EXPLANATORY MEMORANDUM TO

THE COMPANIES ACT 1985 (OPERATING AND FINANCIAL REVIEW AND DIRECTORS REPORT ETC) REGULATIONS 2005

2005 No.1011

1. This explanatory memorandum has been prepared by the Department of Trade and Industry and is laid before Parliament by Command of Her Majesty.

1.1. This memorandum contains information for the Joint Committee on Statutory Instruments.

2. Description

2.1. This statutory instrument amends the Companies Act 1985 [1](the 1985 Act) to –

- introduce a requirement for quoted companies to prepare an Operating and Financial Review (OFR);
- extend the fair review of the company's business in the directors' report;
- provide for a review by the auditors of the OFR and amend the existing requirement for auditors' review of directors' reports; and
- establish a parallel criminal and administrative enforcement regime for the OFR and directors' reports.

3. Matters of special interest to the Joint Committee on Statutory Instruments

3.1. The provisions in the instrument which relate to the directors' report implement Articles 1.14, 1.17 (part) and 2.10 of Directive 2003/51/EC of the European Parliament and of the Council (the "Modernisation Directive"). The Government was required to implement the Modernisation Directive by 1 January 2005. Most of that Directive was implemented by the Companies Act 1985 (International Accounting Standards and Other Accounting Amendments) Regulations 2004 (S.I. 2004/2947).

3.2. Because of the similarities and overlap between the remaining provisions to be implemented and the provisions for the OFR contained in the instrument, the Government considers that the amendments to the directors' report should be introduced at the same time, and for the same financial years, as the OFR.

3.3. On 25 November 2004 it was announced by the Secretary of State for Trade and Industry that given concerns expressed in consultation about the need for adequate preparation time for introduction of the OFR, the date the instrument comes into

[1] Section 257 was amended by section 13 of the Companies (Audit, Investigations and Community Enterprise) Act 2004.

effect will be delayed until financial years beginning on or after 1 April 2005. This will give business three extra months to absorb the new reporting standard for the OFR to be issued by the Accounting Standards Board (see paragraph 3.4), and prepare for implementation. For the reasons given in paragraph 3.2, the provisions concerning the directors' report will apply to the same financial years.

3.4. The instrument is to be made under section 257 of the 1985 Act which was amended by section 13 of the Companies (Audit, Investigations and Community Enterprise) Act 2004 (c.27). Regulation 11 inserts a new section 256A into the 1985 Act providing for a statement of standard reporting practice for the OFR to be issued by a body or bodies specified in an order made by the Secretary of State. The Secretary of State proposes to specify the Accounting Standards Board in an order to be made in early 2005.

4. Legislative background

4.1. The instrument introduces a new requirement for quoted companies to prepare an OFR. A quoted company is defined in section 262(1) of the 1985 Act as a company whose equity share capital has been included in the official list in accordance with the provisions of Part 6 of the Financial Services and Markets Act 2000, is officially listed in an EEA State or is admitted to dealing on either the New York Stock Exchange or the exchange known as Nasdaq.

4.2. The instrument also implements Articles 1.14, 1.17 (part) and 2.10 of Directive 2003/151/EC of the European Parliament and of the Council of 18 June 2003 amending directives 78/660/EEC, 83/349/EEC and 91/674/EEC on the annual and consolidated accounts of certain types of companies, banks and other financial institutions and insurance undertakings, OJ L178/16 of 17 July 2003[2]. The remainder of the Directive was implemented by the Companies Act 1985 (International Accounting Standards and Other Accounting Amendments) Regulations 2004 (S.I. 2004/2947).

4.3. 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 Modernisation Directive.

4.4. Small and medium sized companies will be allowed to take full advantage of reporting exemptions under the Modernisation Directive.

4.5. Transposition notes for the Modernisation Directive are attached as **Annex A** to this Memorandum.

Scrutiny

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[2] The Directive is on the EC Commission's web site at http://europa.eu.int/comm/internal_market/accounting/index_en.htm.

4.6. DTI Explanatory Memorandum 9730/1/02 REV1 COM (2002) 25912 Final was submitted on 26 February 2002. The Commons European Scrutiny Committee considered it politically important and cleared it (Report No 37, Item 23522, Session 01/02). The Lords Select Committee on the EU cleared it on 09.07.02 (Progress of Scrutiny 22.07.02, Session 01/02).

4.7. DTI Explanatory Memorandum OYNYREM was submitted on 05 December 2002. The Commons European Scrutiny Committee considered it politically important and cleared it (Report No.5, Item 24060, Session 02/03). The Lords Select Committee on the EU did not report on it (Progress of Scrutiny 21.12.02, Session 02/03).

5. Extent

5.1 This instrument applies to Great Britain.

6. European Convention on Human Rights

6.1 The Minister for Industry and the Regions and Deputy Minister for Women and Equality, Jacqui Smith has made the following statement regarding Human Rights:

> In my view the provisions of the Companies Act 1985 (Operating and Financial Review and Directors' Report etc) Regulations 2005 are compatible with the Convention rights.

7. Policy Background

7.1. The Government established the Company Law Review (CLR) in 1998 to undertake a fundamental review of British Company Law. One of the recommendations in its final report published in July 2001 was that all companies of significant economic size should be required to prepare and publish an OFR. A voluntary form of OFR has been available 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.

7.2. In July 2002 the Government published a White Paper which set out the Government's position on many of the CLR proposals including the OFR. The Government agreed with the CLR recommendation to introduce a statutory OFR. In July 2003 the Government announced its intention to implement a statutory OFR by secondary legislation under existing company law.

7.3. The objective of the OFR is to achieve good corporate governance by improving the quality, usefulness and relevance of information provided by quoted companies, thus improving the understanding of the business and its prospects and encouraging shareholders to exercise effective and responsible control. The Modernisation Directive has a similar objective in that it aims to achieve greater transparency and precision of company reporting on performance on financial and non financial matters. Because of a degree of overlap between the OFR provisions and those for the expanded directors' report the Government has dovetailed the Modernisation Directive requirements with the OFR.

7. 4. Directors of quoted companies will be required to provide 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.

7.5. In May 2004 the DTI published a consultation seeking views on draft Regulations to introduce a new statutory OFR for quoted companies, and to implement provisions in the Modernisation Directive requiring an enhanced review of companies' business in the directors' report. The consultation generated 140 responses from a wide range of stakeholders including companies, institutional investors, auditors, professional bodies and trade unions. The DTI also held stakeholder events and meetings to discuss the OFR proposals.

7.6. As a result of the consultation, the Government proposals were amended to accommodate simpler audit requirements, avoid duplication and unnecessary publication costs and to provide companies with more time to manage the transition. More information concerning the outcome of the consultation exercise is set out in the Regulatory Impact Assessment attached at **Annex B**.

8. Impact

8.1. Transposition Notes are attached at **Annex A**.

8.2. A Final Regulatory Impact Assessment, which takes account of the outcome of consultations, is attached at **Annex B**.

8.3. There is no impact on the public sector as this statutory instrument only applies to companies.

9. Contact

9.1 Julie Ford at the Department of Trade and Industry will answer any queries regarding the instrument. Telephone 020 7215 2162, or e-mail Julie.ford@dti.gsi.gov.uk .

Jacqui Smith Date 8th January 2005

Jacqui Smith
Minister for Industry and the Regions and Deputy Minister for Women and Equality

ANNEX A TO THE EXPLANATORY MEMORANDUM

TRANSPOSITION NOTES – THE MODERNISATION DIRECTIVE (DIRECTORS' REPORT PROVISIONS)

THE COMPANIES ACT 1985 (OPERATING AND FINANCIAL REVIEW AND DIRECTORS' REPORT ETC) REGULATIONS 2005

Introduction

1. The Companies Act 1985 (Operating and Financial Review and Directors' Report etc) Regulations 2005 ("the 2005 Regulations") implement Articles 1.14, 1.17 (in part) and 2.10 of 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 ("the Modernisation Directive"). Transposition notes detailing implementation of the majority of the provisions of the Modernisation Directive by the Companies Act 1985 (International Accounting Standards and Other Accounting Amendments) Regulations 2004 (S.I. 2004/2947) were laid before Parliament on 11 October 2004.

2. European Union (EU) accounting requirements are based primarily on four Accounting Directives; the Fourth[3] and Seventh[4] Directives on the annual and consolidated accounts of companies: the Directive on the annual and consolidated accounts of banks and other financial institutions[5] ; and the Directive on the annual and consolidated accounts of insurance undertakings[6] .

3. The Accounting Directives have been transposed into national law by the Companies Act 1985 ("the 1985 Act"). The transposition of the Modernisation Directive therefore takes the form of amendments to the 1985 Act.

4. The provisions of the Modernisation Directive which are the subject of these transposition notes amend the requirements of the Accounting Directives regarding the annual report (referred to in the 1985 Act as the directors' report) prepared by companies. The 2005 Regulations also introduce a related report to be prepared by quoted companies – the Operating and Financial Review.

5. Responsibility for the measures described in this transposition note taken to implement part of the Modernisation Directive lies with the Secretary of State for Trade and Industry.

6. The Table below describes where the substantive amendments made by Articles 1.14, 1.17 (in part) and 2.10 of the Modernisation Directive are being implemented in the 2005 Regulations.

