Developments in environmental reporting and the rise of environmental and social governance

Why should law and business consider these issues?

Colleen Theron *Director, CLT Envirolaw*[1]

Introduction

The shifting global economic and environmental landscape is challenging the role of governments, civil society and businesses. The ripples of Hurricane Sandy[2] are still discernible and the uncertainty surrounding financial markets and climate change has heightened expectations for the need of good governance, transparency and ethical business.

Businesses can no longer deliver products or services, turn a profit, publish their annual reports and be considered model organisations. The perception is that they must operate in a responsible, sustainable and ethical manner that is transparent and contributes to the communities in which they operate. This applies not only to multinational companies but also to small and medium-sized enterprises (SMEs). Lawyers advising companies about their affairs need to understand these shifts and be able to address them, particularly as the law increasingly requires company directors to understand their reporting and other obligations, as well as how to implement them.

International trends in reporting

Public reporting is essential for improving the impact of business activity. It is a vehicle for greater transparency, accountability and building trust between companies and their stakeholders.[3] Reporting requirements have become more prominent. Where businesses operate in more than one jurisdiction the compliance burden is increasing.

Environmental concerns are one of a number of factors (such as heightened expectations of governance) that has changed the way that businesses operate and what they should disclose about their operations. Regulation is no longer the main driver of social/environmental externalities. A market driven model taking up these issues can create havoc for companies, especially in the current networked world of Facebook, twitter, LinkedIn and other social media.[4]

The issues

Traditional reporting is viewed as being too narrow, focusing merely on historical financial performance. As a result new reporting requirements have been created through laws, regulations, standards, codes, guidance and stock exchange listing requirements. However, these developments have been fragmented. The result is that the reporting landscape is considered to be confusing and cluttered. There is also a lack of a universal format that makes it difficult to assess relative performance.

Although there has been an explosion of 'extra-financial' reporting on sustainability in response to greater interest on the part of stakeholders, this lack of universal formatting makes performance ever more opaque. Another challenge in reporting is materiality, ie prioritising the issues deemed significant enough to be covered and explaining how stakeholder engagement has informed the process.[5]

The UK Department for Environment, Food and Rural Affairs (Defra) commissioned a report to look at the environmental disclosures in the statutory annual reports and accounts of FTSE All Share companies. The 2010 report found that disclosure levels and the quality of information provided varied significantly even within sectors.[6] The most significant finding was that very few disclosures are comprehensive or enable stakeholders to assess environmental risks or opportunities facing a company.

So why report?

Questions as to why companies report on their sustainability performance, why investors care and how far existing approaches to reporting meet their needs are common.

However, reports indicate that companies that do measure, manage and report their environmental (and other) impacts help to deliver broader business goals such as cost savings, productivity gains, regulatory compliance, business continuity and a stronger position in the market place and lower costs of capital.[7]

1 CLT Envirolaw (setting standards for sustainability) http://clt-envirolaw.com/. The author would like to thank Deidre Lyons for her contribution to this article.

2 Hurricane Sandy devastated portions of the Caribbean, the Mid-Atlantic and Northeastern United States during late October 2012.

3 http://198.170.85.29/Discussion-paper-reporting-7-Aug-2006.pdf.

4 See Deloitte 'Integrated reporting: a better view?' available at http://www.deloitte.com/view/en_GX/global/services/sustainability-and-climate-change/110db00aea282310VgnVCM100000 1a56f00aRCRD.htm.

5 Accountability 'Redefining materiality' available at www.accountability.org/images/content/0/8/085/Redefining%20Materiality%20-%20Full%20Report.pdf.

6 http://www.environment-agency.gov.uk/business/topics/performance/124795.aspx.

7 ibid.

