INSTITUTE OF DIRECTORS

"Draft Regulations on the Operating and Financial Review and Directors' Report"

Response to the Consultative Document

4th August 2004

This paper gives the Institute of Directors' response to the Consultative Document "Draft Regulations on the Operating and Financial Review and Directors' Report", published by the Department of Trade and Industry in May 2004.

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DRAFT REGULATIONS ON THE OPERATING AND FINANCIAL REVIEW AND DIRECTORS' REPORT – A CONSULTATIVE DOCUMENT

THE INSTITUTE OF DIRECTORS

The Institute of Directors (IoD) is a non-party political organisation of individual members founded in 1903 and has more than 53,000 members in the United Kingdom. The membership is drawn from across the business spectrum. Over 75% of *The Times* Top 1000 companies have IoD members on their boards but the majority of members (some 60%) are directors of small and medium-sized enterprises, ranging from long-established businesses to start-up companies. The organisations from which our members are drawn employ over 10 million people in the UK, i.e. over 40% of the workforce.

In addition to representing the interests of its members, the IoD is strongly committed to delivering improvements in professional standards and boardroom practice. The IoD's Chartered Director qualification is the world's first independently accredited professional qualification for directors. This, combined with professional development programmes and publications, puts the IoD at the forefront of improving standards in boardrooms.

I INTRODUCTION

The IoD has commented on the proposals to legislate to require certain companies to produce an Operating and Financial Review ("OFR") over a number of years. Our stance when commenting initially in June 1999[1] to the *Company Law Review* ("CLR") was that we were not convinced of the need for mandatory requirements to report on employee relations, supplier relations, customer relations, community relations, philanthropic activity and/or environmental performance. Over the years (February 2001[2], November 2002[3]) we welcomed the move towards matters being included at the discretion of the directors. In this response we are not going to re-visit past arguments, but will confine our comments to the way in which it is proposed to introduce the mandatory requirement for an OFR for certain companies, and the related issue of the business review required by the EU *Accounts Modernisation Directive (Directive 2003/51/EC)* ("Modernisation Directive").

II SUMMARY

Our response is divided into two main parts: firstly our key areas of concern which are:

- *The level of the standard of care and the time/cost implications of directors satisfying themselves that there could be no allegation that they have failed to meet that standard.*

- *Potential liability for forecasts that are not fulfilled.*

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[1] The Government's Company Law Review: *Modern Company Law for a Competitive Economy: The Strategic Framework* (IoD response June 1999)
[2] *Modern Company Law for a Competitive Economy: Consultative Document 8: Completing the Structure* (IoD response February 2001)
[3] *Modernising Company Law: Response to the White Paper* (IoD November 2002)

- *The intended audience for the OFR (i.e. those to whom the directors owe a duty of care).*

- *The role of the auditors.*

In addition we have serious doubts about the number of shareholders who will be interested in receiving the OFR. Our overall opinion is that these proposals require substantial re-consideration if the OFR is not to be a costly burden on companies out of all proportion to its value as a tool to improve transparency and accountability.

In addition to these key areas of concern we provide answers to the questions posed in the Consultative Document and address a number of areas where we consider that the draft *Companies Act 1985 (Operating and Financial Review and Directors' Report) Regulations* (the "Regulations") require amendment.

III KEY CONCERNS

(i) The level of the standard of care and the time/cost implications of directors satisfying themselves that there could be no allegation that they have failed to meet that standard

The "due and careful enquiry" standard is a particularly onerous one and is akin to that seen in relation to prospectuses. This brings into the arena of regular reporting all the implications of the work entailed in producing a document that is not part of a regular reporting exercise, but one undertaken on an occasional basis for a very particular purpose.

This will in turn have a detrimental effect on the content of the OFR. Any document prepared to this standard, which eliminates risk of liability, will produce excessively detailed reports, likely to obscure the wood from the trees and not be easy to read or comprehensible. The effect could be for the true state of affairs to be obscured rather than clarified. The application of this standard will have the converse effect to that intended and will detract from the clear reporting that is the stated aim of the OFR.

