MAZARS

Reporting your full potential

Developing effective Business Reviews

Business reviews are mandatory for all but small companies. We'll help you use your business review to highlight your company's full potential.

Ensuring effective reporting

The seven point challenge for business reviews

Does your business review:

- Articulate a compelling vision for creating sustainable value?
- Demonstrate that you have a highly capable and focused leadership team?
- Sound as if it is in your board's own words?
- Show you have the confidence to discuss both challenges and successes?
- Comply with relevant legal requirements and best practice guidance?
- Stand out from the crowd as clear, concise and comprehensive?

Above all, does it:

- Improve your key stakeholders' understanding of the business and its full potential?

1.

Getting the most from your business review

1.1 Introduction

The requirements to prepare an enhanced business review came into force in March 2005 and are applicable to all British companies, apart from exempt small companies, for financial years beginning on or after 1 April 2005 (Figure 1).

The business review has to include a balanced and comprehensive analysis of the development, performance and position of the business; a description of its principal risks and uncertainties; and analysis generally using appropriate financial and non-financial Key Performance Indicators (KPIs) (Figure 2).

The preparation of a business review will be the key corporate reporting change facing many finance directors and boards at this year end and provides them with the opportunity to articulate their strategy for the creation of sustainable value in the business and to report on progress towards achieving their goals.

For companies listed on the London Stock Exchange, those traded on AIM, and others with external shareholders, especially those seeking investment by institutional shareholders, a well received business review could yield valuable returns. These will be generated by an enhanced understanding of your business and greater recognition that the company is led by a high quality focused team that has a clear view of where it is heading and the ability to reach its destination successfully.

Figure 1 Who needs to prepare a business review?

It applies to all companies other than most small companies

All British companies, except those falling within the statutory definition of a small company, have to include a business review in their Directors' Report. A small company satisfies at least two of the following criteria:

- turnover not more than £5.6m
- balance sheet total not more than £2.8m
- not more than 50 employees.

A small company cannot avail itself of this exemption if it:

- is a public company
- has permission under Part 4 of the Financial Services and Markets Act 2000 to carry on regulated activities
- carries on an insurance market activity.

It applies to non-exempt individual companies in group

All individual companies, other than exempt small companies, are required to prepare a business review.

A parent company that prepares group accounts has to produce a group Directors' Report but not an individual Directors' Report. This only needs to cover the parent and those subsidiaries included in the consolidation and it can do this on a consolidated basis.

Exempt small companies that are part of a group can take advantage of exemptions regarding the Directors' Report and act as if they are stand alone companies.

Figure 2 The business review – contents

- Business review identified as part of the Directors' Report
- A fair review of the business of the company
- A description of the principal risks and uncertainties facing the company
- The review required is a balanced and comprehensive analysis of the development and performance of the business of the company during the financial year and the position of the company at the end of the year, consistent with the size and complexity of the business
- The review must, to the extent necessary for an understanding of the development, performance and position of the business, include analysis using financial KPIs
- The review must, to the extent necessary for an understanding of the development, performance and position of the business, and, where appropriate, include analysis using other KPIs, including information relating to environmental matters and employee matters
- The review must include, where appropriate, references to and additional explanations of, amounts included in the annual accounts of the company
- As part of the duty to prepare such a report, the Directors' Report should contain an indication of likely future developments in the business of the company

1.2 Board ownership of the business review

The board should make sure it owns the business review and that it does not sound as if it has been written by copywriters with only limited input from it. The business review, more than may be realised, will provide significant insights into whether the board and executive team have coherent and well considered views on the direction of the business and its unique strengths. It will also highlight the relative priority they give to strategic and operational matters and the extent to which they focus on non-financial indicators as well as the financial numbers in running the business. In some instances, preparing the business review for external publication may lead to reflection on such leadership and management issues, and changes in how the board operates.

1.3 Operating and Financial Review or business review?

An early decision for boards coming within the scope of the business review requirements for the first time is whether they wish to prepare a business review in line with the requirements of the Companies Act 1985 or go beyond this and publish a full Operating and Financial Review (OFR) in accordance with the Accounting Standards Board's Reporting Statement, The Operating and Financial Review. This statement is now voluntary but OFRs prepared in accordance with it will meet the legal requirements for a business review. The Financial Reporting Council considers that it represents the most up-to-date and authoritative best practice guidance on the topic.

