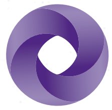


Grant Thornton

An instinct for growth™

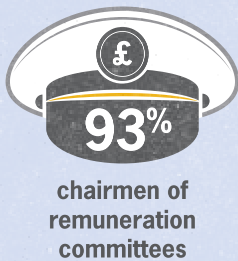
CORPORATE GOVERNANCE REVIEW 2014

Plotting a new course to improved governance

2014 highlights

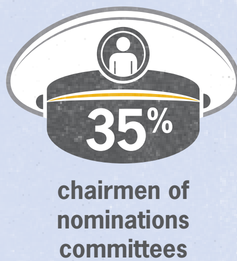
Grant Thornton's annual review of FTSE 350 annual reports has produced some fascinating figures that suggest both progress and continuing flaws.

Personal introductions from:

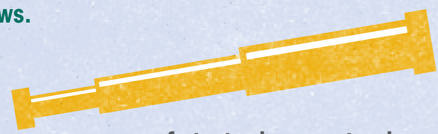
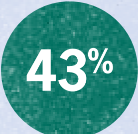


chairmen of remuneration committees

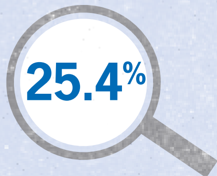
chairmen of audit committees



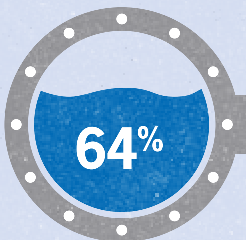
chairmen of nominations committees

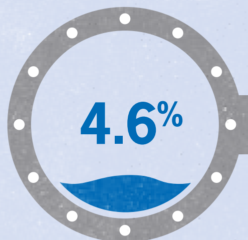
of strategic reports give an informative discussion of the future



of companies discuss the outcome of board evaluations and disclose subsequent actions for the year ahead

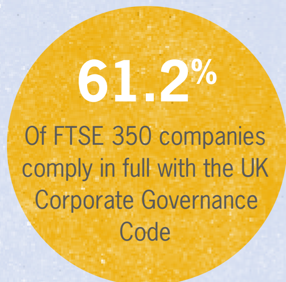


clearly demonstrate engagement with shareholders

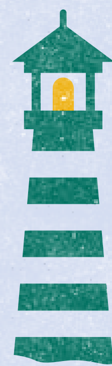


explain communication with debt holders

provide insights into monitoring internal controls effectiveness



Average remuneration over and above base salary represents 319% of basic pay



75%

have clawback provision for LTIPs, but no company exercised it this year

2/3

of audit committees offer detailed descriptions of work on significant accounting issues

14%

of companies meet all strategic report criteria and offer informative insight

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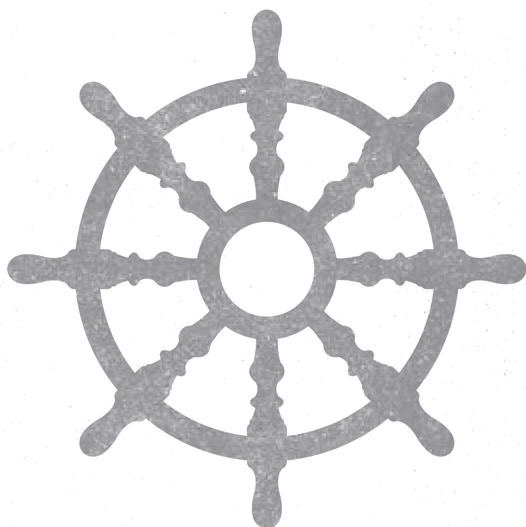


Methodology

This review covers the annual reports of 307 of the UK's FTSE 350 companies with years ending between June 2013 and June 2014. 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 2012
- the requirements for narrative reporting as set out in s417 of the Companies Act 2006 as amended.

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

Simon Lowe would like to thank Claire Fargeot, Alex Hosking, Sergio Lopez Varela, Osama Nawab, Natasha Teeling, Sarah Willis and Alex Worters for their help in preparing this report.

The regulator's perspective

"One area particularly close to my heart is stewardship – how companies engage with their shareholders. I believe that exchange of information and open lines of communication engender confidence on both sides. The trend towards greater engagement, I am pleased to say, has continued and partly owes its success to the requirements of the Stewardship Code."

Sir Winfried Bischoff, Chairman, FInancial Reporting Council

The UK's strong governance culture is designed to encourage companies to list in London and to provide assurance to investors that the information they receive is fair, balanced and understandable.

Grant Thornton's high quality research and analysis in its report underpins the FRC's work on governance and helps us track the success of our Governance Code and its implementation.

It is pleasing that compliance continues to improve year-on-year. The 2014 figures show 93.5% of FTSE 350 companies complied with all but one or two provisions. At the same time, the report highlights a concern that we at the FRC share: that the Code should not become too much like a rulebook. The report aptly states: "proof of effective governance should not be 100% compliance". It is important that companies have the opportunity to deviate from the Code, but if they do so boards should give sufficient and detailed explanations. The 'comply or explain' method of adherence gives companies flexibility and has made it possible to set standards which may on occasion be more demanding than hard rules. The report shows that the vast majority of companies attain these standards. Requiring companies to report to shareholders rather than regulators means that the decision on whether a company's governance is adequate is rightly taken by those in whose interest the board is meant to act.

The move towards board members demonstrating personal responsibility for their governance duties is welcomed. As a past Chairman of a number of public listed companies I know well the heavy commitment board members shoulder when they agree to become part of an organisation's governance structure. That more chairmen and committee chairmen are writing introductions in their companies' Governance reports, speaks highly of the greater willingness by directors to reflect on their responsibilities, and how they discharged them.

One area particularly close to my heart is stewardship – how companies engage with their shareholders. I believe that exchange of information and open lines of communication engender confidence on both sides. The trend towards greater engagement, I am pleased to say, has continued and partly owes its success to the requirements of the Stewardship Code, encouraging investors to ask questions, while the Corporate Governance Code prompts boards to provide useful, transparent information.

At the same time, the report highlights that engagement with other key stakeholders, such as major debt holders, has been slow. In order to continue attracting finance from a broad array of sources, companies must focus their interaction more widely – 14 companies out of the 307 surveyed are not enough.

Clearly there are positives as well as challenges emerging from the report. In discharging their governance responsibilities, boards should always work towards the ultimate goal of the Code: to facilitate effective, entrepreneurial and prudent management that delivers long-term success.

Congratulations and thanks to Grant Thornton for this insightful and interesting report.

Foreword

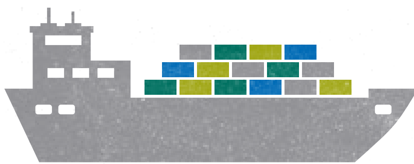
Welcome to Grant Thornton's annual analysis of the governance practices of the UK's FTSE 350 companies.

Simon Lowe, Chairman,
The Grant Thornton Governance Institute

This has been a year of change in the governance landscape.
The 2013 Directors' Remuneration Report Regulations sought to make reporting on pay more transparent and sparked a number of high-profile shareholder revolts on remuneration policy, most notably at Kentz, Hiscox, Burberry and Barclays. The EU legislated to cap bankers' bonuses and passed regulations to introduce mandatory rotation of audit firms and limit their provision of other services. Further scandals in the banking sector prompted lively public debate about conduct and the role of regulation. Meanwhile, the introduction of the 2013 Strategic Report and Directors' Report Regulations heralded significant changes to the style and content of annual report narrative and non-financial information. The increased requirements for audit committee and auditor reporting brought greater transparency into their respective work and focus.

Entering uncharted waters

To reflect this evolution, we have altered the structure of this year's report. Rather than reporting separately on each section of the UK Corporate Governance Code ('the Code'), we now mirror the structure of a FTSE 350 annual report, organising our analysis under the headings of the Strategic report, Governance, Nomination committee, Audit committee, and Remuneration committee. When discussing board composition, we include some comparative information from the US to highlight differing practices that we in the UK often take for granted.



"We are concerned that the ever-rising tide of new guidance – along with the growth of proxy voters – means the need to demonstrate full compliance is beginning to override the principle of comply and explain."

So, what have we found?

We hoped this year's introduction of the strategic report would enhance the clarity and relevance of reporting for shareholders. In practice, the standard is very mixed. There are a few excellent examples, where companies clearly gave serious thought to the report's purpose, what information to include and how best to present it. However, many organisations simply grouped their former financial, operational and CSR reports under a single section with little effort to integrate the information. The fact that many companies make basic errors in presenting the information required, suggests a lack of commitment and buy in to the objective of the report. Further, while companies were comfortable talking about past performance (77%) only 60% were able to clearly articulate their business models and when it came to looking forward this sank to 43%. We are concerned that something that was intended to improve reporting quality is being undermined by this mechanistic approach, which throws into question the commitment to effective governance.

By contrast, there is a clear focus on governance in other areas. The number of companies choosing to comply in full with the Code increased again, from 57% last year to 61%. Yet this may not be all good news.

It is worth considering if the goal of full compliance is desirable, as each company's circumstance will be different and the purpose of 'comply or explain' is to give companies the flexibility to reflect this when in the interest of the shareholders. What is worrying is the anecdotal stories I hear of the rising influence of the proxy voters and the need to be "seen" to fully comply – when not doing so can lead to red tops and negative voting.

Are we getting to the stage now where the need to demonstrate full compliance is actually overriding the principle of 'comply or explain', pushing us towards a regulatory based system? It's rather ironic when you consider that after many years of doubt, Michel Barnier now agrees that principles are the way forward.

The trend in personal accountability from board and committee chairmen that we noted last year has gathered pace. In particular, 93.1% of remuneration chairmen introduced their remuneration report this year, with 84.2%, up from 70% in the previous year, providing a good or detailed outline of the committee's work and the benefits of the remuneration policy. We support accountability but this increase also comes with a governance health warning. The annual report is not a substitute for direct consultation with shareholders. Better consultation with investors before the AGM could have avoided this year's protest votes against remuneration policies. Having now to agree the policy on a three year cycle might help.

Audit committees seem to be adjusting well to their increased reporting responsibilities. We found that 64.7% produced an effective explanation of the work done in relation to areas of judgment and estimates in the accounts.

Reduced visibility

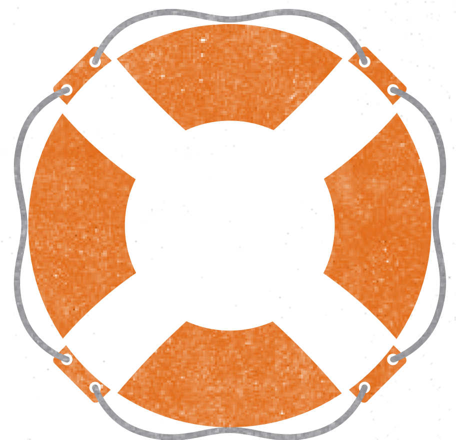
However, this greater insight becomes fog-bound when explaining how they go about monitoring the effectiveness of internal controls where only 18% show the way.

With such progress in transparency and accountability in two committees, in the coming year I expect the search light now to focus on the nominations committee which remains adrift in the doldrums. Thirty-five per cent of chairs introduce the report and only 13.5% give real insight into how they are responding to their recent board review and succession planning is rarely discussed.

Plotting a new course

This year's changes in corporate governance and reporting seek to promote greater transparency about how boards operate, particularly how the balance between short term performance and long term sustainability will be maintained. Our findings show that in many areas companies are still finding their way. However, we are encouraged by the level of debate that recent changes have provoked between boards, investors, auditors and other interested parties. Dialogue between stakeholders is the bedrock of effective governance and we are interested to see whether a consensus emerges over the coming years.

I hope this year's report gives you a fresh perspective on current and emerging governance practice.



"Better consultation with investors before the AGM might have reduced the number of this year's protest votes against remuneration policies."

The strategic report

This year's introduction of the strategic report has presented companies with a number of challenges. Some have done the bare minimum, effectively shuffling the deckchairs and waiting to see what others do. There are however a few who have ripped up the old model and sat down to redesign something relevant and fresh. Companies were clearly comfortable looking back but when it came to looking forward the numbers dropped and those who met all the requirements of the legislation were few and far between. As companies set about drafting their reports for this year, if they are to fulfil the intentions of the regulators and the expectations of the investors, they will need to swing the telescope more firmly toward the future.

In recent years, the content, language and emphasis of the annual report 'front end' have assumed increasing importance, overshadowing the audited information in the 'back end'. Devices such as non-statutory key performance indicators (KPIs), nuanced messages and the highlighting of certain factors have led to new requirements for annual statements to be approved by the board as fair, balanced and understandable.

At the same time, the strategic report was introduced this year to provide shareholders with "a holistic and meaningful picture of an entity's business model, strategy, development, performance, position and future prospects"[1]. The Strategic Report Regulations include the requirement to provide additional non-financial information, such as levels of greenhouse gas emissions, the gender split of the workforce, and community and human rights issues, where material.

To reflect such changes, some companies have significantly rethought their approach to reporting. Their efforts have delivered a greater variation in the quality of annual reports than in the whole 13 years that we have been monitoring UK reporting. The best companies have been extremely innovative, giving genuine insights into how they operate and what they deem as important. Conversely, many failed to grasp the opportunity to refresh their reporting and merely reshuffled existing content. As companies assess their peers' annual reports over coming years, we hope they will appreciate what a more thoughtful document can achieve. Of course, institutions and banks also have a role to play, since without pressure from users little will change. There is no doubt that the new guidance is already leading to greater insight into companies but at the moment it is not necessarily the right insight. The regulator has done its job; market forces must now drive out value.

[1]Guidance on the Strategic Report – June 2014 – FRC

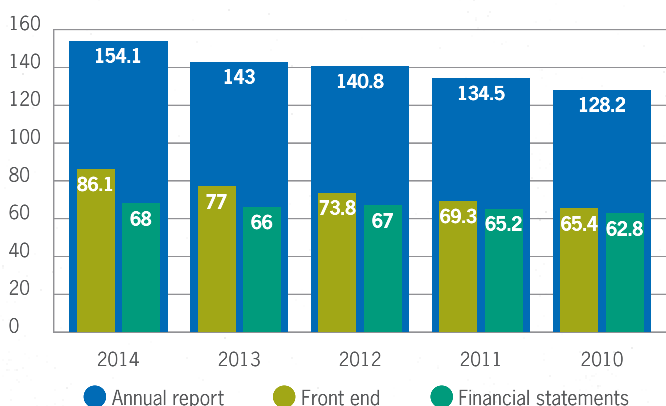
The ever-growing annual report

"The strategic report should be comprehensive but concise."

(FRC Guidance on the Strategic Report, 6.7)

The impetus behind the introduction of the strategic report was to present relevant information to stakeholders, simply and concisely. It was hoped that, by avoiding duplication, the increase in average annual report length of five pages per year over the past five years could be halted, or even reversed. However, the move seems to have had the opposite effect, with a surge in the size of reports. The average document now has 154 pages, compared to 143 a year ago and 128 in 2010. Together, the increase in the remuneration report (five pages) and the strategic report (a net four pages) account for an additional nine pages this year. Do these extensions add value? In some cases the answer is yes, but for the majority hardly at all.

Average page length of annual report (FTSE 350)



The approaches companies have taken to preparing the strategic report fall broadly into three categories:

- **Shuffling the deckchairs:** companies report exactly as they did previously but lump the information into a section called the strategic report. A charitable interpretation might categorise this approach as cautious, that is companies are reluctant to make changes in the information they report because they lack sources of comparison or do not wish to confuse the reader. Anecdotally, we hear that some organisations have been advised by their auditors to take this tack. In other cases, we suspect companies would rather not rethink a well-rehearsed annual reporting process. Whatever the reason, the consequence is that reports have continued to grow as companies add in new disclosures that they may previously have omitted.
- **Navigating the passage:** companies prepare a short strategic report to preface existing business, financial and operational reviews. Although this may add to the overall length of the report, it does at least provide a 'quick reference' section for many users and often includes well thought-through and presented information.
- **Charting new waters:** companies reshape the front end of the report, crafting a strategic report from scratch. Information tends to be well planned and executed. Frequent use of diagrams rather than text leads to clearer, simpler interpretations of the business model/approach. While the additional white space can add to the page count, it improves accessibility and transparency of information.

The regulations were introduced to provide clear, succinct information that would support investors' decision making. In our view, companies that have taken the latter two approaches are likely to have improved their annual reports, despite increasing their length. However, in many cases the waters remain muddy.

Fair, balanced and understandable

"The board should present a fair, balanced and understandable assessment of the company's position and prospects."

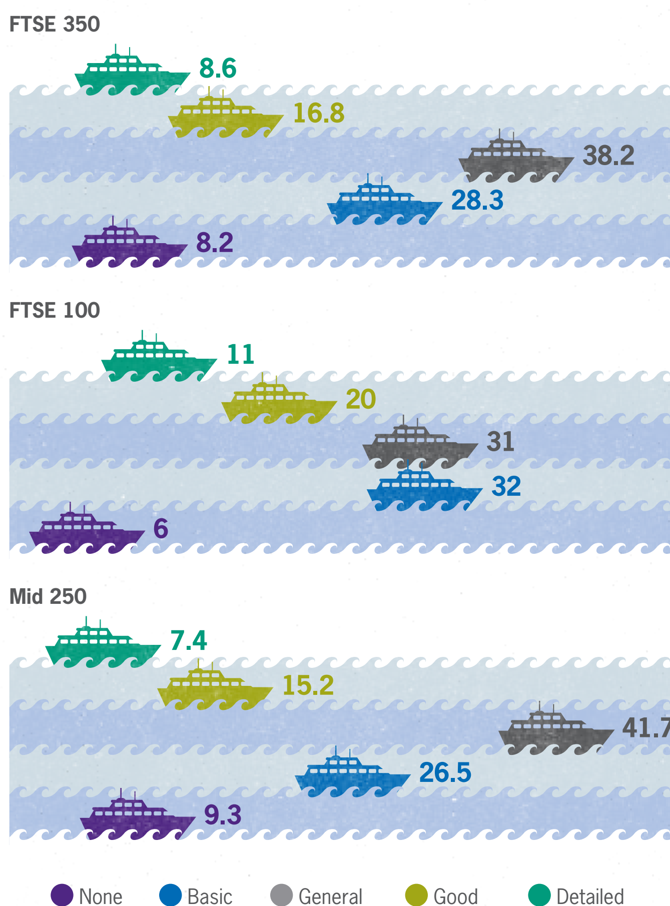
(UK Corporate Governance Code, main principle C.1)

The 2012 Code required boards to state that they believe the annual report is fair, balanced and, a new addition, understandable. The Financial Reporting Council (FRC) has declined to expand on these terms, stating that they should be self-explanatory. There is widespread debate among audit committees, which are often responsible for advising the board on whether the report is fair, balanced and understandable, as to how to address this requirement.

Approaches seem to range from substantive testing of narrative and non-statutory information, to a 'sense checking' of disclosures and the balance of the narrative against the information reported to the board during the year. Regardless of the stance taken, we considered how clearly the basis for asserting that the annual report was fair, balanced and understandable was set out, and found that 25.4% of companies provided good or detailed explanations. However, the majority (66.5%) gave little or no justification to support their claim. And nearly 10% of companies made no statement at all, presumably because they had failed to notice that the Code had been updated to require a comment on 'understandability'.

"The best companies give genuine insights into how they operate and what they deem as important. Conversely, many failed to grasp the opportunity to refresh their reporting and merely reshuffled existing content."

DOES THE BOARD EXPLAIN THE BASIS ON WHICH IT CONSIDERS THE ANNUAL REPORT IS FAIR, BALANCED AND UNDERSTANDABLE? (%)



Looking forward as well as back

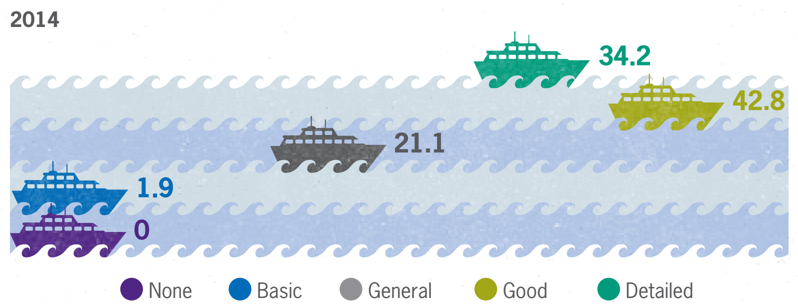
"The strategic report has three main content-related objectives: to provide insight into the entity's business model and its main strategy and objectives; to describe the principal risks the entity faces and how they might affect its future prospects; and to provide an analysis of the entity's past performance."

(FRC Guidance on the Strategic Report, 4.4)

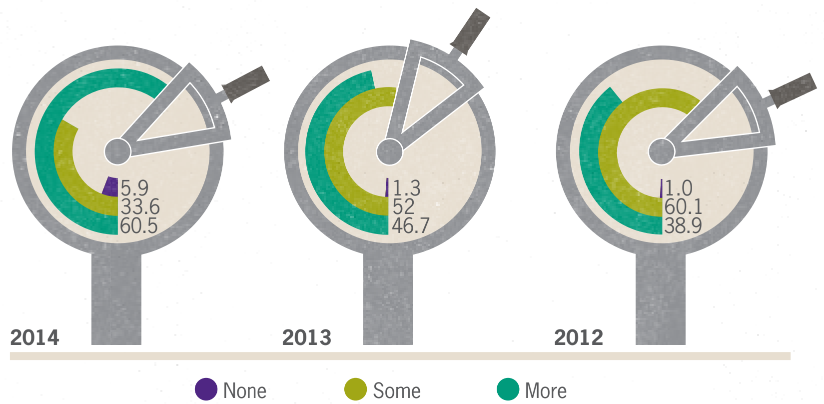
The strategic report is intended to prompt a change in emphasis, with companies providing prospective, forward-looking information to investors. However, our research reveals that companies prefer to report on the past rather than discuss future direction and prospects. Three quarters give an informative description of the business and its performance and 60.5% provide good insight into their business model. However, only 43.4% give a helpful description of the planned future development of the business and fewer than 40% show how their strategy, KPIs and risks interrelate. Considering all the strategic report requirements collectively, only 14% of companies meet all the criteria *and* offer informative insight.

The 2014 Code has been updated to reflect changes in guidance on going concern, risk management and internal control. It now requires companies to comment on their longer-term viability, ie their ability to "continue in operation and meet their liabilities taking account of their current position and principal risks and material uncertainties". In the 2014 Code, the FRC suggests that when included in the strategic report, these disclosures will be covered by 'safe harbour' provisions. This has yet to be tested in law. It will be interesting to see whether these factors result in more transparent disclosures about companies' future plans and prospects.

