



ACCOUNTING STANDARDS BOARD

**A REVIEW OF NARRATIVE REPORTING BY
UK LISTED COMPANIES IN 2006**

JANUARY 2007



ACCOUNTING STANDARDS BOARD

**A REVIEW OF NARRATIVE REPORTING BY
UK LISTED COMPANIES IN 2006**

JANUARY 2007

Accounting Standards Board
Financial Reporting Council
5th Floor
Aldwych House
71-91 Aldwych
London WC2B 4HN

Contacts:

David Loweth
Acting Technical Director and Secretary
d.loweth@frc-asb.org.uk

Simon Billingsley
Project Director
s.billingsley@frc-asb.org.uk

Contents

	<i>Page</i>
Summary of Conclusions	2
One Introduction	6
Two Measuring compliance with Best Practice	9
Three Compliance with the current legal requirements for the Business Review	25
Appendices	
Appendix A The shifting legal and regulatory background	32
Appendix B Companies within the ASB sample	37
Appendix C Summaries of recent reports on narrative reporting	38
Appendix D Summary of current legal requirements for the Business Review	48

Summary of Conclusions

This report sets out the results of a review of narrative reporting by UK companies in 2006 carried out by the staff of the Accounting Standards Board (ASB). The purpose of this review of narrative financial reporting is to highlight strengths and weaknesses of current reporting in the interests of the widespread adoption of best practice. The ASB as part of its role to promote high quality financial reporting will continue to review narrative reporting as practice develops. The objectives of the review are to assess:

- Best practice - the degree to which companies are reporting above and beyond the legal requirements and have adopted the recommendations in the ASB's Reporting Statement on the Operating and Financial Review (OFR), which the FRC believes is the most up-to-date and authoritative source of best practice guidance (covered in section 2); and
- Compliance - how UK companies are performing in the light of the requirement under the Companies Act 1985 to provide a Business Review within the directors' report (covered in section 3 of this report). As noted in Appendix A of this report, further legal requirements will be brought in when the Companies Act 2006 comes into force.

In carrying out the review the ASB has drawn on the results of 5 independent surveys of narrative reporting, in addition to its own detailed review of 23 Annual Reports published since the above legal requirements became effective.

Best Practice

In terms of how companies are reporting against the best practice recommendations set out in the ASB's Reporting Statement, we found the following:

Areas of good reporting

- Companies are generally good at providing **descriptions of their business and markets**, together with their **strategies and objectives**, although some improvements can be made in providing information on their external environment.
- All companies within the sample are providing satisfactory or better descriptions of the **current development and performance** of the business.
- There has been an increase in companies reporting **environmental, employee and social issues**, although very few companies have discussed their contractual arrangements and relationships in any depth.

Areas for improvement

- The greatest area of difficulty for companies when producing their narrative reports is the disclosure of **forward-looking information**. The proposed 'safe harbour' provisions in the Companies Act 2006 may encourage companies to provide greater detail moving forward.
 - *What can companies do?* To help think about how they can improve their reporting in this area, companies should review paragraphs 8-12 and 48-49 of the Reporting Statement, which outline the principle that the OFR should have a forward looking orientation, and sets out potential areas which may affect the future development and performance of the business. A number of companies have been assessed as providing good disclosures in this area with, for example, one company in the sample providing details of forecast demand and planned capital investment over the next ten years.
- Companies need to think carefully about the description of the **resources** available to the entity, in particular on those intangible items not reflected in the balance sheet.
 - *What can companies do?* Companies can refer to paragraph 51 of the Reporting Statement, which sets out examples of resources not included in the balance sheet that may be disclosed. A number of companies have provided information judged as Best Practice, for example, one company in the sample providing details of contractual agreements, reputation, employees and trade marks as examples of resources.
- Companies need to assess carefully what are their **principal risks and uncertainties**, and report on those, together with the approach to managing and mitigating those risks, rather than simply provide a list of all their risks and uncertainties. The number of risks and uncertainties reported in our sample ranged from 4 to 33. We question whether a company can really have 33 **principal** risks and uncertainties.
 - *What can companies do?* Companies should review paragraphs 53-56 of the Reporting Statement which sets out the disclosure recommendations for principal risks and uncertainties. The Best Practice companies in our sample provided details of their principal risks, the potential impact on the business if the risks crystallised and details of how the risks are mitigated.
- Many companies are providing a good deal of information on measures and indicators, but improvements can be made in identifying their **KPIs**, both financial and non-financial.
 - *What can companies do?* Companies can review the implementation guidance accompanying the Reporting Statement, which sets out 23 illustrative KPI's which may assist companies in meeting this recommendation. The Best Practice companies in our sample provided a description of their KPIs and how they link to overall strategy and, in addition, provided details of the results of the KPIs with comparative figures and target figures.

Compliance

In terms of compliance with the current legal requirements, we were able to draw the following overall conclusions;

- Companies are in general complying with the legal requirements for the Business Review.
- However in meeting their legal requirements, companies need to take care that there is appropriate cross-referencing in the directors' report to the other elements of the report and accounts, to ensure compliance with the law.
- All companies surveyed are providing a 'fair review' of their business.
- There is a legal requirement for a 'balanced' analysis and in considering 'balance' companies need to assess what the prominence should be of reporting 'bad' news, where appropriate. The achievement of the legal requirement of balance will require the exercise of judgement by companies.

Areas for improvement

- The legal requirement is for companies to describe their **principal** risks and uncertainties. As noted above, companies need to assess carefully what are their principal risks and uncertainties, rather than simply provide a long list of all possible risks and uncertainties.
- Many companies are finding the disclosure of KPIs, both financial and non-financial, challenging. While the requirement to disclose KPIs is a matter of judgement for the directors, the lack of inclusion of any KPIs in a Business Review in the future will provide the Financial Reporting Review Panel (FRRP) with a possible indicator that the Review may not be compliant with the law.
- The disclosure of forward-looking information is also proving to be a challenge. All the companies surveyed met the current legal test of giving an 'indication' of likely future developments, but the legal requirement will increase in the future and companies will need to prepare themselves to be ready to disclose more forward-looking information.

Overall conclusions

- Companies should think carefully about the structure and placement of their narrative reporting to ensure that cross-referencing is kept as simple as possible and does not adversely impact on the flow of the narrative.
- In the absence of any guidelines on preparing a statutory Business Review, the principles outlined in the Reporting Statement are being widely adopted by quoted companies as best practice in narrative reporting when preparing their annual report.
- This acceptance is higher amongst the larger market capitalisation companies in the FTSE 100, although there are examples of good practice among companies below the FTSE 100. As the survey shows, some companies are achieving Good or Best Practice scores across nearly all the recommendations of the Reporting Statement.

- As compliance with the Reporting Statement will in general more than meet the legal content requirements for the Business Review, there is a practical benefit for companies in following the statement to achieve legal compliance as well as fulfilling best practice.
- The proposed additional reporting requirements for quoted companies contained in the Companies Act 2006 should encourage even more companies to comply with the best practice Reporting Statement. The additional disclosure requirements in the proposed Companies Act are all existing recommendations of the Reporting Statement.

One - Introduction

1.1 This report sets out the results of a survey of the quality of narrative reporting that has been carried out by the staff of the Accounting Standards Board (ASB), an operating body of the Financial Reporting Council (FRC). In carrying out the review the ASB has drawn on the results of 5 independent surveys of narrative reporting, in addition to its own detailed review of 23 Annual Reports published since the Reporting Statement became effective on 1 April 2006.

The purpose of this review of narrative financial reporting is to highlight strengths and weaknesses of current reporting in the interests of the widespread adoption of best practice. We hope that the contents of this report will provide some useful guidance to companies and will help to encourage them to move their reporting beyond compliance and towards best practice. The FRC's stated aim is to promote confidence in corporate reporting and governance and this report is intended to be a contribution in support of that aim. The ASB as part of its role to promote high quality financial reporting will continue to review narrative reporting as practice develops.

1.2 The objectives of the review are to assess:

- Best practice - the degree to which companies are reporting above and beyond the legal requirements and have adopted the recommendations in the ASB's Reporting Statement on the Operating and Financial Review (OFR), which the FRC believes is the most up-to-date and authoritative source of best practice guidance (covered in section 2); and
- Compliance - how UK companies are performing in the light of the requirement under the Companies Act 1985 to provide a Business Review within the directors' report (covered in section 3 of this report). As noted in section Appendix A of this report, further legal requirements will be brought in when the Companies Act 2006 comes into force.

1.3 In carrying out the review we have drawn a distinction between the two objectives above and reported on them separately because we are not only interested to assess how companies are meeting their current legal objectives, but are also keen to get an indication of how far companies are moving further ahead and embracing best practice as set out in the Reporting Statement. The report also seeks to highlight some areas of compliance in advance of the Financial Reporting Review Panel (FRRP) assuming its legal powers to review compliance of the directors' report with the law for financial years beginning on or after 1 April 2006.

1.4 The review for compliance with the legal framework is conducted against legislation currently in place. A review of the changing legal and regulatory requirements is set out in Appendix A.

1.5 The staff of the ASB selected a sample of 23 quoted companies¹, 22 with 31 March 2006 year-ends, one with a year-end of 30 June 2006. A list of the annual reports reviewed is at Appendix B. Of this sample, 15 were at the time of publication of their annual report members of the FTSE 100 index, 4 were within the FTSE 250 index, and 4 smaller quoted companies in the FTSE Small Capitalisation index. Given the year-ends for the sample chosen, it does not include any companies from a number of important sectors, such as financial services and oil and gas.

1.6 The ASB has liaised throughout with a number of other organisations who have been conducting research in this area and carried out their own surveys. The review draws on their research and the ASB acknowledges the support of the following organisations who have (i) devoted their time and expertise as part of the review; and (ii) allowed the ASB to quote from their most recent reports on narrative reporting, as follows:

- Black Sun plc - 'The first 23 - Reporting under the Business Review' (August 2006);
- Radley Yeldar - 'Narrative reporting content in the FTSE 100 - how does it stack up?' (September 2006);
- Deloitte - 'Write to reason: Surveying OFRs and narrative reporting in annual reports' (October 2006);
- The Virtuous Circle - 'Preparedness for the new corporate reporting requirements: A study of FTSE200 Business Reviews and a consideration of their readiness for the new Companies Bill' (October 2006); and
- PricewaterhouseCoopers - 'Show me more than the money: An assessment of how prepared companies are for the business review' (November 2006).

Summaries of each of the above reports are set out in Appendix C of this report.

1.7 Narrative reporting is an area that has been attracting a good deal of attention and comment. As well as the reports referred to above, the importance of good narrative disclosure, whether in a Business Review, an OFR, or other parts of the annual report has been emphasised in a number of other recent reports, including those from the Association of Certified Chartered Accountants (ACCA)², Independent Audit Limited³, the November 2006 'Report Leadership' report⁴, and a document published by Association of British Insurers (ABI) in November 2006 'Developments in Narrative Reporting: an ABI position paper'.

¹ The sample selected is a mix of companies with 31 March 2006 year-ends who were first to publish their annual reports and those chosen at random to try and ensure a mix of FTSE100 and smaller quoted companies.

² ACCA (June 2006) 'Visions of the future "to the extent necessary": the debate on the future of narrative reporting..

³ Independent Audit Limited (October 2006) 'Telling the story...through the eyes of the board: A framework for the Business Review'.

⁴ A report issued by a group comprising the Chartered Institute of Management Accountants (CIMA), PwC, Radley Yeldar and Tomkins plc..

1.8 The ASB is also grateful to Seamus Gillen of h2glenfern for his input and to Tim Ambler of the London Business School (LBS). The LBS has been active in this field⁵ and will be carrying out a further survey on FTSE 50 company annual reports and how well their narrative reporting complies with recommendations in the Reporting Statement.