The Department of Trade and Industry (DTI) has indicated that it is acceptable to cross refer from a voluntary OFR to the business review section of the Directors' Report, as long as users can easily refer to both documents and it is clearly indicated by page numbers, paragraph numbers or headings which specific sections of the voluntary OFR are relevant. It should also be stated in the business review that the relevant parts of the OFR are incorporated in the Directors' Report by reference.

A number of larger listed companies are taking the OFR route and if a board is doing so it is helpful for the directors to indicate the extent to which they are following the Reporting Statement in order to avoid confusion. If complying fully, there will certainly be benefits from making such a statement as is called for in the Reporting Statement.

For those including the business review within their Directors' Report, it will be worthwhile considering whether a restructuring of the narrative section of the Annual Report would improve the flow of the document. Some companies are now including their corporate governance and directors' remuneration disclosures within an expanded Directors' Report. This can, for example, enable the business review disclosures on risks to be dealt with alongside those emanating from the Turnbull Report on risk management and internal control.

1.4 Additional disclosures in the OFR

It is difficult to provide a line by line comparison of the differences in disclosures called for by the business review requirements and the voluntary OFR as the documents are written in different styles. The OFR statement is more detailed and so even where it is covering broadly similar ground to the business review it sets out what is expected to be included in an OFR Statement more fully. As a result, it is a very useful source of reference for companies seeking further guidance on how to address a range of issues required to be covered in the business review and for additional voluntary best practice disclosures.

Broadly speaking, some of the main areas in which additional disclosures may be needed under an OFR prepared in accordance with the Reporting Statement are shown in Figure 3.

1.5 Audit requirements

The auditors are required to state in their report whether in their opinion the information given in the Directors' Report is consistent with the accounts.

Figure 3 Overview of additional disclosures in a full OFR

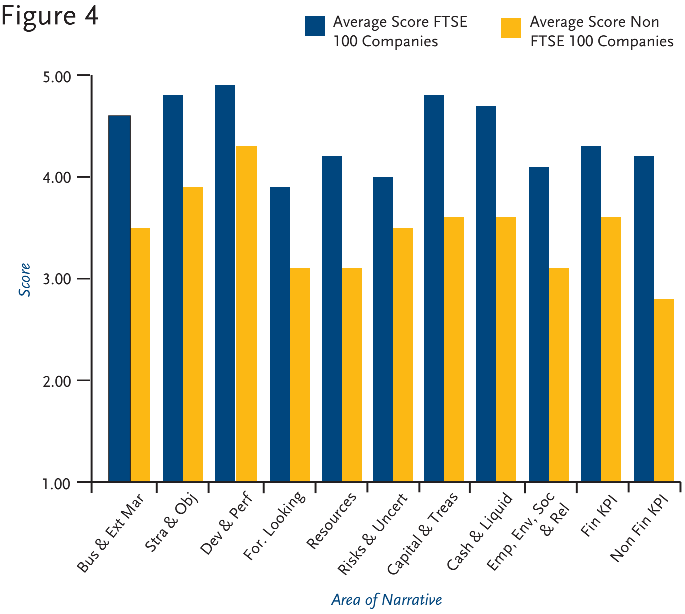
- Strategies adopted by the business and their potential to operate/preserve value over the long-term
- Discussion of the competitive and regulatory environment in which the entity operates
- Future development and performance of the business (but see the Companies Act 2006 requirements for quoted companies)
- Resources and significant relationships with stakeholders that may affect the entity's long-term value
- Description of the entity's capital structure, treasury policies and objectives and liquidity, (including a commentary on borrowings) both in the year under review and the future
- Persons with whom the entity has contractual or other arrangements which are essential to the business of the entity (but see the Companies Act 2006 requirements for quoted companies)
- Receipts from and returns of members of the entity in respect of shares held by them
- Discussion of cash inflows and outflows during the year and of the entity's ability to generate cash to meet known/probable requirements and to fund growth
- Statement as to whether an OFR has been prepared in accordance with the Reporting Statement and particulars of, and reasons for, any departure from it.

