Comments on behalf of The Association of Corporate Treasurers on

Exposure Draft of Reporting Standard 1: The Operating and Financial Review

Accounting Standards Board, November 2004

Introduction

The Association of Corporate Treasurers (ACT)

Established in the UK in 1979, The Association of Corporate Treasurers (ACT) is a centre of excellence for professionals in treasury, risk and corporate finance operating in the international marketplace. It has over 3,300 members from both the corporate and financial sectors, and its membership includes representatives from 95 of the FTSE 100 companies.

The ACT has 1,500 students in more than 40 countries. Its examinations are recognised by both practitioners and bankers as the global standard setters for treasury education and it is the leading provider of professional treasury education.

The ACT promotes study and best practice in finance and treasury management. It represents the interests of non-financial sector corporations in financial markets to governments, regulators, standards setters and trade bodies.

Contact details are provided on the last page of these comments.

This Consultation

The ACT welcomes the opportunity to submit views on this topic to the Board.

We welcome the accessibility and brevity of the draft Reporting Standard and the clear intention of the Reporting Standard (and the Implementation Guidance) as far as possible to be helpful to preparers rather than to be overly prescriptive.

As this is the first Reporting Standard, we have taken the opportunity to make certain comments of general application to such Reporting Standards.

Our comments are organised as follows

- Summary of principal comments, page 2
- General Comments, page 3
- Specific questions raised by the Board, page 6,
- Other comments not arising from specific questions, page 8

We will be very happy to clarify or expand any comments.

February 2005

Summary of principal comments

- It is important that the Reporting Standard emphasise that the OFR goes beyond both the financial and the historical reporting elsewhere in annual reports.
- The Reporting Standard should use terminology consistent with the governing Companies Acts and Regulation.
- Emphasis should be on director's judgement on what is to be included and in setting out their views of future trends and developments. A very high level of unreasonableness of such judgments, without application of perfect hindsight after the event, should be required before directors risk incurring any penalty for those judgements.
- In the discussion of risks and uncertainties it is not possible to understand the implication of individual risks alone, but rather as part of an overall portfolio. Therefore the Standard should require directors to discuss their overall understanding and general approach to integrated risk management.
- There are a number of paragraphs of the Standard which we believe go too far or not far enough in requirements for disclosures.

General Comments

Background

The ACT welcomes the new approach to the OFR of which this Reporting Standard will be a key part.

Beyond financial reporting

First, it is important that the Reporting Standard not allow the OFR initiative to fall back towards a narrowly-based financial reporting mentality. It is an operating *and* financial review. It is noteworthy that 1. of Schedule 7ZA of the Companies Act 1985 (Operating and Financial Review and Directors' Report etc) Regulations 2005 ("the Regulations") uses the word "financial" only in relation to "the financial year": development, performance and position of the business and the company and the trends and factors affecting their future are not so qualified. While the ASB and the FRC generally are clearly creatures originating in financial reporting, we believe they need to and can look beyond that background in carrying out their new responsibilities in relation to OFR.

Secondly, we attribute great importance to the Regulations' inclusion of forward-looking aspects into the OFR. This requires setting out of a point of view rather than the historical accountability (to members) implicit in the traditional annual report. The Reporting Standard should not allow directors minimise attention to this aspect in OFRs, while recognising that directors will need to qualify forward looking statements to avoid their becoming in any way actionable commitments.

Terminological consistency with governing instruments

We note that the terminology used for the reporting legal entity in the Exposure Draft is not that which we would have expected given this Reporting Standard's origin in the Regulations:

- the Regulations' "quoted companies" is replace by "entities".
- reference to "investors" rather than "members" (of the company)

We consider this use to be inappropriate. Further comment on this is made on page 8, below and variously in the context of certain paragraphs of the Standard.

Adherence to the statutory terminology will be important in all cases where the ASB is preparing Standards which implement legislation of the type relevant here.

