The UK Society of Investment Professionals

A member society of the CFA Institute

Regulations on the Operating and Financial Review and Directors Report

Response to the DTI by the

UK Society of Investment Professionals

About UKSIP

The UK Society of Investment Professionals ("UKSIP") is a professional organisation whose main aim is to foster and maintain high standards of professional ability and practice in investment analysis, portfolio management and related disciplines. It currently has over 4,500 members, who work or have an interest in the UK financial services industry. UKSIP is the second largest member society worldwide of the CFA Institute, and the largest in Europe. CFA Institute is a global non - profit organisation of more than 67,000 investment professionals, and is best known as the organisation that develops and administers the Chartered Financial Analyst (CFA®) Program.

UKSIP also oversees the Investment Management Certificate ("IMC"), the benchmark qualification for those working in investment management in the UK and currently held by over 15,000 investment professionals. UKSIP members who successfully completed UKSIP's former Associate examination, which was similar to the CFA, can use the designation ASIP.

Overview

UKSIP's members are major users of financial statements and the Society has long supported the use of the Operating and Financial Review (OFR) as a means of providing both quantitative and qualitative information about an enterprise. Specifically the OFR can assist users in the "evaluation of the ability of the enterprise to generate cash and cash equivalents and of the timing and certainty of their generation. Users are better able to evaluate this ability to generate cash and cash equivalents when they are provided with information that focuses on the financial position, performance and changes in financial position of an enterprise. (IASB Framework Paragraph 15) Accordingly, UKSIP has consistently encouraged the corporate sector to make full and imaginative use of the OFR.

Company management and the OFR

UKSIP is disappointed that the various initiatives from the Accounting Standards Board (ASB) and others have not been more enthusiastically adopted by the corporate sector generally. In UKSIP's view the reasons for this have been twofold.

Firstly, management may believe it is in its own best interest to limit and control the flow of information to shareholders. This enables management to present itself - and the business - in what it believes may be the most favourable light. As a consequence the information set provided is unlikely to be balanced and will almost always be less comprehensive than investors require. An additional factor reinforcing this basic tendency has been the increasing use of share price performance criteria as the basis for executive remuneration.

Understandably, perhaps, management can be reluctant to release information that it believes would reveal an unpleasant truth about the business. If all such information were available, the market might lower its valuation of the business, resulting in management suffering financially and reputationally. However, UKSIP believes that the market is more likely to reward those managements that display a consistent frankness about their enterprises. Candour, despite what some managers may believe, is beneficial.

The second major reason for the lack of a complete information set lies with the failure of the capital markets themselves. Shareholders and more particularly their agents, the fund managers, rarely, as a group, demand - in a coherent, effective and focused way - improvements in the financial information provided where this is perceived to be inadequate. Many fund managers have neither the time nor the resources to commit to such time consuming lobbying of business and are not directly rewarded for it. Accordingly, therefore, much more notice needs to be taken of those few who do voice strong opinions in this area.

This cannot make for efficient markets and a more systematic process is needed. Accordingly, therefore, UKSIP welcomes the proposals in the consultative document mandating a balanced and comprehensive analysis of the business through the publication of an effective OFR.

However, the current proposals do not address directly the two forces outlined above which have served to constrain the development of an effective OFR. UKSIP would, therefore, suggest three important amendments to strengthen the structure of the OFR and hopefully prevent the production of “boiler plate” and irrelevant material.

Strengthening the OFR regulations

Firstly, in order to provide the context for the “Review objective” UKSIP believes that the OFR must contain a statement of the directors’ strategy for the business, a justification of why that strategy is appropriate, how it is proposed to deliver that strategy and the measures by which its failure or success should be assessed. The OFR is “prepared so as to enable the members of the company to assess the strategies adopted by the company and the potential for those strategies to succeed” yet the draft regulations relegate the requirement for strategy to a part of a subset of “Other general requirements”. **UKSIP recommends, therefore, that the strategy statement should be included as the first section of the “Review objective” in order to set the whole “Review objective” in its proper context**.

Secondly, in order to provide a framework for delivery of the “Review objective”

UKSIP recommends the OFR should, of necessity, include a descriptive and quantitative analysis of the key elements of the economic model of the entity, its sources of revenue, the cost structure and hence the sources of the primary streams of its profitability - essentially how the company works in economic terms. Such an analysis could relate directly to the segment reporting in the primary accounts. Based upon that, the other elements of the "Review objective" will then been seen in their full significance and relevance, adding powerfully to the overall structure and usefulness of the OFR.

Thirdly, as mentioned in the Society's response to the consultation paper published last year, care should be taken to ensure that the process for determining what is material does not become an end in itself. **UKSIP, therefore, recommends as vital that the outcomes of the OFR itself are validated by an audit procedure and that the auditors' role is not limited just to auditing the process of producing the OFR. The auditors should, therefore, be required to comment upon the outcomes of the OFR as well as its process, stating whether, in their view, the OFR as published is consistent with the "Review objective".** The Financial Reporting Review Panel (FRRP) will have responsibility under the proposals for ensuring that the OFR outcomes are appropriate and the FRRP's role will be strengthened if those outcomes have already been audited. Indeed, once the proposals have been implemented, companies should be required to comment in subsequent years as to whether previous remarks made in the OFR about the nature of the business remain valid or not.