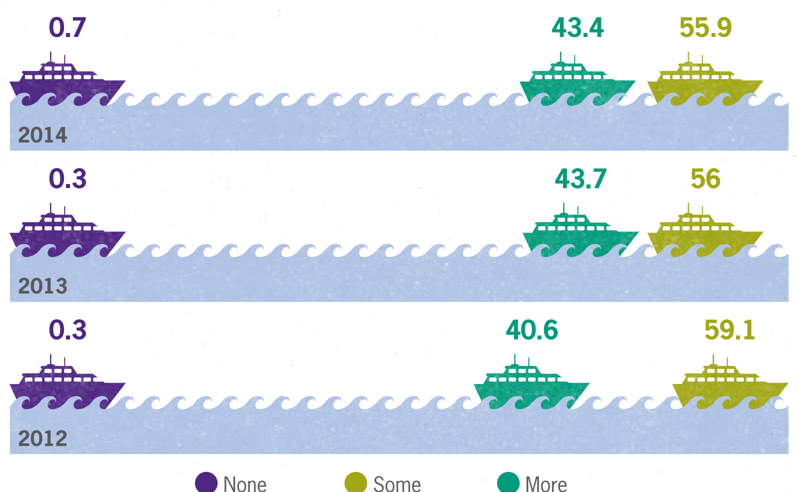
TO WHAT EXTENT DO COMPANIES GIVE A BALANCED AND COMPREHENSIVE ANALYSIS OF THE BUSINESS (%)

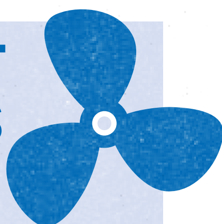


TO WHAT EXTENT DO COMPANIES DESCRIBE THEIR BUSINESS MODEL? (%)



TO WHAT EXTENT DO COMPANIES DESCRIBE THE LIKELY FUTURE DEVELOPMENT OF THE BUSINESS? (%)





FAST FACTS

- 31% of FTSE 100 companies gave an effective description of how the board had determined that the annual report was fair, balanced and understandable compared to only 22.5% of the Mid 250
- 41% (14%) companies gave a good description of the performance, future prospects, business model and strategic risks in the strategic report. Most companies gave weak disclosures in one or more areas
- The shortest annual report, a property trust, is 56 pages. The longest, a high street bank, is 594 pages. 36 companies have annual reports which are longer than 200 pages
- 91 companies in the FTSE 350 have not made any updates to their principal risk disclosures since the previous year's report

Contextualising strategy: risks and KPIs

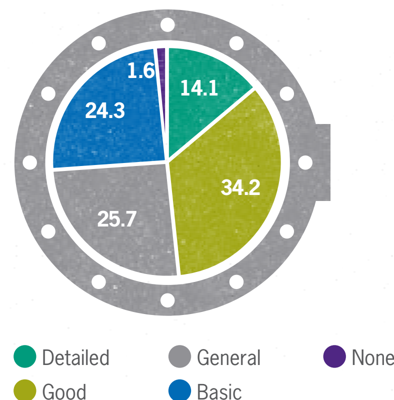
"Where relevant, linkage to and discussion of key performance indicators (KPIs) should be … in order to allow an assessment of the entity's progress against its strategy and objectives. Similarly, emphasising the relationship between an entity's principal risks and its ability to meet its objectives may provide relevant information."

(FRC Guidance on the Strategic Report, 7.10)

Disclosing risks and KPIs provides essential context for the presentation of strategy. KPIs should reflect the measures that are used to monitor the performance of the business, while the discussion of principal risks demonstrates what the company considers would prevent it from achieving its strategic objectives. The best annual reports show the links between the three, recognising that risk and performance management are key to the successful implementation of strategy.

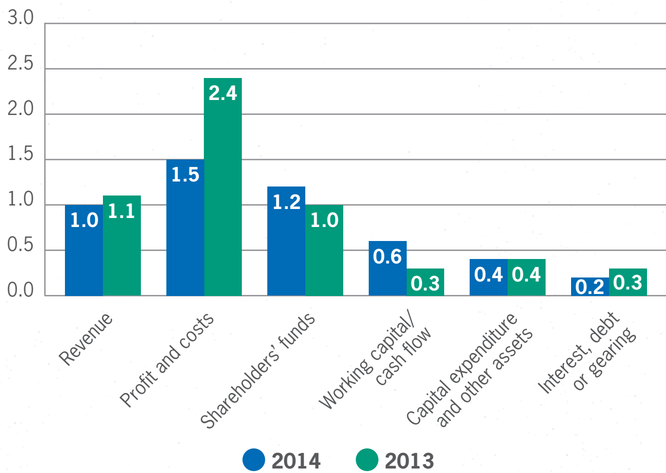
When considering KPI disclosures, we looked for a mixture of financial and non-financial measures, an explanation of the relevance of the KPIs, the company target, pointers of past performance and a discussion of future targets. The score that could be achieved by a company is capped as 'general' (3 out of 5) if it fails to include one or more non-financial KPIs. This year's results are almost identical to 2013, with 48.2% of companies providing insightful disclosures. Many fall down on what we consider the basics, such as explaining the link between KPI performance and strategic objectives, and how performance compares to pre-established targets.

TO WHAT EXTENT DO COMPANIES DESCRIBE KPIs THAT MEASURE THE PERFORMANCE OF THE BUSINESS? (%)

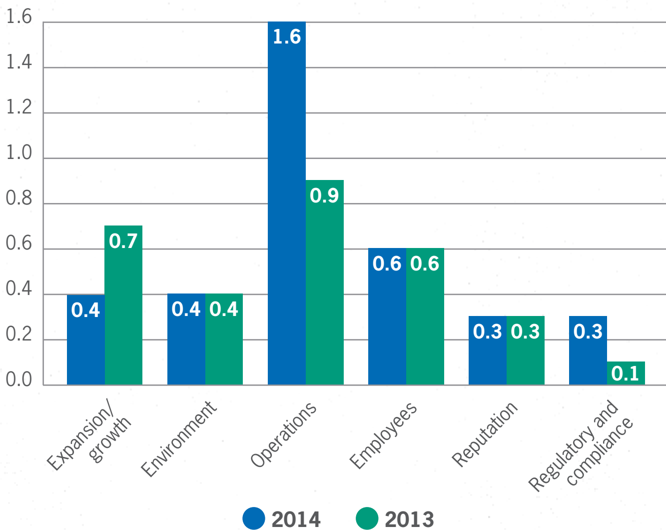


There is evidence of a shift in mind-set in the balance of KPIs presented. Although still biased towards financial indicators, this year companies disclose more non-financial measures. Within financial KPIs, there is a notable shift away from pure profit targets to working capital and in non-financial measures a greater focus on operational metrics and regulation. Taken together these are perhaps an early sign of the challenges, such as access to funding, improving efficiency and the inexorable rise of regulatory intervention, that will arise as the economy picks up.

Average number of financial KPIs disclosed (FTSE 350)

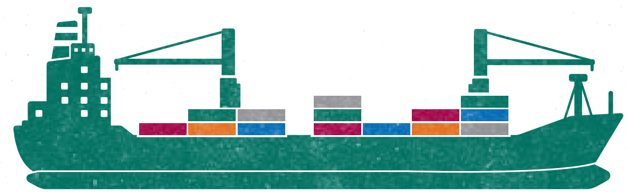


Average number of non-financial KPIs disclosed (FTSE 350)



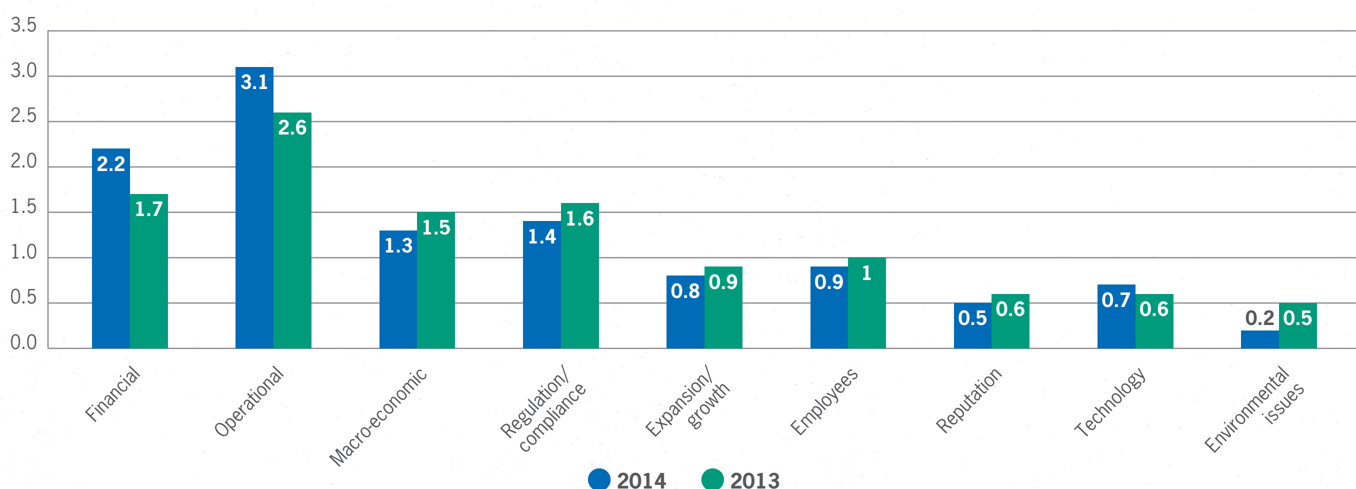
Companies are much better at describing their principal risks than their KPIs. The majority (63.8%) give good or detailed description of their principal risks. The best tend to analyse the company's strategic risks, their impact on the company, the actions taken to mitigate them, and changes to risk exposure. We believe the quality of risk descriptions in the financial statements is a strong indicator of the quality of the risk information and monitoring undertaken by the board. Notably, one third of companies provide only general or weak risk disclosures in their annual reports. This does not inspire confidence in the quality of risk monitoring by the boards of those companies

There was almost no change in the number or balance of risks disclosed. This might suggest a more stable operating environment for businesses, although the fact that 30% of companies duplicated the previous year's risk disclosures suggests that some companies simply haven't reviewed their risk registers in the last 12 months.



"The majority give good or detailed principal risk descriptions, which analyse the company's strategic risks, their impact on the company, the actions taken to mitigate them, and changes to risk exposure."

Average number of principal risks identified by FTSE 350 companies



Lessons learned

Paul Druckman, Chief Executive, International Integrated Reporting Committee

The UK Strategic Report and the IIRC's <IR> Framework are consistent with each other as well as sharing the same goal: to make corporate reporting clear, concise and relevant. In view of this common aim – with 2014 marking both the end of the integrated report's three-year pilot and the first crop of strategic reports – certain learnings could usefully be applied to both:

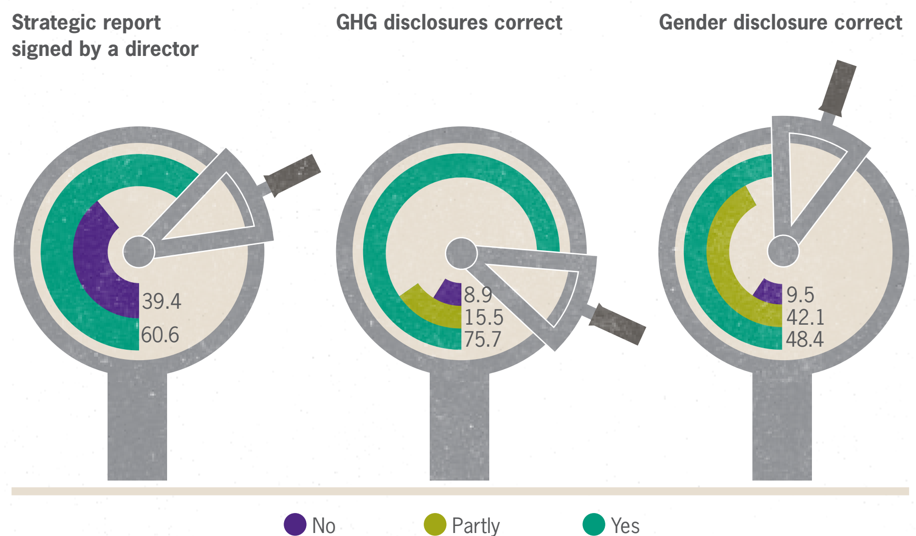
- **Producing a good report is a journey without a destination**. There will always be more to do. It's not about 'cracking' a formula; it's about constantly providing the key information that stakeholders find relevant. And that will keep changing, as sectors and economies evolve. Whatever information they do deliver, companies need to think innovatively about how to present it in the best way for their audiences. There must be greater connectivity. In particular, companies need to get much better at linking their forward-looking statements to strategy. Otherwise they will read like rhetoric, not a statement of purpose.
- **The report should be an articulation of what the board thinks**. The board should understand the report and drive its creation, rather than allowing it to be steered from lower down the organisation. It is very easy to spot the strategic report or integrated report that has a narrative composed by the comms team.
- **It's not an easy job**. Never underestimate the thinking that needs to go into articulating a company strategy. It's a tough process. There is a danger with a strategic report that companies will ask: "What should we add to our annual report?" not "What should be in our annual report?" I think the requirement to provide non-strategic information, like greenhouse gas emissions and diversity statistics, is unfortunate in this respect. These are extremely important pointers to a company's culture that must be easily accessible. But, as well as adding to the ever-increasing length of the annual report, they are not intrinsic to the strategy of most businesses and so should not be mandatory in a strategic report.
- **Companies are unlikely to get it right first time**. With the integrated report pilot we found that, unless companies invested an enormous amount of resources, very few got it right in the first year. A similar pattern is likely with the strategic report. Many companies have made a good start in tackling their first one: it can only get better – and easier – in years two and three.

Mastering the basics

A surprising number of companies make basic errors in applying the Strategic Report Regulations. Mandatory carbon reporting is generally well executed, with three quarters of companies correctly disclosing their greenhouse gas (GHG) emissions. However, nearly 40% fail to have the report signed by a director or the company secretary, and fewer than 50% correctly disclose the gender breakdown of the workforce.

In relation to gender, the most common errors are: failing to include all three required categories (board, senior management and the workforce as a whole); expressing the amounts only in percentages and not as numbers of employees; and including the disclosure in the governance statement, while making no reference to it in the strategic report.

FTSE 350 COMPANIES MEETING BASIC STRATEGIC REPORT DISCLOSURE REQUIREMENTS (%)



"The strategic report is intended to prompt a change in emphasis, with companies providing prospective, forward-looking information. However, companies still prefer to report on the past rather than discuss future direction and prospects."

Corporate responsibility

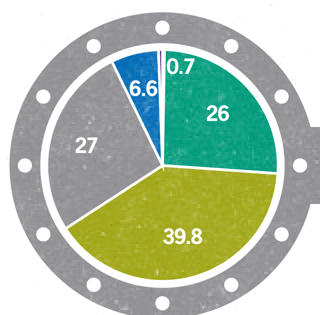
"To the extent necessary for an understanding of the development, performance or position of the entity's business, the strategic report should include information about: environmental matters (including the impact of the business of the entity on the environment); the entity's employees; and social, community and human rights issues."

(Companies Act 2006, s414C (7) (b))

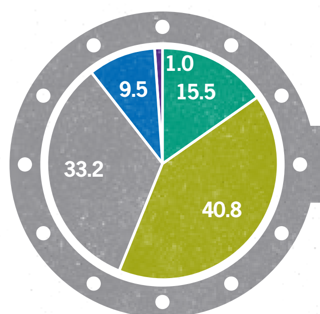
The Strategic Report Regulations require companies to discuss their corporate responsibility policies in relation to employees, the environment, and social, community and human rights issues. Most companies provide informative, considered and clear disclosure, most notably about their employees 72.4% and the environment where 65.8% provided helpful information.

Articulating their policy focus and impact with regards to social, community and human rights activities is clearly more of a challenge, with 43.8% providing very basic information or none at all. The best reports outline where in the business supply chain there is scope for human rights abuses, the steps taken by the company to ensure its own operations are adequate, and how it gains assurance about its suppliers' organisations. They also discuss matters such as anti-discrimination, working time and living wage policy in relation to the UK workforce. However, many companies limit their discussion to charitable work and investment in the local community. It is evident that many companies do not seem to have considered the rationale for the strategic report. Consequently, the integration of corporate responsibility elements of reporting into the discussion of the strategy and business model – leading to more concise, relevant, balanced and understandable reports – may take longer to achieve than had been hoped.

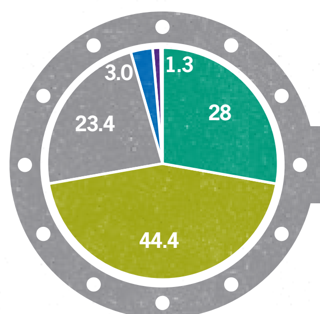
TO WHAT EXTENT DOES THE COMPANY DISCUSS ENVIRONMENTAL MATTERS IN THE STRATEGIC REPORT? (%)



TO WHAT EXTENT DOES THE COMPANY EXPLAIN SOCIAL, COMMUNITY AND HUMAN RIGHTS? (%)



TO WHAT EXTENT DOES THE COMPANY DISCUSS EMPLOYEE-RELATED MATTERS? (%)



Detailed · General · None · Good · Basic

Most companies have published corporate responsibility policies for many years, in the annual report or as a standalone publication. The challenge now is to integrate these considerations into the business model and articulate their relevance to company strategy, rather than merely 'ticking the box' by providing reams of information, references to awards, and photographs.

Finally, it is surprising that only seven companies make explicit reference to the work of the International Integrated Reporting Council (IIRC). This is unfortunate, as the IIRC's Integrated Reporting Framework provides excellent guidance on improving the relevance and impact of corporate reporting and establishes the course for future reporting.

"Most companies have published corporate responsibility policies for many years. The challenge now is to integrate these considerations into the business model and articulate their relevance to company strategy."

Governance

As Code compliance continues to grow, does it mean all is well in the world of governance? Accountability and transparency are clear trends in this year's reporting but the stronger performers are beginning to focus on those areas which have previously been off the radar so how will the nomination committees respond to the increasing attention? Governance has never been higher on the boardroom agenda but as practice continues to evolve companies have to continue to review and adapt their practices to the spirit of the Code rather than the strict letter.

"After a period when compliance hovered around 50%, the past two years have witnessed significant rises."

Compliance

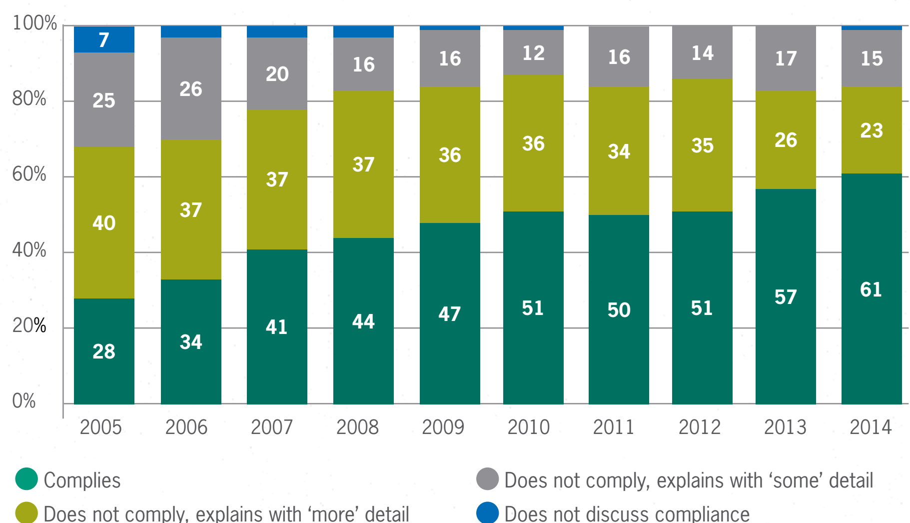
"The Code is not a rigid set of rules. … It is recognised that an alternative to following a provision may be justified in particular circumstances if good governance can be achieved by other means."

(UK Corporate Governance Code, Comply or Explain, paragraphs 2 and 3)

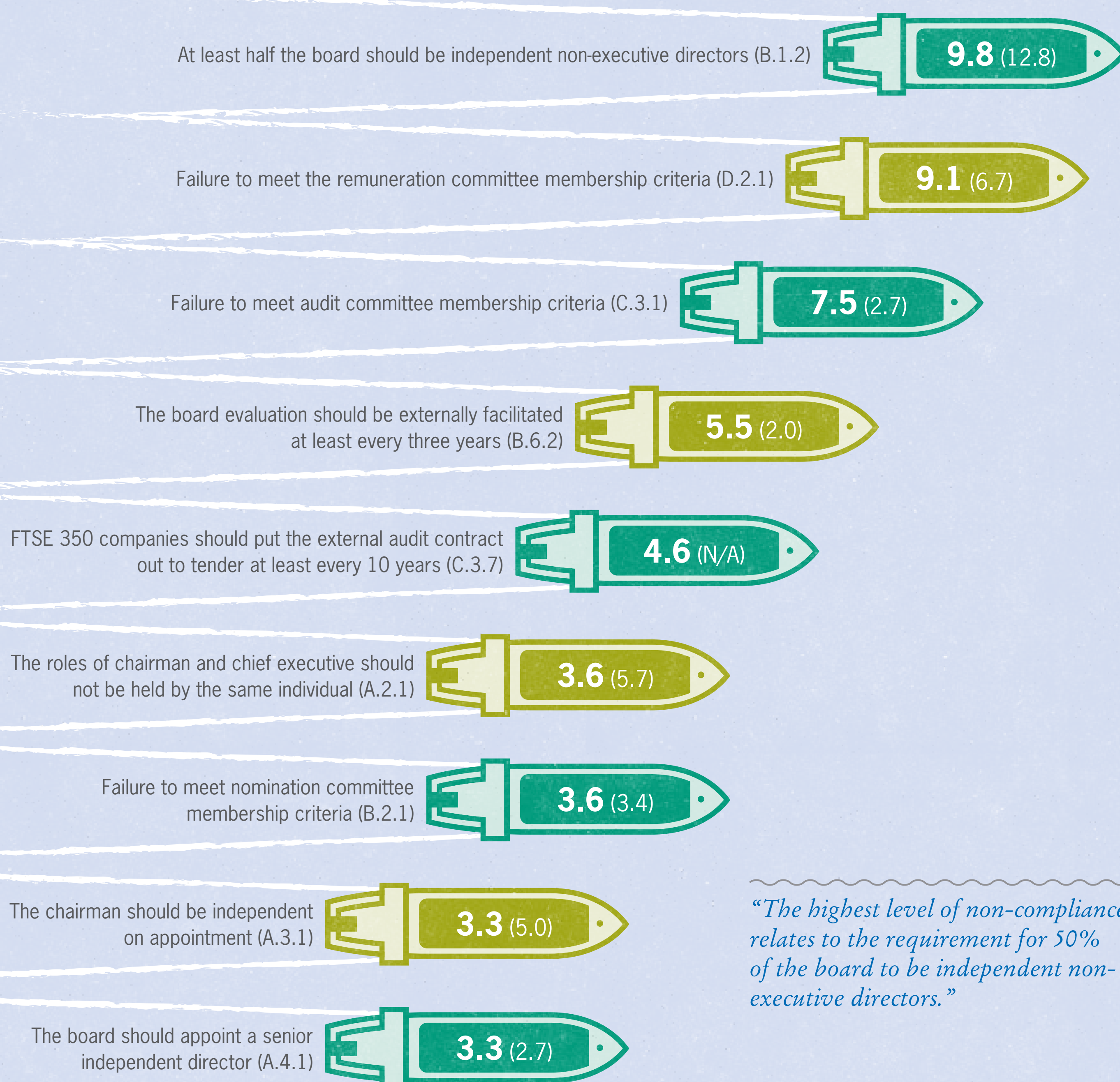
This year there is a substantial increase in the number of FTSE 350 companies claiming full compliance with the UK Corporate Governance Code. After a period when compliance hovered around 50%, the past two years have witnessed significant rises, with the 2014 figure reaching 61.2%. We assessed the explanations for non-compliance given by the remaining 118 companies against the FRC guidance. Sixty per cent of these companies provide informative disclosures, setting out their reasons for non-compliance and explaining their alternative arrangements for maintaining good governance.

The two most common areas of non-compliance remain the proportion of the board made up of independent non-executive directors (NEDs) and the composition of the remuneration committee. However, for the first time there was no single provision with which more than 10% of the FTSE 350 failed to comply. The highest level of non-compliance relates to the requirement for 50% of the board, excluding the chairman, to be made up of NEDs. Twenty eight of the FTSE 350 were unable to comply with this provision, compared to 38 in the previous year. There was a noticeable increase in non-compliance with provision C.3.7, which was amended in the 2012 Code to state that companies should put the external audit out to tender at least once every 10 years. We consider this further in the audit committee section on page 26.

