



HM TREASURY

Financial Reporting Advisory Board Paper

UPDATE ON REQUIREMENT FOR THE PREPARATION OF A MANAGEMENT COMMENTARY “AN ANNUAL REVIEW “

Issue:	Considering the requirement for the preparation of a management commentary in the light of the removal of the statutory requirement for the preparation by quoted companies of an Operating and Financial Review.
Impact on guidance:	Yes: changes to chapter 7 of the FrEM – see paragraph 11 of the paper.
UK GAAP adaptation?	No.
IAS/IFRS compliant?	N/A (but see paragraph 9)
IPSAS compliant?	N/A
Impact on budgetary regime	None
Recommendation:	The FRAB is invited to consider the arguments for the retention of the requirement for bodies covered by the FrEM to prepare a management commentary along the lines of an Operating and Financial Review but described as an Annual Review and, if in agreement, approve the amended wording for the FrEM. The proposals have the approval of the Chief Secretary to the Treasury.
Timing:	The amendments to the FrEM will apply to the financial year 2006-07, although the requirement to prepare an Annual Review will apply for 2005-06 onwards.

DETAIL

Background

1. Section 234AA of the Companies Act 1985 (introduced by SI 2005 No 1011) required quoted companies to prepare an Operating and Financial Review (OFR) in respect of financial years beginning on or after 1 April 2005. Pursuant to powers given to it to make reporting standards for the OFR, the ASB issued Reporting Standard 1 *Operating and Financial Review* in May 2005.
2. Chapter 7 of the FreM was amended to require bodies covered by the FreM to prepare an Annual Report which would include the information required by the Companies Act to be given in a Directors' Report, as well that required by RS1 for an OFR – see FRAB (74)04 24 June 2005.
3. In November 2005, the Chancellor announced a proposal to remove the statutory requirement for an OFR, and regulations to repeal the requirement for an OFR came into effect on 12 January 2006 (SI 2005 No. 3442).
4. As the statutory underpinning for RS1 has been removed, the ASB has reissued it as a statement of best practice, entitled Reporting Statement *Operating and Financial Review* (“the RS”).

Proposal for bodies coming within the scope of the FreM

5. As the RS is indicative of best practice, the proposal is that bodies coming within the scope of the FreM should continue to prepare a management commentary in line with the RS. In response to the Chancellor's announcement in November 2005, departments and other bodies have been advised that they should work on the assumption that some form of management commentary will continue to be required for 2005-06 onwards. However, for presentational reasons, we intend to describe the commentary as an Annual Review rather than as an Operating and Financial Review.
6. We have consulted the Chief Secretary to the Treasury on this proposal as it may be seen as imposing greater burdens on departments than are expected of companies. The Chief has approved the approach we are taking.

Other issue

7. As there have been a few comments that paragraph 7.2.2 of the FReM does not sufficiently clearly refer to the various disclosures required in the Directors' Report following the amendment to section 234 of the Companies Act introduced by the Companies (Audit, Investigations and Community Enterprise) Act 2004, the opportunity has also been taken to amend paragraph 7.2.2 to refer to the 2004 Act. To paraphrase, the amendments to section 234 of the Companies Act require each director (board member in a public sector context) to state that:

- a. so far as he or she is aware, there is no relevant audit information of which the company's auditors are unaware, and

b. that he or she has taken all the steps that he or she ought to have taken as a director in order to make him/herself aware of any relevant audit information and to establish that the company's auditors are aware of that information.

UK GAAP compliance

8. The proposals are GAAP compliant in that the ASB is encouraging companies to prepare an OFR notwithstanding that there is no statutory requirement to do so.

IAS/IFRS compliance

9. There is no IAS or IFRS relating to the preparation of an OFR or similar management commentary, although the IASB has issued a discussion paper which, if adopted, would require the preparation of a document similar to an OFR.

IPSAS compliance

10. There is no IPSAS relating to the preparation of an OFR or similar management commentary.

Proposed amendment to the FreM

11. Proposed amendments to the FreM are given in Annex A attached.

Impact of amendment on Department Yellow

12. None.

Summary and recommendation

13. This paper considers that, notwithstanding the removal of a statutory requirement for the preparation of an Operating and Financial Review, bodies coming within the scope of the FreM should continue to prepare a management commentary in line with the recommendations of the ASB's Reporting Statement *Operating and Financial Review*, but described as an Annual Review. The Chief Secretary to the Treasury has approved this approach.

