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An assessment of how prepared companies are for the business review

Contents

Getting the basics right

Insight. Clarity. Quantified measures and targets. Forward-looking analysis. These are just some of the key elements that investors want to find in corporate reports. The corporate reporting landscape in the UK is evolving and whilst the OFR may have been abandoned, the business review regulations and developing good practices will maintain the drive for companies to meet the needs of investors. But how prepared are quoted companies to meet the requirements of the business review legislation and where can they improve?

Our approach

With the requirements of the business review regulations and best practice recommendations from the Accounting Standards Board's (ASB) 'Reporting statement: Operating and financial review' as a guide, PricewaterhouseCoopers looked at a random sample of annual reports from quoted companies. Our objective was to understand if, and how, the new requirements and recommendations would have an impact on how companies report. Accordingly, our survey focused on the reporting of companies for the year prior to the regulations coming into effect (March 2006 year ends). However, a sneak preview of companies who have reported under the new legislation has provided us with a glimpse of whether they've had an impact.

This publication focuses on how the following four key areas of information in particular were reported:

- A description of the business environment in which the company operates.
- A clear description of company strategy.
- Key performance indicators (KPIs)[1].
- Identification of principal risks and uncertainties[1].

Whilst only two of these areas, KPIs and principal risks and uncertainties, are explicit requirements of the business review, PricewaterhouseCoopers capital markets research clearly shows that a description of the business environment and strategy are critical in providing the information necessary to put KPIs and risk into context. All four are key elements of the ASB's best practice statement.

An underlying theme of our analysis was the extent to which companies adopt a forward-looking view of factors likely to influence performance, a proposed amendment in the forthcoming Companies Act 2006[2].

1 Companies Act 1985, Section 234ZZB

2 Formerly known as the "Company Law Reform Bill" and expected to receive Royal Assent in November 2006.

Falling short in key reporting areas

While most companies provide information about their competitive environment and an indication of strategy, few have really grasped the nettle when it comes to providing detailed disclosure and description of KPIs, principal risks and uncertainties and a view of the future. In short, the key areas of weakness that our survey identifies are or will be, explicit regulatory requirements for all quoted companies.

Signs of progress

The majority of companies still need to tackle the basics in terms of identifying and reporting their principal risks and KPIs. Interestingly, our brief glimpse at companies with year ends that fall under the new regulations (March '06) gives a positive indication that we may begin to see 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.

A way forward

As the regulations bite, best practices emerge and market demand becomes stronger, we would expect to see marked improvement and progress in reporting on the key areas that the survey identifies as largely absent today. We hope that the content of future surveys will reflect the progress that companies are making.

Our Sample

By providing a baseline analysis of reporting for companies with a financial year from March '05 to February '06 we aim to create a reference point that will allow us to track reporting as it responds to regulations and best practice.

A total of 124 companies' annual reviews and reports were analysed. The companies selected were chosen using a random sampler tool on a complete list (excluding investment trusts) of UK listed companies sorted by market cap. The sample comprised:

FTSE 100	16
Mid cap	28
Small cap	80

Giving investors a view of the business environment

Business environment in brief

Our analysis shows:

- A large number of companies provide some description of their business environment
- Far fewer detail specific competitive, macro-economic and regulatory trends
- One third give some insight into trends and factors, but very few quantify these

What we recommend:

- Provide a clear section on trends and factors impacting the business environment both now and in the future
- Give an analysis of relevant competitive, regulatory and macro economic forces
- Support statements with quantified information
- Use externally-sourced supporting data where appropriate

What's required?

Whilst the business review itself remains silent on this area, a description of the business environment is a key part of the ASB's best practice recommendations:

> The OFR should include information on "the nature of the business, including a description of the market, competitive and regulatory environment in which the entity operates…"
> Accounting Standards Board's Reporting statement: Operating and financial review

Our approach

PricewaterhouseCoopers believes that to understand and evaluate a company's strategy and performance, a clear grasp of its business environment is needed.

We looked for a clear discussion of a company's business environment, including how competitive, regulatory and macro influences were identified and discussed. We also examined whether there was any outlook on likely trends and the impact they may have on the business and whether these trends were quantified.