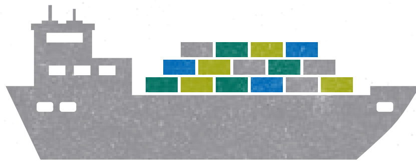
FTSE 350 companies choosing to 'comply or explain'



MOST COMMON AREAS OF NON-COMPLIANCE – % OF FTSE 350 (2013)



"The highest level of non-compliance relates to the requirement for 50% of the board to be independent non-executive directors."

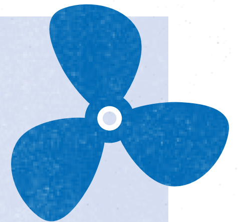


"For the first time there was no single provision with which more than 10% of the FTSE 350 failed to comply."

Record levels of full compliance are to be applauded, but a note of caution is needed. The proof of effective governance should not be 100% compliance. The principle of comply or explain, which until earlier this year was under threat from European regulators, is there for a purpose: because neither companies nor their governance arrangements are homogeneous. The proxy voting agencies and the institutions they serve would do well to remember this. There is anecdotal evidence that companies are under increasing pressure to demonstrate full compliance, or compliance with specific provisions, to meet the expectations of investors and proxy voting agencies. The use of scoring criteria for governance based on compliance with specific provisions provides a disincentive for companies to explain rather than comply. If companies do feel obliged to comply in full to meet criteria imposed by third parties, there is a risk that the principles-based corporate governance system will be subsumed by a de facto prescriptive, rules-based approach.

The FRC and the Department for Business, Innovation & Skills (BIS) have both focused this year on the quality of content and explanation in the annual report, stressing the importance of providing investors with concise, relevant and specific information. That no single provision has more than 10% non-compliance and that the quality of explanations continues to improve should provide the encouragement, if any is needed, that a principles-based governance code can make a difference, even if it takes time to become majority practice.

FAST FACTS



- For the first time, there is no provision with which 10% of the FTSE 350 does not comply
- The number of companies complying with all provisions of the Code has risen to an historic high of 61.2%, despite the Code containing more provisions than it did when we started monitoring compliance in 2001
- 93.5% of the FTSE 350 comply with all but one or two of the provisions of the Code compared to 85% a year ago
- The highest area of non-compliance with the Code relates to board independence. At 9.8% of FTSE 350 companies, less than half the board is made up of independent non-executive directors
- 118 companies did not comply with all the provisions of the Code. 59 companies have not complied for two years running and, of these, 32 have not updated their explanation for non-compliance since the previous year

Rising personal accountability

"Chairmen are encouraged to report personally in their annual statements how the principles relating to the role and effectiveness of the board … have been applied."

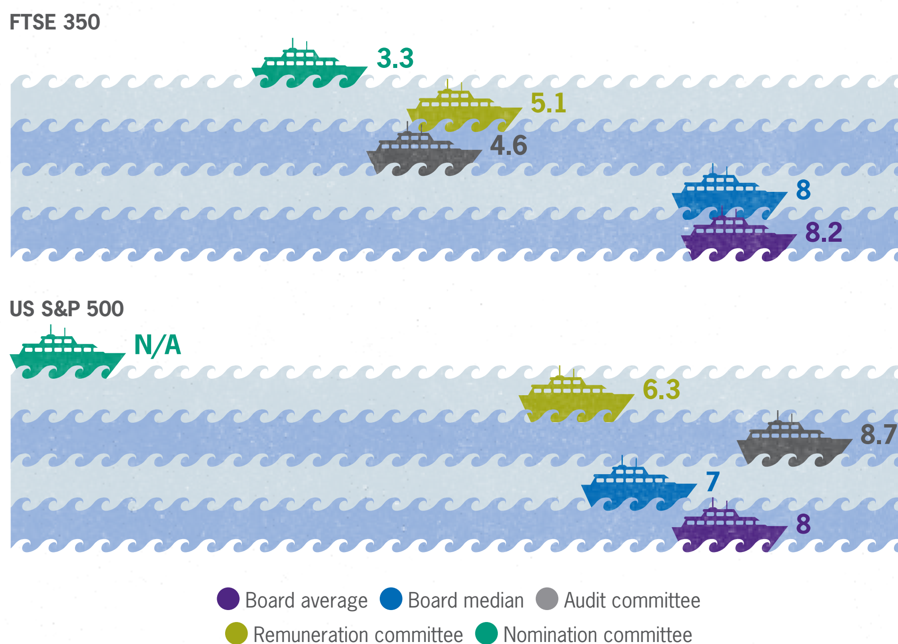
(UK Corporate Governance Code, Preface, paragraph 6)

Many of the changes to the 2012 Code aim to increase transparency about the workings of the board. More than half (56.6%) of companies give an informative description of how the board discharged its duties effectively. Weaker disclosures do not discuss responsibilities and accountabilities, for example the division of roles between the chairman and the chief executive. The best provide more insight into the work undertaken by the board, explaining the key activities on its agenda. Superior examples are also more likely to mention culture and values (which the 2014 Code re-emphasises) and the type of information reported to the board.

Just over 85% of FTSE 350 chairmen discuss governance in their introductions to the annual report. However, there is greater personal emphasis and focus in the corporate governance report. More than three quarters (77%, 2013: 60%) of chairmen make a personal introduction to the statement and over half give an informative description of governance arrangements.

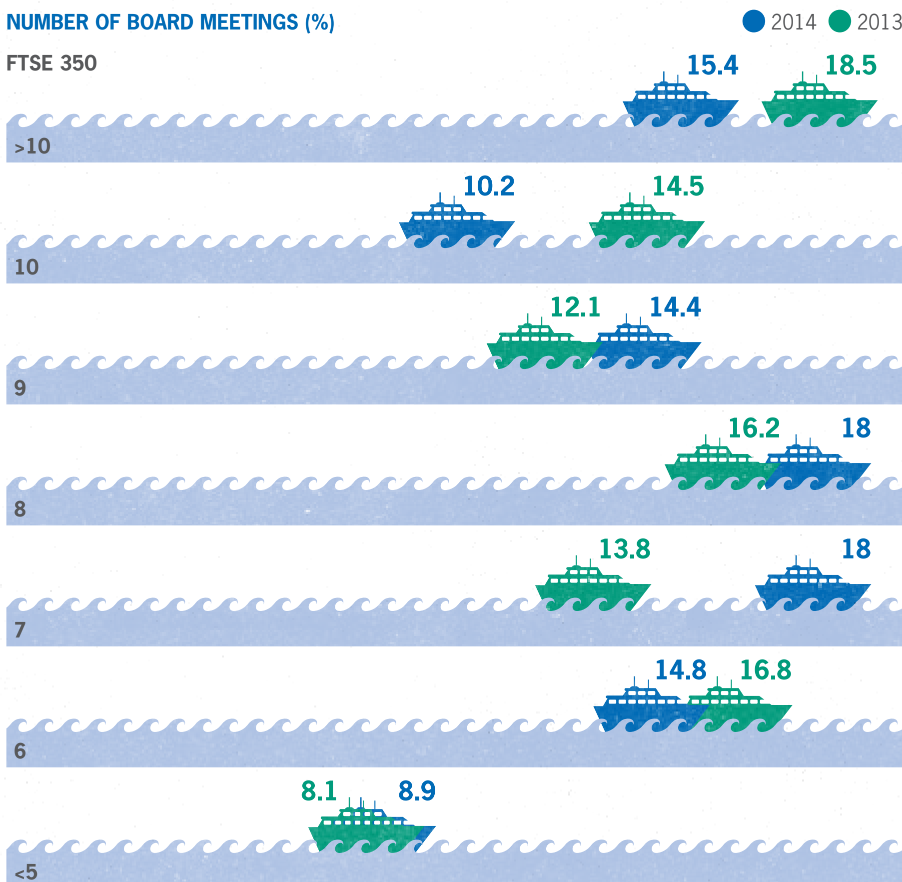
This trend is replicated by committee chairmen taking greater personal responsibility for their committee reports. Remuneration has always led the way and, in light of continuing institutional, public and political scrutiny, it is perhaps not surprising that 93.1% of remuneration committee chairs introduce their report, compared to 70.5% a year ago. For the first time more than half of audit committee chairmen introduce their committee report (55.8%, 2013: 44%), perhaps reflecting the increased focus on their responsibilities in the 2012 Code. However, nomination committees record a more modest increase, with only 35% of chairmen fronting their report, compared to 31% in the previous year. Given that incorrect board composition remains the most common reason for non-compliance with the Code, and since the emerging consensus is that board effectiveness is allied to the quality, expertise, experience and confidence of members, it seems likely that the search light will draw more attention to these committees next year.

COMPARISON OF NUMBER OF BOARD AND COMMITTEE MEETINGS PER YEAR IN THE FTSE 350 AND S&P 500



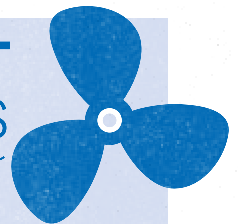
"The proof of effective governance should not be 100% compliance. The principle of 'comply or explain' is there for a purpose, because neither companies nor their governance arrangements are homogeneous."

Boards met less often this year. The average number of board meetings declined to 8.2 per year in 2014, compared to 8.6 in 2013. The results show a significant spread, from a high of 21 to a low of one (a holding company). Barely one in four boards met more than 18 times compared to a third in the previous year. This may reflect more stable market conditions, resulting in fewer extra meetings.



The number of remuneration and nomination committee meetings increased slightly. Our review revealed considerable efforts to prepare new-format remuneration disclosures and to consult with shareholders on policy. This, coupled with the requirement to obtain institutional support for the three-year remuneration policy, has clearly absorbed a great deal of time and attention.

FAST FACTS



- 64.8% of chairmen provide personal comment on governance at least once in the annual report
- The average number of board meetings has fallen slightly to 8.2 per year. Twelve boards have met more than 12 times during the year
- The average FTSE 350 board meets approximately the same number of times as an S&P 500 board. However, US audit committees meet almost twice as often as those in the UK
- 92.9% of FTSE 100 chairmen and 62% of Mid 250 chairmen discuss strategy and governance with major shareholders
- Only 14 companies make reference to communication with debtholders and only two give a good description of what this entails

Relations with stakeholders

"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)

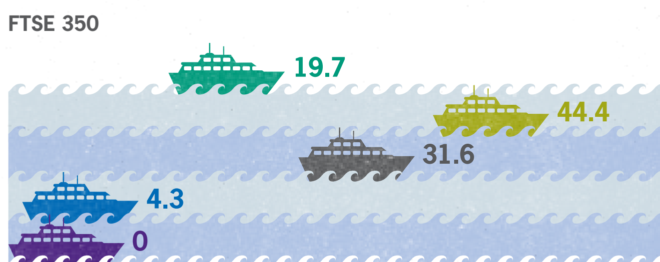
The trend of greater engagement by institutional investors, stimulated by the introduction of the Stewardship Code, appears to be gaining momentum. This year we amended the way we assess disclosures about shareholder engagement. We now reserve the highest ratings for companies that not only explain how they interact with shareholders, but also comment on the issues discussed, the feedback received and how such input was acted on. Just under two thirds (64.1%) of FTSE 350 companies met this criteria.

The 2012 Code introduced a requirement for companies to outline how they seek to understand the views of major debt holders. Initially, this went almost unnoticed, with only 4.6% of companies discussing debt holder relations in their 2013 annual report. This year, we had hoped that organisations would identify their major debt holders and indicate how they engaged with them. However, only 14 companies referred to this area and the quality was generally poor, with only two giving informative disclosures. This suggests that either shareholders remain the priority for companies' external relations, or that disclosing such activity is too commercially sensitive.

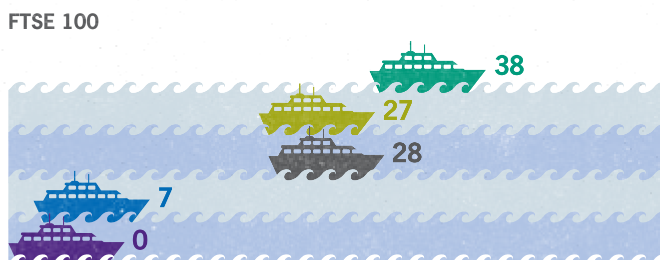
"The trend of greater engagement by institutional investors, stimulated by the introduction of the Stewardship Code, appears to be gaining momentum."

TO WHAT EXTENT DOES THE BOARD DEMONSTRATE THE STEPS TAKEN TO UNDERSTAND THE VIEWS OF MAJOR SHAREHOLDERS? (%)

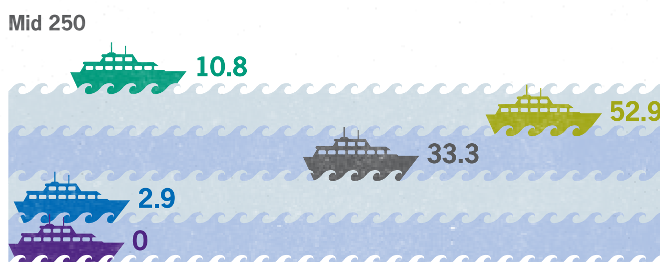
FTSE 350



FTSE 100

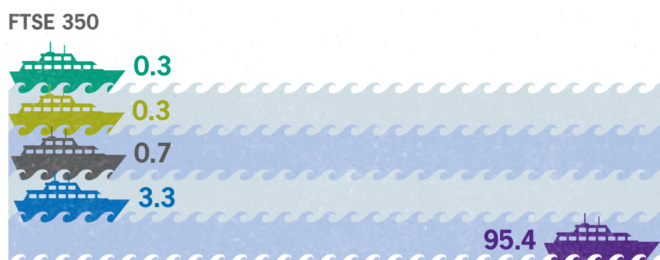


Mid 250



TO WHAT DEGREE DOES THE BOARD DEMONSTRATE THE STEPS TAKEN TO UNDERSTAND THE VIEWS OF MAJOR DEBT HOLDERS? (%)

FTSE 350



None Basic General Good Detailed

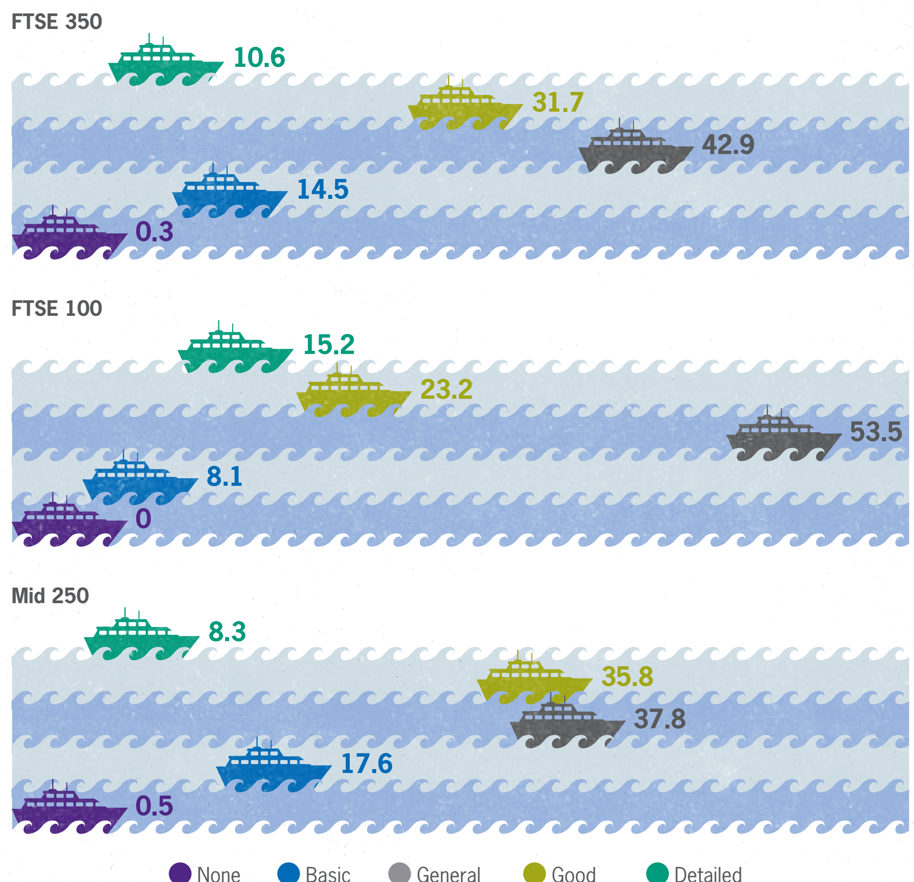
Nomination committee

Compared to other committees, the nomination committee is the 'poor relation' in terms of the number of times it meets annually (3.3 on average), the ratio of chairmen that introduce the report 35% (2013: 31%), and the quality of information given about its activity and focus. In 12 companies, the committee failed to meet even once during the year. Such factors raise the question as to whether many nomination committees consider they only have a role when a new director is required.

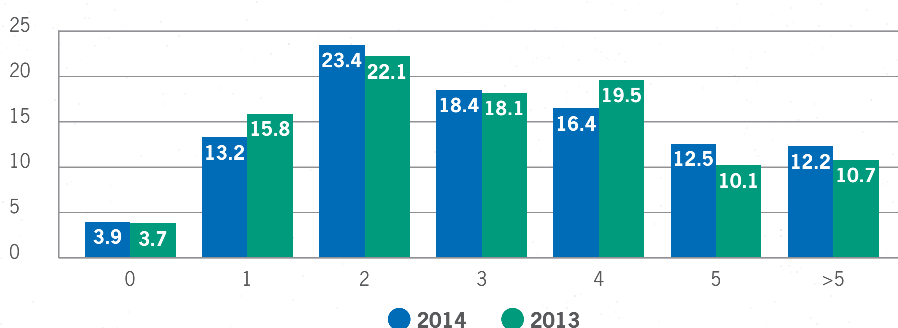
As the governance debate has evolved, much attention has been given to the quality and expertise of the board. While the chairman oversees board effectiveness, it is the nomination committee that should be continually looking ahead, to anticipate and manage succession issues. Some nomination committees also have responsibility for reviewing the structure of the board, updating policies and terms of reference, and monitoring the impact of the company's diversity policy. Where a committee meets only once a year, or not at all, the resilience of the board and the company must be a matter of debate.

Nomination committees tend to be reticent to explain what they do. The best examples (42.3%) provide a useful description covering the scope and focus of their work, including information about succession planning, appointments and the board evaluation process.

IS THERE A DESCRIPTION OF THE WORK OF THE NOMINATION COMMITTEE, INCLUDING THE PROCESS IN RELATION TO BOARD APPOINTMENTS? (%)



Number of nomination committee meetings



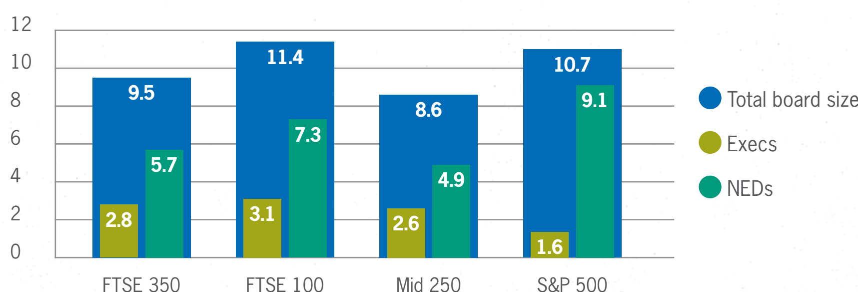
Board composition

"At least half the board should comprise independent non-executive directors."

(UK Corporate Governance Code, B.1.2)

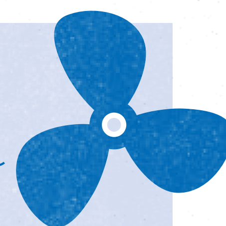
Independent non-executive directors now constitute the majority in more than 93.1% of FTSE 350 companies. There has been little overall change in board composition, with the average company now consisting of 9.5 members: a chairman, 5.7 NEDs and 2.8 executive directors.

Average board size and composition



A typical FTSE 350 board is smaller than in the US, where the average S&P 500 board has 10.7 members. An S&P 500 company typically has around eight NEDs compared to FTSE 350 companies, where the figure is 5.7. A more significant difference relates to executive director representation and the role of the chairman. In 60% of Fortune 500 companies, the chief executive (CEO) is the only executive on the board. In the majority (55%), the chairman is also CEO – a dual position that is forbidden by the UK Code. There has been a slow shift away from this practice since the financial crisis but it remains commonplace.

FAST FACTS



- Six companies combine the role of chairman and chief executive. Of these, two describe the combining of these roles as a temporary arrangement
- 20% of companies have at least once board member who is not considered independent. This represents 115 directors of whom 51% represent significant shareholders and 28% have served on the board for more than nine years
- 12 nomination committees have not met at all during the year. We also identified instances where directors were appointed at several points during the year but the committee had only met once
- 93% of non-executives have served on the board for nine years or less. However, over 19% of chairs and executives have been on the board for longer than 10 years
- On average, FTSE 350 chairs and executives are two years older than their Mid 250 counterparts, but there is no significant difference in the age of non-executives

Independence

"The board should determine whether the director is independent in character and judgment and whether there are relationships or circumstances which are likely to affect, or could appear to affect, the director's judgment."

(UK Corporate Governance Code, B.1.1)

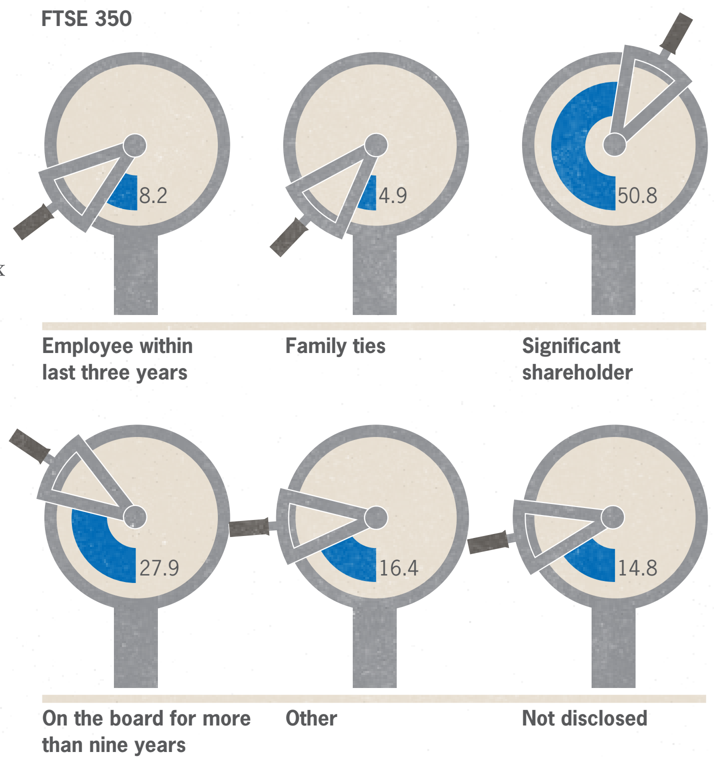
The separation of the role of chairman and chief executive is one of the core principles of the UK Code. This year only six FTSE 350 companies have a combined CEO and chairman, with a further 22 having an executive chairman. This is a long-term arrangement for most of these companies, with only 20% describing it as a temporary solution.

Of the 1,740 non-executives sitting on FTSE 350 boards, 115 are not considered independent by their companies, with 21.4% of firms having at least one such member. Half are representatives of significant shareholders, with a further 28% no longer being considered independent, having served for more than nine years.

Companies may regard a director as independent, even if he or she does not meet the 'length of service' criterion. In the UK, the Higgs Report has led to nine years being taken as the period of time that a non-executive can serve on the board and retain an independent stance. However, many companies evidently dispute this rule of thumb. Forty-six have at least one director who is considered independent despite having been a board member for more than nine years.

Companies rarely excel in explaining why they consider a director to be independent despite them not meeting the Code criteria. The majority set out which criteria have not been met and then make a statement along the lines of "the board has determined that the director is, nevertheless, independent in character". Only 27.8% of companies provide an explanation that gives real insight into why they believe this to be the case.

