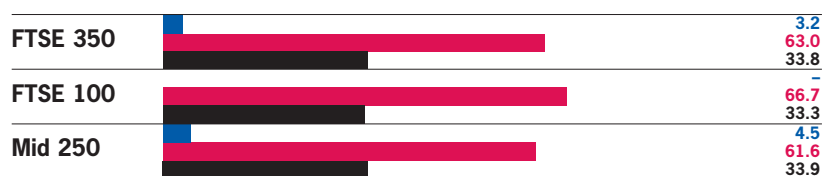
**2005 (%)**



**2004 (%)**



**2003 (%)**



None  
Some  
More

## 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)

#### The main message:

The FTSE 100 continues to drive up the average regarding board balance, with a 10% increase on the previous year. Despite a slight hiatus between 2005 and 2006, the larger

### 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)

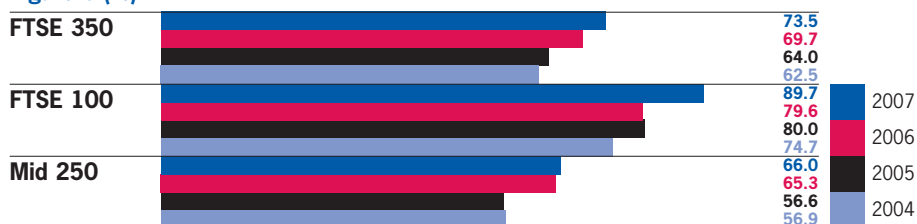
#### The main message:

There is a slight improvement in disclosure levels overall, with all but one of the FTSE 100 companies providing at least some description of their consideration of independence.

There is still a lack of transparency behind the board's consideration of independence, particularly in the Mid 250. The Code gives some considerations, but merely stating that these have been considered does not go far enough. The best disclosure would outline each area and provide support to the board's assessments. In addition, companies should disclose the tools and processes used during this consideration, such as:

- questionnaires
- background and reference checks
- declaration of shareholdings and relevant assets.

Figure 3 (%)

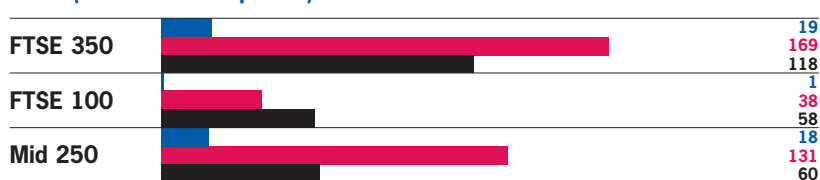


companies have shown that they are able to find what they believe to be the right candidates in the market. There are more independence issues within the Mid 250, with many non-executives either having

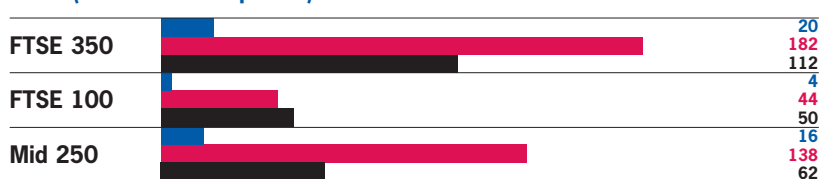
shareholdings, lengthy terms and/or previous executive appointments. The overall improvement of board balance is reflected in the average number of non-executives on FTSE 350 boards.

Figure 4

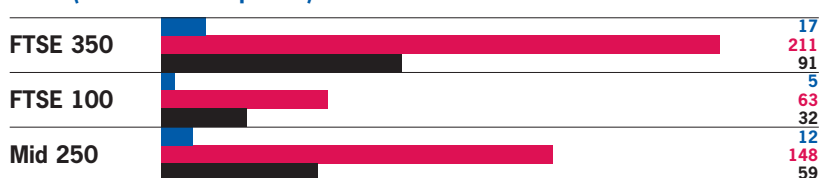
#### 2007 (number of companies)



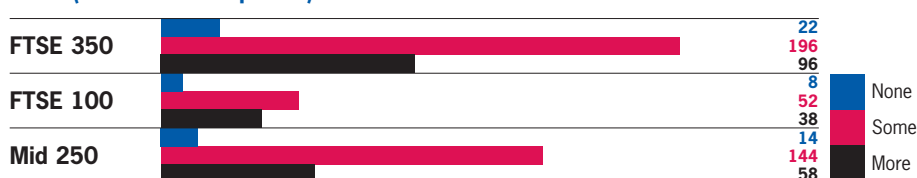
#### 2006 (number of companies)



#### 2005 (number of companies)



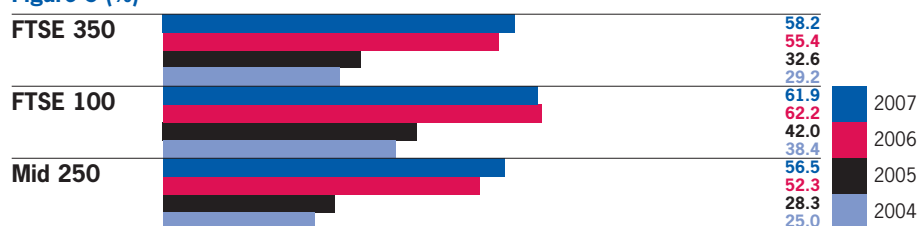
#### 2004 (number of companies)



### 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:

Only very small levels of progress seem to have been made in this area and even then this was only by the Mid 250. Although we would expect companies to be in a position to make the whole statement, it is an easy fix for the

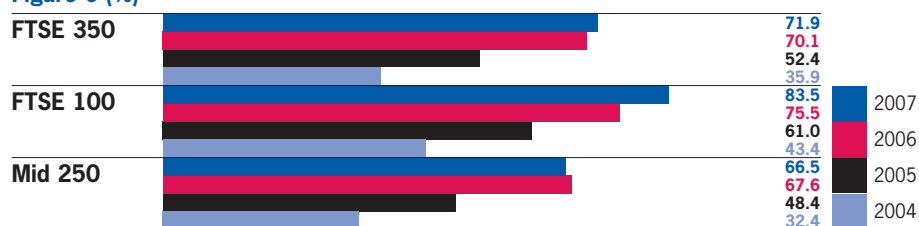
many companies who disclose that the terms and conditions exist, but did not specifically state that they are available for inspection.

This remains one of the weaker areas of compliance for the FTSE 350.

