OPERATING AND FINANCIAL REVIEW: EXPERIENCES AND EXPLORATION

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The Research Committee is grateful to all those who participate in the refereeing process.
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FOREWORD

This survey is published as a contribution towards the Research Committee's continuing interest in investigating a range of aspects of the use of published financial information. An earlier survey, *Operating and Financial Review: A Survey of Compliance with the Spirit of the ASB's Guidance* (1995) identified sixteen annual reports containing Operating and Financial Reviews which were entirely consonant with the expectations of the Accounting Standards Board regarding the spirit of the communication process.

The research team has now interviewed finance directors of a number of leading UK companies and has repeated the survey for the second year of implementation of the ASB's recommendations for the Operating and Financial Review. The number of companies in the highest category has increased to twenty-one and there is evidence of improvements at all levels.

The Research Committee takes the view that accounting measurements must be supported by interpretative wording. A discursive review of a company's financial statements is critical to furthering the reader's understanding of those financial statements and the operations of the company. The Committee welcomes the continuing progress made in this regard by the FTSE-100 companies as shown in this research, and hopes that those reading the document will respond to the good practices which have been identified. The Research Committee is most grateful for the generous assistance provided by these companies.

Professor John Baillie  
Convener, Research Committee  
The Institute of Chartered Accountants of Scotland

August 1996
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Thanks are also due to the anonymous referees for helpful comments on the research project and on earlier drafts of this report. The researchers are appreciative of assistance and comments from Aileen Beattie, Director, Accounting and Auditing, and Ann Lamb, Assistant Director, Accounting and Auditing, ICAS. Typesetting was carried out by Isobel Webber, Personal Secretary to the Director of Research.
SUMMARY

The Operating and Financial Review (OFR) has become an established part of the annual reports of leading UK companies. Recommended by the Accounting Standards Board (ASB), but relying on cooperation for its effectiveness, the OFR appears in a variety of modes of presentation, according to the management strategy in presenting the corporate image.

In making its recommendations in 1993, the ASB expressed a hope that the ‘spirit’ of its non-mandatory Statement on the Operating and Financial Review would be preserved. A survey published by the Research Committee in 1995 evaluated this ‘spirit’ in the annual reports of FTSE-100 companies.

NATURE OF THIS PROJECT

The research project continued after that survey by interviewing a selection of finance directors of those companies in order to record their perception of the ‘spirit’ expected by the ASB and to understand their perception of the role of the OFR in corporate communications.

This report contains the outcome of those interviews and revisits the same companies one year later to trace the development of the ‘spirit’ as companies experiment with and develop the OFR. In order to preserve the overall size of the investigation at 100 companies, new FTSE-100 entrants were added to replace companies taken over since the previous review. New entrants had both years’ OFRs evaluated.
Three questions run throughout the report:

- What are the preparers' perceptions of the 'spirit' of the ASB Statement and of the effectiveness of their application of that 'spirit'?
- What are the characteristics of the company or its managerial structure which influence the nature of the OFR prepared by that company?
- Are there further factors, arising from preparers' perceptions, which should be taken into account when assessing compliance with the 'spirit' of the ASB Statement?

The preparers' perceptions of the 'spirit' of the OFR, as these emerged from the interviews, are presented in Chapter 2. Further analysis of the interview material draws out characteristics of the companies and their management which may have influenced the nature of the OFR, presented in Chapter 3. Chapter 4 draws on the evidence of the interviews to suggest expanding the view of what constitutes the 'spirit' of the OFR. Chapter 5 presents a survey and grading of FTSE-100 companies at their second opportunity to present an OFR which could meet the ASB's expectations. Conclusions and recommendations are in the final chapter. An appendix sets out brief case study sketches showing how the nature of the OFR may be influenced strongly by a key characteristic of the company or of its managerial structure.

The preparers were persuasive in demonstrating that the 'top-down' structure is often established by aspects of the annual report outside the OFR section. It is most evident where there has been strong editorial planning of the OFR. Confidentiality did not appear to have caused problems in respect of past events but does sometimes affect a forward-looking approach.

**GRADING THE OFRS**

The interview discussions with finance directors and colleagues confirmed that the grading system used in the previous survey was suitable for
continued application but some of the criteria used were refined, as explained in the report. The results for the second year of implementation of the ASB statement were:

<table>
<thead>
<tr>
<th>Grade</th>
<th>Number of Companies</th>
<th>Meaning</th>
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<tbody>
<tr>
<td>A</td>
<td>21</td>
<td>High quality document complying with the 'spirit' of the ASB's proposals and providing a significant addition to the understanding of the annual report.</td>
</tr>
<tr>
<td>B</td>
<td>26</td>
<td>High quality document complying with the 'spirit' of the ASB's proposals in a substantial proportion of the areas covered.</td>
</tr>
<tr>
<td>C</td>
<td>28</td>
<td>A document which complies with the 'spirit' of the ASB's proposals in at least half of the areas covered and meets the main requirements overall.</td>
</tr>
<tr>
<td>D</td>
<td>23</td>
<td>A document which contains the technical elements necessary to meet the ASB's proposals but which is lacking in evidence of the 'spirit'.</td>
</tr>
<tr>
<td>E</td>
<td>2</td>
<td>A document where some of the necessary technical elements are missing as well as the 'spirit'.</td>
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In the second survey, only three companies moved down a grade compared with the first. The rest either remained in the same band or moved up, as shown in more detail in the main body of the report.

The grade 'A' documents are distinguished for the way in which they appear informative about what influences the business and for the way in which they could be meaningful to a potentially wide readership. The
twenty-one companies deemed worthy of an ‘A’ grade were (in alphabetical order):

Arjo Wiggins Appleton plc
† Bass plc
† BAT Industries plc
† British Steel plc
† Burmah Castrol plc
† Cadbury Schweppes plc
     Carlton Communications plc
† Coats Viyella plc
     Grand Metropolitan plc
† Imperial Chemical Industries (ICI) plc
† Inchcape plc
† Reuters Holdings plc
† Royal Bank of Scotland Group plc
     Scottish Power plc
† Sears plc
† Shell Transport & Trading Company plc
     Siebe plc
† TI Group plc
† Unilever plc
† United Biscuits (Holdings) plc
     Whitbread plc

Those which were awarded an ‘A’ grade in the first survey are indicated by †. (Glaxo was also in that list but the change of accounting date following its merger with Wellcome meant that the annual report was not available for the relevant period in the second survey.)

CONCLUSIONS AND RECOMMENDATIONS

The report concludes that preparers of the OFR wish to remain very much in control of its style and content. It seems likely that in future the text of the preliminary announcement and the text of the OFR will
become the same document, if only to be clear how much information is in the public domain.

A strong managerial team creates a coherent OFR with a clearly constructed message. Some companies are making considerable efforts to keep in touch with the opinions of the readers of the annual report and to target the OFR accordingly.

In general, the largest companies do appear to pay careful attention to the quality of the OFR and new ideas are emerging.

The following questions, created from the interview analysis, are recommended to companies as the basis of a self-evaluation of the OFR:

- How will the reader proceed through this document? Is there sufficient guidance on how to use it to best effect?
- Are there items of information which we provide in one-to-one meetings which could clarify aspects of our financial position and performance to a wider audience?
- What forward-looking information do we presently provide in meetings with shareholders and their advisers? Why should that information not be provided in the OFR?
- Have we included in the OFR a section on investment for the future? Have we at least quantified the trend and how far away are we from reporting the absolute amount of investment for the future?
- Can we begin to help readers understand some of the more commonly used ratios which we know appear in evaluations of the company in the financial press or other form of public commentary?
- What most interested me in reading the OFR of X plc? Is there an equivalent item of interest in our company’s OFR which would catch the eye of the management of X plc?
- If we were outsiders looking at this text, could we get the measure of the group?
FURTHER RESEARCH

The research team intends to continue developing an understanding of the OFR as potentially representing a key feature of the annual reporting by companies and, by extension, a key feature of more frequent reporting on an interim or quarterly basis. The research team investigated the provisional views of analysts and institutional investors before the ASB Statement was implemented but would seek to evaluate the experiences of users of the OFR once a series of annual reports is available.

The researchers also intend to extend the investigation to companies below the FTSE-100 category. This in-depth investigation of FTSE-100 companies has been necessary to understand the variety of presentation and the causes of that variety, not readily predictable by specific causes. That understanding forms a basis for evaluation of other companies where the communication needs may be different.
CHAPTER 1

INTRODUCTION

This report is part of a continuing programme of investigation in relation to the communication opportunities presented by the Operating and Financial Review (OFR) as recommended by the Accounting Standards Board (ASB) in a Statement published in July 1993. The report presents the findings of interviews with finance directors and their colleagues in a selection of FTSE-100 companies, where the focus of discussion was the 'spirit' of the ASB Statement. Based on the interviews, the OFRs of all FTSE-100 companies are assessed for evidence of meeting that 'spirit' as perceived by the ASB and as interpreted by the preparers of the document.

1.1 Previous survey

A previous survey (Weetman et al 1995) evaluated the OFR of each FTSE-100 company at the first opportunity for preparation of an annual report which could reasonably be expected to include an OFR meeting the 'spirit' of the ASB Statement. (In practice that involved scrutiny of annual reports having year-ends from 31 December 1993 to 31 October 1994.) The nature of that 'spirit' was identified from the Statement itself and from discussions with the ASB secretariat.

That first survey assigned grades A to E to the OFRs, based on criteria specified as meeting, to a greater or a lesser extent, the spirit of the ASB Statement. All FTSE-100 companies showed evidence of some
compliance with the ASB Statement but sixteen companies in particular were found to have presented a high quality document, complying with the spirit of the ASB’s proposals and providing a significant addition to the understanding of the annual report.

In drawing conclusions from the first survey and in suggesting areas for further investigation, the reviewers noted that some aspects of the spirit of the ASB Statement could be identified by observation but some required discussion with those preparing the OFR. It was thought to be particularly important to discuss with preparers the aspects of the OFR where the reviewers had taken a view that the ‘spirit’ of the ASB’s statement was not evident. An explanation could well be that the preparers had a different perception of the spirit of the OFR and of their implementation of that spirit.

The research reported here is based on interviews with a selection of the companies whose OFRs were graded in the first survey. Following the interviews, a second survey of the OFRs of FTSE-100 companies was carried out. That is also reported here.

1.2 Questions for investigation

The key questions addressed by this research report are:

- What are the preparers’ perceptions of the ‘spirit’ of the ASB Statement and of the effectiveness of their application of that spirit?
- What are the characteristics of the company or its managerial structure which influence the nature of the OFR prepared by that company?
- Are there further factors, arising from preparers’ perceptions, which should be taken into account when assessing compliance with the ‘spirit’ of the ASB Statement?

The remainder of this chapter sets out a brief explanation of the ‘spirit’ of the ASB Statement and outlines the approach taken in the interviews with finance directors and senior personnel of FTSE-100 companies.
1.3 The ‘spirit’ of the ASB Statement

In its Preface to the ASB Statement, the Financial Reporting Council (FRC) concludes with the sentence:

_"The FRC therefore welcomes the ASB Statement and, within the framework of necessary commercial confidentiality, invites the directors of all listed companies, and other major corporations, to follow its spirit."_

That spirit is not defined as such in the main body of the ASB Statement but may be deduced from the Introduction and from the early paragraphs setting out the essential features of the OFR. For the previous survey of the OFRs of the FTSE-100 companies, the following key phrases were extracted:

- ‘top-down structure’ (para 3)
- ‘objective discussion’ (Preface, line 4)
- ‘analyses and explains the main features’ (Preface, line 4)
- ‘dynamics’ of operating activities (para 8) and of financial position (para 23)

These phrases formed the basis of the grading of OFRs of FTSE-100 companies in the first survey.

