# GOOD MEDICINE?

## The new, mandatory, OFR might just be red tape that's good for you.

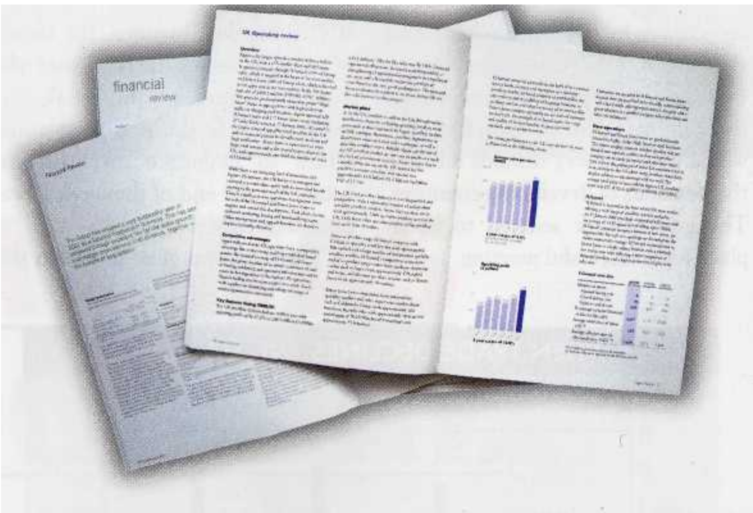
PUBLICLY **QUOTED** FDs stand by. The annual report just got more complex. The government - aided and abetted by quasi-regulators and various professional bodies - is determined to improve the transparency of corporate reporting. Politicians and civil servants believe that by increasing the amount of information available to shareholders, there will be a reduction in the risk of an Enron-type corporate governance scandal in the UK.

Apart from beefing up the Combined Corporate Governance Code - the new version of which comes into force next month — the other main weapon in this ongoing quest is the operating and financial review (OFR).

The OFR started life over a decade ago when the Accounting Standards Board (ASB) published some non-compulsory guidance on drawing it up. Traditional financial statements are, by themselves, inadequate for investors and analysts, said the ASB. More forward-looking disclosure, including non-financial information, was the way forward.

Narrative accounting - including the chairman's statement and OFR disclosures - has since emerged as a standard part of annual reports.

The Company Law Review (CLR) liked the idea of the OFR and suggested making it mandatory. But although it wanted the OFR to be compulsory, it refrained from mandating exact content. It saw the OFR as a channel through which directors could communicate their company's progress and potential. So instead of the CLR setting prescribed content, it recommended broad guidelines.



Now the government, in its response to the CLR, has announced that the OFR is heading for the statute books. This is fine for the investor. But it's not so clever for those in publicly quoted companies who now *have* to produce one. In particular, if you're the FD of a smaller quoted company, you may well feel that the OFR is yet another piece of red tape which will do little for the share price, but will keep you in the office even longer hours.

And it's true that, at first, the OFR does appear daunting. But for the directors of well-run companies, the OFR should be, if not a breeze, then certainly worth the effort.

There are still issues exercising the great and the good, such as defining "materiality" in the context of the OFR. The main thrust is that boards should identify and comment on their company's key performance indicators - the OFR should be a statement of risk and of risk management. But it needn't be over-complex. I'd argue that the raw material for the OFR - it's sub-headings, if you like - should be the main agenda items from the year's board meetings. (Mind you, that's not a hard-and-fast rule. If your board meetings include as much trivia as some that I attend, you'll need to be selective.)

A good OFR should tell a tale. It tells the story of the past year and the likely prospects for the future. Whereas FDs from the FTSE 100 may need PAs and researchers to track down information for the review, FDs of smaller quoted-company should know enough about both the big picture and the detail to to write most of the OFR almost single-handed. Remember that the OFR is a board statement, though. The whole board needs to provide input and must sign up to the contents. But don't overestimate the level of detail or the volume of output involved.

Some worry that the OFR may reveal sensitive information. But think of it like this: if the success of your company depends upon the ignorance or stupidity of your competitors, that's already a cause for concern. Of course, you must not publish sensitive details. But rules already exist to provide information to the market about significant issues. It's highly unlikely that the OFR would be the first time sensitive information would be disclosed.

Because it's a legal requirement, directors have to make "good faith, honest judgements" about what's included. Interpreting that phrase might be a slight concern. Auditors may worry about the processes and procedures that are in place to produce and review the OFR. But such questions are relevant only to global corporations with complicated structures. If your auditor wants to worry about how you produce the thing, I'd let them get on with it.

One final point to stress. The OFR should be even-handed. Corporations, as much as government, stand accused of using spin to bamboozle investors and analysts. The OFR is meant to relate the good news *and* the bad. Somehow I doubt any director of a company can be impartial in the way the law appears to expect. Maybe the non-execs have a role to play in ensuring impartiality. But directors must remember to tell it how it is, not how they would like it to be. I get a lot of turnaround work from firms where bad news was not faced up to and dealt with.

The passing of the OFR into law is a good moment to review how the board manages itself and its information flows. Whether it will improve transparency for investors is unclear. But if approached properly, it should prove a good exercise in discipline for the board.

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