Article	**Objective**	**Implementation**
	Amendments to the Fourth Directive (78/660/EEC)	
1.14a	Article 46 has been amended so that the annual report must include at least a fair review of	A requirement. Regulation 2 replaces section 234 of the 1985 Act (duty to prepare directors' report), and inserts

[3] Fourth Council Directive of 25 July 1978 (78/660/EEC) on the annual accounts of certain types of companies (OJ L222/11 of 14.8.1978).
[4] Seventh Council Directive of 13 June 1983 (83/349/EEC) on consolidated accounts (OJ L193/1 of 18.7.1983).
[5] Council Directive of 8 December 1986 (86/635/EEC) on the annual accounts and consolidated accounts of banks and other financial institutions. OJ L372/1 of 31 December 1986.
[6] Council Directive of 19 December 1991 (91/674/EEC) on the annual accounts and consolidated accounts of insurance undertakings. OJ L374/7 of 31 December 1991.

	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, including (to the extent necessary) both financial and, where appropriate, relevant non-financial key performance indicators.	new sections 234ZZA (directors' report: general requirements) and 234ZZB (directors' report: business review) into the 1985 Act.
1.14b	A new paragraph 4 in Article 46 allows Member States to exempt medium-sized companies from providing non-financial information.	Regulation 5 inserts a new section 246A(2A) into the 1985 Act, and regulation 6 amends section 247A (cases in which special provisions for small and medium-sized companies do not apply).
1.17 (2nd paragraph)	Article 51(1) is amended so that auditors must give a positive opinion as to the consistency of the directors' report with the accounts.	Regulation 3 amends section 235(3) of the 1985 Act.
	Amendments to the Seventh Directive (83/349/EEC)	
2.10a	This is the same requirement as article 1.14a, for consolidated accounts.	A requirement. See regulation 2, and in particular new section 234(2) and (3) inserted into the 1985 Act.
2.10b	Article 2.10b adds a new paragraph to Article 36 enabling companies preparing a consolidated annual report to combine it in a single report with the individual annual report, where appropriate giving greater emphasis to those matters which are significant to the undertakings included in the consolidation taken as a whole.	Regulation 2 inserts new section 234(2) and (3) into the 1985 Act. Regulation 7 makes consequential amendments to Schedule 7 to the 1985 Act.

ANNEX B TO THE EXPLANATORY MEMORANDUM

Final Regulatory Impact Assessment on the Operating and Financial Review and Directors' Report Regulations

Proposal

1. Draft Regulations under section 257 of the Companies Act 1985 introducing a statutory 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)[7] ("the Modernisation Directive").

2. 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.

Purpose and Intended Effect

Objective

3. Vibrant capital markets rely on complex systems of supporting institutions that promote the governance of companies. Corporate governance structures ensure shareholders receive reliable information about the value of companies, while motivating directors and managers to maximise company value over personal objectives.

[7] L178/16 of 17 July 2003

4. The Government believes increased shareholder engagement is a key driver of good corporate governance, deliverable through access to clear and meaningful information about the main drivers of a company's performance.

5. Developing and maintaining a sophisticated financial disclosure regime is crucial to countries with highly developed securities markets. This requires substantial resources to ensure the production and regulation of accounting and disclosure rules for public interest entities, in particular, to follow.

6. Financial accounting information is the product of corporate accounting and external reporting systems that routinely measure and disclose generally audited and typically quantitative data concerning the financial position and performance of companies.

7. Audited balance sheets, income and cash flow statements, along with supporting disclosures, form the foundation of a company specific information set available to shareholders and potential investors. An absence of reliable information impedes the flow of human and financial capital towards sectors that are expected to have high returns and away from sectors with poor prospects.

8. Financial information enhances economic performance by reducing adverse selection and, therefore, liquidity risk. Adverse selection refers to the asymmetries of information that exist between investors with some being classified as 'well informed' (not necessarily the same as insiders). Companies that provide timely, high quality financial information may reduce the risk of loss from trading with these more informed investors. This, in turn, encourages more funds into capital markets as investors' liquidity risk is reduced.

9. As one of a number of proposals already completed or under way and aimed at maintaining confidence in the UK market place[8], 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 shareholders to exercise effective and responsible control.

10. It is essential to note, however, that the governance of companies is exercised through a portfolio of governance mechanisms, and so it is important to understand potential interactions between mechanisms. The OFR is one of only several mechanisms by which Government seeks to improve transparency.

11. Its approach is designed to strike a balance between encouraging enterprise on the one hand, and protecting shareholders on the other; between minimising regulatory burdens and ensuring there are adequate systems for ensuring transparency, compliance and enforcement.

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[8] 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.

12. The **OFR** proposal 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.

13. The objective of extending the fair review as stipulated in 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. The Directive applies to large and medium-sized (but not small) companies, without distinguishing between quoted companies (a major subset of public interest entities) and private or public non-quoted companies (henceforth referred to as "privates").

14. The Government believes that the shareholder base of quoted companies – typically large and diverse – has different and additional information needs to that of private companies, hence the requirement to prepare a more fulsome, and more forward-looking review than that required under the Directive.

15. As the Directive will apply to large companies who may also be quoted companies, 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.

16. Responsibility for company law matters lies with the Secretary of State for Trade and Industry. Company law is a reserved area under the Scottish and Welsh devolution legislation and therefore any changes will also apply in Scotland and Wales. In Northern Ireland, matters arising from the proposal would normally be the responsibility of the Northern Ireland Executive Ministers. Whilst the Northern Ireland Assembly and Executive are suspended, these functions will be discharged by the Northern Ireland Departments subject to the direction and control of the Secretary of State for Northern Ireland.

Background

17. Current financial reporting requirements concentrate on providing quantitative data and financial information about a company's past performance. 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 perspective, such as directors' remuneration or political donations. Little forward-looking information that addresses the company's prospects is required.

18. The business environment is changing dramatically, however, and at an accelerating pace. Companies are becoming increasingly complex and information needs are changing. Some of the forces reshaping the business environment include:

a. **Globalisation**: Powerful shifts in business from local and national to international continue, especially in the areas of cross-border capital formation and the globalisation of finance;
b. **Transparency and Accountability**: Financial models based on transparency, accountability and regulation are being adopted around the world. The shift from inside (or patient) capital to outside (or impatient) capital, is creating a corresponding pressure for increased disclosure and responsiveness;
c. **Democratization of Ownership**: More individuals and families own shares than ever before, either directly or indirectly, through holdings in pension funds, and so forth. Employees often receive share options as part of their remuneration package, or in lieu of cash bonuses;
d. **Competition**: Entrepreneurship is on the rise, sparked in part by the opportunities afforded by new technologies. Starting a business has never been as easy or as inexpensive;
e. **Changes in the Nature of Business Assets**: Assets are increasingly intangible. Business observers and analysts generally agree that some of the biggest contributors to business success are those that are the most difficult to quantify: people, customers, knowledge base, brand, and reputation;
f. **Litigation**: A more aggressive and educated public continues to seek redress for grievances and perceived misconduct in the courts;
g. **Stewardship**: Increasingly, business is being asked to exercise social responsibilities, contributing more to the wellbeing of their employees, their customers, and their communities.

19. In this changing environment, the degree and type of intervention that is warranted depends upon the nature of the market failure, and the balance of economic benefits and issues of unfairness and equity. In this instance, intervention is to be expected because capital markets:

a. Sometimes fail to make adequate provision for the future because of uncertainty, lack of information and incentives to short term decisions;
b. Are not always transparent, and lack of information makes some people and businesses vulnerable to abuse by rogue traders;
c. Rely on confidence for expansion: a vital but also fragile commodity. Even markets that function well do not necessarily deliver "fair" processes or outcomes, disadvantaging particular sections of society or business and, over time, reducing their willingness to participate;
d. Change quickly, and yet institutional infrastructure can be slow to change and make differing demands on business depending upon the region or country where that trade takes place. Participants are not always sufficiently well informed to be confident or to drive innovation and competition;
e. Include some businesses which are simply not responsible; businesses and consumers need to feel confident that government is acting to provide a level playing field and acting against inappropriate behaviour.

20. Against this backdrop 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. Having regard to the OFR – a forward-looking narrative report that had been a matter of best practice for some time, and on which the Accounting Standards Board (ASB) had issued two statements in 1993 and again in 2003 - recommended in its final report (July 2001) that all companies of significant economic size should be required to prepare and publish an OFR.

21. In July 2002 the Government published a White Paper Modernising Company Law (Cm5553 – I & II), in which was set out the Government's position on many of the CLR's proposals including the OFR. The Government agreed with the CLR's recommendation to introduce a statutory OFR, but without committing to the class of company to which it should be applied. Draft regulations published in May 2004 made public its decision to apply the OFR to all UK-registered quoted companies.

22. Responses to the DTI's May 2004 Consultation Paper on implementation of the OFR (and Modernisation Directive), acknowledged the arguments made in these various papers, accepting the need for intervention, and agreeing Government has an ongoing role to play in removing barriers to market driven solutions that stimulate the provision of information, disclosure and promotion of good practice on the one hand, and improve enforcement and compliance on the other.

23. Responses also noted that successful intervention is dependent on a number of factors including:
    a. How it will lead to changes in attitude and/or behaviour by some or all of those operating in the corporate governance or capital markets' supply chain;
    b. How the overall impact will be net positive, notwithstanding changes may have a positive or a negative impact on individual groups within the supply chain;
    c. Where and to what extent direct and indirect costs will be incurred;
    d. Where and to what extent direct and indirect benefits will accrue;
    e. Confirmation that direct and indirect benefits will outweigh the direct and indirect costs of intervention;
    f. Confirmation that benefits will not accrue without intervention.

24. On this basis, consultees suggested a number of specific proposals to ensure the right balance was struck between encouraging enterprise on the one hand, and protecting shareholders and potential investors on the other; between minimising regulatory burdens, and ensuring there are adequate systems for ensuring transparency, compliance and enforcement.