1.9 Drawing on the research that has been performed on narrative reporting, we have drawn a number of conclusions on (i) the extent that quoted companies are complying with the legal requirements for a business review and (ii) providing best practice narrative reporting.

So what have companies been calling their narrative reporting?

1.10 The companies reviewed are titling their narrative reporting sections using a variety of names, such as Business Review, OFR, or Performance review, as well as the more traditional Chairman's and Chief Executive's reviews.

1.11 In this survey when scoring for compliance against the Reporting Statement all narrative sections of the annual report have been reviewed irrespective of the title of the section. Deloitte, in their survey, noted that approximately 75 per cent of companies either prepare a formal OFR or show clear recognition of OFR principles when preparing their annual reports. A similar outcome is shown in this survey with generally high levels of compliance to Reporting Statement requirements even from those companies not preparing a formal OFR.

1.12 Of the 23 annual reports reviewed in this survey 9 included a section entitled "Operating and Financial Review" within their reports. This is a similar figure to that found by Radley Yeldar and Black Sun who, in their reviews, found that 45 per cent and 48 per cent respectively of annual reports included a section entitled OFR. The survey of listed company accounts (including non-FTSE 100 companies) conducted by Deloitte found that the number of formal OFRs has fallen from 41 per cent to 20 per cent. The likely conclusion Deloitte make is that there is likely to be a compliance risk associated with formally titling a narrative report 'OFR'. In addition, the smaller the company's market capitalisation the less likely the company is to include an OFR in the annual report. That said, the results of a survey of 200 UK Middle Market companies (those with a turnover of between £5 million and £500 million a year) announced by KPMG in October⁶ found that 31 per cent said that they still plan to produce an OFR and go beyond the bare requirements.

1.13 While narrative reporting is still evolving, and whatever name is given to the narrative sections of the annual report, the overall impression is that there appears to be a willingness among many companies to go beyond strict legal requirements and to move towards best practice reporting. The ASB hopes that trend will continue.

⁵ See, for example, Ambler and Neely (2006) 'Assessing the Quality of Directors' Reviews in UK Annual Reports' (paper presented to the Performance Measurement Association conference 2006)..

⁶ KPMG News 12 October 2006 'Middle Market companies reflect the growing importance of narrative reporting'.

Two - Measuring Compliance with Best Practice

2.1 The ASB has assessed how companies are reporting as against the ten main areas of the best practice recommendations contained within the ASB's Reporting Statement on the OFR. In so doing, we have looked at all the sections of narrative reporting contained in the annual reports surveyed. The areas assessed are as follows (all paragraph references to the relevant parts of the Reporting Statement):

- Description of business and external environment (paragraphs 30-32);
- Strategy and Objectives (paragraphs 33-37);
- Current Development and Performance of the Business (paragraphs 43-46);
- Future development and performance (paragraphs 47-49);
- Resources (paragraphs 50-51);
- Principal risks and uncertainties (paragraphs 52-56);
- Capital Structure and Treasury policies (paragraphs 63-67);
- Cash flows and Liquidity (paragraphs 68-74);
- Environmental, employee and social issues, and contractual arrangements/relationships; (paragraphs 28-29); and
- Key Performance Indicators (KPIs), both financial and non-financial (paragraphs 38-40).

Scoring Methodology

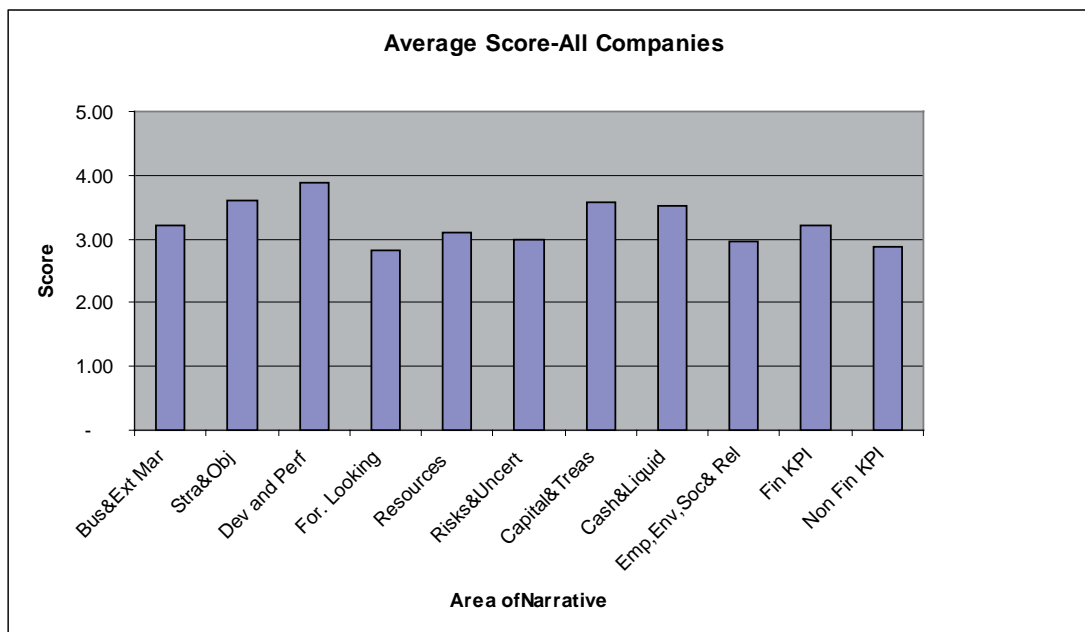
2.2 The ASB has scored each of the areas above on its assessment of how well we think the narrative reporting in the annual report satisfies the criteria contained in the Reporting Statement. The scoring system is set out below;

1. Very poor
2. Poor
3. Fair
4. Good
5. Best Practice (fully meets the Reporting Statement).

2.3 As with any system of attempting to score narrative disclosure, there is an element of subjectivity. The ASB's aim in adopting a scoring methodology has been to give an indication of our view of reporting by companies, rather than anything more scientific, in particular in determining the boundaries between the different scores. The ASB has, however, compared its scoring methodology and results with those of a number of the other organisations referred to in Section 1 of this report and found a good deal of consensus and consistency.

Summary of Overall Results

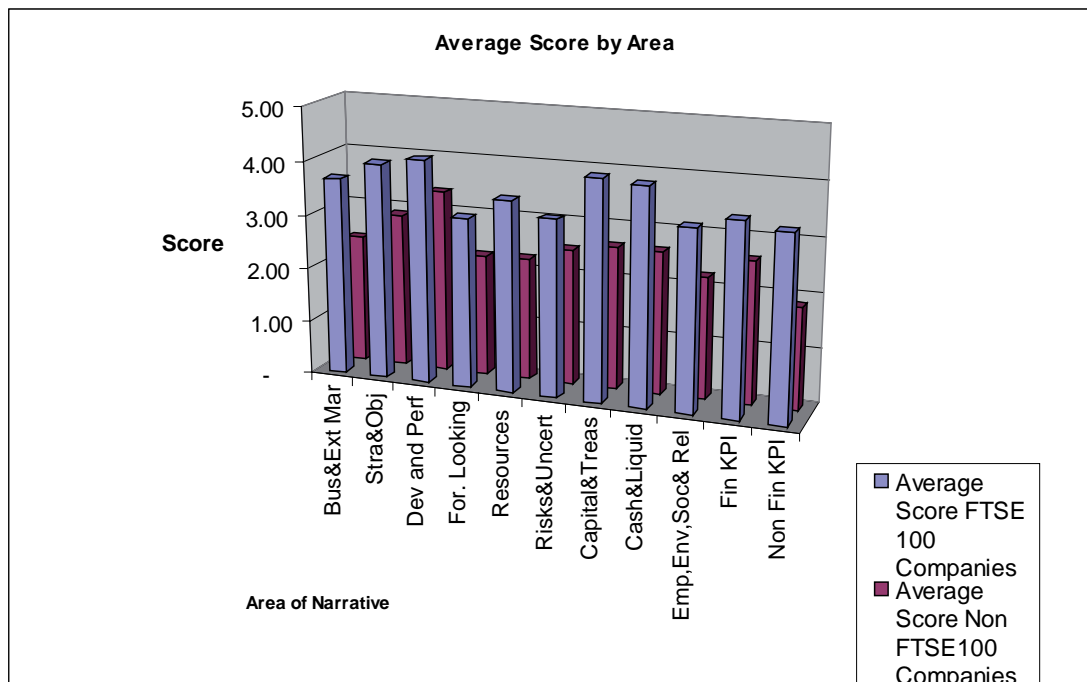
2.4 The average scores by area for all companies are shown in the chart below:



2.5 The areas with the lowest average scores are those relating to the non-financial key performance indicators, and forward looking areas of the Reporting Statement. The overall average score for all the annual reports is 3.2 which indicate a fair level of compliance. It should be noted that the overall score may have been affected by the fact that the ASB sample includes a number of companies who are acknowledged leaders of good practice narrative reporting, but it is pleasing to see that at least some companies are going beyond the minimum statutory compliance in their reporting.

2.6 The average score for companies in the FTSE 100 index is 3.6 whilst for non-FTSE 100 companies it is 2.5. Although the average score for FTSE 100 companies indicates a good level of compliance with the Reporting statement the range of scores achieved shows there is a wide range of performance even within the FTSE 100. The highest achieving FTSE 100 company had an average score of 4.6 whilst the lowest averaged 3.0. The non-FTSE 100 companies can be further divided between companies in the FTSE 250 index and companies in the FTSE Small Capitalisation index. Companies in the FTSE 250 averaged 3.0 with a highest average score of 3.6 and a lowest average score of 2.6. Companies in the FTSE small capitalisation index averaged 2.0 with a highest average score of 2.2 and a lowest average score of 1.7.

2.7 This is highlighted by area in the chart below



2.8 For all areas reviewed the average score for FTSE 100 companies is higher than that for non FTSE 100 companies. The difference in average score is material for all areas of the Reporting Statement.

2.9 The finding that the Reporting Statement has an influence on narrative reporting is supported by the work of Deloitte who found that 76 per cent of the companies in their survey were either “presenting a formal OFR, or clearly recognising and/or adopting the approach in the Reporting Statement”. Radley Yeldar, in their report, note that “despite the advent of the Business Review legislation, the OFR guidance is still clearly setting the pace for best practice in the FTSE 100”

Summaries of Results by Area of Assessment

Description of Business and External Environment

2.10 Paragraph 30 of the Reporting Statement recommends that:

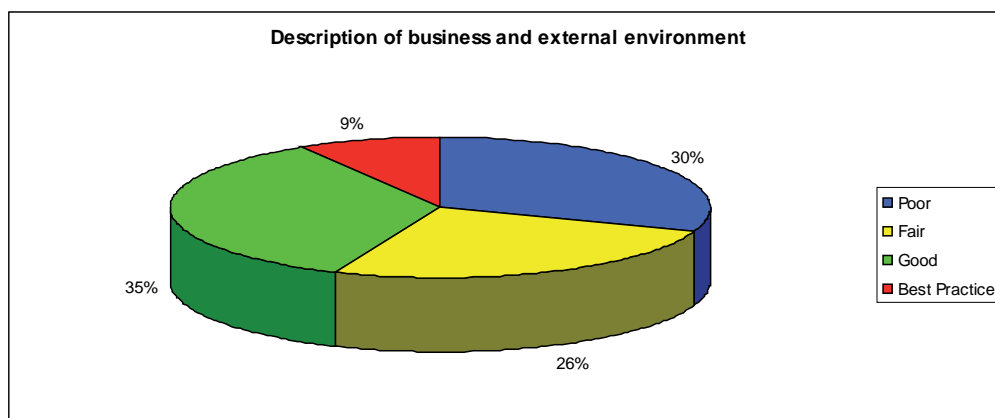
“The OFR should include a description of the business and the external environment in which it operates as a context for the directors’ discussion and analysis of performance and financial position”.

