Telling the story

...through the eyes of the board

A framework for the Business Review

INDEPENDENT
AUDIT LIMITED

INDEPENDENT AUDIT LIMITED

Independent Audit aims to inject new thinking – and new solutions – into board performance, governance and narrative reporting.

ACCA

ACCA is a leading global professional accountancy body, and has kindly sponsored this publication.

FOREWORD

The new Business Review is an opportunity for companies to put narrative reporting back on track.

The framework set out here is welcome in its simplicity and pragmatism. It suggests a Review built around the fundamental questions that boards ask and one based on the information they use to get a clear picture of strategic performance.

This approach meets the need of shareholders and other users of company reports for a clear picture of the company's strategy and performance. At the same time, it provides a useful opportunity for the board to focus on what needs to happen for the business to get to where it wants to be – and how it monitors its progress in getting there.

Adopting the framework will help make company reporting more accessible, more meaningful and more likely to be used by shareholders.

Niall FitzGerald
Chairman, Reuters Group PLC

October 2006

WHAT'S IN THIS FRAMEWORK

This framework aims to help companies think through how to put together the Business Review in a way that meets the needs of shareholders and others for a clear picture of strategy and performance.

It suggests a Business Review which acts as a concise overview and, by signposting to further detail, helps bring together the different parts of the annual report into a coherent picture.

The approach suggested in the framework can be used to meet the Business Review requirements now in force. But as many companies will be looking to the future, it also looks forward to the further requirements for the Business Review as outlined in the Companies Bill.

On the following pages you will find:

On our website at **www.independentaudit.com/goodreporting** you will find:

- A **mock-up** of how a Business Review based on this framework might look
- A outline of how the storyboard approach proposed by this framework ties into the **regulatory reporting requirements**

CONSULTATION

A key aim of this initiative has been to find common ground between the companies needing to report under the Business Review requirements and the users of their reports. As well as reflecting the requirements of the users of reports, the framework has needed to recognise the constraints applying to reporting companies.

So we have consulted representatives from a range of companies, investment institutions, investor representative bodies, the FRC and other users of corporate governance reporting.

Given the diversity of requirements and views, the framework cannot capture all of the different opinions or needs of each of those involved. Inevitably, therefore, the suggestions made in the framework remain those of Independent Audit. However, we hope that the end result goes a long way towards capturing a consensus view.

We would like to express our thanks to all who have participated in the consultation, especially the members of the working group (comprising the individuals asterisked in the list of participants below) who were particularly generous with their time. We are very grateful for the insights and guidance provided by all.

Paul Moxey*	ACCA
Richard Slynn	Allen & Overy
Sir Derek Higgs	Alliance & Leicester
Dick Olver	BAE Systems
Jeremy Booker & David Pearl	BP
Alan Scott*	BT
Richard Lapthorne	Cable and Wireless
Peter Elwin	J P Morgan Cazenove (Cazenove Equities)
Murray Steele	Cranfield School of Management
Trelawny Williams & Donald Cassidy	Fidelity International
Richard Singleton*	F&C Asset Management
Harry Baines*	HBOS
Antony Marsden	Henderson Global Investors
Ian Greenwood* & Paul Lee	Hermes Investment Management
Giles Peel	ICSA
David Rough	Land Securities
Alastair Michie*	Lloyds TSB Group
Anita Skipper* & Iain Richards*	Morley Fund Management
Martin Murray	Old Mutual
Philip Broadley	Prudential Chairman, The Hundred Group
Steve Cowden	Reed Elsevier
Ian Harley	Rentokil Initial
Rosemary Martin	Reuters
Graham Staples	Schroders
George Dallas*	Standard & Poor's
Guy Jubb	Standard Life Investments
Ken Lever	Tomkins
Daniel Summerfield*	Universities Superannuation Scheme
Deepak Kumar	Vedanta

* Working group members

WHAT THIS FRAMEWORK SETS OUT TO DO

From this year, Directors' Reports must include a Business Review. But the legislation includes only a brief outline of what this should contain. In the absence of official guidance, companies are having to work out what style to adopt, what to include, how to make it fit with what is already reported and how to manage any legal risks.

Many companies are anxious not to be pushed too far too fast. And it is important to recognise the constraints companies face and allow them to tell their stories in their own way. Otherwise companies may fall back to compliance-style boilerplate.