### Question 6: Led by the senior independent director, do the non-executive directors meet without the chairman present 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:

Continued growth in compliance for the FTSE 100 has been countered by a stagnation in disclosure levels in the Mid 250. Again a handful of companies (eight) set the standard by not only disclosing this information, but providing further detail

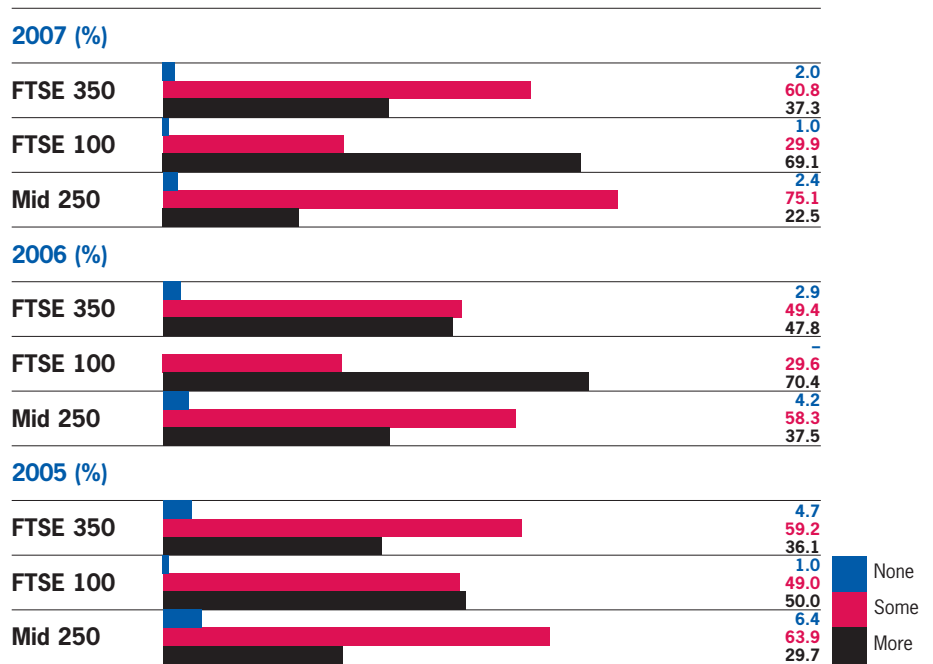
describing the assessment processes undertaken. This included a description of the formal appraisal process, consultation with directors and shareholders, and performance questionnaires.

## 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:

Overall there are less companies who now provide what we would describe as more than the minimum level of disclosure, only 37% of the FTSE 350 (2006: 48%). This shift is most prevalent in the Mid 250 where there is an ongoing fluctuation in membership, with incoming companies typically providing less detailed disclosure. The overall quality noted in the FTSE 100 has remained steady. The best companies gave details in the following areas:

- typical agenda items or topics for discussion within meetings

- formal documentation, accountability and follow-up through minutes, action points and issue trackers
- clearly defined reporting lines and monitoring structures across different levels within the organisation
- delegation of authority.

There is a need for new entrants into the FTSE 350 to address these areas straight away in order to disclose the right level of detail and transparency into how the board operates and discharges its duties effectively.

**Question 8: Does the report identify the chairman, chief executive, senior independent director, 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:**

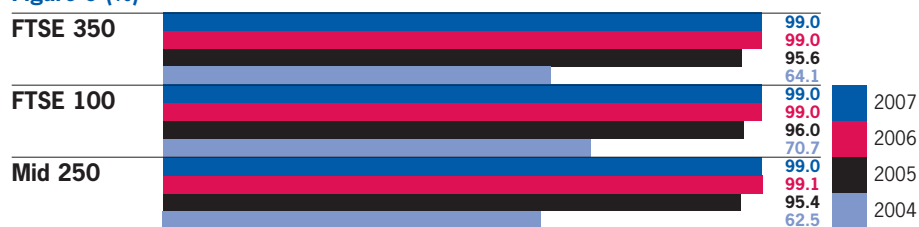
Very simple disclosure is required here and yet some companies still struggle to get the basics down. Arguably this is more likely to

be an attention to detail issue rather than evidence of a minority who disregard the Code.

**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 (%)**



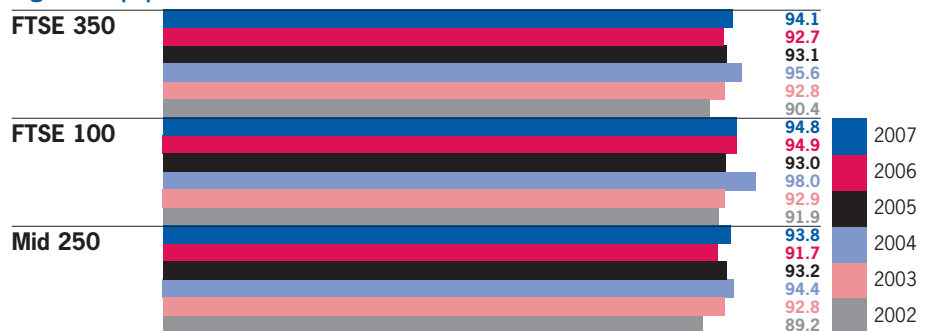
**The main message:**

This is effectively full compliance.

**Question 10: Are the roles of the chairman and chief executive exercised by the same individual?**

**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:**

Some improvement in the Mid 250 has contributed to a slight rise overall, and the continuation of a steady plod towards full compliance. Eighteen companies still believe

that they have good reason for the roles of the chief executive and chairman to be exercised by the same individual.

**Question 11a: For new chairmen that were appointed during the year...if they previously held the role of chief executive, 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)

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

The chief executive went on to be the chairman in 11 companies during the period subject to our review. The vast majority of these fully disclosed that a review of the

independence of the chairman had been undertaken on appointment, and while very few of these were in the FTSE 100, there were a few notable exceptions.

**Figure 11b (%)**



**The main message:**

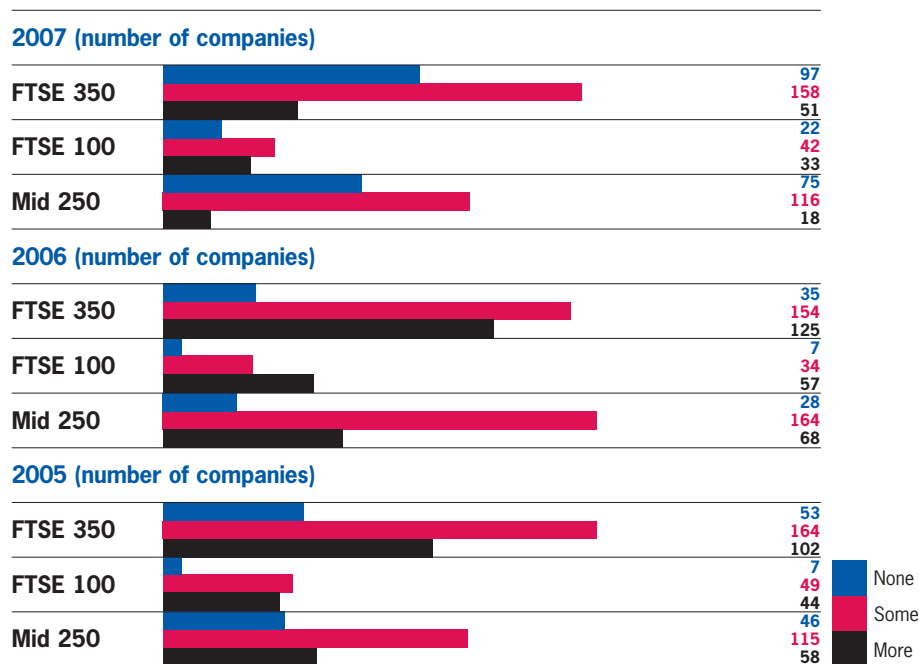
As above, of the few FTSE 100 companies that had a newly appointed chairman who chairs another FTSE 100 company, only one company did not disclose that they had specifically considered the time commitments of the chairman prior to appointment. This is an improvement on

last year, and shows good consultation with shareholders but a process that may cease to be necessary if the proposed changes to the Code are accepted. While the FRC’s recommendations for the Code will ease the pressure on dual appointments, the practice of consultation should continue.

