



COMPANY LAW

Draft Regulations on
the Operating and
Financial Review and
Directors' Report
A consultative document

MAY 2004



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The Department of Trade and Industry invites comments by 6 August 2004 on the issues set out in this paper. Earlier responses would be very welcome.

You are invited to send comments on any issue covered by this consultation preferably by e-mail, to:

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Foreword



by Patricia Hewitt, Secretary of State for Trade and Industry

What are companies for? The primary goal is to make a profit for their shareholders, certainly. But the days when that was the whole answer are long gone. We all have higher expectations of companies in the modern economy.

We expect companies not simply to perform well in the short term, but to have an effective strategy for delivering long-term profitability. This is essential to the millions of us who invest our savings in companies through pension funds, life assurance, unit trusts and other forms of investment. We save for the years ahead, not the months ahead, and we need the companies in which we invest to share our own horizons.

We expect companies to generate the wealth that provides good public services and a decent standard of living for everyone. We need continuing recognition that wealth-creation demands honest and fair dealings with employees, customers, suppliers and creditors. Good working conditions, good products and services and successful relationships with a wide range of other stakeholders are important assets, crucial to stable, long-term performance and shareholder value.

We expect companies to create wealth while respecting the environment and exercising responsibility towards the society and the local communities in which they operate. The reputation and performance of companies which fail to do these things will suffer.

The people who invest in companies are the same people who are employed by them, buy their products, live in the communities around them, and are concerned about their effect on the environment. So, we have multiple reasons for wanting to see good companies.

For this reason, I believe that increased, high-quality shareholder engagement is vital to creating the modern economy that we all want.

Foreword

But, if shareholders are to hold the directors of their company to account for its performance, they need full and accurate information. This will allow them to act if they see a risk that a company may go in the wrong direction. And it will be a discipline on management, making them analyse and report accurately on performance and prospects.

This consultation document contains the Government's proposals for a new statutory Operating and Financial Review (OFR) designed to give shareholders the information they need. The OFR is a narrative report by quoted companies that will be made annually to shareholders, setting out the principal drivers of a company's performance both in the past and in the future. It will cover the issues traditionally seen as key to a company's performance – an account of its business, objectives and strategy, a review of developments over the past year, and a description of the main risks. But it will also cover prospects for the future and, where necessary, information about the environment, employees, customers or social and community issues where that information is important for an assessment of the company.

The OFR will give shareholders information in an accessible form allowing them to make a full assessment of their company. It builds on best practice followed by a number of our larger companies, and follows the recommendations of the independent Company Law Review. It does not constrain companies' freedom of action. It simply demands that directors explain their stewardship to their shareholders.

Transparency has long been recognised as a crucial element in corporate governance. The Government's recent legislation on directors' remuneration reports has demonstrated how increased transparency can lead to greater shareholder engagement. Our intention is that the OFR will enhance this trend through a step-change to the quality of reporting by companies. It will contribute to raising the productivity of British companies, helping to generate prosperity for all. I hope that people representing a wide range of interests will respond to this consultation and help us make the OFR an effective tool.



Patricia Hewitt

1 Executive summary

The purpose of this consultation

1.1 The Government is consulting on draft Regulations to implement:

- a new statutory **Operating and Financial Review** (OFR); and
- certain provisions of the Accounts Modernisation Directive¹ requiring an enhanced review of a company's business in the **directors' report**.

1.2 The key aspects of our proposals on the OFR require the directors of quoted companies to give a balanced and comprehensive analysis of their business as part of their annual reports and accounts to shareholders. This will include a company's objectives, strategies and key drivers of the business, focusing on more qualitative and forward-looking information than has traditionally been included in annual reports in the past. In providing this analysis, directors will need to consider whether it is necessary to provide information on a wide range of factors which may be relevant to an understanding of the business, such as information about employees, environmental matters and community and social issues.

1.3 In July 2003, the Government announced that it intended to implement its proposals on a statutory OFR by secondary legislation under existing company law. This consultative document seeks views on the detailed implementation of this new requirement, and also on the changes to the directors' report stipulated by the Modernisation Directive.

1.4 The Government set out in its White Paper *Modernising Company Law*² the fundamental principles underlying the OFR: it should be a statutory requirement, not a matter of best practice; it should be mandatory for the largest companies; it should always contain certain information designed to meet a high-level objective of greater transparency and should also reflect those matters which, in the view of the directors, are relevant to an understanding of the company. This consultation is not intended to re-open these issues of basic policy.

¹ Directive 2003/51/EC of the European Parliament and of the Council of 18 June 2003 amending 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.
(<http://europa.eu.int/eur-lex/pri/en/oj/dat/2003/1178/117820030717en00160022.pdf>)

² Cm 5553 – I & II, July 2002.

1 Executive summary

1.5 The Government will dovetail certain Modernisation Directive requirements with the OFR so that quoted companies which prepare an OFR in accordance with the Regulations will not also have to report separately, in their directors' report, on the matters specified in the Directive. The Directive requires an enhanced review of the company's business. Under the Directive, medium and large companies will be required to report on the principal risks and uncertainties facing their business and include key performance indicators relevant to their particular business. The main issue on which the Government is consulting here is its proposed use of an option, under the Directive, to exempt medium-sized companies from certain non-financial reporting requirements. Neither the OFR nor the enhanced review of the company's business under the Modernisation Directive will affect **small companies**.

1.6 The Government will issue a summary of responses within three months of the closing date of this consultation. It is our intention that the Government response to this consultation will be issued at the same time as the draft Regulations are laid in Parliament. The timetable to this depends to some extent on the responses to this consultation but we hope that the Regulations will be laid before the end of this year.

Summary of questions

1.7 We would welcome your views on all aspects of this consultation and, in particular, on the following questions. Where appropriate, please supply evidence in support of your views.

Q 1: Do you have any comments on the means by which paragraph 1 of the OFR Schedule 7ZA (inserted by draft regulation 7) implements the CLR objective?

Q 2: Do you agree that quoted companies comprise the appropriate class of companies to be required to prepare an OFR?

Q 3 Do you agree that the draft Regulations should include a specific requirement to include a description of the capital structure, treasury policies and objectives and liquidity of the company?

Q 4: Do you agree that directors should be required to state the fact where they have concluded that there is nothing relevant to report in respect of the items covered by paragraphs 4 to 7 of Schedule 7ZA?

Q 5: Do you agree with the approach taken in, and the drafting of, Schedule 7ZA?

Q 6: Do you agree with the proposed role of the auditors as set out in regulation 8, including whether 'due and careful enquiry' is a reasonable and practicable standard to require of directors?

Q 7: How much do you estimate such a review of process by the auditors might cost?

Q 8: Do you agree with the Government's approach to the OFR enforcement regime as set out in paragraphs 3.60 - 3.73 and draft regulations 9-12?

Q 9: Do you agree with the Government's proposal to implement the Member State option in the Modernisation Directive by providing an exemption for medium-sized companies from the requirement to include non-financial information?

Q 10: Do you agree with the Government's proposal to bring the OFR Regulations into effect for years beginning 1 January 2005? We would welcome suggestions on how the Government can best implement the Regulations.

Q 11: Do you have any general comments or specific suggestions on the drafting of the Regulations at Annex A?

Q 12. Do you agree that all shareholders should receive the OFR? Do you agree that it is not appropriate to legislate to permit companies to send a summary OFR in place of the full version?

Q 13 Do you believe that the draft Regulations should omit any requirement on directors to include information on corporate governance in their OFR, or do you think that such information is sufficiently key to company performance that repetition is justified?

Q 14: Do you agree with the Government's proposal that a provision for confidentiality should not be included for the OFR?

Q 15: Do you agree with the omission of "safe harbour" provisions? If you think a "safe harbour" is necessary how should this be framed?

Q 16: Please comment on the costs and benefits identified in the Partial Regulatory Impact Assessment at Annex D. Do you agree with them?

Q 17: Can you identify and quantify any additional costs or benefits resulting from these proposals that have not been identified in the RIA?

1 Executive summary

How to respond

1.8 When responding please state whether you are responding as an individual or representing the views of an organisation. If responding on behalf of an organisation, please make clear whom the organisation represents and, where applicable, how the views of members were assembled.

1.9 A response can be submitted by letter, fax or preferably by email to:

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Confidentiality

1.11 Your response may be made public by the DTI. If you do not want all or part of your response or name made public, please state this clearly in the response. Any confidentiality disclaimer that may be generated by your organisation's IT system or included as a general statement in your fax cover sheet will be taken to apply only to information in your response for which confidentiality has been explicitly requested.

1.12 We will handle any personal data you provide appropriately in accordance with the Data Protection Act 1998.

Help with queries

1.13 Questions about the policy issues raised in the document can be addressed via:

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2. Policy background

The Operating and Financial Review (OFR)

2.1 The Government is committed to improving standards of corporate governance among our largest companies. Good corporate governance is a crucial element in maintaining market confidence, in improving company performance and returns on investments that we all make through pension funds and other savings, and in meeting wider public expectations about the behaviour of businesses as employers, suppliers and consumers of natural resources with social and environmental responsibilities.

2.2 The Government, in its *Modernising Company Law* White Paper, decided to take forward the three broad proposals of the Company Law Review (CLR) to improve corporate governance:

- a statement of directors' duties;
- improved transparency and accountability, with improvements to the quality, timeliness and accessibility of information available for shareholders and others; and
- more effective machinery for enabling and encouraging shareholders to exercise effective and responsible control.³

2.3 The OFR is a major element of the second of these proposals. The Government believes that the key driver of good corporate governance is increased shareholder engagement. It is through shareholders exercising informed influence over companies that their expectations and those of the wider community will best be met. Shareholders can exercise effective control only if they have clear and meaningful information about the main drivers of a company's past and future performance. The OFR is designed to arm shareholders with that information. Through a narrative report, it will enable them to make a proper assessment not only of past performance but also of the directors' view on the company's future prospects and its approach to managing all those factors – environmental performance, employee issues, relations with suppliers, customers and local communities – which are crucial to the company's future success and reputation.

³ See paragraph 3.4 of the Company Law Review document, *Final Report*, July 2001, URN 01/942. (All the Company Law Review documents can be found at <http://www.dti.gov.uk/cld/reviews.condocs.htm>)

2.4 The Government's proposals recognise that, while the OFR will be prepared for the shareholders, it will be relevant to all users of accounts who include, in the words of the Company Law Review:

- creditors who need to have a clear picture of the position and prospects of their debtor;
- investors (shareholders and creditors) both actual and potential, who wish to know whether to acquire, retain or sell, a stake in the business ("exit" and "entry"); and
- other stakeholders (including employees) and the wider public, who have a variety of relationships with the business.⁴

2.5 The Government believes that the OFR will lead to:

- improved qualitative, non-financial and forward-looking reporting on the performance of the company, and
- directors deciding in good faith what would be most likely to promote the success of the company, taking account of a wide range of factors, within and outside the company, which are relevant to achieving its objectives and to an assessment of its business. These factors may well include the company's impact on the environment and on the wider community, and its relationships with employees, customers and suppliers.

2.6 It is for these reasons that the Government believes that the OFR will represent a step-change in narrative reporting by companies.

2.7 A voluntary form of an OFR has been available to companies as a matter of best 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 (and indeed some other organisations) already prepare such OFRs. Others include some or all the material to be covered by the OFR in other reports, such as the directors' report. A recent survey by Deloitte & Touche⁵ suggests that over 60% of listed companies prepare an OFR or adopt the broad approach set out in the ASB statement, and a further 30% include some recognition of the OFR in their reporting. However, the Company Law Review found that the content and rigour of reporting varies widely, and a significant proportion of large companies fall well short of meeting the ASB's recommended practice.

⁴ Paragraph 5.4 of the Company Law Review document, *Developing the Framework*, March 2000, URN 00/656.

⁵ *Carrots to sticks: a survey of narrative reporting in annual reports*, 2003.

2 Policy background

2.8 The Review commented:

“Company accounting and reporting remains essentially backward looking and based on financial indicators. There are few statutory requirements to report on the main qualitative factors which underlie past and future performance (or for future performance, even financial factors) – in particular on strategy, prospects, opportunities and risks; on intangible, and so-called ‘soft’, assets (which may contribute significantly to success but are not well captured in traditional financial statements); and on key business and wider relationships. As a result, the information provided is defective and directors do not have the discipline of accounting for stewardship on some key responsibilities.”⁶

2.9 Consequently, the Review recommended in its Final Report (July 2001) that companies of significant economic size should be required to prepare and publish an OFR as part of their annual report and accounts.

European developments: the Accounts Modernisation Directive

2.10 In June 2003 the EU adopted the Directive known as the Accounts Modernisation Directive. This Directive makes various amendments to earlier company law Directives, but the most relevant points here are the amendments that it makes to reporting requirements in the directors’ report.

2.11 For company financial years starting on or after 1 January 2005, large and medium-sized (but not small) companies will be required by the Directive to provide “a balanced and comprehensive analysis of the development and performance of the company’s business... [which] shall include both financial and, where appropriate, non-financial key performance indicators ... including information relating to environmental and employee matters”. Medium-sized companies can be exempted from the latter part of this obligation.⁷

2.12 The thresholds defining companies as “small” or “medium-sized” have recently been raised by the Companies Act 1985 (Accounts of Small and Medium-Sized Enterprises and Audit Exemption) (Amendment) Regulations 2004 (SI 2004/16). A company counts as “small” if two or more of the following requirements are met in a year:

Turnover: not more than £5.6 million
Balance sheet total: not more than £2.8 million
Number of employees: not more than 50.

⁶ Paragraph 5.19 of the Company Law Review document, *Developing the Framework*, March 2000, URN 00/656.

⁷ Modernisation Directive Article 1.14.

A company counts as "medium-sized" if two or more of the following requirements are met in a year:

Turnover: not more than £22.8 million

Balance sheet total: not more than £11.4 million

Number of employees: not more than 250.

2.13 The Directive requirements are less detailed and precise than those recommended for the OFR by the CLR, and the Government's intention is that the OFR should be produced as a separate self-standing report like the Directors' Remuneration Report and should not be contained within another report such as the directors' report. However, there is clearly a degree of overlap. In order to avoid duplication and uncertainty, the Government intends to dovetail the relevant Directive requirements with the OFR so that quoted companies which prepare an OFR in accordance with the Regulations will not also have to report separately, in their directors' report, on the matters specified in the Directive. For this reason, in places the draft Regulations use wording derived from the Directive instead of that suggested by the CLR or included in the White Paper.

3. The Government's approach in the draft Regulations

3.1 This section focuses on key issues covered by the draft Regulations in Annex A. For a detailed commentary, see the Explanatory Notes at Annex B. The section looks first at the way in which the draft Regulations deal with the OFR, before considering the implementation, through the draft Regulations, of the enhanced business review required in the directors' report by the Modernisation Directive. Readers should note that the draft Regulations themselves deal with the directors' report (in Part 2) before the OFR (Part 3), because the amendments to the Companies Act 1985 relating to the directors' report affect provisions preceding those relating to the OFR.

Purpose of the OFR

3.2 The Company Law Review (CLR) recommended that the objective of the OFR should be "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."⁸

3.3 The ASB's 2003 statement says that the OFR "should set out the directors' analysis of the business, in order to provide to investors a historical and prospective analysis of the reporting entity 'through the eyes of management'. It should include discussion and interpretation of the performance of the business and the structure of its financing, in the context of known or reasonably expected changes in the environment in which it operates."

3.4 The draft Regulations set out the OFR objective in paragraph 1 of new Schedule 7ZA inserted by draft regulation 7 into the Companies Act 1985. They follow the CLR approach by creating an overarching objective. They also address the question of who, to use the CLR's term, are the "users" of the OFR.

⁸ Paragraph 8.32 of the Company Law Review document, *Final Report*, July 2001, URN 01/942.

3.5 The draft Regulations are designed to transform the CLR **objective** into a legislative requirement that results in useful, honest reporting of information that will allow **shareholders** to assess the company's strategies and their potential to succeed and is consistent with EU requirements. They set out the substance of the OFR as being a "balanced and comprehensive analysis" of four main categories of information (see paragraph 1 of new Schedule 7ZA inserted by draft regulation 7). The terminology used here is designed to ensure compatibility with the Modernisation Directive and the implementation of that Directive in respect of the directors' report in draft regulation 3. It is important to note that "a balanced and comprehensive analysis" is not designed to require directors to cover all possible matters. They must not omit significant but uncomfortable information, nor should they include matters which are not necessary for an understanding of the company.