What we found

The vast majority of companies refer to their business environment and how changes either have had an impact on, or are likely to influence, performance. Some 94% of companies describe their business and what it does and over 80% of all companies surveyed go further and describe the markets in which they operate, as well as providing information relating to specific trends.

But, and it is a large 'but', few analyse in detail or quantify the external factors with which investors and other stakeholders can develop their views of how a company may perform. Too many companies appear to believe that by describing the market as "competitive" or their prospects as "good" that they are providing sufficient and useful information.

Unfortunately a more detailed description of the market and the competitive, regulatory and macro economic trends impacting upon it is provided by a much smaller number of companies. Fewer than half discuss macro economic trends, and only 39% include any discussion of the regulatory environment in which they operate, with even fewer (36%) providing any detailed analysis of their competitive environment.

Looking to the future

Investors want to build a view of the trends and factors likely to have a bearing on performance in the future. Our findings show that companies have some way to go before they satisfy those recommendations.

We found that:

- 42% of companies providing a description of their business environment provide qualitative forward-looking information on markets.
- However, only 10% provide quantitative forward-looking information.
- Even fewer, only 8%, of companies providing a description of their business environment provide both qualitative and quantitative information on future trends and factors impacting their market place.

Few analyse in detail or quantify the external factors

Providing a view of strategic direction

Strategy in brief

Our analysis shows:

- Most companies include a statement on their objectives/strategies
- Fewer explain the rationale of the strategy or provide progress on how it is implemented
- Fewer still highlight the measures used to track the achievement of strategic goals

What we recommend:

- Give a clear description of strategy – it is the foundation of effective corporate reporting
- Provide a rationale and the time frame and manner in which it will be implemented
- Use quantified targets and key measures to track progress

What's required?

Though not an explicit requirement of the business review, the ASB's reporting statement and PricewaterhouseCoopers extensive capital markets research both firmly support the idea that a description of business objectives and strategy is essential.

Further, the Department of Trade and Industry (DTI) also encourages companies to report on their strategy:

> "The business review would include information on objectives, strategies…where necessary to provide a fair review of the company." – DTI, 'Invitation for comments on the business review'

By understanding the strategy that companies will deploy to achieve their objectives, users are able to gauge the relative success of management over time. Further explanation of the measures used by management to assess progress enhances the report's usefulness. Such a description provides the foundation on which all content should be based when reporting performance.

Our approach

We believe that a company's objective should be a clear, simple articulation of the goals it wishes to achieve and the time frame it has set in which to do so should underpin the whole narrative section of the report, helping readers to form a view of the resources needed and the manner in which they will be managed to achieve success.

What we found

The vast majority of the companies surveyed (69%) include some reference to their longer-term objectives/strategies. Even more, 77%, present information about their short-term strategic priorities. However, they were not always easy to find as only 53% of companies clearly signpost their strategy either by including a page or subject heading entitled "strategy", or equivalent term.

A mere 4% of the companies give more detail about the underlying critical measures they have in place

Only a small proportion of these companies elaborate with more detailed explanation and analysis. For example, only 18% of companies who identify individual business segments describe the short-term strategy for each of them.

Having identified their objectives/strategies it is important that companies clarify the specific targets management have set themselves and how they expect to measure progress towards them. Unfortunately our findings suggest that most reports fail to provide such clarity:

- Less than one-fifth (16%) go further than simply stating, for example, that they want to achieve sustainable sales growth and quantify the specific targets that they have for stated objectives.
- A mere 4% of the companies that provide a strategic statement give more detail about the underlying critical measures they have in place to assess progress. For example, where a stated objective may be to create maximum value for shareholders the company goes further than reporting their total shareholder return (TSR) performance to identify what the company believes are the most appropriate internal measures to assess progress towards this objective e.g. free cash flow, or return on invested capital.

Looking to the future

By identifying objectives and strategies, companies have by definition, begun to adopt a forward-looking orientation in their reporting. However, only three companies made any historic reference to previous forward-looking statements and whether expectations had been met.

