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Heads Up
Effective disclosure in an operating and financial review

Contents

"In summary"

- On 17 September 2012, ASIC issued a consultation paper to obtain feedback on its proposals to provide guidance on preparing an operating and financial review (OFR) in the directors' report of a listed entity.
- The proposed guidance is principle based and outlines considerations that will assist directors to practically apply the OFR requirements under s.299A of the *Corporations Act 2001* and may result in additional detail in OFRs given guidance around:
  - Level of detail required
  - Application of the unreasonable prejudice exemption
  - Good disclosure practices.
- Commentary on the current use, perhaps over-use, of the unreasonable prejudice exemption is accompanied by more prescriptive guidance on its application.
- Submissions close on 23 November 2012 with the regulatory guidance expected to be released by March 2013 effective for June 2013 year ends.
- We welcome any comments you may have on the consultation paper.

Overview

On 17 September 2012, ASIC issued Consultation Paper 187 *Effective Disclosure in an Operating and Financial Review* (CP 187) in order to obtain feedback from stakeholders on its proposed draft new regulatory guide for directors on providing useful and meaningful information to investors when preparing an OFR in a directors' report of a company, registered managed investment scheme or disclosing entity that is listed (listed entity).

Whilst an entity's financial report provides useful information to investors about the entity's financial position and performance it will rarely provide all the information needed to readily assess the underlying drivers of the entity's financial performance and to properly understand the reasons for the entity's results. The financial report will also provide little information about expected future performance. Section 299A of the *Corporations Act 2001* (the Act) was introduced to address a lack of contextual information explaining the results set out in an entity's annual financial report and under s.299A(1), the directors' report of a listed entity must contain information about the entity's operations; financial position; and business strategies and prospects for future financial years; which is typically included in a section of the directors' report called 'review of operations' or something similar.

Related Link
www.asic.gov.au
ASIC Website

Through its surveillance program, ASIC has found that whilst many entities provided an OFR of reasonable quality, there is room for improvement. In some instances ASIC has noted:

- a lack of analytical information in OFRs which may have been provided in other documents such as analyst briefings;
- the repetition of information in OFRs that is already contained in the financial report without any analysis or explanation; and
- the possible over-use of the exemption from disclosing information on the basis of unreasonable prejudice.

ASIC are looking for an OFR that complements the financial report, effectively telling a story about the business. ASIC are of the view that the OFR performs a different role to market announcements and investor presentations and such announcements and presentations are not considered to be a substitute in meeting the OFR disclosure requirements under the law. ASIC expect to see information which appears in these sources to be presented in the OFR, where relevant, with a clear analysis and narrative.

The proposed guide would supplement ASIC's Regulatory Guide 230 *Disclosure of non-IFRS financial information (RG 230)* which was issued last year and acknowledges that non-IFRS information may be included in an OFR. ASIC does not expect the application of the guidance to take significantly more time or to result in significantly longer reviews however this is likely to depend on past practice and consideration of other guidance such as the G100s *Guide to review of operations and financial condition* or the IASB's Practice Statement *Management Commentary.*

The nature and content of an operating and financial review

The OFR in a directors' report must contain information that investors in the entity would reasonably require to make an informed assessment of the entity's operations, financial position, business strategies, and prospects for future financial years.

ASIC consider that an OFR is an important opportunity to provide investors with an analysis and narrative about an entity's business to supplement and complement the information contained in the entity's annual financial report. A combination of a financial report and a high-quality OFR would provide investors with a clear understanding of the entity's historical performance and expected future performance.

Under the proposals, an OFR should contain the following key matters (although not expected to be to the same level of detail as is required in a prospectus):

- underlying drivers of an entity's performance that are relevant to understanding its performance and the factors underlying its results including significant factors affecting the total income and significant components of overall expenses, and income and expenses for major operating segments;
- underlying drivers of, and reasons for, an entity's financial position. This might include explaining significant changes in the assets and liabilities as a result of major business acquisitions or disposals, changes in funding or dividend strategy, and references to any issues or uncertainties about going concern;
- exposures not reflected in the financial report (e.g. off-balance sheet arrangements);
- explanation of accounting information, rather than simple repetition;
- outline of key business strategies, and the plans that are a significant part of those strategies. This may include a discussion of the key strengths and weaknesses within the entity that may positively or negatively affect the entity's ability to achieve its business objectives;
- matters that may have a significant impact on future financial performance and condition. This would include discussion on strategies beyond those of the next financial reporting period. In order for investors to make an informed assessment of an entity's business strategies and future prospects, information about the entity's business objectives, how these objectives are to be achieved and significant factors on which the achievements of these objectives depends may be reasonably required; and
- the main risks that could adversely affect the successful fulfillment of the business strategies of the entity.