2.11 In order to achieve a ‘Best Practice’ score the ASB takes the view that the annual report should contain a description of the business to provide members with an understanding of the industry or industries in which the entity operates. Depending on the nature of the business, the annual report

should also include discussion of matters such as the entity's major markets and competitive position within those markets and the significant features of the legal, regulatory, macro economic and social environment that influence the business.

2.12 Companies occasionally provide this information outside the principal narrative reporting section. Although these sections are occasionally not cross-referred into the OFR or Business review they have been included for the purpose of scoring against the Reporting Statement recommendation.

2.13 The overall results from this survey are given in the chart below;



2.14 As can be seen from the above chart, 44 per cent of the reports reviewed were either rated as Good or following Best Practice. In general, companies readily provide descriptions of their business and markets but information on their external environment is less prevalent. Brief descriptions of business and external environment are more prevalent in the smaller market capitalisation companies. This is evidenced by the average score for FTSE 100 companies being 3.7 whilst the score for non-FTSE 100 companies is 2.4.

2.15 However, Deloitte found from their larger survey that the quality of disclosure on markets and external environment did not vary by size of company. This discrepancy may be due to the nature of the companies included in the FTSE 100 sample which contains several companies operating in highly regulated industries. These companies tend to provide considerable legal and regulatory disclosures which may not be common features of the reports of smaller companies. In their report, Radley Yeldar included in their 'Good Work' overview reporting by companies setting out their explanations of the business upfront and marketplace discussions.

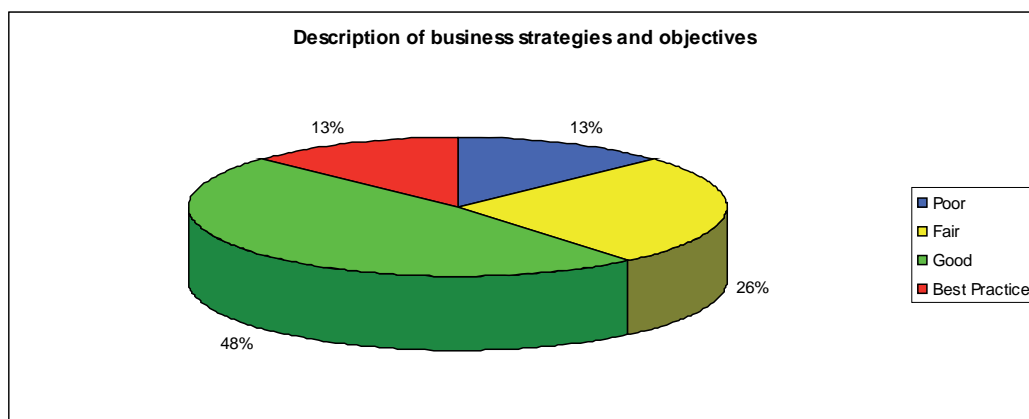
2.16 The findings of this report and similar studies suggest that this is an area of narrative reporting that is generally performed to a good standard. Companies should ensure that where the business operates in a variety of marketplaces all external markets are covered by the narrative report.

Strategy and Objectives

2.17 The recommendations in the Reporting Statement (paragraphs 33-37) ask principally that the OFR should:

- discuss the objectives of the business to generate or preserve value over the longer term; and
- set out the directors' strategies for achieving the objectives of the business.

2.18 In order to achieve a Best Practice score the annual report should contain where appropriate both financial and non-financial objectives. A summary of the results from this survey is given in the chart below;



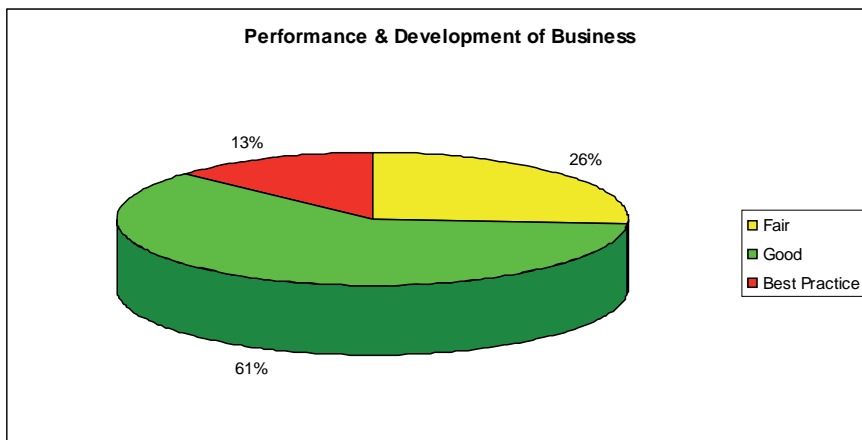
2.19 The average score achieved by FTSE 100 companies is 4.0 whilst for the non-FTSE 100 companies it is 2.9.

2.20 The PwC analysis reveals a high level of references to strategies and objectives (75 per cent of the PwC survey companies with March 2006 present information about their short-term strategic priorities and 89 per cent about the longer-term). The Deloitte survey found that 74 per cent of companies mentioned either financial and/or non-financial objectives. The directors' strategy for achieving their objectives was outlined by 72 per cent of companies.

Current Development and Performance of the Business

2.21 The Reporting Statement (paragraphs 43-46) recommends that the OFR should describe the significant features of the development and performance of the business in the financial year covered by the financial statements. In assessing this aspect, the ASB has also taken into account the principle in the Reporting Statement that the OFR 'should be balanced and neutral, dealing even-handedly with both good and bad aspects'.

2.22 A summary of the results from the survey is given in the chart below;

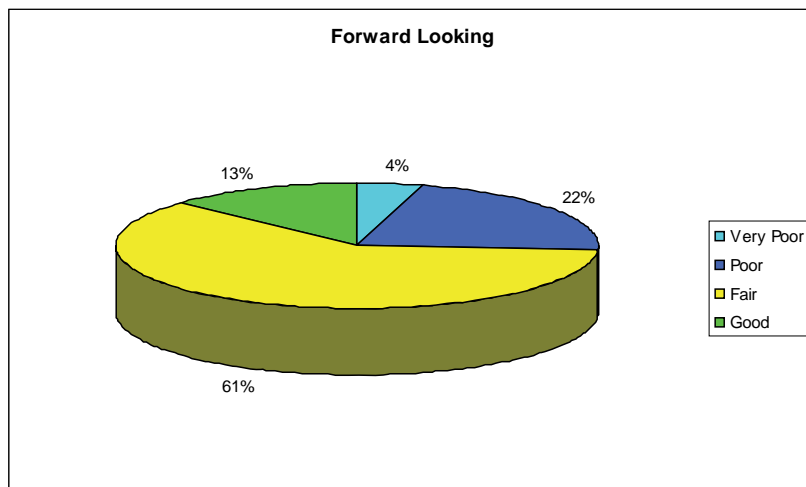


2.23 This is an area that is generally completed to a high standard with no Poor or Very Poor markings. 74 per cent of the ASB sample is assessed to have achieved either Good or Best Practice scores. As in other areas, the average scores are lower for companies with a lower market capitalisation. The average score of a company in the FTSE 100 index was 4.1 compared to 3.4 for those companies outside the FTSE 100.

Future Development and Performance

2.24 The Reporting Statement (paragraphs 47-49) recommends that the OFR should analyse the main trends and factors that directors consider likely to impact future prospects. In addition, one of the principles of the Reporting Statement (paragraph 8) recommends that the OFR should have a forward-looking orientation, identifying those trends and factors relevant to the members' assessment of the current and future performance of the business and the progress toward the achievement of long term business objectives. To achieve a Best Practice assessment a company needs to reflect this principle in its reporting.

2.25 A summary of the results arising from this survey is given in the chart below.



2.26 This area has the lowest average score of all the areas reviewed with an overall average score of 2.8. The average score for FTSE 100 companies was 3.1 whilst for non-FTSE 100 companies the score was 2.2. While the ABI position paper notes that the key aspect that differentiates the best reporters is the forward-looking nature of their disclosures, the ASB found no examples of Best Practice with the majority of companies achieving a Fair rating. This finding is supported by work undertaken by other organisations. For example, Radley Yeldar commented that 'This was the section that caused the most problems for the sample'. As referred to in paragraph 3.27, Black Sun refer to this area as 'most challenging', and Deloitte found that only 59 per cent of companies in their survey commented on trends that were expected to affect future performance. The proposed "safe harbour" provisions to be contained in the Companies Act 2006 may encourage companies to provide greater detail, although there is already a legal opinion⁷ providing advice available on how directors can significantly minimise the risks of criminal and civil liability when providing forward-looking statements.

Resources

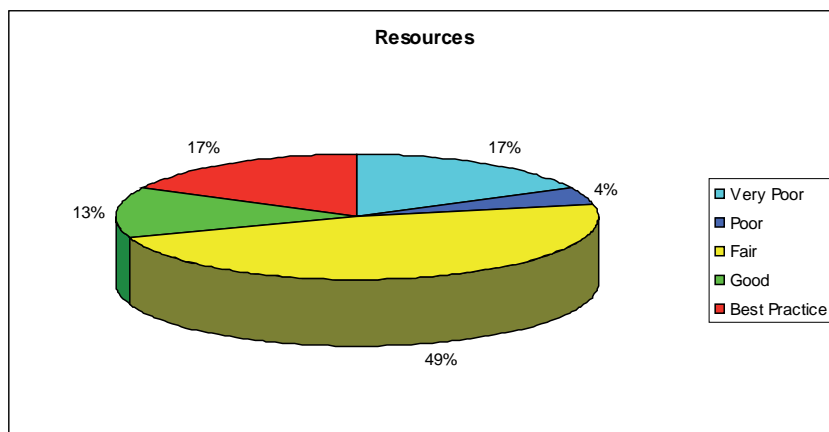
2.27 The Reporting Statement (paragraphs 50 and 51) recommends that the OFR should include a description of the resources available to the entity and how they are managed.

2.28 In order to achieve a Best Practice result the annual report should set out the key strengths and resources, tangible and intangible, available to the business, which will assist it in the pursuit of its objectives and, in particular, those items that are not reflected in the balance sheet. These resources may

⁷ Allen and Overy LLP (July 2005) 'Operating and Financial Reviews and Directors' liabilities' – a letter of advice for the Chartered Institute of Management Accountants (CIMA).

include corporate reputation, brand strength, natural resources, employees, licences, patents, copyright and trademarks. The importance of such intangibles and how they should be reported continues to be highlighted by commentators⁸.

2.29 A summary of the results is given in the chart below



2.30 Only 30 per cent of the reports reviewed achieved either a Good or Best Practice rating, with 17 per cent judged as Very Poor. The average score achieved by all companies was 3.0 which is one of the lowest in the survey. The average score achieved by FTSE 100 companies was 3.5 whilst for non-FTSE 100 companies the score was 2.2. Deloitte noted from their survey that 'there were few examples of a cohesive approach to a discussion in this area'.

2.31 Many companies have addressed this issue by providing a summary balance sheet whilst the Reporting Statement specifically requests disclosure of resources not on the balance sheet.

