

Guidance on the OFR and changes to the directors' report

April 2005

This document provides a guide to the Regulations implementing the OFR and changes to the directors' report.

The guidance has no legal force but is intended to help businesses understand the main features of the Regulations and the circumstances in which they apply. Those affected by the Regulations should refer to them for a full statement of the legal requirements and, in case of doubt, seek legal advice on questions of interpretation.

While every effort has been made to ensure that the information in this document is accurate, the Department of Trade and Industry cannot accept liability for any errors, omissions or misleading statements in that information.

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SECTION 1: INTRODUCTION

The Companies Act 1985 (Operating and Financial Review and Directors' Report etc) Regulations 2005 [S.I. 2005/1011] ("the Regulations") came into force on 22 March 2005.

The Regulations introduce a new requirement into the Companies Act 1985 ("the 1985 Act") for directors of quoted companies to prepare an operating and financial review ("OFR") for financial years which begin on or after 1 April 2005.

The Regulations also:

- expand the existing requirement for companies to include a **fair review** of their business in their directors' report;
- establish a requirement for auditors to express an opinion on the consistency of the OFR and directors' report with the accounts; and
- establish a criminal and administrative enforcement regime for both the OFR and the directors' report.

This guidance outlines the main changes contained in the Regulations, and the effect of those changes. It is not intended to be a comprehensive statement of the law or the recent changes. Companies should not consider it a substitute for familiarising themselves with the legislation itself. In particular, any organisation that wishes to clarify its own position under the law should take its own legal advice.

Legislation will also be passed to bring similar changes into effect for companies in Northern Ireland.

The Regulations can be found at the web address set out in Section 8 of this guidance, which also provides further sources of information.

SECTION 2: SCOPE OF THE REGULATIONS

This Section describes the categories of companies that are required to prepare an OFR and/or the enhanced directors' report.

a. Who is required to prepare an OFR?

The directors of GB companies that are formed under the 1985 Act and which are quoted companies are required to prepare an OFR for financial years commencing on or after 1 April 2005.

b. How do you define a quoted company?

A quoted company is a GB company whose **equity** share capital:

- is included in the official list (under Part 6 of the Financial Services and Markets Act 2000); or
- is officially listed in an EEA State; or
- is admitted to either the New York Stock Exchange or Nasdaq.

c. Do companies traded on AIM or OFEX have to prepare an OFR?

No. Companies trading on the Alternative Investment Market ("AIM") and OFEX, and companies with listed debt securities only, are not covered by the definition of a quoted company as set out above.

d. Do SMEs have to prepare an OFR?

No. Companies defined as small and medium-sized companies ("SMEs") by the 1985 Act are not required to prepare an OFR. However, **all** quoted companies, regardless of size, will have to prepare an OFR.

e. Who is required to prepare the new (that is, the enhanced) directors' report?

All unquoted GB companies, excepting those meeting the statutory definition of small companies, have to include an expanded fair review of their business in their directors' report.

f. Do all companies in a group have to include an expanded fair review in their directors' reports?

All individual companies in a group other than small companies are required to produce an expanded fair review. If these companies, even if small, are quoted, however, they are required to produce individual OFRs.

A parent company that prepares group accounts has to produce a group directors' report (but not an individual directors' report). Where the parent is a quoted company, the OFR is prepared for the group; the parent company does not have to prepare an individual OFR. Where the OFR or directors' report is prepared for a group, it need only cover the parent and those subsidiary undertakings included in the consolidation. It can do so on a consolidated basis.

g. What if my company is part of a group? Can it take advantage of the SME exemptions?

Yes. SMEs that are part of groups can take advantage of the SME exemptions for the directors' report as if they are stand-alone companies. Small and medium-sized companies are allowed to take full advantage of exemptions under EU Accounting Directives for the directors' report, including SMEs that form part of a group. This means that the previous restriction that SMEs that were part of ineligible groups¹ could not take advantage of the directors' report exemptions has been removed.

However, an SME cannot take advantage of the exemption if it:

- Is a public company;
- Has permission under Part 4 of the Financial Services and Markets Act 2000 to carry on one or more regulated activities;
- Carries on an insurance market activity.

h. So, do quoted companies preparing an OFR have to duplicate information in their directors' reports?

