

Litigation

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By post and by e-mail

22 December 2005

Dear Mr Michaels

OPERATING AND FINANCIAL REVIEW

The Treasury Solicitor is instructed on behalf of HM Treasury and the Department of Trade and Industry. This letter is sent in reply to your letters to those departments dated 7 December 2005 and is written pursuant to the pre-action protocol to Part 54 of the Civil Procedure Rules. You will receive separate replies from each of those departments in relation to the requests that you have made under the Freedom of Information Act 2000.

At the outset I should make it clear that it is not accepted that either the decision to abolish the Operating and Financial Review or the steps since taken to implement that decision are unlawful. It was a decision made fairly and based upon accurate and full consideration of the factors and the evidence relevant to the decision.

I should record the current position in respect of the Parliamentary process now underway:

- (i) Regulations have been laid before Parliament repealing the requirement on quoted companies to prepare an OFR for financial years starting on or after 1 April 2005. These regulations will come into force on 12 January 2006.
- (ii) The Government will bring forward amendments to the Company Law Reform Bill currently before Parliament, removing the requirements in that Bill for quoted companies to produce OFRs.
- (iii) The Government has invited views by 15 February 2006 on:
 - whether any particular requirements of the Business Review need to be clarified to achieve more effectively the Government's objectives regarding the Business Review;
 - any other considerations which Ministers should consider in deciding how to frame suitable amendments for the Company Law Reform Bill on these matters.

Underlying your whole approach to this matter is a suspicion, articulated at paragraph 16 of the letter to HM Treasury, that the decision was a "sop" to the CBI which followed contact and discussions with the CBI. This is not the case. There was informal contact with the CBI

about this on one occasion some time before the decision was made. The background to, implications of and reasons for the decision are set out below.

Background

1. The Companies Act 1985 (Operating and Financial Review and Directors' Report etc) Regulations 2005 [S.I. 2005/1011] ("the March Regulations") expanded the existing requirement in section 234 of the Companies Act 1985 ("the 1985 Act") for companies to include a 'fair review' of their business in their directors' report, to a requirement to provide a Business Review as part of that report. This was in implementation of new requirements introduced by the European Accounts Modernisation Directive [2003/51/EC]. The March Regulations also introduced a statutory requirement for directors of quoted companies (as defined in section 262(1) of the 1985 Act) to prepare an Operating and Financial Review for financial years that begin on or after 1 April 2005. This imposed additional reporting and audit review requirements to those required by the European Accounts Modernisation Directive. The March Regulations came into force on 22 March 2005.
2. As part of ongoing consideration of regulatory requirements, the Government has recently looked again at the decision to impose additional reporting requirements on quoted companies over and above EU requirements in this area. It has concluded on reflection that it would be appropriate to realign these requirements with reporting requirements for other companies, consistent with the Directive. It is satisfied that the requirements of the Directive are a proportionate means of achieving the objective of high-quality narrative reporting.
3. The statutory requirement for quoted companies to produce an OFR has been removed by the Companies Act 1985 (Operating and Financial Review) (Repeal) Regulations 2005 (S.I. 2005/3442). Quoted companies will be required to produce a Business Review as part of their Directors' Report under section 234ZZB of the 1985 Act.

Implications of this change

4. Both the option to require the production of a Business Review in line with the Directive and the option to require the production of an OFR, which contains requirements on top of the Business Review requirements, were fully considered in the Government's final Regulatory Impact Assessment when the Government made its decision to introduce a statutory OFR in March 2005. Option 4a set out the option that quoted companies should produce a mandatory OFR that should be subject to a higher level of auditor review; Option 2 that quoted companies should provide a Business Review, on the same basis as other companies.
5. Both of these options represented a significant advance in narrative reporting requirements, including forward-looking requirements, compared to the existing law at that time. The previous requirement was for a more limited 'fair review' of the development of the business.
6. Both of these options are also consistent with the Government's objective to improve narrative reporting. (Narrative reporting is the commentary on the business required to supplement the financial statements, and as financial statements become increasingly complex, narrative reporting is becoming more valued). Appropriate narrative reporting helps shareholders engage better with business, improving the quality of corporate governance. It also has the additional benefit of providing other

stakeholders with information which helps them engage with companies on issues of public concern. The DTI made clear in its final consultation that this is an ancillary benefit and that the report will be prepared for and directed at shareholders in accordance with normal company law principles.