**Question 12: 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 12**



**The main message:**

In order to provide a better picture of the quality of information provided, this year we have been more specific in what we believe constituted “more” disclosure. Examples of good disclosure included discussion of:

- a description of the appraisal process
- use of questionnaires – self and committee review
- peer reviews of directors
- major shareholder feedback
- financial performance KPIs
- non-financial KPIs.

Despite the resulting fall in the number of companies who met this tightened criteria, there is a notable improvement in the quality of disclosure; with 28% of companies demonstrating some form of update to their disclosure from last year, and a vast majority of these appearing to have improved this disclosure in some way.

**Question 13: Are terms of reference available for the audit, remuneration and nomination committees?**

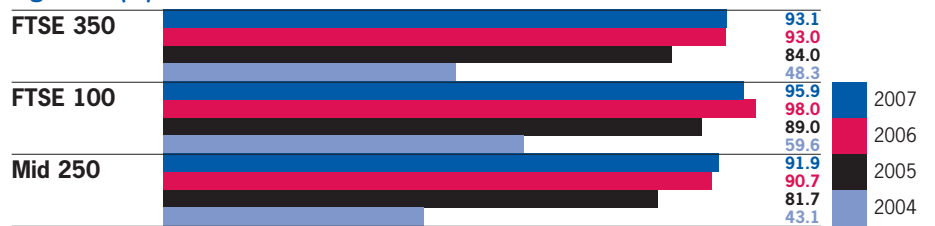
**Guidance:** “The terms of reference of the audit committee, including its role and the authority delegated to it by the board, should be made available.”

(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)

“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:**

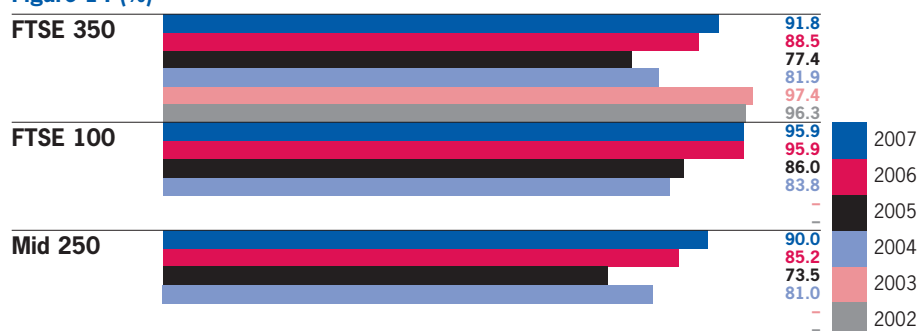
This area continues to follow the trend noted in Question 5 that companies should specifically disclose the availability (either upon request or on the website) of terms of reference for all three committees.

## 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:

The Mid 250 continue to strengthen their compliance although Question 3 above suggests that there is still a resource issue, particularly for the Mid 250 in recruiting to balance the overall board. It is encouraging to

see that companies are able to appoint at least three non-executive directors to the audit committee to meet the expectations set by the Code.

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

**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 15 (%)



#### The main message:

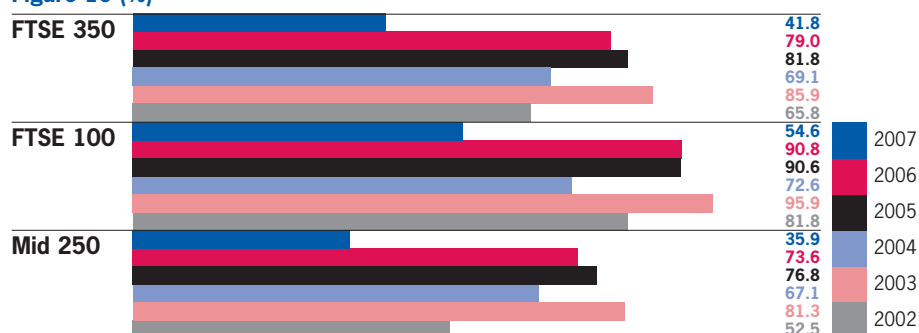
The compliance level has improved this year, with 100% of the FTSE 100 and a small improvement in the number of Mid 250 companies who have internal audit functions of one sort or another. Of those that were

20% of companies are still without such a function, while 19% state that they either partially or fully outsource provision to a third party.

### 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:

Similarly to Question 12, we have applied a greater degree of rigour to this assessment this year, by assessing the substance to the disclosure rather than simply a “boilerplated” statement. In our opinion therefore in order to demonstrate their execution of one of the

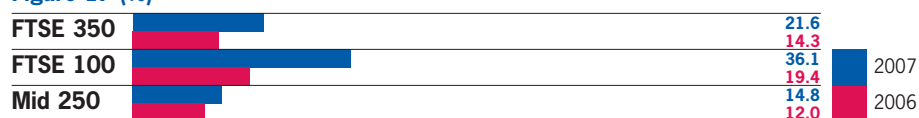
key roles of an audit committee, disclosure should indicate their involvement in:

- setting of scope for internal audit
- reviewing results of audits
- ongoing monitoring of effectiveness.

### Question 17: If the committee performs such a monitoring function, is there specific mention of 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 ...internal audit...; and periodic reviews performed through self-assessment or by other persons...” (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...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:

An increasing number of companies refer to a specific internal audit effectiveness review undertaken during the year. Of the 128 audit committees that perform such a monitoring function, 66 (52%) mention a specific internal audit effectiveness review. However, it is often unclear who, and whether internal or

external, has undertaken this review as the majority of companies have not made this distinction. The 66 companies represent 21.6% of the sample, an improvement on last year. The increase is a reflection of the Smith report which introduced the requirement in 2003.

**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?**

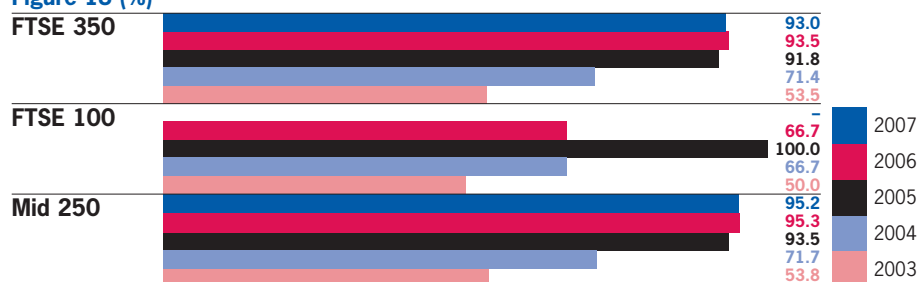
**Guidance:** “Where there is no internal audit function, the audit committee should consider annually whether there is a need for an internal audit function and make a recommendation to the board, and the reasons for the absence of such a function should be explained in the relevant section of the annual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

(Combined Code, C.3.5)

**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 18 (%)**



**The main message:**

Of the 43 companies within the FTSE 350 that do not have an internal audit function, 42 are in the Mid 250. Similar to previous years,

the vast majority (40) have provided an explanation as to why, and have added that the board has reviewed the need.