Cautionary statements

In light of recent high-profile debate over directors' liability we thought it would be interesting to see how many companies already provide some form of cautionary statement in their annual report regarding forward-looking information. Surprisingly 18 companies did. Given standard practice in the US it would seem an obvious assumption that most of these companies are SEC registered but interestingly only half were. However we would expect to see an increase in these statements if, as expected, the proposed amendments to reintroduce the requirements to include forward-looking information in company law reform go through.

Explaining the measures of success

Key Performance Indicators (KPIs) in brief

Our analysis shows:

- KPIs are provided by only one-fifth of companies
- KPIs are often not clearly identified or it is left to the reader to determine what they are
- Very few companies link the KPIs they report to their strategic objectives
- The overwhelming majority of KPIs are financial

What we recommend:

- Clearly identify both financial and non-financial KPIs
- Provide clear links between strategic objectives and KPIs reported
- Use KPIs to enhance the exploration of underlying business performance

What's required?

KPIs are an explicit requirement of the business review as well as an integral part of the ASB's reporting statement.

> "The review must, to the extent necessary for an understanding of the development, performance or position of the business of the company, include
>
> (a) analysis using financial key performance indicators, and
>
> (b) where appropriate, analysis using other key performance indicators, including information relating to environmental matters and employee matters."
> – Directors' report: business review (CA85 Sec 234 ZZB)

KPIs provide users with a vital tool to focus on the 'measures that matter' and should represent the measures that management uses to assess strategic success. The breadth and depth of information in annual reports and reviews can make it challenging for the reader to focus on the specific measures that provide the keenest insight into performance.

Our approach

We believe that KPIs need to be mentioned explicitly or described in similarly clear terms and thus looked for this, whether as a separate heading or elsewhere in the text. We also looked for quantified information regarding performance and trend data that show performance over time.

What we found

Our survey shows that companies are largely not using KPIs to provide users with a clear view of the 'measures that matter', despite it being an explicit requirement of business review legislation.

Only one fifth of all companies surveyed positively identified their KPIs

i) Reporting KPIs

Only one-third of all companies surveyed (32%) mention that they use KPIs as a tool with which management assesses performance. Even more disappointing is the finding that only half of these (or less than one fifth of all companies surveyed) positively identified their KPIs. The average number of KPIs disclosed by these companies was five, and these were overwhelmingly financial in nature, with nearly two-thirds of those reporting KPIs disclosing traditional financial measures:

- 50% had an EPS measure.
- 28% disclosed return on capital employed.
- 11% disclosed turnover.

Supporting data was also mixed:

- Purpose of KPIs - Explaining the purpose of a particular indicator helps a reader to understand its relevance in assessing performance. Of those companies using KPIs 43% provide this additional explanation.
- Historical trend analysis - It is critical for building an expectation of future performance that companies provide prior year data, encouragingly, 78% do.
- Definitions of KPIs – These are critical to an understanding of the metric and in order to facilitate comparisons with other companies. However these were provided by just 22% of companies.

ii) Link to strategy

Overall, we found little evidence of KPIs being clearly linked with strategic priorities. Only 11% of those companies surveyed demonstrated such linkage.

For example, while KPIs associated with environmental performance, customers and people were the most commonly cited non-financial measures, their inclusion is at odds with stated strategies. Environmental KPIs for example were provided by nine companies, but only one of those included environmental performance as a key strategic objective.

Looking to the future

Of those companies that do provide KPIs, only 22% provide associated performance targets. However, of those, 80% quantify those targets. This suggests that once a company becomes comfortable with providing a target, quantification becomes a less daunting prospect.

Identifying and quantifying the risks to success

Principal risks and uncertainties in brief

Our analysis shows:

- Few companies identify their principal risks and uncertainties
- A boilerplate approach predominates
- Traditional financial risks are the most commonly disclosed
- Few companies quantify the potential impact of risks they face

What we recommend:

- Clearly identify the principal risks and uncertainties
- Describe how risks are relevant to the business
- Relate risks to strategic goals and show how risks are managed effectively
- Quantify the risk analysis where possible

What's required?

The business review explicitly requires companies to identify the principal risks and uncertainties that they face and the explanation of management's approach to those risks is a critical element of the best practice set out in the ASB's reporting statement.

