QCA

The Voice of
Quoted Companies

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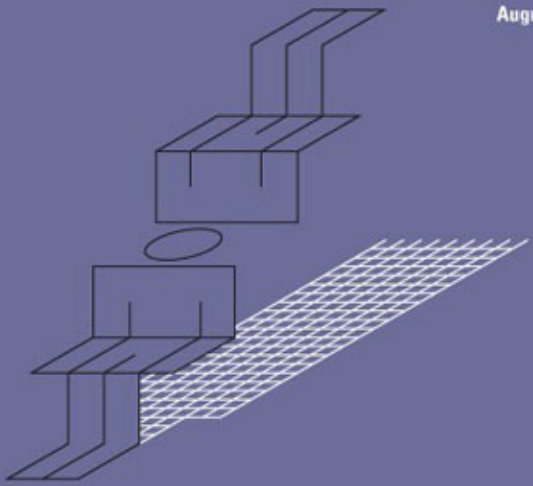

Guidance for Smaller Quoted Companies on preparing a Business Review

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INTRODUCTION

This guide aims to help QCA members to prepare their Business Reviews, the requirement under the EU directive which survived the recent abolition of the Operating and Financial Review (OFR). Now there is clarity over the government's intentions in this regard, we hope that this guidance will provide practical assistance to QCA members in developing their own narrative reporting on the areas covered by the Business Review.

We hope that by producing best practice guidelines which we have developed alongside our peer organisations in the pan-European Unique group, as well as with institutional investors, we can avoid the need for detailed prescriptive guidance from regulators or governments. We believe that better reporting more tailored to individual companies will result from flexible best practice guidance such as this publication, rather than from detailed prescription. The Accounts Modernisation Directive uses similar language to the legal requirements for the OFR, but is less detailed, leaving a looser framework for reporting. This should give much more scope for flexibility.

The Business Review is an opportunity for companies to communicate openly and directly with their shareholders, and thereby to win additional investment and lower their cost of capital. It need not be seen as a cost burden, particularly if companies seize it as an opportunity to set out their stall for current and prospective shareholders rather than feeling obliged to comply with rigid guidelines.

Those companies which already produce outlines of their activities and changes over the year in their statements at the start of their Annual Report will find that they need to develop this in a limited way to fulfil the Business Review requirements. A short but balanced analysis of strategy and future prospects from a financial and operational position will be of greater value to shareholders than lengthy 'boilerplate'.

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THE BUSINESS REVIEW

There is little detail in the EU's Accounts Modernisation Directive about what must be included in the Business Review. This welcome flexibility leaves only a basic framework which can be approached by each board and each company in the way which they believe is most appropriate to their circumstances. An outline of the law which the UK has put in place to implement the Directive is included as an Appendix to this guide.

The demand for a Business Review is a simple one: traditional financial reporting is essentially backward-looking and leaves out much information which shareholders value. In particular, shareholders are keen to understand the future drivers of the company's operations, they want to know what are the key risks and that they are being effectively managed, and they want to gain an insight into the board's thinking on the future. Shareholders need to understand the potential for the company, not just its past or its current state.

Good boards assess past and current performance to ensure management is taking the company forwards, but they avoid getting so tied up in the past that they cannot think about the future direction of the company; much corporate reporting only looks at the past and does not open a window on the future. Boards which demonstrate that they have at least one eye to the future are more likely to convince shareholders that it is worth investing or continuing to invest.

The QCA hopes that its members will be able to avoid their Business Reviews getting buried in detail, and instead keep in mind the overarching aims of such reporting. This short guidance aims to be brief and accessible for the management of small companies, keeping the focus on the macro- rather than the micro-level. We believe that your shareholders would also prefer a brief broad-brush approach to excessive degrees of detail.

Business Reviews are most likely to achieve their overarching aim if they are written genuinely to reflect the unique attributes of each company. This will avoid the boilerplate which is rightly seen by boards as a waste of their time and similarly seen by shareholders as worthless. It is best controlled by market-based mechanisms whereby disclosure can be developed over time through discussion between boards and long-term shareholders, rather than by detailed legislation or formulaic rules.

