# Environmental disclosures under the new Companies Act

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## Introduction

When the UK Government proposed a new Statutory Operating and Finance Review (OFR) in 2004, it introduced the notion that directors would be required to account for their performance in a number of areas and which would include the provision of more detail on a public company's environmental affairs. The OFR contained the idea that for the first time in UK company law, non-financial issues such as environmental, social and employee factors would have to be considered in addition to more traditional the financial issues.[1] As a result many listed companies were well ahead with their preparations for the first statutory OFRs (which were due to start progressively from April 2006); investor bodies such as the ABI and the National Association of Pension Funds, welcomed it. Non-governmental organisations saw it as a first step towards more effective corporate reporting on non-financial performance; the fear of increased litigation risk for directors had been effectively addressed and there was little apparent business opposition. When the requirement to produce an OFR was scrapped by Gordon Brown in November 2005 both companies and investors were taken by surprise and there was a subsequent legal challenge by Friends of the Earth which claimed the government should have consulted before repealing the regulations. The abolition of the OFR led to considerable confusion as it left the impression that large companies no longer need to report on their environmental performance.[2]

Currently all UK listed companies are required to file annual reports and accounts with Companies House. The Accounting Standards Board (ASB) set the accountancy standards and they publish Financial Reports Standards (FRS). From 2005 all listed EU companies are required to report in accordance with International Accounting Standards.[3]

In the UK there are no explicit reporting standards requiring a company to disclose information on environmental issues in its annual report and accounts, although a company with environmental provisions or contingent liabilities is required to disclose the amount and circumstances surrounding them under FRS 12. Under FRS 10 (recognition of tangible and intangible assets) and FRS 11 (impairment of assets) a company is obliged to account for changes to asset values stemming from environmental factors, where it is of the opinion that such factors are materially relevant.

## EU Accounts Modernisation Directive

Despite the government's abolition of the OFR, companies are required to meet similar environmental requirements for the business review under the EU Accounts Modernisation Directive (EU AMD), which is the underlying legislation that the OFR sought to implement in the United Kingdom.[4] This directive, which is effective for financial years beginning on or after 1 April 2005, requires a mandatory addition to the directors' report (an Enhanced Directors' Report (EDR)). Large companies (quoted and unquoted) must produce an EDR with a 'fair review' of the business of the company and should report relevant environment and employee matters using key performance indicators (KPI) to the extent necessary for an understanding of the development, performance or position of the business of a company. The enforcement structure for the EU AMD is similar to that of the abandoned OFR and the Companies Act, namely it is the ultimate responsibility of the company directors to sign off the EDR.

In addition to the existing reporting requirement, from 1 October 2007, the requirement to produce a business review as an element of the directors' report is contained in s 417 of the Companies Act 2006. The obligation does not extend to small companies.[5] Despite this obligation under the EU AMD, Trucost found that only 9 per cent

1 C Nelson 'The Operating Financial Review – What Impact Will it Have on Environmental Disclosure?' (2004) 16 ELM 301.
2 EA report 'Environmental Disclosure in the FTSE All Share First 100 FTSE All Share Companies to Report Under the New Company Law Reporting Requirements' November 2006.
3 Trucost, Environment Agency 'Environmental Disclosures' July 2004 available at http://www.environment-agency.gov.uk p 13.
4 FSN 'Business News for Finance and IT Professionals' 29 May 2006.
5 A small company must satisfy two of the following criteria: (1) have a turnover of not more than £5.6m (2) a balance sheet total of not more than £2.8m (3) have less than 50 employees.

of 161 listed UK Companies had heard of the EU AMD.[6] Under the revised Companies Act, large companies must include, where appropriate, in their business reviews, information relating to environmental matters. Quoted companies must, to the extent necessary for an understanding of the development, performance or position of the company's business, include (inter alia) the following.

