

**RSM! Robson Rhodes**

**CIPFA**

## Public Benefit OFRs

A catalyst for enhancing  
accountability?

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# CONTENTS

	Page
<b>PART I INTRODUCTION AND BACKGROUND</b>	<b>2</b>
<b>PART II KEY OFR IMPLEMENTATION ISSUES FOR PUBLIC BENEFIT ENTITIES</b>	<b>8</b>
<b>PART III NEXT STEPS</b>	<b>20</b>

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CIPFA and RSM Robson Rhodes have issued this discussion paper to promote thought and debate on how narrative reporting in the public benefit sector might best be developed.

The discussion paper is being sent to representatives of public benefit entities in all sectors

A discussion Round Table event will be held in February/March 2006.

We would welcome comments on the discussion paper from interested parties, particularly those working in the public benefit sector. Comments which directly address the

Issues for Discussion set out in Part III of the paper would be particularly helpful.

Comments by email are preferred and should be sent to

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Comments can also be sent by post to

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Comments should be sent to arrive no later than 20 March 2006.

## 1. Purpose and scope of review

The Accounting Standards Board (ASB) published Reporting Standard 1 (RS1) "Operating and Financial Review" (OFR) in May 2005. The standard was intended to apply to all listed companies in the UK and any other entities that purport to produce an OFR.

This joint review by CIPFA and RSM Robson Rhodes sets out to identify important issues relating to the publication of an OFR by public benefit entities with the dual purpose of promoting discussion on them and of raising general awareness on the narrative reporting of performance.

In undertaking the review we held discussions with representatives from the National Audit Office, the Audit Commission, the ASB and HM Treasury.

The scope of our review covers all public sector bodies within the Whole of

Government Accounts boundary and those bodies whose SORPs fall within the 'negative assurance' process of the ASB's Committee on Accounting for Public Benefit Entities (CAPE). It therefore includes:

- central government bodies;
- trading funds and NDPBs;
- local government;
- the higher and further education sectors;
- registered social landlords; and
- charities.

Whilst we have highlighted a number of cross sectoral issues in this discussion paper, we recognise that there may not necessarily be a single solution that is suitable for all bodies within the scope of this review. We have therefore highlighted issues that are relevant to individual sectors where applicable.

## 2. The formulation of Reporting Standard 1 "Operating and Financial Review"

An effective OFR should provide clarification and interpretation on the main factors underlying an entity's performance and an overall framework for assessing its performance and prospects by reference to its strategies and objectives.

RS1 sets out to foster improvement in the overall quality of corporate reporting through the provision of information that complements and supplements that in the financial statements.

RS1 replaces the ASB's 2003 Statement "Operating and Financial Review" which was of persuasive rather than mandatory effect. There were concerns that compliance with the Statement was patchy and that OFRs did not consistently provide users of accounts with sufficiently clear and comprehensive information on which to assess expected future performance and base investment decisions.

The Company Law Review Steering Group therefore considered the requirements for preparation of an OFR and concluded that a mandatory requirement was needed if the quality of OFRs was to be improved. It made recommendations as to their prescribed contents, which were taken forward in the Modernising Company Law White Paper and eventually resulted in Statutory Instrument 2005 No. 1011 The Companies Act 1985 (Operating and Financial Review and Directors' Report etc.) Regulations 2005. The SI requires quoted companies to prepare an OFR and specifies minimum contents through an amendment to the Companies Act 1985 (Schedule 7ZA).

The ASB subsequently published RS1 in May 2005. In preparing RS1 the ASB decided to issue a framework standard providing an open and flexible structure that would enable directors to represent the analysis of the business from their

***An effective OFR should provide clarification and interpretation on the main factors underlying an entity's performance***

perspective whilst complying with the statutory requirements.

RS1 requires company OFRs to provide information to assist members to assess the strategies adopted by the entity and the potential for those strategies to succeed. It notes that the key elements of the disclosure framework necessary to achieve this are:

- the nature of the business including the entity's objectives and strategies and the environment in which it operates;
- the development and performance of the business during the financial year and in the future;
- the resources, principal risks, uncertainties and relationships that may affect the entity's long term value; and

- the position of the business in the financial year, and in the future, including capital structure, treasury policies and liquidity.

The RS also requires bodies preparing an OFR to:

- include disclosures relating to specified particular issues;
- be balanced and neutral;
- produce an OFR that is comprehensive and understandable; and
- ensure comparability over time.

