Accounting Standards Board november 2004 red 1

REPORTING EXPOSURE DRAFT

Reporting Standard 1

OPERATING AND FINANCIAL REVIEW

ACCOUNTING
STANDARDS
BOARD

For the convenience of respondents in compiling their responses, the text of the questions in the Invitation to Comment (see pages 5 to 6) can be downloaded (in Word format) from the 'OFR' page in the Current Projects section of the ASB Website (www.frc.org.uk/asb).

For ease of handling, we prefer comments to be sent by email (in Word format) to:

ofred@frc-asb.org.uk

Comments may also be sent in hard copy form to:

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Comments should reach us by 28 February 2005. All replies will be regarded as on the public record unless the writer asks for confidentiality. If you are sending a confidential response by e-mail, please include the word 'confidential' in the subject line of your e-mail.

REPORTING EXPOSURE DRAFT

REPORTING STANDARD 1:

OPERATING AND FINANCIAL REVIEW

ACCOUNTING
STANDARDS
BOARD

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PREFACE

Introduction

1. This Exposure Draft sets out for comment the proposed reporting standard on the Operating and Financial Review (OFR).

Background

2. The Accounting Standards Board (ASB) originally issued a Statement 'Operating and Financial Review' in 1993. The Statement built on the foundations of existing best practice by providing a framework within which directors could discuss the main factors underlying the company's performance and financial position. The Statement was revised and re-issued in January 2003 to reflect later improvements in narrative reporting. It has persuasive rather than mandatory force and is not an accounting or reporting standard.

3. The Government, in its White Paper 'Modernising Company Law' in 2002, decided to implement a recommendation from the Company Law Review (CLR) requiring certain companies to prepare and publish an OFR as part of their annual report and accounts.

4. On 5 May 2004, the Department of Trade and Industry (DTI) published a consultation document 'Draft Regulations on the Operating and Financial Review and Directors' Report' setting out proposals for a new statutory OFR to be prepared and published by quoted companies. The Government has stated that the statutory requirement for an OFR should be supported by standards, which it intends should be prepared by the ASB, building on its existing Statement.

The Government proposals

5. The Government proposes that quoted companies will be required to prepare statutory OFRs for the first time for financial years beginning on or after 1 April 2005. The Regulations to implement this requirement will be laid before Parliament shortly.

6. The Regulations set out a high-level objective for the OFR, which has to be prepared by directors and addressed to the members of the company so as to assist those members to assess the company's strategies and

their potential to succeed. The Regulations also set out details of general requirements that should always be included in OFRs, as well as details of particular matters which must be reported on ''to the extent necessary'' to meet these general requirements.

The proposals in the Exposure Draft

7. This Exposure Draft, which builds on the Board's existing Statement and the requirements of the Regulations, sets out proposals for a new Reporting Standard to apply to financial years beginning on or after 1 April 2005.

8. The proposals involve:

   - the setting out of a number of principles for directors to apply when preparing an OFR; and
   - the provision of a disclosure framework for directors to apply in order to meet the requirements of the Regulations.

9. These proposals are described more fully in the Exposure Draft and the rationale behind them is set out in Appendix C 'The Development of the Exposure Draft'.

International developments on narrative reporting

10. In preparing the proposals in the Exposure Draft, the Board has taken account of guidance on narrative reporting in other jurisdictions and the work on ''management commentary'' that is being led by the New Zealand Financial Reporting Standards Board (FRSB) for the International Accounting Standards Board (IASB).

Future developments

11. The Government has announced that it intends to review the effects of a statutory OFR, periodically evaluating its performance over time and in the light of market feedback. The Board anticipates that its standard based on this Exposure Draft will be reviewed on a similar timescale to any evaluation by the government.

The ASB's Advisory Committee on the OFR

12. To assist the Board in the development of these proposals, the Board set up an Advisory Committee. The Board is grateful to the members of the Committee for their hard work since May 2004. It has taken full account of the advice of the Committee; it has, however, reached its own conclusions, which are not necessarily the same as those of individual Committee members.

Invitation to comment

13. The Board is requesting comments on this Exposure Draft by 28 February 2005. Comments are most helpful if they indicate the specific paragraph or group of paragraphs to which they relate, contain a clear rationale and, where applicable, a suggestion for alternative wording. Comments are invited on any aspect of the Exposure Draft although the questions below set out some specific issues on which the Board would particularly welcome views.

Q1. Do you agree with the proposed principles for the preparation of an OFR contained in paragraphs 5 to 24 of the draft text? Do you think that there are any other principles that should be included?

Q2. Do you agree with the proposed approach whereby the [draft] Reporting Standard provides a disclosure framework rather than any more detailed list of requirements for the preparation of an OFR?

Q3. Do you think that there are any other elements to the framework that should be added in order to encourage focused and relevant reporting in the OFR?

Q4. What are your views on the Board's proposal to extend the list of particular matters in paragraph 27 beyond those specifically referred to in the Regulations?

Q5. Do you agree with the proposal that the [draft] Reporting Standard should not specify any particular Key Performance Indicators (KPIs) that entities should disclose in the OFR, nor the number of KPIs that should be included?

Q6. Do you agree with the proposed disclosure requirements for KPIs set out in paragraphs 73 to 74? Do you think that they will encourage entities to report on KPIs or result in less disclosure?

Q7. Do you agree with the proposal that the [draft] Reporting Standard should encourage ''other measures and evidence'', both quantitative and qualitative, in addition to KPIs, to support the information provided in the OFR?

Q8. Do you agree with the proposal that where quantified measures, other than KPIs, are included the disclosure requirements should be less onerous than those for KPIs?

Q9. Do you agree with the proposal that illustrative examples of KPIs should be given in [draft] Implementation Guidance that accompanies, but is not part of, the [draft] Reporting Standard?

Q10. What are your views on the [draft] Implementation Guidance? Are there any further examples that might usefully be provided?

[DRAFT] REPORTING STANDARD: OPERATING AND FINANCIAL REVIEW (OFR)

The [draft] Statement of Standard Reporting Practice in [draft] Reporting Standard is set out in paragraphs 1-77. All paragraphs have equal authority. Paragraphs in bold type state the main principles and elements of the disclosure framework.

Accompanying the [draft] Reporting Standard is some Implementation Guidance, which does not form part of the [draft] Statement of Standard Reporting Practice.

[DRAFT] REPORTING STANDARD: OPERATING AND FINANCIAL REVIEW (OFR)

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[DRAFT] REPORTING STANDARD: OPERATING AND FINANCIAL REVIEW (OFR)

SUMMARY

a. The [draft] Reporting Standard applies to all entities that prepare an OFR.

b. The [draft] Reporting Standard requires directors to prepare an OFR addressed to investors, setting out their analysis of the business, with a forward-looking orientation in order to assist investors to assess the strategies adopted by the entity and the potential for those strategies to succeed. The information disclosed in the OFR will also be of relevance to other stakeholders.

c. The [draft] Reporting Standard sets out a number of other principles regarded as essential to the preparation of an OFR, namely that the review shall: both complement and supplement the financial statements; be comprehensive and understandable; be balanced and neutral; and be comparable over time.

d. The [draft] Reporting Standard sets out the key elements of the disclosure framework that directors are required to apply in preparing an OFR, together with requirements to include details on particular matters to the extent necessary to meet the objective of the OFR and the general disclosure requirements.

e. Those Key Performance Indicators (KPIs) judged by the directors to be the most effective to use in measuring the delivery of their strategies and in managing their business shall be disclosed, together with information that will enable investors to understand and evaluate each KPI.

f. The [draft] Reporting Standard encourages the inclusion of other measures and evidence to support the information included in the OFR.

g. The [draft] Reporting Standard is accompanied by [draft] Implementation Guidance that provides illustrative examples of

KPIs that might be disclosed in an OFR, as well as further guidance as to what is envisaged with regard to particular matters.

[DRAFT] REPORTING STANDARD: OPERATING AND FINANCIAL REVIEW (OFR)

OBJECTIVE

1. The objective of this [draft] Reporting Standard is to specify the requirements for an OFR, which shall be a balanced and comprehensive analysis of:

   a. the development and performance of the business of the entity during the financial year;

   b. the position of the entity at the end of the year;

   c. the main trends and factors underlying the development, performance and position of the business of the entity during the financial year; and

   d. the main trends and factors which are likely to affect their future development, performance and position,

   prepared so as to assist investors to assess the strategies adopted by the entity and the potential for those strategies to succeed.

COMPLIANCE WITH COMPANIES ACT 1985 (OFR)

2. Compliance with this [draft] Reporting Standard will be presumed to constitute compliance with the requirements of the Companies Act 1985 (Operating and Financial Review and Directors Report) Regulations 2004*.

SCOPE

3. The [draft] Reporting Standard applies to all entities that prepare an OFR .

* The Regulations have still to be laid before Parliament.

DEFINITIONS

4. The following terms are used in this [draft] Reporting Standard with the meanings specified:

Directors

Reference to either ''directors'' or ''board of directors'' within the Reporting Standard is taken to be the entity's governing body where the entity is not a company.

Key Performance Indicators (KPIs)

KPIs are quantified measurements that reflect the critical success factors of an entity and disclose progress towards achieving a particular objective or objectives.

