

Moving beyond compliance Embracing the spirit of the Code

Corporate Governance Review February 2010





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Introduction

Welcome to our eighth annual review of the UK's FTSE 350 corporate governance disclosures. In our view the annual report is the primary window through which a company showcases its attitude to governance. If a company fails to take this opportunity in such a public document, we consider it reasonable for the stakeholders to conclude that this reflects the underlying culture of the organisation.

We highlight trends in the disclosure of compliance with the Combined Code (the Code) and assess the quality of explanations of underlying practices among the UK's largest listed companies. This year, our review covers 299 companies, assessing their compliance with the policies and provisions of the Code. In addition, we extended our review to cover aspects of the Business Review, including key performance indicators (KPIs) and, for the first time, principal risk reporting.

We have also continued our analysis by industry, using the FTSE Group and Dow Jones Index classification system called the 'Industry Classification Benchmark' (ICB). As in previous years, we exclude investment trusts due to the difference in their nature, structure, management and approach to corporate governance.



Simon Lowe
Head of Business Risk Services



Foreword



Over the last twelve months much has been written that attempts to explain how ‘better’ corporate governance might have prevented, or at least alleviated, the crash in the banking sector.

In response to these failings, Sir David Walker undertook a review of corporate governance in UK banks and other financial institutions. The FRC also brought forward their biennial review of the Code and in December released their second discussion document, following close consultation with Sir David Walker.

Although there are many specific recommendations around board evaluation, board experience, remuneration disclosure and linkage to longer-term objectives, the FRC’s report makes reference to two particular observations. Firstly, that while independence is desirable for governance to work, it needs to be able to draw on a balance of experience that is appropriate to the business, and secondly, effective governance is heavily dependent on behaviour and attitude of mind. It is the latter which presents the FRC and the Code with possibly its greatest challenge. Regulatory bodies direct the process and thus can set out the principles and encourage adoption, and those to whom it applies can adhere to the words, tick the boxes and aim to comply, but if the practice fails to percolate down through an organisation then governance will remain one-dimensional.

This year’s review suggests that the process is working. The number of companies claiming full compliance was 47% (although many of those were in fact not compliant), but by looking at compliance with individual provisions, a much stronger picture emerges with companies typically complying with all but one or two of the Code’s provisions. Overall this suggests 91% compliance with the Code.

So, is it a case of job done or in the light of the recent failings in the boardrooms of some of our largest companies, should one conclude that the Code is not fit for purpose and no amount of fine tuning will resolve the issue? The answer perhaps lies between the two. With such a high level of compliance, now must be the time for the very best companies to recalibrate good practice by raising the bar. The challenge remains for the FRC as to how this compliance can be turned into embedded behaviour.

But how do you bridge the gap between governance disclosure as a compliance exercise and embedding governance into business practice? How do you ensure that it is not circumvented when individuals are faced with an opportunity of a short-term gain to the detriment of those governance principles which they proclaim?

To introduce more ‘process’ would not appear to be the right approach. We have seen over the five years since the last major changes to corporate governance were introduced, that change takes time. Any significant changes to the Code now will take a number of years to take effect and by then there will be other pressures dominating the agenda. And inevitably the next crisis will originate from somewhere not as yet thought of, so changing behaviour rather than process is where the focus needs to be.

However, changing behaviour to anticipate and avoid any future crises is something that it is difficult for further legislation alone to achieve. The FRC with its subtle shift of emphasis from compliance to the quality of application is clearly seeking to influence such a change in behaviour.

An immediate response is to improve the quality of the board's disclosures, thereby demonstrating, both internally and externally, that they are living by the spirit of the Code.

Continuing the theme from our last review, we have found that annual reports are getting longer and longer. The average length of a FTSE 350 annual report is now 120 pages (ranging between 49 and 468), with the front unaudited section being on average 63 pages. We have found that the length of the report has little correlation to the ability of a company to make the necessary disclosures relating to the Code or Business Review. More information is not necessarily in the interests of investors unless it can be presented in such a way that allows meaningful analysis and conclusions to be drawn.

With few companies obtaining any independent assurance as to the accuracy of the information contained in the front section of their annual reports, and then often only on discrete disclosures, there is a real danger that the report gets seen as no more than a vehicle for 'corporate spin'.

Better reporting can encourage better application. For example, the Code already requires companies to carry out regular evaluations of board performance; encouraging the use of external, independent evaluations and the provision of detailed information on the evaluators will provide greater insight and therefore value to investors.

A more joined-up style of reporting on risk management and internal control is another area where a change in reporting style or content could add greater value. While companies are disclosing on average over ten principal risks, the quality of these disclosures vary significantly, thereby limiting their value to investors and wider stakeholders.

If the reporting of principal risks was more directly aligned with the company's strategic objectives and then linked into the controls in place, this would provide greater insight for investors into both the risk appetite and the totality of the risk management processes.

Rethinking the most effective way to present quality information on existing governance practices will provide not only greater transparency for the readers, but will also increase the possibility of making peer group comparisons, adding a further yardstick for qualitative, value-creating assessment.

This need not create a greater burden for UK plc, but would start to build real value by linking independent pieces of information to inform the stakeholder.



So, can companies improve the quality of their disclosures? This could be achieved in a number of ways, for example;

- ensuring that disclosures support the claim for full compliance; this year only 41 of the 141 companies claiming full compliance had all the disclosures to support their claim
- clearly setting out what expertise and experience each non-executive director (NED) is expected to bring to the board
- using experienced external facilitators for the performance evaluations of the chairman, the directors and the board
- providing more disclosure, frequently refreshed, to explain how the Code provisions have been complied with, free from boiler-plate explanations that have been lifted from the Code, and giving practical examples as to how governance in the business has impacted on decision making
- introducing greater connectivity between the specific risks of the business, their impact on strategy and the controls which are integral to managing those risks
- provide more certainty over the statistics and performance measures through greater use of independent verification.

So, is it job done for those who set the tone for governance in the UK, or merely the base camp from which the real assault can commence? We think the latter. The challenge to truly embed effective governance practices rests almost entirely with the organisations themselves. The regulators can only suggest the most appropriate route.

Executive summary

Overview

This year's review of the state of corporate governance among the FTSE 350 reports another increase in the number of companies which consider themselves to be compliant with the Code, 47% (2008: 44%), although the rate of increase is levelling off.

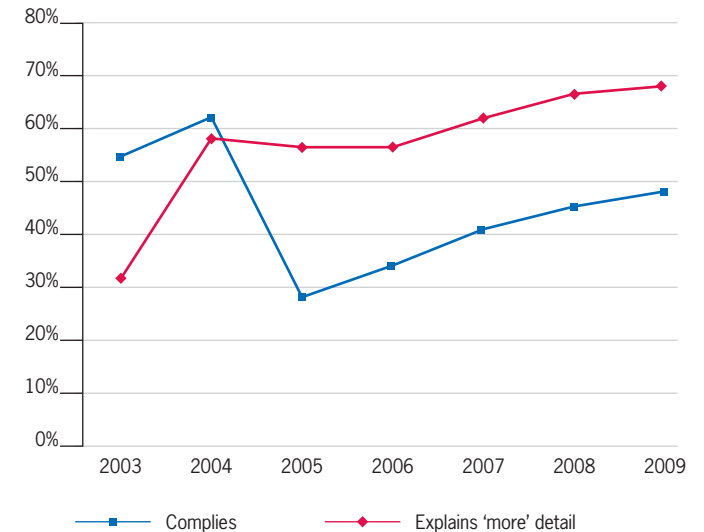
However, there still remains a surprising gap between those 141 companies which claim full compliance and the 41 companies which provide all the necessary detail to support their claim for compliance as set out in Schedule C of the Code. Perhaps this is due to an oversight in reporting rather than a failure in corporate governance itself, but it does suggest a need for a stronger verification process at the very least.

The Code allows companies to explain their departure from the Code where they perceive that this leads to a more appropriate governance practice. We have again seen an increase in the number of companies providing a 'more detailed', 68% (2008: 66%), explanation of why they choose not to comply with certain provisions of the Code.

As the graph shows, the number of companies either complying or explaining has increased each year since the last major revisions were made to the Code in 2004. Those revisions led to the sharp decrease in claimed compliance evident in 2005, and may still be limiting the levels of compliance as the revised provisions are among those cited most often for non-compliance this year.

Of the 158 companies which choose to explain, 119 (75%) are compliant with all but one or two of the Code's provisions. Taking into account those which are fully compliant, the FTSE 350 provide disclosures in the annual reports to support compliance with 90.8% of the Code's provisions.

Companies claiming full compliance or explaining with 'more' detail (FTSE 350)



The board

The average FTSE 350 board has 5.2 NEDs compared to 3.3 executive directors, which is broadly similar to last year. However, the composition of the board continues to be an area of change with 80 companies not having at least half the board made up of independent NEDs for the entire year. This is the single most common area where companies have had to resort to explaining their compliance. With the exception of some unexpected events, the majority appear to have arisen through ineffective succession planning.

Outside the FTSE 100, companies had just 4.5 NEDs. This is reflected in our finding that the Mid 250 find it harder to comply with the provision on board composition: the percentage of FTSE 100 companies choosing to explain their board structure is 15.2%, compared to 32.5% in the Mid 250. There are clearly a number of companies which have only the minimum number of NEDs required in order to be compliant, but if one resigns due to unforeseen circumstances, they become non-compliant while they look for a replacement.

Research undertaken by Grant Thornton (released December 2009) for the FRC reviewed the amount of direct sector experience brought by NEDs on the board. We found that although the average size of the board had fallen over the last five years, the number of NEDs with direct sector experience increased from 23% to 30%, perhaps suggesting that greater consideration is being given to the experience an NED can bring.

Turning to other specific experience required to comply with the Code, 31 companies, including eight in the FTSE 100, still do not disclose who on the audit committee has recent and relevant financial experience.

Both Sir David Walker and the FRC propose an external evaluation of the board is performed every three years. Our findings show that only 14% of the FTSE 350 (FTSE 100: 21%, Mid 250: 11%) undertook such an evaluation in the current year.

Only 16 companies provided detailed disclosure on the process used to evaluate the performance of the chairman, despite 240 companies mentioning that such an evaluation is performed.

The proposed revisions to the Code, while not amending the independence provision are clearly shifting the emphasis toward board expertise and experience. For this shift to be of value, it needs to be supported by more informative explanations.

Audit

Only companies in the Oil & Gas industry paid their external auditor more, on average, for non-audit than for audit services, with non-audit fees accounting for 103% of the audit fee. Overall our review found that the percentage of non-audit fees to the audit fee has fallen to 70% (2008: 90%). However, this appears to be due more to a 22% increase in the average audit fee to £2.8m (2008: £2.3m) rather than a reduction in non-audit fees.

Three FTSE 100 and 13 Mid 250 companies changed their auditors this year, (2008: FTSE 100: 3, Mid 250: 4). While this is an increase on last year, it suggests that the average tenure of an external auditor is over 18 years.

Although 101 companies chose to adopt the FRC guidance to audit committees early and gave their reasons for appointing, reappointing or removing their auditors, only 17 went further and provided detailed explanations as to, for example, the length of tenure, performance quality assessments and criteria for assessing continued independence.

With the concerns over the lack of competition in the FTSE 350 external audit market and the apparent reluctance of companies to appoint new auditors, these explanations provide an opportunity for audit committees to provide some transparency on this matter.



Executive summary

Remuneration

A key focus of the governance debate in banks has been over the incentives and bonuses that have been paid and the influence this can have on operational risk.

The average bonus available to executives was 140% and there were 64 companies offering bonuses in excess of 150% of basic salary (2008: 40 companies). Of companies disclosing potential maximum bonus over 200%, 13 of the 24 companies are from the financials industry.

The guidance on remuneration provided by the Code states that the performance elements of remuneration should form a significant portion of the total remuneration package of executive directors. The current changes being proposed by the FRC are understandably focused on the few rather than the many as represented by the average.

Investors

30% of the FTSE 100 and 52% of the Mid 250 fail to provide detailed explanations of the actions they have taken to understand the views of and engage with major shareholders, an area given considerable attention by both Sir David Walker and the FRC. With the active sponsorship of the FRC including the development of a stewardship code, this statistic should now start to improve.

Business Review

Risk

The statutory Business Review requirements were expanded through the 2006 Companies Act (effective for annual periods commencing on or after 1 October 2007), replacing the much heralded but never enacted Operating and Financial Review (OFR). Many companies appear reluctant to change the way they disclose this information in their annual report. The most informative reviews were produced by companies which have gone back to the drawing board with the new requirements in mind.

The reporting of strategy, risk and control appears inconsistent and often disconnected. While there is a large amount of information included in the Business Review, only a small number of companies report these components of governance in a joined-up way to enable the reader to understand how significant risks could impact on the company's business and how management mitigate them.

Currently only 29.1% provide disclosures detailing their objectives and strategic goals, with the vast majority keeping disclosure to the bare minimum. Many companies argue that to provide too much information about their strategy gives away competitive advantage. Whatever the reason, the effect is to make it hard for the reader to understand whether and how the key strategic risks have been addressed.

A wide range of risks were disclosed, with some companies going for a generic high-level approach while others were much more specific. The average number of risks disclosed was 10.7, although some disclosed information on as many as 30 principal risks and some fewer than four. While financial risks made up the single largest category, with companies disclosing 3.4 on average, most companies also included an average of 7.3 other risks across non-financial categories, with operational and regulatory risk most frequently referenced.

Of over 3,200 risks disclosed, there was some evidence of trends, such as technology and environmental risks being commonly identified in Telecommunications and Utilities companies respectively. Environmental risks make up only 2.8% of all risks disclosed, suggesting that the environment does not feature high on the board agenda.

39% of FTSE 100 companies and 24.5% of Mid 250 companies have specific risk committees. Currently these are most commonly found in the Utilities (56%) and Financials (52%) industries and are less prevalent in other sectors, which supports the FRC and Sir David Walker recommendations that the need for a separate committee is not necessarily appropriate for all.

Key performance indicators

While not directly related, it is still surprising to see only a very limited correlation between the principal risks and key performance indicators (KPIs) which companies choose to monitor their business against. For example, of the 73 companies which include an environmental risk as a principal risk, only 33 companies provide a KPI covering this area. When risks pertaining to regulation or employees are disclosed, there are even fewer companies which disclose key performance indicators in these areas.

KPI reporting remains in its infancy. We recorded over 2,200 KPIs with companies disclosing on average 4.5 financial and 2.9 non-financial KPIs. 42% of those companies do not provide any explanation on why the performance indicators disclosed are relevant to the business, 59% fail to disclose how the KPI information has been used to better manage the business, and 48% fail to provide information about how the KPIs have been calculated.

Verification of non-financial KPI information continues to be largely absent among the FTSE 350, with only 17 using external independent bodies to provide assurance over any one of their non-financial KPIs. Furthermore, few provide clear guidance as to how the information is calculated. As a result any value that might be gained from benchmarking performance has to be limited to a company's year on year performance, as intra and inter sector comparability is clearly some way off.

For as long as companies fail to provide this additional information or some form of assurance over their figures, the information will remain in the 'interesting but of limited value' category for corporate analysis.