Comparison between OFR and Business Review

7. It is important to appreciate the similarity between the OFR as enacted and the Business Review. The Government's decision to take forward its policy of improving narrative reporting in the form of Option 2 rather than Option 4a is an adjustment of policy.
8. The principal requirements of the Business Review are in key respects identical or very similar to those of the OFR. In particular the Business Review (like the OFR) requires a "balanced and comprehensive analysis of the development and performance of the business of the company during the financial year and the position of the company at the end of that year"; a "description of the principal risks and uncertainties facing the company"; and analysis using appropriate financial and non-financial key performance indicators (including those specifically relating to environmental and employee issues).
9. Two areas of substance in reporting have been highlighted as potentially being compromised by reverting to the Business Review standards: reporting on environment, employee, social and community matters; and the strategic focus which is more explicit in the OFR.

Environment, employee reporting, social and community matters

10. The key difference between the OFR and the Business Review as regards reporting environmental, employee and social and community matters is the materiality of information. The OFR specifically requires reporting on the company's policies in these areas and the implementation of those policies. Companies producing a Business Review must still disclose this information where it is necessary for understanding the development, performance and position of the company, and the principal risks and uncertainties facing it. Similarly, this information must be disclosed in the form of key performance indicators (including those specifically relating to environmental and employee issues), where appropriate.

Strategic focus

11. The OFR specifically requires reporting on the current and future trends and factors affecting the development, performance and position of the business. Companies providing a Business Review must still disclose this information where this is necessary for a balanced and comprehensive analysis of the development, performance and position of the business, to describe the principal risks and uncertainties facing it, or to provide an indication of likely future developments in the business of the company¹.
12. The Business Review has a less stringent and less costly auditor review requirement. Section 235 of the 1985 Act (in implementation of the Accounts Modernisation Directive) requires that the auditors give an opinion as to the consistency of information given in the directors' report (including the Business Review) and the

¹ Paragraph 6 of Schedule 7 to the 1985 Act.

OFR, with the financial statements. The OFR has an additional statutory requirement (section 235(3A)(b)) that the auditors should state whether any matters have come to their attention, in the performance of their functions as auditors, which in their opinion are inconsistent with the information in the OFR.

13. The table attached at Annex A provides a more detailed comparison of the requirements of OFR with those of the Business Review.

Basis of decision

14. The Government's decision to make this adjustment was based principally on a reassessment of the existing evidence base. This was gathered over a lengthy consultation period, exceeding five years. The evidence is summarised in a range of DTI documents, notably the Government's Response to Consultation of December 2004 and the Final Regulatory Impact Assessment.
15. The Government's decision reflects its continuing efforts to ensure better regulation and its decision to scrutinise more rigorously the regulatory burden on firms to ensure an appropriate competitive environment for UK business. Following recent initiatives to embed a more effective regulatory approach, government departments were asked to identify opportunities for deregulation. These recent initiatives include the Report of the Better Regulation Task Force (of March 2005), the Hampton Report of March 2005 and the scrutiny presently being carried out by Neil Davidson QC, the former Scotland Solicitor-General, of gold-plating of EU Directives by Government. There is a drive to improve the focus on risk-based regulation and reduce the administrative costs of regulation. An important aspect of this scrutiny is ensuring that any additional burdens on top of new or existing EU regulatory requirements (so called 'gold-plating') are justified.
16. Hence, in undertaking its reassessment, the Government focused primarily on the effect of imposing reporting and auditor review requirements in excess of the EU regulatory requirements in this area, i.e. in excess of Business Review requirements. The Government wishes to ensure that any additional burdens (whether new or existing) on top of EU regulatory requirements are fully justified given that requirements placed on UK companies over and above Directive requirements can put UK companies at a competitive disadvantage to companies in the UK's main trading partners.
17. The Government decided that moving from the OFR to the Business Review, and aligning reporting requirements with those in the EU Directive, was a sensible adjustment of policy, representing a cautious approach to the imposition of additional regulation. The Business Review provides for broadly similar reporting of the principal areas of narrative reporting. Where there are differences the additional information required by OFR does not, in the Government's view, add sufficiently to shareholders' ability to hold management accountable for the performance of the business to justify the cost of producing an OFR. However, the cost of providing a Business Review would be substantially lower than that of providing an OFR, particularly taking into account the lower level of auditor review. Reassessing the evidence on this basis, the Government concluded that the incremental cost of the additional OFR requirements was disproportionate to the incremental benefit, and that the Business Review was a more cost effective option.
18. The Government is committed to improving strategic, forward-looking narrative reporting by companies, and to enhanced dialogue with shareholders based on such reporting. The Government believes it is important for companies to report on non-