Operating and Financial Review (OFR)

An OFR is a narrative explanation, provided in the annual report, of the main trends and factors underlying the development, performance and position of an entity during the period covered by the financial statements, and which are likely to affect the entity's future development, performance and position.

PRINCIPLES

5. The OFR shall set out an analysis of the business through the eyes of the board of directors.

6. The OFR shall reflect the directors' view of the business and accordingly, the entity shall disclose appropriate elements of information used in managing the entity, including its subsidiary undertakings. Where appropriate, the review may give greater emphasis to those matters which are significant to the entity and its subsidiary undertakings taken as a whole.

7. The OFR shall focus on matters that are relevant to the interests of investors.

8. Investors' needs are paramount when directors consider what information shall be contained in the OFR. Information in the OFR will also be of interest to users other than investors, for example customers,

suppliers, employees and society more widely. The directors will need to consider the extent to which they shall report on issues relevant to those other users where, because of their influence on the performance of the business and its value, they are also of significance to investors.

9. The OFR shall have a forward-looking orientation, identifying those trends and factors relevant to the investors' assessment of the current and future performance of the business and the progress towards the achievement of long-term business objectives.

10. The particular factors discussed shall be those that have affected performance in the period and those that are expected to have an effect on the future performance and financial position of the business.

11. The OFR shall comment on the impact on future operations of significant events after the balance sheet date.

12. The OFR shall also discuss predictive comments made in previous statements where these have not been borne out by events.

13. The OFR shall complement as well as supplement the financial statements, in order to enhance the overall corporate disclosure.

14. In complementing the financial statements, the OFR shall provide useful financial and non-financial information about the business and its performance that is not reported in financial statements but which is relevant to the investors' evaluation of past results and assessment of future prospects.

15. In supplementing the financial statements, the OFR shall where relevant:

- provide additional explanations of amounts recorded in the financial statements;
- explain the conditions and events that shaped the information contained in the financial statements.

Where amounts from the financial statements have been adjusted for inclusion in the OFR, that fact shall be highlighted and a reconciliation provided.

16. The OFR shall be comprehensive and understandable.

17. Directors shall consider whether the omission of information might reasonably be expected to influence significantly the assessment made by investors.

18. The requirement for the OFR to be comprehensive does not mean that the OFR shall cover all possible matters: the objective is quality, not quantity of content. It is neither possible nor desirable for a [draft] Reporting Standard to list all the elements that might need to be included, since these will vary depending on the nature and circumstances of the particular business and how the business is run.

19. Directors will need to consider the key issues to include in the OFR that will provide investors with focused and relevant information. The inclusion of too much information may obscure judgements and will not promote understanding. Where additional information is discussed elsewhere in the annual report, or in other reports, cross-referencing to those sources will assist investors.

20. The OFR shall be written in a clear and readily understandable style.

21. The OFR shall be balanced and neutral, dealing even-handedly with both good and bad aspects.

22. Directors shall consider the evidence underpinning the information to be included in the OFR. The directors shall ensure that the OFR retains balance and that investors are not misled as a result of the omission of any information on unfavourable aspects.

23. The OFR shall be comparable over time.

24. Disclosure shall be sufficient for the investor to be able to compare the information presented with similar information about the entity for previous periods. Comparability enables identification of the main trends and factors, and their analysis, over successive time periods. Directors shall also consider the extent to which the OFR is comparable with reviews prepared by other entities in the same industry or sector.

DISCLOSURE FRAMEWORK

25. Paragraphs 26 to 72 below set out a framework for the disclosures to be provided by directors in an OFR. It is for directors to consider how best to use the framework to structure the OFR and the precise content, including the level of detail to be disclosed, under each heading given the particular circumstances of the entity. These circumstances may include:

    a. the industry or industries in which it operates;

    b. the range of products, services or processes it offers;

    c. the number of markets it serves.

26. The OFR shall provide information to assist investors to assess the strategies adopted by the entity and the potential for those strategies to succeed. The key elements of the disclosure framework necessary to achieve this are:

    a. the nature, objectives and strategies of the business;

    b. the development and performance of the business, both in the period under review and in the future;

    c. the resources, risks and uncertainties and relationships that may affect the entity's long-term value; and

    d. position of the business including a description of the capital structure, treasury policies and objectives and liquidity of the entity, both in the period under review and the future.

27. To the extent necessary to meet the requirements set out in paragraph 26 above, the OFR shall include information about*:

    a. market and competitive environment;

    b. regulatory environment;

    c. technological change;

    d. persons with whom the entity has relations, such as customers and suppliers;

* Items (d) to (h) above reflect the wording in the OFR Regulations of "particular matters".

e. employees;

f. environmental matters;

g. social and community issues;

h. receipts from, and returns to, shareholders; and

i. all other relevant matters.

The nature, objectives and strategies of the business

28. The OFR shall include a description of the business and the external environment in which it operates as context for the directors' discussion and analysis of performance and financial position.

29. A description of the business is necessary to provide investors with an understanding of the industry or industries in which the entity operates, its main products and services, business processes and distribution methods, the structure of the business, and its economic model, including an overview of the main operating facilities and their location.

30. Every entity is affected by its external environment. Depending on the nature of the business, the OFR shall include discussion of matters such as the entity's major markets and competitive position within those markets and the significant features of the legal, regulatory, macro-economic and social environment that influence the business. For example, an entity may disclose the fact that it has significant operations in a number of different countries, which could have an impact on the future development and performance of the business.

31. The OFR shall discuss the objectives of the business to generate or preserve value over the longer-term.

32. Objectives will often be defined in terms of financial performance; however, objectives in non-financial areas shall also be discussed where appropriate.

33. The nature of the industry will affect the directors' determination of an appropriate time perspective for reporting in the OFR. For example, a business that focuses on large long-term projects must carry out its strategic planning over the full project lifecycle, which may be 20 years or more. Furthermore, where a project has a long-term impact on the environment, this is likely to affect long-term value and shall therefore

determine the time perspective for reporting in the OFR. By contrast, a service industry with few physical assets and depending on the supply of particular employee skills for its source of competitive advantage, will plan over a period consistent with its ability to recruit, train and develop its staff, which may be much shorter.

34. The OFR shall set out the directors' strategies for achieving the objectives of the business.

35. Disclosure of the directors' strategies is necessary for investors to assess the current and past action undertaken by directors in respect of the stated objectives. The OFR shall provide the information that an investor would want to know in making an investment decision regarding value accruing over time.

36. To the extent necessary to meet the requirements set out in paragraph 26 above, the OFR shall include the key performance indicators, both financial and non-financial, used by the directors to assess progress against their stated objectives.

37. The KPIs disclosed shall be those that the directors judge are the most effective to use in measuring the delivery of their strategies and managing their business. Regular measurement using KPIs will enable an entity to set and communicate its performance targets and to measure whether it is achieving them.

38. Comparability will be enhanced if the KPIs disclosed are accepted and widely used, either within the industry sector or more generally.

39. Directors shall also consider the extent to which other measures and evidence shall be included in the OFR.

40. These could be narrative evidence describing how the directors manage the business or quantified measures used to monitor the entity's external environment and/or progress towards the achievement of its objectives.

Current and future development and performance

41. The OFR shall describe the significant features of the development and performance of the business in the period covered by the financial statements, focusing on those business segments that are relevant to an understanding of the performance as a whole.

42. Trends and factors in development and performance suggested by an analysis of the current and previous periods shall be highlighted. Development and performance shall be described in the context of the strategic objectives of the business.

43. The OFR shall cover significant aspects of the statements of financial performance and where appropriate shall be linked to other aspects of performance.

44. The OFR shall set out the directors' analysis of the effect on current development and performance of changes during the period in the industry or the external environment in which the business operates and of developments within the business. For example, changes in market conditions could have an impact on the development and performance of the entity during the period, as could the introduction, or announcement, of new products and services.

45. The OFR shall analyse the main trends and factors that directors consider likely to impact future prospects.

46. The main trends and factors likely to affect the future development and performance will vary according to the nature of the business, but could include the development of known new products and services or the benefits expected from capital investment. The OFR shall discuss the current level of investment expenditure together with planned future expenditure and shall explain how that investment is directed to assist the achievement of business objectives. Any assumptions underlying the main trends and factors shall be disclosed.

47. Directors will need to consider the potential future significance of issues in deciding whether or not to include an analysis of them in the OFR.

Resources

48. The OFR shall include a description of the resources available to the entity and how they are managed.

49. The OFR shall set out the key strengths and resources, tangible and intangible, available to the business, which will assist it in the pursuit of its objectives and, in particular, those items that are not reflected in the balance sheet. Depending on the nature of the business, these may include: corporate reputation and brand strength; natural resources; employees; research and development; intellectual capital; licences, patents, copyright and trademarks; and market position.

Risks and uncertainties

50. The OFR shall include a description of the principal risks and uncertainties facing the entity, together with a commentary on the directors' approach to them.

51. While different industries and entities use different risk models or approaches for identifying and managing risk, all entities face and shall disclose strategic, operational and financial risks where these may significantly affect the entity's strategies and development of the entity's value.