3.6 The danger, which the Company Law Review well recognised and which the Government is determined to avoid, is that the OFR becomes a mechanical exercise resulting in bland statements or public relations driven disclosure. The objective is quality, not quantity of content.

3.7 The CLR did not define the "users" of the OFR. As in the draft clauses included in the *Modernising Company Law White Paper*, the draft Regulations make clear that the OFR is addressed, as with other company reporting, to the "members" or shareholders. This reflects also the approach of the proposed statement of directors' duties, where the Government stated in its White Paper that it agreed with the CLR that the goal for the directors should be the success of the company in the collective best interests of the shareholders.⁹ The discipline of reporting will encourage directors to focus on the task of stewardship, enabling shareholders to hold directors to account.

3.8 In addition, the Government agrees with the CLR that, in acting in the best interests of shareholders, the directors must recognise the company's need to foster relationships with its employees, customers and suppliers, its need to maintain its business reputation, and its need to consider the company's impact on the community and the environment.¹⁰

⁹ Paragraph 3.3 of the White Paper, *Modernising Company Law*, CM 5553-1&II, July 2002.

¹⁰ Paragraph 3.3 *ibid.*

3 The Government's approach in the draft Regulations

3.9 The OFR reflects this approach through the information that is required to be included, and which is discussed in paragraphs 3.24 to 3.37 below. While it is the shareholders who will hold directors to account, the information in the OFR will be of interest to other stakeholders, such as employees, suppliers and customers of the company, and other users of reports and accounts such as those with an interest in the environment.

Q 1: Do you have any comments on the means by which paragraph 1 of the OFR Schedule 7ZA (inserted by draft regulation 7) implements the CLR objective?

Companies required to prepare an OFR

3.10 The CLR recommended that both public and large private companies should be required to prepare an OFR, but with higher thresholds for private companies. The Government was initially inclined to accept this proposal and followed the CLR's suggested thresholds in the *Modernising Company Law* White Paper.

3.11 However, on reflection, the Government now considers that the OFR is most appropriate for **quoted companies**. Because quoted companies have dispersed shareholdings and there is a market in their shares, increased transparency is likely to be more helpful to their shareholders, particularly institutional investors, who can use the information in the OFR to engage with management. The discipline of the market will also help to ensure that directors prepare high quality OFRs.

3.12 The Government therefore believes that the OFR is most likely to have a positive influence on the governance of quoted companies; and should be a requirement for them. Thus, draft regulation 5 inserts a new section 234AA into the Companies Act 1985, requiring directors of quoted companies to prepare an OFR.

3.13 A quoted company is defined as "a company whose equity share capital:

- (a) has been included in the official list in accordance with the provisions of Part VI of the Financial Services and Markets Act 2000; or
- (b) is officially listed in an EEA State; or
- (c) is admitted to dealing on either the New York Stock Exchange or the exchange known as Nasdaq."¹¹

¹¹ Section 262 of the Companies Act 1985.

3.14 This definition is already used for the scope of application of the Directors' Remuneration Report and is one that is familiar to the financial market. We estimate that it currently applies to approximately 1,290 companies. There are about 1,260 GB companies whose equity share capital is listed on the London Stock Exchange (i.e. included in the "official list"). We estimate that there are a maximum of 30 GB companies which are listed, but not in London. Companies trading on the Alternative Investment Market or 'OFEX' and companies with listed debt securities only will not be covered by this definition so will not have to prepare an OFR. (However, if they are large or medium-sized companies they will have to prepare an enhanced review of the company's business in line with the requirements of the Modernisation Directive). There is an argument that smaller listed companies might find the OFR a burden. However, the Government believes that the importance of improved governance for such companies outweighs that argument.

3.15 The Government intends to review the effects of the statutory OFR after a suitable period of approximately five years and consider whether, in the light of evidence, the class of companies required to prepare an OFR is appropriate.

Q 2: Do you agree that quoted companies comprise the appropriate class of companies to be required to prepare an OFR?

Statutory authority for reporting standards to support the OFR

3.16 The Government agrees with the CLR that the statutory requirement for an OFR should be supported by standards, giving guidance on best practice. Standards will help to ensure that OFRs are prepared to a consistently high level of quality and may help to identify issues affecting particular sectors. The CLR proposed that a new body, the Standards Board, should be created, to make standards for accounting and other company law purposes, including the OFR.

3.17 The Government was initially inclined to support this idea but has reconsidered in the light of subsequent events, such as the use from 2005 of International Accounting Standards and the reorganisation of the Financial Reporting Council and its subsidiary bodies. The Government does not now intend to pursue the Standards Board proposal. Instead it intends to ask the ASB to prepare standards for the OFR, building on its existing statement.

3 The Government's approach in the draft Regulations

3.18 The ASB is making arrangements to develop the content of a standard for the OFR. It will seek to ensure that interested parties with relevant experience in the preparation of a standard are suitably involved. It hopes to issue an exposure draft of the first OFR standard in the second half of 2004, to be finalised in 2005.

3.19 Clearly, OFR standards will be different from accounting standards as recognised in Part 7 of the Companies Act, as the range of issues the OFR standard will deal with is broader. Similarly, OFR standards cannot rely on the history and precedents of accounting standards to confer the appropriate authority and influence.

3.20 Although there is no explicit statutory requirement for companies to follow accounting standards, large companies are required to state whether or not they have done so. It is also generally accepted that compliance with accounting standards will normally be necessary for financial statements to give a true and fair view.

3.21 The Government wants the OFR reporting standard to have similar authority to that which has been achieved for accounting standards. The Government has devised legislative proposals to achieve this.

3.22 In the first instance, a new statutory power is required: clause 13 of the Companies (Audit, Investigations and Community Enterprise) Bill¹² will establish a system to specify a body to issue reporting standards. It will also enable the Secretary of State to introduce in regulations a presumption that compliance with OFR standards will constitute compliance with the requirements of the Act as to the contents of the OFR. That will give companies an assurance that if they follow OFR standards they will be presumed (unless the contrary is proved) to have complied with the statutory requirements to prepare an OFR. This is achieved by draft regulation 6 inserting new section 256A(3) into the Companies Act 1985.

3.23 In addition, paragraph 9 of new Schedule 7ZA, inserted by draft regulation 7, creates a similar requirement to that which currently exists with respect to accounting standards. It requires directors to state whether their OFR has been prepared in accordance with OFR standards and to explain any departures from such standards. The Government believes that this approach is most likely to achieve widespread adoption of OFR standards.

¹² The Companies (Audit, Investigations and Community Enterprise) Bill, published by The Stationery Office Limited in November 2003, can be obtained from The Stationery Office Limited or from the Parliament Website <http://www.publications.parliament.uk/pa/ld200304/ldbills/008/2004008.htm>

Information that must be included in the OFR

General principles

3.24 The Company Law Review envisaged that certain topics should always be covered in an OFR because they will always be “material”, while others should be included whenever directors consider them “material” to an understanding of the business. The Government supports this approach. The primary purpose of the OFR is to improve transparency in the interest of better corporate governance and shareholder engagement. Certain information which is essential to an understanding of the company should always be included, for example information about the company’s business strategies and the principal risks and uncertainties facing the company. As the CLR noted, it is inconceivable that such items could fail to be material every time.¹³ But it is neither possible nor desirable to list all the elements that might need to be included, since these will vary depending on the nature and circumstances of the particular business.

3.25 At the same time, the Government believes it preferable to follow the Modernisation Directive which talks of information being included “to the extent necessary” for an understanding of the business, rather than to use the term “material”. This approach also helps avoid any confusion with the specific use of the word “material” in the context of accounting. Therefore the draft Regulations do not use the term “material”, though the concept remains the same as that proposed by the CLR (see also the discussion below of new Schedule 7ZA inserted in the Companies Act 1985 by draft regulation 7; and the Explanatory Notes at Annex B).

3.26 Moreover, the Government is determined to avoid a “box-ticking” approach where reports are compiled using “boiler-plate” language and contain no useful information. An important part of the value of the OFR is the way it makes directors reflect in turn on each of the many factors affecting the business and consider how the changing environment is likely to influence the company’s future performance.

3.27 The Company Law Review recommended that there should not be a standard on what constitutes “materiality”, but that there should be guidance.¹⁴ As announced in the *Modernising Company Law White Paper*, the Government set up an independent group of experts to help in the process of providing guidance on how directors can assess whether an item is “material”

¹³ Paragraph 8.41 of the Company Law Review document, *Final Report*, 2001, URN 01/942.

¹⁴ Paragraph 8.51 of the Company Law Review document, *Final Report*, 2001, URN 01/942.

3 The Government's approach in the draft Regulations

to their company and hence must be included in the OFR. The group published a consultation document in June 2003 and its final report is being published in conjunction with this consultation document.

3.28 The Government is grateful to the group for its work, which does much to clarify the process of identifying and selecting the necessary information for inclusion in the OFR. The Government believes that the guidance in the working group's report will provide a valuable aid to directors when they consider which issues should be addressed, and will assist the ASB to draw up standards for the OFR.

3.29 Some respondents to the White Paper wished to see reporting on additional specific matters made mandatory in the OFR. The Government has considered these representations carefully but believes they misunderstand the primary purpose of the OFR which, as noted above, is to improve transparency of corporate governance and hence business performance, and, in doing so, to focus both directors' and shareholders' assessment on all internal and external issues affecting that performance. The OFR should cover only those matters that are necessary for an understanding of the business.

3.30 The best way to ensure that companies take an enlightened view of wider matters is to require them to consider the effect of those matters on their performance, both in the short and long term. Moreover, the Government is confident that the information necessary for an understanding of the business and therefore required to be included will be of interest to a wide range of readers in addition to shareholders.

3.31 So the OFR will improve transparency and accountability by providing shareholders with better and more relevant information on the business, its performance in the past and its prospects for the future. Directors will be encouraged to identify the factors likely to affect performance in the future and the most relevant indicators by which the performance of the business can be measured. They should explain the objectives and strategies they have set for the business and the potential for these to succeed.

3.32 Both the ASB and CLR emphasise that the OFR must reflect the **directors'** view of the business. The Government agrees. Each business is different and the factors which affect it will vary. For example, brands may be very important intangible assets to some businesses, such as many in the retail sector, but be of little or no significance to companies producing industrial commodities. However, a good reputation is essential to every large company. So directors need to pay very careful attention to how companies are perceived by customers, employees and the wider community.

3.33 A poor record on environmental or health and safety matters, for example, could adversely affect a company's standing and business prospects. For regulated sectors, non-compliance could lead to the loss of licence to operate, and in some cases, imprisonment for directors. The OFR requires such matters to be covered, both where they constitute a significant external **risk** to the company, and where the company's **impact** on others through its activities, products or services, affects its performance. For example, information which could be necessary for shareholders to make an assessment of the business includes:

- an explanation of risk management approaches employed by a company that stores, transports or uses significant volumes of hazardous or toxic substances that risk damaging the health of workers or others, or polluting the environment or;
- how a company that is a heavy user of natural resources, which may become scarce or the price of which may change significantly, is intending to reduce its dependency on such resources;
- how a company that may be susceptible to the impacts of climate change plans to mitigate the risks and take advantage of the opportunities presented by a changing climate;
- current and likely future compliance record for companies operationally dependent upon legal consents for discharges to air, land or water;
- an explanation of the risk management approaches employed by a company to assess the operational impact on biodiversity where failure to avoid or mitigate damage would put development consents at risk.

3.34 The financial loss to the company from poorly managing these issues could be direct (e.g. through fines, increased material costs, increased labour costs), indirect (through loss of reputation, supply failure, production interruption, property damage, customer loyalty) or from the costs associated with missed opportunities. Failure to anticipate or influence the changing regulatory landscape could also affect long-term performance. Thus directors will need to consider the extent to which their company's impact on the environment, and the impact of the environment on the company, affects their company's current performance and future prospects for success.

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3.35 Similarly, the way a company manages and utilises its workforce can have a significant impact on the performance of the company. Companies need to be able to recruit and retain the staff they need to achieve their business objectives, so a reputation as a good employer will often be an essential factor in business success. For companies with particular skills needs, training may be a crucial factor in the company's future development and performance, and therefore need to be described in the OFR. Companies with large numbers of employees in contact with customers will need to pay particular attention to motivation and morale.

3.36 All companies preparing an OFR will need to consider their employment policies and practices, and the Government expects that most if not all will consider that some aspects of employment are relevant to an understanding of the company. But it is for the directors of each company to review and identify the relevant factors in their particular case.

3.37 The Accounting for People taskforce reported in November 2003, having looked at ways in which organisations can measure the quality and effectiveness of their Human Capital Management (HCM). The taskforce has provided very useful guidelines on the issues companies should consider when reporting on HCM. The Government hopes that companies will use the guidance in the Accounting for People report when preparing their OFR.

Detailed analysis of the treatment of the OFR information requirements in the draft Regulations

3.38 New Schedule 7ZA, which draft regulation 7 inserts into the Companies Act 1985, is the main substantive part of the draft Regulations. It builds on the draft clauses on the OFR published in the 2002 White Paper and is designed to establish a flexible framework for the OFR in line with the general principles set out above. Key aspects of the information requirements under new Schedule 7ZA are as follows (see also the Explanatory Notes at Annex B).

Review objective

3.39 As explained in paragraph 3.4, paragraph 1 of new Schedule 7ZA translates the CLR's recommended high-level objective for the OFR into legislation. The wording at the beginning of paragraph 1 and in points (a) and (b) is derived from the Modernisation Directive.

Other general requirements

3.40 The CLR recommended that certain topics should always be included in an OFR. These were:

- the company's business and business objectives, strategy and principal drivers of performance;
- a fair review of the development of the company's business over the year and position at the end of it, including material post year-end events, operating performance and material change;
- dynamics of the business, i.e. known events, trends, uncertainties and other factors which may substantially affect future performance, including investment programmes.

3.41 Paragraph 2 of new Schedule 7ZA translates these topics into legislation, in line with the general principles set out above. In particular, paragraph 2 (a) requires OFRs to include a statement of the business, objectives and strategies of the company. Paragraph 2(b) is intended to capture one of the two aspects of business dynamics described by the CLR, that is the resources available to the company, and is intended to incorporate the opportunities presented to the business (e.g. changes in market conditions, advances in technology) as well as the inherent strengths of the business (e.g. programmes to enhance intellectual capital, training and research and development).

3.42 Paragraph 2(c) is intended to capture the second aspect of business dynamics in the description of the principal risks and uncertainties that the company faces. Examples of the risks that a company may face include financial risks, health and safety and environmental costs and liabilities.

3.43 The Government has not included the specific requirement to include a fair review of the development of the company's business over the year (the CLR recommendation in the second bullet above) in paragraph 2 of Schedule 7ZA, as it believes this requirement overlaps with the review objective of the OFR covered in paragraph 1 of the Schedule. The Government's view is that companies will automatically need to cover this information in fulfilling the review objective, and that there is therefore no need for a separate specific requirement.

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Capital structure and treasury policies

3.44 The CLR recommendations omitted any requirement for the OFR to refer to capital structures, treasury policies or other matters relating to liquidity, on grounds that such matters should be for rule-making by a new statutory body. The CLR argued that practice in these areas was sufficiently settled to make any statutory intervention inappropriate¹⁵.

3.45 However, OFR standards will be able to expand and interpret only requirements that are specifically set out in legislation. Therefore, paragraph 2(d) refers to capital structures and treasury policy, thus enabling OFR standards to develop guidance in this area.

Q 3: Do you agree that the draft Regulations should include a specific requirement to include a description of the capital structure, treasury policies and objectives and liquidity of the company?

Details of particular matters

3.46 The particular matters are those which must be reported on when "material" to an understanding of the operation and performance of the business. As explained above, the draft Regulations do not use the word "material" but adopt the formula, in paragraph 3 of new Schedule 7ZA, of "to the extent necessary to comply with the general requirements of paragraphs 1 and 2". This wording is derived from the Modernisation Directive.