There is also increasing awareness by companies of both the risks and opportunities of reducing indirect environmental and other impacts from their supply chains. Since the 1990s investors have started to attach importance to environmental information and increasingly are also requesting additional and better disclosures in annual reports and accounts.[8]

Sustainability reporting on environmental, social and governance (ESG) performance has been around since the 1980s. Companies were driven by a variety of reasons to undertake environmental reporting, including progressive environmental practices, the desire better to portray their services, or were spurred on by the threat of litigation that surrounded waste sites, environmental disasters and the like.

Reporting developments within the EU

The European Commission has published a new definition of and agenda for corporate social responsibility (CSR) as part of a package of measures on responsible business. The definition of the term is 'the responsibility of enterprises for their impacts on society'.[9] This is a stronger definition than the previous one[10] and the EU Commission highlights that it is consistent with internally recognised CSR principles and will contribute to greater global consistency in the expectations of business. Further, the EU intends 'to improve company disclosure of social and environmental information: the intention is to bring forward a new legislative proposal on this issue'. The proposed changes to the Transparency Directive are also increasing reporting obligations of government payments in the extractive industry.[11]

It is clear that a more assertive approach is being taken by the EU, as set out in its agenda proposals for 2011–2014. The EU also proposes to 'monitor' the commitments of large European enterprises to take account of internationally recognised guidelines, which include the OECD Guidelines and the UN Global Compact. The agenda is in tune with the UK Department for Business, Innovation and Skills (BIS) consultation on narrative reporting.

Overview of mandatory environmental reporting

The Companies Act 2006[12]

Under the Companies Act 2006 (CA 2006) (which implements the requirements of the EU Accounts Modernisation Directive) the directors of a company must prepare a directors' report for each financial year (CA 2006 ss 415–18). Unless the small companies exemption applies the report must include certain matters, including a business review.

The business review must provide a fair review of a company's business and describe its principal risks and uncertainties so that stakeholders can assess how the directors have performed their duties. The business review must include information about environmental matters to the extent necessary for an understanding of the development, performance or position of the company's business and, where appropriate, should also include analysis using key performance indicators.[13] In the case of a UK listed company, if the business review does not contain this information, it must point out the omission and state the type of information that has been left out.

A UK stock market listed company must ensure that its business review 'to the extent necessary for an understanding of the development, performance or position of the company's business' includes:

- the main trends and factors likely to affect the future development, performance and position of the company's business
- information concerning:
  - environmental matters (including the impact of the company's business on the environment)
  - the company's employees
  - social and community issues.

Defra suggests that environmental information relating to the same accounting period should be published in conjunction with the annual report and accounts.

Key aspects of the draft regulations for narrative reporting

In October 2012, the UK Department for Business, Innovation and Skills (BIS) published draft regulations setting out a new structure for narrative reporting in the UK.[14] The regulations will come into force in October 2013. The measures are aimed at improving the quality of narrative reporting. A concise, stand-alone report focused on strategy and the organisation's business model will replace the existing business review.

The regulation will make amendments to the CA 2006. Regulation 3 creates a new section 414A, which sets out the requirement for directors to prepare a strategic report replacing the business review and putting the strategic information at the front of the report. Additional reporting requirements have been created for quoted companies.

A new section 414C sets out what is required in the strategic report. Although it replicates section 417 of the CA 2006 it includes the following additional requirements for quoted companies:

8 CLT Envirolaw has prepared a user-friendly template explaining how to create a sustainability report. Download the template at www.clt-envirolaw.com.

9 See http://ec.europa.eu/enterprise/policies/sustainable-business/corporate-social-responsibility/index_en.htm, pp 242–47.

10 The previous definition of CSR was 'a concept whereby companies integrate social and environmental concerns in their business operations and in their interaction with their stakeholders on a voluntary basis'.

11 http://eur-lex.europa.eu/LexUriServ/LexUriServ.douri=OJ:L:2004:390:0038:0038:EN:PDF.

12 For more detail on this see C Theron 'The impact of sustainability and corporate social responsibility on company reporting' (2010) 22 ELM 23–27.

13 http://www.legislation.gov.uk/ukpga/2006/46/section/417.