52. The risks and uncertainties facing entities will vary according to the nature of the business, although it is expected that some risks, such as reputational risk, will be common to all.

53. The description of the risks and uncertainties shall cover both the exposure to negative consequences as well as potential opportunities. The directors' policy for managing risks shall be disclosed.

54. The OFR shall cover risks and uncertainties necessary for an understanding of the objectives and strategies of the business, both where they constitute a significant external risk to the entity, and where the entity's impact on other parties through its activities, products or services, affects its performance. Directors will need to consider the full range of business risks.

Relationships

55. To the extent necessary to meet the requirements set out in paragraph 26 above, the OFR shall include information about significant relationships with stakeholders other than investors, which are likely, directly or indirectly, to influence the performance of the business and its value.

56. Directors, in deciding what shall be included in the OFR, will need to take a broad view in considering the extent to which the actions of stakeholders other than investors can affect an entity's performance and thus its value. For example, for many entities, relationships with customers, suppliers, employees, contractors, lenders, creditors and regulators will be important, as will the entity's broader impact on society and the communities affected by its activities. Strategic alliances with other entities can also affect the performance of the entity and its value.

57. Where necessary for an understanding of the business, the OFR shall describe receipts from, and returns to, shareholders in relation to shares held by them. This shall include a description of any distributions, capital raising and share repurchases.

Financial position

58. The OFR shall contain an analysis of the financial position of the entity.

59. The analysis, whilst based upon the financial statements, shall comment on the events that have impacted the financial position of the entity during the period, and future factors that are likely to affect the financial position going forward. The analysis shall supplement the disclosures in particular required by FRS 25 (IAS 32) 'Financial Instruments: Disclosure and Presentation' or [draft] FRS ● 'Financial Instruments: Disclosure'.

60. The OFR shall highlight accounting policies that are critical to an understanding of the performance and financial position of the entity, focusing on those which have required the particular exercise of judgement in their application and to which the results are most sensitive. In addition, it shall draw attention to the accounting policies which have changed during the year.

61. The OFR shall contain a discussion of the capital structure of the business.

62. This could include the balance between equity and debt, the maturity profile of debt, type of capital instruments used, currency, regulatory capital and interest rate structure. The discussion shall include comments on short and longer-term funding plans to support the directors' strategies to achieve the entity's objectives. In addition, the discussion shall comment on why the entity has adopted its particular capital structure.

63. The OFR shall set out the entity's treasury policies and objectives.

64. The OFR shall also discuss the implementation of these policies in the period under review.

65. The purpose and effect of major financing transactions undertaken up to the date of approval of the financial statements shall be explained. The effect of interest costs on profits and the potential impact of interest rate changes shall also be discussed.

Cash flows

66. The OFR shall discuss the cash inflows and outflows during the period under review, along with the entity's ability to generate cash, to meet known or probable cash requirements and to fund growth.

67. Any discussion shall supplement the information provided in the financial statements by, for example, commenting on any special factors that have influenced cash flows in the current period and those that may have a significant effect on future cash flows. This could include, for example, the existence and timing of commitments for capital expenditures and other known or probable cash requirements. Where entities have cash that is surplus to future operating requirements and current levels of distribution, the discussion shall include future plans for making use of the excess cash.

68. Although segmental analysis of profit may be indicative of the cash flow generated by each segment, this will not always be so – for example, because of fluctuations in capital expenditure and depreciation. Where segmental cash flows are significantly out of line with segmental revenues or profits, this shall be indicated and explained.

Liquidity

69. The OFR shall discuss the entity's current and prospective liquidity. Where relevant, this shall include commentary on the level of borrowings, the seasonality of borrowing requirements (indicated by the peak level of borrowings during that period) and the maturity profile of both borrowings and undrawn committed borrowing facilities.

70. The discussion on liquidity shall discuss the ability of the entity to meet its payment commitments. Where appropriate, reference shall be made to the funding requirements for investment commitments and authorisations.

71. The discussion shall cover internal sources of liquidity, referring to any restrictions on the ability to transfer funds from one part of the group to meet the obligations of another part of the group, where these represent, or might foreseeably come to represent, a significant restraint on the group. Such constraints would include exchange controls and taxation consequences of transfers.

72. Where the entity has entered into covenants with lenders which could have the effect of restricting the use of credit facilities, and negotiations with the lenders on the operation of these covenants are taking place or are expected to take place, this fact shall be indicated in the OFR. Where a breach of a covenant has occurred or is expected to occur, the OFR shall give details of the measures taken or proposed to remedy the situation.

KEY PERFORMANCE INDICATORS

73. An entity shall provide information that enables investors to understand each KPI disclosed in the OFR.

74. For each KPI disclosed in the OFR:

- **the definition and its calculation method shall be explained;**
- **its purpose shall be explained;**
- **the source of underlying data shall be disclosed and, where relevant, assumptions explained;**
- **quantification or commentary on future targets shall be provided;**
- **where information from the financial statements has been adjusted for inclusion in the OFR, that fact shall be highlighted and a reconciliation provided;**
- **where available, corresponding amount for the financial year immediately preceding the current year shall be disclosed; and**
- **any changes to KPIs shall be disclosed and the calculation method used compared to previous periods, including significant changes in the underlying accounting policies adopted in the financial statements, shall be identified and explained.**

OTHER MEASURES

75. Where a quantified measure, other than a KPI, is included, the OFR shall disclose:

- the definition and its calculation method; and
- where available, corresponding amount for the financial year immediately preceding the current year.

EFFECTIVE DATE

76. The reporting practices set out in this [draft] Reporting Standard shall be regarded as standard in respect of OFRs relating to accounting periods beginning on or after 1 April 2005.

STATEMENT OF COMPLIANCE

77. The OFR shall include a statement as to whether it has been prepared in accordance with this [draft] Reporting Standard and contain particulars of, and reasons for, any departure.

APPENDIX A
NOTE ON LEGAL REQUIREMENTS

GREAT BRITAIN

A1. The Companies Act 1985 (Operating and Financial Review and Directors' Report) Regulations 2004, which will shortly be laid before Parliament, require the directors of a quoted company to prepare an OFR for financial years beginning on or after 1 April 2005. The specific requirements for the objective and contents of the OFR are contained in Schedule 7ZA of the Companies Act 1985. The requirements of that Schedule that are relevant to the [draft] Reporting Standard are set out below.

A2. A quoted company is defined in Section 262 of the Companies Act 1985 as "a company whose equity share capital:

(a) has been included in the official list in accordance with the provisions of Part VI of the Financial Services and Markets Act 2000; or

(b) is officially listed in an EEA state; or

(c) is admitted to dealing on either the New York Stock Exchange or the exchange known as Nasdaq".

The objective of the OFR

A3. Schedule 7ZA (the Schedule) requires that the OFR shall be a "balanced and comprehensive analysis" of:

a. the development and performance of the business of the company and its subsidiary undertakings during the financial year;

b. the position of the company and its subsidiary undertakings at the end of the year;

c. the main trends and factors underlying the development, performance and position of the business of the company and its subsidiary undertakings during the financial year; and

d. the main trends and factors which are likely to affect their future development, performance and position;

prepared so as to assist the members of the company to assess the strategies adopted by the company and its subsidiary undertakings and the potential for those strategies to succeed.

Other general requirements

A4. The Schedule requires that information on certain matters shall always be included in an OFR:

a. a statement of the business, objectives and strategies of the company and its subsidiary undertakings;

b. a description of the resources available to the company and its subsidiary undertakings;

c. a description of the principal risks and uncertainties facing the company and its subsidiary undertakings; and

d. a description of the capital structure, treasury policies and objectives and liquidity of the company and its subsidiary undertakings.

Details of particular matters ... "to the extent necessary"

A5. The Schedule also sets out details of ''particular matters'' which must be reported on ''to the extent necessary'' to comply with the objective of the OFR and the other general requirements outlined in paragraph A4 above. The wording ''to the extent necessary'' derives from the EU Accounts Modernisation Directive*, which requires an enhanced review of a company's business in the directors' report to be prepared and published for financial years beginning on or after 1 January 2005.

A6. The Schedule sets out a non-exhaustive list of particular matters that directors must consider for inclusion in their OFR to the extent necessary.

A7. The review shall include information about:

a. the employees of the company and its subsidiary undertakings;

b. environmental matters; and

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* Directive 2003/51/EC of the European Parliament and 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.

c. social and community issues.

A8. The review shall also include information about:

a. the persons with whom the company or its subsidiary undertakings have relations (whether contractual or otherwise) which are essential to the business of the company and its subsidiary undertakings; and

b. receipts from, and returns to members of the company and its subsidiary undertakings in relation to shares held by them.

A9. The Schedule also specifies that – to the extent necessary - the review shall include analysis using financial and other key performance indicators, including information relating to environmental matters and employee matters. Key performance indicators are defined as ''the factors by which the development, performance and position of the business of the company and its subsidiary undertakings can be measured most effectively''.

A10. The OFR shall also, where appropriate, include references to, and additional explanations of, amounts included in the company's annual accounts.

Parent companies

A11. The Schedule permits an OFR prepared and published by a parent company, where appropriate, to give greater emphasis to those matters which are significant to the company and its subsidiary undertakings taken as a whole.

