## ACT Comments on

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

Secretary of State for Trade and Industry, May 2004

# *Introduction*

**The Association of Corporate Treasurers (ACT)**

The Association of Corporate Treasurers was formed in 1979 to encourage and promote the study and practice of corporate finance and treasury management and to educate those involved in the field. Today, it is an organisation of professionals in corporate finance, risk and cash management operating internationally. A professional body and not a trade association, it has over 3,000 Fellows, Members and Associate Members. With more than 1,200 students in more than 40 countries, its education and examination syllabuses are recognised as the global standard setters for treasury education. Members of the Association work in many fields. The majority of Fellows work in large UK public companies, responsible for the treasury and corporate finance functions.

The ACT usually comments from the corporate and not the financial services sector standpoint.

# This Consultation

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

# *Summary of comments*

- Much depends on Standards yet to be issued. However, too strict requirements on content and director liability risk reducing OFRs to defensive, pointless blandness.
- "Safe harbours" for statements honestly made in good faith should be provided.
- The OFR should be subject to the same standards as the rest of the Annual Report. "Due and careful enquiry" seems to set new, higher, levels.
- The Auditor's role should be confined to process – not second guessing Directors' judgements.
- There is a risk that excessive expectations will be raised about the work of the FRRP. A phased approach to enforcement by FRRP is essential.
- The burden of introducing the OFR at the same time as International Accounting Standards for listed companies is too great. Deferment of mandatory OFR requirements is urged.
- Support is expressed for the Government's approach to CSR and environmental issues.
- Confidentiality provisions under the Listing Rules should be incorporated – subject to the Listing Rules' provision that the resultant disclosure is not misleading.
- The largest non-listed companies should be required to produce an OFR.

# *General comments*

In general the ACT supports the DTI approach to enhanced disclosures in the form of an Operating and Finance Review. There are however numerous very important points of detail where we believe changes and improvements could be made.

## Support for DTI approach to issues of Corporate Social Responsibility, environmental impacts, etc.

We are aware[1] that a number of NGOs have dismissed the government's approach to CSR issues[2] in the OFR – because the approach taken is that companies should report on such issues *as they affect the company*.

We also note that The OECD Principles of Corporate Governance[3] recognise that for companies "…factors such as business ethics and corporate awareness of the environmental and societal interests of the communities in which a company operates can also have an impact on its reputation and its long-term success." That is to say, long-term success of a company *for* its share-owners may depend on its attention to the interest of stakeholders *other than* its share-owners.

"Society grants legitimacy and power to business. In the long run, those who do not use power in a manner which society considers responsible will tend to lose it"[4]. Of course, formal permission for companies to exist, their rights and powers, and the rules they must follow are established through the mechanism of law and dependent regulation.

For them to endow companies with full, perceived legitimacy societies will also have supplementary, less formal expectations which change and develop. As the Secretary of State says in her foreword to the consultation document "We all have higher expectations of companies in the modern economy." These expectations can look to indirect and second and higher order effects of the companies' activities. They are reflected in customer discrimination in the market place and, more widely in society, by interested groups through direct actions or attempts to influence customers. Some of these "expectations" may eventually be added to the law and regulation – as happened with employment laws. But the wider expectations naturally develop outside formal structures and are potentially boundless.

The last point is key to why we agree with the DTI's approach to corporate reporting of CSR issues. Boards must have attention to the issues raised in the OECD and Davis's papers. The potential (or actual) impact of CSR and environmental issues, etc. on the company's future prospects is something directors can grapple with and in assessing that they need to look widely.

The DTI approach has the great advantage that it inherently provides suitable and dynamic limits for board reporting and these are essential to make reporting practical to achieve. It is potentially responsive to new issues as they are raised by the public – through NGOs or political processes. The alternative to the DTI approach is a massive, permanent, impractical programme of research by each company.

## Risk of pointless blandness

We believe that there is a risk in the proposals of reducing the OFR to pointless defensive statements and "tick box" "boiler plate", especially about factors affecting prospects, rather than encouraging clear explanations of relevant factors, risks and opportunities. Too strict a standard for statements and directors' liability and failure to provide suitable

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[1] "Voluntary groups shun DTI initiative", *Financial Times*, May 29, 2004

[2] Including "the company's impact on the environment and on the wider community, and its relationships with employees, customers and suppliers." (2.5 of the consultation document.)

