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CORPORATE GOVERNANCE REVIEW 2012

# *The chemistry of governance*

## *A catalyst for change*

# 2012 highlights

- Full compliance plateau with 51% choosing to fully comply and 44% of the 144 companies who did not comply planning to do so next year.
- 73% (2011: 69%) of companies gave detailed reasons to support non-compliance but two thirds of those who did not comply in consecutive years made no change to their explanations.
- Almost one in five FTSE 350 companies had insufficient numbers of non-executive directors throughout year to comply with the UK Corporate Governance Code.
- New UK Corporate Governance Code provisions on annual re-election and triennial external board evaluations had immediate effect, with 96% and 98%, respectively, complying in the first year.
- Increasing numbers of non-financial companies, 40% (2011: 33%), have a risk committee.
- 85% (2011: 74%) of companies gave detailed disclosures to support their principal risks and uncertainties, but 21% hardly changed year on year.
- Business model expositions are improving 39% (2011: 27%) but for three out of four companies, linking strategy to risk and KPIs is proving more challenging.
- Average tenure of auditor is 33 years with three out of four companies giving little or no information about past or future intentions.
- 25% of chairmen give no insight into board governance practices.
- Emerging practice shows 5% of chairmen now emphasising the importance of culture as integral to effective governance.
- Annual reports continue to expand – 16.5% over three years.
- 73% (2011: 62%) of companies now actively seek governance dialogue with investors.

**Methodology**

This review covers the annual reports of 296 of the UK's FTSE 350 companies with years ending between June 2011 and April 2012. Investment trusts are excluded as they are permitted to follow the AIC Code of Corporate Governance.

The review assesses compliance with:

- the disclosure requirements of the UK Corporate Governance Code
- the requirements for a business review as set out in s417 of the Companies Act 2006.

Key findings are discussed in the body of this report with full details in the appendix.

Simon Lowe would like to thank Collette Brady, Sajeel Joshi, Ben Langford, Ololade Oyatoye, Sajni Radia, Rebecca Williams and Alex Worters for their help in preparing this report.

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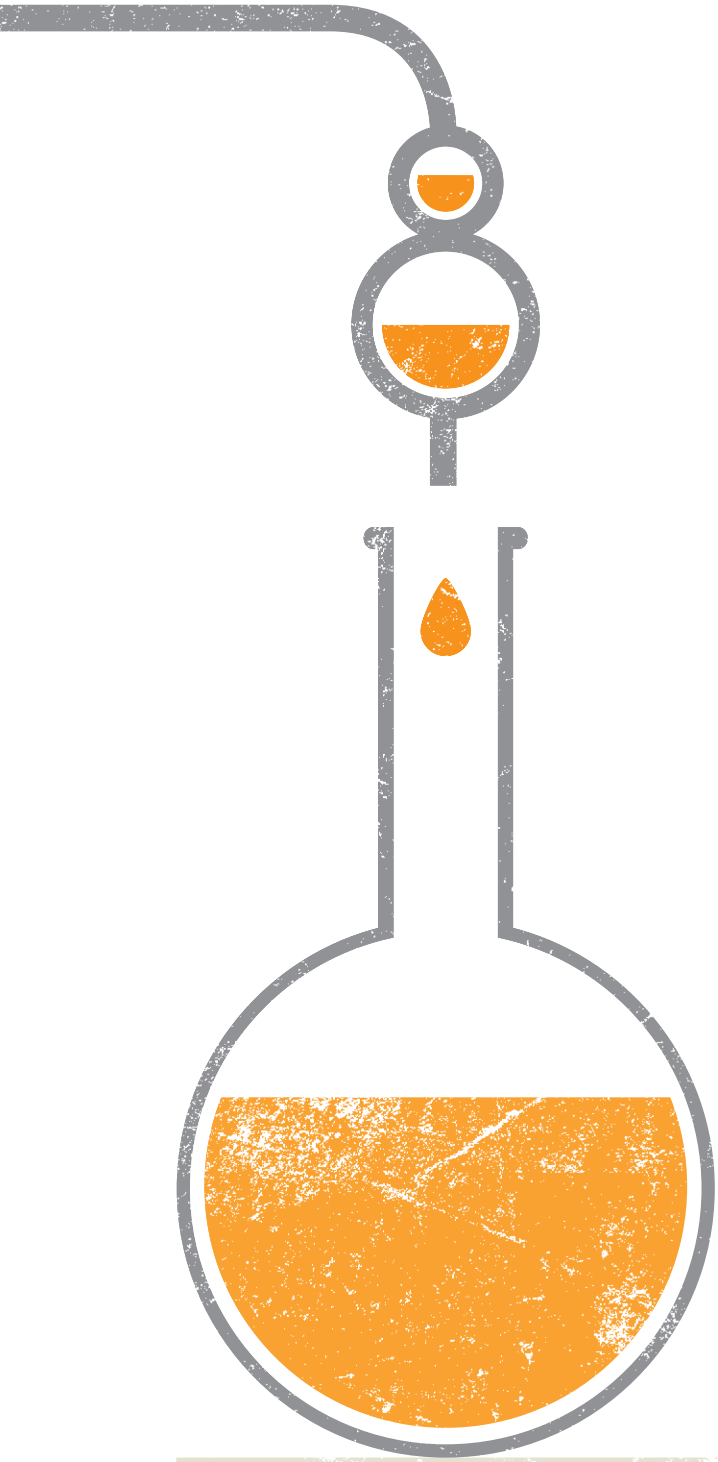


# The regulator's perspective

## *The task of embedding high standards of governance is never complete*

**Peter Montagnon**, Senior Investment Adviser, Financial Reporting Council

The European Commission's decision to affirm the role of comply or explain is both a relief and a challenge. It is a relief because the UK Corporate Governance Code can still play an important role in raising standards of governance. It is a challenge because the Commission has made clear that the concept could be made to work better.

No doubt its remarks are aimed mostly at member states where codes are less effective because of weak explanations and monitoring. Yet the task of embedding high standards of governance is never complete, even in the UK. The compendium of essays published by the FRC to mark the 20th anniversary of the Cadbury Report shows it is a work in progress, even here.

This year's successes include progress on boardroom diversification, achieved without formal quotas, and the widespread take-up of annual re-election of directors, which has improved accountability. Looking forward, we have to work on accounting and audit, risk and reporting of business models, not to mention the perennial problem of remuneration. On the stewardship front, the quality of dialogue is improving but we still need to do more to engage asset owners and persuade investment decision-makers and corporate governance specialists to be more joined up.

It seems like a long list, but the starting point is positive. The UK still has high rates of compliance and few explanations. It is right that the option to explain should always be open, but those that choose this route must be aware that self-serving and weak explanations from a very small minority let the whole side down.

# Foreword

**2012 marks the 20th anniversary of the advent of modern corporate governance – the publication of the Cadbury Report. While business practice has evolved significantly since 1992, much of Sir Adrian Cadbury's landmark analysis still rings true today – not least his definition of effective governance:**
"Companies … must be free to drive their companies forward, but exercise that freedom within a framework of effective accountability. This is the essence of any system of good corporate governance."

**Welcome to Grant Thornton's annual analysis of the governance practices of the UK's FTSE 350 companies.**

**Simon Lowe,** Chairman,
The Grant Thornton Governance Institute

### Building on Cadbury's foundations

The Cadbury committee laid the foundations for today's largely effective system of UK governance and provided the guiding principles for many other national codes. Two decades after Cadbury, this year's review of current corporate governance practice shows how far we have come – and how far we still need to go.

This year, just over half (51%) of all FTSE 350 companies complied with the UK Corporate Governance Code (the Code) – the latest distillation of Cadbury's voluntary code of best practice. A further 10% of companies complied for part of the year.

The level of full compliance appears to have plateaued at around the halfway mark: this year's 51% ratio is 1% up on 2011 and the same as 2010. There are mixed messages around those companies who opt to explain. Encouragingly, they tend to comply in all but one or two provisions, with an increasing number, 73% (2011: 63%), giving more than a basic explanation for non-compliance, and 44% saying they plan to comply next year. However, it is concerning that two thirds of those who have explained in consecutive years have not changed their explanations.

2012 marked the introduction of additional Code requirements. The review shows businesses moved swiftly in response: provisions on annual director re-election and triennial external board evaluations saw 96% and 98%, respectively, complying in the first year.

### Chairmen espouse ethical leadership

We have identified an emerging practice among chairmen: one in 20 now emphasise the importance of company culture to effective governance. Although too early to call this a trend, the role of culture and ethical principles in cementing effective governance is gaining credence. This is seen, for example, in statements by Sir David Walker, Barclays' new chairman, as he endeavours to effect fundamental changes in the bank's culture and thereby governance practice.

Seventy five per cent of chairmen now provide some insights into the governance practices of their boards and a growing number, 23% (2011: 10%), use their principal statements to emphasise the importance of good governance. This suggests chairmen are heeding the Code Preface guidance to "report personally in their annual statements how the principles relating to the role and effectiveness of the board have been applied".

Many companies still give no clear pointers to their strategic vision: just one in five linked strategy to risks and key performance indicators (KPIs). While the disclosure of risks again increased, many companies repeated previous years' almost verbatim rather than reflecting the dynamic discussions at boardroom tables.

*"To deliver effective governance, compliance must be underscored by an ethical tone from the top."*

### Reports grow ever longer

The seemingly inexorable trend of providing more, but not necessarily better, information continued. While a handful of companies slimmed down their reports, for the third consecutive year the average length grew by almost 4%, to 141 pages. This is an increase of a mind-numbing 16.5% since 2009. The Department for Business, Innovation and Skills (BIS) may be asking companies for greater transparency but, in providing it, the wood may be getting lost amongst the trees.

Two decades after Cadbury called for the separation of the roles of chairmen and chief executive, 10 FTSE 350 companies still have combined posts and a further 21 have executive chairmen. This pales in comparison with the US, where more than 57% of S&P 500 companies have combined roles. Yet, the US too is now showing disquiet over joint roles, with recent high profile separations at JC Penney, Avon and Citigroup.

### Raising the game

The governance excellence of the best companies encourages others to raise their game. It also highlights the poor performance of the few – companies that want the rights of access to public capital and market liquidity but shirk the responsibilities that come with it. That said, compliance in itself is no proof of strong governance. As Cadbury acknowledged: "The Code is only a framework: compliance alone does not constitute good governance or effective board behaviour. The spirit… is as significant as the letter".

### Values integral to governance

To deliver effective governance, compliance must be underscored by an ethical tone from the top – manifested in strong board leadership and the establishment – and embedding – of clear values. This was recognised by Cadbury 20 years ago and it remains the case today. As the US separates chairmen and chief executive roles and UK boards acknowledge the importance of ethical leadership, the chairman's part in achieving an effective governance culture has never been so important.

This year, externally-facilitated board effectiveness reviews were embraced by around 30% of companies, with 102 board assessments. Yet companies remain shy about sharing the output, focus or even the name of the facilitators of their reviews: just 35% gave a good account of review outcomes, up from 24%. The Financial Reporting Council (FRC), intent on improving board effectiveness, clearly believes these reviews can get better. From next year, all companies will have to identify their facilitators.

### Institutions must foster better practice

The 'shareholder spring' saw institutional shareholders finding their voice, most notably about executive pay and board elections. Once again, Cadbury had articulated this need: "It is for the shareholders to call the directors to book if they appear to be failing in their stewardship and while they cannot be involved in the direction and management of their company, they can insist on a high standard of corporate governance".

The number of companies actively seeking engagement with investors increased to 73% (2011: 62%). However, anecdotal information suggests the institutions are more reticent to engage, certainly on matters of governance, claiming lack of resource and/or sufficient existing engagement with the executive team. If strong governance is a proxy for long-term success, this balance needs to be addressed urgently.

### A focus on quality

It is now time for shareholders to act to 'encourage' best practice across UK plc. If they do not 'call the directors to book' the regulators may do it for them and, in so doing, threaten the 'comply or explain' cornerstone of UK corporate governance. While deliberations at the European Commission seem to have backed off from wholesale abandonment of the principles-based approach, greater emphasis is being placed on the quality of explanations and shareholder engagement. The FRC's strengthening of the Stewardship Code and the Kay Review on 'UK equity markets and long-term decision making', suggest that neither regulators nor the public will wait another 20 years for best practice to take hold.

### The enduring glass ceiling

Finally, although somewhat overshadowed by the gender issue, our review charts the continuing diversity challenge. With little measureable information about diversity on boards, gender and age provide useful yardsticks. After recent high profile resignations, the gender debate is now turning to the heart of the board: the executive role. Here we find only one female chairman in the FTSE 100 and two in the Mid 250. Twenty one women are in executive positions but only two female chief executives remain. The average age of a company chairman, at 63, is 11 years more experienced than a chief executive. With the effectiveness of the board being very much the responsibility of the chairman and using age as a proxy for experience and gender as part of the answer to diversity, can we afford to wait for over 10 years before we start to see women set the tone from the top?

*"It is now time for shareholders to act to encourage best practice across UK plc."*

# The Cadbury legacy

**The 1992 Cadbury Report continues to shape corporate governance frameworks around the world, with its core 'comply or explain' principle still exciting debate.**

The Cadbury Report – or 'The Report of the Committee on the Financial Aspects of Corporate Governance' – fits firmly into the Anglo-Saxon corporate tradition of favouring checks and balances to regulation. Although its interim report was condemned by some as divisive, the final toned-down recommendations, including the voluntary code of best practice, were widely welcomed.

From the first, however, there was some scepticism about the effectiveness of a purely voluntary code. Sir Adrian Cadbury argued that it was up to shareholders, as company owners, to exert the necessary pressure toward compliance. And, if companies did not comply "it is probable that legislation and external regulation will be sought".

In its on-going review of corporate governance practices, the European Commission focused on the very two areas that Cadbury flagged up: shareholder engagement in pressuring companies to be accountable and the effectiveness of the 'comply or explain' principle in achieving transparency and accountability.

*"The report helped restore battered reputations and investor confidence in company management, following notorious scandals in the 80s and 90s."*

*"It has not stopped companies failing, but nor has it been so prescriptive it has prevented them succeeding."*

The UK Government's 2010 response, the Stewardship Code, brought the role of shareholders into the spotlight, while being tentative in some areas. In its December 2012 Action Plan, the EC seemed to accept 'comply or explain' but turned up the heat on the need for informative explanations. The Stewardship Code's 2012 revisions picked up on this and the FRC, while cautious about getting sucked into a policing role, is considering how further oversight could encourage continued improvement.

While debate around oversight continues, Cadbury's legacy is in no doubt. As Sir Adrian explained 20 years ago, it has not stopped companies failing, but nor has it been so prescriptive it has prevented them succeeding. In this vein, since 1992 it has helped restore battered reputations and investor confidence in company management, following notorious corporate scandals in the 80s and 90s, from BCCI to Maxwell. But most notably, the report has effected a quiet revolution in global governance, with more than 80 countries now having introduced corporate governance codes.

### 1992 CADBURY REPORT

**In response to UK governance failures such as Polly Peck, BCCI and Maxwell**

- Separation of chairman and chief executive roles
- Requirement for two independent NEDs
- Requirement for audit committee of NEDs

### 1995 GREENBURY REPORT

**In response to public anger over executive pay such as the British Gas 'fat cats'**

- Requirement for remuneration committee of NEDs
- Long-term performance related pay introduced

### 1998 HAMPEL REPORT

**Reviewed implementation of Cadbury and Greenbury**

- Combined Code on corporate governance issued
- A focus on principles as opposed to detailed guidelines

### 1999 TURNBULL REPORT

**To clarify reporting on internal control**

- Requirement for the board to review the system of internal control and risk management

### 2003 HIGGS REPORT

**In response to US corporate failures such as Enron, Worldcom and Tyco**

- Last major Code revisions
- Backed the 'comply or explain' principle (as opposed to US approach of regulation through the Sarbanes-Oxley Act)
- Requirement for at least half of board to be independent NEDs
- Introduced annual board and director evaluation

### 2003 SMITH REPORT

**In response to concerns over auditor independence**

- Provides guidance on role and responsibilities of audit committees
- Focus on independence of external auditors and level of non-audit services provided

### 2005 & 2008 – CODE REVISIONS

### 2009 WALKER REVIEW

**Reviewed governance of the UK banking industry in response to the global financial crisis**

- Number of recommendations incorporated into the renamed 2010 UK Corporate Governance Code

### 2010 – CODE REVISION

### 2010 STEWARDSHIP CODE

**Intended to enhance the quality of engagement between institutional investors and companies**

### 2011 FRC'S GUIDANCE ON BOARD EFFECTIVENESS

**Replacement for 2003 Higgs guidance**

- Provides guidance on sections A and B of the Code around leadership and board effectiveness

### 2012 – CODE REVISION

### 2012 FRC'S GUIDANCE ON EXPLANATIONS

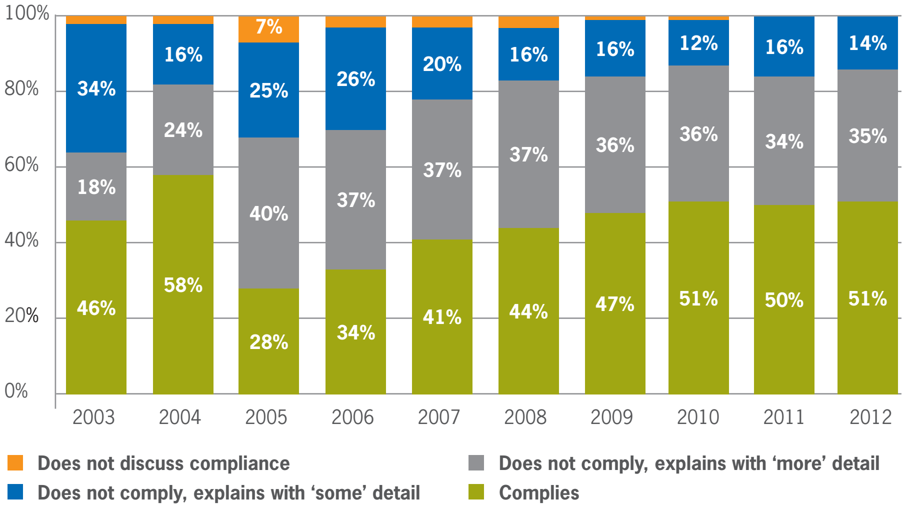
**Report of discussions between companies and investors**

- Provides guidance on quality of explanations

# Compliance with the Code

**As half of the FTSE 350 comply entirely with the Code and, overall, companies embrace 97% of its provisions, UK plc is increasingly embracing good corporate governance.**

**FTSE 350 companies choosing to 'comply or explain'**




For the third successive year, around half (51%) of all FTSE 350 companies claimed full compliance with the UK Code. As this was the first year companies were required to report against the new provisions of the 2010 Code, the fact that levels stayed consistent – whereas previously they have dropped initially – suggests businesses are now more prepared to embrace compliance.

Compliance levels in the FTSE 100 remain around 10% higher than in the Mid 250. While compliance appears to have plateaued, encouragingly 44% of the 144 companies that did not comply, state they are planning to do so. It will be interesting to see if the 2013 results reflect this ambition.

## Compliance with provisions

Although 49% of companies report non-compliance with the Code, this typically relates to just one or two provisions. Taking these together with those who cite full compliance, the FTSE 350 complies with 97% of the Code's provisions.

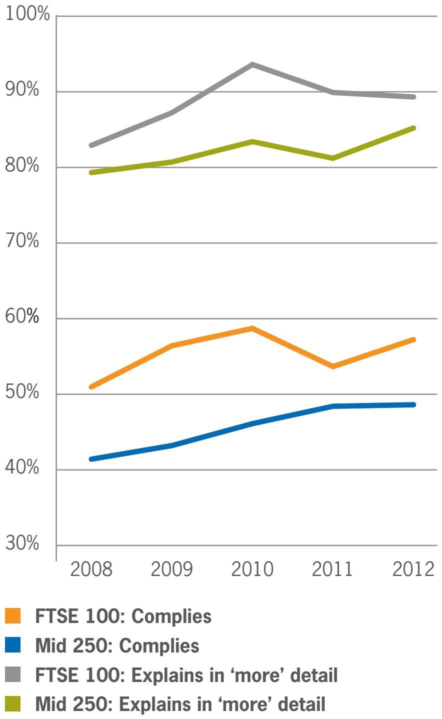
| Number of Code provisions stated in non-compliance statements | Number of companies |
|---|---|
| 1 | 85 |
| 2 | 29 |
| 3 | 11 |
| 4 | 7 |
| 5 | 7 |
| >5 | 5 |
| **TOTAL** | **144** |

## Explanation quality

The Code states that: "an alternative to following a provision may be justified… if good governance can be achieved by other means. A condition of doing so is that the reasons for it should be explained clearly and carefully to shareholders".

The number of companies providing more informative explanations continues to improve, with 72% of those that chose not to comply providing detailed reasoning. Of these, 14 gave particularly clear, informative explanations that covered the background and reasons for their decisions.

**FTSE 100 and Mid 250 companies choosing to ‘comply or explain’**




*“Compliance levels in the FTSE 100 remain around 10% higher than in the Mid 250.”*

While an encouraging trend, of the 73 companies that did not comply in consecutive years, two thirds made no changes to their explanations. There also remain a hard core of 40 companies that still give a bare minimum of explanation.

*“[A good description] should set out the background, provide a clear rationale for the action it is taking and describe any mitigating actions taken. The explanation should indicate whether the deviation from the Code’s provisions is limited in time and, if so, when the company intends to return to conformity with the Code’s provisions.”*

**(UK Corporate Governance Code)**

In February 2012, the FRC paper ‘What constitutes an explanation under “comply or explain”?’ identified features of a meaningful explanation, a summary of which is included within the 2012 Code revision. The FRC said the most informative explanations include: areas of non-compliance; reasons for deviation from the Code; planned actions to overcome non-compliance, and whether the company intended to comply in future.

## Fast FActs

### ON THE FTSE 350:

The varied complexion of the FTSE reinforces how, when it comes to governance, ‘one size cannot fit all’:

- The three largest FTSE 100 companies have a higher market capitalisation than the whole Mid 250
- Market capitalisation of FTSE 350 companies ranges from £330 million to £100 billion
- FTSE 350 membership is fluid: only half of the current list were members a decade ago
- The top 20 companies are larger than the rest of the FTSE 350 combined
- The largest FTSE 350 has more than 650,000 staff, the smallest just 14

## Challenges to full compliance

The most common non-compliance relates to board balance and committee membership.

Only 14 companies failed to comply with the new Code provision for annual director re-election and, of these, almost half committed to introduce it within 12 months.

**MOST COMMON NON-COMPLIANCE FROM FTSE 350 COMPANIES (2012)**


*"Encouragingly, 44% of the 144 companies that did not comply, state they are planning to do so."*

* This Code provision first became effective this year.
**Of the 19 companies that reported non-compliance, 10 did not appoint their chairmen during the year and were not, therefore, required to report against this provision.

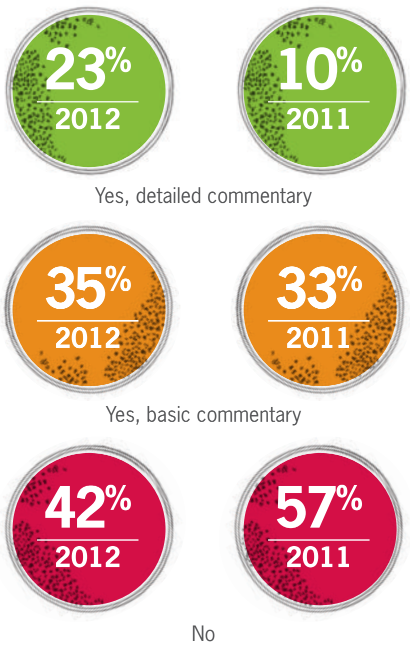
# Emerging trends

### Governance insight

*"Chairmen are encouraged to report personally in their annual statements how the principles relating to the role and effectiveness of the board (in Sections A and B of the new Code) have been applied."*

**(UK Corporate Governance Code, Preface)**

**TO WHAT EXTENT ARE THE FEATURES OF BOARD GOVERNANCE DISCUSSED IN THE CHAIRMAN'S PRIMARY STATEMENT?**




### Moving beyond compliance

There has been a notable improvement in the quality and presentation of board governance disclosures within annual reports, with many companies going beyond mere statements of compliance.