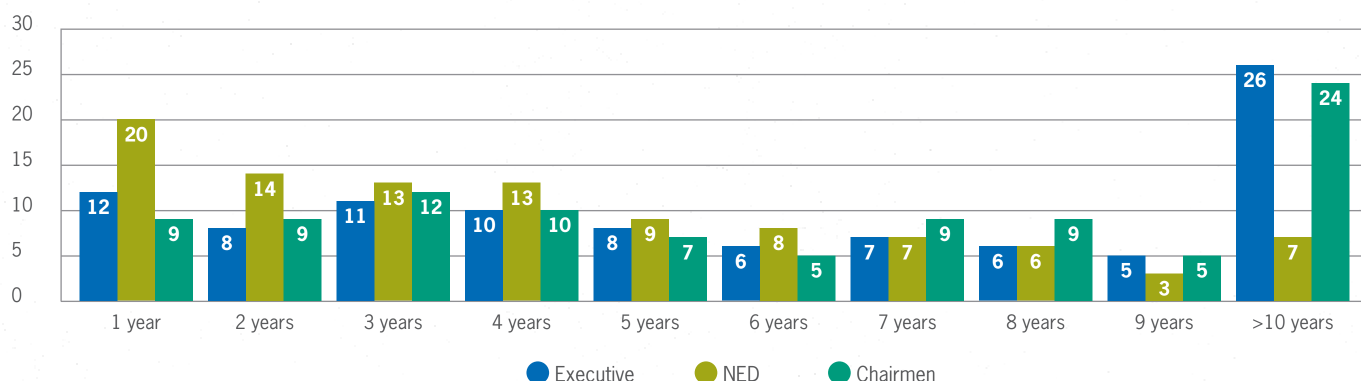
WHY ARE THE NEDs NOT CONSIDERED INDEPENDENT? (%)



Average length of tenure of board members

	2014			2013		
	FTSE 350	FTSE 100	Mid 250	FTSE 350	FTSE 100	Mid 250
Chairmen	6.8	5.8	8.3	8.1	6.5	7.3
Non-executives	4.2	4.1	4.3	4.8	4.6	4.9
Executives	7	6.5	8	7.0	6.5	7.3

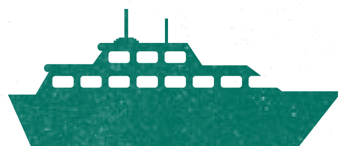
Length of tenure of current FTSE 350 board members (%)



Our research suggests there has been an increase in the turnover among non-executive directors, with the average FTSE 350 NED having served for 4.2 years, compared to 4.8 years in 2013. The average length of time on the board for a chairman (which may include a previous role as a NED) fell by six months to 7.6 years. Further analysis shows that only 7% of NEDs have been in post for 10 years or more, with 60% having served between one and four years. By contrast, a quarter of executives and chairmen have been on the board for at least 10 years.

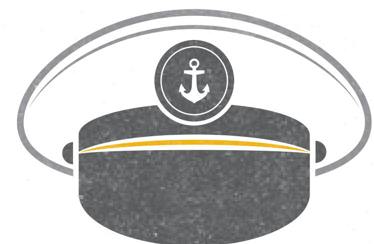
In their succession planning, nomination committees should pursue the right balance between bringing new skills, experience and perspectives to the board and ensuring continuity and knowledge within the company. The Harvard Business Review finds that a turnover of three to four directors in a three-year period can be linked to above-average returns at S&P 500 companies, whereas turnover rates either above or below this threshold tend to accompany below average returns.[2] There is no consistent guidance for US companies about how long directors should serve. As a result, only 3% of S&P 500 companies impose a maximum term for directors and, of these, the longest is 30 years. The criteria used by the remaining companies to gauge the right turnover rate are not clear. The average length of tenure for an S&P 500 is 8.6.

While succession planning is critical to the future successful evolution of the board, based on our review, nomination committees seemed to be reluctant to discuss their work in this area.



"While the chairman oversees board effectiveness, it is the nomination committee that should be continually looking ahead, to anticipate and manage succession issues."

[2]How Much Board Turnover Is Best? George M Anderson and David Chun, Harvard Business Review, April 2014.



"Ensuring that directors' skills and technical knowledge remain current and relevant is an important element of good governance."

Diversity

"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)

Succession planning should also consider the need for a balance of skills, experience and mind-set on boards. Using age as a proxy for experience, we found that FTSE 100 boards tend to be more experienced than their smaller counterparts. Chairmen continue to be the most seasoned board members, although the average age for chairmen and NEDs has fallen in the past 12 months. In particular, the gap between executives and non-executives has reduced from seven years to six.

Average age of FTSE 350 board members

	2014			2013		
	FTSE 350	FTSE 100	Mid 250	FTSE 350	FTSE 100	Mid 250
Chairmen	63	64.4	62.4	63.9	64.9	63.4
Non-executives	59	59.3	58.9	59.7	59.9	59.6
Executives	53.2	54.4	52.4	52.6	53.8	52

Companies tend to be opaque about the contribution that individual board members bring to the table. A basic synopsis of their career is the norm but the best discuss the particular skills, experience, knowledge and ethnic or gender perspective that the director will draw on.

The 2011 Davies Report, Women on Boards, focused attention on gender. Only 40% explain the board's diversity in its fullest sense, although 93.7% of nomination committee reports discuss gender diversity on the board. Some argue that the gender debate has overshadowed the need for a wider consideration of diversity, taking in ethnic background, disability, and even psychological traits; others feel that it has ignited the broader debate. Cranfield University's Female FTSE Board Report 2014[3] found that more than one third of recent board appointments are women and predicts that women will account for over 26% of FTSE board members by the end of 2015. Perhaps nomination committees should now move towards greater transparency about other aspects of diversity.

[3]http://www.som.cranfield.ac.uk/som/ftse

Board evaluation

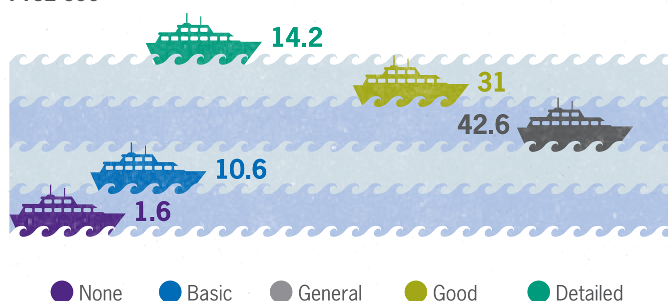
"The board should state in the annual report how performance evaluation of the board, its committees and its individual directors has been conducted."

(UK Corporate Governance Code B.6.1)

Most nomination committee reports explain the board evaluation process. In line with the Code, 45.2% describe what is involved in performance reviews of the board, its committees and individual directors, and summarise their findings. However, only 25.4% of companies discuss the outcome of board evaluations and disclose subsequent actions for the year ahead, often limiting themselves to such bland statements as "the board is operating effectively save for a few minor improvements that will be addressed in the coming year". An audit committee would not be satisfied if an auditor provided this level of insight, and neither should investors.

HOW MUCH EXPLANATION IS THERE OF THE BOARD EVALUATION PROCESS? (%)

FTSE 350



None Basic General Good Detailed

The Code requirement for triennial, externally-facilitated board evaluations has been adopted by most companies, with 117 being assessed during the year. A wide range of providers operate in this field, with 38 independent evaluators named. However, with around 43 evaluations being provided by just three consultants, there may be a wide disparity of approach among the other 35.

Induction and training

"The chairman should ensure that the directors continually update their skills and the knowledge and familiarity with the company required to fulfil their role both on the board and on board committees."

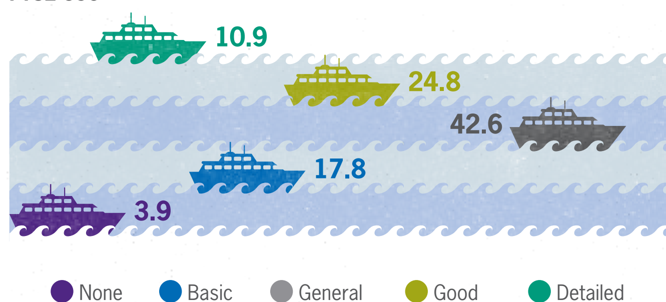
(UK Corporate Governance Code, main principle B.4)

This year, for the first time, we analysed the quality of disclosures about induction and training provision for directors. We wanted to identify how well companies describe their arrangements and demonstrate whether these meet the needs of the company and the individual director.

Approximately 35% of companies provide good or detailed descriptions of their training arrangements. Nearly 43% give general explanations, a significant proportion of which provide a good description of induction arrangements but make no reference to ongoing training of directors. Ensuring that directors' skills and technical knowledge remain current and relevant is an important element of good governance. Since the increasing pace of change in areas such as technology affects a company's competitiveness and risk profile, regular training surely must be considered an essential.

TO WHAT EXTENT DO COMPANIES DESCRIBE THE INDUCTION AND ONGOING TRAINING ARRANGEMENTS FOR DIRECTORS? (%)

FTSE 350



None Basic General Good Detailed

"An audit committee would not be satisfied if an auditor provided this level of insight, and neither should investors."

Audit committee

The 2012 Code introduced the requirement for additional disclosures about audit committee activity. This requires discussion of what work the committee has done on significant areas of the accounts, how it assessed the effectiveness of the external audit process, the approach to appointing the auditor and how it safeguards the auditor's objectivity and independence.

The FRC's challenge to audit committees was not so much to do more; these responsibilities have always been part of their remit. Rather, the emphasis was on providing transparency and insight about the key issues considered by the committee and the work it has undertaken in fulfilling them. The changes were driven in part by investor demands for greater insight, the lack of which makes it difficult for investors to understand and engage with companies on critical accounting issues, and to assess the judgments underlying the financial statements.

The remuneration report contains the most informative disclosures of any annual report section and exceeds 18 pages on average. Over 90% now feature a personal introduction by the committee chairman. The audit committee report, in comparison, is typically shorter, with only 55% of chairmen demonstrating individual accountability through a personal introduction. Nevertheless, this figure is up from 44% in 2013 and 23% in 2012, a sure indication of the increasing focus and attention being given to this important aspect of governance.

Significant financial statement issues

"A separate section of the annual report should describe … the significant issues that the committee considered in relation to the financial statements, and how these issues were addressed."

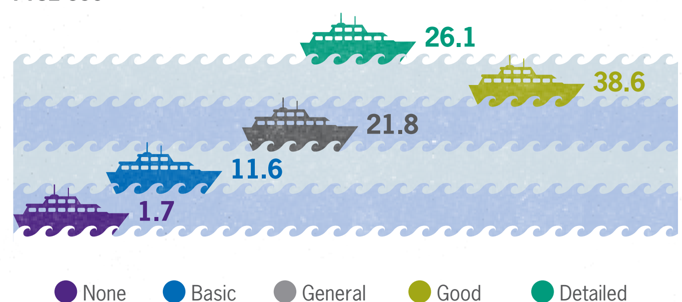
(UK Corporate Governance Code, C.3.8)

In October 2013 the FRC's Financial Reporting Lab published a report on the reporting of audit committees[4], in which it set out the results of discussions between a working party of investor and company representatives. The report recommended that disclosures should focus on the issues that provoke lengthy debate at audit committee meetings, although material emerging issues and post balance-sheet events also merit comment. The investors felt that audit committee reporting should focus on the work undertaken by the committee and provide context to help the reader understand the matter's relevance to the company, what work was undertaken to resolve it and the outcome.

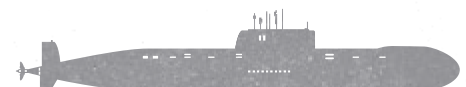
Our review found that approximately two thirds of audit committees provide a good or detailed discussion of significant accounting issues. Most reports give an informative description of the work undertaken. The best distinguish themselves by providing effective context to each issue and its relevance to the company.

THE QUALITY OF DESCRIPTION OF THE ISSUES CONSIDERED BY THE AUDIT COMMITTEE IN RELATION TO THE FINANCIAL STATEMENTS, INCLUDING ANY KEY JUDGMENTS THAT IT MADE (%)

FTSE 350



None | Basic | General | Good | Detailed



[4]Lab project report: Reporting of Audit Committees October 2013

Auditor tenure and independence

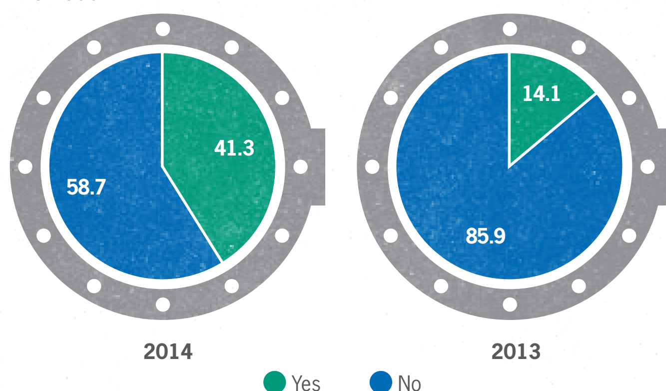
"The audit committee should have primary responsibility for making a recommendation on the appointment, reappointment and removal of the external auditors. FTSE 350 companies should put the external audit contract out to tender at least every ten years."

(UK Corporate Governance Code, C.3.7)

In April 2014, the Council of Ministers adopted legislation requiring audit firm rotation for public interest entities every 20 years with tendering every 10 and restrictions on the non-audit services that can be provided by their statutory auditors. Surprisingly, given the FRC's pre-emptive introduction of mandatory tendering every 10 years and the significant publicity around it, only 41.3% of companies publicly committed to an external audit tender every decade. A small percentage of FTSE 350 companies (4.6%) acknowledged this meant they were not in compliance with the Code but had decided to wait until the European Commission proposals were confirmed. Some of the remaining 37% of companies made similar disclosures in the audit committee report but many simply made no disclosure and/or failed to recognise that they were not in compliance with the Code as a result.

IS THERE A STATEMENT THAT THE EXTERNAL AUDIT CONTRACT WILL BE PUT OUT TO TENDER AT LEAST ONCE EVERY 10 YEARS? (%)

FTSE 350



"The FRC's challenge to audit committees was not so much to do more. The emphasis was on providing transparency about the key issues the committee faces and how it carries out its work."

The audit market is going through unprecedented upheaval. Research suggests that after years of very little movement (where, by our previous calculations, the average tenure of a FTSE 350 auditor was around 34 years), the situation is now changing. Thirty FTSE 350 companies put their audit out to tender in 2013, and this is expected to have almost doubled to 56 in 2014.[5] Activity in 2015 is predicted to rise still further. Whether the result will be companies merely moving from one traditional provider to another, or the start of real market change, will take a number of years to ascertain.

Audit fees

"The audit committee should develop … the company's policy in relation to the provision of non-audit services by the auditor … The audit committee's objective should be to ensure that the provision of such services does not impair the external auditor's independence or objectivity."

(FRC Guidance on Audit Committees, 4.38)

The level of non-audit work awarded to auditors is declining among the largest companies in the FTSE 350. This reflects growing concerns among investors about auditors having conflicting interests and the influence of the European Commission who are seeking to bolster the reputation of the financial markets. Looking back five years, the average FTSE 100 audit fee remains constant, at £6.24m in 2014 compared to £6.34m in 2010. However, the level of non-audit fees has fallen significantly since 2010, with such fees now representing 37% of the audit fee compared to 54% in 2010. The change is even more marked in the FTSE 101–200 bracket, where non-audit fees have fallen from 80% in 2010 to 49%. This trend seems likely to continue.

[5] FTSE 350 audit tenders to almost double in 2014" Financial Times, 17 August 2014

At the lower end of the FTSE 350, fees paid to auditors for non-audit activity remain on a par with those for audit work. A review of the breakdown for these fees shows it reflects a higher proportion of companies undertaking sizeable M&A activity. It is also skewed by a number of companies that listed during the year and used the auditor as reporting accountants and for other IPO related work, both of which, although classed as non-audit work, realistically can only be performed by the auditor.

Average non-audit fees as a percentage of audit fees

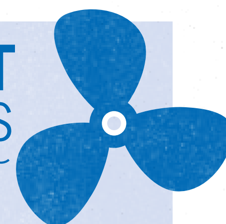
	2014	2013	2010
FTSE 100	37	34	54
FTSE 101–200	49	53	80
FTSE 201–350	91	67	88

Average audit and non-audit fees (£m)

	2014		2013		2010	
	Audit	Non-audit	Audit	Non-audit	Audit	Non-audit
FTSE 100	6.24	1.70	6.45	1.72	6.34	2.48
FTSE 101–200	1.11	0.52	1.06	0.49	1.14	0.66
FTSE 201–350	0.43	0.31	0.65	0.34	0.51	0.39

"The audit market is going through unprecedented upheaval. Research suggests that after years of very little movement the situation is now changing."

FAST FACTS



- 68% of FTSE 100 reports and 63% of Mid 250 provide an effective description of the work undertaken by the audit committee on the financial statements
- Over two thirds of reports give a detailed description of internal control and risk management arrangements, however only 19% adequately explain how the audit committee assessed the effectiveness of the internal controls
- Only 41.3% of companies commit to undertaking an audit tender at least once every 10 years
- 90.4% of FTSE 350 companies have an internal audit function
- For the largest 30 companies in the FTSE 100, non-audit fees represent an average of 28% of the audit fee – which is £14m
- The largest non-audit fee in the FTSE 350 is £8.5m. This represents 43% of the audit fee

Risk and internal control disclosures

"The board should maintain a sound risk management and internal control systems."

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

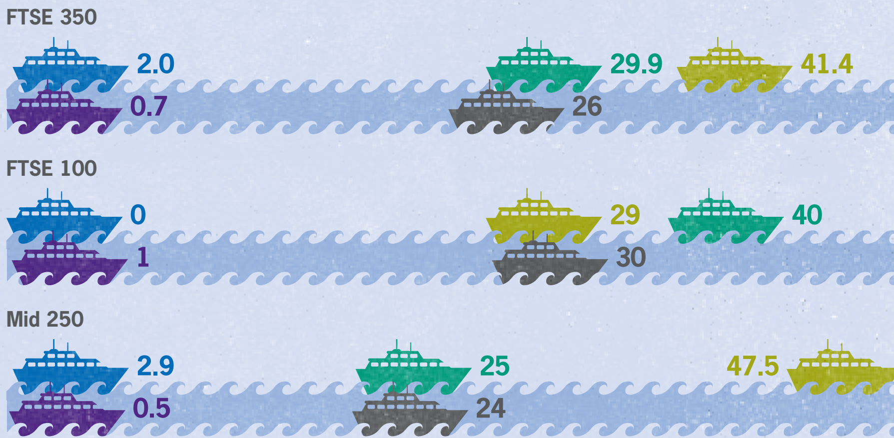
Companies are typically good at describing their risk and internal control frameworks but tend to give less insight into the work undertaken by the audit committee. At least two thirds of annual reports provide informative descriptions of companies' risk management and internal control arrangements, but only 18.2% give the same level of insight as to how the board reviewed their effectiveness. Many reports simply state that the audit committee undertook a review of the internal financial controls and concluded they were effective. The 2014 Code changed the emphasis on this, with an expectation that monitoring should be continuous and the committee should explain the processes used, rather than merely acknowledging that a review took place

A company's inability to describe its internal control or risk management arrangements may not indicate that its underlying processes are weak: anecdotal evidence suggests many companies roll forward pro forma disclosures provided by their auditors. However, as demand for greater audit committee accountability and transparency grows and accounting surprises continue to come to light, such an explanation is likely to become untenable. Audit committees should now be giving thought to how they can maintain effective oversight throughout the year.

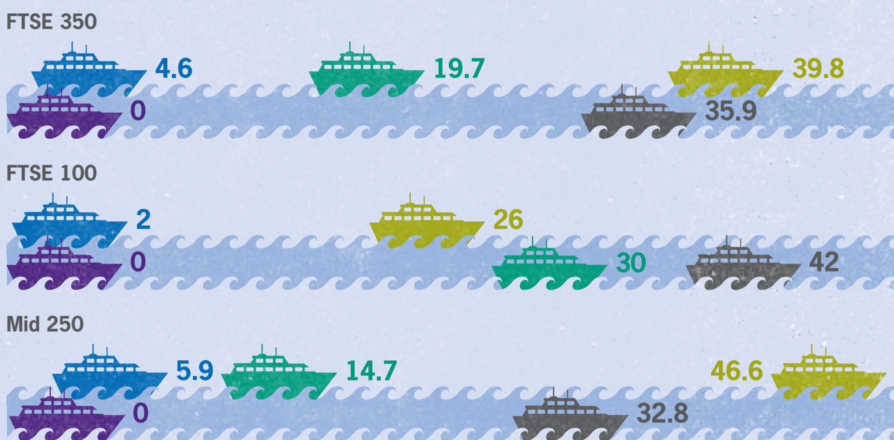
Guidance on Risk Management, Internal Control and Related Financial Information was published by the FRC in September 2014, superseding the Turnbull Guidance. Resultant changes to the Code have increased the focus on linking risks, controls and mitigating actions and emphasise the need for continuous rather than one off monitoring and oversight by the board. With annual reports subject to increasing scrutiny by shareholders and information agencies and a greater focus on the role of audit committees, companies are advised to ensure that disclosures go beyond the boilerplate so as to give greater confidence to the strength of the risk and internal control arrangements regardless of the size of the company.

"With annual reports subject to increasing scrutiny by shareholders and information agencies, companies are advised to ensure that disclosures go beyond the boilerplate. Not least so that they are not perceived as having weak risk and internal control arrangements."

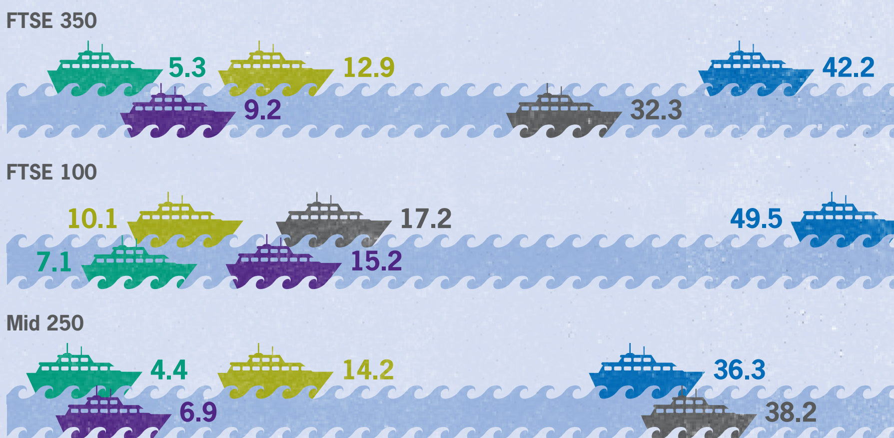
HOW MUCH INFORMATION IS THERE ABOUT THE COMPANY'S RISK MANAGEMENT ARRANGEMENTS? (%)



HOW MUCH INFORMATION IS THERE ABOUT THE COMPANY'S INTERNAL CONTROL SYSTEMS? (%)



HOW MUCH INFORMATION IS PROVIDED ON THE PROCESS THAT THE BOARD AND COMMITTEES HAVE APPLIED IN REVIEWING THE EFFECTIVENESS OF THE INTERNAL CONTROL SYSTEM? (%)



None Basic General Good Detailed

The transatlantic skills clash

We expect UK audit committees to have at least one member with recent and relevant financial expertise, in accordance with the Code. This year all but 15 FTSE 350 companies disclose that they do.