Reporting standards and compliance with them

A12. The Regulations insert into the Companies Act 1985 a new section 256A, a definition of ''reporting standards'' as meaning statements of standard reporting practice which relate to OFRs and which are issued by a body or bodies specified in an order made by the Secretary of State. By complying with those standards, directors shall be presumed (unless proved to the contrary) to have complied with the statutory requirements to prepare an OFR.

A13. Clause 13 of the Companies (Audit, Investigations and Community Enterprise) Act 2004 establishes a system to specify a body to issue reporting standards. The Government has said that it intends to specify in a Regulation the ASB as that body.

A14. The Schedule requires that an OFR must:

a. state whether it has been prepared in accordance with relevant reporting standards; and

b. contain particulars of, and reasons for, any departure from those standards.

NORTHERN IRELAND

A15. There are no legal requirements in Northern Ireland relating to the preparation and publication of an OFR.

REPUBLIC OF IRELAND

A16. There are no legal requirements in the Republic of Ireland relating to the preparation and publication of an OFR.

APPENDIX B
COMPLIANCE WITH INTERNATIONAL ACCOUNTING OR REPORTING STANDARDS

B1. The [draft] Reporting Standard is effective for financial years beginning on or after 1 April 2005. At present, no mandatory international accounting or reporting standard exists.

B2. The International Accounting Standards Board (IASB) has asked a project team of national standard-setters to develop a discussion paper on ''management commentary'', which the IASB intends to publish with its preliminary views for public comment in due course. The project team is led by staff from the New Zealand Financial Reporting Standards Board (FRSB), with the rest of the group comprising representatives of the national standard-setters of Canada and Germany, plus the ASB.

B3. The group is taking forward its work within a framework of general principles that management commentary:

a. should provide information on the principal business factors and strategic and operating decision processes that generated the outcomes reported in the financial statements;

b. should supplement and complement financial statement information by providing a ''through the eyes of management'' analysis of financial position and performance; and

c. should include forward-looking information, focusing on the strategies in place for generating value for investors.

APPENDIX C
THE DEVELOPMENT OF THE EXPOSURE DRAFT

C1. This appendix summarises the background to the development of the exposure draft and the ASB's considerations in reaching the conclusions in the [draft] Reporting Standard.

BACKGROUND

C2. There has for some considerable time been a recognition that financial statements do not meet all the information needs of users and that there is a need for the provision of other information to shareholders giving details of a company's performance and prospects. This was, for example, a conclusion of the report published in 1992 by the Committee on the Financial Aspects of Corporate Governance ('the Cadbury Committee'). The Cadbury Committee recommended that directors should pay particular attention to their duty to present a balanced and understandable assessment of their company's position. The Committee also recognised that there would be an advantage to users if they were provided with some explanation of the factors likely to influence a company's future progress. This could be met by the provision of an essentially forward-looking OFR, a first statement on which was being developed at that time by the ASB.

C3. The Board originally issued the Statement 'Operating and Financial Review' in July 1993. The Statement built on the foundations of existing best practice by providing a framework within which directors could discuss the main factors underlying the company's performance and financial position. It made clear that while the OFR was not a forecast of future results, it should nevertheless draw out those aspects of the year under review that were relevant to an assessment of future prospects. This would give users a more consistent foundation on which to make investment decisions regarding the company. The Statement was issued with persuasive, rather than mandatory, force and was not an accounting standard.

C4. The Statement was updated and a revised version issued in January 2003 to reflect later improvements in narrative reporting.

C5. The Statement makes clear that the OFR should set out the directors' analysis of the business, in order to provide investors a historical and prospective analysis of the reporting entity ''through the eyes of management''. The Statement was developed as a broad framework rather than a set of rules or requirements, putting the emphasis on directors to decide how best to interpret the framework in the particular circumstances of their business.

C6. The desirability of companies preparing an OFR was considered by the Company Law Review (CLR) put in place by the Government in 1998. The final report of the CLR Steering Group, published in 2001, recommended that both public and large private companies should be required to prepare an OFR, but with higher thresholds for private companies. The CLR had found that, while many listed companies already prepared an OFR or adopted the broad approach set out in the ASB's Statement, compliance with the Statement was patchy. The CLR view was that if the practice of the best was to be extended more widely, some form of mandatory requirement was needed.

C7. The Government, in its 'Modernising Company Law' White Paper in 2002, decided to take forward the three broad proposals of the CLR to improve corporate governance:

a. a statement of directors' duties;

b. improved transparency and accountability, with improvements on the quality, timeliness and accessibility of information available for shareholders and others; and

c. more effective machinery for enabling and encouraging shareholders to exercise effective and responsible control.

C8. The OFR is a major element of the second of the above proposals.

C9. In July 2003, the Government announced that it intended to implement its proposals on a statutory OFR by secondary legislation under existing company law. In May 2004, the Department of Trade and Industry (DTI) issued proposals on the detailed implementation of this new requirement in a consultation document 'Draft Regulations on the Operating and Financial Review and Directors' Report'.

C10. The consultation document contained draft secondary legislation to implement:

- a new statutory OFR (as summarised in Appendix A 'Legal Requirements'); and

- certain provisions of the EU Accounts Modernisation Directive requiring an enhanced review of a company's business in the directors' report. Under this Directive, for company financial years starting on or after 1 January 2005, large and medium-sized (but not small) companies will be required to provide "a balanced and comprehensive analysis of the development and performance of the company's business...[which] shall include both financial and, where appropriate, non-financial key performance indicators ... including information relating to environmental and employee matters". Medium-sized companies can be exempted from the latter part of this obligation.

C11. As there is an overlap between the OFR and the provisions of the Directive, the Government proposals in the consultation document dovetailed the two sets of requirements. This meant that 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 Directive. This dovetailing did mean, however, that the draft Regulations on the OFR were proposed to take effect for financial years beginning on or after 1 January 2005. Following consultation, the DTI has now specified that the OFR Regulations will take effect for financial years beginning on or after 1 April 2005.

APPROACH ADOPTED BY THE BOARD

C12. The Board concluded that the best approach to the introduction of a mandatory OFR was the development of a "framework" Reporting Standard to meet the requirements of the Regulations and built on the existing Statement. In taking forward this approach, the Board considered the range of matters that should be included in the OFR and concluded that it was appropriate to set out an open and flexible structure, given that the OFR should represent the directors' analysis of the business and the particular circumstances of the entity. In developing the exposure draft, the Board has reviewed a range of material on OFR and similar reporting, both UK and international.

SCOPE

C13. The Government proposal is that the statutory OFR shall be mandatory for quoted companies. This is a change from the CLR proposal and the 2002 White Paper that the OFR should be required for both public and large private companies. The Government changed the proposed scope on the grounds that, as quoted companies have dispersed shareholdings and there is a market in their shares, increased transparency is likely to be more helpful to their shareholders, particularly institutional investors, who can use the information in the OFR to engage with management.

C14. The [draft] Reporting Standard proposes that it should be applicable to all entities that prepare and publish an OFR.

PRINCIPLES

C15. The Board's existing Statement sets out a number of principles which should be regarded as essential to the preparation of an OFR. In the Board's view, it is necessary to specify a number of principles for directors to apply and these are set out in the [draft] Reporting Standard. In considering the principles to be applied, the Board has taken account of the work of the OFR working group, chaired by Rosemary Radcliffe, which published its report 'The Operating and Financial Review: Practical Guidance for Directors' (the Radcliffe Report) in May 2004. The Board has also taken account of current international guidance on OFR and similar reporting.

C16. The first principle requires the OFR to reflect the directors' view of the business. The Regulations place a statutory duty on the directors to prepare an OFR.

C17. The second principle is that the OFR shall focus on matters that are relevant to investors. The Regulations make clear that the OFR shall be prepared so as to assist the ''members of the company'' to assess the strategies adopted and the potential for those strategies to succeed. But while it is the investors who will hold directors to account, the information in the OFR will be of interest to a wide range of other users. The Board has considered how the interests of these other users might best be referred to in the [draft] Reporting Standard and has taken into account the different views that have been expressed on this issue, including the debates held by the Advisory Committee. The Radcliffe Report concluded that directors will want to take a ''broad view'' in deciding what should be included in their OFR, on the grounds that the decisions and agendas of other stakeholders can influence the performance and value of a company. The drafting of the text under this second principle seeks to reflect these broader interests, while maintaining the primacy of meeting investors' needs in the OFR.

C18. The third principle specifies that the OFR shall have a forward-looking orientation. The Regulations require the directors to analyse the main trends and factors which are likely to affect the entity's future development, performance and position.

C19. The fourth principle requires that the OFR shall complement as well as supplement the financial statements. The Regulations specify that ''to the extent necessary'' to meet the general requirements the OFR shall, where appropriate, include references to, and additional explanations of, amounts included in the financial statements.

C20. The fifth principle is that the OFR shall be comprehensive and understandable. The requirement for the OFR to be comprehensive flows directly from the Regulations. The Board's existing Statement specifies that the OFR shall be written in a clear and readily understandable style.

C21. The requirement for the OFR to be comprehensive does not mean that it shall cover all possible matters and there is a need for the OFR to retain focus and guard against the inclusion of too much information that is not directly relevant.