**Figure 19 (%)**



**The main message:**

Nearly all of the FTSE 100 companies continue to provide a statement of how auditor objectivity and independence has been safeguarded, while the fall in levels of the Mid 250 can be attributed to the turnover of

companies at this end of the FTSE 350. Within the disclosure noted, there is a range of processes described, mainly variations of audit fee restrictions, limits and procedures to monitor the services provided.

**Question 20: Does the company provide a breakdown of non-audit services in terms of value and type?**

**Figure 20 (%)**

2007	
FTSE 350	98.4
FTSE 100	99.0
Mid 250	98.1

**The main message:**

Commonly found as a note to the Accounts, non-audit fee breakdowns are now also referenced by many companies in their governance disclosure. Companies use this

breakdown to help support the limits applied on non-audit work and other auditor independence criteria, although this is not a requirement of the Code.

**Question 21: Does the company provide any detail as to the policy adopted by the audit committee on auditor tendering and switching?**

**Figure 21 (%)**

2007	
FTSE 350	16.7
FTSE 100	28.9
Mid 250	11.0

**The main message:**

Clearly it is not yet common practice for companies to disclose their policies on auditor tendering and switching which is in line with the increasing debate over auditor

choice. We expect this area to receive greater attention in the future as the demand for greater transparency continues.

**Question 22: Have the auditors changed from the previous year?**

**Figure 22 (%)**

2007	
FTSE 350	2.6
FTSE 100	-
Mid 250	3.8

**The main message:**

The figures say it all.

**Question 23: Does the audit committee state that 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 23 (%)**



**The main message:**

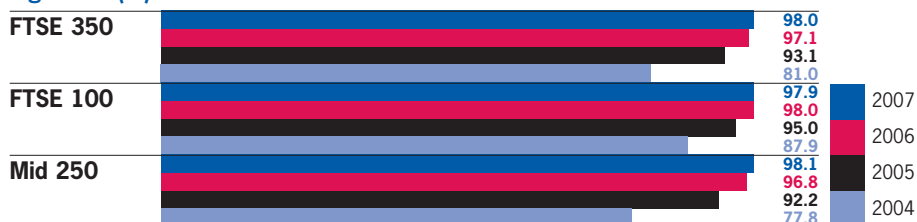
For the second year running just over a fifth of all companies in the FTSE 350 still fail to specifically identify an individual as having the recent and relevant financial experience or claim that this is provided by the committee as a whole. Without this, companies may be

unable to apply the appropriate level of rigour to a large element of their role, particularly when considering the complexity of IFRS and the increasing responsibilities of the members of the audit committee.

**Question 24: 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 24 (%)**



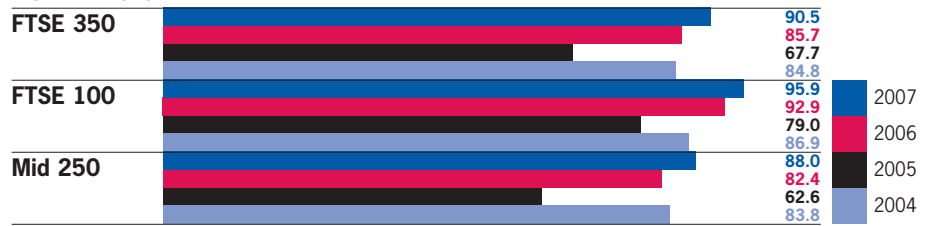
**The main message:**

The Mid 250 have now reached a similar compliance level to the FTSE 100, with the sample as a whole continuing to approach full compliance in this area.

# Remuneration committee

**Question 25: 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 ...independent non-executive directors members.” (Combined Code, B.2.1)

**Figure 25 (%)**



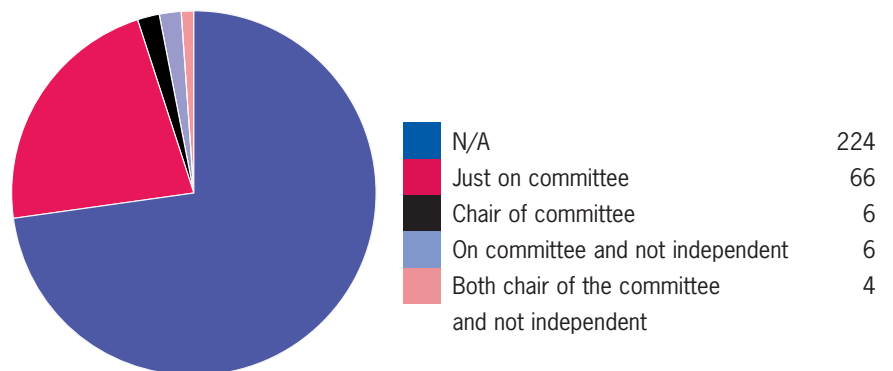
**The main message:**

A strong improvement on last year’s results, with both groups of the FTSE 350 now operating at levels in excess of those reached at the peak of compliance under the original Code. This reflects the heightened attention that reumeration receives from the

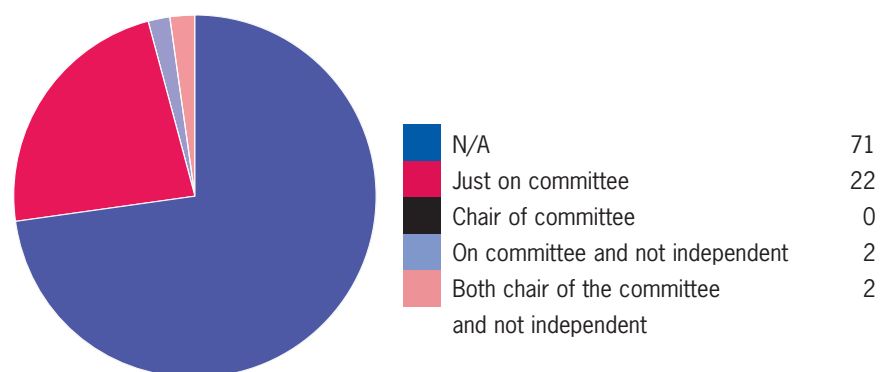
institutions and shareholders, particularly as the average pay of FTSE 100 directors has more closely aligned with US peers, reflecting greater incentivisation and complexity of reward packages.

