# Board reporting in 2006

## A survey of FTSE 100 annual reports

This year's reporting survey has taxed our normally sunny dispositions. Last year we pointed out that, amongst the acres of predictable, indistinguishable compliance statements, there were a good number of examples from leading companies to show that worthwhile communication is possible. So we'd hoped that this year's survey would show continued improvement, with a noteworthy increase in the number of companies going for communication rather than compliance.

And indeed this has happened – but mostly only with audit committees. Many of these show a marked improvement in the interest and usefulness of their reports. Board reports, on the other hand, are showing a similar pattern to last year: enough good examples to keep despair at bay (just), but surrounded by frustratingly large quantities of predictably standard statements.

This year we're combining our board and audit committee surveys into a single document, in the hope that some of that audit committee magic might rub off on boards. For the record, the survey covers the 96 reports published by FTSE 100 companies with year ends since May last year. Most of these were published during the first half of 2006; a small number came out in the second half of 2005.

### Governance is settling down but reporting can still improve

- Audit committees are divided more or less evenly into those who want you to know what they've been up to and those who still don't get this across. Nonetheless, there is real progress on last year. The good ones show how to communicate a sense of the scope and nature of their work, and what they've contributed to their companies.

- Board reporting is far less differentiated and boards remain generally shy of giving much away.

- Most nomination and remuneration committees have little to say about anything except their terms of reference.

- Nearly all boards are now assessing their effectiveness annually. As we predicted last year, rotation between external review and self-assessment is becoming evident. Most give fuller explanations of what they're doing, but then spoil the effect by implying that their rigorous exercises in continuous improvement failed to find anything that could be improved.

- There are signs of an outbreak of common sense over the nine-year issue, with boards showing little inclination to drop directors just because they reach this mark. However, this isn't supported by good descriptions of what makes true independence or of how the checks and balances really work.

- Late last year, major corporates from the FTSE 100 and leading investors worked together with us to put forward a framework for governance reporting[1] that would be both useful and realistic. We have assessed the reports against this and found that many companies will not be short of opportunities and ideas for next year's report.

- Amongst the patchy progress, there are a lot more good examples of reporting on specific features of board and committee work. The listing we provide at www.independentaudit.com/goodreporting now includes more than 50 companies whose reports contain particular sections which might help other companies think through how to improve their own reporting.

[1] "Better governance reporting", available on request or from www.independentaudit.com/us/ourpublications

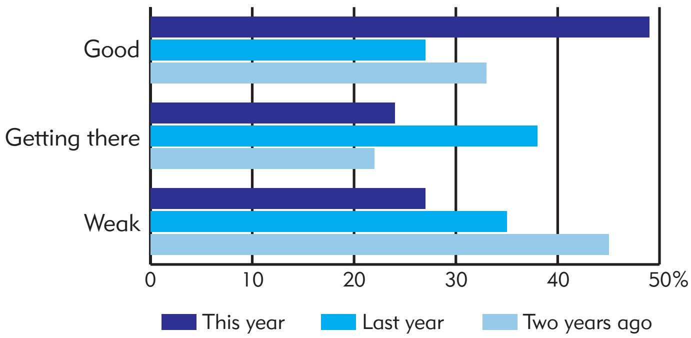
## The board's role

Investors want to understand how in practice the board has set strategic direction, provided leadership and monitored performance, all within a framework of sound controls, standards and values. So what do they get?

### Audit committees as trendsetters?

A novel idea, but it seems to be true. Many of them have become much better at saying what they actually did during the year. Nearly half have made a successful effort to give the reader something of a feel for the nature of their work. They are clearly distinguished from the substantial rump of weak ones who still make up a quarter of the group (last year: 35%). But interestingly, less than half of these are the same companies as last year. 16 companies have moved out of "poor" while 11 have slipped down. This slippage reflects a failure of these companies to develop their reports in line with improving market practice, rather than a deterioration in their reporting.

