

# **The Mandatory Operating and Financial Review**

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The Operating and Financial Review (OFR) represented a major innovation in UK financial reporting. For the first time, regulators formally recognised the importance of qualitative, non-financial information. It enables companies to provide a formalised, structured and narrative explanation of financial performance. The ASB introduced the OFR in 1993. The OFR is voluntary not mandatory. It has two parts: first, the operating review which discusses items such as a company's operating results, profit and dividends; second, the financial review which covers items such as capital structure and treasury policy. The OFR can be treated as a stand-alone document or may be split up and incorporated into other narrative sections (Jones, 2002). Indeed, the OFR has been a very successful form for reporting narratively.

Issuing from a long chain of essentially democratic policy debate under the auspices of the Modern Company Law Review, the new mandatory OFR, which came into force in April 2005, has been held up as a saviour by those supporting mandatory social and environmental reporting. It has also been seen as a focus for narrative disclosures generally. The long process leading to the review of company law in the UK has included a significant level of debate on the importance of inclusivity, in terms of stakeholder needs and environmental/sustainability issues generally. Indeed, a mandatory OFR, which was intended to include disclosure relating to all areas of business risk, both financial and non-financial, has been identified as an ideal vehicle for social, environmental and ethical (SEE) information about a company. In particular the OFR has seemed to be the appropriate outlet for risk-related social and environmental information.

There has, however, been debate over the potential impotence of such an OFR for SEE information, given the materiality constraint (Solomon and Edgley, 2005). As SEE information only has to be disclosed under law in the mandatory OFR, 'to the extent necessary' (i.e. if it was material), then directors and boards would have ways of avoiding full disclosure of SEE risks, if they so wished.

However, the abolition of the mandatory OFR has shocked the business community. The government has decided to 'reduce the corporate red tape burden' (Grant, 2006b, p.1) by replacing the mandatory OFR with a business review which meets the minimum European Union requirements for narrative reporting. The replacement business review significantly reduces the SEE reporting details that companies provide in their annual reports (Grant, 2006a). The Chancellor's decision, as well as baffling most onlookers, is also surprising in that, as the mandatory OFR was to come into existence for the year ending 1 April 2005, most companies had already put in place procedures to produce it.

We are now left asking ourselves whether the whole company law review process has been a waste of time. How do people feel about getting involved in this type of debate in the future, when years of deliberation are washed away overnight by a governmental decision?

Could it be that the materiality 'get-out' clause has rendered the mandatory OFR impotent to the point where the government feels it is not worth introducing? Perhaps the impact would not have been anywhere near as great as anticipated on SEE reporting. Alternatively, the government may simply be trying to soften business by offering them the abolition of the OFR as a potential olive branch, to show their keenness to help business in the UK and reduce their costs.

The immediate reaction from the Friends of the Earth to the government's announcement demonstrates the significant weight NGOs had placed on the OFR as a potential vehicle for SEE disclosure and on raising the profile of sustainability issues. Friends of the Earth are launching a court case against the government in order to force the government to open a consultation over its decision. The group believes that the weight of views could force the government to change its mind (Grant, 2006a).

One saving grace may be European and international-level policy. The OFR U-turn has also put the UK at loggerheads with international developments. The US has long had a Management Discussion and Analysis (MD&A) analogous to the OFR, while at the international level narrative reporting is high on the agenda. The international harmonisation of accounting standards being carried out by the International Accounting Standards Board (IASB) is driving countries towards more similar accounting frameworks (Grant, 2006). In terms of narrative disclosure, the IASB is considering the addition of a management commentary to its platform of standards. This would be similar to the mandatory OFR. If such a standard became mandatory through the IASB, then a management commentary would be mandatory for EU-listed companies. This would mean that all the hard work and substantial resources that UK companies have channelled into developing their OFRs will not have been wasted. They will be able to adapt the OFR framework to respond to calls for this narrative type of reporting.

## **References**

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