

## Introduction and Background

3.1 In this chapter we adopt firm conclusions on the main components of the “scope” issue, by which we mean what answer company law is to provide to the question “For what purpose and in whose interests should companies be operated and controlled?”

3.2 We set out an initial analysis of the problems and possible ways forward on this in Chapter 5.1 of *The Strategic Framework*, and provisional detailed conclusions for consultation in Chapter 3 of *Developing the Framework*. We proposed there that the approach should rest on two pillars:

- a statement of directors’ duties including an “inclusive” duty of compliance and loyalty, restating and clarifying the present legal position – that companies should be operated in the ultimate interest of their members, but subject to their constitutions and taking account of all the relevant considerations, including the implications for the company of the directors’ decisions over time and of their wider relationships and impacts; and
- a new mandatory OFR, to be published by all public and very large<sup>27</sup> private companies as part of the Annual Report, giving an account by the directors of the performance and direction of the business, including in all cases a fair review of achievements, trends and strategic direction, and covering other matters, including wider relationships, risks and opportunities and social and environmental impacts, where these are relevant to an understanding of the performance of the business.

3.3 Both these components have wider purposes than simply addressing the “scope” issue and are integral parts of our wider proposals. The statement of directors’ duties addresses the need for clarity and certainty for company management and members as to what the law expects

<sup>27</sup> We suggested those with annual turnover in excess of £500 million.

of directors. It adopts, with modifications largely needed to address our wider terms of reference, the response to these concerns proposed by the Law Commissions after widespread consultation and careful analysis over many months<sup>28</sup> (consultation and analysis which has continued throughout this Review). The statement also makes some relatively minor but significant reforms in the area of conflicts of interest.

3.4 The OFR is designed to address the need in a modern economy to account for and demonstrate stewardship of a wide range of relationships and resources, which are of vital significance to the success of modern business, but often do not register effectively, or at all, in traditional financial accounts<sup>29</sup>.

## **The Response to Consultation and The Way Forward**

3.5 The overwhelming majority of responses supported these proposals in principle. On directors' duties, a few still supported a "pluralist" approach, imposing a duty to balance the interests of relevant parties without necessarily giving priority to those of members; but none of these responses suggested a practicable means of dealing with the crucial question of how such a duty could be enforced. This is to our mind a key objection<sup>30</sup>. For this and the other reasons already identified<sup>31</sup> against such an approach, our view is confirmed that it would not be workable or desirable here.

3.6 Only a very small number of respondents were still opposed to any restatement in law of directors' duties along the lines we proposed. The main objections came from two bodies representing lawyers, who opposed in principle any attempt by legislation to clarify this area, essentially on the grounds that an effective legislative statement is not achievable. Like the Law

<sup>28</sup> Law Commissions' Report on *Company Directors: Regulating Conflicts of Interest and Formulating a Statement of Duties* Law Com No 261, Scot Law Com No 173, Cm 4436, September 1999.

<sup>29</sup> See *The Strategic Framework* paragraphs 2.16 to 2.18: "The Modern Asset Mix".

<sup>30</sup> The alternative of a discretion for directors to choose whose interests to serve would create an undisciplined and unlimited power. Some responses favoured giving the directors discretion to favour the interest of "the company" over that of its members, which would have the same effect, even though these responses did not apparently favour the pluralist approach. However, we retain the position that these duties are *owed to*, and are *enforceable by*, the company – see paragraph 3.12, below.

<sup>31</sup> See *Developing the Framework*, paragraphs 3.20 to 3.36.

Commissions, we do not find these objections convincing. No alternative workable proposals were made for dealing with the current single mandatory consideration, which is already a component of the duty of loyalty – i.e. the duty to have regard to employees, in section 309. (As we have explained<sup>32</sup>, this provision is ambiguous and unsatisfactory.) But the arguments made were supported by a number of detailed concerns. These need to be met and we discuss them below.

3.7 Responses on the OFR proposal also supported our approach by a very large majority. Some bodies representing employees and non-governmental organisations (NGOs) objected to our proposals as not going far enough, on the ground that they restrict the coverage of the OFR required in all cases to the first two heads (briefly, (i) fair review of performance and (ii) purpose, strategy etc), requiring coverage of other matters (particularly relationships with employees and environmental impact) only where the directors in good faith judge them to be material for the understanding of the performance of the business (we refer to this boundary below as “the materiality threshold”). Some responses representing accountants’ views also believed that there should be stricter auditing, enabling auditors to intervene in judgements of directors to omit such matters on materiality grounds. The effect of this would be to impose something akin to an objective criterion of materiality.