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HOW DOES THE BUSINESS REVIEW DIFFER FROM WHAT IS ALREADY PROVIDED IN THE CHAIRMAN'S STATEMENT AND CEO AND FD REPORTS?

It needn't differ much. In fact, those companies which already produce outlines of their activities and changes over the year in their statements at the start of the Annual Report will find they need to develop this only partly to fulfil the Business Review requirements - though see below for where this should be published.

These developments will be to fit the existing form of disclosures into the outline Business Review framework, including an analysis of changes and performance over the year, a view on the state of the company and its likely future development, and a description of key risks. A little more is likely to be needed by way of concrete key performance indicators (KPIs), and a discussion is necessary of environmental, employee, and social and community issues, where these are relevant. Each of these areas is covered in this guidance.

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WHERE SHOULD BUSINESS REVIEWS BE PUBLISHED?

The new protections for directors in relation to narrative reporting which we expect to pass as part of the Company Law Reform Bill extend to the Directors' Report and the Remuneration Report (and the Summary Financial Statement where it is derived from these two). Directors will be keen to enjoy this protection - which some call a 'Safe Harbour' - which essentially means that they will be liable for errors only if they deliberately mislead or if they are reckless. This means that the Business Review will need to be published within a segment of the Annual Report which is called the Directors' Report.

The protection does not seem to extend to anything outside the Directors' Report, even if it is published to fulfil Business Review requirements and is explicitly referred to. Our strong recommendation is therefore that all relevant material is included within the Business Review within the Directors' Report.

It should be noted that institutional investors have publicly supported the introduction of a 'safe harbour' protection for directors in the expectation that it will lead to better and more forward-looking corporate reporting. QCA members should be aware that their reporting will be scrutinised to see that it does indeed rise to this opportunity.

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WHAT IS THE OVERARCHING AIM OF THE BUSINESS REVIEW?

This guidance repeatedly refers to the overarching aim of the Business Review, because we believe that this must be the primary focus for companies preparing them for the first time - and keeping it in mind will help avoid Reviews becoming a waste of board and of shareholder time.

The legislation states that the purpose is to inform shareholders and to enable them to assess how the directors have performed their duty to promote the company in the interests of all shareholders.

The directive requires a 'balanced and comprehensive analysis' of the development and performance of the company over the year - which will presumably require an analysis of the main factors and trends which have driven that performance - its position at the year-end, and the risks and uncertainties which will impact its future development. It must be a 'fair review', discussing negative issues as well as positives.

To fulfil their role, reviews will need to be prepared to help the shareholders assess the strategies of the company and the prospects for their success.

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WHO AND WHAT IS THE BUSINESS REVIEW FOR?

It is now explicit that the Review is a vehicle for the board to report directly to shareholders. While others will undoubtedly read it, the Review needs to be designed for use by shareholders, and must therefore be written with them in mind.

The Review is not a vehicle for short-term price sensitive information - this must continue to be disclosed when necessary according to the Listing Rules (or AIM Rules) - and note the comment on ongoing negotiations and impending developments in 'Must we disclose competitively sensitive information?' below. The Review is more long-term in its focus and is intended to include information to enable shareholders to make judgements on the prospects for the company and the quality of management. Honesty - discussing negatives as well as positives - will be necessary to build trust, and boards will be unwise to spin positive prospects about their business, because it is then likely to prove difficult to explain weak performance as it occurs. The Review needs to give a realistic assessment of the state of the company and its prospects.

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WHO SHOULD WRITE THE BUSINESS REVIEW?

The Review formally is part of the Directors' Report and so should describe the company through the eyes of the board. Smaller companies will rarely have the funds to pay external consultants to create their Reviews, and are thus likely to rely on key staff members. In many ways, this should help smaller companies create Business Reviews which are more in tune with the aim of the legislation. Reviews should be documents which are owned by the board, and if they are written by board members, or closely overseen by them, so much the better.

This board-level nature of the Business Review drives two other important aspects of these documents in our view: scale and what is worthy of inclusion.

