The impact of sustainability and corporate social responsibility on company reporting

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Introduction

The recent impact of the volcanic ash spill on business and communities in the United Kingdom, EU and northern America is a timely reminder of the era in which companies have to operate. Challenges such as climate change, HIV/AIDS, water scarcity and poverty are unprecedented. These sustainability challenges have reached a point where business is being asked, and expected by the communities they operate in, to respond, often in the absence of government intervention.

Less than 10 years ago environmental risk and compliance issues gave rise to a greater demand for corporate transparency and new, more stringent governance and financial disclosure requirements.[2] In the United States, the passage of the Sarbenes-Oxley Act placed more emphasis on environmental disclosure. In the United Kingdom, the reform of the Companies Act requires the directors of all companies, except small ones, to produce a business review that sets out how directors have taken into account the impact of the company's operations on the community and the environment.[3]

In 2005, Trucost[4] reported that only 5 per cent (18 companies) of FTSE 350 companies linked environmental issues to financial performance. This has increased to 34 per cent.[5] The requirement that directors have to report on the environmental impacts of their company inevitably raises the challenge of relating environmental policy, management and performance directly to the core management and financial performance of the business, issues that were previously linked to the concept of corporate social responsibility (CSR).

Mandatory reporting

The notion that business operations should be more transparent, particularly in respect of their environmental impact, is evidenced by the enormous growth in legislative reporting requirements. For example, companies are required to report on their overall impact on the environment under the Companies Act 2006, the Climate Change Act 2008 and where their businesses are regulated by a specific environmental regime such as the EU Emissions Trading Scheme (EUETS) and the CRC Energy Efficiency Scheme (CRC). The US Securities and Exchange Commission (SEC) also has stringent reporting requirements.

Companies Act

Under the Companies Act 2006 s 415, all companies have to prepare a directors' report for each financial year. This report must include a business review. The business review must provide a fair review of the company's business and give a description of the principal risk and uncertainties facing the company so that the shareholders can assess how the company's directors have performed their duties.

Section 417(5) sets out the reporting requirements for quoted companies. They are to provide:

- information about environmental matters (including the impact of the company's business on the environment) and
- information about any company policies relating to environmental matters and the effectiveness of those policies.

Section 417(6) requires that the review must include an analysis using financial key performance indicators (KPIs) and, where appropriate, analysis using other KPIs, including information relating to environmental and employee matters. Defra has published guidance on KPIs and how to use them in reporting.[6] It suggests that three key principles should be followed by companies to provide assurance to the business and its stakeholders that appropriate processes and procedures have been followed. These are:

- transparency
- accountability
- creditability.

Defra suggests that environmental information should be published at the same time as the annual report and

1 Colleen Theron is an environmental lawyer and consultant and also works for LexisNexis.
2 Colleen Nelson 'Corporate Behaviour: How Environmental Risk and Corporate Governance are Shaping Change or Are They?' (2005) 17 ELM 66–8.
3 Companies Act 2006 s 172(1) and commentary in Colleen Theron 'Environmental Disclosures under the New Companies Act' (2008) 20 ELM 84–7.
4 Trucost is an organization created in 2000 to help investors and organizations understand the environmental impacts of business activities http://www.trucost.com/products.asp?sectionID=1&pageID=2.
5 http://www.sustainabilityreporting.eu/viewreport.php?id=45.
6 Defra 'Environmental Key Performance Indicators: Reporting Guidelines for UK Business' at http://www.defra.gov.uk/environment/business/reporting/pdf/envkpi-guidelines.pdf.

accounts and relate to the same accounting period. The convergence of annual reports and CSR reports will no doubt become more evident following the business review requirements under the Companies Act 2006.