[3] O.E.C.D., (Organisation for Economic Cooperation and Development), *OECD Principles of Corporate Governance*, April 2004 (available at http://www.oecd.org/dataoecd/32/18/31557724.pdf)

[4] K. Davis, "The case for and against business assumption of social responsibilities", *Academy of Management Journal*, 16 312-322, 1973

safe harbours would produce the wrong results as being too costly in management time, internal systems and external review costs.

Full understanding will of course depend on guidance yet to be issued by the Accounting Standards Board and Auditing Practices Board, but the framework of regulations within which they operate is very important.

### Standards setter

The presumption that complying with OFR standards will satisfy statutory requirements is very welcome.

Any Standards should positively state incidentally that the inclusion of material not "*necessary* for an understanding of the business" will not be in the spirit of the standards. "Padding" is a potentially effective way of undermining the utility of the OFR. If the OFR comes to resemble the main body of listing particulars, it will have failed in its objective.

## *Responses to specific questions*

**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?

> No comment. Note, however, our point on para 5 of Schedule 7ZA in answer to Q.5 below.

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

> No. We believe the requirement should be extended beyond quoted companies.
>
> Because of the focus on shareholders as recipients of the OFR coupled with the rather doubtful implicit assumption that non-listed companies' shareholders are in a position to achieve similar disclosure by direct contact and the points made in 3.11 of the consultative document about the dispersed market for listed company shareholders, non-listed companies have been excluded.
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> Non-listed companies are however subject to the Modernisation Directive with exceptions only for very small companies (defined as small and medium sized companies). The Modernisation Directive omits important matter, particularly matter related to prospects, which is dealt with in the OFR.
>
> We regret the government's change of mind from supporting the CLR's view that larger non-listed companies should also be required to prepare an OFR. Over and above the CLR's arguments, we take this view because of our view of the importance of creditors as a constituency for receipt of corporate information Although not reporting directly to or for creditors, this class will be interested in having available OFR type disclosures, even in the case of non listed companies.
>
> If the government continues to have reservations on this point we would urge that a category for this purpose of "very large" non-listed companies, perhaps with a turnover of more than £250m, be subject to the requirement.
>
> Companies for which an OFR is not mandatory should be able to decide to publish an OFR. If they do so, they should be subject all the requirements of the OFR – and be able to benefit from comparable confidentiality and safe harbour provisions (see our responses to Questions 14 and 15).

After a body of experience has built up about OFRs, larger public interest bodies, for example Registered Social Landlords, PFI projects and charitable organisations, should be required to produce an OFR on similar terms.

**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?

We agree strongly with inclusion of this as a specific requirement.

We are able to elaborate on this if required. Suffice it to say here that policies and practices in these areas – which must be linked to the general risk identification, risk management and risk financing polices of the company – are crucial to an understanding of the risks and opportunities of the company and to its prospects.

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 important here[5].

**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?

Such a provision would not be helpful. It would encourage a defensive, "box-ticking" approach and inclusion of non-essential matter.

If some provision of this kind is adopted, however, a required simple statement that the directors have had regard to paragraphs 4 to 7 in considering the contents of the Report would suffice.

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

Yes, generally, but we comment on two particular aspects.

- Para 5 of the Schedule requires "information about…the persons with whom the company…have relations (whether contractual or otherwise) which are essential to the business…". This wording would appear to require those persons to be named, which could be very difficult given the breadth of the word "essential". For example, suppose the group makes significant use of third party licences to enable it to use processes or trade marks in the manufacture or sale of its products. Obviously this fact is important and should be disclosed. But if no individual licence was fundamental to the group, neither it nor the identity of the licensor should have to be disclosed – yet it would have to be as para 5 is worded, as the licence would be "essential" (i.e. legally required) to enable that particular process or trade mark to be used by the group. We would suggest substituting "of fundamental importance" for "essential"

- In 6 of the Schedule, use of the term "key performance indicators" as matters for disclosure makes the provisions very wide. KPIs are established within companies in relation to many sectors of business and at many levels and for many purposes. In 6(2) of Schedule 7ZA, restriction to those KPIs by which effective measurement of the

[5] A useful discussion of US MD&A requirements 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

development etc. of the "business as a whole and which the directors consider appropriate to the company's circumstances" and not merely "business" would confine discussion appropriately. It seems unlikely that similar restriction could be achieved in reporting Standards.

