INDEPENDENT AUDIT LIMITED

Four years on – what's changed?

A survey of governance practice in the FTSE 350

This year we've taken a different approach to our survey of governance practice. In past surveys we've built a picture based on FTSE 100 annual reports. But this time round, to coincide with the FRC's review of the Combined Code, we wanted to get a better understanding of how companies have responded to the changes introduced four years ago. In particular we wanted to have a close look at audit committees as they are increasingly central to oversight.

So we've used an extensive questionnaire and extended the coverage to the FTSE 350. The picture we have put together draws on responses from just over half of FTSE 100 companies and 40% of the FTSE 350 as a whole.

So what's the state of play?

A healthy picture – in general…

- Nearly all boards now look at their own effectiveness each year – and they're finding it useful.
- Self-assessment is the norm, though many companies have established a cycle of different styles of review – often including getting an external view. Committee reviews usually form part of the board review and it's not clear that they're really capturing the particular nature and challenges of committee work.
- Boards feel they get the information they need and in general manage to get the right balance between strategic and operational matters. Awaydays play an important role in this.
- The level of risk facing audit committees doesn't seem to be an issue, and the time demands are manageable even though the time requirement has increased substantially. And audit committees are also happy with the information and support they get. Finding the right people is becoming more difficult but committees have not started drawing on external experts to any great extent.
- The role of audit committees is changing. Most now have responsibility for the oversight of risk management and are spending much more time on internal control and risk questions. But it's not clear that audit committees are looking closely enough at how well internal audit is performing or really doing much on external auditor effectiveness.
- Despite the importance of board governance for creating and protecting value, companies report that institutional investors show little active interest in board evaluations.

Methodology

The survey was conducted during July 2007 and covered the FTSE 350 companies at that time. Different questionnaires were sent to board chairmen and audit committee chairmen seeking their opinions on aspects of board and audit committee practice. A further questionnaire was sent to company secretaries to obtain factual information on how boards and their committees have been operating. Responses were received from145 companies representing 55% of FTSE 100 companies and 40% of the FTSE 350. 20% of board chairmen provided input (31 of the FTSE 100), 16% of audit committee chairmen (23 of the FTSE 100) and 20% of company secretaries (27 of the FTSE 100).

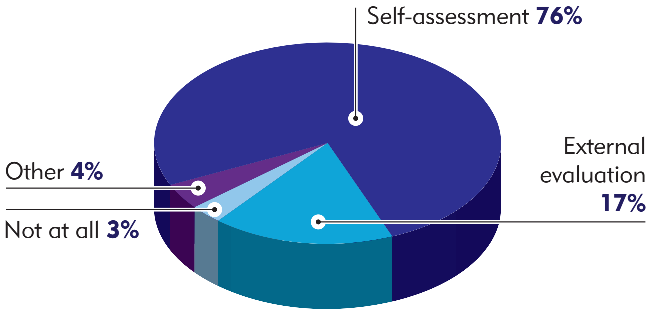
Performance reviews are proving useful

Boards

The newly introduced standard of an annual review of board effectiveness has, despite initial misgivings in many quarters, been near universally adopted. Unsurprisingly, **most boards are opting for self-assessment**, with three-quarters having taken this approach last year (Figure 1).

But **the use of external reviewers is becoming more widespread.** Some 36% of boards have undertaken an external review over the past four years (17% in the last year).

Figure 1: How did the board assess its effectiveness over the past year?



Rather than just seeing the review as an annual compliance step, many appear to be actively looking for value from the exercise by trying different styles of review or refreshing their approach. **Most boards now have a clear cyclical approach** employing different types of evaluation. Two-thirds have settled on a cycle to apply in the future. Of these a third intend to shift the focus of an internal review each year and the rest plan to interchange internal and external review. A few FTSE 100 companies (4) are opting for external reviews each year, with a different focus for each review. Only 10% have not settled on an approach and will decide each time round.

Whatever the method used, nearly all **boards are finding the annual effectiveness review useful** (Figures 2A & 2B). Around 90% of chairmen found the exercise useful or very useful.

Just over half of those who have used external evaluation have found it more useful than an internal evaluation. Less than a quarter found it less useful.

The FTSE 100 respondents found external review more useful than the FTSE 250. FTSE 100 chairmen were also more positive than those from the FTSE 250 about board discussion compared to questionnaires.