### 3. The merits of applying RS1 to public benefit entities

Whilst the standard has principally been prepared for quoted companies (and has been written from a company's perspective to provide information to the members of the company) the framework approach adopted means that it is potentially applicable to other large entities where there is public interest in published information on their performance.

A corporate OFR would provide information on the company's ability to generate or preserve value for members in the long term. In public benefit entities, the equivalent concept could be seen as the extent to which the entity is achieving its objectives and succeeding in being economic, efficient and effective in doing so.

Whilst the purpose of public benefit entities is different from profit-making businesses, there is a common need to discuss performance and the extent to which an organisation has met its strategic aims and, more broadly, to promote accountability.

An OFR is likely to be particularly valuable where it leads to the provision of comparable information by public benefit entities within sectors in which there are a large number of similar organisations.

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## 4. Application of the OFR to public benefit entities

HM Treasury has updated the Government's Financial Reporting Manual (FReM) to require preparation of an OFR as part of the Annual Report.

The National Housing Federation has also included a requirement for Registered Social Landlords (RSLs) to produce an OFR as part of the 2005 SORP. However, no recent guidance has been issued for other sectors.

The information required in the expanded Trustees Report under the 2005 Charities SORP might be seen as a satisfactory response to RS1, as this is specifically designed to provide users of those accounts with sufficient information to assess the performance of the charity against its stated objectives. There may, therefore, be little merit in requiring charities to produce an OFR at this time. HM Treasury has already determined that an OFR will not be required for charitable NDPBs in the Central Government Sector.

Where public benefit entities are asked to prepare an OFR there is the need to consider whether such a requirement would be appropriate for all bodies within a given sector. In particular, it may be that the time and expense of producing an OFR is not justified in the case of smaller entities. The National Housing Federation has, for example, specified that only associations with more than 5,000 units in management will be required to produce a full OFR.

It seems important, in line with the provisions of RS1, that public benefit entities seeking to produce a report which is designated as an "Operating and Financial Review" comply fully with the requirements laid down for their particular sector. Bodies that do not satisfy all of the relevant requirements could include information within another report but this is best not referred to as an OFR.

## 5. Recent Developments

On 28 November 2005, the Chancellor of the Exchequer announced the Government's intention to remove the statutory requirement for quoted companies to publish an OFR. On 15 December 2005, Statutory Instrument 2005/3442 was laid before Parliament, repealing the relevant Companies Act provisions.

However, the government has made it clear that it remains committed to improving strategic forward-looking narrative reporting by companies and to enhanced dialogue with shareholders based on such reporting. The Statutory Instrument leaves intact provisions implementing the EU Accounts Modernisation Directive (2003/51/EC), under which businesses are required to provide a fair review of performance together with a description of principal risks and uncertainties.

Following the Chancellor's announcement, the Financial Reporting Council (FRC)

reiterated its view that RS1 still represents current best practice although, in the light of the announcement, the FRC and its operating bodies have indicated that they will need to consider the implications of detailed government proposals as they become clearer. The ASB is expected to issue revised guidance in January 2006.

It is understood that the Financial Reporting Advisory Board (FRAB) will be discussing the OFR in February 2006. However, given the Board's commitment to promoting high standards of financial reporting in the government sector no significant change to the FReM requirement for an OFR is expected.

These developments do not change the relevance and importance of the issues in this discussion paper. Determining best practice for the public benefit sector must be a key goal whatever the legislative backdrop for the private sector.

### 1. What is the audience for public benefit OFRs?

***OFRs are part of general purpose reports that should provide a meaningful review of performance and prospects to those without the right to obtain non-publicly available information.***

In August 2005 the ASB released for comment an exposure draft of its “Statement of Principles for Financial Reporting: Proposed Interpretation for Public Benefit Entities”. The exposure draft suggests that public benefit entities should see funders and financial supporters as the primary users of their financial statements.

Determination of the needs of ‘funders and financial supporters’ may not always be straightforward, especially for bodies which may be funded through multiple sources. However, a more pressing question is whether funders and financial supporters should be the primary audience for financial reporting information.

The RSL SORP follows the ASB approach with it too being framed in terms of ‘funders and financial supporters’. By contrast, the FreM

states that the term ‘members’ in RS1 should be interpreted as meaning all users of the accounts. These may include, policy makers, advisors and commentators as well as departmental select committees. The FReM does not specify, however, how the users should be defined or how this might impact on the information provided.

