

EXPLANATORY MEMORANDUM TO THE HOUSE OF LORDS COMMITTEE ON THE
MERITS OF STATUTORY INSTRUMENTS

THE COMPANIES (1986 ORDER) (OPERATING AND FINANCIAL REVIEW AND
DIRECTORS' REPORT ETC.) REGULATIONS (NORTHERN IRELAND) 2005

2005 No. 61

- 1.1 This explanatory memorandum has been prepared by the Department of Enterprise, Trade and Investment and is laid before Parliament by Command of Her Majesty.
- 1.2 This memorandum contains information for the House of Lords Select Committee on the Merits of Statutory Instruments.
2. **Description**
 - 2.1 This statutory rule amends the Companies (Northern Ireland) Order 1986 (the 1986 Order) 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 Select Committee**
 - 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 in Northern Ireland by the Companies (1986 Order) (International Accounting Standards and Other Accounting Amendments) Regulations (Northern Ireland) 2004 (S.R. 2004 No. 496).
 - 3.2 Because of the similarities and overlap between the remaining provisions to be implemented and the provisions for the OFR contained in the rule, the Department, in line with decisions taken in Great Britain, 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, the Secretary of State for Trade and Industry announced that, given concerns expressed in consultation about the need for adequate preparation time for introduction of the OFR, the effective date for the requirement would be delayed until financial years beginning on or after 1 April 2005. This gives business three extra months to 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 statutory rule is to be made under Article 265 of the 1986 Order. This corresponds to section 257 of the Companies Act 1985 (c.6) under which the Great Britain statutory instrument has been drafted (see paragraph 5.1 below). Section 257 was amended by section 13 of the Companies (Audit, Investigations and Community Enterprise) Act 2004 (c.27). There is no corresponding provision at present in Northern Ireland to section 13 and equivalent provision for a statement of standard reporting practice for the OFR to be issued by a specified body cannot be included in the statutory rule. This gap will be closed by amending regulations as soon as Northern Ireland has a provision corresponding to section 13.

4. Legislative background

- 4.1 The statutory rule introduces a new requirement for quoted companies to prepare an OFR. A quoted company is defined in Article 270(1) of the 1986 Order 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 (c.8), 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 rule also implements Articles 1.14, 1.17 (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 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 2003¹. The remainder of the Directive was implemented by the Companies (1986 Order) (International Accounting Standards and Other Accounting Amendments) Regulations (Northern Ireland) 2004 (S.R. 2004 No. 496).
- 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.

¹ The Directive is on the EC Commission's web site at http://europa.eu.int/comm/internal_market/accounting/index_en.htm.

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.

5. Extent

5.1 This statutory rule applies to Northern Ireland only. The corresponding Great Britain Regulations are the draft Companies Act 1985 (Operating and Financial Review and Directors' Report etc.) Regulations 2005 which have been laid at Westminster.

6. European Convention on Human Rights

6.1 Barry Gardiner, MP, Minister for Enterprise, Trade and Investment has made the following statement under section 19(1)(a) of the Human Rights Act 1998 (c.42):

"In my view the provisions of the Companies (1986 Order) (Operating and Financial Review and Directors' Report etc.) Regulations (Northern Ireland) 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 In May 2004 the Department of Trade and Industry (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.

- 7.4 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.
- 7.5 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.
- 7.6 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.

8. Impact

- 8.1 Transposition Notes are attached at Annex A.
- 8.2 There is an impact on quoted companies for the preparation of OFRs and directors' reports to comply with the Regulations. This cost is believed to be similar to the costs estimated for an average Great Britain quoted company, that is, between £11,000 and £22,000.
- 8.3 There is no impact on the public sector as this statutory rule only applies to companies.

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

THE COMPANIES (1986 ORDER) (OPERATING AND FINANCIAL REVIEW
AND DIRECTORS' REPORT ETC.) REGULATIONS
(NORTHERN IRELAND) 2005 (S.R. 2005 No. 61)

Introduction

1. The Companies (1986 Order) (Operating and Financial Review and Directors' Report etc.) Regulations (Northern Ireland) 2005 ("the 2005 Regulations") implement, in Northern Ireland, 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"). Separate transposition notes were prepared detailing implementation of the majority of the provisions of the Modernisation Directive by the Companies (1986 Order) (International Accounting Standards and Other Accounting Amendments) Regulations (Northern Ireland) 2004 (S.R. 2004 No. 496) made on 2 December 2004.
2. European Union (EU) accounting requirements are based primarily on four Accounting Directives; the Fourth² and Seventh³ Directives on the annual and consolidated accounts of companies; the Directive on the annual and consolidated accounts of banks and other financial institutions⁴; and the Directive on the annual and consolidated accounts of insurance undertakings⁵.
3. The Accounting Directives have been transposed into law in Northern Ireland by the Companies (Northern Ireland) Order 1986 ("the 1986 Order"). The transposition of the Modernisation Directive therefore takes the form of amendments to the 1986 Order.
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 1986 Order 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.

² 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).

³ Seventh Council Directive of 13 June 1983 (83/349/EEC) on consolidated accounts (OJ L193/1 of 18.7.1983).

⁴ 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.

⁵ 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.

5. Responsibility for the measures described in this transposition note taken to implement part of the Modernisation Directive in Northern Ireland lies with the Department of Enterprise, Trade and Investment.

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 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.	A requirement. Regulation 2 replaces Article 242 of the 1986 Order (duty to prepare directors' report), and inserts new Articles 242ZZA (directors' report: general requirements) and 242ZZB (directors' report: business review) into the 1986 Order.
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 Article 254A(2A) into the 1986 Order, and regulation 6 amends Article 255A (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 Article 243(3) of the 1986 Order.
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 Article 242(2) and (3).
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 Article 242(2) and (3) into the 1986 Order. Regulation 7 makes consequential amendments to Schedule 7 to the 1986 Order.