3.8 Other bodies favoured a more flexible or less mandatory approach than we put forward. These mainly represent some (but by no means a majority) of business and professional opinion. While supporting wider adoption of OFR reporting, they believed it was inappropriate to impose this by statute. Of these a few apparently favoured voluntary best practice in this field (which, given that the first head is a directive requirement is not entirely feasible). But the majority of them favoured mandatory regulation by standards – most thought this should be a matter for Listing Rules or other regulatory standards<sup>33</sup>. The main concerns were that the OFR needed to be

<sup>32</sup> See *The Strategic Framework*, paragraphs 5.1.20 to 21.

<sup>33</sup> Many supported a standards approach as part of a general position that statute should contain the absolute minimum about reporting (e.g. in sum, that companies should present annually a true and fair view of their financial position and performance – leaving the rest to be developed by mandatory standards) because the structure of reports will soon change radically. We see the force of this, but believe such fundamental change should be subject to Parliament’s control via retention of the existing statutory instrument power – see Chapter 12, below.

a flexible and developing instrument, and that inflexible mandatory rules might lead to perfunctory “boilerplate” compliance, as with the “fair review” coverage incorporated in the present directors’ report. There were also concerns about confidentiality and competitiveness.

3.9 Listing Rules are not appropriate here. This is a matter of company governance rather than investor protection, and in our view the companies to be covered go well beyond the listed sector. It would be possible to delegate the whole matter to the Companies Commission standards body proposed in Chapter 12 below. However we do not believe that this would be appropriate, for two main reasons, which are related. First, we regard OFR reporting as a matter of such fundamental importance, and so integral to a balanced approach to the scope issue, that the basic regime should be underpinned by Parliament. Second, subjecting the whole matter of OFR reporting to standards would enable the standards body to make rules requiring disclosure beyond the materiality threshold we propose. Maintaining the threshold requires essentially that it be defined in or under statute.

3.10 However, we entirely recognise the need for flexibility and to prevent perfunctory reporting. This need is a basic driver in favour of an OFR which is owned by directors and which gives the maximum scope for their good faith judgement as to the best means of presenting the business. We agree that the role of standards is vital and the statutory structure should be kept as light as possible. We also believe there are ways of strengthening audit without diluting this approach. So there are useful ways of responding to the concerns both of those who think the OFR proposal does not go far enough and of those who think it goes too far. We set these out below in the context of a detailed discussion of both of the components of our approach to scope.

## **Detailed Concerns on the Statement of Directors’ Duties**

3.11 We raised a series of questions in *Developing the Framework* on the detail of the statement of directors’ duties. While many of these go beyond the question of scope, the statement needs to be developed and justified as a whole. We therefore deal with all the major difficulties and concerns here.

3.12 The first area is the matter of the general positioning of the statement and its relationship with the rest of the law<sup>34</sup>. We have made it clear that the intention is that the statement should be expressed at a sufficiently high level of generality that it can be capable of judicial development within its terms. We believe that this is the effect of the present draft. It will fall to be judged by reference to the final draft in due course. The majority of responses took the view that there was no value in defining the duties as “fiduciary” so long as the intention of achieving substantial continuity with the present law is achieved. We accept this view<sup>35</sup>. We have made it clear that the restated duties are to continue to be owed to the company<sup>36</sup>, and now believe that this is best dealt with by an explicit reference to that effect in the preamble of the text. We believe that the relevant provisions can be drafted so that general principles of statutory interpretation will ensure that to the extent that they enact the common law the existing authorities will be capable of being invoked to explain the nature of the duties which they codify. It is generally agreed that the duties must be subject to the overriding duties of directors towards creditors in an insolvency situation, but also that it is undesirable to lay down any detailed new rule in this area; the law is developing and there is already a carefully balanced statutory provision, which operates *ex post* in a liquidation, in the Insolvency Act 1986 section 214 (wrongful trading). We propose that this issue should be dealt with in a general provision in the statement making it clear that the duties operate subject to the other provisions of the Act and to the supervening obligations to have regard to the interests of creditors when the company is insolvent or threatened by insolvency<sup>37</sup>. We propose that the details should be explored with the draftsman.

3.13 Our proposal to include in the duty of compliance a duty of honesty<sup>38</sup> was very widely supported. However a minority expressed concerns, which we now share, as to the uncertain effect of such a provision. Directors are of course subject to the general law about dishonesty

<sup>34</sup> See *Developing the Framework*, Questions 3.2, 3.11, 3.12.

