The Business Review and AIM*
An assessment of the Business Review from the perspective of AIM companies
This publication is the latest in a series focusing on the Business Review and its impact on UK companies. This is our first report to focus on how the Business Review has impacted companies on the Alternative Investment Market (“AIM”). The editorial team consists of:

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Executive Summary

This survey shows that the publication of the Business Review has widened the gap between the level and depth of narrative reporting given by AIM companies compared with those on the Main Market.

Against a backdrop of ever-increasing regulation and complexity of Accounting Standards, narrative corporate reporting should be seen as an opportunity to get a company’s key messages across in a balanced and easily understood way. It is clear that Main Market companies are increasingly recognising that added value can be generated by greater transparency and fuller disclosures. From our survey it would appear that the majority of AIM companies have yet to see the advantages that enhanced narrative reporting can offer. We believe the main messages for AIM companies coming out of this survey are:

- Ensure that a comprehensive description of the business environment is accompanied by an explanation of the competitive, regulatory and macroeconomic factors impacting it.
- Be specific in respect of both the long term and short term strategy.
- Clearly disclose KPIs and ensure they are aligned with strategic objectives.
- Give details of principal risks and explain how these are being managed.
Introduction – getting the basics right

AIM companies and regulation

AIM is the London Stock Exchange’s market for young and growing companies from all over the world. One of the attractions of AIM is the less rigorous regulatory environment faced by companies on the main market. For example AIM companies are not required to comply with the Combined Code on corporate governance and were given an additional two years to make the transition to International Financial Reporting Standards (IFRS).

The narrative reporting spotlight

However, AIM companies were not given any relief from the requirements of the Business Review which came into force for accounting periods ended 31 March 2006. The Business Review sets out requirements in relation to the narrative aspects of a company’s annual report. Although the requirements state that such information should be contained in the directors’ report, it is often given in the more traditional Operating and Financial Review.

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

1) A description of the business environment in which the company operates
2) A clear description of company strategy
3) Key performance indicators (KPI’s)
4) Identification of principal risks and uncertainties

Whilst only two of these areas, KPI’s and principal risks and uncertainties, are explicit requirements of the business review, we believe that a description of the business environment and strategy are critical in providing the information necessary to put KPI’s and risk into context. This view is supported by the Accounting Standards Board’s (ASB) best practice statement.

Now that we have seen almost a year of reporting under the Business Review, this report looks at how AIM companies have fared and highlights the major areas of difference between the reporting of AIM companies and those on the Main Market. We have taken into consideration the fact that AIM companies are often single entity businesses and therefore we would expect a lower level of segmental reporting.
Purpose of the survey

The survey looks at the quality of narrative corporate reporting in the annual reports of AIM companies both before and after the Business Review came into effect. Each of the four key areas set out in the previous section are considered individually. The aim is to highlight areas of corporate reporting where AIM companies can improve and increase investor confidence.

Our sample

A baseline was created by reviewing companies’ accounts before the introduction of the Business Review. Doing so will allow us to continue to track reporting as it responds to regulations and best practice.

To create this baseline analysis, a random sample of 70 companies was chosen from the AIM index. The sample contained a wide spread of market capitalisation from £0.2m to £1.5 billion.

A further sample of 24 companies, with year ends on or after March 06, was selected to assess the early impact of the Business Review.
Giving investors a view of the business environment

Our analysis shows:

- Half the AIM companies sampled provide some description of their business environment
- The number of companies providing specific details on competitive, macro-economic and regulatory trends was very low
- Over a third gave some insight into trends and factors, but few quantified the data

What we recommend:

- Provide a clear section on trends and factors impacting the business environment both now and in future
- Give an analysis of the relevant competitive, regulatory and macro economic forces

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 assessment criteria for determining compliance with current business review requirements:

“Assessed how companies have met the ‘fair review’ legal requirement against the recommendation in the reporting statement that directors should include a Description of the business and the external environment in which it operates”


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 environments, 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.
Half of the AIM companies sampled included some description of their business environment and almost half (41%) went further and described the markets in which they operated. However, few companies analysed in detail or quantified external factors with which investors and other stakeholders are able to develop their views of how a company may perform.

