

**OPERATING AND FINANCIAL REVIEW (OFR) REGULATIONS:
PROPOSAL TO ROLL-BACK TO EU MINIMA**

Note to Chancellor

11 November 2005

Issue:

Securing the support of your colleagues to your proposal to abolish the regulatory requirement for quoted companies to produce an OFR (which would roll back narrative disclosure requirements to minimum EU levels).

Recommendation:

That you contact Alan Johnson and Margaret Beckett (and possibly also Patricia Hewitt).

Timing:

As soon as possible, if this measure is to be announced in the PBR. (Note that changing the DTI's OFR regulations will require a statutory instrument and may take some months.)

Background:

Our previous submission (11 October refers) explored the opportunity to deregulate reporting requirements for quoted companies, by rolling-back the requirements in the DTI's Operating and Financial Review (OFR) regulations. You are minded to take forward such a proposal with your colleagues.

2. By way of background, the EU Accounts Modernisation Directive has imposed additional narrative reporting requirements on companies. These requirements add to the existing company reporting requirements, by requiring a fair review of the development, performance and position of the business, with a description of the risks and uncertainties facing the business. To the extent it is necessary to understand this, companies will also be required to report on employee and environmental issues.

3. Prior to this Directive being finalised, the Company Law Review considered the matter of company reporting and concluded that there was a need to improve forward-looking reporting, and proposed the OFR. Both the implementation of the Directive and the proposals for the OFR were therefore taken forward simultaneously in the OFR regulations.

4. The DTI imposed further reporting requirements (the OFR) on UK quoted companies, in excess of those required by the Directive, on the basis that this would provide a more detailed narrative with a stronger emphasis on the future prospects of a business and the factors affecting this. In terms of additional content, the OFR requires:

- analysis of main trends and factors underlying development, performance and position of the company and likely to affect it in the future;
- details of capital structure, treasury policies and objectives, company liquidity, and company members' share receipts and returns;

- information about contracting arrangements;
- a statement of objectives, strategies and resources; and
- consideration of environment, employee, social and community issues and reporting on these where material to the business.

5. In addition, auditors are required to state whether anything came to auditors' attention in the course of their audit that was inconsistent with the OFR. The basis for this was that assurance of the more forward-looking content of the OFR would not be sufficient, if it was restricted to checking consistency with the accounts alone.

6. In 2003, 85% of the top 350 companies (by market capitalisation) were producing OFRs, in some shape or form, on a voluntary basis. Because these were not audited, they imposed lower costs on companies that chose to produce them. Among the reasons for moving to a statutory OFR were concerns about the variable quality of these OFRs and a drop-off in the number of companies producing them.

8. The first statutory OFRs must be produced by quoted companies for financial years ending on or after 1 April 2006 and companies have been gearing up for this for some time. However, there are signs of disquiet among some companies and investors as the full implications of the OFR reporting burden becomes apparent.

Proposal for roll-back

9. Your preference is for Option 4 in our submission of 11 October. This represents the minimum required to comply with the EU Directive. (While the Directive is concerned mainly with historical and present information, it would still provide a more enhanced, forward-looking view of companies' business than that previously required under UK companies legislation.) If the proposal were implemented, the UK's 1,290 quoted companies would be subject to the same reporting requirements and audit standard as other medium and large companies (as described earlier in paragraph two). A more detailed outline of the differences between the requirements of the OFR and the Directive minimum requirements is set out in the table in Annex A.

10. It is important to position this deregulation in the broader context. Given trends in the development of narrative reporting, few would doubt that the OFR represents a sensible aspiration for best practice disclosure. The key issue is whether it should be mandatory; in other words, is there a robust case for additional gold-plating over and above the Accounts Modernisation Directive's improvements to narrative disclosure.

11. The balance of cost and benefit suggests this is far from clear. Compliance with the Directive represents only a fraction of the cost of complying with the OFR. The DTI estimated that complying with the Directive would cost less than 20% of the annual cost of OFR compliance (£7.7 million p.a. vs £41.2 million p.a.). While this original analysis did not calculate and compare the relative benefits of Directive minima against OFR, the Directive

requirements represent a significant improvement in narrative reporting and cover the main areas covered in the OFR (albeit in less detail and with less emphasis on the forward-looking element).