14 http://www.bis.gov.uk/Consultations/future-of-narrative-reporting-further-consultation.

- *Strategy and business model*: quoted companies are required to report on their strategy and business model in their strategic report.
- *Human rights issues*: section 414C(4)(d)(iii) includes an explicit requirement that human rights issues be considered (to the extent necessary for an understanding of the development, performance or position of the company's business) in the report.
- *Diversity on the board and beyond*: section 414C(5) and (6) requires that the number of women on the board, in senior executive positions and in the entire organisation be disclosed.

The regulations apply to all companies except small companies. However, they do not require an increase in the level of audit or assurance that applies to reporting, as it was felt that there was no real business appetite for this. The UK Government has retained the provisions that companies employing more than 250 people are to report on how they involve employees through giving them information, consulting them and through share schemes. The rationale behind this is to encourage employee engagement.

Key performance indicators

The business review must include a financial key performance indicators (KPIs) analysis and, where appropriate, analysis using other key performance indicators, such as environmental and employee matters. However, where a company qualifies as medium-sized in relation to a financial year, the directors' report for the year is not required to comply with these requirements in so far as they relate to non-financial information.

A KPI is a tool for measurement. In the context of environmental KPIs they are quantifiable measures that reflect the environmental performance of an organisation in the context of achieving its wider goals and objectives.

Defra has published guidance on KPIs and how to use them in reporting. An informal consultation opened in July 2012 to seek views on revised voluntary guidance and how UK organisations should measure and report on their environmental impacts. The guidance is intended to replace the current guidance. The guidance is in response to the UK Government's commitments set out in the Natural Environment White Paper.[15]

Accounting standards

Companies preparing financial statements must apply accounting standards. They can use International Financial Reporting Standards (referred to as IFRS, and prepared by the International Standards Board (IASB)) or the UK Generally Accepted Accounting Principles (GAAP). A recent study[16] investigated whether the level of environmental disclosure under IFRS is related to the size of the reporting organisation or the strength of legal and regulatory constraints on environmental disclosures in the country where the organisation is domiciled. Results indicate that organisations domiciled in countries with constraining environmental disclosure regulations (France and the UK) report more on environmental issues than organisations domiciled in countries with weak regulations.

Despite numerous studies devoted to voluntary disclosure of environmental information, much less attention has been paid to environmental disclosure by accounting standards in general and IFRS in particular. Although there are no international accounting standards exclusively dedicated to environmental issues, several standards have explicit or implicit provisions related to the recognition, measurement and reporting of environmental expenses, assets and liabilities.[17]

Under FRS 12[18] (an IFRS standard), companies must make provision in their accounts for contingent liabilities if the possibility of an outflow of economic benefit to settle the obligation is more than remote. It is therefore possible that a company will have to disclose the financial impact of certain environmental liabilities. For example, a company should make provision in its accounts where legislation requires clean up of contamination.

The equivalent standard under IFRS is IAS 37.[19] Both the ASB and IASB are currently reviewing FRS 12 and IAS 37.

Some examples of IAS standards are set out below:

- *IAS 1 Presentation of financial statements*
  IAS 1 sets out the basis of general purpose financial statements.[20] Their objective is to provide information about the financial position, financial performance and cash flows of organisations. The financial statements will include information on environmental liabilities and environmental expenses and will also contain remarks on additional information and reporting to provide stakeholders with a comprehensive view of the organisation's environmental and social impacts.
- *IAS 12 Income taxes*
  This standard prescribes the accounting treatment of income taxes. The general principle of the standard is that deferred tax liabilities and assets should be recognised for taxable/deductible temporary differences (subject to some exceptions); for example, when the carrying amount of an environmental asset is bigger than its taxable base.

15 Defra 'Reporting guidance on environmental key performance indicators: a consultation on guidance for UK businesses' (July 2012) available at www.defra.gov.uk/consult/files/consult-kpi-document.pdf.