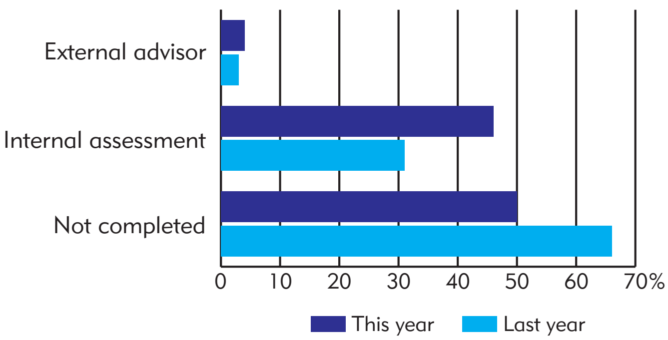
**Figure 1: Quality of reporting on AC activity**




There are many useful descriptions of activity with BAA, BT, Old Mutual and Wolseley being particularly well thought-through examples. Even allowing for it starting off with more room for improvement than most, Morrisons gets this year's "most improved" prize; its report suggests it now has in place not just an audit committee but a serious one.

Nearly all companies explicitly include assessing the independence of their external auditors as part of their work, as last year, but still only half describe how they do it (Aviva, BHP Billiton, Morrisons, Old Mutual and SAB Miller providing useful descriptions). Two-thirds now reflect the complexities of this issue, with references to partner rotation and auditor confirmation. This is an improvement from last year when half simply talked about auditor independence by reference to non-audit services. Still only a handful touch on the auditor's relationship with management.

**Figure 2: Internal audit evaluation**



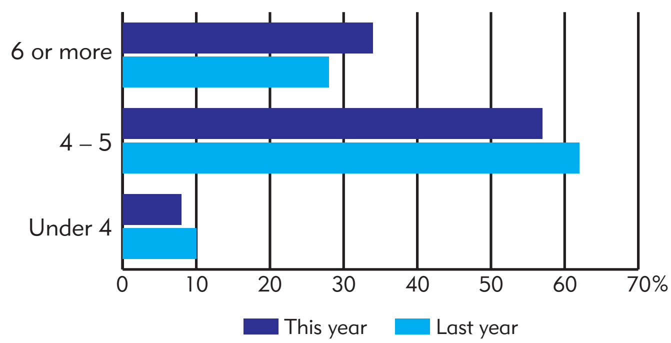

Most committees (77%) now confirm that they assessed the effectiveness of the external auditors (up from 58%). However, only one-third of these explain how they did it, with Associated British Foods, Aviva, Gallaher, Hanson and Rexam standing out.

More audit committees are actively reviewing the effectiveness of internal audit, with 50% having conducted a review over the past year (up from 34%). Most of these explain how they went about it, with Associated British Foods and Aviva among the best. Only four companies report undertaking an external review, although current market activity suggests that the number will be substantially higher next year.

The slight trend towards an increasing number of audit committee meetings continued.

Other interesting features include AstraZeneca talking about how the committee interacts with management, Prudential's clear explanations of its approaches to continuing training and Yell's description of how it reviewed the effectiveness of whistleblowing procedures.

**Figure 3: Number of meetings**

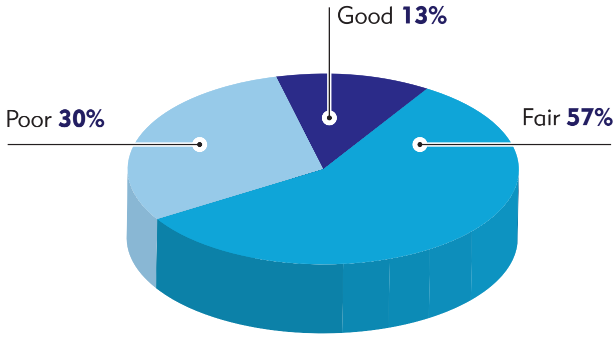


## The board itself

Board reporting, by contrast, remains generally uninspiring and uninformative. We have yet to see a board report which is good all round. Being generous allowed us to classify just over half the board reports as "fair". The twelve companies in our "good" category are there because of specific features.

Practically every board gives a general description of what it does based on its formal remit – ie what a board does in theory. It becomes very difficult to tell one board from another.