25. The Government agrees with a number of these proposals and proposes to amend the draft Regulations for the OFR as a result. As a result, certain of the options, costs and benefits of implementing the OFR as detailed in the previous **partial RIA** (see May 2004 Consultation Document) have changed. These changes are detailed under the Options, Costs and Benefits sections below.

Risk Assessment

26. The Government believes that 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 shareholders and potential investors. Continuing to leave to companies themselves the decision whether or not to prepare an OFR could result in shareholders 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.

27. The ASB's statements on the OFR are persuasive rather than mandatory, and although many companies have produced high quality reports since their introduction, compliance has been uneven, particularly outside the FTSE 100. A 2003 report by HBOS found the average word length to be 12,900, the longest being eighteen times longer than the shortest, with 47% of content dedicated to operating performance, but only 5% to future strategy and 1% to vision and values. For best practice to be extended, therefore, a mandatory requirement is needed.

28. Similar considerations apply to the Modernisation Directive: failure to improve the scope and nature of reporting will result in less useful information for members of the companies concerned. Beyond this, failure to implement this Directive requirement would cause the United Kingdom to be in breach of its Community obligations.

29. As stated by the Secretary of State for Trade and Industry in May 2004[9] "The investment community is vital to our economy. We have the largest investment industry in Europe; the third largest in the world. 360,000 people work in our investment industry; that is, a third of all those who work in financial services jobs. The investment industry manages over £1,000 billion invested in our stock markets, and pays out £240m a day in pension and life assurance benefits."

30. Although a large literature on corporate governance assumes that financial market regulation designed to underpin this sector is unnecessary, this conclusion relies on the idea that sophisticated parties can write enforceable contracts tied to their specific circumstances. Implied in this position is the existence of effective judicial enforcement of complex contractual arrangements and an absence of externalities. However, advocates of market regulation point to a variety of potential failures, such as the ability of insiders to expropriate both potential and existing investors through misrepresentation or asset diversion.

31. Recent corporate scandals across the Atlantic and in the EU highlight the difficulties caused by agency problems – in its simplest form, the relationship between a company's owners (the principal) and its directors/managers (the agents) – and it is these which the OFR and Modernisation Directive are designed to help address.

[9] ABI/IOD Speech 5.5.2004

32. The Government acknowledges that some critics believe stakeholder engagement theory – encouraging shareholders to exercise effective and responsible control to head off the worst excesses of agency problems – is imperfect; providing little guidance to management on how to choose between the multiple, and sometimes, competing interests of stakeholders. But it considers this a first necessary plank in encouraging the adoption of long-term value maximisation as the single objective function of the firm, where shareholders are involved to add positive value to the company.

33. The Government also accepts that research into the impact of mandatory reporting on companies is still at an early stage, and that empirical evidence to support the case for regulation of disclosure is not complete. It proposes to take a positive position on this through the Monitoring and Review process, details of which are provided in paragraphs 185 to 188 below.

34. The Government also accepts that enhanced transparency and disclosure by the *agent* can reduce costs for the *principal*, but may give rise to additional costs for the former. This will be the case here. It accepts the disproportionate burden of costs on the basis that it should lead to an increase in the availability of capital (when considering principals as investors and agents as directors), recognising that in order for there to be a reduction in the cost of capital, there must be a reduction in the risk premium required by investors which, in turn, implies that investors can 'price' good governance.

Options

35. Four options warranting consideration were identified in the partial RIA, being:
    a. Do Nothing – Implement neither the Modernisation Directive, nor a statutory OFR;
    b. Implement the Modernisation Directive, but not a statutory OFR;
    c. Implement the Modernisation Directive and introduce a statutory OFR for quoted companies, which is *not* subject to an auditors' review;
    d. Implement the Modernisation Directive and introduce a statutory OFR for quoted companies, which *is* subject to an auditors' review.

36. There were a significant number of options as to which class of companies should prepare an OFR, together with overlapping options on matters of content, auditor review and enforcement. For practical reasons it was not possible to set out every permutation available. The four options selected represented broad choices whilst permitting discussion on some of the detailed points.

37. Responses to the Consultation required us to consider three additional options to include:
    a. Introducing a statutory OFR for large privates;
    b. Introducing a statutory OFR for large quoted companies only;
    c. Subjecting the statutory OFR to a different level of assurance than that specified in the draft Regulations.

38. These additional options are addressed below under Options 3 and 4.

Option 1 – Do Nothing

39. The partial RIA states that it is not a feasible option to do nothing in the case of the Modernisation Directive, as it places the UK in breach of an EU obligation. This obligation notwithstanding, the Government continues to support the overarching objective of the Modernisation Directive, which is to promote greater transparency and precision of company reporting on performance on financial and non-financial matters.

40. It remains possible to keep the OFR voluntary, which means that quoted companies are subject only to the enhanced fair review requirements of the Modernisation Directive. However, experience to date suggests that this would not lead to the improvements in the quality of reporting that we are seeking from this class of company.

41. Since the equity markets peaked in early 2000, events worldwide have shaken public confidence in the quality of reported information. A number of corporate failures and scandals have undermined the trust investors place in those responsible for reporting that information. Introducing a statutory OFR is one action that would contribute to the efficient and effective operation of markets and restore public confidence.

Option 2 – Implement the expanded directors' report requirements required under the Modernisation Directive, but do not introduce a statutory OFR.

42. Implementation of the Modernisation Directive requires all large and medium-sized companies to prepare an enhanced fair review: a statement of the development and performance of the business in question. The review is to be balanced and comprehensive, consistent with the size and complexity of the business, and include a description of the risks and uncertainties facing the business, as well as key performance indicators relevant to the company's operations.

43. The enhanced fair review provides a snap shot of the company's development and performance at a moment in time, and it is for the directors to determine the amount and type of forward-looking information they include to meet the fair review objective.

44. 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 *in*consistent this fact should be stated in the auditors' report. The change requires auditors to express a positive opinion as to the consistency or otherwise of the information in the Directors' Report.

45. The provision of OFR-type information (i.e. more forward-looking information) over and above statutory requirements continues 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.

46. The underlying assumption of this option is 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 would have the opportunity to demonstrate that their companies are well run, gaining a competitive advantage over those that choose not to follow best practice.

47. 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.

48. There is also a danger that directors would have too much discretion and could 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.

49. In summary the Modernisation Directive provides for an enhanced 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 would 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.

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

51. 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-registered quoted companies would benefit from the increased transparency requirements at home and internationally. Companies that demonstrate they are well run and responsible would be likely to find it easier to raise capital.

52. The originally assumed risk of Option 3 over Option 2 was 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. However, consultees did not highlight this as a major risk, focusing instead on the risk(s) associated with the specifics of the auditors' review outlined under Option 4.

53. On this basis, the current cost/benefit argument for Option 3 is potentially stronger than was previously the case. This is because a non-audited OFR would cost companies significantly less than currently specified (est. £19,000 per average quoted company), but be more substantial in terms of quality than is the case currently (under the voluntary regime). As well, if risk of more defensive disclosure under Option 3 is not proven, then in theory, it should garner support across the stakeholder spectrum, and most particularly from institutional and retail investors and interest groups representing, among others, employees, creditors and suppliers, employees, the environment, and the broader community.

54. On the other hand, when information comes from companies, investors (and others) need confidence that it is complete, accurate and trustworthy, dealing with good and bad news evenly. This is unlikely to occur without the presence and involvement of some independent third party (i.e. auditors). On this basis, the cost/benefit argument for Option 3 is potentially weaker than was previously the case. This is because without any involvement from the auditors, there could be less pressure on the directors to be thorough in their preparation of the OFR. Such reports may fail to strengthen confidence in the market.

Option 3a: Implement the expanded directors' report requirements required under the Modernisation Directive, and introduce a statutory OFR for quoted companies, large privates and public non-quoteds

55. A total of 76 consultees commented on our proposal to require quoted companies to prepare an OFR. Half supported this option, with the balance arguing it be extended to include one or more of debt-only issuers (i.e. bonds), public non-quoted companies or large privates.

56. The chief reason given by business for extending coverage is that the OFR might skew competition, giving non-quoted companies a window into quoted companies' strategies, resources and risks. Among investors and professionals, the chief reason given for extending coverage is the danger that imposing another reporting burden on quoted companies might incentivise more of them to transfer to less well-regulated markets, or even go (or remain) private. Some investors also believe the shareholder base of very large private companies is sufficiently big enough to warrant inclusion.

57. The argument made by interest groups is based on economic and social impacts; interest groups are not persuaded that the absence of shareholders is a "moral or substantive basis" on which to exempt large private companies. In making their argument, interest groups claim the CLR was concerned with more than just shareholders' need for information and that it hinted at the general accountabilities of larger private and public companies; accountabilities that go further than the formal accountability to shareholders, which of course also needs to be considered.

58. None of these arguments addressed the technical issues of how such companies might be defined, however. Assuming that threshold criteria under the Company Law Act prevailed, then extension would result in a further 5,000 companies being caught by the OFR. (Note: The CLR proposed extending the OFR to privates with more than 5,000 employees, which gives a much smaller number of companies, but does not achieve a level playing field between listed and unlisted companies, and would lead to increased regulatory burdens overall).

59. Extending to the OFR also cuts across the Government's policy agenda – increased shareholder engagement – as non-quoted companies typically have a narrower and more direct shareholder base (i.e. are involved in the day to day operations of the business) than that of non-quoted companies.

Option 3b: Implement the expanded directors' report requirements required under the Modernisation Directive, and introduce a statutory OFR for large quoted companies only.

60. The chief reason for contracting coverage is that smaller quoted companies are being unduly penalised relative to similar sized 'standalone' companies, and should not be subjected to cost-burdens more appropriate to larger quoted companies.