Furthermore, when it comes to a more detailed discussion of the market and the competitive, regulatory and macro economic trends having an impact on it, very few companies provide any additional detail. Just 16% of companies discussed macro economic trends, only 11% discussed their regulatory environment and a mere 7% discussed their competitive environment.

Following the publication of the Business Review we found only a small increase (54% from 50% in base year) in the number of AIM companies giving a description of the business environment, so there is still a significant way to go for many AIM companies.

This is an area in which AIM companies are significantly behind companies on the Main Market as the chart below shows.

<table>
<thead>
<tr>
<th></th>
<th>Main Market base year</th>
<th>97%</th>
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<tbody>
<tr>
<td></td>
<td>Main Market March '06 year end</td>
<td>100%</td>
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<tr>
<td>AIM base year</td>
<td>50%</td>
<td></td>
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<tr>
<td>AIM post March '06 year end</td>
<td>54%</td>
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Companies giving a description of the business and the environment it operates in
Providing a view of strategic direction

Our analysis shows:

- A third of AIM companies sampled (54% post Business Review legislation) include a statement on their objectives/strategies
- A third of AIM companies (54% post Business Review legislation) gave some explanation as to how they will achieve their strategy
- Very few highlight the measures used to track the achievement of strategic goals and the related targets

What we recommend:

- Give a clear description of strategy – it’s the foundation of effective corporate reporting
- Provide a rationale, timeframe and manner in which the strategy will be implemented
- Use key measures and, where applicable, quantified targets to track progress

Though not an explicit requirement of the Business Review, the ASB’s assessment criteria for determining compliance with the Business Review and PricewaterhouseCoopers extensive capital markets research both firmly support the need for a full description of business objectives and strategy.

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

“The business review should include information on objectives, strategies… where necessary to provide a fair review of the company.” – Source: 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. Such a description provides the foundation on which all content should be based when reporting performance.
**Our approach**

We believe that a company’s objectives should be clear, with a simple articulation of the goals it wishes to achieve and the timeframe it has set in which to do so. This should underpin the whole narrative section of the report, helping readers to form a review of the resources needed and the manner in which they will be managed to achieve success.

**What we found**

Prior to the introduction of the Business Review legislation, only 33% of AIM companies included some reference to their objectives and strategies, the remainder leaving their investors and other stakeholders with no clear idea of the direction of intended future achievements of the company. Another 33% of companies did, in fact, give some description of how it would achieve its strategies, although, it was not the same 33% as had stated their strategies. Only one company of the 70 surveyed gave this information by segment (but this was not unexpected as only 20% of companies surveyed recorded any segmental reporting) and only one company set any targets for their objectives and strategies.

Many companies make reference to factors that are key to corporate success, for example the workforce, innovation, brands etc. However, very few companies provide clear strategic objectives for these factors or additional explanations on the management of these factors and ultimately strategic success.

With regard to cautionary statements, 7% of AIM companies provided statements explaining the uncertainties of forward looking information. These companies were mainly in the mining sector and other similar industries where regulation requires disclosure of this sort of information.

No companies made any statement that disclosure would be prejudicial to the company’s interests and no companies discussed their forward looking information with reference to information which appeared in previous reports. Finally, there was no discussion of whether or not previous expectations had been met.
More AIM companies need to disclose their objectives and strategies clearly. It is also desirable to clearly explain the actions necessary in order to achieve them. AIM companies have made some disclosure of targets but have not related these to objectives and strategy, so this is an area which requires improvement.

There has been marked improvement following the adoption of the Business Review. However, once again, AIM companies are left behind the standards set by those on the Main Market.