<sup>35</sup> The position will also be clarified if proposals in Chapter 13 to restate the remedies are adopted. The current proposal proceeds on the basis that some, but not all, of the duties, are fiduciary.

<sup>36</sup> *Developing the Framework*, paragraph 3.80.

<sup>37</sup> One response suggested that the interests of creditors should be included in the “inclusive” list of circumstances to be had regard to in paragraph 1c of the statement. However this would give them the wrong status – these interests are covered by contract while the company is solvent; but if insolvency threatens they *override* any considerations of success of the company for members.

<sup>38</sup> See Question 3.39 of *Developing the Framework* – originally mooted by the Law Commissions: see Cm 4436, page 39.

(theft, fraud etc). An explicit duty of honesty on directors would be relevant only where it could be argued that honesty required directors to do something which was contrary to their other duties, in particular their duty to act for the success of the company for the benefit of its members as a whole. It is very difficult to predict how such an indefinite duty of honesty would be interpreted – for example, if it was in the interest of the company in this sense to terminate a contract would a duty of honesty prevent this? Such a termination would be entirely proper in many cases. Opinion may differ about whether it would be “honest”. Uncertainty of this kind is undesirable and in our view unnecessary. We doubt whether an explicit duty of honesty would add significant protection over and above that provided by the general law, and it risks creating uncertainty. We do not therefore propose to include an explicit duty of honesty as part of the directors’ duties to the company.

3.14 Responses generally believed that the duty to use powers for a proper purpose should not be tied to the provisions of the company’s constitution; but some suggested that it was appropriate to associate it with the duty to comply with the constitution by continuing to deal with both matters together – an approach we propose to retain.

3.15 On the structure of the core duty of loyalty<sup>39</sup>, a number of concerns were expressed on the hierarchy of duties which is created in paragraph 1 of the draft. The intention is that the duty of compliance to the constitution and to use powers for a proper purpose is overriding. Only if that is complied with are directors bound to promote the success of the company for the benefit of members under paragraph 1b. The constitution in this sense needs to include any decisions validly taken under it which bind the directors (such as a special resolution binding the directors<sup>40</sup>). The draft is intended to achieve this, but it has been pointed out that it needs to be extended to cover decisions of the company under the general law which have the same effect, such as unanimous decisions of members<sup>41</sup>. A phrase such as “decisions of the company under the constitution or the general law” may be needed to cover this point.

<sup>39</sup> Paragraph 1b of the draft on page 29 of *Developing the Framework*.

<sup>40</sup> See Table A, regulation 70, SI 1985/805.

<sup>41</sup> See *Developing the Framework* paragraphs 4.21 to 4.23, “The Unanimous Consent Rule and the Elective Regime”.

3.16 The proposal to express the ultimate criterion for the duty of loyalty as “the success of the company for the benefit of members”, while welcomed by the great majority of responses, was criticised by some on the ground that the “success” concept was superfluous, and by others, that the reference to the members’ interest should be dropped. The overriding interest of members is central to the concept. Questions have been raised as to how success is to be determined where the criteria for it are not apparent from the constitution or company decisions taken under it. The intention and effect of the draft is that this will be a matter for the directors to determine by their good faith business judgement, subject of course to the constitutional powers of the general meeting. We believe that this is the correct result and propose to retain the concept of success as the core objective of a purposeful association of persons. It has been very widely welcomed in that spirit.

3.17 However, one of the objectives of this flexible approach was to ensure that primacy was given to the constitution, so as to ensure that where companies had unselfish objectives (incorporated charities for example) their constitutional framework and decision-making process would prevail over the selfish interests of members (as opposed to their interests as associates in the enterprise in achieving its unselfish objectives). It has been suggested that the draft does not achieve that result with sufficient certainty. We believe that this issue can be resolved and propose that it should be explored with the draftsman.

3.18 Under the trial draft the director is to promote that objective “taking account of both the short and the long term consequences of his acts”. This attempt to capture the need to assess decisions in terms of their consequences over time was particularly prompted by evidence that the obligation to look beyond the short term was not widely recognised by directors or members. It was again very widely supported. It has been suggested that the draft would not enable directors to put appropriate emphasis on short term considerations where there are no long term ones (for example where the company will lose its independence in any event and the question is what course to take in the interim) or where a transfer of assets to members, such as a distribution or winding up, is in issue. We reject both points. The draft does not require the directors to give weight to long term issues if there are none, nor even to give them weight if

they exist but the directors regard them in good faith as not material. To regard the return of assets to members as necessarily inconsistent with success is an economic solecism.