We suspect that the figures quoted for time and cost are grossly underestimated for very many companies. Examination of the *Practical Guidance for Directors*[4] ("Guidance") shows the suggested level of activity involved in the process of preparing the OFR. Quite apart from the assembly of the information (both internal and external), the Guidance suggests:

- the use of advisers and others to provide the additional skills and competencies (e.g. specialist independent Advisory Panels or specialist external bodies),
- consultation with members and other key groups,
- external review,
- appointment of a Board committee for some of the detailed work of review,
- several iterations of the Board level review, and

[4] *The Operating and Financial Review Practical Guidance for Directors* (Department of Trade and Industry May 2004)

- post-OFR reviews (both annual and more detailed after 3 – 5 years).

What concerns us particularly is that the Guidance is not practical, it is in fact unhelpful. It suggests a standard which in a very large number of cases a reasonable director would consider inappropriate, overburdensome and out of proportion to the benefits conferred. The Guidance should be withdrawn, and the reporting standards should be based on the standard of care envisaged by the regulations.

The result of the standard will be that the OFR becomes an expensive white elephant, with those gaining most from the exercise being lawyers and accountants, neither of which groups have the skills required to do the forward looking strategic thinking that the OFR is intended to encourage.

(ii) Potential liability for forecasts that are not fulfilled

As the Regulations are drafted directors are required to make forecasts and other forward looking statements. If these forecasts are not fulfilled (even where honestly and reasonably made) directors are at risk – without a safe harbour provision - of litigation and the impositions in time, expense and uncertainty even if ultimately held to be not liable, merely if their honest forecasts are not fulfilled. There should be a safe harbour combined with placing the onus on the claimant to prove that the forward looking statement was one that no reasonable director could have made.

(iii) The intended audience for the OFR (i.e. those to whom the directors owe a duty of care)

The Consultative Document states that increased shareholder engagement is the key driver of good corporate governance, and that "the OFR is designed to arm shareholders with that information". The Consultative Document, while stating that other users of the accounts will find the OFR of relevance, makes clear it is to be prepared for the shareholders. This basic premise must be kept in sight. Any public document is available to all users, but it is not prepared for them, and there must be no question of any duty of care being owed to them in relation to its content.

The Guidance is particularly unhelpful in this respect. Statements in the Guidance such as: "Directors will also need to recognise the implications of the objective for **the users of the OFR** in deciding what should be included…… it will be used as a basis for assisting people in making decisions… they may be the decisions of others – employees, customers, suppliers" imply that the OFR is addressed to these and other groups. If the Guidance is allowed to stand, the courts would have to have regard to it in any case involving questions of to whom a duty of care was owed in respect of the OFR. We reiterate that it should be withdrawn.

Any outcome that might be construed as creating an obligation of the directors to any other than the shareholders of the company must be avoided in the Regulations and the reporting standards. Such an outcome would be contrary to the conclusions of the CLR and would undermine the objective of the proposed

statutory statement of directors' duties that is due for inclusion in the forthcoming Companies Bill.

(iv) The role of the auditors

The proposed role of the auditors goes beyond their area of expertise. Auditors are not businessmen. The role they are being required to assume will lead to them second-guessing the judgement of the board. To fulfil the role placed upon them in determining whether the directors have prepared the OFR after due and careful enquiry will entail conducting a verification exercise akin to that undertaken when a company offers its shares to the public. This will further contribute towards making the production of an OFR an extremely costly and time-consuming exercise. At most the auditors should be required to report only on issues of inconsistency with the accounts.

The overall impact of these key concerns is to strengthen our belief that as a matter of urgency the whole of company law needs to be reformed. A piecemeal approach will create additional problems. Areas that this consultation highlights as in need of reform are:

- The statutory definition of directors' duties;
- Issues of directors' potential liability, so that transparency of reporting is encouraged not stifled[5];
- Company reporting, which should be addressed in its totality, to create a logical system that limits the total burden, avoids duplication and clearly identifies both those to whom liability is owed and the standard of care.

We comment in more detail on these key concerns in our responses to the questions asked in the Consultative Document.

IV QUESTIONS POSED IN THE CONSULTATIVE DOCUMENT AND DRAFTING COMMENTS

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?

a. This provision is intended to take forward the Company Law Review ("CLR") objective for the OFR and its target addressees into regulation. The regulations are also intended to implement the Modernisation Directive.

The relevant provision of the CLR states these objectives to be:

> "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."

The Modernisation Directive requires that:

[5] Institute of Directors Response to the Consultative Document *Director and Auditor Liability* (IoD March 2004)

"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".