<table>
<thead>
<tr>
<th></th>
<th>Percentage</th>
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<tbody>
<tr>
<td>Main Market base year</td>
<td>69%</td>
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<tr>
<td>Main Market March '06 year end</td>
<td>89%</td>
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<tr>
<td>AIM base year</td>
<td>33%</td>
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<tr>
<td>AIM post March '06 year end</td>
<td>54%</td>
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Number of Companies providing information about long term objectives

<table>
<thead>
<tr>
<th></th>
<th>Percentage</th>
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<tbody>
<tr>
<td>Main Market base year</td>
<td>77%</td>
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<tr>
<td>Main Market March '06 year end</td>
<td>75%</td>
</tr>
<tr>
<td>AIM base year</td>
<td>33%</td>
</tr>
<tr>
<td>AIM post March '06 year end</td>
<td>54%</td>
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</table>

Number of Companies providing information about short term priorities
Explaining the measures of success (KPIs)

Our analysis shows:
- The vast majority of AIM companies in our sample made no mention of KPIs or included any discussion of them
- In the few instances where key performance indicators were mentioned, they were not clearly identified or defined; they were not linked strategic objectives

What we recommend:
- Identify and report on the KPIs the board uses to routinely manage the business and assess strategic progress
- Clearly identify, where relevant, both financial and non-financial KPIs
- Provide clear links between strategic objectives and KPIs, as reported
- Use KPIs to enhance the exploration of underlying business performance

What's required?

KPIs are an explicit requirement of the Business Review.

“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.” Source: 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 use to assess strategic success.

Our approach

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. We believe that KPIs need to be mentioned explicitly or described in similarly clear terms and thus we 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

Within the AIM companies we surveyed, key performance indicators are being largely ignored.

i) Reporting KPIs

Prior to the introduction of the Business Review legislation, only 7% of all companies surveyed mentioned that they used KPIs (or an equivalent term) as a tool with which management assesses performance. Even more disappointing is the finding that only 3% of all AIM companies surveyed disclosed their KPIs. Following the introduction of the Business Review legislation, there was a marked improvement in the number of companies acknowledging the existence of KPIs (21%) although 83% of AIM companies still failed to disclose them.

ii) Link to strategy

The primary reason for including KPIs in corporate reporting is to enable readers to assess the strategies adopted by the company and their potential to succeed. We therefore believe it is important for companies to clearly align their KPIs with their stated strategic priorities. KPIs presented in isolation from strategies and objectives cannot fulfil this requirement and will fail to provide the reader with the level of understanding they need.

Overall, we found little evidence of KPIs being clearly linked with strategic priorities. No companies within the base year sample provided such a linkage whilst only one company in the post March 2006 year/end sample did.
AIM companies need to reconsider their handling of KPI information, both in the light of regulatory requirements and with regard to the information their investors and other stakeholders are likely to expect of them.

This is an area in which Main Market companies have traditionally been weak. However they have reacted much more positively to the requirements of the Business Review than their AIM counterparts.

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<thead>
<tr>
<th></th>
<th>Main Market base year</th>
<th>32%</th>
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<tbody>
<tr>
<td>Main Market March '06 year end</td>
<td>75%</td>
<td></td>
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<tr>
<td>AIM base year</td>
<td>7%</td>
<td></td>
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<tr>
<td>AIM post March '06 year end</td>
<td>21%</td>
<td></td>
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</table>

Number of Companies who acknowledge they have KPIs

<table>
<thead>
<tr>
<th></th>
<th>Main Market base year</th>
<th>19%</th>
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</thead>
<tbody>
<tr>
<td>Main Market March '06 year end</td>
<td>57%</td>
<td></td>
</tr>
<tr>
<td>AIM base year</td>
<td>3%</td>
<td></td>
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<tr>
<td>AIM post March '06 year end</td>
<td>17%</td>
<td></td>
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</tbody>
</table>

Number of Companies who report on their KPIs
Identifying and quantifying the risks to success

Our analysis shows:

- Few companies identify their principal risks and uncertainties
- Where risks are discussed, traditional financial risks are the most commonly disclosed
- Very few AIM companies quantify the potential impact of the risks they face

What we recommend:

- Clearly identify the principal risks and uncertainties and explain their potential impact on the business
- Relate risks to strategic goals and explain how risks are managed
- Quantify the risk analysis where possible

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 in the best practice guidelines 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.” Source: Directors report: business review (CA85 Sec 34 ZZB)

However, the requirement for the risks to be the principal risks suggests that they should be specific to each company’s business activities rather than common to all businesses. 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:

“…issuers should not present risks that could apply to any issuer or any offering.” Source: Amended Item 503c of Regulation S-K

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.
What we found

Risk was a subject that was mentioned rarely in the AIM sample we surveyed. Where risk was discussed, it was only infrequently that the risk was quantified or any description given of the way that risk was managed.