What's more, companies need to see the value in investing time and effort in pushing further forward with their narrative reporting. Should they simply comply with the new requirement – or should they use it as an opportunity to review how they communicate their performance?

This framework helps companies work out how to structure their Reviews and what to put in them. It proposes a **short strategic performance review** which lays out a picture of performance as seen **through the eyes of the board** and **acts as a signpost** to the rest of the Report.

Why through the board's eyes? In part because legally the Business Review has to be part of the Directors' Report and the responsibility for its contents is placed on the directors. But also because this perspective helps companies stand back and focus on the main objectives, drivers and measures. This approach is key. It reflects what investors are saying they want. And it is of value to the company itself, helping it keep a clear picture of what it needs to get right, how it is doing and how it can know how well it is doing.

The framework is simple and flexible for companies while meeting the needs of users. It should act as a

The Business Review Storyboard

WHAT ARE WE AIMING TO ACHIEVE?

What our business is about
- Our objectives, values and priorities
- What gives us confidence that we have the right strategy
- The emerging opportunities
- The market we're in

WHAT DO WE HAVE TO GET RIGHT?

Driving the business
- What drives strategic success
- What we have to manage
- Interdependencies
- What's changing over time
- How we're allocating resources

Protecting value
- Managing the strategic risks
- Managing the financial and operational risks
- Oversight and control

HOW DO WE ENCOURAGE STRONG PERFORMANCE?

Behaviour
- Driving the right behaviour
- Having the right skills
- Aligning compensation with strategic goals
- Managing the pressures

HOW DO WE KNOW WE ARE GETTING IT RIGHT?

The Input Performance Indicators
- What the board monitors to make sure that what needs to be managed is being managed
- What went right, what needs to change
- What has changed since last year

The Output Performance Indicators
- The financial impact of our operations
- The non-financial impact
- The impact on shareholder value

HOW DOES THIS POSITION US FOR THE FUTURE?

What's In Store
- Where performance to date leaves us against our goals
- How what we've done positions us for the future
- What can be expected of us
- The uncertainties

basis for further development as companies become more comfortable with, for example, expanding the use of performance indicators in their reporting. It:

- draws out the story of performance in a way that is useful to the shareholders and to other users of reports who need to understand how the company is managed and governed
- provides a better basis for dialogue with shareholders about strategy, performance and prospects – at least with those taking a longer-term perspective
- is straightforward for the company to put together, since the questions shareholders and others would like to see answered are largely those a board should already be asking of management
- provides a structure which encourages the telling of a story rather than a lengthy commentary on historical financial performance
- gives companies flexibility in telling their story in a way that fits their business, while recognising the importance of consistency between years and of avoiding selective commentary
- draws on information already made available, pulling together the story presented in analyst briefings and analysis provided elsewhere in the annual report.

How does it sit with the other bits of the annual report?

Where does it fit? The framework envisages the Business Review as the first and major part of the Directors' Report, with this being moved to the front of the annual report. Some companies may, as a result, choose to merge the Chairman's letter into it.

How does it tie into the other parts? The Business Review should bring coherence to the annual report by tying together the threads and drawing out the relevance of the information it contains, rather than a lengthy, separate and unconnected addition to an already unwieldy and increasingly incoherent structure. It should also be seen as a "bridging statement", strengthening the continuity between successive reports.

What about the OFR? Voluntary OFRs will continue to be included, but act more as a repository of detailed information. So some might choose to combine the OFR with the CEO's statement.

Won't it add a lot of pages? No. The type of Business Review suggested by the framework should be short – maybe as short as four or five pages. The OFR would shorten as it will contain detail rather than strategic discussion. And the Chairman and CEO's statements could be integrated or significantly reduced. And even if it means a couple of extra pages, won't this be worth it if it brings coherence to the other hundred-odd?

Why not just use the OFR? Since, according to the DTI guidance, cross-referencing between the Business Review and the OFR is permitted, it would be possible for the OFR, in effect, to be drafted using this framework so that it constituted the Business Review. But this would not result in what users in our consultation exercise have said they want from the Review: a short, readily accessible overview of strategic performance. The OFR has its place, as does the Accounting Standards Board Reporting Statement guidance issued to support it. But the Business Review is an opportunity to meet a need for a concise and coherent telling of the story, rather than detailed commentary.