1.4 Interview research

On completion of the first survey of OFRs a report was published and sent to the finance directors of all FTSE-100 companies with a request to indicate willingness to participate in interviews. From the responses, a limited number (14) was selected to cover the entire range of grades awarded.
The interviewees

Interviewees ranged across four companies graded ‘A’ in the first survey, four graded ‘B’, two graded ‘C’ and four graded ‘D’. They were self-selecting to the extent that they agreed to participate in interview discussion although, at the time of agreeing to participate, only those graded ‘A’ in the first survey knew of their grade.

The selection of interviewees is not intended to present an exhaustive review of all aspects of the OFRs of the FTSE-100. The range was planned to allow the reviewers’ evaluations to be compared with company perspectives across a range of companies. This chapter, taken with the case study sketches in Appendix A, shows that each OFR had particular characteristics as a result of influences which were specific to the company concerned.

Interview agenda

The interview questions were directed towards issues arising from the first survey, namely:

(1) Process of preparation

How was the ‘top-down’ structure planned and how did the process of preparing the OFR lead to the particular format used in the annual report?

(2) Nature of the document

How was a balanced and objective discussion achieved, dealing even-handedly with both good and bad aspects?

Were there any problems in identifying those trends and factors underlying the business that have affected the results but are not expected to continue in the future, or in identifying those which are expected to have an impact on the business in the future?
(3) *Extent of confidentiality issues*

In a situation where information is not disclosed on grounds of confidentiality or commercial sensitivity, how is it ensured that the user is not misled by a discussion that is no longer complete and balanced?

(4) *Aspects of the operating review*

Are there any aspects of the operating review which the company would identify as being particularly interesting or worthy of note?

(5) *Aspects of the financial review*

Are there any aspects of the financial review which the company would identify as being particularly interesting or worthy of note?

(6) *Other factors*

Are there any other factors which should be taken into account in assessing whether the company's annual report conveys the 'spirit of the OFR'?

For the purposes of an interview, questions 4 and 5 above are too broad. It would be impractical to discuss lists of topics in an interview and it is likely that each list would be specific to the company and therefore not easily comparable. Two items were therefore chosen for enquiry. These were investment for the future and the use of ratios. Investment for the future was used as a focus for exploring attitudes to a relatively novel item in the operating statement, specifically identified by the ASB for inclusion. Evidence of inclusion of this item in the OFR would be an indication of the extent to which opinion has mellowed since company management rejected investment for the future as an item for the financial statements within FRS 3. Ratio analysis was included as an item for discussion because the first survey indicated a relatively low incidence of this tool of analysis.
Form of the discussion

The interview agenda was used primarily as an initial focus rather than as a rigid framework. The format of the interviews was quite general in nature, with interviewees being asked to focus in particular on the OFR of their own company and the factors relevant to the 'spirit' of the ASB Statement for their particular OFR. Each interview began with the interviewee’s self-evaluation of the OFR, followed by the interviewer explaining the perceptions of the reviewers in their reading of the OFR. The interview then moved to discussion of the reviewers' findings in the context of the company's particular circumstances and concluded with the interviewee’s perceptions of how the OFR will progress in future for the company in particular and for companies in general.

The text of each interview was analysed to allow the main issues, identified by the interviewee, to emerge from the interview record. In carrying out the analysis the three key questions of the research project were used as the framework.

1.5 Structure of the report

The next three chapters consider each research question in turn. In Chapter 2 the preparers’ perceptions of the ‘spirit’ of the OFR are presented in terms of the key aspects identified for questions. In Chapter 3 there is a discussion of the characteristics of the companies and their management which may have influenced the nature of the OFR. Chapter 4 draws on the evidence presented in Chapters 2 and 3 which suggests expanding the reviewers’ earlier view of what constitutes the ‘spirit’ of the OFR.

Chapter 5 reports on the survey and grading of FTSE-100 companies at their second opportunity to present an OFR which could meet the ASB’s expectations. Chapter 6 draws conclusions and makes recommendations for companies to consider in preparing the OFR.

An appendix to the report sets out thumb-nail case study sketches linking the material of Chapters 2 and 3 in order to demonstrate how the nature of the OFR may be influenced strongly by a key characteristic of the company or of its managerial structure.
CHAPTER 2

PREPARERS’ PERCEPTIONS

The first research question of this investigation addresses the perceptions of preparers regarding the ‘spirit’ of the ASB Statement and the effectiveness of their application of that spirit.

The following areas of interest were discussed in the interviews:

- ‘top-down’ structure
- good and bad aspects
- confidentiality issues
- forward-looking information
- specific features of the operating review and the financial review (investment for the future and ratio analysis)

Some of these areas of interest were planned following the first survey, as indicated in the interview agenda outlined in Chapter 1. There was also an opportunity for interviewees to provide other views. The first three items in this list were identified for the interview agenda because they are the ASB’s perception of key features of the spirit of the OFR (as identified for, and used in, the first survey). The interviewees extended the general question of confidentiality issues into the specific area of forward-looking information. This particular concern for forward-looking information is consistent with the views expressed by those who made submissions to the ASB on its 1992 discussion paper which
preceded the 1993 Statement (Weetman et al, 1996). Forward-looking information was also included in the first survey as a particular item for identification in each of the operating review and the financial review.

The interviewees' observations are outlined below for each area of investigation, indicating in each case the range and variety of response. The companies' views are preceded in each case by an explanation of the nature of each area of investigation and an indication of the interest arising from the first survey. There is no quantified analysis of responses because each interviewee revealed different characteristics in the responses and in the factors which might affect those responses. At the end of the chapter there is a summary of the interview findings.

2.1 'Top-down' structure

The nature of the 'top-down' structure is explained in the ASB Statement as discussing individual aspects of the business in the context of a discussion of the business as a whole (para 3). For the reader, the question could be put in the form:

'How readily do you gain an overview of the business as you read the OFR?'

A practical limitation on obtaining this overview is that the ASB Statement allows each company's directors to decide whether to deal with the matters addressed in the Statement by means of a stand-alone section, or whether to incorporate them within the structure of one or more other sections such as a Chief Executive's Report (para 2). The only caveat applied is that the combination of OFR information with other material should not obscure its impact or impair the balance and objectivity envisaged by the Statement.

Issues from the first survey

In the first survey, identifying the 'top-down' structure was possibly the most difficult task facing the reviewers because it became apparent that for many companies the structure of the first half of the annual report
is built on the Chairman’s Statement and the Chief Executive’s Report. At some point there is likely to be an extensive review of the business and a report by the finance director. The title *Operating and Financial Review* may or may not be used.

In several of the annual reports examined, the introductory wording which established the ‘top-down’ structure was not found within the *OFR* or the Financial Review. There was in some cases a Chairman’s Statement or a Chief Executive’s Report which provided the principal features to be expanded in later sections of the report. In other cases a Business Activity Report set out a summary of divisional performance, to be followed by a Divisional Review. In such cases the Financial Review appeared as a stand-alone document almost sweeping up the *OFR*-type items not reported elsewhere. In the case of some of those companies which preserve in the annual report the functional boundaries of operations and finance, the province of the Finance Director’s Review appears to be restricted.

The reviewers took the view that if functional boundaries affect the structure of the annual report then more cross-referencing might be required to establish the ‘top-down’ element. They were, however, interested to learn of company views with regard to the problems of functional boundaries and the possibilities for greater integration or cross-referencing.

**What the companies say**

The interviews showed that companies plan the non-statutory section as a whole, so that the ‘top-down’ structure has to be assessed on the basis of the entire ‘front-end’. The title *Operating and Financial Review*, where used, becomes an umbrella description for some part of the total but the packaging into the *OFR* varies from one company to the next. The conclusion emanating very strongly from the interviews is that, while the liberal attitude to presentation is welcomed, the perceived need to have a title *Operating and Financial Review* may itself impose a constraint because it may not dovetail with the headings chosen by the companies.
2.2 Good and bad aspects

As part of the specification of desirable features of the OFR, the ASB Statement proposed that the OFR should be balanced and objective, dealing even-handedly with both good and bad aspects (ASB Statement para 3).

Issues from the first survey

For a survey based only on the published OFR, a test of objectivity in discussion would be very difficult to devise. The reviewers decided that the balance of good and bad aspects was a matter which could not be ascertained by observation of the published OFR but would be better dealt with in the interviews. The question asked at the interviews was therefore how a balanced and objective discussion was achieved, dealing even-handedly with both good and bad aspects.

What the companies say

All the interviewees could point to some wording somewhere in the annual report which set out an explanation or indication of an adverse aspect of the results of the period. However, this was not always in the area designated as an OFR and there was no systematic signposting of such information. The persistent reader could locate information on good and bad aspects of the performance of the period but could the reader be sure this was the totality of bad news?

Some interviewees, in response to questions regarding the extent of bad news included in the OFR, said they would not wait to use it to report actual bad news emerging during the period. They would make use of one of the several occasions on which they meet investors and analysts (preliminary announcement, AGM, interim or quarterly results) to make such announcements. More immediate crises would be dealt with by the procedures of the Stock Exchange. Other interviewees would indicate the problem in the preliminary announcement and expand on the details to the analysts and investors through meetings held soon after the announcement date. It was pointed out that there is,
internally, an expectation that potential bad news can be avoided by management action, so that premature announcement would be a matter of concern. The internal perception of potential bad news is something very different which would be impossible to convey to external users of accounts.

Where bad news has occurred, the company may seek to explain the positive aspects of the improvements which have been put in place. It appears that the interviewees are all aware of the importance of giving warning of bad news to the market in order to avoid unpleasant surprises but are constrained in reporting such bad news by factors which they regard as part of the reality of the business environment.

The impression from the interviews overall was that FTSE-100 companies take seriously their reporting responsibilities and do not shy away from objective reporting. They would regard it as naïve, on the part of the reader of the annual report, to expect entirely even-handed treatment of good and bad news because directors have a duty to their shareholders in relation to maintaining the value of the company.

2.3 Confidentiality issues

Prior to issuing its Statement, the ASB produced a discussion paper inviting views on potential problems of confidentiality. Concerns expressed in many of the comment letters are acknowledged in the introduction to the Statement:

“Directors will naturally be concerned to ensure that the benefits to the users of the annual report of particular disclosures, and, in competitive capital markets, the consequent benefit to the company, outweigh the potential commercial damage to the business from the disclosure of sensitive information to competitors. Accordingly, the emphasis in this Statement is on discussion of matters of significance to the business as a whole, and it is expected that in most cases directors will be able to provide a reasonably comprehensive and informative OFR whilst avoiding disclosures of a confidential or sensitive nature.”
The discretion given to directors is repeated later in para 3 of the Statement, although this is accompanied by a warning that the user should not be misled by a discussion that is no longer complete and balanced.

In previous research, interviewing analysts and fund managers on their perceptions of the OFR, (Weetman et al 1994) the research team established that users took the position that such fears on confidentiality were unfounded because most of the information proposed for inclusion in the OFR is in the public domain already for those who have access to trade magazines, trade federation newsletters, industry reviews, and the know-how which comes from familiarity with the industry.