3.47 Paragraphs 4 to 7 contain a non-exhaustive list of topics that directors must consider for inclusion in their OFR to the extent necessary. Paragraph 3.33 above gives examples of information on environmental matters, such as the impact of the company on the environment and the impact of the environment on the company, which might need to be included in the OFR where necessary to comply with the general requirements¹⁶. Similarly paragraph 3.35 has examples of information on employment, which may be necessary.

¹⁵ Paragraph 5.96 of the Company Law Review document, *Developing the Framework*, March 2000, URN 00/656.

¹⁶ For example taking into account the EC Recommendation of 30 May 2001 on the recognition, measurement and disclosure of environmental issues in the annual accounts and annual reports of companies.

3.48 OFR standards will give further guidance on these and other aspects of paragraphs 4 to 7 of Schedule 7ZA. In addition, the Government expects that standards will contain examples of further matters, such as health and safety, that directors will need to consider in addition to those listed in paragraph 4 of the Schedule in order to meet the requirements of paragraphs 1 and 2. Standards may also give more detail on aspects of the matters listed in paragraph 4, such as issues specific to particular sectors.

3.49 Many companies already provide information on such issues in separate reports such as reports on corporate social responsibility and sustainability. The directors of these companies will be well placed to make informed judgements as to the relevance of these issues for the OFR. The OFR will thus be complementary to, and not a substitute for, such reports, which the Government continues to encourage on a voluntary basis.

3.50 The Company Law Review believed that it would not be necessary or desirable to require directors expressly to refer to an omission made on the grounds of lack of relevance. The CLR believed that this would emerge from the report itself.¹⁷ However, the Government is not persuaded that this will be the case. Readers of the OFR who are familiar with the legislation will indeed be aware that coverage of certain issues, such as environmental matters, is required where necessary for an understanding of the business. Such readers will, as the CLR envisaged, be aware from a company's silence that it has considered environmental matters and judged that there is nothing material to report. However, readers of the OFR who are unaware of the legislation will not be able to make such a conclusion. They will not know whether silence indicates that the directors have considered the matter, or that the directors have not considered the matter at all. This could lead to such readers being misled about the company in respect of some of the matters covered by paragraphs 4 to 7.

3.51 In the light of this, the Government is considering adding a requirement to the Regulations to the effect that, where directors have concluded that there is nothing to report under any of the items in paragraphs 4 to 7, they should make an explicit statement to that effect. Directors would not have to state their reasons for deciding that a matter is not relevant; that could lead to lengthy explanations that might exceed the length of the OFR itself. However, with such a provision silence would not be an option; if there is no relevant information to report, the OFR would say so. The Government would welcome views on this possible refinement to the draft Regulations.

¹⁷ Paragraph 5.86 of the Company Law Review document, *Developing the Framework*, March 2000, URN 00/656.

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Q 4: Do you agree that directors should be required to state the fact where they have concluded that there is nothing relevant to report in respect of the items covered by paragraphs 4 to 7 of Schedule 7ZA?

3.52 Paragraph 5 of new Schedule 7ZA further requires directors to consider whether information about essential business relationships and about receipts from and returns to shareholders should be included in the OFR.

3.53 In addition, for the OFR to deliver meaningful and relevant information, it is important for directors to include where necessary the key performance indicators they use to measure the company's development, performance and financial position. Paragraph 6 requires directors to include such information where necessary to meet the high-level objective and other general requirements. The use of key performance indicators is also required by the Modernisation Directive. Therefore, as with other aspects of the Regulations, paragraph 6 adopts wording from the Directive. It refers to key performance indicators including environmental and employee matters. This is not intended to be exhaustive. On the contrary, directors should include all key performance indicators that are relevant to their particular business.

3.54 Paragraph 7 of new Schedule 7ZA requires directors also to consider including additional explanations of amounts in the accounts. Paragraph 8 makes clear that where a company is a parent company, the OFR may be prepared from a group perspective.

Compliance with standards

3.55 The requirement to state whether an OFR has been prepared in accordance with a reporting standard and explain any departures from such a standard has been discussed in paragraph 3.23 above.

Q 5: Do you agree with the approach taken in, and the drafting of, Schedule 7ZA?

The role of the auditors

3.56 The role of the auditors in respect of the OFR is critical in providing quality assurance that the OFR has been prepared in a careful and balanced manner. The very nature of the OFR, and the fact that it relies heavily on the directors' judgements, present particular challenges. A key challenge is likely to be in relation to the omission of information.

3.57 The Government agrees with the CLR's recommendation that the role of the auditors should be centred on a process review of the OFR, that is to say, the auditors would express an opinion on the process that had been followed in producing the OFR, as distinct from the content of the OFR. The CLR recommended that the OFR should be subject to an auditor review for:

- the propriety of the directors' process for preparing it, i.e. how they have satisfied themselves that adequate, supportable information was considered in making their decisions as to inclusion of information; and how they have satisfied themselves that there is an adequate, supportable basis for statements made, whether factual or judgemental;
- consistency with the auditors' knowledge from the audit of the accounts (including consistency with the financial accounts themselves); and
- compliance with any applicable standard¹⁸.

3.58 Draft regulation 8 inserting a new section 235(3A) into the Companies Act 1985 is intended to achieve this outcome. The auditors would thus be required to express an opinion on whether the directors have prepared the OFR after 'due and careful enquiry'. The auditor review would not second-guess the directors' judgements, but would rather examine the process the directors followed in making their judgements and come to a view as to its adequacy.

3.59 The Government thus expects the auditors to examine whether the directors have taken appropriate steps to satisfy themselves that the OFR presents a balanced and comprehensive analysis of the development and performance of the company. In so doing, the auditors must satisfy themselves that each statement made in the OFR has been made after due consideration and is not inconsistent with the accounts and matters that have come to their attention during the course of the audit (this requirement for a positive opinion derives from the Modernisation Directive – see paragraph 3.86 below).

Q 6: Do you agree with the proposed role of the auditors as set out in regulation 8, including whether 'due and careful enquiry' is a reasonable and practicable standard to require of directors?

Q 7: How much do you estimate such a review of process by the auditors might cost?

¹⁸ Paragraph 8.63 of the Company Law Review document, *Final Report*, July 2001, URN 01/942.

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Enforcement of the OFR

3.60 The CLR recommended that the powers of enforcement regarding the OFR be confined to defects with regard to:

- the omission of matters required always to be included in an OFR;
- non-compliance with applicable standards; and
- the propriety of the preparation process (as for the auditors' review)¹⁹.

3.61 The Government proposes to introduce an enforcement regime for the OFR (and also for directors' reports) that mirrors the existing regime in respect of financial statements. The intention is to establish similar criminal offences and penalties in each case, and to provide for administrative enforcement through the Financial Reporting Review Panel (FRRP) in each case.

Criminal offences and penalties

3.62 Under section 233(5) of the Companies Act 1985 a director who is party to the approval of defective accounts and knows that they are defective, or is reckless as to whether or not they are defective, commits an offence. The accounting requirements are also backed up by an administrative enforcement regime: under sections 245 to 245C the Secretary of State, or a body authorised by her (currently, the FRRP) may apply to the court for an order directing a company to revise defective accounts.

3.63 The Government intends to introduce a parallel criminal offence of knowingly or recklessly approving an OFR that does not comply with the relevant provisions of the Act (new section 234AA(3) inserted by draft regulation 5(1)). There will be a similar offence of knowingly or recklessly approving a defective directors' report (see below).

3.64 The penalty would be the same as currently applies for knowing or reckless approval of defective accounts: a fine up to £5000 (in summary proceedings) or an unlimited fine (on conviction on indictment) – see draft regulation 14(8).

¹⁹ Paragraph 8.66 of the Company Law Review document, *Final Report*, July 2001, URN 01/942.

3.65 There is a further criminal offence, again matching the existing offence in the case of failure to sign the accounts. Thus, if a copy of the OFR is laid before the company, circulated or delivered to the registrar without having been signed, an offence will have been committed. The penalty would be the same as currently exists in the case of failure to sign a copy of the accounts: a fine up to £1000 – see draft regulation 5(1) inserting new section 234AB into the Companies Act 1985; and draft regulation 14(8).

3.66 As indicated below in paragraph 3.89, a similar offence and penalty apply for failure to sign a directors' report.

Administrative enforcement

3.67 Currently, under sections 245B and 245C of the Companies Act 1985, the Secretary of State or a person authorised by her (the FRRP has been so authorised) has the right to apply to the court for an order directing a company to revise defective accounts. In practice, the FRRP, under an arrangement with DTI, looks at the accounts of public and large private companies.

3.68 The Government believes that the approach of administrative enforcement is both proportionate and effective, as well as being consistent with the existing approach for annual accounts. It therefore intends to extend the scope of the current administrative enforcement regime so as to include both the OFR and the directors' report (see also paragraph 3.90 below).

3.69 In the case of the OFR, draft regulation 9 amends section 245 of the Companies Act 1985 so that the discretion for directors to make voluntary revisions (as they can already do for accounts, the directors' report and the directors' remuneration report) would apply to the OFR. Draft regulation 10 amends section 245A of the 1985 Act so that the Secretary of State will be able to give notice to a company, as is the case with defective accounts, where she considers that it has prepared a defective OFR or directors' report; and may require an explanation. Draft regulation 11 amends section 245B of the 1985 Act so as to enable the Secretary of State or a person authorised by her to apply to the court for revision of a defective OFR or directors' report. Draft regulation 12 amends section 245C of the 1985 Act so that the criteria to be met by authorised persons include matters relating to the OFR and directors' report.

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3.70 The FRRP will be required to consider the OFR (and directors' report) **outcome** as well as the process of producing the OFR. In the Government's view, an administrative enforcement regime focusing on process alone would not provide an appropriate level of enforcement where the aim is to ensure that the correct disclosure has been made. If enforcement were confined to a review of process, the risk is that the enforcement body would be confined to asking the directors to go through the process again, potentially leading to the same disclosure outcome as before. This is neither an effective nor an efficient means of enforcement.

3.71 However, the subjective nature of some aspects of the OFR presents practical challenges for enforcement. Some matters will be factual (such as the omission of a matter required always to be included in an OFR under paragraphs 1 and 2 of new Schedule 7ZA). On such issues directors should reasonably expect to be challenged. Other matters will be less clear-cut. This reinforces the need to adopt an administrative enforcement regime but it presents practical difficulties for the enforcer.

3.72 In practice, the enforcement body would need to consider the propriety of the process on judgemental issues, questioning directors on the relevant issues in order to understand why and how a particular conclusion was reached. Ultimately though the enforcement body would have the power to go to court to seek revision of the OFR.

3.73 The Government's expectation is that in practice difficulties should be capable of resolution without recourse to court action, as has been the case so far when revisions have been made to accounts following FRRP intervention.

Q 8: Do you agree with the Government's approach to the OFR enforcement regime as set out in paragraphs 3.60 – 3.73 and draft regulations 9-12?

Power of enforcement body to require information

3.74 Draft regulation 13 amends a new section 245F of the 1985 Act, to be inserted by clause 12 of the Companies (Audit, Investigations and Community Enterprise) Bill. New section 245F would give the authorised person (FRRP) the power to require information from companies in relation to accounts and to apply to court for an order directing the production of such information. Draft regulation 13 extends this information power so that the authorised person will also be able to require information relating to the OFR and directors' reports.

3.75 For further details on the effect of the draft Regulations in respect of the OFR, see the Explanatory Notes.

Implementation of the enhanced business review required in the directors' report by the Modernisation Directive

3.76 As indicated above (paragraph 1.1), the draft Regulations at Annex A will implement the requirements of the Modernisation Directive in relation to the review of a company's business. The Modernisation Directive also includes various other amendments to the existing EU accounting directives. The Government has consulted already, in the consultation document "Fair Value Accounting", published on 12 June 2003²⁰, on the Modernisation Directive provisions amending the Insurance Accounts Directive to allow Member States to permit or require insurance companies to account at fair value for some financial instruments. The remaining elements of the Directive, designed mainly to remove existing conflicts between the Accounting Directives and International Accounting Standards (IAS), are subject to a consultation document *Modernisation of Accounting Directives/ IAS Infrastructure*, March 2004²¹.

3.77 The Directive must be implemented by 1 January 2005. As far as this consultation is concerned, there is a degree of potential overlap between the EU requirements in relation to the contents of the "annual report" (referred to in the Companies Act 1985 as the "directors' report"); and the Government's proposals in respect of the OFR. That is why the Government proposes to implement these amendments in the same set of Regulations as the OFR and why this consultation covers both elements.

3.78 Details of the proposed amendments are contained in the Explanatory Notes. The main issues are as follows.

Application of the new requirements

3.79 The new requirements affecting the content of the directors' report are implemented through draft regulations 2 to 4. As indicated above (paragraph 1.5), the requirements will not affect small companies at all (see definition in paragraph 2.12 above) which are exempt under section 246 of the Companies Act 1985 from providing such information in the directors' report (see the amendment of section 246 in draft regulation 14(6)).

3.80 The new requirements will affect medium-sized companies (see definition in paragraph 2.12 above). However, the Government is proposing to adopt the option in the Directive, which allows medium-sized companies to be exempted from the requirement to provide certain non-financial information (e.g. relating

²⁰ URN 03/960.

²¹ http://www.dti.gov.uk/cld/pdfs/ias_infrastructure.pdf

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to environmental and employee matters). This exemption is in new section 234ZZA(3) inserted by draft regulation 3. The Government's general approach under the accounting Directives has been to take full advantage of exemptions allowed for small and medium-sized enterprises. The Government believes that additional burdens over and above those strictly required by EU company law should not be imposed on SMEs unless a clear case has been made of the benefits that will result. The benefits of reporting by large companies on non-financial matters are clear. Large companies will generally have a much wider shareholder base that will have an interest both in the impact that such matters have on the company's prospects and in the impact that the company has on those matters. Better information on non-financial matters in respect of large companies will encourage increased shareholder engagement. Moreover, the reports of large companies will also be of interest to users of accounts other than shareholders. These factors will not apply to the same extent to the vast majority of medium-sized companies.

3.81 Large companies will be required to meet all the new requirements as to the content of the directors' report. Quoted companies required to produce an OFR will not be required to produce what amounts to the same information in the directors' report as well. (This is achieved by new section 234 (4B) inserted by draft regulation 2(4)). Large companies which are not quoted companies will of course be subject to the new requirements for the directors' report but not to the OFR.

3.82 New section 234(4A) inserted by draft regulation 2(4) makes clear that where a company is a parent company, the OFR may be prepared from a group perspective.

Q 9: Do you agree with the Government's proposal to implement the Member State option in the Modernisation Directive by providing an exemption for medium-sized companies from the requirement to include non-financial information?

Enhanced content of Directors' Report

3.83 The Modernisation Directive revises the content requirements for the directors' report so that it will need to contain a review of the development and performance of the business and of its position, together with a description of the principal risks and uncertainties that it faces. The review must be a balanced and comprehensive analysis, consistent with the size and complexity of the business (see article 1.14 and 2.10 of the Directive).

3.84 The analysis must include key performance indicators relevant to the particular business to the extent necessary for an understanding of the business and, where appropriate, include references to and additional explanations of amounts reported in the financial statements.

3.85 The draft Regulations achieve this effect in the case of the directors' report as follows. Under draft regulation 2(2), the directors' report will have to contain both a fair review as specified in new section 234ZZA inserted by draft regulation 3, together with a description of the principal risks and uncertainties facing the company and its subsidiaries. New section 234ZZA spells out the content of the "business review" required for the directors' report, in line with the Modernisation Directive.

Role of the auditors in relation to the directors' report

3.86 Articles 1.17 and 2.11 of the Directive amend the requirements of the auditors' report in respect of the directors' report. This is reflected by draft regulation 4 inserting new section 235(3). Currently, auditors are required to consider whether information in the directors' report is consistent with the accounts, and if they are inconsistent this fact should be stated in the auditors' report. The change would require auditors to express a positive opinion as to the consistency or otherwise of the information in the directors' report.

Enforcement of the directors' report

3.87 As indicated above in respect of the OFR (paragraphs 3.60-3.73), the Government's intention is to put enforcement (criminal and administrative) of the accounts, directors' report and OFR on the same footing.