Corporate Responsibility

Greater consideration is being given to how corporate responsibility issues are being presented. 79% of FTSE 100 and 60% of Mid 250 companies are now issuing a separate Corporate Responsibility report. While some companies cross reference this report, many continue to provide a summary of the information in their annual reports.

It is the same story as non-financial KPIs with only 24% of companies disclosing that the corporate responsibility information has been subject to any form of verification.



Corporate governance

General

The Code states that its provisions should not be viewed as a rigid set of rules, but as a guide to the components of good practice. It is expected that companies will comply “wholly or substantially” with its provisions; however, it is recognised that “non-compliance may be justified in particular circumstances if good governance can be achieved by other means”. Accordingly, companies can demonstrate good governance even when they choose to explain.

Our eighth Corporate Governance Review reports another increase in the percentage of companies claiming full compliance with the Code (2009: 47%, 2008: 44%), although the rate of increase continues to level off, carrying on the trend we reported in 2008.

Further assessment of the 141 companies claiming full compliance shows that only 41 (29%) of these provided all of the required disclosures to fully support their claim. While still surprisingly low, this shows a marked improvement from 15 (11%) in 2008. The disclosures most commonly omitted from company reports related to the following provisions:

- the review of internal controls to cover all material controls including financial, operational and compliance controls, and risk management systems (C.2.1)
- the terms and conditions of appointment of non-executive directors to be available for inspection (A.4.4)
- the audit committee to monitor and review the effectiveness of internal audit activities (C.3.2).

It seems probable that these represent a failure in reporting rather than in practice of the Code, but at best it suggests that companies need to pay more attention to their internal verification processes.



Good governance is not simply reflected by the percentage of companies that fully comply, but also by the quality of their explanations when they do not. Of the companies choosing to explain, our review finds a continued increase in the number of companies providing quality, informative, detailed disclosures to 68% (2008: 66%), although again the rate of improvement is levelling off. There now remain only three companies which give no explanation and a further two which fail to disclose their areas of non-compliance, although acknowledge their non-compliance.

However, of the 158 companies that have chosen to explain their departure from the Code, only 18% have revisited their explanations from those given in last year. The remaining 82% of companies are apparently both satisfied with their governance environment and feel that their current practices remain as explained in the previous year and continue to be in the best interests of their shareholders. Given the dynamic and uncertain environment of 2008 and 2009, this is perhaps a little surprising.

Of those companies which choose explain over comply, for the vast majority it only relates to one or two provisions of the Code.

Seven of the top ten reasons for non-compliance relate to provisions in Section A of the Code, on directors.

The most common explanation relates to board composition where they did not have at least half the board comprised of NEDs (46%). Of these, there were 20 cases where companies found themselves to be non-compliant due to retirements or other unforeseen director departures during the year. The number of NEDs available also led to the other common reasons for non-compliance, with 25% unable to fill the audit committee entirely with NEDs and 19% without at least three NEDs on the remuneration committee.

Of the 85 companies which explain in relation to only one provision, 30 of these identify that they did not have the requisite number of NEDs on the board; 16 (19%) identified that either the chairman was not independent on appointment or that they were non-compliant with provision A.3.1 which lists the criteria for independence, and seven did not separate the roles of the chairman and chief executive for at least part of the year. The remainder cited a variety of different provisions.

Although the statistics for compliance show nearly half of the FTSE 350 to be compliant, the remaining companies are also predominantly compliant on a provision by provision basis. On average, including those which claim full compliance, the FTSE 350 claim compliance with 97% of the code provisions, although our review finds they disclose information to support compliance with 91% of the provisions.

The Code therefore appears to be working well in encouraging companies to adopt governance practice.

However, any nascent sense of euphoria needs to be tempered in view of the apparent permanence of the majority of explanations. Nevertheless, it seems that the debate should now move on from 'comply or explain' to one more focused on the quality, value and nature of governance practice.

Number of Code provisions stated in non-compliance statements	Number of companies
1	85
2	34
3	15
4	11
5	3
>5	5
No disclosure	5
TOTAL	158

Corporate governance

By industry

The table outlines the levels of compliance and depth of explanation across the ten industries in the FTSE 350.

Best practice disclosures can be viewed as being those companies which either claim full compliance or provide a full explanation for non-compliance. The smallest industries, Healthcare and Telecommunications (albeit with smaller populations), had on average the highest percentages of companies claiming full compliance, or providing detailed explanations to support only a single departure from the Code.

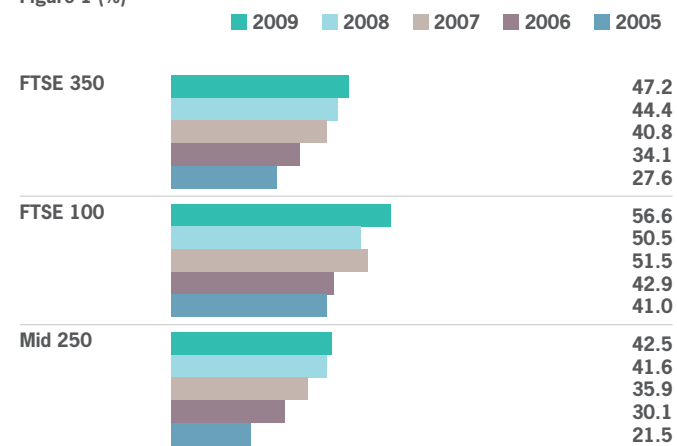
Within the Oil & Gas, Consumer Service and Technology industries, at least 20% of companies are only providing the bare minimum of information to support their compliance, or at worst no explanation for non-compliance. Perhaps these industries do not perceive there to be the same degree of pressure to improve their governance disclosures. A role for the institutional shareholders?

Industry (size)	Claim full compliance or provide 'more' explanation %
Healthcare (9)	100.0
Telecommunications (5)	100.0
Utilities (9)	88.8
Industrials (71)	88.7
Financials (56)	83.9
Consumer Goods (30)	83.4
Basic Materials (21)	80.9
Oil & Gas (19)	79.0
Consumer Services (64)	76.9
Technology (15)	73.3

Q1. Do they claim full compliance with the Combined Code?

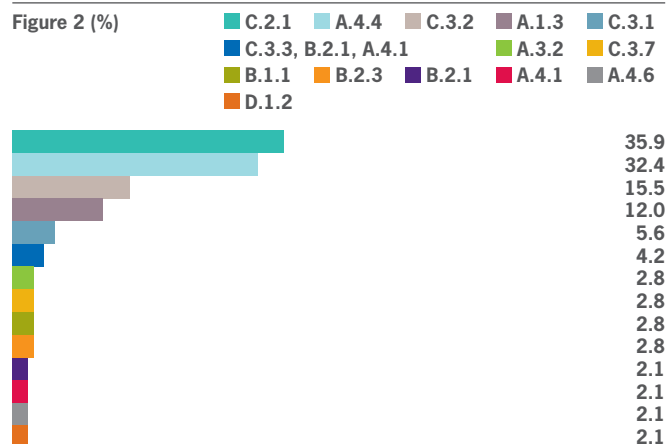
Guidance: The following additional items must be included in its financial report: statement as to whether the listed company has complied throughout the accounting period with all relevant provisions set out in Section 1 of the Combined Code. (Listing Rule 9.8.6(6) (a))

Figure 1 (%)



Q2. When companies do not disclose information to support their claim of full compliance with the Code, which provisions do they most commonly fail to disclose?

Figure 2 (%)



Code provisions

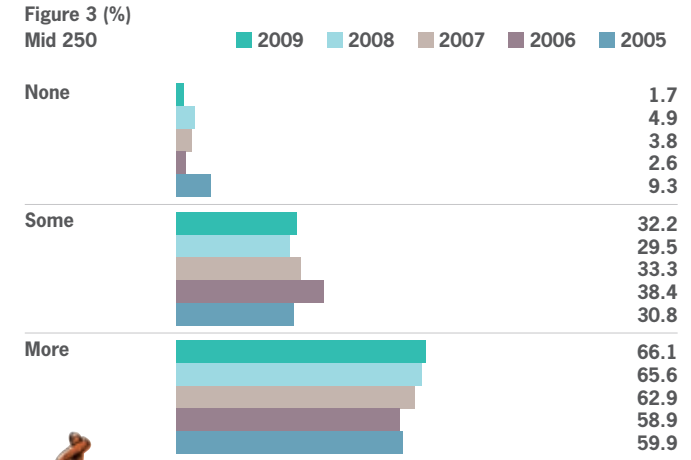
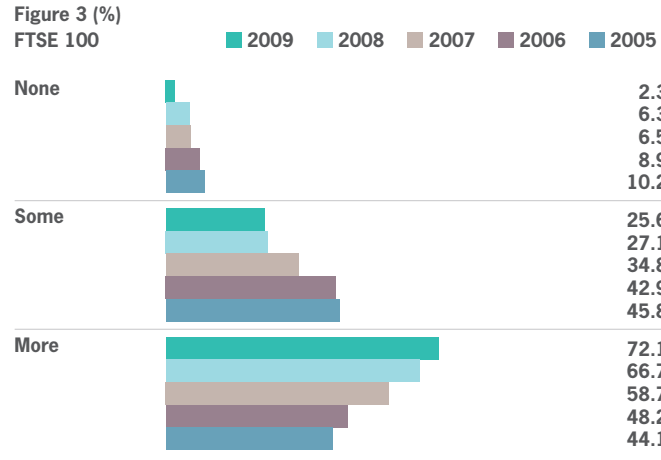
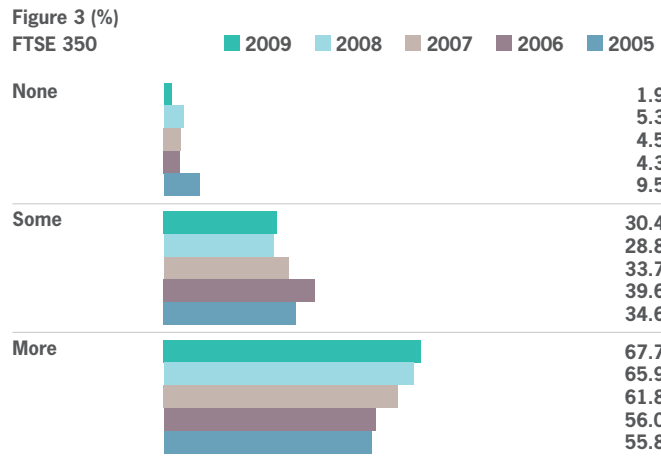
- C.2.1 The review of the effectiveness of the group's system of internal controls should... cover all material controls, including financial, operational and compliance controls and risk management systems.
- A.4.4 The terms and conditions of appointment of non-executive directors should be made available for inspection.
- C.3.2 The main role and responsibilities of the audit committee should be set out in written terms of reference and should include... to monitor and review the effectiveness of the company's internal audit function.
- A.1.3 Led by the senior independent director, the non-executive directors should meet without the chairman present at least annually to appraise the chairman's performance.
- C.3.1 The board should satisfy itself that at least one member of the audit committee has recent and relevant financial experience.
- C.3.3, B.2.1, A.4.1
 C.3.3 The terms of reference of the audit committee, including its role and the authority delegated to it by the board, should be made available¹.
 B.2.1 The remuneration committee should make available¹ its terms of reference, explaining its role and the authority delegated to it by the board.
 A.4.1 The nomination committee should make available¹ its terms of reference, explaining its role and the authority delegated to it by the board.
- ¹The requirement to make the information available would be met by including the information on a website that is maintained by or on behalf of the company
- A.3.2 At least half the board, excluding the chairman, should comprise non-executive directors determined by the board to be independent.
- C.3.7 The annual report should explain to shareholders how, if the auditor provides non-audit services, auditor objectivity and independence is safeguarded.
- B.1.1 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 enhance shareholder value. Upper limits should be set and disclosed.
- B.2.3 The board itself or, where required by the Articles of Association, the shareholders should determine the remuneration of the non-executive directors.
- B.2.1 The board should establish a remuneration committee of at least three... independent non-executive directors.
- A.4.1 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.
- A.4.6 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.
- D.1.2 The board should state in the annual report the steps they have taken to ensure that the members of the board, and in particular the non-executive directors, develop an understanding of the views of major shareholders about their company.



Corporate governance

Q3. If not compliant, to what degree do they explain their reason for non-compliance?

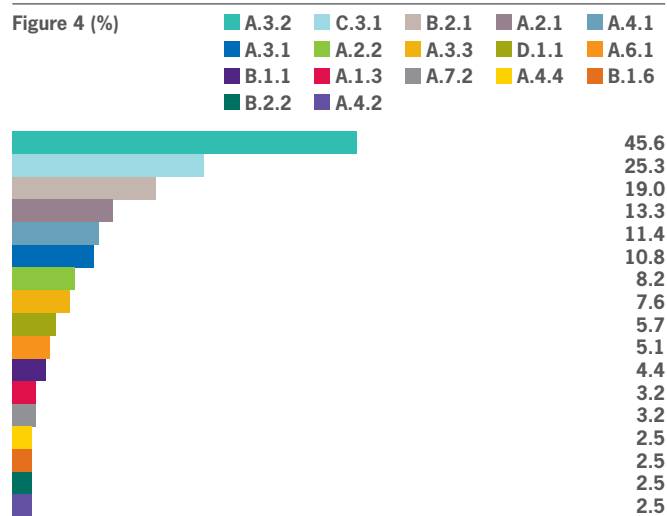
Guidance: A company that has not complied with the Code must include in its financial report a statement setting out the company's reasons for non-compliance. (Listing Rule 9.8.6(6) (b) (iii))



'More' disclosure is achieved where a company provides a detailed explanation as to which areas of the Code they are not compliant with. 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 stakeholders. 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.

Q4. Of the 153 companies which do not claim full compliance with the Code which provisions do they most commonly disclose within their compliance statement?

Figure 4 (%)



Code provisions

- A.3.2 At least half the board, excluding the chairman, should comprise non-executive directors determined by the board to be independent.
- C.3.1 The board should establish an audit committee of at least three, or in the case of smaller companies [sub FTSE 350] two, independent non-executive directors. In smaller companies the company chairman may be a member of, but not chair, the committee in addition to the independent non-executive directors, provided he or she was considered independent on appointment as chairman. The board should satisfy itself that at least one member of the audit committee has recent and relevant financial experience.
- B.2.1 The board should establish a remuneration committee of at least three, or in the case of smaller companies two, independent non-executive directors. In addition 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.
- A.2.1 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.
- A.4.1 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.
- A.3.1 The board should identify in the annual report each non-executive director it considers to be independent. The board should determine whether the director is independent in character and judgement and whether there are relationships or circumstances which are likely to affect, or could appear to affect, the director's judgement. The board should state its reasons if it determines that a director is independent notwithstanding the existence of relationships or circumstances which may appear relevant to its determination.
- A.2.2 The chairman should on appointment meet the independence criteria set out in A.3.1 above. A chief executive should not go on to be chairman of the same company. If exceptionally a board decides that a chief executive should become chairman, the board should consult major shareholders in advance and should set out its reasons to shareholders at the time of the appointment and in the next annual report.
- A.3.3 The board should appoint one of the independent non-executive directors to be the senior independent director.
- D.1.1 The chairman should ensure that the views of shareholders are communicated to the board as a whole. Non-executive directors should be offered the opportunity to attend meetings with major shareholders and should expect to attend them if requested by major shareholders.
- A.6.1 The board should state in the annual report how performance evaluation of the board, its committees and its individual directors has been conducted.
- B.1.1 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 enhance shareholder value. Upper limits should be set and disclosed.
- A.1.3 Led by the senior independent director, the non-executive directors should meet without the chairman present at least annually to appraise the chairman's performance.
- A.7.2 Non-executive directors should be appointed for specified terms subject to re-election and to Companies Act provisions relating to the removal of a director.
- A.4.4 The terms and conditions of appointment of non-executive directors should be made available for inspection.
- B.1.6 Notice or contract periods should be set at one year or less. If it is necessary to offer longer notice or contract periods to new directors recruited from outside, such periods should reduce to one year or less after the initial period.
- B.2.2 The remuneration committee should have delegated responsibility for setting remuneration for all executive directors and the chairman, including pension rights and any compensation payments.
- A.4.2 The nomination committee should evaluate the balance of skills, knowledge and experience on the board and, in the light of this evaluation, prepare a description of the role and capabilities required for a particular appointment.