**Issues from the first survey**

In an investigation based only on the published document the question of confidentiality cannot be explored by observation. There is no form of observation which can test the aim of ensuring that the user is not misled by a discussion that is no longer complete and balanced. The survey acknowledged that the experience of dealing with confidentiality aspects could only be investigated by interview.

**What the companies say**

This is a very sensitive area and the questions asked were addressed to the issue of confidentiality in general rather than to any matter specific to the interviewee's company. All said that there had been no case of someone in a senior position having to take a red pen to a section of the OFR in order to delete a sensitive paragraph. Obviously, that could not be accepted alone as sufficient reassurance that confidentiality is not a problem but it provides some form of reassurance that the issue has been considered. Some respondents helped by instancing the kind of matters which would certainly lead to internal debate about the relative merits and difficulties of disclosure. The list of such matters collected from the interviews is:
• Where the input costs of raw materials are significant, the company knows the theoretical range but would not want to put figures to a range because this might restrict bargaining power with suppliers
• situations of reorganisation/redundancy where employee representatives must be consulted
• reporting liquidity position might precipitate a crisis
• potential predictive aspects (none in particular specified)
• profit margins on different products
• segment information beyond that required for SSAP 25
• market share
• reliance on a particular customer
• information which could be of use to competitors
• specific expense items known to be of interest in the industry

One respondent indicated an item of information contained in the OFR, relating to franchise arrangements, which had been included after discussion because it was an item requested regularly by the analysts. It would be of interest to the major competitor and, because it aggregated operations world-wide, gave information which the competitor could not generate with confidence from other sources.

2.4 Forward-looking information

The general lack of fear regarding confidentiality relates to events which have passed. However, it is also intended that there is a forward-looking aspect to the OFR. The ASB Statement recommends (para 3) that the discussion of trends and factors that have affected results should distinguish those that are not expected to continue and those that are expected to have a future impact. The phrase ‘known events, trends and uncertainties’ appears in para 3 of the ASB Statement. In relation to the operating review (para 9) there is a reference to changes in the industry or the environment within which the business operates, developments within the business, and their effect on the results.

Forward-looking information was linked closely with confidentiality in the comments offered by those who made submissions to the ASB on the discussion paper which preceded the ASB Statement (Weetman et al,
1996). It also emerged from the interviews as an issue influenced strongly by confidentiality considerations.

**Issues from the first survey**

The reviewers carrying out the original survey were in a position to identify examples of forward-looking wording meeting the requirements of para 9. This appeared for the main part in the business or operating reviews. What they could not identify was the reason for a lack of forward-looking wording. Was this a policy decision or was it absent by default? Were there any problems for the company in identifying those trends and factors underlying the business that have affected the results but are not expected to continue in the future, or in those which are expected to have an impact on the business in the future?

**What the companies say**

Forward-looking information was perceived by several interviewees as a confidentiality-related issue. In some of the OFRs surveyed, the reviewers had observed forward-looking sentences and sections. Interviewees providing such commentary confirmed that this had been planned carefully. In the case of other OFRs, identified by the reviewers as not having the forward-looking tone, the interviewees were aware of that limitation.

Various reasons were given:

- we prefer to give this information at intervals throughout the year (quarterly or half-yearly announcements) or to give it as a gloss at the presentation of preliminary results. To put the information in the annual report would take away the cushion of flexibility for the remainder of the year
- at present we need to retain scope for flexibility throughout the year but we may eventually gain confidence in using words in the OFR
- it is easier to say what will not be there in future than to comment on trends which are expected to continue. There is a fear of readers misunderstanding the written word taken in isolation
the long-term nature of the business [life insurance] means it is more important to give reassurance and information on risk management

we prefer not to be a 'what if' company

our US lawyers are quite strict on what can be said in the MD&A and it is our policy to keep the same text for both the OFR and the MD&A

These reasons indicate concern with uncertainty rather than confidentiality, and a desire to avoid being held hostage to fortune if future events take an unexpected turn.

2.5 Investment for the future

As explained earlier in this chapter, investment for the future was taken as one particular item which the ASB has identified specifically for inclusion in the OFR. It was discussed in the context of a more general question as to whether there were any aspects of the operating review which the company would identify as being particularly interesting or worthy of note.

The most obvious measure of investment for the future is capital expenditure but the ASB Statement (paras 13 to 18) also emphasises expenditure passing through the profit and loss account which will enhance future profit (sometimes referred to as 'revenue investment'). It suggests that the OFR should emphasise change in the level of activity and management policy and should refer to the benefits expected from such activities.

The idea of reporting expenditure which is in the profit and loss account, but nevertheless represents a benefit for the future, was at first proposed by the ASB for inclusion in FRS 3 Reporting Financial Performance, but was rejected at the exposure draft stage. There is evidence that the users of financial statements welcomed the item as an inclusion in the OFR (Weetman et al 1994).

Issues from the first survey

In the survey a few companies had produced a section headed 'Investment for the future' but in most cases the reviewers had to hunt for
the information. Where it was found it tended to be qualitative rather than quantitative. Two examples were shown as appendices to the survey where specific sections were given to the subject but these were the exceptions. The reviewers were interested to know from interviewees whether omission of information was because nothing existed or because a decision had been made to report nothing.

**What the companies say**

None of the companies interviewed had an identifiable section in the OFR headed 'investment for the future'. However, all were able to point to some form of words which they regarded as indicating investment for the future. There was a preference for qualitative rather than quantitative description. It was suggested that the analysts are more concerned with trends of maintaining expenditure on such items rather than with the absolute amount of expenditure. Expenditure headings indicated as examples of non-capital investment for the future were:

- *marketing*
- *research and development*
- *advertising*
- *spending on people*
- *repairs*

One interviewee suggested that such information may be of help to competitors - for example repair expenditure on hotels and public houses is an indirect measure of maintaining standards. Another interviewee explained some of the technical problems of separating out the marketing expenditure representing investment for the future.

The information given by interviewees regarding specific items of interest in the company's OFR was used primarily by the reviewers as a means of checking their own evaluation of the company's OFR. The details are not reported here because they are too specific to the companies concerned.
2.6 Use of ratios for analysis

The ASB Statement (para 3) expects the OFR to make clear how any ratios or other numerical information mentioned in the review relate to the financial statements.

Issues from the first survey

Ratio interpretation of any kind was found in only 59% of the OFRs surveyed - a low percentage in comparison with other items. Good quality explanations and definitions were even less frequent. A small number of companies presented definitions, calculations which could be related clearly to the source data, and interpretative commentary.

What the companies say

There was a view from several interviewees that they should not use ratios in interpretation because of the variety of different businesses. It was perceived that there may be some danger with ratios of taking a text-book approach to calculating ratios which may not be capable of meaningful interpretation.

2.7 Summary

The views of preparers have shown that the flexibility encouraged by the ASB is generally being used by companies in a constructive manner.

'Top-down' structure

The interviews confirmed the reviewers' intuition that the 'top-down' structure seen as essential to the spirit of the ASB's Statement should be created within the annual report document but may not necessarily be confined to a particular group of pages labelled Operating and Financial Review. For the survey of the second year of OFR experience (reported in Chapter 5) the reviewers have modified their assessment of the 'top-down' structure to look at the annual report as a whole, starting with the
contents and highlights pages and looking for evidence of guidance for the reader in establishing that the OFR material envisaged by the ASB is present.

Good and bad aspects

The ability of companies to balance even-handedly the good and bad news is something which will probably be evidenced more by the trend over time than by examining OFRs at any one point in time. All the companies interviewed were aware of the responsibility laid at the doors of FTSE-100 companies to give a balanced report but there was also a strong view that factors potentially leading to bad news may be turned round by management before the matter becomes irrecoverable. In carrying out the new survey, reported in Chapter 5, the reviewers have looked in particular for instances of retrospective evaluation of good or bad aspects coming from the previous year.

Confidentiality

Confidentiality is not indicated by interviewees as restricting the scope of the OFR. That reassurance, given after the event, that confidentiality had not been a problem in preparing the OFR, is in stark contrast to the volume and intensity of comment prior to the issue of the ASB Statement. Did the letters of comment received by the ASB in response to the 1992 discussion document overstate the preparers’ objections? The question remains unanswered from these interviews but the indications are that any matters of confidentiality are dealt with long before the annual report is drafted. Confidential matters in relation to events which have occurred are not a limiting factor in drafting the OFR document.

Forward-looking information

The interviews showed that the presentation of forward-looking information remains a concern, perceived partly as a confidentiality issue but primarily as a concern related to uncertainty. The interviews showed that confining the OFR analysis to commentary on past events was a
deliberate decision on the part of those companies which had chosen not to give forward-looking information indicating trends which would or would not continue. In only one case was there an expressed fear of litigation, sometimes cited elsewhere as inhibiting the US MD&A reports. However, the variety of other forms in which the fears of forward-looking disclosures were expressed means that they would not readily be remedied by any single course of action on the part of a standard-setting body.

The positive finding, from the point of view of encouraging development of OFR reporting, is that the companies are aware of the forward-looking aspects of some other reports and of their own lack of similar comments. Peer group comparisons could, therefore, take practice forward. That process, however, could also work the other way if companies which are presently including forward-looking statements begin to feel they have been too adventurous and fall back to join the others. Identifying forward-looking information remains a strong factor in the survey reported in Chapter 5.

**Investment for the future**

There was an acknowledgment that this is an area which attracts questions from professional investors and analysts. Interviewees indicated that the questions put to them are about trends and maintaining current levels of expenditure rather than about absolute amounts. For this reason and for technical reasons of definition, monetary amounts are rarely attached to descriptions of investment for the future, other than items of capital expenditure. The interview findings did not establish any strong views about the feasibility or otherwise of providing this information. It would appear that investment for the future remains a useful item for use in the survey in monitoring the 'spirit' of the ASB Statement since it is an item which can be traced to that document as a prime influence on disclosure.
Use of ratios for analysis

The interviews indicate that the companies, who know the complex circumstances surrounding the data, are reluctant to reduce it to simple ratio comparisons. Taking that caution one step further might give cause for doubt about the usefulness of the many tables of data published commercially for comparative analysis, or the analyses carried out by professional investors and their advisers looking for changing trends of particular ratios as a clue to asking questions. It is likely that reality lies somewhere in the middle - the companies may be over-cautious and aware that one period's data may be taken out of context of the trend. Those who publish comparative analyses of data must reflect some of the caution (as many of them do in the explanatory sections on sources) and those who form views based on ratio trends must ensure that the interpretation is valid for the particular circumstances of the company under consideration.

For survey purposes it remains important to establish that ratios, where used, meet the criteria of the ASB Statement. It would probably be wrong to use lack of ratios as a sign of weakness in the OFR, because of the doubts expressed by preparers. The ASB Statement emphasises that the OFR should be presented by the directors in a way that best complements the format of the annual report as a whole.
CHAPTER 3

CHARACTERISTICS INFLUENCING THE OFR

The second research question of this investigation addresses identifying those characteristics of the company or its managerial structure which influence the nature of the OFR prepared by the company. The influences set out in this section are mainly factors emerging from the interviews as a result of interviewees explaining their approach to the OFR. As may be seen from the interview agenda (set out in Chapter 1) there was a prior decision to ask about the process of preparation of the OFR but the other factors set out in this section are those which emerged without prior prompting, from the responses of interviewees. This chapter reports on:

- Planning and preparing the OFR
- Target readership
- Self-monitoring by comparison with other FTSE-100 companies
- Impact of the ASB
- Influence of the MD&A
- Other factors

3.1 Planning and preparing the OFR

The interviews revealed a wide range of methods of planning the OFR, in the context of the entire annual report. One approach is that of a team giving a strong lead on style and content. Team work is led by
the finance director or by the chief executive, starting with a theme for the annual report as a whole and then asking for various contributions from the different constituent elements of the business within that theme. This approach is matched with a well-structured 'top-down' framework for the document although the 'top-down' aspect of the OFR depends on its location in relation to the Chairman's Statement and Chief Executive's Report.