16 Barbu et al 'Mandatory environmental disclosures by companies complying with ISA/IFRS: the case of France. Germany and the UK' available at http://halshs.archives-ouvertes.fr/docs/00/65/84/09/PDF/Barbu-Dumontier-Feleaga_WP-CERAG.pdf.

17 ibid p 25.

18 http://www.icaew.com/en/technical/financial-reporting/uk-gaap/uk-gaap-standards/frs-12-provisions-contingent-liabilities-and-contingent-assets.

19 http://www.iasplus.com/en/standards/standard36ons-contingent-liabilities-and-contingent-assets.

20 http://www.iasplus.com/en/standards/standard5.

- *IAS 16 Property, plant and equipment*[21]
  Some assets may be acquired for safety or environmental reasons. The acquisition may be necessary to ensure that the operation of fixed assets is not compromised; for example, the necessity to introduce new processes to certain operations in order to comply with current legal requirements for operational improvements. The resulting operational improvements are capitalised as environmental assets as the organisation would not be able to sell or market its products without these processes. IAS 16 also requires the incorporation of future dismantling and decommissioning costs into the value of fixed assets.
- *IAS 32, IAS 39, IFRS 7 and IFRS 9 on financial instruments*
  These standards are linked to present and future risks emerging in cases such as hedge accounting, the measurement of environmental derivatives and the treatment of other financial elements occurring as a result of environmental impacts.
- *IAS 37 Provisions, contingent liabilities and contingent assets*
  The standard provides details on the recognition and measurement of the provisions, contingent liabilities and contingent assets of an organisation.

Climate Change Act 2008

The UK Government is introducing regulations on mandatory reporting of greenhouse gas (GHG) emissions for quoted companies under the Climate Change Act 2008 (CCA 2008 s 85).[22] The new regulations will be introduced in April 2013 (subject to the consultation on narrative reporting, in which case the introduction of the regulations could coincide with an implementation date of October 2013).[23] A review to include large companies will be made in 2015.

The regulations are aimed at quoted companies and cover all GHG emissions that are released into the atmosphere and are attributable to human activity. GHG emissions cover carbon dioxide, methane, nitrous oxide, hydrofluorocarbons, perfluorocarbons and sulphur hexafluoride.

The relevant information must be disclosed annually. The UK Government is proposing that the first reporting year will be for the company's first financial year ending after 6 April 2013. The information for the first year's emissions must be repeated each year so that the company's emissions are comparable and allow progress in emissions management to be transparent.

The obligation would fall on all companies that prepare directors' reports. Directors of quoted companies are required to report on environmental matters as part of the business review under the CA 2006 s 417. The draft regulations require that the directors' report must state the annual quality of emissions in tonnes of carbon dioxide equivalent resulting from a number of specified activities undertaken by the company.

As the regulations are made under the CA 2006, the Conduct Committee of the Financial Reporting Council will carry out enforcement of these provisions. The council monitors annual reports and accounts of public and large private companies for compliance with the requirements of the CA 2006. It has the power to apply to the court under section 456 for a declaration that the annual report or accounts of a company do not comply with the requirements of the Act and for an order requiring directors to prepare a revised report or set of accounts.

Defra and the Department of Energy and Climate Change (DECC) have published guidance for companies and organisations on how to measure and report their GHG emissions, as required by CCA 2008. Defra's reporting guidance is based on the Greenhouse Gas (GHG) Protocol.

Stock exchange disclosure rules and dual listings

Stock exchanges globally have been implementing initiatives related to sustainability and such efforts are increasing every year.[24] The stock exchanges of France, Denmark, the Netherlands and South Africa require reporting on non-financial dimensions, although with varying degrees of enforcement.

The UK Listing Authority currently has no plans to introduce environmental reporting rules beyond the requirements for business reviews under the EU Accounts Modernisation Directive. Companies that are also listed in the stock markets of other countries will have to comply with local listing requirements for financial reporting to include sustainability issues. Several stock exchanges are strengthening sustainability requirements for listed companies.

