EU Accounts Modernisation Directive

Trucost Guide – 28th November 2005

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Highlights:

- **The Operating and Financial Review has been abolished**
- **The EU Accounts Modernisation Directive now applies for all medium and large GB companies including listed companies**
- **Mandatory new enhanced business review required as part of an 'enhanced directors' report'**
- **Less emphasis on forward-looking statements but an indication of likely future developments in the business of the company is still required**
- **Key Performance Indicators (KPIs) required for analysis of financial and non-financial information including environmental and employee matters where relevant**

Background

On the 28th November the Chancellor announced that the Government would be abolishing the Operating and Financial Review (OFR) requirements for GB listed businesses in line with the aim of reducing regulatory burden. Directors of listed companies will no longer have to produce an OFR from April 2006 onwards, and will no longer be required to report according to the detailed requirements specified by the OFR regulations.

The OFR was a specific implementation of the EU Accounts Modernisation Directive (AMD), which requires companies to produce an 'enhanced directors' report'. The OFR extended the requirements of the Directive in order to provide greater disclosure for shareholders. As the OFR has been abolished the EU AMD will now apply to all medium and large businesses, and will therefore affect nearly all listed businesses.

> ***"Best practice is of course for companies to report on social and environmental strategies relevant to their business. But I understand the concerns about the extra administrative cost of the goldplated regulatory requirement that from April next year all quoted companies must publish an operating and financial review….So we will abolish this requirement and reduce the burdens placed upon you"***
>
> Rt. Hon. Gordon Brown MP, Chancellor of the Exchequer, 28-11-05

The EU Accounts Modernisation Directive is intended to increase the comparability between companies in the EU through a common reporting framework. To achieve this objective, the Union requires common financial reporting standards – that are transparent, fully understood, properly audited and effectively enforced. The Directive brings European accounting requirements in line with modern accounting practice and increases the reporting remit to take account of the growing demand for non-financial comment and analysis.

Which companies must produce an enhanced directors' report?

All GB companies, apart from those meeting the statutory definition of small companies, have to include an expanded fair review of their business in their directors' report. Two or more of the requirements in the table below need apply:

	Medium	**Large**
Turnover more than	£5.6m	£22.8m
Balance sheet total more than	£2.8m	£11.4m
Number of Employees greater than	50	250

The directors' report on qualifying medium-sized companies does not need to include analysis using key performance indicators, so far as they relate to non-financial information (see below).

What does the Directive require?

The Directive also requires Member States to make changes to national law concerning the form and content of company accounts and brings European accounting practice in line with International Accounting Standards.

In the UK, from the 1st April 2005 it requires a mandatory addition to the directors' report providing an enhanced review of your company's business.

What should directors include in an enhanced review?

The regulations state that "the review required is a balanced and comprehensive analysis of:

(a) the development and performance of the business of the company during the financial year, and
(b) the position of the company at the end of that year, consistent with the size and complexity of the business."

This contrasts with the requirements of the OFR regulations, which in addition to the above stipulated the following be reported:

"(c) the main trends and factors underlying the development, performance and position of the business of the company during the financial year, and

(d) the main trends and factors which are likely to affect the company's future development, performance and position".

It was the final clause that was causing consternation amongst directors, given that no safe harbour provision was provided for directors who reported on future issues facing their business.

Key Performance Indicators (KPIs)

KPIs are "factors by reference to which the development, performance or position of the business of the company can be measured effectively".

Under the AMD regulations, "the review must, to the extent necessary for an understanding of the development, performance or position of the business of the company, include:

(a) analysis using financial key performance indicators, and

(b) where appropriate, analysis using other key performance indicators, including information relating to environmental matters and employee matters."[i]

Medium-sized companies, while not required to include analysis using non-financial KPIs, are "very much encouraged to report on these issues voluntarily in recognition of the benefits such disclosure brings to the operation of the business."[ii]

The Regulations do not say how many KPIs should be included, nor mandate any particular KPIs for companies to report on. The selection and number of KPIs included in the review is for directors to decide.

The DTI's guidance states that "Companies [that have to produce an enhanced directors' report] can look for guidance to the [Accounting Standards Board] reporting standard that underpins the OFR."

The Accounting Standards Board (ASB) Reporting Standard on the OFR details how KPIs should be reported on. It states:

"For each KPI disclosed….:
- 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…, that fact shall be highlighted and a reconciliation provided
- Where available, the corresponding amount for the financial year immediately preceding the current year shall be disclosed."

The review must, to the extent necessary for an understanding of the development, performance or position of the business of the company, include:

(a) analysis using financial key performance indicators, and

(b) where appropriate, analysis using other key performance indicators, including information relating to environmental matters and employee matters.

Liability, Enforcement and Non-compliance

The regulations establish a criminal and administrative enforcement regime equivalent to that existing for accounting requirements. There are criminal sanctions for directors who are party, knowingly or recklessly, to the approval of defective accounts, and for the failure to sign accounts. These will apply to directors' reports for financial years beginning on or after 1 April 2005.