THE BUSINESS REVIEW STORYBOARD

The Business Review should look at the business through the eyes of the board. It should describe how the directors, through management, are running the business to achieve success and how the board monitors the results.

In putting the Review together, companies need to remember what they are trying to produce: a short strategic performance review that shows **how the board knows that its strategy is being implemented and how far it is being achieved.** At the same time it can act as a signpost to supporting information which, through clear labelling, can be tied into the Business Review[1].

The Storyboard asks five basic questions:

What are we aiming to achieve?

- The board's objectives and strategy for the business and what makes us think that we have the right strategy
- Our values – what this business is all about
- Our priorities – what's going to happen by when
- How the strategic objectives relate to the market and competitor activity and other factors (eg technological change, demographic trends) as they are seen by the board
- External developments and market trends impacting the strategy and results and what we are doing to try to influence them
- How we are responding to the competitive environment
- How what has happened during the year has changed our strategy or management's approach, or how it has reinforced our view that the strategy is the right one. If things have not gone to plan, what makes us think we are back on track or getting there
- The opportunities we see emerging and how well we're positioned to exploit them

What do we have to get right?

In driving the business…

- The main business drivers we need to get right to meet specific objectives and more generally for strategic success (eg in terms of people, customers, technology, innovation, selling, information etc)
- These drivers' interdependence and relative importance
- How what matters is changing over time
- How resources are being allocated, the investment decisions we've made and our funding

In protecting value…

- How we are responding to the strategic risks, the uncertainties which might affect us further – and what we think will still apply regardless
- What we see as the strategic, financial and operational risks and how we go about mitigating them
- How our governance approach helps us get things right

[1] Under current DTI guidance, cross-referencing into the Business Review from the OFR is permitted as long as it is clear. If, as expected, this is allowed under the future requirements to be introduced through the Companies Bill, it should still allow information contained outside the Directors' Report to be covered by the proposed safe-harbour provisions as long as it is clearly imported into the Business Review.

How do we encourage strong performance?

- How the board has made sure the right people are in place and that their skills are made the most of
- How the board has aligned senior executive remuneration with strategy and key business drivers
- How the reward structures across the business are tied into the performance drivers
- How the board promotes the right culture, ethics and values – what we do in practice and how we measure performance in these areas
- The organisational pressures and how we are managing them

How do we know we are getting it right?

- The performance indicators the board monitors to make sure that what needs to happen is happening – for achieving specific objectives and the overall strategic targets
- The performance indicators (both quantitative and qualitative) relating to business drivers (ie the "inputs") – how we monitor our performance for those we can manage and how we're protecting ourselves against those outside our control
- The performance indicators measuring the financial impact of our operations (ie the financial "outputs") and the implications for shareholder value
- The performance indicators measuring the non-financial impact of our operations (ie the non-financial quantitative or qualitative measures of "outputs" such as the environmental and social implications, which could impact financial results but which require different types of measures) and the potential consequences for all stakeholders
- How we make sure that the environmental and social impact of our activity does not damage shareholder interests, whether directly (eg losses, lawsuits, fine, regulatory response) or indirectly (eg employee turnover, loss of customers and markets)

How does this position us for the future?

- What we have achieved – the board's assessment of where performance to date leaves us in relation to the strategic goals and opportunities
- What we need to do going forward – strategically and operationally – in the light of this performance
- How we have positioned ourselves to exploit the opportunities we can see and to deal with the risks
- Uncertainties we can foresee
- The outlook – what we can be expected to do and how we see the likelihood of it being achieved given where we stand, our plans and the uncertainties

USING THE STORYBOARD

Questions companies will need to consider

How does it fit into the Directors' Report?

The Business Review must be part of the Directors' Report. In theory, it could, through the use of cross-referencing, sit outside the Directors' Report. But this separation could complicate the overall structure and limit scope in legal terms for using the Business Review to signpost to other parts of the report.

So we suggest that the Business Review should be the first and major part of the Directors' Report. (The required disclosures which form the other parts of the Directors' Report could be included at the end, clearly differentiated from the Business Review.)

The Business Review, as proposed by this framework, acts as an overview. At the same time as satisfying the reporting requirements, it pulls the different parts of the performance story together in a strategic context and signposts more detailed information elsewhere in the report. So the Directors' Report should be moved to the front of the annual report.