The proposed guidance does not at this point encompass integrated reporting which would widen the scope of corporate reporting to include environmental, social governance and employee-related factors, but ASIC would welcome views on this issue.

Good disclosure practices

CP 187 includes numerous examples of disclosure believed appropriate under s.299A but it also outlines some general good disclosure practices that ASIC believe would be useful and relevant in the context of preparing an OFR. These include:

- the OFR should be presented in a single self-contained section (separate from the directors' report) of the annual report to assist users in identifying the OFR;
- the information in the OFR should complement and be consistent with the information in the financial report. This may involve providing a narrative explaining various sections of the financial report – such as segment reporting, business combinations and impairment testing – in a way that is relevant to the entity's operations, business strategies and prospects;
- disclosure must be balanced and unambiguous. Consequently representations or statements about a future matter should only be made if there are reasonable grounds for the representation or statement, both good and bad news/prospects and risks should be provided, and misleading disclosure (including disclosure that misleads by omission) should be avoided; and
- the OFR should present information in a clear, concise and effective manner. Information is 'clear, concise and effective' if it highlights key information, uses plain language, explains complex information, and is presented in a logical order.

Use of the unreasonable prejudice exemption

The Act provides an exemption from disclosing information about business strategies and prospects for future financial years if disclosure of that information is likely to result in 'unreasonable prejudice' to the entity, however ASIC are concerned that the exemption may be currently over-used due to uncertainty regarding its application. ASIC believe that it would be rare for an entity to be able to rely on the exemption to disclose no information at all about its business strategies and prospects. In most cases, an entity should be able to provide a level of information about business strategy without causing unreasonable prejudice to the entity.

In ASIC's view, in determining whether there is prejudice and whether it is likely to occur, the entity should identify the adverse consequences that are likely to occur as a result of the disclosure, and then consider whether such consequences would be unreasonable. The consequences would be unreasonable if disclosing the information is likely to give third parties a commercial advantage, resulting in a material disadvantage to the entity. ASIC consider that, at a minimum, the word 'likely' means 'more than a possibility', or 'more probable than not' not just a mere possibility.

CP 187 proposes that if information has been omitted in relation to the exemption, that a summary of the type of information omitted and the reasons for the omission be disclosed in the directors' report, where possible. Furthermore, it acknowledges that because ASIC may ask for reasons for the omission, it may be useful for directors to maintain an internal report which identifies the information that has not been disclosed and explains how disclosure of the excluded information would be likely to result in unreasonable prejudice.

Entities may often consider that disclosure of confidential information which is commercially sensitive would lead to unreasonable damage to its business and it is likely to be possible to establish a basis for this view. However, ASIC believe it would be rare to establish that unreasonable prejudice is likely for the disclosure for business strategies and prospects in an OFR if that information is already available in the public domain (e.g. announcements to the market, analyst briefings, newsletters, advertising).

Hence, rather than omit all information about business strategies and prospects, CP 187 proposes that entities should identify the information that would reasonably be required by investors and remove specific parts that would give rise to unreasonable prejudice.

Next Steps

Companies should consider whether they wish to respond to ASIC with comments on the proposals due by 23 November 2012. If you would like us to consider your comments for inclusion in our response to ASIC on the consultation paper please email them to Anna Crawford at acrawford@deloitte.com.au or call her on 02 9322 7177 or Tina Cabela at tcabela@deloitte.com.au

Directors of listed entities may also wish to review their current operating and financial review for compliance with the CP and consider whether they wish to implement any of these changes as best practice early. Note, that although any regulatory guidance issued by the ASIC is not mandatory under the Act, it may form the basis on which ASIC may challenge a company's reporting, as it reflects ASIC's interpretation of the Act.

A copy of the Consultation Paper can be obtained from the ASIC website by clicking here.