61. For the reasons cited in paragraphs 59 above, this option cuts across the Government's policy agenda, only this time in reverse: excluding smaller quoted companies from preparing an OFR.

62. Smaller quoted companies are subject to the same Company Law requirements and FSA Listing Rules as their larger counterparts, including the requirement to disclose and present time and price critical information. As well, these companies enjoy the same advantages as their larger counterparts in terms of access to capital and fast-tracked production growth, and which provide a competitive edge over their private and public non-quoted counterparts. The Government does not believe the costs associated with preparing an OFR are disproportionate or unfair given these circumstances.

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.

63. Option 4 requires companies to disclose all the information that would be required by Option 3, with a further requirement that the OFR be subject to an auditors' review, the exact terms of which were identified in the draft Regulations. These stated that the auditors would be required to state in their assurance report:
    a. Whether in their opinion the directors had prepared the OFR after due and careful enquiry;
    b. Whether in their opinion the information given in the OFR was consistent with the accounts; and
    c. Whether any matters had come to their attention, in the performance of their functions as auditors of the company, which in their opinion was inconsistent with the OFR.

64. Consultees were broadly supportive of auditors checking the OFR against the accounts and any other matters, but were concerned about their reaching a judgement about *how* directors have prepared the OFR. Typical arguments were:

a. That the term ‘due and careful enquiry’ was too high a standard of care, more in keeping with the level of assurance and verification required when preparing a company prospectus;
b. Opining on the level of care directors applied could be problematic and possibly confrontational for auditors;
c. Making a distinction between review of process and content could prove easier in theory than practice, i.e. assessing whether a judgement had been thought through would be close to assessing the judgement itself;
d. Whether auditors had sufficient skills and resources to make judgements about how directors’ arrived at certain non-financial information, e.g. forward-looking statements;
e. What standard of care auditors would need to apply in reaching their judgement; and
f. Whether the requirement to check the directors’ process could prove cost-ineffective, and drive a safety-first attitude.

65. Two specific statements made in support of these arguments were:
a. “It is imperative that the burden of assurance is not so great as to discourage directors’ from providing a full and informative discussion of their performance and strategies.”
b. “It risks introducing a bureaucratic paper trail into the process of developing the OFR, which in turn risks driving a safety-first attitude to OFR disclosures which will substantially reduce their value”.

66. One respondent said our proposal would cause the UK to take a “world leading position” as far as assurance for a narrative report was concerned. Other respondents said it would extend directors’ liability, while yet others noted the higher level of assurance being required of the OFR compared to the Modernisation Directive (which requires only that auditors check the DR for consistency with the accounts).

67. Consultees also commented on the additional cost burden this requirement could impose on quoted companies. One of the audit firms claimed ”there would be a larger than predicted increase in audit fees”, while another claimed business could expect costs to rise by 10-20% of current audit fees to assure the OFR.

68. The Government recognises that business is concerned that the OFR will increase directors’ liability and understands that this concern may have been exacerbated by the proposal for the standard of care on directors to be equivalent to ‘due and careful enquiry’.

69. The Government’s intention is not to extend directors’ liability. It expects directors to apply the same level of care to preparation of the OFR as all other financial and accounting statements and has amended the Regulations to reflect this. For absolute clarity, this means that in preparing the OFR directors should be subject to their normal common law duty to exercise due care, skill and diligence.

70. Further, on September 7th 2004 the Government announced additional protection to directors as part of the wider reforms on directors' liability.[10] Sections 19 and 20 of the Companies (Audit, Investigations and Community Enterprise) Act 2004 introduce two important relaxations of the current prohibition on companies indemnifying their directors against liability. The reforms:
    a. permit, but do not require, companies to indemnify directors in respect of proceedings brought by third parties;
    b. permit, but do not require, companies to pay directors' defence costs as they are incurred, even if the action is brought by the company itself.

71. In reviewing the auditors' role in light of consultees' concerns, the Government found Statement of Auditing Standards (SAS) 160 to be a useful reference point. This standard requires auditors to identify any material inconsistencies between the financial statements and other information that could lead to a misstatement of fact, insofar as the synthesised information has been presented in a misleading manner.

72. At the same time, the Government believes the OFR contains sufficiently different information to the Modernisation Directive to warrant a higher level of assurance than consistency with accounts only. This is because certain information – about future objectives, strategies by which these might be achieved, and milestones, for example – will not be verifiable against accounts and so other sources need to be considered.

73. For this reason, the Government proposes that the auditors' review be extended beyond checking for consistency with accounts to include consideration of any other matters that have come to their attention in the conduct of the (annual) audit. **This is Option 4a.** It is satisfied that these two requirements will provide the level of assurance required to satisfy investors (and other users) that the information is complete and trustworthy.

74. One of the previously identified risks with Option 4 was that requiring an auditors' review of the OFR would result in reports that were more costly to prepare and which, in turn, might lead to less innovation thus hampering the development of best practice. The Government is satisfied that clarifying that directors, in preparing the OFR, will be subject to their normal common law duties, and requiring auditors to check the OFR against the accounts and any other matters arising, will both reduce consultees' concerns about extended liability (for both directors and auditors) and address unintended cost burdens arising from the original proposals.

Benefits

75. The main potential benefits of voluntary disclosures such as the enhanced fair review and OFR fall into two categories: benefits borne by investors and benefits borne by the general economy. A 2001 paper issued by the US Financial Accounting Standard Board, *Insights into Enhancing Voluntary Disclosures*,

[10] Written statement on Directors' and Auditors' liability available from http://www.dti.gov.uk

opined that investors benefit chiefly from the reduced likelihood that their capital will be misallocated, while companies benefit in a range of ways including:

a. A lower average cost of capital;
b. Enhanced credibility and improved investor relations;
c. Access to more liquid markets with narrower price changes between transactions.

76. Positive benefits that accrue to the general economy include:
    a. More effective allocation of capital;
    b. The investment effect of a lower cost of capital;
    c. More liquid capital markets.

77. A 2004 MORI paper, *Where Have All the Goal Posts Gone?* makes note of various empirical studies including that carried out by Governance Metrics International (GMI) in the United States, into the relationship between public disclosure and performance. Recently concluded research by GMI found the shares of 26 companies that scored highest in their latest survey outperformed the Standard & Poors 500 index by 5-10% over five years.

78. Additional benefits include the impact of voluntary disclosure requirements on Boardroom discussions and decisions. Several consultees commented on the potential of the OFR to generate greater awareness of, or help drive improvement in a range of social and environment issues including, for example:
    a. health, safety and environmental performance (with a reduction of costs associated with poor performance in these areas);
    b. ability to negotiate lower insurance premiums;
    c. attraction of ethical investment; and
    d. improved ability to recruit and retain key personnel."

79. The opportunity costs associated with non-disclosure of information are harder to pinpoint, but have been proved to be a contributing factor in the destruction of value through inappropriate corporate behaviour and/or loss of reputation. A separate 2004 paper issued by MORI, *The Rise and Rise of Non-Financial Reporting*, made this point referring to billion dollar losses incurred by such companies as Texaco, Motorola and Enron as a result of reputational failure.

80. Two recent papers summarise the economic arguments that have been put forward to support the vital role of such information:
    a. Bushman, R.M. and Smith, A.J., 'Transparency, Financial Accounting Information and Corporate Governance', Federal Reserve bank of New York Economic Policy Review, 9:1, Special Issue, 2003.
    Available at http://www.newyorkfed.org/researc h/epr/2003.html
    b. Michael, I., 'Accounting and Financial Stability', Bank of England Financial Stability Review, June 2004.
    Available at http://www.bankofengland.co.uk/Links/setframe.html

81. These arguments assume that provision of financial information assists managers and investors in identifying and evaluating investment opportunities (the so called screening and verification role) which helps reduce costs and ensures human and financial capital is directed towards those investments with the highest returns. Such information facilitates not only the allocation of capital in primary markets, but also supports the informational role of share prices in secondary markets which, in turn, ensures ongoing liquidity.

82. Financial disclosure lowers liquidity risk by reducing adverse selection, addressing the asymmetries of information that exist between investors with some being classified as 'well informed'. Companies that provide timely, high quality financial information may reduce the risk of loss from trading with these more informed investors that in turn, encourages more funds into capital markets.

83. Smooth and continuous information disclosure results in lower equity price volatility than less frequent disclosure, while the emergence of sudden shocks to markets can cause high price volatility and sudden losses of market liquidity. Lower liquidity risk and reduced volatility, arising from effective and timely disclosure, has a direct and favourable impact on financial stability.

84. At the same time, for disclosure to be effective it must be relevant; it must provide investors with a realistic understanding of a company's business model and the economic risks and potential rewards that it faces. In addition, it must not reach the pivotal point where further information actually reduces transparency by obscuring important information amidst a wealth of detail.

85. The information requirements of the OFR and Modernisation Directive are designed to ensure this pivotal point is not reached, and that the benefits of disclosure are fully optimised for investors and the general economy alike.

86. Conclusions reached in the partial RIA about the benefits of the four options under consideration therefore remain.

Option 1 – Do Nothing

87. 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. There are no additional benefits to this option, however, because existing best practice is not sufficiently consistent or of high enough quality to provide comparability and transparency for investors.

Option 2 – Implement the expanded directors' report requirements required under the Modernisation Directive, but do not introduce a statutory OFR.

88. The Modernisation Directive promotes consistency and gives additional guidance concerning the information that an enhanced fair review is expected to contain. The Directors' Report provides 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 generates a positive statement of consistency with the accounts that results in greater clarity and certainty.