How does it meet regulatory requirements?

The storyboard approach can be used to meet the requirements for the Business Review currently in force under the Companies Act 1985. In the future, once the Companies Bill is enacted, it can also be used to accommodate the proposed requirements for discussion of the factors affecting future development of the business and more extensive reporting on environmental, employee and social and community matters and performance indicators.

For US registrants it can, when combined with the detail elsewhere in the report, also be used to help meet the US 20-F requirements. See our website at www.independentaudit.com/goodreporting for a more detailed discussion.

How does it sit with the Chairman's and Chief Executive's statements?

That will depend on what you expect these statements to achieve. There may be a case for ditching them altogether and letting the Business Review say it all. Or the Chairman's statement might be used as a brief introduction to the Business Review: Chairmen often comment that investors fail to appreciate that strategy has to change as a result of market developments – could a discussion of pressures and how the board has responded be an effective lead into the Business Review? In turn, the CEO's statement could become an introduction to the OFR.

Who should take ownership?

As a view of strategy and performance through the eyes of the board, the Chairman should own the Review. Naturally the CEO and FD will be involved, but it's important that the balanced view that is developed in the boardroom provides the basis for the Business Review narrative. And, as the Chairman will want to communicate effectively, this level of ownership will help avoid slippage into boilerplate.

How should it tie in to the current sections in the annual report?

The Business Review should be a punchy summary that draws the links together into a short story. So large parts of the commentary provided elsewhere are likely to remain: they will provide the detail behind the story, especially when it comes to past performance. The Business Review should provide signposts to this detail, pointing to the financial statements, OFR, governance report and remuneration report.

Where should it come in the annual report writing process?

Ideally you would write the Business Review first. It should provide the themes and framework which are then supported by more detailed parts of the report. In practice, the picture to be presented in the Review may not emerge until other bits are drafted. It's a question of getting the balance right and not letting the detailed commentary on past performance dictate the flavour of the strategic overview.

When should it be released?

The value of the Review would be considerably enhanced if it were to be published in advance of the annual report, along with the preliminary results. There are practical and legal implications to consider – and it's not something that investors see as an issue for now – but companies may want to start thinking about this as a longer-term goal.

How does it sit with CSR reporting?

The Review gives the board an opportunity to explain how it considers the company's impact on stakeholders (social, environmental and as an employer and business counterparty) and the potential consequences for financial value. Again it can signpost more detailed information.

The use of performance indicators

Here are some simple guidelines to help companies identify which performance indicators to include in their Business Review:

Does the board use it?

If so, include it. You will need to feel comfortable with the quality of the information and any commercial sensitivity. But if it's used at board level, it's likely to be the kind of information investors find useful in making judgements on future. Furthermore, in terms of understanding what drives value, the performance indicators reported to the market should be the same as those reported to the board.

How many to include?

If the board uses it and it adds substance to the strategic story, consider including it. If it doesn't, leave it out. The Review needs to be kept short and punchy – don't include a raft of performance indicators just because you have them.

Don't forget the inputs as well as the outputs

Often performance indicators are presumed to be output measures – indicators of the financial or non-financial impact of activity. But often it's as important to understand those which reflect the business drivers. Examples include staff-related measures (training, turnover…), customer satisfaction, innovation or research. If the board doesn't use input measures, it should ask itself, and be prepared to explain, how it otherwise checks that the company is doing what it needs to do to achieve its objectives.

Profit isn't the only output

Think carefully about the mix of financial measures. As well as profitability measures, use value indicators (eg Total Shareholder Return, return on invested capital, cash flow return on investment).

And, as well as covering performance against financial targets, make sure you include key indicators of performance against strategic targets (eg sales growth, market share).

Think about lead indicators

Shareholders are interested in the future. A focus on past performance can easily mean slipping into financial commentary. Talking about what will make a difference in the future gives an interesting insight into what's driving performance, and brings the commentary into the present and future rather than letting it get stuck in the past. This does not have to involve making forecasts!

The wider use of performance indicators

Numerous other guides or standards produced by regulatory or professional bodies or advisory firms have suggested what types of performance indicators should be included. A selection of other sources can be found at www.independentaudit.com/goodreporting.