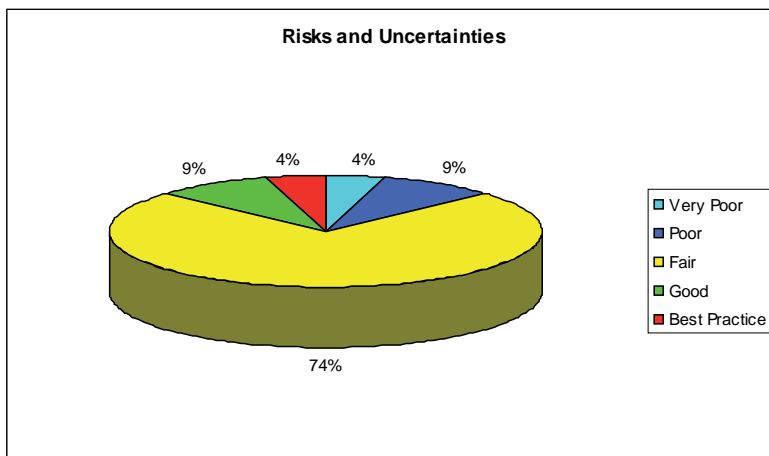
Principal Risks and Uncertainties

2.32 The Reporting Statement (paragraph 52) recommends that the OFR should include a description of the principal risks and uncertainties facing the entity together with a commentary on the directors' approach to them.

2.33 In order to achieve a Best Practice result the annual report should disclose strategic, commercial, operational and financial risks where these may significantly affect the entity's strategies and value.

⁸ See, for example, Institute of Practitioners in Advertising (IPA) (October 2006) 'The Intangible Revolution: How intangible assets are transforming management and reporting practice'

2.34 The chart below provides a summary of the results:



2.35 The average score for this area was 3.0 with FTSE 100 companies averaging 3.3 and non FTSE 100 companies 2.5. 74 per cent of companies achieved a fair score with only one assessed as a Best Practice example. As noted in paragraph 3.13 below many companies provide details on a great number of risks with little explanation of potential mitigation or of how the risks may affect the entity's strategy. The number of risks described ranged from 4 to 33. Given that the requirement is for a description of principal risks companies need to distinguish better what they believe to be their **principal** risks and uncertainties.

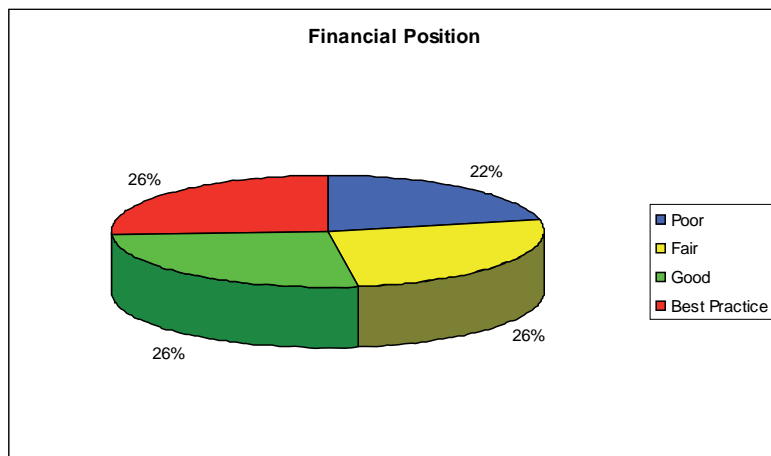
Capital structure and Treasury

2.36 The Reporting Statement recommends companies to disclose details of their financial position. Paragraphs 63 and 65 require companies to:

- provide a discussion of the capital structure of the entity; and
- set out the entity's treasury policies and objectives.

2.37 In order to achieve a Best Practice result the annual report should disclose the balance between equity and debt, the maturity profile of debt, type of capital instruments used, currency, regulatory capital and interest rate structure.

2.38 A summary of the results is given in the chart below:



2.39 Of the reports reviewed, 52 per cent were assessed as either achieving a Good or Best Practice rating. The average score for all companies was 3.6, which is one of the highest average ratings achieved. Companies with smaller market capitalisations in the sample have provided limited information on capital structure. This is evidenced by the considerable difference in ratings achieved between FTSE 100 and non-FTSE 100 companies with the average score for FTSE 100 companies being 4.1 whilst for non FTSE 100 companies this score drops to 2.6.

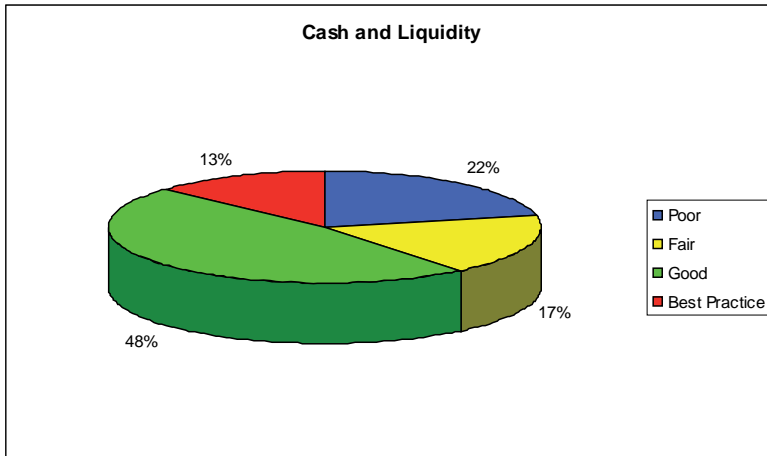
Cash Flows and Liquidity

2.40 The Reporting Statement recommends companies to disclose details of the entity's cashflows and liquidity (paragraphs 68 and 71). The OFR should discuss:

- the cash inflows and outflows during the financial year, along with the entity's ability to generate cash, to meet known or probable cash requirements and to fund growth; and
- the entity's current and prospective liquidity. Where relevant, this should include commentary on the level of borrowings, the seasonality of borrowing requirements (indicated by the peak level of borrowings during that period) and the maturity profile of both borrowings and undrawn committed borrowing facilities.

2.41 In order to achieve a Best Practice result the discussion should supplement the information provided in the financial statements by, for example commenting on any special factors that have influenced cash flows in the financial year.

2.42 A summary of the results is given in the chart below:



2.43 Some 61 per cent of the reports reviewed received either a Good or Best Practice rating. The average score is high at 3.5 with FTSE 100 companies averaging 4.0 whilst non-FTSE 100 companies average 2.6. This is another area where levels of compliance with the Reporting statement have generally been good.

Environmental, Employee, Social issues and Contractual Arrangements/Relationships

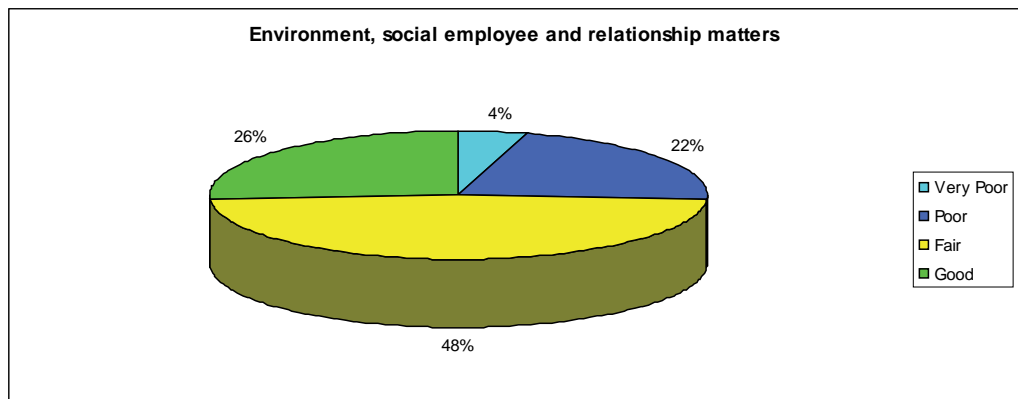
2.44 The Reporting Statement (paragraph 28) recommends that 'to the extent necessary' to meet the overall requirements of the OFR, the OFR should include information about;

- environmental matters (including the impact of the business of the entity on the environment),
- the entity's employees
- social and community issues.
- persons with whom the entity has contractual or other arrangements which are essential to the business of the entity.

2.45 Meeting the first three recommendations above are often satisfied by companies producing corporate responsibility sections within the annual report. Many companies also produce stand alone Corporate Social Responsibility (CSR) reports which are referenced to from the annual report. For the purposes of the scoring only information contained in the annual report was reviewed.

2.46 In order to achieve a Best Practice score the annual report should contain for environmental matters, the entity's employees, and social and community issues the policies of the entity in each area and the extent to which those policies have been successfully implemented.

2.47 A summary of the scores for this area is contained in the chart below.



2.48 As can be seen from the above chart, 26 per cent of the reports reviewed were rated as Good with no Best practice examples. The average score amongst the FTSE 100 companies reviewed was in excess of 3.3 falling to 2.2 for the non-FTSE 100 companies. Many companies provided considerable amounts of information on employee and environmental matters and policies however this information rarely discussed the extent to which these policies had been successfully implemented. Very few companies discussed information concerning persons who the entity has contractual arrangements with, such as significant customers or suppliers.

2.49 Deloitte also found that there has been a significant increase in the proportion of companies providing information on employee, environment and social issues, with only 5 per cent of companies in their survey not discussing employee matters. Radley Yeldar included the provision of CSR information in their "Could do better" section. However, this appears to be primarily because of the lack of integration with the rest of the annual report rather than because of the quality of the content.

2.50 The findings of this report and other similar work would suggest that the provision of employee, environmental and social information in annual reports is increasing. However companies are not providing information on contractual arrangements with third parties. As noted in paragraph 12 of Appendix A, the provision of information on contractual arrangements in the business review, will be a requirement for quoted companies 'to the extent necessary' for an understanding of the business following the passing of Companies Act 2006.

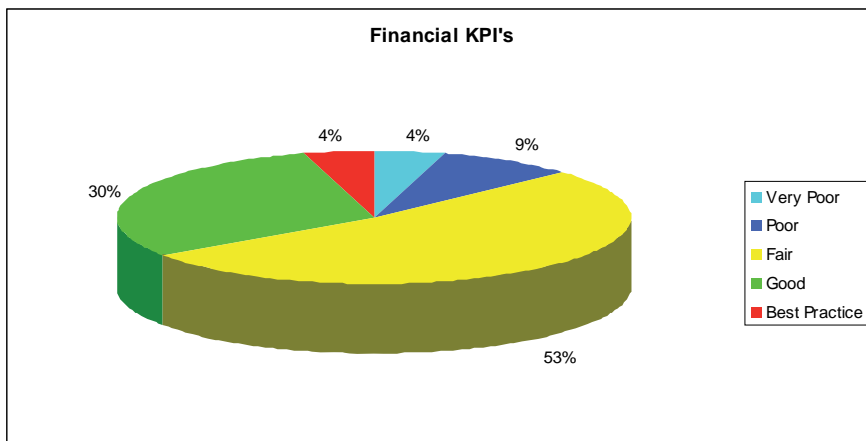
KPI reporting: Financial and Non Financial

2.51 The recommendations for KPI reporting are set out in paragraph 38 of the Reporting Statement. This is another ‘to the extent necessary’ recommendation where the OFR should include the KPIs, both financial and, where appropriate, non financial, used by the directors to assess progress against their stated objectives.

2.52 When assessing the level of disclosure in annual reports, separate assessments have been made for financial and non financial KPIs. In order to achieve a Best Practice score, the annual report should provide information that enables members to understand each KPI disclosed. Paragraphs 75 and 76 of the Reporting Statement recommend the information that should be provided for each KPI disclosed. This information should contain:

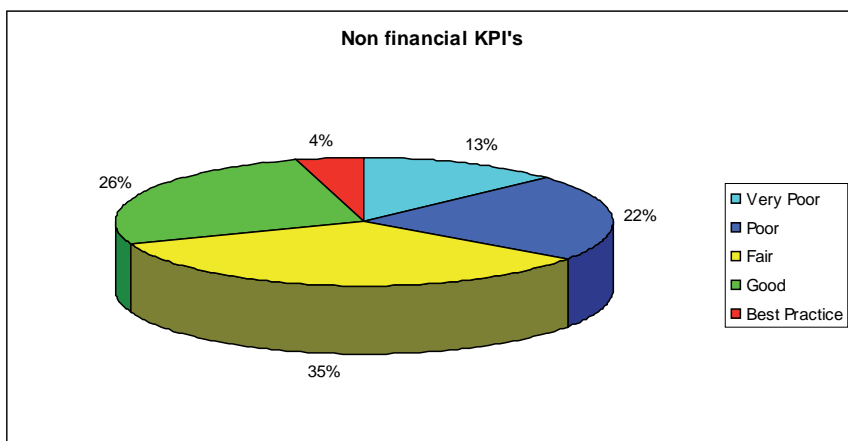
- the definition and calculation method;
- an explanation of the purpose of the KPI;
- the source of underlying data and any assumptions made;
- quantification or commentary on future targets;
- where information from the financial statements has been adjusted, that fact should be highlighted and a reconciliation provided;
- where available, corresponding amounts; and
- any changes to KPIs.