In UKSIP's view these three additional elements will be vital in ensuring that the OFR does deliver the step-change in narrative reporting that is widely anticipated by Government and others.

UKSIP also wholeheartedly supports the position now set down in the draft regulations that the OFR is essentially a statement prepared for shareholders - although other stakeholders and interested parties will find it of benefit. As the IASB Framework paragraph 10 states "Whilst all of the information needs of these users (investors, employees, lenders, suppliers, creditors, customers, governments and their agencies and the public – our parentheses) cannot be met by financial statements, there are needs which are common to all users. As investors are providers of risk capital to the enterprise, the provision of financial statements that meet their needs will also meet most of the needs of other users that financial statements can satisfy." This position as the ultimate provider of risk capital does resolve the apparent conflict between investors and other users of financial statements. The OFR itself should be written "through the eyes of management" as a means of demonstrating what it is that management believes are those matters that are most significant in any assessment of the entity and the strategy that the Board is pursuing.

Detailed response

UKSIP's response to the specific questions set out in the Consultative Document on Draft Regulations on the Operating and Financial Review and Directors' Report is as follows:

Q1 *Do you have any comments on the means by which paragraph 1 of the OFR Schedule 7ZA (inserted by draft regulation 7) implements the CLR objective?*

UKSIP believes this to be a pragmatic and sensible approach.

Q2 *Do you agree that quoted companies comprise the appropriate class of companies to be required to prepare an OFR?*

UKSIP agrees that all quoted companies should prepare an OFR. Additionally, UKSIP would suggest that those private entities that have publicly traded debt instruments should also prepare an OFR. In particular, UKSIP would also extend the requirements to any entity whose equity shares or debt instruments are publicly traded in any form. UKSIP would, therefore, also expect to see companies on the AIM prepare OFRs. Indeed for such small companies which do not receive wide scale recognition in the market place, it would represent a particularly useful way of providing information on the enterprise to any interested party. In addition, it may also be socially valuable if all large private companies of a certain size, including the unquoted subsidiaries of foreign multinationals, were also required to prepare an OFR for the benefit of other stakeholders and interested parties.

Q3 *Do you agree that the draft Regulations should include a specific requirement to include a description of the capital structure, treasury policies and objectives and liquidity of the company?*

Agreed. In particular the capital structure descriptions should be made in the context of the business model and should explain why the existing capital structure is or is not appropriate. Again linking capital structure to the form of the business model would prove very informative. Moreover, financial derivatives can transform the shape of a balance sheet as a result of just a few quick transactions and any statement that ignored such considerations would be inadequate. UKSIP would look to the ASB to provide guidance on the precise form of the description.

Q4 *Do you agree that directors should be required to state the fact where they have concluded that there is nothing relevant to report in respect of the items covered by paragraphs 4 to 7 of Schedule 7ZA?*

UKSIP regards this as unnecessary. The whole OFR is based upon a "through the eyes of management approach". Thus the completed OFR as a whole should be management's definitive statement about the business. Therefore, that which is not mentioned in the OFR can always be deemed as management's implicit assertion that its inclusion is not necessary for a balanced and comprehensive analysis of the high level objectives. Much other information will also be deemed not to be relevant and a statement that there is nothing to report specifically in respect of the items in paras 4-7 will add little.

Indeed, dropping this proposed requirement to comment should avoid the inclusion of unnecessary, irrelevant and confusing content. Such a tendency is already evident both in the draft regulations and in the Practical Guidance for Directors. Page 12 of the draft regulations make it clear that, in the Government's view, environmental performance, employee issues and relationships with suppliers "are crucial to the company's future success and reputation", (paragraphs 3.34-3.36 refer). This leaves little room for directors to be able to say that, whilst all these factors are indeed important, they are not central to complying with the "Review objective" and other general requirements even though they will not be pertinent.

Q5 *Do you agree with the approach taken in, and the drafting of, Schedule 7ZA?*

As UKSIP argued in the overview to this response, the context for assessing the "Review objective" will be considerably strengthened if the OFR contains a statement of the directors' strategy for the business, a justification of why that strategy is appropriate, how it is intended to deliver that strategy and the measures by which their failure or success should be assessed. The OFR is "prepared so as to enable the members of the company to assess the strategies adopted by the company and the potential for those strategies to succeed", yet the draft regulations relegate the requirement for strategy to a part of a subset of "Other general requirements". UKSIP believes the strategy statement should be included as the first section of the "Review objective" in order to set the whole "Review objective" in its proper context.