With the different techniques involved, and the different requirements and expectations of each board at any point in time, it's not possible to be conclusive about the relative value of external versus internal review. But a picture emerges of companies using different approaches at different times and with various objectives, but getting value whichever the method used.

Figure 2A: How useful was self-assessment?

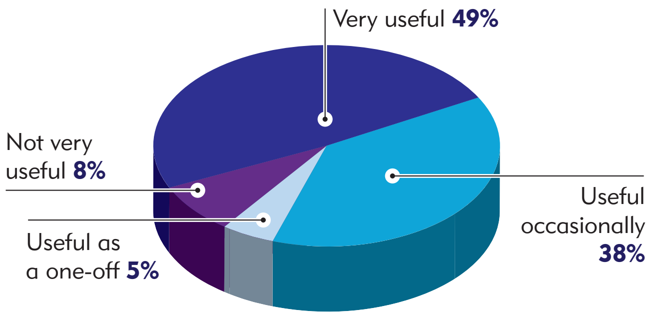
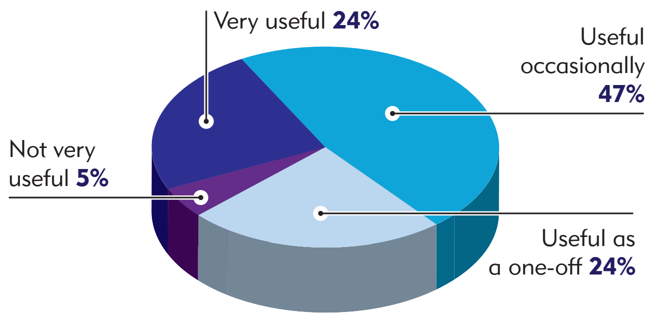


Figure 2B: How useful was external evaluation?

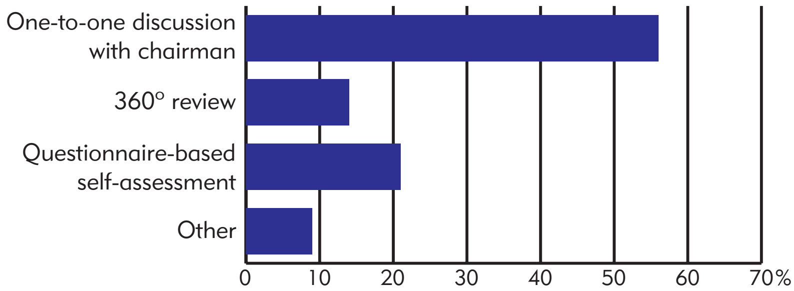


Individual directors

When it comes to evaluating individual directors, most companies have opted for one-to-one discussions with the chairman, 80% taking this route last year. Only one company reports having used psychometrics. Given the criticality of personal characteristics and director mix to the question of board effectiveness, it is interesting that more companies have not gone down this route – maybe more is done than appears but under the guise of nomination discussions. Around a quarter have used a 360° review at some stage and 40% a self-assessment questionnaire. Some 11% of companies haven't yet done a formal review of individuals' contribution to the board.

Having tried different approaches, **most companies have found one-to-one discussions with the chairman to be the most useful** (56%). But significant numbers have found other approaches useful too (Figure 3), suggesting that it could well be worth trying out different techniques from time to time.

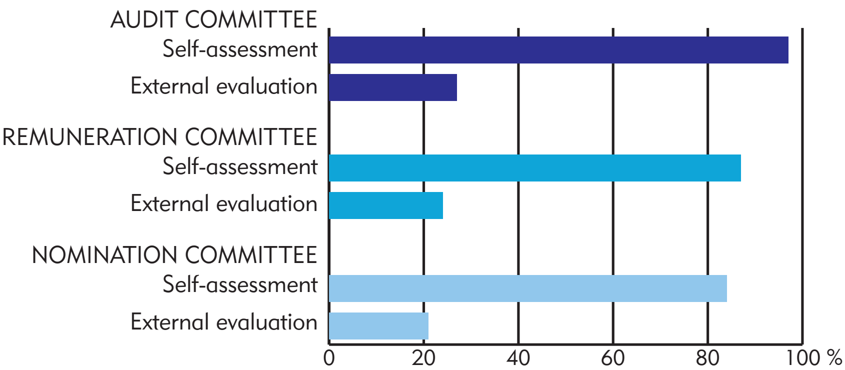
Figure 3: Which approach to assessing individual director performance have you found most useful?