Quotation from governing instruments

We find very helpful the FSA's practice of using typography in making clear in its Codes whenever something is a direct quotation from a governing act or Regulations – rather than the FSA's implementation, interpretation or explanation of that. We recommend adoption of that practice by the ASB in its Reporting Standards.

Consistency with other reporting requirements

We are concerned that as far as possible the OFR Reporting Standard be complementary to and consistent with other related initiatives, for example from the

EU and the FRC's current review of the Turnbull guidance. This may require regular revision of the Standard.

Complementarity with other reporting requirements

The comprehensiveness of the OFR can provide a way to overcome the narrowness of some other reporting requirements. The ASB should be alert to the opportunities here. It should avoid compounding the problems.

An example:

> The IASB's ED 7 on Financial Instruments disclosure.
>
> This requires discussion of risks and sensitivities to market risks arsing from financial instruments. It also seeks enhanced disclosure on capital, the policies applied to capital management and internal targets. Such narrow disclosures are at risk of being relatively meaningless or even misleading unless discussed in the context of the directors' overall understanding of the risks involved in all aspects of the company's activity and their general approach to integrated risk management, of which they are parts. The OFR is a natural home for discussion of the integrated approach to risk.
>
> 59 of the Framework refers to ED 7 – but again purely in a financial context, compounding the IASB's narrow view. The place for this is mostly in 50 ff "Risks and Uncertainties" in the context of other risks and the directors' views on their interactions and overall risk and its management.

The need for director judgement

Two areas of director judgement in relation to the OFR are very important.

- *Judgement on matter to be included*

  The requirement for directors fairly to set out matters affecting the future trends in the performance and position of the business and the company means that many factors may be relevant. Such factors will include matters which may not previously have been explicitly discussed in financial reporting and this is a welcome development. The Reporting Standard must not minimise this.

  On the other hand to keep the size of the Review reasonable, both good selection of the more important issues and concision in the writing will be necessary.

- *Judgement in setting out their views of future trends and developments*

  We note the recommendation at 3(i) for a caution about forward looking matter.

The need for directors to exercise judgement in these decisions should run throughout the Reporting Standard. The Reporting Standard is likely to be very important in influencing the mentality with which Directors approach the task of preparing an OFR. The Reporting Standard should then, within the limitations of the Regulations, emphasise that Directors need not fear penalty in making such judgements except in the most egregious of cases. Otherwise the views of directors' lawyers and a tendency to obscurantism will dominate content – rather than the views of directors themselves and the "interests of investors" (members).

Unknowns

Many items falling in the category of "known unknowns" which SEC reporting companies in the US are required to discuss in their Management Discussion and Analysis are potentially important to the OFR[1].

A few examples might be the outcome of major litigation, changes in regulation in regulated industries, reviews by health authorities of product safety.

And, from the area of most concern to the ACT, where a major bond issue by a company comes up for repayment in one or two years, a material "known unknown" would be whether or not replacement financing will be available on reasonable terms – or at all. This would be discussed in the context of Framework paragraph 62 and perhaps 70 as well as 50 ff.

We would regard a reminder in the Disclosure Framework (perhaps in 25 or in 50 ff) to directors that discussion of material "known unknowns" may be relevant to their OFR as helpful. That is because this is in direct contrast to the normal historical reporting frame of mind which directors will bring forward from the past..

[1] A useful discussion of US MD&A requirements, including for treatment of unknowns, by Robert D. Strahota, Assistant Director, SEC Office of International Affairs and others can be found at http://www.ewmi.hu/file.php?id=Presentation+-+Management's+Discussion+and+Analysis+-+September+10%2C+2002.ppt

Specific questions raised by the Board

Q1. *Do you agree with the proposed principles for the preparation of an OFR contained in paragraphs 5 to 24 of the draft text? Do you think that there are any other principles that should be included?*

Generally, yes. Detailed comments on some of paragraphs 5 to 24 are given in Other comments not arising from specific questions, starting on page 8

Q2. *Do you agree with the proposed approach whereby the [draft] Reporting Standard provides a disclosure framework rather than any more detailed list of requirements for the preparation of an OFR?*

Yes, strongly. We emphasise the application of the directors' judgement. These judgements will be an important differentiator between different boards.