UKSIP also believes that the "Review objective" should include a specific requirement for a description of the economic model of the business providing a clear context for all the other "Review objective" issues. Whilst it may be considered as being implicit within the section on the dynamics of the business, such a requirement should make the whole OFR far more structured to make it an explicit description of the business's economic model as part of the review objective. Giving the OFR structure and form will help to focus what is really important in conveying appropriate high level information without either "boiler plate" or unnecessary irrelevance.

Q6 *Do you agree with the proposed role of the auditors as set out in regulation 8, including whether 'due and careful enquiry' is a reasonable and practicable standard to require of directors?*

UKSIP believes this to be a profoundly mistaken approach and a fundamental flaw in the proposals. Despite all the opportunities afforded by the existing voluntary arrangements the OFR has generally been an inadequate statement. The auditors' role must, therefore, be much more than just validating the process. The process is intended to deliver a high quality OFR. The auditors' role should be to confirm that the outcome delivers the intended high level objective. Indeed, if shareholders mistakenly rely on an outcome that is not valid but has the cachet of audited process review, we will have actually gone backwards. UKSIP would therefore envisage a role for auditors that validates the outcomes of the process as well as the process itself.

Q7 *How much do you estimate such a review of process by the auditors might cost?*

In the context of the gains to be achieved by the markets being offered an improved and more transparent information set and thereby being able to apply a more appropriate cost of capital, the costs are likely to be modest compared to the potential gains.

Q8 *Do you agree with the Government's approach to the OFR enforcement regime as set out in paragraphs 3.60 - 3.73 and draft regulations 9-12?*

Agreed. It is an appropriate approach that builds on the existing arrangements. UKSIP questions, however, whether the FRRP will need more guidance in order to achieve effective enforcement. *(To be amplified)*

Q9 *Do you agree with the Government's proposal to implement the Member State option in the Modernisation Directive by providing an exemption for medium-sized companies from the requirement to include non-financial information?*

UKSIP agrees that it is appropriate for medium sized companies, that are not subject to other requirements, to be treated in this way. Nevertheless, UKSIP would reiterate that for such companies who do not receive wide scale recognition it might represent a particularly useful way of providing information on the enterprise to any interested party.

Q10 *Do you agree with the Government's proposal to bring the OFR Regulations into effect for years beginning 1 January 2005? We would welcome suggestions on how the Government can best implement the Regulations.*

UKSIP agrees with the proposed timetable. It seems all the more appropriate given the forthcoming introduction of International Financial Reporting Standards and the extra explanations that these will require. UKSIP actively supports early adoption by companies.

Q11 *Do you have any general comments or specific suggestions on the drafting of the Regulations at Annex A?*

No.

Q12 *Do you agree that all shareholders should receive the OFR? Do you agree that it is not appropriate to legislate to permit companies to send a summary OFR in place of the full version?*

Agreed. All shareholders must be encouraged to take their responsibilities as owners and as investors very seriously. UKSIP would encourage all shareholders to receive the full statutory accounts and the full OFR. Indeed if properly delivered the OFR should represent a definitive statement about the entire entity which all shareholders should find immensely useful. As a document the OFR may prove quite difficult to summarise in a meaningful and balanced way. However, unless the publication of all summary accounts is prohibited, those shareholders who insist on not receiving full accounts will, presumably, receive a truncated version of the OFR.

Q13 *Do you believe that the draft Regulations should omit any requirement on directors to include information on corporate governance in their OFR, or do you think that such information is sufficiently key to company performance that repetition is justified?*

UKSIP agrees that the draft Regulations should omit any requirement on directors to include information on corporate governance in their OFR. This is another important part of the information sub set and is already available elsewhere within the financial statements. Repetition would be unjustified and possibly confusing if also included in another abbreviated form within the OFR.

Q14 *Do you agree with the Government's proposal that a provision for confidentiality should not be included for the OFR?*

Agreed. UKSIP would never expect truly confidential information to be disclosed. Specifically allowing confidentiality would in UKSIP's view merely provide a means for information to be withheld unnecessarily.

Q15 *Do you agree with the omission of "safe harbour" provisions? If you think a "safe harbour" is necessary how should this be framed?*

Agreed. The absence of safe harbour provisions seems unlikely to restrict the development of an informative and useful OFR. Such provisions are not applied to other parts of the financial statements and it seems unnecessary to apply it here. However, if it would help to encourage frank and honest reporting it might be necessary to provide safe harbour provisions but only to prospective information as in the US and not to matters that should be historic, factual and objective.

Q16 *Please comment on the costs and benefits identified in the Partial Regulatory Impact Assessment at Annex D. Do you agree with them?*

UKSIP believes that the gains to be achieved by the capital markets having an improved and more transparent information set are likely to exceed significantly the costs of compliance with the draft regulations in producing an effective high quality OFR.

Q17 *Can you identify and quantify any additional costs or benefits resulting from these proposals that have not been identified in the RIA?*

No.