No. Information contained in the OFR that would otherwise be required in the directors' report need not be duplicated in the latter.

¹ A group is ineligible if any of its members is-

- A public company or body corporate which (not being a company) has power under its constitution to offer its shares or debentures to the public and may lawfully exercise that power,
- A person who has permission under Part 4 of the Financial Services and Markets Act 2000 to carry on a regulated activity, or
- A person who carries on an insurance market activity.

SECTION 3: HOW DO THE REGULATIONS AFFECT DIRECTORS?

This Section has been written for directors. It covers to whom the OFR is addressed, information to be included in or excluded from the OFR, information to be included in or excluded from the directors' report, the standard of care directors must apply to preparing the OFR, the ASB's OFR standard, and penalties for breach of the statutory requirements for the OFR and directors' report. References to "the OFR Schedule" are to Schedule 7ZA inserted into the 1985 Act by the Regulations.

3A: HOW DO THE REGULATIONS AFFECT DIRECTORS OF GB QUOTED COMPANIES?

a. What do the Regulations require us to provide in the OFR?

The OFR Schedule specifies matters that must be included in the OFR.

Directors are required to provide a balanced and comprehensive analysis consistent with the size and complexity of the business of:

- The business's development and performance during the financial year;
- The company's (or group's) position at the end of the year;
- The main trends and factors underlying the development, performance and position of the company (or group) and which are likely to affect it in the future.

This will include a company's (or group's) objectives, strategies and the key drivers of the business, focusing on more qualitative and forward-looking information than has traditionally been included in annual reports in the past. It must include a description of the resources available to the company (or group), of the principal risks and uncertainties facing the company (or group), and of the capital structure, treasury policies and objectives and liquidity of the company (or group).

In fulfilling these general requirements, directors will need to consider whether it is necessary to provide information on a range of factors that may be relevant to the understanding of the business, including, for example, environment, employee and social and community issues.

b. To whom are we addressing the OFR?

Directors are addressing the OFR to shareholders. The purpose of the OFR is to assist shareholders assess a company's strategies and the potential for them to succeed. It will assist shareholders to make an assessment not only of the company's past performance, but also of the directors' view on its future prospects. Information in the OFR will also be of interest to other stakeholders, including: employees, suppliers, customers, regulators and other users of reports and accounts such as those particularly interested in the environment and broader community.

c. Does the OFR have to include information about corporate governance issues?

Not explicitly. The OFR should contain information on such issues only to the extent the directors believe it to be necessary to achieve the general requirements of paragraphs 1 and 2 of the OFR Schedule.

d. Does the OFR have to include information about the environment, company employees, social and community issues?

To the extent necessary for directors to comply with the general requirements of paragraphs 1 and 2 of the OFR Schedule, yes it does. The OFR Schedule specifies what information directors need to consider for inclusion. Directors will need to make judgements about what data and analysis to include, and the level of detail to which it is appropriate to go.

e. Can the OFR cross-refer to other documents?

Yes, in order to indicate where further information can be obtained on matters covered by the OFR. However the OFR must contain all the information necessary to meet the legal requirements. The review by the auditors (see [Section 4](#)) will cover all the information given in the OFR.

f. What if we judge we have nothing to say on one or more of these issues?

If the nature of the business leads directors to decide that it is not necessary to disclose information about one or more of these issues, or about the company's key relationships, or about receipts from and returns to shareholders, they must make a positive statement to this effect, saying which of the issues the statement applies to. Directors are not required to explain how they have arrived at their decision.

g. Does the OFR have to include key performance indicators (“KPIs”) - financial and/or non-financial? If so, which ones and how many?

To the extent necessary for directors to comply with the general requirements of paragraphs 1 and 2 of the OFR Schedule, the OFR has to include KPIs. The Regulations do not specify how many KPIs should be included, nor mandate any particular KPIs for all companies to report on. The number and choice of KPIs included in the OFR is for directors to decide.

h. What are KPIs?

Key performance indicators are factors that measure effectively the development, performance or position of the business of the company or, as the case may be, the group.

i. Do we have to include information about the company’s future plans and prospects?