**Figure 4: Quality of board reporting**




A few companies do go beyond this and give insight into what the board actually did during the year (3i, Cable & Wireless, M&S, Reuters, Sainsburys, Scottish Power and Schroders more than most). BP helpfully sets out the report in the context of its governance philosophy. Some give insights into particular aspects of the board's work, such as its oversight of risk management (Kingfisher and WPP) and how it works with management in developing strategy (BAE Systems). Tate & Lyle gives a flavour of the balance of time spent by the board. Others help build on the generic picture by using their websites effectively to give a fuller picture of their governance approach (BHP Billiton, Unilever). Going this bit further brings the report to life and sends a message that the board does actually want the reader to understand what it does.

Many annual reports mention the importance of their company values or ethics but hardly any board says anything about how it reinforces values and ethics from the top. Presumably most feel they do this but hardly any discuss how. BP, International Power and M&S begin to show how it can be done.

## The nomination and remuneration committees

Investors always have a high level of interest in pay and appointments and they tell us that this extends to how the remuneration and nomination committees are reporting. Unfortunately, reports from these committees on their work generally appear to be afterthoughts. Almost all continue to state what they do, not what they did, in words which are largely interchangeable between companies and between years.

Maybe remuneration committees think that the formal remuneration reports speak for themselves. At any rate, very few of them choose to explain how they went about aligning rewards with strategic goals, making sure that peer comparisons made sense or monitoring the continuing relevance of remuneration strategies. Noteworthy remuneration committee reports came from Boots, ICI, Lloyds TSB, Royal Sun Alliance, Unilever and Xstrata.

When it comes to nomination committee reports, Xstrata is again worth mentioning along with Scottish Power for giving some flavour of the committee's work during the year. Most companies (69%) at least refer to the nomination committee's role in succession planning – the HBOS description stands out, along with WPP's. Schroders' nomination committee report is laid out with unusual clarity, suggesting an acknowledgement of the committee's importance.

## Having the right people

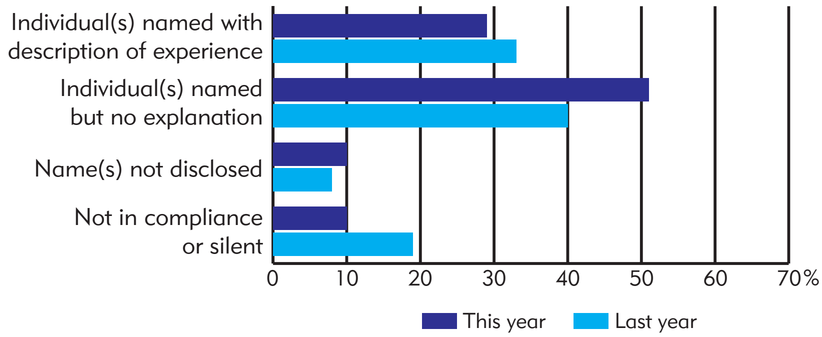
Even though every board will say that the quality of its members is paramount, very few address this explicitly. BHP Billiton is the best example while Aviva and Tesco stand out for describing the relevance of newly-appointed directors' experience. Otherwise, you have to figure it out from the brief career information contained in directors' biographies. BAA helps here with effective signposting to more detailed information on its website.

Having the right mix of non-executive directors to support strategic success is a central concern of investors. Most companies now work closely at this, and it would be of interest to hear how they do it. But few touch on this, with BP, Rexam and BAE Systems amongst the handful to explain how their nomination process and planning take into account long-term strategic needs.

There are more signs of life in audit committee reports, where some (for example, Reed Elsevier, Rexam and SAB Miller) do a good job of explaining the relevance of the committee members' experience.

Two companies say they are not in compliance with the requirement to have "recent and relevant financial experience", and another eight are silent on the matter. This is better than last year when six were not in compliance and ten failed to report. Of the audit committees that confess to having financial experts, most name them, but only about a third explain how the expert's experience is relevant (a slight drop on last year).

**Figure 5: Relevant financial experience**




## The board working together

Few companies do much in the way of meeting the Code's requirement to explain how the board adopts a balanced approach to decision-making. They do, however, respond to that part of it which relates to non-executive independence. Nearly all companies (97%) make the requisite statement on independence and 82% report having a majority of independent directors – slightly down on last year's 88%.

