

The Operating and Financial Review Working Group on Materiality

A Consultation Document

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Executive Summary

Introduction

In July 2002 the Government published its White Paper “Modernising Company Law”. This represented the first part of the Government’s response to the final report of the Company Law Review (CLR) published a year earlier. In the White Paper the Government gave its support to many of the CLR proposals; amongst these was the recommendation that UK companies over a certain size threshold should be required to prepare and publish an Operating and Financial Review (OFR). The White Paper makes clear that it will be for directors to decide precisely what information is material to their particular business and thus should be published in their OFR; it also states that the Government intends to devolve to a Standards Board the task of drawing up detailed rules for the compilation of the OFR but that, as a first step, an independent group would be asked to help in the process of providing guidance to directors on the key issue of materiality in the context of the OFR.

The Operating and Financial Review Working Group was accordingly set up in December 2002. A list of the members of the Working Group is at Annex A. Its Terms of Reference are as follows.

“The Working Group will develop broad principles and practical guidance on how directors can assess whether an item is material to their company and hence whether it must be included in an OFR. This will include the company’s impact on the environment and the wider community, but the same broad approach to materiality is required across all the subject matter of the OFR.

The Working Group will determine how to achieve this, including the scope of their consultations.

The Working Group should aim to report by the Autumn of 2003.”

This Consultation Document sets out our proposals in response to these Terms of Reference. In it we address the concept of materiality; the principles to be applied in arriving at a judgement on materiality; and the process directors should go through, as part of the total process of good governance, in deciding what should be included in their OFR. We believe that these three components together will provide the guidance required by our Terms of Reference. We welcome views, and hope that firms and organisations will be willing to test our ideas against their own experience and feed back the results to us as part of the consultation exercise. And we would be particularly interested to hear about ‘real life’ examples of materiality decisions in the context of an OFR that might be of general interest. The formal consultation period will extend from **Friday, 27 June 2003**, the date of the launch of this document, to **Friday, 19 September 2003**. Thereafter, we aim to publish our Final Report **early in December 2003**.

The Concept of Materiality

We have identified six issues that we think can be used as criteria in working towards a definition of materiality. They are described in detail in paragraph 20(i) to (vi); in summary, they are the desirability of **building on existing guidance**; the need to recognise **the context** and **the scope** of the OFR; the importance of recognising who are **the potential users of the OFR**; the **link between the OFR and decision-taking**; and the need to couch guidance in as **clear and simple language** as possible. Our definition, based on these criteria, is set out in paragraph 21 and is as follows.

'In making their good faith, honest judgements about what information is material and should be included in their OFR, directors should be governed by the high level objective of the OFR, which is to enable users to assess the strategies adopted by the business and the potential for successfully achieving them. Information will be material to the OFR if failure to disclose it clearly, fairly and unambiguously might reasonably be expected to influence members' assessments of the company and hence the decisions they may take, either directly, or indirectly as a result of the significance that the information has for other stakeholders and thus the company. Information that is material to the OFR may be quantitative or qualitative; and may relate to facts or probabilities, and to past, present or future events and decisions.'

Questions for consultation:

- Q1 Do you agree that the six issues set out in paragraph 20(i) to (vi) together provide a useful set of criteria that should be applied to any definition of materiality for the purposes of the OFR? Are there other important issues that should be taken into account?*
- Q2 Do you think the definition of materiality set out in paragraph 21 is appropriate in the context of the OFR?*

Principles

We have identified six sets of broad principles that directors might apply in arriving at their judgements on materiality. They are summarised in paragraph 23 and discussed in detail in paragraphs 24 to 41; in summary they cover **the starting point for directors**, which addresses knowledge and experience; skills and competencies; and good faith, honest judgements; **the starting point for the OFR**, which addresses the objective of the OFR; the purpose and values of the business; and taking a broad view; **the scope of the information in the OFR**, which addresses the balance between historic review and a focus on the future; quantitative and qualitative information; and facts and events, probabilities, risks and opportunities; **identifying the information for the OFR**, which addresses the nature and size of items; the significance of issues; and variability and volatility; **reporting in the OFR**, which addresses measuring and describing; consistency from year to year; and consistency with other information and reports; and **the approach to disclosure in the OFR**, which addresses balanced judgements; confidential information; and future possibilities.

Questions for consultation:

- Q3 Do you agree that the six sets of broad principles summarised in paragraph 23 and described in paragraphs 24 to 41 are appropriate in arriving at judgements on materiality for the purposes of the OFR? Are they described clearly enough?*
- Q4 Are there other principles that should be applied in making such judgements?*

Process

We have identified, based on established best practice, six key criteria against which the directors' process for making their materiality judgements could be assessed. These are set out in detail in paragraph 43; in summary they are that the process should be **transparent**, should provide for **appropriate consultation**, should allow **account to be taken of appropriate comparisons**, should be **comprehensive**, should be **consistent** and should be **subject to review**.

We have also developed a set of ten questions that together provide a checklist that directors may find helpful in applying their process. These are set out in detail after paragraph 44; in summary they are:

- Q.1 Does the board have, or does it have ready access to, all the relevant knowledge and skills to make its judgements as to what is or is not material? If not, how will this be addressed?
- Q.2 An early task for the board will be to approve the process and satisfy itself that the process is being properly applied before it can exercise its judgements on materiality. How will the board work in discharging these key responsibilities?
- Q.3 What information should be considered at the outset for possible inclusion?
- Q.4 What do other sources suggest might be important?
- Q.5 What key information do the corporate management information systems provide now on these topics?
- Q.6 What, in the light of all this, are the information gaps? What should the plans be for filling these gaps? How will the information be put together?
- Q.7 How should the board obtain assurance as to the reliability of the information put before it, and who should do this?
- Q.8 How, once the information is there, does the board decide whether it is material or not? What processes of challenge, both internal and external, should be used? What sign-off procedures should be in place?
- Q.9 How should 'material information' be presented in the OFR? And how should the information in the OFR be linked to other published information?
- Q.10 What feedback arrangements and review procedures should be in place between one cycle and another?

Questions for consultation:

- Q5 *Do you agree that the six key criteria set out in paragraph 43 are appropriate for assessing the directors' process for making their materiality judgements? Are there other criteria that should also be used?*
- Q6 *Do you agree that the ten questions set out following paragraph 44 would be helpful to directors in applying their process in practice? Are there any other matters that they should have in mind?*

How to respond

We are asking for written comments on this Consultation Document by **19 September 2003** at the latest. Earlier responses would, of course, be very welcome.

If organisations are arranging meetings or other events and would like to have a Group member attend, either to participate or to listen to feedback, please contact Michael Stewart on 020 7 215 5507 in the first instance.

Please send responses, by email if possible, to:

Email: ofrworkinggroup@dti.gsi.gov.uk

OFR Working Group Consultation Document
Bay 664
Department of Trade and Industry
1 Victoria Street
London SW1H 0ET
Telephone enquiries: 020 7 215 5507

All responses will be acknowledged. In accordance with the code of practice on open government, comments will be made publicly available unless respondents specifically request otherwise. Any 'real life' examples included will, however, always be treated as non-attributable.