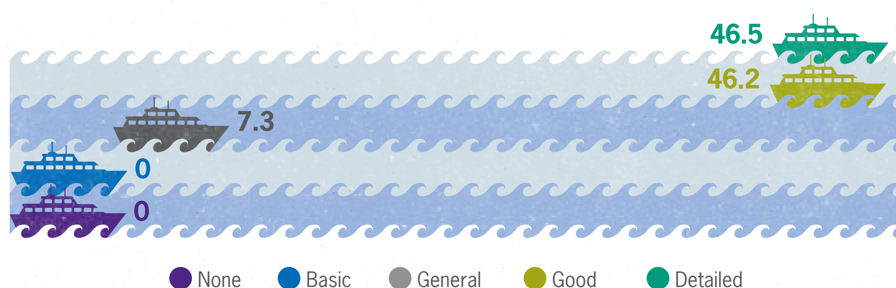
The US has had a different emphasis. There, experience as a CEO or board chairman is the traditional, desirable background for audit committee members, particularly the chairman. Ten years ago, nearly 50% of S&P 500 audit committee chairmen were current or retired CEOs or chairmen, and a further 16% had experience in a CFO or public practice role. However, a heavy increase in the level of regulation – most notably the introduction of the Sarbanes-Oxley Act – has prompted a shift towards finance professionals. More than one third (35%) of audit committee chairmen now have a finance background, compared to 38% who have been a chairman or CEO.

Remuneration committee

The introduction of single-figure reporting and the requirement for the triennial shareholder vote on the remuneration policy has caused the remuneration report to mushroom in size. The average report now stands at 18.2 pages compared to 12.8 in 2013.

HOW CLEARLY DOES THE COMPANY DESCRIBE ITS REMUNERATION POLICY? (%)

FTSE 350



"With a number of high-profile disagreements and changes of committee chairman over the past two years, chairmen are engaging with investors through the remuneration report like never before."

With a number of high-profile disagreements and changes of committee chairman over the past two years, unsurprisingly, chairmen are engaging with investors through the remuneration report (among other channels) like never before. This year, 93.1% of chairmen provide a personal introduction to their report, compared with 50% two years ago. In some cases this can run to three or four pages, outlining the content of and rationale for the remuneration policy. The number of meetings per year, meanwhile, has increased to 5.1 (2013: 4.9) no doubt influenced by the increased requirements mentioned above.

Intense scrutiny from institutions, politicians and the regulators has inevitably led to much higher-quality remuneration reporting. We found that 92.7% give a very informative description of their remuneration policy, making this the most consistently well-explained matter in the front end of the annual report. Nevertheless, high-quality disclosure is no substitute for close engagement and communication with shareholders. This was demonstrated during the 2014 AGM season, which saw a spate of well-publicised protest votes against both remuneration policies and reports.

Kentz became the first company to have its three-year remuneration policy rejected by shareholders, while 42% of Hiscox shareholders voted against its policy. And as for remuneration reports, almost 53% of shareholders voted against the Burberry report, with 16% rejecting the remuneration policy. At the time of writing, nine companies from the FTSE 100 alone have published clarification statements about executive remuneration.

There are two factors at work here. Undoubtedly, investor information services have very specific criteria by which they score companies' disclosures and these are not always clear to companies. Surprisingly, some companies still rely on the annual report and AGM to communicate with shareholders on executive pay when early face to face consultation well in advance of the AGM might serve them better. Perhaps we might soon start to see more such references in the narrative around shareholder engagement?

The 2014 Code introduced a requirement for companies, when publishing general meeting results, to explain how they intend to engage with shareholders if a significant percentage votes against a resolution. Let us hope that, as companies learn the lesson about the need for effective consultation with investors about remuneration, few will have cause to act on this requirement.

Executive pay

"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."

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

In an attempt to identify the typical executive remuneration package, this year we analysed pay disclosures but found that practice is too diverse for a simple formula. As one would expect, the average salary is higher in the FTSE 100 than the Mid 250, as are the level of bonus, pension and share options as a percentage of salary. The significant variation between sectors is perhaps the most striking finding. The basic materials sector, which covers areas ranging from mining and forestry to chemicals, has an average basic salary of £598,680, compared to £357,120 in the technology industry. However, basic materials executives receive lower bonuses and pensions contributions as a proportion of salary than their peers in other sectors. The actual bonus paid in financial services is an average of 194% of salary compared to 58.1% in the utilities sector. Financial services executives also enjoy one of the highest levels of share options: valued at an average of 217.7% of salary. However, possibly as a legacy of having been state industries, executives in the utilities sector enjoy the most generous pension contributions, at 51.2% of basic salary.

Components of executive pay 2014 (including selected sectors)

	Basic salary £	Actual bonus % salary	Pension % salary	Options % salary	Other % salary	Total % salary
FTSE 350	441,356	111	24	170	14	419
FTSE 100	583,291	123	32	208	20	484
Mid 250	369,420	102	17	140	9	368
Basic materials	598,680	65	16	67	22	270
Financial services	415,191	194	22	218	16	551
Technology	357,120	63	16	154	7	340
Utilities	491,358	58	51	169	9	387

Components of executive pay 2013

	Basic salary £	Actual bonus % salary	Pension % salary	Options % salary	Other % salary	Total % salary
FTSE 350	427,540	91	16	65	11	284
FTSE 100	578,602	98	18	92	15	324
Mid 250	348,635	85	14	41	8	249

Performance-related pay

"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)

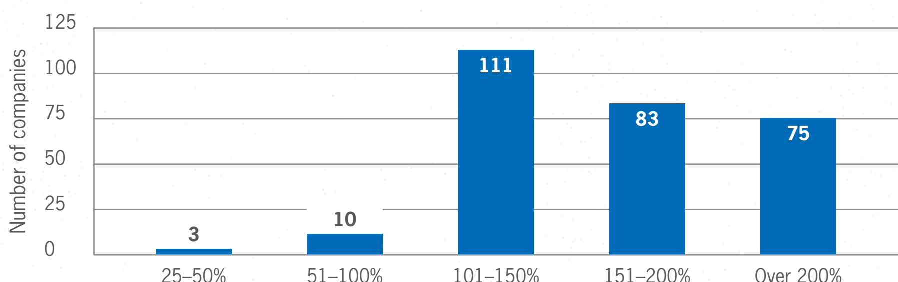
Changes to remuneration reporting, and moves at the European Commission to cap bonus payments to senior bankers, have ensured that remuneration remains a contentious topic. The 2014 Code included revisions to the provisions on remuneration, stating that greater emphasis should be placed on aligning remuneration to long-term performance, and that companies should "put in place arrangements that will enable them to recover or withhold variable pay when appropriate to do so, and should consider appropriate vesting periods and holding periods for deferred remuneration".

"Some firms still rely on the annual report and AGM to communicate with shareholders on executive pay. Companies should rather consult with shareholders well in advance of the AGM."

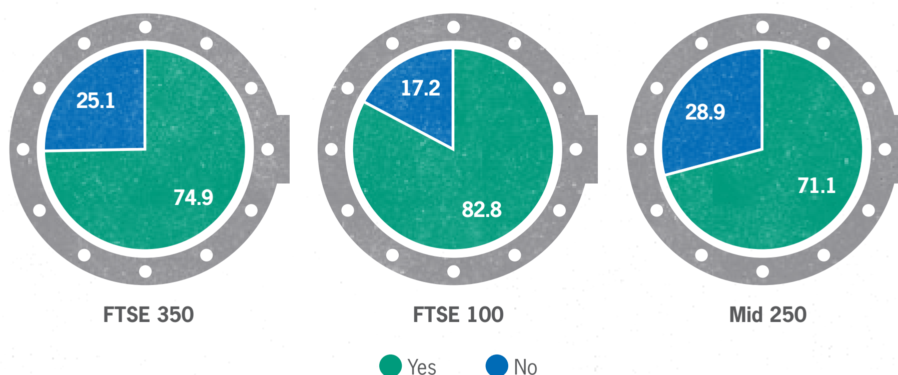
The rallying of the economy and a push towards performance-related pay is evident in the overall payments made. Base salaries have not risen significantly this year. This is particularly noticeable in the FTSE 100, where average basic salary is now £583,291 compared to £578,602 in 2013. There has, however, been a marked increase in the level of bonus payments, pensions and, most significantly, options realised. This year, the average bonus was 111% of salary compared to 91%, while share options are now valued at 170% of salary compared to 65% in 2013.

In the same period the average maximum bonus rose from 151% to 157% of salary, suggesting that this year's higher bonus payments reflect better company performance.

Level of potential maximum bonus (FTSE 350)



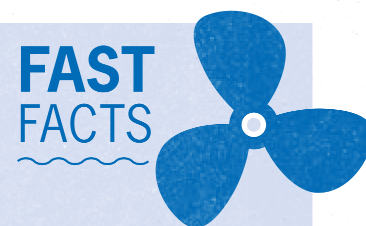
DOES THE COMPANY HAVE A CLAWBACK POLICY? (%)



Clawback policies are now common among listed companies, with three quarters of businesses disclosing one compared to only 21.1% when we started gathering this data in 2011. No company said it had exercised its policy during the year.

We support the alignment of directors' long term interests with those of investors. For this move to be truly effective, boards must be willing to give the remuneration policy teeth. Judging by recent press comment, we expect to see more examples of boards clawing back reward in the coming year.

FAST FACTS



- Only 7.6% of companies fail to give a good or detailed description of their remuneration policy
- The average remuneration report is now 18.2 pages, compared to 12.8 pages a year ago
- Basic salary has risen only 3% for FTSE 350 directors
- The average bonus has risen from 91% of salary to 111% of salary
- 98 companies have a maximum bonus of more than 150% of salary, of which 22 are financial services companies
- 75% of FTSE 350 companies have a clawback provision, but no company has exercised this provision

Recent developments

<table>
<tr><th></th><th>Comments</th><th>Timing</th></tr>
<tr><td colspan="3">Governance of companies</td></tr>
<tr><td>The UK Corporate Governance Code</td><td>In September 2014, the FRC published a revised edition of the UK Corporate Governance Code following earlier consultations on director’s remuneration (October 2013) and risk management, internal control and the going concern basis of accounting (November 2013). The revised edition includes the following updates to the 2012 UK Corporate Governance Code:

Greater emphasis be placed on ensuring that remuneration policies are designed with the long-term success of the company in mind, and that the lead responsibility for doing so rests with the remuneration committee
Companies should put in place arrangements that will enable them to recover or withhold variable pay when appropriate to do so, and should consider appropriate vesting and holding periods for deferred remuneration
Companies should explain when publishing AGM results how they intend to engage with shareholders when a significant percentage of them have voted against any resolution
Companies should state in their financial statements whether they consider it appropriate to adopt the going concern basis of accounting and identify any material uncertainties to their ability to continue to do so
Companies should robustly assess their principal risks and explain how they are being managed and mitigated
Companies should state whether they believe they will be able to continue in operation and meet their liabilities taking account of their current position and principal risks, and specify the period covered by this statement and why they consider it appropriate. It is expected that the period assessed will be significantly longer than 12 months
Companies should monitor their risk management and internal control systems and, at least annually, carry out a review of their effectiveness, and report on that review in the annual report
Companies can choose where to put the risk and viability disclosures. If placed in the strategic report, directors will be covered by the “safe harbour” provisions in the Companies Act 2006

The FRC also highlighted the importance of the board’s role in establishing the ‘tone from the top’ in terms of a company’s culture and values.</td><td>The 2014 Code applies to accounting periods beginning on or after 1 October 2014.

The Code is next scheduled to be reviewed in 2016. At that time it is currently expected that the FRC will be looking at changes to the section of the Code dealing with the audit committee and appointment of the external auditor as well as websites being a used as a medium for some or all corporate governance reporting rather than relying on the annual report.</td></tr>
<tr><td>QCA, AIM rules and unlisted companies</td><td>The QCA small company corporate governance code and the IoD corporate governance guidance for unlisted companies have not been updated throughout 2013/14. However, the QCA expert group is currently working on revising the Audit Committee Guide for Smaller Quoted Companies.

Changes to the AIM Rule 26 governing website informational requirements for AIM listed companies came into effect on 11 August 2014. The London Stock Exchange now requires all AIM companies to provide on their website:

Details of the corporate governance code that the AIM company has decided to apply
How the AIM company complies with that code
Or if no code has been adopted this should be stated together with the company’s current corporate governance arrangements

AIM companies currently are free to choose their basis of governance (either the UK Corporate Governance Code, the QCA Corporate Governance Code for Small and Mid-Size Quoted Companies, another code or none at all).</td><td>Updated AIM Rules came into effect on 11 August 2014.</td></tr>
</table>

Governance of investors		
The Stewardship Code and the Kay Review	Stewardship Code (2012) is currently effective, no changes imminent. Kay Review (2012) update is due to be published in 2015. The 2013 progress report of Professor Kay's review of equity markets and long term decision making illustrated that much of what had been recommended was already a good business practice for many stakeholders. Some key initiatives are being overseen by the IMA, whilst areas such as the legal concept of fiduciary duty and independent review of metrics and models for the investment chain (amongst others), remain under consideration.	Update anticipated to the Kay Review in 2015.
FCA Listing Regime	The FCA made changes to the Listing Rules following concerns from investors regarding the governance of premium listed companies with a controlling shareholder, and the need to protect the interests of minority shareholders. The November 2013 consultation which formed the basis for these changes included a question on changing the rules on cancelling a listing and whether premium listed issuers with a controlling shareholder would to gain approval from the majority of independent shareholders before seeking to delist; or retain the existing rules on cancellation. Therefore, if a premium listed company has a controlling shareholder and wishes to apply for a cancellation it would have to both: • obtain a majority of at least 75% of the votes attaching to the shares of those voting on the resolution • gain approval by a majority of the votes attaching to the shares of independent shareholders. Furthermore, in takeover offer situations, an equivalent requirement based on acceptances applies, except that when an offeror has acquired or agreed to acquire more than 80% of voting rights no further approval/acceptances by independent shareholders would be required to cancel the premium listing.	Changes to the Listing Rules came into effect on 16 May 2014.
European Commission		
Audit Policy	On 14 April 2014, the Council of Ministers finally adopted the Audit legislation that has been under debate since October 2010. The legislation is wide-ranging and includes some controversial requirements such as the imposition of a mandatory audit firm rotation for the statutory auditors of all Public Interest Entities, (PIEs), across the EU, as well as significant restrictions on the range of non-audit services that can be provided to these entities by their statutory auditors. PIEs are defined as companies with transferable securities traded on an EU regulated market as well as other public interest companies such as banks, insurance companies and other financial entities.	As this legislation comprises a Regulation and a Directive there may well be differences in speed of adoption across the EU. However, the majority of the provisions are expected to take effect by July 2016.
Gender diversity		
The Davies Report	Since the launch of the Davies report in 2011, women's representation on FTSE 100 boards has risen significantly and currently stands at 20.7%, up from 12.5% in 2011. Admittedly the bulk of these additions have been non-executive positions and therefore the challenge to strengthen the executive pipeline to include more women still stands. The smaller FTSE 250 company bracket has achieved 15.6%, up from 7.8% in 2011 – with 83 of the FTSE 250 all male boards in 2011 now having recruited one or more women onto their boards.	The Davies target is for FTSE 100 companies to have 25% female representation on the board by 2015.

Executive remuneration		
Director's Pay: Revised Remuneration Reporting Regulations	The regulations introduced a binding vote by shareholders on remuneration policy once every three years. The regulations specify that the remuneration report should contain two distinct parts: • When there is a shareholder vote on remuneration policy, a policy report setting out all elements of a company's remuneration policy and key factors taken into account in setting the policy • An annual report on how the policy was implemented in the last financial year, setting out actual payments to directors and details on the link between company performance and pay	Currently in effect.
Narrative reporting		
FRC Guidance on the Strategic Report	The FRC published Guidance on the Strategic Report providing guidance on the requirements of the Companies Act 2006 (Strategic Report and Directors' Report) Regulations 2013. The purpose of this strategic report is to provide a company's shareholders with a holistic and meaningful picture of a company's business model, strategy, development, performance, position and future prospects. The Guidance outlines the content of the strategic report and includes communication principles that emphasise the qualities of good financial reporting. The Guidance also encourages companies to focus on the application of materiality to disclosures and to be innovative in the structure of information to improve the clarity and conciseness of information. The Guidance on the Strategic Report replaces the ASB's 2006 reporting statement on the Operating and Financial Review (OFR).	The guidance was published in June 2014.
EU Directive on Non-Financial Reporting	The FRC monitors and responds to European and international developments in narrative reporting which includes the planned UK implementation of the EU Directive on non-financial reporting. On 15 April 2014 the plenary of the European Parliament adopted the EU Directive on disclosure of non-financial and diversity information by certain large companies and groups. Companies concerned will need to disclose information on policies, risks and outcomes as regards environmental matters, social and employee-related aspects, respect for human rights, anti-corruption and bribery issues, and diversity in their board of directors. The new rules will only apply to certain large companies with more than 500 employees. The majority of the disclosures in the Directive are already reflected in the strategic report requirements in the Companies Act. The main change for UK companies will be the introduction of disclosures on anti-corruption and bribery issues.	The EU Directive will enter into force once adopted by the Council and published in the EU Official Journal.

Narrative reporting (continued)

International Integrated Reporting Council (IIRC)	The IIRC published its Reporting Framework at the end of 2013 with the aim of speeding adoption of integrated reporting across the world. Integrated reporting applies principles and concepts that are focused on bringing greater cohesion and efficiency to the reporting process, and adopting 'integrated thinking' as a way of breaking down internal silos and reducing duplication. The Framework was released following extensive consultation and testing by businesses and investors, including 140 businesses and investors from 26 countries that participated in the Pilot Programme. The purpose of the Framework is to establish Guiding Principles and Content Elements that govern the overall content of an integrated report, and to explain the fundamental concepts that underpin them. The following Guiding Principles underpin the preparation and presentation of an integrated report, informing the content of the report and how information is presented: Strategic focus and future orientation, connectivity of information, stakeholder relationships, materiality, conciseness, reliability and completeness, consistency and comparability. The content elements of an integrated report should cover the following: • Organisational overview and external environment • Governance • Business model • Risks and opportunities • Strategy and resource allocation • Performance • Outlook • Basis of preparation and presentation • In addressing the above, takes account of general reporting guidance	The International <IR> Framework was published in December 2013

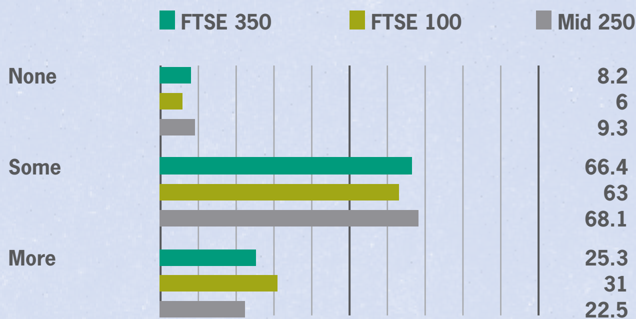
Appendix

Strategic report

QUESTION 1. DOES THE BOARD EXPLAIN THE BASIS ON WHICH IT CONSIDERS THE ANNUAL REPORT IS FAIR, BALANCED AND UNDERSTANDABLE?

Guidance: "The board should establish arrangements that will enable it to ensure that the information presented is fair, balanced, and understandable". (UK Corporate Governance Code, C.1 Accountability – Supporting principle)

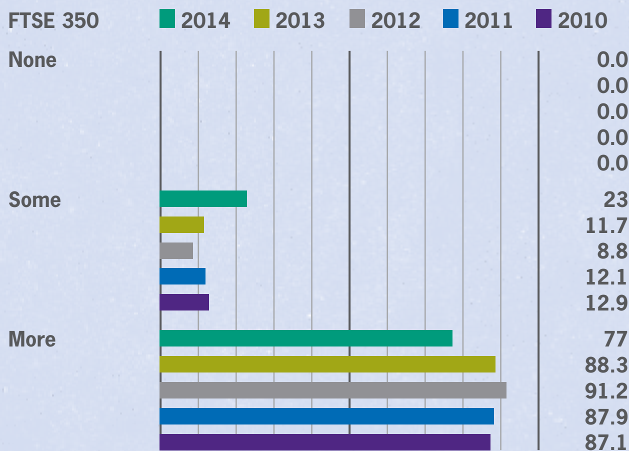
Figure 1 (%)

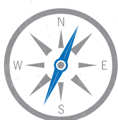


QUESTION 2. TO WHAT EXTENT DO COMPANIES DESCRIBE THEIR BUSINESS AND THE EXTERNAL ENVIRONMENT IN WHICH THEY OPERATE?

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 2 (%)





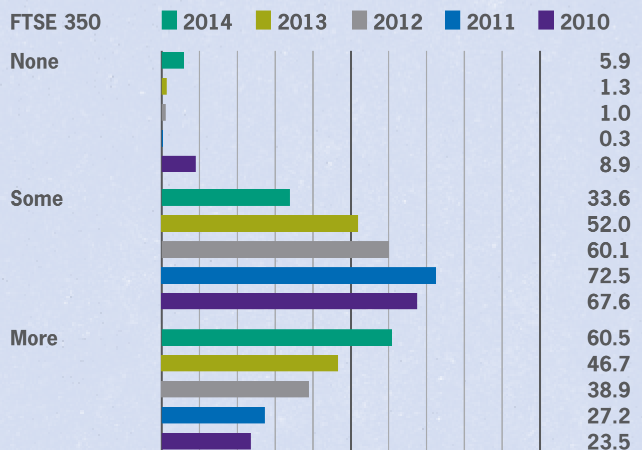
Companies providing 'more' detailed disclosures give a description of:

- the structure of the business
- the company's main products and services
- main operating facilities and locations
- key customers and suppliers
- relevant sector or industry specific information including the regulatory and competitive environment.

QUESTION 3. 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 3 (%)



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

- provided clarity around how they create and sustain value
- structured their narrative reporting around the business model
- explained not just what they do, but how they do it
- described their key strengths and differentiators from competitors such as financial strength, intellectual property, human capital and access to natural resources
- recognised the impact of external factors.

QUESTION 4. TO WHAT EXTENT DO THE COMPANIES DESCRIBE THE LIKELY FUTURE DEVELOPMENT OF THE BUSINESS?

