

OPERATING AND FINANCIAL REVIEW (OFR)
Internal Discussion Note
29 September 2005

1. Overview

The Government has recently introduced more comprehensive reporting requirements for UK companies.

As a result of the EU Accounts Modernisation Directive (the Directive), large and medium companies are required to produce an expanded directors' report (Expanded Report). Beyond bare compliance with the Directive, 1,290 UK quoted companies are required to produce a more detailed Operating and Financial Review (OFR). This requirement applies from the year beginning March 2005. The OFR is a forward-looking analysis that describes the underlying trends and factors likely to affect business performance now and in the future.

The new reporting requirements are intended to increase transparency in reporting and have been welcomed, or at least accepted, by most stakeholders, including directly affected businesses.

During consultation on the OFR there were, however, concerns around some aspects of the proposals. DTI responded to the significant concerns of businesses by reducing the level of care directors would be required to exercise in preparing the OFR, partly reducing the additional audit requirements, and thereby substantially reducing the compliance costs of the final proposals.

While DTI substantively addressed the main concerns of consultees at the time, the OFR still seems expensive, costing quoted companies an average £31,969 more than previous reporting requirements. There is a window before the first reports are produced to revisit the requirements. The choices are to move reporting requirements for UK quoted companies to, or closer to, the Directive requirements on:

- the information side (for an average saving of £3,256 per company);
- the audit side (for an average saving of £22,713 per company); or
- both (for an average saving of £25,969 per company).

Any scaling back of requirements would not be without some resistance, e.g. the environmental group CORE would be likely to oppose this as they seek higher assurance and disclosure requirements from large companies as a matter of principle. Other companies have already begun preparation for the OFR and would see this is a rather belated u-turn.

Handling is an issue. The key priority will be to avoid perceptions that we are losing momentum on governance. Doing this as part of other measures, e.g. mandatory voting disclosures, will minimise this risk.

We think it would be useful to work with DTI to see whether options for scaling back current reporting requirements for quoted companies might be explored further, especially in light of the significant cost savings this represents and the pressure on DTI to meet its deregulatory targets.

2. Background

For some time now, pressure has been growing to improve the quality of forward-looking narrative reporting by directors. The first Cadbury report led to a voluntary standard for OFRs (although compliance with this has been patchy). The Company Law Review recommended that large public and private companies be required to produce beefed-up disclosures in the form of an OFR. Recent accounting scandals reinforced such calls. The IASB is now working on an international principles-based standard for improved management commentary.

As part of the company law review and the implementation of EU Directives, Government has made changes to reporting requirements from March 2005. Under the Directive all medium and large-sized companies are required to produce an expanded directors' report. In addition, quoted companies are required demonstrably to comply with a higher requirement to produce an OFR. More stringent audit requirements apply to both the Expanded Report and OFR.

Underpinning the OFR is the argument that the shareholder base of quoted companies has additional needs to that of private companies, hence the requirement to prepare a more fulsome, and more forward-looking, dispersed review than that required under the Directive.

There is general support for the principle of improved disclosure of forward-looking and strategic narrative. Investor groups such as the ABI and NAPF have welcomed improved disclosure, while external pressure groups (e.g., environmental lobbyists) have been strongly supportive. However, there has been scepticism from businesses over the scope and timing of the OFR proposals.

While there has been a high degree of support from stakeholders for increased transparency, there has also been significant scepticism of the specific proposals. A MORI poll suggested that 34% of institutional investors opposed the Government's original OFR proposals that went out to consultation in 2004. Although proposals have since been revised, a more recent survey of business leaders indicated that 48% opposed the new requirement.

A number of other stakeholders (e.g. IoD, CBI and Association of Chartered Certified Accountants, ICAEW) expressed concern at the timing of implementation, in the face of broader changes to corporate governance and reporting. Some also asked that implementation of the OFR requirement be delayed initially. A number of corporate advisors (e.g. KPMG, Deloitte & Touche, Justassurance) also expressed concern about the ability of companies to comply with the Standard by the first year. DTI has therefore decided to delay enforcement of the OFR Reporting Standard by one year.

Directive Minimum

The Expanded Report requires companies to provide a 'fair review' of the development and performance of the business and its position at the end of the financial year, consistent with the nature and size of the business. It must also contain a description of the principal risks and uncertainties facing the company, using key performance

indicators to the extent necessary to understand the development, performance or position of the company.

The Expanded Report must be audited to a higher standard than the previous director's report. Instead of stating only where auditors observe an inconsistency between the Report and the accounts, auditors will now be required to express a positive opinion as to the consistency or otherwise of the information in the Report.

OFR

As well as incorporating the information required in the Expanded Report, the OFR will require 1,290 quoted companies to:

- provide an analysis of main trends and factors underlying the development, performance and position of the company and likely to affect it in the future; and
- provide a description of capital structure, treasury policies and objectives, a statement of objectives, strategies and resources, company liquidity, information about contracting arrangements essential to the business, share receipts and returns of company members.
- consider and report on environment, employee, social and community issues, where material to the business. (These disclosures were particularly sought by external pressure groups)

The underlying objective of both reporting regimes is to provide greater transparency, to improve the quality, usefulness, and relevance of information provided by companies.

3. Key issues

The key issues relate to the higher reporting requirements imposed on the 1,290 UK quoted companies and are whether options other than the OFR achieve the same transparency objectives more cost-effectively. And, if that is the case whether we should consider:

- scaling back the higher audit requirements of the OFR; and
- down-scaling the current reporting requirements to meet the basic Modernisation Directive requirements.