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Introduction

Background

- 1 In July 2001 the Company Law Review (CLR) Steering Group published its Final Report on the fundamental review of company law initiated by the Government three years earlier. The recommendations of the CLR, as set out in the Final Report, focused on the original aims of that review, as laid down by the then Secretary of State, which were to provide a framework that would promote the competitiveness of British companies; to strike a proper balance between the interests of the various groups concerned with company activity; and to promote consistency, predictability and transparency in the law.
- 2 Playing a key role in the CLR's package of proposals was a new statutory statement of directors' duties that would not only give directors clarity as to what their duties are but would also encourage them to take account of long term as well as short term consequences; and to recognise the importance to the success of their business of relations with all their stakeholders, of maintaining high standards of business conduct, and of the impact of their actions on the community and the environment. To reinforce this principle, the CLR also included proposals for new approaches to the disclosure of information. In particular, the Final Report included a recommendation that all companies of 'significant economic size' should be required to produce an Operating and Financial Review (OFR) as part of their Annual Report and Accounts. The objective of the OFR was to "provide a discussion and analysis of the performance of the business and the main trends and factors underlying the results and financial position and likely to affect performance in the future so as to enable users to assess the strategies adopted by the business and the potential for successfully achieving them"¹.
- 3 In July 2002 the Government published its White Paper "Modernising Company Law"². This represented the first part of the Government's response to the CLR. In the White Paper the Government gave its support to many of the CLR proposals. Amongst these was the recommendation that UK companies over a certain size threshold should be required to prepare and publish an OFR³. Thus the Government followed the philosophy of the CLR in this respect: it accepted that the primary role of directors is to promote the success of the company but it also recognised that success is best promoted when directors take a broad view of all the factors that influence success, and report upon them.
- 4 The CLR in its Final Report gave consideration to the various areas to be covered in the OFR. It identified two categories: items that must always be included; and items that should be included "whenever the directors in good faith judge them material"⁴. The items that in the CLR's view could not fail to be judged as material every time an OFR was prepared, and therefore would always be included, were the company's business and business objectives, strategy and principal drivers of performance; a fair review of the development of the business over the year and position at the end of it; and the dynamics of the business⁵.

¹ Modern Company Law for a Competitive Economy: Final Report paragraph 8.32

² Cm 5553-I

³ The concept of the OFR is not, of course, new. Guidance in relation to an Operating and Financial Review was published by the Accounting Standards Board in 1993 and revised in January 2003. A number of large companies have therefore been publishing OFRs on a voluntary basis for some years.

⁴ Modern Company Law for a Competitive Economy: Final Report, paragraph 8.40

⁵ Modern Company Law for a Competitive Economy: Final Report. See table following paragraph 8.40 for full details.

Other examples of items that would, whenever the directors judge them material, be included were corporate governance, values and structures; an account of key relationships with employees, customers, suppliers and others; policies and performance on environmental, community, social, ethical and reputational issues; and receipts from and returns to shareholders. The Government in the White Paper accepted this overall logic, and thus its consequence: that directors' judgements as to what is and is not material at the time they prepare and publish an OFR will be fundamental to its scope and coverage.

- 5 The White Paper makes clear that it will be for directors to decide precisely what information is material to their particular business. But it also makes clear the Government's intention that directors will be responsible for how these facts are covered in the OFR. Thus companies that fail to provide information of the right quality "will risk adverse comparisons and questions from shareholders and others"⁶. And ultimately directors might need to defend the process behind their reporting in the courts. The White Paper states that the Government intends to devolve to a Standards Board⁷ the task of drawing up detailed rules for the compilation of the OFR but that, as a first step, an independent group would be asked to help in the process of providing guidance to directors on the key issue of materiality in the context of the OFR.

Terms of Reference

- 6 The Operating and Financial Review Working Group was accordingly set up in December 2002. A list of the members of the Working Group is at Annex A. Its Terms of Reference are as follows.

"The Working Group will develop broad principles and practical guidance on how directors can assess whether an item is material to their company and hence whether it must be included in an OFR. This will include the company's impact on the environment and the wider community, but the same broad approach to materiality is required across all the subject matter of the OFR.

The Working Group will determine how to achieve this, including the scope of their consultations.

The Working Group should aim to report by the Autumn of 2003."

The Working Group's approach

- 7 In addressing our Terms of Reference the Working Group has taken as its starting point the overall philosophy of the CLR and of the White Paper. We accept that consultation on the White Paper finished only last November and the Government is still considering its final position on the issues. But we believe, as did the CLR Steering Group, that the package of proposals put forward to provide a basis for legislation has the capacity not only to create a climate that encourages competitiveness but also to enhance public confidence in the framework within which wealth creation takes place in our society. Our starting point has been the view put forward in the CLR that the primary role of directors is to promote the success of the company for the benefit of its shareholders as a whole but that this duty can only be discharged effectively when directors look at long term as well as short term issues and when all the factors affecting the company's relationships and performance are taken appropriately into account. This implies an appreciation of the implications of a wide range of social and ethical, environmental and economic impacts. We recognise that there already exists in the UK a sound and well-developed system of financial reporting. But, as the

⁶ Cm 5553-I, paragraph 4.33

⁷ In the White Paper, the Government said that it intended to devolve to a single body, referred to as the Standards Board, the power to make detailed rules on a range of accounting, reporting and other disclosure issues. See Cm 5553-I, paragraphs 5.7 and 5.8.

CLR argued, the OFR needs to go beyond this. Information of both a quantitative and a qualitative kind about future plans, opportunities, risks and strategies is all important to a proper assessment of the business, as well as giving a proper context to the financial statements. We thus believe that the CLR's recommendations concerning the OFR have the capability to reshape and refocus corporate reporting to the benefit of shareholders and all other stakeholders.

- 8 Against this background, and recognising the considerable body of experience that already exists in relation to the OFR, our work focuses on how to help directors best meet their obligations with regard to the OFR. It is clear that it will be for directors to decide what items are or are not material. This applies as much to items that fall under the broad headings of the mandatory items as to the other broad topics. Directors will have to decide exactly what information, in relation to the broad topic headings, they are going to disclose. The CLR makes this clear. "Our proposals are designed to put the onus on directors themselves to give their own account, based on their own judgement, of the matters which are important in assessing the performance and prospects of the business"⁸. "The OFR is prepared by the directors from their perspective as managers of the business. Its purpose is to show, in the directors' own terms, what matters about the business as regards performance and direction"⁹. The White Paper and our Terms of Reference also reinforce this point. The OFR must reflect the company's priorities: its own vision as to the purpose and values of the business; and the way it analyses the business, sets strategy, and measures success in all its key relationships. Our aim in developing broad principles and practical guidance is thus to assist directors as they go through a process of determining, for themselves, what should be included in their OFR.
- 9 It follows that our approach recognises the importance of process. Directors will need to have in their minds a clear understanding of the concept of materiality in the context of the OFR, and of the principles that are relevant to a consideration of materiality, but they will also need a sound process, consistent with the relevant principles, if they are to demonstrate that they have discharged their duties responsibly in making their materiality judgements. Indeed, in practice they in any case need to have such processes in order to oversee effectively the management of the business. A well-run board will already have in place most if not all of what is needed and it will not be necessary in such cases to invent new processes purely in order to arrive at judgements on materiality. But it may be necessary to review current processes and make sure they are adequate to the task. In this context, the White Paper itself acknowledges the importance of process in proposing that the company's auditors will be required to report on the OFR, and in particular on the adequacy of the process of its preparation, as well as on compliance with applicable rules and consistency with the financial statements and other information derived from the audit¹⁰.
- 10 In this Consultation Document, therefore, we address the concept of materiality; the principles to be applied in arriving at a judgement on materiality; and the process directors should go through, as part of the total process of good governance, in making their judgements on materiality and thus deciding what should be included in their OFR. We believe that these three components together will provide the guidance required by our Terms of Reference.

⁸ Modern Company Law for a Competitive Economy: Final Report, paragraph 3.40

⁹ Modern Company Law for a Competitive Economy: Final Report, paragraph 8.33

¹⁰ Cm 5553-1, paragraph 4.40

Our work plan and timetable

- 11 From the outset, the Working Group recognised that, if we are to provide guidance that is helpful, practical and durable, we would need to consult widely. So, also from the outset, we made clear that we would welcome early input from any organisation or individual with an interest in the issues we are addressing, and we have been greatly encouraged by the degree of interest generated in our work and the willingness of so many to contribute. But we also decided that it would be essential, once we had developed some propositions on which to consult, to build in a period of formal consultation, and this has governed both our work plan and our timetable.
- 12 We had our first meeting late in 2002, when we agreed that we should first review the extensive material relevant to our Terms of Reference that already exists, together with input provided by other organisations and individuals, and prepare and consider in the first few months of 2003 a series of papers looking at aspects of our remit in detail, with a view to producing a Consultation Document in the early summer. We decided that, in view of the considerable amount of information and practical experience already available, we would not, at that point, commission any special new research.
- 13 Recognising the importance of engaging a very broad constituency of different interests in our emerging proposals, our aim is to be as proactive as possible during the consultation phase. Thus we welcome formal written comments on our suggestions; but we also want groups and organisations to feed in their views by whatever means may be helpful to them. We welcome, for example, the opportunity of having a Group member attend, where practicable, meetings or feedback sessions that organisations may wish to arrange and contributing to internet 'chat sessions' if organisations wish to set these up. We also hope that firms and organisations will be willing to test our ideas against their own experience and feed back the results to us as part of the consultation exercise. We would be particularly interested to hear about 'real life' examples that might be of general interest: examples of where a decision on materiality resulted in appropriate disclosure; and also examples of where a different decision might, with the benefit of hindsight, have been taken.
- 14 The formal consultation period will extend from **Friday, 27 June 2003**, the date of the launch of this document, to **Friday, 19 September 2003**. Thereafter we aim to consider all the responses and input we receive and review our proposals in the light of this feedback. We shall then prepare our Final Report setting out broad principles and practical guidance, which we aim to publish **early in December 2003**.