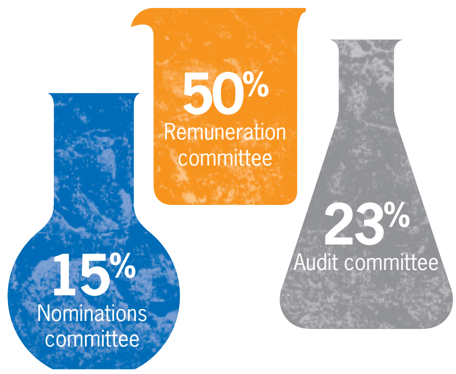
As explored in our report 'The tone of governance'[1], more chairmen are establishing their personal governance credentials. However, there is a disparity between chairmen who used their primary statement to give this insight and those who left it to the corporate governance statement: the latter can suggest compliance box-ticking.

In all, three quarters of chairmen referred to governance in their primary statements or the corporate governance report. More than half (58%) emphasised its importance through their primary statement. On closer scrutiny, the majority kept their explanations to a minimum but 23% (2011: 10%) of chairmen truly embraced the Code's Preface and used their primary statement to enable valuable insight into board practices. In contrast, 25% of chairmen still give no insight into board governance practices.

### Increasing personal ownership

The improvement in disclosures around board committee activity is another notable trend. An increasing number of company reports now include personal overviews from committee chairs on the key issues and priorities for the following year.

**DO COMMITTEE CHAIRS INTRODUCE THEIR REPORTS? (YES %)**




Remuneration committee chairmen, perhaps spurred on by the intense and widespread interest in executive reward, are increasingly putting their names to their reports, with more personal accounts of committee activities. Such 'by-lining' is also growing among chairmen of audit and nomination committees but, at 23% and 15% respectively, at a slower rate.

Indeed, personal accountability is one of this year's emerging trends: seen in both the personalising of sub-committee reports and in company chairmen taking responsibility for governance and values. As shareholders and regulators demand more information and sub-committees receive increased guidance on how and what they should report to boards, this pattern is likely to continue. Whether this will lead to sub-committee chairmen reporting at AGMs remains to be seen but the momentum towards greater accountability is clear.

[1]Governance insights: The tone of governance, Grant Thornton, October 2012.

# Leadership

**Recent corporate scandals have heightened the need for a strong and principled tone from the top. Chairmen, along with the two other members of the 'governance holy trinity' – CEOs and company secretaries – have a crucial role to play.**

## The role of the board

*"The board should set the company's values and standards and ensure that its obligations to its shareholders and others are understood and met."*

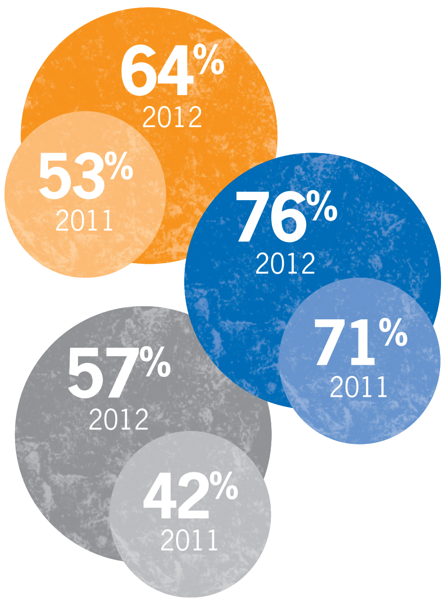
**(UK Corporate Governance Code, supporting principle A.1)**

There is increasing emphasis on the way boards carry out their role, the behaviours they display and the culture they promote. This message was reinforced in the 2011 FRC Guidance on Board Effectiveness:

*"An effective board develops and promotes its collective vision of the company's purpose, its culture, its values and the behaviours it wishes to promote in conducting its business."*

**(FRC Guidance on Board Effectiveness, 1.2)**

**HOW MUCH DETAIL IS PROVIDED ON HOW THE BOARD OPERATES AND DISCHARGES ITS DUTIES? (MORE/OUTSTANDING %)**



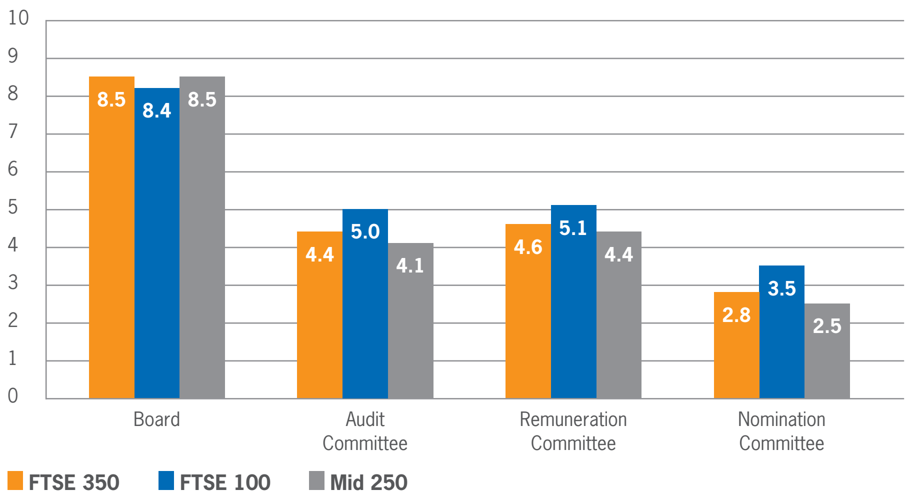

With mounting scrutiny of the leadership and operation of boards, it is encouraging to see increasing coverage of the way they work.

### Meeting frequency

The Code does not advise on the frequency of board and committee meetings, merely specifying that "the board should meet sufficiently regularly to discharge its duties effectively".

This year, the average number of board meetings was 8.5, with a range of between two and 25. (When Cadbury published his report, 20 years ago, the average number was six.) Helpful disclosures explained both how many meetings were originally planned and the number of, and reasons for, unscheduled meetings.

**Average number of board and committee meetings**



## The chairman

*"The chairman is responsible for leadership of the board and ensuring its effectiveness on all aspects of its role."*

**(UK Corporate Governance Code, main principle A.3)**

*"The chairman should promote a culture of openness and debate."*

**(UK Corporate Governance Code, supporting principle A.3)**

The chairman has a crucial role in establishing a positive company culture. Corporate scandals, from Barclays' Libor-fixing to RBS and Olympus, are potent reminders of what can go wrong when leaders fail to instil a principled tone from the top. And this tone should not just be demonstrated in the chairman's statement and the boardroom but in all actions within and outside the company – including interaction with shareholders.

In a positive emerging practice, a small number of chairmen are now taking overt responsibility for setting the right tone. This year, 5% embraced A.1 of the Code, reinforced by the FRC Guidance on Board Effectiveness 1.2, and firmly turned the spotlight on the importance of culture and values in underpinning effective governance practice.

As we argue in 'The tone of governance'[1], the regulator could help convert such exceptional practice into the norm: "As the external investors' primary representative inside the boardroom, the chairman has a crucial role in standard setting and embedding the tone. Perhaps now is the time for the FRC to pick up on this emerging practice of the few and expand its Preface to the Code to encourage the many to recognise the importance of values in establishing the right governance culture in an organisation".

However, even the most determined chairman cannot steer a company in the right direction alone. A growing pre-requisite to success is the governance 'holy trinity' of the CEO, chairman and company secretary. This was recognised by the FRC in its 2010 Board Effectiveness guidance, where it increased the emphasis on the importance of company secretaries in supporting chairmen on governance issues.

*"Executive chairmen are typically former CEOs or founding shareholders, a background that can lead to them retaining significant influence on the board."*

[1]Governance insights: The tone of governance, Grant Thornton, October 2012.

**Fast FActs**

ON CHAIRMEN:

- Four chairman head three FTSE 350 boards, 24 chair two
- There are 31 executive chairmen in the FTSE 350
- One in four FTSE chairs have sat on the board for more than nine years and six for over 25 years
- The average FTSE 350 chairman is 11 years older than the executive
- 78% of chairman in the FTSE 100 have held executive roles previously, 42% as chief executive
- There are only three female chairs in the FTSE 350

## Independence of chairmen

During the year, 39 companies appointed a new chairman. Of these, 20 disclosed they were independent on appointment (a Code requirement) and eight reported they were not independent and so non-compliant. The remaining 11 failed to state whether the new chairman was independent, in breach of the Code.

## Division of responsibilities

*"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."*

**(UK Corporate Governance Code, main principle A.2)**

One of the most significant changes to come out of the Code, in marked contrast to the traditional US model, is the separation of the role of chairman and chief executive. Although more than 10% of UK companies still either combine the roles or blur the responsibilities, in the US it remains the case for 57% of S&P 500 companies.

Drilling down into detail: 10 UK companies had a joint chairman and chief executive, with another seven combining the roles at some point during the year. In a further 21, the roles of chairman and CEO were not combined, but the chairman held executive powers and was actively involved in running the business. While this is not a technical breach, it strains the spirit of the Code.

Executive chairmen are typically former CEOs or founding shareholders: a background that can lead to them retaining significant influence on the board. In several cases, a review of the division of responsibilities suggests the chairman is CEO in all but name.

When assessing whether a board meets the Code's independence requirements, the chairman is excluded, whether or not they hold executive responsibilities. For boards with executive chairmen, a board with equal numbers of executive and non-executive directors will be deemed in compliance with the Code, despite the fact that the executive team forms a majority with the executive chairman holding the casting vote – an apparent anomaly and one that several shareholder groups are presently seeking to address.

*"There is increasing emphasis on the way boards carry out their role, the behaviours they display and the culture they promote."*

# Effectiveness

**As companies face pressure to achieve a diverse boardroom spread, female directors remain under-represented across the FTSE 350.**

### Board composition

*"The board and its committees should have the appropriate balance of skills, experience, independence and knowledge of the company to enable them to discharge their respective duties and responsibilities effectively."*

**(UK Corporate Governance Code, main principle B.1)**

### Increasing non-executive presence

Boards seem to have reached their 'natural size' with the average FTSE 350 board having 5.5 non-executive directors (NEDs) (2011: 5.3), a chairman and three executive directors (as last year).

### Board effectiveness

Populating boards is proving a growing challenge, particularly outside the FTSE 100 where approximately 22% of companies failed to either maintain or achieve the required balance of independent non-executive directors at some time in the year. As the natural cycle of retirement is planned, this suggests that unplanned retirements are on the increase or it is taking longer to find the right candidates. Either way, sourcing independent NEDs and addressing the growing demand for greater diversity should be moving up the agenda of chairmen and nomination committees.

Of the 55 companies without sufficient independent members, a third (18) were compliant for part of the year.

| FTSE rank | Number of companies in group | Insufficient independent NED membership | Independent NEDs on board (average) |
|---|---|---|---|
| 1–100 | 99 | 12% | 6.7 |
| 101–200 | 91 | 22% | 5.1 |
| 201–350 | 106 | 22% | 3.9 |
| **TOTAL** | **296** | **18.6** | **5.2** |

*"Chairs of nomination committees may wish to work with their company chairmen to identify potential candidates from inside and outside the business, to meet long term needs."*

## Fast Facts

### ON BOARD NUMBERS:

- Almost one in five (18.6%) of FTSE 350 boards had too few independent NEDs
- All companies had at least two non-executives, with one having 14
- Three boards had no executive directors
- Four FTSE 100 companies had 16 directors
- The average FTSE 100 board had 11 members, the average Mid 250 board had 8.4
- The smallest board, with four directors, is in the Mid 250
- Around 15% of directors have multiple FTSE 350 directorships

### A question of independence

Across the FTSE 350, 83 non-executive directors (5%) were not considered independent. Of these, 27 represented significant shareholders and 39 were recent employees or board members of more than nine years' standing.

| | FTSE 350 | FTSE 100 | Mid 250 |
|---|---|---|---|
| Total number of NEDs | 1,629 | 692 | 937 |
| Number of NEDs who were not independent | 83 | 25 | 58 |
| % non-independent NEDs | 5% | 4% | 6% |

A further 39 NEDs were considered independent by the board despite not meeting the independence criteria set out in provision B.1.1 of the Code. Of these, the majority (30) had served on the board for more than nine years.

### Board appointments

*"There should be a formal, rigorous and transparent procedure for the appointment of new directors to the board."*

**(UK Corporate Governance Code, main principle B.2)**

With the growing focus on the need for greater diversity, coupled with the apparent shortage of candidates, nomination committees are coming under increased scrutiny from shareholders.

Despite this, nomination committee disclosures were relatively poor with more than half of all companies, 55%, (2011: 63%) providing only basic information. This is often limited to a commentary on appointments with little or no discussion around board composition, succession planning or desirable characteristics.

There is a noticeable difference between the largest companies in the FTSE 100, where 62% (2011: 59%) provide informative disclosures, and the Mid 250 where only 37% (2011: 26%) gave similar detail.

Most companies have a long way to go to provide meaningful disclosures in this area, although there are signs of improvement. That only 15% of nomination committee chairmen contributed a commentary to their report suggests that the drive has to come from the chairs themselves.

The most frequently given reason for non-compliance (see page 41) relates to insufficient numbers of NEDs. This – along with pressure to address the gender imbalance, particularly among executive board members – is likely to push succession up the institutional agenda. In anticipation, chairs of nomination committees may wish to work with their company chairmen to identify potential candidates, from inside and outside the business, to meet long term needs.

John Kay's July 2012 review, 'UK equity markets and long-term decision making' recommends that companies consult major shareholders around key board appointments such as chairmen and important non-executive appointments. While this is not mentioned in the Code, it is another point that nomination committee chairs may wish to consider.

### Diversity

*"The search for board candidates should be conducted, and appointments made, on merit, against objective criteria and with due regard for the benefits of diversity on the board, including gender."*

**(UK Corporate Governance Code, supporting principle B.2)**

The Davies Report on Women on Boards focused attention on the lack of female directors – and the need to rectify this imbalance. Lord Davies' recommendation that 25% of board members should be female by 2015 has prompted action. Encouragingly, the number of recent female appointments, at least among non-executives, has increased significantly. However, Mid 250 female representation still lags the FTSE 100 by some margin. While many companies are confident of achieving the 25% target, it raises a fundamental issue around the short-to-medium term availability of female executive talent. With the recent high profile departures of Anglo American's Cynthia Carroll, WH Smith's Kate Swann, and Pearson's Dame Marjorie Scardino, female executive representation is at risk of, at best, remaining static.

**GENDER DIVERSITY (% DIRECTOR POSITIONS HELD BY WOMEN)**

| | FTSE 350 | FTSE 100 | Mid 250 |
|---|---|---|---|
| **2012** | | | |
| Chairman | 1.0 | 1.0 | 1.0 |
| Executive Director | 5.1 | 6.8 | 4.2 |
| NED | 14.4 | 21.0 | 13.0 |
| Total | 10.8 | 16.7 | 9.8 |
| **2011** | | | |
| Chairman | 0.7 | 1.0 | 0.5 |
| Executive Director | 4.9 | 5.9 | 4.3 |
| NED | 14.4 | 18.2 | 11.5 |
| Total | 9.8 | 13.0 | 7.7 |
| **2010** | | | |
| Chairman | 1.3 | 2.0 | 1.0 |
| Executive Director | 4.4 | 4.9 | 4.1 |
| NED | 12.9 | 17.2 | 9.8 |
| Total | 8.8 | 12.2 | 6.7 |

Female representation in the boardroom has grown to 10.8% (2011: 9.8%) with a marked penetration among the FTSE 100 NEDs, where 21% of positions (2011: 18.2%) are held by women.

The number of female executive directors remains low at 5.1% (2011: 4.9%) and has taken a step backwards in the Mid 250 at 4.2% (2011: 4.3%).

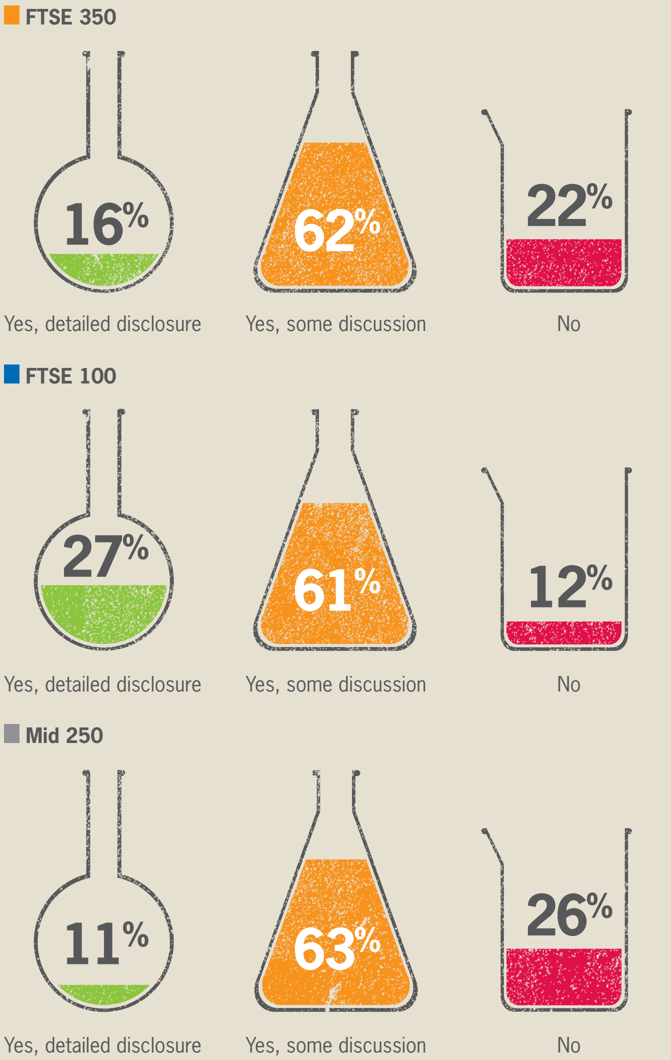
Despite 38% of FTSE 100 and 36% of Mid 250 director appointments from March 1 to November 15, 2012 being female[3], a significant number of all-male boards endure. Eight FTSE 100 boards and 79 of Mid 250 companies have no women around the table. As FTSE 100 directors often 'cut their teeth' in the Mid 250, the low female representation on the latter's boards suggests FTSE 100 recruitment of women directors – already challenging – will become even tougher. As the obvious sources dry up and the experience path for executive appointments remains long and intensive, achieving greater female representation at the heart of the UK's largest companies is likely to remain a distant goal.

*"[The annual report] should include a description of the board's policy on diversity, including gender, any measurable objectives that it has set for implementing the policy, and progress on achieving the objectives."*
**(UK Corporate Governance Code 2012, provision B.2.4)**

*"Twenty two per cent of companies failed to maintain/achieve the required balance of independent non-executive directors at some time in the year."*


[3]Professional Boards Forum BoardWatch. http://www.boardsforum.co.uk/boardwatch.html

**DO COMPANIES DISCUSS GENDER DIVERSITY?**




This year has seen a significant increase in the number of companies discussing their approach to gender diversity, driven largely by the Davies Report. Seventy eight per cent (2011: 28%) now provide at least a basic outline, with 16% (2011: 6%) setting out detailed disclosures.

Only 13% of companies (FTSE 100: 23%, Mid 250: 7%) committed to, and disclosed, a target for female representation in the boardrooms by 2015, with a handful setting more ambitious goals than 25%. In our experience, disclosure practices take four to five years to evolve, so for 84% of the FTSE 350 evolution has some way to go.

### Fast FActs ON GENDER DIVERSITY:

- At the time of our review, just 268 of 2,484 FTSE 350 directorships were held by women
- 36% of companies had exclusively male boards (FTSE 100: 13%, Mid 250: 47%,)
- 47 companies met Lord Davies' 25% criteria (FTSE 100: 25, Mid 250: 22) with three companies having boards made up of more than 40% women
- More directorships are held by women in the FTSE 100 (147) than the whole Mid 250 (121)
- The number of female executive directors on Mid 250 boards fell to 23 from 25

*"While the spotlight on women on boards can only be positive, attention should not be diverted from the need to reflect breadth in other areas, including age, ethnicity, nationality, background, profession and personality type."*

# A broader definition of diversity

While the spotlight on women on boards can only be positive, attention should not be diverted from the need to reflect breadth in other areas, including age, ethnicity, nationality, background, profession and personality type.

## Age and experience

**Average age**

| | FTSE 100 | Mid 250 | FTSE 350 |
|---|---|---|---|
| Exec | 52.7 | 50.9 | 51.5 |
| Non Exec | 59.0 | 58.6 | 58.7 |
| Chair | 63.5 | 62.5 | 62.9 |

**Average tenure**

| | FTSE 100 | Mid 250 | FTSE 350 |
|---|---|---|---|
| Exec | 6.7 | 6.8 | 6.8 |
| Non Exec | 4.6 | 4.5 | 4.5 |
| Chair | 5.6 | 7.6 | 6.9 |

With little information available other than the directors' biographies to assess diversity among the FTSE, age is the only readily available proxy for experience.

**Fast Facts**

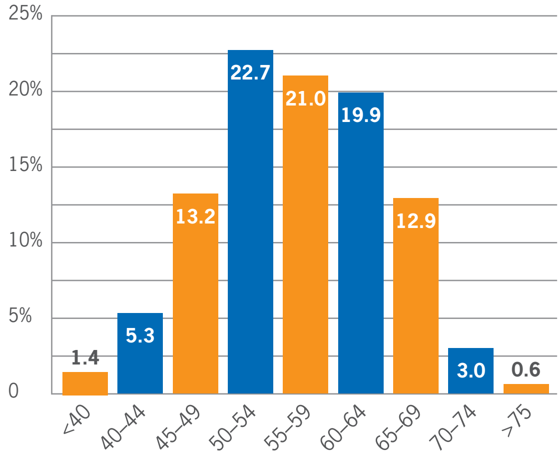
ON DIRECTORS' AGE AND TENURE:

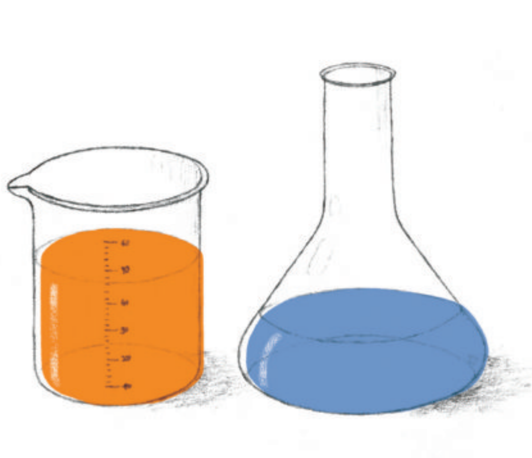
- FTSE 100 executives have two years more experience than in the Mid 250
- Mid 250 chairs have been in post for more than 7.5 years on average, two years longer than in the FTSE 100
- NEDs have an average tenure of 4.5 years, suggesting nine years of full service (in line with the Code's recommended minimum)
- Eight per cent of NEDs have more than nine years' tenure, most of whom are not classified as independent
- The average age of an NED is 59
- The oldest NED is 86, with 12 over 75 and one in six over retirement age

## Experience of the chairman

The average age of a chairman is 63, 4.5 years older than a non-executive and 11 years older than an executive director. Interestingly, 63 is almost identical to the average age of a member of the US Senate, perhaps confirming at what point age and experience come together. Where experience is concerned, 78% of FTSE 100 chairs previously held executive main board positions, 43% of them as chief executive.