The committees

Audit committee effectiveness reviews are now standard practice. **Most audit committees assess their own effectiveness** with 86% having done this last year. External review is becoming more common with a quarter of audit committees (27%) having opted for this at some point over the past four years (Figure 4).

Figure 4: How has effectiveness been assessed over the past four years?



The general picture is the same for all committees. Most have had effectiveness assessments, generally as part of an overall board review. Self-assessment, usually using questionnaires, is much the most popular method. Around a quarter have had external review at some point in the last four years – less than the 36% of boards which have had an external review.

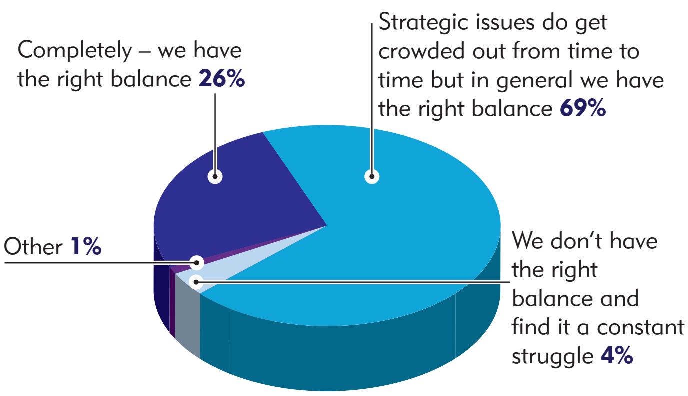
Chairmen are happy with how their boards operate

Chairmen are satisfied that their **boards get the information they need** with only 17% saying that, while reasonably satisfied, they can see room for improvement.

Virtually all chairmen say their **boards are able to devote enough time to strategic discussions and leadership** (Figure 5) although a majority (69%) find that strategic issues do get crowded out from time to time. FTSE 100 company chairmen (33%) are more confident that they have the right balance than are FTSE 250 chairmen (19%).

Most boards (almost 90% of responding companies) now have **awaydays.** Nearly all describe them as important – but for different reasons, splitting fairly evenly between those who say that without awaydays they would find it difficult to focus on strategy, and those who say they are important more from a team and relationship perspective.

Figure 5: How far do you manage to devote enough time in board meetings to strategic discussions and leadership?



And audit committee chairmen are happy too

Risk doesn't appear to be an issue. Most audit committee chairmen see the risk of being on an audit committee as having increased but still being reasonable (Figure 6). Only 5% see the risk as unreasonably high, all of these being FTSE 100 respondents. Interestingly, they did not see chairmanship as significantly riskier than membership.

No audit committee chairman saw the time demands on themselves as chairmen as unreasonable (Figure 7). But there's a clear difference between FTSE100 companies and the rest. Only 14% of the FTSE 100 committee chairmen described the demands as "reasonable" compared to 54% of FTSE 250 audit committee chairmen.

When it comes to chairmen's views on the time demands on *members* of the committee, 80% of the FTSE 250 chairmen think they are "reasonable". The figure drops to 59% for the FTSE 100.

This picture of time and risk is broadly in line with the views expressed by board chairmen who, in general (63%), feel that, while expectations are making life for audit committees increasingly difficult, it's still manageable. Only two board chairmen (both FTSE 100) felt that expectations are completely unrealistic.

