11 May 2006

ICAEW REP 30/06

Anthea Heffernan
Department for Trade and Industry
1 Victoria Street
London
SW1H OET

Dear Ms Heffernan

DRAFT LIABILITY CLAUSES & THE BUSINESS REVIEW

The Institute of Chartered Accountants in England & Wales welcomes the opportunity to comment on the proposed draft clauses regarding liability for disclosures under the Companies Act, published by the DTI for comment on 3 May 2006.

We have reviewed the draft clauses with particular reference to their impact on the likely quality of business reviews, and set out our comments below. We have also taken this opportunity to comment on the draft clauses on the *content* of the business review referred to in the DTI press release of 3 May.

Liability

The abolition of the statutory Operating and Financial Review has focused attention on the variable quantity and quality of forward-looking disclosures in corporate annual reports, and the limited prospects for any radical improvement in the near future in this area, principally as a result of concerns amongst directors over potential legal liability in respect of such disclosures.

In our letter of 20 March 2006 on this topic, addressed to the Secretary of State, we recommended that the DTI explore as a matter or urgency the case for creating a 'safe harbour' in relation to forward-looking information. We explained that this should involve ascertaining the true extent of the relevant litigation risk and exploring the merits of the various types of 'safe harbour' available, with due reference to the scope for unintended consequences and the impact of similar defences in law in other jurisdictions.

We would welcome confirmation that in drawing up the proposed clauses restricting liability for narrative statements the DTI has satisfied itself over these important considerations. We would also welcome clarification of the rationale for restricting the scope of the clauses to the directors' report and the directors' remuneration report. Whilst improvements in the scope and quality of the information provided in the annual report as a whole is the prime objective, we believe it is likely that many companies will seek to move as much narrative information as possible into the directors' report to take advantage

of the safe harbour. It would, however, be undesirable if changes regarding the location of narrative information and the style of existing narrative reports were driven by factors other than the clarity and coherence of the various components of the annual report.

We also note that the migration to the directors' report of a substantial amount of information currently presented elsewhere in the annual report would have implications for the Financial Reporting Review Panel, which will examine the contents of directors' reports (but not the annual report as a whole) relating to accounting periods commencing on or after 1 April 2006.

Content

We see no compelling reason at this stage to amend the requirements relating to the contents of the business review. The business review requirements are generally non-prescriptive and high level, unlikely in themselves to stifle innovative narrative and non-financial reporting by encouraging a rigid, tick-box approach by directors. Nonetheless, we recognise that there are serious concerns regarding the lack of specific reference in the legislation to forward-looking information or to environmental, employee and social issues. We therefore accept the proposed augmentation of clause 395, subject to two important provisos.

Firstly, in our view no further guidance on the *contents* of the business review should be published by the DTI or the Accounting Standards Board, at least pending the first year or two of experience of the new regime. Even if presented as non-mandatory in nature, further guidance might encourage a tick-box approach by companies preparing business reviews. Good practice and common understandings emerge over time, through discussions between companies and their stakeholders and through the good example of innovative reporters within a sector. Further guidance could hamper this evolutionary process.

Secondly, the proposed new requirements should not in practice be extended - through law or through other means - to unlisted companies. We believe that in general any benefits that would follow for users of the financial reports of such companies would be heavily outweighed by the costs of preparation.

We welcome in principle the decision of the DTI to seek to explain in the legislation the *purpose* of the business review. However, the implications of the cross-reference in the draft clause to the directors' responsibilities listed in section 156 may be profound and merit very careful consideration by the DTI and other interested parties. For example, the current clause could be interpreted to mean that the business review must satisfy in full the information needs of the wider stakeholder groups referred to in section 156. This topic may be addressed in more detail in a future Institute briefing note on the company law reform bill.

Finally, we note that no reference is made in the DTI announcement of 3 May to the lack of specific exemptions in the business review legislation for wholly-owned subsidiaries. In practice, unless such companies have material external obligations, little value is likely to be attributed to their separate business reviews. It is likely that there will be considerable time and cost involved in producing the business review for such companies out of all

proportion to the potential benefit. We recognise that the wording of the relevant EU legislation may prevent the introduction into UK law of any specific relaxations for subsidiaries. However, we would again urge the DTI to discuss with the European Commission whether there is scope for relaxing the relevant requirements of the Accounts Modernisation Directive or at least for clarifying expectations in respect of wholly-owned subsidiaries.

I would be very pleased to provide any further details or information.

Yours sincerely

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