Accounting standards

When companies are preparing financial statements they can apply accounting standards. Most companies prepare their accounts in accordance with Generally Accepted Accounting Principles (GAAP) or the International Financial Reporting Standard (IFRS), prepared by the International Accounting Standards Board (IASB). In the United Kingdom, under FRS12 companies must make provision in their accounts for the financial impact of certain environmental liabilities, for example, where clean up of contamination is required under legislation. The equivalent standard under IFRS is IAS 37. Both the Accounting Standards Board (ASB) and the IASB are currently reviewing FRS12 and IAS 37.

Pension funds

Since 1995, UK pension fund trustees have been required to disclose the extent to which they take environmental issues into account in their investment decisions.[7] They are required to disclose their policies in considering social, environmental and ethical matters in selecting, retaining and realizing investments. These disclosures are made in the Statement of Investment Principles that has to be prepared and maintained. Underlying this requirement is the trustees' obligation to maximise financial returns for their beneficiaries. The conflict between the duty to maximise profits and the extent that pension fund trustees should invest ethically is arguably the result of greater interest in sustainability issues. In 1984, the court decided in *Cowan v Scargill*[8] that trustees' primary concern must be to maximise financial returns for beneficiaries. A joint report[9] produced in 2005 by the United Nations Environment Programme Finance Initiative (UNEP FI) and Freshfields Bruckhaus Deringer LLP argued that the decision in this case was wrong and that institutional investors can integrate environmental, social and governance issues (ESG) into investment decisions. This would result in a more reliable prediction of financial performance.

A follow up report was produced by UNEP FI in 2009, providing more commentary on trustees' fiduciary duties to integrate ESG issues into investment decisions.[10] The key element of this report is a growing emphasis on the integration of social and governance issues in decision making, beyond environmental impact alone.

In 2006, UNEP FI and the UNEP Global Compact launched a set of voluntary principles called the Principles for Responsible Investment (PRI). These provide a framework for institutional investors, including pension fund investors, to integrate environmental, social and corporate governance issues into their investment decisions. The follow up report by UNEP FI states that the market impact of the voluntary instruments should not be underestimated. In practice, they are applied widely by their signatories throughout the financial sectors where they have been adopted.[11]

The interest in robust corporate disclosure by investors has been gathering momentum. In the United States, though the Ceres Investor Network on Climate Risk, over 40 institutional investors have asked regulators, including the SEC, to provide better guidance to companies on disclosure of key ESG issues and climate change and water scarcity.[12] In January 2010, the SEC acted on these requests issuing guidance to companies clarifying what publicly traded companies need to disclose to investors in terms of material climate-related risks and opportunities, including physical risks such as water scarcity.[13]

The CSR/sustainability influence

The financial and economic crises, coupled with the perceived increase of the impact of natural catastrophes, have prompted companies to have to move away from a 'business as usual' model. The move toward aligning financial interests with environmental objectives has also been driven by stakeholder activism and investors. Recently, the European Commission has reported that the debate on responsible corporate behaviour in the context of CSR is going to be revived at commission level,[14] after years of stagnation. They are looking at whether CSR reporting should become mandatory.

The concept of 'sustainability 'is often used interchangeably with the concept of CSR at corporate levels, but clarity on the differences is important for the way business behaves. The European Union started to develop the concept of CSR in 2000/2001 in line with the strategy adopted in Lisbon in 2000. The so-called Lisbon objective called on the EU to become the foremost economy in the world, focusing on sustainable economic growth and greater social cohesion by 2010.[15] The EU's