Figure 6: Level of risk for audit committees

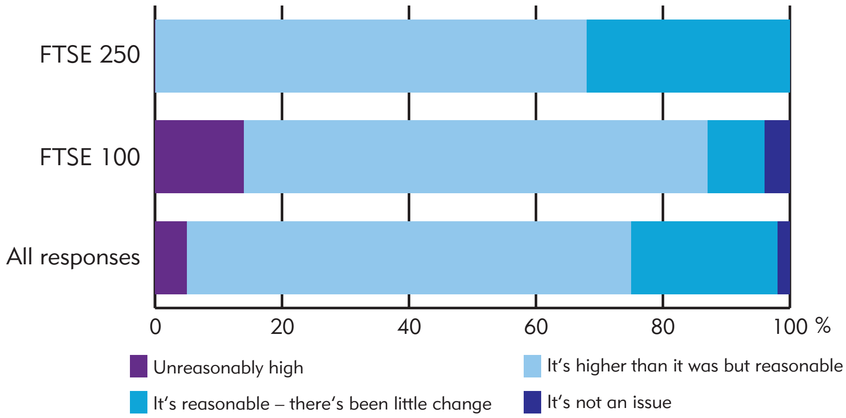
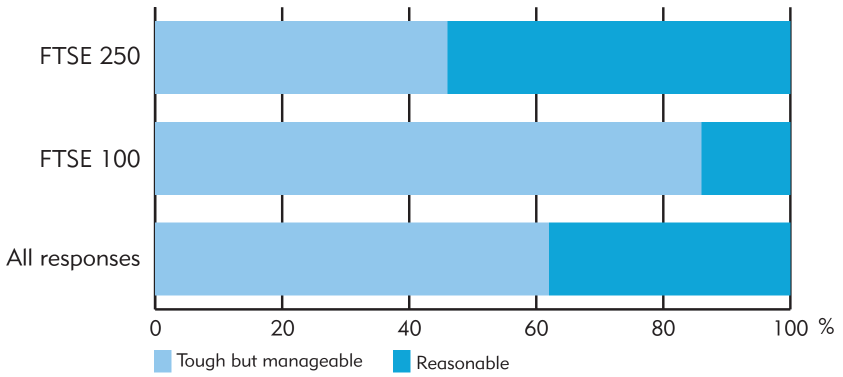


Figure 7: Time demands on audit committee chairman



The majority of companies (61%) find that **the time demand has increased** by about half over the past four years. There's little difference between the bigger and smaller companies in expressing this view.

Audit committee **meetings have increased in length in the past few years but not to any great extent.** The majority (60%) find that they take from $1^1/_2$ to $2^1/_2$ hours with another 30% saying up to 4 hours (split equally between the larger and smaller companies).

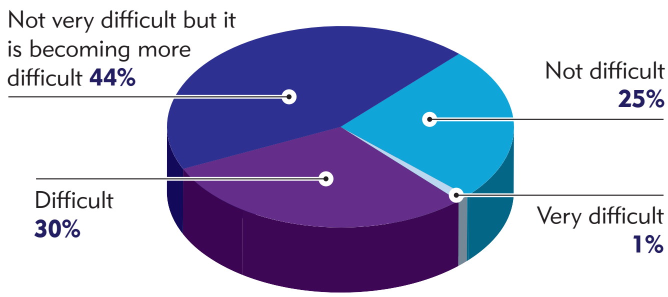
Perhaps surprisingly, a few FTSE 100 committees meet for less than $1^1/_2$ hours, and these committees didn't meet any more frequently than most. Most committees are meeting more frequently than four years ago – three-quarters meet four to six times a year – but only 10% (mostly FTSE100) are meeting more than six times.

Most audit committee chairmen (62%) spend between two and four hours reading the meeting papers with a further 30% spending more than that. FTSE 100 papers generally require more time.

There's a **high degree of satisfaction with the information and support committees are getting.** 84% are satisfied or very satisfied with the information they get, with none saying they are unhappy. The same picture applies to the level of support they get, with 75% being happy and only a handful suggesting that support needs to be increased.

The acceptance of the time and risk involved in the chairmen's eyes does not seem to be mirrored in the eyes of potential candidates for the audit committee. When it comes to finding suitably qualified potential members, three-quarters of companies are finding it difficult or at least becoming more difficult (Figure 8). This is particularly pronounced amongst the FTSE 100.

Figure 8: How would you describe the current level of difficulty in finding suitably qualified people to serve on the audit committee?

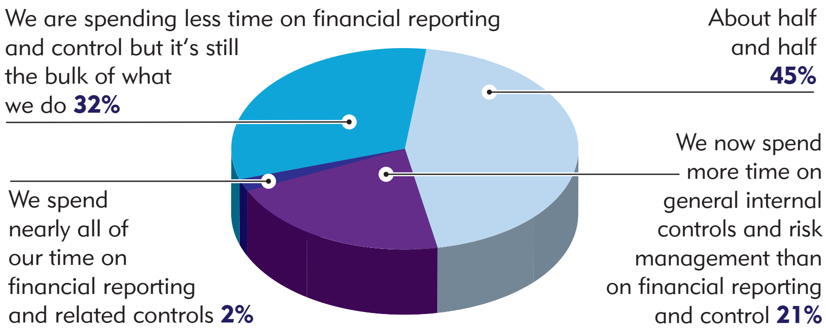


…and they appear to be doing things differently

The work of audit committees appears to have shifted towards internal controls and risk management. Most committees (80%) now also have responsibility for risk management oversight as well as financial reporting controls. Two-thirds of committees now spend half or more of their time on internal controls and risk management (Figure 9). This is a particular trend among FTSE 100 companies.