2. The disclosures in more detail

2.1 Current levels of reporting practice

The Accounting Standards Board (ASB) has recently published *A Review of Narrative Reporting by UK Listed Companies in 2006*. This includes a survey of how listed companies are reporting against the ten main areas of best practice recommendations included within its Reporting Statement (Figure 4).

Figure 4



The areas with the lowest average scores are those relating to non-financial KPIs, forward-looking information, risk and uncertainties and employee, environmental, social and related information. These are all areas that companies preparing a business review are likely to have to cover, either explicitly or in meeting more generally expressed requirements.

It was also noticeable that whilst the overall average score for FTSE100 companies surveyed was 3.6 (range 3.0 to 4.6), it fell to 3.0 (range 2.6 to 3.6) for FTSE250 companies and it stood at just 2.0 (range 1.7 to 2.2) for those in the FTSE Small Capitalisation Index. This was on a 5 point scale with 1 = very poor, 2 = poor, 3 = fair, 4 = good and 5 = best practice. Companies outside the FTSE100 therefore have a great opportunity to 'stand out from the crowd' and be seen to be addressing their key shareholders' and potential investors' information needs seriously through striving for best practice standards in their narrative reporting.

2.2 Setting out the strategy

A compelling exposition of the company's strategy, even though not a formal requirement for a business review, provides the foundations on which the OFR or business review is built and is essential to the discussion on the performance and development of the business, its position at the end of the financial year, and the risks and uncertainties confronting it. The board must be able to demonstrate that it has a clear vision of how the long-term value of the business will be grown in a sustainable fashion.

The strategy section should outline, from both a financial and operational perspective, the company's or group's competitive advantage, the markets targeted and the positioning within those markets. Where there is a widely diversified range of businesses, it will be particularly important for there to be a discussion of the links between them and the rationale for them being part of the same company or group.

It will also be helpful for the business review to set out the strategy in the context of the external environment of the business. It should comment on the impact that any significant changes that are occurring in its marketplace may have on the business.

2.3 Balanced and comprehensive analysis

The need for the Directors' Report to contain a fair review outlining the business of the company and a balanced and comprehensive analysis of its development and performance during the year and its position at the year-end, means that the review should not include just 'good news' but should also discuss any important setbacks which have occurred. There is a natural reluctance to discuss 'problem' areas but often they are known about in the company's marketplace anyway and a balanced analysis will have far more credibility especially if a well thought out roadmap to overcome the challenges concerned is outlined.

In terms of the length of the business review, the Quoted Companies Alliance (QCA) in its Guidance for Smaller Quoted Companies on preparing a Business Review has suggested that for many, especially smaller companies, five pages will be more than sufficient and this may be at the upper end for businesses that are not fully listed or traded on AIM. As the QCA points out, the law specifically states that the review should be 'consistent with the complexity of the business' supporting the view that smaller companies' reviews should be fairly brief as their business models will tend to be relatively straightforward.

2.4 Key Performance Indicators

The requirement for the business review to include analysis using financial KPIs is caveated by the phrase that the business review must include them 'to the extent necessary for an understanding of the development, performance and position of the business'. When it comes to using other KPIs, including information relating to the environment and employee matters, the words 'and where appropriate' are added to the earlier caveat.

The KPIs that will be most relevant will naturally be determined primarily by reference to the industries in which a company or group operates and its own circumstances, not least its strategy.

The ASB's Reporting Statement provides best practice guidance on factors to be taken into account when selecting KPIs. The Reporting Statement points out, for instance, that comparability will be enhanced if the KPIs disclosed are widely used, either within the industry concerned or more broadly. It also suggests disclosures for each KPI should include (amongst other items):

- the definition of the KPI
- its method of calculation
- its purpose
- the source of the underlying data
- quantification or commentary on future targets
- comparatives for the preceding year.

A list of illustrative KPIs (Figure 5) is provided in the Implementation Guidance attached to the Reporting Statement.

On financial KPIs, the ASB Report found that just over half of the companies whose Annual Reports it reviewed – 52% – were providing KPIs. ASB expressed concern that whilst many companies provide a considerable amount of detail on financial KPIs they are not defined, nor are sufficient explanations given as to why they are key indicators. Meanwhile, non financial KPIs were a source of even greater concern with the report finding less than two out of five companies – 39% of the total in their sample – disclosed what they termed non-financial KPIs.