Companies should aim to include definitions, calculation methods, explanations of purpose and all the related commentary that is set out in the Reporting Statement. There are positive reasons for doing this: it is a good discipline; integrity and consistency of calculation are still very relevant to the indicators included within the Business Review and elsewhere; and some analysts will find it helpful. But it would be better not to clutter the story presented in the Business Review with this detail. The company's website or an appendix to the report could well be the best place for this kind of background material.

Consistency

Consistency in the use of performance indicators from year to year is of particular concern to users of the report. Information that was a key part of the previous year's picture must not be left out, just because it's less positive this year. Changes in either the basis of calculation or the selection of performance indicators should be disclosed and explained, preferably in an appendix to the annual report or on the website.

The style of the report

The framework can be used flexibly, with companies arranging the different elements in the most effective way for them. The key is to maintain a storyline.

A fictional example is available on our website (at www.independentaudit.com/goodreporting), but each company will find its own way to tell its story. Here are some thoughts to take into account on the style:

Story telling

- Write something that you would find an interesting and informative read. Start with a clean sheet of paper, not with last year's report
- Think in terms of the analyst briefings. These often put the picture across succinctly with a good narrative flow
- Keep the story visibly flowing throughout. This will help the reader understand the strategy and see the completeness of the board's vision
- Try to avoid drafting by committee, or delegating the drafting far from the board or into a lawyer's hands
- Be balanced and even-handed. An overly rosy story is likely to be unconvincing. Readers understand that there are challenges and disappointments en route so be open about them: avoiding them undermines the credibility of the whole story

Flexibility

- Tell it in a way that fits your business and that you're comfortable with
- Use other guidance as suggestions on what to include, not as prescriptive checklists
- Start out with the full picture, then pare it back to take sensitivities into accoun

Simplicity

- Tell it straight. Investors detest spin and boilerplate
- Keep to the main drivers that will have the biggest impact on performance and value
- Keep it short. Don't repeat detail that is covered elsewhere

Linking

- Build the story around the strategic objectives, not around financial measures or the profit and loss account
- Tie it into what drives business performance, rather than simply providing a commentary on output measures
- Bear in mind that shareholders will be looking for a link to remuneration. They will look to see how the drivers you identify are reflected in the reward structures. And don't forget the cultural issues that influence how people behave and perform
- Link it to the governance report. The Business Review should help with what companies seem to find most difficult in reporting on their governance: explaining to shareholders how the board has actually approached its role of exercising stewardship
- Take care over consistency with what's been said before with the rest of the report and accounts. And liaise with the auditors to make sure that the board's commentary is consistent with the financial statements

WHAT COMPANIES ARE HAVING TO TACKLE…

The "why bother?" question

Some boards may well question how far they really need to go, particularly when it comes to including performance indicators. Conscious of exposure issues and sceptical over the responsiveness of shareholders to their efforts to communicate, some boards may ask "why stick our necks out?" But there are good reasons.

Firstly, shareholders and other users tell us that the **Business Reviews and the performance indicators are wanted and *will* be used.** This won't be the case universally, with the needs of the sell-side and the buy-side being different. But rather than the company's response being driven by its experience of one group of analysts, a good communication strategy will recognise that there is a different group of users who will value a good Business Review.

So companies should see the Review as a good **opportunity for succinct communication** to shareholders on what the business is about and how they are performing. And they should not forget their broader audience, such as potential investors, creditors, customers and suppliers, some of whom actively make use of annual reports as a primary information source but will not have the resources to plough through detail.

Also there is a **sound business reason** for seizing this as an opportunity. Working out how best to tell the story to an external audience helps a board make sure it, too, has a clear picture of what drives performance and how the company is being run. Communicating a clear picture helps focus the board's attention on what it really wants or needs. And careful analysis of what can and can't be published helps identify where information on key business drivers and output indicators is either missing or subject to quality concerns.

These aren't theoretical benefits. Some companies that have started shifting to more narrative reporting are telling us that they are already getting a positive reaction from shareholders (at least from those with a longer-term perspective) and also finding the discipline of putting the story down on paper useful for the board.

What's more, bringing together the picture presented in briefings to analysts and the commentary provided in the annual report should help companies check the **consistency of different communications** and ensure that information is being provided equitably.

A good Business Review could also **enhance value**, seen by some as a Holy Grail-style quest. It should put the company-investor dialogue on a firmer footing, over time reducing the scope for value-destroying surprises and helping shareholders to understand changes in strategy. And it should also help at least some of them take a longer term view of strategic decisions and operational developments.