Guidance: "In the case of a quoted company the strategic report must, to the extent necessary for an understanding of the development, performance or position of the company's business, include – (a) the main trends and factors likely to affect the future development, performance and position of the company's business". (Companies Act 2006 s414C; 7)

Figure 4 (%)

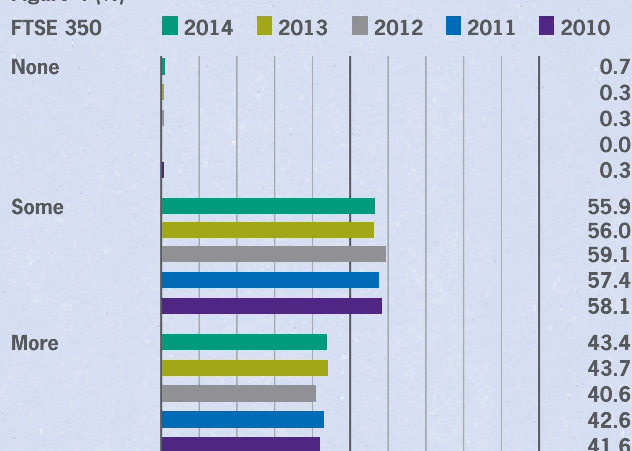


Figure 5 (%)

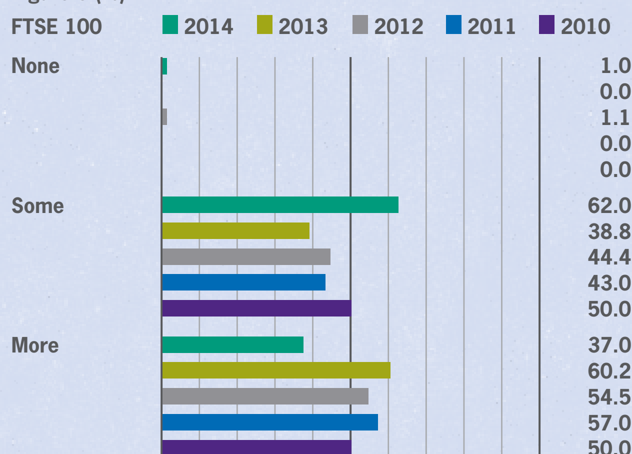
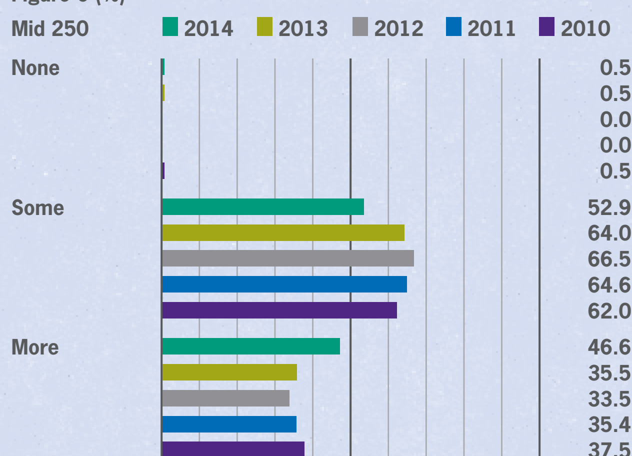


Figure 6 (%)



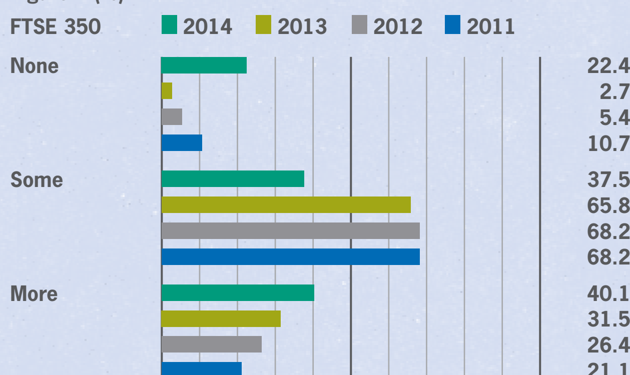
The best disclosures provided:

- 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 5. 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 7 (%)



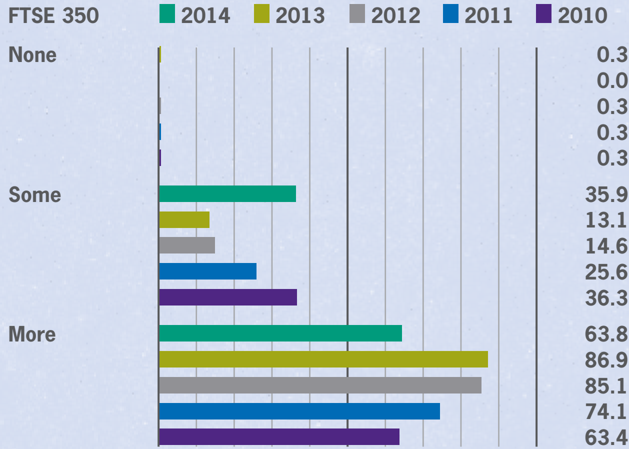
Setting strategy includes determining the extent to which the company is willing and able to bear exposure to key risks. Best practice to consider:

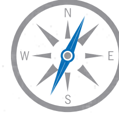
- Transparent linkage between strategy/strategic objectives, KPIs and principal risks, through use of symbols or references
- Avoid confusing repetition
- Clear and informative disclosure individually of strategic objectives, KPIs and risks
- Links should be specific and quantified

QUESTION 6. 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)

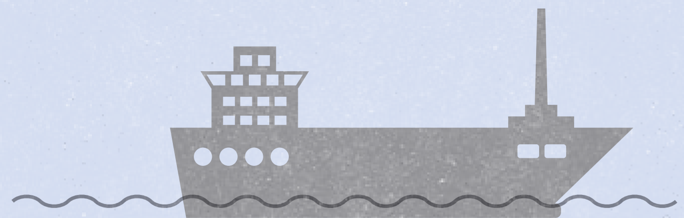
Figure 8 (%)





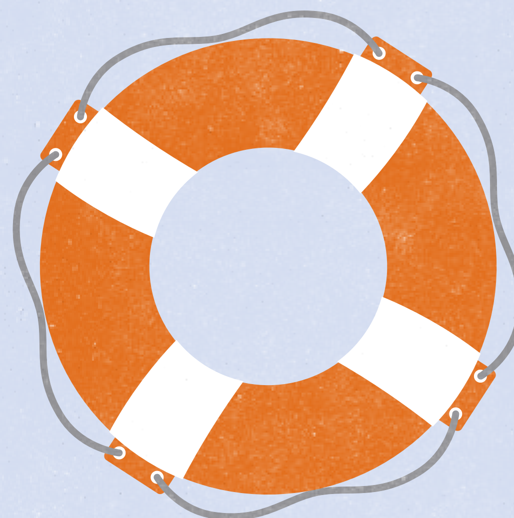
Companies giving more detailed descriptions provided:

- 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.



Average number of principal risks disclosed by companies (Figure 9)

	FTSE 350 (307)	Basic Materials (25)	Consumer Goods (28)	Consumer Services (62)	Financials (70)	Healthcare (11)	Industrials (67)	Oil & Gas (16)	Technology (12)	Telecommunications (8)	Utilities (7)
Financial	2.2	2.3	2.3	2	2.9	2.6	1.7	2.5	1.3	0.5	1.1
Operational	3.1	3.5	3.0	3.4	3.0	4.5	2.6	4.2	3.4	3.6	2.3
Macro-economic	1.3	1.4	1.8	1.5	1.2	1.2	1.3	1.2	0.8	0.6	1.7
Regulation/compliance	1.4	1.4	1.9	1.4	1.2	2.5	1.2	1.9	0.9	1.1	1.4
Expansion/growth	0.8	1.0	1.1	0.7	0.3	1.7	0.8	0.9	1.7	0.8	0.6
Employees	0.9	1.0	1.0	0.9	0.7	1.0	0.9	1.1	0.7	0.3	0.3
Reputation	0.5	0.3	0.6	0.6	0.4	0.4	0.4	0.5	0.4	0.5	0.3
Technology	0.7	0.4	0.5	1.1	0.3	0.7	0.7	0.3	1.0	1.1	0.7
Environmental issues	0.2	0.5	0.4	0.1	0	0.2	0.2	0.5	0	0.1	0.3
Average total number of risks	**10.9**	**11.9**	**12.6**	**11.6**	**10**	**14.9**	**9.6**	**13**	**10.1**	**8.6**	**8.7**



QUESTION 7. TO WHAT EXTENT HAS THE COMPANY PROVIDED AN EFFECTIVE DESCRIPTION OF ITS CORPORATE RESPONSIBILITY POLICIES AS REQUIRED IN THE STRATEGIC REPORT REGULATIONS?

Guidance: "In the case of a quoted company the strategic report should include [...] (b) information about –

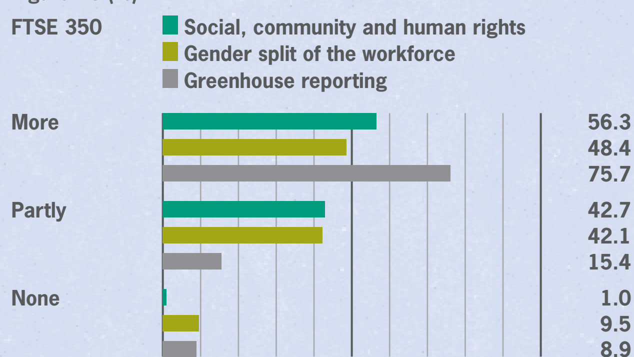
(i) environmental matters (including the impact of the company's business on the environment),

(ii) the company's employees, and

(iii) social, community and human rights issues,

including information about any policies of the company in relation to those matters and the effectiveness of those policies". (Companies Act 2006 s414C; 7)

Figure 10 (%)



Average number of KPIs disclosed (Figure 11)

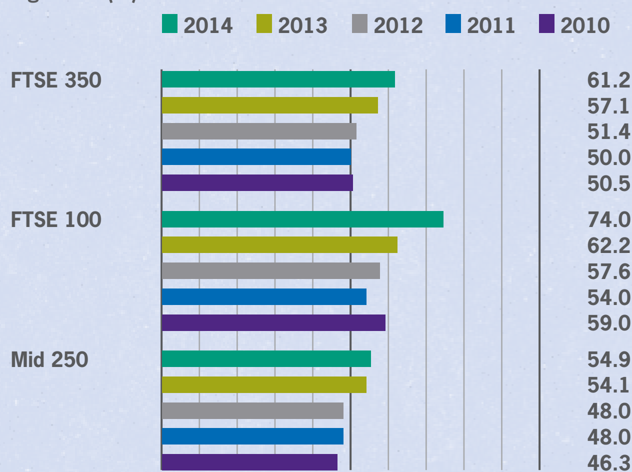
	FTSE 350 (307)	Basic Materials (25)	Consumer Goods (28)	Consumer Services (62)	Financials (70)	Healthcare (11)	Industrials (66)	Oil & Gas (15)	Technology (12)	Telecommunications (8)	Utilities (7)
Revenue	1.0	0.6	1.0	0.9	1.1	1.5	0.9	0.8	2.1	2.0	0.7
Profit and costs	1.5	1.5	1.8	1.5	1.4	1.4	1.4	1.5	1.8	1.4	2.3
Shareholders' funds	1.2	1.0	1.3	1.0	1.5	1.1	1.1	1.3	1.2	0.8	2.4
Working capital/cash flow	0.6	0.6	0.7	0.5	0.5	0.5	0.8	1.3	0.5	0.6	0.4
Capital expenditure and other assets	0.4	0.4	0.3	0.2	0.7	0.3	0.2	0.5	0.1	0.3	1.1
Interest, debt or gearing	0.2	0.3	0.2	0.2	0.2	0.3	0.2	0.3	0.4	0.4	0.4
Expansion/growth	0.4	0.4	0.3	0.5	0.3	0.7	0.4	0.5	0.6	0.4	0.3
Environment	0.4	1.3	0.8	0.3	0.1	0.0	0.5	0.2	0.3	0.1	0.9
Operation	1.6	2.1	1.6	2.3	1.4	1.6	1.0	1.1	2.0	1.0	3.3
Employees	0.6	0.7	0.4	0.4	0.5	1.2	0.7	0.9	0.2	0.8	1.0
Reputation	0.3	0.1	0.4	0.4	0.3	0.1	0.2	0.0	0.1	0.3	0.7
Regulation and compliance	0.3	0.8	0.5	0.2	0	0.5	0.6	0.6	0.2	0.0	1.1
Total average	**8.6**	**9.9**	**9.3**	**8.3**	**8.0**	**9.1**	**8.0**	**8.9**	**9.3**	**7.9**	**14.7**

Governance

QUESTION 8. 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 11 (%)



Top 10 areas of non-compliance

Figure 12

CODE PROVISIONS	REQUIREMENT	% OF NON-COMPLIANT COMPANIES	% OF ALL FTSE 350 COMPANIES
B.1.2	At least half the board, excluding the chairman, should comprise non-executive directors determined by the board to be independent.	25.4%	9.8%
D.2.1	The board should establish a remuneration committee of at least three independent non-executive directors. In addition, the company chairman may also be a member, but not chair, if he or she was considered independent on appointment.	23.7%	9.1%
C.3.1	The board should establish an audit committee of at least three independent non-executive directors. The board should satisfy itself that at least one member of the audit committee has recent and relevant financial experience.	19.5%	7.5%
B.6.2	Evaluation of the board of FTSE 350 companies should be externally facilitated at least every three years. The external facilitator should be identified in the annual report and a statement made as to whether they have any other connection with the company.	14.4%	5.5%
C.3.7	The audit committee should have primary responsibility for making a recommendation on the appointment, reappointment and removal of the external auditors. FTSE 350 companies should put the external audit contract out to tender at least every 10 years.	11.9%	4.6%
A.2.1	The roles of chairman and chief executive should not be held by the same individual. The division of responsibilities between the chairman and chief executive should be clearly established, set out in writing and agreed by the board.	9.3%	3.6%
B.2.1	A majority of members of the nomination committee should be independent non-executive directors. The chairman or an independent non-executive director should chair the committee.	9.3%	3.6%
A.3.1	The chairman should, on appointment, meet the independence criteria set out in B.1.1. A chief executive should not go on to be chairman of the same company.	8.5%	3.3%
A.4.1	The board should appoint one of the independent non-executive directors to be the senior independent director, in order to provide a sounding board for the chairman and serve as an intermediary for the other directors when necessary.	8.5%	3.3%

QUESTION 9. IF NOT COMPLIANT, TO WHAT DEGREE DO THEY EXPLAIN THE REASON FOR NON-COMPLIANCE?

Figure 13 (%)

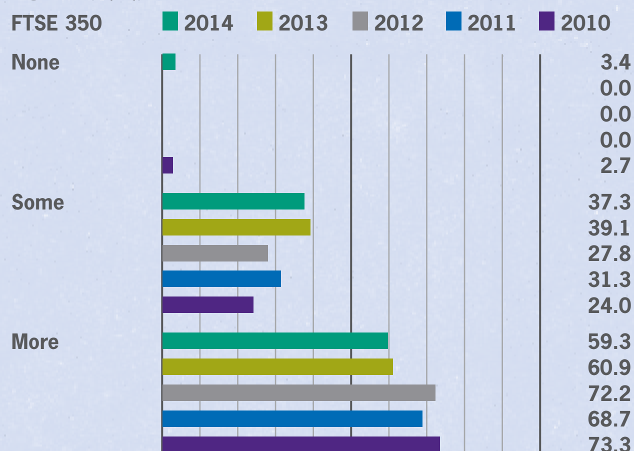


Figure 14 (%)

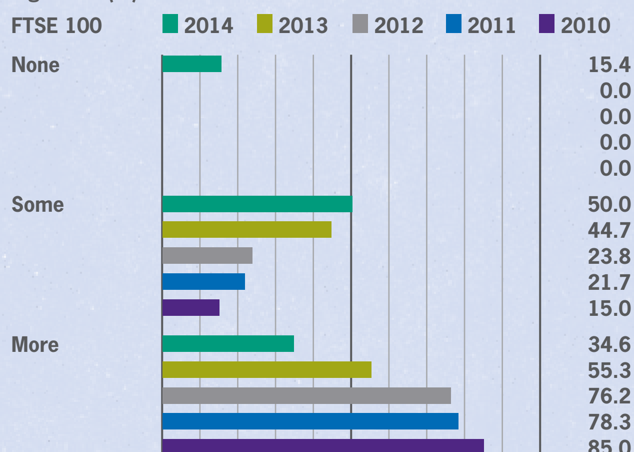
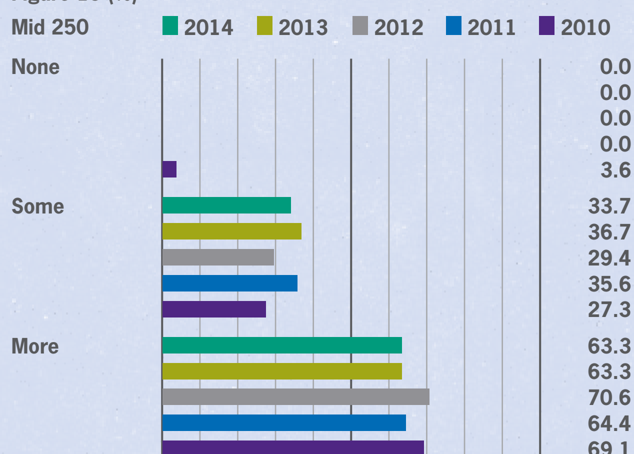


Figure 15 (%)

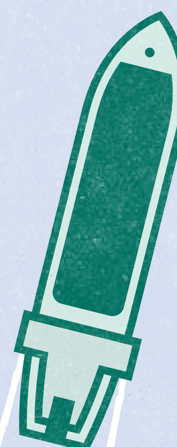


'More' disclosure is achieved where a company provides a detailed explanation to support each area of the Code with which they choose not to comply. This includes the reasons for their non-compliance and an explanation as to why they feel that this non-compliance is in the best interests of the company and the shareholders. There would normally be reference to a regular review of the rationale for non-compliance to assess whether it continues to be in the best interests of the company.

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.

According to the FRC, explanations for areas of non-compliance with the UK Code should cover:

- **background** – the provisions with which the company doesn't comply and what alternative arrangements are in place
- **rationale** – why the company believes its alternative arrangements are appropriate
- **mitigating actions** – what risks to good governance/shareholders' interests the non-compliance might create and how have they been mitigated
- **timescale** – whether the arrangement is temporary or permanent, and if temporary when it will end



QUESTION 10. 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 6)

Figure 16 (%)

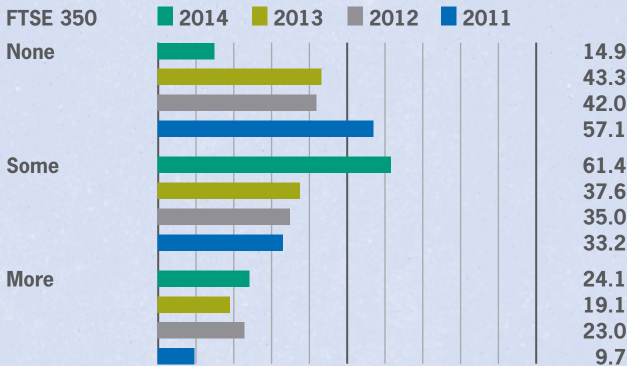


Figure 17 (%)

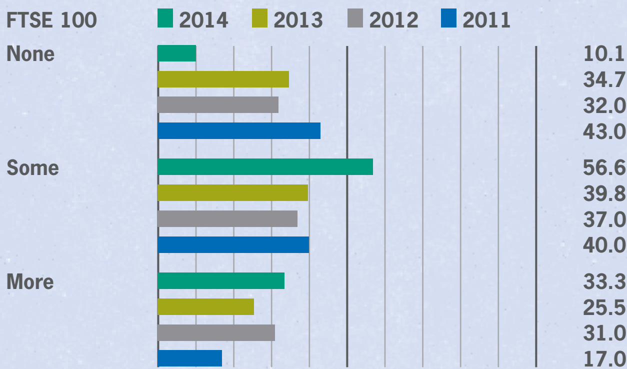
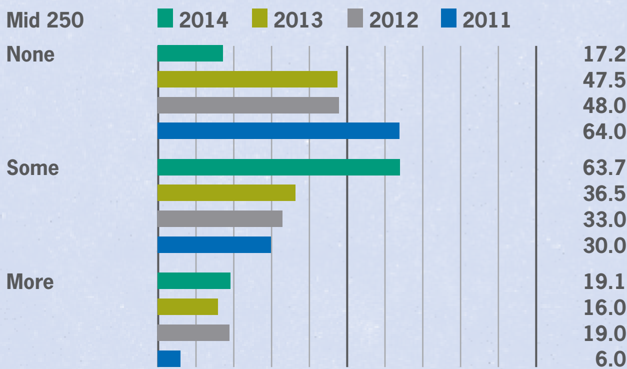


Figure 18 (%)



The most informative disclosures included detail of the following areas:

- The key governance issues facing the business
- Their key governance targets
- Board activities throughout the year
- The company's governance framework
- The corporate governance report
- The company's approach to regulation and guidelines
- Their approach to remuneration
- The key governance objectives and focus of the board for the next year
- Importance of governance to running a successful business
- Stated their personal responsibility for the smooth running of the board
- The results of board evaluation reviews and resultant actions, such as long-term succession planning or increased training
- The key features of governance as they see it
- The significance of good governance in achieving business success and linked what was written in the Chairman's Statement to the Corporate Governance section of the report

QUESTION 11. TO WHAT EXTENT DOES THE CHAIRMAN DESCRIBE KEY FEATURES OF GOVERNANCE IN THE GOVERNANCE REPORT?

Figure 19 (%)

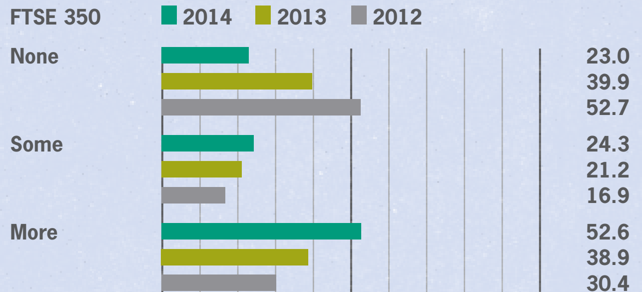


Figure 20 (%)

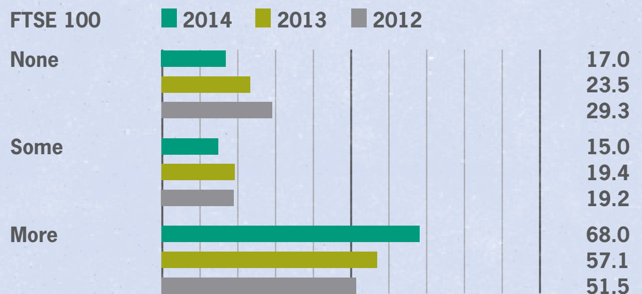
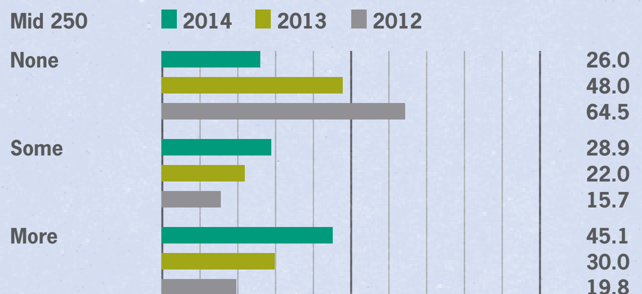


Figure 21 (%)



QUESTION 12. TO WHAT EXTENT DOES THE ANNUAL REPORT DESCRIBE HOW THE BOARD OPERATES AND HOW 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 is to be taken by the board and which are to be delegated to management".
(UK Corporate Governance Code, A.1.1)

Figure 22 (%)

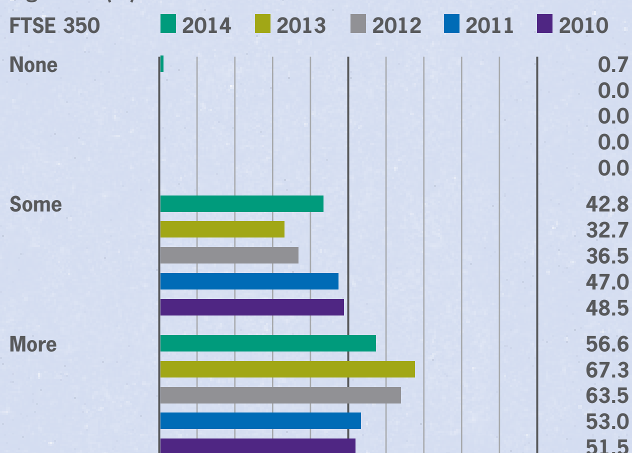


Figure 23 (%)