For companies wishing to comment on their impact on the environment, the Department for Environment, Food and Rural Affairs has produced *Environmental Key Performance Indicators: Reporting Guidelines for UK Business* which identifies 22 KPIs considered to be significant to UK businesses. These are divided into the following categories: emissions to air; emissions to water; emissions to land; and, resource use. The guidance goes on to suggest which KPIs may be particularly relevant to given sectors.

Similarly, on human capital issues the *'Accounting for People'* task force report suggests reports on human capital management should include information on:

- the size and composition of the workforce
- retention and motivation of employees
- the skills and competencies necessary for business success, and training to achieve these
- remuneration and fair employment practices
- leadership and succession planning.

The task force, however, stopped short of recommending specific metrics as it felt this should be left up to each individual organisation.

As there is not an absolute requirement to provide KPIs, the ASB Report recognises that one cannot say that their absence implies a failure to comply with the legal requirements for the business review. The Report does, however, suggest that it may lead to the Financial Reporting Review Panel (FRRP) looking at a Directors' Report to determine whether it does comply with the Companies Act (Section 3.2).

2.5 Risks and uncertainties

For a number of years the Turnbull Report has called on listed companies to make disclosures on their risk management and internal control systems but not of the risks themselves. It is important to note that whilst Turnbull applies at the level of the group, the disclosures of risks and uncertainties, other than in the parent company's Directors' Report, will be at the level of the individual company.

The ASB Report suggests that best practice calls for companies to disclose strategic, commercial, operational and financial risks where these may significantly affect the entity's strategies and value. A list of some possible visits is shown in Figure 6. Concern is expressed in the Report that many companies are giving details on a great many risks. For the companies surveyed by ASB, the number ranged from 4 to 33, with little accompanying discussion of how they might be mitigated or of their potential impact on achievement of the company's strategic goals. That said, such disclosures would seem to be beyond the minimum necessary to satisfy the legal requirements relating to the business review. The ASB Report emphasises that the disclosure called for is of the principal risks and uncertainties, not an extensive listing of them without prioritisation.

Figure 5 Possible KPIs

Business objectives and strategies

- Return on capital employed
- Economic profit (operating profit after tax adjusted for one-off items and the cost of capital)

Development, performance and position

- Market share
- Average revenue per customer
- Number of subscribers
- Sales per square foot
- Percentage of revenue from new products
- Number of products sold per customer
- Products in the development pipeline
- Cost per unit produced

Resources, principal risks and uncertainties

- Customer churn
- Market risk
- Business continuity management

Environmental matters

- Environmental spillages
- CO_2 emissions
- Waste

Employee matters

- Employee morale
- Employee health and safety

Social and community matters

- Social risks in the supply chain
- Noise infringement

Other resources

- Reserves (extractive industries)

Financial position

- Economic capital
- Cash conversion rate

2.6 Amounts included in the company's annual accounts

The business review is required, where appropriate, to include references to, and additional explanations of, amounts included in the annual accounts.

The ASB's Reporting Statement suggests an entity preparing an OFR should discuss accounting policies that are critical to an understanding of its performance and financial position especially those calling for 'particular exercise of judgement' and the ones in relation to the application of which the results are most sensitive. Furthermore, attention should be drawn to accounting policies that have changed during the financial year.

The Reporting Statement also calls for discussion of the entity's capital structure, treasury policy and objectives, cash flows and liquidity. The following are among wide-ranging disclosures expected to be made by entities preparing an OFR in line with the Reporting Statement and which companies preparing a business review may find helpful to consider. They include:

- the debt maturity profile
- types of capital instrument used
- the reason for the chosen capital structure
- the implementation of treasury policies
- the purpose and effect of major financing transactions
- the effect of interest costs on profit
- special factors influencing cash inflows and outflows
- commentary on the level and seasonality of borrowings (indicated by peak level borrowings in the period)
- the maturity profile of borrowings and undrawn committed facilities
- restrictions on the transfer of funds from one part of the group to another, if a potentially significant restraint on the business
- negotiations on covenants.