Some OFRs present an incomplete picture when read in isolation because the forward-looking tone and the strongest messages are in the Chairman's Statement, reinforced by the Chief Executive's Report. The OFR label may be attached to the Business Reports and Finance Director's Report which are accounts of what has passed during the period. However, if the OFR heading is set aside, the elements required by the ASB are all present.

A quite different pattern is that of a coordinating group taking a neutral role of collator of the various reports. Again the finance director will probably be involved in the collation exercise and will provide a Financial Review but there will be relatively little guidance given to the business sections on the content of their reports. This may provide interesting material regarding the business segments but may leave gaps in the information desirable for the OFR. Some finance directors are aware of this limitation but have limited scope for making editing suggestions relating to the Business Reviews of the OFR. Historically the Business Reviews appeared before the Finance Director's Review was introduced. As a result the Finance Director's Review becomes a place to collect items which otherwise would be omitted.

3.2 Target readership

The ASB's Statement on the OFR does not specify a target readership although the detail of the recommended content probably indicates that the sophisticated investor was seen as the primary readership. However the comments on the 1992 discussion paper which preceded the Statement were quite strong in the suggestion that the ASB should clarify the intended readership. Despite the extent of that lobbying, the ASB did not amend the Statement to deal with this particular problem. The
professional investors and analysts view themselves as a target readership (Weetman et al, 1994) but acknowledge also the need to extend the OFR to a wider interest group potentially encompassing all shareholders.

Some of the finance directors interviewed acknowledged the need to report to all shareholders, the non-professionals as well as the professionals. There was recognition that there exists a range of interest groups, including employees, major customers and suppliers. Others considered that the target was primarily the professional investor and advisers although they acknowledged the need to think about less sophisticated readers. Finally there was a group of interviewees which thought the target was primarily the professional analysts, doubting that others would understand.

3.3 Self-monitoring against other FTSE-100 companies

The interviews revealed a strong awareness of the annual reports of other companies. In some cases the finance director's office contained a selection of annual reports of other companies. All the finance directors interviewed had considered the style and approach of their company's OFR in the context of other FTSE-100 companies. There does appear to be an element of ensuring that the company's annual report is of comparable standard to that of other companies seen as being of comparable status.

3.4 Impact of the ASB

This was a topic discussed in the interviews because in the survey the reviewers found inconclusive direct evidence that the ASB had caused a move towards producing the OFR. Other factors might exist to explain the trends in disclosure. One such factor would be that some companies were already moving down that route before the ASB Statement was issued, because they were subject to the US influence (around 20 of the FTSE-100 companies have a US listing).

Interviewees said that in general the Business Reviews had been established for some time, predating by several years the ASB's proposals, but the Finance Director's Review tended to be a more recent insertion
in response to increasing questions about matters such as treasury policy. It predated the final version of the ASB Statement but the introduction of the Finance Director's Review could be matched in time with the discussions leading to the ASB Statement. The ASB's proposals for an OFR had provided finance directors with a reason for encouraging a more financially-oriented set of comments in the Business Review and had allowed the more centrally planned annual reports to move down a route which the finance director and chief executive might be encouraging in any event.

The message conveyed in the interviews was largely that the ASB's proposals matched the developments which the companies were putting in place independently but these gave confirmation that the OFR was likely to be a useful initiative on the part of the company. Consequently there was strong support for the ASB, in relation to its proposals on the OFR, from the finance directors interviewed. The ASB was seen as encouraging movement in a direction which was already desired.

3.5 Influence of the MD&A

The Management Discussion and Analysis (MD&A) is a report required from any listed company by the Securities and Exchange Commission (SEC) in the USA. The requirement extends to UK companies having a full US listing, who report on form 20-F. The ASB's ideas for the OFR have some similarities to the MD&A except that the ASB has said from the outset that it wanted to avoid some of the rigidity of MD&A.

Of the companies interviewed, only two have a full US listing. One interviewee said that the MD&A had no influence on the OFR because the annual report is published before the 20-F return is submitted to the SEC. The other said that, because it is company policy to use the same text for the OFR and the MD&A, it is constrained by the views of US lawyers where there is a greater fear of litigation.

Other interviewees referred to an initial fear that the ASB's recommendations might go down the MD&A route and become rather stereotyped. These fears had been allayed by the experience of producing the OFR and they were satisfied that the ASB's proposals had allowed
companies sufficient discretion in choice of items and in choice of presentation.

3.6 Other factors

It is a feature of interview research that new ideas emerge in discussion which were not planned in the initial agenda. Ideas arising part of the way through the exercise, cannot be investigated systematically but are worth noting as matters to be considered for further investigation. From the interviews some of the matters raised by individual interviewees were:

- We will be splitting our annual report next year and the OFR material will be the major feature of the ‘front’ part
- I believe that frequency of reporting (quarterly basis) is the key to providing useful and timely information of the type envisaged for the OFR. We prefer to use the quarterly report for forward-looking aspects
- Non-executive directors and the audit committee have an influence on the OFR. We have an additional section on research and development expenditure at the request of one non-executive director
- The annual report has other purposes, such as briefing new recruits, or giving reassurance to overseas customers
- The finance director must have an operational role. If the finance director is not involved in operations then the financial review will be oriented towards accounting standards, treasury policy and hedging against risk. There will be no attempt to reconcile financial aspects with operational aspects
- The title Operating and Financial Review is appropriate because it lines up closely with the monthly internal review. It brings internal and external reporting closer
- Our company states Financial Objectives at the end of the financial review. This draws on the American experience of the finance director
- There is a problem of length of the annual report - printing and postage costs rise incrementally depending on the number of pages and so an overall target is set
- The company is relatively simple in relation to many FTSE-100 companies and the OFR may not appear to match up to the complexity and depth of
others. On one particular issue the analysts had not previously believed that the matter was straightforward but were more persuaded when they saw it in writing:

- The dynamics of the business may be difficult to convey because there is a dynamic aspect to each of the separate businesses (three in this case) and there is a dynamic aspect of the group operation. It would be difficult, because of space constraints, to give the dynamics of each separate business, but it would be misleading to give only the group perspective. The analysis of dynamics may be more appropriate for the analysts to undertake and include in their reports.

- For the insurance industry, management reporting to shareholders will remain problematic until there is a common set of ground rules. This is primarily a matter for the statutory financial statements but has implications for the OFR.

- Because the company’s product is so well known, there is less need to explain so much about the business. Most of the readers of the annual report will also consume the product.

- There are two segments. Different degrees of detail are applied because one segment has only three significant products while the other has many more. Space becomes a constraint.

- There may be internal tensions. Divisional managers may have won a trade prize which is important to employees and customers but will not affect the views of investors and analysts. Some chief executives of businesses are reluctant to say that things are going too well because the customers may think the prices should be lower. The corporate centre wants to emphasise how well things are going.

- The company knows that shareholders will not accept obfuscation and lack of information.

3.7 Summary

Although the companies showed different characteristics which limit the scope for generalisation, there are some tentative indications of characteristics which may be matched to the nature of the OFR produced.
Planning and preparing the OFR

All the interviewees who had been awarded an ‘A’ grade in the first survey explained a process where a strong editorial lead had been given on themes, content and style. Some of the interviewees gaining a high ‘B’ grade had a similar strength of direction but that planning process had led to a structure for the annual report which cut across aspects of the OFR. This is the group to which the reviewers have paid particularly careful attention in the new survey (Chapter 5), taking a broader view of the success in establishing the ‘top-down’ structure.

Target readership

The higher grades awarded in the survey of 1993 OFRs matched those companies taking a wider view of the target readership. Those who said that their report was directed primarily at the professional readership had been identified in the first survey as lacking the full ‘spirit’ of the ASB Statement.

Self-monitoring against other FTSE-100 companies

Although the interviews sought only to discuss the OFR prepared by the interviewee’s company, all participants were interested in the reviewers’ perceptions of the OFRs of other FTSE-100 companies. It was clear that the companies themselves carry out evaluation of annual reports of other companies and look for examples of good practice. This may give reassurance to the ASB that OFRs as a form of corporate communication will continue to improve while they are used by leading companies which seek to set the trends. It is probably too early to bring this into the survey criteria, as many companies are only beginning to evaluate their annual report presentation against that of others, but it is clear that as practice develops, the best examples could be used for benchmarking purposes in judging other companies of similar size.
Other factors

The interview research explored the influence of the MD&A and also identified other factors which may affect the OFR. At present these could not be brought into a systematic survey evaluation because they are specific to particular companies. The factors revealed do, however, indicate the caution needed in attempting to interpret a classification of OFR statements.
CHAPTER 4

EXPANDING THE ‘SPIRIT’ OF THE ASB STATEMENT

The third question of this investigation asks whether there are further factors, arising from preparers’ perceptions, which should be taken into account when assessing compliance with the ‘spirit’ of the ASB Statement. The interviews suggested a different focus for the grading of OFRs in relation to meeting the spirit of the ASB Statement. The focus lies in the question asked by those interviewees whose OFRs were deemed in the first survey not to have met the conditions for the highest grade:

What more does this company have to do to reach the ‘A’ grade?

That question seems to embody the essence of starting with the OFR as the company chooses to present it, rather than trying to impose a particular framework.

4.1 Preparers’ perceptions

The interviews revealed that in some instances where the reviewers had observed a lack of depth in discussion or interpretation, those preparing the OFR were already aware of this potential limitation. Some were making plans to develop their OFR to overcome the limitation. Others could present a range of reasons for taking no action at present,
ranging from lack of space to a view that no-one would actually read the
information even if it were presented. Future survey work should expect
to see evidence of a process of development based on self-assessment and
review of peer practice but evaluation of the findings should recognise
that not all companies will wish to make changes, because of perceived
constraints.

A further feature emerging from the interviews is that the preparers of
the OFR may be assuming that the reader has some prior knowledge of
the company and therefore the OFR is treated as being an annual
updating service rather than a briefing for a newcomer. Because the
reviewers were observing all 100 companies, they could not have depth
of knowledge of all companies and relied largely on the OFR as a stand-
alone source. The ASB Statement does not specify the intended
readership or the presumed level of prior knowledge. Future surveys of
the OFR may be forced to make a judgment about the likely readership,
in order to assess the suitability of the OFR for its purpose.

The particular features arising from the interview analysis are now
discussed and the impact on the new survey is explained.

4.2 Refining the classification grades

With the outcome of the interviews in mind, the reviewers inspected
the OFRs of the second year of implementation of the ASB Statement
and found a variety of ways in which the ‘top-down’ structure was
created around the OFR. Among these were:

- *A highlights statement with key features explained in bullet points*
- *A contents page using sub-headings to indicate groupings of documents
  forming the Operating Review and the Financial Review*
- *Cross-referencing (eg the Chairman’s Statement indicates follow-up in the
  Finance Director’s Review or the Directors’ Report makes reference to the
  OFR presentation)*
- *An index of sufficient detail to allow the OFR material to be identified in
  various locations*
On this basis the template used to evaluate the OFRs of all companies was revised as shown in Appendix B and applied to the FTSE-100 companies in relation to the second opportunity to apply the ASB’s recommended approach. The definitions of the grades are not changed from those used in the first survey but the experience of that survey taken with the interview findings has allowed a refinement of the analysis. In particular, the evaluation of each key aspect of the OFR (shown on the first section of the template in Appendix B) applies a categorisation of evaluation which could be used to comment on each of the aspects separately. The resulting gradings are reported in Chapter 5.