2.53 A summary of the results for financial KPIs is given in the chart below:



2.54 Of the reports reviewed, 30 per cent were rated Good with only one Best Practice example. The average score for FTSE 100 companies was 3.5, compared to 2.6 for non-FTSE 100 companies. Many companies provide a considerable amount of detail on financial performance indicators; however, in many cases the indicators are not defined nor are there sufficient explanations as to why they are considered key.

2.55 A summary of the results for non-financial KPIs is given in the chart below:



2.56 Of the reports reviewed, 26 per cent were rated Good with one Best Practice example, which is a similar figure to that achieved for financial KPIs. However, 35 per cent of the reports were rated either Poor or Very Poor for non financial KPIs, as compared to only 13 per cent for financial KPIs. The average score for FTSE 100 companies was 3.4, compared to 1.9 for non-FTSE 100 companies, with an overall average of 2.9. Many companies provide information concerning employee or environmental performance, however these are often not accompanied by an explanation as to why these indicators are considered to be key. These findings are supported by reviews of annual reports undertaken by other organisations.

2.57 Radley Yeldar in their review of the FTSE 100 noted that: 'Many companies now highlight their financial KPIs in some shape or form. However, few companies provide a good range of non-financial KPIs or explain why they have chosen particular indicators'. Black Sun found non-financial reporting of KPIs 'to be an area where companies are struggling to achieve the same level of performance as in their financial reporting'. Deloitte, in their review, found that 68 per cent of companies in their sample with market capitalisations in the top 350 disclosed KPIs compared with only 18 per cent of companies with market capitalisations in the lowest 350.

2.58 These results would suggest that, whilst disclosure of financial KPIs by companies is generally performed to a fair standard, companies have greater difficulty highlighting non financial KPIs and that this difficulty is more prevalent in companies with smaller market capitalisations.

Conclusions

2.59 The conclusions of this aspect of the review are:

Areas of good reporting

- Companies are generally good at providing descriptions of their business and markets, together with their strategies and objectives, although some improvements can be made in providing information on their external environment.
- All companies are providing satisfactory or better descriptions of the current development and performance of the business.
- There has been an increase in companies reporting environmental, employee and social issues, although very few companies have disclosed their contractual arrangements and relationships.

Areas for improvement

- The greatest area of difficulty for companies when producing their narrative reports is the disclosure of forward-looking information. The proposed 'safe harbour' provisions in the Companies Act 2006 may encourage companies to provide greater detail moving forward.
- Companies need to think carefully about the description of the resources available to the entity, in particular on those intangible items not reflected in the balance sheet.
- Companies need to assess carefully what are their principal risks and uncertainties, and report on those, together with the approach to managing and mitigating those risks, rather than simply provide a list of all their risks and uncertainties. The number of risks and uncertainties reported in our sample ranged from 4 to 33. We question whether a company can really have 33 principal risks and uncertainties.
- Many companies are providing a good deal of information on measures and indicators, but improvements can be made in identifying, defining, linking to strategic objectives and providing targets for their KPIs, both financial and non-financial.

Overall conclusions

- Companies should think carefully about the structure and placement of their narrative reporting to ensure that cross-referencing is kept as simple as possible and does not adversely impact on the flow of the narrative.
- In the absence of any guidelines on preparing a statutory Business Review, the principles outlined in the Reporting Statement are being widely adopted by quoted companies as best practice in narrative reporting when preparing their annual report.
- This acceptance is higher amongst the larger market capitalisation companies in the FTSE 100, although there are examples of good practice among companies below the FTSE 100.

As the survey shows, some companies are achieving Good or Best Practice scores across nearly all the recommendations of the Reporting Statement, proving that it can be done.

- As compliance with the Reporting Statement will in general more than meet the legal content requirements for the Business Review, there is a practical benefit for companies in following the statement to achieve legal compliance as well as fulfilling best practice.
- The proposed additional reporting requirements for quoted companies contained in the Companies Act 2006 should encourage even more companies to comply with the best practice Reporting Statement. The additional disclosure requirements in the proposed Companies Act are all existing recommendations of the Reporting Statement

Three - Compliance with the current Business Review requirements

3.1 This section sets out the ASB's assessment of how companies are reporting against the current legal requirements for the Business Review which are set out in Appendix D. Each of the specific legal requirements is considered in turn, together with some conclusions concerning compliance with the current legislation.

3.2 The ASB has also drawn in particular on the findings of the Black Sun report, which used the Business Review requirements as a guide, focusing on a number of specific areas, relating to: risks and uncertainties, financial and non-financial Key Performance Indicators (KPIs), and forward-looking information. The Deloitte and PwC reports also provide information on how companies are meeting their legal requirements.

Business Review identified as part of the Directors' Report

3.3 The Companies Act 1985 requires that the Business Review is identified as part of the directors' report. The Government has confirmed that it is acceptable to cross-refer in the Business Review section of the directors' report to information contained in a voluntary OFR (or other parts of the annual report), provided that they are published together in a way that users can easily refer to both sections.

3.4 In its guidance to companies, the Department for Trade and Industry (DTI)⁹ has advised that the cross-reference must clearly indicate which specific sections of the voluntary OFR are relevant, whether by page numbers, paragraph numbers or headings, for example:

“The information that fulfils the requirements of the Business Review can be found in the OFR on pages x to y, which are incorporated into this report by reference”.

3.5 Many companies within the FTSE 100 are already showing a high level of compliance with the more demanding Reporting Statement. Therefore, satisfying the requirements of the Business Review can be achieved by an accurate cross-reference from the director's report to the other narrative sections of the annual report. Deloitte found that 92 per cent of their eligible sample had achieved compliance this way. This high level of compliance reflects the fact that much of the FTSE 100 has improved its narrative reporting over a number of years, witnessed for example by the results of a number of surveys undertaken over time by Deloitte.

3.6 In the ASB's sample review, one instance was found where an area of narrative reporting containing information that is needed to satisfy the requirements of the legislation has been omitted from the directors' report by a lack of a cross-reference or by inaccurate drafting of cross-references. In this example, a description of principal risks and uncertainties was included in a narrative section

⁹ DTI 'Guidance on the changes to the Directors' Report requirements in the Companies Act 1985' (April and December 2005). Available at <http://www.dti.gov.uk/bbf/financial-reporting/business-reporting/page21339.html>

described as a financial review which was not included in the cross reference from the directors' report. Deloitte also found one example of a mid-tier company that did not obviously include a business review or a cross-reference in the directors' report to existing material.

3.7 When companies are cross-referring from the directors' report to other sections of narrative reporting they are not including material which may be of assistance in satisfying the Business Review requirements. In the ASB sample, 12 companies excluded the Chairman's report, 3 excluded the Chief Executive's report, 4 excluded information on strategy and one excluded a section entitled 'Business Review'. In all cases, the sections included material that could, and should, come within the Business Review in the directors' report, although material is located in a number of different parts of the annual report, that can make the cross-referencing more complicated, and the narrative less of a coherent piece. Some of the difficulties that arise through cross referencing would be reduced by preparation of an OFR in accordance with the Reporting statement. A single cross reference from the Directors report to an OFR prepared in accordance with the Reporting statement should satisfy the legal requirements of a business review.

A fair review of the business

3.8 The Companies Act 1985 and the DTI guidance do not elaborate further on what is meant by a 'fair review' of the business. There is also an overlap between the fair review and the requirement to prepare a 'balanced and comprehensive analysis'. To distinguish between the two, the ASB has assessed how companies have met the 'fair review' legal requirement against the recommendation in the Reporting Statement (paragraph 30) that the directors should include a description of the business and the external environment in which it operates. The recommendations in the Reporting Statement that the directors should also discuss the objectives of the business and the strategies to achieve those objectives are not explicit legal requirements for the business review, although the Government has stated that the 'central requirements of the Business Review are largely identical to those of the statutory OFR'¹⁰. The Government has also commented that the Business Review should include information on objectives, strategies and resources where necessary to provide a fair review of the company¹¹.

3.9 The results are summarised in Section 2 (paragraphs 2.10 to 2.16). In terms of compliance with the law, the ASB found that – in general – companies are providing fair reviews to an acceptable standard. All 23 companies in the ASB sample have provided information that would meet the test of compliance of a 'fair review'. This fits with the results of the other reports referred to in Section 1. The PwC survey

¹⁰ HM Treasury (December 2005) '2005 Pre-Budget Report – Britain meeting the global challenge: Enterprise, fairness and responsibility' (paragraph 3.40)

¹¹ Annex A of Letter entitled 'Operating and Financial Review' of 22 December 2005 from the Treasury Solicitor to the Friends of the Earth, available on the HM Treasury website.

found that some 100 per cent of companies surveyed with March 2006 year ends describe their business and the environment in which they operate. Radley Yeldar commented that this is the one area in which companies performed relatively well. The Virtuous Circle also found companies to be generally good at providing a fair review.

3.10 As noted above, in a number of cases companies are providing this information in sections of the annual report outside the directors' report, without appropriate cross-referencing. This is in line with the comment in the Deloitte report that many companies include a separate description of the business within an introduction to the annual report. While the information is being provided, companies need to take care that it is cross-referenced into the directors' report.

A description of the principal risks and uncertainties

3.11 The Companies Act 1985 asks simply for a 'description' of the principal risks and uncertainties facing the company. This requirement is less than the disclosures recommended in the Reporting Statement, which are summarised in Section 2 (paragraphs 2.32 to 2.35), together with an assessment of how companies are reporting their risks and uncertainties.

3.12 As should be expected, the vast majority of companies reported on their risks and uncertainties. This accords with the conclusion in the Black Sun report that risk reporting is the area where there is the greatest improvement to date. Deloitte also record an increase in the proportion of companies disclosing information regarding risks facing the business. The Deloitte report highlights that 96 per cent of companies, presenting OFRs or OFR-style information, met the legal requirement, although many companies focus on financial risks only, without also commenting on strategic, commercial and operational risks. The ASB found one example where risks and uncertainties were not discussed in the directors' report. The company in question had omitted the relevant section of its narrative reporting from the director's report by use of an inaccurate cross reference.

3.13 In some other instances, the ASB found that companies reported a high number of risks. The number of risks described ranged from 4 to 33. Given that the requirement is for a description of **principal** risks, companies need to consider what these actually are, rather than simply providing a list of all the possible risks they may face. This is a key feature identified in the PwC report. PwC note that the some 57 per cent of companies with March 2006 year-ends identify their principal risks, up from 22 per cent of those surveyed with year ends between March 2005 and February 2006. The Virtuous Circle also highlighted the need for a distinction between risks and principal risks.

3.14 The Black Sun report also noted that companies have found uncertainties more difficult to identify and report on. In its sample, the ASB found that companies were providing their risk and uncertainty information in different places in the annual report. From the sample, 2 companies provided their risk information in the Corporate Governance section with appropriate cross-referencing to the directors' report, 15 provided the information in their principal narrative section (OFR or Business Review) with appropriate cross-referencing to the directors' report, 5 provided the

information in the directors' report and 1, as outlined above, omitted the information by use of an inaccurate cross-reference.