The ASB suggests that by attending to the information requirements of funders and financial supporters, the financial information requirements of other users will also be satisfied. However, many public sector bodies still consider that account should be taken of additional information needs of service users. RS1 recognises that OFRs may be of interest to others than the members for whom it is intended but asserts that the OFR should not be seen as a replacement for other forms of reporting addressed to a wider stakeholder

group. An issue that needs to be addressed in the public benefit context is whether an OFR should be focussed on the same audience as the financial statements or whether the needs of a wider constituency ought to be explicitly taken into account.

Another aspect to be considered is that OFRs are part of general purpose reports that should provide a meaningful review of performance and prospects to those without the right to obtain non-publicly available information. Preparers of OFRs will have to

be careful that in seeking to satisfy users’ needs they do not include information that would only be of interest to a limited number of users or of marginal interest to users generally and which could result in reports becoming unnecessarily detailed. OFRs should not therefore be prepared to meet the special needs of particular regulators, funders or other users if this detracts from the understanding of general users. Where specialised information is required, this should be produced under separate arrangements rather than in the OFR.

***The effectiveness of OFRs will be enhanced where information is provided on a consistent basis to facilitate comparisons between bodies.***

## 2. Who should determine the nature of information to be included in OFRs?

RS1 emphasises that it is for directors to determine the content of their OFRs taking account of the individual circumstances of their businesses. It does, however, specify a disclosure framework and sets out key principles that have to be adhered to in the preparation of OFRs.

For sectors in which there are a large number of similar organisations the effectiveness of OFRs will be enhanced where information is provided on a consistent basis to facilitate comparisons between bodies. There is therefore some merit in central guidance being issued on the necessary content of the OFR, for example by SORP making bodies. However, it is unclear as to whether the ASB's negative assurance role with regard to the SORP making bodies could be seen as extending to the content of the OFR as opposed to being limited to the financial statements themselves. We note that Monitor and the Department of Health are providing specific guidance on health sector issues to

supplement the general requirements included within the FReM.

Further sector-specific guidance to be issued by other regulatory or similar bodies could cover matters such as:

- which common Key Performance Indicators (KPIs) should be used across the sector;
- how results from independent inspections or negotiated targets should be presented; and
- the need to discuss progress in relation to specific initiatives such as efficiency savings arising from the Gershon Review.

There may also be other sector-specific matters where it may be appropriate to require disclosure. For example, the Department of Health will be requiring NHS bodies to include information on their Major Incidents Plan to deal with Emergency Preparedness.

## 3. To what extent can existing published information be used in the OFR?

As discussed in Part I of this paper, RS1 requires bodies to provide information on a range of issues including:

- strategic objectives;
- development of the business and its position at the year end;
- performance against those objectives; and
- policies and results in respect of particular matters.

Many public benefit entities already publish their strategic objectives either as part of a published business plan or an annual report. In some instances existing annual reports provide a summary of performance against overall business objectives but the quality of reporting varies considerably and reports on these matters are not always comprehensive nor necessarily balanced in terms of discussion of both successes and setbacks.

Annual reports or their equivalent also usually include some narrative explanation of the principal movements on the income and expenditure account or operating cost statement but rarely include detailed explanations of significant balance sheet or cash flow

movements. Some specific issues such as treasury management policies and activities are, however, currently reported separately by other means.

Furthermore, many public sector bodies already produce extensive performance information, including KPIs. This information is, in some instances, critical in terms of the rating of the body concerned and may affect the level of regulation or operational flexibility granted to it.

Performance may be reported against:

- performance indicators set by a government department, e.g. the Office of the Deputy Prime Minister or regulators such as the Healthcare Commission or the National Housing Federation;
- negotiated targets agreed with central government, e.g. Public Service Agreement (PSA) targets on how spending review objectives are to met; or
- internally generated performance indicators.

In addition, some public bodies publish their forward plans and objectives concerning the planned future shape and cost of services.

In many areas of the public sector, the budget, which is used for tax raising or other income generating purposes, is currently considered to be the most critical document in the annual reporting cycle.