89. Companies are able to continue developing their OFRs in line with best practice, which allows them the freedom to innovate and develop best practice. This does not address the findings of a 2004 study by HSBOS plc into the Annual Report and Accounts of FTSE 100 companies, however, which found significant variations in the length, format, content and analytical depth of OFR or OFR-related disclosures, and a disturbing lack of information about companies' future strategies, vision and values. We therefore assume additional benefits to this option would be contained to the enhanced fair review requirements of the Directors' Report.

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.

90. Option 3 provides the same benefits as with Option 2, but also requires the directors of quoted companies to prepare an OFR.

91. The information in the OFR is linked directly to those trends and factors underlying the performance of the business and includes a forward-looking element to permit shareholders to assess the strategies of the business and the potential for those strategies to succeed. It therefore focuses on matters that are relevant and meaningful to investors; one of the key factors underpinning the economic argument(s) for disclosure.

92. Option 3 also creates benefit to companies from the discipline of preparing an OFR. Recent research conducted by the Work Foundation (formerly the Industrial Society) suggests that the information generated by the preparation of the OFR is a benefit to the company in its own right. The OFR reporting requirements, therefore, encourage directors to consider a wide range of factors within and outside the company, which are relevant to the business and key to delivering high performance.

93. Option 3a – extending the OFR to large privates – increases these benefits (by applying them to a wider group of companies). However, large privates typically and legitimately eschew quoted status for the express purpose of retaining or regaining closer control over their financial affairs, and to require them to report on an equal basis with quoted companies would be unmerited.

94. Option 3b – narrowing the OFR to larger quoted companies only – decreases these benefits, and does not support the Government's overall policy objective(s).

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.

95. Option 4 provides all the benefits of Option 3 and in addition includes an appropriate level of assurance provided by the auditors' review.

96. The auditors' review introduces a level of rigour and due diligence to the reporting process that is otherwise absent. It ensures that the directors prepare the OFR conscientiously with due regard to the balance between good news and bad.

97. However, these benefits are compromised if the level of assurance has the unintended consequence of reducing transparency and "chilling" innovation. As a result, the Government believes Option 4a – amending the auditors' role – is the more appropriate option. This requires auditors to state whether the OFR is consistent with the financial statements, and that no matters have come to the attention of the auditors during the annual audit that they consider inconsistent with the information and statements contained in the OFR.

Business Sectors Affected

98. Business sectors that are affected by the Modernisation Directive and OFR are several. Those sectors directly affected are:
    a. Quoted companies;
    b. Large and medium-sized companies of (any) class;
    c. Auditors;
    d. Investment groups (including pension funds).

99. Those sectors indirectly affected are:
    a. Other financial institutions, including lenders;
    b. Other professional advisers, including law firms;
    c. Other stakeholders, including employees, customers and suppliers.

Companies

100. The partial RIA identified 1,290 quoted companies that would be caught by the OFR and 95,000 companies that would be caught by the Modernisation Directive. These figures were based on several statistical reports including the August 2003 research report prepared by ICC Information on DTI's behalf, and which the Government considered to be over-estimated due to very recent changes in company thresholds. [11]

101. Analysis conducted since publication of the partial RIA confirms the total number of "live" medium and large companies at 36,000, of which an estimated 12,000 are categorised large, and the balance medium-sized. Included in these numbers are the (same) 1,290 quoted companies identified in the partial RIA.

Auditors

102. The audit market is characterised by a very high level of concentration, with just four accountancy firms (the 'Big Four') and a significant size gap between the fourth and fifth largest firms.

103. According to the 2002/3 accounts of listed firms, the Big Four control 100% of FTSE-100 audits and 99% of FTSE-350 audits. It can be assumed, therefore, that the vast majority of assurance work associated with the OFR will be conducted by these auditors, with assurance work associated with the OFR conducted by 'Group A' auditors: the 20 largest firms in the second tier of auditors.

104. Additional requirements on auditors occur under Options 2 through 4a, with the nature and level of assurance varying according to the option in question. The Government is confident that auditors can meet these additional requirements under its preferred option: Option 4a.

Investors

105. The investor market is also characterised by a high level of concentration, with institutional (wholesale) investors making up over 80% of all trading on the (UK) capital markets.

106. Introduction of a statutory OFR will impose additional work on institutional investors by way of analysis time, but the Government is content that the benefits that will accrue to them and their clients (individual investors) from these disclosures will outweigh associated costs.

Other business sectors (including financial institutions, professional advisers, employees, customers and suppliers.

107. Each of these sectors will be impacted to varying degrees, however, none will bear hard costs by way of preparation and/or contribution to the principal outputs (i.e. the reports). Employees, customers, suppliers are expected to benefit from the introduction of these reports.

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[11] The Companies Act 1985 (Accounts of Small and Medium Sized Enterprises and Audit Exemption (Amendment) Regulations 2004 (SI 2004/16)

Equity and Fairness

108. Neither the Modernisation Directive nor OFR correct a current inequality and, in the case of the OFR, might arguably be introducing an inequality between quoted and non-quoted companies. This potential inequality would manifest itself in two ways. First, an uneven distribution of costs borne by those required to disclose more information than is currently the case. Second, an uneven distribution of information that may cause a degree of competitive advantage to those who are *not* required to disclose (the additional) information.

109. On the matter of costs, the Government is content these are justified on the basis of shareholder need. The arguments for proceeding with legislation that may disadvantage one group of companies over another group are contained in paragraphs 155 to 169 below.

110. On the matter of coverage, 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. The Government does not believe the proposals for the OFR do so.

111. The information requirements for the OFR are designed to vary according to the size and complexity of each individual business. As a result, we expect the costs for preparation and assurance to be less for smaller quoted companies. The Government does not believe, therefore, that either of the two proposals will disproportionately impact any particular class of company.

Costs

Economic, Social and Environmental Costs

112. The main potential costs of informative disclosures fall into two categories: costs borne by companies (the preparers) and costs borne by the general economy. The 2001 paper issued by the US Financial Accounting Standard Board, *Insights into Enhancing Voluntary Disclosures*, stated that companies (and their owners) bear the costs of:

a. Preparation, assurance and publication (distribution) of the disclosure;
b. Competitive disadvantage from their informative disclosure;
c. Bargaining disadvantage from their disclosure to suppliers, customers and employees;
d. Litigation from merit-less suits attributable to informative disclosure.

113. The general economy bears the costs of:

a. Developing, presenting, understanding, and analysing informative disclosure;
b. The drag on growth from merit-less suits attributable to informative disclosure.

114. In estimating costs for the Modernisation Directive and OFR, four sources were used:

a. Responses to the Consultation;
b. Independent research conducted by the DTI during the consultation process;

c. The Chaney, Jeter, Shivakumar January 2002 paper, *Audit Pricing in Private Firms*;[12]
d. The Office of Fair Trading July 2004 paper, *An Assessment of the Implications for Competition of a Cap on Auditors' Liability*.

115. Costs fall into five categories; three pertaining to preparers, two to third parties: the Accounting Standards Board (whose role is to prepare a supporting standard for the OFR), and the Financial Review Reporting Panel (FRRP), (whose role is to enforce the legislation, supported by the Secretary of State, who has an enforcement role as far as criminal penalties are concerned).

116. The three sets of costs pertaining to preparers are preparation, assurance (principally from the audit community but also possibly the legal community), and publication / distribution. Regarding preparation costs, it is assumed that the major impact of the legislation is likely to be on employees' and executive directors' time with additional time impacts borne by subsidiaries, central finance and secretarial functions and Audit Committees.

Option 1 - Do Nothing

117. Option 1 does not affect any companies. There is no change to the existing Directors' Report requirements and no statutory requirement for an OFR. No additional costs arise. However, failure to implement the Modernisation Directive runs the risk of infraction proceedings being brought against the UK for failure to implement the requirements of the Directive.

Option 2– Implement the expanded directors' report requirements required under the Modernisation Directive, but do not introduce a statutory OFR.

118. Option 2 does not impose a cost on most small companies, as they would be exempt from providing the enhanced fair review in the Directors' Report. It should be noted, however, that in light of the responses to the consultation, the Government believes it is appropriate to review the application of the Directors' Report requirements to companies that would be ineligible to claim the small company exemption. As the requirements of the Modernisation increase and become more onerous to companies, the Government intends to take full advantage of exemptions permitted by miscellaneous EU Accounting Directives.

119. For other companies, the Government does not believe the cost of preparing the Directors' Report will increase significantly. Companies are already required to prepare this, and the new requirements emphasise the need for the review to be consistent with the size and complexity of the business.

120. Under Option 2, changes to the auditors' report affect those companies that are required or voluntarily opt to have an audit. The total number of companies affected would be 37,290 (see paragraph 123 below for detail). Guidance on who is impacted (and how) would be provided by the DTI.

[12] www.london.edu/accounting/ressearch/working_papers/ACCT011.pdf

121. The partial RIA identified potential costs for companies preparing the enhanced fair review under Option 2 to be around £500 - £1000 in preparation costs and £500 - £5,000 in assurance costs.

122. The partial RIA also identified the number of companies to be captured by the Modernisation Directive. As stated in paragraph 101 above, the new, higher thresholds put the total number of "live" medium and large companies at 36,000 of which an estimated 12,000 are large and the balance medium sized.[13]

123. Costs for the Modernisation Directive are expected to rise proportionally with the size and complexity of the business, and it is assumed that large-sized companies will incur the maximum costs and medium-sized ones the least. Estimated total costs for implementation of the Modernisation Directive are, therefore, $96 - £99m (see Table 1 below).

Table 1. Estimated Mean Average Costs to Prepare and Assure the Enhanced Fair Review

Size/Class of Company	Average Cost per Company	Total Number of Companies	Total Costs
Medium	£1,000	24,000	£24.0m
Large	£6,000	12,000	£72.0m
Quoted	£6,000	1,290	£7.74m
		37,290	**£103.74m**

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.