A balanced and comprehensive analysis

3.15 The current legal requirement is that the business review 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 that year, consistent with the size and complexity of the business'. The ASB has interpreted this as being the requirements for the backward-looking part of the Business Review. Accordingly, the ASB has assessed this requirement in line with the recommendations in the Reporting Statement covering the current development and performance of the company (assessed in paragraphs 2.21 to 2.23) and the financial position (paragraphs 2.36 to 2.43).

3.16 The ASB has found 'balance' a difficult area to assess, unless a reader has a very good knowledge of the development and performance of the company throughout the period covered by the Business Review or OFR. A number of companies included in the ASB sample faced some high-profile and well-publicised 'challenges' during the financial year, which the ASB found have been covered in their narrative reporting, so achieving 'balance' in terms of strict legal compliance, even if – in a number of instances – the prominence given to such events could be questioned.

3.17 The sample results revealed a high level of compliance with 74 per cent of companies reviewed achieving a Good or Best Practice score when assessed against the current development and performance recommendations of the Reporting Statement. Some 57 per cent of companies achieved Good or Best practice results when reviewing for compliance with the recommendations of the Reporting Statement concerning financial position.

Financial KPIs

3.18 The law requires that, 'to the extent necessary for an understanding of the development, performance and position of the business', the Business Review must include analysis using financial KPIs. The ASB has assessed how companies have met the financial KPIs 'to the extent necessary' requirement against the similar recommendation in the Reporting Statement (paragraphs 38-40).

3.19 The results are summarised in Section 2 (paragraphs 2.51 to 2.54). In terms of compliance with the law, the ASB found that 52 per cent of the companies surveyed are disclosing what they term financial KPIs. This is on the basis of disclosure alone and not on any assessment of quality (which is dealt with in Section 2). Some 3 companies have not provided any financial performance information in terms of indicators or measures, although even here it is difficult to conclude, without further analysis, that they are not complying with the law, given that the requirement is disclose financial KPIs 'to the extent necessary'. The lack of inclusion of financial KPIs in a Business Review in the future will provide the FRRP with a possible indicator that the Review may not be compliant with the law.

3.20 Black Sun argue that the use of financial KPIs ought not to pose any difficulty, given the strength of financial reporting systems within companies, but they found that only 57 per cent of companies specifically identified financial KPIs in their annual reports. The Deloitte survey found that 45 per cent of companies, formally adopting or clearly recognising OFR principles, disclosed KPIs, but without providing a breakdown between financial and non-financial KPIs. Many other companies are providing a good deal of data and indicators, but not labelling them KPIs.

Non-Financial KPIs

3.21 The law requires that, 'to the extent necessary for an understanding of the development, performance and position of the business', and 'where appropriate', the Business Review must include analysis using non-financial KPIs. The ASB has assessed how companies have met the non financial KPIs 'to the extent necessary' requirement against the similar recommendation in the Reporting Statement (paragraphs 38-40).

3.22 The results are summarised in Section 2 (paragraphs 2.55 to 2.58). The ASB found that, in common with the other reports, this has proved to be an area that companies have found to be one of the most challenging. The requirements are, as noted above, caveated and many companies may have concluded that this is an area that falls currently into the 'too difficult' category. Black Sun found only 26 per cent of companies identifying non-financial KPIs, with 52 per cent of companies failing to provide any non-financial performance information. As the Black Sun report concludes, companies 'have a considerable way to go to develop their non-financial analysis and articulate its relevance to investors'.

3.23 In terms of compliance with the law, the ASB found that 39 per cent of the companies surveyed are disclosing what they term non-financial KPIs. This is on the basis of disclosure alone and not on any assessment of quality (which is dealt with in Section 2). Some 8 companies have not provided any non-financial KPI information, although even here it is difficult to conclude, without further analysis, that they are not complying with the law, given that the requirement is disclose non-financial KPIs 'to the extent necessary' and 'where appropriate' for an understanding of the business. Again, the lack of inclusion of non-financial KPIs in a Business Review in the future will provide the FRRP with a possible indicator that the Review may not be compliant with the law.

Annual accounts: additional references and explanations

3.24 The law requires that, where appropriate, the Business Review must include references to, and additional explanations of, amounts included in the annual accounts. The ASB has assessed this requirement in particular in line with the recommendations in the Reporting Statement covering resources (paragraphs 50-51) and the financial position (paragraphs 60-74).

3.25 The results are summarised in Section 2 (paragraphs 2.27 to 2.31 and 2.36 to 2.43). The ASB's sample results revealed that the area of the Reporting Statement covering resources was generally not well covered with only 30 per cent of the sample achieving a Good or Best practice score. As noted above, 57 per cent of companies achieved Good or Best Practice results when reviewing for compliance with the recommendations of the Reporting Statement concerning financial position.

Forward-looking information

3.26 The requirement in Schedule 7 (paragraph 6) of the Companies Act 1985 that the directors' report shall contain an 'indication' of likely future developments in the business of the company is one which predates the business review requirements introduced in 2005. The ASB has assessed this requirement in particular in line with the recommendations in the Reporting Statement covering strategy and objectives (paragraphs 33-37) and future development and performance (paragraphs 47-49) (although other parts of the Reporting Statement are relevant for disclosing forward-looking information in line with best practice). Neither area is strictly speaking an explicit legal requirement, as they suggest more than an 'indication' of future development.

3.27 As the Black Sun report notes, companies are finding the provision of forward-looking information 'challenging', notably due to fears of liability, but there is significant evidence of companies willing to offer some form of forward-looking information, accompanied by appropriate (legal) caveats. The Deloitte survey found that 74 per cent of OFRs surveyed were forward-looking, a marked increase from 38 per cent in their 2005 survey. The results of the ASB survey are summarised in Section 2 (paragraphs 2.17 to 2.20 and 2.24 to 2.26). The ASB has found better disclosures relating to companies' strategies and objectives than specifying future developments. The PwC and Deloitte analyses reveal similar high levels of references to strategies and objectives (see paragraph 2.20). Radley Yeldar found that while most companies do, at least, include some strategic content in their reports, the quality and value of that content varies greatly.

3.28 But in terms of compliance with the law, the requirement is simply that the directors' report should contain an 'indication' of likely future developments. Of the 23 reports in the sample, all 23 do contain such an 'indication', although as noted above this is a very low threshold. For quoted companies, the legal hurdle will increase when the Companies Act 2006 comes into force, with the requirement for the Business Review to include the main trends and factors likely to affect the future development, performance and position of the business.

Conclusions

3.29 The overall conclusions of this aspect of the review are:

In terms of compliance with the current legal requirements, we found the reporting by companies on the following specific areas needs to be improved:

- The legal requirement is for companies to describe their **principal** risks and uncertainties. Companies need to assess carefully what are their principal risks and uncertainties, rather than simply provide a long list of all possible risks and uncertainties.
- Many companies are finding the disclosure of KPIs, both financial and non-financial, challenging. While the requirement to disclose KPIs is a matter of judgement for the directors, the lack of inclusion of any KPIs in a Business Review in the future will provide the FRRP with a possible indicator that the Review may not be compliant with the law.
- The disclosure of forward-looking information is also proving to be a challenge. All the companies surveyed met the current legal test of giving an 'indication' of likely future developments, but the legal requirement will increase in the future and companies will need to prepare themselves to be ready to disclose more forward-looking information.

We were also able to draw the following overall conclusions;

- Companies are in general complying with the legal requirements for the Business Review.
- In meeting their legal requirements, companies need to take care that there is appropriate cross-referencing in the directors' report to ensure compliance with the law.
- All companies surveyed are providing a 'fair review' of their business, but – as noted above – they need to take care that it is incorporated into the directors' report by appropriate cross-referencing.
- There is a legal requirement for a 'balanced' analysis and in considering 'balance' companies need to assess what the prominence should be of reporting 'bad' news, where appropriate.

Appendix A - The shifting legal and regulatory background

A short history

A1 There has for some considerable time been a recognition that financial statements do not meet all the information needs of users and that there is a need for the provision of other information to shareholders giving details of a company's performance and prospects. This was, for example, a conclusion of the report published in 1992 by the Committee on the Financial Aspects of Corporate Governance ('the Cadbury Committee'). The Cadbury Committee recommended that directors should pay particular attention to their duty to present a balanced and understandable assessment of their company's position. The Committee also recognised that there would be an advantage to users if they were provided with some explanation of the factors likely to influence a company's future progress. This could be met by the provision of an essentially forward-looking OFR, a first statement which was being developed at that time by the ASB.

A2 The ASB originally issued the Statement 'Operating and Financial Review' in July 1993. The Statement built on the foundations of existing best practice by providing a framework within which directors could discuss the main factors underlying the company's performance and financial position. The Statement was updated and a revised version issued in January 2003 to reflect later improvements in narrative reporting.

A3 Following a recommendation in the final report of the Company Law Review (CLR) Steering Group (2001) and the Government response on the White Paper 'Modernising Company Law' (2002), the Government decided to require quoted companies to prepare and publish OFRs. In May 2004, the Government issued proposals on the detailed implementation of this new requirement in a consultation document 'Draft Regulations on the Operating and Financial Review and Directors' Report'. The consultation document contained draft secondary legislation to implement a new statutory OFR as well as certain provisions of the EU Accounts Modernisation Directive¹² requiring an enhanced review of a company's business (the Business Review) in the directors' report. Under this Directive, for company financial years starting on or after 1 January 2005, large and medium-sized (but not small) companies will be required to provide "a balanced and comprehensive analysis of the development and performance of the company's business...[which] shall include both financial and, where appropriate, non-financial key performance indicators ... including information relating to environmental and employee matters". Medium-sized companies can be exempted from the latter part of this obligation.

A4 Following consultation, the final OFR Regulations¹³ were passed into law in March 2005, taking effect for financial years beginning on or after 1 April 2005.

¹² Directive 2003/51/EC of the European Parliament and the Council of 18 June 2003 amending Directives 78/660/EEC, 83/349/EEC, 86/635/EEC and 91/674/EEC on the annual and consolidated accounts of certain types of companies, banks and other financial institutions and insurance undertakings..

¹³ The Companies Act 1985 (Operating and Financial Review and Directors' Report etc) Regulations 2005 (Statutory Instrument, SI, 2005/1011).

A5 The Government also gave the ASB a statutory power to make reporting standards for the OFR. In November 2004, the ASB issued Reporting Exposure Draft (RED) 1 'The Operating and Financial Review'. Following consultation, Reporting Standard (RS) 1 was issued in May 2005.

A6 On 28 November 2005, the Chancellor of the Exchequer announced the Government's intention to remove the statutory requirement on quoted companies to publish OFRs, on the grounds that the central requirements of the Business Review are largely identical to those of the statutory OFR and the Government has a general policy not to impose regulatory requirements on UK businesses over and above the relevant EU Directive requirements. Regulations to repeal the requirement for the OFR were laid in December 2005 and came into force on 12 January 2006¹⁴.

The current legal position

A7 The current legal requirements are that all companies, with the exception of small companies, have to provide a business review in the directors' report. The specific requirements are summarised in Appendix D and an assessment of how companies are complying with those requirements is set out in section three of this report.

A8 A further development under the current legislation is that the Financial Reporting Review Panel (FRRP), another operating body of the FRC, will have the legal authority to review directors' reports for compliance with the provisions of the Companies Act 1985 for financial years beginning on or after 1 April 2006. In cases of non-compliance the FRRP will have the power, if necessary to go to the court to compel a company to revise its report.

From Reporting Standard to Reporting Statement

A9 The statutory underpinning for RS 1 was removed as a result of the removal of the statutory requirement for the OFR. As a consequence, the ASB 'converted' RS 1 into a Reporting Statement of best practice on the OFR, which was published on 26 January 2006. In preparing this statement, the ASB has sought to limit the changes to those required as a consequence of the repeal of the OFR legislation and to make the language consistent with a voluntary statement of best practice rather than a standard.