Non-executive directors

Across the 299 companies reviewed there were 1,537 NED positions listed excluding the chairman. There has been little movement in board sizes in the FTSE 350, with only minor decreases in both NED and executive membership. The average number of NEDs remained the same at 5.2, while the average number of executive roles dropped from 3.4 (2008) to 3.3.

Seventy-two companies (46% of those which choose to explain) disclosed that, for at least part of the year, half of their board did not consist of independent non-executive directors. This was the most commonly cited area for non-compliance this year, and for the first time in five years we have seen a decline in the number of companies achieving compliance in this area. In addition we identified a further eight companies which were non-compliant (two of which claimed full compliance). In three cases, companies have incorrectly claimed compliance through including their non-executive chairman in their assessment of board makeup although the Code clearly states that the chairman should be excluded from the calculation, and the remaining five simply did not recognise that they did not comply with the Code.

Inability to maintain the recommended board balance becomes more prevalent as companies get smaller. Should

companies be increasing their NED membership to ensure that they do not find themselves without the required independent element?

Although more companies are now providing at least some consideration of independence, few companies are joining the ranks of those going beyond the bare minimum towards more detailed disclosures. Of those companies which did not have the required number of NEDs, only two provided no explanation with the majority (52 companies) providing some explanation as to how they have assessed independence amongst their NEDs.

The small decline amongst FTSE 100 companies (2009: 54.5%, 2008: 58.8%) represents the changing membership, with eight companies which were FTSE 100 in 2008 either stepping down to the Mid 250 or being taken over. New entrants to the FTSE 100 this year appear to be slower to adopt best practice.

The improving trend in compliance regarding the chairman's performance review has tailed off this year, with disclosures being in line with 2008, although there has been an improvement in the number of companies providing at least some detail in this area (79%), but only 16 companies provide more detail. Perhaps an indication that the process has yet to evolve. Best companies provided detail as to the methods used to assess the chairman's performance, any

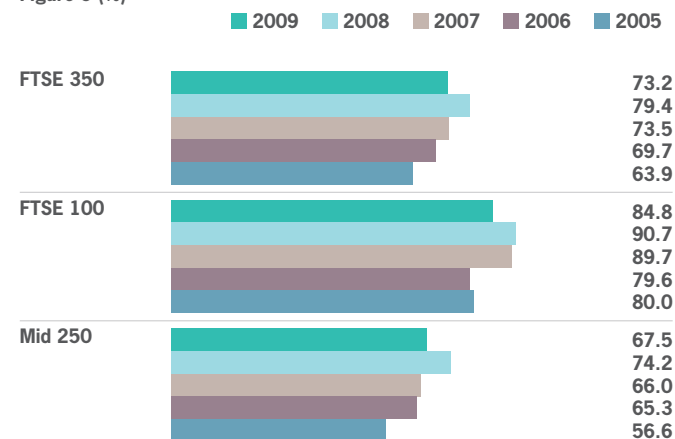
areas of focus (such as leadership of the board), and any other aspects that differed from the review of the other directors.

A third of companies still do not state that the terms and conditions of appointment for the NEDs are available for inspection; however, only four companies identified their non-compliance in this area.

Q5. Does at least half of the board (excluding the chairman) consist of independent non-executive directors?

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

Figure 5 (%)

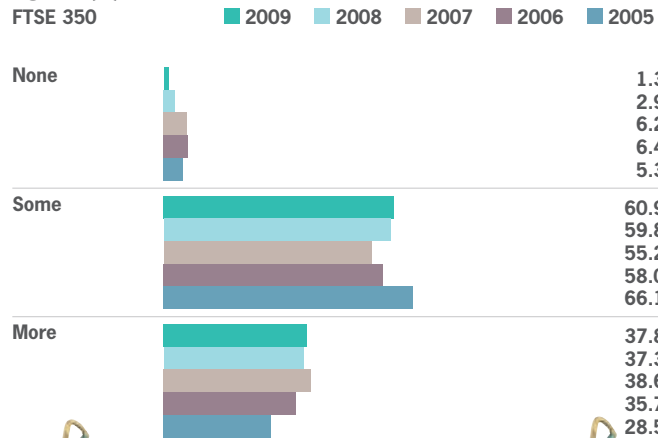


FTSE rank	Number of companies in group	Insufficient NED membership	NEDs on board (average)
1-100	99	15.2%	6.5
101-200	91	26.4%	5.1
201-350	109	37.6%	4.0
1-350	299	26.8%	5.1

Q6. How well do companies describe the consideration of independence?

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

Figure 6 (%)

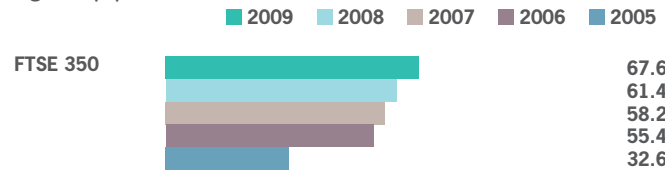


Best disclosure examples detailed the basis on which directors are considered to be independent, utilising the criteria listed in the combined code including areas such as shareholdings, tenure on the board, previous positions held in the company, any material relationship with the company in the last three years, any remuneration received (apart from director's fees), any participation in company's share or pension schemes, and any close family ties with the company, its major customers or suppliers.

Q7. Is it disclosed that the terms and conditions of appointment of non-executive directors are available for inspection?

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

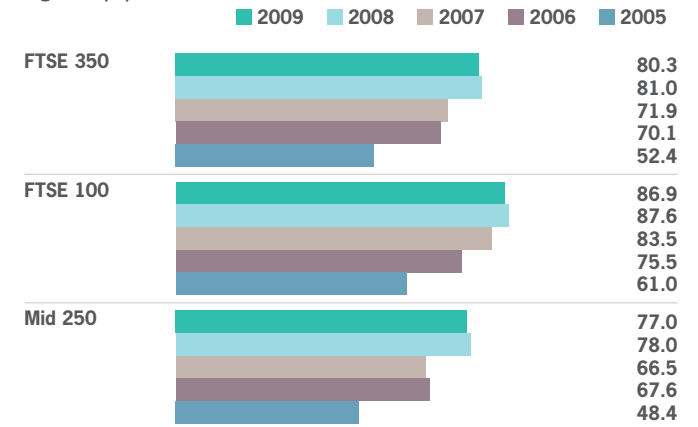
Figure 7 (%)



Q8. Led by the senior independent director, do the non-executive directors meet without the chairman at least annually to appraise the chairman's performance?

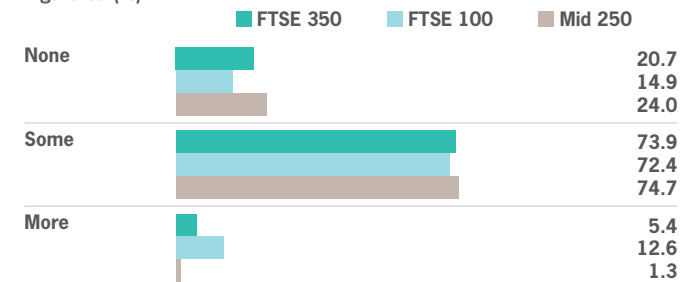
Guidance: Led by the senior independent director, the non-executive directors should meet without the chairman present at least annually to appraise the chairman's performance. (Combined Code, A.1.3)

Figure 8 (%)



Q8a. Of those which do appraise the chairman's performance, how much detail is provided on the process?

Figure 8a (%)



Boards and committees

Board processes

The spotlight has recently focused on the activities of the board. While most companies provide some information on board processes and responsibilities, only 49.5% of the FTSE 350 provide 'more' information in this area. This is clearly an area where improvements in quality of disclosures could be achieved, especially among FTSE 100 companies where 33% are providing only the minimum required to claim compliance.

Performance evaluation disclosures have also improved this year, with the number of Mid 250 companies providing enhanced disclosure doubling in each of the last two years while the FTSE 100 figures have remained relatively static. With all but three FTSE 100 companies now providing some information in this area, the quality of their explanation is beginning to show signs of plateauing.

The vast majority of companies are not submitting themselves to independent board performance evaluations. Only 14.7% (FTSE 100: 21%, Mid 250: 11%) engaged an independent body for their performance review, representing 44 companies in total. A further 12 companies stated that they were using independent evaluators on a rolling basis, usually once every three years, but had not in the current year.

Following the recommendation of both Sir David Walker and the FRC that companies utilise an external, independent evaluator at least every third year, this is an area that will see significant change over the next few years.

In describing the process for evaluating board performance, best companies report on the content of the evaluation including: the use of tailored questionnaires and interviews;

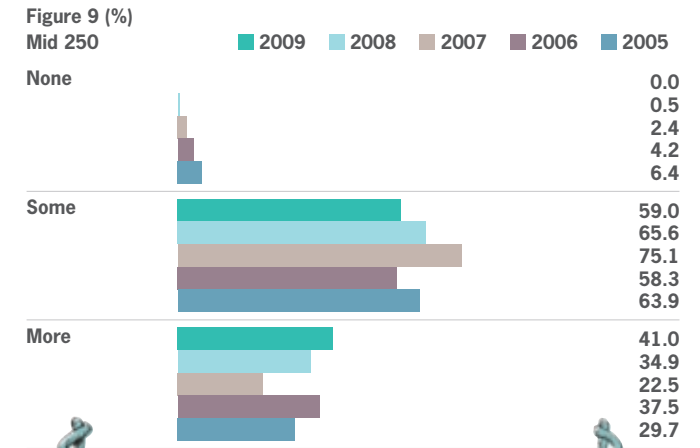
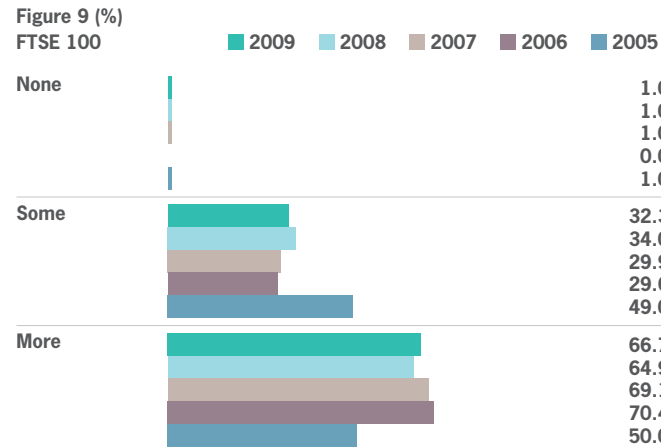
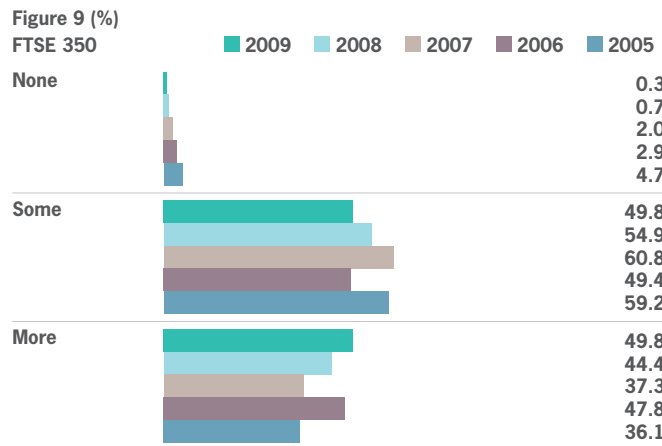
clear evaluation criteria linked to overall strategy, as well as operational and financial performance; the role, function and contribution made by the board; developments in the year regarding strategic planning, risk management processes, and board balance; and specific references to objectives set for the board and committees for the coming year.

These companies used the interview and questionnaire responses as discussion points at meetings of the board, as well as for individual discussions between the chairman and each director and results of the evaluation presented to the board.

Eighteen companies (2008: 14) that have combined the role of chairman and chief executive disclosed this in their accounts. In seven cases this was for only part of the year until a new chief executive or chairman could be appointed, and were predominantly due to retirements or the need to guide the company through an anticipated period of upheaval or transition. Ten of the remaining eleven companies explained that, in their view, the company did not require a separation of these roles, four providing no explanation, although three explained that the chief executive was the most qualified to act as the chairman, and three outlined that having the chief executive as chairman gave them the best leadership through current periods of change.

Q9. Is there a statement of how the board operates and how its duties are discharged effectively?

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



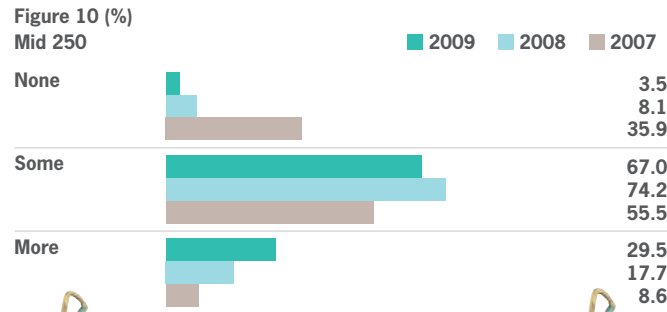
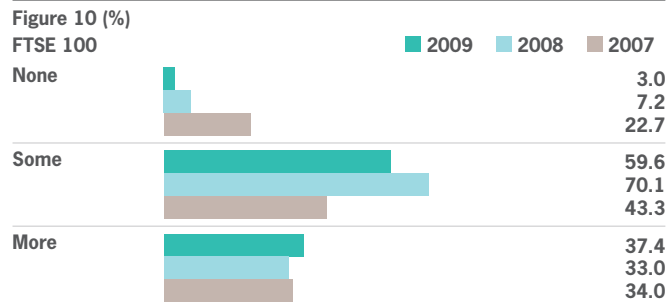
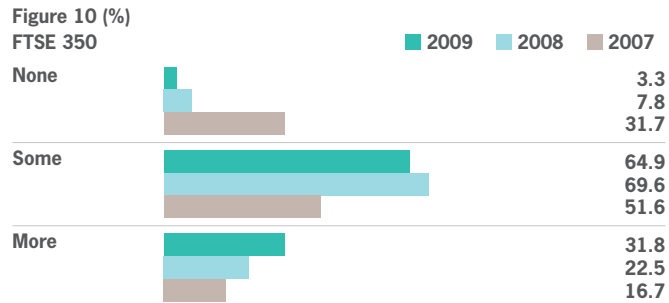
The most informative disclosures included detail of the following areas:

- the board's governance practices and commitments to ethical business
- management processes based on an established framework
- details of meetings of the board and committees, including any key recurring themes discussed
- powers and authorities retained by the board and those responsibilities delegated to management
- the board's focus on areas of strategic importance.