Much of the existing information is prepared for specific purposes and required by government bodies and regulators to monitor performance against objectives which they consider to be important, as part of their overall goals for the service. Bodies may also publish information as part of their management activities such as the Best Value Performance Indicators included within corporate plans published by local authorities.

A large amount of the information already published is produced to a different timetable and in many cases is more detailed than would be suitable for inclusion in an OFR. Selecting appropriate indicators for disclosure and discussion will be critical in ensuring that bodies can produce OFRs that are comprehensive and balanced without being unduly lengthy.

The timing differences between publication of an OFR and other currently required information

may raise issues in some cases of how to ensure that information included within the OFR, or referred to in it through cross-referencing, is up-to-date at the time of its publication. It may be necessary in some cases to comment on changes that have occurred between the dates of publication of performance indicators and the finalisation of the OFR.

If the OFR is to be readily understandable by all readers it should be able to be read as a self-contained document with sufficient information provided on objectives and performance to enable the reader to gain an overall understanding of the organisation, its mission and activities without having to refer to other documents. The OFR should, however, include cross-references to associated documents where this is considered to be helpful for readers seeking more detailed information on issues.

Whilst an OFR is not necessarily intended to replace existing information it could act as a valuable catalyst in leading to a review in the various sectors of the timing and presentation of information currently put into the public domain as part of the annual reporting cycle.

## 4. How should public benefit entities select their principal KPIs?

Examples of information already collected and published on KPIs include CPA Scorecards for local authorities and Health Care Commission assessments for health bodies. It is important that the OFR concentrates on those measures which are key indicators of progress against the overall strategic objectives of the body. For sectors where extensive detailed performance information is produced, additional guidance may be needed on how to select the appropriate indicators on which to report.

To achieve comparability over time, bodies need to consistently publish performance information against previously published targets along with the targets for the period ahead. Bodies are likely, however, to have to consider the impact of changing policy objectives, such as changes to PSAs, when determining the information included within their OFR.

We have outlined the case for some reporting against centrally specified indicators in certain sectors. It may also be appropriate for bodies to report against self-determined indicators

where these are important in assessing the degree to which strategic objectives are being met. Further national and self-selected local indicators should be separately presented.

Whilst RS1 calls for disclosure of KPIs, it does not include a requirement to explain the assurance procedures adopted to ensure the integrity of this data. This is an area where bodies may feel it is helpful to provide additional information. The extensive use of performance information within the public sector means that assurance arrangements in relation to it are generally more developed than in the private sector. There remains however, a lack of accepted guidance or standards specifying the procedures to be adopted in ensuring the robustness of performance data. This has been recognised by the Public Audit Forum which is shortly to publish its views on the preparation and audit of performance information. The initiative may help to clarify the responsibilities of accounts' preparers for the integrity of information provided in OFRs and the extent to which this is or is not covered by standard audit opinions.

## 5. How should organisations report on qualitative assessments of performance?

In many sectors the perception of service standards is important, eg hospital cleanliness or the quality of care provided by social services departments. Bodies will need to consider whether there are any qualitative factors that should be included within an OFR to give a balanced and comprehensive view of their performance during the period and of their future plans.

The results of external qualitative assessments are of particular importance in assessing the performance of bodies in some sectors such as health, local government and education. It is important therefore that OFRs

give sufficient prominence to the results of these assessments where appropriate.

Those organisations which decide to include qualitative indicators, other than information on independent inspections, will have to decide how this data can be collected. The use of self-assessment measures of performance may not always be considered reliable. If, for instance, customer or patient satisfaction surveys are used, the way in which they are undertaken and particularly the degree of independent involvement in them may have an important bearing on how they are perceived.

***If the OFR is to be readily understandable by all readers it should be able to read as a self-contained document with sufficient information provided on objectives and performance...***

## 6. Is additional guidance needed on employee, social and environmental issues?

RS1 requires bodies to provide details of specified 'particular matters' such as employee, social and environmental issues to the extent that these are necessary for a proper understanding of the performance and prospects of the business. RS1 adds that it has only provided a minimum list and that directors should make additional disclosures where considered necessary. It also calls for the disclosure of key relationships on which the entity is dependent.