CHAPTER 5

SURVEY - SECOND YEAR

This second survey applies the grading scale used in the first survey, which is shown in Table 5.1.

Table 5.1 Definitions for the first OFR survey

<table>
<thead>
<tr>
<th>GRADE</th>
<th>MEANING</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>High quality document complying with the spirit of the ASB’s proposals and providing a significant addition to the understanding of the annual report.</td>
</tr>
<tr>
<td>B</td>
<td>High quality document complying with the spirit of the ASB’s proposals in a substantial proportion of the areas covered.</td>
</tr>
<tr>
<td>C</td>
<td>A document which complies with the spirit of the ASB’s proposals in at least half of the areas covered and meets the main requirements overall.</td>
</tr>
<tr>
<td>D</td>
<td>A document which contains the technical elements necessary to meet the ASB’s proposals but which is lacking in evidence of the spirit.</td>
</tr>
<tr>
<td>E</td>
<td>A document where some of the necessary technical elements are missing as well as the spirit.</td>
</tr>
</tbody>
</table>
This second survey does not change the definition of the grades but draws on the interviews, as explained in Chapter 4, to refine the criteria used to determine the most appropriate grade.

A broader view was taken of the 'top-down' structure, as explained in Chapter 2, arising from the interview discussions. In particular, evidence of the 'top-down' structure was established in some instances by taking into account the statements by the chairman and the chief executive, where it appeared the reader might be able to construe these as part of the OFR provision. Evidence of the 'top-down' structure was also drawn from the contents pages where, in some cases, sub-headings or groupings of headings helped the reader to identify OFR-type material.

5.1 Selection of companies for review

FTSE-100 companies were chosen for the first survey in order to provide an understanding of the variety of practice in the largest companies. They were also selected because the ASB Statement places particular emphasis on large listed companies. In that first survey three of the FTSE-100 annual reports could not be included due to changes in accounting date which delayed their issue.

Since the time of the first survey there have been changes in the composition of the FTSE-100 index. One purpose of this second survey is to estimate the extent of improvement since the first survey. Therefore it is appropriate to work as far as possible with the companies used for the first survey. In the spirit of making comparison as far as possible, new companies have been inserted only where one of the original selection is no longer available. Annual reports for four companies in the original selection were not available due to changes of accounting date or takeover. Seven new FTSE-100 entrants were substituted and evaluated for both years in order to give a measure of change over the period. Table 5.2 shows how the first survey sample was adjusted to give a revised starting point for the second survey.
Table 5.2 Adjusted sample for second survey

<table>
<thead>
<tr>
<th>Grade</th>
<th>First Survey as reported</th>
<th>Not available for second survey</th>
<th>New FTSE-100 companies added</th>
<th>Adjusted starting position for second survey</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>16</td>
<td>1</td>
<td>1</td>
<td>16</td>
</tr>
<tr>
<td>B</td>
<td>24</td>
<td>2</td>
<td>3</td>
<td>22</td>
</tr>
<tr>
<td>C</td>
<td>21</td>
<td></td>
<td>2</td>
<td>24</td>
</tr>
<tr>
<td>D</td>
<td>30</td>
<td>1</td>
<td>2</td>
<td>31</td>
</tr>
<tr>
<td>E</td>
<td>6</td>
<td></td>
<td>1</td>
<td>7</td>
</tr>
<tr>
<td>Total</td>
<td>97</td>
<td>4</td>
<td>7</td>
<td>100</td>
</tr>
</tbody>
</table>

5.2 Second survey: results

Table 5.3 shows the resulting grades and how these compared to the corresponding grades for these companies in the first survey.

Table 5.3 Grading of second survey: Company year ends from 31 December 1994 to 31 October 1995

<table>
<thead>
<tr>
<th>Grade</th>
<th>Total for second survey</th>
<th>Remain as previous grade</th>
<th>Change from B</th>
<th>Change from C</th>
<th>Change from D</th>
<th>Change from E</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>21</td>
<td>16</td>
<td>4</td>
<td></td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>B</td>
<td>26</td>
<td>15</td>
<td></td>
<td>9</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>C</td>
<td>28</td>
<td>15</td>
<td></td>
<td>2</td>
<td>10</td>
<td>1</td>
</tr>
<tr>
<td>D</td>
<td>23</td>
<td>19</td>
<td>1</td>
<td></td>
<td></td>
<td>3</td>
</tr>
<tr>
<td>E</td>
<td>2</td>
<td>2</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>100</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

In the light of the interview discussions and the conclusion that the spirit of the OFR extends through much of the first half of the annual report, the broader view, as explained in Chapter 4, was taken in the second survey. This broader view was avoided deliberately in the first survey because that was intended as an evaluation based purely on the
stated criteria in the ASB Statement. The work of the first survey was reviewed using this broader view and it may be seen that there would have been a marginal difference in the overall scores, as shown in Table 5.4.

Table 5.4 First survey OFRs regraded to take a broader view of the ‘top-down’ structure

<table>
<thead>
<tr>
<th>Grade</th>
<th>First survey: number of companies</th>
<th>First survey: regraded</th>
<th>Adjusted first survey</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>16</td>
<td>from B to A</td>
<td>1</td>
</tr>
<tr>
<td>B</td>
<td>24</td>
<td>from C to B</td>
<td>5</td>
</tr>
<tr>
<td>C</td>
<td>21</td>
<td>from D to C</td>
<td>3</td>
</tr>
<tr>
<td>D</td>
<td>30</td>
<td>from E to D</td>
<td>1</td>
</tr>
<tr>
<td>E</td>
<td>6</td>
<td></td>
<td>-</td>
</tr>
<tr>
<td>Total</td>
<td>97</td>
<td></td>
<td>10</td>
</tr>
</tbody>
</table>

Had the broader view been taken in the first survey, one OFR in category ‘B’ would have been an ‘A’ grade, while five ‘C’ grades would have been ‘B’ grades, three ‘D’ grades would have been ‘C’ grades and one ‘E’ grade would have been a ‘D’ grade. There is therefore a marginal adjustment on each grade boundary but most of the gradings remain as classified originally. Table 5.3 shows improvements in all classes beyond the effect of taking a broader view.

5.3 Observations

For this second survey, there were four companies moving into the ‘A’ grading as a result of clear evidence of changing the OFR to move closer to the ‘spirit’ of the ASB Statement. One further company, previously a high ‘B’, was already producing ‘A’ class work, seen from the broader view. There was also upward movement from ‘C’ to 4B’ grades but the most marked area of improvement was that of grade ‘D’ reports moving up to the grade ‘C’ band. In some cases this improvement was because there was more space devoted to the OFR and more information contained therein. In other cases there was more of a hint of willingness
to provide forward-looking information. Some companies had renamed sections of the annual report to indicate more clearly that an OFR or a financial review was being provided.

Table 5.5 sets out the companies receiving an ‘A’ grading for the OFR in respect of the year ends 31 December 1994 to 31 October 1995.

**Table 5.5 OFRs having an ‘A’ grading in respect of the year ends 31 December 1994 to 31 October 1995.**

<table>
<thead>
<tr>
<th>Company Name</th>
</tr>
</thead>
<tbody>
<tr>
<td>Arjo Wiggins Appleton plc</td>
</tr>
<tr>
<td>Bass plc</td>
</tr>
<tr>
<td>BAT Industries plc</td>
</tr>
<tr>
<td>British Steel plc</td>
</tr>
<tr>
<td>Burmah Castrol plc</td>
</tr>
<tr>
<td>Cadbury Schweppes plc</td>
</tr>
<tr>
<td>Carlton Communications plc</td>
</tr>
<tr>
<td>Coats Viyella plc</td>
</tr>
<tr>
<td>Grand Metropolitan plc</td>
</tr>
<tr>
<td>Imperial Chemical Industries (ICI) plc</td>
</tr>
<tr>
<td>Inchcape plc</td>
</tr>
<tr>
<td>Reuters Holdings plc</td>
</tr>
<tr>
<td>Royal Bank of Scotland Group plc</td>
</tr>
<tr>
<td>Scottish Power plc</td>
</tr>
<tr>
<td>Sears plc</td>
</tr>
<tr>
<td>Shell Transport &amp; Trading Company plc</td>
</tr>
<tr>
<td>Siebe plc</td>
</tr>
<tr>
<td>TI Group plc</td>
</tr>
<tr>
<td>Unilever plc</td>
</tr>
<tr>
<td>United Biscuits (Holdings) plc</td>
</tr>
<tr>
<td>Whitbread plc</td>
</tr>
</tbody>
</table>
‘A’ gradings

All the companies which had ‘A’ grades in the previous year maintained their rating but it is perhaps worth indicating some interesting features appearing for the first time in particular cases.

Arjo Wiggins Appleton appears to have made considerable changes over the previous year and now presents a specific OFR for the first time. The company presented a split report in both years. In 1993 there was a Chief Executive’s Review and a Financial Review. In 1994 there is a Chief Executive’s Operating and Financial Review. However there is much more than a change of title. The entire report is restructured around the main geographical and product segments, with this structure being followed through into the financial review section. The Financial Review therefore escapes the potentially dull approach of a checklist created from the ASB Statement.

In the OFR of Bass plc there is new information on share price and the quality of presentation is high overall. Grand Metropolitan is an example of the type of annual report where it is necessary to look for the ‘top-down’ structure being established in the Chairman’s Statement, which is then built upon in the subsequent sections. ICI has a split annual report where the full OFR is in the statutory section but is summarised in the non-statutory part using wording of a slightly friendlier nature for the non-expert reader. The heading "Creating value" is new from last year. A forward-looking sense of the text is strong from the start of the OFR, which includes an ‘outlook’ section. Scottish Power has made considerable efforts to rearrange its two-section report where, in the previous year, the OFR information had appeared fragmented. In the March 1995 annual report of Scottish Power there is clear identification of the OFR in the statutory section and a supporting Annual Review which also contributes to the ‘top-down’ structure. Whitbread provides another example of an OFR which has to be read with the Chairman’s Statement, where the forward-looking tone is set.
**Upward trends**

Almost all the second round of OFRs show either a similar performance or an improvement over the first. Most of the improvements are related to location of OFR information in the overall text of the annual report. Interesting features are the use of highlight statements, expanded Financial Reviews, better quality of explanations and more careful planning of the split where a two-part annual report is used.

The quality of the text also shows improvements in some cases, with explanations having a forward-looking flavour. Highlights statements have changed, in some cases, to include bullet-point sentences or phrases which set the scene for the key themes of the annual report, ensuring that the reader no longer has to rely on highlights figures alone.

*From grade ‘C’ to grade ‘B’*

Five companies were already marginally ‘B’ from the first survey, taking a broader view, but four other companies strengthened either the situation or content of their OFRs. Taking one example for illustration, although the overall structure of the OFR is similar, there is a particularly informative note on restructuring, giving more information than is available in the notes to accounts. This seems a particularly interesting example of the use of the OFR to augment the statutory information.