Only 10% of companies sampled identified their key risks and uncertainties, rising to 13% following the introduction of the Business Review legislation. Financial risks were the most commonly reported, with 4% reporting internal risks, 3% reporting external risks and 3% reporting environmental, social and ethical risks. For those companies which did disclose risk information, almost none gave a description of how risk was managed or quantified the risk.

Looking to the future

The market capitalisation of companies quoted on AIM varies greatly. All companies will need to take notice of regulatory requirements on risk disclosure and larger companies should be benchmarking themselves against the level of disclosure and clarity of presentation of Main Market companies.

Investors acknowledge that risks exist in any business and therefore the reporting of them should not be a cause of concern. What is more important is how companies describe the management of these risks.

Again, the Main Market has taken on board the requirements in this area more fully than AIM companies.

<table>
<thead>
<tr>
<th></th>
<th>Number of Companies identifying principal risks</th>
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<tbody>
<tr>
<td>Main Market base year</td>
<td>22%</td>
</tr>
<tr>
<td>Main Market March '06 year end</td>
<td>57%</td>
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<tr>
<td>AIM base year</td>
<td>10%</td>
</tr>
<tr>
<td>AIM post March '06 year end</td>
<td>13%</td>
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</table>

Number of Companies identifying principal risks
For financial years beginning on, or after, 1 April 2005 all companies except small companies (as defined by section 247 of the Companies Act) are 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.

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.”
Accounting Standards Board (ASB) guidance

In January 2007 the ASB published their review of narrative reporting by UK listed companies with the aim of ‘keeping the spotlight on narrative reporting and the importance of encouraging continuing improvement in this area.’ As part of this review the ASB set out their assessment criteria for determining compliance with their best practice Reporting Statement and current business review requirements. The views relating to the business review are summarised below:

<table>
<thead>
<tr>
<th>Business review</th>
<th>ASB Interpretation</th>
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<tr>
<td>“a fair review of the business of the company”</td>
<td>Assessed how companies have met the ‘fair review’ legal requirement against the recommendation in the reporting statement that directors should include a:</td>
</tr>
<tr>
<td></td>
<td>Description of the business and the external environment in which it operates</td>
</tr>
<tr>
<td></td>
<td>Discussion on the objectives of the business and the strategies to achieve those objectives</td>
</tr>
<tr>
<td>“a description of the principal risks and uncertainties facing the company.”</td>
<td>Given that the requirement is for a description of principal risks, companies need to consider what these actually are, rather than simply providing a list of all the possible risks they may face.</td>
</tr>
<tr>
<td>“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.”</td>
<td>Explicit identification of financial and non-financial key performance indicators</td>
</tr>
<tr>
<td>“the review must, where appropriate, include references to, and additional explanations of, amounts included in the annual accounts of the company.”</td>
<td>Assessed this requirement in particular in line with the recommendations in the reporting statement covering resources and financial position.</td>
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Source: Accounting Standards Board “Review of Narrative Reporting by UK Companies in 2006”, published 2007
Other narrative publications

Other narrative reporting publications

Report Leadership
Report Leadership is a multi-stakeholder group that aims to challenge established thinking on corporate reporting. The contributors to this initiative are the Chartered Institute of Management Accounts (CIMA), PricewaterhouseCoopers LLP, Radley Yeldar and Tomkins plc.

If you would like to receive copies of any of the reports highlighted above please contact Emma Charlesworth on 020 7804 6814.