3.19 The third element in the duty of compliance and loyalty is the “inclusive” list of matters to which regard is to be had by a director “for that purpose” – i.e. in determining in good faith what is judged to be most conducive to the overall objective of success for the benefit of members. The main concern here was that it should be absolutely clear that these are matters which, so long as they are identified and assessed in accordance with the duty of care and skill, are subject to the good faith business judgement of directors both as to whether they are relevant and as to the weight to be attached to them, in considering the promotion of the success of the company. Doubt was expressed as to whether the words “for that purpose” were sufficiently clear. We propose to explore in drafting a means of making it absolutely clear that the hierarchy of obligations is:

1. to obey the constitution and decisions of the company which bind the director;
2. to promote what he calculates in good faith to be likely to promote success for members’ benefit; and
3. as part of that process, to take account of the factors (after identifying and assessing them in accordance with his duty of care and skill) which he believes in good faith to be relevant for that purpose including (where he believes them relevant) the matters listed in paragraph 1c.

3.20 Some responses argued that there should be an “*entitlement*” to take account of such matters, rather than an obligation. This is clearly unsustainable. The obligation only arises where the director after assessing a matter in accordance with his duties of care and skill in good faith believes that weight should be attached to the matter. Once he has reached that position he cannot be permitted to disregard it.

3.21 Others suggested that some, or all, of the listed matters should be omitted from the draft.

3.22 The removal of all was proposed on the ground that it was only an illustrative list and that it would give undue prominence to some matters in inappropriate contexts. But most responses believed that the list was of value, and we believe that all items are at least capable of influencing decision-making in most companies. Removal of all would involve repealing the present “one item list” in section 309 (duty to have regard to the interests of employees), which we regard as neither desirable nor politically sustainable. No response which favoured removing the whole provision dealt satisfactorily with this point.

3.23 Paragraph 1aa of the draft includes employees with the other participants in the supply chain. We regard this reference to the supply chain, which will be relevant to practically all companies in practically all circumstances, as an essential part of the inclusive duty concept. We have considered whether omission of the other items would usefully simplify the statement without damaging effect. This is a matter of judgement, but we believe that the other items mentioned (community and environmental impact and business reputation) are also sufficiently important and pervasive in the modern economy to be worthy of inclusion<sup>42</sup>. Their omission would destroy an important link with the parallel provisions in the OFR and remove any reference to the wider implications for a company of its “corporate citizenship” in a colloquial sense.

3.24 Finally it has been argued in a very few responses that this list will encumber boardroom decision-making with legalistic analysis and pedantic, defensive minute taking. This is a matter of judgement, but the great majority of responses, including all those from experienced business bodies, do not take this point. We are unaware of any such effect from section 309; the draft only requires boards to behave in the way which we are advised the best boards do already; and we judge the point as without foundation.

<sup>42</sup> Our attention has been drawn to the discrepancy in the draft between the company's *need* to foster business relationships and *need* to maintain its reputation as opposed to the impact on the environment and the community where the company's need is not mentioned. The reference to need is intended to stress that it is the needs of the company which are in issue and not the external interests in their own right. We propose to explore a redraft, which includes the need concept in the impact items as well – e.g. “the company's need to have regard to the impact of its operations on the communities affected and on the environment”.

3.25 No major issues were raised on principle 2 (independence of judgement)<sup>43</sup>, but a number of detailed points were made on principle 3, conflict of interest<sup>44</sup>. It was suggested that the draft did not resolve the issue where a person is a director of two companies with conflicting interests. To the extent it does not, nor does the present law. But the effect of the draft will be to require the director to declare the interest, if material, in the case of a transaction, and to oblige him not to take a secret profit and to be accountable if he does in cases not involving such a transaction. Similarly, while the draft is silent on whether a director is free to vote and how he should do so where he declares an interest, the effect will be that he will be obliged to comply with his other duties, in particular with the constitution and his duty in good faith to promote the success of the company for the benefit of members. In both these cases the law is arguably less than clear; but the draft would not make the position worse, and in our view it in fact produces a clear and desirable result. In the case of a very serious conflict the position of a director may well be untenable, in which case he may have no course open to him except resignation.