We believe that the Reporting Standard would be improved by a new 26 following 25 drawing attention to the need for directors to integrate and relate the various topics covered within the framework and not to present them as compartmentalised, stand alone issues. How directors see that integration and relation is a key discriminator between boards.

Q3. *Do you think that there are any other elements to the framework that should be added in order to encourage focused and relevant reporting in the OFR?*

No. Detailed comments on some of the paragraphs in the framework are given in Other comments not arising from specific questions, starting on page 8.

Q4. *What are your views on the Boards proposal to extend the list of particular matters in paragraph 27 beyond those specifically referred to in the Regulations?*

We are supportive of this.

The list should, however, be expanded to include "creditors" and "investors other than members".

We are concerned about certain aspects of 27.

The footnote says that the wordings of 27.d to h "reflect" Schedule 7ZA's listing of "particular matters". 27 restricts itself to information necessary to meet the requirements of 26. 5(a) of Schedule 7ZA requires and confines itself to "matters essential to the business of the company". We doubt that 27.d achieves these requirements.

As discussed under Terminological consistency with governing instruments, page 3, above and page 8, below use of "shareholders" in 27.h, rather than "members of the company in respect of shares held by them" raises difficulties.

Additionally, 27.h does not to restrict itself to "receipts and returns in respect of shares" (5(b) of Schedule 7ZA). This is important as members may have dealing with the issuer of the shares in a variety of capacities, for example persons as employees, institutional investors as insurers. This generalisation is inappropriate.

Q5. *Do you agree with the proposal that the [draft] Reporting Standard should not specify any particular Key Performance Indicators (KPIs) that entities should disclose in the OFR, nor the number of KPIs that should be included?*

We strongly support this.

Q6. *Do you agree with the proposed disclosure requirements for KPIs set out in paragraphs 73 to 74? Do you think that they will encourage entities to report on KPIs or result in less disclosure?*

We do not believe that 73 and 74 will lead to less disclosure.

The apparent extensive requirements relating to each particular KPI is a great encouragement to directors to restrict themselves to a minimum number of simple KPI's. That is not a bad thing.

However, we do not understand why KPI requirements (74) should be different from those of other measures (75).

Quantified measures can be helpful. But poorly defined quantified measures can be misleading. Changes in the definition or information source for a KPI or other quantified measure used in more than one OFR should be disclosed. Directors should be discouraged from selective disclosure of quantified measures with no continuity from year to year according to what looks good at the time.

We think that concision in satisfying the requirements of 74 is important. And such concision should be applicable to 75, rather than a lower standard of disclosure.

Q7. *Do you agree with the proposal that the [draft] Reporting Standard should encourage other measures and evidence, both quantitative and qualitative, in addition to KPIs, to support the information provided in the OFR?*

Yes – again having in mind the need for careful selection and for concision.

Q8. *Do you agree with the proposal that where quantified measures, other than KPIs, are included the disclosure requirements should be less onerous than those for KPIs?*

See our comments in response to Question 6, above.

Q9. *Do you agree with the proposal that illustrative examples of KPIs should be given in [draft] Implementation Guidance that accompanies, but is not part of, the [draft] Reporting Standard?*

Yes. The examples are useful in illustrating the range of topics that can be illuminated by KPIs. But director judgement is the key to making them a useful feature of the OFR.

Q10. *What are your views on the [draft] Implementation Guidance? Are there any further examples that might usefully be provided?*

At this stage of implementation of new-style OFRs, any guidance companies can be given is of value.

Other comments not arising from specific questions

Terminological consistency with governing instruments

- The Regulations set up the OFR requirement for "quoted companies". The ED refers to entities.

  Should the ASB wish to issue a Reporting Standard which could be adopted as guidance on a voluntary basis by entities other than quoted-companies, such adoption should be dealt with in a separate section. This would clarify the non-mandatory nature of such OFRs and ask such entities to interpret the quoted companies' Reporting Standard in light of their own governing instruments and circumstances.