**Question 26: If the Chairman does sit on the committee, does he/she chair it?**

**Figure 26 – 2007 FTSE 350 (number of companies)**

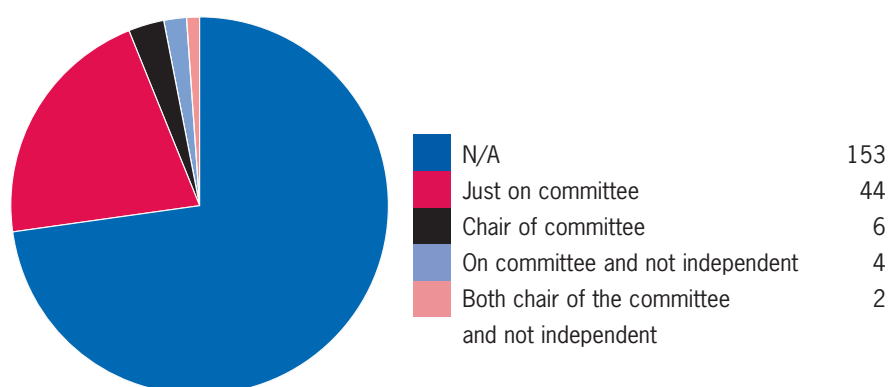


**Figure 26 – 2007 FTSE 100 (number of companies)**



**Question 26 continued: If the chairman does sit on the committee, does he/she chair it?**

**Figure 26 continued – 2007 Mid 250 (number of companies)**



**The main message:**

This year we have seen a movement of chairmen onto the remuneration committees (2007: 72, 2006: 37), no doubt due to the consultation and then amendment to the Code requirements in 2006. The Code now allows the chairman to sit on the committee provided that he/she was considered independent on appointment. A number of companies appear to have taken advantage of

this relaxation, with a marked increase in the number of chairmen sitting on the committee, now 22 in the FTSE 100 (2006: 3) and 44 in the Mid 250 (2006: 24). Companies have also adhered to the residual requirement that the chairman should not chair the committee, which is now only the case for 10 of the companies in question.

**Question 27: Is there disclosure that the chairman was considered independent on appointment?**

**Figure 27 (%)**



**The main message:**

A significant increase in compliance as companies begin to take advantage of the revised Code in respect of considering independence prior to appointing the chairman to the remuneration committee,

with over 60% of companies reviewed considering the chairman’s independence. Notably, many companies made reference to the Code’s revisions as part of their disclosure.

**Question 28: 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 28 (%)**



**The main message:**

Despite a strong improvement by the FTSE 100, the overall level of disclosure has only seen a slight improvement. This was due to a decline in disclosure levels for the Mid 250 population which is perhaps due to new entrants being less geared up to providing this

disclosure. Nine out of ten FTSE 100 companies now state the potential maximum remuneration limits for performance related pay, including the split between cash and non-cash bonuses.

**Question 29: Is it stated that 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 29 (%)**



**The main message:**

In many remuneration reports it is not immediately obvious or clear that the board (or shareholders) set the remuneration of the non-executives. Companies that disclosed

with greater clarity provided a dedicated section to non-executive remuneration. This is more apparent in the FTSE 100, where an increase in disclosure levels is noted.

## Nomination committee

### Question 30: 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 30 (%)



#### The main message:

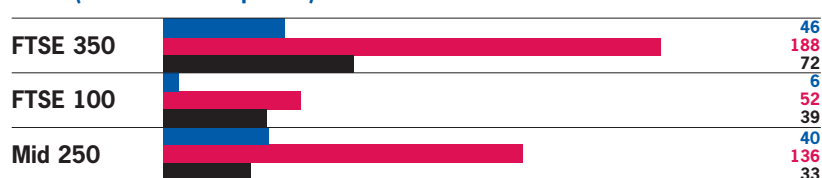
Disclosure levels have been maintained this year with a slight increase across the board, taking further steps towards full compliance.

### Question 31: Is there a description of the work of the nomination committee, including the process it has used in relation to board appointments?

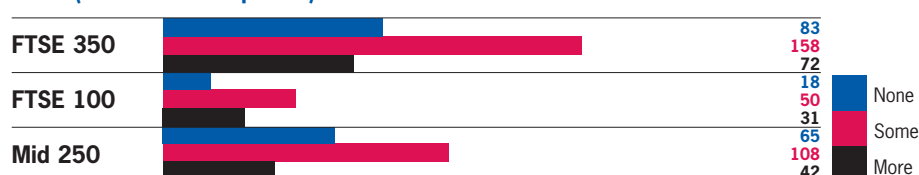
**Guidance:** "A separate section of the annual report should describe the work of the nomination committee, including the process it has used in relation to board appointments." (Combined Code, A.4.6)

Figure 31

#### 2007 (number of companies)



#### 2006 (number of companies)



#### The main message:

Companies merely disclosing a brief narrative do not go far enough to provide decent disclosure to stakeholders. However more companies are at least providing a basic

description, with only around 15% of companies providing nothing to describe of the work of the committee (2006: 27%).

# Turnbull compliance – internal control and risk management

**Question 32: 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 32 (%)**



**The main message:**

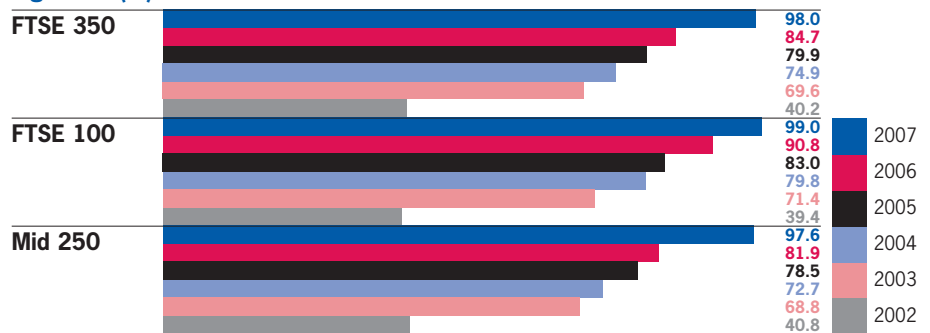
This statement should specifically mention that a control effectiveness review has taken place during the year, rather than merely a statement of responsibility from the board. The changing membership of the Mid 250 has

led to the slight decline in these scores, with one incumbent FTSE 100 altering their statement to remove this statement from their report.

**Question 33: 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 material controls, including financial, operational and compliance controls and risk management systems.” (Combined Code, C.2.1)

**Figure 33 (%)**



**The main message:**

To be considered in compliance with this provision, companies had to state that financial, operational and compliance controls are covered by the effectiveness review, and all risk management systems are included. The number of companies disclosing this fact has increased impressively in this year’s review suggesting that most

companies are taking a more rigorous approach to internal control assessment. The Mid 250 has made a significant improvement in compliance on last year, with nearly all companies (97%) disclosing that all material controls are considered (2006: 82%). The FTSE 350 as a whole is almost at full compliance.

**Question 34: Is there a statement that there is an ongoing process for identifying, evaluating and managing the significant risks faced by the company?**

**Guidance:** “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, [and] that it has been in place for the year under review.”  
(Turnbull, paragraph 34)

**Figure 34 (%)**



**The main message:**

Again the disclosure level is still close to full compliance. Although this is arguably an area which companies may be tempted to “boilerplate”, the whole statement needs to

be made in order to be assessed as fully compliant with the guidance in this area, particularly stating whether the process is “ongoing”.