C22. The sixth principle calls for the OFR to be balanced and neutral. This takes forward the principle of reliability in the Board's existing Statement and the requirement in the Regulations for the OFR to be a balanced analysis. The Radcliffe Report also noted that balanced judgements will be needed to meet the objective of the OFR.

C23. The seventh principle is that the OFR shall be comparable over time. This reflects the principle of comparability in the Board's existing Statement. There is also an encouragement for the OFR to be comparable with reviews prepared by other entities in the same industry or sector, although it is anticipated that such comparability will evolve over time.

DISCLOSURE FRAMEWORK

C24. The [draft] Reporting Standard sets out a disclosure framework for the content of the OFR, which is designed to give directors guidance on how to meet the requirements of Schedule 7ZA of the Regulations. Given that the OFR shall reflect the directors' analysis of the business, the Board's view is that it is for directors to consider how best to use this framework to structure the OFR, given the particular circumstances of the entity.

C25. The [draft] Reporting Standard replicates the headings set out in the Regulations of the topics that should always be included in an OFR as they will always be essential to an understanding of the business. That said, in line with the Regulations, the [draft] Reporting Standard does not set out all the elements that might need to be included on each of the topics, since these will depend on the nature and circumstances of any particular business.

C26. The [draft] Reporting Standard also replicates the headings set out in the Regulations of the further information on particular matters that must be included ''to the extent necessary'' to comply with the general requirements. To meet the ''to the extent necessary'' criterion, directors will need to consider how ''significant'' the particular matters are to the business, and the [draft] Reporting Standard uses both terms interchangeably. In its consultation document, the Government notes that this is a non-exhaustive list and the directors will need to consider whether information on any other relevant matters is necessary to assist investors to assess the entity's strategies. The disclosure framework gives some further examples of matters that might be covered. The Board has also been conscious of the need for information on any of the particular matters within an overall context. For example, while directors will need to consider the extent that information on environmental risks should be included within the OFR, this should be set in the context that there is a wide range of risks to which business are subject.

C27. The Board has considered how the [draft] Reporting Standard should treat the requirement in the Regulations that the OFR ''shall include analysis using financial and other key performance indicators, including information relating to environmental matters and employee matters''. The Board notes that the requirement to include such analysis is ''to the extent necessary'' to comply with the general requirements.

C28. The Board is aware that there are differing views on what is meant by the term ''key performance indicators'' (KPIs) and whether or not entities should be required to report on specific indicators. The approach taken by the Board is that the [draft] Reporting Standard should not specify any particular KPIs that entities should disclose, or the number of KPIs, on the grounds that it is for directors to decide which KPIs, and how many, best reflect their judgement of what is required for an understanding of the business. Rather, the [draft] Reporting Standard builds on the approach in its existing Statement and sets out requirements as to what should be disclosed for each KPI included in the OFR, in order that investors can understand and evaluate each one.

C29. In determining its approach, the Board reviewed a range of available material relating to performance measurement. This review revealed that there are many performance measures in current use and that the measures used vary by company and industry. For example, the 'Cranfield School of Management Performance Measure Catalogue' contains over 200 performance measures. Research undertaken by PricewaterhouseCoopers, as part of their industry survey programme, shows that the specific measures used by companies vary depending on the industry or industries in which they operate. The Board also considered the measures outlined in frameworks such as the Global Reporting Initiative (GRI) and the AccountAbility AA1000 series. On KPIs relating to human capital, the Board noted the conclusion of the report of the Task Force on Human Capital Management 'Accounting for People' that: ''there is no single set of HCM practices widely accepted as ''best practice'' applicable to all organizations, nor agreement on a set of universally relevant indicators.''

C30. The Board, however, is conscious that some guidance on KPIs would be useful to directors. It has accordingly prepared [draft] Implementation Guidance to accompany, although not be part of, the [draft] Reporting Standard setting out some illustrations and suggestions of specific content and related KPIs that might be included in an OFR, together with some signposting of the areas under each of the particular matters referred to in the Regulations that directors should consider in determining what to include in their OFR. The specific suggestions given in the [draft] Implementation Guidance include examples on employee matters, environmental matters and social and community issues, as referred to in the Regulations, in order to encourage directors to think more widely about their businesses.

C31. The Board has also considered the issue of the disclosure of measures other than KPIs and other evidence in the OFR. It has taken the view that where quantified measures, other than KPIs, are included, the disclosure requirements for such measures shall be less onerous than those for KPIs. The Board's hope is that this will encourage the disclosure of a broader range of measures in the OFR.

[DRAFT] IMPLEMENTATION GUIDANCE

This guidance accompanies, but is not part of, the [draft] Reporting Standard.

INTRODUCTION

IG1. This [draft] Implementation Guidance:

a. Outlines some suggestions and illustrations of the content required to be covered in the OFR with regard to the disclosure framework as set out in paragraph 26 of the [draft] Reporting Standard, and related Key Performance Indicators (KPIs) (paragraphs 36 to 38). However, these suggestions are non-exhaustive and illustrative only.

b. Provides some further ''signposting'' guidance as to the areas directors will need to consider with regard to the particular matters identified in paragraph 27 (d)-(h) of the [draft] Reporting Standard.

CONTENT RELATED TO THE DISCLOSURE FRAMEWORK AND RELATED KPIs

IG2. The guidance in paragraphs IG11-IG35 suggests possible content envisaged for each element of the disclosure framework, whilst IG Examples 1-21 provide illustrative examples of KPIs and the disclosure required under paragraphs 73 and 74 of the [draft] Reporting Standard.

IG3. Paragraph 26 of the [draft] Reporting Standard requires that the OFR shall provide the information to assist investors to assess the strategies adopted by the entity and the potential for those strategies to succeed. To this end, the [draft] Reporting Standard provides a disclosure framework which sets out the areas to be considered by directors in preparing their entity's OFR. As acknowledged in the [draft] Reporting Standard, it is for directors to consider how best to use the framework to structure the OFR.

IG4. Paragraphs 73 and 74 set out the disclosure requirements relating to each KPI, which are dealt with in paragraphs 36 to 38 of the [draft] Reporting Standard.

IG5. Whilst IG Examples 1-21 are expressed as KPIs, they could also be considered as examples of quantified other measures as set out in paragraphs 39 and 40 of the [draft] Reporting Standard. If any of these examples were disclosed as quantified other measures, then the required disclosure would only require the measures definition, its calculation method and the corresponding amount as set out in paragraph 75 of the [draft] Reporting Standard.

IG6. Other trends and factors monitored by the entity may also be considered quantified other measures, although they would not ever be KPIs as they are outside of the control of the entity. For example, an insurance company might monitor changing demographics as a key trend in the external operating environment, due to the impact of demographics on future demand for its products. Accordingly, in such circumstances, quantified demographic information would be included in the OFR as an example of a quantified other measure.

IG7. Definitions and other criteria set out in IG Examples 1-21 are illustrative and should not be taken to imply generally accepted definitions or calculations. They are simply provided to demonstrate the information that could be provided for a particular measure. It is important that the information provided in the OFR with regard to any KPIs or quantified other measures makes explicit the definition and precise calculation method used by the entity.

PARTICULAR MATTERS

IG8. The guidance below includes some background material that might be useful to consider when developing an entity's OFR with regard to the specific "particular matters" set out in paragraph 27(d)-(h) of the [draft] Reporting Standard. In addition, where the management of a particular matter has been identified as being essential to the successful implementation of a stated strategy or could have an effect on the entity's short or long-term value, the guidance provides some illustrations of areas that might be covered.

IG9. Paragraph 27(d)-(h) of the [draft] Reporting Standard requires that, to the extent necessary to meet the requirements set out in paragraph 26 of the [draft] Reporting Standard, the OFR shall include information about a number of particular matters, e.g. employees, and environment. As explained in paragraph 26 of the [draft] Reporting Standard, the OFR shall provide the information necessary to assist investors to assess the strategies adopted by the entity and the potential for those strategies to succeed. Accordingly, where the management of a particular matter could significantly affect the entity's ability to successfully implement its strategies or the entity's short or long-term value, that matter shall be addressed within the OFR.

IG10. Paragraph 27(a)-(h) contains a non-exhaustive list of topics that directors need to consider for inclusion in their OFR to the extent necessary. Accordingly, paragraph 27(i) provides a further requirement that directors, to the extent necessary, include within the OFR "all other relevant matters." The directors will have to consider what other topics also need to be included in the OFR, as these will be specific to the entity, its objectives and strategies, as well as dependent on the industry in which it operates.

Nature, objectives and strategies of the business

IG11. The [draft] Reporting Standard requires the provision of meaningful contextual information regarding the directors' objectives and strategies, along with a description of the business and its external environment, to assist investors to assess the strategies adopted and the potential for those strategies to succeed.

IG12. Specifically, the OFR shall set out of the objectives of the business and the directors' strategies for generating or preserving value for investors over the long term. A number of economic measures exist that are commonly used by companies in order to assess the company's ability to create value over time, and which are likely to be considered a KPI. These include:

- Return on capital employed.
- Incremental returns on investments.
- Economic profit type measures.
- Organic rates of growth and returns thereon.