> "The director's report for a financial year must contain a description of the principal risks and uncertainties facing the company." – Directors' report: business review (CA85 Sec 234 ZZB)

However, the requirement for the risks to be the principal risks suggests they should be specific to each company's business activities rather than common to all. Interestingly, the idea of avoiding boilerplate disclosure of risk is a view that is also shared by the SEC in the United States which requires the provision of specific risk information:

> "...that issuers should not present risks that could apply to any issuer or any offering." - Amended Item 503c of Regulation S-K

Our approach

The key to these requirements, and implicit in our approach, is the need for the identified risks to be specific to the company in question. Undifferentiated statements about risks in general, or those that appear as simply boilerplate summaries of the risk environment could not be described as principal. A key element of our analysis of the reporting of risk was that the risks disclosed had to be clearly identified, or described, as principal – or an equivalent term.

Few companies try to quantify the risks they face

We also looked for explanation of how risks are identified and measured and management's outlook on the risks it faced; an approach encouraged by the ASB's reporting statement. We sought to discover whether risks were quantified and similarly, how management performance in responding to those risks was measured. Of course, as was the case with other aspects of this survey, we also looked for evidence of risks and uncertainties that could have an impact on business performance in the future.

What we found

Companies struggle with reporting on the risks they face. The temptation to provide a generic list of all risks is one to which many yield. US reports tends to follow this 'kitchen sink' approach, perhaps driven by senior management's concern about litigation risk, and this approach is often replicated in the UK.

Very few companies identify their principal risks, with only 22% of those surveyed outlining what they consider to be their principal risks and uncertainties. The vast majority relied on the standard risk disclosure found elsewhere in reports which explains why traditional financial risks – such as credit, interest rate, liquidity, and currency - are the most commonly disclosed. Only one-third of companies surveyed disclose non-financial forms of risk.

Few companies try to quantify the risks they face. So, while nearly three-quarters discuss financial risks, only one-third of them attempt to quantify their potential exposure. With non-financial risks, even fewer provide numbers: of the 26 that discuss internal risks only one tried to quantify their impact on performance and none of the companies discussing external risks make any attempt to quantify theirs.

Where should risk be reported?

We found considerable variation when we examined where in the report risks, principle or otherwise were disclosed:

- 21% of companies discuss risk within their main narrative report
- 44% of companies discuss risk in their corporate governance or directors' report
- 2% discuss risk in a specific risk section
- 14% merely focus on their financial risks within the financial review
- 19% don't discuss risk at all

A positive response to regulatory change

Since completing our original baseline analysis, March year-end companies have become the first required to report under the requirements of the business review. Rather than wait another year to provide an update of the legislation's impact, we felt it would be interesting and informative to have a sneak preview of how these first few companies have responded and whether the regulations have had an impact on the information reported.

All of the key areas covered by this report have witnessed improvements

Overall, it is pleasing to note the positive impact the new legislation appears to have had on companies corporate reporting. There have been improvements in the key areas covered by this report, particularly in respect of KPIs and principal risks and uncertainties, which are explicit requirements of the business review legislation. This, in itself, is not surprising although the fact that a number of companies still fail to identify clearly their KPIs or principal risks and uncertainties is.

Our approach was to use a similarly random sample of companies, consistent with the number (28) of March year ends used in the original survey. Some of the high level findings are summarised below:

The business environment

Proportion providing a description of the business and the environment in which they operate:

- Baseline year 94%
- March '06 year end 100%

Strategic direction

An increasing number of companies are communicating their longer-term objectives, although the number that support these with a description of their short-term priorities remains about the same.

Proportion providing information about long-term objectives/ overall future direction:

- Baseline year 69%
- March '06 year end 89%

Proportion providing information about their short-term strategic priorities:

- Baseline year 77%
- March '06 year end 75%

Key performance indicators

As an explicit requirement of the business review legislation more companies are acknowledging the existence of KPIs, although a third still fail to clearly identify them. Although it is too early to say, the increasing average number of KPIs reported may perhaps be a natural reaction of companies to report as many as possible in order to ensure they comply rather than considering what are most pertinent to their business. Certainly the fact that 75% of companies still fail to clearly demonstrate a link between these KPIs and their strategies appears to support this view.