124. The costs of Option 3 include the costs of Option 2 plus the additional costs for introducing a statutory, non-assured, OFR for quoted companies.

125. The introduction of a statutory OFR would 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

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

[13] The definition of a small company is currently one that meets 2 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 2 or more of the following requirements: turnover not more than £22.8million, 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)).
Note: The 12,000 estimate for large companies excludes quoted companies.

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.”

126. We estimate the number of companies caught by this definition to be 1,290. For absolute clarity, the definition for the 1,290 figure is UK incorporated companies listed on the main LSE exchange with Ordinary Equity Shares. This includes all types of investment companies (e.g. 3i and Investment Entities), and excludes Alternative Investment Market listings (AIM) as well as debenture, loan and preference shares.

127. The proposal also requires the OFR to be prepared on behalf of the consolidated entity including all of its subsidiary undertakings, meaning any subsidiary undertaking as defined in section 258 of the Companies Act 1985. Broadly this means -

a. undertakings in which the parent holds a majority of the voting rights,
b. undertakings of which the parent is a member and where the parent has the right to appoint or remove a majority of its board of directors,
c. undertakings over which the parent has the right to exercise a dominant influence by virtue of provisions contained in the memorandum and articles or a control contract,
d. undertakings of which the parent is a member and where it controls alone, pursuant to an agreement with other shareholders, a majority of the members' voting rights.

128. The major impact of legislation under Option 3 is expected to be on employees’ and executive directors’ time, with additional time impacts in subsidiaries, central finance and secretarial functions. Companies that produce an OFR-type review already will, in most instances, incur no or marginal extra costs. Other companies will need additional resources in the longer run.

129. The partial RIA estimated the total costs to quoted companies of preparing an OFR under Option 2 could be in the region of £6.5 - £19.0m, based on per company costs of £5,000 - £15,000. Additional costs were anticipated as companies familiarised themselves with the new requirements, and acknowledgement was made that a statutory regime would necessarily require companies to apply additional time and attention, increasing the time spent on preparing the OFR overall and the proportion of time spent by the Board.

130. Later identified costs associated with publication costs of the OFR are estimated at £1,500 - £3,000 per company for design and artwork[14]. Distribution and postage costs will vary according to the size of the shareholder base. A number of consultees advised that our proposal to have the OFR distributed in full to all recipients of summary financial statements could run into the hundreds of thousands for companies with very large shareholder bases (i.e. greater than 500,000). The Government accepts this represents an inappropriate cost burden and has therefore amended this proposal.

[14] Based on additional 12-24 pages: indicative only and for purpose of estimating costs.

131. Under the revised draft Regulations, quoted companies which distribute summary financial statements will be required to report the availability of the OFR on their website, make available a full hard copy version to any shareholder(s) who request one, and electronically publish the full version. On this basis, companies will have been deemed to have met their obligation to make the OFR available to all shareholders. Electronic publication costs are expected to be marginal.

132. Total costs for companies under Option 3 have therefore been revised to **£11.1m**.

Table 2. Estimated Mean Average Costs to Prepare and Publish the OFR Where Coverage is Based on 1,290 Quoted Companies

Size/Class of Company	Average Cost per Company[15]	Total Number of Companies[16]	Total Costs
Larger Quoted	£18,000	100	£1.8m
Mid Cap Quoted	£13,000	250	£3.2m
Smaller Quoted	£6,500	940	£6.1m
		1,290	**£11.1m**

*Not subject to an auditors' review

133. Option 3a is based on a statutory OFR is extended to around 5,000 large privates and non-quoted that are not subsidiaries of ineligible groups. This 5,000 figure is based on the 12,000 large privates referenced in paragraph 101 above, minus those who form part of a public or ineligible group, and whose "parent" company has already been counted among the 1,290 quoted companies. Applying costs for mid-cap quoted companies to these new 5,000 companies takes up the total costs for companies to **£76.1m**

Table 3. Estimated Mean Average Costs to Prepare and Publish the OFR Where Coverage is Extended to 5,000 Large Privates & Non-Quoteds

Size/Class of Company	Average Cost per Company[17]	Total Number of Companies[18]	Total Costs
All Quoted (Ave)	£8,651	1,290	£11.1m
Large Privates	£13,000	5,000	£65.0m
		6,290	**£76.1m**

134. Option 3B, in which a statutory OFR is narrowed to large quoted companies only (the FTSE 350, say), reduces the total costs for companies to **£5.0m**.

[15] Larger Quoted based on £15,000 for preparation, £3,000 for publication. Mid Cap Quoted based on £10,000 for preparation, £3,000 for publication. Smaller Quoted based on £5,000 for preparation, £1,500 for publication.

[16] Indicative only and for purpose of estimating an absolute cost rather than range of costs.

[17] Larger Quoted based on £15,000 for preparation, £3,000 for publication. Mid Cap Quoted based on £10,000 for preparation, £3,000 for publication. Smaller Quoted based on £5,000 for preparation, £1,500 for publication.

[18] Indicative only and for purpose of estimating an absolute cost rather than range of costs.

Table 4. Estimated Costs to Prepare and Publish the OFR*
Where Coverage is Narrowed to 350 (Large) Quoted Companies

Size/Class of Company	Average Cost per Company[19]	Total Number of Companies[20]	Total Costs
Larger Quoted	£18,000	100	£1.8m
Mid Cap Quoted	£13,000	250	£3.2m
		350	**£5.0m**

135. Costs of preparing the initial OFR standard – and borne by the Accounting Standards Board – are estimated to be in the region of £200,000, and apply under each of the three permutations: 3, 3a and 3b.

136. Costs of enforcing the OFR are fluid, as the number of cases that the FRRP will need to respond to is not known. Initial estimates are that it will cost the FRRP approximately £500,000 per annum. This estimate is based on 1,290 companies and so would likely increase / decrease the more / less companies captured under Options 3a and 3b.

137. Costs to companies investigated by the FRRP are also fluid, but we would expect them to 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 on the following basis:

138. Average management time: 20 – 60 hours (the finance director, audit partner, audit manager and technical partner may be involved in an enquiry from the FRRP);
   a. Legal advice: sought in about 20% of cases;
   b. Auditors' time: 20 – 60 hours.

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.

139. The costs of Option 4 include the costs of Option 3, plus the cost of the auditor review of the OFR.

[19] Larger Quoted based on £15,000 for preparation, £3,000 for publication. Mid Cap Quoted based on £10,000 for preparation, £3,000 for publication. Smaller Quoted based on £5,000 for preparation, £1,500 for publication.
[20] Indicative only and for purpose of estimating an absolute cost rather than range of costs.

140. The principal work involved in carrying out the auditor review of the OFR as originally proposed is described in paragraph 63 et seq above. Although the 'due and careful enquiry' proposed has precedent in the Listing Rules in relation to listing particulars, there are no existing requirements directly equivalent to the OFR proposals.

141. Under the Listing Rules requirements in relation to the Combined Code, directors are expected to review the effectiveness of internal controls and then provide shareholders with a summary of their review process. The auditors then consider the company's claim to have complied or not with the relevant provision of the Combined Code, and where the auditors considered there was not proper disclosure the auditors report this.

142. The auditors are not asked or expected to consider whether the board's statements on internal control covered all risks and controls, or to form an opinion on the effectiveness of the company's corporate governance procedures or its risk and control procedures.

143. This contrasts with the approach mandated under section 404 (a) of the US Sarbanes-Oxley Act of 2002, and the Securities and Exchange Commission's related rules. Under US law, the auditors are required to attest to, and report upon, management's assessment of the effectiveness of internal control. In other words, the auditors 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.

144. The partial RIA acknowledged the lack of precedent under UK law and the difference in approach under US law posed difficulties in estimating the additional costs auditors might charge to assure the OFR. The final estimate was given as £19,000, based on an increase in audit fees of 5% (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 mean average cost burden on companies under Option 4 was given as £29,000 per company (excluding publication and distribution).

145. A large number of consultees disagreed with our analysis noting, in particular, the requirement for auditors to state whether directors had prepared the OFR with 'due and careful enquiry' required both more and more extensive verification than that used in relation to internal controls. Also, that it extended directors' and auditors' liability beyond that which exists currently.

146. As previously stated, one of the audit firms claimed *"there would be a larger than predicted increase in audit fees"*, while another claimed business could expect costs to rise by 10-20% of current audit fees to assure the OFR. The London School of Chartered Accountants suggested fees could be £50 - 500,000 depending on the size and complexity of the business. Business itself submitted a range of estimates well above ours of £19,000: the highest – from a FTSE 100 company – at £1.25m.

147. The January 2002 paper, *Audit Pricing in Private Firms*, put the average audit fee for (all) listed firms at **£272,480**, [21] The July 2004 paper, *An Assessment of the Implications for Competition of a Cap on Auditors' Liability*, put the average audit fee for FTSE 100 companies at **£2.34m**. Using either of these figures in combination with the suggested 10-20% increase in fees puts audit costs for the OFR nearer to £27,000 - £54,000 on average and £234,000 - £468,000 for FTSE 100 companies, compared to original estimates of £19,000.

148. However, reverting to common law duty in lieu of 'due and careful enquiry' and removing either the requirement for auditors to consider both the process directors follow in preparation of the OFR and consistency with any other matters arising in the conduct of the audit, or process alone (Option 4a) reduces the cost burden significantly.