IG Example 1: Return on capital employed (ROCE)

As an example of a measure of the creation of value, the required disclosure would need to incorporate the following:

- Definition and calculation: ROCE, measures the profit as a percentage of the total capital employed (invested) in the business.

- Purpose: The company's aim is to increase shareholder value. This is measured by the extent to which this goal has been achieved by using ROCE, as it is a measure of how well the money invested in the business is providing a return to investors.

- Source of underlying data: GAAP financial statement figures as adjusted below.

- Reconciliation of financial statement information:
  Operating result for calculation of ROCE =
  Operating result as per financial statements
  Plus interest from sales financing
  Capital employed =
  Intangible assets/property, plant and equipment
  Plus investments
  Plus accumulated goodwill amortisation
  Plus inventories
  Plus trade accounts receivable
  Plus other assets including prepaid expenses
  Less non-interesting bearing provisions/liabilities

- Quantified target: 10%

- Quantified data: 2005 – Consolidated ROCE 10.4%, 2004 – 10.2%, 2003 – 9.8%

- No changes have been made to the source of data or calculation methods used.

IG Example 2: "Economic profit"

Economic profit is a further example of a measure that a company might use to quantify the creation of value. The required disclosure would need to incorporate the following:

- Definition and calculation: Economic profit, being a measure of capital adjusted profit. Based upon operating profit after tax, adjusted for one-off items and the cost of capital.
- Purpose: The company's key objective is to increase shareholder value, which is measured and managed using economic profit.
- Source of underlying data: GAAP financial statement figures as adjusted below.
- Quantified target: Economic profit for 2006 of £200 million, 2005 target was £150 million.
- Reconciliation of financial statement information:
  Profit after tax and minority interests, excluding goodwill amortisation =
  Operating profit after tax and minority interests
  Plus goodwill amortisation
  Less tax credit on goodwill
  Economic profit =
  Profit after tax and minority interests, excluding goodwill amortisation
  Less cost of capital
- Quantified data: 2005 – £160 million, 2004 – £145 million, 2003 – £140 million
- No changes have been made to the source of data or calculation methods used.

Market positioning

IG13. Directors may also set their long term objectives around market positioning. In such cases, KPIs commonly used by the board, and accordingly included in the OFR might include:

- Market position.
- Market share.

IG Example 3: Market Share

For a company reporting market share as a KPI, the required disclosure would need to incorporate the following:

- Definition and calculation: Market share, being company revenue over estimated market revenue.
- Purpose: To assess how the company is performing in its particular market.
- Source of underlying data: No external verifiable source for market share exists; accordingly data are internal estimates.
- Quantified target: Achieve market share of 25% within 5 years.
- Quantified data: Five year trend data, 2001 – 17%, 2002 – 18%, 2003 – 17%, 2004 – 19%, 2005 – 20%.
- No changes have been made to the source of data or calculation methods used.

Development, performance and position

IG14. The [draft] Reporting Standard requires that the OFR shall set out an historical and prospective analysis of the development, performance and position of the company. Whilst a number of the measures used to monitor the development, performance and position of the company may be traditional financial measures, directors often supplement these with other measures common to their industry to monitor their progress towards stated objectives.

IG Example 4: Average revenue per user (customer)

A telecoms company may measure average revenue per user (ARPU) by types of product offerings as a KPI. By doing this, the directors are able to monitor customer buying patterns as this is a key factor that is likely to affect the development of future revenues. Required disclosure would need to incorporate the following information:

- Definition and calculation: Average revenue per user (ARPU) by major product segments, e.g. pre-pay and post-pay customers.
- Purpose: In the mobile network industry, ARPU is one of the key drivers for future revenue growth.
- Source of underlying data: Internal company data.
- Quantified target: To increase ARPU by 15% per annum for pre-pay customers and 5% per annum for post-pay customers.
- Quantified data: ARPU graph showing comparatives and percentage change year on year e.g. Pre-pay 2004 – £121, 2005 – £141, growth of 16.5%, Post-pay 2004 – £503, 2005 – £525, growth of 4.4%.
- No changes have been made to the source of data or calculation methods used.

IG Example 5: Number of subscribers

A pay TV company with an objective of achieving revenue growth may monitor the effectiveness of their actions and progress towards their goal through measuring of the number of subscribers as a KPI. Required disclosure would need to incorporate the following information:

- Definition and calculation: Number of subscribers by type of connection, i.e. direct to home (DTH) and cable.
- Purpose: In the pay TV industry, the level of subscribers is the key driver for future revenue growth.
- Source of underlying data: Internal company data.
- Quantified target: To increase the number of subscribers by 10% per annum for each type of connection.
- Quantified data: Table of number of subscribers and percentage increase from year to year e.g. 2005 – DTH 4,532 million, cable 3,241 million, 2004 – DTH 4,013, cable 3,004, growth of 12.9% and 7.9%.
- No changes have been made to the source of data or calculation methods used.

IG Example 6: Sales per square foot

A retail company with an objective of increasing revenues may monitor and measure revenue per square foot as a KPI. Required disclosure would need to incorporate the following information:

- Definition and calculation: Average revenue per square foot (£ per week), with square footage measured as store space excluding storage/delivery space, checkout and administrative space.

- Purpose: In the retail industry, sales per square foot is one of the key drivers for future revenue growth.

- Source of underlying data: Internal company data.

- Quantified target: To increase sales per square foot to £20 per square foot/week.

- Quantified data: Graph showing weekly sales per square foot over the past five years, 2005 – £18.53, 2004 – £17.56, 2003 – £16.99, 2002 – £16.04, 2001 – £15.67

- No changes have been made to the source of data or calculation methods used.

IG Example 7: Percentage of revenue from new products

A consumer products company that has a strategy of providing innovative products to its customers may measure and monitor the percentage of revenue from new products as a KPI. Required disclosure would need to incorporate the following information:

- Definition and calculation: Percentage of revenue from new products = revenue from those products launched over the past two years over total revenue for the year.
- Purpose: In order to continue to grow in the fast paced market of consumer products, the company needs to ensure that it is continually renewing its product portfolio. One way of measuring success is to look at the percentage of revenue generated by new products.
- Source of underlying data: Internal company data.
- Quantified target: To achieve 35% of revenue from new products per annum.
- Quantified data: Percentage of revenue from new products, 2005 – 37%, 2004 – 33%, 2003 – 36%.
- No changes have been made to the source of data or calculation methods used.

IG Example 8: Number of products sold per customer

In the financial services industry, a company may have an objective to increase margins by increasing the number of products sold to existing customers. Directors may monitor the number of products sold per customer, or ''customer penetration'' rates as a KPI. Required disclosure would need to incorporate the following information:

- Definition and calculation: Customer penetration rates by geographic segment. Penetration rates are measured by taking the number of products sold to each customer on an annual basis.
- Purpose: Increasing customer penetration rates, leads to increased revenues without incurring significant customer handling costs.
- Source of underlying data: Company data from UK and South Africa.
- Quantified target: To increase customer penetration rates to 5.0 products per customer territory.
- Quantified data: Penetration, 2005 – UK 4.3, South Africa 4.9, 2004 – UK 4.5, South Africa 4.5, 2003 – UK 4.0, South Africa 4.1.
- No changes have been made to the source of data or calculation methods used.

IG Example 9: Products in the development pipeline

In the pharmaceutical industry, for example, future revenues may be greatly affected by the launch of new products from the company's product development pipeline. Directors may monitor number of products at each stage of development and the markets/timing for future launches as a KPI. Required disclosure would need to incorporate the following information:

- Definition and calculation: Product development pipeline being the key products currently under development, and the stage of development (Phase I, II or III). Phase I initial evaluation, Phase II determination of dose and initial evaluation of efficacy, Phase III large comparative study in patients to establish clinical benefit and safety.

- Purpose: In order to achieve a strategy of continuing growth, the company must have a productive product development pipeline.

- Source of underlying data: Company data.

- Quantified target: To have 5 new products launched annually.

- Quantified data: Phase I – 25 projects, Phase II – 18 projects, Phase III – 12 projects, number of new products launched this year 4. Detailed information for those projects in Phase III and those launched during the year, e.g. name of product, description, projected market launch dates by territory.

- No changes have been made to the source of data or calculation methods used.

IG Example 10: Cost per unit produced

The directors in a utility company may measure costs per unit produced as a KPI in order to monitor progress towards becoming a low cost producer. Required disclosure would need to incorporate the following information:

- Definition and calculation: Exploration and production finding and development unit costs, being costs per £ per boe (E&P F&D costs (£/boe)). Boe means barrel of oil equivalent, which is a standard method of equating oil, gas and natural gas liquids by converting gas and natural gas liquids to oil based on their relative energy contents.

- Purpose: One of the key drivers to strong economic returns is to reduce E&P F&D costs.

- Source of underlying data: Internal company data.

- Quantified target: To be in the top quartile of low cost producers in Europe as compared to benchmarking studies produced by Evaluate Energy for 2004.

- Quantified data: E&P F&D unit costs (£ per boe) graph showing comparatives for three years e.g. 2003 – 3.22, 2004 – 3.20, 2005 – 3.08.

- No changes have been made to the source of data or calculation methods used.