**Question 35: Is there information to assist the understanding of the company's main features of its risk management and internal control process?**

**Guidance:** "The annual report and accounts should include such meaningful, high-level information...to assist shareholders' understanding of the main features of the company's risk management processes and system of internal control."  
(Turnbull paragraph 33)

**The main message:**

Forty-three companies in the FTSE 350 lead the way with truly "outstanding" disclosure to help users of the accounts to fully understand their risk management and internal control processes.

**Figure 35**

**2007 (number of companies)**

FTSE 350	None	7
	Some	78
	More	178
<hr/>		
FTSE 100	None	43
	Some	1
	More	10
<hr/>		
Mid 250	None	63
	Some	23
	More	6
<hr/>		
Mid 250	None	68
	Some	115
	More	20

**2006 (number of companies)**

FTSE 350	None	6
	Some	88
	More	182
<hr/>		
FTSE 100	None	38
	Some	1
	More	10
<hr/>		
Mid 250	None	65
	Some	22
	More	5
<hr/>		
Mid 250	None	78
	Some	117
	More	16

**2005 (number of companies)**

FTSE 350	None	7
	Some	89
	More	189
<hr/>		
FTSE 100	None	34
	Some	2
	More	12
<hr/>		
Mid 250	None	66
	Some	20
	More	5
<hr/>		
Mid 250	None	77
	Some	123
	More	14

**2004 (number of companies)**

FTSE 350	None	13
	Some	90
	More	211
<hr/>		
FTSE 100	None	6
	Some	15
	More	77
<hr/>		
Mid 250	None	7
	Some	75
	More	134

**2003 (number of companies)**

FTSE 350	None	43
	Some	116
	More	147
<hr/>		
FTSE 100	None	10
	Some	31
	More	57
<hr/>		
Mid 250	None	33
	Some	85
	More	90

**2002 (number of companies)**

FTSE 350	None	97
	Some	58
	More	64
<hr/>		
FTSE 100	None	2
	Some	8
	More	89
<hr/>		
Mid 250	None	35
	Some	57
	More	28



**Question 36: Is there specific reference to the financial reporting process and associated controls?**

**Figure 36 (%)**

**2007**

<b>FTSE 350</b>		<b>47.4</b>
<b>FTSE 100</b>		<b>53.6</b>
<b>Mid 250</b>		<b>44.5</b>

**The main message:**

Nearly half of all companies assessed are providing information on their financial reporting process. This is an early adoption of the 4th EU Company Law Directive, which will come into force in June 2008.

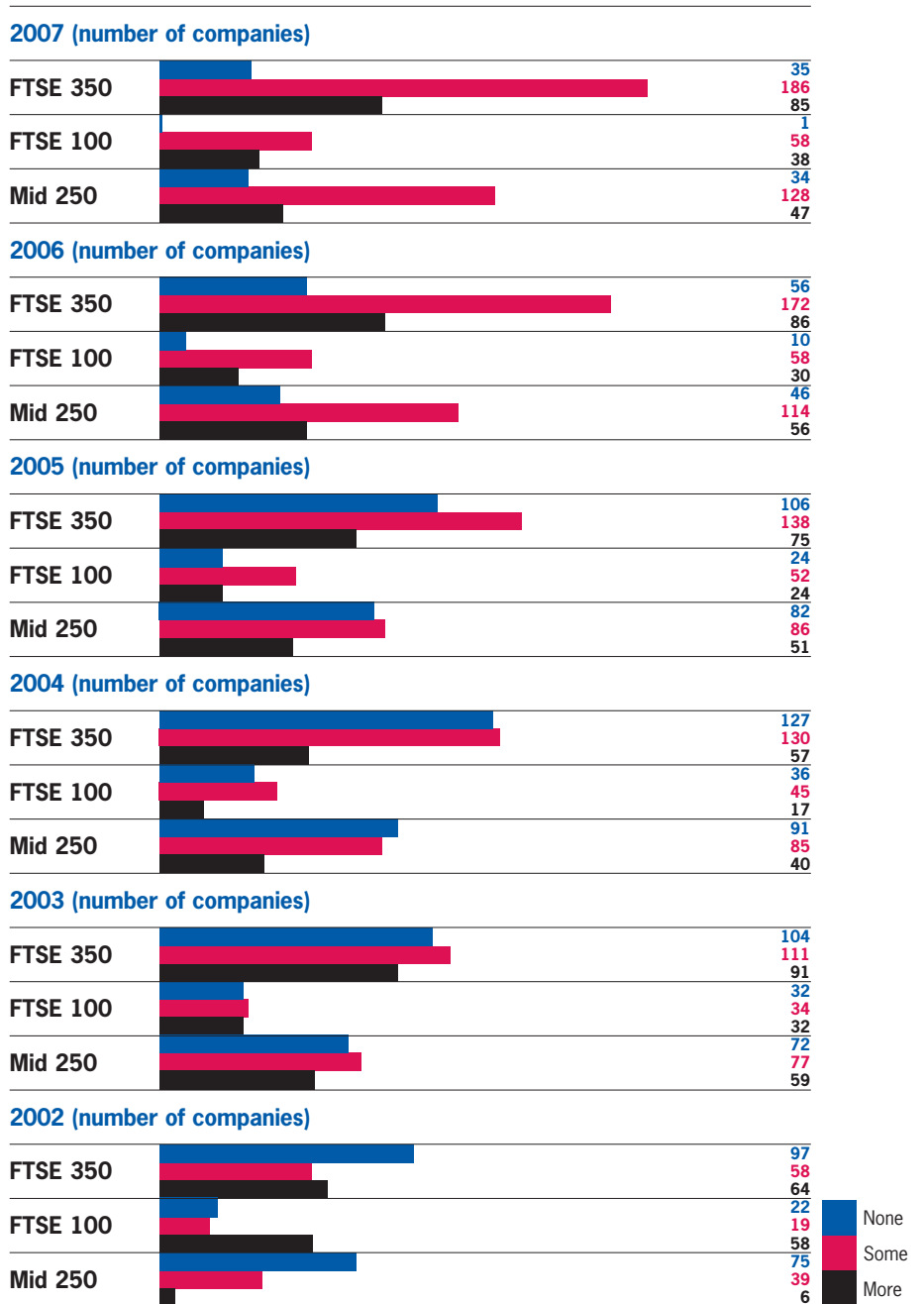
**Question 37: Is there a summary of the process the board/committees have applied in reviewing the effectiveness of the internal control system?**

**Guidance:** "In relation to Code provision C.2.1, the board should summarise the process it has applied in reviewing the effectiveness of the system of internal control." (Turnbull, paragraph 36)

**The main message:**

Twenty-eight per cent of companies managed to provide "more" detail when summarising their review of the internal control system this year and eight additional FTSE 100 companies are providing "more" detail this year in comparison to 2006. This leaves a great deal of room for improvement from the other 221.