financial issues relevant to the development and performance of the business, including, for example, environmental matters and human capital management, and they will need to do so under the Business Review requirements. The Business Review will need to cover principal risks and uncertainties as well as giving a balanced and comprehensive analysis of the business. The Government also believes that disclosures – both mandatory and voluntary – are only part of the picture. On their own, disclosures are insufficient to generate responses by businesses to the legitimate concerns of civil society. Dialogue with and pressure from stakeholders, including the public, NGOs, shareholders and Government, is vital for achieving this outcome.

19. The Government also took into account, in removing the statutory requirement for quoted companies to produce an OFR, that companies will retain the choice of disclosing additional information, where they believe this is of value to shareholders or other stakeholders. Before the enhancement of narrative reporting requirements, many companies chose to produce an OFR on a voluntary basis, using existing best practice guidance. The background against which such decisions will be made has, of course, changed as a result of the raising of the minimum ‘floor’ for narrative reporting substantially, to levels similar to that of the OFR, by the implementation of the Accounts Modernisation Directive. For companies considering the appropriate level of disclosures, the reporting standard for the OFR prepared by the Accounting Standards Board will provide helpful guidance.
20. The Government will continue to review developments in the area of reporting including the operation of the Business Review. On 15 December the Government asked for comments on the wording of the Business Review to determine whether any changes are needed to clarify its scope and requirements. It is clear that alternatives include encouragement of additional voluntary reporting, potentially more closely aligned to the business review.

Grounds given for seeking Judicial Review of the Government’s decision

21. It is against this background, that we respond to your specific grounds for seeking a Judicial Review of the Government’s decision to adjust narrative reporting requirements.
 - i *Fairness and expectation*
22. You argue that the previous extensive consultation, the stated intention to review the effects of the OFR, and a proposed monitoring and review programme created a legitimate expectation that there would be a future review process and that your representations at that time would be taken into account. Accordingly, you argue that there was a duty to consult and to do so fairly in any review of the OFR regulations.
23. The Government’s objective is to improve forward-looking narrative reporting, subject to an appropriate balance between cost and benefit. The Government has chosen to adjust its narrative reporting requirements by removing the obligation for quoted companies to produce an OFR. Having reviewed the evidence gathered during the consultation process again, it has decided to adjust its decision and implement a different option. That option was considered in the original process and was, of course, one that the Government could have chosen at that time.
24. What is clear is that the similarities between the OFR and the Business Review are more notable than their differences. Both options represent a significant

improvement in narrative reporting from that which prevailed earlier; both options have principal requirements that are in key respects identical or very similar.

25. The Government is firmly of the view that consultation was neither appropriate nor necessary for the adjustment of an earlier decision. The Government altered its decision between options which had been explicitly and fully considered through public consultation. Both options are in accordance with the Government's policy of improving the quality of narrative reporting.
26. The Government has had a substantial body of evidence from the OFR consultation process on which to adjust its decision, and this body of evidence was taken into account. The options considered during the consultation process were thoroughly explored and costed. The Government does not consider that additional evidence was needed or required to make the decision.
27. Timing was also an issue and further consultation would have had cost implications. Quoted companies with financial years starting on or after 1 April 2005 would be required to produce OFRs, meaning that in practical terms a group of companies with financial years ending on 31 March 2006 or earlier are preparing to produce OFRs. If the Government were to have consulted on this policy adjustment, given the lead time required for preparation of narrative reports (and the fact that some companies may have shorter financial years), many companies would have incurred the additional preparatory costs associated with reporting under the OFR, rather than the Business Review requirements.
28. Your argument that the Government's decision pre-empts any future review process is not correct.