First, scale. Thankfully for those board members who take responsibility for their creation, Reviews need not be sizeable documents. This is particularly true for smaller companies whose operations will tend to be relatively small and whose business models relatively straightforward. Some FTSE 100 companies produce Business Review-type operating and financial reviews which are around 50 pages; we aren't sure that these are appropriate or useful for those companies and their shareholders, and we certainly think that nothing approaching that length would be appropriate or helpful for smaller companies. For many, five pages would be more than sufficient, and we believe it will be extremely rare that a small company will find merit in creating a Business Review that ran to a dozen pages. The law specifically states that the Review should be 'consistent with the size and complexity of the business', reinforcing the view that smaller companies' reports can and should be brief.

Second, nature of the Review. As the document should be a board-level view of the company, it should encompass all issues which fall to be considered at board meetings and about which the board receives regular reports. That does not mean that every detail seen by the board must be shared in the Business Review; far from it. But if an issue is important enough to fall to the board for consideration, it is likely to merit some reference in the Review.

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Similarly, if a matter does not fall to the board for consideration and decision, it is unlikely to merit inclusion in the Business Review. Shareholders should not seek to micromanage the companies in which they invest and so neither should they seek disclosure of information which is at the micro level of those companies. Having said that, it may be that companies will find that shareholders ask legitimate questions about issues of concern which boards had previously not paid attention to; in that case, the wise board will rapidly close the gaps in its own oversight of the company, and reflect its consideration of these issues in future Reviews. This may be particularly the case in the areas of environment, employee and community issues, which must now actively be considered by boards for inclusion in their Business Reviews. Business Reviews will work best if they are living documents, reflecting the valuable content of discussions at board level and between companies and their shareholders.

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WHAT SHOULD BE IN THE BUSINESS REVIEW?

The focus of the Review needs to be a discussion of the strategy of the business, setting a context for past performance, current position, and future risks and opportunities. This will require discussion not of PR-based spin but of a hard analysis of strategy from a financial and operational position: the markets targeted, the positioning within those markets, and the company's competitive advantage. This last area will probably involve the most detailed discussion. If, say, a company depends on patents for competitive advantage, some discussion of current patent protection and investment in R&D will be necessary. Where a company believes it has an advantage through superior customer service, this will need to be discussed, as will for example the staff training which goes alongside it. And so on. The board will need to consider disclosing the Key Performance Indicators (see below) which it uses to assess and manage these areas of advantage. This indicates the extent to which Reviews must be directly tailored to each individual business and avoid boiler-plate.

Above all, shareholders wish to see and understand how it is that the board will ensure how shareholder value will be maximised into the future. It will therefore be important to discuss not just the current sources of competitive advantage but how competitive market positions will be defended and enhanced into the future. If there are key developments in the company's markets, then this will also be of vital importance.

This discussion of competitive advantage can be at a broad-brush level, we believe, enabling an overview understanding for shareholders, but not disclosing information which is hidden in any way from market participants and competitors. This theme is developed below under 'Must we disclose competitively sensitive information?'.

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WHAT ABOUT RISKS AND UNCERTAINTIES?

The way the directive talks about the future is mainly in terms of "the principal risks and uncertainties facing the company". It's clear that no discussion of risks and uncertainties will make sense without some allied commentary on opportunities and aims for the future, against which those risks and uncertainties will bite. So the directive implicitly calls for a broad-brush discussion of opportunities and threats to the future prospects of the company.

It's also clear that this should not be a comprehensive list of all possible risks to the business but should focus on those 'principal' ones that are significant enough to be discussed at board level (with the same comment as above, that boards should be open to expanding what they consider relevant matters for concern if they receive helpful input from shareholders). Tying this disclosure to that required under the Turnbull guidance will be key to providing assurance to shareholders that their board is managing the key risks which their company faces. This discussion of threats and risks may be the right place for disclosures on some of the environmental, employee and community matters which are discussed further below.

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MUST WE DISCLOSE COMPETITIVELY SENSITIVE INFORMATION?

The Business Review is a communication with shareholders. They will not want boards to harm their company's interests with excessive disclosure. So boards should not feel obliged to disclose, for example, the exact percentage of the company's dependence on a key supplier or customer. But the Review will need to make clear that there is an issue in this regard (such things will in any case be transparently obvious to competitors and others operating within their sector). It should be possible for boards to disclose with a broad brush the fundamental strategic issues for their businesses without going further and disclosing detailed information which is not clear to market participants and which therefore might be commercially damaging.