Because of the Modernisation Directive the analysis has to be comprehensive (which goes beyond the requirements of the CLR), but paragraph 1 should therefore also include the qualification contained in the Modernisation Directive that this be "consistent with the size and complexity of the business". The language of section 234ZZA does this for business reviews, and Schedule 7ZA must reflect this. Although Schedule 7ZA applies only to quoted companies, there is a wide range of size and complexity among quoted companies (including some SMEs) and the appropriate level of analysis will vary. This qualification should also apply to paragraph 2 of Schedule 7ZA. By addressing these concerns, some of the issues of the appropriate class of company to be required to prepare an OFR might also be addressed (see Question 2 below).

b. The Consultative Document, rightly in our view, makes it clear that whoever else may use the OFR it is addressed to the members of the company (paragraphs 3.5, 3.7 and 3.9) and this is reflected in the last sentence of paragraph 1 of Schedule 7ZA. However, since Schedule 7ZA is subsidiary to section 234ZZA, and the section will in any event apply to many more companies than Schedule 7ZA, section 234ZZA should reflect the last phrase of Schedule 7ZA. Without such a statement, the inclusion of the reference to members in Schedule 7ZA could be construed as an indication that the understanding of persons other than members were being contemplated in section 234ZZA. It is important to have an express statement as to the persons to whom both the business review and the OFR are directed to limit the duty of care of directors, particularly in the light of the references in the Guidance – see e.g. page 9, last sentence; page 13, last paragraph; page 19, criterion ii; page 22, last paragraph; page 26, last two lines, all of which imply reliance on the OFR by other stakeholders.

c. The tailpiece of paragraph 1 (to enable members to assess the strategies adopted by the company and the potential for those strategies to succeed) and paragraph 2(a) (statement of the strategies of the company) are too wide in that they do not limit the strategies referred to. The current position of the company will be a reflection of strategies adopted over many years (even though no longer being followed). The statement of strategies required by paragraph 2(a) should be limited to current strategies.

d. We question whether it is appropriate that the obligation for the OFR to provide an analysis of the development and performance over the year and of the position at the year end should be limited by the tailpiece, i.e. be limited by reference to the ability to assess the strategies and their success. It seems to us that this limitation should relate only to items in (c) and (d) – main trends and factors. The limitation does not appear in the Modernisation Directive and it may well be that members are interested in other value factors, e.g. availability of cash for dividend cover/repurchase

of shares, where the members intend to achieve changes in the current board's strategy.

e. Likewise, in the definition of "key performance indicators" in paragraph (5) of section 234ZZA and paragraph 6(2) of Schedule 7ZA it should be made clear that the development and performance referred to is only the development and performance during the financial year and that the position referred to is only the position at the year end.

f. The Guidance is confusing about the extent of the information to be included in the OFR. At page 17 it is stated that "information not necessary [for members to assess the company's strategies] should not be included……..This approach need not, however, deter directors from providing, in parallel reports, information over and above what is needed to meet the OFR objective". Other parts of the Guidance – see the passages referred to at b. above - indicate that other information should be included.

2. Do you agree that quoted companies comprise the appropriate class of companies to be required to produce an OFR?

We had no problems with the approach adopted in the CLR and the 2002 White Paper "Modernising Company Law" that an OFR should be produced by all companies of economically significant size. As we agree that the OFR should be addressed to the shareholders rather than other possible users, we are also mindful that unless there is dispersed ownership of shares there is a small audience with a legal interest in its content.

However, concerns have been expressed to us. Smaller quoted companies (some of which fall into the definition of medium-sized companies which would otherwise not only be exempt from the requirement to produce an OFR but also, under the government's proposals, be exempt from the requirements of the Modernisation Directive in relation to non-financial information) consider that the OFR is unduly burdensome. From another viewpoint both quoted companies and investors consider that very large private companies will not only benefit from not incurring the considerable cost and effort of producing an OFR, but will also be able to hold information about their own business confidential while at the same time having access to information about the future strategies and prospects of their quoted rivals.

Against these views we do believe that quotation cannot come without a cost. A large part of that cost is appropriately the provision of information to those who invest in (or are potential investors in) the company's shares. However, as we mentioned in relation to Question 1 the imposition of reporting requirements on all companies should be "consistent with the size and complexity of the business". While a very detailed report may be appropriate for the largest quoted companies with turnover in excess of £30 billion (but see comments on Question 7), the same level of detail is not appropriate for all c.1900 quoted companies, many of whose turnover does not exceed £100 million. It is presumably not the intention that

quoted companies become restricted to those in the FTSE 350, but that could be the effect if this qualification is not included. This is an outcome that would not “contribute to raising the productivity of British companies, helping to generate prosperity for all”.