We suggest that further guidance would be helpful on a sector by sector basis on the particular matters specified within RS1 in order to clarify expectations in this area and to promote, as far as is appropriate, consistency of disclosures in given sectors. It may be that the following factors should be taken into account in respect of employee, social and environmental issues:

- careful consideration will be needed on how to discuss social and community issues given that the nature of many public benefit entities is such that these often form a core part of their activities and this may lead to extensive disclosures;
- on environmental matters, it may be appropriate for disclosures to focus principally on environmental impacts arising directly from the entity's activities. Examples of relevant disclosures may be waste disposal activities for local authorities or the risk of nuclear contamination in the case of the Department of Trade and Industry. This approach would be consistent with the examples given in the Implementation Guidance attached to RS1;
- existing HM Treasury guidance on environmental matters refers to the adoption of sustainable reporting and further guidance may be necessary to ensure that disclosures within the OFR focus on those necessary to form an assessment of progress against strategic objectives; and
- the section on key relationships may require discussion of the respective roles and impacts that other public sector bodies may have on the organisation.

## 7. Do any particular issues arise from the political nature of many of the bodies concerned?

The forward-looking orientation of an OFR renders it subject to inherent uncertainties over future changes in policy. There are specific issues facing public sector entities where there are changes in central government policy, which would include those resulting from a change in administration, or where a change occurs in the control of the body itself. Whilst changes in company leadership or ownership may equally, for example, result in the adoption of a different strategy, this differs from the situation in many public bodies where changes in key policy objectives are often determined from outside the organisation itself. This risk will be especially to the fore in relation to OFRs published shortly before elections are due.

There is also an additional factor to be considered, namely the possibility of an incoming administration commenting on the previous administration's performance. Particular care may be required in these circumstances to ensure a balanced presentation.

The above notwithstanding, many parts of the public sector are extending their

planning cycle with some bodies now required to produce overall long-term objectives and a medium-term financial plan (usually 3-5 years) as to how these objectives are to met. This links in with moves to provide greater certainty on the level of funding over the same time horizon, enabling the organisations concerned to take a longer-term perspective on the delivery of future services.

As with private sector OFRs, the best way to deal with these issues may be by including a statement in the OFR on the basis of which assumptions about the future have been included.

There is also a risk that OFRs may be used by bodies to make political statements on the level of funding in, for example, explaining the reasons for deficits. Particular risks may be encountered in relation to:

- health bodies, if there is an underlying deficit across a local health economy as a whole;
- educational institutions, if actual grants received are less than expected; and

- local government bodies, if restrictions in the level of Revenue Support Grant and other grants cause pressure on either the level of services or the amount to be collected through Council Tax.

To some extent, however, these risks already exist under current reporting arrangements and are generally managed satisfactorily.

## 8. When should it be acceptable not to disclose relevant information?

Publication of information under consideration for inclusion in the OFR may occasionally be considered to be potentially detrimental to public policy. In such circumstances public bodies will have to decide whether this information should be put into the public domain. A similar risk is borne by listed companies which, for example, may be concerned that publication of sensitive performance information could be used by competitors.

The RS includes a 'seriously prejudicial' exemption in respect of impending developments or matters in the course of negotiation. This narrow definition of what is prejudicial suggests, however, that it should not be used to restrict publication of information on past transactions that may be considered merely embarrassing to those presenting the information.

In deciding on their degree of openness in including information within their OFR, bodies should also consider their obligations under the Freedom of Information Act, 2000. Under the Act, public sector bodies are encouraged to publish information unless this is covered by specific exemptions within it. This is part of overall government policy to promote a culture of openness and accountability amongst public sector bodies by providing rights of access to the information held by them, facilitating better public understanding of how public authorities carry out their duties, why they make the decisions they do and how they spend public money.

## 9. Who should be responsible for signing off the OFR?

Whilst the OFR accompanies the financial statements, its preparation should not be seen solely as the responsibility of the finance director. The importance of wider collective responsibility is confirmed in the wording of RS1 which requires an analysis of the business through the eyes of the board of directors. The discussion on strategy, performance and risks take this beyond the finance function. This should be recognised when deciding on the governance arrangements for the preparation and approval of an OFR within public benefit entities with it being made clear that the overall responsibility rests with the governing body.

***Whilst the OFR accompanies the financial statements, its preparation should not be seen solely as the responsibility of the finance director.***

Bodies will have to review the extent to which their objectives are linked with those of other bodies (for example the link between health commissioners and providers) and whether they therefore need to discuss and agree disclosures with these bodies before publication of their OFR.