*From grade ‘D’ to grade ‘B’*

One company made this leap. In the first survey the company used the heading OFR to enclose a Chief Executive’s Review, Business Sector Review and two pages for Financial Review. The Financial Review covered two pages where there were no headings, no diagrams, and no indication of taking account of the ASB Statement. In the second survey the OFR is clearly in the spirit of the ASB Statement, using headings geared to the company’s situation. On the negative side, there are some OFR aspects in the Directors’ Report, such as treasury policy, with no cross-referencing from or to the OFR.
From grade 'D' to grade 'C'

Three companies were marginally 'C' grade in the first survey, taking the broader view, but seven companies made significant changes in the presentation of the OFR. Taking one as an example, in the first survey the Financial Review covered less than two pages, contained no headings or diagrams, and was isolated from the Chief Executive's Review. In the second survey there is an OFR covering eight pages, showing good presentation, diagrams and charts. The Financial Review section remains limited in scope, covering mainly treasury policy. Taxation appears as an afterthought at the end of the page. Headings of the Financial Review could be more informative.

From grade 'E' to grade 'C'

One company improved from grade 'E' to grade 'C'. In the first survey the company presented a Chairman's Statement and Chief Executive's Review. In the second survey it presents a Financial Review and an Operating Review both of which use headings which indicate that the ASB Statement has been applied.

Moving down a grade

Three companies moved down in the gradings. The company which moved down from grade 'B' to grade 'D' was demoted because in the second survey there is no Contents page for the first half of the annual report. The Financial Review is reduced from six to four pages.

Two companies moved down from grade 'B' to grade 'C'. One company which retains its Financial Review keeps each heading but presents less text in each section. There is a strong impression that the writer found the task irksome and lacking interest. The other company presents an OFR which is almost word-for-word equivalent to that of the previous year, giving an impression of not trying very hard.
Going concern reassurance

The ‘going concern’ reassurance required by the Cadbury Committee is now appearing in some OFRs but is not always in that location. The locations of the going concern statement in the second survey were:

- Operating and Financial Review: 33
- Directors’ Report: 23
- Directors’ Responsibility Statement: 23
- Corporate Governance Statement: 21, 100

This was the first occasion on which the statement on going concern was required. It is clear that there is no consensus on its location. In some cases the statement was located by the reviewers with the help of a reference in the audit report but in many cases the location was not readily found.

5.4 Summary

The review of the second year of OFRs since the ASB Statement was issued confirms, on a wider scale, the interview findings that many FTSE-100 companies are taking an active approach towards improving the OFR within the ‘spirit’ of the ASB Statement.

In order to find the ‘top–down’ structure of the OFR it is essential, in several cases, to look through the whole of the first part of the annual report and this imposes an additional time constraint on the reader. The well-constructed OFR, however, is often part of a well-constructed annual report and has to be taken in that context for a full understanding of the main issues and the supporting detail.

There are indications of forward-looking information and a ‘storyline’ is beginning to emerge where the OFR makes reference to progress, or lack of it, since the previous report.
CHAPTER 6

CONCLUSIONS AND RECOMMENDATIONS ON THE 'SPIRIT' OF THE OFR

Three questions were set in Chapter 1:

- What are the preparers' perceptions of the 'spirit' of the ASB Statement and of the effectiveness of their application of that spirit?
- What are the characteristics of the company or its managerial structure which influence the nature of the OFR prepared by that company?
- Are there further factors, arising from preparers' perceptions, which should be taken into account when assessing compliance with the 'spirit' of the ASB Statement?

The preparers' perceptions on key aspects of the 'spirit' of the OFR have been presented in Chapter 2. The interview findings have been used in Chapter 3 to identify the characteristics of the company or its managerial structure which may have influenced the type of OFR produced. Chapter 4 has explained how the evaluation of the OFRs on a graded basis may be more adaptable to the preparers' perceptions of the 'spirit' of the OFR.

The second survey, reported in Chapter 5, has shown evidence of more companies moving towards the 'spirit' of the ASB Statement; with only three taking a backward turn. The modifications and improvements observed are consistent with the interviewees' explanations of their monitoring of peer performance. The relatively liberal approach of the ASB, in allowing the companies to develop their format rather than
prescribing this by regulation, is producing OFRs which are tailored to the specific nature of the company.

6.1 Preparers' perceptions

The preparers' perceptions as revealed by the interviews are that they wish to remain very much in control of the style and content of the OFR and do not wish to be driven down a standardised route. The MD&A of companies in the USA is seen to be driven too much by an implicit uniform 'format' of presentation. The OFR is perceived as being essentially similar to the preliminary announcement in its content and direction. It seems likely that in future the text of the preliminary announcement and the text of the OFR will become the same document, if only to be clear as to how much information is in the public domain.

6.2 Characteristics of the companies

The case studies demonstrate clearly that a strong managerial team creates a coherent OFR with a clearly constructed message. Consensus-based managerial systems, while perhaps good for other managerial purposes, do not lend themselves to the drafting of a concise document which requires to report a number of issues within a considerable space constraint. An awareness of the potential readership influences the nature of the OFR and there appear to be some companies making considerable efforts to keep in touch with the opinions of the readers of the annual report.

6.3 Evidence of the 'spirit'

Although the comments from preparers reinforce the ASB's perception of the 'spirit' of the OFR, one particularly restricting aspect may prove to be the phrase Operating and Financial Review as a title for one part of the annual report. The ASB's flexible approach is applauded by the interviewees but there is then the problem of where to place the title in an annual report containing several sections contributed for different purposes. The annual reports of most companies have two clearly defined
sections. The non-statutory nature of the OFR makes it a candidate for the first half rather than for the statutory report and it may be that companies should seek to indicate in the contents page how the OFR information may be located, rather than try to put a heading around particular pages.

6.4 Practical suggestions

The following suggestions are offered as practical approaches to implementing the spirit of the ASB Statement to best effect:

‘Top-down’ structure

It may be appropriate to encourage companies to identify which sections of the annual report constitute the OFR. The ASB Statement refers to “an” OFR (Intro, para 3) “the” OFR (para 1,4) “this section of the OFR” (para 23) but allows that the matters addressed in the Statement may be incorporated in one or more other sections of the annual report. It would be helpful if companies taking the latter approach could give more attention to signposting location. One question the authors of an OFR report could ask themselves is:

_How will the reader proceed through this document? Is there sufficient guidance on how to use it to best effect?_

Good and bad aspects

The reader is entirely reliant on the company to produce a balanced report. Time will eventually reveal omissions or mis-reporting of items but by then decisions will have been made. The interviewees indicated a strong sense of the responsibility placed on FTSE-100 companies but also indicated a strong sense of the duty of directors towards their shareholders in avoiding unnecessary alarms which could harm the value of the investment. The preference for using more frequent communication opportunities was also quite strong. Evaluating this issue from only one
year's experience was difficult but as time passes one question for preparers could be:

Looking back to the expectations of one year ago what can be said about good and bad aspects of the period?

Confidentiality

Confidentiality did not emerge from the interviews as a concern for the preparers and it is not evident from the OFR, in hindsight, that matters have been kept confidential which ought to have been reported. However, there remains an active demand for one-to-one meetings between company personnel and the institutional investors or professional analysts (Marston, 1996). One question for the preparers of the OFR could be:

Are there items of information which we provide in one-to-one meetings which could clarify aspects of our financial position and performance to a wider audience?

Forward-looking information

The interviewees did indicate a desire for caution in presenting in the OFR a discussion of known events, trends and uncertainties that are expected to have an impact on the business in the future. Reasons given indicated a desire to avoid being held a hostage to fortune, rather than a desire to keep matters confidential, but there may be a longer term problem for the ASB in encouraging this forward-looking approach. One step along this route might be for companies to admit in the following year how much their private expectations of trends and uncertainties had been met during the year. That would at least give an indication of the company's own perceptions of its skills in being forward-looking and might eventually lead to communication in the OFR. The company could also consider the extent to which forward-looking information is provided at analysts' meetings and consider why such information is not presented also in the annual report.
One question for the company to ask itself would be:

*What forward-looking information do we provide presently in meetings with shareholders and their advisers? Why should that information not be provided in the OFR?*

**Investment for the future**

Investment for the future is only one example of items which might appear in the Operating Review but it is a useful indication of the spirit of the OFR because its existence there is readily traceable to the ASB Statement. The most prominent feature from the survey is the lack of quantification of investment for the future, other than in respect of capital expenditure. Interviewees explained that there is more interest in trends than in absolute amounts, therefore this particular item may provide a useful monitor of companies’ willingness to explain trends and to begin to attempt giving more explicit information. A question for the company would be:

*Have we included in the OFR a section on investment for the future? Have we at least quantified the trend and how far away are we from reporting the absolute amount of investment for the future?*

**Use of ratios**

Although the interviewees indicated their doubts about the value of much of the ratio analysis using published accounting information, the survey continues to show some interesting examples from companies which define, apply and explain some of the commonly occurring financial ratio measures. The ASB Statement does not press the point that ratios should be used but does encourage directors to “discuss and analyse” the results and financial position. The use of ratio analysis may be similar to the provision of forward-looking information, in that exploration and experimentation is needed. Companies know that ratios are used to appraise financial performance and should perhaps be
presenting these selectively with a suitable explanation to the reader of the annual report.

The question for the company would be:

*Can we begin to help readers understand some of the more commonly used ratios which we know appear in evaluations of the company in the financial press or other form of public commentary?*

**Self-monitoring**

Indications from the interviews are that self-monitoring by reference to the annual reports of other companies is already taking place. The authors of the OFR within the annual report could ask themselves:

*What most interested me in reading the OFR of X plc? Is there an equivalent item of interest in our company’s OFR which would catch the eye of the management of X plc?*

It may be helpful for those who write the text of the OFR to look at each sentence with the eye of the reader who wants to gain an understanding but does not have the inside knowledge of the author. It is clear this role is being taken in some instances by non-executive directors. One useful test suggested by an interviewee was:

*If we were outsiders looking at this text, could we get the measure of the group?*

### 6.5 Future research

The reviewers intend to continue developing an understanding of the OFR as potentially representing a key feature of annual reporting by companies and, by extension, a key feature of more frequent reporting on an interim or quarterly basis. In previous work, the research team established the provisional views of the analysts and institutional investors before the ASB Statement was implemented but would seek to evaluate
the experiences of users of the OFR once a series of annual reports is available covering several years.

The reviewers also intend to extend the investigation to companies below the FTSE-100 category. This in-depth investigation of FTSE-100 companies has been necessary to understand the variety of presentation and the causes of that variety, not readily predictable by specific causes. That understanding forms a basis for evaluation of other companies where the communication needs may be different.
REFERENCES

Marston C (1996), Investor Relations: Meeting the Analysts, Research Committee of The Institute of Chartered Accountants of Scotland.


APPENDIX A

CASE STUDY SKETCHES

As a result of the variety in the responses of interviewees there is more information to be gained from considering the variety of ways in which the different grades of OFR may be produced. The case studies cover four companies graded ‘A’ in the first survey, four graded ‘B’, two graded ‘C’ and four graded ‘D’.

At the time the interviews were undertaken, many of these companies had already produced the second OFR since the ASB Statement was introduced. The discussion in those cases turned on the company’s own reflections on the previous OFR and the changes made in the light of experience. The nature and tone of the discussion depended to some extent on the grade given by the reviewers. Companies who agreed to participate were keen to understand the views of the reviewers and were concerned to be seen as presenting a good quality of annual report.