Civil penalties will also apply to directors' reports for financial years beginning on or after 1 April 2006.

The directors' report will be enforced by the same regime that administers financial statements, namely the Financial Reporting Review Panel (FRRP).

Role of Auditors

Consistency. Auditors have to ensure that the director's report is consistent with their knowledge of the accounts and make a positive statement to this effect.

Source of Guidance

Practical Guidance for Directors[iii] is a publication produced by an independent group of experts set up by the government and chaired by Rosemary Radcliffe. The guidance was intended for company directors preparing OFRs but it offers advice that helps clarify the process of identifying and selecting the necessary information that could be included in the enhanced directors' report. The Guidance asks company directors a number of key questions including:

- Does the board have all the relevant knowledge and skills to make its judgements as to what should or should not be included?
- How should the information put before the board be validated and by whom?
- What processes of challenge, both internal and external, should be used? What sign-off procedures should be in place?
- How, once the information has been put together, does the board decide whether it should be included or not?

Department of the Environment, Food and Rural Affairs (Defra) Environmental Reporting Guidelines

Defra has produced a general set of guidelines[iv] which set out in straightforward terms how to produce a good quality environmental report. In addition Defra has published separate guidelines on how to measure and report on the Key Performance Indicators, which will prove useful for businesses wishing to report on environmental KPIs in their enhanced directors' report. These Guidelines were co-authored by Trucost.

> ***""These guidelines seek to set a standard which will give business some assurance that it has reported its environmental performance to an appropriate minimum level of accuracy and detail."***
>
> Elliot Morley MP, Minister of State, Climate Change and Environment, 27-06-05

How can Trucost help?

Reporting on company's environmental impacts with the use of appropriate KPIs in an audited document will be new for many directors.

As the co-authors of the Government's new Environmental Reporting Guidelines Trucost is well-placed to provide your company with expert guidance on how to devise and report on the appropriate KPIs.

Trucost has an environmental performance measurement system used by FTSE 100 and other leading companies that provides directors with a means of determining the appropriate KPIs to use in the enhanced directors' report.

Rosemary Radcliffe CBE, Chairman, OFR Independent Working Group, says: "Trucost has a well established and robust process which can help boards of directors decide which of their businesses' environmental impacts should be disclosed."

In providing a transparent process that allows environmental impacts to be ranked in terms of financial impact and related to turnover and profit, Trucost can help company directors satisfy the requirements of the Accounts Modernisation Directive in a highly cost-effective manner. The Trucost system allows for performance benchmarking against peer companies and across the industry. If directors believe their business has no relevant impact on the environment then Trucost's system can provide directors with independent assurance to that effect.

David Glinski, Head of Group Environment Health & Safety at Prudential Plc: "During 2004 Trucost Plc was commissioned to carry out research into the environmental impacts of our business activities, and to present the findings in financial terms. As a result of this research, we were able to rank our environmental impacts in order of significance and materiality."

Workshops on the Accounts Modernisation Directive are being held across the UK.

Please go to http://www.trucost.com/workshops for more information or call +44 (0)20 7321 3833

Issue	Abolished OFR regulation	EU Accounts Modernisation Directive
What is it?	Mandatory report providing "a balanced and comprehensive analysis" of a company's business. The OFR was forward-looking in nature and required more information on the strategies and policies the company is deploying for long term success.	Mandatory addition to existing directors' report to provide an enhanced review of a company's business. The enhanced directors' report provides a 'snapshot' of the company at a moment in time, addressing principal risks and uncertainties, but not necessarily the trends and factors affecting the future development, performance and/or position of the company.
Which companies it applies to	All UK listed companies.	All large and medium EU companies.
What the report should contain	An overview of the company's objectives, strategy, past performance and future prospects. It would have included, where necessary, information about employees, environmental matters and social and community issues.	The review should be a balanced and comprehensive analysis of the development, performance and position of the company's business. The analysis should include both financial and, where appropriate, non-financial key performance indicators (KPIs) relevant to the particular business, including information relating to environmental and employee matters.
Who signs off content	Directors.	Directors.
Role of Auditors	Auditors were required to state whether the information given in the OFR was consistent with a company's accounts as well as whether any other matters that came to their attention in the performance of their functions as auditors of the company were inconsistent with information directors might have given in the OFR.	Auditors required to state whether the information given in the directors' report is consistent with a company's accounts.
Standard of Verification	Due care, skill and diligence.	Due care, skill and diligence.
Enforcement	As per existing regime for financial statements.	As per existing regime for financial statements.
Revision of defective reports	Financial Reporting Review Panel.	Financial Reporting Review Panel.
Effective Date	Was 1st April 2005.	1st April 2005.

[i] EU Accounts Modernisation Directive, 18 June 2003

[ii] Guidance on the OFR and changes to the directors' report Department of Trade and Industry April 2005

[iii] OFR Practical Guidance for Directors DTI, May 2004

[iv] http://www.defra.gov.uk/environment/business/envrp/index.htm