Boards and committees

Q10. How much explanation is there of how the board, committees and individual directors are annually formally evaluated for their performance?

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

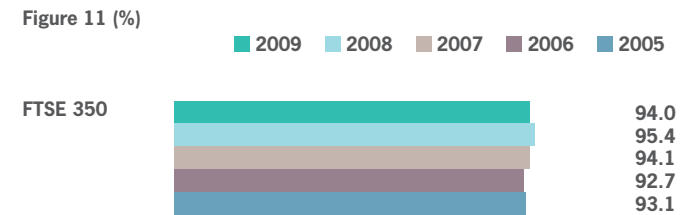


In 2007, we tightened our definitions of what constitutes 'none', 'some' and 'more' detail. Strong disclosures included the following:

- a full description of the appraisal process, including the use or consideration of independent experts
- the key categories considered (eg board and committee structures, board dynamics, the conduct and frequency of board meetings, the consideration of strategic issues by the board and the information provided to directors)
- use of peer review between directors and senior management
- inclusion of major shareholder feedback as a measure of performance
- achievement of any key targets or KPIs established
- outcomes from the evaluation and any actions resulting from these evaluations.

Q11. Are the roles of the chairman and chief executive separate?

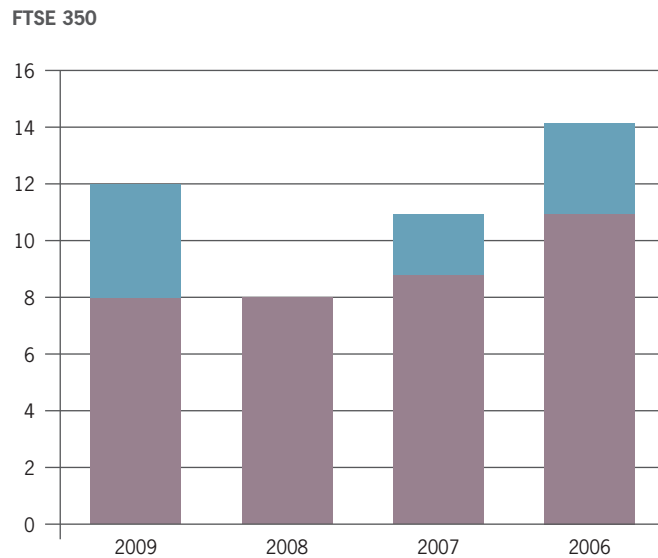
Guidance: There should be a clear division of responsibilities at the head of the company between the running of the board and the executive responsibility for the running of the company's business. (Combined Code, A.2.1)



Q12. For new chairmen that were appointed during the year... if they previously held the role of chief executive, had his/her independence been assessed and fully disclosed?

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

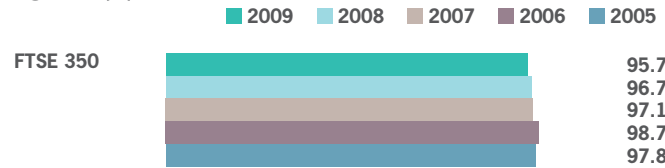
Figure 12 ■ Yes ■ No



Q13. Does the report identify the chairman, the deputy chairman (where there is one), chief executive, senior independent director, members and chairs of the nomination, audit and remuneration committees?

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

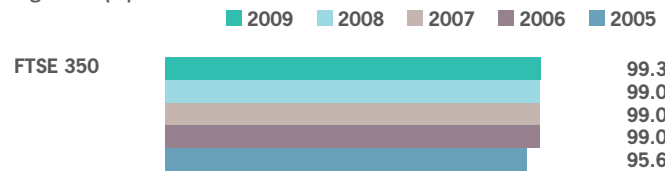
Figure 13 (%)



Q14. Is the number of meetings of the board and overall attendance disclosed?

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

Figure 14 (%)



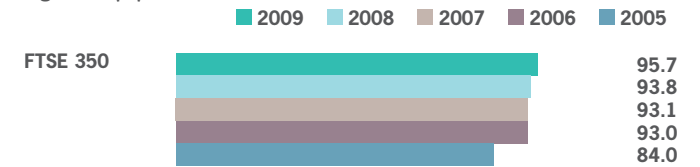
Q15. Is it disclosed that the terms of reference for the audit, remuneration and nomination committees are available for inspection?

Guidance: The terms of reference of the audit committee, including its role and the authority delegated to it by the board, should be made available¹. (Combined Code, C.3.3)

The remuneration committee should make available¹ its terms of reference, explaining its role and the authority delegated to it by the board. (Combined Code, B.2.1)

The nomination committee should make available¹ its terms of reference, explaining its role and the authority delegated to it by the board. (Combined Code, A.4.1)

Figure 15 (%)



¹The requirement to make the information available could be met by including the information on a website that is maintained by or on behalf of the company

Boards and committees

Board committees

FTSE 350 compliance with provisions regarding committees of the board has all but reached full compliance.

Only 4.4% failed to disclose that the committee's terms of reference were available; 4.4% neglected to state that shareholders set the remuneration for NEDs and 4.0% provided no explanation regarding board appointments.

Compliance with the provisions relating to the required membership of the committees of the board remains strong, with only minor variations due to changing membership year on year. Retirements and unforeseen changes by NEDs during a year have more often than not been the cause for non-compliance in these areas, and companies have responded with appropriate disclosure and explanation.

More than half of non-compliant companies in this area are failing to fulfil both the audit and remuneration committee membership requirements which highlights that where only three NEDs are deemed necessary by the board, the retirement or departure of any one of them leads to non-compliance in that year with these provisions. The potential need for increased NED membership is further demonstrated by the 34 companies (11.4%) being non-compliant with the membership requirements of the remuneration committee, of which 19 stated that they only had two or fewer independent NEDs on the committee. However, the Code provision on composition of the nominations committee is more easily complied with since it only requires a majority of NEDs rather than a specific number.

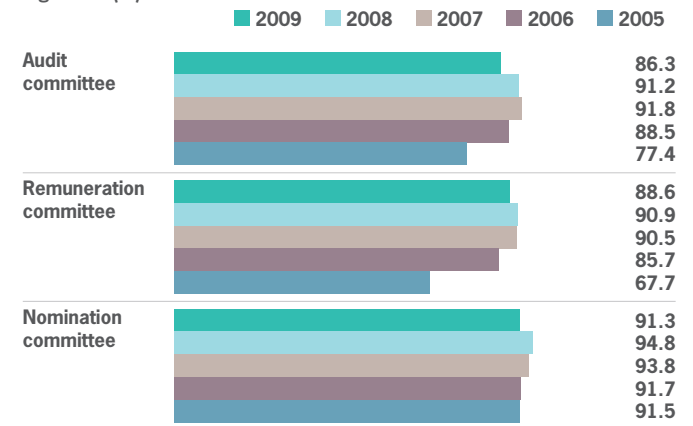
Q16. Are the committee membership requirements met?

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

The board should establish a remuneration committee of at least three... independent non-executive director members. (Combined Code, B.2.1)

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

Figure 16 (%)



Audit committee

Mid 250 companies have shown a significant increase in disclosing the member of the audit committee who has the recent and relevant financial experience. However, 31 companies (FTSE 100: 8, Mid 250: 23) (2008: 55) still do not currently have an experienced member or do not provide this disclosure.

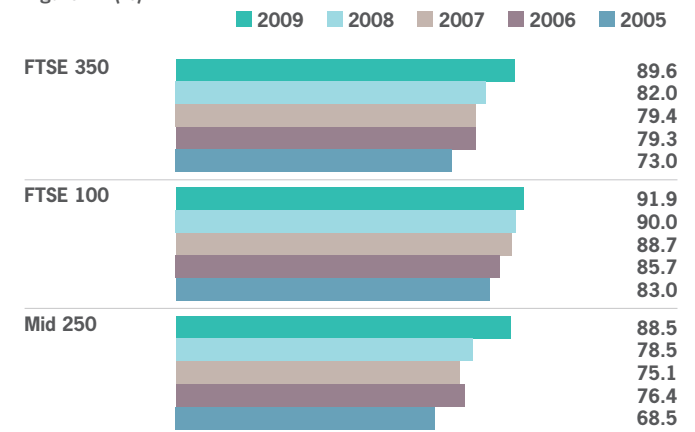
While two of these companies state that the committee as a whole has the required experience, and a further two explain that recent departures have resulted in current non-compliance, the remaining 27 companies do not provide any reason for their non-compliance in this sensitive area. With companies facing increasing risks, including, for example, operational, credit and going concern, should not the shareholders of those companies be questioning this apparent absence of relevant expertise?

Of the 27 companies providing no information on the director they consider to have recent and relevant financial experience, all but two undertook a performance evaluation of the board and committees and four used external consultants to assist them.

Q17. Does the audit committee state to have at least one member with recent and relevant financial experience?

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

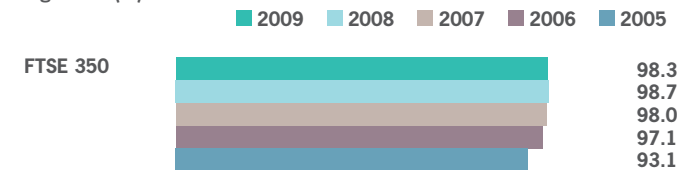
Figure 17 (%)



Q18. Is there a separate section of the annual report which describes the work of the committee?

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

Figure 18 (%)



Boards and committees

Internal audit

There has been little variation in this area from the 2008 results with 252 companies utilising an in-house internal audit department or operating a co-sourced or out-sourced arrangement.

Of those 47 companies which do not have an internal audit function, only three failed to provide disclosure as to whether they had reviewed the need for such a function in the current year and none of these three highlighted their non-compliance. Of the 44 which did provide such a statement, two still claimed non-compliance in this area, revealing potential misinterpretations of the Code.

78% of FTSE 350 companies acknowledge the role the audit committee has in monitoring and reviewing the effectiveness of internal audit activities. 94% acknowledged receiving and reviewing the reports from internal audit and 75% confirmed that they set the scope.

The number of companies which undertake internal audit effectiveness reviews (IIA best practice and as recommended in the Smith Report from 2003, is for such a review to take place once every five years) has remained relatively stable at 33% (37%: 2008). Half of those companies which report that they undertook such a review this year, also reported that such a review took place in the prior year (39 companies of 84 companies) with 18 companies reporting a review in 2007, 2008 and 2009. It is not clear whether these companies are undertaking reviews annually, or simply failing to update their disclosures. More importantly, this analysis does show that there is a core group of companies making this disclosure each year, rather than a rotating group as one might expect based upon the guidance.

Q19. Does the company have an internal audit function or equivalent?

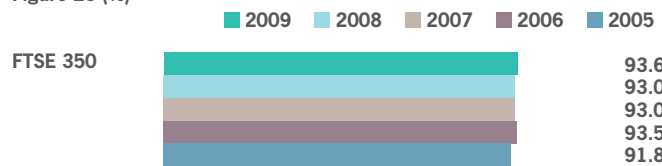
Guidance: The main role and responsibilities of the audit committee should... include... to monitor and review the effectiveness of the company's internal audit function. (Combined Code, C.3.2)

Industry (size)	Do they have an internal audit function or equivalent? (%)
Telecommunications (5)	100.0
Utilities (9)	100.0
Consumer Services (64)	90.6
Industrials (71)	90.1
Consumer Goods (30)	90.0
Financials (56)	82.1
Basic Materials (21)	81.0
Healthcare (9)	66.7
Technology (15)	66.7
Oil & Gas (19)	52.6
AVERAGE	84.3

Q20. If there is currently no internal audit function, is the absence of the function explained and is there disclosure that a review of the need for one has been carried out during the year and a recommendation been made to the board?

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

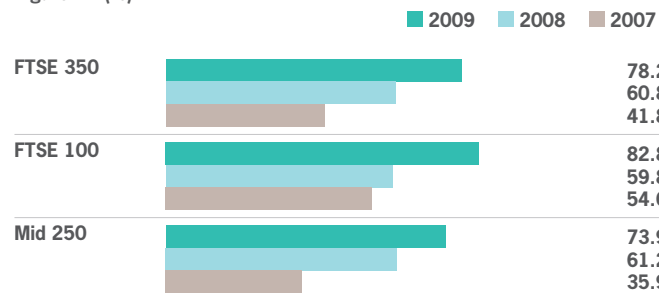
Figure 20 (%)



Q21. Does the audit committee monitor and review the effectiveness of internal audit activities?

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

Figure 21 (%)



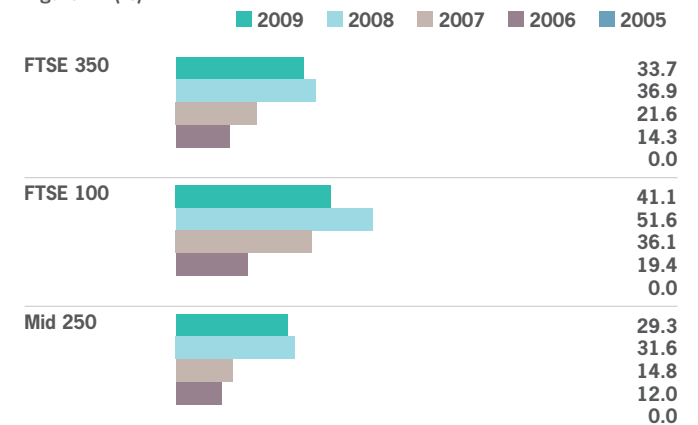
Q22. If the committee performs such a monitoring function, is there specific mention of an internal audit effectiveness review?

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

Internal assessments should include: Ongoing reviews of the performance of... internal audit...; and periodic reviews performed through self-assessment or by other persons... (International Standards for the Professional Practice of Internal Auditing – 1311)

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

Figure 22 (%)



Boards and committees

External audit

Sixteen companies have changed external auditors in the last year (2008: 7). While this represents a significant increase on previous years, it still suggests that on average a FTSE 350 company changes auditor only once every 18.6 years.

There is a large increase in the number of companies which have elected to early adopt the FRC guidance (October 2008) to audit committees for annual reports ending after 30 June 2009. 33.8% of companies provided at least some information on their reasons for the appointment, reappointment or removal of the auditors (2008: 14.1%). Seventeen companies went further and gave information to provide the reader with greater insight into the decision process, such as: length of tenure, performance quality assessments, reasons for non-audit services, and the criteria for assessing continued independence.

The average audit fee paid by the FTSE 350 (for statutory audits and other services pursuant to legislation) has increased

by 18.1% this year and the average non-audit fee has increased by 15.4%. FTSE 100 companies have seen the largest increases, representing a 21.2% increase in audit fees and a 19.6% increase in non-audit fees, while Mid 250 companies have experienced smaller increases of 7.0% and 4.4% respectively. Although non-audit fees as a percentage of audit fees have fallen (2009: 70.1%, 2008: 89.5%), this is as a result of a relatively greater increase in audit fees rather than an actual decrease in non-audit fees. The increasing disclosure requirements introduced in October 2008 (only early adopted by a few companies) will perhaps bring greater clarity to these surprising results next year.

