



# HM TREASURY

## Financial Reporting Advisory Board Paper

### OPERATING AND FINANCIAL REVIEW

<b>Issue:</b>	Amending the FreM to reflect the requirements for an operating and financial review (OFR).
<b>Impact on guidance:</b>	The proposals will require amendments to chapter 7.2 of the FreM.
<b>UK GAAP adaptation?</b>	No.
<b>IAS/IFRS compliant?</b>	Yes.
<b>IPSAS compliant?</b>	Yes.
<b>Impact on budgetary regime?</b>	None.
<b>Recommendation:</b>	The FRAB is invited to approve the proposed amendments to the FreM, and to suggest a title for the new document.
<b>Timing:</b>	2005-06.

### DETAIL

#### Background

1. The requirement for quoted companies to include an Operating and Financial Review (OFR) has recently been formalised by amendments to the Companies Act *SI 2005 No 1011 "The Companies Act 1985 (Operating and Financial Review and Directors' Report etc) Regulations 2005* and the publication of Reporting Standard (RS)1 *Operating and Financial Review* in May 2005. The amendments to the Companies Act (as they affect OFRs) and the RS become effective for financial periods beginning on or after 1 April 2005. Hitherto, the preparation of an OFR, although best practice, was not a statutory requirement, and there had been no Reporting Standard on the subject.

2. The proposal is to apply the new requirements to departments, agencies, trading funds, and some NDPBs by suitable amendments to chapter 7.2 of the FreM.

#### Current requirements

3. **Departments** are required by section 11.2 of the RAM to prepare an annual report which contains

- information about the departmental “group”;
- an operating and financial review;
- details of the management structure and remuneration policy; and
- various items of a public interest (based on the Companies Act’s requirements for a Directors’ Report).

4. For 2005-06 onwards, a remuneration report will also form part of the annual report. Details of the requirements for the remuneration report have already been incorporated into the FreM (see FRAB(71) 06 which was discussed at the FRAB’s meeting in January 2005).

5. The content of the operating and financial review is based on the guidance issued in January 2003.

6. **Agencies** and **trading funds** prepare a Foreword which is based on the Companies Act’s requirements for a Directors’ Report and forms part of the accounts, and a separate Annual Report. The content of the Annual Report is set out in guidance issued by the Cabinet Office in January 2003 that, to a large extent, mirrors the requirements for an OFR. The requirement for a separate Annual Report is contained in Cm 914 *The Financing and Accountability of Next Steps Agencies* (agencies) and section 4(6)A of the Government Trading Funds Act 1973 (trading funds).

7. The accounts and the Annual Report are presented to Parliament as a combined document.

8. **Non-departmental public bodies** (other than charities and limited companies) prepare a Foreword that forms part of the accounts. Where there is a statutory requirement for one, they also prepare a separate Annual Report; where there is no such requirement, NDPBs are encouraged to prepare one in the interests of greater public accountability and transparency. The accounts and Annual Report are presented to Parliament as a combined document where there is a statutory requirement for an Annual Report; if there is not, the Annual Report may be published separately from the accounts.

9. NDPBs that are charities or limited companies comply with the Charities SORP or the Companies Act and prepare a Trustees’ Report or a Directors’ Report.

## Proposals

10. The proposal is, for 2005-06, to implement the requirement for an OFR, as described in RS1, for departments, agencies, trading funds and NDPBs.

## Departments

11. As far as departments are concerned, this will mean little difference to the current arrangements. Departments will continue to prepare an annual report, containing the same information as now except that details of the remuneration policy will be shown in the remuneration report and the OFR will be based on the requirements of RS1 rather than those of the January 2003 guidance.

### ***Agencies and trading funds***

12. It is proposed that the separate Annual Report and Foreword currently prepared by agencies and trading funds should be replaced by a single document for inclusion in the accounts, in line with the arrangements for departments. This approach is considered to be consistent with the requirement in section 4(6)A of the Government Trading Funds Act for “a report in such form and containing such information as to the performance of the funded operations as the Treasury may require”. The Act further provides for the report to be published by the responsible Minister in such manner as the Treasury may require; this is consistent with the current arrangements whereby the accounts and report are presented to Parliament as a combined document. As there is no statutory requirement for agencies to prepare an Annual Report, the proposals described above will not cause a problem from a legal viewpoint.