Companies graded ‘A’

Interviews with these companies were largely asking them to explain the procedures used in-house which had allowed them to demonstrate clearly the spirit of the ASB’s requirements.

Company A1

This is a well structured, self-contained OFR with information apparently selected carefully from the annual report, supported by a
sentence or two of explanation for every item which adds to the reader's understanding.

The 'top-down' structure of the OFR, and of the rest of the annual report, is created by team work of the finance department working with the chairman and the chief executive. The target readership is primarily the professional analysts because there is doubt that other readers would understand the detail. However, the team asks itself:

"If we were outsiders looking at this data, could we get the measure of the group? Could we see what is driving profit? Could we understand the dynamics?"

Some reluctance to provide strongly forward-looking statements is explained partly by the restrictions of a US listing and partly by the finance director's preference for a cushion of flexibility as the year progresses. The company would not wait for the issue of the OFR to disclose bad news which might affect the views of investors, because there are other opportunities to communicate with the market.

The finance group responsible for the OFR is aware of the potential for further development of the text and researches the OFRs of other companies in the FTSE-100.

Company A2

This company produces an OFR which explains two very different types of business activity in a skilful manner, containing a good balance of explanation and forward-looking information. Team work on the production of the OFR is led by the finance department consulting with the chairman and chief executive. The readable style of the OFR reflects a perception that it is regarded as important to communicate to non-professional investors as well as the professionals.

Some three years earlier, when the group was re-shaped organisationally, a professional survey was commissioned to ask shareholders, professional and private, what information they sought. The annual report, with quarterly reports during the year, is seen as the key to presenting what the company has achieved and where it is going.
Quarterly reporting is seen as an opportunity to present information to shareholders on a regular basis. Documents produced by the company must pass the test of being helpful to the private shareholder.

**Company A3**

The company holds to a fundamental principle of pushing against the barriers of disclosure. It seeks to be open in its annual report and to apply the same principle in communication with analysts. A strategy group plans the annual report, including the OFR, using clear initial guidance from the chief executive as to the overall message he wishes to convey. This key message is then broken down into key messages from each operating division and from the finance director. The OFR is a self-contained document which reflects the same planning of 'top-down' structure. The forward-looking aspect is strongest in the Chief Executive's Report.

The company has consulted the readers of its annual report by taking a straw poll of analysts as to the usefulness of the annual report.

**Company A4**

The major decision-making body for the structure and content of the annual report is the chairman's policy committee. The annual report is planned and monitored by that committee. The preparation of the annual report is regarded as an important process, equivalent to the budgeting and planning processes.

The OFR shows a 'top-down' structure from the outset. There is a strong forward-looking tone to the document and the Financial Review uses headings relevant to the business. The annual report is seen as a document which conveys the image of the company. The desire is to present a modern company being very open in its communication. The decision to present this image was a consequence of change in the organisation but the ASB's Statement coincided usefully and provided additional justification for change in the annual report.
Companies graded ‘B’

Interviews with these companies were to some extent similar to those with the ‘A’ graded companies but with the important addition that these companies were keen to know why they were perceived as having less than the full ‘A’ grade. Company B1 probably expressed the strongest sense of concern at not being perceived as an ‘A’ grade. Companies B2 to B4 had independently identified the points indicated by the reviewers and were giving attention to making changes.

Company B1

The construction of the front section of the annual report is planned with regard to the content of the press release and the presentation to analysts at the time of the preliminary announcement. The chairman presents the top level overview, the chief executive puts more detail on key features and then the Business Review (called an Operating Review) and Financial Review follow. The text of the annual report is almost identical to that of the press release and presentation.

The reviewers looking at this company’s OFR had confined their attention to the sections labelled Operating Review and Financial Review. From the interview with the finance director it became apparent that, to be consistent with the ASB’s permissive attitude as to how and where a company should produce the OFR, the Chairman’s Statement and Chief Executive’s Review should also be taken into the survey process. That would take the grade to ‘A’ on a basis consistent with other ‘A’ gradings.

The company prepares a MD&A for the Securities and Exchange Commission. It is prepared after the UK report and based on it. The lawyers insist that every statement in the MD&A is verifiable by evidence. In that context the finance director feels that there is more scope for interpretation in writing the UK annual report than there is in the US MD&A report.
Company B2

The reviewing team had given this company a high ‘B’ grade, stopping short of an ‘A’ grade on the ‘top-down’ criterion only. The quality of discussion and clarity of explanation were excellent. When the interview was held, the second OFR was available and this formed the focus of the discussion.

The finance director and his team had not felt totally satisfied with the 1993 presentation, recognising that it had been prepared by a ‘bottom up’ process whereby each divisional manager filed a separate report. For 1994 this changed, with the director of public relations taking editorial control of the Operating Review and the Business Reports. This gave the 1994 Annual Review a strong ‘top-down’ structure. The structure is established from page 2 onwards, with overviews being followed by an index to the business reports. The style of the Business Reports relates more closely to the ASB’s expectations of an Operating Review.

The decision to make changes in 1994 was not due solely to the desire to improve the OFR. It was based on a change of organisational structure and focus and the desire to emphasise the new image based on that structure. The overall effect is sufficient to take the OFR grading from high ‘B’ to ‘A’ grade in respect of the 1994 report.

Company B3

The reviewers had noted a strong forward-looking aspect on investment and a ‘top-down’ structure established within the OFR by the Chief Executive’s Operating Review. They had more difficulty with the two-page Financial Review which clearly contained all aspects expected by the ASB but lacked the sentences of interpretation which could be found in other OFRs.

The finance director explained that the wide range of shareholders meant that the company gave careful thought to methods of communication. Since many private shareholders were also consumers of the product, there were documents other than the annual report which were the main form of communication with them. The OFR is intended
primarily for the professional investors and their advisers. The company gives careful thought to the target readership of all its documentation.

The annual report for 1993 was the first to be drafted centrally with sections being sent out for comment. This was partly due to the OFR requirement but also to ensure that each section had a similar style and yet a degree of freshness.

Chapter B4

The reviewers found some good examples of informative and forward-looking disclosures but stopped short of awarding the ‘A’ grade because the ‘top-down’ structure of the operating results did not always seem to stand out clearly.

The annual report was written mainly by the finance director but taking text drafted by the various managing directors of the businesses. He had tried to put into their separate reports some of the information required by the ASB Statement. Where the managing directors could not be persuaded to have their text modified, the missing information was placed in the Financial Review. The Financial Review was, to some extent, a backstop for the Business Reviews.

The preparation of the 1993 annual report as a book written by a number of different people reflects the consensus approach which runs through all the company’s work. There is a collaboration culture with no powerful figure imposing an approach.

Nevertheless the 1994 annual report gives a much stronger sense of the ‘top-down’ structure, starting on the first page with a guide to the contents of each section of the first part of the annual report. The finance director feels that the next step in securing the ‘top-down’ structure would be for himself and the copywriter to explain what is needed to the managing directors at the outset, before they begin to draft their reports. That should provide greater cohesion in the annual report.

Companies graded ‘C’

Perhaps by chance, the two companies graded ‘C’ which agreed to participate were both insurance companies. With the benefit of hindsight
it may be that the spirit of the ASB Statement is less easy to match against insurance company annual reports because of the specialist nature of the industry. There was also, at the time of the first survey, continuing uncertainty over the resolution of major questions of principle relating to insurance company accounts, all of which created considerable practical problems for those trying to draft an OFR.

**Company C1**

This is an insurance company where risk management is seen as the key feature and the OFR was presented with risk management as a strong linking theme. The reviewers’ main reservations on reading the report had been the difficulty of finding the forward-looking aspects. Having heard the explanation of the reason for taking the risk management perspective as being most meaningful (emphasised also in discussions with other insurance companies) the reviewers were persuaded that this OFR was sufficiently within the spirit of the ASB’s Statement to merit a higher grade.

The ‘top-down’ structure was good and the company used the OFR heading. The company used the OFR heading to encompass the Chairman’s Statement and Chief Executive’s Overview, so that the ‘top-down’ structure was incorporated within the OFR. The company provided good quality explanations. The OFR comprised a Financial Review written by the finance team and a Business Review written by the business team. This was one example of team work which appeared to have produced a cohesive OFR. However, there was an internal review process where a small group from the various units met with the aim of integrating all sections.

It is the strong view of the company’s audit committee that any information given to the professional investors and their advisers must also be given to other shareholders (although sometimes in more concise form). Nothing should disadvantage one shareholder compared with another. One result of this was that the OFR contains more segment information than does the statutory section of the annual report.
Company C2

The various sections of the annual report originate with the separate authors (chairman, chief executive, business area managers and the finance director). The Financial Review was slotted into the annual report before the ASB Statement was issued but the finance director would admit that the policy of not repeating material stated earlier left the Financial Review as something of a residual document. It was the Financial Review which the reviewers had graded mid-C because it lacked the ‘top-down’ structure and forward-looking tone of other OFRs surveyed.

However, the finance director’s explanation of the approach to creating the annual report made it clear that the ‘spirit’ of the ASB’s proposals are identified more clearly by taking the Chairman’s Statement and the Chief Executive’s Report in conjunction with the Financial Review. This would create an ‘OFR package’ much more clearly in line with the spirit apparently sought by the ASB.

The view of the finance director is that the annual report is addressed increasingly to those with sufficiently deep technical knowledge to interpret it (primarily the analysts specialising in insurance companies) but the company also tries to make the front half of the annual report comprehensible to a wider readership, such as fund managers. The company tries to see the top 50 shareholders once a year. Most of the fund managers who come to these meetings do appear to have read the front part of the annual report, which suggests that it is seen as an important part of the report and accounts.

Companies graded ‘D’ and ‘E’

None of the six companies graded ‘E’ volunteered to participate in interviews. It had been decided that the companies who volunteered to take part would only be given the grade at the meeting (so that the grade could be set in the context of the particular issue or issues of concern to the reviewers). None of the four companies graded ‘D’ had initially volunteered to participate but business contacts produced the necessary agreement. The interviews with these companies were very helpful and
indicated that in the cases of D1 and D3 the company was aware of the potential for improvement and was taking steps to refine the OFR within the annual report. Company D2 felt that it had made sufficient effort towards meeting the ASB's recommendations and had no immediate plans to make changes. Company D4 was aware that perhaps the OFR was not as much in the ASB spirit as some but was equally convinced that the OFR did present the information which the analysts and institutional investors seek most frequently.

**Company D1**

A grading of 'D' for the 1993 OFR was a reflection of a rather dull presentation with a lack of 'top-down' structure and no forward-looking aspects. However the 1994 OFR was available in time for the interview and showed considerable improvements in both respects. The particularly interesting feature here was the force driving that observed change.

The improvements perceived between 1993 and 1994 were attributed to the chairman redefining his role and changing the style and content of his Statement to reflect that new role. The report became more incisive and forward-looking, with the chairman seeking to demonstrate his non-executive role. A further explanation of the stronger forward-looking emphasis might lie in seeking to restore confidence after a second year of disappointing results.

There is a variety of sources of information for the OFR (one section being written by each of the main board directors) and one person has the task of trying to apply a comparable structure after first drafts have been written. There is a strong element of independence for each director, with committee work on feedback to harmonise balance and contrast. The company would regard the finished product as a fair reflection of the business.

The document is probably written with the professional investors in mind, although with an acceptance of the need to consider the needs of the less sophisticated readership. Readers' opinions on the annual report are collected on an anecdotal basis only.
Company D2

The reviewers, in grading this OFR, found that the technical material was largely present, as might be expected from the ASB Statement, but had no forward-looking element and lacked the 'top-down' structure essential for meeting the 'spirit' of the ASB Statement.