Pre-meetings between the committee chairmen and management and/or internal audit are now standard practice. They are seen as "very important" by 60% of committee chairmen, with less than 10% regarding them as unimportant.

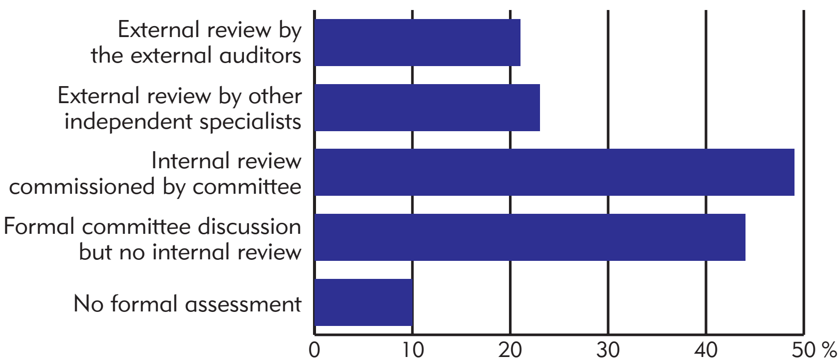
Figure 9: How would you describe the balance you currently maintain between financial reporting and controls and general internal controls / risk management?



The timing of work on the financial statements has shifted forward. A majority of audit committees (56%) split it roughly half and half before and after the year end and a further 12% do most of it before the end of the year.

Most committees also appear to be timing their meetings to make sure management and auditors have enough time to respond to their questions – two-thirds allow three to five days before the preliminary announcement, with another 18% allowing more than this.

Figure 10: What have you done to assess the effectiveness of internal audit during the past four years (in addition to continuous evaluation during the meetings)?



Despite the increased time demands and the Code having encouraged committees to secure themselves the right to accessing **external advice,** only one-third have called on it. Three-quarters of these have done so more than once.

Review of internal audit effectiveness is still largely done in-house. Last year three-quarters of audit committees either commissioned an internal review (36%) or relied on a committee discussion (35%).

However, the international internal auditing standard requiring an external review every five years is having an impact: over the past four years nearly half have commissioned an external review (Figure 10).

There is a heavy reliance on the finance function to review the effectiveness of external audit. Over the past four years 60% of audit committees have done this (45% last year), despite the fact that they are asking those being audited to assess objectively the effectiveness of their auditors.

Most other committees have done the external audit assessment themselves, using a range of tools. They mainly relied on questions from committee members (31%) or on an internally developed set of questions (23%). Surprisingly few (10% last year, 26% over the past four years) have asked internal audit to do it, although the FTSE 100 tend to do this more. Four companies have engaged an independent third party.

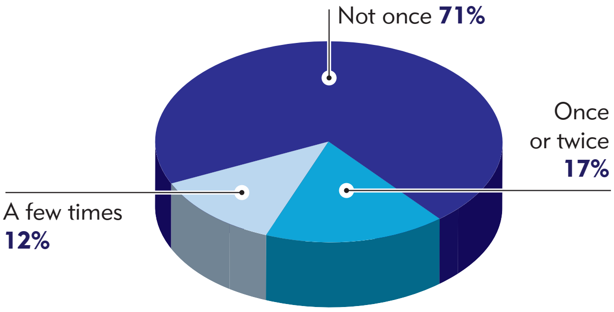
But investors don't seem very interested

In our experience institutional investors are interested in board evaluation, but this interest is not perceived by the companies themselves.

Over the past four years, only 29% of companies have had questions from institutional investors on their board evaluations, and most of these were only "once or twice" (Figure 11).

Hardly any companies (4%) have found institutional shareholders putting questions to the audit committee chairman at the AGM. Only 28% have received any comments on the audit committee section of the annual report – and most of these were described as "only vague".

Figure 11: Over the past four years how often have you had questions from institutional investors on board evaluation?



We would like to thank all the chairmen, audit committee chairmen and company secretaries who responded to our survey. We hope that the insights they have provided will help companies think through how to develop further their approaches to meeting the principles set out in the Combined Code. We would also like to thank the FRC for their interest and support.

If you have any views on our analysis and the value of the survey, we would welcome your comments.

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 risk management and high-level controls, and external and internal audit. 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 7220 6583, or by email at richard.sheath@independentaudit.com

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