Some 90% of non-executive directors are classified as independent, the same as last year. Nearly half of the boards surveyed still have one or more non-executive directors who have served in excess of nine years, of whom two-thirds are to said to remain independent. Allowing for the timing of board changes, the number of long-serving directors across all FTSE 100 companies (65 on 43 boards) is broadly in line with last year. Few of them are due to retire in the next year, which means the situation is likely to persist.

This absence of any significant reduction despite the large number of companies with long-serving directors suggests that companies are taking less of a box-ticking approach to this issue and are not shedding directors just because of the passage of time. This could be a good thing – after all, the Code's Principle is that independent directors should be independent in mindset and approach, with the so-called nine-year rule being a suggested indicator of declining independence and not a rule at all.

However, it would strengthen companies' positions with investors if they were to make more of an effort to provide convincing explanations of how they assess independence in these and other cases. Only about two-thirds (61%) of all companies explain how they interpret independence. Of these, most simply rely on the formal definitions in the Code or in Sarbanes-Oxley, or offer bland statements about the application of independent judgement. Only a handful of companies – Aviva, Barclays and Unilever being the best examples – go further and provide some insight. Most disappointingly, almost all of those companies with long-serving directors make no particular attempt to show that they've really thought about independence, with rather unconvincing boilerplate formulations starting to appear.

A few boards (3i, BT, Old Mutual, Scottish & Newcastle) have started to reflect the central importance of the chairman's role by giving fuller, clearer descriptions. Less than a third make a statement on the role of the senior independent director, and those that do limit it to being available to shareholders and reviewing the chairman's performance. Maybe there is little more to say.

## Management support for the board

Descriptions of any steps taken to improve board information are conspicuous by their near-total absence, despite this being a known area of frustration for many boards. It would be interesting to know what boards are doing to get the information they need to be effective, as activity and the external picture change. Vodafone tells us more than most.

More light is shed on induction and training, which has been identified by investors as important in giving them confidence that board skills remain relevant. Two-thirds of companies now give an explanation of their induction and training approach. Good examples include the explanation given by Rexam, which indicates an approach with strong commitment from the chairman and management, and the level of detail provided by 3i, Aviva, BAT, BT, HBOS, International Power, Kingfisher, L&G, M&S, Reuters, Scottish Power and Unilever.

## Dialogue with shareholders

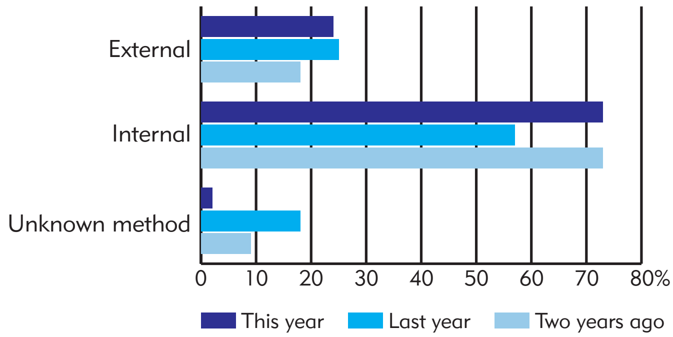
Although their efforts are generally unimaginative, most boards do tell us something about how they talk to investors. They say much less about how they listened to what investors had to say. Even though BAE Systems, BT, HBOS, Reckitt Benckiser, Royal Bank of Scotland and Vodafone show how it can be done, three-quarters of companies said nothing about how their boards get investor and other stakeholder feedback.

No company dared to comment on their experience of being on the receiving end of communication with investors, despite the Code's emphasis on investor responsibility for maintaining an open dialogue with companies.

## Making sure the board was effective

Nearly all boards (94%, in line with last year) conducted a review of their effectiveness. Four-fifths of them explained their approaches, with half of these using a questionnaire approach, some 20% relying on interviews, 10% using a combination of the two and the rest working through a self-assessment discussion.