In addition see our response to Q.14 regarding disclosure of confidential information.

**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?

First, while we note that (b) and (c) of the inserted (3A) seem to be required by the Modernisation Directive, they appear to go to content - beyond process (only (a) is limited to process). We can envisage it becoming more common for the auditors, in complying with (b) and (c), to have to second-guess the directors' judgments, as the auditors will be aware of all the matters that the directors will have taken into account in forming their judgments. If the auditors disagree with those judgments, it is quite possible that they will have involved some question of consistency with the accounts, which is the ground covered by (b) and (c).

As regards "due and careful enquiry", we find the wording unhelpful. It seems to be a very high standard to require – especially if "due" is assessed retrospectively. The standard required should not exceed that of other reports and accounts. As noted above, the wording of Standards from the APB and ASB will be very important in forming a view of the actual impact of any particular words.

Regarding auditor involvement, it is worth noting that most boards will ask for a "comfort statement" from their auditors to the effect that in so far as the OFR refers to matters dealt with in other reports or accounts of the company they are consistent with those other reports and, generally, that the auditors in course of their normal reviews generally have not come across anything which would conflict with facts stated or opinions given in the OFR – and their insurers are likely to ask for this to be done.

As currently drafted, there could be considerable extra audit work involved and an inevitable escalation of costs. Auditors' roles should generally be limited to comment on process and they should not be opining on directors' judgements in operational and financial matters.

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

We believe that others are better placed to provide such an estimate.

**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?

We regard the *current* processes of the FRRP as working well.

However, it is too early to tell whether the new proactive role of the FRRP will (a) work well, and (b) be considered by others to do so. The new proactive regime places a very heavy perception burden on the FRRP. It runs the risk of creating unreasonable expectations in the minds of the public/analysts/journalists.

There is a danger that this will be even worse with the OFR. It is important to provide a framework which will help preserve the credibility of the FRRP.

It seems most unlikely in reality that the FRRP (or any other agency) will be able to "enforce" the OFR's requirements effectively. In contrast to the auditors' role, which focuses on *process and consistency with the accounts*, no such limitation is proposed to be placed on the FRRP's role. If the auditors have not unearthed a serious problem, it is difficult to imagine that FRRP will be able to do so. This seems especially so given that the OFR requirements will necessarily be vaguer, in their application to a particular case, than the relevant accounting requirements and much more based on judgments than compliance with accounting requirements would involve.

A further barrier to enforcement is likely to be para 9 of Schedule 7ZA, which arguably introduces a mandatory requirement for a 'comply or explain' type of approach. The provisions of the Schedule will be mandatory by law. The Standards will presumably cover the categories within the Schedule but yet para 9 appears to allow non compliance if suitably explained. This gives the FRRP an impossible enforcement task in that a company may decide not to comply with any element.

An alternative approach might be to incorporate a true and fair (or balanced) view override, so that certain categories of disclosure may be omitted if necessary to give such a true and fair (or balanced) view.

Experience may help to adjust expectations, to provide a body of cases to assist Standards setters and to help companies and the FRRP in reaching judgements.

Accordingly a gradual phasing in of FRRP activity seems to be appropriate – with its actions limited in early years perhaps to publishing commentaries, allowing accommodation by Standards setters and reporting companies, with stricter enforcement only following that period of "bedding down" and only if real enforcement is practicable.

**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?

No comment.

**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.

While 2005 may be more easily accommodated by companies which have already been producing an OFR, we believe that it is not appropriate generally. Listed companies will be facing introducing IAS accounts for 2005 – the impact of which is very significant for some companies. Accordingly, while some companies will be able to move earlier on a voluntary basis, we recommend that 2006 be the earliest year for mandatory introduction.

In any case we believe that ASB and APB consultation on Standards should not be be rushed and deferment of mandatory introduction will facilitate a much better consultation process.

If ASB and APB Standards are not available very early in 2005, a further year's delay should be provided.