Companies should bear in mind that some shareholders are saying that they will use the quality of the Business Review as an **indicator of the quality of the board:** it will show them how effectively the board sees the strategic picture. It will also indicate its attitude to shareholder communication – it's a chance for companies to show that they think beyond boilerplate, aren't spinning, and are rigorous in rewarding management.

Not least, they shouldn't lose sight of what's **required by law.** The Business Review requirements currently in force may well be less than what was proposed in the now abolished OFR requirements. And they are not as full as the requirements expected to come into force with the passage of the Companies Bill. But they still require use of financial and other key performance indicators and an "indication of likely future developments in the business of the company".

Quality of information

Non-financial indicators tend to be harder to measure and subject to greater uncertainty than financial indicators, being unaudited and possibly falling outside reporting controls. Also, the consistency of data may vary over time as companies develop new or better ways of measuring their non-financial performance. So this framework suggests a gradual approach: the first step is for the board to explain how it monitors performance and to include those measures it is already comfortable with.

This is a key area in which companies can derive value from narrative reporting: it brings focus to the question of the availability and quality of non-financial indicators used by the board for overseeing and managing the business, and encourages the board to scrutinise more closely the non-financial indicators they are using to measure performance.

Legal concerns

Concerns over liability for statements made in the Business Review are understandable. But it's important to keep this issue in proportion. These concerns can often be addressed through careful drafting and the use of cautionary statements. And, regardless of whether information is contained in the Directors' Report or elsewhere, companies are already highly sensitive to the need to ensure that any information provided externally is sound. The Business Review does not change this (although any future protection through the safe harbour proposed in the Companies Bill is going to help).

When it comes to forward-looking statements, it's important to bear in mind that "an indication of likely future developments in the business of the company" (as currently required) or "a discussion of the main trends and factors likely to affect the future development, performance or position of the company's business" (as proposed in the Companies Bill as a future requirement) does not automatically mean that quantified targets should be provided.

Shareholders and other users (at least those for whom the Business Review is of interest) aren't looking for projections that a company cannot support or which may put it at risk. And they aren't looking for extensive lists of performance indicators to feed into models. What they are looking for is a clear, integrated summary of performance in the context of the company's strategy, together with an understanding of how the board monitors this performance.

A discussion of how the business is positioned for the future based on performance to date, how the business is overseen and managed, and the opportunities, risks and challenges facing it, provides the basis for understanding future performance. Complemented with the board's comments on how they see the outlook and what they expect to do going forward, this goes a long way to helping shareholders form their own judgements. Quantified targets – which are rarely met anyway – are of limited value.

Avoiding boilerplate is often a matter of intent – and of helping your lawyers understand what you are trying to achieve from a business perspective. If you embark on the story-telling process without a clear view of your objectives, you're more likely to get pushed onto the ropes and end up saying little of interest, or at least not saying it in a useful and readable way.

We invited Richard Slynn, Corporate Partner at Allen & Overy LLP, to set out certain key legal issues to bear in mind when preparing a Business Review.

ALLEN & OVERY

CHECKLIST OF KEY LEGAL ISSUES WHEN PREPARING A BUSINESS REVIEW

- Ensure that the business review is contained in the directors' report and that it covers all of the content required by the Companies Act 1985*. DTI guidance on cross-referencing should be followed if information required to be included in the business review is contained in other sections of the annual report.

- To reduce the risk of potential civil liability for negligent misstatements (particularly in relation to forward-looking statements in the business review) it should be made clear that the business review is addressed only to the shareholders and that its purpose is to give a review of the business and to explain the principal risks and uncertainties facing the company (or group, as applicable).

- A cautionary statement should be included within the annual report to safeguard the directors against potential liability for forward-looking statements – if the business review cross-refers to other sections, care should be taken to ensure that the cautionary statement covers all relevant sections of the annual report.

- Ensure records are kept in relation to the preparation of the business review in case the Financial Reporting Review Panel, when exercising its enforcement powers, requests evidence as to how the business review was compiled.

- Consider the Accounting Standards Board's Reporting Statement: Operating and Financial Review. This goes beyond the current statutory requirements for narrative reporting but is perceived as best practice. Consider the legal issues in relation to the contemplated forward-looking orientation pending the introduction of a statutory safe harbour.