7 Pensions Act 1995 s 35.
8 *Cowan v Scargill* [1984] 2 All ER 750. The fiduciary duty of trustees investing in a pension scheme for miners was challenged on grounds that objections were raised to the proposed investments of the funds.
9 'A Legal Framework for the Integration of Environmental, Social and Governance Issues into Institutional Investment' (October 2005).
10 'Fiduciary Responsibility: Legal and Practical Aspects of Integrating Environmental, Social and Governance Issues into Institutional Investment' (July 2009).
11 ibid Ch 7 Pt I 'Legal commentary on fiduciary duty and the implementation of ESG in investment mandates'.
12 For further discussion on this see http://www.lexisnexis.com/Community/environmental-climatechangelaw/blogs/environmentallawandclimatechangeblog/archive/2010/04/27/cop15-will-not-change-climate-change-reporting-requirements-for-companies.aspx.
13 US SEC 'Commission Guidance Regarding Disclosure Related to Climate Change' Release Nos 33-9106, 34-61469, FR-82 (Feb 2 2010) www.wec-gov/rules/interp/2010/33-9106.pdf.
14 EurActive news release 'Corporate Responsibility: Back on the EU Agenda' (published 7 February 2007 updated 2 April 2010) www.euractiv.com/en/print/socoa;europe/csr.
15 T Lowe and others 'Significance of the CSR Debate for Sustainability and the Requirements for Companies' (future e.V. and Institute for Ecological Economy Research GmbH (IÖW) 2004).

sustainability strategy is also tied up with the Lisbon objective. From a business perspective CSR came first and was primarily concerned with social matters. Sustainable development emerged from the environmental protection debate. The Brundtland Commission concluded that social, ecological and economic concerns must be given equal weight. CSR tends to be restricted to ecological and social challenges and economic contributions to sustainability are not considered in detail. Thus, whilst the concepts overlap they are applied differently.

The concept of 'sustainable development' is not always interpreted in the same way by different countries. The standard definition is the one contained in the Brundtland Commission's report, namely 'Sustainable development is development that meets the needs of the present without compromising the ability of future generations to meet their own needs'.[16]

Whilst the concept of CSR broadly stems from the concept of sustainable development with an initial objective of accountability, it still largely appears to be an evolving paradigm. Essentially it is a means that companies use to measure, manage and communicate their environmental performance to investors and the general public. For many companies, in the United Kingdom and globally, CSR has become a key feature of business strategy. Over 1,000 companies worldwide that currently report on their environmental performance can be found listed on CorporateRegister.[17] The website provides the world's largest online directory of CSR and sustainability reports.

Producing CSR reports makes companies focus beyond the compliance agenda on ethical, social and environmental issues. The globalization of the economy has also led to the increase in companies across the world producing CSR reports and looking at how they can operate sustainably.

Sustainability, in the context of the business world, is used to refer to how environmental, social and economic considerations are integrated into corporate strategy and capital markets for the long term. Ceres[18] states that the 'licence to operate' can no longer be taken for granted by business. Companies, they suggest, cannot consider sustainability challenges in isolation. A recent PricewaterhouseCoopers survey of 140 chief executives of US-based multilateral companies found that 85 per cent of them believe that sustainable development will be even more important to their business model in five years time than it is today.

Sustainability reporting is becoming the norm amongst large companies globally, as financial statements only capture a portion of corporate risks. In 2008, the Global Reporting Initiative (GRI)[19] reported that more than 1000 organizations worldwide had registered sustainability reports based on the GRI G3 Guidelines. As sustainability and climate change are being addressed by governments and investors, companies are being forced to pay more attention to how sustainability issues impact their business and to implement strategies and actions to enable them to participate and grow in a sustainable global economy. Notwithstanding the fundamental recognition that companies should comply with statutory provisions, the focus has remained on voluntary measures above and beyond what is required by law, but this focus is changing, particularly in Europe.

The quandary of voluntary reporting

Industry has stressed [20] that undertaking CSR reporting on a voluntary basis allows companies to find methods suitable for their own cultures and needs. On the other hand, NGOs, such as the Friends of the Earth, have claimed that social reporting, auditing and labelling are inefficient and lack credibility without standardized methods or independent monitoring. For example, definitions of CSR vary across different cultures, companies and industries. There is also the question of how CSR practice remains credible and transparent.

As a result of the financial crises there have been amplified calls by stakeholders for greater regulation, not only aimed at the financial sector but at all industries. It is recognized by stakeholders that ESG measures have a significant effect on company valuation.