Resources, risks and relationships

IG15. The [draft] Reporting Standard requires that the OFR shall set out the resources, risks and relationships that may significantly affect the company's short and long-term value. A number of the examples highlighted in the [draft] Reporting Standard could be considered either resources, risks or a relationship, or all three. Key resources of an entity may also be key stakeholders and accordingly lead to risks and uncertainties.

IG16. The KPIs used by directors will be those used to monitor the effective management of their resources, risks and relationships, as these will be the areas that may significantly affect the company's short and long-term value.

Persons with whom the entity has relations

IG17. The decisions of those with whom the entity has relations – regulators, customers, suppliers, employees, community and society at large – can affect a company's prospective performance and accordingly its value. For example, in regulated sectors, the risk of non-compliance with regulatory requirements could lead to the loss of a licence to operate. Accordingly the effective management of these relationships could significantly impact on the success of the entity's strategies and affect the long-term value of the entity.

IG18. The directors will need to consider whether such relationships could have a significant impact. The directors could do this by seeking the answers to a number of key questions, such as:

a. How do our customers view the service we provide?

b. How do our employees' feel about the entity?

c. How do our suppliers view the entity?

d. How do our regulators view the entity?

IG19. For example, in considering the first question above, IG Example 11 provides an illustration of how an entity could measure the customers' relationship with the entity, by measuring ''customer churn'' rates as a KPI. Ultimately, the selection of appropriate customer measures will depend on the nature of the business and the strategies adopted by the board.

IG20. Areas of importance relating to employees, the community and society at large, including environmental matters, are addressed in paragraphs IG21-31. For other stakeholders with which the entity has relations, such as customers, suppliers, regulators, contractors and pensioners, some areas of interest might be:

- Profile of the stakeholder and nature of the relationship (length of relationship, is it subject to contract, if so when does the contract expire).

- Level of dependency.

- Satisfaction with relationship – feedback results, levels of complaints, fines etc.

IG Example 11: "Customer churn"

In the telecoms industry, future prospects are greatly affected by the number of customers they can retain. Directors may monitor "customer churn" rates by the types of products offered as a KPI. Required disclosure would need to incorporate the following information:

- Definition and calculation: Churn rates by geographical market. Churn measured as the percentage of customers who do not renew their contract with the company at the end of the contract, over the total number of customers under that contract type.
- Purpose: Reducing churn rates means there is less pressure to increase customer acquisitions in order to improve revenues. Lower churn rates lead to direct savings in the form of savings in marketing, sales, installation and disconnection costs.
- Source of underlying data: Company data from UK, Germany and France.
- Quantified target: To reduce customer churn by 5% per annum in each territory.
- Quantified data: Churn rate, 2005 – UK 15%, Germany 18%, France 22%, 2004 – UK 14%, Germany 21%, France 25%, 2003 – UK 15%, Germany 24%, France 26%.
- No changes have been made to the source of data or calculation methods used.

Employees

IG21. Employees may be a particularly key resource – and accordingly a key risk – for many entities. The strengths of a company's workforce and the ways it is managed can play a major role in both current and future company performance. Entities will need to be able to recruit and retain the staff they need to achieve their business strategies. Accordingly, the risks and uncertainties associated with the management of recruitment and retention of staff with the particular skills required for the entity's strategies could have a significant impact on the entity's future development and performance. For example, poor employment relationships can carry the risk of costly litigation, low workforce morale and ultimately affect company reputation. In addition, directors will need to consider their employment policies and practices and to assess which aspects are relevant to an understanding of the entity. For example, the degree to which the human resources of the entity represent a significant competitive advantage or are critical to a key product, service or process.

IG22. The employee matters that will be of concern to directors will vary from entity to entity, depending on the industry in which the entity operates and the strategies it has adopted.

IG23. In order to assess employee performance and development, the following areas, along with related performance measures, may be helpful:

- Employee health and safety (which could also be considered a "social matter" see paragraph IG30) – details of RIDDOR (Reporting of injuries, diseases and dangerous occurrences regulations 1995), lost days to injury, levels of occupational related diseases in the workforce, compliance levels with working hours directives;

- Recruitment and retention – employee turnover, retention rates, remuneration policies, number of applicants per post, offer/acceptance statistics, levels of skills shortages;

- Training and development – hours spent on training, number of courses taken, leadership/career development;

- Morale/motivation – employee feedback results, absence rates, levels of employee engagement;

- Workforce performance and profile – employee productivity, revenue/profit per employee, diversity (see also IG30), number of professionally qualified employees.

IG24. IG Examples 12 and 13 provide some illustrations of where entities might set objectives relative to employees and monitor their progress as KPIs. Alternatively, the board may monitor employee measures to assess how effectively the entity is managing its employees' resources, development and performance to ensure that adequate resources are available to the entity, even though these performance measures are not considered KPIs. In such circumstances, it would be appropriate for the OFR to include these performance measures as other evidence, as set out in paragraphs 39 and 40 of the [draft] Reporting Standard.

IG Example 12: Employee morale

A professional services company may measure "employee satisfaction" in order to monitor employee morale, as decreasing levels of morale indicate higher levels of leavers in the future. Required disclosure would need to incorporate the following information:

- Definition and calculation: Employee satisfaction on a scale of 1 to 5 where 1 is low and 5 is high.
- Purpose: A professional services company needs to ensure it retains its best and brightest employees in order to properly service clients.
- Source of underlying data: Annual employee surveys in the UK, France and Germany, representing 85% of the total client facing employees.
- Quantified target: For 2006 to achieve a rating of 4.5, with the populations surveyed to cover at least 95% of client facing employees.
- Quantified data: Employee satisfaction graph showing comparatives e.g. 2004 – 4.1 rating, 2005 – 4.4 rating.
- Comparability: The 2004 survey results were based on surveys in the UK and France, representing 65% of total client facing employees.

IG Example 13: Employee health and safety

In an industry such as mining, where the ''licence to operate'' is based on effectively managing a myriad of issues, including health and safety, the directors may monitor ''lost time injury frequency rate'' as a KPI. Required disclosure would need to incorporate the following:

- Definition and calculation: Lost time injury frequency rate (LTIFR) — the number of lost-time injuries per million hours worked.
- Purpose: As the industry involves large equipment and working with hazardous materials, safety is a core value and a major priority.
- Source of underlying data: Injury data returns from 100% owned facilities only.
- Quantified target: To reduce LTIFR by 10% per annum.
- Quantified data: LTIFR table showing comparatives e.g. 2004 – 10 injuries/million hours worked, 2005 – 8.4 injuries/million hours worked.
- No changes have been made to the source of data or calculation methods used.

Environmental matters

IG25. Environmental matters, particularly environmental risks and uncertainties, impact to some extent on all businesses, as they can affect investment decisions, consumer behaviour and Government policy. Poor management of energy, natural resources or waste can affect current performance; failure to plan for a future in which environmental factors are likely to be increasingly significant may risk the long-term future of the business. Proper attention to the environmental impacts of supply chains and products and to regulatory compliance of the company's own operations are both important for a business' public reputation and for its licence to operate.

IG26. Environmental matters cover a very wide range of areas. The matters that will be of concern to a particular entity will vary depending on both the industry in which it operates and the strategies it has adopted. However, some consensus as to the generic environmental concerns facing all companies has been reached, which might serve as a useful reference point for directors:

- Water use;
- Energy use;
- Waste;
- Climate change, including global warming contribution or emissions management and ozone depleting substances.

IG27. Entities in industries that have a significant environmental footprint may set objectives and adopt strategies to specifically address key environmental risks, as illustrated in IG Examples 14 and 15. For others, whilst the management of environmental risks will impact the company's reputation, monitoring of performance in this area will not be considered a KPI. However, as set out in paragraph 22 of the [draft] Reporting Standard, the directors shall support the information provided in the OFR with other evidence, for example consumption rates of scarce resources (energy and/or water) if this significantly impacts the entity's reputation, by providing the information required in paragraphs 39 and 40 of the [draft] Reporting Standard.

IG Example 14: Environmental spillage

A company involved in the transportation of hazardous materials may monitor "significant spills" as a KPI due to the potential impact of a spill on the reputation of the company. Required disclosure would need to incorporate the following information:

- Definition and calculation: Significant spills, being spills exceeding 100,000 litres.
- Purpose: To assess the effectiveness of the management of hazardous waste.
- Source of underlying data: All data from 100% controlled companies, representing 85% of the total group on a revenue basis.
- Quantified target: Reduce significant spills to below 10 per annum within 3 years.
- Quantified data: In 2005 there were 25 significant spills, in 2004 there were 30 spills, all due to leaking tanks.
- No changes have been made to the source of data or calculation methods used.

IG Example 15: CO_2 emissions

A company involved in energy production may monitor CO_2 equivalent emissions due to both potential fines and the impact of growing emissions on the reputation of the company. Required disclosure would need to incorporate the following information:

- Definition and calculation: CO_2 emissions, being on-site greenhouse gas emissions measured in million of tonnes of CO_2 equivalents (CO_2-e)
- Purpose: To assess the effectiveness of the management of the company's impact on greenhouse gas emissions.
- Source of underlying data: Data from 100% controlled companies within Europe and Africa, representing 95% of the company on a revenue basis.
- Quantified target: A 5% annual reduction in CO_2 equivalents
- Quantified data: 2005 CO_2-e 5.7, 2004 6.0, 2003 6.2
- No changes have been made to the source of data or calculation methods used.