If our recommendation that the requirement be extended to very large non-listed companies were to be considered, years beginning 1 January 2008 would be more appropriate for them.

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

As referred to in other comments.

**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?

We believe that all shareholders should be *entitled to* receive the OFR but question the value of mailing the full report to all shareholders.

The OFR ought to be limited to matter which is necessary to gain a proper appreciation of the company; therefore, there ought to be no scope for a summary - and to provide for one might send the wrong message about the OFR itself.

For those shareholders who have elected to received only the Summary Financial Statements, it should be sufficient to include reference to the availability of the OFR and the topics it deals with.

**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?

There appears to be no benefit in requiring duplication in the OFR of information about corporate governance. Duplication would be even more discouragement for people to read the OFR. If it is pertinent to other matter in the OFR (aspects would commonly be pertinent to risk management processes) corporate governance material already included elsewhere can be incorporated by reference rather than repeated. If certain aspects of corporate governance are especially important, the FSA rule 12.43 statements can be partly reproduced in the OFR – but this should be at directors' discretion.

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

Our comments in response to the Modernising Company Law White paper are still pertinent (although the standards setter will not be the Standards Authority):

> The most difficult area is the discussion of the prospects for the future.
>
> Premature indication of plans for new products or to enter new markets, for acquisitions or disposals, or of litigation could risk destroying value. However if a reasonable opinion is to be formed about the prospects for the company or an assessment made of what is happening to risk these are often the key areas for consideration.
>
> Directors will have to bear in mind their obligations under the FSMA 2000, under the take-over code, implications of current or prospective litigation, and so on. It is important that these interactions do not result in the OFR being too lacking in content. The guidance from the Standards Authority will be important in this regard. However, it is an important principle that a lack of information can be as misleading as misstatements.
>
> A factor companies will have in mind is that competitors not facing similar disclosure obligations will have a material advantage.

In the listing particulars requirements, there is provision for the Listing Authority to permit, on application, commercially sensitive information to be withheld, so long as the resulting disclosure is not misleading. In the continuing obligations, new developments of material importance to the group do not have to be disclosed prematurely – e.g. an important new contract need only be disclosed when it has been signed.

Incorporation of the exemptions in the Listing Rules (and proposed changes consequent upon MAD implementation) would be helpful. Guidance from the Standards will subsequently be helpful in clarification of requirements.

We have previously commented that companies should be required to state if information has been withheld on confidentiality grounds and subsequently to state when later announcements or developments mean that that qualification is no longer necessary.

**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?

No, we strongly disagree.

We repeat our comments in response to the 2003 Modernising Company Law White Paper.

> It is appropriate to provide a safe harbour for those who after reasonable enquiry believe a statement to be true (or reasonable in case of a projection) at the time it is made. FMSA obligations for the company to avoid a false market in its shares where applicable would be sufficient to ensure that corrective information was put out if statements/projections turn out to be wrong/unreasonable.
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> The protections in Schedule 10 of the FSMA 2000 are a possible model as the White Paper suggests.
>
> Indeed, great care is required in developing the requirement for forward-looking disclosure and comment. Without measures of protection for directors who act reasonably and in good faith, these aspects of the OFR will be bland and, in practice, quite useless.

We note that other jurisdictions provide safe harbours for statements honestly made in good faith and the UK should not lack that[6].

We do not believe that the standard of care required of directors in respect of preparation of the OFR should be higher than that required in carrying out their normal duties.

It seems reasonable to assume that the Standards will not require directors to predict the future. But in discussing factors affecting prospects, directors will have to consider what is known, and what is known to be unknown. Discussion of "known unknowns" as under SEC requirements in the US is a reasonable expectation. For this discussion to be of value to shareholders, Directors must have confidence that their reasonable, good faith treatment of these potentially difficult areas will not expose them to liability or even censure.

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

No comment.

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

No comment.

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[6] Both required and voluntary disclosure of prospective or forward-looking information in a US reporting company's Management Discussion and Analysis are covered by SEC "safe harbor" rules, which provide that the disclosure, if subsequently found to be incorrect, will not result in liability for materially false or misleading information if the disclosures were made in good faith and with a reasonable basis.

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