

**EXPLANATORY MEMORANDUM TO
THE COMPANIES ACT 1985 (OPERATING AND FINANCIAL REVIEW)
(REPEAL) REGULATIONS 2005**

2005 No.3442

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

2. Description

2.1 The Companies Act 1985 (Operating and Financial Review) (Repeal) Regulations 2005 amend the Companies Act 1985 (“the 1985 Act”) to remove the statutory requirement for GB quoted companies to produce an Operating and Financial Review (OFR).

3. Matters Of Special Interest To The Joint Committee On Statutory Instruments

3.1 None.

4. Legislative Background

Operating and Financial Review

4.1 The Companies Act 1985 (Operating and Financial Review and Directors’ Report etc) Regulations 2005 (S.I. 2005/1011) came into force on 22 March 2005. They amended Part 7 of the Companies Act 1985.

4.2 The amendments to the 1985 Act made by Part 3 of the March 2005 Regulations require all GB quoted companies to prepare an operating and financial review for financial years commencing on or after 1 April 2005. 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.

4.3 Under the provisions on the OFR introduced by the Regulations, all quoted companies must provide certain information such as objectives and strategies of the company and the main factors affecting, and likely to affect, the company’s performance. In other cases, information on matters such as the environment, employees and social and community issues must be provided to the extent they are relevant to the business. It is for directors to decide what is relevant to their particular business.

- 4.4 The Companies Act 1985 (Operating and Financial Review and Directors' Report etc) Regulations 2005 also amended the 1985 Act in order to:
- expand into a Business Review, the existing requirement for companies to include a fair review of their business in their directors' report;
 - establish a requirement for auditors to express an opinion on the consistency of the OFR and directors' report with the accounts and – for the OFR – to state whether there was any matter that had come to their attention in the performance of their functions as auditors of the company which was inconsistent with information given in the OFR; and
 - establish a criminal and administrative enforcement regime for both the OFR and the directors' report.
- 4.5 The fair review in the Directors' Report is a requirement of European law, introduced by the EU Accounts Modernisation Directive.¹ It applies to all companies except those which qualify as small.²
- 4.6 These Regulations remove the requirement for quoted companies to prepare an OFR. The enhanced Business Review requirements of the Directors' Report remain and will apply to quoted companies.
- 4.7 The Regulations also make amendments to 3 sets of regulations consequential on the repeal of the OFR - i.e. the Companies (Revision of Defective Accounts and Report) Regulations 1990³, the Companies (Summary Financial Statement) Regulations 1995⁴ and the Limited Liability Partnerships Regulations 2001⁵.

Scrutiny

- 4.8 Accounts Modernisation Directive - 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).
- 4.9 DTI Explanatory Memorandum OTNYREM 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).

¹ . 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.

² . Section 247 of the Companies Act 1985 gives the qualification of a small company as follows: Turnover- not more than £5.6 million, Balance sheet total- not more than £2.8 million, Number of employees – not more than 50. Medium sized company: Turnover – not more than £22.8 million, Balance sheet total – not more than £11.4 million and Number of Employees – not more than 250.

³ S.I. 1990/2570, as amended.

⁴ S.I. 1995/2090.

⁵ S.I. 2001/1090.

5. Extent

- 5.1 This instrument applies to Great Britain.

6. European Convention On Human Rights

- 6.1 No statement is required.

7. Policy Background

- 7.1 The independent Company Law Review, established by the Government in 1998, recommended a mandatory OFR for companies of significant economic size in its final report of July 2001. In July 2002, there was a consultation on the fundamental principles underlying the OFR in the Government White Paper *Modernising Company Law*. This was followed by another Government consultation in Summer 2004 on draft regulations introducing a statutory OFR for quoted companies. The Government believes that increased shareholder engagement is vital to good corporate governance. The best way to achieve this is through the provision of complete and accurate information. As already explained, the OFR and directors' report regulations were made earlier this year.
- 7.2 However the burden of statutory requirements should be proportionate and necessary and due consideration should be given to the impact of such requirements on the competitive position of UK businesses. With these Regulations, the Government is therefore streamlining directors' reporting requirements by removing the statutory requirement for quoted companies to produce an OFR for financial years commencing on or after 1 April 2005.
- 7.3 The Government has already introduced (for financial years beginning on or after 1st April 2005), a requirement for companies to produce a Business Review in their directors' report in line with the minimum requirements of the EU Accounts Modernisation Directive. This requirement applies to all large and medium-sized companies (with certain exemptions for medium sized companies), including quoted companies. The implementation regulations provided that when quoted companies are producing an OFR, information contained in the OFR that would otherwise be required in the Business Review need not be duplicated in the latter.
- 7.4 The Business Review includes the key material reporting requirements and performance indicators that are necessary to monitor business performance and risks, including on environmental and employee issues (where these are material to the business). Therefore, it has been concluded, on reflection, that the OFR requirements are unnecessary.
- 7.5 Under the central requirements of the Business Review companies must disclose all material information. The Business Review requires a balanced and comprehensive analysis of the development, performance and position of the business; a description

of its principal risks and uncertainties; and analysis using appropriate financial and other key performance indicators.

- 7.6 The Business Review also requires the disclosure of any information that is material to understanding the development, performance and principal risks affecting the business, including on environmental matters, employees, social and community issues, and information about the company's policies and their implementation. Key performance indicators must be used where appropriate.
- 7.7 Companies that have been preparing to produce an OFR will be able to use that work to produce their Business Review. In addition, many companies have been producing a voluntary OFR for some years, and may wish to continue doing so using work that they have done towards the mandatory OFR.
- 7.8 Abolishing the statutory requirement for quoted companies to produce an OFR will reduce the burden on businesses by an estimated £33 million p.a., particularly by reducing the audit compliance costs.
- 7.9 The Government is committed to improving strategic forward-looking narrative reporting by companies and believes this to be the best way of achieving that objective.
- 7.10 In particular, the language of the OFR requirements is more prescriptive than the requirements in the Business Review. In addition, the OFR provisions require auditors to do more than the minimum necessary under the Directive and provided for in Business Reviews. This accounts for the bulk of the estimated annual additional cost of the OFR over the minimum implementation costs of the Modernisation Directive.

Consultation

- 7.11 Consultations on the OFR and Business Review were carried out in July 2002 and May 2004. The Accounting Standard Board (ASB) also carried out a consultation on its draft Reporting Standard on the OFR in November 2004. Given the nature of the proposed change, which is a recalibration of existing policy rather than a fundamental change, and given the extensive evidence collected in the previous consultations on this issue, it was not considered necessary to carry out further public consultation. A further consultation process would also have caused difficulties for the companies required under the current regulations to prepare an OFR for the financial year ending 31 March 2006.

8. Impact

The RIA was attached to the original Explanatory Memorandum for S.I. 2005/1011. The Government is now implementing Option 2 rather than Option 4a.

- 8.1 There is no impact on the public sector as this Statutory Instrument only applies to companies.

9. Contact

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