149. Discussions with business representative groups suggest that under Option 4a, assurance estimates could reduce by 60% because the requirement to opine on the process directors follow in preparing the OFR would require new and significant work to that undertaken in the normal course of an audit. The relative cost impact of Option 4 versus 4a is detailed in Table 5 below.

Table 5 – Impact of Changes to Directors' Care and Auditors' Role on Audit Review Costs

	Audit Fees	Option 4		**Option 4a**	
		Best Case (10% x Fees)	Worse Case (20% x Fees)	Best Case (10% x Fees)	Worse Case (20% x Fees)
				Discount x 60%	
Average Quoted Company	£272k	£27k	£54k	**£11k**	**£22k**
FTSE 100 Company	£2.34m	£234k	£468k	**£94k**	**£187k**

[21] www.london.edu/accounting/Research/working_papers/ACC011.pdf

150. Taking the worse case scenario on both counts – £54k for the average quoted company under Option 4 and £22k for the average quoted company under Option 4a – this means Option 4 imposes total assurance costs on companies of **£69.7m**, while Option 4a reduces that total assurance cost to **£28.1m**.

Summary of Costs by Option

151. Total costs of the Options are detailed in Section 11 below. The least burdensome Option is Option 3b (£107.4m), in which the Modernisation Directive is implemented and applied to 36,000 companies, with a statutory OFR being introduced for large quoted companies (estimated as 350).

152. The most burdensome Option is Option 4 (£179.3m), in which the Modernisation Directive is implemented, together with a three-stage assured OFR for 1,290 quoted companies, for which auditors are required to consider the directors' process, consistency with accounts and any other matters arising during the conduct of the audit.

153. Having regard to the cost-benefit arguments underpinning the implementation of the Modernisation Directive and OFR, **the Government recommends Option 4a (£137.2m).**

Small Firms' Impact Test

154. The Small Business Service accepts that the OFR proposals and the enhanced requirement of the fair review required by Modernisation Directive will not apply to small businesses, and that this is appropriate to avoid unnecessary regulatory cost burdens.

Competition Assessment

155. Any change in the competitive environment can affect the effective working of markets. New regulations, while delivering necessary policy objectives, risk affecting competition. Some of the ways in which this risk manifests include:

a. Having a substantial effect on companies' costs;
b. Affecting the relative market position of companies;
c. Altering the rate of technical or commercial progress;
d. Directly impacting on the competitive process by raising or lowering barriers to entry, or by altering the concentration of markets.

156. As competition assessment relates to the OFR and Modernisation Directive, two issues have to be considered:

a. Whether one, other, or both will inhibit the market structure and individual companies' growth: discouraging listing for private companies in the case of the OFR; staying under the medium-size threshold for small companies in the case of the Modernisation Directive;

b. In the case of the OFR, whether the requirement to disclose information about strategy and future prospects (inclusive of risks and resources) will place quoted companies at a competitive disadvantage to private companies operating in the same industry sector.

Market Structure and Company Growth

157. The OFR proposals apply to GB-registered companies listed on the London Stock Exchange. Non-GB companies on the same market will not be obliged to prepare an OFR. Other markets in the UK (e.g. the Alternative Investment Market) and overseas markets have no directly equivalent requirements.

158. An estimated 1,290 companies will be required to prepare an OFR. Based on three sets of criteria – turnover, balance sheet total and number of employees - the largest of these companies has less than 10% market share, and the three largest less than 50% market share. Regulation will not affect the market structure, nor will companies that choose to list (and thus be captured by the OFR upon commencement of operations as a quoted company) have to meet higher set-up or ongoing costs than existing quoted companies.

159. All of the 1,290 will bear regulation costs over and above those incurred by private and public non-quoted companies, some of which will be of a similar size as defined under the Companies Act. As a result, introduction of the OFR could 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.

160. Companies that choose to list (go public) enjoy a number of advantages, however, including: the ability to raise large amounts of capital through the sale of shares or financial institution lending; improved production costs through ever greater economies of scale; and market power. These advantages are unlikely to be ceded as a result of new or additional reporting requirements, especially where these build on existing or to-hand information gathered in the ordinary course of business.

161. As well, anecdotal evidence and public commentary suggests that time and costs burdens incurred in the preparation and assurance of the OFR will be comparatively less for UK registered companies listed on the LSE than third country companies listed on other exchanges, in particular the main US exchanges: NASDAQ and NYSE. The Government believes, therefore, that it is unlikely that introduction of the OFR will result in companies choosing not to list (or to list elsewhere).

162. The Modernisation Directive will apply to all large and medium-sized UK-registered companies (and their counterparts in Europe). An estimated 36,000 companies will be required to prepare an enhanced Directors' Report to comply with the Directive.[22] The Government does not expect the Directive to affect the market structure in any way.

Competitive Disadvantage Occasioned by the OFR

163. Three factors appear to determine whether information creates competitive disadvantage: the type of information, the level of detail, and the timing of the disclosure. Routine operating data is generally less likely to cause competitive disadvantage than information about product development. However, the greater the level of detail about new product plans – for example, including unique features and the reasons for their potential appeal – the greater the likelihood of competitive disadvantage.

164. The timing of a disclosure also affects its potential for competitive disadvantage because at some stage disclosure loses its capacity to create competitive disadvantage. Strategies become obvious from actions, and information about them no longer leads to competitive disadvantage. Products in development eventually come to market, and the closer to that date that product plans are disclosed, the less time there is for a competitor to respond.

165. Even with awareness of the factors just cited, it is difficult to generalise or be certain about the effect of particular disclosures on competitiveness. For example, a potential competitor evaluating the investment hurdle to enter an industry might as likely be dissuaded by the disclosures as encouraged to enter the field.

166. On the other hand, there is also disclosure behaviour that runs counter to the intuitive notion of competitive disadvantage. New products, for example, sometimes are announced early in order to convince competitors that the market has been pre-empted or to give the product a head start in name recognition.

167. It cannot be forgotten, either, that competitors often already know a great deal about a company from the company's former employees, mutual suppliers and customers, market research, industry publications, dismantlement and engineering studies of competitors' products, and the marketplace itself. The competitive cost of disclosing information thus depends on the incremental insight that information brings to competitors relative to the competitors' other sources of intelligence.

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[22] Excluding the 1,290 that will be caught by the OFR and will therefore be exempted from filing two sets of reports.

168. The Government believes quoted companies will be able to comply with the Regulations and disclose meaningful information to shareholders without placing themselves at a competitive disadvantage. Consultees broadly agreed with the government's view.

Enforcement and Sanctions

169. The Consultation Document outlined the Government's proposal to introduce an enforcement regime for the OFR (and also for directors' reports) that mirrored the existing regime in respect of financial statements.

170. There are two elements to the enforcement regime for financial statements: criminal sanctions for directors who are party, knowingly or recklessly to the approval of defective accounts, and for the failure to sign accounts; and the administrative procedure whereby the Secretary of State or a body authorised by her (in practice, the Financial Reporting Review Panel - FRRP) may apply to the court for an order obliging a company to prepare revised accounts where it appears that the accounts do not comply with the law.

171. The existing criminal sanctions are rarely invoked but are an important signal. They are designed to punish directors who either fail to produce accounts at all or deliberately or recklessly fail in their duty to prepare accounts that give a true and fair view. Consultees made very little comment on this aspect of enforcement, suggesting that the principle is well understood and uncontroversial. The Government therefore intends to implement the proposed criminal sanctions for the OFR and directors' report as set out in the consultation and draft regulations and for those sanctions to apply to financial years beginning on or after 1st April 2005.

172. The administrative element of the enforcement regime for the OFR elicited rather more responses from consultees, from which it was apparent that the Consultation Document had failed to convey the Government's intentions sufficiently precisely. There was concern from some respondents that the FRRP would 'second-guess' directors' judgements and be a heavy-handed enforcer, while others doubted whether the FRRP would be able to enforce the OFR effectively.

As one respondent put it: *"If the auditors have not unearthed a serious problem, it is difficult to imagine that FRRP will be able to do so."*

173. The Government has had further discussions with the Financial Reporting Council and its relevant constituent bodies, the Accounting Standards Board, the Auditing Practices Board and the FRRP and is satisfied that the proposed administrative enforcement mechanism is workable and balanced. However, in order to ease the introduction of the OFR, the Government intends to delay by one year the commencement of the administrative enforcement mechanism.

174. The administrative mechanism resembles that for accounts but differs in small but important respects, notably the status of the respective standards , and the consultation document may have been inadvertently misleading in saying that the

proposed new regime "mirrors" that for accounts. The starting point is that for the OFR, even more so than for accounts, the application of the law and standards to the multitude of complex, real-world situations will not always be clear cut and automatic.

175. There is plenty of room for genuine debate and difference of view on what is required in particular circumstances, for example whether a particular issue needs to be included for "a balanced and comprehensive analysis", or whether a forecast of company performance is sufficiently supported by evidence. Nevertheless, there needs to be a means of obliging companies to correct mistakes in the OFR, in order to ensure that shareholders and other users are not given false or misleading information. That is why there is a fundamental difference between deliberately or recklessly preparing a defective OFR (subject to criminal sanction on individual directors) and making an 'honest mistake' (which could ultimately result in a civil order to the company to revise its OFR).

176. The status of accounting standards is the product of several factors including statute, case law, the history of the development of standards and their general acceptance by both the accounting profession and preparers and users of accounts. OFR standards will, at least initially, only have statutory support, although the Government expects their status to develop in much the same way as accounting standards in due course.

177. A company that prepares its OFR in accordance with the relevant standards will enjoy a presumption that it has complied with the law on the contents of the OFR. This will provide a strong incentive to follow standards while providing flexibility, should a company decide it is necessary or desirable, to depart from the standards provided that it gives particulars of, and reasons for, any such departure.