3.26 It has been argued that the draft requires directors to declare immaterial interests. Our intention is that interests should be declared to the extent required by the Act, but not otherwise; we shall also need to clarify the new position of sole directors who, we have suggested above, should be required to declare their interest to the members<sup>45</sup>. It was argued in some responses that there is a case too for clarifying that even an opportunity which the company has decided not to, or cannot, pursue is still subject to the “secret profit” rule under paragraph 3b. This was the outcome which, on balance, we provisionally favoured<sup>46</sup> but it may

43 One response suggested that this was part of general agency law and did not require a mention, but most of these principles are applications of the general law in the context of directors.

44 The text of principle 3 is reproduced here for ease of reference:

“A director must not:

- a. authorise, procure or permit the company to enter into any transaction in which he has an interest unless the interest has been disclosed to the relevant directors to the extent required under the Act; nor
- b. use any property, information or opportunity of the company for his own or anyone else’s benefit, nor obtain a benefit in any other way in connection with the exercise of his powers, unless he is allowed to make such use or obtain such benefit by the company’s constitution, or the use or benefit has been disclosed to the company in general meeting and the company has consented to it”.

45 See paragraph 2.26 above. The draft might read “A director must not authorise, procure or permit the company to enter into any transaction in which he has an interest which is required to be disclosed under the Act unless it has been disclosed to the extent so required to the relevant directors, or (in the case of a sole director) to the members”.

46 See *Developing the Framework*, paragraph 3.63.

not be clear from the draft<sup>47</sup>. However a significant number of responses suggested there was a case for a much less strict rule on such conflicts, allowing transactions to proceed, for example, where they were “fair to the company”. It was also pointed out that at least where an opportunity had been irrevocably abandoned, it would not fall within the provision anyway. There is an argument that where directors (in their capacity as such) encounter business opportunities, it is for the shareholders and not their fellow directors to authorise the exploitation of those opportunities by the directors for their personal benefit – as is indeed the case under present law. But there is a counter-argument to the effect that company directors are most unlikely to be aware of this strict rule which, arguably, is counter-intuitive and fetters entrepreneurial and business start-up activity by existing company directors. The law should only prevent the exploitation of business opportunities where there is a clear case for doing so.

3.27 The present law does allow flexibility; but in the light of responses we believe there is a case for making it easier for companies to make use of it, and there may be a case for going further. The present law, and the duty as drafted, do allow exemption under the constitution (which is of course in principle agreed by the shareholders) and we see a particular case for a qualified constitutional exemption for private companies. We therefore propose that the new model constitution for private companies should include a provision to the effect that it is a defence to an action under this duty for a director to show that he fully informed his fellow directors of the use or benefit in question and that they waived the company’s rights under this duty<sup>48</sup>. The question remains whether we should go further, either, first, by excluding opportunities which the company is incapable of exploiting, and/or, second, by allowing authorisation by the independent directors on behalf of the company. The second proposal gives rise to major concerns about the scope for collusion and abuse; on the other hand general meeting authorisation is slow and cumbersome in cases where speed and business expertise may be essential; insistence on it may mean that in practice directors do not pursue such opportunities.

<sup>47</sup> It was suggested in one response that it should be made clear whether “permitting” a transaction by a director included “passive permitting” e.g. silence in the meeting approving the transaction. We are not convinced that there is a real doubt on the effect but this is the sort of detailed point which we believe is best left for judicial resolution on the particular facts. Compare paragraph 3.12, above.

<sup>48</sup> In this context we should note that where under the duties a waiver in general meeting is available (as here) we envisage that this should be capable, in the case of a private company, of being achieved by the written resolution procedure.

The first proposal is logical but raises difficult issues of proof. If the decision as to what the company is capable of doing, which is a business judgement, is to be left to the directors then it becomes practically indistinguishable from the second proposal. This problem might be reduced if the burden of proving that the company could not have exploited the opportunity were imposed on the director. Section 727, which enables a director to apply to the court for relief from liability in such cases, amongst others, where he has acted honestly and ought fairly to be excused, would be available here; however the provision is expensive to invoke and could not safely be relied upon to provide relief in all the cases we regard as potentially deserving. We find this a difficult issue and would be grateful for comments on these various approaches.

3.28 Finally, doubts have been raised as to the relationship between paragraph 3a, which concerns interests in company transactions, and paragraph 3b, which concerns exploitation of other opportunities in relation to the company. The intention is that matters falling within 3a should not be subject to 3b. This intention appears to have been widely assumed in responses, but we will explore whether the draft should be clarified on this point.