FTSE rank	Number of companies in group	Average non-audit fees as a percentage of audit fees (%)	
		Current year	Prior year
1–100	94	54.7	65.1
101–200	88	77.6	95.6
201–350	109	77.4	105.7
1–350	291	70.1	89.5

Industry (size)	Average non-audit fees as a percentage of audit fees (%)	
	Current year	Prior year
Oil & Gas (19)	103.1	106.4
Consumer Goods (30)	95.0	113.5
Consumer Services (64)	77.8	90.8
Basic Materials (21)	71.6	166.9
Healthcare (9)	65.5	68.7
Utilities (9)	64.6	105.3
Financials (56)	61.7	77.5
Technology (15)	59.2	114.2
Telecommunications (5)	56.8	90.1
Industrials (71)	54.9	58.6
OVERALL AVERAGE	70.1	89.5

Of the 12 companies which failed to disclose how the audit committee safeguards the objectivity and independence of the auditors, six were new to the FTSE 350 in the year (of the 29 new joiners) and only two were in the FTSE 100.

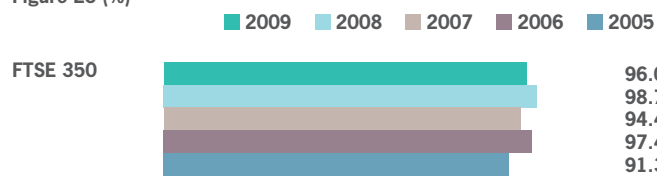
While the above data details the average non-audit fee as a percentage of the audit fee for companies in industry and FTSE bands, the table below shows the average audit and non-audit fee for the FTSE 350.

	Current year		Prior year	
	Average audit fee (£m)	Average non-audit fee (£m)	Average audit fee (£m)	Average non-audit fee (£m)
FTSE 350	2.83	1.22	2.32	1.03
FTSE 100	6.87	2.71	5.42	2.18
Mid 250	0.90	0.50	0.84	0.48

Q23. If the auditor provides non-audit services, is there a statement as to how the auditor's objectivity and independence is safeguarded?

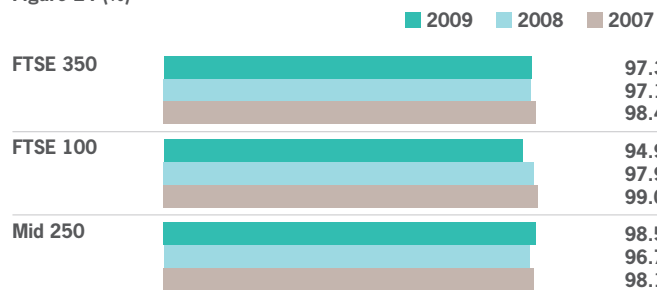
Guidance: The annual report should explain to shareholders how, if the auditor provides non-audit services, auditor objectivity and independence is safeguarded. (Combined Code, C.3.7)

Figure 23 (%)



Q24. Does the company provide a breakdown of non-audit services in terms of value and type?

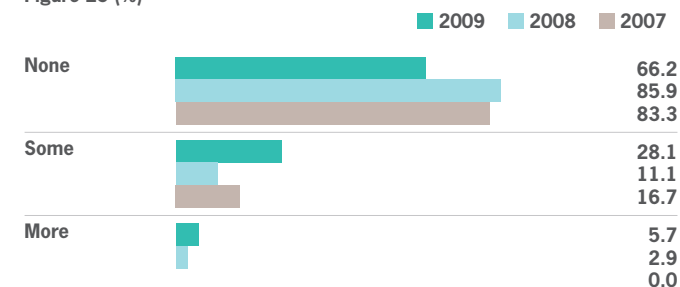
Figure 24 (%)



Q25. To what degree does the audit committee report on how it reached its recommendation to the board on the appointment, reappointment or removal of the external auditors?

Guidance: Companies are encouraged to include in the audit committee's report information on the appointment, reappointment or removal of the auditor, including supporting information on tendering frequency, the tenure of the incumbent auditor and any contractual obligations that acted to restrict the committee's choice of auditor. (FRC Guidance on Audit Committees released October 2008. Effective June 2009)

Figure 25 (%)



'More' disclosure is achieved by including reference to: dates of appointment, tender processes, restrictions and/or contractual obligations, or a review of effectiveness of the auditors.

Boards and committees

Remuneration committee

Companies have continued to take advantage of the 2007 revisions to the Code allowing chairmen of the board to sit on the remuneration committee. This is now the case for 116 companies. However, 12 companies diverge from best practice by using their chairman as the chairman of the remuneration committee.

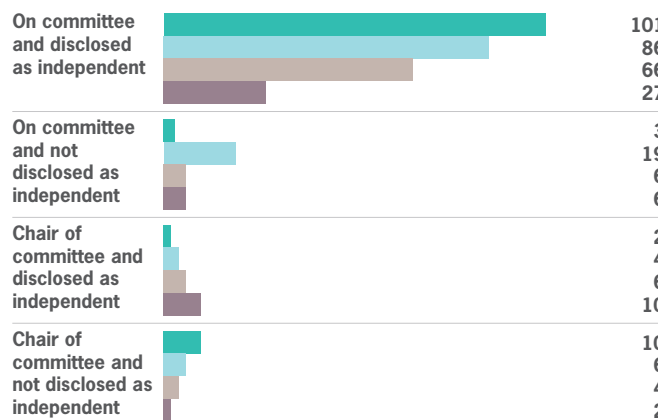
Schedule A of the Code requires that upper limits for annual bonuses should be set and disclosed in the annual accounts. The average bonus in excess of basic salary was 140%. There were 64 companies (2008: 40) offering bonuses in excess of 150% of basic salary. The Financials industry was the highest with average maximum bonuses of 213%: its constituent sectors include Banks (331%) and Insurance Brokers (400%). Of companies disclosing the highest potential maximum remuneration, 13 of the 24 companies are from the Financials industry.

% of salary	2009	2008
Not stated	29	28
Between 0–50%	7	18
Between 51–100%	125	137
Between 101–150%	74	83
Between 151–200%	40	28
Over 200%	24	12
TOTAL	299	306

Industry (size)	Average maximum potential bonus as a % of salary
Financials (56)	213
Consumer Goods (30)	166
Telecommunications (5)	165
Basic Materials (21)	138
Technology (15)	134
Oil & Gas (19)	132
Healthcare (9)	129
Consumer Services (64)	129
Industrials (71)	107
Utilities (9)	107

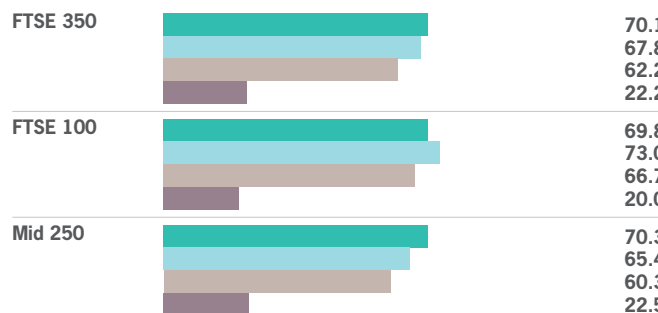
Q26. If the chairman does sit on the committee, does he/she chair it?

Figure 26
FTSE 350



Q27. Is there disclosure that the chairman of the board was considered independent on appointment to the remuneration committee?

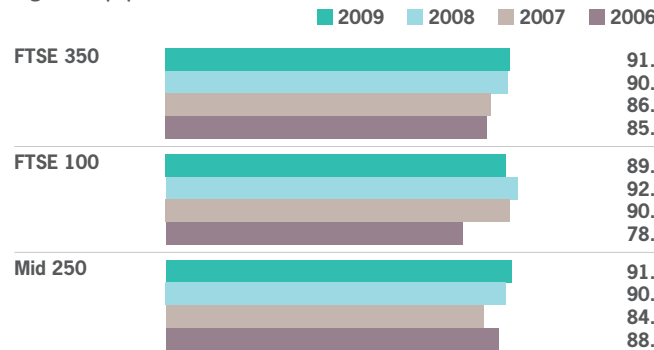
Figure 27 (%)



Q28. Does the company state the potential maximum remuneration available for executive directors?

Guidance: The performance-related elements of remuneration should form a significant proportion of the total remuneration package of executive directors... (Combined Code, B.1.1) ...and upper limits should be set and disclosed. (Combined Code, Schedule A)

Figure 28 (%)



Q29. Is it stated that the board (or shareholders where required) set the remuneration for the non-executive directors?

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

Figure 29 (%)



Boards and committees

Nomination committee

Explanations of the nomination committee's role and processes have continued to follow the trend of previous years with improvements in the quality of reporting, and only 12 companies now failing to provide any information (2008: 30).

In relation to board appointment, the most informative disclosures describe a formal, rigorous and transparent process with clear objectives for identifying the expertise and experience profile required. They also outlined a description of the appraisal and selection process for potential candidates, consideration as to the expected time requirements and the need for consultants to assist in the process.

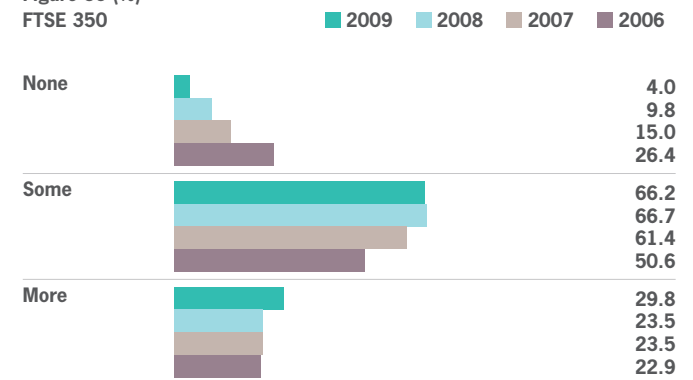
Some companies also commented specifically about candidates appraised in the year, or gave further detail of the requirements of the roles to be filled and the relevance of the methods used to identify the best candidates.

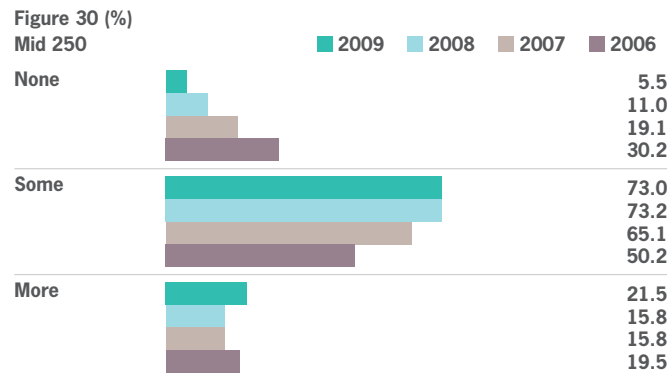
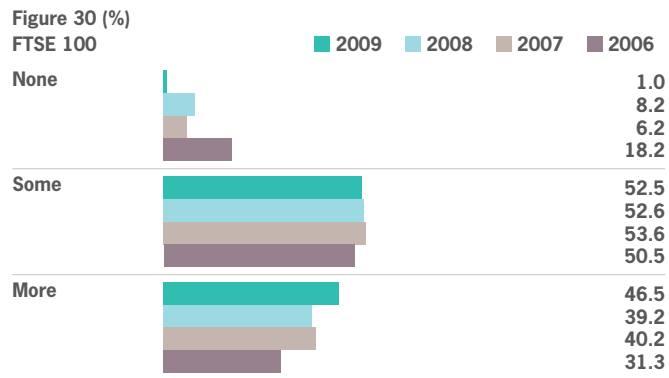
Where companies had no changes in their board make-up during the year, there was often little disclosure from the nomination committee. While it is more difficult to comment on the role of the committee in the absence of a specific appointment in the year, the process itself is a disclosure requirement of the Code and hence should be communicated to the readers of the annual accounts.

Q30. Is there a description of the work of the nomination committee, including the process it has used in relation to board appointments?

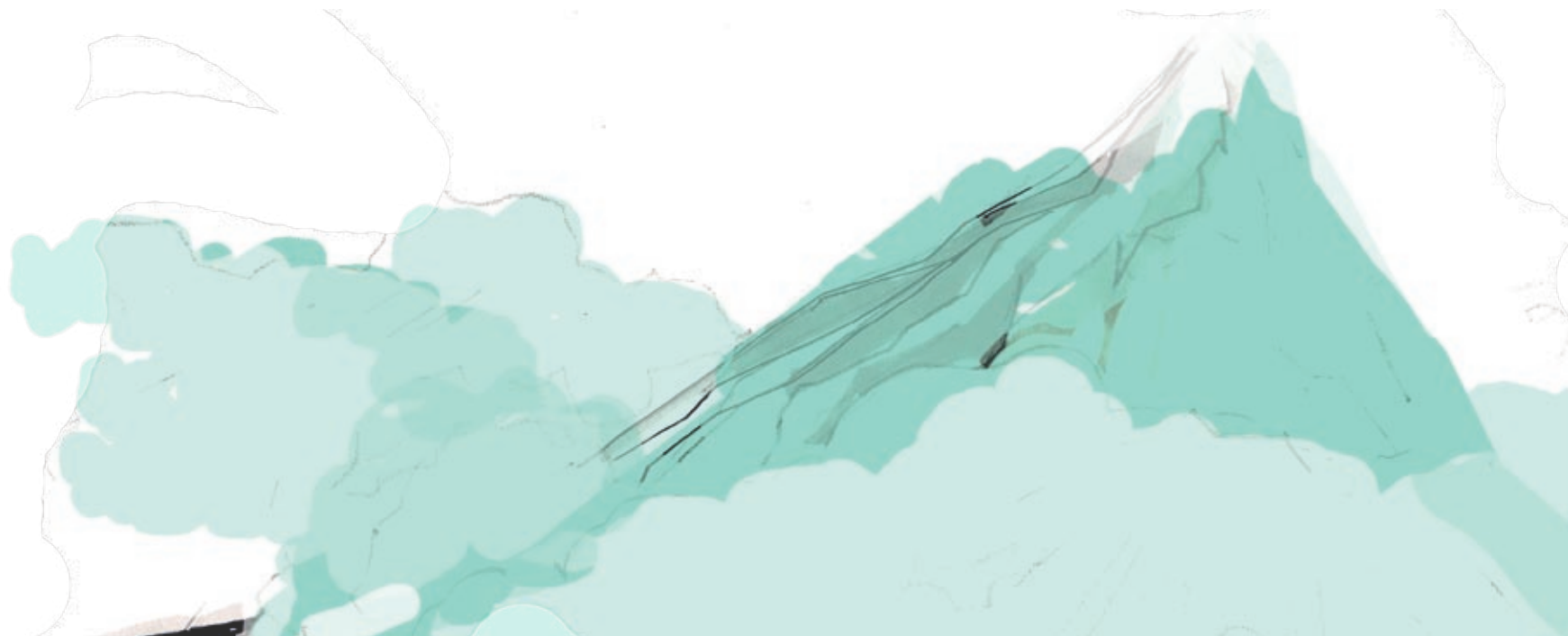
Guidance: A separate section of the annual report should describe the work of the nomination committee, including the process it has used in relation to board appointments. (Combined Code, A.4.6)

Figure 30 (%)
FTSE 350





Those companies providing 'more' disclosure gave details on succession planning, search and interview processes, and assessments of skills required for the board.