ii "Gold-plating" – a fundamental error

29. You argue that the Government's decision is based on an "entirely false premise" (material error of fact, irrelevant consideration), insofar as the OFRs are not examples of 'gold-plating', having not come about as a result of the UK's transposition of the Modernisation Directive but as a result of an independent process.
30. Your argument is incorrect. The term 'gold-plating' in relation to EC Directives is commonly understood to mean the imposition of regulatory requirements over and above the minimum required by the Directive in its area of regulation.
31. The subject matter of the EU Accounts Modernisation Directive includes the narrative reporting requirements of EU companies and how they are reviewed by auditors. The Directive amended the EC 4th and 7th Company Law Directives (78/660/EEC and 83/349/EEC) dealing with the narrative reporting requirements of EU companies and groups. The EU Accounts Modernisation Directive has been transposed into UK law by S.I. 2005 No. 1011. The standard minimum narrative reporting requirements for UK companies are set out in section 234ZZB and require the production of a Business Review in the directors' report. The OFR requirements incorporate the minimum requirements of the Business Review almost in their entirety, and then impose additional requirements. This overlap between the two levels of reporting was recognised by s234(4) of the Companies Act which provided that a directors' report need not contain any information included in the OFR for that financial year. The OFR was also subject to a higher level of auditor review. The DTI's final RIA confirms that these additional requirements of the OFR impose a substantial additional cost on quoted companies. The requirement for quoted companies to produce an OFR clearly represents the imposition of additional regulatory

requirements over and above the minimum required by the EU Accounts Modernisation Directive in the area of narrative reporting.

iii Perversity, irrationality and reasons

32. You argue that the Government's decision was perverse, in that it conflicts with the Government's previous findings and judgements "all of which strongly supported the OFR" (your paragraph 9.4). You also argue that it appears that the Government's decision was made without analysing or even revisiting the findings underlying the Government's previous judgements.
33. This is not correct. The reasons for the Government's decision have been given in the background and basis of decision sections above. Given these, it is clear that the Government's decision is consistent with its policy of improving narrative reporting, consistent with the balance of cost and benefit. This policy has been consistently held as the Government's goal during a long consultative, evidence-gathering and deliberative process, during which the range of policy proposals under consideration has changed substantially. The Government has chosen to adjust its final decision by substituting one option from the final consultation process for another. The options are very similar in terms of their reporting requirements and both represent a significant improvement in narrative reporting from the situation prior to the Accounts Modernisation Directive.
34. The Government's decision is not in conflict with the evidence on which earlier decisions were based. The Government's decision was made after revisiting and re-assessing the evidence underlying the Government's previous decision. After this reassessment, the Government decided to make an adjustment to the narrative reporting requirements for quoted companies in a way which retained their material content, whilst reducing their compliance costs.

iv Predetermination – draft simplification plan

35. The Government is committed to reducing the regulatory burden and reviewing options for removing gold-plating of EU Directives. The government is addressing this on multiple fronts, and while both the removal of the OFR and the review by Neil Davidson QC were announced together, they are in fact separate processes. The review by Neil Davidson does not preclude the Government from responding to any cases in advance of that review (as with OFR) where it concludes that such gold-plating is unjustified. We confirm that there is no intention to use the DTI's Draft Simplification Plan to consult on the Government's decision to adjust narrative reporting requirements. As is stated elsewhere, it is not appropriate for the Government to consult on this decision.

v Breach of Government policies (e.g. regarding consultation, RIA etc)

36. You argue that the process by which the Government reached its decision egregiously disregarded without justification the principles of good policy-making embodied in Government codes and guidance, such as the 2004 Code of Practice on Government Consultations.
37. This is incorrect. Over a period of more than five years, the Government has undertaken an extensive consultation, evidence-gathering and deliberative process considering how it can most effectively improve the narrative reporting of companies, taking account of the balance of cost and benefit. The Government made a decision based on that evidence. The Government has now re-assessed the evidence and

has chosen to adjust its final decision by substituting one option from the final consultation process for another. The options are very similar in substance and both represent a significant improvement in narrative reporting from the situation prior to the Accounts Modernisation Directive.