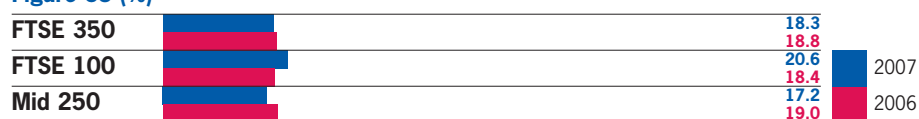
Figure 37



**Question 38: 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.” (Turnbull, paragraph 36)

**Figure 38 (%)**



**The main message:**

Not all companies may be willing to disclose that such issues had been identified. However, the Turnbull guidance is aimed at increasing transparency of disclosure and this should not be interpreted as an admission of weaknesses in a company’s internal control

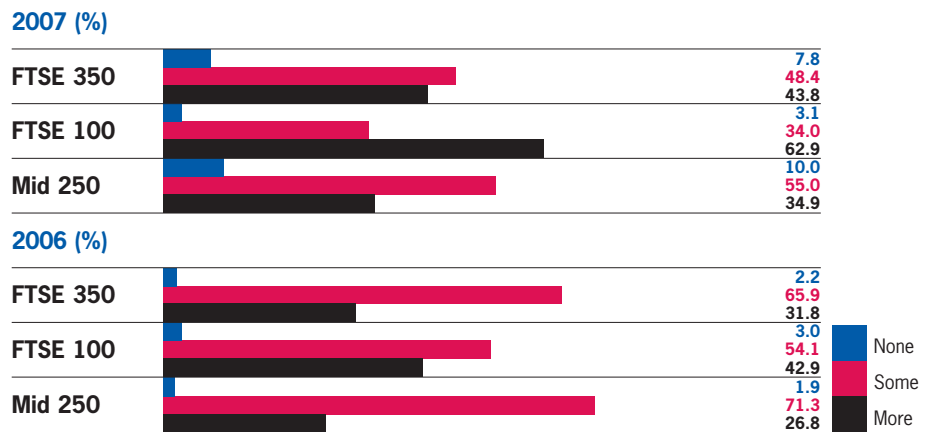
system, but rather a disclosure of the policy and procedures of actions to be taken. Despite this, there is clearly a great deal of reticence, possibly due to fear of the disclosure being misinterpreted.

## Shareholder relations

### Question 39: 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 39



#### The main message:

The greater proportion of investors in the London Stock Exchange are institutional. Although Banks, Pension Funds, Insurance and Fund Managers may not directly exert significant influence on their assets, we can see a more positive improvement in disclosure levels in the FTSE 100 rather than the Mid 250. Sixty-one of the FTSE 100 lead the way, specifically disclosing how relationships with the institutions are maintained using a variety of communication

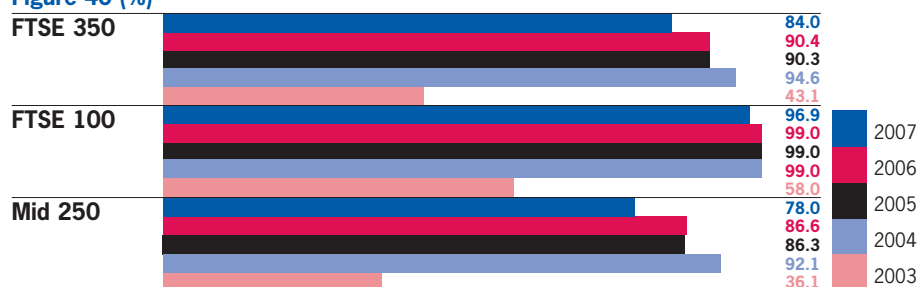
channels. From our review, a strong level of disclosure includes:

- standard communication through the AGM
- dedicated resources including an investor relations department
- inviting institution financial analysts to financial presentations
- presenting to the City and financial institutions on a regular basis.

# Corporate responsibility

**Question 40: 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 40 (%)**



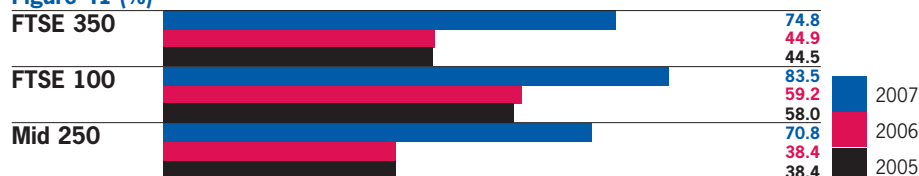
**The main message:**

As Corporate Responsibility (CR) reporting evolves, so too has our assessment criteria. Our assessment for this question this year has been more detailed including the need to provide named individuals, committees and reporting and monitoring structures designed

specifically for CR. The fact that this has not caused a dramatic fall in numbers of companies that meet this standard of detail is perhaps consistent with the level of public and media attention given to CR issues.

**Question 41: Is there an apparent consideration of risks relating to key stakeholder matters?**

**Figure 41 (%)**



**The main message:**

This year we see a large increase in disclosure. Three quarters of companies across the sample disclose risks relating to other stakeholders. It is encouraging to see this uptake of the revised Companies Act, and also consideration being given to all risks

facing a business, not just financial. Perhaps this also recognises that demonstrating good corporate responsibility could also be considered as a way of managing your reputation risk.

**Question 42: Is the corporate responsibility 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 – Guidelines on Responsible Investment Disclosure)

**Figure 42 (%)**



**The main message:**

Ninety-four per cent (2006: 85%) of companies now provide disclosure as responsible corporate citizens. Only a small number of companies sampled make no

mention of CR in their annual reports while a core group of companies (61) lead the way by providing a separate CR report – two-thirds (40) of these were in the FTSE 100.

**Question 43: Is there a statement of company policy regarding issues such as energy consumption, employment, recycling, carbon emissions, water/electricity consumption, etc?**

**Figure 43 (%)**



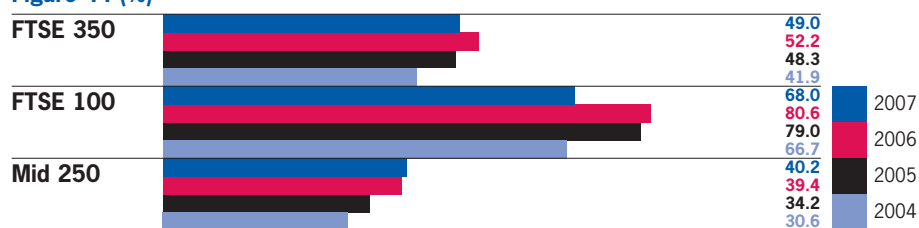
**The main message:**

This year we have assessed the companies on several policies rather than isolated disclosures. Those that have been awarded credit for this question have stated policies covering several issues. While the overall percentage score for this question has

remained constant, the companies assessed provided detailed policy statements regarding a number of environmental issues, with the Mid 250 approaching FTSE 100 disclosure levels.