Structure of this Consultation Document

- 15 As explained above, we see the guidance that directors will need in considering what is or is not material in the context of their OFR as having three key components. The first two components - the concept of materiality in the context of the OFR and the set of principles that directors might apply in arriving at their judgements on materiality - together provide an answer to a key question that will be in directors' minds: "what are we aiming to do?" The third component is the process directors go through in arriving at their judgements on materiality and thus deciding what should be included in their OFR; it therefore addresses the parallel question: "how shall we do it?" This Consultation Document follows this structure: it looks first at the concept of materiality; second at the principles; and third at the process. Questions for consultation are included at the end of each section.

The concept of materiality

Background

- 16 At the outset, it should be noted that the existing disclosure provisions in the Companies Act 1985 require the directors to make judgements as to what should be included and what should be left out of any narrative report. Companies are required, amongst other reporting requirements, to include a fair review of the development of the business; particulars of important post-balance sheet events; and likely future developments. All these require decisions to be made as to what information is required and how to present it. Directors frequently have to make judgements on what they should disclose to meet their obligations, whether these obligations derive from the Companies Act, the Listing Rules, or other regulations. In this sense, the OFR introduces no radically new concept; directors have always had to make judgements of this kind.
- 17 On the other hand, the proposed new approach to company law brings the concept of materiality into a new framework. The CLR and the White Paper do this in the context of the proposed new general duty that will apply to directors. The White Paper sets out these duties in Schedule 2¹¹; it contains, inter alia, the requirement that a director must, in deciding what would be most likely to promote the success of the company, “take account in good faith of all the material factors that it is practicable in the circumstances for him to identify”. The accompanying Notes observe that “material factors” means the likely consequences (short and long term) of the actions open to the director, so far as a person of care and skill would consider them relevant; and all such other factors as a person of care and skill would consider relevant¹².
- 18 The new general duty, once enacted, will of course apply to all directors of all companies, not just those required to prepare an OFR. And, whilst it provides essential context, it does not give a definition of materiality that directors might have in mind in making judgements about their OFR. Information that is material in the context of one specific decision made during the year may not be material to an understanding of the business as a whole in that year. For example, the robustness of the assumptions underpinning an appraisal of a new project might represent a material factor in discharging the general duty at the time the directors decide whether or not to go ahead with that project. But it need not be material in the context of an assessment of the business as a whole and, indeed, the project itself might not be of sufficient importance to merit mention in the OFR. The concept of materiality needed in making OFR judgements is thus not identically equal to the concept as applied in the general duty; we have to look beyond company law for help in this regard.

Materiality in the context of the OFR

- 19 The CLR gave some consideration to the concept of materiality and offered the following observation: “We remain of the view that this should be a matter for directors to determine on the basis of the question: ‘Given my good faith, honest judgement about the best way of presenting the operations of the business for the defined purpose, does this item matter?’”¹³ Whilst we have some sympathy with this approach, and in particular with its emphasis on good faith, honest judgement, we believe it leaves too much to conjecture, not least because it fails to address the important issue of to whom it might matter.

11 This Schedule may change: the Government is currently considering how the text of the draft duties might be improved and will consult in detail on a revised draft in due course.

12 This would include such of the following matters as he would consider relevant: the company’s need to foster its business relationships, including those with its employees and suppliers and the customers for its products or services; its need to have regard to the impact of its operations on the communities affected and on the environment; its need to maintain a reputation for high standards of business conduct; its need to achieve outcomes that are fair as between its members. See Cm 5553-II pages 112 and 113.

13 Modern Company Law for a Competitive Economy: Completing the Structure, paragraph 3.34

20 Instead, we have sought to explore what seem to us to be the key issues in a consideration of materiality in the context of the OFR, and which can be used as criteria in working towards a definition. These are as follows.

- i. As a starting point, we have examined a large number of definitions of materiality produced for other purposes at other times. There is, for example, much existing guidance available relating to the concept of materiality as applied to financial statements and in the context of the auditors' report. And there is guidance produced for other jurisdictions as well. We can see considerable advantage in **building on existing guidance**; it has the advantage of familiarity for many directors, albeit that guidance developed in relation to financial statements does not encompass the entirety of matters that may fall within the scope of the OFR.
- ii. Following on from this, however, we think it is important to make clear that, for our purposes, materiality is being considered not in the context of financial statements only but specifically **in the context of an OFR**. There needs to be a clear link to the high level objective of the OFR, which, in the CLR, is stated to be to enable users "to assess the strategies adopted by the business and the potential for successfully achieving them"¹⁴. We think it important that the approach to defining materiality should recognise the objective of the OFR: both in terms of the issues included in it and its emphasis not just on past but on future performance and potential.
- iii. We also believe it is important for the approach to defining materiality to recognise the **scope of the OFR**. Information provided in the OFR may be qualitative as well as quantitative; it may describe a probable event, a risk or an opportunity as well as a past event or a matter of fact. And the words chosen to describe the information will therefore be of great importance. Where material information cannot be quantified it must nonetheless be fairly and unambiguously described.
- iv. We further believe it is important to think about the various classes of **potential users of the OFR** in considering materiality. The philosophy of the CLR and the White Paper rests on the proposition that companies are managed for the benefit of their members and thus it follows that the primary audience of the OFR must be the members, albeit that the information provided in it will clearly, and rightly, be of direct benefit to other users who may have an interest in the company's affairs¹⁵. But the CLR and the White Paper also recognise that it is vital for directors to take a broad view of the factors determining the success of their business and, in particular, this means recognising the role that all the company's relationships play in its success. Issues that are of significant interest to customers, to employees, to suppliers and to society more widely are, or will very likely become, matters of concern for shareholders too. If there is the potential, for example, for the way the company manages a particular environmental challenge to affect, directly or indirectly, significant numbers of people and thus affect its reputation, this is clearly relevant to shareholders because of the likely consequential effect on profitability and hence on shareholder returns. A key objective of the OFR is to strengthen accountability, including accountability for the way in which such issues are managed. So the key question in deciding whether or not an item is material (which we think the

¹⁴ Modern Company Law for a Competitive Economy: Final Report paragraph 8.32. We have followed the objective set out in the CLR rather than that of the draft clauses of the White Paper as the latter are designed to aid discussion rather than being a conclusive view on the best legislative approach. It may therefore be necessary to revisit certain matters once the legislative approach is finalised but we expect the criteria we have adopted to remain appropriate.

¹⁵ The White Paper itself clearly recognises that, whilst the OFR addresses the information needs of members, the information provided in it will be very useful to other stakeholders and this will represent an additional benefit. See Cm 5553-I, paragraph 4.32. See also the recent report from the Trade and Industry Committee published in May 2003, which observed that the OFR "...would be of benefit not only to shareholders and potential investors ...but also to all those concerned with the wider aspects of company behaviour ...as employees, local residents or as interest groups involved in environmental/social issues or general corporate governance".

CLR definition leaves too open-ended) should be: “Does this item matter to the members, either directly, or indirectly as a result of its significance to other stakeholders and thus to the company?”