3.29 Our proposal to retain section 310 (provision exempting an officer or auditor from liability to be void) for directors was widely welcomed<sup>49</sup>. But a relaxation was suggested to allow directors to be indemnified for their own costs of defending themselves in proceedings by third parties, the indemnity being made available in advance of or during such an action, but with the money to be recoverable if the defence fails. There is a strong case for allowing this in meritorious cases (perhaps particularly in the case of expensive litigation overseas in litigious jurisdictions); but if the defence does fail the prospects of recovering the indemnity may be remote. On balance we would favour such a provision where the independent directors (or, in a case where all the directors are conflicted, the majority of members) believe in good faith, on the basis of appropriate independent advice, that the prospects of a successful defence are good; but we would be interested in views<sup>50</sup>. There may be a case for allowing the indemnity to be retained in such circumstances if the defence does fail.

<sup>49</sup> Our proposal for a minor relaxation in section 727 (court's power to grant relief from misfeasance liability) was unanimously supported and we propose to adopt it.

<sup>50</sup> There was one proposal to allow the duties to be amended generally by the company constitution. This would allow a blanket indemnity along lines allowed in many US jurisdictions. We would not support this.

3.30 There was a very high level of support for retention of the present law on the powers of a company to ratify a breach of these duties, including an appropriate exception for cases of threatened insolvency, and for this power being recognised in the Act. We consider below the extent to which the powers of the majority to ratify misfeasance should be limited to protect the minority<sup>51</sup>, a matter which will need to be dealt with at the same time. As to how the exception for threatened insolvency should be expressed, the same basic approach is required as to the directors' duties above, but the material time will be the time of the ratification. We suggest a rule that a ratification is not valid if made at a time when the company is insolvent or threatened by insolvency and the effect of the ratification would have been to reduce the assets available to meet the claims of creditors. We would be interested in comments on this proposal.

3.31 Finally on directors' duties, we suggested that the statement should be exhaustive, in the sense that it should not be open to the courts to develop new principles, as opposed to developing the existing principles by reference to particular cases. We argued that such wider developments in this very important commercial field should be a matter for Parliament. Almost all responses supported this view, but one opponent suggested that the statement should be capable of amendment by statutory instrument. We generally support such flexibility and would err on the side of generosity in conferring subordinate legislative powers in the fast moving field of company law. But in the particular case of directors' duties we believe that the issues are so fundamental that they should be reserved to the full procedure of primary legislation. However we recognise that this is a peculiarly political and constitutional question which will be resolved by government and Parliament.

## Detailed Comments on the OFR

3.32 There has been debate about the purpose of, and audiences for, the new OFR, in particular as to whether the purpose is a financial one and whether the audience should be regarded as limited to investors. It is recognised that it is on the basis of the purpose that the issue of materiality will fall to be addressed. Our proposal in *Developing the Framework* was that the purpose should be:

<sup>51</sup> See Chapter 5.

“to provide a discussion and analysis of the performance of the business and the main trends and factors underlying the results and financial position and likely to affect performance in the future, so as to enable users to assess the strategies adopted by the business and the potential for successfully achieving them”.

3.33 A number of responses suggested that the approach should be narrowly financial and the target audience limited to shareholders. But a wide range of responses advocated a broader approach, including some business players and accountants as well as those representing the wider range of users of company accounts. Our approach is that the document is not financial in the narrow sense; as the title indicates, it is a qualitative, as well as a financial, evaluation of performance and trends and intentions. On the other hand it is an analysis and description of the business as an operational and commercial entity prepared by the directors from their perspective as managers of the business. This does not of course mean it is to be a mere marketing document – they are required to give a good faith objective assessment from their perspective. As to the matter of the target audience, the issue is resolved by the fact that the document is to be published like financial accounts. The directors will need to consider in accordance with their general duties how best to perform their function of preparing this document so as, subject to the law, to promote the success of the company for the benefit of its members. This approach appears to fall somewhere in the middle of the range of opinion on these questions, and we propose to retain it.

3.34 As for materiality, in the light of the above it is clear that the standards of materiality cannot be the familiar financial ones, and that was not our intention. The materiality exercise here is bound to be much more judgmental than for financial accounts because there will be much more scope, and indeed necessity, for selectivity in what is included, and for judgement as to how to give readers the best picture and understanding of the business. It has been suggested that the test should be “what might reasonably be expected to influence decisions by users?” (This could potentially require a very wide range of material to be included on the back of an expressed need from anyone who could legitimately claim to be a user.) An alternative view was that the criteria of materiality should be set by standards, on the ground that it is not reasonable to expect auditors to stand by when matters are omitted which in their judgement should be

included. We do not accept these views, which could lead to very sweeping interference in the judgement of directors on this question. We remain of the view that this should be a matter for directors to determine on the basis of the question “Given my good faith, honest judgement about the best way of presenting the operations of the business for the defined purpose, does this item matter?” However we recognise the difficulty in relation to audit, and make a proposal below on proper preparation of the document, which addresses this and other concerns that the structure proposed is so discretionary as to be without discipline.

