

## **DIRECTORS' REPORTING – REMOVING THE STATUTORY REQUIREMENT TO PRODUCE AN OPERATING AND FINANCIAL REVIEW**

**Note to Chancellor  
23 November 2005**

### Issue:

Securing agreement from Ministers of deregulatory opportunity: removal of gold-plating from directors' reporting for quoted companies

### Recommendation:

Note the attached letter to Alan Johnson, DTI, Margaret Beckett, DEFRA and John Hutton, DWP.

### Timing:

Urgent. Action required this week.

## **Background**

Attached to this submission is a letter proposing to DTI, DEFRA and DWP Ministers that you announce in the pre-budget report the removal of the gold-plating from directors' reporting requirements for quoted companies.

2. It is anticipated that a number of Ministers will have concerns about this proposal, given their departments' specific interests in the initiative. It is therefore suggested that you discuss this with them (a letter is attached as an aide memoire, and you may choose to send this later).

3. While Alan Johnson was not the Secretary of State for Trade and Industry when the OFR was introduced, he may raise concerns. The DTI has spent some years bringing the OFR to fruition and have put it at the heart of their corporate governance strategy. It is important that this proposal is positioned so that DTI, who are the lead agency, see this as a positive deregulatory opportunity, rather than as an implicit criticism of their policies. Margaret Beckett is likely to oppose the proposal, as DEFRA was very keen on more extensive disclosures and explicit reporting requirements for social and environmental issues, even though the Business Review requires the consideration of these issues and inclusion of them, where material. John Hutton (DWP) may be concerned about reducing mandatory reporting on social matters and employee matters because of possible reactions from unions, however, his previous role focused on reducing regulatory burdens, thus he may support the initiative. Patricia Hewitt, Secretary of State for Health, may also show an interest in this proposal, as she championed this initiative while she was Secretary of State for Trade and Industry.

4. The following are the key points for discussion with your Ministerial colleagues:

- The Government supports improvements in forward-looking narrative reporting by companies to better inform shareholders. However, the statutory OFR is not the best way of achieving this
- Removing the requirement for quoted companies to produce OFRs signals the Government's commitment to removing unnecessary gold-plating and to the Better Regulation Agenda
- Quoted companies will still be accountable to shareholders, and would need to produce a Business Review (i.e., the EU Directive minima).
- The Business Review has broadly similar content requirements (except social and environmental reporting) to the OFR but is less detailed and prescriptive and has a lower assurance standard.
- Important to signal to mainstream investors that the Government is committed to further improving narrative reporting and good corporate governance. The Government will keep a close eye on reporting practices to make sure companies are improving disclosures.
- The accounting standard for producing OFRs (reworked and substantially improved) will be retained as a voluntary standard.

## DEFENSIVE LINES

For Secretary of State for Trade and Industry, Alan Johnson (current 'owner' of OFR policy) and possibly Secretary of State for Health, Patricia Hewitt (former champion of OFR reporting)

- 1 This will be seen as a U-turn on our commitment to improving corporate governance / reporting.

A great deal has changed since the OFR was mandated. We are more focused on reducing the regulatory burden facing business, and there is a stronger presumption against 'gold-plating' EU Directives. We have heard the growing concern from business and are responding to this.

There have also been significant advances in improving corporate reporting and governance:

- Listed companies will need to produce a Business Review (i.e., the EU Directive minima) and must apply the principles in the Combined Code.
- The ASB (Accounting Standards Board) has produced a rigorous new standard which reflects best practice for producing OFRs.
- The Company Law Reform Bill contains provisions for the FSA to make corporate governance rules.
- Companies and shareholders are increasingly aware of the importance of good corporate governance.

- 2 We will lose the strategic, forward-looking narrative which shareholders demand

The Business Review, which companies will have to produce, is in large part identical or similar to the OFR. While it is not principally focused on providing strategic narrative, companies will be required to describe the principal risks

and uncertainties facing the business. This will need to include some consideration of the strategy of the company in identifying how it will manage these. (In addition, the Combined Code reinforces the importance of managing risk by recommending reviews of the effectiveness of risk management systems to safeguard shareholders' assets and the company's investments).