- Companies should follow the developments concerning narrative reporting currently in the Companies Bill. The Bill contains a new statutory purpose provision which links to the proposed new directors' duty to promote the success of the company having regard to a non-exhaustive list of factors (reflecting the enlightened shareholder value concept). The Bill also proposes extended reporting requirements for quoted companies as well as statutory safe harbour provisions for matters contained in the directors' report (which would include the business review). The timing of the implementation of the Bill is currently uncertain but the safe harbour provisions may come into force in advance of the proposed new narrative reporting provisions and could apply from as early as January 2007.

Richard Slynn
Partner
Allen & Overy LLP

*The business review (which must now be produced by all British companies subject to certain exemptions) must contain a balanced and comprehensive analysis of the development and performance of the business 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. To the extent necessary for an understanding of the development, performance or position of the business, the business review must include analysis using financial key performance indicators and (where appropriate) analysis using other key performance indicators, including information relating to environmental matters and employee matters. The review must contain a description of the principal risks and uncertainties facing the company. It must also, where appropriate, include references to, and additional explanations of, amounts included in the annual accounts of the company. There is also a requirement that the directors' report must contain an indication of likely future developments in the business of the company.

WHAT SHAREHOLDERS (AND OTHERS) ARE LOOKING FOR...

Accessibility

- A short summary that pulls together, in an easy to read style, a clear picture of the company's positioning and performance and communicates the board's view and approach
- A series of signposts which point to the detailed information in the rest of the report

A longer-term picture of performance

- The business's strategy, with an explanation of how this is designed to take advantage of the opportunities and respond to the risks
- A description of what the business needs to get right: how the business needs to be developed and managed, and the board's view on how successfully these "inputs" were managed
- How strategy and operations are being changed in the light of performance and developments
- How the company performed during the year against its short-term and longer-term objectives, explained in a way that brings the results to life, including performance indicators not explicitly captured in the financial statements
- How the story links to reward systems both for senior executives and across the organisation – and how reward is aligned with the drivers, not just outputs
- How longer-term value is generated by involvement in public policy debate, social contribution and ethical development
- How the board and its governance structures contribute to performance and how their stewardship is effective in protecting shareholder interests
- How the board assesses the potential impact on value of the environmental and social effects of its activity and how it responds to the interests of non-investor stakeholders
- Realistic timeframes for achieving targets and how these tie in to accountability, remuneration and securing the right management resources
- Pointers to the future, with a discussion of factors likely to have an impact on the business

Credibility and consistency

- A story which is consistent over time in discussing performance drivers and results, not selective focus on the good news or an avoidance of the inevitable difficulties
- A discussion of risks as uncertainties needing to be managed, rather than as caveats
- Explanations when target measures are hit but objectives not met
- Timeliness: a reflection of what has happened recently, rather than formulaic coverage

...and how they will use it

- As a series of signposts, pointing to more detailed information while making the links to strategy, governance, management, reward and performance (especially for the buy-side analysts and governance/engagement teams, who tend to use the annual report as a primary source)
- As an easily-accessible summary when preparing for one-to-one meetings with the board
- As a basis for improving the quality and focus of these discussions, particularly through highlighting the linkages between strategy and reward policies
- As an insight into the way the board thinks and works in providing strategic leadership and exercising oversight, giving confidence that the board has a clear vision and clear information
- As a tool for engagement on governance issues

Independent Audit is at the forefront of helping boards strengthen their strategic leadership and control.

As well as helping to improve board and committee performance, we have provided advice and assurance on a range of issues such as control culture, risk management, governance frameworks, and internal and external audit effectiveness. And, of course, we help companies to understand their own stories and how best to tell them.

Other recent Independent Audit publications

- Board reporting in 2006: A survey of FTSE 100 annual reports (July 2006)
- Making your audit committee more effective (May 2006)
- Better Governance Reporting: A practical framework (January 2006)

Copies can be obtained on request or downloaded (along with our other publications) from www.independentaudit.com/ourpublications.

Contacts

Richard Sheath	+44 (0)20 7220 6583	richard.sheath@independentaudit.com
Jonathan Hayward	+44 (0)20 7220 6582	jonathan.hayward@independentaudit.com

Independent Audit Limited Holland House, 4 Bury Street, London EC3A 5AW

www.independentaudit.com