3.35 On the “materiality threshold”, as defined in paragraph 3.7 above, a strong majority supported our proposal, as enabling a flexible and gradualist approach to the development of practice in this field. Some favoured subjecting the whole issue to standards, an argument we have dealt with above. Others believed that some or all of those items which we suggest should be required only if the directors regard them in good faith as material, should be required to be included in all OFRs. Support was strongest for mandatory coverage of business relationships, especially with employees, followed by the environment. We suggest below that the Combined Code on Corporate Governance including the “Turnbull” requirements on disclosure of risk should be made a matter for delegated mandatory disclosure standards under the aegis of the Companies Commission (see Chapter 12.) The effect of this will be to make some disclosure on these matters mandatory where the Combined Code is applied<sup>52</sup>. However this will not necessarily fully displace the OFR proposals.

3.36 We believe that the case for our proposals on the materiality threshold stands up and is widely supported. But here again our proposal below on proper preparation will add an element of discipline.

3.37 We do however accept that there is a case for clarifying the scope of mandatory standards in this field. Such standards should be capable of applying to the presentation of the fully mandatory items and to the other items if they are disclosed, but not to the materiality judgement. We have proposed that the standards-setting body should have the power to define “safe harbour” areas, where reporting and audit should be exempt from potential liability to

<sup>52</sup> The Combined Code currently applies only to listed companies, but in Chapter 12 below we argue that a wider view needs to be taken of the appropriate scope of the Code in the context of the developing global market for securities.

encourage candid and experimental reporting<sup>53</sup>. However there should also be scope for standards laying down general rules for the document as a whole, covering how the material which directors are required, or judge themselves required, to include is to be presented, e.g. on such matters as the disclosure of prior year figures and treatment of financial matters covered in the accounts. We also proposed a broad discretion to exclude matters which raise confidentiality risks<sup>54</sup> (a matter already covered in the OFR guidance of the Accounting Standards Board (ASB), but a source of continuing concern in some responses). We believe that this is a field in which standards would be appropriate. Finally, although we do not believe that materiality should be regulated by standards, we do recognise a case for developing best practice, and believe that it would be appropriate to confer a power to issue guidance covering the whole of the OFR, including this matter, on the standards body.

3.38 We proposed that audit of the OFR should be restricted to:

- consistency with financial and other records;
- the factual basis of the claims made, to the extent that the information is factual;
- compliance with any applicable standard, perhaps with delegation to an expert; and
- consistency with the auditor's knowledge gained in the audit of the accounts.

We stressed that the audit should not second-guess the directors' judgements on materiality. We asked how much of the audit should be covered in standards. Our approach was widely supported, with inclusion of the basic requirements in law and the rest being dealt with by standards. Some favoured the whole matter of audit being governed by standards, which is open to the same objection as to the whole document being dealt with in this way, that is to say, that in order to prevent it leading to the directors' judgements being displaced, the scope of OFR audit must be defined in law. Others believe that the OFR is so important that these scruples about directors' judgement are misplaced and the whole document, including all materiality judgements, should be subject to audit.

<sup>53</sup> This was practically unanimously supported.

<sup>54</sup> *Developing the Framework*, paragraph 5.87.

3.39 While we do not accept the arguments for audit of materiality judgements, we recognise the concern that the discretion might be abused. We therefore propose to adopt the suggestion from the APB and others that the directors should be subject to an obligation properly to prepare the document, and that proper preparation (that is to say the process by which the document has been prepared) should be subject to audit. This would not require or enable the auditors to substitute their own judgements for that of directors, but it would require them to examine whether a proper process had been gone through in reaching those judgements. We also believe that proper preparation should be an area where the Financial Reporting Review Panel (FRRP) should be able to pursue enforcement proceedings. This should help to minimise risk of the flexibility we believe to be vital in this area being abused. See the discussion of the powers of the FRRP in Chapter 12 below. We have considered whether it would be desirable to confer on the standards body a power to lay down rules on proper preparation and/or on the auditing standards body to make rules on audit of the process. On the whole we think this is a matter best left to develop, but we would be interested in views.