**Average age of directors**



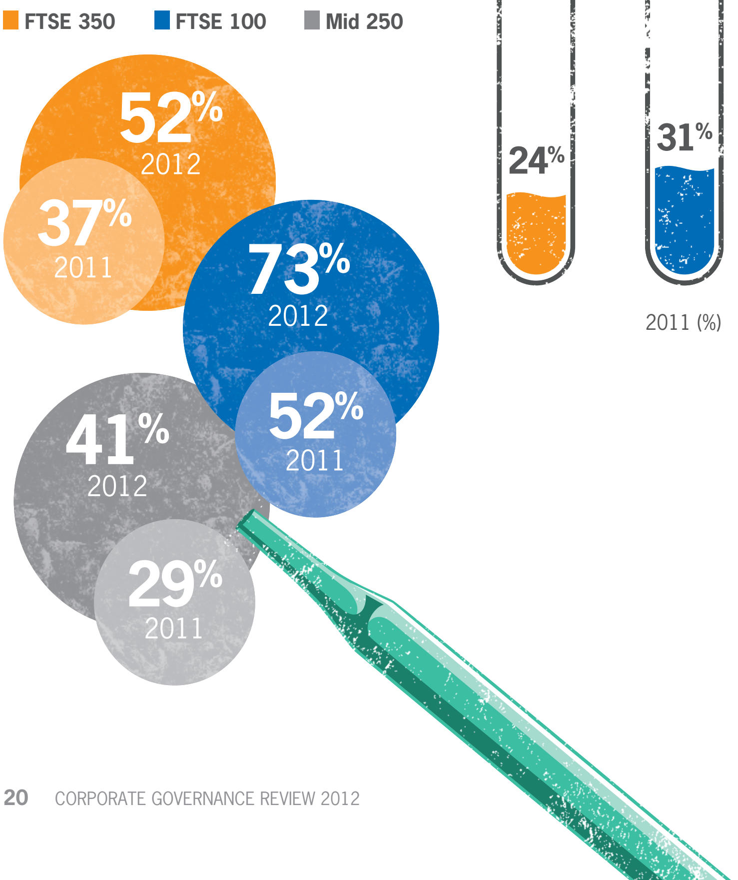
# Evaluation

*"The board should undertake a formal and rigorous annual evaluation of its own performance and that of its committees and individual directors."*

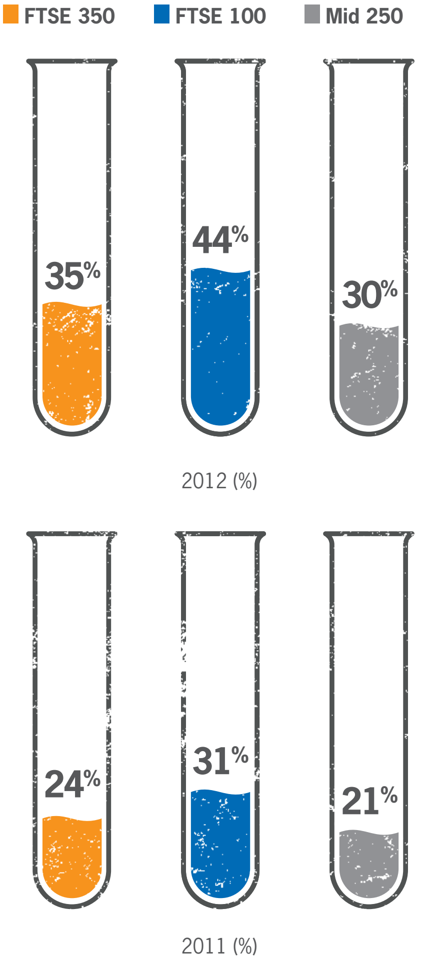
**(UK Corporate Governance Code, main principle B.6)**

More than half of companies, 52% (2011: 37%), provide good descriptions around their board evaluation process. Encouragingly, a former reticence to share output from reviews is easing with 35% (2011: 24%) now giving some insight into the findings.

**LEVEL OF EXPLANATION OF BOARD EVALUATIONS (MORE DESCRIPTION OF PROCESS)**




**IS INFORMATION GIVEN ABOUT EVALUATION FINDINGS?**




**Externally-facilitated board evaluations**

*"Evaluation of the board of FTSE 350 companies should be externally facilitated at least every three years."*

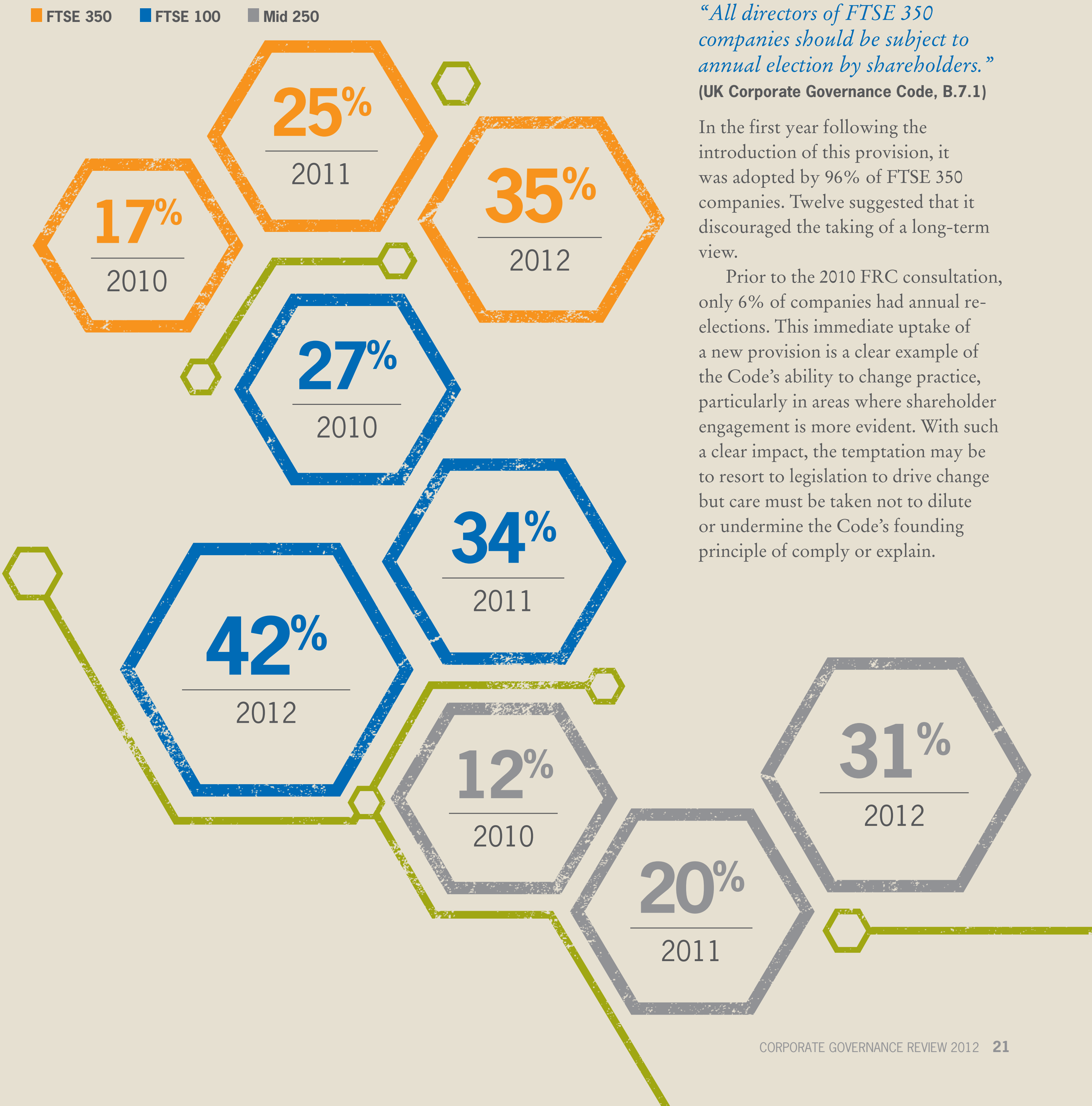
**(UK Corporate Governance Code, B.6.2)**

The Code provision for FTSE 350 companies to have externally facilitated board evaluations at least triennially became effective this year. Evaluations were undertaken by 102 companies (2011: 74), with 40 more announcing plans to do so next year.

To help improve the quality of evaluations, in its 2012 Code revisions, the FRC introduced a requirement to name external facilitators. More than two thirds (71) of the 102 that had been externally evaluated gave this information. Twenty eight different organisations were used, with three being engaged by more than 10 companies and 18 being involved with just one. Anecdotal evidence suggests a wide variation in review quality and approaches, ranging from questionnaires and attendance observations to the use of psychometrics.

Although the format, focus and style will continue to be heavily influenced by the chairman, this greater transparency will hopefully raise the bar of expectation among investors, participants and the consultants themselves.

**WAS THE BOARD EVALUATION EXTERNALLY FACILITATED?**




## Re-election

*"All directors of FTSE 350 companies should be subject to annual election by shareholders."*

**(UK Corporate Governance Code, B.7.1)**

In the first year following the introduction of this provision, it was adopted by 96% of FTSE 350 companies. Twelve suggested that it discouraged the taking of a long-term view.

Prior to the 2010 FRC consultation, only 6% of companies had annual re-elections. This immediate uptake of a new provision is a clear example of the Code's ability to change practice, particularly in areas where shareholder engagement is more evident. With such a clear impact, the temptation may be to resort to legislation to drive change but care must be taken not to dilute or undermine the Code's founding principle of comply or explain.

# Accountability

**Companies need to give genuine insight into their risk management and control operations, rather than just ticking the compliance boxes for these crucial areas.**

## Risk management and internal control

*"The board is responsible for determining the nature and extent of the significant risks it is willing to take in achieving its strategic objectives. The board should maintain sound risk management and internal control systems."*

**(UK Corporate Governance Code, main principle C.2)**

The Turnbull report, 'Internal control: guidance to directors', was issued in 1999 and revised in 2005. While interim consultations supported the FRC's belief that it was still fit for purpose, the regulator is expected to begin a formal review in 2013.

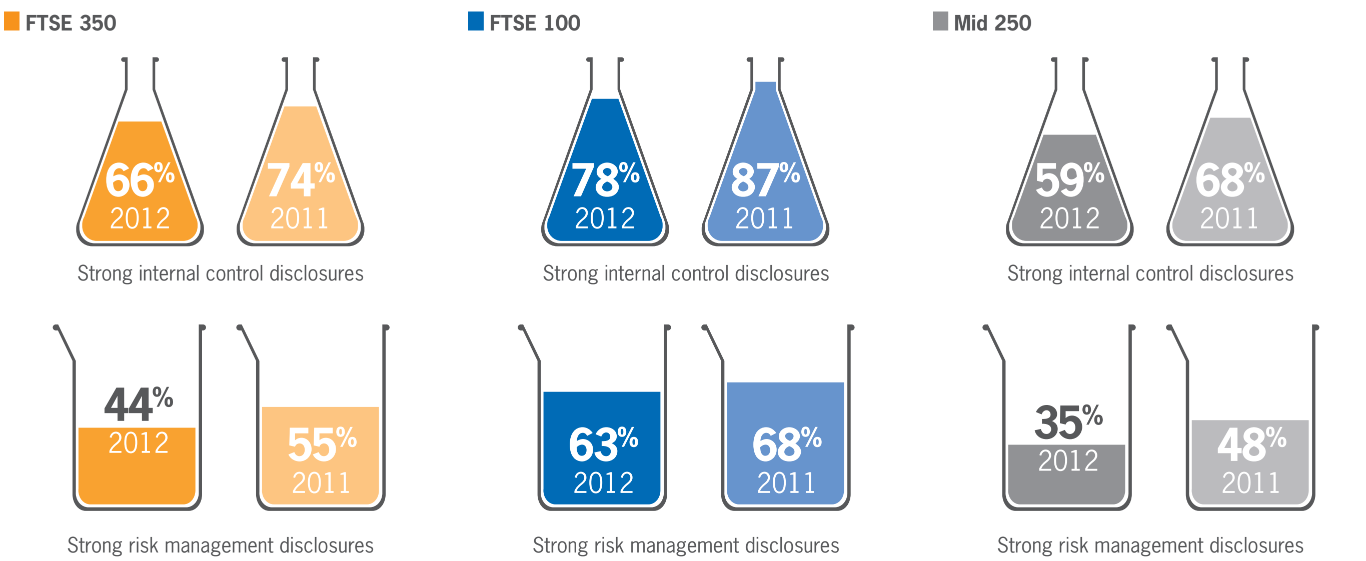
### Assessing internal control effectiveness

The Turnbull guidance put the spotlight on both risk management and internal control. Since then the emphasis on these two aspects of governance has gathered momentum. While all companies now claim full compliance with Turnbull, many offer little insight to readers. Reports tend toward the boilerplate, merely confirming the existence of appropriate systems and practices. Only one in four companies enable real understanding of their systems and how their boards measure their effectiveness. This figure has barely altered in five years.

With a growing focus on risk management and both the FRC and BIS seeking greater transparency, the emphasis needs to move from acknowledging that the annual internal controls review took place towards revealing actual risk management practices and the role internal control plays in mitigating risks. The FRC will be commencing its consultation in early 2013.

*"Thirty three FTSE 350 companies claimed their small size, lack of complexity, and proximity of senior management to operations precluded the need for internal audit."*

**GOOD QUALITY DISCLOSURES ON RISK MANAGEMENT AND INTERNAL CONTROL**



*"The emphasis needs to move from acknowledging the annual internal controls review took place towards revealing actual risk management practices."*

While most companies set out their risks clearly (see page 35), they often struggle to explain their risk management processes with less than half providing helpful disclosures. The often scant attention paid to the quality of disclosure for internal control and risk management makes the FRC's forthcoming review particularly timely.

More positively, a small number of companies clearly spent time refining their disclosures. Fifteen provided detailed descriptions of their processes covering:

- risk management roles and responsibilities
- reporting, monitoring and mitigation of risk
- how risk management is embedded into operations
- risk appetite.

## Disclosure of control weaknesses

Three companies reported significant weaknesses (2011: 4) with 80 (2011: 76) stating they had none. Of the remaining companies, 129 companies did not refer to weaknesses (2011: 133) and 84 said, rather opaquely, that if there were any they would be remedied.

## Risk committees

Sir David Walker's November 2009 'Review of corporate governance in UK banks and other financial entities' recommended that all financial institutions (banks and life insurance companies) introduce risk committees.

All FTSE 350 financial institutions do now have a separate risk committee, in line with the report. This practice is being adopted by a growing number of non-financial services companies, with 40% (2011: 33%) now separating risk away from the audit committee – although not always with board representation. Perhaps this reflects a growing importance and sophistication of risk management on the agenda of UK's corporate boards. It has the added advantage of keeping a rein on the increasing workload and focus of audit committees while raising the profile of risk management throughout these organisations.

| Industry (size) | Separate risk committee % | | With board representation % | |
|---|---|---|---|---|
| | 2012 | 2011 | 2012 | 2011 |
| Financials (13) | 100 | 92.3 | 100.0 | 100.0 |
| Non-financials (283) | 39.6 | 33.0 | 86.6 | 88.3 |

## Internal audit

The internal audit function is increasingly seen to have an important role to play, particularly in smaller companies, in supporting the risk management functions.

However, 33 FTSE 350 companies (2011: 36) still claimed their small size, lack of complexity, and proximity of senior management to operations precluded the need for internal audit.

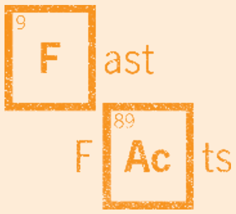
For most, the function is a mixture of fully outsourced, co-sourced or wholly in-house provision. As yet, no information is given about the level of resources committed to the function but following recent frauds, for example at UBS, this may need to change.

| FTSE rank | Do they have an internal audit function or equivalent? (2012) |
|---|---|
| 1–100 | 100% |
| 101–200 | 86% |
| 201–350 | 81% |
| 1–350 | 89% |

## Audit committees

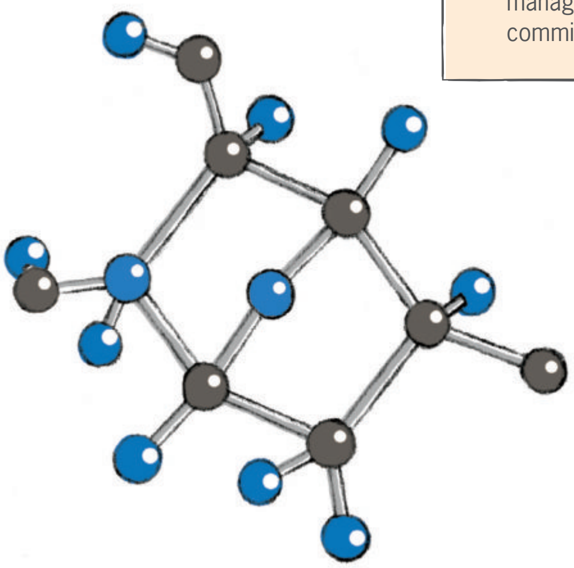
*"The board should establish formal and transparent arrangements for considering how they should apply the corporate reporting and risk management and internal control principles and for maintaining an appropriate relationship with the company's auditor."*

**(UK Corporate Governance Code, main principle C.3)**




ON AUDIT COMMITTEES:

- The average number of audit committee meetings held was 4.4 (FTSE 100: 5, Mid 250: 4.1)
- Two companies held 14 audit committee meetings
- 80% of companies had between one and five meetings
- 17 companies (2011: 22) did not identify a committee member with recent and relevant financial experience
- 23% provided a personalised report from the committee chairman
- Four out of 10 audit committees have passed oversight of risk management to a separate committee



*"The board should establish an audit committee of at least three, or in the case of smaller companies two, independent non-executive directors."*

**(UK Corporate Governance Code, C.3.1)**

### Audit committee composition

Nine out of 10 audit committees are made up of independent non-executive directors. However, as in 2011, around 10% of companies did not maintain properly constituted audit committees throughout the full year.

The FRC guidance on audit committees was recently amended and reissued to support the changes made to the September 2012 Code. The guidance provides further detail on the roles and responsibilities of the audit committee and, in particular, how they report to the board.

The FRC co-authored report 'Walk the Line: discussions and insights with leading audit committee members' provides a useful guide for reviewing audit committees. The February 2012 publication, based on discussions with audit committee chairs from the UK, Australia and other markets, offers insights into the role of the committee and its relationship with the board, management and external auditors.

# Assurance

**As the spotlight focuses on competition and choice in the large company audit market and FTSE 350 companies remain unwilling to adapt long-held practices, change in audit regulation seems inevitable.**

## External audit

### Market scrutiny

The large company audit sector is under scrutiny. The UK Competition Commission is investigating the market, to see if it prevents, restricts or distorts competition and, if so, what action might be taken. Provisional findings are due in January 2013 with a final report planned for July 2013.

The European Commission has also published legislative proposals. Issues being considered include restricting the provision of non-audit services by a company's auditor, mandatory audit firm rotation and regular tendering. The EC seeks to address concerns about the volume and nature of non-audit services provided by large company auditors, the risks to quality from long tenure, and the limited diversity in the market. It is also considering ways to encourage large companies to use more auditors, including shared or joint audits.

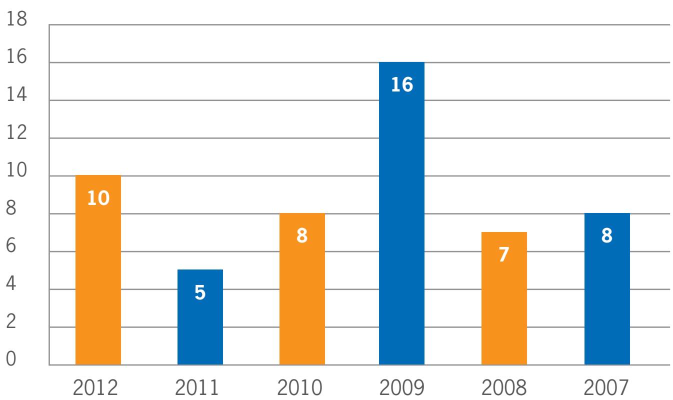
In September 2012, the FRC revised the UK Code to require all FTSE 350 companies to retender their external audit at least once every 10 years or to explain why not. This year, only 23% of companies indicated whether they had met this requirement, with many only acknowledging that a tender had taken place within the decade, rather than saying when. Only 14 companies disclosed having tendered the audit in 2011: this included eight of the 10 companies who changed audit in the year.

*"An extrapolation of the past six years of data suggests that the average auditor tenure at a FTSE 350 company is 33 years."*

### Changing auditors

In the period under review, 10 FTSE 350 companies changed external auditor, with two moves in the FTSE 100 and eight in the Mid 250. A further four companies said they will be tendering next year.

**Auditor changes in last 10 years (FTSE 350)**




While an improvement on the five companies who changed auditor last year, this still suggests considerable inertia. By disclosing little about when audits were last tendered or the auditor changed, companies are failing to provide shareholders with the information needed to exercise their statutory rights on auditor appointment through the annual vote. An extrapolation of the past six years of data suggests that the average auditor tenure at a FTSE 350 company is 33 years.

The new Code provisions will introduce a greater degree of transparency for shareholders. Whether they will enable a diverse audit market in the FTSE 350 remains to be seen. Much depends on whether shareholders are able to use the information given to engage investee companies and facilitate change in the market. The National Association of Pension Funds, for one, has already called for audit committees to disclose "…their approach to shared audits. Such a disclosure could aid competition in the audit market by highlighting a firm's approach to building relationships with non-Big Four audit firms".

**DISCLOSURE QUALITY ON APPOINTING, REAPPOINTING OR REMOVING AUDITORS (FTSE 350)**


The 2012 Code revisions will also require companies to assess their external auditor's effectiveness and length of tenure. These disclosures have been included in the FRC Guidance on Audit Committees for a number of years. Encouragingly, the number giving no information reduced considerably, to 15%. However, just one in four companies made informative disclosures around such areas as how the relationship is managed, how performance is evaluated, the length of tenure and the dates of appointment and last tender. As a result, investors gain little sense of how long auditors have been engaged, what other services they provide and, ultimately, whether their independence has been compromised.

## Auditor fees

FTSE 350 companies regularly use their external auditor to provide additional, non-audit related services. The current FRC guidance recognises that auditors are often best placed to deliver certain types of work and suggests when they might be used.

Considerable debate continues around whether auditors should undertake non-statutory services: viewpoints range from audit committees being able to set appropriate parameters to the outright prohibition of such services and the establishment of audit-only firms.

*"With so many questions being raised about the impact of non-audit fees on auditor independence, and the EC and FRC taking steps, change seems inevitable."*

At one end of the scale there were 10 companies whose non-audit fees, as a percentage of audit fees, ranged between multiples of 2.5 and 10. Excluding these, the average drops to 55%.

This year, the average audit fee fell by 3%. There is, however, a significant divide between the FTSE 30 and the rest. The audit fees paid by the top 30 FTSE companies represent 53% of the total audit fees paid by the entire FTSE 350. The audit fee for a top 30 company averages £13.4 million, with non-audit fees being £4.3 million. Although the latter represents only 32% of the audit fee, given the quantum of the fee it is perhaps understandable why auditor independence is coming under scrutiny in very large companies.

With so many questions being raised about the impact of non-audit fees on auditor independence, and the European and UK competition commissions reviewing this issue, change seems inevitable. Audit committees and finance directors may want to reflect on the providers available, for both their advisory and audit services, and look to establish new relationships – before circumstances force the issue.

| FTSE rank | Number of companies in our review | Average non-audit fees as a percentage of audit fees (%)* | |
|---|---|---|---|
| | | Current year | Previous year |
| 1–100 | 99 | 59.2 | 56.4 |
| 101–200 | 91 | 63.0 | 93.2 |
| 201–350 | 106 | 68.3 | 89.2 |
| **TOTAL** | **296** | **68.3** | **79.5** |

*These figures represent the average non-audit fees paid by each FTSE 350 company as a percentage of their audit fees; as such they are not weighted by value of fees.

