

OPERATING AND FINANCIAL REVIEW (OFR): DEREGULATORY OPPORTUNITY
Note to Chancellor
11 October 2005

Issue:

Opportunity to deregulate reporting requirements for quoted companies by rolling back the DTI's gold-plating of directors' reporting requirements through the OFR. Options include:

- (i) removing *all* gold-plating; higher audit requirements and higher reporting requirements (saving £33.5m¹ per annum), or
- (ii) removing higher audit requirement and keeping *some* extra reporting requirements, saving £31.4 m per annum.

Recommendation:

Choosing between options. Rolling back to minimum directive requirements is in line with the Government's policy on no gold-plating and has presentational attractions. However, option 3 (retaining social and environmental reporting) addresses concerns of CSR groups, unions and environmentalists about the need to improve company reporting and at minimal additional cost (ca. £1,500 per quoted company).

Timing and Handling:

It would be possible to make an announcement on the OFR earlier than the PBR. However we would need to persuade both DTI Ministers and No 10. Our view is that this would play much better as part of any broader deregulatory package (potentially in the PBR or CBI/IOD speeches). Rolling back the OFR will not be universally welcomed. Environmental groups – and perhaps trade unions – will oppose this. In addition, it is important to prepare business, especially the CBI (there is a risk of criticism that we have made them spend significant amounts preparing for the OFR).

¹ Note – all costs taken from DTI RIA, dated 8 October 2004. These costs should be verified with DTI.

The following table shows the additional components which make up the OFR (and their associated costs) over and above bare compliance with the EU Directive minimum.

Current OFR (Total cost £41.2 million p.a.)

Audit Additions	→	<p>Audit requirement² OFR requires auditors to advise if matters have come to their attention in the performance of their functions as auditors which are <u>inconsistent</u> with the OFR</p> <p>Additional cost : £29.3 million p.a.</p>	
Content additions	→	<p>Social content Consideration of environment, employee, social and community issues and reporting on these where material to the business</p> <p>Additional cost: £2.1 million p.a.</p>	<p>Other content³ Analysis of main trends and factors underlying development, performance and position of the company and likely to affect it in the future Description of capital structure Statement on company liquidity Information about contracting arrangements Statement of objectives, strategies and resources</p> <p>Additional cost: £2.1 million p.a.</p>
Directive minimum	→	<p>Fair review of development, performance and position of business⁴ Description of risks and uncertainties Provision of key performance indicators (KPIs)Auditors to provide an opinion as to <u>consistency</u> with accounts</p> <p>Base cost: £7.7 million p.a.</p>	

² It should be noted that the audit requirements stem from the Regulations prepared by the DTI, and not from anything issued by the Auditing Practices Board or the accountancy profession generally.

³ Note that this requirement is taken from the Securities and Exchange Commission’s requirements and thus would apply to UK companies listed on US exchanges in any event.

⁴ Where company Directors consider appropriate, the fair review will include information relating to environmental matters and employee matters.

Background

1. There has been a long-standing trend to improve narrative reporting to shareholders and improve transparency, which gained impetus post-Enron. The EU Accounts Modernisation Directive imposes additional reporting requirements on companies in response to this trend. More detailed reporting and disclosure was also recommended in the DTI's Company Law Review.
2. Last year, the DTI imposed additional financial and non-financial reporting requirements on UK quoted companies, in excess of those required by the Directive. It was believed that a more detailed and more forward-looking narrative review would benefit shareholders. The additional requirements were applied only to quoted companies (excluding large private companies as first proposed).
3. In effect, the OFR as adopted represented a compromise between activists' wants (who sought further mandatory reporting of non-financial information by more companies) and the wants of business and investors (who supported some additional disclosures but were concerned by the costs of additional regulation).
4. The first OFRs must be produced by quoted companies for financial years ending on or after 1 April 2006 and companies are gearing up for this. There are signs of growing disquiet among some companies and investors as the full implications of the OFR reporting burden becomes apparent. Because of concerns about the implementation timetable, DTI has agreed that enforcement of the OFR will be delayed until April 2007.
5. There is therefore a window of opportunity to reassess the requirement to produce an OFR to the current standard.