Over the years a fusion of guidelines and standards has emerged to provide a framework for companies that wanted to pursue voluntary reporting. There is also body of relevant law and regulation which, inevitably, provides a certain amount of the framework for CSR/sustainability strategies, especially as regards reporting. For example, the Combined Code on Corporate Governance[21] provides that: 'The board should set the company's values and standards and ensure that its obligations to its shareholders and others are understood and met' (supporting Principle A1). Good governance includes systems of internal control to ensure that a company operates effectively and complies with legal requirements. Listed companies have to state whether they have complied with the code provisions and justify and explain any non-compliance. Although the code does not include specific recommendations on environmental matters, companies should apply the principles and consider whether they need to include systems to manage environmental risk within their internal control systems.

Many companies now publish separate CSR reports, independent of their statutory annual reporting. There are many drivers for this, such as reputation, risk

16 Brundtland Report 1987 *Our Common Future* Ch 2 'Towards Sustainable Development'? http://www.un-documents.net/wced-ocf.htm.

17 http://www.corporateregister.com/.

18 Ceres is a national coalition of investors, environmental groups and other public interest organizations working with companies to address sustainability challenges such as water scarcity and climate change. See www.ceres.org.

19 http://www.globalreporting.org. The GRI is a networks based organization that pioneered the world's most used sustainability reporting framework.

20 http://www.euractiv.com/en/print/socialeurope/csr-corporate-social-responsibility/article-153515.

21 http://www.frc.org.uk/CORPORATE/COMBINEDCODE.CFM.

management and the need to satisfy pressures from investors. In recent years, more companies have started integrating their financial and non-financial data into the same report, for instance, by adding a section on non-financial data at the end of the annual report, which raises the question whether mandatory CSR reporting will help standardize and align the way companies report on CSR issues.

Companies, however, are faced with the complexity of corporate reporting, due to increased legislation and a lack of harmonized standards globally. Making more reporting mandatory will continue to complicate things unless a uniform approach is adopted. The ASB published a report in 2009 entitled 'A Review of Narrative Reporting by UK Listed Companies in 2008/2009'.[22] The report analysed how companies are reporting on CSR in their annual reports. Its results indicated that whilst companies often provided relevant discussion of all three areas they are still struggling to explain the reason why CSR is important to their business. It appears to be more lip service than setting goals and targets in the area of CSR. Perhaps this is the reason why there is increased emphasis on adopting a sustainability approach, so that these issues become embedded in company strategy and operations.

After the European Commission's publication of a Green Paper (2001)[23] and Communication (2002) on CSR,[24]discussions have mainly focused on mandatory versus voluntary rules. In March 2007, the EU executive reaffirmed its long-held stance that CSR is a uniquely voluntary measure which should not be regulated at EU level. However, the European Commission now appears to be aligning its position close to the views expressed by NGOs.

In Denmark, the voluntary approach to CSR reporting has now become mandatory. From 2010, 1100 of the largest private and state-owned companies and institutional investors are to include corporate social responsibility information in their annual financial reports.[25] This appears to go further than the UK Company Law requirement that a business review should contain information about the company's impact on the environment and the community. The Danish model, however, encourages companies to use the international framework that already exists for CSR such as the UN Global Compact and the UN Principles for Responsible Investment.[26]

Notwithstanding the debate on the status of CSR reporting, the inclusion of sustainability into company strategies is gaining momentum as many more global companies seek to operate in line with 'best practice'.

What are the business issues?

Businesses can no longer afford to ignore the movement to establish a low carbon sustainable global economy. Corporate bottom lines will be impacted by emerging ESG issues, particularly where disclosure must now be included in financial filings. Impacts will flow from the physical risks arising from climate change, whether or not anthropogenic, or the physical and economic risks arising from the scarcity of energy and water resources, or from legal and regulatory burdens which may be imposed by reference to those risks. The overall governance and disclosure by companies relating to ESG issues must be improved. More details are required on actions and policies or assessing and managing environmental risks.