A10 The Reporting Statement sets out what the FRC and the ASB believe to be best practice guidance for companies to follow. The guidance set out in the statement is more specific than the requirements set out in legislation, in particular with regard to forward-looking information. As part of this review, the FRC has assessed how companies are reporting against some of the key provisions of the Reporting Statement. The results of this review are set out in section four of this report.

¹⁴ The Companies Act 1985 (Operating and Financial Review) (Repeal) Regulations 2005 (SI 2005/3442)

And there's more to come...the Companies Act 2006

A11 The Companies Act 2006 received Royal Assent on 9 November. The Act contains a number of further provisions in relation to the Business Review requirements. The Business Review is to be given a statutory purpose, which is to inform the 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:

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

A12 The Act will also require quoted companies to provide additional disclosures that were previously required by the statutory RS1 and are now contained in the Reporting Statement. For quoted companies, their Business Reviews must, to the extent necessary for an understanding of the development, performance or position of the company's business, include:

- a. the main trends and factors likely to affect the future development, performance and position of the company's business;
- b. information about –
 - i. environmental matters (including the impact of the company's business on the environment),
 - ii. the company's employees, and
 - iii. social 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 any of the above in its Business Review it has to state that it has not done so) , and

- c. information about persons with whom the company has contractual or other arrangements which are essential to the business of the company. This provision is subject to a specific exemption concerning disclosure about a person if, in the opinion of the directors, disclosure would be seriously prejudicial to that person and contrary to the public interest.

A13 All companies are to be exempt from disclosing in the Business Review information which, in the opinion of the directors, would be seriously prejudicial to the interests of the company.

A14 The Companies Act 2006 also contains a provision giving directors protection from liability for statements or omissions in – amongst other things - the directors' report. Directors will only be liable for such statements or omissions if such statements are untrue or misleading and are made in bad faith or recklessly, and if such omissions are as a result of deliberate and dishonest concealment of material facts.

A15 The Government's intention is to commence all parts of the Act by October 2008. It is not yet known when the additional provisions relating to the Business Review will be commenced.

International developments

A16 The importance of narrative reporting accompanying the financial statements has long been recognised by regulators and standard-setters in a number of major jurisdictions, for example 'Management Discussion and Analysis' (MD&A) in the United States and Canada, 'Management Reporting' in Germany, and a 'Review of Operations and Financial Condition' in Australia. There are also EU legal requirements for narrative reporting. As noted in paragraph A3 above, the Accounts Modernisation Directive requires companies to present an annual report that provides 'at least a fair review of the development and performance of the company's business and of its position, together with a description of the principal risks and uncertainties that it faces'. In addition, the Transparency Directive¹⁵ requires – from 20 January 2007 – all securities issuers to provide annual and half-yearly management reports. The annual management report must be in accordance with the provisions of the Accounts Modernisation Directive. The half-yearly management report 'shall include at least an indication of important events that have occurred during the first six months and their impact on the financial statements together with a description of the principal risks and uncertainties for the remaining six months of the financial year'.

A17 The International Organisation of Securities Commissions (IOSCO) endorsed disclosure standards in 1998¹⁶, one of which established standards applicable to the narrative information that foreign issuers should provide in documents used in initial offerings and listings of equity securities by foreign issuers. In 2003, IOSCO published its 'IOSCO General Principles Regarding MD&A'¹⁷ to explain the purpose behind MD&A and to note general precautions for issuers when preparing such disclosure.

¹⁵ Directive 2004/109/EC of the European Parliament and the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC.

¹⁶ IOSCO (1998) 'International Disclosure Standards for Cross-Border Offerings and Initial Listings by Foreign Issuers (International Equity Disclosure Standards).

¹⁷ IOSCO (2003) 'General Principles Regarding Disclosure of Management's Discussion and Analysis of Financial Condition and Results of Operations (IOSCO General Principles Regarding MD&A)'.

A18 At a meeting held in October 2002 between the International Accounting Standards Board (IASB) and its partner national standard-setters, it was agreed that work should begin on a project to examine the potential for the IASB to develop standards or guidance for management commentary (MC)¹⁸. There was general acknowledgement that guidance on this topic was needed and that preparers of financial statements were looking to both the IASB and IOSCO (and others) to provide it. The IASB asked the Financial Reporting Standards Board (FRSB) of the Institute of Chartered Accountants of New Zealand to provide staff to lead the project, with further members being provided by staff of the ASB, the Canadian Institute of Chartered Accountants (CICA) and the Deutsches Rechnungslegungs Standards Committee (DRSC).

A19 The project team's report was published by the IASB as a preliminary views discussion paper 'Management Commentary' (MC) in October 2005. The discussion paper set out the views of the project team on which the IASB invited comments to help it consider whether it should add a project on MC to its agenda.

A20 The main conclusion of the MC discussion paper is that the IASB can improve the quality of financial reports by developing a standard on management commentary. The project team's proposals for what such a standard should contain are largely similar to those in the ASB's Reporting Statement.

A21 The comment period for the MC discussion paper closed in April 2006. The paper attracted a total of 117 responses, over 90 per cent of which agreed that MC is an integral part of financial reporting. The project team has prepared an analysis of responses to the discussion paper which is scheduled to be discussed by the IASB and its Standards Advisory Council (SAC) in early 2007.

¹⁸ Initially, the term 'MD&A' was used, but it was noted that different terms were used in other jurisdictions and the generic term 'management commentary' was selected.

Appendix B - Companies within the FRC sample

FTSE 100

3i plc

BAA plc (delisted from the London Stock Exchange 15 August 2006)

Boots plc (from 31 July 2006 merged with Alliance UniChem)

British Airways plc

BT plc

GUS plc (demerged 10 October 2006)

Johnson Matthey plc

Kelda plc

Land Securities plc

Marks and Spencer plc

National Grid plc

SAB Miller plc

Tate and Lyle plc

Vodafone plc

Yell plc

FTSE 250 index

Electrocomponents plc

EMAP plc

EMI plc

Firstgroup plc

FTSE Small Cap index

Fullers Smith and Turner plc

Centaur Media plc

Domestic and General Insurance plc

Hyder Consulting plc

Appendix C - Summaries of recent reports on narrative reporting

Black Sun plc - 'The first 23 - Reporting under the Business Review. Analysis of the 23 March year end FTSE 100 companies (August 2006).

Black Sun is a corporate reporting agency. Each year, Black Sun audits the narrative content of the FTSE 100 annual reports, annual reviews and corporate responsibility reports and benchmarks them against best practice.

This latest report reviews annual reports for compliance with the Business Review requirements set out in the Companies Act 1985, in the following areas:

- Risks and uncertainties;
- Financial KPI's;
- Non-financial KPIs; and
- Forward looking information.

Black Sun has also used the principles provided in the ASB's Reporting Statement as a guide to identify best practice communications.

Data Used and Scoring Methodology

Black Sun has analysed the annual reports of the 23 FTSE 100 companies with 31 March 2006 year ends.

The companies have been scored based on an assessment of how well they communicated their performance against each of the above four areas:

- Very poor communication;
- Poor communication;
- Fair communication;
- Good communication;
- Best Practice communication (at a level consistent with the guidance outlined in the Reporting Statement).

Results

The analysis confirms the potential of a new and improved disclosure, reporting and communications regime emerging.

- 11 out of 23 companies (48 per cent) use the term OFR to describe their narrative, with 6 companies referring specifically to following the principles in the Reporting Statement;

- 9 companies (39 per cent) explain their commitment, aims and approach to narrative reporting;
- two companies (Land Securities and National Grid) are identified as examples of overall best practice, with good to best practice embodied by two more (Kelda Group and Tate and Lyle);
- the greatest improvement in communication is in the area of risks and uncertainties (74 per cent of companies dedicating between 2 and 10 pages to discussing 'risk') – with the majority of companies starting to go beyond traditional risk reporting to provide greater insight into the risks and uncertainties confronting their businesses and how these may affect long-term value;
- overall KPIs – the majority of companies are producing 'poor' or 'fair' communication about KPIs, although – encouragingly – there are two leadership companies (National Grid and Land Securities) emerging at the best practice end of the spectrum, viewing their financial and non-financial KPIs as integral to business success and clearly linking them to strategy and business objectives;
- financial KPIs – again the majority are producing 'poor' or 'fair' communication about KPIs, although Kelda Group and 3i Group are identified as examples of good and best practice respectively;
- non-financial KPIs is an area where companies are struggling to achieve the same performance as with their financial reporting - 26 per cent of companies are specifically identifying non-financial KPIs, but 52 per cent are failing to provide any non-financial performance information. There is a greater disparity between those performing well and those performing badly than in any other area;
- forward-looking information is the other aspect that companies are finding most challenging, with narrative reporting in this area not well developed. Only 13 per cent of companies are featuring 'forward-looking' information in the contents; 17 per cent of companies treat forward-looking information as a separate section; and 26 per cent of companies discuss forward-looking information by division. No best practice examples were found.

Conclusion

Despite the difficulties encountered by some companies, many have demonstrated their willingness, and ability, to strengthen their narrative reporting performance. Black Sun see better narrative reporting as an opportunity, not an obligation, but accept that big practical challenges remain, in particular:

- proving a logical narrative flow between different parts of the annual report so that the 'investment proposition' reads persuasively and coherently;
- accommodating the accompanying changes in the reporting framework and structure; and
- ensuring that communication is clear, meaningful, business-focused and investor-relevant.

Radley Yeldar – ‘Narrative reporting content in the FTSE 100 - how does it stack up?’ (September 2006-Complete FTSE 100 update)

Radley Yeldar is a corporate reporting agency. Radley Yeldar has an on-going programme to lead thinking in the corporate reporting field. As part of this programme, Radley Yeldar monitors best practice reporting and has published a number of reports on this.

The latest report reviews the annual reports of all FTSE 100 companies, which have a range of year-ends (many pre-dating the enhanced Business Review requirements). Radley Yeldar have assessed all the reports against eight key areas of the ASB’s Reporting Statement, plus two communication criteria. The areas reviewed were:

- Business overview;
- Strategy;
- Marketplace;
- Key Performance Indicators (KPIs);
- Forward Looking information;
- Risk Management information;
- Environment and Social;
- Employees;
- Navigation; and
- Appeal.

Data Used and Scoring Methodology

All 100 annual reports of companies within the FTSE 100 were reviewed. The performance of companies in each area was graded between 1 and 10 with indications given in the report of what was required for top marks. The scores of the ‘Top Twenty’ companies are listed.

Results

The overall analysis has found that the Business Review legislation has made no difference to the FTSE 100 narrative reporting content. Many FTSE 100 companies are already exceeding the base level of the legal requirements. There has been some increase in the number of KPIs clearly reported, but Radley Yeldar comment that this could equally be a reflection of the type of companies with March year-ends.