14. The FRAB is invited to comment on this conclusion, and the consequent amendments to the FReM

HM Treasury

20 March 2006

PROPOSED AMENDMENTS TO CHAPTER 7 OF THE GOVERNMENT FINANCIAL REPORTING MANUAL (FReM)

The annual report

Introduction

7.2.1 This section of the chapter applies to all entities covered by the requirements of this Manual except charitable NDPBs which should follow the requirements of the Charities SORP and regulations made under Charities legislation. It provides guidance on the content of the annual report, including the operating and financial review and the remuneration report.

Scope of the annual report

7.2.2 Departments, executive agencies and trading funds shall prepare an **annual report** for inclusion as part of the accounts containing the following information:

- a) the matters to be dealt with in a Directors' Report as set out in section 234 and Schedule 7 to the Companies Act 1985 (as amended by the Companies Act 1989; SI 1996 No. 189; the Companies (Audit, Investigations and Community Enterprise Act) 2004.; SI 2005 No. 1011; and SI 2005 No. 3442), as interpreted for the public sector context in paragraphs 7.2.6 - 7.2.8¹. Entities should note that Part IV of Schedule 7 was repealed by SI 1996 No 189;
- b) an Annual Review (paragraphs 7.2.9 to 7.2.18); and
- c) a remuneration report (paragraphs 7.2.19 to 7.2.27). *[DN: not for reproduction. Subsequent paragraph numbers will need checking.]*

In the case of **executive agencies** and **trading funds**, the preparation of an annual report as described above will satisfy the requirement for the preparation of a Foreword (as required hitherto) and a report as required by Cm 914 The Financing and Accountability of Next Steps Agencies (agencies) and section 4(6A) of the Government Trading Funds Act 1973 (trading funds). There is thus no need to produce a separate report in addition to the annual report described above. The document presented to Parliament will be described as "Annual Report and Accounts".

7.2.3 **Non-departmental public bodies** (other than those that are limited companies (see 7.2.5 below) or charities (see 7.2.1 above) shall prepare an annual report as described in 7.2.2 above which will supersede the requirement to prepare a Foreword. In the case of NDPBs which already have a statutory obligation to prepare a separate report, the document described in 7.2.2 above will satisfy the requirement for the production of this separate report. The annual report as described above will be presented to Parliament with the accounts as a combined document described as "Annual Report and Accounts".

7.2.4 Where there is currently no statutory requirement for the preparation of a separate report, NDPBs will prepare an annual report as described in 7.2.2 above for inclusion in the accounts which will be described as "Annual Report and Accounts" and presented to Parliament.

¹ The relevant sections of the Companies Act are:

234A – approving and signing the Directors' report; 234B – duty to prepare a remuneration report; 234C – signing the remuneration report; Schedule 7 – general requirements for a Directors' report; Schedule 7A – requirements for the remuneration report.

- 7.2.5 Companies legislation requires NDPBs which are limited companies to prepare a Directors' Report; in addition such NDPBs shall prepare an Annual Review as described in 7.2.9 to 7.2.18

Interpretation of the Companies Act requirements for the public sector context

- 7.2.6 In disclosing the matters to be dealt with in a Directors' Report, entities should note that the information about Directors' interests required by Part I and the information required by Part II of Schedule 7 is not applicable to the entities covered by the requirements of this Manual.
- 7.2.7 The requirement in section 234ZZA for the disclosure of the names of the directors during the financial year is to be interpreted to mean the disclosure of;
- a) (departments only) the ministerial titles and names of all ministers who had responsibility for the department during the year;
 - b) (departments) the name of the person occupying the position of the permanent head of the department;
 - c) (other entities) the names of the chairman and chief executive; and
 - d) (all entities) the composition of the management board during the year.
- 7.2.8 In addition to the matters described in section 234 and Schedule 7 of the Companies Act, entities to which this Manual applies shall disclose the following information:
- a) (departments only) a description of the entities within the departmental accounting boundary;
 - b) (departments only) the names of any public sector bodies outside the boundary for which the department had lead policy responsibility in the year, together with a description of their status (for example, trading fund or public corporation); and
 - c) (departments only) a description of the departmental reporting cycle, including an outline of the matters covered in the spring Departmental report, in the Estimates, and in the Autumn Performance Report, and information about how readers can obtain these documents.
 - d) (executive agencies which are not whole departments, trading funds and NDPBs only) a note that the accounts have been prepared under a direction issued by [relevant authority] under [reference to appropriate legislation];
 - e) (executive agencies which are not whole departments, trading funds and NDPBs only) a brief history of the entity and its statutory (or equivalent) background;
 - f) an indication of how pension liabilities are treated in the accounts and a reference to the statements of the relevant pension scheme. A cross-reference to the accounting policy note in the accounts and the remuneration report will normally be sufficient;
 - g) details of company directorships and other significant interests held by Board members which may conflict with their management responsibilities. Where a Register of Interests that is open to the public is maintained, disclosure may be limited to how access to the information in that Register may be obtained; and
 - h) information regarding the disclosure of the remuneration paid to the auditors for any non-audit work undertaken by the auditors as required by SI 1991 No 2128 *The Companies Act 1985 (Disclosure of Remuneration for Non-Audit Work) Regulations 1991* as amended by SI 1995 No