Proportion acknowledging that they have KPIs within the annual report:

- Baseline year 32%
- March '06 year ends 75%

Proportion of companies who report their KPIs:

- Baseline year 19%
- March '06 year ends 57%

Average number of KPIs:

- Baseline year 5
- March '06 year ends 9

Proportion of companies who demonstrate a link between their strategy and KPIs:

- Baseline year 11%
- March '06 year ends 25%

Principal risks and uncertainties

Unsurprisingly, as an explicit requirement, far more companies were clearly identifying their principal risks and uncertainties. However over a third still fail to do so.

Proportion identifying principal risks and uncertainties:

- Baseline year 22%
- March '06 year ends 57%

We intend to update this survey and draw more comprehensive conclusions on the impact of the business review regulations next year once we have a broader set of companies to survey. It will be very interesting to see if the positive changes that the early results indicate are reinforced with the results from a larger group of companies.

Appendix – making sense of what's required

What's required

The table below sets out how the key areas of information in this publication relate to current legislation.

	Business review CA85 Sec 234 ZZB	Proposed amendments to business review	Operating and financial review ASB's reporting statement
Market overview		Forward looking orientation	Key recommendation
Strategy	Implicit requirement		Key recommendation
Key performance indicators	Explicit requirement		Key recommendation
Principal risks and uncertainties	Explicit requirement		Key recommendation

Business review legislation (specific requirements)

For financial years beginning on, or after, 1 April 2005 all companies except small companies (as defined by section 247 of the Companies Act) will be required to prepare a business review in accordance with Companies Act legislation section 234 ZZB. The key requirements are as follows:

(1) The directors' report for a financial year must contain –

(a) a fair review of the business of the company, and

(b) a description of the principal risks and uncertainties facing the company.

(2) The review required is a balanced and comprehensive analysis of –

(a) the development and performance of the business of the company during the financial year, and

(b) the position of the company at the end of that year,

consistent with the size and complexity of the business.

(3) The review must, to the extent necessary for an understanding of the development, performance or position of the business of the company, include -

(a) analysis using financial key performance indicators, and

(b) where appropriate, analysis using other key performance indicators, including information relating to environmental matters and employee matters.

DTI invitation for comments on the business review (implicit requirement)

The Department of Trade and Industry encourages companies to report on their strategy:

> "The business review would include information on objectives, strategies…where necessary to provide a fair review of the company."

Proposed amendments – Companies Act 2006

The following are proposed amendments to section 234 ZZB as part of the companies bill. Additional reporting requirements for quoted companies in their business review are as follows:

a) Description of the main trends and factors likely to affect the future development, performance and position of the company's business.

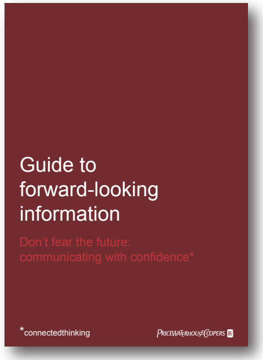
b) Information about:
   i. Environmental matters (including the impact of the company's business on the environment)
   ii. The company's employees
   iii. Social and community issues including information about any policies of the company in relation to those matters and the effectiveness of those policies.

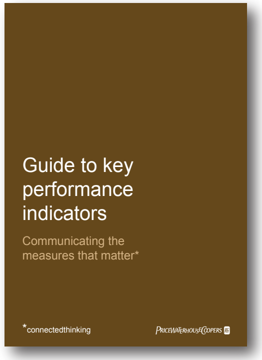
c) Information about persons with whom the company has contractual or other arrangements which are essential to the business of the company.

If the review does not contain information of each kind mentioned in paragraph (b)(i), (ii) and (iii) and (c), it must state which of those kinds of information it does not contain.

Other Narrative Publications

Other narrative reporting publications





Contacts

Specialist support for narrative reporting and their areas of expertise

Set out below is a list of individuals who can help you begin to consider the implications of narrative reporting regulations, both internally and externally, and how you might address them. In particular they have specific expertise around the following areas critical to narrative reporting.

Narrative reporting strategy

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Quality of narrative reporting

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