Social and community matters

IG28. The management of an entity's social and community matters can affect its reputation and licence to operate in a similar way to the management of environmental matters. Social concerns with regard to product safety, e.g. genetically modified foods, product responsibility, e.g. underage drinking or smoking, and the ethical management of the supply chain are all examples of issues that can significantly impact on the reputation of an entity. Furthermore, disregard for local community concerns can result in successful opposition to development applications.

IG29. As with the other areas noted under particular matters, the areas that will be of concern to a particular entity will vary depending on both the industry in which it operates and the strategies it has adopted.

IG30. Currently, there is no commonly held definition of social and community matters*, nor is there a common understanding of the generic issues. It is

* As noted in the International Organisation for Standardization (ISO) document 'Working Report on Social Responsibility' (2004), page 67.

also the case that specific matters within the broad social and community category can change as new issues arise. However, areas that directors might want to consider include:

- Public health issues, such as obesity, perceived safety issues related to high use of mobile phones, smoking;
- Employee health and safety (can also be considered an area under employees, see IG23);
- Social risks existing in the supply chain, for example the use of child labour and payments of "fair wages";
- Diversity in either the employee (see IG23) or customer base;
- Impact on the local community, for example noise, pollution, transport congestion (these areas could also link to environmental matters);
- Indigenous and human rights issues relating to communities local to overseas operations.

IG31. Entities where reputation is a key concern might set objectives and adopt strategies that specifically address key social or community concerns, as illustrated in IG Examples 16 and 17. Alternatively, the monitoring of social and community matters may not be considered a KPI, however, directors will still monitor their performance in these areas. In such situations, it would be appropriate for the OFR to include these performance measures, as set out in paragraphs 39 and 40.

IG Example 16: Monitoring of social risks in the supply chain

A company that sources its branded products from overseas could face additional risks relating to stakeholder, in particular customer, concerns around local labour practices. In this situation, a company might have put in place a system to validate and monitor supply chain performance, specifically related to adherence to stated policies. The directors may monitor the extent of the programme and compliance rates as KPIs. Required disclosure would need to incorporate the following:

- Definition and calculation: Number of factories subject to ratings by independent accredited monitors, number of factories in each rating category, where one star signifies numerous severe non-compliance issues and four stars reflects those factories with no non-compliance issues.

- Purpose: Whilst the company has outsourced its supply chain, it wants to reassure customers that it has not outsourced its moral responsibility for the way its products are made. The objective is for all parts of the business – including suppliers – to share a common set of values and live up to them.

- Source of underlying data: Results of assessments made by accredited monitors in the current period.

- Quantified target: To increase the number of suppliers monitored by 20% per annum and reduce non-compliance to below 3%.

- Quantified data: Geographical split (for current year and prior year) of results for overseas suppliers, by Asia, Americas and Europe. Total factories in each of the four rating categories.

- No changes have been made to the source of data or calculation methods used.

Example 17: Noise infringements

An airport operator might want to measure the number of noise infringements as a KPI in order to monitor the success of its management of this "licence to operate" and reputational risk issue. Required disclosure would need to incorporate the following information:

- Definition and calculation: Number of noise infringements being the number of aircraft exceeding Department of Transport take-off noise limits.
- Purpose: Our ability to expand any airport is dependent on continuing support from local communities. If we fail to ensure aircraft using our airports comply with local noise limits, we are putting at risk future developments which are necessary given the growth in the airline industry in the country.
- Source of underlying data: Internal company data.
- Quantified target: Reduce noise infringements by 5% per annum.
- Quantified data: Annual noise infringements table showing comparatives, e.g. 2005 – 55, 2004 – 57, 2003 – 60, 2002 – 64, 2001 – 63.
- No changes have been made to the source of data or calculation methods used.

Receipts from, and returns to, shareholders

IG32. Paragraph 57 of the [draft] Reporting Standard requires that the OFR shall include information relating to receipts from, and returns to, shareholders. This would include details of, and the rationale behind, any of the following:

1. Receipts from shareholders resulting from capital raising activities;
2. Distribution via dividends or special dividends;
3. Return of capital by means of share repurchases and share reconstructions.

Other resources

IG33. Paragraph 48 of the [draft] Reporting Standard requires that the OFR shall include a description of the resources available to the entity and how they are managed. In addition to employee and customers already featured in IG Examples 11 to 13, other resources could include areas such as corporate reputation and brand strength; the condition of infrastructure; research and development; intellectual capital; licenses, patents, copyright and trademarks; market position and reserves of natural resources, as illustrated in IG Example 18.

Example 18: Reserves

In an extractive industry, future revenues are greatly affected by the reserves controlled by the company. Accordingly, proven and probable reserves may be monitored by the directors as a KPI. Required disclosure would need to incorporate the following:

- Definition and calculation: Reserves are defined as those quantities of petroleum which are anticipated to be commercially recoverable from known accumulations from a given date forward. Reserves are reported net of the gas required for processing and transportation to the customer. The reporting process is in line with reserves definitions and resource classification systems published by the Society of Petroleum Engineers (SPE) and the World Petroleum Congress (WPC).

- Purpose: The most critical driver of growth of any oil and gas company is reserve replacement.

- Source of underlying data: Internal company data reviewed by an independent expert (who should be named, along with professional qualifications)}.

- Target: To replace current year's sales volume through reserve growth in the year.

- Quantified data:

Proven at end of 2004 = 316, less production 57, add revisions 27, add exploration additions 41, Proven at end of 2005 = 327.

Proven and probable at end of 2004 = 724, less production 57, add revisions -4, add exploration additions 69, Proven and probable at end of 2005 = 732.

- No changes have been made to the source of data or calculations methods used.

Other business risks

IG34. As set out in paragraph 50 of the [draft] Reporting Standard, the OFR shall include a description of the principal risks and uncertainties facing the entity, together with a commentary on the directors' approach to them. In addition to risks related to environmental, social and community matters addressed in IG Examples 14 to 17, other risks might arise due to the external environment, dependencies on others, and the management of resources, both non-financial and financial, as illustrated in IG Example 19.

IG Example 19: Market risk

A bank might measure market risks arising from uncertainty about changes in market prices and rates, such as interest rates, equity prices, exchange rates, commodity prices) by using "value-at-risk" approaches as a KPI. Required disclosure would need to incorporate the following information:

- Definition and calculation: Value-at-risk (VaR) uses a Monte Carlo simulation process. Volatilities and correlations of market parameters are observed over the most recent twelve-month period and used on an unweighted basis. The VaR estimates are made at a 99% confidence level for a one-day time horizon.
- Purpose: Tracking the daily VaR allows the bank to derive a quantitative measure of market risk in order to monitor the risk profile it has taken on related to all market risk areas.
- Source of underlying data: VaR of trading units in the UK and of the units responsible for management of interest rate and foreign exchange risks of non-trading units.
- Target: The goal is not to exceed the limit set by the VaR calculation on any day of trading during any year.
- Quantified data: VaR histogram, showing the number of days VaR was at certain levels.
- No changes have been made to the source of data or calculation methods used.

Financial position

IG35. The [draft] Reporting Standard requires that the OFR shall set out an analysis of the position of the entity both in the period under review and the future, including a description of the capital structure, treasury policies and objectives, and liquidity of the entity. Whilst a number of the measures used to monitor the position of the company may be traditional financial measures, directors often supplement these with other measures common to their industry to monitor their progress towards stated objectives. Such disclosures may include sensitivity analysis in respect of financial instrument disclosures.

IG Example 20: "Economic capital"

The directors of a financial institution may measure economic capital, in addition to regulatory capital, as a risk management tool and to monitor risk positions in individual business units. Required disclosure would need to incorporate the following information:

- Definition and calculation: Economic capital is the amount of capital that a transaction or business unit requires in order to support the economic risks it creates. A 99.95% confidence interval and a one-year time horizon are used to calculate economic capital. The economic capital calculation is subdivided into five distinct risk types: credit risk, market risk, transfer risk, business risk and operational risk.

- Purpose: The directors measure economic capital in order to monitor the efficient use of group's capital base.

- Source of underlying data: Internal company data.

- Quantified data: Economic capital for each business unit, reconciling to total economic capital for 2004 and 2005.

- No changes have been made to the source of data or calculation methods used.

IG Example 21: Cash conversion rate

To supplement the cash flow information provided in the financial statements, directors may measure operating profit cash conversion rates as a KPI. Required disclosure would need to incorporate the following information:

- Definition and calculation: Cash conversion rate being cash flow from operations as a percentage of operating profit.
- Purpose: One of the key drivers to strong economic returns is the ability to convert operating profits into cash.
- Source of underlying data: Internal company data.
- Quantified target: A minimum target of 85% cash conversion for any year.
- Quantified data: Cash conversion 2001 – 74%, 2002 – 101%, 2003 – 92%, 2004 – 85%, 2005 – 92%.
- No changes have been made to the source of data or calculation methods used.

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