The annual report contained an Operating Review section, put together by the operating companies with input from the investor relations section and the finance section. The Financial Review is put together separately by the finance team at head office. The audit committee reviews the document and makes comments, although changes are rare. It would be appropriate to say that the OFR shows how the authors see the business and contains what they think should be communicated about the business.

The products of this company are well known to investors as consumers and the finance director indicated that this familiarity with the products could justify less detail about the business in the OFR sections. The finance director explained that the lack of a forward-looking aspect was due partly to the seasonal nature of business, with the bulk of sales occurring in the final quarter, some considerable distance in time from the publication of the OFR.

The company's self-assessment of its OFR was that it covers the ground expected by the ASB, provides a balance and complies with best practice, albeit without pushing forward beyond that point.

Company D3

This company gave no formal indication in the 1993 annual report that it had any OFR information but scrutiny by the reviewers indicated that the major part of the information expected by the ASB Statement could be found somewhere in the annual report. It was on that basis that a 'D' grade was given. The heading Operating Review was used in the 1994 annual report but with the underlying content substantially similar to that of the previous year.

The explanation lay in a chief executive of strong personality and a leader in the industry. He had strong views as to the content of his report
and the rest of the annual report fitted round that. His retirement had occurred when preparation of the 1994 report was under way so the content had remained largely unaltered for that year. The finance director and his team were now giving active consideration to the design of the 1995 OFR, making careful analysis of the reports of other companies in the industry.

The finance director had identified those which he could see were attractive in presentation on first impression but he then asked himself whether they were flattering to deceive. Did they leave matters out? Did they stand the scrutiny of a deeper read? He identified one company in particular where he would be very pleased to produce an OFR of similar quality but even then asked himself what he gained from reading that OFR. Was it informative for those seeking a deeper understanding? Would it add significantly to the understanding of those who know the business less well?

He is aware that, when the company takes careful steps to explain a particularly difficult technical aspect of its accounting, people say that it has helped their understanding but then ask further questions which indicate that they do not understand the complexities. His present conclusion is that the OFR is not for the expert reader (such as the sell-side analysts) but may be of some interest to the relatively uninitiated (which could include fund managers as well as private investors).

**Company D4**

The reviewers had given this company a ‘D’ grade because, although the information expected by the ASB Statement could be identified in various parts of the annual report, the overall impression seemed to be one of reporting a long string of detailed segment information on a factual basis with little explanation, and also with no forward-looking aspect. The ‘top-down’ picture seemed to disappear in the detail.

The finance director provided an explanation which suggested that in this particular case the format probably does convey what the expert users want. The company operates in different geographical markets and the analysts like to build a matrix of products and markets. The apparently dull recital of detailed facts would therefore be of interest to the experts.
The finance director explained further that the company has low business risk and low financial risk so that there is less need for the forward-looking commentary. The company is very straightforward to understand but the analysts have only been convinced in this by the detail provided.

The style of the Operating Review has changed little over several years. The company reviews the style each year but has not seen any way of changing it to be any more informative than it already is. The Financial Review is a recent introduction, facilitated by the ASB recommendations.

The overall impression from the interview, and the very helpful explanations provided by the finance director, was that the reviewers would have found the OFR material more helpful to their understanding if they already had some familiarity with the company. It concentrated on the matters of particular interest to a reader who understood the stated mission and the disaggregated nature of managerial control. For the reader less familiar with the company some additional description of the business might be helpful.

Summary

The common feature of the 'A' grade companies was a strong sense of the structure of the annual report being planned as a cohesive document flowing from a central 'theme'. There was also an element of self-evaluation, either in attempting to take the reader's point of view, or in sampling reader perceptions. The OFR was generally self-contained and therefore did not rely on the Chairman's Statement for the creation of the 'top-down' structure.

The 'B' grade companies interviewed had generally recognised that they were not entirely satisfied with the first OFR after the ASB Statement and, by the date of the interviews, had already made changes to the succeeding OFR. In some of these cases there was a stronger element of the 'top-down' structure if the Chairman's Statement and Chief Executive's Report were read prior to the OFR, although the need to follow that sequence was not made explicit. In other respects these companies had provided some interesting examples of informative disclosures and forward-looking indications.
The 'C' grade companies had clearly made strong efforts to comply with the ASB Statement but the coincidence of two insurance companies being interviewed makes it difficult to generalise. The ASB Statement may implicitly be directed towards manufacturing and general service companies but may need some adaptation for companies providing financial services. These companies had particular accounting problems to contend with and required to communicate a risk management approach to all activities, whether classed as operating or financial.

The 'D' grade companies which agreed to take part in the interviews felt that they had carried out a thorough exercise in presenting the OFR material. They were aware of the nature of the OFR and could explain the background to the present state of the document. There was no single explanation to cover all interviewees - the nature of the OFR depended in one instance on the personality of a chief executive, in another on the fragmented nature of the market for products, and in the other two on the OFR being constructed as an amalgam of reports from various parts of the organisation, not necessarily working to a single theme.

It was particularly encouraging in all interviews to find that the company's self-evaluation and its plans for revision in the following OFR had largely anticipated the views of the reviewers on the first OFR surveyed. There were different views as to the communications role of the annual report, and hence of the OFR within that annual report, but the concept of communicating OFR-type material was seen universally as being important. It was also clear from the interviews that there is considerable overlap with the preliminary announcement and that the time is fast approaching when the OFR will become identical to the text of the preliminary announcement.
# APPENDIX B

Name of company

Year-end ..................................................  Pages reviewed ........................................

Grade awarded ........................................... Grade last year ........................................

<table>
<thead>
<tr>
<th>TOP-DOWN STRUCTURE</th>
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</tbody>
</table>

5 = no further work to be recommended
4 = rearrange existing text - no further wording
3 = needs further text/rewriting
2 = wording present but not helpful
1 = no wording but we think there should be
0 = no wording but apparently not needed
### Operating Review

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<td>Other:</td>
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</tbody>
</table>

5 = clear explanation, forward-looking
4 = clear explanation, adds to understanding
3 = adequate explanation
2 = facts and some wording
1 = facts from accounts, nothing more
0 = not mentioned, probably not relevant
## APPENDIX C

### LIST OF COMPANIES SURVEYED, WITH ACCOUNTING YEAR-ENDS

<table>
<thead>
<tr>
<th>Company</th>
<th>Year-End</th>
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<td>Abbey National plc</td>
<td>31 December 1994</td>
</tr>
<tr>
<td>Argyll Group plc</td>
<td>1 April 1995</td>
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<td>Arjo Wiggins Appleton plc</td>
<td>31 December 1994</td>
</tr>
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<td>Asda Group plc</td>
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<td>Associated British Foods plc</td>
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<td>BAA plc</td>
<td>31 March 1995</td>
</tr>
<tr>
<td>Bank of Scotland</td>
<td>28 February 1995</td>
</tr>
<tr>
<td>Barclays plc</td>
<td>31 December 1994</td>
</tr>
<tr>
<td>Bass plc</td>
<td>30 September 1995</td>
</tr>
<tr>
<td>BAT Industries plc</td>
<td>31 December 1994</td>
</tr>
<tr>
<td>Blue Circle Industries plc</td>
<td>31 December 1995</td>
</tr>
<tr>
<td>The BOC Group plc</td>
<td>30 September 1995</td>
</tr>
<tr>
<td>The Boots Company plc</td>
<td>31 March 1995</td>
</tr>
<tr>
<td>Bowater plc</td>
<td>31 December 1994</td>
</tr>
<tr>
<td>British Aerospace plc</td>
<td>31 December 1994</td>
</tr>
<tr>
<td>British Airways plc</td>
<td>31 March 1995</td>
</tr>
<tr>
<td>British Gas plc</td>
<td>31 December 1994</td>
</tr>
<tr>
<td>The British Petroleum Company plc</td>
<td>31 December 1994</td>
</tr>
<tr>
<td>British Steel plc</td>
<td>1 April 1995</td>
</tr>
<tr>
<td>British Telecommunications plc</td>
<td>31 March 1995</td>
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<tr>
<td>BTR. plc</td>
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<td>Burmah Castrol plc</td>
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<tr>
<td>Cable &amp; Wireless plc</td>
<td>31 March 1995</td>
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<tr>
<td>Cadbury Schweppes plc</td>
<td>31 December 1994</td>
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<tr>
<td>Caradon plc</td>
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Carlton Communications plc 30 September 1995
Coats Viyella plc 31 December 1994
Commercial Union plc 31 December 1994
Courtaulds plc 31 March 1995
De La Rue plc 31 March 1995
Dixons Group plc 29 April 1995
Enterprise Oil plc 31 December 1994
Forte plc 31 January 1995
GKN plc 31 December 1994
General Accident plc 31 December 1994
General Electric Company plc 31 March 1995
Granada Group plc 30 September 1995
Grand Metropolitan plc 30 September 1995
Great Universal Stores plc 31 March 1995
Guardian Royal Exchange plc 31 December 1994
Guinness plc 31 December 1994
HSBC Holdings plc 31 December 1994
Hanson plc 30 September 1995
Imperial Chemical Industries plc (ICI) 31 December 1994
Inchcape plc 31 December 1994
Kingsfisher plc 28 January 1995
Ladbroke Group plc 31 December 1994
Land Securities plc 31 March 1995
Lasmo plc 31 December 1994
Legal & General Group plc 31 December 1994
Lloyds Bank plc 31 December 1994
Marks & Spencer plc 31 March 1995
MEPC plc 30 September 1995
National Power plc 26 March 1995
National Westminster Bank plc 31 December 1994
NFC plc 30 September 1995
North West Water Group plc 31 March 1995
Northern Foods plc 31 March 1995
Pearson plc 31 December 1994
The Peninsular and Oriental Steam Navigation Company (P & O) 31 December 1994
Pilkington plc 31 March 1995
PowerGen plc 2 April 1995
Prudential Corporation plc 31 December 1994
Reckitt & Colman plc 31 December 1994
Redland plc 31 December 1994
Reed International plc 31 December 1994
Rentokil Group plc 31 December 1994
Reuters Holdings plc 31 December 1994
RMC Group plc 31 December 1994
Rolls Royce plc 31 December 1994
Royal Bank of Scotland Group plc 30 September 1995
Royal Insurance Holdings plc 31 December 1994
RTZ Corporation plc 31 December 1994
J Sainsbury plc 11 March 1995
Scottish & Newcastle plc 30 April 1995
Scottish Power plc 31 March 1995
Sears plc 31 January 1995
Severn Trent plc 31 March 1995
Shell Transport & Trading Company plc 31 December 1994
Siebe plc 1 April 1995
Smith & Nephew plc 31 December 1994
SmithKline Beecham plc 31 December 1994
Smiths Industries plc 5 August 1995
Southern Electric plc 31 March 1995
Standard Chartered plc 31 December 1994
Sun Alliance Group plc 31 December 1994
Tarmac plc 31 December 1994
Tate & Lyle plc 30 September 1995
Tesco plc 25 February 1995
Thames Water plc 31 March 1995
Thorn EMI plc 31 March 1995
TI Group plc 31 December 1994
Tomkins plc 29 April 1995
Unilever plc 31 December 1994
United Biscuits (Holdings) plc 31 December 1994
Vodafone Group plc 31 March 1995
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<td>Zeneca Group plc</td>
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