There is also a specific exception: if there are "impending developments" or negotiations are ongoing, directors need not disclose them if to do so would seriously damage the interests of the company.

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WHAT'S ALL THIS ABOUT KPIs?

The legislation requires every company to judge its overall performance using key performance indicators (KPIs). It's helpful that there are no specific KPIs against which companies are required to report. Instead, the board should highlight those it believes are relevant. These may not just be financial measures such as those arising from the accounts, but need to include richer measures of performance. Where relevant, they should include KPIs on environmental, employee or community matters. These KPIs should be disclosed - not necessarily the target levels, just the criteria against which the board judges corporate progress. Rare companies - particularly perhaps those with early stage technologies in development - might want also to note milestone performance targets. There should be enough discussion of how these measures are developed and used to give shareholders a rounded discussion of the performance metrics used.

As the intention is that the Business Review should allow a clearer view of the prospects of the business, shareholders will want an insight into how it is that boards judge performance and stretch management to perform into the future. That is what the discussion of KPIs should do. The most useful KPIs will therefore be those which give a rounded view of the future of the company rather than those simply reiterating the current financial position.

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DO WE NEED TO DISCUSS CAPITAL STRUCTURE AND OTHER FINANCIAL MATTERS?

There needs to be some discussion of these issues, to the extent that they relate to the company's strategy. Thus, the board's intentions with regard to any significant cash pile would need to be explained, how the company's cost of capital is minimised across the cycle, and so on. Where treasury and hedging operations are important to the strategy and future performance and success of the business, then these too will need to be disclosed - at a broad-brush level. In the same way as the disclosure of KPIs is needed to allow shareholder insight into the operational aspects of strategy and management, so Business Reviews will need to make some disclosure of the framework which the board has put in place to provide financial discipline for the business.

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WHAT MUST WE DISCLOSE IN RELATION TO SOCIAL, ETHICAL AND ENVIRONMENTAL MATTERS?

The legislation is clear that these issues (it uses the terms environmental matters, the company's employees, and social and community issues) must be discussed "to the extent necessary" to understand the development, performance or position of the company. Furthermore, "where appropriate", companies must also disclose KPIs on such issues where necessary to understand the business. In approaching this area, we recommend that directors consider how these factors fit within the context of the overarching aim of the Business Review, to report on the company to its shareholders. So, where such factors are important risks to the future success of the company, this will need to be disclosed and discussed. Many companies may need to think about environmental impacts and the future costs that these may entail. Consumer-facing businesses are likely to need to discuss customer relations and management of risks to their reputation. Most boards will need to consider discussing the retention and development of key staff. If any of these three areas are not covered in the Review, there needs to be a statement to this effect.

Such discussions could be used as an opportunity to answer the increasing requests smaller companies face for information on social, environmental and ethical issues. We believe that most shareholders will see a value in having these issues addressed briefly, and note that brief discussions should substantially fulfil the ABI Guidelines on the disclosure of social, environmental and ethical risks (for reference, these can be found at **www.ivis.co.uk/pages/gdsc7_1.PDF**).

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AUDITOR OVERSIGHT

The role of the auditors is limited to assuring that they believe the Business Review discussions are consistent with the knowledge of the company they have gained through the audit. This is broadly the requirement which auditors already apply themselves to any non-audited information in company accounts, and so should not create an undue burden or additional cost - or an unnecessary paper trail to justify what is published in the Review. We believe that this is welcome.

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IN CONCLUSION

The Business Review is an opportunity for companies to communicate openly and directly with their shareholders, and thereby to win additional investment and lower their cost of capital. It need not be seen as a cost burden, particularly if companies seize it as an opportunity to set out their stall for current and prospective shareholders rather than feeling obliged to comply with rigid guidelines. We hope that this practical guide assists companies in this.

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APPENDIX: BUSINESS REVIEW - THE LEGAL REQUIREMENTS

According to the current draft clauses of the Company Law Reform Bill:

The purpose of a business review "is to inform members of the company and help them assess how the directors have performed" their duty to promote the success of the company.

A directors' report must contain: "a fair review of the business of the company"; and "a description of the principal risks and uncertainties facing the company".