However, the FTSE4Good Index[25] is among several sustainability indices that include criteria for companies to report on environmental issues. Mandatory rules and guidance that require companies to report on environmental performance outside of the UK create a further driver for disclosure.

Overview of voluntary reporting

The financial crisis has reinforced focus on the 'triple bottom line' (environmental, social and economic performance). The aim of CSR[26] reporting is to measure, dis-

21 www.ifrs.org/Documents/IAS16.pdf.
22 http://www.defra.gov.uk/consult/2012/07/25/ghg-reporting-draft-regs/. Also see CLT Envirolaw for a user guide template to prepare the report.
23 http://www.defra.gov.uk/consult/2012/07/25/ghg-reporting-draft-regs/.
24 See 'Sustainable stock exchanges; real obstacles, real opportunities' available at http://www.responsibleresearch.com/Responsible_Research_Sustainable_Stock_Exchanges_2010.pdf.
25 http://www.ftse.co.uk/About_Us/FTSE_Corporate_Responsibility/FTSE4Good.jsp. The FTSE4Good series was launched in response to growing investor demand for socially responsible investment (SRI) indices and products.
26 CSR is sometimes used as a synonym for sustainability, although it often omits other elements. For example, it may be focused solely on social impacts, fail to refer to environmental issues or focus on a company's image, thus bypassing the strategic elements.

close and account to internal and external stakeholders of an organisation the company's environmental, social and economic performance. Many companies now publish separate CSR reports, independent of their statutory annual reporting requirements. As noted elsewhere in this article, companies may choose to report on environmental matters for a number of reasons:

- reporting is seen as good business
- investor and stakeholder demands
- supply chain and procurement pressures
- NGOs and consumers.

There are a growing number of international guidelines, standards and initiatives to assist companies in developing their sustainability policies.[27] International standards such as ISO26000[28] provide guidance for organisations on how to implement better environmental and social programmes. Such standards are intended to encourage organisations to go beyond legal compliance. Other guidance for companies on sustainability reporting and disclosure are:

- the Carbon Disclosure Project (CDP)
- Defra's KPIs
- UN Principles of Responsible Investment (PRI)
- the Global Reporting Initiative (GRI)
- UN Global Compact
- OECD Guidelines for Multinational Enterprises
- The Equator Principles.

Integrated reporting

Whilst most corporate responsibility reports are stand-alone documents and are separate from the annual report and accounts (AR&A), increasingly companies are combining non-financial aspects into their AR&As and the best are integrating them fully, rather than including only a small section of non-financial information.

In recognition of the shortcomings of existing reporting models and driven by an urgent need to find more effective reporting solutions, the spotlight is turning on integrated reporting. Integrated reporting is 'a holistic and integrated representation of the company's performance in terms of both its finance and its sustainability'.[29] A central integrated reporting objective is to enable stakeholders to assess an organisation's ability to create and sustain value over the short, medium and long term, and provide stakeholders with a 'concise overview of an organisation, integrating and connecting important information about strategy, risks and opportunities and relating them to social, environmental, economic and financial issues'.[30]

Integrated reporting seeks:[31]

- to support investors' information needs, by illustrating the broader and longer-term consequences of decision-making
- to reflect the interconnections between environmental, social, corporate governance and financial factors in decisions that affect long-term performance conditions, making clear the link between sustainability and economic value
- to provide the necessary framework for environmental and social factors to be taken into account systematically in reporting and decision-making
- to rebalance performance metrics away from an undue emphasis on short-term financial performance and
- to bring reporting closer to the information used by management to run the business on a day-to-day basis.