Criminal offences and penalties

3.88 The existing offence of failure to prepare a directors' report in compliance with the Act is committed whether or not a director does so knowingly or recklessly. In order to align this offence with that for approval of defective accounts or a defective OFR, draft regulation 2(5) modifies section 234(5) and (6) of the 1985 Act accordingly. The penalty for knowing or reckless approval of a defective report remains the same as at present: on conviction on indictment, an unlimited fine; in summary proceedings, a fine up to £5000.

3.89 The existing offence under section 234A of failure to sign a directors' report is unchanged by the draft Regulations.

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Administrative enforcement

3.90 Currently, the enforcement regime for the directors' report relies solely on criminal prosecutions. As indicated above for the OFR (paragraph 3.68), the Government intends to extend the existing administrative enforcement regime in relation to defective accounts, to cover defective OFRs and directors' reports as well. In practice, the authorised person (FRRP) may intervene if the directors' report is incomplete or the information contained in it appears incorrect.

Timing

3.91 The Modernisation Directive, including its requirements for an enhanced directors' report, must be implemented for financial years beginning on or after 1 January 2005.

3.92 There is no European Directive requirement driving the timetable for the OFR. However, in view of the strong linkages between the nature of the OFR and the enhanced review of the company's business required for the directors' report, and subject to the responses arising from this consultation, the intention is to make the Regulations during 2004, with a view to companies preparing statutory OFRs for the first time for financial years beginning on or after 1 January 2005 (draft regulation 1(2)). In line with the timing set out in paragraph 3.18 above, we would not expect the first OFR standard to be available until 2005.

Q 10: Do you agree with the Government's proposal to bring the OFR Regulations into effect for years beginning 1 January 2005? We would welcome suggestions on how the Government can best implement the Regulations.

Q 11: Do you have any general comments or specific suggestions on the drafting of the Regulations at Annex A?

4. Issues not included in the draft Regulations

Summary financial statements

4.1 Currently under section 251 of the 1985 Act, a public company whose shares or debentures are listed may circulate summary financial statements rather than the full financial statements and reports. Such summaries are derived from the full financial statements, directors' report and Directors' Remuneration Report.

4.2 However, unlike other statutory documents required under Part 7 of the Act, it is not clear that it would be practicable to identify particular elements of the OFR to be included in a summarised version, or that the OFR could be narrowed down in a prescribed manner. The OFR is designed to give **key** information to shareholders. The Government does not therefore propose to amend section 251 to allow for a summarised version of the OFR to be sent to shareholders. The draft Regulations do not contain any such provision. The Government believes that all shareholders should receive the OFR in its entirety. Hence, where shareholders elect to receive summary financial statements, the full version of the OFR should accompany them.

Q 12: Do you agree that all shareholders should receive the OFR? Do you agree that it is not appropriate to legislate to permit companies to send a summary OFR in place of the full version?

Corporate governance

4.3 Although the Company Law Review acknowledged the existence of a well-established and widely recognised system for reporting on corporate governance, it recommended that directors should include information on this issue whenever they judged it to be necessary for an understanding of the business, as any overlap in information could be dealt with by cross referencing in the annual reports.

4.4 The White Paper consultation in 2002 referred to this proposal. However, various responses pointed to the practical difficulties and resulting confusion in allowing OFR disclosures to be made anywhere in the annual report.

4 Issues not included in the draft Regulations

4.5 The draft Regulations omit any reference to reporting on corporate governance in the OFR. Corporate governance issues are covered by the requirements on listed companies set out in rule 12.43 of the Listing Rules of the Financial Services Authority. Under that rule, all listed companies must provide a two-part statement of corporate governance, which describes how they have applied the principles of the Combined Code, and confirms that they have complied with the Code's provisions, or, where they have not, provides an explanation. By omitting corporate governance as a separate topic for the OFR, duplication of these requirements could be avoided.

4.6 Of course, the very essence of the OFR requires directors to use their judgment in deciding what information should be included. This goes for matters of corporate governance as well. Directors might consider it appropriate in their specific circumstances to repeat information on, or cross-refer to, corporate governance disclosures.

Q 13: Do you believe that the draft Regulations should omit any requirement on directors to include information on corporate governance in their OFR, or do you think that such information is sufficiently key to company performance that repetition is justified?

Exclusion of confidential information

4.7 The draft Regulations do not provide for any exclusion on the grounds of confidentiality or commercial sensitivity. The Government has no desire to prejudice the interests of the company or its shareholders by requiring the disclosure of information that could damage the business or lead to a loss of competitive advantage. However, directors should provide honest, meaningful and relevant information that shareholders wish and need to know in order to understand the business and its prospects.

4.8 The Government believes that directors will be able to fulfil the requirement to provide a balanced and comprehensive discussion and analysis without the need to disclose information of such confidentiality or commercial sensitivity that to do so would significantly prejudice the company's and the shareholders' interests. Price-sensitive information must be disclosed under the Listing Rules. Informal soundings have not produced any convincing examples of information which would normally be required to be included in the OFR but which is so sensitive that it should not be included even in general terms. Moreover, a legal provision allowing confidential information to be withheld from the OFR could be open to abuse and very difficult to police. Therefore, no such provision is included in the draft Regulations.

Q 14: Do you agree with the Government's proposal that a provision for confidentiality should not be included for the OFR?

"Safe harbour" provisions

4.9 "Safe harbour" provisions may provide protection from liability in respect of claims, statements, projections or the like made in an OFR or similar document. The CLR recommended that the OFR requirements should be supplemented by a "safe harbour" provision exempting OFR reporting and auditing from liability for certain areas such as forward-looking statements. The CLR thought a safe harbour would encourage "candid and experimental reporting" because directors would not fear being sued if they made a forecast, quite reasonably, which turned out to be wrong.

4.10 The initial conclusion reflected in the 2002 White Paper was that a safe harbour provision would be impracticable and inappropriate. The Government continues to hold this view. Therefore, there is no such provision in the draft Regulations.

4.11 However, the Government is keen to encourage frank and honest reporting, including information of a forward-looking nature. The Government has indicated that if directors comply with the OFR standard, they will be presumed to have complied with the requirements as to the contents of the OFR. The Government expects this to provide a framework within which directors may be encouraged to report in an open and innovative manner.

Q 15: Do you agree with the omission of "safe harbour" provisions? If you think a "safe harbour" is necessary, how should this be framed?

5. Costs and benefits

5.1 The attached draft, partial Regulatory Impact Assessment (RIA) (Annex D) seeks comments on the likely costs and benefits of the proposals for the OFR and an enhanced directors' report under the Modernisation Directive.

5.2 The RIA indicates our assessment of where costs and benefits may occur and offers initial estimates of these. Currently, our estimate of the OFR-related costs of pursuing the proposed Option 4 (as reflected in this consultation), could amount to £29,000 per quoted company. Against this, the benefits are less easy to quantify but in our view could be substantial, both for the companies affected – through better and fuller reporting of relevant factors, greater shareholder engagement and reduced costs of capital for well run companies – and for the economy as a whole, as a result of greater transparency and comparability in the performance and prospects of the most important companies.

5.3 It is important to identify these factors as closely as possible. It would therefore be very helpful if consultees could comment on the potential costs and benefits of the proposals as estimated. Information on any additional costs and benefits not identified would also be welcomed.

Q 16: Please comment on the costs and benefits identified in the Partial Regulatory Impact Assessment at Annex D. Do you agree with them?

Q 17: Can you identify and quantify any additional costs or benefits resulting from these proposals that have not been identified in the RIA?

Annex A: Draft Regulations

*Draft Regulations laid before Parliament under section 257(2) of the
Companies Act 1985, for approval by resolution of each House of Parliament.*

DRAFT STATUTORY INSTRUMENTS

2004 No.

COMPANIES

The Companies Act 1985 (Operating and Financial Review and Directors'
Report) Regulations 2004

Made - - - - 2004

Coming into force - 2004

The Secretary of State, in exercise of the powers conferred upon her by section 257 of the Companies Act 1985⁽¹⁾ and of all other powers enabling her in that behalf, hereby makes the following Regulations of which a draft has been laid before Parliament in accordance with section 257(2) of that Act and approved by a resolution of each House of Parliament:

PART 1 General

Citation, commencement and interpretation

1.-(1) These Regulations may be cited as the Companies Act 1985 (Operating and Financial Review and Directors' Report) Regulations 2004.

(2) These Regulations come into force on the day after the day on which they are made and have effect as respects companies' financial years which begin on or after 1st January 2005.

(3) In paragraph (2) the reference to financial years beginning on or after 1st January 2005 includes financial years which would have so begun but for the exercise (on or after the date of making of these Regulations) of the power conferred by section 223 of the 1985 Act (calculation of company's financial year)⁽¹⁾.

(4) In these Regulations, "the 1985 Act" means the Companies Act 1985.

PART 2 Directors' reports

⁽¹⁾ 1985 c.6.

⁽¹⁾ Section 223 was substituted by section 3 of the Companies Act 1989 (c.40).

Duty to prepare directors' report

2. –(1) Section 234 of the 1985 Act (duty to prepare directors' report) ⁽¹⁾ is amended as follows.

(2) In subsection (1), for paragraph (a) substitute –
“(a) containing a fair review of the business of the company and its subsidiary undertakings complying with section 234ZZA,
(aa) containing a description of the principal risks and uncertainties facing the company and its subsidiary undertakings, and”.

(3) In subsection (2), omit “and any significant change in those activities in the year”.

(4) After subsection (4) insert –

“(4A) If the company is a parent company, the report may, where appropriate, give greater emphasis to those matters which are significant to the company and its subsidiary undertakings taken as a whole.

(4B) The directors of a quoted company are not required by this section or section 234ZZA to include information in a report for a financial year to the extent that the information is included in the operating and financial review prepared by them for that financial year in accordance with section 234AA.”

(5) For subsections (5) and (6) substitute –

“(5) Where a directors' report is approved under section 234A which does not comply with the provisions of this Part relating to the preparation and contents of the report, every director of the company who–

(a) knew that it did not comply or was reckless as to whether it complied, and
(b) failed to take all reasonable steps to prevent the report from being approved,
is guilty of an offence and liable to a fine.”

Business review

3. After section 234 of the 1985 Act ⁽¹⁾ insert –

“234ZZA Business review

(1) The review required for the purposes of section 234(1)(a) is a balanced and comprehensive analysis of –

(a) the development and performance of the business of the company and its subsidiary undertakings during the financial year, and
(b) the position of the company and its subsidiary undertakings at the end of that year,
consistent with the size and complexity of the business.

(2) The review shall, to the extent necessary for an understanding of the development, performance or position of the business of the company and its subsidiary undertakings, include–

⁽¹⁾ Section 234 was substituted by section 8(1) of the Companies Act 1989 (c.40), and amended by regulation 5 of S.I. 1996/189, and by regulation 2 of S.I. 1997/571.

⁽¹⁾ Section 234ZA was inserted by section [11(5)] of the Companies (Audit, Investigations and Community Enterprise) Act 2004.

- (a) analysis using financial key performance indicators, and
- (b) where appropriate, analysis using other key performance indicators, including information relating to environmental matters and employee matters.

(3) If a company –
(a) qualifies as medium-sized in relation to a financial year by virtue of section 247, and
(b) is not a parent company that is required to prepare group accounts for that year in accordance with this Act,
the review for that year need not comply with the requirements of subsection (2) so far as they relate to non-financial information.

(4) The review shall, where appropriate, include references to, and additional explanations of, amounts included in the annual accounts of the company.

(5) In this section, “key performance indicators” means factors by reference to which the development, performance or position of the business of the company and its subsidiary undertakings can be measured most effectively.”

Auditors' reports on directors' reports

4. In section 235 of the 1985 Act (auditors' report), for subsection (3) substitute -

“(3) The auditors shall state in their report whether in their opinion the information given in the directors' report for the financial year for which the annual accounts are prepared is consistent with those accounts.”

PART 3

Operating and financial reviews

Duty to prepare operating and financial review

5.-(1) After section 234A of the 1985 Act (approval and signing of directors' report)⁽¹⁾ insert the following -

“234AA Quoted companies: operating and financial review

(1) The directors of a quoted company shall for each financial year prepare an operating and financial review.

(2) The review shall comply with Schedule 7ZA (objective and contents of operating and financial review).

(3) Where an operating and financial review is approved under section 234AB which does not comply with the provisions of this Part relating to the preparation and contents of the review, every director of the company who—

(a) knew that it did not comply or was reckless as to whether it complied, and

(b) failed to take all reasonable steps to prevent the review from being approved,

is guilty of an offence and liable to a fine.

⁽¹⁾ Section 234A was inserted by section 8(1) of the Companies Act 1989.

234AB Approval and signing of operating and financial review

(1) The operating and financial review shall be approved by the board of directors and signed on behalf of the board by a director or the secretary of the company.

(2) Every copy of the operating and financial review which is laid before the company in general meeting, or which is otherwise circulated, published or issued, shall state the name of the person who signed it on behalf of the board.

(3) The copy of the operating and financial review which is delivered to the registrar shall be signed on behalf of the board by a director or the secretary of the company.

(4) If a copy of the operating and financial review –
(a) is laid before the company, or otherwise circulated, published or issued without the review having been signed as required by this section or without the required statement of the signatory's name being included, or
(b) is delivered to the registrar without being signed as required by this section,
the company and every officer of it who is in default is guilty of an offence and liable to a fine."

Reporting standards for operating and financial reviews

6. After section 256 of the 1985 Act insert –

"256A Reporting standards

(1) In this Part, "reporting standards" means statements of standard reporting practice which relate to operating and financial reviews and which are issued by a body or bodies specified in an order made by the Secretary of State.

(2) References in this Part to relevant reporting standards, in relation to a company's operating and financial review, are to such standards as are, in accordance with their terms, applicable to the company's circumstances and to the review.

(3) Where or to the extent that the directors of a company have complied with a reporting standard, they shall be presumed (unless the contrary is proved) to have complied with the corresponding requirements of this Part relating to the contents of an operating and financial review."

Objective and contents of operating and financial review

7. After Schedule 7 to the 1985 Act insert -

**"SCHEDULE 7ZA
OPERATING AND FINANCIAL REVIEW**

Review objective

1. An operating and financial review shall be a balanced and comprehensive analysis of –
(a) the development and performance of the business of the company and its subsidiary undertakings during the financial year,

- (b) the position of the company and its subsidiary undertakings at the end of the year,
 - (c) the main trends and factors underlying the development, performance and position of the business of the company and its subsidiary undertakings during the financial year, and
 - (d) the main trends and factors which are likely to affect their future development, performance and position,
- prepared so as to enable the members of the company to assess the strategies adopted by the company and its subsidiary undertakings and the potential for those strategies to succeed.

Other general requirements

2. The review shall include –
- (a) a statement of the business, objectives and strategies of the company and its subsidiary undertakings;
 - (b) a description of the resources available to the company and its subsidiary undertakings;
 - (c) a description of the principal risks and uncertainties facing the company and its subsidiary undertakings; and
 - (d) a description of the capital structure, treasury policies and objectives and liquidity of the company and its subsidiary undertakings.

Details of particular matters

3. Paragraphs 4 to 7 apply to an operating and financial review to the extent necessary to comply with the general requirements of paragraphs 1 and 2.
4. The review shall include information about -
- (a) the employees of the company and its subsidiary undertakings,
 - (b) environmental matters, and
 - (c) social and community issues.
5. The review shall also include information about -
- (a) the persons with whom the company or its subsidiary undertakings have relations (whether contractual or otherwise) which are essential to the business of the company and its subsidiary undertakings; and
 - (b) receipts from, and returns to, members of the company and its subsidiary undertakings in relation to shares held by them.
- 6.-(1) The review shall include analysis using financial and other key performance indicators, including information relating to environmental matters and employee matters.
- (2) In sub-paragraph (1), “key performance indicators” means the factors by reference to which the development, performance or position of the business of the company and its subsidiary undertakings can be measured most effectively.
7. The review shall, where appropriate, include references to, and additional explanations of, amounts included in the company's annual accounts.

Parent companies

8. If the company is a parent company, the review may, where appropriate, give greater emphasis to those matters which are significant to the company and its subsidiary undertakings taken as a whole.

Compliance with standards

9. The review must -
(a) state whether it has been prepared in accordance with relevant reporting standards, and
(b) contain particulars of, and reasons for, any departure from such standards.”