The proposition that quoted companies should provide investors with forward-looking information on their business, which underpins the OFR, is uncontroversial. However, it is not clear that in trying to achieve this, the OFR in its final form has managed an appropriate balance between costs and benefits.

It is at least plausible that a scaled back OFR (by reducing the audit requirements and/or the content to the Directive requirements) could reduce the cost substantially while achieving much of the benefit sought from improved narrative disclosure.

The OFR standard (already prepared by the ASB) would remain for those companies that felt that their members would benefit from more extensive voluntary disclosure. Were we to scale back, it would be open, of course, to companies to produce OFR reports with more disclosure and/or enhanced sign-off from auditors. FRRP will be monitoring compliance with the Standard for those that produce OFRs after the first year of implementation, (although if the standard becomes voluntary we may need to review that role).

The section below (and the following summary table) set out a range of options, from bare compliance with the Directive (with which all large and medium sized companies must comply) to options for gold-plating.

Option 1. Compliance with the Directive: Expanded Directors' Report

This is the minimum option required to comply with the Directive. The 1290 quoted companies would simply be subject to the same reporting requirements and audit standard as other medium and large companies.

Basic compliance with the Directive is estimated to cost £7.74m, an average of £6,000 per company.

Option 2. Operating and Financial Report

Quoted companies would be required to produce an OFR, which would be audited to the same standard as the Expanded Report, i.e. auditors will be required to express a positive opinion as to the consistency or otherwise of the information in the Report with the accounts.

The OFR would also need to comply with the mandatory ASB Reporting Standard, which sets out the key elements of the disclosure framework. FRRP would undertake checks to ensure compliance with the Standard.

The additional cost of the OFR is estimated at £4.2m, i.e. an additional £3,256 per company.

Option 3. Operating and Financial Report and enhanced audit requirements

This option represents the status quo: namely the OFR which quoted companies are currently required to produce.

In addition to the audit requirements of the Expanded Report, auditors are required to state whether anything came to auditors' attention in the course of their audit that was inconsistent with the OFR. The argument is that information about the fuller picture is not verifiable against accounts and so other sources need to be considered. OFRs capture more of this sort of information than the expanded directors' report, which is why only OFRs would be subjected to the higher assurance standard.

The additional audit test is estimated to cost an extra £29.3m, i.e. £22,713 more per company. (NB: this increment seems unusually large. We need to confirm that the DTI RIA did not make an error).

Option 4. Operating and Financial Report and audit standard initially proposed

This option is only included for comparative purposes. It shows the costs of the OFR as initially proposed by the DTI but which was modified after consultation.

Directors would have been required to apply a much higher duty of care, equivalent to the prospectus verification standard of 'due and careful enquiry', rather than that typically applied to all other financial and accounting statements, (i.e. their normal common law duty to exercise 'due care, skill and diligence'). Auditors would have been required to

state in their assurance report whether in their opinion the directors had prepared the OFR after 'due and careful' enquiry.

The combination of these higher assurance levels was estimated to cost an additional £41.6m, i.e. £32,248 more per quoted company.

Table 1. Estimated costs of regulation – Quoted companies

	Incremental Costs (£m)¹	Incremental costs per quoted company	Reporting and auditing requirements
Directive compliance only (Option 1)	7.74	£6,000	<ul style="list-style-type: none"> • Fair review of development, performance and position of business • Description of risks and uncertainties • Use of KPIs • Audit opinion as to consistency with accounts
OFR, assurance as per Directive (Option 2)	4.2	£3,256	<ul style="list-style-type: none"> • As above • Analysis of main trends and factors underlying the development, performance and position of the company and likely to affect it in the future • Description of capital structure, treasury policies and objectives • Statement on company liquidity • Information about contracting arrangements essential to the business, share receipts and returns of company members • Consideration of environment, employee, social and community issues, where material • Statement of objectives, strategies and resources • FRRP review of OFRs
OFR, higher assurance* (Option 3 – Status Quo)	29.3	£22,713	<ul style="list-style-type: none"> • As above • Auditors to advise if matters inconsistent with the OFR have come to their attention
OFR, higher assurance and directors' duty of care (Option 4)	41.6	£32,248	<ul style="list-style-type: none"> • As above • Directors' standard of care is 'due and careful enquiry' rather than 'due care, skill and diligence' • Auditors to advise whether Directors had prepared the OFR after due and careful enquiry

* NB: Need to check whether this figure includes a component of assurance required as part of the Directive or whether this is in addition to the base requirement under the Directive.

4. Strategy

The process for revisiting the requirement to produce an OFR to the current audit standard requires careful handling as the standard has only recently been introduced.

The pro's of scaling back OFR requirements would be:

- rolling back of regulatory burdens leading to non-negligible 'savings';

¹ Note – all costs taken from DTI RIA [dated 8 October 2004]

- reinforcement of policy of minimal gold-plating; and
- shows government responsive to concerns.

The main con's would be:

- possible perception of muddled Government policy in this area;
- wasted efforts by companies that have already started work; and
- concerns by investors, and perception of companies, that there is reduced importance attached to governance issues.

In taking forward any deregulation in this area there are clearly presentational issues. The key policy concern would be that we do not undermine efforts made to improve the efficiency of the investment chain. Doing this at the same time, or in close proximity to, bringing forward proposals on mandatory disclosure, the ISC principles, etc, minimises this risk.

The current OFR requirements were brought into force via Statutory Instrument, so we would expect any changes could go via the same procedure.

5. Conclusion and Next Steps

Are you content for us to engage with DTI on this issue?

While we would expect initial resistance given the PRA targets they may well be content to work with us on proposals to deregulate here.

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