38. Such an adjustment does not require additional consultation. The original consultation process was unusually thorough and gave the Government a detailed picture of the views of various parties.
39. For similar reasons, there was no need to undertake a revised RIA. The information provided in the DTI's final RIA was used by the Government to adjust its decision and was appropriate for this purpose. Nor is there any change in Government policy sufficient to require a reworked RIA (per your paragraph 36). The Government's policy of improving narrative reporting, subject to the balance of cost and benefit, has not changed. The Government's view as to how best this should be achieved has changed, but not sufficiently to justify an extension of the consultation process, given that the Government has simply chosen one of the original options rather than another.

Request for information/disclosure

You have made a request for information and documents relating to the process by which the decision came to be made. Your request is underpinned by the misconception that there were extensive contacts with the CBI prior to the decision being made and seeks a range of information and material which the Government considers it is unnecessary to produce pursuant to the pre-action protocol (and in the light of the prospective claim as summarised at paragraph 9 of your letter).

It is considered appropriate to provide the following information about the process that led to the decision:

- (i) In July 2005 officials at HM Treasury were asked to identify deregulatory opportunities.
- (ii) In September 2005 a discussion note concerning OFRs was produced at HM Treasury for use at official level (enclosure A).
- (iii) On 11 October 2005 a submission on OFRs was made to the Chancellor of the Exchequer (enclosure B).
- (iv) On 11 November 2005 a further submission was made to the Chancellor (enclosure C).
- (v) On 23 November 2005 a final submission was made to the Chancellor (enclosure D). The Chancellor thereafter spoke to ministerial colleagues as set out in this submission, using the draft letter annexed to the submission (the letter was not in fact sent) as a speaking note.

For the sake of completeness, I can advise you that the issue of OFRs was discussed with HM Treasury officials by third parties on the following occasions before the decision was made:

- (i) On 8 June 2005, at a meeting with Hermes (enclosure E – irrelevant material redacted).
- (ii) On 12 August, at a meeting with the ABI (enclosure F – irrelevant material redacted)
- (iii) On 19 August, at a meeting with the London Stock Exchange (enclosure F - irrelevant material redacted).
- (iv) At the end of October/beginning of November, in a telephone conversation with the CBI. There is no contemporary written record of this conversation. We are instructed that it was a call at official level in which the CBI representative was informed that

although no decision had been taken, an option being considered in the context of deregulatory possibilities was paring back the OFR. The CBI official was asked, hypothetically, how he thought the CBI might react to this. He indicated that the CBI would be strongly supportive.

- (v) On 8 November 2005, at a meeting with an informal advisory group (enclosure H - irrelevant material redacted).

After the decision was made, there was contact with the CBI about the OFRs on the weekend of 26/27 November. The purpose was to give the CBI notice of what the Chancellor would be saying in his speech on 28 November.

Conclusion

In the light of all of the above, the decision to abolish the OFR will not be withdrawn and the steps taken consequent upon it will continue.

Yours sincerely

ADAM CHAPMAN
for the Treasury Solicitor

Annex A

BUSINESS REVIEW AND OPERATING AND FINANCIAL REVIEW

The table below shows the main requirements of the Business Review and the Operating and Financial Review, from the amendments to the Companies Act 1985, inserted by SI 2005, No. 1011.

Operating and Financial Review (Schedule 7ZA of the Companies Act 1985)	Directors' Report: Business Review (Section 234ZZB of the Companies Act 1985)	Comment
<p>1. An operating and financial review must be a balanced and comprehensive analysis, consistent with size and complexity of the business, of -</p> <p>(a) the development and performance of the business of the company during the financial year,</p> <p>(b) the position of the company at the end of the year,</p> <p>(c) the main trends and factors underlying the development, performance and position of the business of the company during the financial year, and</p> <p>(d) the main trends and factors which are likely to affect the company's future development, performance and position,</p> <p>prepared so as to assist the members of the company to assess the strategies adopted by the company and the potential for those strategies to succeed.</p>	<p>2. The review required is a balanced and comprehensive analysis:</p> <p>(a) the development and performance of the business of the company during the financial year; and</p> <p>(b) the position of the company at the end of that year,</p> <p>consistent with the size and complexity of the business</p>	<p>Trends and factors affecting the development, performance and position of the business would be included in the Business Review where necessary for a balanced and comprehensive analysis of the development, performance and position of the business or to describe the principal risks and uncertainties facing the business.</p> <p>The Directors' Report must also contain (paragraph 6 of Schedule 7) "an indication of likely future developments in the business of the company".</p>
<p>2. The review must include –</p> <p>(a) a statement of the business, objectives and strategies of the company;</p> <p>(b) a description of the resources available to the company;</p> <p>(c) a description of the principal risks and uncertainties facing the company; and</p> <p>(d) a description of the capital structure, treasury policies and objectives and the liquidity of the company.</p>	<p>1. The directors' report for a financial year must contain</p> <p>(a) a fair review of the business of the company, and</p> <p>(b) a description of the principal risks and uncertainties facing the company.</p>	<p>The Business Review would include information on objectives, strategies and resources where necessary to provide a fair review of the company.</p> <p>The Takeover Directive will require companies with securities carrying voting rights admitted to trading on a regulated market to publish information on capital structure in the directors' report. This requirement is implemented in Clause 649 of the Company Law Reform Bill.</p>