Auditors' reports on operating and financial reviews

8. –In section 235 of the Act (auditors' report) ⁽¹⁾ after subsection (3) insert -

“(3A) If an operating and financial review is prepared for the financial year for which the annual accounts are prepared, the auditors shall state in their report—
(a) whether in their opinion the directors have prepared the review after due and careful enquiry;
(b) whether in their opinion the information given in the operating and financial review is consistent with those accounts;
(c) whether any matters have come to their attention, in the performance of their functions as auditors of the company, which in their opinion are inconsistent with the information given in the operating and financial review.”

PART 4 Revision of defective reports

Voluntary revision of defective reports

9.-(1) Section 245 of the Act (voluntary revision of defective accounts and reports) ⁽¹⁾ is amended as follows.

- (2) In subsection (1) -
(a) after “directors' report” insert “, operating and financial review”; and
(b) after “revised report” insert “or review”.
- (3) In subsection (2), for “or report”, in each place, substitute “, report or review”.
- (4) In subsection (3) after “ a revised directors' report” insert “, a revised operating and financial review”.
- (5) In subsection (4)(a),(b) and (c) (in the first place it occurs), for “or report” substitute “, report or review”.

Secretary of State's notice in respect of reports

⁽¹⁾ Section 235 was substituted by section 9 of the Companies Act 1989, and amended by regulation 4 of S.I. 2002/1986.

⁽¹⁾ Section 245 was substituted by section 12 of the Companies Act 1989, and amended by regulation 4 of, and paragraph 2 in Part 1 of Schedule 1 to, S.I. 1994/1935 and regulation 10(9) of S.I. 2002/1986.

10. –(1) Section 245A of the 1985 Act (Secretary of State's notice in respect of annual accounts) ⁽¹⁾ is amended as follows.

(2) For subsection (1) substitute –

“(1) Where-

(a) copies of a company's annual accounts, directors' report or operating and financial review have been sent out under section 238, or

(b) a copy of a company's annual accounts, directors' report or operating and financial review has been laid before the company in general meeting or delivered to the registrar,

and it appears to the Secretary of State that there is, or may be, a question whether the accounts, report or review comply with the requirements of this Act, he may give notice to the directors of the company indicating the respects in which it appears to him that such a question arises or may arise.”

(3) In subsection (2), for “or prepare revised accounts” substitute “, report or review or prepare revised accounts or a revised report or review”.

(4) In subsection (3), for the words from “no satisfactory explanation” onwards substitute “the directors have not –

(a) given a satisfactory explanation of the accounts, report or review, or

(b) revised the accounts, report or review so as to comply with the requirements of this Act,

he may if he thinks fit apply to the court.”

(5) For subsection (4) substitute-

“(4) The provisions of this section apply equally to revised annual accounts, revised directors' reports and revised operating and financial reviews, in which case the references to revised accounts, reports or reviews shall be read as references to further revised accounts, reports or reviews.”

Application to court in respect of defective reports

11. (1) Section 245B of the 1985 Act (application to court in respect of defective accounts) ⁽¹⁾ is amended as follows.

(2) In subsection (1)-

(a) after “comply” insert “, or a directors' report or operating and financial review does not comply,”; and

(b) at the end insert “or a revised report or review”.

(3) After subsection (3) insert –

“(3A) If the court orders the preparation of a revised directors' report or a revised operating and financial review it may give directions with respect to –

(a) the review of the directors' report or operating and financial review by the auditors,

(b) the revision of any directors' report, directors' remuneration report, operating and financial review or summary financial statement,

⁽¹⁾ Section 245A was inserted by section 12 of the Companies Act 1989.

⁽¹⁾ Section 245B was inserted by section 12 of the Companies Act 1989.

- (c) the taking of steps by the directors to bring the making of the order to the notice of persons likely to rely on the previous report or review; and
- (d) such other matters as the court thinks fit.”

(4) In subsection (4) –

- (a) after “that the accounts” insert “, report or review”;
- (b) after “revised accounts” insert “or a revised report or review”;
- (c) after “defective accounts” insert “, report or review”;
- (d) for “the accounts were approved” substitute “of the approval of the accounts, report or review”;
- (e) for “their approval” substitute “ the approval”;
- (f) for “their being approved” substitute “that approval”.

(5) In subsection (5), after “accounts” (in both places) insert “, report or review”.

(6) For subsection (7) substitute –

- “(7) The provisions of this section apply equally to revised annual accounts, revised directors’ reports and revised operating and financial reviews, in which case the references to revised accounts, reports or reviews shall be read as references to further revised accounts, reports or reviews.”

Persons authorised to apply to court in connection with defective reports

12. In subsection (1) of section 245C of the 1985 Act (other persons authorised to apply to court) ⁽¹⁾–

- (a) in paragraph (a), for “the accounting requirements of this Act” substitute “the requirements of this Act relating to accounts, directors’ reports and operating and financial reviews”; and
- (b) in paragraph (b), after “companies” insert “, directors’ reports and operating and financial reviews”.

[Power of person authorised to require documents, information and explanations

13. In subsection (1) of section 245F of the 1985 Act (power of person authorised to require documents, information and explanations) ⁽¹⁾ after “annual accounts” insert “, directors’ report or operating and financial review”.]

PART 5 Minor and consequential amendments

Minor and consequential amendments

14.-(1) The following minor and consequential amendments to the 1985 Act have effect.

(2) In subsection (1A) of section 238 of the 1985 Act (persons entitled to receive copies of accounts and reports) ⁽¹⁾–

- (a) after paragraph (b) insert –

⁽¹⁾ Section 245C was inserted by section 12 of the Companies Act 1989, [and amended by section [10] of the Companies (Audit, Investigations and Community Enterprise) Act 2004].

⁽¹⁾ [Section 245F was inserted by section 12 of the Companies (Audit, Investigations and Community Enterprise) Act 2004.]

⁽¹⁾ Section 238 was substituted by section 10 of the Companies Act 1989 (c.40), and amended by article 12 of S.I. 2000/3373, and by regulation 10(4) of S.I. 2002/1986.

- “(bb) (in the case of a quoted company) the operating and financial review for that financial year,”; and
- (b) for paragraph (d) substitute—
“(d) the auditors’ report on those accounts and that directors’ report and (in the case of a quoted company) on that operating and financial review and the auditable part of that directors’ remuneration report.”
- (3) In subsection (1) of section 239 of the 1985 Act (right to demand copies of accounts and reports)⁽¹⁾ –
(a) after paragraph (b) insert –
“(bb) (in the case of a quoted company) the last operating and financial review,”; and
(b) for paragraph (d) substitute –
“(d) the auditors’ report on those accounts and that directors’ report and (in the case of a quoted company) on that operating and financial review and the auditable part of that directors’ remuneration report.”
- (4) In subsection (1) of section 241 of the 1985 Act (accounts and reports to be laid before company in general meeting)⁽¹⁾ –
(a) after paragraph (b) insert –
“(bb) (in the case of a quoted company) the operating and financial review,”; and
(b) for paragraph (d) substitute –
“(d) the auditors’ report on those accounts and that directors’ report and (in the case of a quoted company) on that operating and financial review and the auditable part of that directors’ remuneration report.”
- (5) In subsection (1) of section 242 of the 1985 Act (accounts and reports to be delivered to the registrar)⁽¹⁾ –
(a) after paragraph (b) insert –
“(bb) (in the case of a quoted company) the operating and financial review,”; and
(b) for paragraph (d) substitute –
“(d) the auditors’ report on those accounts and that directors’ report and (in the case of a quoted company) on that operating and financial review and the auditable part of that directors’ remuneration report.”
- (6) In subsection (4) of section 246 of the 1985 Act (special provisions for small companies)⁽¹⁾, for paragraph (a) substitute –
“(a) section 234(1)(a), (aa) and (b) (business review, description of principal risks and uncertainties, and amount to be paid as dividend);”.
- (7) In the Table in section 262A of the 1985 Act (defined expressions), at the appropriate place insert –
- “reporting standards and relevant reporting standards section 256A”

⁽¹⁾ Section 239 was substituted by section 10 of the Companies Act 1989 and amended by article 13 of S.I. 2000/3373 and by regulation 10(6) of S.I. 2002/1986.

⁽¹⁾ Section 241 was substituted by section 11 of the Companies Act 1989, and amended by regulation 10(7) of S.I. 2002/1986.

⁽¹⁾ Section 242 was substituted by section 11 of the Companies Act 1989, and amended by sections 30(1) and (4) and 35(1) of, and Schedule 2 to, the Welsh Language Act 1993 (c.38), and by regulation 10(8) of S.I. 2002/1986.

⁽¹⁾ Section 246 was substituted by regulation 2(1) of S.I. 1997/220, and amended by regulation 6(1) of S.I. 1997/550 and by regulation 8(1) of S.I. 2000/1430.

Annex A

(8) In Schedule 24 to the 1985 Act (table of punishment of offences under the 1985 Act), after the entry for section 234A(4) insert-

234AA(3)	Non-compliance with Part 7 as to operating and financial review and its content; directors individually liable	1. On indictment 2. Summary	A fine The statutory maximum
234AB(4)	Laying, circulating or delivering operating and financial review without required signature	Summary	Level 3 on the standard scale

Minister of State for Industry and the Regions
and Deputy Minister for Women and Equality,
Department of Trade and Industry.

2004

Annex B: Explanatory notes on the draft Regulations

THE DRAFT COMPANIES ACT 1985 (OPERATING AND FINANCIAL REVIEW AND DIRECTORS' REPORT) REGULATIONS 2004

Overview

1. This note is a guide to the draft Companies Act 1985 (Operating and Financial Review and Directors' Report) Regulations 2004. The intention is to lay the Regulations before Parliament under section 257(2) of the Companies Act 1985. Section 257 gives the Secretary of State the power through regulations to modify the accounting and reporting requirements in Part 7 of the 1985 Act. Subsection (2) requires regulations to be subject to affirmative procedure (that is to say, debate and approval in both Houses of Parliament) if they meet certain criteria, including – as these draft Regulations do – adding to the classes of documents required to be prepared by companies.

2. Section 257 already provides the power to do most of what the draft Regulations do. However, the power to specify a body to formulate reporting standards for the Operating and Financial Review (OFR) (compliance with which will be presumed to be compliance with the legislative requirements) is a new power. It is to be provided by clause 13 of the Companies (Audit, Investigations and Community Enterprise) Bill, which is currently before Parliament. Subject to Parliamentary scrutiny, the Bill is expected to receive Royal Assent in the summer or autumn of 2004. It is intended to lay the Regulations before Parliament later in the year.

3. The draft Regulations are divided into five parts. Part 1 is introductory. Part 2 implements the relevant articles of the Modernisation Directive as set out at Annex C, which affect the content of the directors' report and the auditors' report on it. Part 3 implements the proposals for quoted companies to prepare an OFR. Part 4 amends the enforcement regime applying to the directors' report and introduces an enforcement regime for the OFR. Part 5 contains minor and consequential amendments.

PART 1: General

Citation, commencement and interpretation

Draft regulation 1

4. Draft regulation 1(2) provides for the Regulations to come into force on the day after the day on which they are made. They can be made, that is to say signed by the Minister, as soon as they have received approval in both Houses of Parliament. The Regulations are intended to have effect for companies' financial years beginning on or after 1 January 2005. The consultation document (paragraphs 3.91 to 3.92 and question 10) draws attention to the question of timing. The Modernisation Directive requirements apply to financial years commencing on or after 1 January 2005, and as envisaged by the present timetable, the OFR requirements will also apply to such years.

5. Regulation 1(3) applies the requirements of the draft Regulations to financial years that would have begun on or after 1 January 2005 but for the directors taking advantage of the seven day leeway in section 223 of the Companies Act 1985.

PART 2: Directors' reports

6. The purpose of the amendments made in Part 2 is to implement the requirements of articles 1.14, 1.17, 2.10 and 2.11 of the Modernisation Directive. These are also discussed in paragraphs 3.76 to 3.90 of the consultation document.

7. This Part does not affect companies that qualify as "small", which are exempt under section 246 of the Companies Act 1985 from many of the directors' report disclosure requirements (including the "fair review"). (See the consequential amendment to section 246 in draft regulation 14(6)). The thresholds defining companies as "small" have recently been raised by the Companies Act 1985 (Accounts of Small and Medium-Sized Enterprises and Audit Exemption) (Amendment) Regulations 2004 (SI 2004 No.16). A company counts as "small" if two or more of the following requirements are met in a year:

Turnover: not more than £5.6 million

Balance sheet total: not more than £2.8 million

Number of employees: not more than 50.

8. In addition, companies that qualify as medium-sized are exempted from providing non-financial information under the new requirements for the directors' report, see the note on regulation 3(3) below. A company counts as "medium-sized" if two or more of the following requirements are met in a year:

Turnover: not more than £22.8 million

Balance sheet total: not more than £11.4 million

Number of employees: not more than 250.

9. As indicated in the consultation document this means that the new requirements in this Part to provide a fuller "review", in the directors' report, will apply to large companies including those quoted companies required to produce an OFR. To avoid potential duplication, the regulations are drafted in such a way that quoted companies which meet the OFR requirements in Part 3 of the regulations will automatically also meet the new directors' report requirements in Part 2.

Duty to prepare directors' report

Draft regulation 2

10. This draft regulation amends section 234 of the Companies Act 1985 (duty to prepare directors' report) in line with the new requirements of the Modernisation Directive.

11. Articles 1.14 and 2.10 of the Modernisation Directive contain changes to the requirement for companies to include a fair review in their "annual report" (referred to in GB legislation as the "directors' report"). The changes are intended to promote greater consistency and specify more precisely the information a "fair review" should contain. The main changes are as follows.

12. Section 234 sets out the current requirements in respect of the directors' report for both individual companies and groups. Section 234(1)(a) contains the existing requirement to include a fair review of the development of the business of the company and its subsidiary undertakings. Under regulation 2(2), the report will have to contain both a fair review, as specified more precisely in regulation 3 inserting a new section 234ZZA ("Business review"); and a description of the principal risks and uncertainties facing the company and its subsidiary undertakings.

Annex B

13. Regulation 2(4) adds two new subsections (4A) and (4B). Subsection (4A) allows parent companies discretion to give greater emphasis in their directors' reports to matters which are significant for the group as a whole. This should avoid unnecessary duplication and assist clarity and simplicity. Subsection (4B) provides that directors of quoted companies will not have to include information in the directors' report to the extent that it is included in the OFR. This is intended to avoid duplication (see paragraph 9 above).

14. Regulation 2(5) modifies the existing offence of failure to prepare a directors' report and to include in it the required content, currently contained in sections 234(5) and (6). The key changes are that:

- in future, the offence will be triggered by approval of a (defective) directors' report;
- it will be conditional on the director's knowledge, when the board approved the report, that it was defective, or on his recklessness as to whether or not the report was defective.

The reason for providing these new conditions is to bring the offence into line with that for approving accounts which are defective (see section 233(5)). The overall intention is to put the enforcement of the directors' report, OFR and company accounts on the same basis, including a parallel system of administrative enforcement by the Secretary of State or a person authorised by her (see the description below of Part 4 of the draft Regulations).

15. In addition, the existing reverse burden of proof is removed. Currently, under section 234(6), a director can mount a defence if he can prove that he took all reasonable steps to secure compliance with the Act's requirements concerning the preparation and contents of a directors' report. Under new subsection 234(5) inserted by regulation 2(5) the prosecution will have to prove that the director failed to take all reasonable steps to prevent the defective report being approved.

16. The level of the penalty for approval of a defective report remains the same as at present: on conviction on indictment (that is to say, in proceedings before a Crown court), an unlimited fine; alternatively, in summary proceedings (before a magistrate's court), a fine up to the statutory maximum (currently, £5,000).

Business review

Draft regulation 3

17. This draft regulation inserts a new section 234ZZA into the Companies Act 1985. The new requirements reflect the Modernisation Directive provisions relating to the required review of the business to be contained in the directors' report.

18. The key features of new section 234ZZA are:

- a requirement to provide a fuller and more detailed analysis, consistent with the size and complexity of the business, covering the performance as well as the development of the business (subsection (1));
- the review must include, to the extent necessary for an understanding of the business, an analysis using financial and other key performance indicators, including information relating to environmental matters and employee matters (see subsections (2) and (5));
- an exemption, as indicated above, for medium-sized companies from the requirement to produce non-financial information (eg relating to environmental matters and employee matters) (subsection (3));
- where appropriate, references to, and additional explanations of, amounts included in the accounts (subsection (4) implementing articles 1.14 and 2.10 of the Modernisation Directive).