The majority of non-audit services relate to transaction support (such as share offerings, initial offerings and acquisitions) and taxation services. Transactional fees can often be a large multiple of audit fees.

| FTSE rank | Current year | | Previous year | |
|---|---|---|---|---|
| | Average audit fee (£m) | Average non-audit fee (£m) | Average audit fee (£m) | Average non-audit fee (£m) |
| 1–100 | 6.09 | 2.26 | 6.24 | 2.21 |
| 101–200 | 1.13 | 0.65 | 1.23 | 0.68 |
| 201–350 | 0.50 | 0.28 | 0.54 | 0.36 |
| **1–350** | **2.58** | **1.06** | **2.66** | **1.08** |

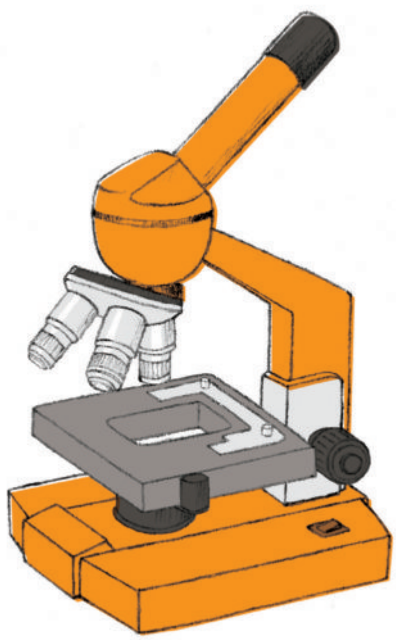
Note: Audit fees include fees paid for audit related services

*"The EC seeks to address concerns about the volume and nature of non-audit services provided by large company auditors, the risks to quality from long tenure, and the limited diversity in the market."*

## A guide to best practice

To follow best practices, audit committees could address shareholder needs by disclosing their company's approach to audit services. This could cover:

- re-tendering
- maximum auditor tenure
- any obligations to third parties about the company's choice of auditor
- building relationships with a range of audit firms
- non-audit services, including the maximum volume of non-audit services provided by the auditor, services which may only be provided by the auditor with the audit committee's prior approval, and the use of firms other than the auditor
- naming audit firms used in the annual report, and disclosing those parts of the company that have been audited by a firm other than the company auditor.



# Remuneration

**Remuneration remained a sensitive area, with stakeholder revolt, public outrage, bonus clawbacks and the Kay Review all keeping reward in the public eye.**

## The reward package

*"Levels of remuneration should be sufficient to attract, retain and motivate directors of the quality required to run the company successfully, but a company should avoid paying more than is necessary for this purpose. A significant proportion of executive directors' remuneration should be structured so as to link rewards to corporate and individual performance."*

**(UK Corporate Governance Code, main principle D.1)**

*"The sensitivity around executive reward is increasingly drawing attention to the role of the remuneration committee chairmen."*

Reward remains a contentious topic, with the 'shareholder spring' highlighting a number of controversial cases. The sensitivity around executive reward is increasingly drawing attention to the role of the remuneration committee chairmen. Perhaps in response to this, this year, half of them personalised their reports.

Many consultations on remuneration disclosures have aimed to improve quality and reduce complexity. The FRC Financial Reporting Lab's June 2012 report 'A single figure for remuneration', which involved input from companies, investors and unions, typified this search for the holy grail of simplicity and accountability.

The BIS-requested report cautioned that a single figure would require 'coordination around the reporting requirements for remuneration between BIS and other regulators'. It called for education around the single figure to prevent misunderstanding and 'inappropriate conclusions being reached'. It also emphasised that the need to value long-term incentives complicates matters. These concerns aside, clarity around the total value of remuneration could start to exert downward pressure on the worst excesses.

*"Consideration should be given to the use of provisions that permit the company to reclaim variable components in exceptional circumstances of misstatement or misconduct."*

**(UK Corporate Governance Code, schedule A)**

The Code's new requirement for a clawback arrangement – to recover bonuses where it emerges they have not been properly earned – was introduced by the 2010 Code revisions and became effective for the first time this year. More than a third (38%) of companies now have clawback facilities – up from 21% last year. They are most common in financial services but are increasingly apparent in other sectors.

Companies showed they were not afraid to use clawbacks: Lloyds Banking Group (LBG) retrospectively reduced the 2010 bonuses of senior executives involved in mis-selling loan insurance and UBS clawed back awards paid to senior investment bankers to reflect a loss in its investment banking division in 2011. The CEOs of state-supported banks, RBS and LBG, found it was not only contractual clawbacks that could scupper promised bonuses. Both Stephen Hester and António Horta-Osório bowed to public pressure and declined hefty awards.

## Bonus limits

*"Upper limits should be set and disclosed"*

**(UK Corporate Governance Code, schedule A)**

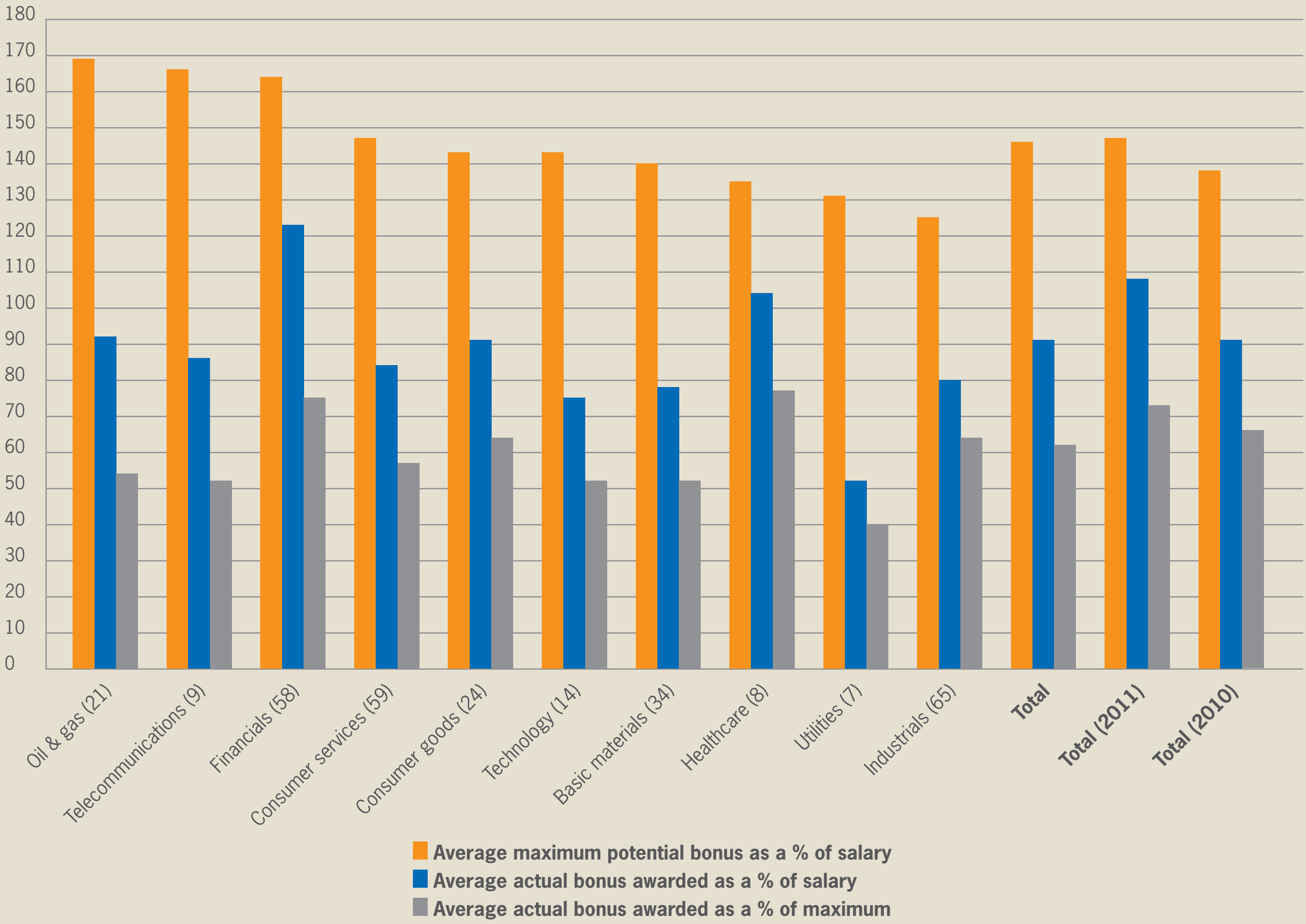
Upper limits for executive director annual bonuses, as required by the Code, were set by 92% of FTSE 350 companies (2011: 91%). Twenty-four companies did not impose limits.

The average maximum bonus remained broadly constant at 146% (2011: 147%) of basic salary. There were 94 companies (2011: 111) offering bonuses above 150% of basic salary. Of the 24 companies unwilling to set any upper limits, 11 are in the financials industry.

**Level of potential maximum bonus**

| Percentage of salary | 2012 |
|---|---|
| Between 25 – 50% | 6 |
| Between 51 – 100% | 75 |
| Between 101 – 150% | 98 |
| Between 151 – 200% | 63 |
| Over 200% | 30 |
| No limit | 24 |
| **TOTAL** | **296** |

**BONUS DETAILS BY INDUSTRY**



**Fast Facts**

ON REWARD:

- 42% of companies pay executive bonuses in cash and shares
- 21% pay bonuses in cash only, 2% in shares alone
- 35% of companies did not provide any information on how bonuses are paid (2011: 16%)
- 50% of chairs made personal statements
- 38% of companies have bonus clawback mechanisms
- Long-term incentive schemes are provided for executive directors in almost all (95%) companies

On average, companies awarded actual bonuses at 91% of basic salary (2011: 108%), representing 62% (2011: 73%) of the potential maximum bonus available. This probably reflects a combination of pay restraint and the difficult trading environment.

The financials industry continued to award the highest level of bonuses as a percentage of salary (123% representing 75% of maximum potential), despite some well-publicised hesitancy at state-controlled banks.

The Kay Review recommended that long-term performance incentives be provided in shares, to be held at least until an individual's retirement from the business. This is much more restrictive than the Code which states only that schemes should not be exercisable in less than five years, although directors are encouraged to hold shares for a further period after vesting. It remains to be seen if these recommendations will be embraced as the need for directors to leave a business before accessing earned funds may be considered too restrictive.

### Procedure

*"There should be a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual directors. No director should be involved in deciding his or her own remuneration."*

**(UK Corporate Governance Code, main principle D.2)**

The average remuneration committee met 4.6 times last year, more than any other board committee. This demonstrates the high profile of executive remuneration, the extensive disclosures in the annual report and the growing complexity of executive pay and long-term incentive schemes.

Thirty-two companies could not meet remuneration committee membership criteria. Of these, 10 either had their chairman acting as committee chair or had an insufficiently independent board chairman as a committee member. Twenty-two did not have enough independent non-executives.

*"The financials industry continued to award the highest level of bonuses as a percentage of salary, despite some well-publicised hesitancy at state-controlled banks."*

# Shareholder relations

**Companies seem to be taking their relationships with shareholders more seriously, with increasing numbers seeking engagement on matters of governance and providing useful disclosures on interaction.**

*"There should be a dialogue with shareholders based on the mutual understanding of objectives. The board as a whole has responsibility for ensuring that a satisfactory dialogue with shareholders takes place."*
**(UK Corporate Governance Code, main principle E.1)**

*"The chairman should discuss governance and strategy with major shareholders."*
**(UK Corporate Governance Code, E1.1)**

The Kay Review recognised that: "The fragmented structure of shareholding and the widely diversified structure of share portfolios have limited both the capacity and the incentive for asset managers to engage effectively with companies".

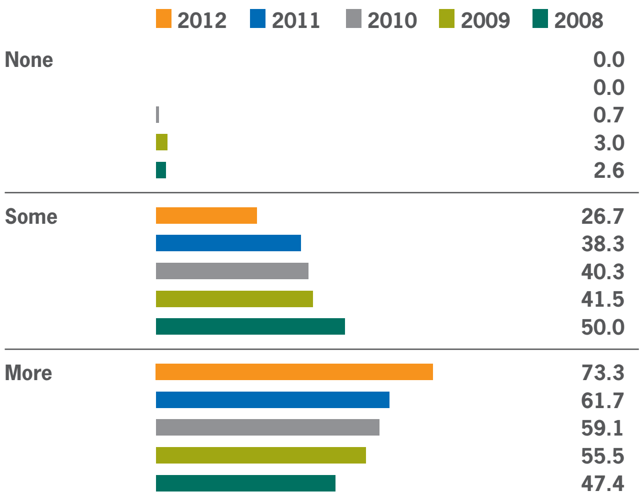
## Engagement disclosures

The success of the 'comply or explain' principle relies on the active engagement of shareholders. As the Cadbury Report pointed out: "The way in which institutional shareholders use their power to influence the standards of corporate governance is of fundamental importance".

There continues to be improvement in company disclosures around engagement. A growing desire for shareholder contact may be the spur for this improvement. Almost three quarters (73%, 2011: 62%) now describe how they actively seek discourse with investors. Not surprisingly this is much stronger among the FTSE 100 (88%), but the Mid 250 is also on an upward trend – 65% up from 53% in 2011. However encouraging these findings, the Investment Management Association recognised there are some fundamental barriers to effective engagement. The FRC review of the Stewardship Code's first year states: "Companies have as much responsibility as investors to make engagement work. Anecdotally some companies appear to be making more effort to engage, with more chairmen taking the initiative to meet major shareholders. Yet criticism has also been made of some companies that are perceived as being less responsive to shareholder concerns... The FRC considers such a reaction short sighted".

Some confusion prevails as to which board member has the shareholder engagement remit. The Code states that: "The chairman should discuss governance and strategy with major shareholders". Many companies state that their chairman is available to meet with shareholders but only 17% of companies state positively that they discuss both governance and strategy. Some argue that the chairman should be responsible for governance, leaving strategy to the CEO.

**FTSE 350 SHAREHOLDER ENGAGEMENT**




## Kay Review recommendations

The Stewardship Code should be developed to incorporate a more expansive form of stewardship, covering strategic issues as well as corporate governance.

An investors' forum should be established to facilitate collective engagement by investors in UK companies.

# Narrative reporting

**Narrative reporting quality is rising – with improved KPIs, risk disclosures and business model expositions – but, less positively, the length of annual reports continues to increase.**

## Financial and business reporting

*"The board should present a balanced and understandable assessment of the company's position and prospects."*
**(UK Corporate Governance Code, main principle C.1)**

*"The directors should include in the annual report an explanation of the basis on which the company generates or preserves value over the longer term (the business model) and the strategy for delivering the objectives of the company."*
**(UK Corporate Governance Code, C.1.2)**

Business model expositions have got better, with 39% (2011: 27%) of companies providing strong and clear descriptions. While there is no one best way to set out a business model, the best examples: make good use of diagrams and charts; are concise, covering no more than two pages in the report; and are linked to disclosures around strategy, risks and KPIs.

However, few provide the same clarity around strategy with barely one in five able to make an effective link to risks and KPIs. The work of the International Integrated Reporting Council (IIRC) in this area will hopefully lead to improvement.

Paul Druckman, International Integrated Reporting Committee CEO, said: "Connecting company strategy to KPIs, risks, and other data, is at the heart of integrated reporting. Data and information don't tell you anything in isolation: they are only useful in so far as they support and illustrate the strategic story".

## External viewpoint – building investor engagement

**Paul Druckman**, Chief Executive, International Integrated Reporting Committee

From Cadbury to Kay, governance commentators have urged investors to engage more with their companies: Paul Druckman believes integrated reporting (IR) could be the answer.

Mr Druckman, International Integrated Reporting Committee CEO, argues that by telling investors the 'whole story', rather than merely what compliance demands, IR can build greater understanding of investee companies and so engender responsible stewardship.

### The reality of business

"We need to express the reality of business – not just the compliance mind-set," he says. "Value isn't just about the financials, it's about the intangibles too. Not just social and environmental ones, but intellectual property, software rights, brands, client retention and people."

The challenge, of course, is getting investors and companies to subscribe to IR. There is already a bedrock of global interest in both camps: over 80 companies and a 28-strong investor network are participating in the IIRC's three-year pilot programme.

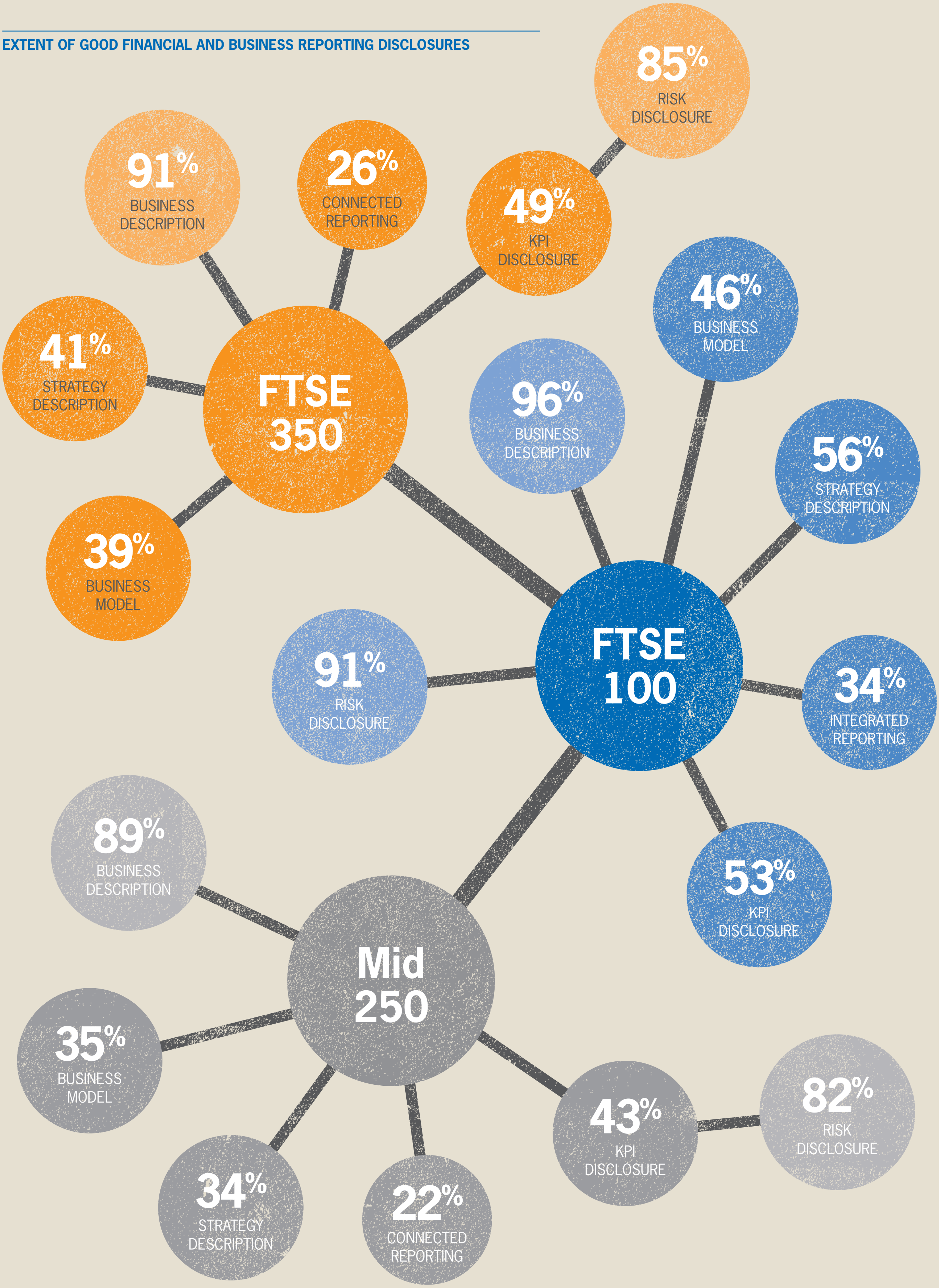
Mr Druckman admits the investor network consists of particularly "enlightened and far-sighted" investors. However, he believes that when the IR framework is launched in late 2013, its capacity to present holistic company value – over the short, medium and long term – rather than just reflecting the balance sheet will convince many on the sidelines.

### Joining together silos

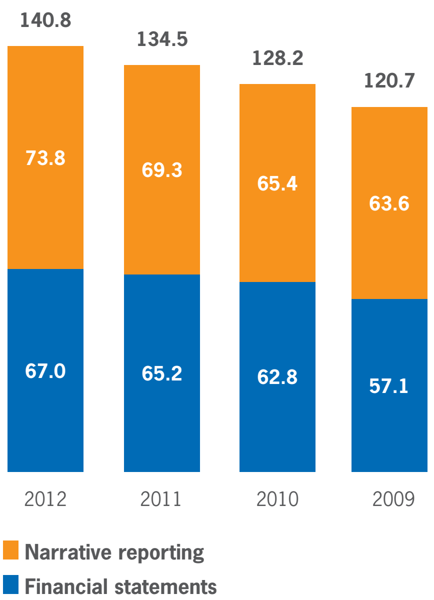
He believes that, as well as prompting investors to be better stewards, IR can also motivate companies to improve themselves. "IR helps join together the silos that exist in most companies. This enables businesses to better understand themselves and apply better corporate governance across their organisation."

Mr Druckman embraces recent UK governance initiatives, including the Kay Review, the Stewardship Code and the concept of strategy reports, as entirely complementary to IR. "IR is just bolder," he says. "Those initiatives focus on the financials. We go further."

EXTENT OF GOOD FINANCIAL AND BUSINESS REPORTING DISCLOSURES



**LENGTH OF ANNUAL REPORTS**




### Fast Facts

ON ANNUAL REPORT SIZE:

- The four longest annual reports, all above 400 pages, were in financial services
- Just two FTSE 100 companies kept their annual reports under 100 pages
- The average length of a FTSE 350 report is 141 pages (2011: 135.5). FTSE 100 179:173
- Annual reports have grown by 16.6% in three years

*"High quality, succinct narrative reporting should be strongly encouraged."*
**(Kay Review, recommendation 12)**

Last year we challenged companies to reduce their annual report size by 10%. The challenge remains but the goal seems ever more remote. Reports again grew by 4% with the average length now exceeding 140 pages. In the past three years reports have expanded by 20 pages, growing across both the front-end narrative and the audited financial statements. It is difficult to see how these figures square with Kay's recommendation for "high quality, succinct narrative reporting".

BIS recently issued its proposals on narrative reporting. These suggest a strategic overview of headline information that all shareholders are likely to find interesting. This may include the company business model, strategy and objectives, principal risks, KPIs and an overview of governance and remuneration. A proposal for an annual director's statement on company websites was not progressed.

*"In the past three years reports have expanded by around 20 pages, growing across both the front-end narrative and the audited financial statements."*

## Principal risks

*"The business review must contain… a description of the principal risks and uncertainties facing the company."*
**(Companies Act 2006, Section 417; 3b)**

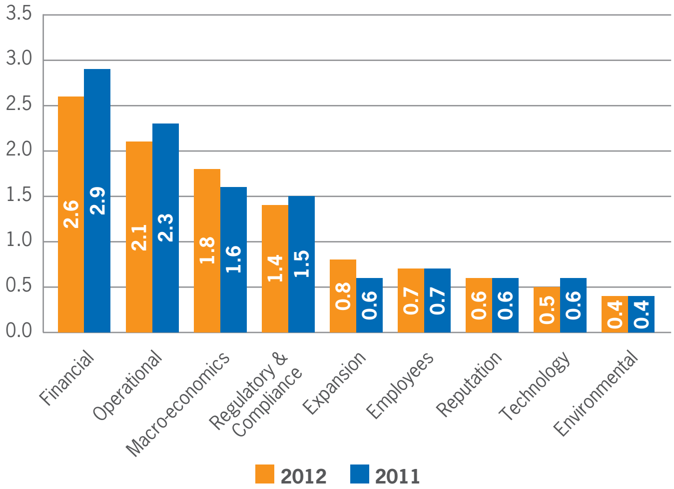
As more companies strengthen their risk disclosures, the benchmark for good risk reporting continues to rise. Detailed descriptions of principal risks and uncertainties are now provided by 85% (2011: 74%) of companies.

However, more than one in five (21%) companies gave risk disclosures that were virtually identical to the previous year. Investors, who focus on key risks, especially industry and business-specific ones, are unlikely to find such boilerplate valuable. Directors should perhaps ask themselves whether the risks they disclose are the ones they discuss around the boardroom table. And if not, why not?

FTSE 350 companies disclose on average 11.0 (2011: 11.3) risks with virtually all companies identifying principal financial (2.6), operational (2.1) and macro-economic (1.8) risks. Over the past year, companies have become noticeably more concerned around macro-economic risks to UK plc.