In addition, the ASB Report has suggested that a discussion on resources could be relevant within the context of commenting on amounts included in the annual accounts. The ASB's Reporting Statement asks, for example, for a discussion of key strengths and resources available to the business especially with regard to items not included in the balance sheet. These could include corporate reputation and major brands, research and development, patents and other forms of intellectual capital and market position. Those seeking merely to comply with the business review requirements rather than to achieve best practice standards of disclosure may, however, feel that the commentary called for is on amounts in the accounts rather than on assets not included, though there may, of course, be income and expenditure amounts in the accounts related to them.

Figure 6 Examples of possible risks

Strategic risks

- Strategy not aligned to capabilities
- Failure to develop/protect brands
- Damage to corporate reputation
- Inadequate innovation
- Failure to keep up with market trends
- Too slow to respond to sector developments eg. consolidation of leading players
- Too heavily exposed to declining markets
- Anticipated acquisition benefits not secured
- Vulnerability to takeover at less than full value
- Political risks – change in government policy, instability in key markets
- Economic risks at national, regional, global levels
- Climate change – potential impact on business
- Failure of a crucial cultural change project
- Failure of a major IT project
- Succession planning difficulties

Financial

- Liquidity risk
- Going concern problems
- Overtrading
- Breach of bank covenants
- Currency risk
- Interest rate risk
- Problems with maturity profile of borrowings
- Inappropriate debt/equity mix
- High cost of capital/borrowings
- Insufficient financial resources to implement strategy
- Losses from types of fraud to which the business is susceptible
- Accounting irregularities
- Inability to meet financial commitments to investors eg. dividend growth

Compliance

- Breach of Listing Rules
- Breach of Companies Act requirements
- Breach of competition laws
- Failure to observe money laundering/anti-corruption requirements
- VAT difficulties
- Tax penalties
- Health and safety risks
- Environmental breaches
- Litigation risk

Operational

- Quality control issues
- Supply chain issues (quality, human rights etc)
- Inadequate service levels
- Poor levels of customer satisfaction
- Loss of key contracts
- Over-reliance on a small number of customers/suppliers
- Cost base too high
- Loss of key people
- Skills shortages
- Physical disasters (fire, flood etc.)
- Business continuity management issues

2.7 Forward-looking information

The business review does not explicitly ask for forward-looking information though Para 6 of Schedule 7 of the Companies Act 1985 already requires the Directors' Report to contain 'an indication of likely future developments in the business and of its subsidiary undertakings ....'

The DTI in their *Guidance on the changes to the Directors' Report requirements in the Companies Act 1985* has advised that information on a company's future plans and prospects should be included in the business review to the extent that it is necessary for a balanced and comprehensive analysis of the development, performance and position of the business, to describe the principal risks and uncertainties facing it, or to provide an indication of likely future developments in the business of the company.

In addition, quoted companies, which include fully listed but not those traded on AIM, will be asked, when the relevant sections of the Companies Act 2006 are brought into force, to comment on the trends and factors likely to affect the future development, performance and position of the company's business. In doing so, they should have the benefit of protection by reference to the relevant safe harbour provisions (Section 3.1).

The ASB Report found that the provision of forward-looking information was the area which achieved the lowest average scores amongst companies in their survey on best practice disclosure. Moreover, the Association of British Insurers has indicated that the forward-looking nature of disclosures made is the aspect that differentiates those at the leading-edge of narrative reporting from the rest.

An important reason for the lack of forward-looking information is undoubtedly the concern about its giving rise to litigation. The ASB Report recognised this and thought forward-looking disclosures may improve when the 'safe harbour' provisions of the Companies Act 2006 come into force. Furthermore, the ASB's Reporting Statement already indicates that nothing in it requires disclosure of information in an OFR about impending developments or about matters in the course of negotiation if the disclosure would, in the opinion of the directors, be seriously prejudicial to the interests of the entity. Obviously this would equally apply to the publication of a business review.

The ASB Report also refers to a legal opinion providing advice on how directors can significantly reduce the risks of criminal and civil liability when making forward-looking statements.