Yes. An appropriate amount of information that addresses the main trends and factors that are likely to affect the company’s future development, performance and position must be included. However, directors are not required to disclose information about impending developments or matters in the course of negotiation where to do so would in their opinion seriously prejudice the company’s interests. This exception is intended in part to avoid disrupting existing practices in informing the market on such matters.

Given the nature of some forward-looking information, in particular elements that cannot be objectively verified but have been made in good faith, directors may want to advise readers to treat some or all of these elements with caution.

j. What standard of care must we apply in preparing an OFR?

The standard of care on directors in preparing the OFR is the same as that for preparing other company reports and accounts; that is the standard of common law. Directors have to comply with their common law duty as directors to exercise due care, skill and diligence when preparing the OFR. The Regulations do not extend the scope of the duty of care beyond existing case law.

k. What statutory protections from liability are available to directors?

Sections 19 and 20 of the Companies (Audit, Investigations and Community Enterprise) Act 2004 introduce additional protection to directors, which can be summarised as:

- Permitting, but not requiring, companies to indemnify directors in respect of proceedings brought by third parties; and
- Permitting, but not requiring, companies to pay directors' defence costs as they are incurred, even if the action is brought by the company itself.

l. Are the duties of part time non-executive directors the same as full time directors in respect of the OFR?

All company directors (whether executive or non-executive, part time or full time, with a business background or not) are expected to carry out their roles with care, skill and diligence. This is a matter of common law, and the Regulations do not change that position.²

m. Where can we obtain further information on what should be included in the OFR?

The Accounting Standards Board (ASB) has been recognised by an Order³ as the body to issue a reporting standard relating to the OFR. The ASB has issued a draft Reporting Standard (termed a "Reporting Exposure Draft" or "RED") on the OFR. Compliance with the final standard will be presumed (unless the contrary is proved) to be compliance with the corresponding requirements of the 1985 Act regarding content of the OFR.

The OFR must contain a statement as to whether it has been prepared in accordance with the ASB standard, and must contain details of, and reasons for, any departure from the standard.

² There are two elements to this existing common law duty. The first is a basic duty that applies to every director, whatever his position. That duty may be greater in extent if the director carries out particular functions, such as the functions of a finance director. In all cases, the duty is an objective one: what is expected of someone in that position.

The second element is a subjective one, taking account of the director's personal knowledge, skill and experience, which can increase - but not reduce - the extent of the directors' duty. So, for example, a full time finance director, or a part time non-executive director who is also the finance director of a FTSE 350 company, would be required to bring to bear his actual knowledge, skill and experience.

³ The Reporting Standards (Specified Body) Order 2005 [S.I. 2005/692]

The ASB has also prepared draft Implementation Guidance setting out illustrations and suggestions of specific content and key performance indicators that might be included in an OFR, especially on specific matters referred to in the Regulations. The Guidance can be found at: www.frc.org.uk/asb/technical/projects/projectOOS4.html

n. What if we breach the OFR requirements?

There are criminal penalties for breach of the requirements that will apply to OFRs for financial years beginning on or after 1 April 2005. Civil penalties will apply to OFRs for financial years beginning on or after 1 April 2006. Further detail on the civil penalties is contained in [Section 6](#).

3B: HOW DO THE REGULATIONS AFFECT DIRECTORS OF LARGE AND MEDIUM-SIZED NON-QUOTED COMPANIES?

o. How does the enhanced directors' report differ from the existing directors' report?

The Regulations expand the existing requirement that the directors' report give a fair review of the development of the business and its position at the end of the financial year. The review required is a balanced and comprehensive analysis of the development and performance of the business of the company during the year and the position of the company at the end of the year, consistent with its size and complexity.

The review must also contain a description of the principal risks and uncertainties facing the company. It may also need to include KPIs (see q below). Where appropriate, the directors' report must also include references to (and additional explanations of) amounts included in the annual accounts of the company.

If the report is a consolidated report, it only needs to cover the parent and those subsidiary undertakings included in the consolidation.

p. Broadly, how does the enhanced directors' report differ from the OFR?

The directors' report provides a 'snapshot' of the company at a moment in time, addressing principal risks and uncertainties, but not necessarily the trends and factors affecting the future development, performance and/or position of the company. The OFR is more forward-looking in nature and includes more information on the strategies and policies the company is deploying for long term success.

q. Does the directors' report have to include key performance indicators ("KPIs") - financial and/or non-financial? If so, which ones and how many?