- The main trends and factors likely to affect the future development, performance and position of the company's business (s 417(5)(a)).
- Information about environmental matters (including the impact on the company's business on the environment), the company's employees, social and community issues (s 417(5)(b)).
- Information about persons with whom the company has contractual or other arrangements which are essential to the business of the company (s 417(5)(c)). Effectively disclosure of risks down supply chains.
- Information about any company policies relating to environmental matters and the effectiveness of those policies.[7]

Environmental matters include a company's impact on the environment, as well as how the company is managing or intending to manage those impacts. This information must include details of company policies relating to those environmental matters and the effectiveness of those policies. Trucost states that disclosures relating to environmental policy, management and performance are more often linked to the concept of Corporate Social Responsibility (CSR) rather than being an integral part of the core management and financial performance of business.[8]

## The business review

Since the repeal of the requirement to produce an OFR, the content of the business review element of the directors' report has come under much scrutiny. Under the 2006 Act the business review is now given a statutory purpose. This purpose is to inform the members of the company and help them assess how the directors have performed their duty under s 172. The government has indicated in the explanatory notes to the Act that the non-exhaustive list provided in s 172 of the things that a director should consider merely highlights areas of particular importance which reflect wider expectation of responsibility.[9] The duty codifies the current law and enshrines what is commonly referred to as the principle of 'enlightened shareholder value'.[10]

Section 172(1) of the Companies Act 2006 provides that when considering how to act in a way that would be most likely to:

> … promote the success of the company for the benefit of its members as a whole, a director must have regard to:
> (a) the impact of the company's operations on the community and the environment
> (b) the desirability of the company maintaining a reputation for high standards of business conduct.

The review has to include the contents specified in s 417(3),(4),(6) and (8). There are additional requirements for quoted companies. The review must be fair and contain a description of the principal risks and uncertainties facing the company. For companies with securities admitted to trading on a regulated market, the Transparency Rules include additional requirements for the publication of financial information to give a fair review of the company's business.[11]

In order to facilitate analysis and reporting in a style familiar to that of the financial community, Trucost and Defra published a set of guidelines to make it easier for companies to report in a uniform manner. The guidelines, 'Environmental Key Performance Indicators – Reporting Guidelines for UK Business',[12] were produced to help businesses address their most significant impacts and report on these in a way that meets the needs of their shareholders and other stakeholders.

The key provision setting out the contents of the business review is s 417. The underlying purpose of the review is to inform members of the company and help them assess how the directors have performed their duty under s 172.

Section 417(5) requires that quoted companies must include information on trends and factors likely to affect the future development, performance and position of the company's business and information about environmental issues, the company's employees, social and community issues.

Quoted companies have a forward-looking element to their business whereas the business reviews of unquoted companies look back over the past year. As a result of directors' fears (associated with having to make forward-looking disclosures), safe harbour provisions were introduced in s 463. There is a notion that the inclusion of forward-looking statements, which are inherently uncertain and difficult to verify, will lead to the inclusion of cautionary language to qualify the degree of reliance that shareholders should place on these statements.

6 Trucost, Press release 8 December 2007 http://www.trucost.com/uksurvey.html.
7 PLC Corporate 'Business Review' October 2007 p 7.
8 Trucost, Environment Agency (n 3) 1.
9 These notes received royal assent on 8 November 2006. The explanatory notes prepared by the DTI do not form part of the Act but are to be read in conjunction with the Act.
10 Companies Act 2006 explanatory notes p 50.
11 Practical Law Business Review 1 October 2007 http://www.practicallaw.com/7-203-5631.
12 Defra, Trucost 'Environmental Key Performance Indicators Reporting Guidelines for UK Business' 2006 available at http://www.defra.gov.uk/ENVIROMENT/business/index.htm.

Where directors of quoted companies have nothing to report on environmental, employee, social and contractor issues the review must state this to be the case (s 417(5)), the implication being that environmental matters are not a significant issue for their business. Information about a contractor need not be disclosed if to do so would be seriously prejudicial to the contractor and contrary to public interest (s 417(11)).

Practically speaking, directors will have to keep adequate records in relation to the preparation of the business review in case evidence is required of how the review was compiled and to demonstrate that the director discharged the new duty to promote the success of the company. The DTI has issued guidance regarding directors' duties.[13] Decisions as to what will promote the success of the company and what constitutes such success is one for the directors' good faith judgment. In having regard to the factors listed, the duty to exercise reasonable care, skill and diligence will apply. A director is not required to do more than act in good faith and comply with the duty to exercise reasonable care, skill and diligence.

## Environmental key performance indicators

KPIs provide a tool for measuring performance and defining targets and benchmarks. Under the OFR, one of the most significant issues that would have been instigated was the requirement for directors to include KPIs in the OFR. The number and type of KPIs disclosed should have reflected what the directors consider to be critical in the management of business. There are no statutory requirements on how KPIs should be presented and no business requirements to produce explanatory information with KPIs. The ASB recognised that directors may have needed additional guidance in this area, given the wide range of measures that were available. The implementation guidance to the OFR set out examples of KPIs that might have been used and the issues that the directors would have needed to consider in each case.[14] For example, possible KPIs might have included:

- return on capital employed
- market share
- average revenue per customer/user
- sales per square foot
- environmental spillage
- $CO_2$ emissions
- employee morale
- employee health and safety.

