

OFR has Important Implications for Director's Liability

What is the OFR?

Patricia Hewitt announced today that the Operating and Financial Review (OFR) will be introduced as a regulation, which will not need legislation, contrary to original statements published in July 2002 that it would be integrated into the far-ranging Company Law Review. The regulation will mean that the largest 1000 UK companies will be required to publish an OFR as part of their annual report and accounts. The OFR should provide analysis of the main trends and factors underlying the results and current financial position, and those that are likely to affect performance in the future.

Environmental policies and performance, together with corporate governance, community, social, ethical and reputational issues, should be included where directors judge them material. The proposals make clear that it will be for directors to decide what is and isn't material to their business but that ultimately directors might need to defend the process behind their reporting in the courts.

'Directors of large quoted companies may, in extremis, find themselves having to defend in court a decision on the materiality of information, both qualitative and quantitative, on such things as future performance, risks...and environmental impact of their business.'
Financial Times, 23rd June 2003

Consultation Phase

The OFR Working Group was set up to develop broad principles and practical guidance on how directors can assess whether an item is material and hence whether it should be included in an OFR. Responses to their consultation paper, published on 27 June 2003, are invited before 19 September 2003. Some key recommendations are:

- **The primary audience for the OFR should be company shareholders**
 - **Materiality should be determined with reference to possible impacts on shareholder value**
 - **The broader concerns of customers, suppliers, employees and pressure groups should be addressed because they can represent risks to shareholder value**
 - **The OFR is the responsibility of the board as a whole**
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What is Material?

The OFR should strike a balance between historic review and a focus on the future. It may be qualitative as well as quantitative but where information can be quantified it should be quantified. Whether information is material will depend upon the nature and, where relevant, the size

and effect of the item. This concept is the same as is applied to the preparation of financial statements. It is desirable to provide measurement wherever possible. The processes used to make these decisions will need to be reviewed internally, perhaps by a special board committee, and externally by auditors.

Directors should note that these OFR processes might be subject to external challenge from stakeholders. The processes should be transparent, be subject to appropriate consultation, include appropriate internal and external comparisons, and be comprehensive and consistent over time.

How can Trucost help?

Presently around 100 UK companies produce environmental reports. This regulation represents a challenge to those that do not, both in terms of understanding the implications of the OFR and in terms of establishing appropriate processes to comply with it.

Trucost exists to help companies and fund managers understand environmental impacts in financial terms and we believe that our methodology will be of assistance to companies when deciding whether environmental impacts are material to the OFR.

In a speech at INSEAD's conference, 'Investor Interest in Corporate Sustainability and the Disclosure of Material Risk', Simon Thomas, Chairman of Trucost, said:

'Materiality is about relevance. Relevance can only be determined by relative scale. Relative scale requires a common denominator and the common denominator of business is money'.

INSEAD conference, 19th June 2003

In providing a system, which allows environmental impacts to be considered in financial terms, Trucost allows for conventional tests of materiality to be employed and for the process to be audited.

Trucost will be organising a series of briefing seminars on the OFR in order to promote better understanding. Please contact us if you would like to attend.

For further information about the OFR and how it may impact your company, please contact Rob Barker or Vince Chaney on +44 (0)20 7321 3833 or visit our website at www.trucost.com