3. Future developments and enforcement issues

3.1 More to come

It is not all over and back to altering up the previous year's Directors' Report once the initial business review has been prepared. By its nature, this part of the Directors' Report will, of course, need to be looked at afresh each year. It will also be very important, particularly in the coming year, to review the business review of other companies in your sector as part of your assessing best practice.

Moreover, there are the additional disclosures for quoted companies in the Companies Act 2006 along with the 'seriously prejudicial' exemption and 'safe harbour' provisions which are available to all companies (Figure 7).

It will also be important for companies to keep up to date with any pronouncements from the FRRP as it starts to review Directors' Reports.

3.2 Enforcement issues

For financial years beginning on or after 1 April 2005, criminal penalties apply in relation to a Directors' Report (which of course includes the business review) that does not comply with the Companies Act 1985. Every director who knew that it did not comply, or was reckless as to whether it complied and failed to take all reasonable steps to ensure compliance, is guilty of an offence and liable to a fine.

In addition, civil remedies will apply for financial years beginning on or after 1 April 2006. The FRRP will be able to apply to the court for a declaration that the Directors' Report does not comply with the provisions of the Companies Act 1985 and for an order requiring the directors to provide a revised report, with the court having the powers to order that certain expenses incurred by the company are borne by the directors. In practice, the FRRP normally agrees the necessary changes needed with companies though this can lead to a press notice on occasions.

3.3 Conclusions

The introduction of the statutory business review heralds the coming of age of narrative reporting and, as discussed in this briefing, further changes are in the pipeline.

Preparing the business review will require additional work but it offers boards and executive teams the opportunity to improve key stakeholders' understanding of their business and thereby to strengthen relationships with them and build long-term value.

Figure 7 The business review – additional measures in the Companies Act 2006

Statutory purpose

The purpose of the business review is to inform members of the company and help them assess how the directors have performed their duties under the Act to promote the success of the company and, in particular, to have regard to:

- the likely consequence of any decision in the long-term
- the interests of the company's employees
- the need to foster the company's business relationships with suppliers, customers and others
- the impact of the company's operations on the community and the environment
- the desirability of the company maintaining a reputation for high standards of business conduct
- the need to act fairly between members of the company.

Additional disclosures for quoted companies

The business review must include, to the extent necessary for an understanding of the development, performance and position of the company's business:

- the main trends and factors likely to affect the future development, performance and position of the company's business
- information about:
  - environmental matters (including the impact of the company's business on the environment)
  - the company's employees
  - social and community issues

  including information about any policy of the company in relation to those matters and the effectiveness of those policies (and where a company does not discuss one or more of the above it has to state that it has not done so)
- information about persons with whom the company has contractual or other arrangements which are essential to the company's business (this is subject to a specific exemption concerning disclosure about a person if, in the directors' opinion, it would be seriously prejudicial to them and contrary to the public interest).

Exemptions from disclosure

All companies are exempt from disclosing information in the business review which, in the directors' opinion, would be seriously prejudicial to the company's interests.

Safe harbour provisions

The Companies Act 2006 gives directors protection from liability for statements or omissions in, amongst other things, the Directors' Report. Directors will only be liable if such statements are untrue or misleading and are made in bad faith or recklessly and if such omissions are the result of deliberate and dishonest concealment of material facts.

Date from which effective

To be advised by the government but its intention is for the whole act to be in force by October 2008.

Further reading

Accounting Standards Board	'*A Review of Narrative Reporting by UK Listed Companies in 2006*', January 2007 (www.frc.org.uk/asb)
Accounting Standards Board	'*Reporting Statement, The Operating and Financial Review*', January 2006 (www.frc.org.uk/asb)
Department of Trade and Industry	'*Guidance on the changes to the Directors' Report requirements in the Company Act 1985, April and December 2005* (www.dti.gov.uk)
The Quoted Companies Alliance	Guidance for Smaller Quoted Companies on preparing a Business Review. (further details on www.quotedcompaniesalliance.co.uk)
Task Force on Human Capital Management Reporting	'*Accounting for People*' (Task force set up by the Secretary of State for Trade and Industry in 2003) (www.accountingforpeople.gov.uk)
Department for Environment, Food and Rural Affairs	'*Environmental Key Performance Indicators, Reporting Guidelines for UK business*', January 2006 (www.defra.gov.uk)

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