

GOVERNANCE RECEIVES BOOST IN GOVERNMENT OFR DRAFT

The government's plan for strengthening corporate governance continues with the publication of the long-awaited consultation on draft regulations for the Operating and Financial Review (OFR).

The government offers four options:

1. Do nothing.
2. Implement an expanded directors' report, but do not introduce a statutory OFR.
3. Implement an expanded directors' report, introduce a statutory OFR, but without an auditors' review.
4. Implement an expanded directors' report, introduce a statutory OFR, together with an auditors' review.

Option 4, favoured by the government, can be taken as given.

Key aspects

The key aspects of the OFR require directors of quoted companies to give a balanced, comprehensive analysis of their business as part of their accounts to shareholders.

The OFR builds on the existing best practice followed by a number of larger companies, and it follows the recommendations of the Company Law Review (CLR).

The OFR will report and comment on 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.

Fundamental principles

- It should be a statutory requirement, not a matter of best practice, and 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.

Quoted companies only

- It is proposed that all quoted companies (about 1,290) would complete an OFR. The government is rejecting the CLR's suggestion that large private companies should be required to prepare an OFR.
- The government intends to review the effects of the statutory OFR after five years and will consider whether the class of companies required to prepare an OFR is appropriate.

Statutory authority for reporting standards to support the OFR

- 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 government has rejected the proposal of setting up an OFR standards board. Instead, it has delegated to the Accounting Standards Board the task of preparing standards for the OFR, building on its existing statement.

- The ASB is making arrangements to develop the content of a standard for the OFR. It hopes to issue an exposure draft of the first OFR standard in the second-half of 2004, to be finalised in 2005.

Statutory backing

The government wants the OFR reporting standard to have the same authority as accounting standards. Clause 13 of the Companies (Audit, Investigations and Community Enterprise) Bill will establish a system to specify a body to issue reporting standards. Under company legislation, companies that follow OFR standards are presumed to have complied with the statutory requirements.

Company law will also require directors to state whether their OFR has been prepared in accordance with OFR standards and to explain any departures from such standards.

Role of the auditors

The government says the role of the auditor 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.

Under company legislation, the auditors would 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 examine the process the

directors followed in making their judgements and come to a view as to its adequacy.

Auditors will be expected 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.

Costs of implementation

The ASB estimates the initial cost for preparing the first OFR standard will be in the region of £200,000.

Enforcing the OFR

Initial estimates are that it will cost the Financial Reporting Review Panel approximately £500,000 a year.

The government estimates that fees in relation to the auditors' review of the OFR might increase audit fees by 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).

Peter Williams

A wide range of Briefings can be found at www.financialdirector.co.uk/briefing

Useful links

- The consultation will close on 6 August. Email ofr.condoc@dti.gsi.gov.uk
- A copy of the document is at www.dti.gov.uk