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Ref PMON/vs

You asked for comments on the Government's proposed amendments on narrative reporting. I am happy to reply on behalf of the ABI.

The Government's decision late in 2005 to abolish the statutory requirement for companies to produce an Operating and Financial Review reflected, amongst other things, concerns by Directors and Auditors over the consequences of making additional narrative disclosures. Our Association believes strongly that these concerns need to be satisfactorily addressed if we are to meet the objective underlying the OFR, and now the Business Review, of delivering good quality narrative reporting by companies to shareholders. Such reporting is an important tool of communication and engagement. It also introduces a longer-term perspective into the debate. The Government's proposed clauses are therefore welcome as an attempt to encourage achievement of these objectives.

That said, it is essential that the regime of liability in this area is soundly based with appropriate checks and balances. Careful thought should be given to ensuring that protection of Directors is not achieved whilst creating an undue burden of proof on the part of investors and shareholders in establishing that they have suffered financial loss as a result of misleading or reckless narrative reporting for which Directors or Auditors should be liable.

In formulating our position we have also been mindful of the fact that the implementation of the EU Transparency Obligations Directive will extend the scope of the liability of Directors and Auditors of quoted companies, and that these, henceforth, will be on a different footing from companies which are unquoted and therefore not subject to securities market regulation. This is reflected in the drafting of the proposed new wording following Clause 859. The appropriateness of the proposed new provisions (after Clause 447), which would be applicable to all companies, needs to be considered in this light.

Clause 447 positively identifies that Directors do incur liability for false or misleading statements but then goes on to circumscribe the scope of this liability. We consider this to be a helpful approach. We further believe that restricting liability under companies legislation such that it is to the company, consistent with

the Caparo principle, is right. It is also appropriate that liability should relate specifically to statements that are knowingly misleading or reckless.

Our major concern is that blanket exemptions from liability should not be extended unless justified. Directors have particular and legitimate concerns over their potential liability for forward-looking statements which must, by their very nature, involve an element of subjective judgement and therefore uncertainty. It is in this respect, rather than with regard to statements of verifiable fact, that their concerns over liability are legitimate. Whilst we are aware that there are some difficulties in framing clauses, which only target forward looking narrative statements rather than all such statements, we believe further consideration should be given to confining the exemption to forward looking statements.

It is also important to ensure that the clauses as proposed do not lead to any reduction in long term standards of disclosure by companies to shareholders. We believe that steps should be taken to safeguard standards and maintain confidence in company disclosure. The Financial Reporting Council should monitor and report publicly on the quality narrative disclosures covered by the clauses. There should also be a formal review of their impact by the Government within five years.

Subject to these qualifications we believe that the government should proceed with its initiative. In so doing, it is important to secure progress towards improved narrative reporting as soon as possible, as this will show the initiative is capable of achieving the desired result. With an exemption from liability, particularly for forward looking statements, there is no reason for Directors to feel constrained in making meaningful statements in narrative reports.

We have accordingly written this week to the Financial Reporting Council urging it as a matter of urgency to take the lead in working with companies and shareholders to raise standards of narrative reporting. A copy of the letter is attached. Our understanding, moreover, is that the exemption from liability would apply to Directors publishing a voluntary Operating and Financial Review so long as it is included in the Directors Report as means of fulfilling the requirements of the Business Review. It would be helpful if the Government could clarify this as there appears to be some misunderstanding in the market.

This would give a further and welcome push towards raising the standard of narrative reporting, which, we have argued, is in the interest of both companies and their shareholders.

Peter Montagnon
Director of Investment Affairs