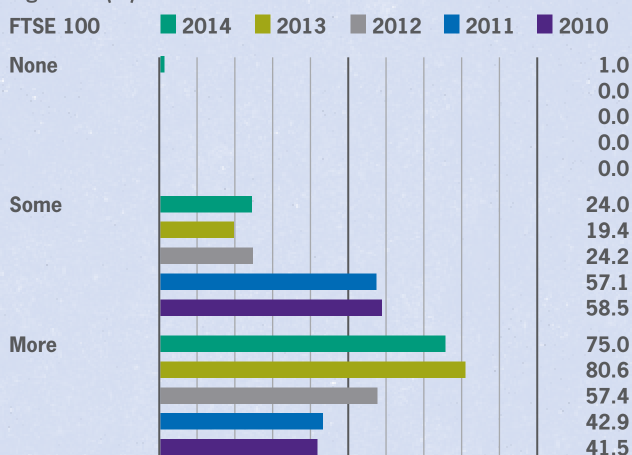
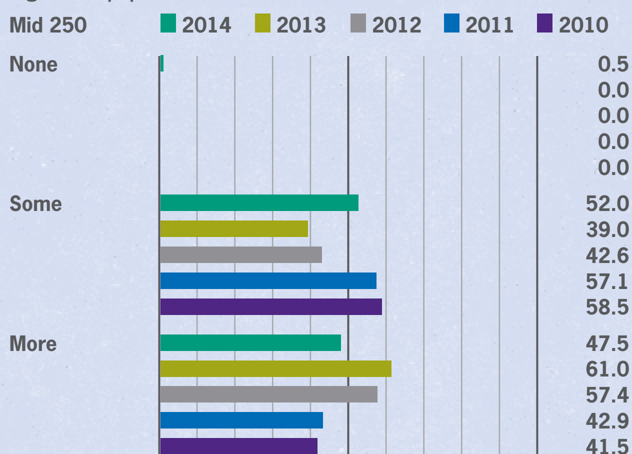
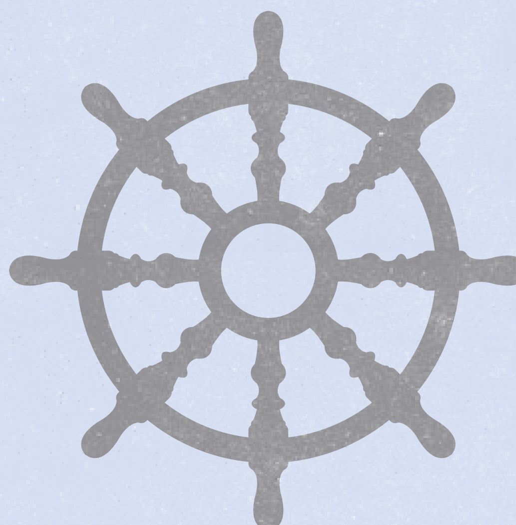


Figure 24 (%)





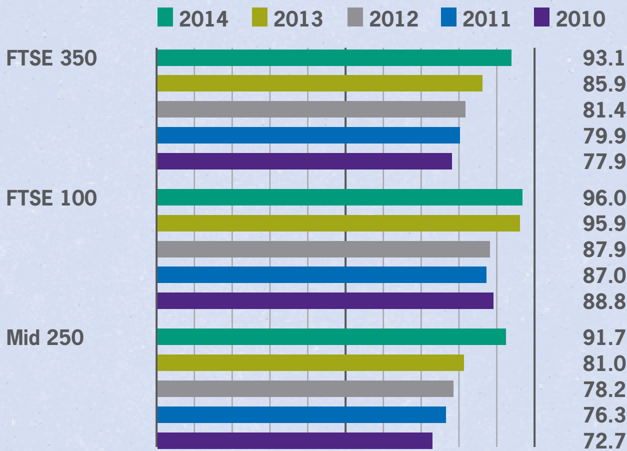
The best disclosures include details such as the following:

- 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
- Demonstration of ethical leadership
- Powers and authorities retained by the board and those delegated to management
- Clearly defined reporting lines and monitoring structures across different levels within the organisation
- Information flows to the board
- Consideration of governance arrangements
- Performance culture created
- Accountability (especially to investors)
- Roles of chairman, chief executive, executives and NEDs
- Areas of strategic importance
- Governance oversight practices

QUESTION 13. 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. A smaller company should have at least two independent non-executive directors". (UK Corporate Governance Code, B.1.2)

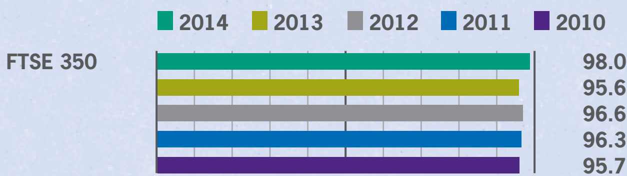
Figure 25 (%)



QUESTION 14. ARE THE ROLES OF THE CHAIRMAN AND CHIEF EXECUTIVE COMBINED?

Guidance: "The roles of chairman and chief executive should not be exercised by the same individual. The division of responsibilities between the chairman and chief executive should be clearly established, set out in writing and agreed by the board". (UK Corporate Governance Code, A.2.1)

Figure 26 (%)



QUESTION 15. 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 27 (%)

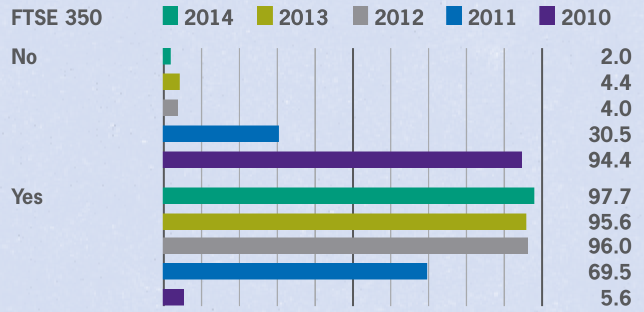


Figure 28 (%)

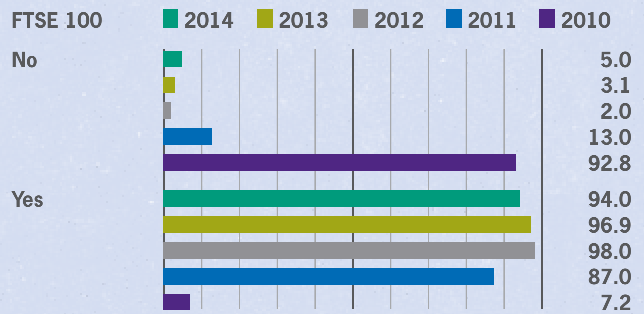
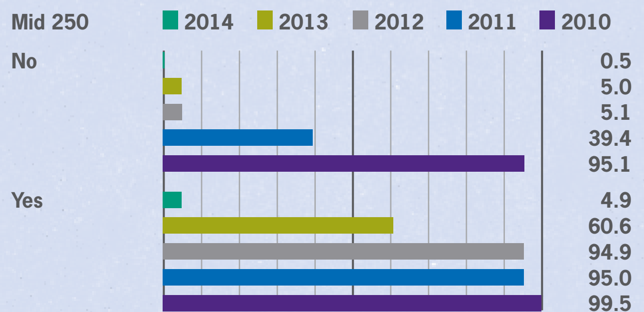
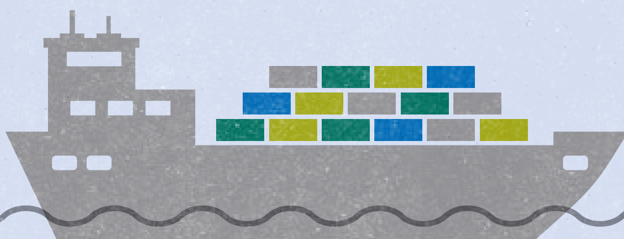


Figure 29 (%)





QUESTION 16. 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, for example through direct face-to-face contact, analysts' or brokers' briefings and surveys of shareholder opinion". (UK Corporate Governance Code, E.1.2)

Figure 30 (%)

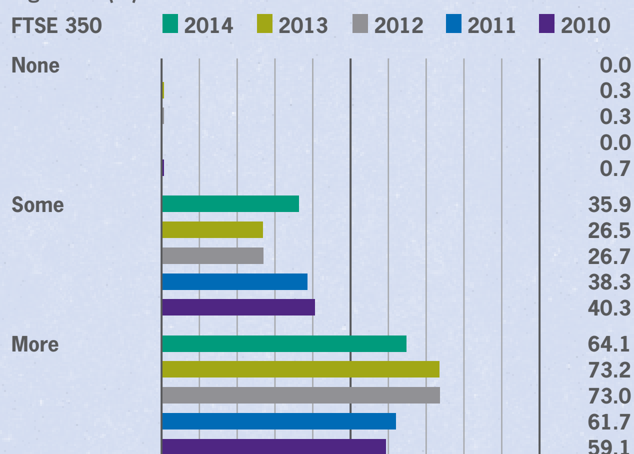


Figure 31 (%)

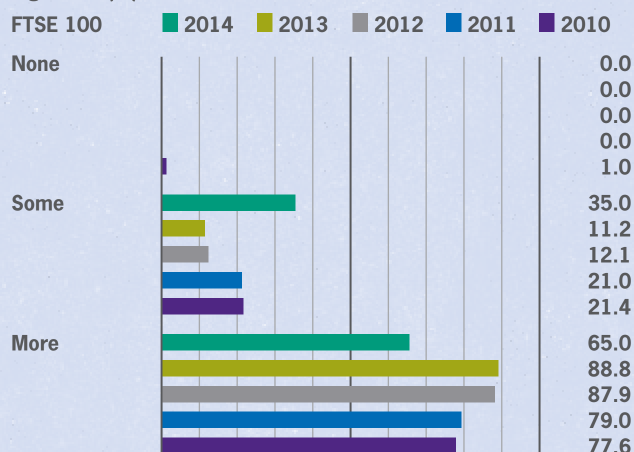
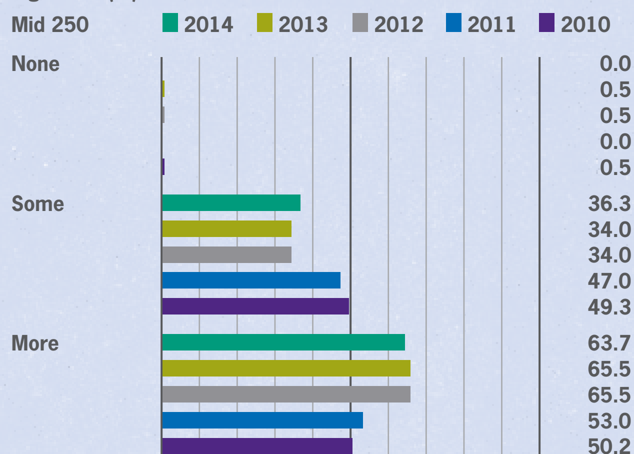


Figure 32 (%)



Many companies had separate sections for shareholder relations, with the best companies making reference to:

- Regular dialogue with shareholders
- Non-executive directors availability to meet with shareholders
- Surveys of shareholder opinion
- Use of the AGM to communicate with investors and to encourage their participation
- Private investors as well as institutions

QUESTION 17. TO WHAT DEGREE DOES THE BOARD DEMONSTRATE THE STEPS TAKEN TO UNDERSTAND THE VIEWS OF MAJOR DEBTHOLDERS?

Guidance: "While in law the company is primarily accountable to its shareholders, and the relationship between the company and its shareholders is also the main focus of the Code, companies are encouraged to recognise the contribution made by other providers of capital and to confirm the board's interest in listening to the views of such providers insofar as these are relevant to the company's overall approach to governance". (UK Corporate Governance Code, Preface, 7)

Figure 33 (%)

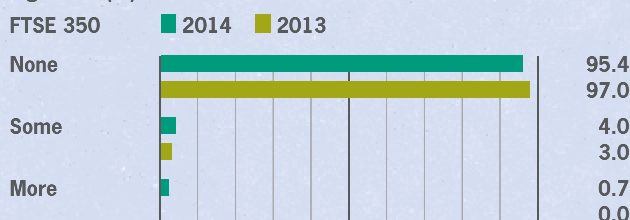


Figure 34 (%)

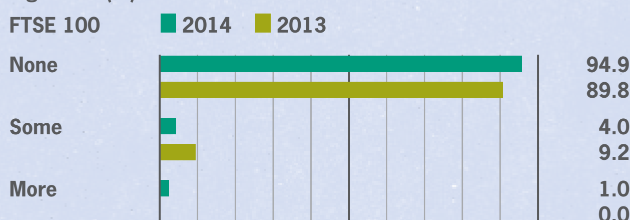
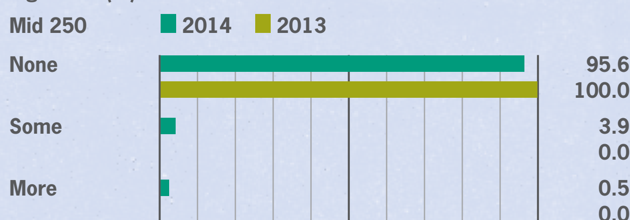


Figure 35 (%)

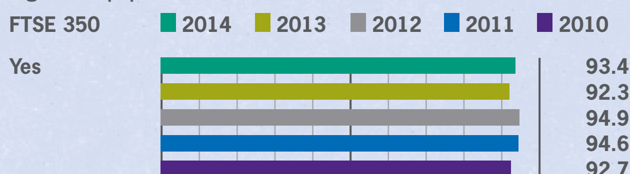


Nomination committee

QUESTION 18. ARE THE NOMINATION COMMITTEE MEMBERSHIP REQUIREMENTS MET?

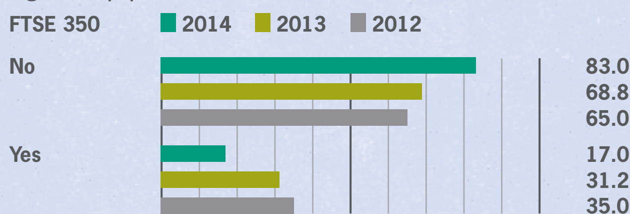
Guidance: "There should be a nomination committee which should lead the process for board appointments and make recommendations to the board. A majority of members of the nomination committee should be independent non-executive directors. The chairman or an independent non-executive director should chair the committee, but the chairman should not chair the nomination committee when it is dealing with the appointment of a successor to the chairmanship. 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 36 (%)



QUESTION 19. IS THERE ANY PERSONAL COMMENTARY FROM THE CHAIRMAN OF THE NOMINATION COMMITTEE?

Figure 37 (%)



QUESTION 20. 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.

This section 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. An explanation should be given if neither an external search consultancy nor open advertising has been used in the appointment of a chairman or a non-executive director. Where an external search consultancy has been used, it should be identified in the annual report and a statement made as to whether it has any other connection with the company". (UK Corporate Governance Code, B.2.4)

Those companies providing 'more' disclosure gave details on:

- succession planning
- search and interview processes and the use of external recruitment consultants
- the skills required for the board
- process for reviewing the effectiveness of the board
- consideration of re-appointment of directors
- consideration of diversity
- activity in year.

Figure 38 (%)

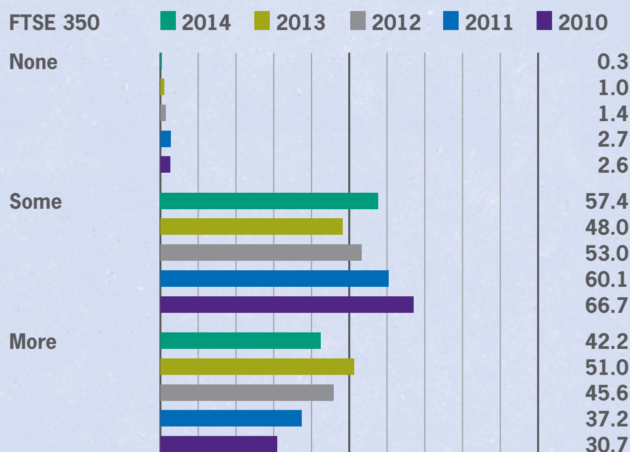


Figure 39 (%)

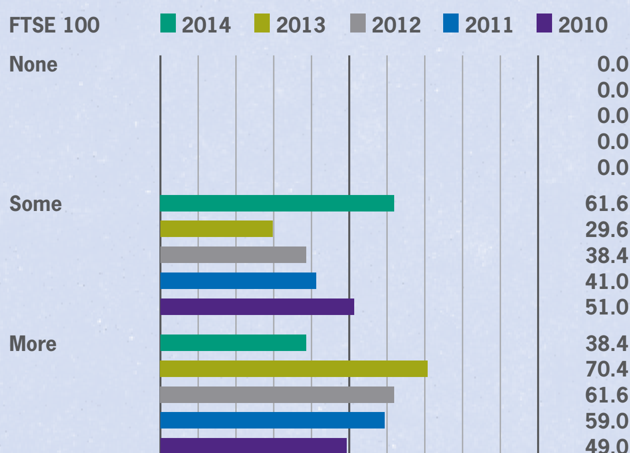
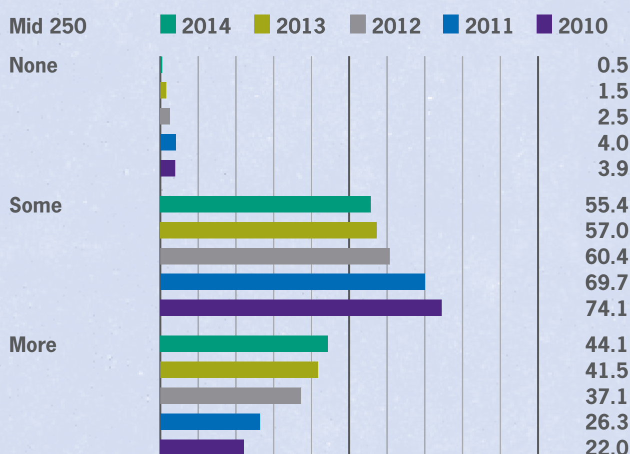


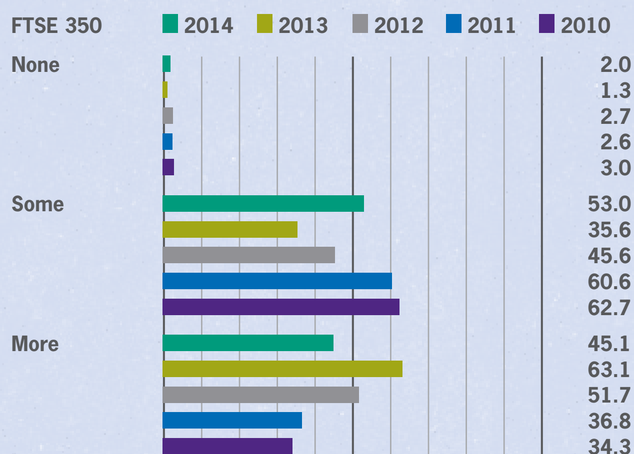
Figure 40 (%)



QUESTION 21. 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 41 (%)



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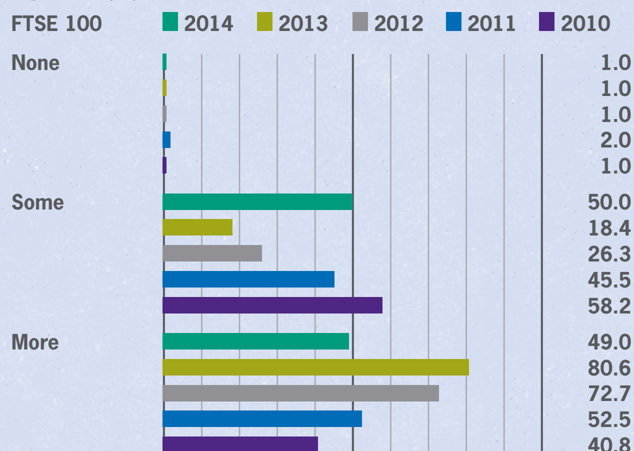
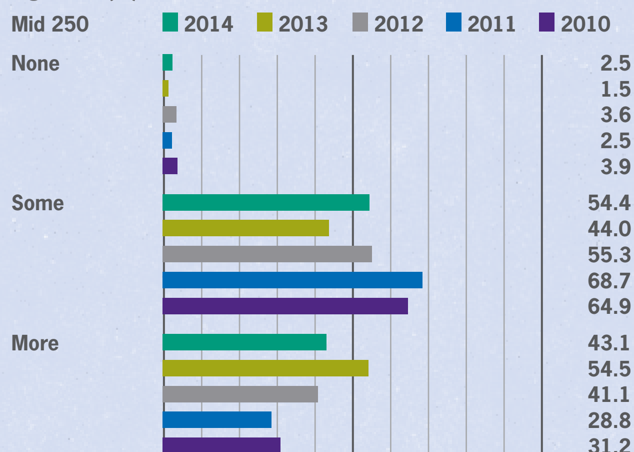


Figure 43 (%)



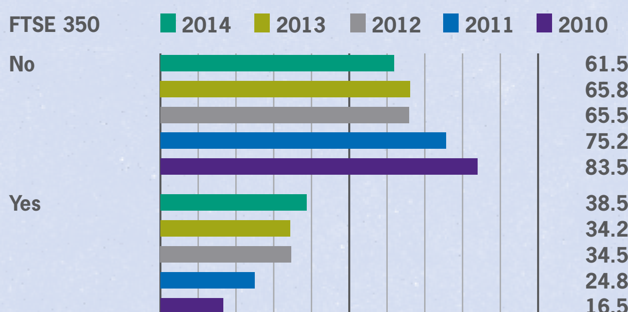
Strong disclosures may include the following details:

- a full description of the appraisal process
- key categories considered, including board and committee structure, board dynamics, the conduct and frequency of board meetings and information provided to directors
- evaluation criteria linked to strategy and performance
- use of peer review between directors and management
- inclusion of major shareholder feedback
- achievement of KPIs
- outcomes of the evaluation and action plans.

QUESTION 22. 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. The external facilitator should be identified in the annual report and a statement made as to whether they have any other connection with the company". (UK Corporate Governance Code, B.6.2)

Figure 44 (%)



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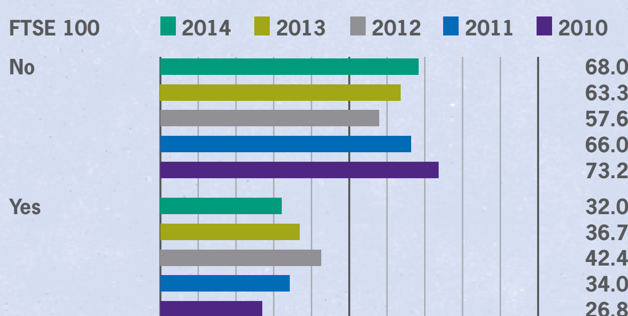
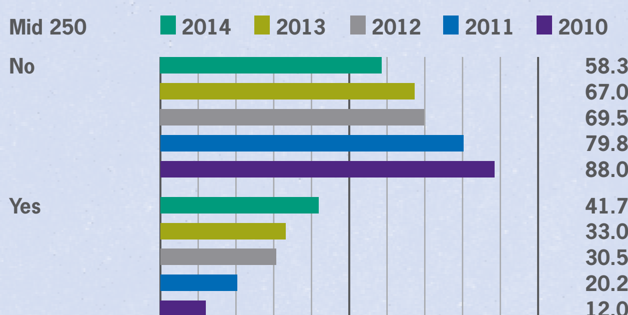


Figure 46 (%)

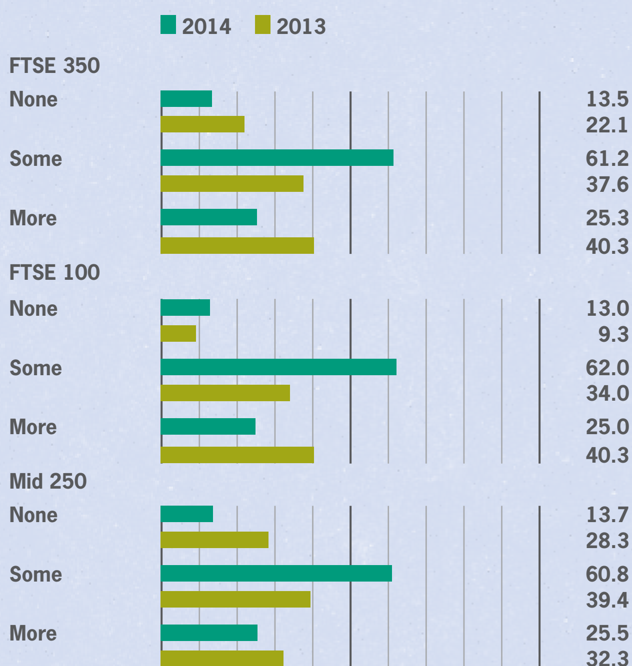


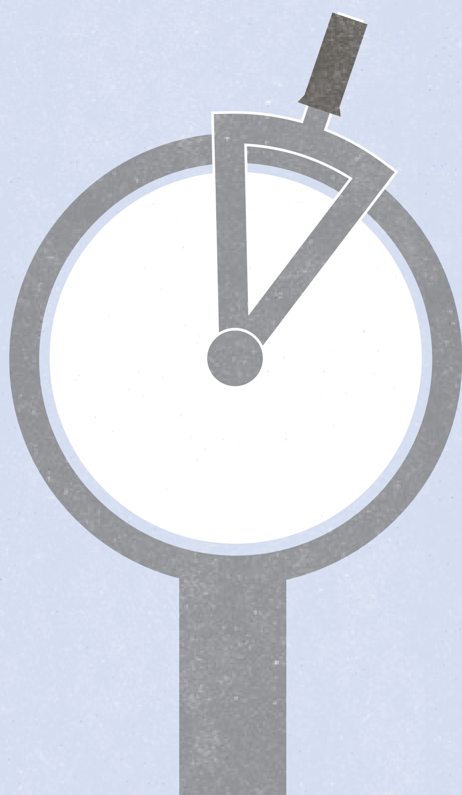
Audit committee

QUESTION 23. DO THEY DISCLOSE THE OUTCOME OF THE PERFORMANCE APPRAISAL FOR BOARD MEMBERS?