### ***Non-departmental public bodies (other than charities)***

13. For non-departmental public bodies (other than charities) the proposal is the same as for agencies and trading funds, ie a single document in the accounts will replace the Foreword and the separate Annual Report, although the following points should be considered as (unlike trading funds) there is no single piece of legislation applying to all NDPBs.

14. For those NDPBs which have a statutory requirement to prepare an Annual Report, our view is that the single document proposed above will satisfy such requirements. Although the question of compatibility with legislative requirements was raised specifically in consultation, none of the NDPBs that responded to the consultation raised this point as giving rise to problems, and legal opinion supports this view.

15. Where there is a statutory requirement for an Annual Report, legislation normally provides for the Secretary of State to lay the Annual Report, with the accounts being laid by the C&AG. However, we have already established that the Annual Report can be combined with the accounts and laid as a single document (usually by the C&AG) and currently recommend that this approach should be adopted. We therefore see no problems with the proposal that a “new-style” annual report should be included within the accounts.

16. As noted above, where there is no statutory requirement for an Annual Report, NDPBs are encouraged to prepare one in the interests of public accountability and transparency. The Report is, however, published separately from the accounts. The inclusion of an OFR as part of the accounts will overcome the problems that preparation of a Report is, in effect, voluntary, and that of separate publication.

17. However, the above arrangements will be difficult to apply where there is a statutory requirement for an annual report which covers a different period from that for the accounts (eg Higher and Further Education Funding Council which prepares an annual report in respect of the academic year, notwithstanding that its accounts cover the financial year). It is proposed that, in these circumstances, the body should continue to prepare a Foreword and a separate annual report, the content of which is based on the requirements for an OFR.

### ***NDPBs which are charities***

18. NDPBs which are charities will follow the requirements of the Charities SORP and prepare a separate Trustees' Report.

### ***NDPBs which are limited companies***

19. Although some NDPBs are limited companies, none is a quoted company. Nonetheless, NDPBs which are limited companies will prepare an OFR and a Directors' Report.

### **Disclosures of Environmental Issues**

20. Paragraph 29 of RS1 requires the disclosure of "environmental issues (including the impact of the business on the environment)" and "social and community issues". These disclosures feed into the debate on reporting on sustainability (see FRAB(74) 03) as defined by the Forum for the Future as "a public account of an organisation's sustainability performance achieved through a combination of leadership, strategic partnering, stakeholder engagement, policy outcomes, and the management of the organisation's impacts on the local environment, social well-being and economic prosperity".

21. As noted in FRAB(74)03, departments report performance against agreed Public Service Agreement targets for environmental issues and some NDPBs already prepare sustainability reports. Our view is that, while we would not dissuade departments and other bodies from preparing sustainability reports, the level of disclosures required by the OFR and already given in autumn performance reports does not justify any additional guidance to be given in the FreM regarding the reporting requirements for the accounts.

### **Description of the new document**

22. There is currently a degree of confusion between the separate "Annual Report" prepared by agencies, trading funds and NDPBs, and the "annual report" prepared by departments which forms part of the accounts. In addition, departments also prepare a Departmental Report. It would thus be helpful if something other than "annual report" could be used to describe the new document.

"Operating and Financial Review and Remuneration Report" is rather long-winded – Management Discussion and Analysis, perhaps?

### **UK GAAP compliance**

23. The proposals are compliant with UK GAAP.

### **IAS/IFRS compliance**

24. There is no international accounting standard relating to Operating and Financial Reviews.

## **IPSAS compliance**

25. N/A.

## **Proposed amendment to the FReM**

26. See Annex A for the proposed amendments to the FReM

## **Summary and recommendation**

27. This paper sets out a proposal for departmental and other accounts to include a document including an operating and financial review in line with RS1. This document will replace the separate Annual Report prepared by agencies, trading funds and most NDPBs.

28. The FRAB is invited to approve the proposals and the consequent amendments to the FReM, and to suggest a title for document to avoid confusion over the use of "annual report".