*"Directors should perhaps ask themselves whether the risks they disclose are the ones they discuss around the boardroom table. And if not, why not?"*

**Average number of principal risks identified**




While 15 companies believe they face more than 15 principal risks, including one that is troubled by 36, it is encouraging to see that the number of outliers is reducing.

## Key performance indicators

*The business review should include: "to the extent necessary for an understanding of the development, performance or position of the company's business, analysis using financial key performance indicators, and where appropriate, analysis using other key performance indicators".*

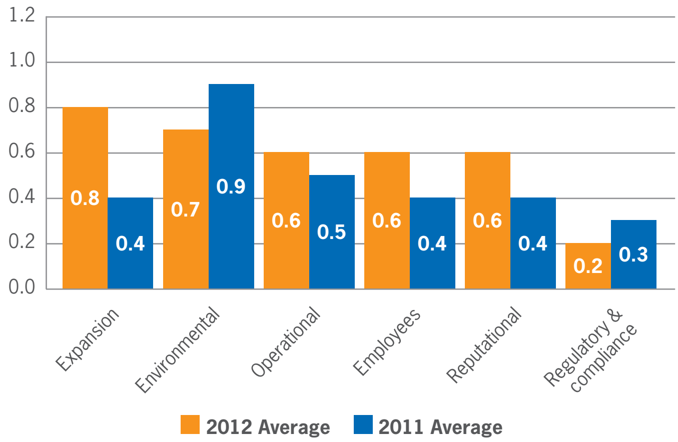
**(Companies Act 2006, Section 417, 6)**

The best company KPIs go beyond financial data – such as earnings before interest, tax, depreciation and amortisation (EBITDA) and return on capital employed (ROCE) – to embrace indicators that measure success against the business model. For example, retailers may measure brand awareness, customer footfall and sales per square foot while pharmaceuticals look at new patent numbers and service companies at employee satisfaction.

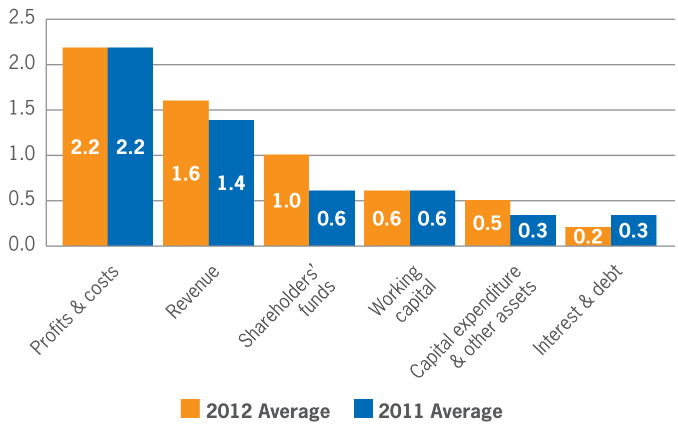
The average number of KPIs reported was 9.6 (6.1 financial and 3.4 non-financial). Encouragingly, there was evidence of a strong improvement in the quality of KPI disclosures, with nearly half of all FTSE companies, 49%, (2011: 38%) now providing detailed descriptions.

For this information to be of optimum value, FTSE-wide consistency of calculations and some form of 'independent' assurance would also be helpful in grounding the figures and providing comparability.

**Breakdown of non-financial KPIs by type. Average number in FTSE 350**




**Breakdown of financial KPIs by type. Average number in FTSE 350**



# Recent developments

| | Comments | Timing |
|---|---|---|
| **Governance of companies** | | |
| The UK Corporate Governance Code (September 2012) | • The 2012 Code revisions require:<br>– companies to disclose their policy on boardroom diversity and report progress against it annually<br>– the board to consider its diversity amongst other factors, when assessing its effectiveness<br>– the board to confirm that it considered the annual report and accounts, taken as a whole, to be fair and balanced<br>– audit committees to disclose more information about their activities;<br>– FTSE 350 companies to put the external audit contract out to tender at least every 10 years (FRC comments on transitional arrangements published on FRC website)<br>• The FRC paper "What Constitutes an Explanation under 'Comply or Explain'?" provided guidance on a number of features of a meaningful explanation. This has been included in the 2012 Code revisions<br>• The FRC published an annual report in December 2011 on the impact and implementation of the UK Corporate Governance and Stewardship Codes<br>• Future consultation on the Code to cover executive remuneration and changes to corporate reporting, following expected government legislation in these areas | • New edition of the Code published in September 2012, to be applied to financial years beginning on or after 1 October 2012<br>• The next annual monitoring report on the Code is scheduled to be published by the FRC in December 2012 |
| QCA Corporate Governance Guidelines for Smaller Quoted Companies (September 2010) | • Adapted from the UK Corporate Governance Code specifically for AIM and smaller quoted companies | • Currently effective |
| Corporate Governance Guidance and Principles for Unlisted Companies in the UK (November 2010) | • Issued by the Institute of Directors as a practical tool for the shareholders, directors and stakeholders of unlisted companies<br>• Adapted from pan-European guidance published by the European Confederation of Directors' Associations (ecoDa) in March 2010 | • Currently effective |
| Internal Control: Guidance to Directors (formerly known as the Turnbull Guidance) | • Sets out best practice on risk management and internal control for UK listed companies, and assists them in applying section C.2 of the UK Corporate Governance Code<br>• The FRC issued a paper on Boards and Risk in September 2011, which summarises the main issues to emerge from discussions with companies, investors and advisers. While this is not guidance, it may be helpful to other companies in thinking about their own approach to risk<br>• The FRC intends to begin consultation before the end of 2012 on whether the guidance needs to be further updated | • Currently effective<br>• Consultation document to be issued provisionally December 2012 |

| | | |
|---|---|---|
| FRC guidance on Audit Committees (September 2012) | • Guidance revised to support the 2012 changes to UK Corporate Governance Code and to give effect to the FRC's Effective Company Stewardship proposals<br>• Audit Committee to report to the Board on:<br>– the significant issues that it considered in relation to the financial statements and how these issues were addressed<br>– the basis for its advice that the annual report is fair, balanced and understandable and provides the information necessary for users to assess the company's performance, business model and strategy<br>– its assessment of the effectiveness of the external audit process and its recommendation on the appointment or reappointment of the external auditor, including the steps taken in deciding whether or not to recommend that the audit be put out to tender<br>• FRC co-authored a report 'Walk the Line' summarising discussions with the audit committee chairs of leading companies in the UK, Australian and other markets. The report provides insight into the role of the audit committee and its relationship with the board, management and the external auditor | • Revisions effective from 1 October 2012 |
| FRC Guidance on Board Effectiveness (March 2011) | • Relates primarily to Sections A and B of the Code on the leadership and effectiveness of the board<br>• Intended to stimulate board's thinking on how they can carry out their role most effectively<br>• Emphasises the role of the chairman in leading the board | • Currently effective |
| **Governance of Investors** | | |
| Stewardship Code for Institutional Investors (September 2012) | • The 2012 Stewardship Code revisions include:<br>– clarifying what is meant by stewardship, and the respective responsibilities of asset owners and asset managers<br>– asking investors to disclose their policy on stock lending, and whether they recall lent stock for voting purposes | • Revisions effective from 1 October 2012 |
| Kay review of equity markets and long-term decision making (July 2012) | • Report commissioned by BIS to review activity in UK equity markets and its impact on the long-term performance and governance of UK quoted companies<br>• Concludes that short-termism is a problem in UK equity markets, and that the principal causes are the decline of trust and the misalignment of incentives throughout the equity investment chain<br>• Report sets out a series of 10 Principles and 17 Recommendations which were broadly endorsed by the government in their November 2012 response<br>• The Government is promoting Professor Kay's 'good practice statements' for company directors, asset managers and asset holders, as the basis for industry-led standards of good practice | • Government response to recommendations published on 22 November 2012<br>• An update to be published by Summer 2014 setting out progress achieved |

| | | |
|---|---|---|
| **European Commission** | | |
| European Commission Green Paper on the EU corporate governance framework | • Considers the comply or explain principle and introduces concept of monitoring bodies<br>• Initial consultation in July 2011 posed 25 questions ranging from board governance practice to institutional engagement<br>• Action plan issued in December 2012 reaffirming the 'comply or explain' principle.<br>• 'Non-legislative' initiative expected in 2013 to improve the quality of corporate governance reports in particular the quality of explanations | • Action plan issued in December 2012<br>• Further detail to be provided in 2013 |
| European Commission Green Paper on audit policy | • Considers market concentration of auditors<br>• Audit quality and governance<br>• Audit mandate and communication | • Initial consultation ended December 2010 with summary of responses published in February 2011<br>• No imminent change expected |
| European Commission Green Paper on corporate governance in financial institutions | • Questions the future of the 'comply or explain' principle | • Initial consultation ended September 2010<br>• No imminent change expected |
| **Gender diversity** | | |
| The Davies Report on Women on Boards (February 2011) | • Recommends that FTSE 350 chairmen announce the percentage of women they aim to have on boards in 2013 and 2015<br>• FTSE 100 boards should aim for a minimum of 25% female representation by 2015 | • FTSE 350 companies to publish 2013 and 2015 targets by September 2011<br>• Regular status reports published |
| **Executive remuneration** | | |
| Directors' Pay: Revised Remuneration Reporting Regulations | • These regulations are intended to replace existing legislation and specify that the directors' remuneration report is to contain two distinct parts:<br>– a policy report setting out all elements of a company's remuneration policy and key factors that were taking into account in setting the policy. This part of the report will only be required to be produced when there is a shareholder vote on the policy<br>– an annual report on how the policy was implemented in the past financial year, setting out actual payments to directors and details on the link between company performance and pay | • Consultation closed September 2012 and government response expected shortly |

| Narrative reporting | | |
|---|---|---|
| A new structure for Narrative Reporting in the UK | • The draft regulations will replace existing legislation on narrative reporting in the Companies Act 2006 and will require companies to produce a strategic report<br>• This will be similar to the business review, with quoted companies being required to report on their strategy, their business model, and the number of men and women on their board, in executive committees and in the organisation as a whole<br>• The draft regulations remove several reporting requirements to simplify reporting.<br>• Guidance on the strategic report to be developed by BIS and FRC, with a consultation on the style of draft guidance expected early next year<br>• Proposal for a separate Annual Director's Statement to be made available on-line not pursued at present | • New regulations to apply for financial years ending after October 2013<br>• Guidance expected in 2013 following FRC consultation |
| FRC Financial Reporting Lab | • The Financial Reporting Lab provides an environment where investors and companies can come together to develop pragmatic solutions to today's reporting needs<br>• The following reports have been published to date:<br>– a single figure for remuneration<br>– net debt reconciliations<br>– operating and investing cash flows<br>– debt terms and maturity tables | • Financial Reporting Laboratory launched in October 2011<br>• Agenda and priority of activities set by companies and investors |
| International Integrated Reporting Council (IIRC) | • Discussion Paper, Towards Integrated Reporting – Communicating Value in the 21st Century published in September 2011. Summary of responses published May 2012<br>• The IIRC's Pilot Programme, the innovation hub for this market-led initiative, includes:<br>– over 80 businesses from 22 countries and a variety of sectors in its Business Network<br>– over 25 investor organisations from 11 countries in its Investor Network<br>• The journey towards Integrated Reporting is presented in the Pilot Programme Year Book and through the IIRC's emerging examples database<br>• Prototype of the International Integrated Reporting Framework released in November 2012 | • Papers on value, business model, capitals, connectivity and materiality to be published in early 2013<br>• Consultation Draft to be released in April 2013 with a three month consultation period ending in July<br>• Version 1.0 of the International Integrated Reporting Framework to be published by the end of 2013 |

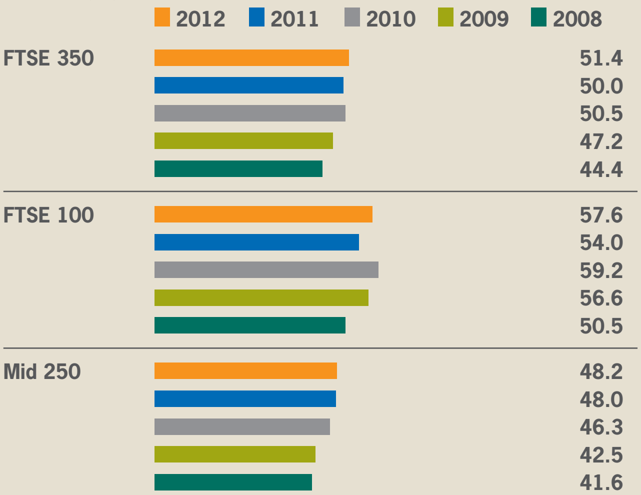
# Appendix

## Compliance with the code

**QUESTION 1.** DO THEY CLAIM FULL COMPLIANCE WITH THE CORPORATE GOVERNANCE CODE?

Guidance: "The following additional items must be included in its annual financial report: a statement as to whether the listed company has: (a) complied throughout the accounting period with all relevant provisions set out in the UK Corporate Governance Code; or (b) not complied throughout the accounting period with all relevant provisions set out in the UK Corporate Governance Code". (Listing Rule 9.8.6 (6))

**Figure 1 (%)**




COMPLIANCE BY INDUSTRY

**Figure 2**

| Industry (size) | Claim full compliance or provide "more" explanation % 2012 | 2011 | 2010 |
|---|---|---|---|
| Healthcare (8) | 100 | 100 | 100 |
| Telecommunications (8) | 100 | 100 | 100 |
| Technology (13) | 92 | 80 | 88 |
| Basic Materials (33) | 88 | 96 | 96 |
| Industrials (65) | 88 | 86 | 87 |
| Consumer Goods (24) | 88 | 85 | 82 |
| Utilities (8) | 88 | 100 | 100 |
| Financials (58) | 86 | 78 | 77 |
| Oil & Gas (21) | 86 | 89 | 95 |
| Consumer Services (58) | 79 | 79 | 88 |
| **TOTAL (296)** | **87** | **84** | **87** |

**QUESTION 2.** OF THE 144 COMPANIES WHO DO NOT CLAIM FULL COMPLIANCE WITH THE CODE, 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 financial report a statement setting out the company's reasons for non-compliance". (Listing Rule 9.8.6(6)(b) (iii))

**Figure 3 (%)**

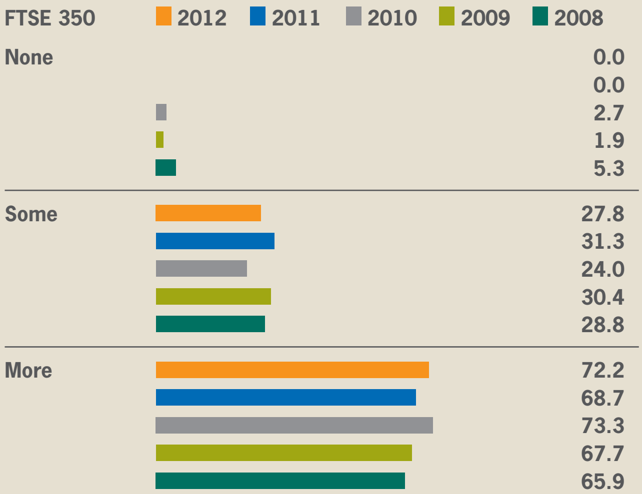



**Figure 4 (%)**

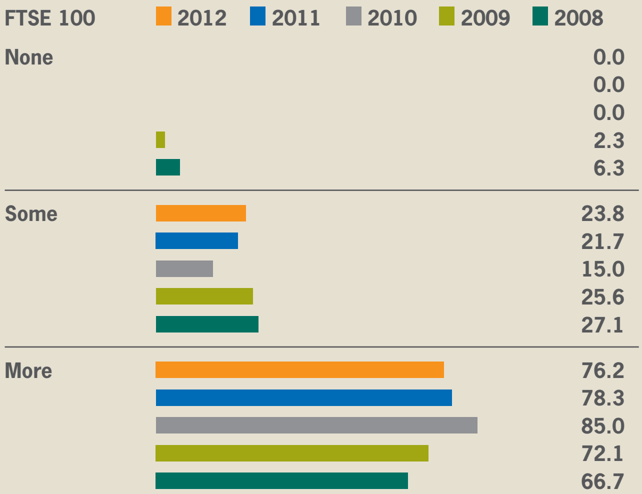
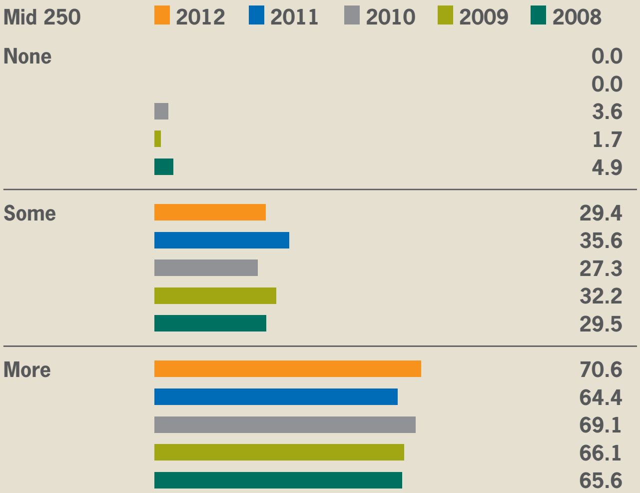


Figure 5 (%)

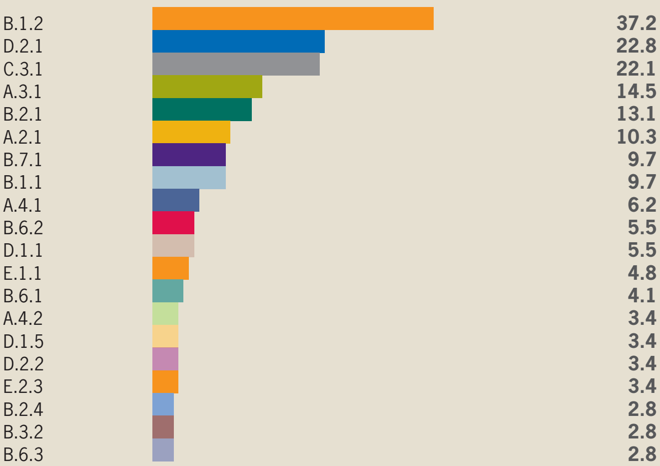



'More' disclosure is achieved where a company provides a detailed explanation to support each area of the Code with which they choose not to comply. This includes the reasons for their non-compliance, an explanation as to why they feel that this non-compliance is in the best interests of the company and the shareholders, a description of mitigating actions taken and, where appropriate, when the company intends to comply with the provision.

Those companies providing 'more' disclosure often laid out this information in a tabular format, providing an easy to digest set of explanations for shareholders, who may be unfamiliar with the Code's provisions.

**QUESTION 3.** OF THE 144 COMPANIES WHO DO NOT CLAIM FULL COMPLIANCE WITH THE CODE WHICH PROVISIONS DO THEY MOST COMMONLY CHOOSE NOT TO COMPLY WITH?

Figure 6 (%)




## Code provisions

| | | |
|---|---|---|
| B.1.2 | 37.2% | At least half the board, excluding the chairman, should comprise non-executive directors determined by the board to be independent. |
| D.2.1 | 22.8% | The board should establish a remuneration committee of at least three independent non-executive directors.<br>The company chairman may also be a member of, but not chair, the committee if he or she was considered independent on appointment as chairman. |
| C.3.1 | 22.1% | The board should establish an audit committee of at least three independent non-executive directors.<br>The board should satisfy itself that at least one member of the audit committee has recent and relevant financial experience. |
| A.3.1 | 14.5% | The chairman should on appointment meet the independence criteria set out in B.1.1. |
| B.2.1 | 13.1% | There should be a nomination committee. A majority of members should be independent non-executive directors. |
| A.2.1 | 10.3% | The roles of chairman and chief executive should not be exercised by the same individual.<br>The division of responsibilities between the chairman and chief executive should be clearly established, set out in writing and agreed by the board. |
| B.1.1 | 9.7% | The board should identify in the annual report each non-executive director it considers to be independent. The board should state its reasons if it determines that a director is independent notwithstanding the existence of relationships or circumstances which may appear relevant to its determination. |
| B.7.1 | 9.7% | All directors of FTSE 350 companies should be subject to annual election by shareholders. |
| A.4.1 | 6.2% | The board should appoint one of the independent non-executive directors to be the senior independent director. |
| B.6.2 | 5.5% | Evaluation of the board of FTSE 350 companies should be externally facilitated at least every three years. |
| D.1.1 | 5.5% | In designing schemes of performance-related remuneration for executive directors, the remuneration committee should follow the provisions in Schedule A to this Code. |
| E.1.1 | 4.8% | The chairman should discuss governance and strategy with major shareholders.<br>Non-executive directors should be offered the opportunity to attend meetings with major shareholders and should expect to attend them if requested by major shareholders. |
| B.6.1 | 4.1% | The board should state in the annual report how performance evaluation of the board, its committees and its individual directors has been conducted. |
| A.4.2 | 3.4% | 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. |
| D.1.5 | 3.4% | Notice or contract periods should be set at one year or less. If it is necessary to offer longer notice or contract periods to new directors recruited from outside, such periods should reduce to one year or less after the initial period. |
| D.2.2 | 3.4% | Remuneration committee should have delegated responsibility for setting remuneration for all executive directors and the chairman, including pension rights and any compensation payments.<br>The committee should also recommend and monitor the level and structure of remuneration for senior management. |
| E.2.3 | 3.4% | The chairman should arrange for the chairmen of the audit, remuneration and nomination committees to be available to answer questions at the AGM and for all directors to attend. |
| B.2.4 | 2.8% | 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. |
| B.3.2 | 2.8% | The terms and conditions of appointment of non-executive directors should be made available for inspection. |
| B.6.3 | 2.8% | The non-executive directors, led by the senior independent director, should be responsible for performance evaluation of the chairman. |

# Leadership

## The role of the board

### QUESTION 4. TO WHAT EXTENT ARE THE FEATURES OF GOVERNANCE DISCUSSED IN THE CHAIRMAN'S STATEMENT?

Guidance: "Chairmen are encouraged to report personally in their annual statements how the principles relating to the role and effectiveness of the board (in Sections A and B of the new Code) have been applied".
(UK Corporate Governance Code, Preface, paragraph 7)

**Figure 7 (%)**

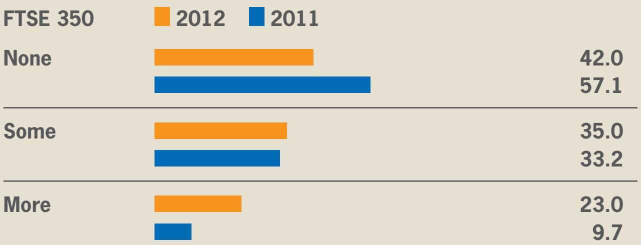



**Figure 8 (%)**

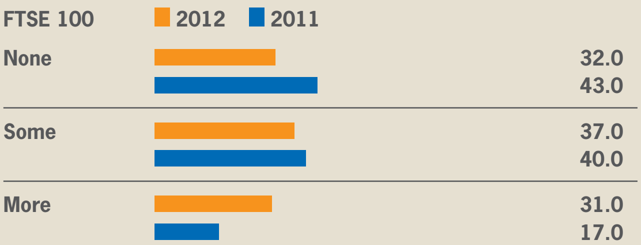
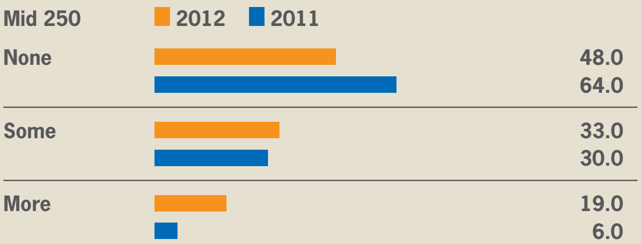



**Figure 9 (%)**

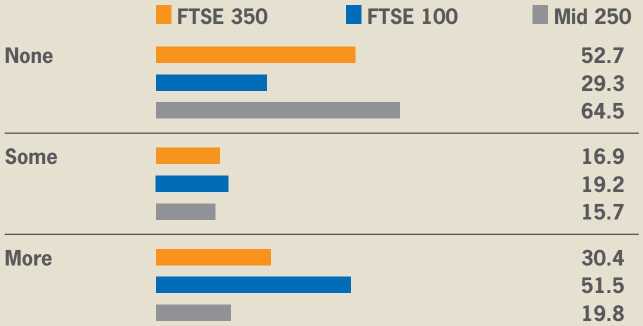



The most informative disclosures included detail of the following areas:

- company culture and the values they intend to instil in the business
- an overview of their governance framework
- the key governance objectives and focus of the board for the next year.