Internal controls – Turnbull

In line with the last five years practically all companies (98%) provided the disclosure that there is an ongoing process for identifying, evaluating and managing the significant risks faced by the company, and all disclosed that a review of the effectiveness of the group's internal controls had been undertaken in the year. However, 7% failed to mention their risk management systems and 30% made no reference to their operational and compliance systems of control.

Disclosures around the internal controls process introduced by the Turnbull review have shown steady improvement over the last five years. However, when assessing the quality of disclosures in relation to the review of the effectiveness of internal controls, results vary considerably with only 24% of companies providing a detailed explanation of how the review was carried out. Although there has been an encouraging increase in companies providing at least 'some' information, this is an area where the bulk of FTSE companies need to provide high quality disclosures on an area of key concern for shareholders. This is perhaps another example of where companies are failing to buy into the spirit of the Code, and the FRC's planned review of the Turnbull guidance in 2010 is to be welcomed.

39% of FTSE 100 companies and 24.5% of Mid 250 companies have a separate risk committee.

Although the board as a whole retains the responsibility for risk management, there is a danger that through the use of a committee, risks may not be assessed by all directors. Of the 88 risk committees mentioned, 15 had an NED as chairman. It appears that risk committees are more prevalent in certain industries, such as Utilities and Financials.

Industry (size)	Separate risk committee %
Utilities (9)	55.6
Financials (56)	51.8
Telecommunications (5)	40.0
Technology (15)	33.3
Oil & Gas (19)	26.3
Basic Materials (21)	23.8
Consumer Services (64)	23.4
Industrials (71)	21.1
Consumer Goods (30)	20.0
Healthcare (9)	11.1

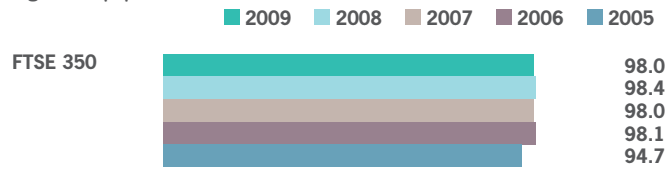
This year 21% of companies have disclosed actions that had been or would have been taken to remedy weaknesses in their internal controls (2008: 24%). However, we noted that there was some confusion as to what should be reported. Perhaps it would be more beneficial to provide a positive statement whereby companies highlight that there have been no material internal control failures identified in the year.

In the light of the recent financial crisis it is possible that we will see an increase in the reporting of significant control failures in the 2009 reporting season.

Q31. Is there a statement that there is an ongoing process for identifying, evaluating and managing the significant risks faced by the company?

Guidance: The board should, as a minimum, disclose that there is an ongoing process for identifying, evaluating and managing the significant risks faced by the company, [and] that it has been in place for the year under review. (Turnbull, paragraph 34)

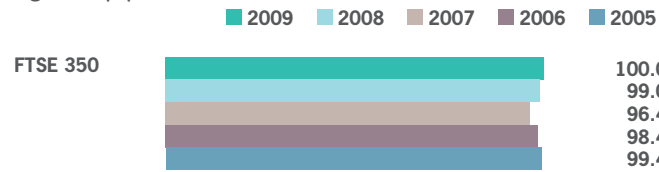
Figure 31 (%)



Q32. Is there a statement that a review of the effectiveness of the group's internal controls has been undertaken at least annually?

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

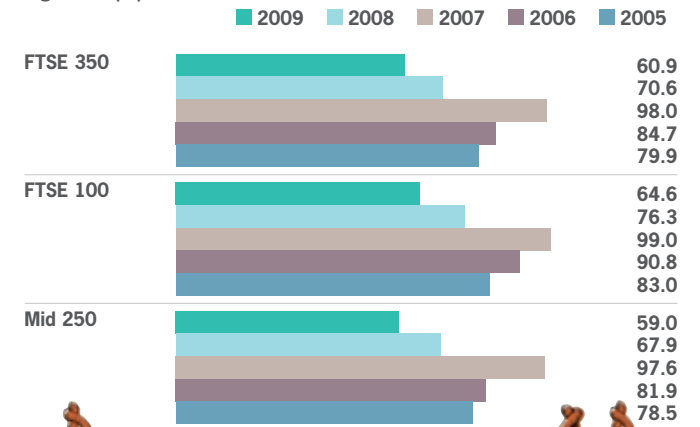
Figure 32 (%)



Q33. Is there a statement that this review covers all material controls including financial, operational and compliance controls, and risk management systems?

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

Figure 33 (%)

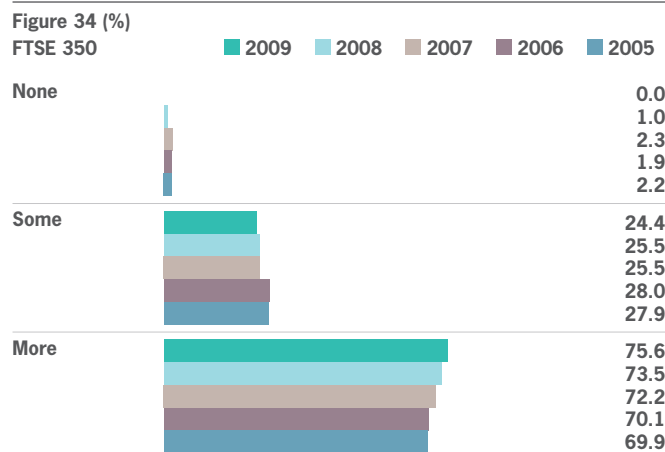


Following near full compliance with this requirement in 2007, our assessment was adjusted to determine which of the material control types, identified in the Code, are identified by companies as having been subject to review. In previous years, disclosure that material controls had been reviewed was deemed sufficient.

Internal controls – Turnbull

Q34. How much information is there surrounding the company's risk management and internal control process?

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

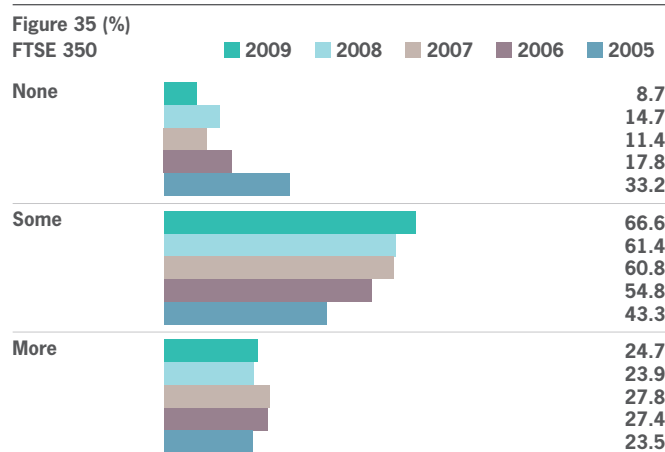


Best disclosures outlined the key elements of the internal control system including, inter alia:

- the key business objectives
- the organisation structure and reporting lines
- procedures to ensure compliance with external regulations aligned with corporate values and a code of ethics
- procedures to learn from control failures
- a wide range of corporate policies, procedures and training
- regular reviews of control activities and report findings and regular dialogues with senior management.

Q35. Is there a summary of the process the board/committees have applied in reviewing the effectiveness of the internal control system?

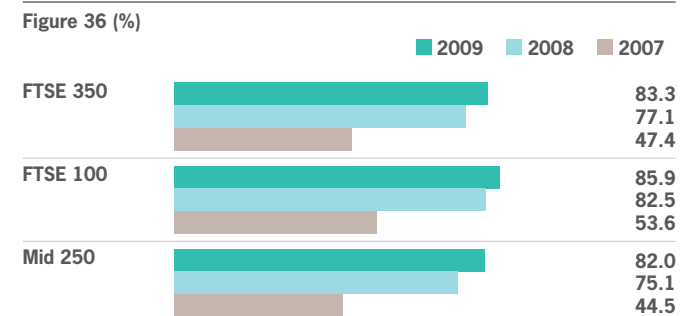
Guidance: In relation to Code provision C.2.1, the board should summarise the process it has applied in reviewing the effectiveness of the system of internal control. (Turnbull, paragraph 36)



Most companies made reference to their application of the Turnbull guidance in this area, but 'more' was achieved by those companies that then went on to provide a detailed description of how they have applied this guidance to their own process. This could include, inter alia, the areas of the system that have been reviewed, the method used for analysis (eg through analysis of reports from management and/or internal audit), reviews of any internal guidance documents on internal control and any specific areas which are given a more detailed review due to their importance to the sector/industry in which the company operates.

Q36. Is there specific reference to the financial reporting process and associated controls?

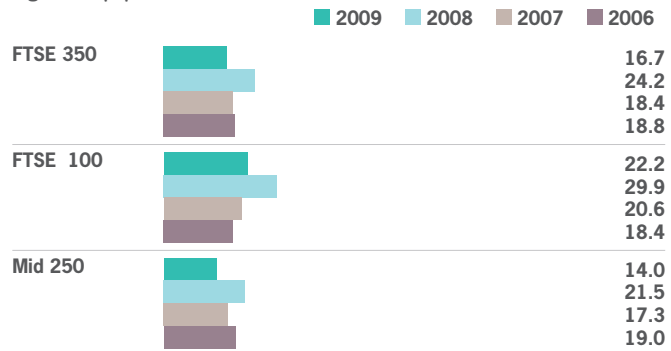
Guidance: Disclosure and Transparency Rules 7.2.5 R
The corporate governance statement must include a description of the main features of the company's internal control and risk management systems in relation to the financial reporting process. (Provision, C.2.1)



Q37. Does the company disclose that any necessary actions have been or are being taken to remedy any significant failings or weaknesses?

Guidance: In relation to Code Provision C.2.1, the board should... confirm that necessary actions have been or are being taken to remedy any significant failings or weaknesses identified from that review. (Turnbull, paragraph 36)

Figure 37 (%)

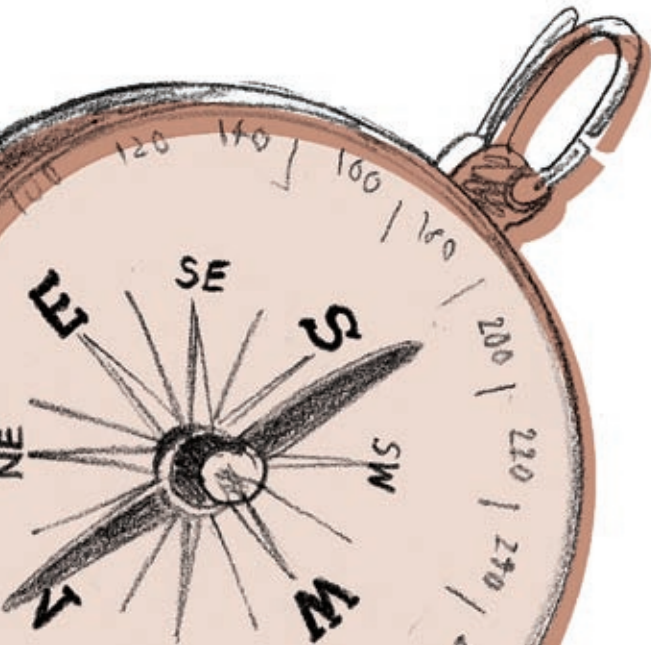


Shareholder relations

The preamble to the Code states that shareholders have an important role to play in maintaining and promoting corporate governance. Over half of the companies surveyed now provide a greater level of detail as to how the board has demonstrated the steps taken to understand the views of major shareholders.

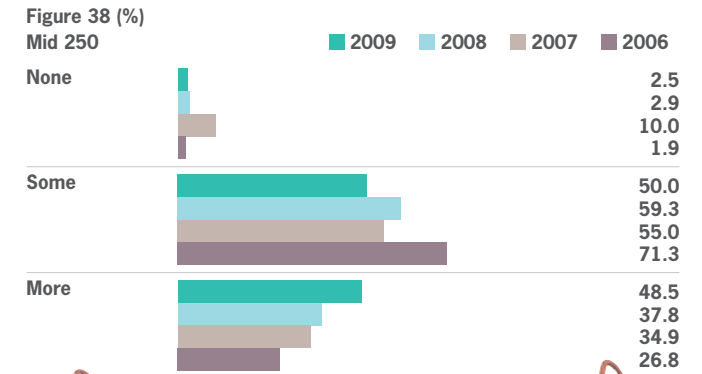
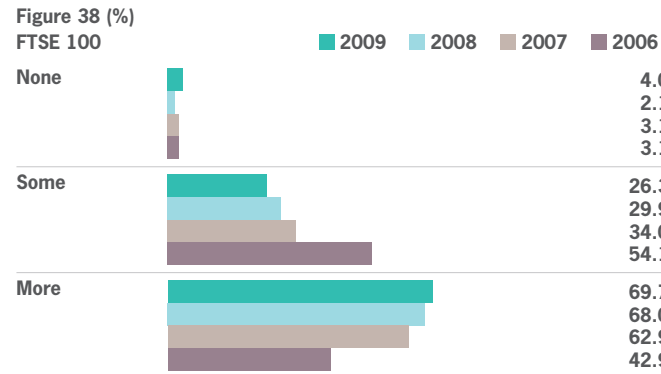
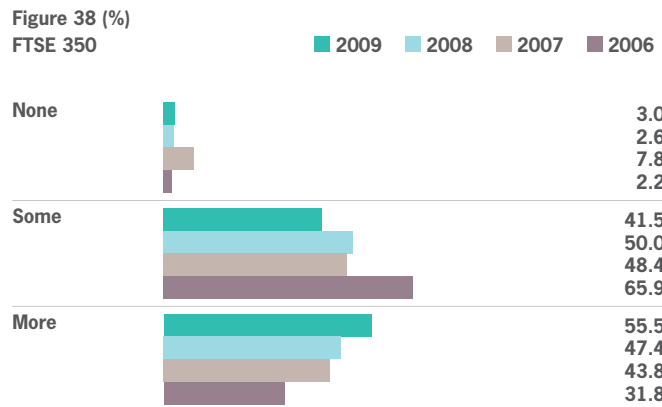
There remains a disparity between the FTSE 100 and Mid 250 companies on this topic as only 48% of Mid 250 companies are providing detailed 'more' information on this provision, whereas nearly 70% of FTSE 100 companies provide such disclosure. While our assessment of disclosures shows improvement, there are still 45% of companies which could improve the quality by providing more information on this important part of governance practice.

Eight companies failed to give any explanation as to how they have attempted to understand the views of shareholders, although none of these identified this as an area of non-compliance. Nine different companies claimed non-compliance with the Code provision relating to meetings with shareholders, mainly relating to the reluctance of the senior independent NED to be involved in discussions, or did not feel that meetings with shareholders were necessary.