Options

6. The proposition that underpins the OFR, that quoted companies should provide investors with forward-looking information on their business, is uncontroversial. However, there is growing concern that the OFR in its current form may not have an appropriate balance between costs and benefits, or the most useful mix of reporting requirements. It is plausible that a scaled back OFR could reduce the cost substantially, whilst achieving much of the benefit sought from improved narrative disclosure.
7. There are two aspects of the higher reporting requirements imposed on the 1,290 UK quoted companies that could be scaled back to, or towards, minimum Directive requirements:

- the more stringent audit requirements of the OFR; and/or
 - the requirement to report additional information.
8. Four options are summarised below from the most burdensome to the least burdensome.

Option 1. Operating and Financial Review and Higher Audit – Status Quo

This option represents the status quo: namely the OFR which quoted companies are currently required to produce. The OFR has a more stringent audit requirement than the Directive requires. In addition, auditors are required to state whether anything came to auditors' attention in the course of their audit that was inconsistent with the OFR. The logic behind this is that the narrative information is not verifiable against the financial reporting and so other sources need to be considered. The cost of this option is estimated at **£31,969** per company (£41.24m).

Option 2. Directive Audit Minimum plus Full OFR Content

Companies would need to comply with all reporting requirements in option 1, but would be audited to the standard required by the Directive, i.e. audit opinion as to the consistency of the report with accounts. The cost of this option is estimated at **£9,256** per company (£11.94m⁵).

Option 3. Directive Minimum plus Social and Environmental Report

Quoted companies would comply with the EU minima on audit. They would not have to provide all the information currently required by the OFR but would have to consider environment, employee, social and community issues, and report on these where material to the business. The cost of this option would be **£7,628** per company (£9.84m).

Option 4. Directive Minimum: Expanded Directors' Report

This is the minimum option required to comply with the Directive. The 1,290 quoted companies would simply be subject to the same reporting requirements and audit standard as other medium and large companies. This includes a fair review of the business, a description of risks and uncertainties, use of key performance indicators. Basic compliance with the Directive (which is mandatory) is estimated to cost an average of **£6,000** per company (£7.74m).

⁵ We assume this figure includes a component of assurance required as part of the Directive, but would this would need to be confirmed with DTI.

Impact

9. There are handling issues. The requirement for an OFR was only introduced at the end of 2004 and the first OFRs are not due to be produced until 1 April 2006. Changing the requirement so soon would be perceived in some quarters as a U-turn.
10. Companies will broadly welcome this as a useful deregulatory measure, but there may still be the odd moan about the initial imposition of the OFR and the fact that they have wasted expenditure preparing for this.
11. We would expect institutional investors to be neutral to broadly supportive. Although shareholders are the proposed audience for these disclosures, a general theme in their comment has been that additional disclosures are not required as information pertinent to investment decisions is generally being disclosed. A MORI poll revealed that 34% of investors opposed the initial proposals, and only 41% of fund managers said they would support the proposals.
12. However, deregulation is likely to be opposed by significant lobby groups. Corporate social responsibility (CSR) groups were keen to see more detailed narrative reporting, particularly on social, environmental and employment issues. For example, CORE (Corporate Responsibility Coalition representing over 100 charities including Amnesty Intl.) supported the decision to mandate OFR reporting and argued that more companies should have been included. They are also likely to be supportive of the more stringent OFR auditing standard on the basis that it increases the pressure on companies to provide accurate and high quality narrative reporting (although the Association of British Insurers (ABI) argue that removing the audit requirement would enhance the quality of CSR reporting by reducing the incentive to provide 'boiler-plating' standardised information).
13. The trade unions have also been interested in seeing greater disclosure requirements imposed on companies in relation to employee issues. For example, the TUC also supported the decision to mandate OFR reporting and argued that more companies should have been included.

Next steps and recommendation

14. The key issue is determining how close to the EU Directive minimum is appropriate, in order to balance the concerns of CSR groups, environmental groups, and unions, with those of investors and businesses.

15. We expect any changes could be brought into force via Statutory Instrument.
16. We recommend that you
- **agree** to scale back the reporting and/or audit requirements of the OFR towards, or down to, the minimum level set by the EU Accounts Modernisation Directive;
 - **discuss** the proposals with your Cabinet colleagues, and especially DTI Ministers who have the lead on this policy, and
 - subject to this, **announce** the proposal to review the OFR as part of a wider package of deregulatory proposals.

Are you content with this?