- v. Linked to this point, the OFR not only imparts information about the business, it will, as a consequence, also be used as a basis for taking decisions. Our definition of materiality therefore needs to recognise this **link between the OFR and decision-taking**. In the first instance this link may be to members’ decisions. Members can decide to buy, hold or sell shares; or to exercise voting rights; or to influence the decisions of management¹⁶. But other users of the OFR may also take decisions. Actual or potential customers may, for example, decide whether or not to buy the company’s products. Employees can decide to work with greater or less commitment. Interest groups may campaign against, or in favour of, a particular plan or project and may be able significantly to influence its outcome. All such decisions may impact upon the actual or expected value of the business. In this way the OFR informs members’ decision-taking both directly and indirectly.
- vi. Last, as has already been noted above, the directors have a vital and complex task to perform in making their judgements about materiality if their OFR is to meet the objectives set for it. We believe this points in the direction of couching guidance in as **clear and simple language** as possible, and this belief has been strongly reinforced in the comments we have received to date during the course of our work.

Defining materiality

21. Against this background, we have sought to move towards a definition of materiality to be used in the context of the OFR. We think it is neither necessary nor desirable to try and formulate a definition in one sentence; instead, our definition follows the six criteria set out above that recognise the richness and complexity of the OFR concept. Our definition is as follows.

‘In making their good faith, honest judgements about what information is material and should be included in their OFR, directors should be governed by the high level objective of the OFR, which is to enable users to assess the strategies adopted by the business and the potential for successfully achieving them. Information will be material to the OFR if failure to disclose it clearly, fairly and unambiguously might reasonably be expected to influence members’ assessments of the company and hence the decisions they may take, either directly, or indirectly as a result of the significance that the information has for other stakeholders and thus the company. Information that is material to the OFR may be quantitative or qualitative; and may relate to facts or probabilities, and to past, present or future events and decisions.’

Questions for consultation:

- Q1 Do you agree that the six issues set out in paragraph 20(i) to (vi) together provide a useful set of criteria that should be applied to any definition of materiality for the purposes of the OFR? Are there other important issues that should be taken into account?*
- Q2 Do you think the definition of materiality set out in paragraph 21 is appropriate in the context of the OFR?*

16 While the financial statements, and by extension the new OFR, may influence a range of decisions by members and others, the law recognises a duty owed only to current members and with regard only to the exercise of their governance rights: see *Caparo Industries v Dickman*. Having considered the matter in some detail, the CLR concluded that the case had not been made out for an extension of the duties owed by directors, companies or auditors in this respect. See *Modern Company Law for a Competitive Economy: Final Report*, paragraphs 8.127 – 8.135.

Principles

Introduction

- 22 As noted above, we see the guidance that directors will need in considering what is or is not material in the context of their OFR as having three key components: the concept of materiality in the context of the OFR; the set of principles that directors might apply in arriving at their judgement on materiality; and the process that directors might go through in arriving at their judgements on materiality and thus deciding what should be included in their OFR. In this section we turn to a consideration of the principles we believe directors may find useful to apply in making their judgements. In doing this, we are mindful of the fact that any set of principles derived independently of one another may give rise to internal contradictions. We are doubtful whether this will present many problems in practice but we should emphasise that it must be for directors to exercise their own judgement as to the relative importance of any principles that appear to be in conflict in their particular circumstances.
- 23 Following on from the discussion of materiality in the previous section, we have identified six sets of broad principles as follows.
- i. The starting point for directors:**
 - knowledge and experience;
 - skills and competencies;
 - good faith, honest judgements.
 - ii. The starting point for the OFR:**
 - the objective of the OFR;
 - purpose and values of the business;
 - taking a broad view.
 - iii. The scope of the information in the OFR:**
 - the balance between historic review and a focus on the future;
 - quantitative and qualitative information;
 - facts and events, probabilities, risks and opportunities.
 - iv. Identifying the information for the OFR:**
 - nature and size of items;
 - significance of issues;
 - variability and volatility.
 - v. Reporting in the OFR:**
 - measuring and describing;
 - consistency from year to year;
 - consistency with other information and reports.
 - vi. The approach to disclosure in the OFR:**
 - balanced judgements;
 - confidential information;
 - future possibilities.

Each of these is considered in more detail overleaf.

The starting point for directors

- 24 It is self-evident that judgements are most likely to be sound when those making them have a sound basis of **knowledge and experience**. The OFR will be concerned with all the key aspects of the business and the judgement as to what is material will thus require knowledge and experience of all these key aspects. It is a fundamental principle of good corporate governance that there needs to be available around the board table, from amongst the executive and non-executive directors taken together, the appropriate knowledge and experience to run the company in the best interests of its members; in this sense the requirements of the OFR are the same as those anyway needed to run the company. And the OFR will, potentially, reflect the issues that are on the board's agenda.
- 25 The overall objective of the OFR does, however, require a broader range of judgements on materiality to be made by directors than may have been needed for other, more limited forms of reporting. It therefore highlights the importance of **the balance of skills and competencies** available to the board, both from amongst the directors themselves and indirectly from advisers and others, and the need for this to be adequate in relation to all the potentially material issues. Boards have, for example, found that assessing the significance of some of the wider issues identified in the CLR as likely candidates for inclusion in the OFR, such as environmental, community, social or ethical considerations, may require access to additional skills and competencies.
- 26 It is also an important principle that, in making judgements about materiality, the board should act collectively. Such judgements need to be the well-informed, **good faith, honest judgements of the board as a whole**. This means that, whatever arrangements are made for doing the detailed work in advance, the whole board must be fully engaged in the judgement-making process.

The starting point for the OFR

- 27 We have argued above, in defining materiality in the context of the OFR, that directors should be **governed by the high level objective of the OFR**, which is to enable users to assess the strategies adopted by the business and the potential for successfully achieving them. This has to be the primary starting point and the framework for decision-making and for the exercise of judgement that follows.
- 28 We also consider, however, that, to achieve this objective, directors will find that they need to start their consideration of materiality from an informed understanding and expression of their vision as to **the purpose and values** that govern the business and drive their decision-making as directors. This will provide the basis for the essential criteria against which to assess the strategies of the business; without it, the objective of the OFR cannot be met.
- 29 And alongside this, as we have also argued above, we think it essential, if the objectives of the OFR are to be met, that directors in making their judgements on materiality **take a broad view** about the approaches and perspectives that users of the OFR, in the first instance the members but also other key stakeholders, will bring to their assessments. This implies taking a proactive approach, including a willingness to consider society's changing norms and expectations of business, and to explore and understand the agendas of a range of different stakeholder groups that may reasonably be expected, directly or indirectly, to affect significantly the performance of the business, including customers, employees, suppliers, and local, national and international interest groups of a variety of kinds. Such groups can often not only articulate the norms and expectations that society has of business but can anticipate future changes in consumer behaviour and can influence regulatory change.

The scope of the information in the OFR

- 30 It is fundamental to the objective of the OFR that the information contained in it will be relevant to an assessment of the future as well as of the past and the present. The emphasis hitherto in financial reporting has been more towards describing and explaining past events. Of course, the OFR must do this too. But it also has a broader scope. It should not only include material information in relation to past events but also information about, and the directors' views on, the trends and future events that will shape the prospects for the business. This does not mean formal forecasting; it means looking ahead and giving a view, where appropriate, not only in relation to next year but beyond. Hence, in making their judgements as to what is material for the purposes of the OFR, directors will wish to strike a proper **balance between historic review and a focus on the future** in their thinking.
- 31 There are, in addition, two further aspects relating to the scope of the OFR that directors will wish to recognise in making their judgements on materiality. As we observed above, information provided in the OFR may be **qualitative as well as quantitative**. Where information can be quantified it should be quantified, but in some instances qualitative information may be crucial to an assessment of the strategies and potential of the business. For example, in commenting on a company's plans to embark on a new business venture, a qualitative assessment of the depth, breadth and relevance of top management's experience in relation to such a venture might well be material to its chances of success.
- 32 And the information in the OFR may be a description of an important issue or the expression of a probable future event as often as a past event or a matter of fact. These should be judged in the context of the risks, opportunities and threats facing the business, including an assessment of non-financial issues, such as environmental, ethical or reputational risk. So **facts and events, probabilities, risks and opportunities** may all be material and qualify for inclusion in the OFR if it is to meet its objectives. For example, the directors' opinion on the strategic implications for the company of the UK's deferring for some years a decision on whether or not to join the European Single Currency might be material. Or, for a business involved in mobile telephony, the directors' views on possible health hazards arising from masts or from use of handsets might well be material for its future reputation.