To the extent necessary to understand the development, performance or position of the business of the company, the directors' report will have to include financial KPIs and, where appropriate, analysis using other KPIs, including information relating to environmental and employee matters. Companies can look for guidance to the (ASB) reporting standard that underpins the OFR.

However, the Regulations do not specify how many KPIs should be included, nor mandate any particular KPIs for all companies to report on. The number and choice of KPIs included is for directors to decide.

r. What are KPIs?

Key performance indicators are factors that effectively measure the development, performance or position of the business of the company.

s. As my company is medium-sized do I need to report on all those factors?

The directors' report on qualifying medium-sized companies need not include analysis using key performance indicators, so far as they relate to non-financial information (including information relating to environmental and employee matters).

However, even if not required to include such analysis, medium-sized companies are very much encouraged to report on these issues voluntarily in recognition of the benefits such disclosure brings to the operation of the business. Companies that do so can look for guidance to the (ASB) reporting standard that underpins the OFR.

t. What if we breach the Directors' Report requirements?

There are criminal penalties for breach of the requirements that will apply to directors' reports for financial years beginning on or after 1 April 2005. Civil penalties will also apply to directors' reports for financial years beginning on or after 1 April 2006. Further detail on civil penalties is contained in [Section 6](#).

SECTION 4: HOW DO THE REGULATIONS AFFECT AUDITORS?

This Section has been written for auditors. It covers what auditors are required to state in their audit report and where they can obtain further information.

a. What are auditors required to state in the auditors' report in respect of the OFR?

Auditors are required to state in their report whether in their opinion:

- The information given in the OFR is consistent with a company's accounts; and
- Any other matters that have come to their attention in the performance of their functions as auditors of the company are inconsistent with information directors have given in the OFR.

b. Where can auditors get further information and guidance on considering the OFR and enhanced directors' report?

Statement of Auditing Standard (SAS) 160 establishes standards and provides guidance on auditors' consideration of other information issued with audited financial statements. Copies of SAS 160 can be obtained from the APB's website:

<http://www.asb.org.uk/apb/>

c. What are auditors required to state in the auditors' report in respect of the enhanced directors' report?

Auditors are required to state in their report whether in their opinion the information given in the directors' report is consistent with the accounts.

SECTION 5: HOW DO THE REGULATIONS AFFECT SHAREHOLDERS AND OTHER STAKEHOLDERS?

This Section has been written for shareholders and other stakeholders. It covers what the OFR is intended to achieve for shareholders and how shareholders and other stakeholders can obtain a copy of the OFR and the amended directors' report.

a. What does the OFR mean for me?

The OFR is addressed to shareholders. Its purpose is to assist shareholders assess a company's strategies and the potential for them to succeed. Through the narrative, it will assist shareholders to make an assessment not only of the company's past performance, but also of the directors' view on its future prospects.

b. What new or different information does the OFR give me?

The Regulations require directors to disclose information about a range of factors affecting the development and performance of the company. This includes, but is not limited to, a number of qualitative factors that contribute significantly to a company's success, but which are often not well captured in traditional financial statements. Examples include: the company's strategy, prospects, opportunities and risks; intangible and so-called 'soft' assets; and key stakeholder relationships.

Information in the OFR will also be of interest to other stakeholders, including: employees, suppliers, customers, regulators and other users of reports and accounts such as those particularly interested in the environment and broader community.

c. How do I obtain a copy of the OFR?

Those quoted companies that distribute full accounts to shareholders are required to distribute the OFR with those accounts. Those companies that send summary financial statements ("SFS") are not required to include a summary of the OFR (though they may choose to include information from or summarise the OFR). Such companies must send shareholders the full OFR or, if they do not, signpost in the SFS where the OFR can be accessed on the company's website.

d. What if I don't have access to the internet?

Shareholders have the right at any time to request a hard copy of the OFR from the company

e. How do I obtain a copy of the OFR if I am not a shareholder?