HM Treasury

June 2005

## **PROPOSED AMENDMENTS TO CHAPTER 7 OF THE GOVERNMENT FINANCIAL REPORTING MANUAL (Frem)**

*NB: The current paragraphs 7.1.1 to 7.1.5 are unchanged. The following paragraphs will replace the current paragraphs 7.2.1 to 7.2.7; subsequent paragraphs in section 7.2 (which deal with the Remuneration Report) will need to be renumbered.*

### ***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, agencies and trading funds shall prepare an annual report containing the following information:

- a) the matters to be dealt with in a Directors' Report as set out in Schedule 7 to the Companies Act 1985 (as amended by the Companies Act 1989 SI 1996 No. 189 and SI 2005 No. 1011), as interpreted for the public sector context in paragraphs 7.2.2 - 7.2.8. Entities should note that Part IV of Schedule 7 was repealed by SI 1996 No 189;
- b) an operating and financial review; and
- c) a remuneration report.

In the case of **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 an annual 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).

7.2.3 Subject to the provisions of 7.2.4 below, **non-departmental public bodies** (other than those that are limited companies or charities) shall prepare an annual report as described above which will supersede the requirement to prepare a Foreword. In the case of NDPBs which already have a statutory obligation to prepare an annual report, the document described in 7.2.2 above will satisfy the requirement for the production of an annual report as required by statute. The annual report as described above will be presented to Parliament with the accounts as a combined document.

7.2.4 Where legislation provides for the preparation of an annual report covering a different period from that for the accounts, the entity shall prepare a Foreword containing the matters to be dealt with in a Directors' Report (see 7.2.2.a above), as well as an annual report based on the requirements for an Operating and Financial Review. The annual report will be presented separately to Parliament.

7.2.5 Where there is currently no statutory requirement for the preparation of an annual report, NDPBs will prepare a document as described in 7.2.2 above for inclusion in the accounts.

## **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 statutory 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) (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) (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.
  - 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*.

## **Operating and financial review: Reporting Standard 1**

### **Applicability**

7.2.9 Reporting Standard 1 *Operating and Financial Review* applies to all entities covered by this Manual.

### **Objectives of RS1**

7.2.10 The objective of RS1 is to specify the requirements for an Operating and Financial Review (OFR), 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 RS1 for the public sector context**

7.2.11 Not all of the areas covered in the Disclosure Framework section of the RS1 (paragraphs 27-76) will be appropriate to all entities covered by the requirements of this Manual. The precise content of the OFR is for the entity to consider, and it should concentrate on relevant areas only.

7.2.12 Departments need not provide detailed information concerning key performance indicators (such as Public Service Agreement targets) where such information is given in other reports (such as the Autumn Performance Report), although performance against targets will be an important aspect of the OFR prepared by agencies, trading funds and NDPBs.

7.2.13 In addition to the requirements of RS1, 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;
- b) progress in relation to Public Service Agreement targets (see also 7.2.12 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.

- 7.2.14 (Primarily for NDPBs) The OFR 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.
- 7.2.15 To avoid unnecessary duplication of detail, references may be made to other documents in the cycle of accountability to Parliament and the public but summary information should still be given in the OFR.
- 7.2.16 As noted in the preamble to the Implementation Guidance in RS1, the examples are illustrative and should not be taken to be a template. In reporting on their key performance indicators, bodies should report against those targets agreed with the department and normally promulgated by means of a Parliamentary question.
- 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 RS1.

## **IMPACT ON WHOLE OF GOVERNMENT ACCOUNTS**

### **OPERATING AND FINANCIAL REVIEW**

<b>Issue:</b>	Amending the FreM to reflect the requirements for an operating and financial review (OFR).
<b>Impact on guidance:</b>	The proposals will require amendments to chapter 7.2 of the FreM.
<b>UK GAAP adaptation?</b>	No.
<b>IAS/IFRS compliant?</b>	Yes.
<b>IPSAS compliant?</b>	Yes.
<b>Impact on budgetary regime?</b>	None.
<b>Recommendation:</b>	The FRAB is invited to approve the proposed amendments to the FreM, and to suggest a title for the new document.
<b>Timing:</b>	2005-06.