Identifying the information for the OFR

- 33 Whether or not a piece of information is material will depend upon **the nature and, where relevant, the size and effect of the item concerned** judged in the particular circumstances of the case¹⁷. This concept applies equally to the OFR as it does to the preparation of financial statements, and similar considerations apply also in that directors need to consider not only the size and nature of an item taken individually but also set it in the wider context of the OFR as a whole. An item of information that does not appear material when taken on its own may become so when considered in the context of other disclosures. For example, the resignation of an individual board director of a subsidiary company might itself not ordinarily warrant mention in the OFR, but if a number of directors resigned from the same board in quick succession this information might well be deemed material. The test should be whether the information, were it to be omitted, mis-stated or inadequately described, would change or influence an understanding of other matters reported upon and thus, potentially, influence decisions.

¹⁷ Accounting Standards Board 1999: Statement of Principles for Financial Reporting, paragraph 3.31

- 34 A particular issue arises in the context of materiality judgements in the case of an issue that is well-managed, and thus does not give rise to material consequences for the business, but where it is, of itself, nonetheless of significance. An obvious example is the management of business continuity risk where not only does the extent of the risk vary significantly by organisation and over time but also management's ability to mitigate the risk varies too. The principle determining materiality here should be the **significance of the issue to the business** in the future, not just its actual consequence in terms of its quantified impact today; users' decisions may well be affected by an appreciation both of the risk and of the management action to mitigate it.
- 35 Similarly, directors will, in considering materiality, wish to consider not only the size of an item this year in comparison with last year, and its likely size in the future, but also the degree of **variability or volatility** that it exhibits. Averages that conceal significant variations may not be an adequate pointer to materiality. For instance, for an insurance company it may not be sufficient to report on the effect of global warming on claims experience if in fact it is the variability of claims experience that impacts more substantially on profitability.

Reporting in the OFR

- 36 Once the directors have determined that an item is material, precisely how it is reported upon in the OFR may be subject to whatever detailed rules are laid down in due course by the standard-setting body. Directors will, however, wish to have in mind in considering their materiality judgements the whole range of measures used by the company itself to assess performance and prospects. Whilst the discipline of preparing the OFR may itself reveal areas of the business where existing measures are inadequate or need revision, the requirements of the OFR are unlikely to diverge markedly from the needs that the board anyway has in order effectively to oversee the management of the business. So existing **measures of performance and prospects** will provide a useful starting point. But the OFR will need to go beyond those factors that affect performance and prospects and can be measured. Although it will be desirable to provide measurement wherever possible, by its nature the OFR may need to contain information that does not readily lend itself to clear measurement. Directors should not exclude from the OFR information that is material to an assessment of the performance or, in particular, the prospects for the business solely because it cannot be measured, although they will need to consider **how best to describe the information** – the state of affairs, the expectation or the assessment – that is in their view material.
- 37 In making their materiality judgements directors should aim to be **consistent from year to year** in their approaches to the OFR. This does not mean that a matter once covered, or an item of information once included, should thereafter always feature in the OFR. It will, however, help to promote understanding of the directors' approach if an explanation is offered as and when an item hitherto included is dropped from inclusion in subsequent years. Furthermore, if a matter was judged material and disclosed in an earlier year, and was unresolved at that point and remained open-ended, the presumption should be that it will continue to be covered in subsequent OFRs unless and until the matter is closed, when it can be reported upon as such. For example, in the run-up to Year 2000 many companies commented in their OFRs on the extensive preparations that were underway to ensure the continuity of their systems and processes, but fewer companies commented after the event on whether or not these efforts had been successful. But this approach need not extend to matters that are not open-ended and are a matter of public record. For example, businesses that may be significantly affected by possible tax changes in a forthcoming Budget may

wish to disclose that, and the possible consequences, in their OFR. If the change is then not made, however, there is no need for the ensuing year's OFR to return to the issue. The possibility of Budget change is material but it is not open-ended and is a matter of public record.

- 38 Directors will also wish to ensure that their judgements, as well as being consistent from year to year, are also **consistent** with the judgements they make **with regard to disclosure generally in other reports or statements** that have been or may be issued by the company, for example preliminary results announcements and other presentations to shareholders. They may also wish to consider the approaches adopted by others in the same industry sector to see whether a consistent approach with some or all of these might be appropriate.

The approach to disclosure in the OFR

- 39 The OFR requires the disclosure of material items. It does not imply the disclosure of non-material items; indeed, the inclusion of too much information in the OFR may be as likely to result in a failure to meet its objectives as the inclusion of too little (although the OFR, desirably, can act as an effective 'signpost' to more detailed information published elsewhere). There will be occasions, however, where directors are undecided about whether or not a particular matter is material and in these circumstances a bias in favour of disclosure is entirely reasonable. Directors will wish to ensure their **judgements are balanced** in this regard in the light of the high level objective of the OFR.
- 40 With regard to the disclosure of **confidential information**, the CLR recommended that "companies should be permitted not to disclose information which is, in the directors' judgement, of such confidentiality or commercial sensitivity that to do so would materially prejudice the company's interests"¹⁸. The draft clauses in the White Paper contain no provision regarding the disclosure of confidential information, with the Government preferring to seek further views on the issue¹⁹. We are not persuaded that such a provision is needed²⁰; nonetheless, we have considered what principles, given the high level objective of the OFR, might govern directors' judgements as to whether, if a matter is in their view material, it nevertheless need not be disclosed in the OFR. This would appear to relate in practice to the approach to commercially sensitive information. Price-sensitive information in the case of listed companies must anyway be disclosed without delay and, although it would need to be considered for repetition in the OFR, it is very unlikely that, for listed companies, the OFR would ever be the vehicle for first disclosure of such information. And confidential information (information that is subject to an obligation to a third party such as an employee, customer or supplier) would, as now, be subject to disclosure if it were material unless it were "materially prejudicial" to the company's interests²¹. The principle that directors should have in mind, therefore, ought to be that all material information should be disclosed in the OFR unless the directors have explicitly satisfied themselves that, in all probability, disclosure would of itself result in "material prejudice" to the company's interests. This is consistent with the recommendations of the CLR.

¹⁸ Modern Company Law for a Competitive Economy: Final Report, paragraph 8.37

¹⁹ See Cm 5553-1, Annex D, paragraph 27

²⁰ We note that the Accounting Standards Board in the recent revision of its Guidance does not refer to the need for any such provision.

²¹ Or where disclosure might be prohibited under other legislation. This might apply, for example, if the business were under investigation under certain provisions of the Financial Services and Markets Act, or had contractual arrangements covered by the Official Secrets Act.

41 The forward-looking nature of the OFR also has implications for the approach to disclosure. The need to prepare an OFR will encourage boards to consider and comment upon the full implications of plans and projects that may be very long term in nature. This, however, does not imply the disclosure of all possible future decisions that, if taken, or events that, if they were to transpire, could have material consequences. This should not be necessary to meet the objective of the OFR and could be highly damaging to the business. The approach adopted in the Listing Rules provides a useful principle here: “ A company need not notify to a Regulatory Information Service information about impending developments or matters in the course of negotiation”²². The UKLA’s guidance on the dissemination of price sensitive information goes on to suggest that, in general terms, this would cover such matters as merger talks or new product development. Our view is that, in the context of the OFR, information about **future possibilities** need not be disclosed unless these are much more likely to happen than not, i.e. they are probable rather than merely possible, or unless failure to disclose might itself be misleading (because, for example, market expectations are to the contrary)²³.

Questions for consultation:

Q3 Do you agree that the six sets of broad principles summarised in paragraph 23 and described in paragraphs 24 to 41 are appropriate in arriving at judgements on materiality for the purposes of the OFR? Are they described clearly enough?