Other stakeholders can obtain a copy of the OFR from Companies House, where it will be kept on the public file. They may also be able to access the OFR on the internet via the company's website or to request copies of the OFR from the company.

f. If I get SFS, do I receive a copy of the OFR automatically?

You will either receive a copy of the OFR with the SFS, or be told where it can be accessed on the internet.

g. How do I obtain a copy of the directors' report?

Those companies that distribute full accounts to shareholders are required to distribute the directors' report with those accounts. Those companies that send SFS are not required to include a summary of the directors' report (though they may choose to include information from the directors' report). Companies may send shareholders the full directors' report. Shareholders have the right at any time to request a copy of the directors' report from the company.

SECTION 6: HOW WILL THE REGULATIONS BE ENFORCED?

This Section sets out how the Regulations will be enforced, who will be enforcing them and when enforcement of the Regulations will commence.

a. How are the Regulations being enforced?

The existing administrative enforcement regime in relation to defective accounts is being extended to cover defective OFRs and directors' reports as well for financial years beginning on or after 1 April 2006.

b. Who is enforcing the Regulations?

The Secretary of State and the Financial Reporting Review Panel ("FRRP"), part of the Financial Reporting Council ("FRC"). By agreement, the FRRP deals with public and large private companies and the Secretary of State (through Companies House) with the rest.

c. What does the FRRP do?

The FRRP's aim is to ensure that financial information provided by public and large private companies complies with relevant reporting requirements. The FRRP's operating procedures can be found on the FRC's website at:

<http://www.frc.org.uk/frp/how/procedures.cfm>

d. What is the FRRP's role in respect of the OFR?

Where a company claims that its OFR complies with relevant standards, the FRRP needs to satisfy itself that the standards have been followed. Any departure from the standards, although not of itself necessarily constituting a failure to comply with the legal requirements on the contents of the OFR, must nevertheless be noted and explained.

e. What would prompt the FRRP to make an enquiry about an OFR?

The FRRP may make an enquiry about an OFR if there is a possibility that:

- The OFR appears factually wrong in a material respect, or
- The OFR contains an opinion that no reasonable board could have formed if it had followed a proper process of collecting and evaluating evidence.

f. What powers do the FRRP have to obtain information?

The FRRP may require the following people to produce documents, or provide information and explanations:

- the company;
- any officer, employee or auditor of the company;
- anyone who was an officer, employee or auditor of the company at the time to which the document or information required relates.

g. What action(s) can the FRRP take in respect of the OFR?

If the FRRP comes across something in, or an omission from, an OFR that appears questionable, it may contact the company to seek further information and explanation. It may need to ask for evidence of how the company compiled the OFR and reached conclusions on particular issues. If it is not satisfied with the response, it may seek to persuade the company to revise its OFR voluntarily to correct the point, or make a corrective statement. In the last resort, it will be able to apply for a court order to compel the company to revise the OFR.

h. What is the enforcement regime for the directors' report?

The FRRP has the legal authority to review companies' directors' reports and, if necessary, go to the court to compel a company to revise its report. The FRRP shares this responsibility with the Secretary of State.

SECTION 7: BACKGROUND

The Operating and Financial Review (OFR)

The OFR is a key recommendation arising from the independent Company Law Review⁴.

The Government first consulted in July 2002 on the fundamental principles underlying the OFR in its White Paper *Modernising Company Law*.⁵ A voluntary form of OFR has been provided by many companies as a matter of good practice for some time. The Accounting Standards Board (ASB) issued a statement of best practice for the OFR in 1993 and a revised statement in 2003. Many companies already prepare OFRs whilst others include some or all the material to be covered by the voluntary OFR in other reports such as the directors' report. However, the Company Law Review found that the content and adherence to the guidance in reporting varied widely and recommended that companies of significant economic size should be required to prepare and publish an OFR as part of their annual report and accounts.

In July 2003, the Government announced its intention to implement its proposal on a statutory OFR by secondary legislation under existing company law. The proposals were the subject of extensive consultation⁶ during the Summer 2004.

The OFR Regulations will be supported by standards issued by the ASB and an enforcement regime that follows the existing regime in respect of financial statements.

Further background on the OFR (including details of the consultation and the responses) are available on the DTI's website at:

<http://www.dti.gov.uk/cld/financialreview.htm>

⁴ Modern Company Law for a Competitive Economy, July 2001, URN 01/942

⁵ CM 5553 - I & II, July 2002.