Companies face real risks in failing to get to grips with these issues. There are growing risks stemming from lawsuits or other legal actions as regulators and communities give these issues increased attention. For example, in the chemicals industry the makers of Atrazine (a weed killer banned by the United States in 2004) were sued by 43 water systems in six US states, forcing them to pay for removing the chemical from drinking water supplies.[27]

Besides the risk of litigation there are the potential costs related to physical and regulatory risks. Regulations to ensure that natural resources are protected are becoming more stringent, in line with the emphasis on sustainable development. The reputational and physical pressures are resulting in more stringent policies that could raise costs and limit industrial activity.

The growing interest of investors in these issues will also mean increased pressure to disclose and manage risks. There is a likelihood that more institutional investors will stipulate how asset managers are assessing and engaging companies on water and other ESG risks and opportunities.

Businesses that fail to recognize the pressures that could arise in their supply chain risk being able to deliver its products. Having a clear sustainability strategy in place will enable a company to understand its sustainability risks and how to manage them. For example, water demand is critical to brewing companies and water supply risks are often hidden in companies' raw material inputs. In a recent study of its agricultural supply chain, the brewing company SAB Miller found that the water footprint of its grain procurement in South Africa accounted for 98 per cent of total water used to produce a single litre of beer.[28]

Companies should also be aware of the growing trend of the global business and human rights agenda. Companies are also going to have to track their policies and operations in the local communities within which they operate.[29]

Companies that also fail to embrace the movement

22 http://www.frc.org.uk/asb/technical/projects/project0108.html.
23 'Promoting a European Framework for Corporate Social Responsibility' COM (2001) 366 final (18 July 2001).
24 'Corporate Social Responsibility – A Business Contribution to Sustainable Development' COM (2002) 347 final (2 July 2002).
25 http://www.sustainabilityreporting.eu/denmark/index.htm.
26 ibid.

27 Ceres 'Murky Waters? Corporate Reporting on Water Risk' (February 2010) 19 http:// www.ceres.org/Document.Doc?id=547.
28 ibid 17.
29 http://www.euractiv.com/en/print/socialeurope/csr-corporate-social-responsibility/article-153515.

towards more open reporting will fail to reap the benefits of wider market opportunities.[30] However, one cannot ignore the many challenges for companies concerning how to integrate sustainability into their strategies and how to report on these matters. A real issue is the lack of standardization and harmony in the reporting framework. There are also the costs to companies of implementing adequate and integrated risk management and reporting. However, many global companies are seeing improved performance and shareholder value as a reason for investments of this kind.

Conclusions

New standards and expectations are being set by business, shaped by the global climate and the challenges it is presenting. Those challenges include the influence of adopting sustainability as an approach, the development of legislation and the actions taken by investors and shareholders who want to see more transparent and accurate disclosure of companies' performance.

Companies that have not already started looking at formulating their sustainability strategy and determining how it aligns with both mandatory and voluntary reporting requirements should create a roadmap for doing this. In particular companies should be:

- assessing the company's baseline environmental and social performance.
- analyzing its corporate management and accountability structures and systems.
- conducting a materiality analysis of risks and opportunities.

They should also ensure that where any reporting requirements are to be met the information is included in the financial filings and that more detailed risk assessments are set out.

Practically, companies should also be looking at how they can set disclosure targets to reduce waste and water usage and other environmental impacts. Critical stakeholders should be engaged and supply chain risks addressed.

Those companies producing the best annual reports and CSR reports are those which grasp the connection between the non-financial data and their business. As a result, these companies have fully integrated non-financial data with financial data in their reports. The trend towards mandatory CSR reporting will continue to shape these challenges, as will the issue of sustainability.

It is not only companies that should be thinking about these issues. Lawyers should be thinking more about the implications for their clients and looking for opportunities to advise and steer on these matters. In particular, there needs to be a merger of national and local developing legislation with international standards and frameworks.

30 The SustAinability report 'Tomorrow's Value' (2006) sets out how current evidence links economic value with sustainability reporting http://www.sustainability.com/researchandadvocacy/reports_article.asp?id=865.