In terms of more detailed results:

- 43 per cent of companies name their principal narrative report as an OFR;
- areas that Radley Yeldar note as “Good Work” by companies are their explanations of the business upfront, strategic content/objectives, improved marketplace discussions, and an increase in reporting on KPIs;

- the best reports –
 - provide some form of narrative and graphical explanation of their businesses;
 - do not just identify strategies, but explain why the companies are following them, how they are managing the business, and how those strategies affect the performance of the business;
 - include detailed information on trends in key markets, what this means for the business and how the company is reacting to those trends;
 - give a clear definition of the KPIs, both financial and non-financial, with a link to strategy and some insight as to why they have been chosen;
- areas that Radley Yeldar included in their “Could do better section” were the need for a clear investment message, more reporting of non-financial KPIs, more forward-looking information, linking strategy to measurement, and a tendency to report on corporate social responsibility (CSR) as an afterthought;
- forward-looking information was found to be the most challenging area ,with marketplace discussion the easiest;
- a common mistake among companies is to mention the importance of staff in the Chairman’s statement and then make virtually no other reference to employees throughout the annual report

Deloitte – ‘Write to reason: Surveying OFRs and narrative reporting in annual reports’ (October 2006)

This report sets out the details of Deloitte’s latest survey of narrative reporting by listed companies. Deloitte have been reviewing practice in this area since 1996. The 2006 survey was prompted by a desire to discover how companies have responded to the changing regulatory landscape

The main objectives of the survey were to discover;

- what narrative reporting listed companies have provided in their annual reports;
- how disclosures varied depending upon the size of the company;
- to what extent companies have adopted the recommendations in the ASB’s Reporting Statement;
- how companies perform in the context of meeting the new requirements of the Companies Act 1985 to provide an enhanced business review within the directors’ report; and
- how the results compared with the earlier surveys performed by Deloitte in 2005, 2003, 2000 and 1996.

Data Used and Scoring Methodology

The annual reports of 100 listed companies were reviewed, spread evenly between the largest 350 companies by market capitalisation, the smallest 350 by market capitalisation and those in the middle. The annual reports used were those that were most recently available for the sample companies and published in the period 1 August 2005 to 31 July 2006. No scores are given for the companies surveyed, but – instead - details are provided of the percentages of the sample complying with various requirements and recommendations.

Results

The highlights from the Deloitte survey are:

- the increasing length of annual reports, with an average of 85 pages for the 2006 survey, almost double the 45 page average in 1996;
- only 20 per cent of the companies surveyed presented a formal OFR. While this might seem shocking at first glance, the Deloitte view is that it does not mean that the information content in annual reports has declined, but is more likely to result from the compliance risk of producing a report called an ‘OFR’;
- 76 per cent of companies either prepared a formal OFR or showed a clear recognition of the OFR;
- 74 per cent of those companies disclosed information concerning principal risks and uncertainties, compared with 54 per cent in the prior year. Of those 39 per cent focused only on financial risks, without also covering strategic, commercial and operational risks.

This issue will become more significant when the Transparency Obligations Directive, requiring disclosures on all principal risks and uncertainties in the half-yearly report as well as the annual report, is implemented;

- coverage of key non-financial aspects of the business in the annual report has improved dramatically, with 95 per cent of the relevant companies discussing their employees (up from 67 per cent in 2005), and 84 per cent discussing the environment (54 per cent in 2005);
- 45 per cent of companies formally adopting or clearly recognising OFR principles presented KPIs (although this result improved to 88 per cent when only the FTSE 100 companies in the sample were considered). Of those companies that disclose KPIs, the average number is six, with the average number of non-financial KPIs being two;
- information about the future is improving but is still patchy. 59 per cent of relevant companies commented on trends that were expected to affect future performance. The anticipated clarity on directors' liability for their report, in the forthcoming Companies Act 2006, should encourage more forward-looking disclosure, when the law comes into effect;
- 24 of the companies reviewed were required to produce an enhanced business review and of these 22 satisfied the requirement by cross-referring from the directors' report to other areas of the narrative report.

Conclusion

Deloitte conclude that: "The introduction of the statutory EBR, the changes in the forthcoming Companies Act 2006 and the introduction of the Transparency Obligations Directive into the UK will ensure that narrative reporting receives continuing scrutiny over the next few years. Writing to reason will, it is hoped, remain the norm for the bulk of narrative reporting so that directors can faithfully write their own account of the business".

The Virtuous Circle - 'Preparedness for the new corporate reporting requirements: A study of FTSE200 Business Reviews and a consideration of their readiness for the new Companies Bill' (October 2006)

The Virtuous Circle (TVC) is a specialist consultancy, operating in the fields of corporate social responsibility (CSR), non-financials, risk management and communications.

TVC have reviewed compliance with the current statutory Business Review requirements, but have also assessed the extent to which companies have built an informed picture of the business for the shareholders and investors, as a means of developing a view of best practice narrative reporting.

Data Used and Scoring Methodology

TVC reviewed the annual reports of 25 listed companies with 31 March 2006 year-ends: 4 FTSE 30, 12 FTSE 100 and 9 FTSE 250. As part of their study, TVC evaluated compliance against the statutory Business Review requirements using a framework that included a ten point scoring system. Individual scores have not been revealed, but overall compliance scoring by the companies has been disclosed. TVC have grouped companies by whether they are asset rich (in sectors such as utilities and real estate) or people rich (in sectors such as retail, media and financial).

Results

TVC found that 48 per cent of the companies surveyed produce an OFR, rising to over 50 per cent for companies in the FTSE 30 or FTSE 100. TVC note that some companies had both a Business Review and an OFR, which illustrates some confusion.

TVC's overall impression is that the Business Review has been drawn together from a series of silo functions, with inadequate alignment between description of the business segments, the strategy and outlook, the risks and the KPIs used to manage the business.

Companies producing an OFR had a better compliance with the statutory Business Review requirements (around 70 per cent) than those that produced a Business Review (64 per cent). A higher level of compliance was achieved by FTSE 30 companies, than those in the FTSE 100 and FTSE 200.

On the detail:

- FTSE 30 companies produce longer reports than the others;
- bearing in mind a requirement is to offer further explanation to the accounts, only about a third of companies have done so (around 50 per cent of the FTSE 30, but only 10 per cent of the FTSE 200). Asset rich companies are better at providing additional explanations (around 45 per cent) than people rich ones (just over 20 per cent);
- very little explanation has been provided about the purpose of the Business Review;

- companies have generally been good at providing a 'fair review' of the business, but less good in giving a 'balanced and comprehensive analysis'. The TVC view is that this analysis should incorporate disclosure of the companies' strategies and to the future outlook for each business area;
- risks have been reported by nearly all the companies surveyed, although they tended to be little more than a list. Very few companies have reported upon their mitigation actions related to each risk area, although where they have done so, it tends to be a very effective description of how the management is handling each risk area. The average number of risks identified is 11, with a maximum of 33, with people rich companies identifying more than asset rich ones;
- KPIs have clearly caused companies problems, with too few appearing to identify key measures. Too often, there is a surfeit of data, but nothing that could be described as an indicator of performance;
- on average, companies have reported 2 financial and 5 non-financial KPIs, although the maximum was 33 non-financial KPIs, and 14 for financial KPIs;
- asset rich companies have identified more KPIs (both financial and non-financial) than people rich ones;
- in terms of quality, very few companies have reported more than 2 years' data for KPIs.

Conclusion

The obligation to produce a comprehensive Business Review is going to place a new responsibility and workload on preparers, but analysts and investors are going to rely increasingly on these Reviews to supplement the mainly financial information on which they have relied in the past.

The Business Review offers the opportunity 'to give a full and fair portrayal of the company's strategy and performance. It is likely, in time, to become a very significant tool in investor relations, to ensure that a true appreciation of shareholder value is achieved'.

TVC also offer some advice on how companies can prepare for the production of their Business Reviews, both now and for when the new legal requirements come into force.

PricewaterhouseCoopers (PwC) – ‘Show me more than the money. An assessment of how prepared companies are for the business review’ (November 2006)

PwC have been reviewing and reporting on good practices in corporate reporting for a number of years. Good practice examples from around the world have been published in annual ‘Trends’ documents, structured around the PwC ValueReporting Framework, which is the codification of around a decade of capital markets research into the information needs of management and investors.

The objective of PwC’s latest survey was to understand if, and how, the new requirements for the business review in the Companies Act 1985 and recommendations in the ASB’s Reporting Statement would have an on how companies report. The survey focuses on four key areas:

- a description of the business environment in which the company operates;
- a clear description of company strategy;
- KPIs; and
- identification of the principal risks and uncertainties.

Data Used and Scoring Methodology

PwC analysed a total of 124 companies’ annual reviews and reports. The companies selected were chosen using a random sampler tool on a complete list (excluding investment trusts) of UK listed companies sorted by market capitalisation. The sample comprised: FTSE 100 – 16 companies, Mid-cap 28, Small cap 80. The reports had a financial year end between March 2005 and February 2006 from which PwC aim to provide a baseline reference point to allow tracking of reporting as it responds to regulations and best practice. On top of the baseline analysis, PwC analysed 28 reports with March 2006 year-ends. No scores are given for the companies surveyed, but – instead – details are provided of the percentages of the sample complying with various requirements and recommendations.

Results

The highlights from the PwC survey are:

- in the baseline analysis, a large number of companies (94 per cent) provide some description of their business environment, rising to 100 per cent of the March 2006 year-ends;
- however, far fewer detail their specific competitive, macro-economic and regulatory trends;
- 42 per cent of companies providing a description of their business environment give qualitative forward-looking information on markets, but only 10 per cent give quantitative forward-looking information;
- an increasing number of companies are communicating their long-term objectives: 69 per cent of the baseline survey, rising to 89 per cent of the March 2006 year-ends;

- the number of companies that provide a description of their short-term priorities remains about the same: 77 per cent of the baseline survey, 75 per cent of the March 2006 year-ends;
- however, fewer companies explain the rationale of their strategy or provide progress on how it is implemented, and fewer still (only 4 per cent) highlight the measures used to track the achievement of strategic goals;
- an increasing number of companies are (i) reporting that they use KPIs as a tool to assess performance: 32 per cent of the baseline survey, rising to 75 per cent of the March 2006 year-ends and (ii) reporting their KPIs: 19 per cent of the baseline survey, rising to 57 per cent of the March 2006 year-ends;
- however, very few companies link the KPIs they report to their strategic objectives: 11 per cent of the baseline survey, rising to 25 per cent of the March 2006 year-ends;
- the overwhelming majority of KPIs are financial;
- the number of companies identifying their principal risks and uncertainties has risen: 22 per cent of the baseline survey, rising to 57 per cent of the March 2006 year-ends, but over one-third of companies still fail to do so;
- a 'boilerplate' approach exists in many cases, with some companies providing a generic list of all risks;
- traditional financial risks are the most commonly disclosed, although few companies quantify the potential impact of risks they face.

Conclusion

PwC conclude that there are still key areas of weakness, although the results of the analysis of the companies with March 2006 give a position indication that companies may begin to provide fuller disclosure. For those that have done this, the next challenge is to demonstrate the links between strategy and the management actions taken to deliver it, along with disclosure of the quantified measures and indicators that track the achievement of strategic goals. As the regulations bite, best practices emerge and market demand becomes stronger, PwC expect to see marked improvement and progress in reporting in key areas.

Appendix D - Summary of current legal requirements for the business review

1. Business review identified as part of the Directors' report (CA 1985, Section 234(1))
2. A fair review of the business of the company (Section 234ZZB (1)(a))
3. A description of the principal risks and uncertainties facing the company (Section 234ZZB (1)(b))
4. 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 that year, consistent with the size and complexity of the business (Section 234ZZB (2)(a) and (b))
5. The review must, to the extent necessary for an understanding of the development, performance and position of the business, include analysis using financial KPIs (Section 234ZZB (3)(a))
6. 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 (Section 234ZZB (3)(b))
7. The review must, where appropriate, include references to, and additional explanations of, amounts included in the annual accounts of the company (Section 234ZZB (4))
8. As part of the duty to prepare such a report, the directors' report shall contain an indication of likely future developments in the business of the company (Section 234 and Schedule 7, paragraph 6(1)(b))

ISBN: 978-1-84140-907-8

© The Financial Reporting Council Limited



FINANCIAL REPORTING COUNCIL

5TH FLOOR

ALDWYCH HOUSE

71-91 ALDWYCH

LONDON WC2B 4HN

TEL: +44 (0)20 7492 2300

FAX: +44 (0)20 7492 2301

WEBSITE: www.frc.org.uk