Q38. 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 members of the board, and in particular the non-executive directors, develop an understanding of the views of major shareholders about their company... (Combined Code, D.1.2)



Many companies had separate sections for shareholder relations, with the companies rated as 'more' disclosing:

- dialogue with shareholders
- feedback to the board
- non-executives being available for meetings
- standard communication through the annual general meeting
- dedicated resources (including an investor relations department)
- presenting to the City and financial institutions on a regular basis.

Business Review

General

The Enhanced Business Review was introduced through the Companies Act 2006 (effective October 2007). It incorporated information which had been originally planned for inclusion in the OFR. Requirements include disclosures on the company's development, performance and position at the year-end, its principal risks and KPIs.

Reporting styles continue to vary, with some companies choosing not to create a separate business review section and instead directing the reader to other areas of the annual report. Only 12 companies did not specifically identify a Business Review section or cross reference the reader. All of these companies did however provide the information required by the Business Review within other sections of their reports.

The most effective disclosures were where companies have taken the opportunity to make a fresh start, rearranging their annual report to suit the legislation, with titled sections for each area of required disclosure.

Among the FTSE 350, 84% of companies provide detailed explanations of the business and external environments but when it comes to the future there appears to be greater reluctance to give information with the majority of companies giving only a limited insight into objectives and strategy. The most informative disclosures provided clear links between strategy, risks and control responses.

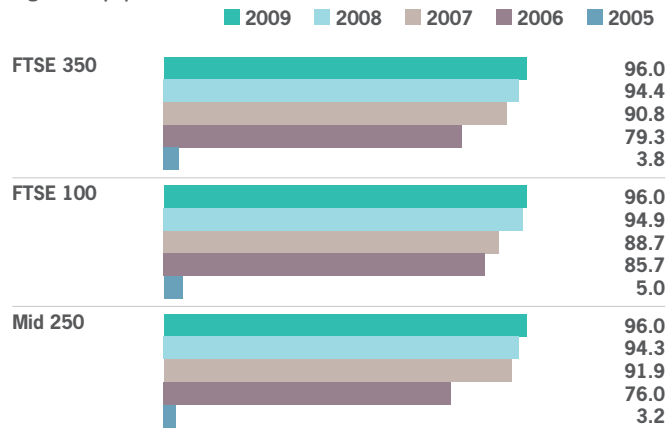
The ASB in their 'Rising to the Challenge' report released in October 2009, conclude that there is still some way to go in their assessment of the quality of disclosures. They noted that best companies:

- provide explanations of the business model and support discussions with relevant industry trends and external advice
- clearly describe their objectives and strategic goals which are then linked to the KPIs
- provide context for principal risks and provide information on the impact of the risk crystallising
- use tables to link principal risks to control responses
- only include non-financial KPIs and CSR information where they are relevant to the business.

Q39. Does it appear that the company has provided a separate business review in the director's report?

Guidance: Unless the company is entitled to small companies exemption in relation to the director's report, the report must contain a business review. (Companies Act 2006 s417; 1)

Figure 39 (%)



Q40. 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 the development and performance of the company's business during the financial year, and 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 40 (%)

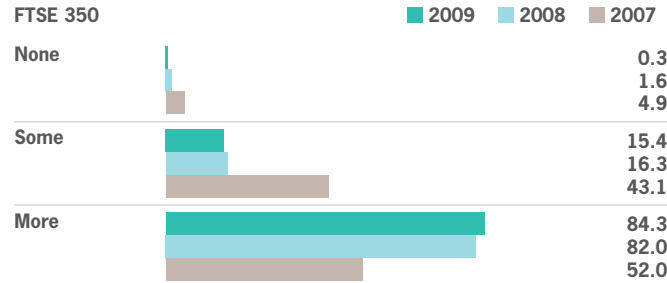


Figure 40 (%)

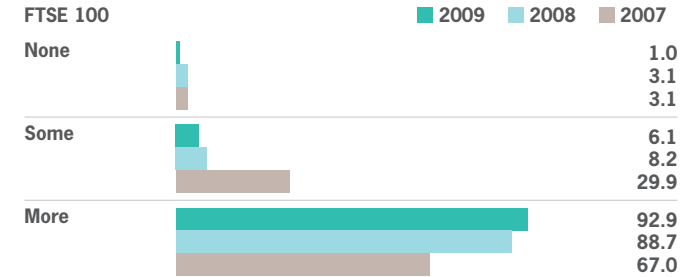
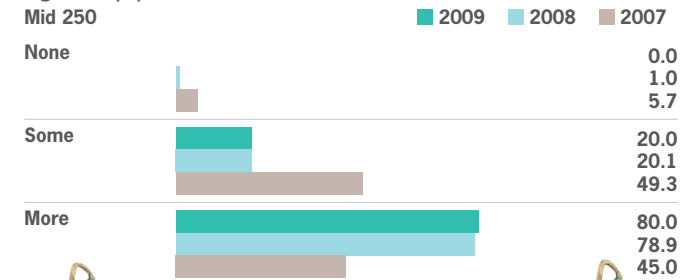


Figure 40 (%)

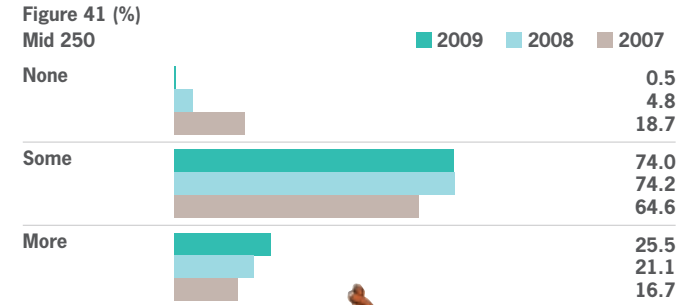
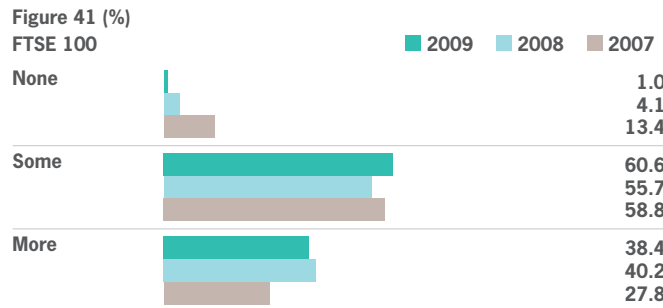
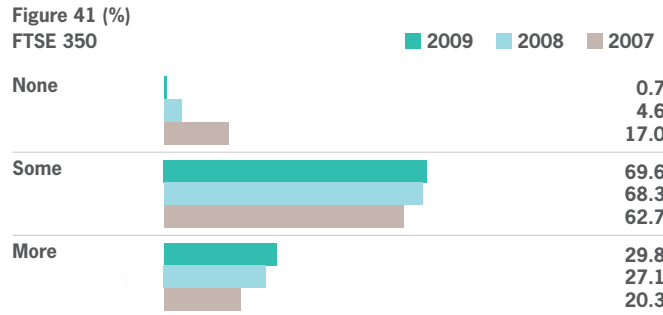


Companies providing 'more' give a description of the company's main products and services, geographical areas of operation, key customers and suppliers, and some relevant sector or industry specific information.

Business Review

Q41. Do they [or to what extent do they] provide any indications of the likely future development of the business?

Guidance: the business review must contain a fair review of the company's business. (Companies Act 2006 s417; 3a)

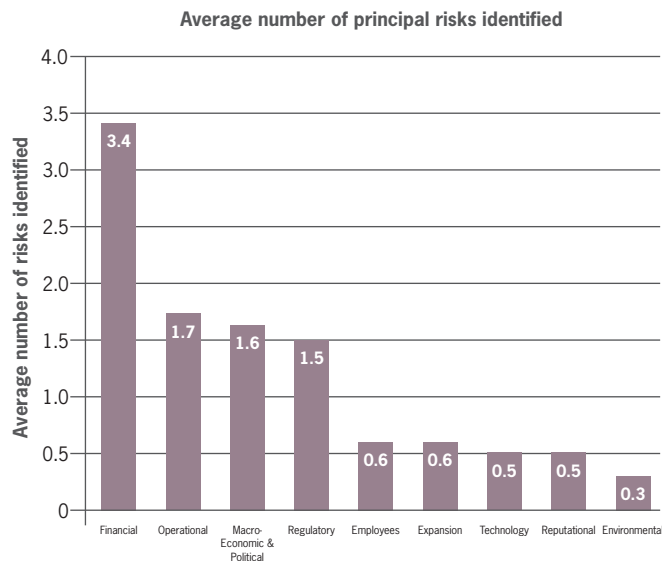


The best disclosures provide a review of the strategy for the coming years as well as any areas of business which the company expects to develop in the near future. If there are more long-term plans in place (dependent of the industry in question) these are often discussed in more general terms.

Risks

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

This year, for the first time, we have assessed the range of risks disclosed across the FTSE 350 to determine the granularity of disclosure and identify common themes and issues.



On average companies report 10.7 principal risks. However, this average represents a wide disparity ranging from 10 companies identifying fewer than four risks, nine reporting 20 risks or more and one more than 30.

One might conclude that some companies do not have sufficient robust risk management processes to identify the principal risks relevant to their business, while others struggle to prioritise risks effectively.

The type of risks identified varied, although these were predominantly in line with industry specific factors, for example, Healthcare companies focus on regulatory risks, Utilities on environmental risks and Telecommunications on technology risks. All industries reported more financial risks (eg foreign exchange, liquidity, or interest rates) than any other category, except for Healthcare which reported on more regulatory risks.

The quality of the explanations supporting the risks varied; some companies provided detailed descriptions of the risk, its specific impact, and the steps being taken to mitigate such an impact; others reported in more generic terms about a type of risk to which the company is exposed without providing the reader with information as to how the crystallisation of this risk would impact on the company’s business.

55% of the FTSE 350 disclosed risks relating to employees, and 88% of these highlighted reliance on staff amongst their greatest concerns, showing the greatest consensus in any risk category. Risks surrounding business growth (including both organic growth and growth by acquisition) were reported more frequently than technology or reputational risks. Acquisition risks represented 61% of the risks in this category, perhaps surprising in an environment where acquisitions had all but dried up.

Technology risks often showed a lack of clarity in reporting where almost half of the risks reported were in relation to ‘Information Technology Systems’, with the remainder being more explicitly outlined in areas such as the security or failure of key systems or the risks associated with undertaking IT change projects.

The identification of IT as a principal risk continues to grow with 41% of FTSE 350 companies (2008: 36%) now identifying this as a key risk. However, only 7.4% of FTSE 350 (2008: 8.2%) companies have a chief information officer on the board.

Reputational and environmental risks were least frequently mentioned, with only 40% and 24% of companies respectively identifying these as a risk.

For reputational risks, the majority (64%) cited risks regarding reputation or brand damage, with a few companies providing more detailed risks in relation to key facets such as customer perception, product reputation or ethical business. Environmental risks were similarly stratified with 42% referring to ‘environmental risk’, with the remainder detailing the risk to the company with reference to climate change, environmental disasters, sustainability issues, or specifically defining the risk of ‘human impact’ on the environment.

Business Review

58.6% of new members of the Mid 250 (representing 19 companies) this year have not reported on risks to other key stakeholders such as employees, the environment and the local community, which has led to the fall in their levels of overall compliance in the Mid 250. In contrast, we continue to see FTSE 100 companies considering the potential impact of their actions on these wider groups, maintaining their primacy in levels of reporting.

While there is a considerable amount of information on risks disclosed in the Business Review, for this to be useful to the shareholder it needs to be presented clearly. The best companies provided a joined-up picture linking strategy to risk, and their control responses. While there is not necessarily a direct link between the risks and the KPIs which a board may choose to monitor, one would expect an alignment with the areas where business risk is recognised.

We have looked for a correlation between the risks and KPIs reported. The table below shows the percentage of companies which reported at least one non-financial risk in a category and went on to report one KPI in the same category.

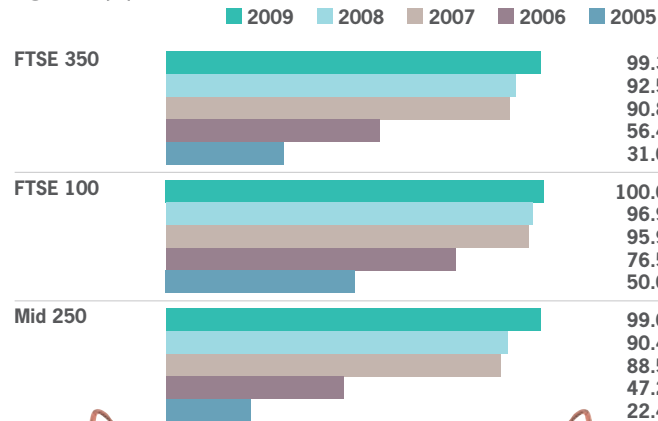
Joined-up thinking on non-financial topics appears to be absent in the majority of companies and perhaps is an indication that the quality of risk reporting in the FTSE 350 still has some way to go.

Category	Of companies identifying at least one non-financial risk, % providing at least one KPI in this category
Environment	45.2
Employees	33.4
Business Growth	28.1
Reputational	26.4
Regulatory	23.1
Operational	16.4

Q42. Do they describe what their principal business risks are?

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

Figure 42 (%)

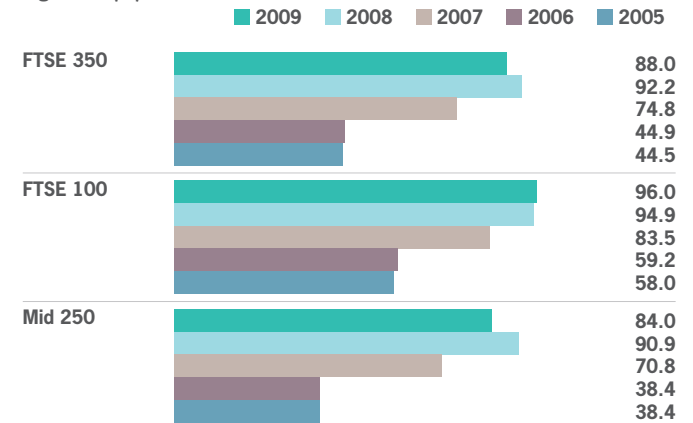


Best companies highlight what they consider to be their principal risks under a separate section, and go on to provide details as to how they are mitigating or avoiding these risks.

Q43. Is there an apparent consideration of risks relating to other key stakeholder matters?