178. The role of the FRRP will be to consider, both as part of its proactive role of examining the financial statements of larger companies and in response to specific complaints, whether companies' OFRs comply with the legal requirements. The FRRP already looks at any voluntarily prepared OFR when examining a company's accounts. The regulations will formalise its role in relation to those companies obliged to prepare an OFR.

179. The basic question the FRRP must therefore answer is whether it complies with the legal requirements. Where a company claims that its OFR complies with relevant standards, the FRRP will also need to satisfy itself that the standards have indeed been followed, since any departure from the standards, although not of itself necessarily constituting a failure to comply with the legal requirements on the contents of the OFR, must nevertheless be noted and explained (see paragraph 177 above).

180. For both the company and the FRRP, complying with relevant standards will make it much easier to demonstrate compliance with the law. In effect, the burden of proof will be shifted on to someone complaining that an OFR is not compliant to show why, despite complying with the relevant standards, the OFR in question fails to comply with the underlying legal requirements. Where a company makes the deliberate choice to depart from standards, it will be in the knowledge that it

must explain why it is doing so, and in the expectation that its OFR will be closely scrutinised by readers to see whether it nevertheless meets the legal requirements. For this reason the Government expects that even initially few companies will need or wish to depart from standards, and as practice develops and standards evolve and become more comprehensive, departures will become even rarer, as with accounting standards.

181. The crucial question is what criteria the FRRP will apply in deciding whether to challenge an OFR. The FRRP will be carrying out a quasi-public function (on behalf of and with the authority of the Secretary of State) and will therefore be subject to the principles of administrative law, in particular the duty to exercise its power reasonably and proportionately. Its practice for the OFR will be along the same lines as for accounts. Where it comes across something in, or an omission from, an OFR that appears questionable, it will contact the company to seek further information and explanation. It may need to ask for evidence of how the company compiled the OFR and reached conclusions on particular issues. If it is not satisfied with the response, it may seek to persuade the company to revise its OFR voluntarily to correct the point, or make a corrective statement. In the last resort, it will be able to apply for a court order to compel the company to revise the OFR. However, the Government's clear expectation is that an application to the court should only be necessary if :

a. The OFR omits a requirement of Schedule 7ZA;
b. The OFR purports to comply with the OFR standard but does not do so;
c. the OFR is factually wrong in a material respect;
d. it contains an opinion which no reasonable board could have formed if it had followed a proper process of collecting and evaluating evidence.

182. The Government believes that this is a balanced and effective way of ensuring that defective OFRs can be corrected ctors acting reasonable. Nevertheless, the Government accepts that the preparation of statutory OFRs will represent a new challenge for both companies and the FRRP.

183. Therefore, as noted in paragraph 173 above, the Government proposes that the FRRP's administrative enforcement role in respect of the Modernisation Directive and OFR will not be commenced until one year after the duty to prepare OFRs. In other words, the FRRP will only start looking at OFRs prepared for financial years beginning on or after 1 April 2006.

184. This will give the FRRP time to put in place the necessary procedures and expertise to deal with OFRs, and will allow all parties the opportunity to have a 'settling in' period to become familiar with the new requirements and relevant standards, and to share good practice.

Monitoring and Review

185. The Government wishes to ensure that the cost/benefit arguments for introducing the OFR remain positive. This is best achieved through a structured piece of research. The Government therefore proposes to look at a study based on pooled data focusing on:

a. How, and to what extent, risk from a particular investment is (being) reduced through the provision of more and/or different information: a standard benefit of enhanced disclosure;
b. How and to what extent any such reduction in risk has resulted in investors accepting a lower return on their investments which, in turn, leads to a lower cost of capital for companies.

186. An approach involves setting up a study to look at volatility (as measured by the variance of share price performance) or liquidity (as measured by bid-ask spreads on shares) of shares pre OFR with that post OFR. If volatility was reduced post OFR and liquidity increased, this would suggest certain aspects of risk had been lowered. The next step, to link the OFR to changes in cost of capital, is slightly more problematic but feasible.

187. In addition to these studies of the benefits of introducing the OFR would be the monitoring of associated costs. This would require a comprehensive survey of the companies affected. This may be achieved through the establishment of a research program to conduct interviews with a sample of companies to get some hard data on costs rather than relying on 'perceptions' of how much it was costing.

Consultation

Within government

188. Prior to publication of the Consultation Document, the Government had already consulted widely on the OFR proposals when these were contained within the White Paper, Modernising Company Law, published in July 2002.

189. 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

190. The DTI had also 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.

Public Consultation

191. Prior to publication, the DTI had also 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.

Activities During the Formal Consultation Period

192. A written statement to Parliament preceded the launch of the consultation. The consultation document was published on the DTI website and announced by a press notice. Several organisations arranged meetings during the consultation process to allow their members and others to discuss the OFR.

193. DTI officials participated at events organised by Business in the Community, the IoD, the London Stock Exchange, the ICAEW. The DTI also organised a major stakeholder workshop to discuss the consultation proposals. Over 40 participants from a range of stakeholder organisations attended the event. In addition, throughout the consultation period DTI officials discussed the OFR with various interested parties.

Summary and Recommendation

194. Detailed costs and benefits of the options are contained in Tables 6 and 7 below. Summary costs are:

Table 6 – Summary of Costs by Option

Option		Total Per Annum Cost
1	Do Nothing	**£0**
2	Implement the Modernisation Directive only	**£103.7m**
3	Implement the Modernisation Directive and a non-assured statutory OFR for quoted companies	**£107.9m**
3a	Extend OFR to large private companies	**£142.9m**
3b	Narrow OFR to large quoted companies	**£107.4m**
4	Implement the Modernisation Directive and a statutory OFR for quoted companies with a three-stage assurance regime	**£179.3m**
4a	Implement the Modernisation Directive and a statutory OFR for quoted companies with a two-stage assurance regime NB. If extended to large private companies	**£137.2m** **£247.5m**

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Table 7 – Summary of Costs and Benefits by Option

Option	**Cost**	**Benefit**
1. Do nothing	Risk of infraction proceedings for failure to implement the requirements of the Modernisation Directive.	• No benefits accrue.
2. Implement the expanded directors' report requirements required under the Modernisation Directive but do not introduce a statutory OFR.	Estimated cost for preparation and assurance of Directors' Report by 37,290 companies is: **£103.7m**.	• Comprehensive analysis of 36,000 large and medium-sized UK-registered companies, plus 1,290 UK-registered quoted companies through enhanced Directors' Report, with references to and additional explanations of amounts reported in consolidated accounts.

		• Some improvement in shareholder dialogue and engagement where applicable (i.e. 1,290 quoted companies).
3. Implement the expanded directors' report requirements required under the Modernisation Directive and introduce a statutory OFR, but without any requirement on the latter for an auditors' review.	Estimated cost for preparation and assurance of Directors' Report by 36,000 companies is £96m. Estimated cost for preparation and publication of OFR by 1,290 companies is £11.1m, Additional £200k payable to the ASB for preparation of the first OFR standard Additional £500k per annum payable to the FRRP for enforcement of the OFR. First Year Costs: **£107.9m** Ongoing PA Costs: **£107.7m**[23]	• As for Option 2 with regard to large and medium-sized UK-registered companies. • Option 3 delivers significant improvement in shareholder dialogue and engagement through OFR, courtesy of comprehensive discussion and analysis of business operations, past and future, including resources, risks and uncertainties. • Reduced likelihood of misallocation of capital. • Lower average cost of capital. • More liquid capital market. • Promotes long-term value creation.
3a. Extend coverage of OFR to 5,000 large private UK-registered companies.	Ongoing PA Costs: £66.0m (Mod Dir) £76.2m(OFR) £ 0.5m (FRRP) **£142.7m**	• Option 3a extends benefits to additional 5,000 large private companies.
3b. Narrow coverage of OFR to large quoted	Ongoing PA Costs: £101.6m (Mod Dir)	• Option 3b limits benefits to an est. 350 large quoted companies.

[23] Subtract one-off payment to ASB

companies (est. 350).	£ 5.0m (OFR) £ 0.5m (FRRP) **£107.2m**	
4. Implement the expanded directors' report requirements required under the Modernisation Directive and to introduce a statutory OFR, together with an auditors' review based on: directors' process; consistency with accounts; any other matters arising. 4a. Amend auditors' review to: consistency with accounts; any other matters arising Note: 4a Extended to large privates	Estimated cost for preparation and assurance of Directors' Report by 36,000 companies is: £96m. Estimated cost for preparation, assurance and publication of OFR by 1,290 companies is: £82.6m Additional £200k payable to the ASB for preparation of the first OFR standard Additional £500k per annum payable to the FRRP for enforcement of the OFR. First Year Costs: **£179.3m** Ongoing PA Costs: **£179.1m** First Year Costs: **£137.2m** Ongoing PA Costs: £96.0m (Mod Dir) £40.5m (OFR) £ 0.5m (FRRP) **£137.0m** Ongoing PA Costs: **£247.5m**	• As for Options 2 & 3 with regard to quoted, large and medium-sized companies. • Option 4 delivers additional level of assurance for investors through auditors' review. Contributes to strengthening of confidence in the market place. • Option 4a delivers greater likelihood of open, candid and meaningful disclosures relevant to primary beneficiaries: investors. • Option 4a extend to large privates.

The Government proposes to implement Option 4a with total first year costs of £137.2m and ongoing per annum costs of £137.0m.

12. Declaration

I have read the Regulatory Impact Assessment and I am satisfied that the benefits justify the costs.

Jacqui Smith 8th January 2005

Jacqui Smith
Minister for Industry and the Regions and Deputy Minister for Women and Equality

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