Benefits of integrated reporting

Within this context, integrating reports should:[32]

- reflect the extent to which:
  - the organisation's governing structure has applied its collective mind in identifying and addressing the social, environmental, financial and economic issues that impact the organisation
  - these issues have been integrated into the organisation's strategy
  - a systematic process exists to take into account material financial, social, economic, environmental and governance issues in the organisation's strategic decision-making, in determining its key performance and risk indicators, and in reviewing and reporting on its performance and
  - performance metrics adopt a more forward-looking and holistic perspective without an undue emphasis on short-term financial performance
- respond to stakeholders' information needs by providing sufficient material information about the organisation's performance
- provide high-level information about the organisation's existing resources, any claims against it, and how efficiently and effectively the organisation's executive team and governing structure have discharged their responsibilities to use the organisation's resources responsibly.

Integrated reporting is a challenge to conventional reporting. It calls into question the efficiency of markets based on current reporting standards and the efficiency of markets in serving society.[33]

27 For more detail on this see C Theron (n 12).
28 http://www.iso.org/iso/home/standards/iso26000.htm.
29 'Framework for integrated reporting and the integrated report – Discussion Paper' 25 January 2011 https://www.globalreporting.org/information/.
30 Framework report p 3.
31 International Integrated Reporting Council (IIRC) http://www.integratedreporting.org/node/3.
32 Framework report p 5.
33 David Wood 'What should be done with integrated reporting?' Director, Initiative for Responsible Investment, Harvard Kennedy School of Government.

Rise of ESG

ESG (environmental, social and governance) is a generic term used in capital markets and is used by investors to evaluate corporate behaviour to determine the future financial performance of companies. This is sometimes also referred to as the 'triple bottom line'.

Key to environmental and social governance is how a company manages its environmental and social impacts, risks, performance and opportunities. Whilst traditionally financial indicators only appeared in reports, recently reports have seen the growth of sustainability reporting and the acknowledgement that 'intangible' values that do not always appear in company accounts are very likely to have a financial impact. An example of these 'intangible indicators' are reputation, innovation, competitive advantage and risk avoidance.

Studies indicate that there is strong evidence that where a company has sound environmental governance policies, practices and performance, it is highly likely to result in improved financial performance.[34] Companies seeking to identify opportunities to improve business performance and their market position should follow the continued interest and developments in this area.

What do businesses and directors need to do?

To the extent that reporting is a mandatory legislative requirement, companies and their officers need to identify and understand what they are required to report on and decide on the structure of the report. Facility managers may have to engage top executives and the board. Other steps that should be considered are:

- identifying audience and KPIs for activities in their relevant business sectors
- establishing annual measurement and reporting processes
- to collect and standardise data
- to decide on whether to verify data
- reporting on relevant KPIs in business reviews (Defra report)
- assigning a 'point person'
- understanding how to map sustainability risks
- to consider if the company's compliance structure is correct
- consulting with stakeholders
- ensuring compliance with human rights issues
- to seek guidance from experts.

Conclusion

There can be no doubt that sustainability has become an important priority for many businesses across Europe and that the growth in voluntary and mandatory reporting on environmental and social issues will continue to drive change in companies to measure and report on their environmental and social impacts.

The core message, however, is that sustainability is good for business – not only does it appeal to customers' changing values but it strengthens relationships with suppliers and impacts on the positioning of a brand, reduces costs of running a business and will therefore drive profitability. The challenge globally will be in adopting common frameworks to enable businesses and investors to apply similar standards.

Reporting disclosures have traditionally focused on a company's financial position, including a company's financial risks. Sustainability risks, however, also affect a business's finances, as there are potential environmental and social liabilities and reputational risks. Increasing disclosure of sustainability is not only being driven by mandatory reporting requirements but is increasingly demanded by stakeholders and, in particular, by investors. Therefore, although many companies only see the 'push' of government regulations, they should really start focusing more on the 'pull' of stakeholder recognition.

34 Environment Agency 'Corporate environmental governance' (2004) http://a0768b4a8a31e106d8b0-50dc802554eb38a24458b98ff72d550b.r19.cf3.rackcdn.com/geho0904bkfe-e-e.pdf.