Disclosures will also be partly driven by shareholder demand, and shareholders are increasingly vocal about their desire for this type of narrative.

- 3 Companies will only produce the bare minimum they are legally required to produce.

The OFR will be retained as a voluntary standard, and we expect many companies will decide to comply with it. (The previous OFR was a voluntary standard and more than 60% of listed companies were producing an OFR or an OFR-type report). Many companies with strong interests in the environment and social development are also likely to produce these in response to shareholders and interest groups.

Numbers of the larger quoted companies also have their securities traded on US exchanges. The overlap between US disclosures and OFR content will provide an incentive to produce an OFR.

For Secretary of State for Environment, Food and Rural Affairs, Margaret Beckett, (who has a strong commitment to enhancing social and environmental reporting) and Department for Work and Pensions Secretary, John Hutton

- 4 Reducing mandatory reporting on social, environmental and employee issues will mean less of this information is disclosed.

Probably, but the primary purpose of directors' reporting is to inform shareholders and the company about the company's position, performance and development. Complying with the EU Directive minimum (i.e., the Business Review) will still require analysis of information relating to environmental and employee matters, to the extent necessary to understand the company position, performance and development. Responsible companies will still disclose material information on social and environmental matters.

We would also expect many companies with strong interests in the environment and social development to choose to produce OFRs in response to demands from shareholders and interest groups.

Dear

## Deregulating Directors' Reporting Requirements

As you know, I have been working with my officials to find ways of reducing regulatory burdens on business.

The Company Law Reform Bill seeks to build on the significant improvements the Government has made to corporate governance and to improve the efficiency of the investment chain, through measured and proportionate responses. Following representations from interested parties, I have concluded that there is an opportunity to take this a step further by announcing in the PBR that the Government is, on reflection, removing the mandatory requirement for quoted companies to produce an Operating and Financial Review (OFR).

This would represent a bold step and some would no doubt seek to portray it as a reversal. However, for these very reasons, it would send out the strongest signal that we are serious about the Better Regulation Agenda.

A great deal has changed since the OFR was mandated. In Government, we are focusing more resources on reducing the regulatory burden on business. In the business community the growing appreciation of forward-looking narrative reporting is tempered by growing concern about the burden of the OFR. We are also adopting a much stronger presumption against 'gold-plating' EU Directives, as we did when we introduced the OFR.

This has prompted me to think further about directors' reporting requirements, and I am not convinced that a strong positive case exists for mandating the incremental requirements of the OFR over the newly introduced Business Review (which is in line with the requirements for director reporting in the EU Accounts Modernisation Directive). Whilst I believe we should continue to emphasise that reporting in this way remains best practice, removing the requirement for quoted companies to produce an OFR could reduce business costs by up to £33 million p.a. according to the DTI's RIA. There would nonetheless be an appreciable improvement in narrative reporting, when compared to the pre-statutory OFR situation, because of the higher reporting requirements imposed through the EU Accounts Modernisation Directive (the Business Review). A substantial part of the benefits identified by the DTI as resulting from the OFR (including enhanced credibility and improved investor relations, lower average cost of capital and more liquid capital markets) would still be realised.

In terms of handling, I propose that we move quickly to remove the reporting requirement before companies are required to report against it from April 2006.

As I understand it, this will require changes to the Company Law Reform Bill, currently before Parliament, and Statutory Instrument 2005 No. 1011.

I am also keen that we build on the good work of the Accounting Standards Board in developing the OFR standard RS1 and look at how best to retain it as a voluntary standard for use where shareholders and companies believe an OFR would add value.

I believe we should announce this initiative in the speech I am giving to the CBI on 28 November, and it would be helpful to have your views before then.

I am copying this letter to [...]