Q4 Are there other principles that should be applied in making such judgements?

²² UK Listing Authority Rules, paragraph 9.4

²³ Directors may also find it helpful to refer to the UKLA’s guidance on the use of ‘health warnings’. See The UKLA’s guidance on the dissemination of price sensitive information, chapter 26.

Process

Introduction

42 In the previous two sections of this Consultation Document we addressed the first key question that will be in directors' minds: "What are we aiming to do when we make our materiality judgements?" We have considered the concept of materiality in the context of the OFR, and offered a definition, and set out some principles that directors can apply in arriving at their judgements. We now turn to the second key question: "How shall we do it? What process should we go through in deciding what is material and therefore should be included in our OFR?" A sound process, consistent with the principles set out in the previous section, would in our view provide good evidence that directors have discharged their duties responsibly with regard to their materiality decisions. Accordingly, below we put forward, first, a set of criteria that directors could use in assessing their process; and, second, a set of questions that directors may find helpful in applying the process in practice. In doing so, we should stress that, in accordance with our Terms of Reference, we are focusing here only on the process for making judgements about materiality. Our guidance thus relates to one component only, albeit a crucial one, of the overall process for preparing and publishing an OFR. Of course, many companies that have been producing OFRs on a voluntary basis for some time already have well-developed processes upon which to base their materiality judgements, but others may have less internal experience to draw on. Thus this section of the Consultation Document provides a checklist that directors can use, in assessing their existing process or in devising a new one, to help determine whether or not it is sound and whether or not they have applied it appropriately.

Criteria for assessing a process

43 As we have already indicated, the processes that directors use in arriving at their materiality judgements, and the information on which these judgements are based, are those which, in large measure, are likely anyway to be in place in order to help them oversee the management of the business. But it may be useful to review these to make sure they are adequate to support the board's materiality judgements; indeed, such a review has the potential to add value to the business over and above the particular requirements of the OFR. We have therefore examined established best practice and, on the basis of this, have identified six key criteria against which directors could assess their process for making materiality judgements. These are as follows.

- i. The process should be **transparent**. By this we mean not only that it should be **written down and/or mapped** in some way, with **clearly-defined responsibilities** for key tasks assigned within a **clear timetable**, but that the process should be **well-communicated** to, and hence **well-understood** by, all those involved, both with its preparation and as users.
- ii. The process should provide for **appropriate consultation within the business and externally** with key stakeholders.
- iii. The process should allow **account to be taken of appropriate comparisons**, both **within the business** (prior years' OFRs, other published reports and information) and **externally** (models of best practice, industry guidance etc).

- iv. The process should be **comprehensive** (i.e. it should be applied across the whole business unless there are sound, documented reasons for not doing so).
- v. The process should be **consistent** (i.e. it should be applied the same way both across the business and from year to year, unless there are sound, documented reasons for not doing so).
- vi. The process should be **subject to review**, both internally and by the external auditors. This might, for example, include a review after each cycle, with a major review perhaps every three to five years, linked to the strategic planning cycle. Directors should also note that their OFR processes may be subject to external challenge by affected stakeholders.

Key questions to be addressed

- 44 The following ten questions together provide a checklist that directors may find helpful in applying their process.

Q.1 Does the board have, or does it have ready access to, all the relevant knowledge and skills to make its judgements as to what is or is not material? If not, how will this be addressed?

Judgements on materiality in the context of the OFR should, we have argued above, be the well-informed, good faith, honest judgements of the board as a whole, hence the board should be responsible both for the process it uses to arrive at its judgements and the application of that process. A fundamental starting point for a good process for determining materiality, therefore, is that the board as a whole, taking the executive and non-executive directors together, has the necessary knowledge and skills in this respect, or has ready access to them. And it follows from the scope of the OFR, and thus the scope of the materiality decisions to be taken, that this knowledge will need to encompass all the actual and potential sources of value creation in the business. Other reports have commented on the extent of the expertise generally required of directors, particularly non-executive directors, if they are to discharge their current responsibilities²⁴.

The requirements imposed by the OFR reinforce this message.

The board, therefore, may want to consider additional training and support for the directors in meeting this challenge. For example, some companies have on-going familiarisation programmes for directors that, via a series of co-ordinated visits to different parts of the business, ensure they widen their basis of knowledge and experience and connect what they see with what is reported to them, and thus are able to ask challenging questions.

The board will also want to review what additional advice and support may be needed. Of course, the senior management responsible for each key area of the business will be closely involved in supporting the board in making their judgements but there may also be a need for special work to be done on a particular issue or topic that the board feels may be material but does not fit readily into existing management structures. This may apply, for example, to issues in the social and environmental areas in the case of some businesses that do not, as yet, have well-developed approaches in these areas. And the board will also want to consider whether it wishes to take advice from others, including external advisers, on such issues. This may include advice from specialist sources.

²⁴ See, for example, Higgs, D. (2003) 'Review of the Role and Effectiveness of Non-Executive Directors'

Q.2 An early task for the board will be to approve the process and satisfy itself that the process is being properly applied before it can exercise its judgements on materiality. How will the board work in discharging these key responsibilities?

The board will want to consider arrangements whereby a committee or committees of the board might do some of the detailed work of review in advance of the board as a whole making its judgements. Again, there is nothing new here. It is common practice, for example, for a special committee to be set up to work on the information requirements to support a particular strategic initiative. Many boards have established risk committees that could have an important role to play. And increasingly boards are considering setting up special committees, not necessarily made up solely of board members, to examine environmental, social and ethical matters under the broad heading of corporate responsibility.

In the context of the OFR, the Audit Committee is likely to have a role in seeking assurance as to the reliability of the information to be included (see Q.7 below). It may be appropriate for the Audit Committee to take a wider role than this in relation to the OFR, but this may add yet another burden to what is a rapidly expanding workload in many businesses. Instead, it may be appropriate to involve the special committee that examines environmental, social and ethical matters on behalf of the board, where such a committee exists. In general, the extent to which existing or new committees are used must be for the board to judge but this judgement should be made in the light of the need to apply to the work the requisite knowledge and skills. In this context, involvement of non-executive directors as well as executives in any special committees is likely to be required, together with the provision of appropriate specialist support.

Q.3 What information should be considered at the outset for possible inclusion?

The CLR makes clear that certain broad topics should always be covered in the OFR; these are the company's business and business objectives, strategy and principal drivers of performance; a fair review of the development of the business over the year and position at the end of it; and the dynamics of the business. There are also broad topics that should be included "whenever the directors in good faith judge them material". These include corporate governance, values and structures; an account of key relationships with employees, customers, suppliers and others; policies and performance on environmental, community, social, ethical and reputational issues; and receipts from and returns to shareholders²⁵. These broad topics will need to be considered at the outset by virtually every board of directors in thinking about what might be included in their OFR; the key area of judgement will lie not in whether these broad topics are relevant but in deciding precisely what information, under each broad topic heading, should be reviewed in order to determine whether it is material and thus should be disclosed. The board will therefore want to consider information under each of these broad headings in order to make their materiality judgements; the directors will also want to consider, against the overall objective of the OFR, whether there are any other topics special to their business that merit consideration.

Q.4 What do other sources suggest might be important?

It will be helpful to examine all other relevant sources to see whether they suggest issues or information that might be material to the OFR. This would include internal information, and in this context earlier OFRs will be

25 Modern Company Law for a Competitive Economy: Final Report. See table following paragraph 8.40 for full details.

very important. This year's OFR should follow up statements made in previous OFRs to report progress or explain divergences. Also important in this context will be all the financial and operating statements made in the year, and any public statements or press releases. And a further very important source is the board's own agenda: the matters that have occupied the time of the board in the past year will be a good, though not always a perfect, guide to what have, in practice, been key issues affecting performance and prospects.