The review must be "a balanced and comprehensive analysis of": "the development and performance of the company's business" over the year; and "the position of the company's business at the end of that year".

It is expected to be "consistent with the size and complexity of the business".

To the "extent necessary" to understand the development, performance and position of the company, the review must include: "the main trends and factors likely to affect the future development" andperformance of the company; and information on environmental, employee and community factors. If it does not cover any of these issues, it must state that it does not do so.

To the "extent necessary" to understand the development, performance and position of the company, the review must include: "analysis using key performance indicators"; and "where appropriate, analysis using other key performance indicators" including information on environmental, employee and community factors.

"The review must, where appropriate, include references to, and additional explanations of, amounts included in the company's annual accounts."

The directors are required to report on the consolidated group rather than just the state of the parent company.

On the current timetable, we expect these requirements to apply to reporting for financial years starting at the earliest from April 1st 2006. For

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reporting for the financial year starting from April 1st 2005 to then, a slightly more restricted Business Review requirement applies, which was put in place by earlier legislation to implement the EU's Accounts Modernisation Directive. Apart from a few purely cosmetic changes, this does not include the clause on the purpose of the Business Review, and nor does it include the first "to the extent necessary" paragraph above, making explicit the requirement to cover the future development issues and the information on environmental, employee and community issues.

However, given the other requirements - to report on the position of the business and to disclose relevant KPIs on the environmental, employee and community issues - we do not believe that there is a substantive difference between requirements for the different years. We would therefore recommend that QCA members approach their Business Reviews for all years in the context of this practical guidance.

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ADDENDUM: WHAT DO I NEED TO SAY ABOUT SUPPLIERS?

There was much public debate about the last-minute addition to the Business Review disclosure requirements of a duty to disclose "information about persons with whom the company has contractual or other arrangements which are essential to the business of the company". The addition was so last-minute that it came after the original publication of the QCA guide! Hence this short addition.

The broad drafting of this requirement and the noise from NGOs and others that it was a requirement for companies to report comprehensively on their supply chains have led to a good deal of nervousness about what is required. But the efforts of the QCA among others have meant that ministers have made statements in parliament that make clear that the requirement is much less demanding than this. Therefore, it should not add significantly to the reporting burden.

The ministerial statements make clear that there is not a requirement to list suppliers, or customers, or others; rather the requirement is to report significant relationships which are likely to have an impact on performance or value. This should be done within the context of the overall aim of the business review - to give shareholders a balanced and comprehensive analysis of the development and performance of the company, and of the risks and uncertainties which will impact its future development. It is in the area of risks and uncertainties that the new requirement comes into play.

Thus, what is required is not a broad brush discussion of all parties with which a company has contractual relationships. Rather, companies will need to report where there is a risk or uncertainty: where they have a dominant customer, or a single supplier, such that there might be disruption to their business if that relationship broke down or the customer/supplier hit financial difficulties. This does mean that smaller companies will be disproportionately affected by the new requirement, but it also means that not all smaller companies will need to add to their reporting burden.

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If a company does need to include such a disclosure in its Business Review, it is not required to disclose the details of the relationship - there is certainly no requirement to disclose commercially sensitive details. The 'information' that needs to be disclosed is much less - a the overview information which would in any case be apparent to competitors (and to the contracting party) - that the named customer/supplier represents around X% of the customer/supplier base and there might be disruption to the business if this relationship broke down. If directors can also give some assurance that relations continue to go well and that they have plans in place to mitigate any problems that may arise, their investors would welcome it.

It is worth noting that while this discussion focuses on suppliers and customers, the clause is not restricted to such parties, and could extend to employees, local communities, regulators and the like. So in many ways it is just a restatement of the general requirement to discuss risks and uncertainties which face the business.

It is worth also noting that there is a specific exclusion from the requirement to report on parties with which the company has contractual arrangements. This was introduced for the benefit of the pharmaceutical industry worrying about animal rights extremists: there is no requirement to disclose information where disclosure would be - in the opinion of the directors - "seriously prejudicial" to the person reported about, and contrary to the public interest. This is a steep test, and it explicitly does not absolve directors from responsibility to report on matters which are prejudicial to the reporting company itself. But the exclusion may be of interest to certain QCA members.