3.40 We originally proposed that all public companies and private companies with more than £500 million turnover should be required to prepare and publish an OFR. Most responses supported this; but some supported limiting the OFR requirement to listed companies only, while others made a case for exempting small public companies. We find the latter point persuasive and would propose that the requirement to prepare an OFR should apply to private companies with a turnover exceeding £500 million (as previously proposed) and public companies with a turnover exceeding £5 million. We think it entirely appropriate that these two thresholds should be set at very different levels; but we would be grateful for views as to the merits of introducing a threshold for public companies and on the proposed level.

3.41 The application of the OFR requirement to groups of companies raises difficult questions. We proposed that for a group with a British registered ultimate holding company, that company should prepare a consolidated OFR and other companies in the group should be exempt. Where the group had a parent undertaking overseas or which was not a company we proposed that the “top” British registered holding company should prepare an OFR for its group. But we recognised the difficulties in this approach, particularly where it required a consolidated

OFR in circumstances where consolidated financial accounts were not prepared<sup>55</sup>. About half the responses favoured this solution, but the rest favoured making the whole question of the preparation of consolidated OFRs and the exemption of subsidiary companies a matter for standards. We see great merit in this, particularly since the extent of the consolidation obligation will be subject to standards for financial accounts (see Chapter 6). However we think it reasonable to suggest a way forward in this area, which is that all quoted companies should provide an OFR, consolidated if they are holding companies; all other public and private companies which, taken with their subsidiaries if any, would be required to provide an OFR should also do so (consolidated where they are holding companies) unless they are subsidiaries and their holding company prepares a consolidated OFR which includes their affairs. (See also our proposals at paragraphs 10.42 to 10.44 in respect of group companies in an elective regime.)

3.42 We would add a final word on flexibility. We propose to retain the main features of our original proposal with this very much in mind. However we also propose the retention of the existing power to amend the accounting provisions by statutory instrument; this has been very widely welcomed. Many of the arguments in favour of delegation to standards also depend on the need for flexibility. Finally we have proposed that the standards body should have the power to issue guidance. We believe that this is the best combination of powers and requirements to achieve the appropriate balance of flexibility and discipline in what we expect and hope will be a fast developing and much debated area.

## **Conclusions on Scope, Directors' Duties and the OFR**

3.43 These conclusions are based on careful consideration of all the responses we have received on these questions. We would however be grateful for new points on the issues at large and in particular for views on the following new points which have emerged in the process of preparing these views.

<sup>55</sup> *Developing the Framework*, paragraph 5.101.

**Question 3.1:** Do you agree that the model constitution for private companies should include a provision that where a director can show that he informed his fellow directors of a proposed use of company property or other benefit within paragraph b of principle 3 and they waived the company's rights, he should be free of the relevant duty?

**Question 3.2:** Do you believe that there is a case for going further to enable directors to exploit on their own behalf company opportunities either:

(i) by allowing the independent board members to waive the company's rights;

(ii) by allowing the director to exploit the opportunity if he can show that the company could not have done so; or

(iii) in some other way?

**Question 3.3:** Do you agree that it should be lawful for an unconflicted board, or the general meeting, to indemnify a director in advance against his own costs of defending misfeasance proceedings brought by third parties, where it is satisfied in good faith on the basis of appropriate independent advice that the prospects of a successful defence are good, on the basis that if the defence fails the indemnity should be recoverable? Or would you allow such an indemnity to remain valid even if the defence fails?

**Question 3.4:** Do you agree that a ratification of a breach of duty by a director should not be valid if at the time of the ratification the company was insolvent or threatened by insolvency and the effect of the ratification would have been to reduce the assets available to meet the claims of creditors, and if not, what solution would you propose to this problem?

**Question 3.5:** Do you agree that the relevant standards body should have power to issue non-mandatory guidance on all aspects of preparation of the OFR?

**Question 3.6:** Do you agree that there should be an obligation on directors properly to prepare the OFR and that the propriety of the process used should be a matter for scrutiny and report by auditors, and in an appropriate case, for enforcement action by the FRRP?

**Question 3.7:** Do you agree that the relevant reporting standards and auditing standards bodies should not have power to issue standards governing the process for preparation of the OFR?

**Question 3.8:** Do you agree that the following companies should be subject to the OFR obligation: all public companies except those with a turnover of £5 million or less, and private companies with a turnover in excess of £500 million?