Guidance: In the case of a quoted company the business review must, to the extent necessary for an understanding of the development, performance or position of the company's business, include information about (i) environmental matters, (ii) the company's employees, and (iii) social and community issues. (Companies Act 2006 s417; 5b)

Figure 43 (%)



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

Risk category	Industry (size)										
	Average	Healthcare (9)	Basic Materials (21)	Consumer Services (64)	Utilities (9)	Consumer Goods (30)	Oil & Gas (19)	Technology (15)	Telecom- munications (5)	Industrials (71)	Financials (56)
Financial	3.4	3.1	3.9	3.4	4.6	3.0	3.4	2.6	2.2	3.0	3.9
Operational	1.7	1.4	2.1	1.7	1.7	2.0	2.1	2.1	1.6	1.5	1.8
Macro-Economic & Political	1.6	2.0	1.3	1.9	1.4	1.6	1.5	1.7	2.0	1.7	1.2
Regulatory	1.5	3.3	1.7	1.5	1.4	2.2	1.4	1.3	1.6	1.3	1.0
Employees	0.6	0.4	0.8	0.7	0.4	0.7	0.6	0.9	0.2	0.7	0.5
Business Growth	0.6	0.9	0.8	0.6	0.1	0.5	0.5	0.7	0.4	0.7	0.5
Technology	0.5	0.2	0.4	0.8	0.2	0.2	0.3	0.9	1.8	0.5	0.3
Reputational	0.5	0.2	0.3	0.7	0.4	0.5	0.6	0.3	0.4	0.4	0.4
Environmental	0.3	0.4	0.6	0.3	1.6	0.5	0.5	0.1	0.0	0.2	0.1
Average total number of risks	10.7	12.1	12.0	11.5	11.9	11.2	11.0	10.5	10.2	10.0	9.7

Business Review

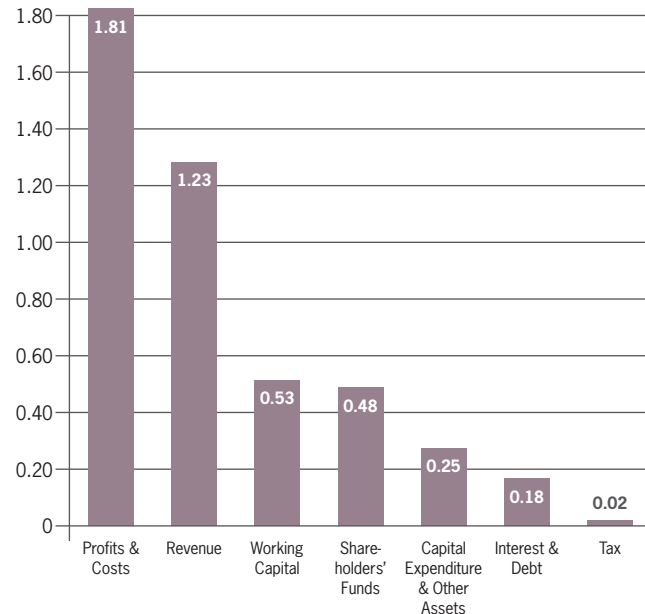
Key performance indicators

The Companies Act (2006) requires that the Business Review include, “to the extent necessary for an understanding of the development, performance or position of the company’s business, analysis using financial key performance indicators, and where appropriate, analysis using other key performance indicators” (Companies Act 2006, Section 417: 6).

A diverse range of KPIs are being used, making it difficult for readers to benchmark the information against similar companies. While the FTSE 100 disclosures are consistently of a higher quality than the Mid 250, a large proportion of companies still do not explain why they have chosen their KPIs (42%) or provide an explanation of how the KPI information has been used to better manage the business (59%).

48% of companies fail to provide details as to how the KPIs have been calculated, and with only 17 utilising external independent bodies to provide assurance over any of their non-financial KPIs, it brings into question the relevance, reliability and comparability of the data, and therefore its ability to add value.

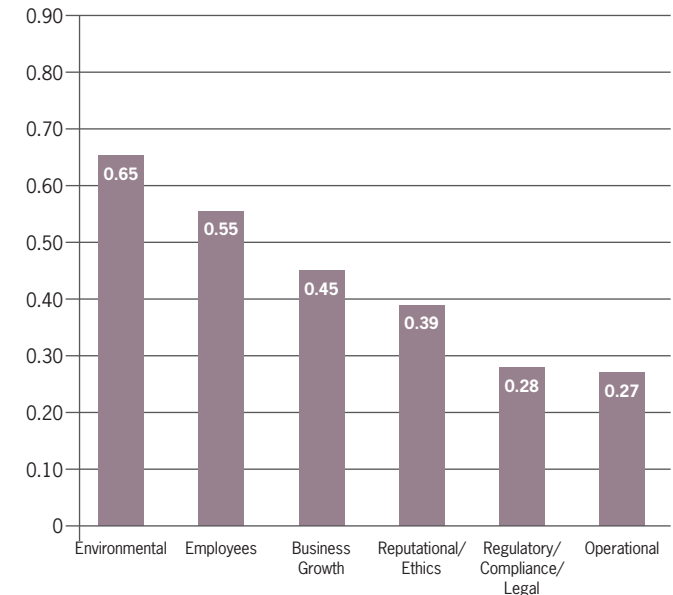
Breakdown of financial KPIs by type
Average number per FTSE 350



The average number of KPIs reported this year was 7.1 (4.5 financial and 2.6 non-financial). Financial KPIs are well established but for non-financial, practice is continuing to emerge, particularly among the Mid 250. There remain 35% of companies (103 companies) which have yet to provide any non-financial KPIs.

Telecommunication and Utility are leading the way in non-financial reporting, although non-financial KPIs seem to have less relevance to some of the other industries; for example, Healthcare and Financials.

Breakdown of non-financial KPIs by type
Average number per FTSE 350



Telecommunication and Utility companies focused on environmental measures where on average each Telecommunication company provided 3.6 KPIs and Utilities provided 1.4. Utility companies also provided evidence of joined-up reporting by providing a higher number of risks surrounding environmental matters.

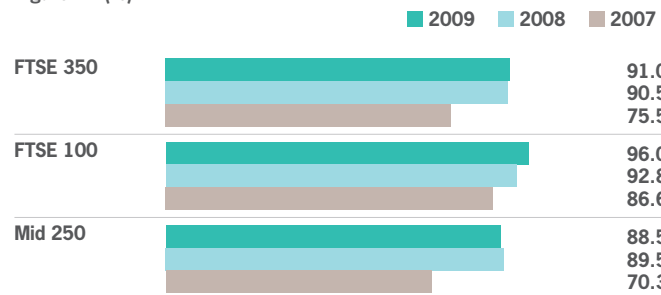
The types of financial KPIs reported continue to show some consistency across industries; the non-financial KPIs continue to be spread across a broad range of categories with environmental and employee KPIs being the most predominantly reported.

Average number of KPIs disclosed by industry

Industry (size)	Financial KPIs	Non-Financial KPIs	Total
Telecommunications (5)	5.2	7.2	12.4
Utilities (9)	4.6	6.1	10.7
Basic Materials (21)	3.6	4.0	7.6
Consumer Services (64)	5.2	2.2	7.4
Technology (15)	4.7	2.5	7.2
Consumer Goods (30)	3.9	3.3	7.2
Industrials (71)	4.4	2.3	6.7
Financials (56)	4.7	1.8	6.5
Oil & Gas (19)	4.2	2.3	6.5
Healthcare (9)	3.4	1.3	4.8
Overall Average (299)	4.5	2.6	7.1

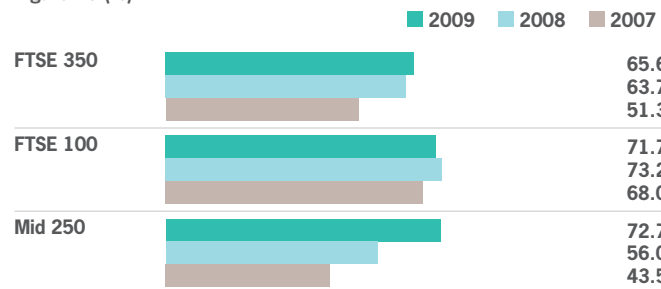
Q44. Does the business review contain specific key performance indicators to measure financial performance of the business?

Figure 44 (%)



Q45. Are other key performance indicators stated for non-financial performance measures (including information relating to environmental and employee matters)?

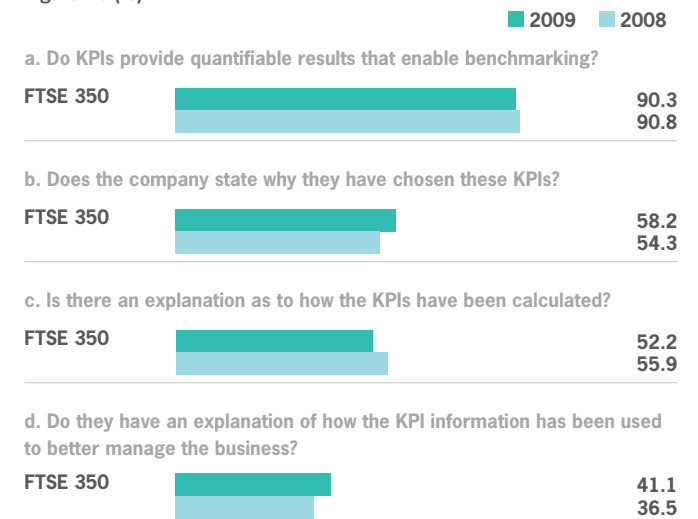
Figure 45 (%)



Q46. KPI Attributes

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

Figure 46 (%)



Business Review

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

Financial KPIs	Industry (size)										
	Average	Basic Materials (21)	Consumer Goods (30)	Consumer Services (64)	Financials (56)	Healthcare (9)	Industrials (71)	Oil & Gas (19)	Technology (15)	Telecommunications (5)	Utilities (9)
Profits and costs	1.8	1.7	1.5	2.2	1.7	1.2	1.7	1.7	2.3	2.8	2.1
Revenue	1.2	0.4	1.2	1.8	1.1	1.1	1.2	0.8	1.5	1.4	0.4
Working capital	0.5	0.4	0.4	0.4	0.5	0.7	0.7	0.6	0.7	0.6	0.6
Shareholders' funds	0.5	0.5	0.5	0.4	0.8	0.3	0.4	0.5	0.1	0	0.7
Capital expenditure and other assets	0.3	0.3	0.1	0.2	0.4	0	0.2	0.3	0.1	0.4	0.4
Interest and debt	0.2	0.2	0.2	0.2	0.2	0.1	0.2	0.2	0	0	0.3
Tax	0	0.1	0	0	0	0	0	0	0	0	0
Average total number of KPIs	4.5	3.6	3.9	5.2	4.7	3.4	4.4	4.2	4.7	5.2	4.6

Non-Financial KPIs	Industry (size)										
	Average	Basic Materials (21)	Consumer Goods (30)	Consumer Services (64)	Financials (56)	Healthcare (9)	Industrials (71)	Oil & Gas (19)	Technology (15)	Telecommunications (5)	Utilities (9)
Environmental	0.6	1.8	1.1	0.4	0.3	0	0.5	0.1	0.8	3.6	1.4
Employees	0.6	0.9	0.6	0.4	0.5	0	0.6	0.4	0.5	1.8	0.8
Business growth	0.4	0.2	0.3	0.5	0.5	0.7	0.5	0.5	0.5	0.6	0.2
Reputational/Ethics	0.4	0	0.5	0.5	0.4	0.3	0.1	0.1	0.5	1.0	1.8
Operational	0.3	0.5	0.3	0.3	0.1	0.1	0.1	0.7	0.2	0.2	0.7
Regulatory/Compliance/Legal	0.3	0.5	0.5	0.1	0	0.2	0.4	0.4	0.1	0	1.2
Average total number of KPIs	2.6	4.0	3.3	2.2	1.8	1.3	2.3	2.3	2.5	7.2	6.1

Corporate Responsibility

79% of the FTSE 100 now produce a Corporate Responsibility (CR) report or an equivalent separate to their annual report. Although the Mid 250 are behind this trend at 60%, the growing awareness of company's responsibility for the social, environmental and ethical performance is evident.

Although this means that much of the sustainability and CR reporting is no longer presented within the annual report, we have seen a further rise in the number of companies reporting that they have established dedicated monitoring programmes for the company's wider social environment and ethical performance.

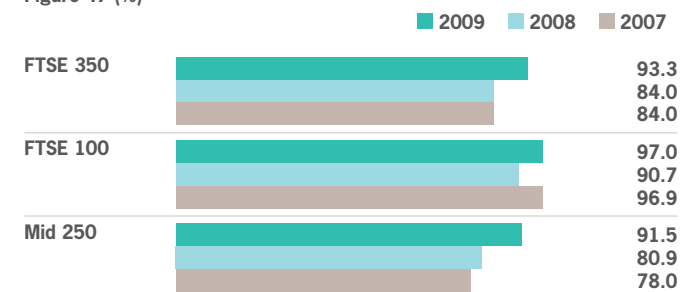
There has been a significant increase in the reporting of the impact of a company's business on the environment, with nearly all companies now referring to their emissions and waste production even if they do not use specific KPIs. In 2010, a large proportion of companies will be required to report to the Environment Agency on their emissions under the Carbon Reduction Committee initiative. Reporting on Business Review requirements, environmental matters, company employees and social and community issues, is now being provided by 98% of companies with 57% providing this information in the Business Review.

Only 24% of companies provided disclosure that any aspect of their CR reporting had been reviewed, with only half of these reporting that this had been undertaken by an external, independent assurance provider.

Q47. Have they established dedicated structures and processes to direct and regularly monitor the company's wider social environment and ethical performance and report to the board?

Guidance: In the case of a quoted company the business review must, to the extent necessary for an understanding of the development, performance or position of the company's business, include information about (i) environmental matters, (ii) the company's employees, and (iii) social and community issues. (Companies Act 2006 s417; 5b)

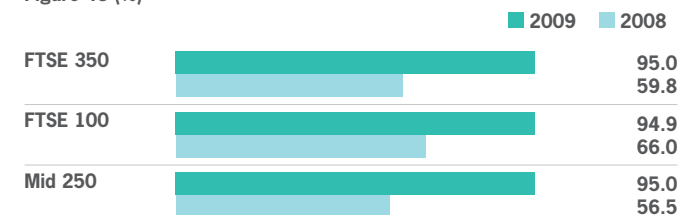
Figure 47 (%)



Q48. Is there a statement that an assessment of the impact of the company's business on the environment has been undertaken?

Guidance: In the case of a quoted company the business review must, to the extent necessary for an understanding of the development, performance or position of the company's business, include information about (i) environmental matters, (ii) the company's employees, and (iii) social and community issues. (Companies Act 2006 s417; 5b)

Figure 48 (%)



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- Fee income \$4bn
- More than 500 locations in over 100 countries
- Over 30,000 staff and 2,500 partners
- The fastest growing international accounting organisation for the past three years

Grant Thornton UK LLP

- Over 4,000 staff across 29 locations
- 235 partners
- Fee income of £394m
- Full service practice with extensive specialist advisory services
- Provide non audit services to 1 in 6 of the FTSE 100

Business Risk Services

Globally

- Over 1,300 dedicated internal audit and business risk professionals worldwide in key financial centres
- Revenues US \$280 million

In the UK

- Over 120 professionals with significant experience in the provision of governance, risk and compliance services
- Significant experience in providing international services to complex global organisations
- Numerous FTSE 350 and equivalent clients
- Integrated financial services and technology risk teams

Business Risk Services

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

Assurance

- Outsourcing or co-sourcing of internal audit
- Internal audit effectiveness reviews
- Operational audit
- Revenue, contract and cost verification audits
- SAS 70 and AAF 01/06

Advisory

- Governance
- Enterprise risk management
- Process and control improvement
- Post-merger integration
- Fraud risk assessment
- Programme management
- Sarbanes-Oxley

Information Technology

- IT governance and strategy
- IT assessment and due diligence
- Security services
- Selection and implementation effectiveness
- Data centre reviews
- Business continuity and disaster recovery
- Data mining and investigations

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