**Question 44: Are such policy objectives stated with quantified results?**

**Figure 44 (%)**



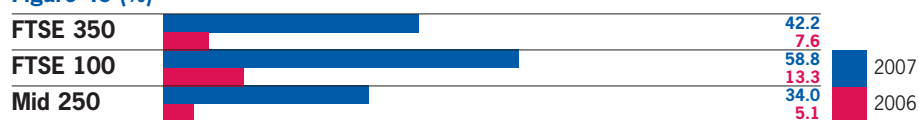
**The main message:**

For this question we now look for multiple quantified results with comparatives and a narrative explanation. Although we see a drop in disclosure in the FTSE 100, of those

companies that do provide quantified results the detail of disclosure has improved, most notably with accompanying descriptions to the numerical results.

**Question 45: Are disclosures supported by reference to some form of external assurance?**

**Figure 45 (%)**



**The main message:**

This dramatic increase in obtaining some form of external assurance demonstrates not only has CR clearly risen up the agenda but companies are also keen to prove that the result of their efforts has credibility.

Should users of the financial statements place any reliance on results that do not have external verification? The type of bodies who provided some form of external verification

ranged from the company's auditors to indices such as the Dow Jones Sustainability Index. Some bodies provide more specific assurance over CR metrics and processes, while other bodies appear to be provide a potentially less rigorous CR accreditation. Whatever the quality, there is no doubt that this is a growing area of importance for the FTSE 350.

# The Business Review

**Question 46: Does it appear that the company has provided a separate business review in the Director's Report in accordance with Section 234ZZB of the Companies Act?**

**Figure 46 (%)**



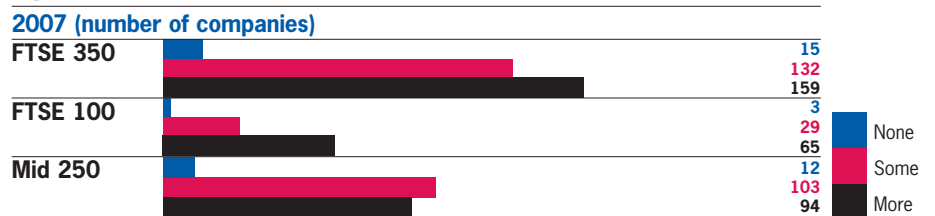
**The main message:**

Overall, all companies are providing at least some information that is in line with Section 234ZZB of the Companies Act. While the majority have a separate section of their annual report titled 'Business Review', some

companies have Business Review elements often fractured across other sections of the annual report (Chairman's Statement, Chief Executive's Statement, Directors' Report etc).

**Question 47: Do they [or to what extent do they] describe their business and the external environment in which they operate?**

**Figure 47**



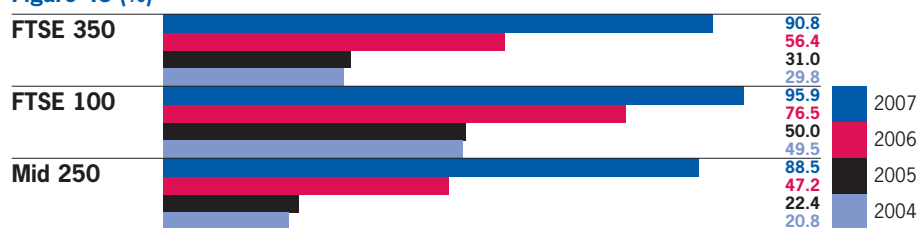
**The main message:**

Only 15 companies do not really provide a description of their business. Sixty-seven per cent of the FTSE 100 and 45% of the Mid 250 provide extensive descriptions, which help

the user of the accounts to fully understand the business and the environment in which it operates.

**Question 48: Do they give an indication of what their principal business risks are?**

**Figure 48 (%)**



**The main message:**

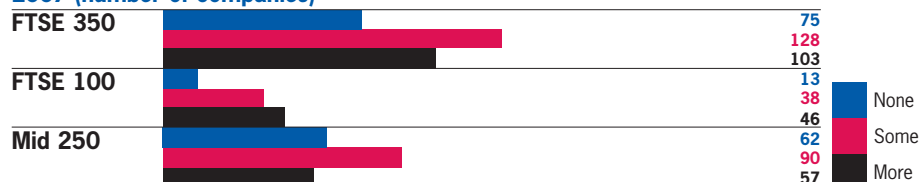
The arguments from some corners regarding competitive disadvantages for disclosing key business risks seem to have faded. This year

shows a large increase in disclosure in the Mid 250, with nearly 90% providing disclosure on their principal business risks.

**Question 49: Does the business review contain specific key performance indicators to measure financial performance of the business?**

**Figure 49**

**2007 (number of companies)**



**The main message:**

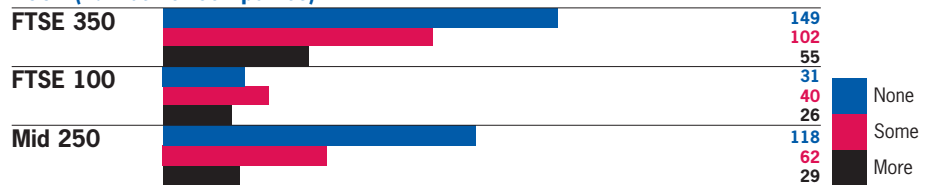
There is a strong level of disclosure for financial key performance indicators across the FTSE 350, with a third of companies providing a good level of detail and

description for each KPI used. The FTSE 100 generally provide more detail and just under a third of the Mid 250 did not provide any detail at all.

**Question 50: Are other key performance indicators stated for non-financial performance measures (including information relating to environmental and employee matters)?**

**Figure 50**

**2007 (number of companies)**



**The main message:**

Not as strong a result as for Question 49, with nearly half of all companies not stating that they use non-financial measures. The quality of disclosure for non-financial KPIs is also of poorer quality to the more traditional financial measures, with only 18% of companies providing “more” detail. Examples of non-financial KPIs used include:

- staff turnover
- customer complaints answered and resolved

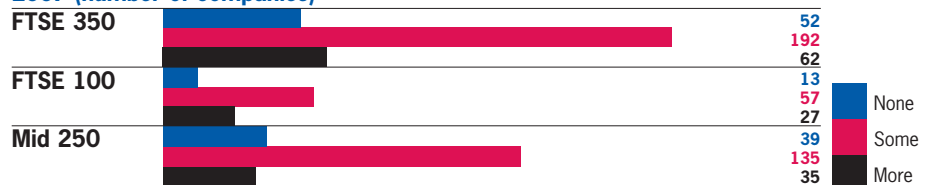
- workforce make-up
- energy consumption.

We expect this area to grow in future years as metrics for non-financial performance measurement continue to develop. The need to seek independent verification on KPIs and metrics used is also likely to increase in the future (Question 45).

**Question 51: Do they [or to what extent do they] provide any indications of the likely future development of the business?**

**Figure 51**

**2007 (number of companies)**



**The main message:**

Part of the requirements for the 2006 Companies Act is to provide forward-looking strategic statements as part of the Business Review. While it is encouraging to

see only 17% of companies providing no future outlook, the majority of companies (63%) appear to provide disclosure at the “some” level, without much detail.

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