Auditors' reports on directors' reports

Draft regulation 4

19. This draft regulation amends section 235(3) of the Companies Act 1985. Currently, under that provision, auditors must consider whether the information given in the directors' report is consistent with the annual accounts, and if they are of the opinion it is not, must state that fact in their report. Articles 1.17 and 2.11 of the Modernisation Directive amend the auditors' duty so that a positive opinion must be expressed as to the consistency or otherwise of the directors' report with the annual accounts. Draft regulation 4 reflects this new requirement.

PART 3: Operating and financial reviews

20. This Part contains key provisions on the OFR, including: the companies which will be required to produce an OFR; the offence of approving a defective OFR; procedures for approval, signature and distribution of the OFR and the offence of failing to comply; the status of reporting standards for the OFR; the objective and contents of the OFR; the role of the auditors in relation to the OFR. As indicated in the consultation document (paragraphs 3.60 to 3.73) the Government's aim is to fit the OFR as smoothly as possible within the existing framework of reporting requirements and enforcement arrangements, consistent with those for the directors' report.

21. The OFR is intended to be a separate document, like the directors' remuneration report. Quoted companies required to produce an OFR will therefore also need to produce a separate directors' remuneration report. New section 234(4B) manages the overlap between the directors' report and the OFR as explained in paragraph 13 above.

Duty to prepare operating and financial review

Draft regulation 5

22. Regulation 5 inserts two new sections into the 1985 Act. New section 234AA establishes the requirement to prepare an OFR. New section 234AB deals with approval and signing of the OFR.

23. New section 234AA(1) requires directors of quoted companies to prepare an OFR for each financial year. The definition of a quoted company is set out in section 262 of the 1985 Act and is the same as is used for companies which must produce a directors' remuneration report. (See paragraphs 3.10 to 3.15 of the consultation document). The OFR must be prepared in accordance with the content requirements of new Schedule 7ZA (section 234AA(2)), to be inserted in the 1985 Act by draft regulation 7. New section 234AA(3) sets out the criminal offence for non-compliance. The offence is similar to the amended offence of approval of a defective directors' report (see draft regulation 2(5)); and the offence of approval of defective accounts under section 233(5) of the 1985 Act. The penalty is also the same as for those other offences and is shown in draft regulation 14(8): on conviction on indictment, an unlimited fine; in summary proceedings, a fine up to the statutory maximum (£5,000).

24. New section 234AB sets out the approval, distribution and signature requirements in respect of the OFR. These are similar to those for the directors' report (section 234A of the 1985 Act) and directors' remuneration report (section 234C of the 1985 Act). The penalty for non-compliance is also the same as for those other cases: a fine up to level 3 (£1000) on the standard scale (see draft regulation 14(8)).

Reporting standards for operating and financial reviews

Draft regulation 6

25. Draft regulation 6 inserts a new section 256A into the 1985 Act, using the proposed new power to be inserted into section 257 by clause 13 of the Companies (Audit, Investigations and Community Enterprise) Bill currently before Parliament. The amended section 257 would give the Secretary of State power to specify by order a body for issuing reporting standards; and to provide that compliance with such standards may count as compliance with the reporting requirements of the Act unless the contrary is proved.

26. New section 256A gives authority to such reporting standards, matching the authority given to accounting standards under existing section 256. They will have a statutory footing under subsection (3), because compliance with the standards will be taken to mean compliance with the law (unless the contrary is proved); and, under subsection (1), the only "reporting standards" which will count for such purposes will be those issued by a body or bodies specified by the Secretary of State. The current intention is that the Accounting Standards Board will be the specified body for purposes of the OFR, as it is for accounting standards.

Objective and contents of the operating and financial review

27. Draft regulation 7 inserts a new Schedule 7ZA in the 1985 Act. This new Schedule specifies the contents of the OFR and is also discussed in paragraphs 3.38 to 3.55 of the consultation document.

28. Paragraph 1 of new Schedule 7ZA establishes the high-level objective of the OFR. This objective follows the recommendation of the Company Law Review. In paragraph 1, (a) and (b) follow the wording of the required general content of the business review in the directors' report (see draft regulation 3). The main distinguishing feature of the OFR is the requirement that it should look ahead at possible future trends and developments, and this is reflected in (d).

Annex B

29. It is important to note that the objective of the OFR is focused on the members (i.e. shareholders) of the company (as in the case of other company reporting). It must enable the members to assess the strategies adopted, and their potential to succeed. Thus, the judgement as to whether any particular OFR has met its objective will be made from the perspective of the members of the company. Of course, the information which an OFR contains, may also be of interest to a wider range of interested parties.

30. Paragraph 2 of new Schedule 7ZA establishes what must always be contained in an OFR, again as recommended by the Company Law Review (except in one case as indicated below). Each OFR must include a statement of the business, objectives and strategies of the company and its subsidiary undertakings; a description of the resources available to the company and its subsidiary undertakings (this forms one part of the requirement to state the “dynamics of the business” as recommended by the Company Law Review); a description of the principal risks and uncertainties facing the company and its subsidiary undertakings (this forms the other part of the “dynamics of the business”); and a description of the capital structure, treasury policies and objectives and liquidity of the company and its subsidiary undertakings. The Company Law Review did not refer to such a “financial” reporting requirement (see paragraphs 3.44 to 3.45 of the consultation document) leaving it to rule making by a new statutory body. In the absence of such a body, the envisaged OFR reporting standard will be able to expand on this requirement (d) (as on the specific content of requirements (a) to (c) in this paragraph).

31. Paragraph 3 of Schedule 7ZA makes it clear that further information (set out in paragraphs 4 to 7) must also be included “to the extent necessary to comply with the general requirements of paragraphs 1 and 2”. As explained in paragraph 3.25 of the consultation document, the draft regulations do not use the word “material”. However, the effect of the wording in paragraph 3 is equivalent, that is to say the directors will need to judge whether the further information is necessary to enable the members of the company to assess the company’s strategies; and to complete the statement and descriptions required under paragraph 2. Where directors do not report on such matters, the implication will be that they have not considered them to be necessary within the terms described.

32. Thus, contingent on the directors’ judgement, an OFR must contain information about the company’s employees, environmental matters and social and community issues (paragraph 4).

33. Again, contingent on the directors' judgement, an OFR must contain information about key business and other relations (e.g. with a regulator) and shares (paragraph 5, reflecting a further recommendation of the Company Law Review).

34. Additional information required if considered necessary by the directors is:

- under paragraph 6, an analysis using financial and other key performance indicators, including information relating to environmental matters and employee matters. This equates with the analysis required, "to the extent necessary..." for the new business review under the Modernisation Directive (see draft regulation 3).
- where appropriate, references to and additional explanations of amounts included in the accounts as required by the Directive.

35. Where a company is not a parent company, only an individual OFR report is required. Where a company is a parent company, the OFR may be prepared from a group perspective (paragraph 8 implementing article 10(b) of the Directive).

36. Under paragraph 36A in Schedule 4 of the Companies Act 1985, the accounts of large companies are required to state whether the accounts have been prepared in accordance with applicable accounting standards. Paragraph 9 of new Schedule 7ZA adopts a similar approach in the case of the OFR. It requires directors to include in the OFR a statement as to whether the OFR has been prepared in accordance with the OFR standard and particulars of any departure from the Standard. While most OFRs might be expected to comply with the OFR reporting standard, it is possible that there may be circumstances where an OFR departs, quite legitimately, from the standard while conforming to the requirements of new Schedule 7ZA – in such cases the OFR must explain any such departure.

Auditors' reports on operating and financial reviews

Draft regulation 8

37. Draft regulation 8 inserts a new subsection 235(3A) which sets out the responsibility of the auditors in respect of the OFR. (See also paragraphs 3.56 to 3.59 of the consultation document). In short, and in line with the recommendation of the Company Law Review, the auditors' duty will be to report on the propriety of the process by which the directors prepared the OFR. Thus, under (a), the auditors must state whether the OFR has been prepared "after due and careful enquiry". They must also, under (b), state whether the information is consistent with the accounts (as required by article 1.17 and 2.11 of the Directive); and under (c) must state whether any matters have come to their attention in the performance of their functions as auditors of the company which in their opinion are inconsistent with the information in the OFR.

PART 4: Revision of defective reports

38. This Part deals with the new administrative enforcement arrangements for the directors' report and the OFR. Administrative enforcement arrangements already exist, under sections 245A to 245C of the Companies Act 1985, for the revision of defective accounts. These arrangements sit alongside the criminal penalties applicable where defective accounts are approved. Under section 245B the Secretary of State has authorised the Financial Reporting Review Panel (FRRP) to take companies to court for an order compelling them to change defective accounts.

39. The intention of Part 4 is to introduce a similar administrative system for enforcement of the directors' report and the OFR. The Secretary of State and the FRRP would be authorised to apply to the court for an order to revise a defective directors' report or OFR.

Voluntary revision of defective reports

Draft regulation 9

40. Existing section 245 allows directors voluntarily to revise defective accounts, directors' reports or the directors' remuneration report. It also gives the Secretary of State a power to make regulations in relation to such revisions. Draft regulation 9 amends section 245 so that the discretion to make voluntary revisions, and the Secretary of State's regulation-making power, apply to the OFR as well. Appropriate amendments will be made to the Companies (Revision of Defective Accounts and Reports) Regulations 1990 (S.I. 1990/2570 as amended).

Secretary of State's notice in respect of reports

Draft regulation 10

41. Draft regulation 10 amends section 245A of the 1985 Act so that its provisions extend to the directors' report and the OFR. Currently, section 245A relates only to annual accounts and gives the Secretary of State power to give notice to a company where she considers that the accounts may be defective, requiring an explanation. If no satisfactory explanation is forthcoming, the Secretary of State may apply to the court.

Application to court in respect of defective reports

Draft regulation 11

42. Draft regulation 11 amends section 245B of the 1985 Act. Section 245B enables the Secretary of State, or a person authorised by her (the FRRP has been so authorised), to apply to the court for an order requiring the directors to prepare revised accounts.

43. The effect of the amendments in draft regulation 11 is that the Secretary of State, or a person authorised by her, will be able to apply to the court for an order requiring the preparation also of a revised directors' report or OFR. As at present, the court may give directions which may be quite wide-ranging – see new subsection (3A) of section 245B.

Persons authorised to apply to court in connection with defective reports

Draft regulation 12

44. Draft regulation 12 amends section 245C of the 1985 Act. Existing section 245C sets out the criteria to be met by persons authorised by the Secretary of State to apply to court in connection with defective accounts. The effect of the amendments in draft regulation 12 is to widen those criteria beyond accounting requirements so as to embrace amongst other things, "... an interest in, and [...] satisfactory procedures directed to securing, compliance by companies with the requirements of this Act relating to accounts, directors' reports and operating and financial reviews", and satisfactory procedures for receiving and investigating complaints about accounts, directors' reports and OFRs.

Power of person authorised to require documents, information and explanations

Draft regulation 13

45. Draft regulation 13 amends a new section 245F of the 1985 Act. Section 245F is to be inserted by clause 12 of the Companies (Audit, Investigations and Community Enterprise) Bill. The purpose of new section 245F is to give the “authorised person” (i.e. the FRRP) power to require information from companies; and to apply to court for an order directing the production of such information. Currently, as it appears in the Bill, this power relates only to information, documents and explanations in relation to accounts. The effect of draft regulation 13 is to expand the information requirement to include information relating to directors’ reports and the OFR.

PART 5: Minor and consequential amendments

Draft regulation 14

46. Regulation 14 makes a number of minor and consequential amendments to various related sections of the 1985 Act. In particular, the OFR will form part of the annual reports and accounts package to be sent to the members of the company under amended section 238; as also will the auditors’ report on the directors’ report and the OFR. Any member of the company will have a right to demand copies of the OFR and auditors’ report on the OFR and directors’ report under amended section 239. The duty to lay documents before the company in general meeting will include the OFR and the auditors’ report on the directors’ report and OFR under amended section 241. The OFR and auditors’ report on the OFR and directors’ report must be filed with the registrar of companies under amended section 242.

47. In addition, amendments are made to section 246(4)(a) to ensure that small companies are exempt from the need to produce a “business review” under the Modernisation Directive; to section 262A (list of defined expressions) to include a reference to the definition of “reporting standards and relevant reporting standards” in new section 256A; and to Schedule 24 (list of offences and penalties).

Annex C: Extracts from the Modernisation Directive

Article 1

Directive 78/660/EEC is hereby amended as follows:

14) Article 46 shall be amended as follows:

(a) paragraph 1 shall be replaced by the following:

'1. (a) The annual report shall include at least a fair review of the development and performance of the company's business and of its position, together with a description of the principal risks and uncertainties that it faces.

The review shall be a balanced and comprehensive analysis of the development and performance of the company's business and of its position, consistent with the size and complexity of the business;

(b) To the extent necessary for an understanding of the company's development, performance or position, the analysis shall include both financial and, where appropriate, non-financial key performance indicators relevant to the particular business, including information relating to environmental and employee matters.

(c) In providing its analysis, the annual report shall, where appropriate, include references to and additional explanations of amounts reported in the annual accounts.';

(b) the following paragraph shall be added:

'4. Member States may choose to exempt companies covered by Article 27 from the obligation in paragraph 1(b) above in so far as it relates to non-financial information.';

17) Article 51(1) shall [include the following paragraph]:

'The statutory auditors shall also express an opinion concerning the consistency or otherwise of the annual report with the annual accounts for the same financial year.'

Article 2

Directive 83/349/EEC is hereby amended as follows:

10) Article 36 shall be amended as follows:

(a) paragraph 1 shall be replaced by the following:

‘1. The consolidated annual report shall include at least a fair review of the development and performance of the business and of the position of the undertakings included in the consolidation taken as a whole, together with a description of the principal risks and uncertainties that they face.

The review shall be a balanced and comprehensive analysis of the development and performance of the business and of the position of the undertakings included in the consolidation taken as a whole, consistent with the size and complexity of the business. To the extent necessary for an understanding of the such development, performance or position, the analysis shall include both financial and, where appropriate, non-financial key performance indicators relevant to the particular business, including information relating to environmental and employee matters.

In providing its analysis, the consolidated annual report shall, where appropriate, provide references to and additional explanations of amounts reported in the consolidated accounts.’;

(b) The following paragraph shall be added:

‘3. Where a consolidated annual report is required in addition to an annual report, the two reports may be presented as a single report. In preparing such a single report, it may be appropriate to give greater emphasis to those matters which are significant to the undertakings included in the consolidation taken as a whole.’;

11) Article 37 shall [include the following paragraph]:

‘The report of the statutory auditors shall include:

(e) an opinion concerning the consistency or otherwise of the consolidated annual report with the consolidated accounts for the same financial year.’

Annex D: Partial Regulatory Impact Assessment on the Operating and Financial Review and Directors' Report Draft Regulations

I Proposal

1. Draft Regulations under section 257 of the Companies Act 1985 introducing a mandatory Operating and Financial Review ("OFR") for quoted companies and extending the fair review of the company's business required in the directors' report under Directive 2003/51/EC of the European Parliament and of the Council (18 June 2003)¹ ("the Modernisation Directive"). The draft Regulations also establish an auditors' review for the OFR, adjust the existing auditing requirement for the directors' report and establish a criminal and administrative enforcement regime for both the OFR and the directors' report which puts them on the same footing as the existing criminal and administrative enforcement regime for accounting requirements.

II Purpose and intended effect

(i) Objective

The OFR

2. As one of a number of proposals already completed or under way and aimed at rebuilding confidence in the market place², the objective of the OFR is greater transparency: to improve the quality, usefulness and relevance of information provided by quoted companies, thus improving the understanding of the business and its prospects and encouraging members (shareholders) to exercise effective and responsible control.

¹ L178/16 of 17 July 2003.

² For example, revisions to the Combined Code following the Higgs Review and Smith Review on Audit Committees; and stronger accounting, auditing and company investigation measures proposed in the Companies (Audit, Investigations and Community Enterprise) Bill currently before Parliament.