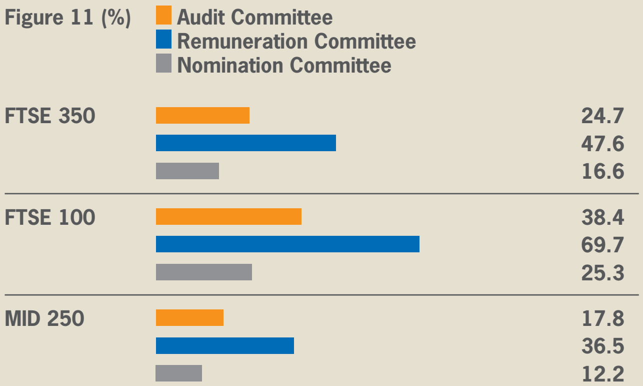
### QUESTION 4A. TO WHAT EXTENT DOES THE CHAIRMAN DESCRIBE KEY FEATURES OF GOVERNANCE IN THE GOVERNANCE REPORT?

**Figure 10 (%)**




### QUESTION 4B. IS THERE ANY PERSONAL COMMENTARY FROM THE CHAIRMAN OF THE AUDIT, NOMINATION AND REMUNERATION COMMITTEES?

**Figure 11 (%)**




### QUESTION 5. TO WHAT EXTENT DOES THE ANNUAL REPORT DESCRIBE HOW THE BOARD OPERATES AND ITS DUTIES ARE DISCHARGED EFFECTIVELY?

Guidance: "The board should meet sufficiently regularly to discharge its duties effectively. There should be a formal schedule of matters specifically reserved for its decision. 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".
(UK Corporate Governance Code, A.1.1)

**Figure 12 (%)**

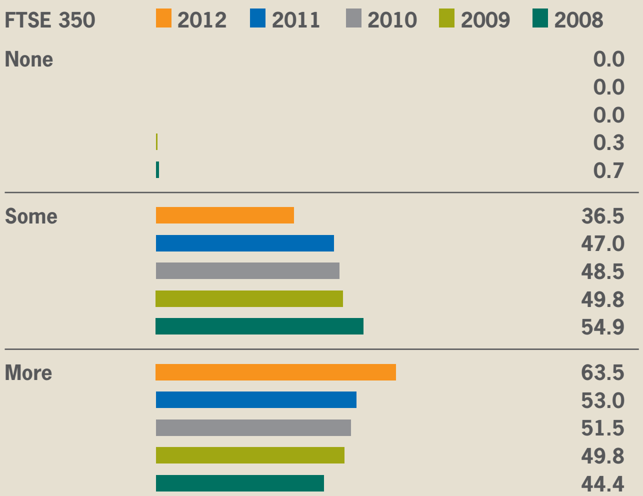


Figure 13 (%)

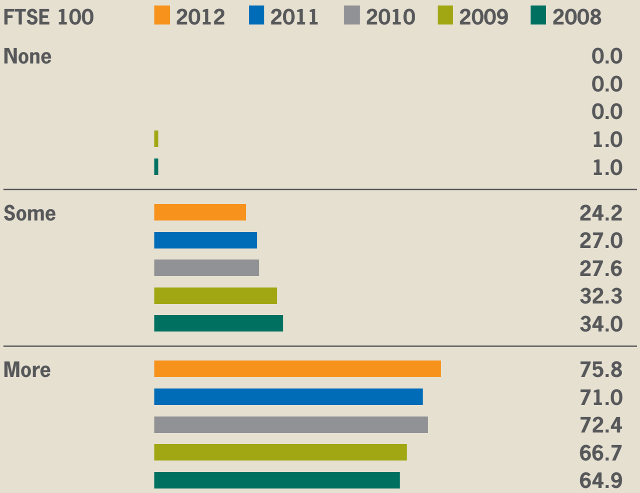
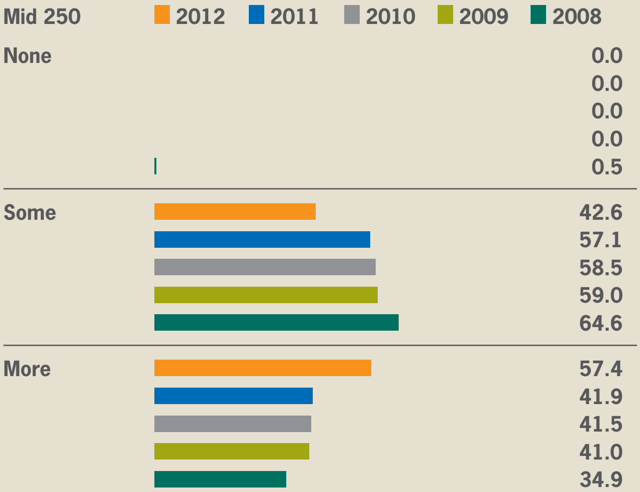



Figure 14 (%)



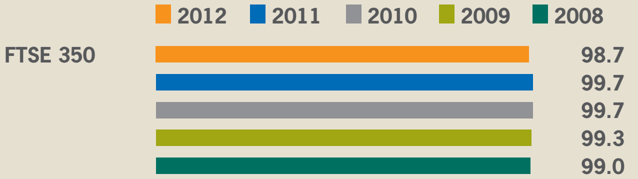

The best disclosures include details such as the following:

- the board's governance practices and linkage to ethical practices
- an established framework for management practice
- details of meetings of the board and committees, including focus and remit
- accountability (especially to investors)
- roles of chairman, chief executive, executives and NEDs
- key priorities to be discussed in the year ahead.

**QUESTION 6.** IS THE NUMBER OF MEETINGS OF THE BOARD AND OVERALL ATTENDANCE DISCLOSED?

Guidance: "The annual report … should also set out the number of meetings of the board and its committees and individual attendance by directors". (UK Corporate Governance Code, A.1.2)

Figure 15 (%)



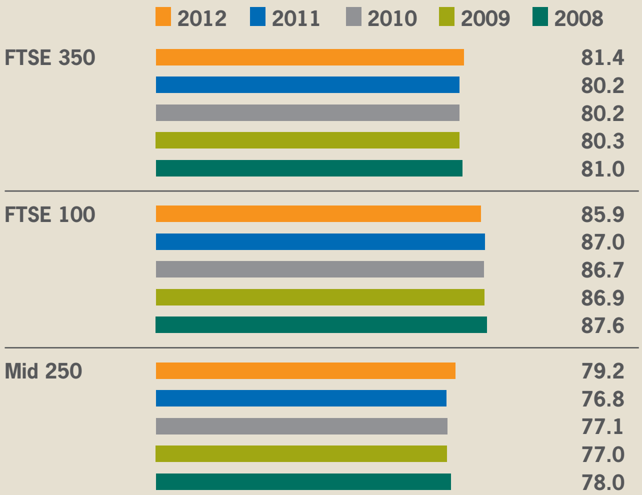

## The Chairman

**QUESTION 7.** 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 and on such other occasions as are deemed appropriate". (UK Corporate Governance Code, A.4.2)

"The non-executive directors, led by the senior independent director, should be responsible for performance evaluation of the chairman, taking into account the views of executive directors". (UK Corporate Governance Code, B.6.3)

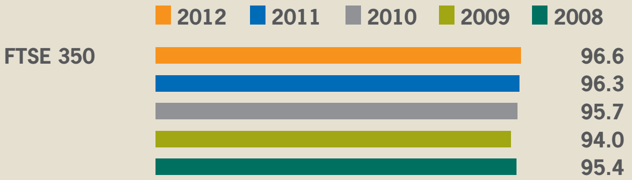
Figure 16 (%)



### QUESTION 8. ARE THE ROLES OF THE CHAIRMAN AND CHIEF EXECUTIVE SEPARATE?

Guidance: "The roles of chairman and chief executive should not be exercised by the same individual". (UK Corporate Governance Code, A.2.1)

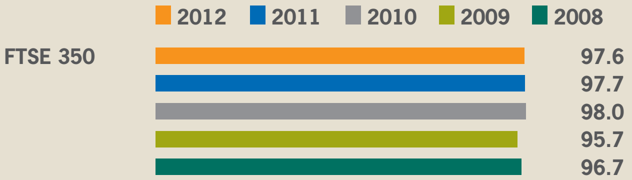
**Figure 17 (%)**




### QUESTION 9. 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". (UK Corporate Governance Code, A.1.2)

**Figure 18 (%)**



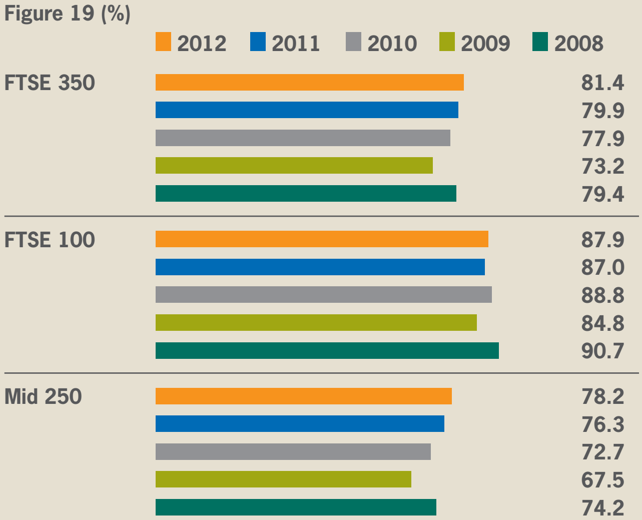

# Effectiveness

## Composition of the board

### QUESTION 10. IS AT LEAST HALF OF THE BOARD, EXCLUDING THE CHAIRMAN, COMPRISED OF INDEPENDENT NON-EXECUTIVE DIRECTORS DETERMINED BY THE BOARD TO BE INDEPENDENT?

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". (UK Corporate Governance Code, B.1.2)

**Figure 19 (%)**

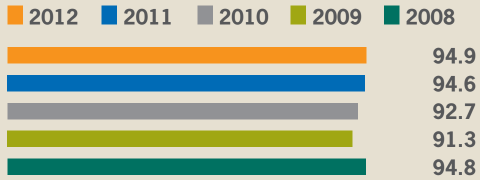



## Appointments to the board

### QUESTION 11. ARE THE NOMINATION COMMITTEE MEMBERSHIP REQUIREMENTS MET?

Guidance: "A majority of members of the nomination committee should be independent non-executive directors. The chairman or an independent director should chair the committee". (UK Corporate Governance Code, B.2.1)

**Figure 20 (%)**




### QUESTION 12. 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". (UK Corporate Governance Code, B.2.4)

**Figure 21 (%)**

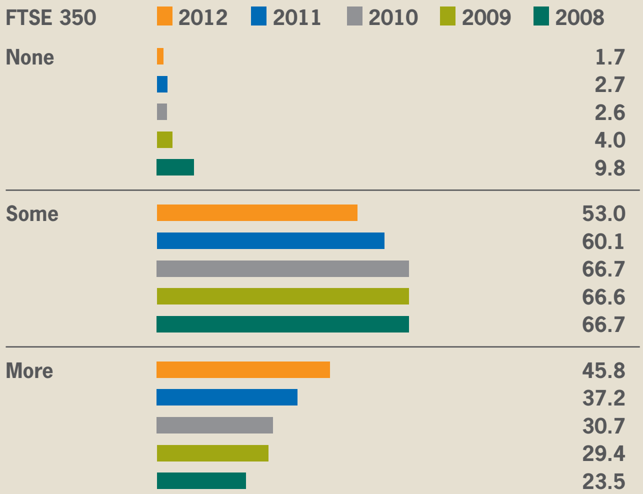


**Figure 22 (%)**

| FTSE 100 | 2012 | 2011 | 2010 | 2009 | 2008 |
|---|---|---|---|---|---|
| None | 0.0 | 0.0 | 0.0 | 1.0 | 8.2 |
| Some | 38.4 | 41.0 | 51.0 | 52.5 | 52.6 |
| More | 61.6 | 59.0 | 49.0 | 46.5 | 39.2 |

**Figure 23 (%)**

| Mid 250 | 2012 | 2011 | 2010 | 2009 | 2008 |
|---|---|---|---|---|---|
| None | 2.5 | 4.0 | 3.9 | 5.5 | 11.0 |
| Some | 60.4 | 69.7 | 74.1 | 73.0 | 73.2 |
| More | 37.1 | 26.3 | 22.0 | 21.5 | 15.8 |

Those companies providing 'more' disclosure gave details on:

- key topics discussed in year and priorities for next year
- succession planning
- search and interview processes and the use of external recruitment consultants
- the skills required for the board, including consideration of diversity
- consideration of re-appointment of directors.

## **QUESTION 13.** HOW MUCH EXPLANATION IS THERE OF THE COMPANY'S POLICY ON GENDER DIVERSITY IN THE BOARDROOM?

Guidance: "The search for board candidates should be conducted, and appointments made, on merit, against objective criteria and with due regard for the benefits of diversity on the board, including gender". (UK Corporate Governance Code, B.2)

**Figure 24 (%)**

| FTSE 350 | 2012 | 2011 |
|---|---|---|
| None | 21.6 | 72.1 |
| Some | 62.2 | 21.5 |
| More | 16.2 | 6.4 |

**Figure 25 (%)**

| FTSE 100 | 2012 | 2011 |
|---|---|---|
| None | 12.1 | 54.0 |
| Some | 60.6 | 33.0 |
| More | 27.3 | 13.0 |

**Figure 26 (%)**

| Mid 250 | 2012 | 2011 |
|---|---|---|
| None | 26.4 | 81.3 |
| Some | 62.9 | 15.7 |
| More | 10.7 | 3.0 |

The best companies stated a commitment to improve female representation at board level, setting out broad targets and reporting on progress against them.

## Evaluation

**QUESTION 14.** 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". (UK Corporate Governance Code, B.6.1)

**Figure 27 (%)**

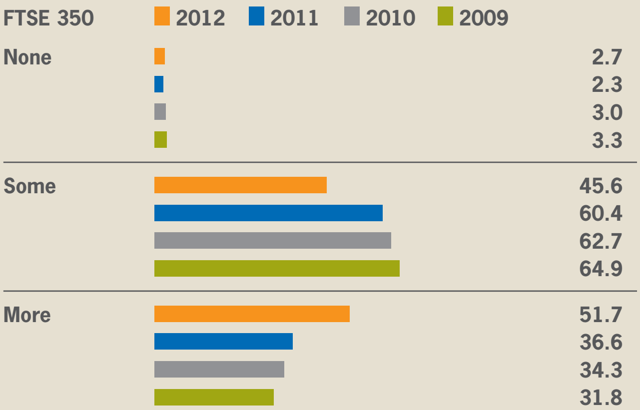



**Figure 28 (%)**

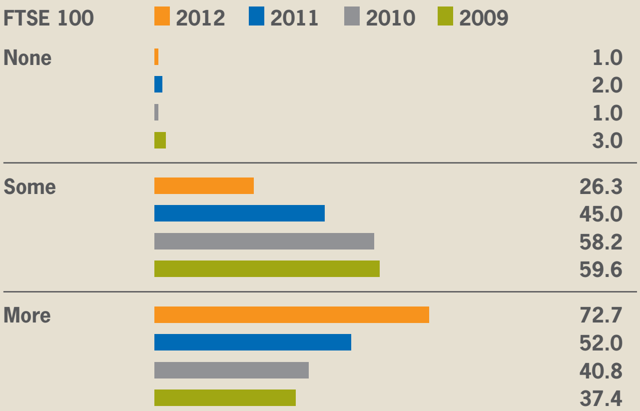
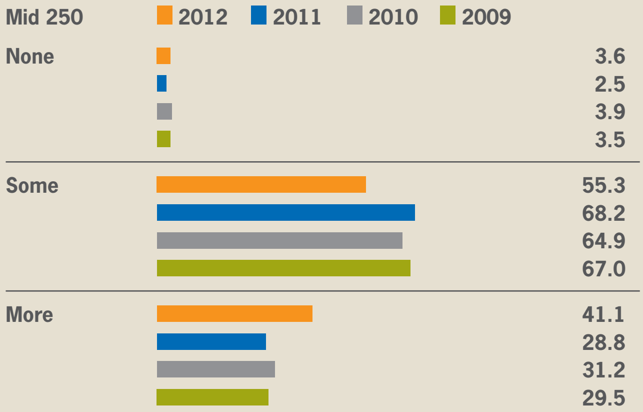



**Figure 29 (%)**



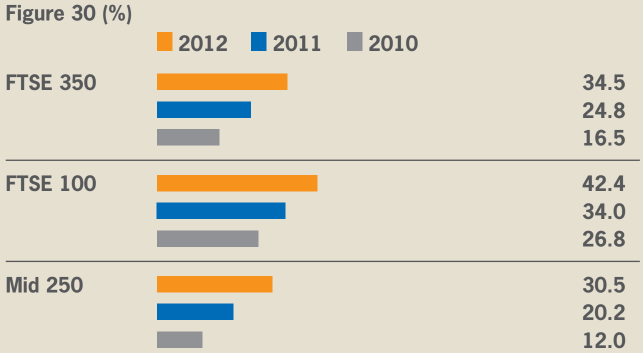

Strong disclosures may include the following details:

- a full description of the appraisal process, including the use of external facilitators
- key categories considered, including board and committee structure, board dynamics, the conduct and frequency of board meetings, the consideration of strategic issues by the board and information provided to directors
- evaluation criteria linked to overall strategy (as well as operational and financial performance)
- use of peer review between directors and management
- inclusion of major shareholder feedback as a measure of performance
- achievement of KPIs and specific reference to objectives set for the coming year
- outcomes of the evaluation and action plans.

**QUESTION 15.** WAS THERE AN EXTERNALLY FACILITATED BOARD EVALUATION IN THE YEAR?

Guidance: "Evaluation of the board of FTSE 350 companies should be externally facilitated at least every three years". (UK Corporate Governance Code, B.6.2)

**Figure 30 (%)**

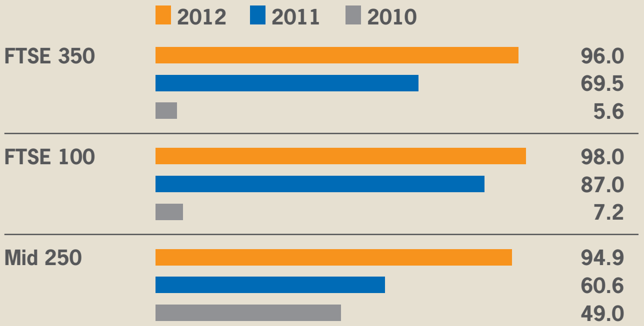


## Re-election

**QUESTION 16.** ARE ALL DIRECTORS SUBJECT TO RE-ELECTION ON AN ANNUAL BASIS?

Guidance: "All directors of FTSE 350 companies should be subject to annual election by shareholders". (UK Corporate Governance Code, B.7.1)

**Figure 31 (%)**

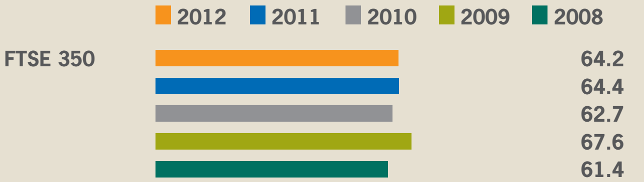



## Commitment, development, information and support

**QUESTION 17.** 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. The letter of appointment should set out the expected time commitment". (UK Corporate Governance Code, B.3.2)

**Figure 32 (%)**




## Committee membership and terms of reference

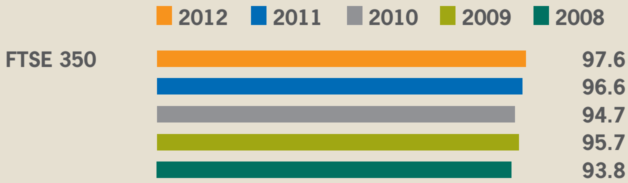
**QUESTION 18.** IS IT DISCLOSED THAT THE TERMS OF REFERENCE FOR THE AUDIT, REMUNERATION AND NOMINATION COMMITTEES ARE AVAILABLE FOR INSPECTION?

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". (UK Corporate Governance 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". (UK Corporate Governance Code, D.2.1)

"The nomination committee should make available its terms of reference, explaining its role and the authority delegated to it by the board". (UK Corporate Governance Code, B.2.1)

**Figure 33 (%)**




# Accountability

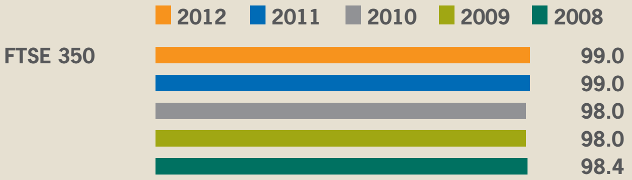
## Risk management and internal controls

**QUESTION 19.** 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". (Internal Control: Guidance to Directors*, paragraph 34)

*formerly known as the Turnbull Guidance

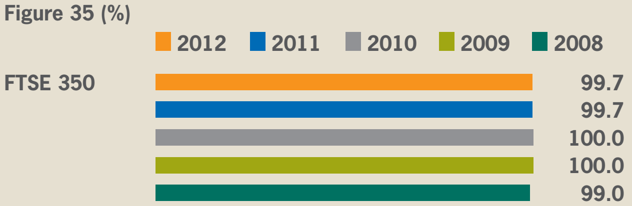
**Figure 34 (%)**




**QUESTION 20.** IS THERE A STATEMENT THAT A REVIEW OF THE EFFECTIVENESS OF THE GROUP'S INTERNAL CONTROLS HAS BEEN UNDERTAKEN IN THE YEAR?

Guidance: "The board should, at least annually, conduct a review of the effectiveness of the group's system of internal controls and should report to shareholders that they have done so". (UK Corporate Governance Code, C.2.1)

**Figure 35 (%)**




**QUESTION 21.** HOW MUCH INFORMATION IS PROVIDED ON 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". (Internal Control: Guidance to Directors, paragraph 36)

**Figure 36 (%)**

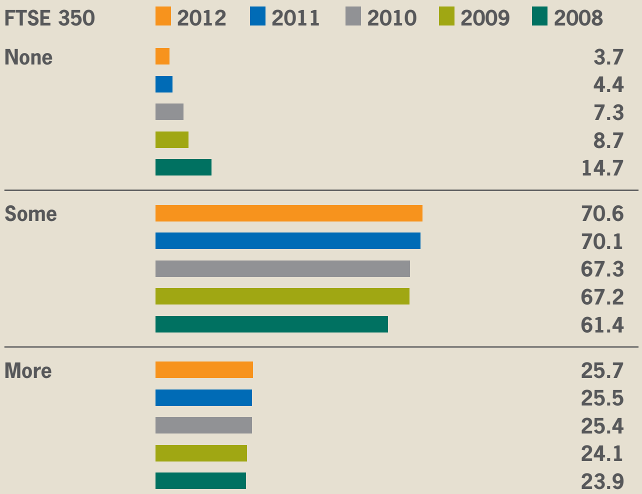



**Figure 37 (%)**

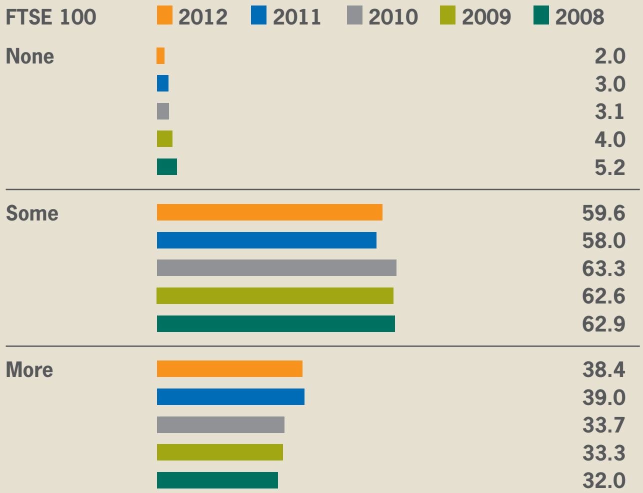
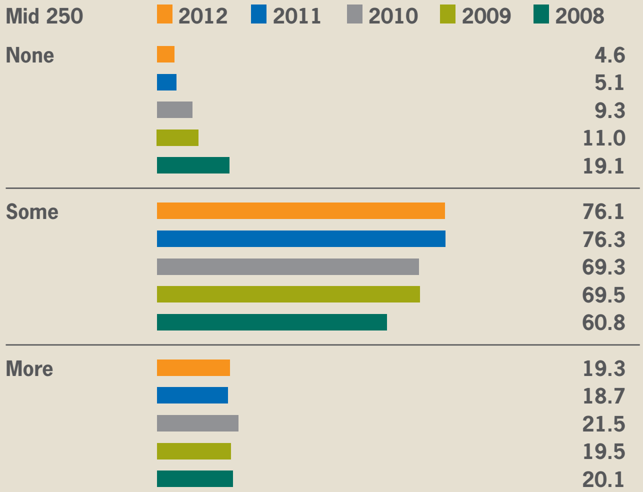



**Figure 38 (%)**




Most companies made reference to their application of the Turnbull guidance in this area, but the best companies went on to provide a description of how they applied this guidance to their own process. This could include:

- the areas of the system that have been reviewed and the rationale for their selection
- the method used for analysis (eg through analysis of reports from management, self-certification and/or internal audit)
- reviews of any internal guidance documents on internal control
- any specific areas which are given a more detailed review due to their importance to the sector/industry in which the company operates
- sources of assurance considered and/or reviewed.