12. Our view is that a combination of retaining the OFR as a voluntary best practice standard, and mandating only the Enhanced Director's Report as per EU Directive minima, would be a more cost-effective solution to drive improvements in narrative reporting. It would provide a voluntary process to see if there is a demand for additional reporting and assurance above the Directive minimum, and whether voluntary compliance with a high-quality OFR standard would be sufficient, without imposing the additional gold-plating burden on quoted companies.

13. It should be noted that in proposing a statutory OFR, the DTI rejected the arguments for a voluntary OFR, arguing in its Final Regulatory Impact Assessment that experience to date showed voluntary compliance was limited and of variable quality. However, its conclusion in favour of a statutory OFR was based on an assessment of the previous voluntary regime, and did not assess how a voluntary OFR might work in an environment of improved narrative reporting driven by the EU-mandated Enhanced Directors Report.

Handling

14. As we explained in our submission of 11 October, rolling back the OFR regulations will certainly not be universally welcomed. It will be important to emphasise that the intention in rolling back to the EU Directive minimum is not to undermine efforts towards improved transparency and corporate reporting. The deregulation is aimed at reducing the costs of the current reporting regime, so that regulation is proportionate to the benefits of improved reporting.

Interest Groups

15. Environmental and CSR groups will strongly oppose any deregulation as they want greater accountability by companies, through enhanced disclosure of non-financial matters, particularly in relation to the environment and company engagement with wider society. Indeed, many would prefer more detailed social reporting than the OFR regulations require. Trade unions are also likely to oppose for similar reason, as they would like more explicit reporting on employee matters. The National Consumer Council also seeks greater disclosures of corporate impacts.

Audit profession and regulators

16. Audit professionals initially expressed concerns around the timing of implementation and the possibility of reporting being bland and caveated. They also were concerned that many companies do not understand how to comply with the necessary requirements. In spite of reservations, the audit profession may have concerns about reducing the scope of corporate reporting and loss of an anticipated workflow.

17. We would also expect the Accounting Standards Board to raise concerns about any policy reversal, as they have invested significant time and effort in developing the OFR standard. The proposal in no way denigrates the good work of the Accounting Standards Board in drawing up the relevant Reporting Standard 1 (Operating and Financial Review). The requirements of RS 1 remain a good basis for those companies that wish to continue, or to start, preparing comprehensive management commentary, and should be seen as a statement of best practice in those circumstances. However, the decision to prepare an OFR, and not an Enhanced Directors' Report in line with the EU Directive, would need to be taken in the light of the wishes of shareholders.

Business

18. Businesses are bearing the costs of producing OFRs, and would therefore welcome moves to deregulate. However, they may also express concern about the lateness of this proposal, when they are already gearing up for the first year of the mandatory reporting regime. Nonetheless, informal soundings with the CBI suggest that they would strongly support such a move. It is important that there is good support from business and investors for roll-back.

Investors

19. When polled a significant proportion of individual investors indicated their opposition to the OFR. However, we would expect a mixed reception from investment institutions, as there is quite a range of opinion.

20. At a recent meeting of an informal advisory group¹ (comprising the London Stock Exchange, Association of Private Client Brokers, Investment Management Association, London Investment Banking Association and the British Banking Association), the OFR regulations were identified as regulations that could be wound back. The position of the Association of British Insurers is more nuanced: publicly they have welcomed a statutory OFR (although private discussions suggest some concerns with the audit requirement).

21. Other investors that explicitly promote socially responsible investment, such as Morley, UK Social Investment Forum and Institutional Investors Group on Climate Change, would probably oppose the reduction to the Directive minimum of the reporting requirements on social, environmental and employee issues.

¹ The informal advisory group meets very occasionally to discuss issues relevant to financial markets and is one of the many ways in which the Treasury seek to identify areas where further work on aspects of financial regulation may be worthwhile. Its members are invited on a personal rather than organisational basis, the discussion is very informal and the proceedings are on a Chatham House basis. At the meeting referred to, towards the end of the meeting the idea that the OFR regulations could be scaled back was put forward by some members of the group. There was no detailed discussion of this item and it was not an idea supported by all members of the group. The Treasury, which had already done some internal analysis on the OFR (see the note dated 29 September) neither commented on nor discussed the idea further at this meeting.

Other Ministers and government agencies

22. To take forward this proposal smoothly, it is important to first secure the agreement of Alan Johnson and Margaret Beckett. Both can be expected to have significant reservations about deregulating the OFR reporting requirements, given long-held positions on the importance of the additional reporting requirements for quoted companies.