On balance we consider that quoted companies comprise the appropriate class, but that the regulations should be drafted so that the burden is not unduly onerous – in terms of e.g. the standard of care, the ability to issue summary reports, and the safe harbour aspects. Above all the size and complexity of the business must be taken into account.

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 consider that the references to these matters should appear in paragraph 4 or 5 as they are particular matters rather than generic matters. For example, there is little difference in essence between information about employees and information about financial capital resources – indeed, for some companies employee matters are more critical than its financial capital.

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?*

The asking of this question is closely linked to how lucid and accessible OFR will be. If it is necessary to report on negatives there is an implication that without such statements the reader will be unable to ascertain whether or not there is anything on the subject in the report. This does not say much for the ability of the OFR to fulfil its objectives as quoted under Q 1 above. The inclusion of a requirement for a negative statement on each of the matters listed in paragraphs 4 to 7 of Schedule 7ZA will make for a lot of very tedious negative reporting, probably in a bland and mechanistic form. This will create the wrong tone, both for the author and the reader, and will be no more helpful to the reader than would be omission of the ‘irrelevant’ items. Failure to refer to a matter where it is in fact required to ensure the OFR complies with paragraphs 1 and 2 will of course be an offence. We share the views of the CLR on this point.

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

Subject to the comments above, yes.

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

We disagree with the proposed role of auditors. Auditors are experts in accounting matters. They are not (or not necessarily) directors, business managers or entrepreneurs. It would be appropriate (and is a requirement

of the Modernisation Directive) that they should report on the consistency or otherwise of the OFR with the accounts – as is to be required in relation to non-quoted companies by new section 235(3). This will ensure that the OFR is not to be regarded merely as a PR document.

For the auditors to comment on whether the directors have prepared the OFR after due and careful enquiry (or to opine as proposed in paragraph 8(c)) would, however, require them to 'second guess' the directors' judgements and to apply tests which go beyond those in which auditors are skilled. In order for the auditors to be able to prove that they have discharged their duties properly (and avoid potential liabilities), they will have to insist on full documentation of the due and careful enquiry process and conduct a verification exercise. This would in effect amount to the process currently undertaken in relation to the offer of shares to the public (where the 'due and careful enquiry' standard is that applied). The expense to the company of carrying out such due diligence would, we believe, in many cases substantially exceed the time and cost estimates given in the RIA, as well as delay finalising and issuing the annual report and accounts. This in turn could lead to problems in complying with the provisions of the Transparency Directive under which quoted companies will be required to issue periodic reports within tight timescales. We appreciate that the United Kingdom has not supported the proposition that speed of reporting equates with transparency of reporting, but the reality is that companies will in future have less, not more, time to issue their periodic reports at a time when the burden of content is increasing. If, as we believe will be the case, few shareholders will be interested in the full OFR if they have a choice not to, the inappropriateness of the 'due and careful enquiry' standard is further emphasised.

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

Almost every company we have spoken to has commented on the time and cost implications of the process if the 'due and careful' standard is adopted. As yet they have not been able to be specific about the cost, but if the exercise is regarded as comparable to that undertaken under the US Sarbanes-Oxley Act a major FTSE 100 financial institution could be facing costs in the region of £20 million per year. Another FTSE 250 company, which has issued Supplemental Listing Particulars within the past year commented that although of the total £8 million cost (excluding sponsors' fees) the verification element was not separately identified, that figure would include the work performed by the Investigating Accountants, the due diligence process conducted by solicitors and document verification. Also, quite apart from direct external costs: "the process was very intensive and absorbed internal resources from across the …. group, including both the organisation of verification/due diligence process, collation of underlying information, conduct of management interviews and investigation of specific issues."

The above examples of possible costs are not going to be reflected across all quoted companies, but we suggest that the cost estimates given in the RIA are grossly understated and this will be particularly true if the 'due and

careful' standard is maintained. The DTI should obtain information from audit firms in the light of the contents of the Guidance.

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?*

These penalties and remedies are an extension of the existing penalties to an additional part of the company's reporting structure. However, what distinguishes the OFR from the accounts or the directors' report is the necessarily less clear-cut nature of the information. We would advocate the primary remedy in cases of defective OFRs to be exercise of the powers of the FRRP to order rectification of the report.