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3. The proposals will place an additional requirement on quoted companies by requiring them to prepare and publish an OFR alongside their annual accounts and reports. The OFR is intended to be a balanced and comprehensive analysis of the development and performance of the business, including the main trends and factors underlying the performance and financial position of the business during the year, and those which are likely to affect its performance in future years. The company's auditors will be required to carry out a review of the OFR and the propriety of its preparation.

4. While the purpose of the OFR is to provide greater transparency in the first instance for the members of the company and hence to encourage the company itself to sharpen its all-round perspective and operation, it will benefit all those with an interest in corporate reporting, both within the business community and more widely, and serve to encourage high standards of business practice.

Enhanced review of the company's business required in the directors' report

5. The objective of the enhanced review required by the Modernisation Directive is similar to that of the OFR: greater transparency and precision of company reporting on performance on financial and non-financial matters. However, in the case of medium-sized companies the Government is proposing to exercise the Member State option to exempt them from the requirement to provide information on certain non-financial matters (e.g environment, employee relations), in order to limit the potential burdens on such businesses.

6. All the enhanced review requirements will apply to large companies, so there is a potential overlap between these requirements and those of the OFR where a quoted company potentially might have to do both. To remove such duplication, the Government is proposing that quoted companies completing an OFR will not have to duplicate information in a separate directors' report.

7. These proposals apply to England, Scotland and Wales. Company law in Northern Ireland is a transferred matter under the Northern Ireland Act 1998. Company law matters relating to Scotland are reserved under the Scotland Act 1998 and no relevant functions have been transferred to Wales.

(ii) Background

8. Current financial reporting requirements concentrate on providing quantitative data (about a company's assets) and financial information about a company's past performance (profit/loss on business activities). The annual reports that accompany the financial statements contain some items relating to business performance, such as a fair review as required by law, and a number of other requirements focused solely on a particular issue or public policy objective, such as directors' remuneration or political donations. Little forward-looking information is required.

9. Companies are becoming increasingly complex and information needs are changing. Information about future plans, opportunities and risks is as important as an historical review of performance. There is growing recognition that companies are reliant on many "intangible" factors, such as the skills and knowledge of the workforce, key relationships with customers, suppliers and regulators, or the company's impact on the environment and the community.

10. Requiring quoted companies to report on such matters will permit their members (shareholders) to assess the future strategies of the business and their potential for success; and this will lead to greater transparency and accountability. It will encourage senior management to consider a wide range of factors relevant to the business. The OFR will thus be an opportunity for companies to demonstrate that they are well run, and it may be expected, as a result, to give them a competitive advantage in securing capital. Relevant and more comprehensive disclosure will allow a better assessment to be made of the company's operations, its financial position and its future business strategies and prospects.

11. A form of the OFR has been a matter of best practice for some time. The Accounting Standards Board (ASB) issued a statement of best practice for an OFR in 1993 and a revised statement in 2003. The Company Law Review established by the Government in 1998 to undertake a fundamental review of British company law considered the matter of company reporting and commented:

"Company accounting and reporting remains essentially backward looking and based on financial indicators. There are few statutory requirements to report on the main qualitative factors which underlie past and future performance (or for future performance, even financial factors) – in particular on strategy, prospects, opportunities and risks; on intangible, and so-called "soft" assets (which may contribute significantly to success but are not well captured in traditional financial statements); and on key business and wider relationships.

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As a result, the information provided is defective and directors do not have the discipline of accounting for stewardship on some key responsibilities.” (CLR: Developing the Framework, March 2000 paragraph 5.19).

12. Consequently, the Review recommended in its final report (July 2001) that companies of significant economic size should be required to prepare and publish an OFR.

13. In July 2002 the Government published a White Paper Modernising Company Law (Cm 5553 – I & II). The White Paper set out the Government’s position on many of the Review’s proposals including the OFR. The Government agreed with the CLR’s recommendation and contained some illustrative clauses on the OFR designed to aid discussion. The responses to the White Paper were mostly supportive of the principle of a statutory OFR though there was a wide range of views on the detail.

14. The enhanced requirements for a business review, to be contained in the directors’ report, form a relatively minor part of a package of requirements and improvements introduced by the Modernisation Directive. Given the similarity of rationale (greater transparency) and potential degree of overlap between the EU requirements and those of the OFR, the Government wishes to consult on both measures in the same set of draft Regulations. Other requirements deriving from the Modernisation Directive are subject to a separate consultation³.

(iii) Risk assessment

15. As far as the OFR is concerned, failure to establish a statutory OFR in the terms proposed will mean that existing reporting arrangements of quoted companies will continue to provide inadequate information to members. Continuing to leave the decision whether or not to prepare an OFR to companies themselves could result in members not having sufficient information to understand and assess the businesses in which they have invested and to hold the directors to account. It will also reduce the possibility of comparing companies’ performance across the board.

16. The Accounting Standards Board statement on the OFR is designed to be persuasive rather than mandatory and although many companies are already producing high-quality reports, compliance is uneven, particularly outside the FTSE 100. If best practice is to be extended a mandatory requirement is needed.

³ *Modernisation of Accounting Directives/IAS Infrastructure*, March 2004. http://www.dti.gov.uk/cld/pdfs/ias_infrastructure.pdf

17. As far as the enhanced requirements for a business review in the directors' report are concerned, similar considerations apply: failure to improve the scope and nature of reporting will result in less useful information for members of the companies concerned. Failure to implement this Directive requirement would cause the United Kingdom to be in breach of its Community obligations.

III Options

18. There is no simple categorisation of the options available due to the complex nature of the OFR and its interplay with the requirements under the Modernisation Directive. There are of course a significant number of options as to which companies should prepare an OFR, together with overlapping options on matters of content, auditor review and enforcement. For practical reasons it is not possible to set out every permutation available. The four options selected represent broad choices whilst permitting discussion on some of the detailed points.

Option 1

Do nothing.

19. This is not possible in the case of the enhanced review of the business in the directors' report as it would put the UK in breach of an EU obligation. It would be possible to keep the OFR voluntary. Quoted companies would thus only be subject to the enhanced disclosure requirements of the Modernisation Directive. However, experience to date suggests that this will not lead to the improvements in the quality of reporting that we are seeking.

Option 2

Implement the expanded directors' report requirements required under the Modernisation Directive but do not introduce a statutory OFR.

20. Requiring a description of the risks and uncertainties facing the business would enhance the existing statutory requirement for a fair review in the directors' report. The review would have to be balanced and comprehensive, consistent with the size and complexity of the business, and the analysis would have to include key performance indicators relevant to the particular business.

21. The Modernisation Directive also amends the requirement on the auditors' report in respect of the directors' report. Currently, auditors are required to consider whether information in the directors' report is consistent with the accounts, and if the two are inconsistent this fact should be stated in the auditors' report. The change would require auditors to express a positive opinion as to the consistency or otherwise of the information in the directors' report.

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22. The provision of OFR-type information (e.g. more forward-looking information) over and above statutory requirements would continue to be on a voluntary basis, although this might be influenced or driven by best practice, market expectations, and pressure from investors and other interested parties.

23. The underlying assumption of this option would be that a voluntary approach to the OFR would deliver the most appropriate disclosure necessary to meet the needs of shareholders, the markets and other interested parties and that it would allow for innovation and development in a way that legislation would not. Under this option directors have the opportunity to demonstrate that their companies are well run, gaining a competitive advantage over those that choose not to follow best practice.

24. The risk is that experience over 10 years of the voluntary standard has shown best practice remains restricted to the very largest companies, even within the category of quoted companies, and fails to deliver improving standards across a wider cross-section of companies. There is also a danger that directors have too much discretion and can thus pick and choose the matters to report, producing reports that are uneven in content and designed to present the best possible gloss, rather than a balanced and comprehensive view that will allow for a full understanding of the directors' view of the business. Comparison between companies would be restricted to partial rather than complete information. An expanded directors' report, reviewed by auditors, will provide for a fair review of a company's performance, including an assessment of the principal risks and uncertainties. However, experience to date suggests that, without a statutory OFR, the more substantive information we are seeking from quoted companies will not be forthcoming.

Option 3

Implement the expanded directors' report requirements required under the Modernisation Directive and introduce a statutory OFR for quoted companies without any requirement for an auditors' review of the OFR.

25. Option 3 would require companies to disclose all the additional information that would be required by Option 2. In addition, Option 3 would require the directors of a quoted company to prepare an OFR. The onus would be on directors themselves to give their own account of the matters that are important in assessing the business. There would be no role for the auditors.

26. The assumption is that this approach would deliver improvements in understanding business performance and prospects, accountability and standards of business practice. Best practice would be extended more widely

than the very largest companies. GB companies would benefit from the increased transparency requirements at home and internationally. Companies that demonstrate they are well run and responsible are likely to find it easier to raise capital.

27. The risk of Option 3 over Option 2 is that introducing the OFR in legislation would make OFRs less flexible and could make directors more likely to be defensive in what they disclose. This might reduce the quality of information provided rather than improve the current position. The risk of Option 3 over Option 4 is that, without any involvement from the auditors, there would be less pressure on the directors to be thorough in their preparation of the OFR and shareholders would have less assurance. Such reports may fail to strengthen confidence in the market.

Option 4

Implement the expanded directors' report requirements required under the Modernisation Directive and introduce a statutory OFR for quoted companies, together with an auditors' review of the OFR.

28. Option 4 would require companies to disclose all the information that would be required by Option 3. Furthermore, Option 4 would require the auditors to examine whether the directors have taken appropriate steps to satisfy themselves that the OFR presents a balanced and comprehensive analysis of the company's business. In doing so auditors will need to satisfy themselves that each material statement of fact is accurate, each statement of opinion has been made after due consideration and statements made in the OFR are not inconsistent with the accounts and matters that have come to their attention during the course of the audit.

29. The risk with option 4 is that requiring an auditors' review of the OFR would result in reports that are more costly to prepare. This may lead to less innovation thus hampering the development of best practice.

IV Costs and benefits

(i) Business sectors affected

Option 1

30. The "do nothing" Option 1 would not affect any companies. There would be no change to the existing directors' report requirements and no mandatory requirement for an OFR. As a result, the risk of differing reporting standards and quality and lack of comparability between companies will continue. No additional costs would arise.

Option 2

31. The implementation of the enhanced directors' report under the Modernisation Directive would affect all companies required to prepare a fair review of the company's business in their directors' report. Small companies will be exempt from the requirements so in effect the provisions would catch medium-sized companies or above⁴. Several existing statistical reports, including for example an August 2003 research report for DTI by ICC Information Ltd on the GB company population, reflect the old thresholds for definition of small, medium and large companies. The new, higher thresholds apply in relation to financial years ending on or after 30 January 2004, under the Companies Act 1985 (Accounts of Small and Medium-Sized Enterprises and Audit Exemption) (Amendment) Regulations 2004 (SI2004/16). ICC Information Ltd put the number of "live" medium and large companies in Great Britain at 95,000. However, this number is almost certainly an over-estimate because of the effect of increasing the thresholds. A revised set of numbers will be prepared for the final Regulatory Impact Assessment and will include final estimates of implementation costs.

32. The changes to the wording of the auditors' report would affect those companies that are required or voluntarily opt to have an audit⁵. As above we provisionally estimate there to be 95,000 companies affected.

33. The ASB's statement would remain the relevant best practice guidance. It is drafted with listed companies in mind, but is also applicable to other large entities where there is a legitimate public interest in their financial statements. Any extension beyond those companies currently preparing OFRs in line with best practice would be demand driven.

Option 3

34. The introduction of a mandatory OFR will directly affect all quoted companies. "Quoted" is defined in section 262 of the Companies Act 1985:

" "quoted company" means a company whose equity share capital

(a) has been included in the official list in accordance with the provisions of Part VI of the Financial Services and Markets Act 2000; or

⁴ The definition of a small company is currently one that meets two or more of the following requirements in their first financial year, or in the case of a subsequent year, in that year and the preceding year: turnover not more than £5.6 million, balance sheet total not more than £2.8 million, number of employees not more than 50. The definition of a medium-sized company is one that meets two or more of the following requirements: turnover not more than £22.8 million, balance sheet total not more than £11.4 million, number of employees not more than 250. These thresholds apply in relation to financial years ending on or after 30 January 2004 (Section 247(3) of the Companies Act as amended by The Companies Act 1985 (Accounts of Small and Medium-Sized Enterprises and Audit Exemption) (Amendment) Regulations 2004(SI 2004/16)).

⁵ Under the current section 249A of the Companies Act 1985, companies meeting the following criteria are exempt from the requirements to have an audit: turnover not more than £5.6 million, balance sheet total not more than £2.8 million.

(b) is officially listed in an EEA State; or

(c) is admitted to dealing on either the New York Stock Exchange or the exchange known as Nasdaq;

and in paragraph (a) "the official list" shall have the meaning given it by section 103(1) of the Financial Services and Markets Act 2000."

35. We estimate the number of companies caught by this definition to be 1,290. There are around 1,260 GB companies whose equity share capital is included in the official list. There are approximately 30 GB companies not on this list but with equity share capital listed in the EEA, or traded on the New York Stock Exchange or Nasdaq.

36. There are a number of organisations that choose to follow the Companies Act 1985 reporting requirements even though they are not directly bound by the legislation. Such organisations may also follow the OFR requirements in due course. This may happen as a result of either option 3 or 4.

37. The proposals would require the preparation of OFR standards. This would require initial work from the Accounting Standards Board, followed by review from time to time. The Financial Reporting Review Panel would consider possible failures to comply with the content requirements of the Act, whether relating to the OFR or to the enhanced requirements for the business review in the directors' report. The FRRP preliminary estimate of its costs for enforcement is £500,000 per annum. We expect that the costs for a company whose OFR is challenged by the FRRP would be similar to those of an FRRP inspection of accounting standards. From soundings with accountancy practitioners, we can estimate the existing cost in time to an average company and its auditors of a single FRRP inspection in the following way:

- average management time: 20 hrs to 60 hrs (the finance director, audit partner, audit manager and technical partner may be involved in an enquiry from the FRRP);
- legal advice: sought in about 20% of cases;
- auditors' time: 20 hrs to 60 hrs.

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Option 4

38. The same companies and organisations would be affected under either option 3 or 4.

39. The proposals under option 4 would affect the auditors of these companies, as they would be required to express an opinion on the OFR as part of their auditors' report and train staff accordingly. The costs of this will be included in the auditors' fees (see paragraph 71). Although in theory there are a large number of auditors eligible for appointment as company auditors⁶, in practice only the largest audit firms currently perform the audits of quoted companies. There may be a familiarisation cost to auditors, though we would not expect this to be extensive.

(ii) Benefits

Option 1

40. Additional benefits to this option accrue to companies and auditors only, insofar as this option would not require either to familiarise themselves with new rules. However, existing best practice is not sufficiently consistent or of high enough quality to provide comparability and transparency for shareholders.

Option 2

41. The enhanced requirements will promote consistency and give additional guidance concerning the information which a "fair review" is expected to contain. The directors' report would provide additional information on the risks and uncertainties facing the business and would include, in the analysis of the business, key performance indicators relevant to the business. The change in the audit requirement of the directors' report to produce a positive statement of consistency with the accounts will result in greater clarity and certainty.

42. Companies would be able to continue developing their OFRs in line with best practice. This would allow companies the freedom to innovate and develop best practice. There would be no legislation on this matter.

Option 3

43. Option 3 will provide the same benefits as with Option 2 regarding the enhanced requirements of the directors' report.

44. Option 3 would require the directors of quoted companies to prepare OFRs. The information in the OFR would be linked directly to those trends

⁶ The rules setting out the eligibility requirements for appointment as company auditor are set out in section 25 of the Companies Act 1989.

and factors underlying the performance of the business and would include a forward-looking element to permit shareholders to assess the strategies of the business and the potential for those strategies to succeed. It would therefore focus on matters that are relevant and meaningful to shareholders.

45. We expect leading companies to benefit from the discipline of preparing an OFR. During the Company Law Review, the Industrial Society (now known as the Work Foundation) carried out research with five companies, which prepared OFRs on the lines initially proposed by the Review⁷. It suggested that the information generated by the preparation of the OFR is a benefit to the company in its own right. The OFR reporting requirements would encourage directors to consider a wide range of factors within and outside the company, relevant to the business and key to delivering high performance.