1520 *The Companies Act 1985 (Disclosure of Remuneration for Non-Audit Work)(Amendment) Regulations 1995.*

Annual Review

Applicability

7.2.9 When preparing the Annual Review, entities covered by this Manual shall take into consideration the recommendations outlined in the Reporting Statement *Operating and Financial Review* (“the RS”).

Objectives of the RS

7.2.10 The objective of the RS is to specify the requirements for a management commentary, which shall be a balanced and comprehensive analysis of:

- a) the development and performance of the business of the entity during the financial year;
- b) the position of the entity at the end of the year;
- c) the main trends and factors underlying the development, performance and position of the business of the entity during the financial year; and
- d) the main trends and factors that are likely to affect the entity's future development, performance and position.

Interpretations of the RS for the public sector context

7.2.11 Although the RS refers to an Operating and Financial Review, its recommendations should be read as applying to the Annual Review required by paragraph 7.2.2(b) above. Following the spirit of paragraph 6 of the RS, the Annual Review shall focus on matters that are relevant to the interests of members. In the context of the public sector, “members” shall be interpreted to be all users of the accounts.

7.2.12 The Annual Review should be self-standing and be as comprehensive as possible. However, there may be cases where information is also given in other documents in the cycle of accountability to Parliament and the public such as the Autumn Performance Statement or Departmental Report. In such cases, the Annual Review should provide summarised information with adequate cross-references to the other documents.

7.2.13 For departments, the Consolidated Statement of Operating Costs by Departmental Aim and Objectives and supporting notes will replace the requirement in the RS to disclose performance against key performance indicators (see 7.2.18 (a) and (b)).

7.2.14 Other central government entities are required to report progress against those targets agreed with the Minister and normally promulgated by means of a Parliamentary question.

7.2.14 Paragraphs 28(a) and (c) of the RS require the inclusion of information on, respectively, environmental matters and social and community issues. The preparation of Sustainability Reports to complement the Annual Report and Accounts is encouraged and where such a Report is already produced, the Annual Review should cross-refer to it. Further information on the kinds of information to be provided in the Annual Review in respect of environmental and social and community issues can be found in the Practical Examples and Proformas section of the FreM website (www.financial-reporting.gov.uk).

- 7.2.15 (Primarily for NDPBs) The Annual Review should explain the adoption of the going concern basis of accounting where this might be called into doubt, for example where there are net significant net liabilities that will be financed from resources voted by Parliament (eg grant in aid) in the future.
- 7.2.16 As noted in the Introduction to the Implementation Guidance in the RS, the examples are illustrative and should not be taken to be a template.
- 7.2.17 In disclosing information relating to the achievement of financial targets based on a return on capital employed, relevant bodies should use the definitions of “return” and “capital employed” as agreed in their Treasury Minute or other document rather than those given in IG example 1 in the RS.
- 7.2.18 In addition to the requirements of the RS, the departments to which paragraph 7.1.2 refers should include the following information:
- a) a comparison of outturn against Estimate, with detailed explanations of the causes of significant variances where applicable (see 7.2.13 above);
 - b) progress in relation to Public Service Agreement targets (see 7.2.13 above);
 - c) where applicable, the financing implications of significant changes in the department’s objectives and activities, its investment strategy and its long-term liabilities (including significant provisions and PFI and other leasing contracts) in the light to the department’s spending review settlement; and
 - d) commentary on the department’s significant remote contingent liabilities (that is, those that are disclosed under Parliamentary reporting requirements and not under FRS12) to enable the reader to understand their nature and what steps the department is taking to minimise the risk of their crystallising.