External sources are also extremely important as a potential guide to materiality. Relevant here are the OFRs of other companies, particularly those operating in similar business areas, but also industry guidance and models of best practice. There are a number of these covering issues that are likely to be material in many cases. For example, a number of major companies now report and benchmark their performance against guidelines such as the Global Reporting Initiative and this has helped to shape the content of their OFRs. And work is being done in other key areas as well. The Accounting For People Task force is considering, amongst other issues, best practice in the area of human capital reporting. The Task Force is due to report in the autumn. We believe the board will wish to examine these and other forms of guidance as to best practice in each of the broad topic areas potentially covered by the OFR to help them decide what is material in their particular case. There is a growing body of standards and guidance in these areas; further information is presented in Annex B.

Additionally, particularly in the case of larger businesses with significant groups of key stakeholders, the board is likely to benefit from the results of consultation with such groups to ascertain what, in their view, are the key issues. This may be feedback from earlier OFRs (which we suggest below should be obtained each year – see Q.10 below) but also from surveys or workshops with groups of key stakeholders. Experience suggests that such consultation may be valuable not only in the context of deciding what is material for the purposes of the OFR – it may reduce the possibility of the board discovering that an issue is material only after the event – but also for increasing understanding and awareness of opportunities and risks more generally across the business. Boards are increasingly seeking to go beyond conventional information sources and seek out new approaches in this area by which, for example, they may be able to engage affected stakeholders in a more formal manner²⁶.

Q.5 What key information do the corporate management information systems provide now on these topics?

It is to be expected that most companies required to produce an OFR will have information from their corporate systems relating to many of the broad topics identified in the CLR, and will already recognise the need to bring this together to give the board an effective overview of the health, performance and prospects of the business. The strategic business plan will have information about purpose and values, strategy and goals, and the regular board information pack will measure performance against the key performance indicators contained in the business plan. Information about the company's competitive position and its key relationships will also normally be contained in the analysis underpinning the business plan. Risk management and corporate governance processes are, similarly, well-developed in most large businesses, and are subject to existing standards, including the Combined Code. Increasingly, companies are maintaining information on corporate responsibility issues, such as environmental, community and HR issues, although this is often less well-developed than other areas of the business (see also Q. 6 below).

26 Leading companies are building these processes more formally into decision-making and reporting structures, such as through the application of new stakeholder consultation guidelines. See AccountAbility, AA1000 standard.

In general, therefore, existing information and measurement will often be sufficient for the OFR but the board may well also want to consider whether changes or improvements are needed in the light of the overall objective of the OFR. For example, it is noticeable that customer-based information, such as customer numbers and products sold to these customers, has in recent years become important data to many companies who did not analyse such information before but who have invested significant sums in order to produce better information, prompted in part by the need to report in the OFR. In this way, the spur provided by the need to use fair and balanced information in the OFR has had a directly beneficial effect in terms of improved management information and, in all probability, decision-taking.

Q.6 What, in the light of all this, are the information gaps? What should the plans be for filling these gaps? How will the information be put together?

There are two areas of difficulty with regard to information gaps that frequently arise. First, it is very likely to be the case in large organisations that management information is not standard or fully integrated across all business units; this may for example be because of mergers or acquisitions or because different territories have different regulatory requirements. It may not be feasible to standardise and approximations may have to be made. In this context, the quality of the information upon which the materiality judgements are made is something the board may need to comment upon in the OFR itself.

Second, as noted above, some types of information tend to be relatively less well-developed in many businesses²⁷. These may include what are now often referred to as the ‘corporate responsibility’ topics²⁸ but may also extend to information about the nature and health of all the relationships that contribute to the success of the business including, for example, the crucial relationships with employees, with customers and with suppliers. We are aware that many companies have expanded their OFRs to cover the full range of such topics from a base that previously focused on just one or two, such as HR matters or environmental issues. For companies that have not already expanded the scope of their OFR in this way, the board may wish to develop a plan for improving the scope and coverage of the information it needs to make its judgements; however, in doing this it will have to take a balanced view as to how quickly it can move towards better-quality information without incurring excessive costs in relation to the benefits (see also Q.10 below), although we note that there is evidence to support the view that companies with a mature and complete reporting system ultimately realise financial benefits²⁹. This can also be commented upon in the OFR and can, perhaps, helpfully be seen as part of a wider plan to improve the effectiveness of board decision-making.

Q.7 How should the board obtain assurance as to the reliability of the information put before it, and who should do this?

As part of the total process for preparing the OFR, obtaining assurance is a two-stage process. The board will need adequate assurance that the information it is considering is reliable before it makes its materiality decisions: in other words, before the formal processes that will be applied to the OFR once drafted. But insofar as the information the board is considering is derived from a system that is itself subject to effective monitoring this may provide sufficient comfort to support the materiality decisions. Again, compliance with other standards should help here; if the Combined Code requirements on internal control are met, for

²⁷ For example, of the 20 or so major BITC companies reporting their ‘impact on society’, on average only around 60% of the required information is available, and frequently this is just for their UK operations.

²⁸ Market, environment, HR issues, human rights, community issues, ethical considerations all fall within this broad heading.

²⁹ See, for example, ‘Report on a Survey of Environmental Costs and Benefits of Reporting’, prepared for DEFRA, November 2001.

example, that of itself gives comfort that the information derived from these systems is adequately reliable. For other information, it will often be the case that it will already have been checked to an acceptable level because it has been used for another purpose, such as to support an earlier board decision. But there may be a need to decide on an appropriate approach for 'new' information. This could simply be to get the relevant business heads to certify the processes by which the information has been collected and checked and to describe the nature and source of the checks that have been undertaken, but however it is done the board will need adequate assurances to support its materiality decisions. In this context, many businesses are now seeking support in this part of the process from a range of specialist external bodies, and the board may wish to consider this option.

To help in this part of the process, the board could also consider developing an OFR template that shows the information, its source, and any comments specifically in relation to the objective of the OFR; it will also be useful to indicate the extent to which any items have been subject to special checks. The ability to see the complete picture of possibilities in advance of the final judgement being made is an important step in the process; the board needs to be able to take a view as to whether an item of information may be relevant and hence needs to be collated and considered **before** it makes its judgements on materiality if it is to provide a balanced and complete picture for the OFR.

This, it should be noted, does not in any way detract from the need, once the materiality judgements have been made and the OFR drafted, for the board to obtain final comfort that their statements are correct. In many companies the Audit Committee will be the body that looks at this on behalf of the board; the responsibility for obtaining assurance as to the reliability of the information in the OFR template could, similarly, fall to the Audit Committee, which will need to ensure that it has available to it sufficient independent expertise to judge the wide range of information that will potentially be involved.

Q.8 How, once the information is there, does the board decide whether it is material or not? What processes of challenge, both internal and external, should be used? What sign-off procedures should be in place?

The board, in making its materiality judgements, will want to test the information it receives in order to decide whether it meets, or does not meet, the objective of the OFR. It will not want to rely solely on the formal checks that have taken place thus far (see Q.7 above) but will expect to apply knowledge and experience and ask appropriate questions of management and of external advisers. This is the part of the process where, whatever arrangements may have been made for doing more detailed work in advance, the whole board will want to become fully engaged. It is likely to take time and, perhaps, several iterations. Each item should be capable of challenge; there should be no presumptions. And there should be a formal sign-off by the board both that individual items are judged material, or not, but that, together, the information provides a comprehensive and balanced picture, and that nothing of significance has been overlooked.

Q.9 How should 'material information' be presented in the OFR? And how should the information in the OFR be linked to other published information?

This guidance relates to the process for determining whether or not information is material rather than to the form of reporting in the OFR. The latter is a matter for the standard-setting body and not for this Working Group. But it will be an important element of the process for determining materiality that the board approves the way in which items judged to be material are presented; this is particularly important given the scope and focus of the OFR. And the board should satisfy itself as to consistency as between the judgements that underpin the OFR and any other reports and published information produced by the company. The OFR should contain all the information necessary to enable users to assess the strategies adopted by the business and the potential for successfully achieving them, which is the objective of the OFR. It does not have to contain (but may helpfully provide a link to) other published information that may also be of interest to some groups of users³⁰. Thus, in the case of companies who currently produce an environmental report or a community or a social report, for example, we would not envisage these being subsumed into the OFR. They would continue to be produced separately. Information relating to environmental, community or social issues that is material in the light of the OFR's objective would be included in the OFR (and it is probable that most companies will have material information of this kind to disclose, whether or not they produce separate reports on these issues) but there will be a considerable amount of additional information in the separate reports that is of interest to members and other users but not material to the OFR.