## QUESTION 22. HOW MUCH INFORMATION IS THERE SURROUNDING THE COMPANY'S 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". (Internal Control: Guidance to Directors, paragraph 33)

**Figure 39 (%)**

| FTSE 350 | 2012 | 2011 | 2010 | 2009 | 2008 |
|---|---|---|---|---|---|
| None | 0.0 | 0.0 | 0.0 | 0.0 | 1.0 |
| Some | 34.5 | 25.8 | 22.4 | 24.4 | 25.5 |
| More | 65.5 | 74.2 | 77.6 | 75.6 | 73.5 |

**Figure 40 (%)**

| FTSE 100 | 2012 | 2011 | 2010 | 2009 | 2008 |
|---|---|---|---|---|---|
| None | 0.0 | 0.0 | 0.0 | 0.0 | 1.0 |
| Some | 22.2 | 13.0 | 10.2 | 12.1 | 11.3 |
| More | 77.8 | 87.0 | 89.8 | 87.9 | 87.6 |

**Figure 41 (%)**

| Mid 250 | 2012 | 2011 | 2010 | 2009 | 2008 |
|---|---|---|---|---|---|
| None | 0.0 | 0.0 | 0.0 | 0.0 | 1.0 |
| Some | 40.6 | 32.3 | 28.3 | 30.5 | 32.1 |
| More | 59.4 | 67.7 | 71.7 | 69.5 | 67.0 |

Best disclosures outlining the key elements of a company's internal control system discussed:

- the organisation structure and reporting lines
- procedures to ensure compliance with external regulations
- procedures to learn from control failures
- a range of corporate policies, procedures and training
- examples of reviews of control activities and response resolution
- active engagement of senior management in process.

### QUESTION 23. HOW MUCH INFORMATION IS THERE SURROUNDING THE COMPANY'S RISK MANAGEMENT PROCESS IN PARTICULAR?

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". (Internal Control: Guidance to Directors, paragraph 33)

**Figure 42 (%)**

| FTSE 350 | 2012 | 2011 |
|---|---|---|
| None | 0.7 | 0.0 |
| Some | 55.4 | 45.0 |
| More | 43.9 | 55.0 |

Best disclosures outlined the key elements of a company's risk management system including:

- the process by which risks are identified and prioritised
- how the effectiveness of risk responses are assessed
- responsibilities for risk management within the business
- the frequency and nature of risk reporting and key risk indicators
- the extent to which risk is embedded in strategic decision making
- how their risk appetite has been determined and communicated.

## Audit committee

### QUESTION 24. ARE THE AUDIT COMMITTEE MEMBERSHIP REQUIREMENTS MET?

Guidance: "The board should establish an audit committee of at least three, or in the case of smaller companies two, members, who should all be independent non-executive directors". (UK Corporate Governance Code, C.3.1)

**Figure 43 (%)**

| | 2012 | 2011 | 2010 | 2009 | 2008 |
|---|---|---|---|---|---|
| | 89.5 | 91.8 | 91.2 | 86.3 | 91.4 |

### QUESTION 25. DOES THE AUDIT COMMITTEE IDENTIFY 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". (UK Corporate Governance Code, C.3.1)

**Figure 44 (%)**

| | 2012 | 2011 | 2010 | 2009 | 2008 |
|---|---|---|---|---|---|
| FTSE 350 | 94.3 | 92.6 | 90.8 | 89.6 | 82.0 |

### QUESTION 26. IS THERE A SEPARATE SECTION OF THE ANNUAL REPORT WHICH DESCRIBES THE WORK OF THE AUDIT COMMITTEE?

Guidance: "A separate section of the annual report should describe the work of the committee in discharging those responsibilities". (UK Corporate Governance Code, C.3.3)

**Figure 45 (%)**

| | 2012 | 2011 | 2010 | 2009 | 2008 |
|---|---|---|---|---|---|
| FTSE 350 | 99.3 | 98.7 | 98.3 | 98.3 | 98.7 |

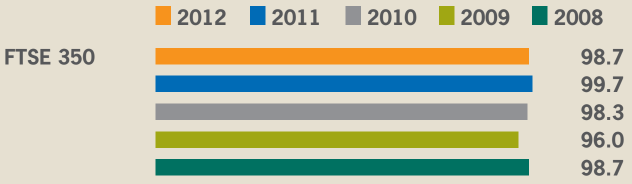
# Assurance

## External audit

**QUESTION 27.** IF THE AUDITOR PROVIDES NON-AUDIT SERVICES, IS THERE A DESCRIPTION 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". (UK Corporate Governance Code, C.3.7)

**Figure 46 (%)**




**QUESTION 28.** DOES THE COMPANY PROVIDE A BREAKDOWN OF AUDIT AND NON-AUDIT FEES?

Guidance: "[The annual report] should: … set out … the fees paid to the auditor for audit services, audit related services and other non-audit services; and if the auditor provides non-audit services, other than audit related services, explain for each significant engagement, or category of engagements, what the services are". (FRC Guidance on Audit Committees, 4.46)

**Figure 47**

| | Average non-audit fees as a percentage of audit fees % | | |
|---|---|---|---|
| **Industry (size)** | **2012** | **2011** | **2010** |
| Technology (13) | 104.9 | 49.3 | 70.3 |
| Utilities (8) | 86.3 | 74.0 | 140.2 |
| Consumer Services (58) | 80.2 | 87.3 | 75.0 |
| Consumer Goods (24) | 76.4 | 99.3 | 84.0 |
| Telecommunications (8) | 70.8 | 61.0 | 110.7 |
| Healthcare (8) | 70.1 | 97.9 | 66.7 |
| Basic Materials (33) | 68.3 | 117.6 | 34.9 |
| Oil & Gas (21) | 59.7 | 91.1 | 123.7 |
| Financials (58) | 56.9 | 73.4 | 83.6 |
| Industrials (65) | 56.2 | 57.6 | 53.3 |
| **Total (296)** | **68.0** | **79.5** | **74.7** |

*Audit fees include fees paid for audit related services

**QUESTION 29.** HOW MUCH INFORMATION DOES THE AUDIT COMMITTEE REPORT PROVIDE ON HOW IT REACHED ITS RECOMMENDATION TO THE BOARD ON THE APPOINTMENT, REAPPOINTMENT OR REMOVAL OF THE EXTERNAL AUDITORS?

Guidance: "The audit committee section of the annual report should explain to shareholders how it reached its recommendation to the board on the appointment, reappointment or removal of the external auditors. This explanation should normally include supporting information on tendering frequency, the tenure of the incumbent auditor and any contractual obligations that acted to restrict the committee's choice of external auditors". (FRC Guidance on Audit Committees, 4.26)

"A separate section of the annual report should describe the work of the committee in discharging its responsibilities. This report should include … an explanation of how it has assessed the effectiveness of the external audit process and the approach taken to the appointment or the reappointment of the external auditor, and information on the length of tenure of the current audit firm and when a tender was last conducted". (UK Corporate Governance Code 2012, C.3.8)

**Figure 48 (%)**


The most informative disclosures included information on:

- dates of appointment and length of tenure
- tender frequency and processes, including date of last tender
- an assessment of the auditor's qualifications, expertise and resources
- any contractual obligations that acted to restrict the audit committee's choice of external auditors
- the non-audit fee policy
- explanation of the type, scope and reason for non-audit services to the auditor.

## Internal audit

**QUESTION 30.** DOES THE COMPANY HAVE AN INTERNAL AUDIT FUNCTION OR EQUIVALENT?

Guidance: "The audit committee … should monitor and review the effectiveness of the internal audit activities". (UK Corporate Governance Code, C.3.2)

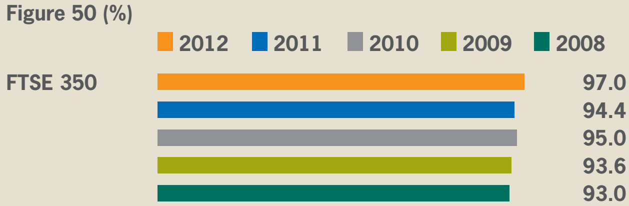
**Figure 49**

| FTSE rank | Do they have an internal audit function or equivalent? |
|---|---|
| 1–100 | 100% |
| 101–200 | 86% |
| 201–350 | 81% |
| **1–350** | **89%** |

**QUESTION 31.** OF THE COMPANIES WHICH DO NOT HAVE AN 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 …" (UK Corporate Governance Code, C.3.5)

**Figure 50 (%)**




# Remuneration Committee

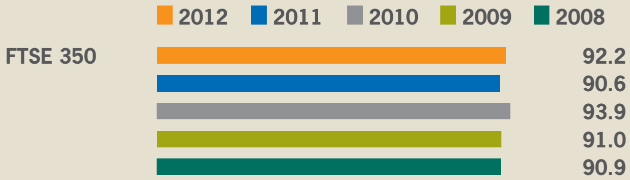
## Levels and components of remuneration

**QUESTION 32.** DOES THE COMPANY SET AND DISCLOSE THE MAXIMUM CASH BONUS AVAILABLE TO EXECUTIVE DIRECTORS AS A PERCENTAGE OF BASE SALARY?

Guidance: "The performance-related elements of executive directors' remuneration should be stretching and designed to promote the long-term success of the company". (UK Corporate Governance Code, Supporting Principle D.1)

"Upper limits should be set and disclosed". (UK Corporate Governance Code, Schedule A)

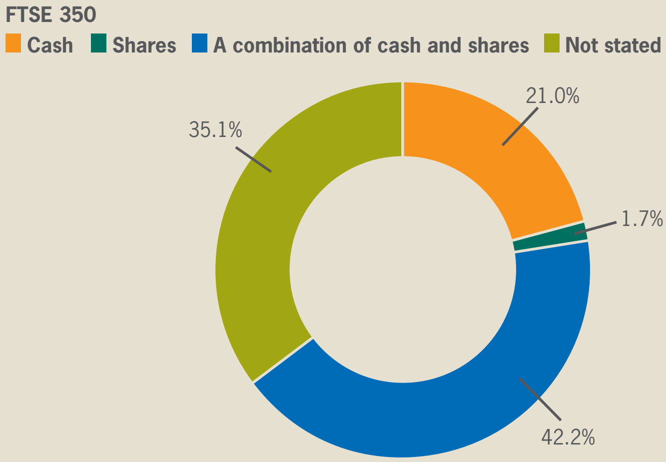
**Figure 51 (%)**




**QUESTION 33.** HOW ARE ANNUAL EXECUTIVE BONUSES PAID?

Guidance: "The remuneration committee should consider whether the directors should be eligible for annual bonuses. If so, performance conditions should be relevant, stretching and designed to promote the long-term success of the company. Upper limits should be set and disclosed. There may be a case for part payment in shares to be held for a significant period". (UK Corporate Governance Code, Schedule A)

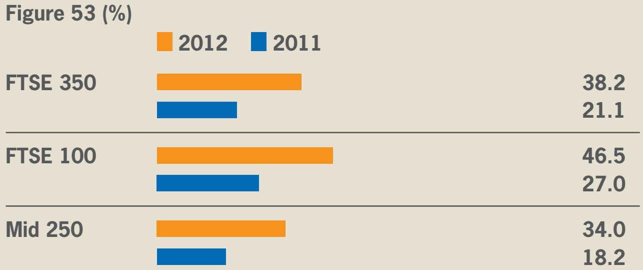
**Figure 52 (%)**




**QUESTION 34.** IS THERE ANY POTENTIAL CLAWBACK OF THE BONUS PAID?

Guidance: "Consideration should be given to the use of provisions that permit the company to reclaim variable components in exceptional circumstances of misstatement or misconduct". (UK Corporate Governance Code, Schedule A)

**Figure 53 (%)**

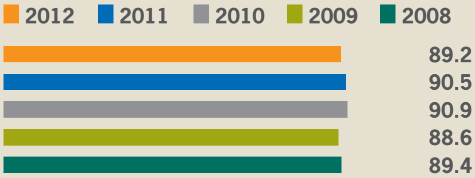


## Procedure

**QUESTION 35.** ARE THE REMUNERATION COMMITTEE MEMBERSHIP REQUIREMENTS MET?

Guidance: "The board should establish a remuneration committee of at least three members, or in the case of smaller companies two independent non-executive directors". (UK Corporate Governance Code, D.2.1)

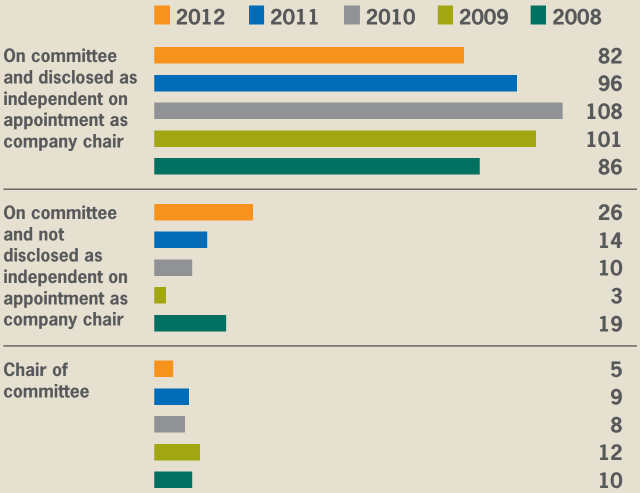
**Figure 54 (%)**




**QUESTION 36.** IF THE CHAIRMAN SITS ON THE REMUNERATION COMMITTEE, DOES HE/SHE CHAIR IT?

Guidance: "The company chairman may also be a member of, but not chair, the committee if he or she was considered independent on appointment as chairman". (UK Corporate Governance Code, D.2.1)

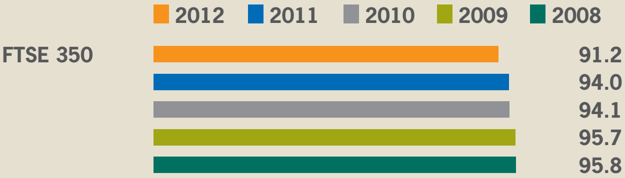
**Figure 55**

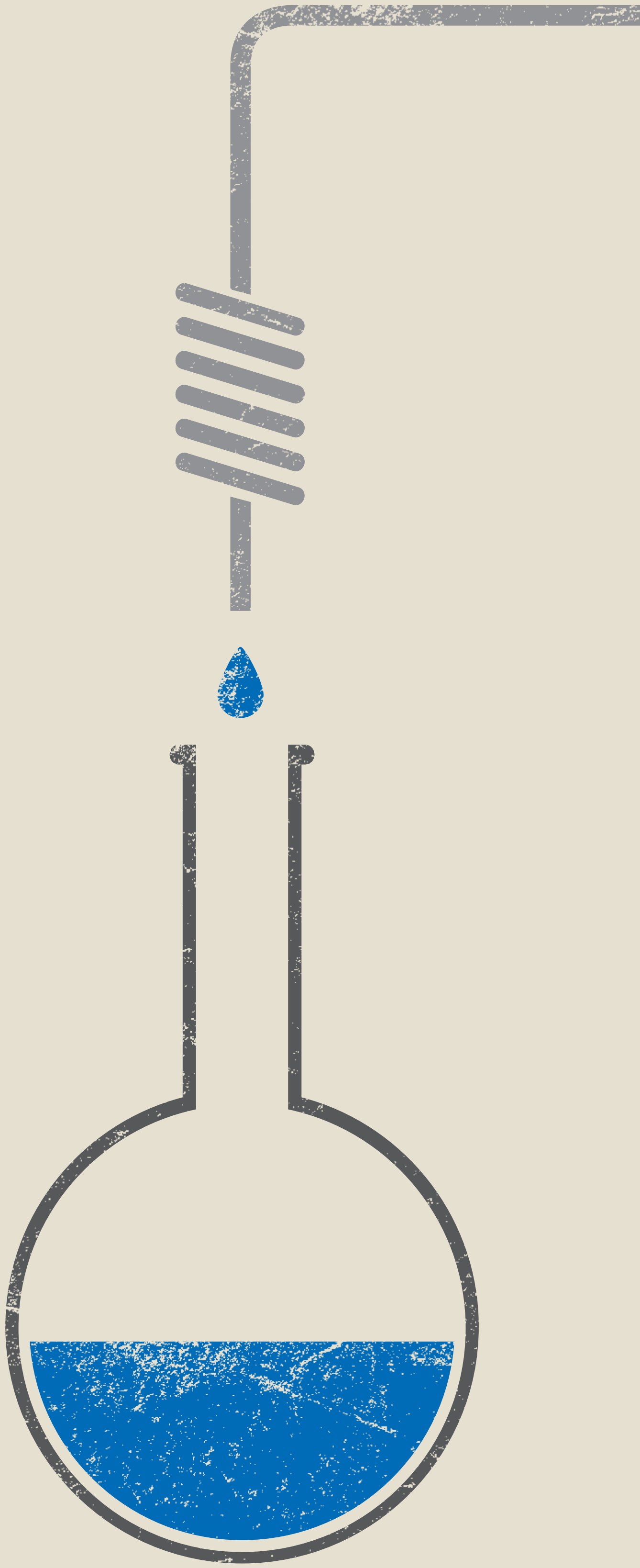



**QUESTION 37.** IS IT STATED THAT THE BOARD (OR SHAREHOLDERS WHERE REQUIRED) SET THE REMUNERATION FOR THE NON-EXECUTIVE DIRECTORS?

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

**Figure 56 (%)**



# Relations with shareholders

**QUESTION 38.** TO WHAT DEGREE 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 the company". (UK Corporate Governance Code, E.1.2)

Figure 57 (%)

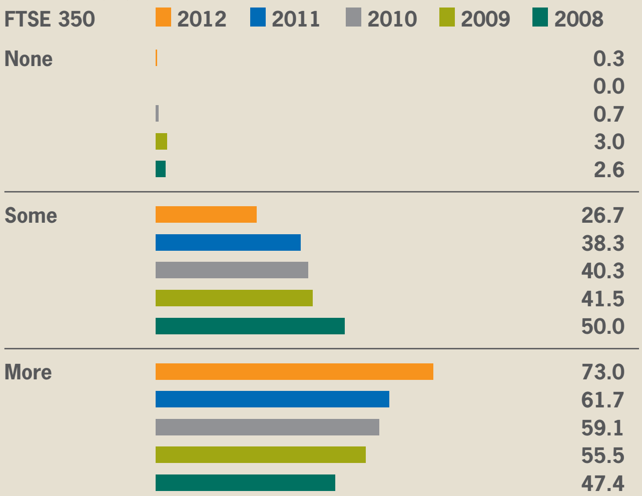



Figure 58 (%)

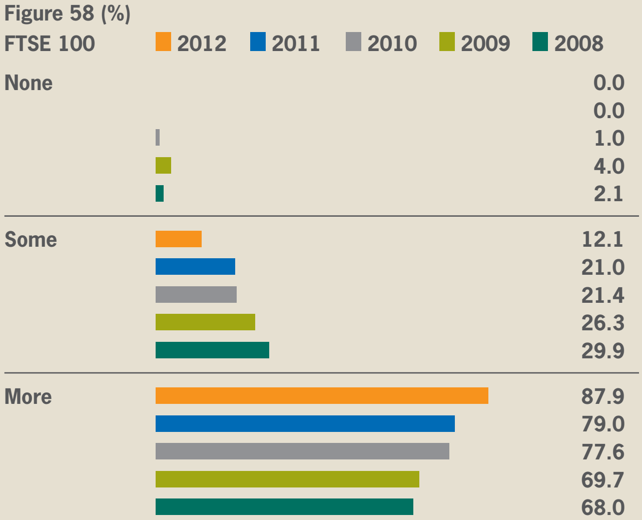
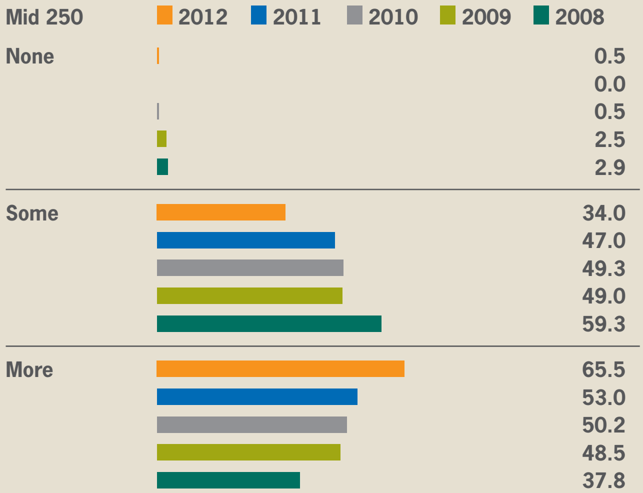



Figure 59 (%)




The most informative disclosures on dialogue with investors includes:

- availability of chairman, senior independent director and chairs of board committees (notably remuneration) to meet with major shareholders
- efforts to engage with private shareholders as well as institutional investors
- reference to an investor relations team and access to information on companys websites or dedicated investor portals
- use of the AGM to communicate with investors and to encourage their participation.