Operating and Financial Review (Schedule 7ZA of the Companies Act 1985)	Directors' Report: Business Review (Section 234ZZB of the Companies Act 1985)	Comment
<p>3. (2) If the review does not contain information and analysis of each kind mentioned in paragraphs 4 and 5, it must state which of those kinds of information and analysis it does not contain.</p> <p>4. (1) [To the extent necessary to comply with the general requirements of paragraphs 1 and 2,] the review must include -</p> <p>(a) information about environmental matters (including the impact of the business of the company on the environment),</p> <p>(b) information about the company's employees, and</p> <p>(c) information about social and community issues.</p> <p>(2) The review must, in particular, include -</p> <p>(a) information about the policies of the company in each area mentioned in sub-paragraph (1), and</p> <p>(b) information about the extent to which those policies have been successfully implemented.</p> <p>5. [To the extent necessary to comply with the general requirements of paragraphs 1 and 2,] the review must also include -</p> <p>(a) information about persons with whom the company has contractual or other arrangements which are essential to the business of the company; and</p> <p>(b) information about receipts from, and returns to, members of the company in respect of shares held by them.</p>		<p>Information on environmental, employee, social and community matters, policies and the implementation of policies would be included in the Business Review where necessary to provide:</p> <p>(i) a fair review of the business,</p> <p>(ii) a description of the principal risks and uncertainties, or</p> <p>(iii) a balanced and comprehensive analysis of the development, performance and position of the business.</p> <p>Information on these matters would also be included in the Business Review as analysis using key performance indicators, including information relating to environmental matters and employee matters, where necessary for an understanding of the development, performance or position of the business.</p>

Operating and Financial Review (Schedule 7ZA of the Companies Act 1985)	Directors' Report: Business Review (Section 234ZZB of the Companies Act 1985)	Comment
<p>6. (1) [To the extent necessary to comply with the general requirements of paragraphs 1 and 2, the review must] include analysis using financial and, where appropriate, other key performance indicators, including information relating to environmental matters and employee matters.</p> <p>(2) In sub-paragraph (1), "key performance indicators" means factors by reference to which the development, performance or position of the business of the company can be measured effectively</p>	<p>3. The review must, to the extent necessary for an understanding of the development, performance or position of the business of the company, include –</p> <p>(a) analysis using financial key performance indicators, and</p> <p>(b) where appropriate, analysis using other key performance indicators, including information relating to environmental matters and employee matters</p> <p>5. In this section, "key performance indicators" means factors by reference to which the development, performance or position of the business of the company can be measured effectively</p>	
<p>8. The review must-</p> <p>(a) state whether it has been prepared in accordance with relevant reporting standards and</p> <p>(b) contain particulars of, and reasons for, any departure from such standards.</p>		
<p>Section 235 (3A). If the company is a quoted company, the auditors must state in their report –</p> <p>(a) whether in their opinion the information given in the operating and financial review for the financial year for which the accounts are prepared is consistent with those accounts; and</p> <p>(b) whether any matters have come to their attention, in the performance of their functions as auditors of the company, which in their opinion are inconsistent with the information given in the operating and financial review.</p>	<p>Section 235 (3). The auditors must state in their report whether in their opinion the information given in the directors' report for the financial year for which the accounts are prepared is consistent with those accounts</p>	