23. You may wish to consider if it would be beneficial to present this as a DTI initiative to deliver against its commitment to better regulation. Attached at Annex B, as an aide-memoire, is a summary of the case for roll-back of the OFR regulations in these terms. It also includes potential objections from your colleagues and indicative responses. You should also consider seeking the support of Patricia Hewitt (who was Secretary of State for Trade and Industry and can be expected to have concerns given her support for the development of the OFR).

Possible handling themes

24. Some concerns of different groups might be reduced by emphasising the following themes when presenting any measure.

- The Government is keen to preserve the competitiveness of the UK business sector. Gold-plating should be avoided unless there is a clear case for doing so (which is not the case with the EU Accounts Modernisation Directive).
- The Government will consult on the deregulatory measure, to ensure that mandatory narrative reporting is proportionate to the costs and the risks associated with any reduction in reporting transparency.
- The current accounting standard for the OFR (RS 1) will remain as the model for voluntary best practice disclosure. Government will work with industry to ensure consistency with other voluntary measures employed in the area of corporate governance.

Timing

25. We envisage that the DTI would lead the process for revising the OFR regulations, although we would expect to work closely with them. The OFR was introduced via a Statutory Instrument (2005, No.1011) and the Secretary of State for Trade and Industry would need to introduce a further SI to either amend, or revoke and appeal, the existing instrument. If this required affirmative resolution, it could take 3-4 months to reverse. SI amendments also require public consultation – unless a case can be made against it – which would add a further 3-4 months to the process. The Cabinet Office and the devolved administrations would also need to be consulted (as they were when agreeing the original OFR policy).

This submission relates to the policy responsibility of another department and thus is exempt from publication under the Freedom of Information Act.

ANNEX A

The following table breaks down the additional components which make up the OFR (and associated costs) over and above bare compliance with the EU Directive minimum.

Current OFR (Total cost £41.2 million p.a.)

Audit additions	→	<p>Audit requirement² OFR requires auditors to advise if matters have come to their attention in the performance of their functions as auditors which are <u>inconsistent</u> with the OFR</p> <p>Additional cost : £29.3 million p.a.</p>	
Content additions	→	<p>Social content Consideration of environment, employee, social and community issues and reporting on these where material to the business</p> <p>Additional cost: £2.1 million p.a.</p>	<p>Other content³ Analysis of main trends and factors underlying development, performance and position of the company and likely to affect it in the future Description of capital structure, and treasury policies & objectives Statement on company liquidity Information about contracting arrangements, and company members' share receipts & returns Statement of objectives, strategies and resources</p> <p>Additional cost: £2.1 million p.a.</p>
Directive minimum	→	<p>Fair review of development, performance and position of business⁴ Description of risks and uncertainties Provision of key performance indicators (KPIs) Auditors to give opinion on <u>consistency</u> with accounts</p> <p>Base cost: £7.7 million p.a.</p>	

² It should be noted that the audit requirements stem from the Regulations prepared by the DTI, and not from anything issued by the Auditing Practices Board or the accountancy profession generally.

³ Note that this requirement is taken from the Securities and Exchange Commission's requirements and thus would apply to UK companies listed on US exchanges in any event.

⁴ Where company Directors consider appropriate, the fair review will include information relating to environmental matters and employee matters.

ANNEX B – AIDE MEMOIRE FOR DISCUSSIONS

Case for rolling back the OFR regulations to EU minima

- Appreciate DTI's efforts to improve the quality of narrative reporting by companies, as part of the excellent work they have been doing on advancing Company Law Reform. The recent introduction of the Bill into the House is testament to their success. In particular, we appreciate their inclusion of our work on mandatory disclosure of institutional investor voting.
- The Bill builds on the significant improvements the Government has made to corporate governance and the investment chain. Deregulating the gold-plating in the OFR regulations would strengthen this agenda by demonstrating a proportionate response to the need for increased transparency.
- This would represent a bold step. It may be perceived as a significant U-turn by Government. But it would also send out the strongest signal that we are committed to the deregulation agenda. It would also be consistent with the Government's – and DTI's – commitment to compensatory simplification measures (i.e. one in, one out).
- Deregulating in this area will also help to shore up support for other measures by showing that Government is committed to ensuring only demonstrably effective measures are implemented.
- There is no question that a statutory, and more comprehensively audited, OFR has clear benefits. But we are not persuaded that the cost to quoted companies justifies this level of regulation. Rolling back to the requirements of the EU Accounts Modernisation Directive minima would reduce business costs by around £33 million p.a. It would nonetheless still result in an appreciable improvement in narrative reporting (compared to the pre-statutory OFR situation). A substantial part of the benefits identified by the DTI (including enhanced credibility and improved investor relations, lower average cost of capital and more liquid capital markets) should still be realised.
- The OFR would remain as a voluntary best practice standard. If business and shareholders valued the additional disclosures, we would expect these to be made.