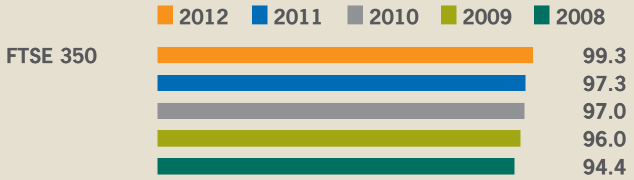
# Narrative reporting

## Financial and business reporting

**QUESTION 39.** HAS THE COMPANY PROVIDED A SEPARATE BUSINESS REVIEW IN THE DIRECTOR'S REPORT?

Guidance: "Unless the company is subject to the small companies' exemption, the directors' report must contain a business review". (Companies Act 2006 s417; 1)

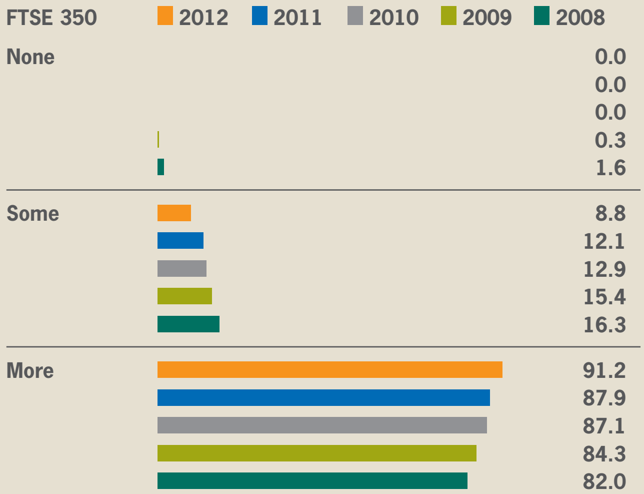
**Figure 60 (%)**




**QUESTION 40.** TO WHAT EXTENT DO COMPANIES DESCRIBE THEIR BUSINESS AND THE EXTERNAL ENVIRONMENT IN WHICH THEY OPERATE?

Guidance: "The review required is a balanced and comprehensive analysis of a) the development and performance of the company's business during the financial year, and b) the position of the company's business at the end of that year, consistent with the size and complexity of the business". (Companies Act 2006 s417; 4)

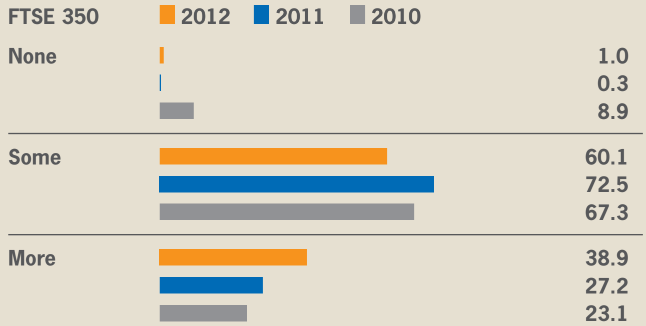
**Figure 61 (%)**




**QUESTION 41.** TO WHAT EXTENT DO COMPANIES DESCRIBE THEIR BUSINESS MODEL?

Guidance: "The directors should include in the annual report an explanation of the basis on which the company generates or preserves value over the longer term (the business model) and the strategy for delivering the objectives of the company". (UK Corporate Governance Code, C.1.2)

**Figure 62 (%)**




Business model disclosures are evolving and there is not one best practice approach. Good disclosures we have seen:

- make good use of diagrams and charts to provide clarity over not just what they do, but how they do it
- cover no more than two face to face pages in the annual report
- structure their narrative reporting around the business model.

## QUESTION 42. TO WHAT EXTENT DO COMPANIES DESCRIBE THE LIKELY FUTURE DEVELOPMENT OF THEIR BUSINESS?

Guidance: "The business review must… include the main trends and factors likely to affect the future development, performance and position of the company's business" (Companies Act 2006 s417; 5a)

**Figure 63 (%)**

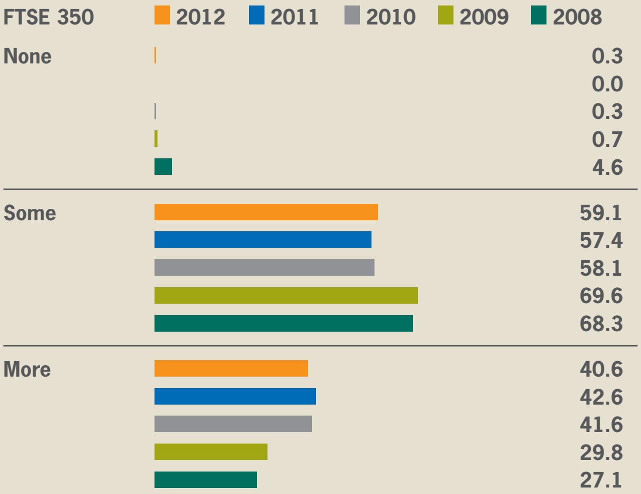



**Figure 64 (%)**

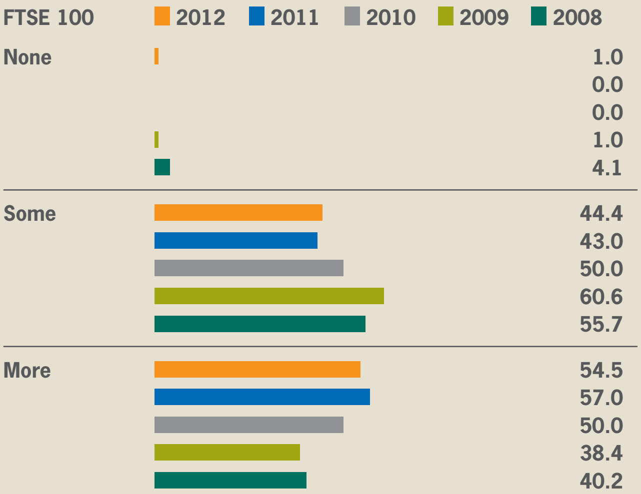
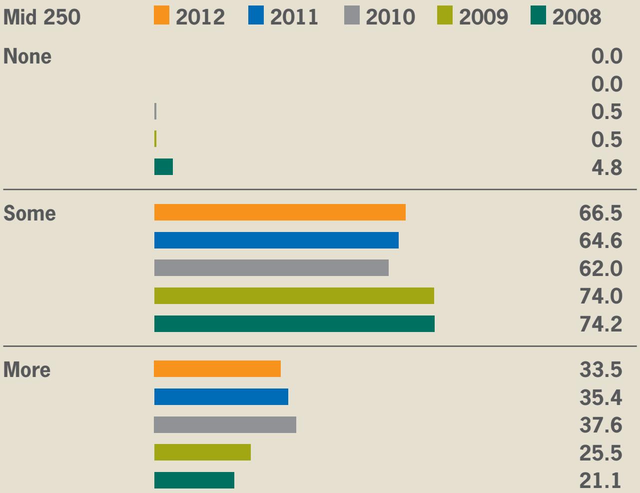



**Figure 65 (%)**



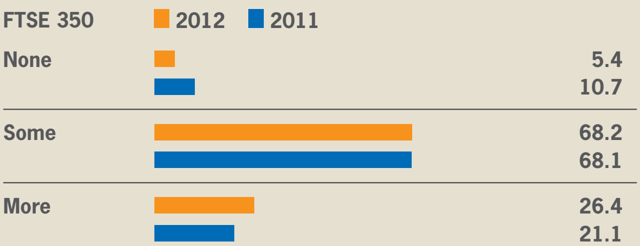

The best disclosures provide:

- a clear description of the company's objectives
- an explanation of strategies designed to achieve these objectives
- areas of business which the company expects to develop in the near future
- general discussion of more long term plans
- relevant information on trends and factors, both company specific and market-wide.

## QUESTION 43. TO WHAT EXTENT DOES THE COMPANY'S STRATEGY/ STRATEGIC OBJECTIVES LINK TO SPECIFIC RISKS, OPPORTUNITIES AND KPIS?

Guidance: "The FRC believes that, in future, narrative reports should focus primarily on strategic risks rather than operational risks and those risks that arise naturally and without action by the company; and disclose the risks inherent in their business model and their strategy for implementing that business model". (FRC Effective Company Stewardship: Next Steps, Summary of Action)

**Figure 66 (%)**



## Principal risks

**QUESTION 44.** TO WHAT EXTENT DO COMPANIES DESCRIBE THEIR PRINCIPAL RISKS AND UNCERTAINTIES?

Guidance: "The business review must contain … a description of the principal risks and uncertainties facing the company". (Companies Act 2006 s417; 3)

**Figure 67 (%)**

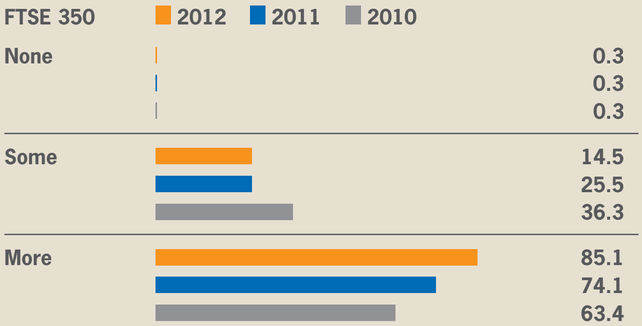



**Figure 68 (%)**

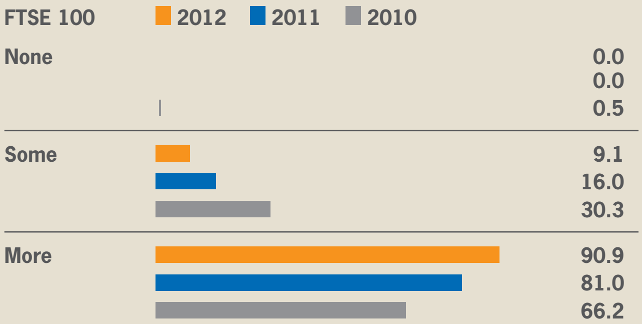
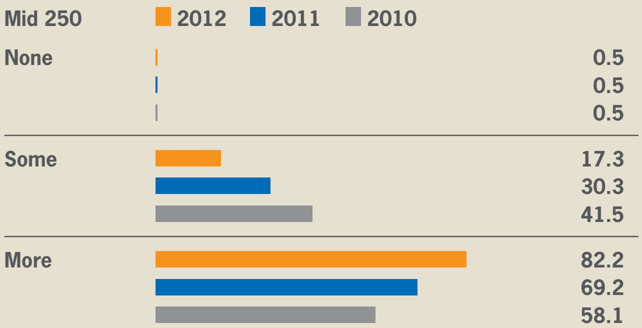



**Figure 69 (%)**




Companies giving more detailed descriptions provided:

- sufficient detail to understand the risk, and how it specifically relates to the business
- an indication of how company strategy is impacting the risk profile
- an analysis of the potential impact of the risk
- information on how each risk is being mitigated
- detail on how the risk is being monitored and measured through, for example, the use of key risk indicators.

**An analysis of the average number of risks disclosed by category by industry**

**Figure 70**

| | FTSE 350 | Healthcare (8) | Oil & Gas (21) | Basic Materials (33) | Consumer Services (58) | Industrials (65) | Utilities (8) | Consumer Goods (24) | Financials (58) | Telecommunications (8) | Technology (13) |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Financial | 2.6 | 3.6 | 3.7 | 2.4 | 2.3 | 2.2 | 2.6 | 2.5 | 3.8 | 0.6 | 1.5 |
| Operational | 2.1 | 2.1 | 3.1 | 2.9 | 2.1 | 1.9 | 2.6 | 2.0 | 1.8 | 2.5 | 1.7 |
| Macro-economic | 1.8 | 1.6 | 2.0 | 1.6 | 2.2 | 2.0 | 0.8 | 1.5 | 1.7 | 1.3 | 1.5 |
| Regulatory & compliance | 1.4 | 4.3 | 1.8 | 1.2 | 1.2 | 1.3 | 1.8 | 1.5 | 1.1 | 1.4 | 0.9 |
| Employees | 0.7 | 0.6 | 1.1 | 1.0 | 0.8 | 0.8 | 0.4 | 0.8 | 0.5 | 0.1 | 0.7 |
| Expansion | 0.8 | 2.0 | 0.8 | 1.0 | 0.8 | 0.9 | 0.6 | 0.6 | 0.4 | 0.4 | 0.8 |
| Reputation | 0.6 | 1.1 | 1.1 | 0.5 | 0.6 | 0.5 | 0.5 | 0.6 | 0.5 | 0.9 | 0.2 |
| Technology | 0.5 | 0.5 | 0.2 | 0.3 | 0.8 | 0.6 | 0.5 | 0.3 | 0.3 | 0.8 | 0.5 |
| Environmental | 0.4 | 0.6 | 1.1 | 0.9 | 0.3 | 0.5 | 0.8 | 0.3 | 0.1 | 0.1 | 0 |
| **Average total number of risks** | **11.0** | **16.5** | **14.9** | **11.7** | **11.0** | **10.7** | **10.5** | **10.1** | **10.0** | **8.0** | **7.8** |

## QUESTION 45. TO WHAT EXTENT DO COMPANIES DESCRIBE SPECIFIC KEY PERFORMANCE INDICATORS (KPIS) WHICH MEASURE THE PERFORMANCE OF THEIR BUSINESS?

Guidance: "The [business] review must, to the extent necessary for an understanding of the development, performance or position of the company's business, include (a) analysis using financial key performance indicators, and (b) where appropriate, analysis using other key performance indicators...

"Key performance indicators' means factors by reference to which the development, performance or position of the company's business can be measured effectively". (Companies Act 2006 s417; 6)

**Figure 71 (%)**

| FTSE 350 | 2012 | 2011 | 2010 |
|---|---|---|---|
| None | 2.7 | 3.4 | 4.3 |
| Some | 48.6 | 59.1 | 65.0 |
| More | 48.6 | 37.6 | 30.7 |

**Figure 72 (%)**

| FTSE 100 | 2012 | 2011 | 2010 |
|---|---|---|---|
| None | 0.0 | 0.0 | 2.0 |
| Some | 39.4 | 46.0 | 54.1 |
| More | 60.6 | 54.0 | 43.9 |

**Figure 73 (%)**

| Mid 250 | 2012 | 2011 | 2010 |
|---|---|---|---|
| None | 4.1 | 5.1 | 5.4 |
| Some | 53.3 | 65.7 | 70.2 |
| More | 42.6 | 29.3 | 24.4 |

The best disclosures:

- link KPIs to the company's objectives explaining why they have been selected and what they measure
- disclose quantifiable results that are compared to prior years
- explain how they are calculated and the source of data
- include future targets or expectations.

## Key performance indicators

**An analysis of the average number of KPIs disclosed by category by industry**

**Figure 74**

| | FTSE 350 | Utilities (8) | Consumer Goods (24) | Basic Materials (33) | Oil & Gas (21) | Consumer Services (58) | Industrials (65) | Technology (13) | Financials (58) | Telecommunications (8) | Healthcare (8) |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Profits and costs | 2.2 | 2.1 | 2.7 | 2.5 | 1.5 | 2.5 | 2.0 | 1.9 | 2.0 | 1.9 | 2.3 |
| Revenue | 1.6 | 0.6 | 2.1 | 0.6 | 0.8 | 2.5 | 1.9 | 1.8 | 1.1 | 1.1 | 1.9 |
| Shareholders' funds | 1.0 | 1.9 | 0.6 | 0.8 | 0.8 | 1.0 | 1.0 | 0.6 | 1.4 | 0.6 | 1.3 |
| Working capital | 0.6 | 0.4 | 0.8 | 0.6 | 1.0 | 0.3 | 0.8 | 0.7 | 0.5 | 0.5 | 0.5 |
| Capital expenditure and other assets | 0.5 | 1.3 | 0.3 | 0.6 | 0.3 | 0.2 | 0.3 | 0.2 | 1.0 | 0.1 | 0.0 |
| Interest and debt | 0.2 | 0.3 | 0.1 | 0.2 | 0.2 | 0.3 | 0.3 | 0.2 | 0.2 | 0.1 | 0.0 |
| **Average total number of financial KPIs** | **6.1** | **6.5** | **6.7** | **5.3** | **4.6** | **6.7** | **6.3** | **5.3** | **6.3** | **4.4** | **5.9** |

| | FTSE 350 | Utilities (8) | Consumer Goods (24) | Basic Materials (33) | Oil & Gas (21) | Consumer Services (58) | Industrials (65) | Technology (13) | Financials (58) | Telecommunications (8) | Healthcare (8) |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Environmental | 0.7 | 2.4 | 1.3 | 1.0 | 0.6 | 0.7 | 0.7 | 0.2 | 0.4 | 0.1 | 0.3 |
| Operational | 0.6 | 2.1 | 0.7 | 1.0 | 1.3 | 0.7 | 0.4 | 0.3 | 0.3 | 0.1 | 0.0 |
| Expansion | 0.8 | 0.5 | 0.9 | 0.4 | 0.6 | 1.6 | 0.7 | 1.4 | 0.5 | 0.4 | 1.4 |
| Employees | 0.6 | 1.0 | 0.4 | 0.7 | 0.7 | 0.5 | 0.9 | 0.5 | 0.3 | 0.4 | 0.5 |
| Regulatory & compliance | 0.2 | 0.6 | 0.7 | 0.2 | 0.5 | 0.3 | 0.1 | 0.2 | 0.0 | 0.0 | 0.4 |
| Reputation | 0.6 | 1.9 | 1.0 | 0.2 | 0.1 | 1.0 | 0.4 | 0.4 | 0.4 | 0.5 | 0.3 |
| **Average total number of non-financial KPIs** | **3.6** | **8.5** | **5.0** | **3.4** | **3.7** | **4.8** | **3.2** | **2.9** | **1.9** | **1.5** | **2.8** |
| **Total number of KPIs** | **9.6** | **15.0** | **11.6** | **8.7** | **8.3** | **11.5** | **9.5** | **8.2** | **8.2** | **5.9** | **8.6** |

# About Grant Thornton

## A global footprint

**Grant Thornton International**
- Fee income $4.2 billion
- $1.7 billion assurance
- Over 100 countries
- 490 locations
- Over 31,000 staff
- Over 2,600 partners
- Global strategy, global brand, global values

**Grant Thornton UK LLP**
- c. 4,000 staff
- 27 offices
- Over 200 partners
- Fee income £417m
- Full service practice with extensive specialist advisory services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Denmark
Dominican Republic
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Honduras
Hong Kong
Hungary
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Kenya
Korea
Kosovo
Kuwait
Latvia
Lebanon
Lithuania
Luxembourg
Macedonia
Malaysia
Malta
Mauritius
Mexico
Moldova
Morocco
Mozambique
Namibia
Netherlands
New Zealand
Nicaragua
Norway
Oman
Pakistan
Panama
Peru
Philippines
Poland
Portugal
Puerto Rico
Qatar
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South Africa
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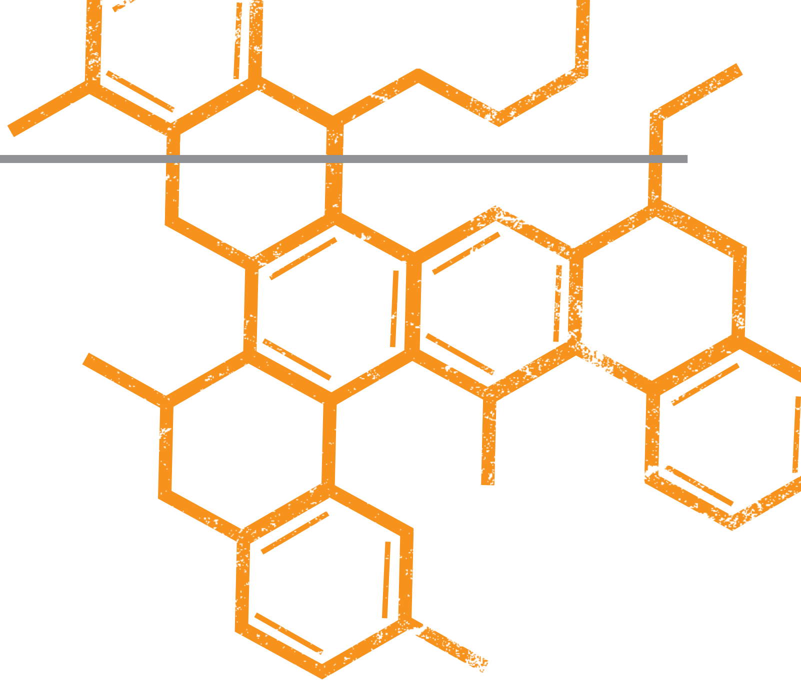
United States
Uruguay
Uzbekistan
Venezuela
Vietnam
Yemen
Zambia
Zimbabwe



## International service lines

### Assurance
- Group and statutory audit
- Financial reporting advisory
- Outsourced accounting and payroll
- Shared audit

### Tax
- Corporate tax
- International tax
- Transaction tax
- Personal tax
- Employer solutions
- Expatriate tax
- Indirect tax
- Tax investigation services
- Transfer pricing
- Wealth management and financial planning
- SFO assurance

### Advisory services
- Business risk services
- Corporate finance and transaction support
- Forensic and investigation services
- Government and infrastructure advisory
- Recovery and reorganisation
- Valuations

## Business Risk Services

We have proven international capability and experience of adding value to clients' governance, risk, internal audit, technology and business process change programmes.

### Internal audit
- Fully outsourced internal audit
- Co-sourced internal audit
- Internal audit effectiveness reviews
- Operational audit
- Training, benchmarking, methodology development and audit plan assessment

### Process assessment and advisory
- Corporate governance/supervisory controls
- Process and control improvement
- Post-merger integration
- Sarbanes-Oxley
- Pre and post implementation project reviews
- Risk framework/risk register reviews
- Revenue, contract and cost verification audits
- SSAE16/ISAE 3402 and AAF 01/06 assurance reports on internal controls
- Business continuity planning

### Technology Risk Services
- General information technology control and assurance
- Integrated business and applications reviews
- Business and IT pre-implementation reviews
- Data/information analysis and mining
- Technology infrastructure security
- Business information security practices and control
- Application performance and capacity
- Business resilience and resumption planning

# Contact us

For further information on any of the issues explored in this report contact: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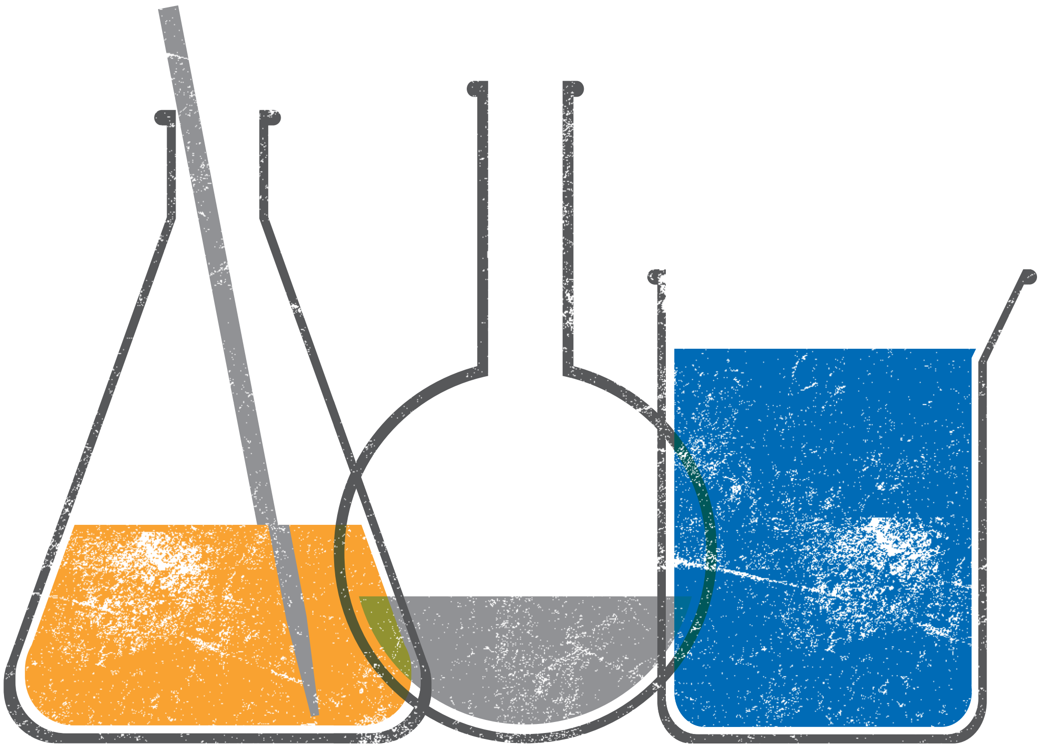
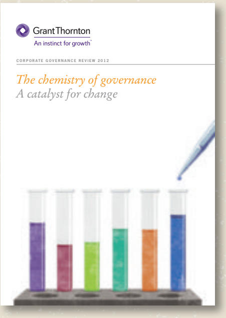
heretohelp@uk.gt.com

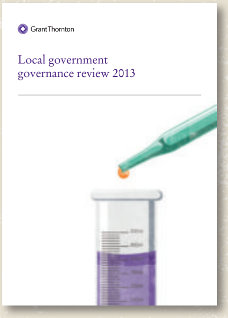



# Governance matters




**Corporate Governance Review 2012**


**NHS Governance Review 2013**




**Local Government Governance Review 2013**


**Charities Governance Review 2013**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