- Companies have different types of investors, not just shareholders.

  Use in the ED of "investors" rather than "members" is inappropriate.

  Under the Companies Acts, directors are to report to the company's members (i.e. shareholders), and not to other investors such as bondholders (even if the bonds are listed).

  Reference in 27 in the Framework to "shareholders" (reflecting Schedule 7ZA's use of "members of the company") implies that "investors" (used elsewhere for members) is a wider term than "shareholders" (i.e. members) – which we presume the ASB did not intend.

  The ACT did propose in comments made in response to the DTI Paper *Modernising Company Law* that especial consideration be given to information relevant to creditors and potential creditors (reflecting companies' use of the privilege of limited liability). "Creditors" here includes bondholders, lending banks, etc. On policy grounds, then, we would welcome a requirement for provision of "information relevant to the interests of investors" as including some creditors. However, our argument was rejected and, perhaps reluctantly, we suppose that the ASB should not go beyond the Regulations in this case.

  For regulatory consistency, retaining the terminology of the Regulations is important.

Comments on paragraphs of the Reporting Standard not addressed in specific questions, above.

8

We welcome the broad outlook encouraged by 8.

The ACT has urged especial attention to the information needs of creditors and potential creditors of limited liability companies as a condition of the use of the privilege of limited liability.

We would urge the addition of "creditors" to the list of interested categories in the second sentence of 8.

12

We consider the negative focus - on previous forward looking statements which have not been borne out by subsequent events - is unfortunate. We think that reference to the importance of reviewing previous forward looking statements, with particular attention to those not borne out by subsequent events would be better.

16 - 19

These strike an appropriate balance regarding content. We particularly welcome the wording in 19 regarding the "inclusion of too much information".

24

In 24 we are concerned at the implication of an expectation of similar issues being covered in different companies' OFRs.

For example, consider the soft drinks industry. The main players are Coca Cola, Pepsi and Cadbury Schweppes. Coke's main interests are in soft drinks. For Pepsi and Cadbury soft drinks are only one of two major areas of activity. Coke and Pepsi have global soft drinks operations. Cadbury has a global confectionery but only a regional soft drinks business. At the holding company level then, avoiding the "too much information" trap, matters which Coke might want to include may not make it into the Pepsi or Cadbury OFRs (were they all producing one). And in any case their judgements and conclusions of the implications of any particular matter can be expected to differ.

We attach great importance to directors' own analysis of their own company, its business and its environment. Accordingly, we would suggest revision of the last sentence of 24 along the following lines (the original text is italicised):

> While *Directors shall also consider … in the same industry or sector* they must make their own judgement, in their own circumstances, of what matters to include and how to deal with them.

This would also help reduce the development of routine industry classification boiler-plate, which 24 may otherwise encourage.

26.

26 seems to run together the ideas from A3 and A4 of Schedule 7ZA.

The "future development, performance and position" considered in A3 .d is of "the company and its subsidiary undertakings". It is not of "the capital structure, treasury policies and objectives and liquidity of the entity"[2].

We recommend that 26.c and d be replaced with a new sentence as follows (text taken from 26.c and d is italicised):

> Consideration of a and b above will require discussion of *the resources, risks and uncertainties and relationships that may affect the entitities*[2] *long-term value* and *of the capital structure, treasury policies and objectives and liquidity of the entity*[2].

[2] We have recommended that the terminology of the Regulations, "company", rather than "entity" be used throughout – see Terminological consistency with governing instruments, page 3 and page 8

27

Comments on paragraph 27 are made in response to Question 4, on page 6, above.

48 and 49 Resources

We would regard capital as a key resource of most businesses.

Reference to the "balance sheet" in 49 is in fact to the "top half" of an old fashioned balance sheet. Cross reference to provisions of the Framework section "Financial position" is important.