Guidance: “The chairman should act on the results of the performance evaluation by recognising the strengths and addressing the weaknesses of the board and, where appropriate, proposing new members be appointed to the board or seeking the resignation of directors”. (UK Corporate Governance Code, Supporting Principles B.6)

Figure 37 (%)

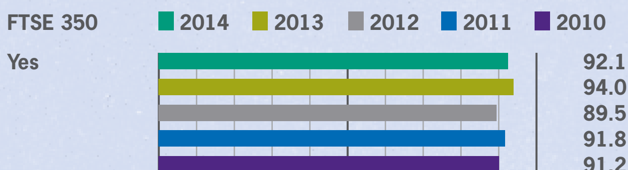




QUESTION 24. ARE THE AUDIT COMMITTEE MEMBERSHIP REQUIREMENTS MET?

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)

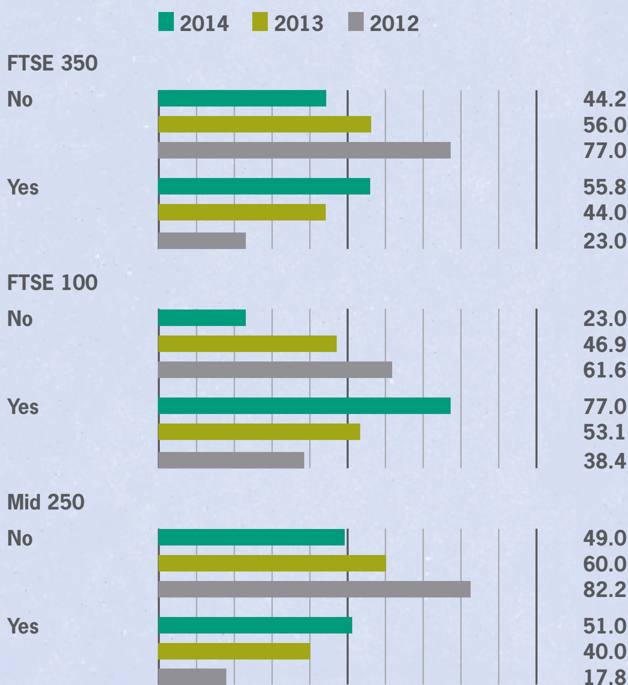
Figure 38 (%)



QUESTION 25. IS THERE ANY PERSONAL COMMENTARY FROM THE CHAIRMAN OF THE AUDIT COMMITTEE?

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)

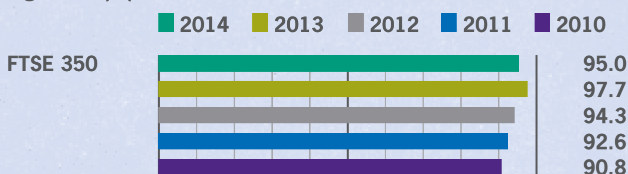
Figure 39 (%)



QUESTION 26. 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)

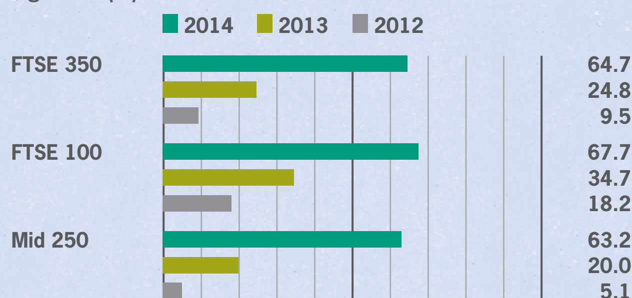
Figure 40 (%)



QUESTION 27. DOES THE AUDIT COMMITTEE REPORT ON THE ISSUES CONSIDERED IN RELATION TO THE FINANCIAL STATEMENTS, INCLUDING ANY KEY JUDGMENTS THAT IT MADE?

Guidance: "The main role and responsibilities of the audit committee should be set out in written terms of reference and should include: to monitor the integrity of the financial statements of the company and any formal announcements relating to the company's financial performance, reviewing significant financial reporting judgments contained in them". (UK Corporate Governance Code, C.3.2)

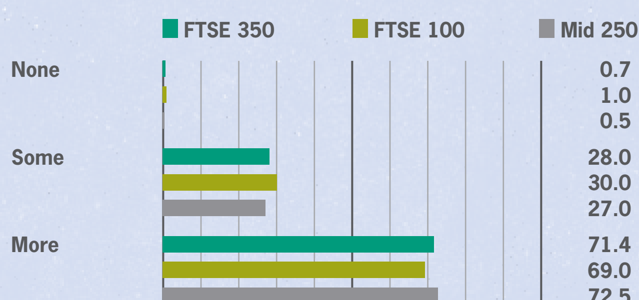
Figure 41 (%)



QUESTION 28. HOW MUCH INFORMATION IS THERE SURROUNDING THE COMPANY'S RISK MANAGEMENT PROCESS?

Guidance: "The annual report should include such meaningful, high-level information as the board considers necessary to assist the shareholders' understanding of the main features of the company's risk management processes". (Internal Control: Revised Guidance to Directors, paragraph 33)

Figure 42 (%)



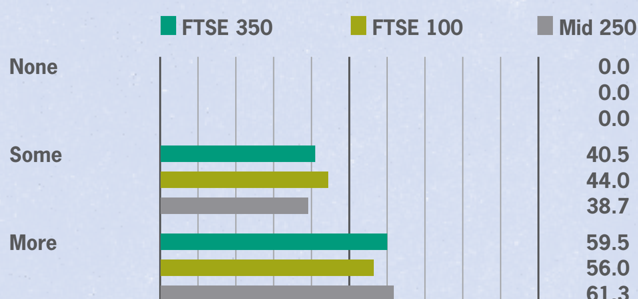
Best disclosures outlining the key elements of a company's internal control system discussed:

- Who is included in the process
- How often risks are assessed
- Who these risks are reported to
- Procedures to ensure compliance with external regulations
- Evidence of a risk group or committee to monitor the process
- Organisation structure and reporting lines
- Procedures to learn from control failures
- Corporate policies, procedures and training
- Links to key business objectives or values
- Examples of reviews of reviews of control activities and response resolution

QUESTION 29. HOW MUCH INFORMATION IS THERE SURROUNDING THE COMPANY'S INTERNAL CONTROL SYSTEMS?

Guidance: "The annual report and accounts should include such meaningful, high-level information as the board considers necessary to assist shareholders' understanding of the main features of the company's ... system of internal control". (Internal Control: Revised Guidance to Directors, paragraph 33)

Figure 43 (%)



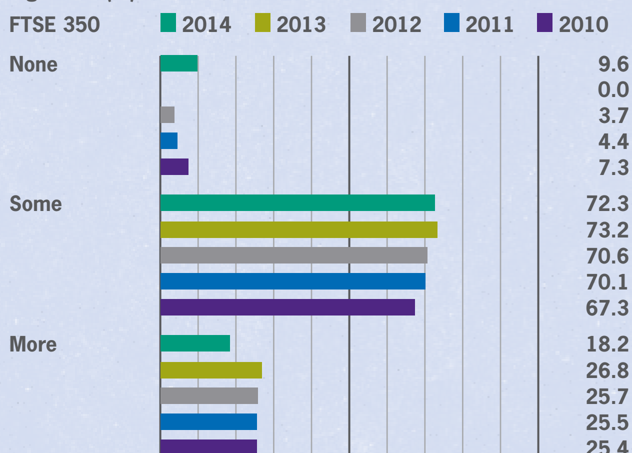
Companies providing good detail on internal controls include:

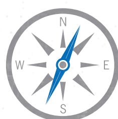
- makes reference to ensuring proper accounting records
- high level procedures to ensure compliance with external regulations
- organisation structure and reporting lines
- corporate policies, procedures and training
- financial controls
- fraud detection and prevention
- safeguarding assets
- companies should provide relevant and specific information of the company.

QUESTION 30. HOW MUCH INFORMATION IS PROVIDED ON THE PROCESS THE BOARD/COMMITTEES HAVE APPLIED IN REVIEWING THE EFFECTIVENESS OF THE INTERNAL CONTROL SYSTEM?

Guidance: "The board should summarise the process it (where applicable, through its committees) has applied in reviewing the effectiveness of the system of internal control and confirm that necessary actions have been or are being taken to remedy any significant failings or weaknesses identified for that review. It should disclose the process it has applied to deal with material internal control aspects of any significant problems disclosed in the annual report and accounts." (Internal Control: Revised Guidance to Directors, paragraph 36)

Figure 44 (%)





Most companies made reference to their application of the Internal Control: Guidance to Directors 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.

QUESTION 31. 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)

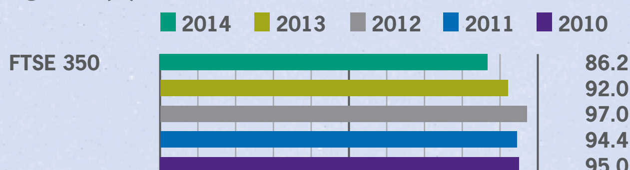
Figure 45 (%)

FTSE rank	2014	2013	2012
1–100	99	100	100
101–200	91	88	86
201–350	79	86	81
1–350	90	91	89

QUESTION 32. 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.3.6)

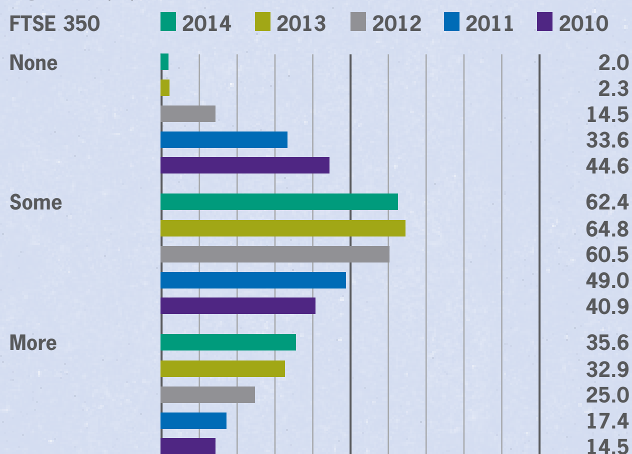
Figure 46 (%)

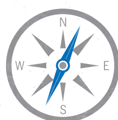


QUESTION 33. HOW MUCH INFORMATION DOES THE AUDIT COMMITTEE REPORT PROVIDE ON HOW IT REACHED ITS RECOMMENDATION TO THE BOARD ON THE APPOINTMENT, REAPPOINTMENT OR REMOVAL OF THE EXTERNAL AUDITORS?

Guidance: "The [annual] 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 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, C.3.8)

Figure 47 (%)





The most informative disclosures included information on:

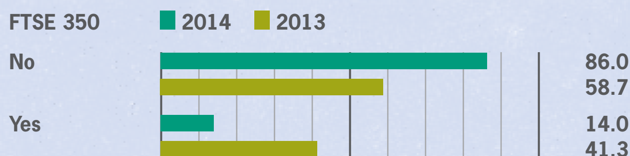
- dates of appointment and length of tenure
- tender frequency and processes
- an assessment of the auditor's qualifications, expertise and resources
- any contractual obligations that acted to restrict the audit committee's choice of external auditors
- when the audit was last subject to tender
- when the current group auditor was appointed.

QUESTION 34. IS THERE A STATED COMMITMENT THAT THE EXTERNAL AUDIT CONTRACT WILL BE PUT OUT TO TENDER AT LEAST ONCE EVERY 10 YEARS IN LINE WITH THE NEW CODE?

Guidance: "FTSE 350 companies should put the external audit contract out to tender at least every ten years". (UK Corporate Governance Code, C.3.7)

Figure 48 (%)

FTSE 350 2014 2013

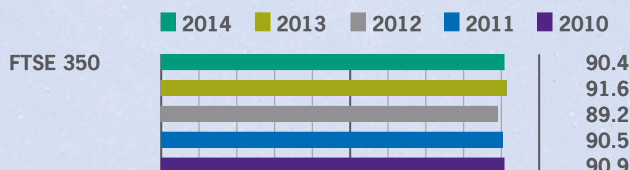


Remuneration Committee

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)

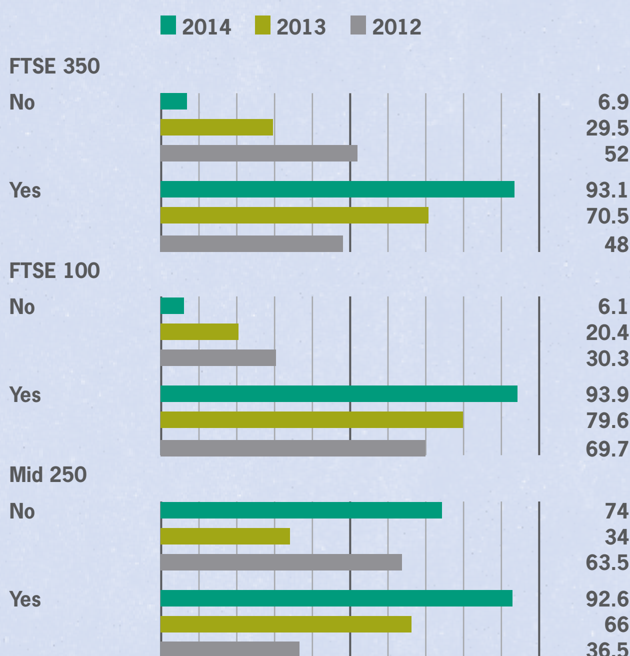
Figure 49 (%)



QUESTION 36. IS THERE ANY PERSONAL COMMENTARY FROM THE CHAIRMAN OF THE COMMITTEE IN THE REMUNERATION REPORT?

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)

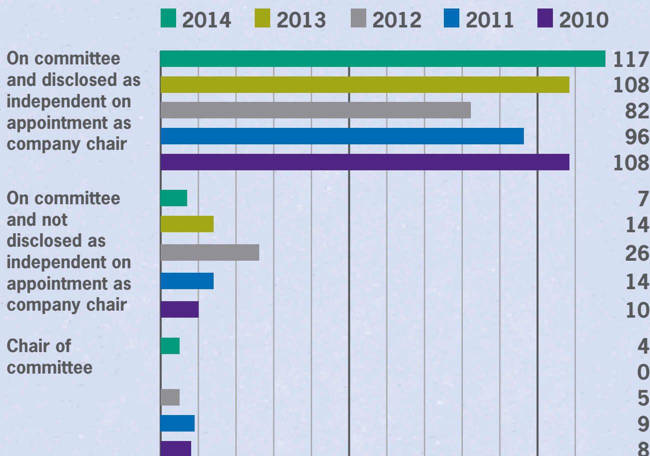
Figure 50 (%)



QUESTION 37. 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)

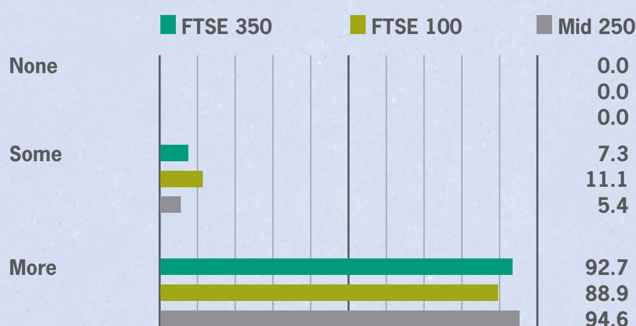
Figure 51



QUESTION 38. HOW CLEARLY DOES THE COMPANY DESCRIBE ITS REMUNERATION POLICY?

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)

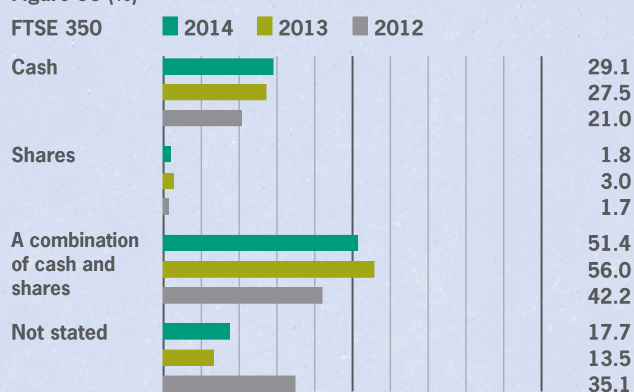
Figure 52 (%)



QUESTION 39. 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)

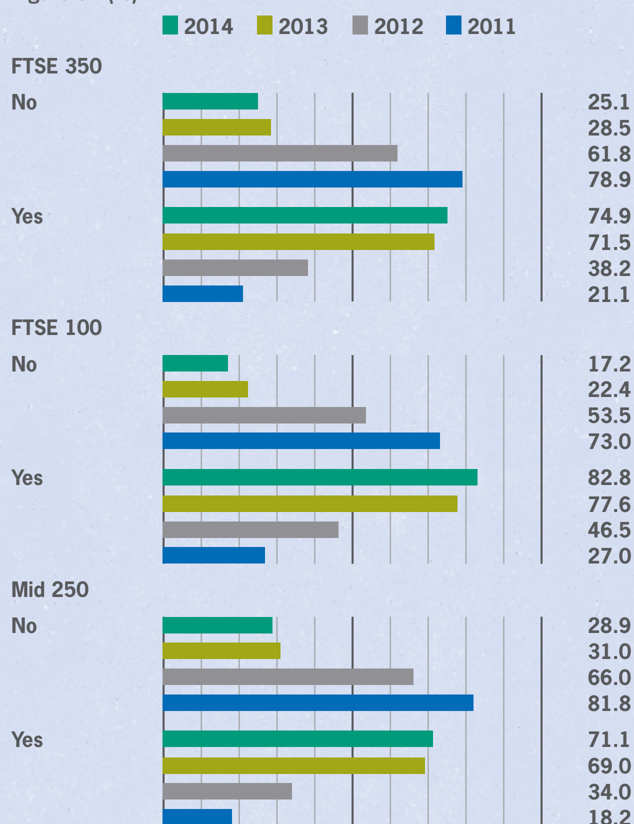
Figure 53 (%)



QUESTION 40. 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 54 (%)



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Advising on governance

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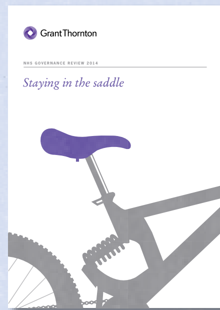
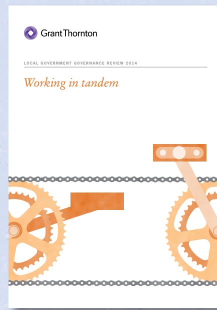
Governance matters

Corporate Governance Review 2014



NHS Governance Review 2015



Local Government Governance Review 2015

Charities Governance Review 2015

Housing Governance Review 2015

New reports to be released Spring 2015

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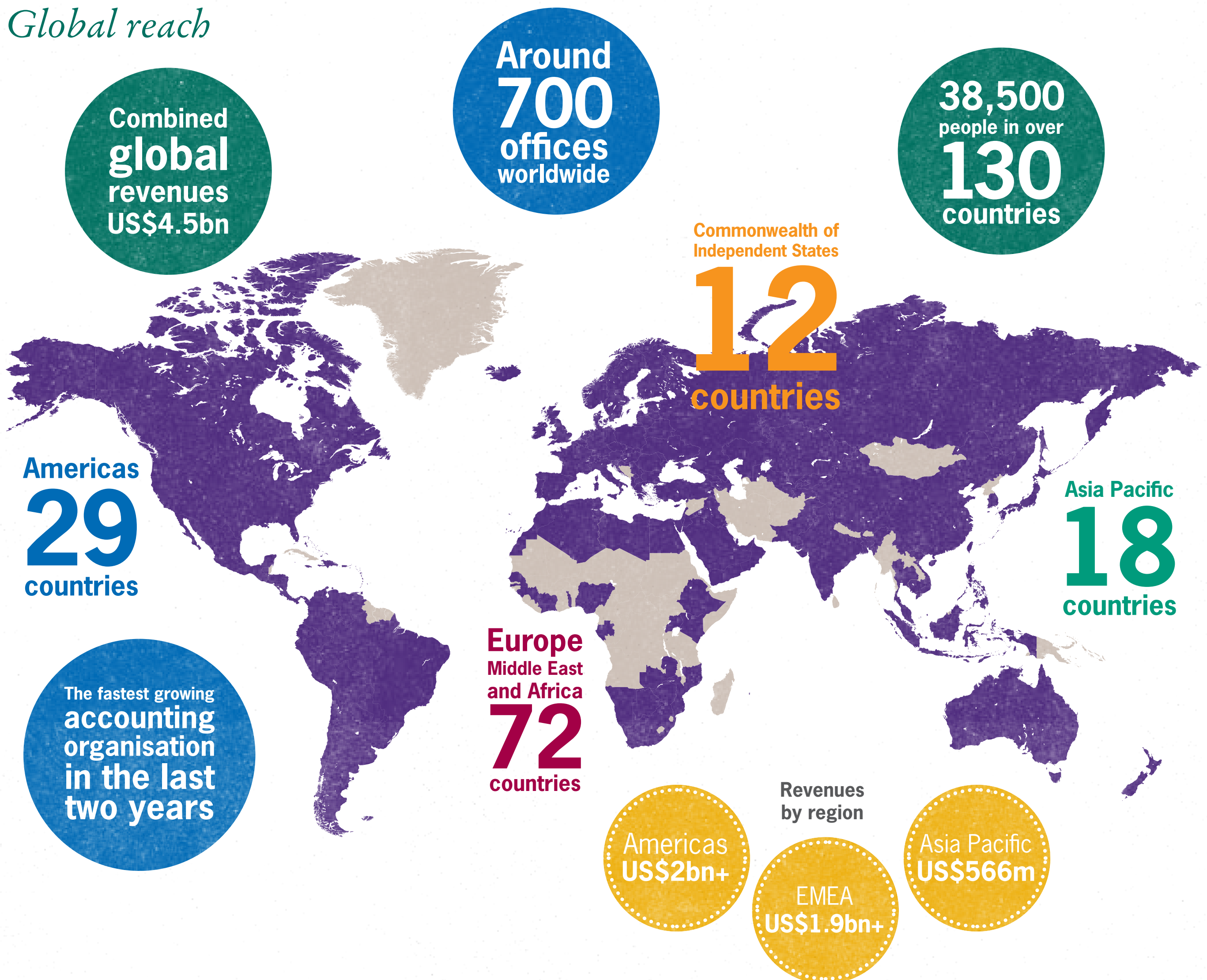
Global reach



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