Expected responses to proposal

Alan Johnson will oppose the proposal. The DTI has spent some years bringing the OFR regulations to fruition and have put it at the heart of their corporate governance strategy. It is therefore important that this proposal is positioned so that DTI, who have the lead in this policy area, see the positive

better regulation benefits, rather than the negative implications of a change of policy. It may be beneficial for this proposal to come forward as a DTI initiative to deliver against its commitment to better regulation.

It will also be important to get other Ministers on board. In particular, Margaret Beckett is likely to oppose the proposal, as DEFRA strongly supported more extensive disclosures by companies on social and environmental issues. In addition, Patricia Hewitt was Secretary of State for Trade and Industry during the development of the OFR concept and took a keen interest in it.

Your colleagues may raise the following points with you (suggested response follows in bold).

1 The OFR regulations are a sensible and necessary regulation. Better narrative reporting and assurance is integral to the Government's policy of improving the efficiency of the investment chain through greater transparency.

Better narrative reporting is important. This, however, is ensured by the EU Modernisation Directive and a voluntary OFR standard. The key point is that business is opposed and investors – the primary users of the reporting – have not shown in sufficient numbers that they value the additional mandatory reporting requirements imposed by the OFR regulations.

There is a significant body which argues that the required information is already available, and adding to information already available only creates information overload. There are also concerns that auditing the OFR will lead to reduce the quality of reporting, as directors make uninformative 'boiler-plate' compliance disclosures.

2 There is a widespread support for the OFR's requirements. It was recommended by the Company Law Review and supported in consultation. There is keen support from the voluntary sector, NGO sector, and trade unions. Business and investors acquiesced, after their main concerns were taken on board.

The strongest supporters are groups that want to know more about the operations of big companies. No objection – when the information is disclosed for business purposes. However, the OFR is produced primarily for the benefits of shareholders, to whom directors owe a duty of care. Businesses (who will have bear the costs of providing the information) and a significant number of institutional investors (who are the primary users of the information) are simply not strong supporters of mandatory OFR disclosures.

3 The Government will be heavily criticised. The Government has promoted and supported the statutory OFR for more than three years as vital to improve corporate reporting. We consulted widely and considered the issue at the highest levels (e.g., PMPRA). Many companies have invested significant resources in gearing up for this new requirement. Such an abrupt reversal would leave supporters asking why we supported the statutory OFR in the first place, and opponents furious.

This is an opportunity to send a positive signal of the Government's support for better regulation and we would expect support from business and investors for the Government's actions. The Government would demonstrate that it is prepared to listen and to act decisively, where required. Nor would the effort in preparing for the OFR be wasted: a significant part of this would be required to meet the EU Directive requirements; and we would expect numbers of companies to comply with the voluntary OFR standard, where their shareholders valued this.

4 The timing is bad. There is no pressure to get rid of the OFR; it would be much better to review in a few years.

Announcing now maximises the impact and reinforces the Government's better regulation agenda. While business have already begun preparing for their first statutory OFRs, reversal now would be preferable to waiting until they have spent more money complying.

5 The largest companies have a significant impact on the public and should be obliged to make disclosures about the impact of their business on social and environmental issues. This is consistent with broader Government policy on transparency and freedom of information.

While there are important external benefits from corporate disclosures, the primary purpose of these is to serve shareholders' needs. Significant numbers of investors do not support mandatory OFR disclosure requirements. Furthermore, directors will have other avenues – including voluntary compliance with the OFR – where they have a demand from shareholders for additional reporting on social and environmental issues.

6 Reversing the Government's long-standing promotion of the OFR would alienate a broad and influential swathe of opinion in the voluntary sector, NGO sector, trade unions and media.

The broad principles of narrative disclosure are embodied in the EU Directive minima. While parties wanting additional social and environmental disclosures would be disappointed, roll-back would signal the Government's support for better regulation and would be supported by the business and a significant part of the investor community.