In the context of "Resources" the key issue is whether capital "resources available to the entity[2]" is a constraint or an opportunity for the business. This is particularly stark where a major re-financing is in contemplation because of inadequate capital resources. Directors will not want prematurely to reveal their hand in such cases. Outcome of such financing may however, be a material "known unknown[3]" and we find it difficult to think that where such action has been taken by a company, a recent OFR not making some reference to capital constraints could have been satisfactorily prepared.

50 ff Risks and uncertainties

These paragraphs tend to focus on consideration of specific risks and uncertainties. It is not possible to understand the implication of individual risks alone but only as part of an overall portfolio of risks and how they are managed and, ultimately, financed. We believe it is important to add to this part of the Reporting Standard a requirement for directors to discuss their overall understanding and general approach to integrated risk management.

Companies operating in regulated industries may have the equivalent of "covenants" included in their operating licences (they may lose the licence if financial ratios move to unacceptable levels). Companies with long-term contracts with customers, especially with the public sector, may have similar provisions in those contracts.

We believe that the general nature of any contractual or regulatory covenants or requirements referenced from the financial position of the company or group and which if breached could reasonably cause material disruption to the company or group should be disclosed in the OFR and this part of the Framework may be an appropriate place to refer to this.

Our comments, Unknowns, on page 5, are relevant to this part of the Framework.

61 and 62 – capital structure

First, 61 refers to "the capital structure of the business". This is unhelpful. How does "the business" relate to the company (or the company and its subsidiaries) or even the drafts' word "entity"?

62 lacks a requirement to relate the "capital structure" to the nature of the assets in the "top half" of an old fashioned balance sheet of the company or

[3] See Unknowns, page 5

group it is financing and its business and the risks involved. The discussion under 50 ff, Risks and uncertainties, is important.

62's reference to future financings is linked to our discussion of capital resources under 48 and 49, Resources, above.

69 ff Liquidity

Discussion here should be related to the discussion of cash flows, cash requirements and surpluses in 66 ff, Cash flows as well as 50ff, Risks and uncertainties.

71 and 72

71 refers to restraints on the group (taken to be the company and its subsidiaries) from exchange controls and tax consequences of funds transfers.

We believe that contractual constraints in financial contracts are in most cases rather more important.

72 which refers to constraints from loan contract covenants where there is an actual or expected breach or active anticipatory action. This is important and should not be removed from the Reporting Standard. We understand that where a listed company is in financial difficulty, the FSA regards the fact of the financial difficulty is a disclosable matter under the Listing Rules. The state of negotiations themselves on what to do about it may not be disclosable if such disclosure may materially affect the outcome. The Reporting Standard is compatible with this.

However, as an OFR may be prepared for a company and its subsidiaries, we believe that it is too broad.

Breach of covenant by a minor subsidiary undertaking within a group may be quite immaterial for group level reporting. Parent companies may often agree to local operating companies, especially for non wholly-owned bodies and especially in certain parts of the world, being subject to locally granted covenants etc. in financing contracts as a way of restraining local management and the influence of fellow shareholders. Note that cross-default within a group of companies is commonly limited to certain named companies or companies making up a certain percentage of the total assets or sales of the group, and cross default is always avoided in the cases being contemplated.

Thus a materiality provision related to the potential consequences of breach for the reporting company or the reporting group as a whole is essential for 72. The concept in 71 of "… where these represent, or might reasonably come to represent a significant restraint on the group" could be applied here.

On the other hand, 72 is rather narrow.

Covenants may be referred to as "covenants" or as "representations" or as "warranties" or as "events of default". 72 should apply to "covenants, however characterised".

72 confines itself to "covenants with lenders". Companies may include "covenants" in a range of financing contracts. "Covenants with lenders" should be replaced by "Covenants in financing contracts".

> 72 confines itself to "… of restricting the use of credit facilities". It should be extended to "or of financing arrangements, or of accelerated repayment of financial obligations" to include repayment of fixed loans (which are not "credit facilities") or bonds.

72 deals with the subject only after there is some difficulty. We believe that companies should disclose the general nature of material potential restrictions on access to finance even if at the time of writing the OFR breach is not in prospect. (See also our comments under 50 ff above.)

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