In addition, bodies producing group accounts will have to consider the extent to which they need to disclose information on the strategies and activities of other entities within the group boundary if they are to provide an overall view of the group's activities.

## 10. What assurance considerations should be taken into account?

The OFR does not form part of the financial statements. It will, by its nature, contain information outside the scope of the annual audit of those statements especially with regard to future developments and strategies, non-financial performance measures and budgets.

In October 2005, the Auditing Practices Board published exposure draft ISA 720 (Revised) which covered the auditors' responsibilities in respect of Directors' reports and OFRs. This required auditors to consider whether the information in the OFR was consistent with the financial statements but not to perform additional testing to verify the accuracy or completeness of information contained in it. The draft ISA also provides guidance to auditors on how to respond to any inconsistencies noted during their review.

The guidance on OFR responsibilities has since been withdrawn from the exposure draft although it may still be considered to

represent indicative guidance on the nature of auditors' responsibilities where OFRs are published as separate documents.

The position of auditors may, however, be less clear if the OFR is included as part of an annual report, or other document, on which auditors are expected to give an opinion.

This might arise in the case of local authorities where the Explanatory Foreword forms part of the accounts and is consequently covered by the audit report. In such circumstances, auditors will have to ensure that the extent of their responsibility in respect of various parts of the document is made clear when providing their audit opinion. Bodies seeking to combine the OFR within another report may need to discuss the implications with their auditors.

## 1. Opportunity for a significant enhancement in reporting

We believe the introduction of the OFR offers an excellent opportunity to enhance further the quality of reporting by public benefit entities. It should be seen as another step in the ongoing process of continual improvement in accountability.

There has been a positive response in a number of quarters to the proposed publication of OFRs by public benefit entities and in some cases useful additional guidance has already been published.

## 2. Issues for discussion

The principal issues on which we consider further consultation would be helpful include:

### *Support for the principle of an OFR*

- 1) Should public benefit entities generally be required to publish an OFR broadly in line with the requirements of RS1? If you agree, will this lead to a significant improvement in reporting by public benefit entities? Do you believe the recent decision not to introduce a statutory OFR for quoted companies will have an impact on support for the OFR in the public sector? Should charities be called

If the full potential of this innovation is to be realised, however, there are a number of challenges outlined in this paper which, need to be addressed. It is also essential that the governing bodies of public benefit entities review their state of preparedness for implementing enhanced narrative reporting and, in particular, identify any new information they will need to collect for inclusion in it.

on to include an OFR in their annual reports or are the relevant provisions in the 2005 Charities SORP adequate?

### *Size thresholds*

- 2) In sectors where an OFR will be required to be prepared, should there be a size threshold exempting smaller entities? Should this just apply to public benefit entities such as housing associations and smaller educational institutions or should it also be available within the public sector itself, eg smaller health trusts and local authorities?

### *Sector-specific guidance*

- 3) Is additional sector-specific guidance needed in respect of local authorities and educational institutions to enable them to apply the OFR in a manner appropriate to their respective sectors and to ensure comparability in disclosure across the sector? If so, who should develop the guidance? Has sufficient guidance been published for the health and central government sectors and for RSLs?

### *Implications for current reporting arrangements*

- 4) How will the OFR dovetail with the current reporting arrangements in the various sectors (eg departmental reports and autumn performance reports for central government departments)? Are there any other changes that it would be helpful to introduce in particular sectors, for example, in relation to the reporting cycle, that would enhance the overall quality of reporting and enable OFRs to be published whilst minimising any duplication of disclosures?

### *General guidance*

- 5) In addition to any further sector-specific guidance, is there a need for any additional general guidance on OFRs which would cover

all public benefit entities? If so, what issues should be addressed? Who should prepare the guidance?

### *Principal users of OFRs*

- 6) Who should be the defining class of users of OFRs in public benefit entities? If 'funders and financial supporters' how should this be defined in particular sectors? Does any special account need to be taken of service users?

### *KPIs and external assessments*

- 7) What are the KPIs that you think should be disclosed in OFRs in particular sectors? Are there any additional assurance measures that should be applied to KPIs? Should entity-specific KPIs be allowed as well? Should guidance be provided on how external inspection reports should be discussed in OFRs?

### *Other issues*

- 8) Are there any issues relating to the publication of OFRs by public benefit entities that have not been covered in this discussion paper? Do you have any further comments on the matters raised in this paper?