⁶ Draft Regulations on the Operating and Financial Review and Directors' Report. A consultation document. May 2004. URN 04/1003.

The Directors' Report

The Accounts Modernisation Directive⁷ was adopted by the EU in June 2003. This Directive made various amendments to earlier company law Directives to facilitate the use of International Accounting Standards and to bring European accounting requirements into line with modern accounting practices. There were certain options within the Directive on whether or how Member States implemented the changes.

These were taken forward by Regulations⁸ that came into force for financial years beginning on or after 1 January 2005. The Directive included amendments to the requirements of the directors' report. Because there are some similarities between these provisions and the Government's proposals for an OFR these were taken forward together with the OFR proposals and apply for financial years beginning on or after 1 April 2005.

⁷ Directive 2003/51/EC of the European Parliament and of the Council of 18 June 2003 amending Council Directives 78/660/EEC, 83/349/EEC, 86/635/EEC and 91/674/EEC on the annual and consolidated accounts of certain types of companies, banks and other financial institutions and insurance undertakings. OJL 178/16 of 17 July 2003.

⁸ SI 2004/2947. The Companies Act 1985 (International Accounting Standards and Other Accounting Amendments) Regulations 2004.

SECTION 8: FURTHER INFORMATION

The Companies Act 1985 (Operating and Financial Review and Directors' Report) Regulations 2005 [SI 2005/1011]

The Regulations introducing the OFR and making the changes to the directors' report came into force on 22 March 2005. Copies of the Regulations are available to download from Her Majesty's Stationary Office at:
<http://www.legislation.hmso.gov.uk/stat.htm> - 2005

Accounting Standards Board (ASB) Draft Standard on the OFR

In November 2004 the ASB issued an Exposure Draft of a Reporting Standard on the OFR (RED 1). The proposals in the RED build on the requirements of the Regulations and the ASB's existing 2003 statement of best practice on the voluntary OFR.

The proposals involve a principles-based standard, which in particular makes clear that the OFR must reflect the directors' view of the business. The objective is to assist investors to assess the strategies adopted and the potential for those strategies to succeed. The information will be useful to both shareholders and other users of accounts.

They also provide a basic framework for directors to apply in order to meet the requirements of the Regulations. It is for directors to consider how best to use this framework to structure the OFR, given the particular circumstances of the entity.

The ASB has also prepared draft Implementation Guidance setting out illustrations and suggestions of specific content and key performance indicators that might be included in an OFR, especially on specific matters referred to in the Regulations.

Copies of the RED can be downloaded, free of charge, from the ASB's website at www.frc.org.uk/asb. Hard copies can be ordered, price £6.00 post-free, from ASB Publications, 145 London Road, Kingston upon Thames, Surrey, KT2 6SR (020 8247 1264) or on the website at www.asbpublications.com.

Statement of Auditing Standards (SAS 160)

SAS 160 is published by the Auditing Practices Board (APB). SAS 160 establishes standards and provides guidance on auditors' consideration of other information issued with audited financial statements. Copies of SAS 160 can be obtained from the APB's website at <http://www.asb.org.uk/apb/>.

Practical Guidance for Directors

The OFR reflects ideas developed by the Company Law Review and further work by a working group chaired by Rosemary Radcliffe, which was set up by the Secretary

of State of Trade and Industry in 2003. A copy of the guidance is available at http://www.dti.gov.uk/cld/pdfs/ofr_guide.pdf.

Human Capital Management

The OFR reflects ideas developed by the Company Law Review and further work by an independent task force - Accounting for People - chaired by Denise Kingsmill and set up by the Secretary of State for Trade and Industry in 2003. The Accounting for People report is available at www.accountingforpeople.gov.uk.

Financial Review Reporting Panel ("FRRP")

Further information on the FRRP, including details of the FRRP's operating procedures, can be found on the Financial Reporting Council's website at <http://www.frc.org.uk/frfp/>.

The consultation process

Further information about the consultation on the OFR, the summary of responses to the proposals and other background information is available from the DTI's website at <http://www.dti.gov.uk/cld/financialreview.htm>.