Q.10 What feedback arrangements and review procedures should be in place between one cycle and another?

It is suggested that the overall approach to the OFR, and thus to the process used to determine materiality, should be one of 'continuous improvement'. This is particularly pertinent during the first few cycles after the mandatory OFR is produced for the first time; as was noted above, it may well not be feasible to move immediately to the best possible process for determining materiality, and thus for the best possible disclosure of all the material items, and directors will, quite properly, have to balance costs and benefits. It may, however, be appropriate for the board to endorse an 'improvement programme' for the OFR itself and for the materiality judgements that underpin it, and this should include a review after each cycle to ascertain what went well and what lessons can be learned for next year. This annual 'post-OFR' review should encompass input from within the business but should also include feedback from members and other users. And a more detailed review, perhaps every three to five years and/or when the business has undergone major change in its purpose or in the scope of its activities, should be undertaken; this should link in with the strategic planning cycle of the business.

Questions for consultation:

- Q5 Do you agree that the six key criteria set out in paragraph 43 are appropriate for assessing the directors' process for making their materiality judgements? Are there other criteria that should also be used?*
- Q6 Do you agree that the ten questions set out following paragraph 44 would be helpful to directors in applying their process in practice? Are there any other matters that they should have in mind?*

³⁰ It may be helpful to see the OFR as the 'spinal cord' with the more detailed reports linked to it by a single coherent reporting logic. See 'Sooner, Sharper, Simpler: Tomorrow's Company', 1998 page 4.

Annex A: Membership of the Operating and Financial Review Working Group

Chairman

Rosemary Radcliffe CBE

Economist and business consultant.

Independent Complaints Commissioner for the Financial Services Authority.

Member of the Company Law Review Steering Group

Members

Gerry Acher CBE LVO

Chairman, Company Reporting Working Party, Advisory Committee for Business and the Environment

Deborah Doane

Head, Corporate Accountability Programme, New Economics Foundation

Mark Goyder

Director, Tomorrow's Company

Phil Hodgkinson

Chief Executive, Insurance & Investment Division, HBOS Plc

Mary Keegan

Chairman, Accounting Standards Board

Rob Lake

Head of SRI Engagement and Corporate Governance, Henderson Global Investors

John Parkinson

Professor of Law, University of Bristol

Member of the Company Law Review Steering Group

Graham Ward

Senior Partner, Global Energy & Utilities Group, PricewaterhouseCoopers

Annex B: Suggested sources of information

Directors may find it helpful to examine other relevant sources of information to see whether these suggest issues or information that might be material to the OFR. Some examples are below. They are intended simply to be a pointer; inclusion in this annex does not constitute an endorsement by the Working Group and the list is not intended to be exhaustive. Directors will want to exercise their own judgement as to the extent to which they make use of these and other sources in order to support a sound process and the proper discharge of their duties with regard to their materiality decisions*.

The **Accounting Standards Board** published guidance in relation to the Operating and Financial Review in 1993 and issued a revised statement in January 2003. (www.asb.org.uk)

Business in the Community published reporting guidance in the publication entitled “Winning with Integrity – a guide to social responsibility” (Nov 2000). Updated reporting advice based on a 2 year pilot of the recommended impact indicators will be published in July 2003. (www.bitc.org.uk)

DEFRA Guidelines on Environmental Reporting. The Guidelines from the UK Government set out the main elements the Government expects to see included in a basic, good quality environmental report. They are aimed at companies new to reporting and provide key performance indicators for a company to report against. (www.defra.gov.uk/environment/envrp/index.htm)

Global Reporting Initiative. The GRI provides an extensive guide to triple bottom-line reporting – and serves as a global voluntary framework by which companies can compare procedures and performance. (www.globalreporting.org)

Health and safety reporting. Guidance relating to the inclusion of health and safety performance in annual reports is provided within Guidance provided by the Institute of Occupational Safety and Health (IOSH). (www.iosh.co.uk/technical)

The **AA1000 Assurance Standard** provides a coherent and robust basis for assuring a public report and the underlying processes, systems and competencies against the AA1000 Accountability Framework’s definition and principles of accountability. It offers a complete approach to assuring public reporting that adheres to particular reporting standards and guidelines, as well as those customised by the reporting organisations. The AA1000 Assurance Standard is specifically designed to be consistent with the Global Reporting Initiative Sustainability Reporting Guidelines. (www.accountability.org.uk)

The **OECD Guidelines for Multi-national Enterprises** are recommendations addressed by governments to multinational enterprises. They provide voluntary principles and standards for responsible business conduct consistent with applicable laws. (www.oecd.org)

*Some of the sources included in this annex are those included in the Guidance for the Corporate Responsibility Index 2002, published by Business in the Community, and have been reproduced with permission.

The **UN Global Compact** seeks to advance responsible corporate citizenship so that business can be part of the solution to the challenges of globalisation. It is a voluntary corporate citizenship initiative aiming to make the Global Compact and its principles part of business strategy and operations. It sets out nine principles in the areas of human rights, labour and the environment. (www.unglobalcompact.org)

The Institute of Chartered Accountants of Scotland has published a document entitled “Voluntary Annual Report Disclosures: What Users Want”. Based on a detailed research to elicit and compare interested parties’ views regarding the usefulness of a broad set of disclosure items this report provides an insight into what particular elements of information users of annual reports find most relevant and useful, and it includes the views of finance directors and auditors on these matters too. (www.icas.org.uk)

“Sooner, Sharper, Simpler” by **Tomorrow’s Company** provides a concept of the purposes of the annual report, an account of the issues and opportunities with which companies are now faced, a lean vision of the direction in which annual reports need to change, and criteria and a scorecard for a successful annual report. Appendices One and Two contain suggestions about the content of future reports. (www.tomorrowcompany.com)

The Sustainability Resource Centre, part of the **Institute of Chartered Accountants in England and Wales** online Library & Information Service, covers extensive resources on corporate reporting, including full-text articles and papers, reading lists, and links to key sources of information on other websites. (www.icaew.co.uk/library) (www.icaew.co.uk/sustainability)

A **Task Force on Human Capital Management (Accounting For People)** has been established to look at the performance measures currently used to assess investment in human capital; to consider best practice in human capital reporting, and the performance measures that are most valuable to stakeholders; and to establish and champion the business case for producing such reports. The Task Force has published a consultation paper and is due to report in the autumn. (www.accountingforpeople.gov.uk)

Annex C: Code of practice on written consultations

The following criteria apply to all UK national public consultations, and have been applied to this consultation paper.

1. Timing of consultation should be built into the planning process for a policy (including legislation) or service from the start, so that it has the best prospect of improving the proposals concerned, and so that sufficient time is left for it at each stage.
2. It should be clear who is being consulted, about what questions, in what timescale and for what purpose.
3. A consultation document should be as simple and concise as possible. It should include a summary, in two pages at most, of the main questions it seeks views on. It should make it as easy as possible for readers to respond, make contact or complain.
4. Documents should be made widely available, with fullest use of electronic means (though not to the exclusion of others), and effectively drawn to the attention of all interested groups and individuals.
5. Sufficient time should be allowed for considered responses from all groups with an interest. Twelve weeks should be the standard minimum period for a consultation.
6. Responses should be carefully and open-mindedly analysed, and the results made widely available, with an account of the views expressed, and reasons for decisions finally taken.
7. Departments should monitor and evaluate consultations, designating a consultation coordinator who will ensure the lessons are disseminated.

Responses to the OFR Working Group's consultation should be sent to the address given above in this Consultation Document. If, however, you wish to make any comments about the handling of this consultation, please contact

Philip Martin
Better Regulation Team
Department of Trade and Industry
Room 725
1 Victoria Street
London SW1H 0ET

Further information about this code of practice can be found at:
www.cabinet-office.gov.uk/servicefirst/consultation.htm.



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