Option 4

46. Option 4 would provide all the benefits of Option 3 and in addition would include an appropriate level of assurance provided by the auditors' review.

47. The auditors' review would introduce a level of rigour and due diligence to the reporting process that would otherwise be absent. It would ensure that the directors prepare the OFR conscientiously with due regard to the balance between good news and bad. Shareholders would receive an independent opinion from the auditors providing a high level of assurance that the directors had prepared the OFR after due and proper enquiry, that it was consistent with the financial statements and that no matters had come to the attention of the auditors that they consider inconsistent with the information and statements contained in the OFR.

48. The Government welcomes comments from respondents on the benefits of the proposals.

(iii) Costs

Option 1

49. Failure to implement the Modernisation Directive requirements in respect of the directors' report runs the risk of infraction proceedings being brought against the United Kingdom for failure to implement the requirements of the directive.

⁷ The Industrial Society's report (Company Law Review Research Project – Final Report), is available on the DTI website www.dti.gov.uk/cld/industrial.pdf

Option 2

50. Option 2 will not impose a cost to small companies as they are exempt from providing a fair review in the directors' report under section 246 of the Companies Act 1985.

51. We do not anticipate the cost of preparing the directors' report to increase significantly. Companies are already required to prepare a directors' report and the new requirements emphasise the need for the review to be consistent with the size and complexity of the business.

52. Many companies already produce business risk assessments and identify the key performance indicators relevant to the business. For such companies the increase in costs is likely to be marginal. The initial costs would be greater for those companies that need to introduce systems in order to meet the new requirements. We estimate the increased costs of preparing a directors' report, as a result of the requirement for an enhanced review of the company's business, to increase on average by around £500 – £1,000 depending on the size of the company and what systems they will need to introduce. Costs to prepare a directors' report for subsequent years will be significantly less as the initial systems will have been introduced. We will do further work on this issue and would welcome comments on this estimate. Such comments will enable us to give better information in the final Regulatory Impact Assessment.

53. It is difficult to get a hard and fast idea of what impact the revised audit requirement to produce a positive statement on the directors' report would have and what additional work auditors would carry out in order to arrive at an opinion. Currently the work carried out by the auditors in respect of the directors' report focuses on reading the report, considering any apparent misstatements therein, or any material inconsistencies with the financial statements, and seeking to resolve any difficulties through discussion with the directors. The impact of the new requirements on workload and auditor liability is expected to be minimal.

54. SMEs have commented that the auditors may need to do substantially more than this when asked to issue a positive statement of consistency. For instance, in obtaining sufficient evidence to arrive at an opinion, auditors may feel obliged to review the company's methodology for identifying its principal risks and uncertainties. This could then have an impact on the costs of preparation as management would have to spend additional time preparing information for the auditors. Of course, the requirement will only apply to medium-sized companies and above, not to small companies.

55. We have not been able to obtain any agreed assessment of the effect of the enhanced business review on audit costs for medium and large companies. We have received different suggestions ranging from little or no additional cost to £500-£5,000 depending on the size and circumstances of the company. We will do further work on this issue and would welcome evidence on whether there will be additional audit costs, and if so, what those costs might be. Such evidence will enable us to give better information in the final Regulatory Impact Assessment.

56. Any decision by quoted or other companies to prepare an OFR beyond the statutory requirements for the directors' report would be a voluntary one. Any additional costs to the company would also be voluntary. A recent survey of listed companies indicated that the number of companies producing either a voluntary OFR or following the broad recommendations in the ASB's best practice statement fell from 68% in 2000 to 61% in 2003. This compared with an increase of 46% between 1996 and 2000⁸. There is therefore no evidence to suggest a voluntary approach would lead to greater levels of reporting over time. Indeed there is a danger that reporting on information of an OFR nature may fall. This may provide savings to the companies themselves, but suggests the voluntary approach would not deliver any of the benefits of Options 3 and 4.

Option 3

57. The costs of the Modernisation Directive requirements would be as those stated above in Option 2. The additional costs imposed by Option 3 would be those imposed as a result of a statutory requirement to prepare an OFR for quoted companies set out below.

Costs of preparing an OFR

58. The Industrial Society's report includes the following assessment:

"The general impression is that time and costs allocation was relatively minimal and not burdensome, when compared with the reporting process companies comply with now. In other words, companies appear to see the effort to produce an OFR as a marginal increase on the (substantial) work they do to publish the full report and accounts.

The main reason for this, to repeat a point that emerges earlier, is the fact that the companies tend to have most of the required information to hand, or, in several cases, already publish it in some form, or at least have well established systems for compiling such information.

⁸ "From carrots to sticks: A survey of narrative reporting in annual reports", Deloitte & Touche LLP 2003.

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Investment estimates vary relatively widely. Among the rough figures offered were these:

- maximum two days core work, in addition to requests to eight additional people to write a short section (i.e. additional to current reporting)
- between ten and twelve days for a one person equivalent
- additional cost of around £3,000 over and above sums committed to current annual review process
- one person-week equivalent primarily involving the time of the company secretary and group financial director.

Emphasising the pilot nature of this project, several interviewees refer to 'cut and paste' in the compilation of these OFRs, but add that for a real OFR – i.e. post-legislation – significantly more time, and probably expense, would be invested in the exercise.

One comment fairly sums up responses to this question: 'relatively painless to produce and less onerous than expected'."

59. A further small survey of companies likely to be required to complete an OFR was completed prior to the publication of the White Paper, *Modernising Company Law*. This showed that some believed the cost of preparing an OFR would be as much as £50,000, while others thought it could be produced at little significant cost. A number of larger companies said that their reporting already covers issues similar to those which would be included in the proposed OFR, so they would face little, if any, increased cost.

60. The actual costs are likely to be somewhere in between these two marks of £3,000 and £50,000. Inevitably a statutory requirement would require directors to apply additional care and attention in preparing the OFR. We therefore consider costs of the order of £3,000 per company likely to be on the low side. There will be additional costs as companies familiarise themselves with the new requirements. A statutory regime would necessarily require companies to apply additional care and attention, increasing the time spent on preparing the OFR overall and the proportion of time spent by the Board.

61. In the light of this we suggest a more realistic figure will be in the region of £5,000 to £15,000 depending on the size and complexity of the company, and whether the company had existing systems in place to gather and consider all the relevant information. The total costs to quoted companies of preparing an OFR could be in the region of £6.5–£19m (£5,000 x 1,290)–(£15,000 x 1,290).

Costs of preparing an OFR Standard

62. The Accounting Standards Board will prepare OFR standards. They estimate the initial cost for preparing the first OFR standard will be in the region of £200,000.

Costs of enforcing the OFR

63. It is difficult to estimate the cost of enforcing the OFR as the number of cases that the FRRP will need to respond to is not known. However, initial estimates are that it will cost the FRRP approximately £500,000 per annum. We expect the costs to companies investigated will be as described in paragraph 37.

Option 4

64. The costs of option 4 will include the costs of Option 3 and in addition the cost of the auditor review of the OFR.

65. The principal work involved in carrying out the auditor review of the OFR is described in paragraph 28. Although the 'due and careful enquiry' being proposed in relation to the role of the auditors has precedent in the Listing Rules in relation to listing particulars, there are no existing requirements directly equivalent to the OFR proposals. It is therefore difficult to estimate the additional costs the requirement for an auditors' review of the OFR is likely to impose. However, by reviewing existing requirements we are able to make broad comparisons to arrive at an estimate of costs.

66. Under current Listing Rules requirements in relation to the Combined Code, directors should review the effectiveness of internal controls and then provide shareholders with a summary of their review process. They should then report to shareholders on whether they have complied with the relevant provision of the Combined Code. The auditors consider the company's claim to have complied or not with the relevant provision of the Combined Code and where the auditors consider there is not proper disclosure the auditors report this.

67. This means determining whether the process described in the report and accounts is both supported by the documentation prepared by and for the directors and appropriately reflects that process. It also involves relating the statement made by the directors with the auditors' knowledge of the company obtained during the audit of the financial statements. The auditors are not asked or expected to consider whether the board's statements on internal

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control cover all risks and controls, or form an opinion on the effectiveness of the company's corporate governance procedures or its risk and control procedures.

68. Internal control reviews are so embedded into the corporate governance procedures of companies and in the work auditors carry out in respect of their audit of the financial statements that it is extremely difficult to determine accurately the marginal cost of these requirements. However, informal estimates received indicate costs of £5,000 per company, marginal relative to the cost of the audit.

69. At the other end of the spectrum, section 404(a) of the US Sarbanes-Oxley Act of 2002, and the Securities and Exchange Commission's related implemented rules, will require the management of a public company to assess the effectiveness of the company's internal control and to include, in the company's annual report to shareholders, management's conclusions as a result of that assessment about whether the company's internal control is effective. The auditors will be required to attest to, and report upon, management's assessment of the effectiveness of internal control. In other words, the auditors will have to form an opinion, not as to the board's process for assessing effectiveness, but as to whether or not the auditor concurs with the board's view as to the effectiveness of their internal controls.

70. Companies do not have to reflect compliance with the new rules yet and therefore only estimates are available of the typical costs of compliance. The Securities and Exchange Commission have estimated the cost per company to be \$91,000.⁹

71. The OFR proposals fall considerably short of the Sarbanes-Oxley requirements but are more onerous than those required under the Combined Code. We estimate that fees in relation to the auditors' review of the OFR might increase audit fees by the order of 5%, or £19,000 (based on an average audit fee of £385,000 for quoted companies). When taken together with the average, mean internal costs of preparing the OFR of £10,000, the average cost burden on companies under Option 4 would be £29,000 per company. On this basis, the total cost to quoted companies of audit fees for auditors' review of an OFR is estimated to be £25m (£19,000 x 1,290).

⁹ U.S. Securities and Exchange Commission, Final Rule: Management's Report on Internal Control over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports <http://www.sec.gov/rules/final/33-8392.htm>

72. The Government welcomes comments on the possible costs of the proposal.

V Equity and fairness

73. The CLR was concerned not to impose disproportionate burdens on smaller quoted companies and loading new requirements on companies at the stage they are going public. We do not believe the proposals for the OFR will do so. The information requirements for the OFR will vary according to the size and complexity of each individual business. The costs of the auditors' review will also be less for smaller quoted companies. We do not believe the proposals, whether for the OFR or for the enhanced review of the business to be included in the directors' report, will have a disproportionate affect on particular groups.

74. The Government welcomes comments on whether the proposals would disproportionately affect particular companies.

VI Small Firms' Impact Test

75. The Small Business Service accept that the OFR proposals and the enhanced requirement of the fair review required by the Modernisation Directive will not apply to small businesses. The Small Business Service have asked us to estimate the costs to medium-sized companies, please see paragraphs 52 and 55.

76. The Government welcomes comments on the possible costs of the proposals on small and medium-sized enterprises.

VII Competition assessment

77. The Modernisation Directive proposals will have no significant adverse impact on markets.

78. The OFR proposals will initially affect GB companies listed on the London Stock Exchange. Non-GB companies on the same market will not be obliged to prepare an OFR, although the FSA has indicated they should do so as best practice. Other markets in the UK (e.g. the Alternative Investment Market) and overseas markets have no directly equivalent requirements. The proposals could therefore influence whether a company applies for a listing on the London Stock Exchange or chooses to raise capital from an alternative source. The proposals could also have a marginal influence on the choice of country of incorporation for new, quoted companies.

79. The Government welcomes comments from respondents on this assessment.

VIII Enforcement and compliance

80. The reports currently required of the directors under Part 7 of the Companies Act 1985 are the directors' report and the directors' remuneration report. The latter was introduced in 2002 but the directors' report has been in existence for many years. Failing to prepare either of these reports, and a failure to comply with the content requirements of the Act, are currently subject to criminal sanction.

81. The Government considers that administrative measures may be more suited than criminal sanctions to the enforcement of requirements that contain a high degree of judgement. There is already an administrative procedure (alongside criminal sanctions) for the enforcement of accounting requirements. Currently the Secretary of State (or the person authorised on her behalf – the Financial Reporting Review Panel) may apply to the court for a declaration that the accounts do not comply with the requirements of the Act and for an order requiring the directors to prepare revised accounts. The draft Regulations would introduce an administrative enforcement regime, alongside criminal sanctions for both the directors' report and the OFR by extending the scope of the current power of the Secretary of State, or a person authorised on her behalf.

82. There may be some difficulties with enforcement because of the inherent subjectivity in the disclosure requirements, in particular the directors' judgement of what needs to be included as "material" to an understanding of the business; or perhaps more likely, their judgement that certain matters may be omitted as not being "material". As best practice develops for example over a period of 2–5 years and industry expectations emerge it may be possible for the enforcement regime to be more robust in challenging company reports where there are questions concerning whether the report meets the requirements of the Act.

IX Consultation

(i) Public consultation

83. The Government has already consulted widely on the OFR proposals when these were contained within the White Paper, *Modernising Company Law*, published in July 2002. The policy had been developed previously as part of the wide-ranging review of company law, and was twice subject to consultation during that review, including a special research project. Responses to all these consultations have demonstrated broad support for the OFR proposals. A breakdown of the responses received to the White Paper is available from the Department's website www.dti.gov.uk/cld/modern/index.htm

(ii) Within Government

84. The Department of Trade and Industry has consulted with the Small Business Service, Companies House, Department for Environment Food and Rural Affairs, HM Treasury, Department for Work and Pensions, and the Financial Services Authority.

X Monitoring and review

85. The Department of Trade and Industry keeps under review the reporting requirements of Part 7 of the Companies Act 1985, where the new OFR and enhanced directors' report requirements will be included. The Government intends to review the effects of the statutory OFR after a suitable period of approximately five years. The Accounting Standards Board keeps under review the standards it issues and will advise if further changes are needed to the OFR.

XI Summary and recommendation

86. The table below shows a summary of the costs and benefits of the proposals:

87. The Government proposes to implement Option 4.

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Option	Cost	Benefit
1. Do nothing	Risk of infraction proceedings for failure to implement the requirements of Directive.	No benefits
2. Implement the expanded directors' report requirements required under the Modernisation Directive but do not introduce a statutory OFR.	<p>Estimated range of internal costs for medium and large companies to preparing a directors' report is £500-£1,000.</p> <p>Estimated audit costs for medium and large companies: £0-£5,000 (see paragraph 55).</p>	Increased consistency and fuller information in company fair reviews.
3. Implement the expanded directors' report requirements required under the Modernisation Directive and introduce a statutory OFR, but without any requirement for an auditors' review.	<p>Costs for option 2 as above.</p> <p>Costs in the region of £6.5m-£19m to quoted companies for preparing an OFR.</p> <p>Cost of £220,000 to the ASB for preparing the first OFR standard.</p> <p>Cost of £500,000 to the FRRP for enforcing the OFR</p>	Greater transparency and accountability by improving discussion and analysis of the business, the main drivers of performance and the strategies adopted by the business.
4. Implement the expanded directors' report requirements required under the Modernisation Directive and introduce a statutory OFR, together with an auditors' review.	<p>Costs of option 3 as above.</p> <p>Cost of auditors' review of the OFR to quoted companies of £25m.</p>	Greater transparency and accountability, coupled with an assurance that the directors had taken due and proper care. Greater strengthening of confidence in the market place.

Annex E: Code of Practice on Consultations

1. Consult widely throughout the process, allowing a minimum of 12 weeks for written consultation at least once during the development of the policy.
2. Be clear about what your proposals are, who may be affected, what questions are being asked and the timescale for responses.
3. Ensure that your consultation is clear, concise and widely accessible.
4. Give feedback regarding the responses received and how the consultation process influenced the policy.
5. Monitor your department's effectiveness at consultation, including through the use of a designated consultation co-ordinator.
6. Ensure your consultation follows better regulation best practice, including carrying out a Regulatory Impact Assessment if appropriate.

The complete code is available on the Cabinet Office's web site, address <http://www.cabinet-office.gov.uk/servicefirst/index/consultation.htm>.

Comments or complaints

If you wish to comment on the conduct of this consultation or make a complaint about the way this consultation has been conducted, please write to Louisa Renwick, DTI Consultation Co-ordinator, Room 723, 1 Victoria Street, London SW1H 0ET or telephone her on 020 7215 6913 or email to: Louisa.renwick@dti.gsi.gov.uk



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