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?*

We agree with this exemption being adopted. We would expect the government to take advantage of all possible exemptions on reporting for small and medium-sized companies, and also to interpret the Directive in the manner imposing the least regulation on companies.

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 the modernisation directive is required to be implemented by 1 January 2005, we would suggest that the full OFR requirements should be delayed by one year. Although many larger listed companies already produce an OFR, for smaller listed companies this will be a considerable change in their reporting, and one which will have stringent legal requirements and penalties attached to it. Also, this is the same implementation date for International Accounting standards and, for companies with a US listing, the implementation date for Sarbanes-Oxley section 404. Implementing so many different requirements at the same time may be difficult for companies to achieve without the quality being seriously impaired. In addition, shareholders may not be well-placed to cope with so many changes at once.

In addition, much of the OFR is taken up with matters that are continuing obligations. It is unlikely that re[porting standards will have been developed in good time for companies to assimilate them into their systems before 1 January 2005.

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

See previous comments.

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 issues of company reporting and its value have to be looked at in their totality. Volume of information is by no means synonymous with transparency of reporting. Company reporting is now becoming unmanageable in volume terms and extremely costly to produce. Most institutional investors are interested in the fundamental and long-established accounting data, and obtain much of their information from their dialogue with the company. Most private investors either elect to receive Summary Financial Statements (SFS) or are not the registered owner of the shares and are therefore not entitled to receive a copy of the annual report and accounts in any event. They do not want the level of detail in the Annual Report and Accounts, and are unlikely to want the level of detail of the full OFR. Of one FTSE 100 company's 1.2 million shareholders only 12,000 elect to receive the full Annual Report and Accounts. There are an additional 5,000 'hits' to these pages on-line. The question has to be asked; for whom is the OFR being prepared? If there is any case for the full OFR to be published it is preferable for it to be produced electronically, rather than being issued in full in hard copy form.

From our discussions, there is a belief that the requirement to send the OFR in full to all registered shareholders will lead to the demise of the SFS. This is because the full OFR is likely to be at least twice the length of the SFS and as such disproportionate to the rest of the information and tending to distort the impression of the reports. The issue is of particular concern to those companies with large numbers of shareholders, a high percentage of whom frequently hold no more than a few hundred shares. If companies cease to publish a SFS the overall cost implications for companies with a large shareholder base go way beyond the costs quoted in the RIA.

We do not know how many companies would choose to produce a summary OFR if permitted to do so as the editorial aspects would add to the expense of preparation. There would, however, be very significant savings in physical production costs and environmental and waste paper implications. This should be left to companies to determine and we would not legislate against summary reports.

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 should be no such requirement.

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

Yes, but the issue of competitors being able to gain useful information from OFRs (especially risks, uncertainties and future trends) is a real one,

especially where the competitor is not subject to similar rules and does not have to make equivalent disclosures. The guidance and standards must make it clear that general descriptions of such issues are permissible, so long as the overall effect of the company's position is capable of being understood.

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 agree with the CLR and believe that a safe harbour is required for forward looking statements. The Standards must offer sufficient protection to directors against both 'unreasonable' liability for forecasts which are not fulfilled, through no fault of the directors, and against claims made on the basis of gold-digging contingency fee claimants (where the cost - in terms of both finance and time – of litigation is such that is often cheaper to settle than to fight). A director should not have an onus to defend himself purely because a forecast is not fulfilled. The onus should be on the claimant to show that the forward-looking statement was one that no reasonable director in his position could have made.

    Without a safe harbour provision for forward-looking statements the potential liability of directors is increased. This in turn will lead to bland, boilerplate phraseology that provides shareholders with little meaningful information and defeats the object of the OFR.

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

    Please see our previous answers. In addition to the examples we quote, we suspect that the figures quoted for time and cost are underestimated for very many companies. Examination of the Guidance shows the considerable extent of the level of activity involved in the process of preparing the OFR. If all companies are expected to accede to the expectations of all the various bodies that have expressed an "interest" in the contents of the OFR (e.g. the Environment Agency[6]), the costs will be significantly higher than estimated in the RIA.

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

    See above.

Institute of Directors
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[6] *Environmental Disclosures in the Annual Report & Accounts of Companies in the FTSE All-Share* (Environment Agency July 2004)