**Figure 6: Person conducting the evaluation**




An external reviewer was used by 22 companies. The proportion this year was similar to last year, with half of these companies featuring in both years. Some 40% of boards have now opted for some form of external review since the revised Combined Code came into force in 2003, nine companies for the first time this year. This adds up to a picture of an increasing number of companies trying out external review, with some opting for a cyclical approach (alternating internal and external reviews) and others finding it useful enough to repeat it in successive years.

As in previous years, boards remain very shy of giving any indication of the outcomes. Investors tell us they would find it reassuringly normal for a board to identify scope for improvement; apparently, not many boards agree. Of the half who say anything about the result of their evaluation, most simply state that they are effective, very effective or fully effective, which perhaps gives more reassurance to the boards than to readers of their reports. 3i, BAE Systems, BT, Hanson and Rexam are good examples of the 12 companies which say something about how they are going to continue to improve their board's performance.

Most companies (83%) reviewed individual director performance. Less than half of these (35 companies) give any indication that such reviews were distinct from the assessment of the board; the others presumably wrap them in with the board review. The lack of information makes it difficult to judge how boards are tackling this.

Similarly, while around 70% of boards reviewed the effectiveness of their committees, only half of these distinguish the committee reviews from the board review. Audit committees in particular have very specific characteristics which means their effectiveness needs to be looked at rather differently. But only 38 committees (last year: 27) conducted a specific review and only 21 mention the review in their own committee reports.

The most popular approach for audit committees was self-assessment through questionnaires (36%). Some 20% opted for an external review of the audit committee (as have around 30% of companies since 2003). This is pretty much in line with external reviews of the board itself and reflects the fact that most were conducted as part of the board review. Nine audit committees opted for an external review for the first time this year; a further nine have done so more than once.

Reporting on remuneration and nomination committee effectiveness remains entirely uninformative.

## Turning the statement into a story?

We know from company secretaries' comments that space constraints can be an obstacle to more insightful reporting. We also understand that the need to make certain statements and satisfy box-ticker needs can hamper your style. But if we can make a few simple suggestions…

- **Drop statements of the obvious.** Readers know what boards are and are unlikely to be carried away by boilerplate statements that boards support sound governance.
- **Separate out the compliance statements.** These might be unavoidable but you can help by putting them in separate boxes out of the way so they don't break the flow.
- **Focus on the changes.** Repeating the same content from year to year could be avoided in many places. Referring back to last year's report (or preferably the website) so you can focus on what has changed, will make for a much more interesting and informative read.

Also, a little imagination goes a long way. A few companies such as BAE Systems and WPP have started using different styles and structures that inject more life into their boards' reports.

Maybe it's a question of resisting the temptation to tweak last year's report. Instead, boards might want to start with a clean sheet of paper and see whether they can begin changing compliance statements into informative stories about performance. That's what investors would like to read.

## Where now?

Boards haven't made a lot of progress over the last year in communicating what they do, how they do it and what makes them special. But audit committee reporting gives some pointers to what might be achieved – and to how reports can differentiate companies. Maybe it will just take a bit of time for boards to get used to this idea. After all, board effectiveness assessments met with initial resistance but are now widespread.

The case for more informative reporting remains strong. There is widespread recognition that genuinely good governance will have a positive impact on long-term performance. Yet, even though progress is visible, reporting remains patchy and investors are still some way from getting what they say they want.

It would be good to see more companies take up the baton (or hold on to it more securely). Doing this voluntarily would help keep the ever-hungry regulatory wolf from the door. Although the erstwhile OFR requirements may no longer give a statutory shove to better reporting, the renewed focus on directors' liabilities will keep attention on governance. It would be good to see boards stepping up to the mark and painting a clearer picture of how their strategic leadership and oversight helps their companies succeed.

Independent Audit helps boards make sure that strategic leadership and control are working well and supporting business performance. As well as reviewing board and committee effectiveness, we work across the governance framework by advising on the effectiveness of external and internal audit, risk management and high-level controls. We also help boards with their narrative reporting.

If you would like to discuss this survey, or require further copies, please contact Richard Sheath on +44 (0)20 7618 7722, or by email at richard.sheath@independentaudit.com

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