Some of the practical examples in the implementation guidance attached to the ASB statement cover the disclosure of KPIs on environmental issues.

Medium-sized companies are exempt from reporting non-financial key performance indications (s 417(7)); but they may decide to report voluntarily where appropriate, in recognition of the benefits that such disclosure brings to the operation of the business. Defra has also published guidance on environmental reporting in its documents, drafted with Trucost.[15]

Defra has emphasised that the management of environmental matters is not just a reporting issue but one that can result in genuine benefits for the business. Whilst many of the issues may be considered to be of most relevance to larger companies, the guidance emphasises that SMEs will often be part of a supply chain and that many businesses are now demanding environmentally responsible behaviour from their commercial partners. Although this apparent direct link between environmental issues and financial performance should encourage better performance management, Trucost stated that they found that only 5 per cent (18 companies) of FTSE 350 companies link environmental issues to financial performance.[16]

This combined report defines which KPIs are likely to be the most relevant to each business sector and provides guidance on how companies can use these to manage their environmental performance. Whilst the guidelines have been developed primarily to help directors to meet their responsibilities, especially those who are new to environmental reporting, the document notes that investors and other stakeholders may also find them useful in assessing an entity's environmental performance and overall management of environmental issues.

According to guidelines, the government understands 'environmental matters' to include impacts of the business on the environment (eg greenhouse gas emissions) and of the environment on the business (eg operating in a carbon restrained first world), the policies adopted for managing these and the companies actual performance in doing so. Defra notes that no business should need to report on more than 10 environmental KPIs.[17]

The Defra guidelines look at the underlying principles of environmental reporting, including the need for transparency, accountability and credibility, and the need for KPIs to be quantitative, relevant and comparable, so that the performance of an entity can be assessed over time and in relation to its competitors. As far as possible, the recommendations on measuring KPIs make use of information that should already be available within companies. Businesses should present KPIs in absolute terms for the reporting period and also in relation to a normalising factor, such as turnover or production output. Each KPI reported should be accompanied by a general narrative explaining its purpose and impacts, the calculation methods used and any relevant assumptions made. Progress against targets should also be discussed, regardless of whether this reflects improvements or

13 Office of Public Sector Information, Companies Act 2006 http://www.opsi.gov.uk/acts/acts2006/20060046:htm. The DTI is now Department for Business Enterprise and Regulatory Reform (BERR)

14 Accounting Standards Board OFR 'Reporting Statement – Operating and Financial Review' January 2006. The guidance accompanies, but is not part of the reporting statement.

15 Defra, Trucost (n 12) 5.

16 ibid Executive Summary.

17 ibid Executive Summary.

setbacks, with information on how any problems areas are being tackled.

The 22 KPIs identified in the Defra guidelines are set out under the following main headings:

(i) emissions to air
(ii) emissions to water
(iii) emissions to land
(iv) resource use.

A separate section looks briefly at the issue of biodiversity.

The guidelines also highlight the importance of reporting on any fines and associated costs incurred by the business in respect of environmental issues, regardless of the amount and materiality of these, together with the number of any related prosecutions. The reasoning behind this seems to be that the impact of fines and pollution abatement costs (and possibly the removal of permits and operating licence) will impact directly on the financial performance of a company.

## Conclusions

The requirements under the Companies Act for quoted companies to provide environmental disclosures relating to their businesses goes at least some of the way towards implementing what the OFR intended which was for shareholders to be able better to assess how directors have performed their duties.

There is still a long way to go. The Trucost report states that the environmental reporting in the annual report and accounts has not yet reached 100 per cent for the FTSE 100, let alone the FTSE 350. The emphasis on using KPIs in the Companies Act, when discussing the environment should improve the quality and usefulness of disclosures in the future.

It may be that the reporting requirements will become an important source of quantitative data that will be more efficiently utilised to augment financial reporting and subsequently the decision of investment analysts and shareholders. For example, assessing the financial materiality of regulations will stem from the potential risk associated with the loss of 'licence to operate' and compliance with conditions of the licence in circumstances where the Environment Agency/SEPA have the authority to deny a company's licence to operate or close or restrict operation.

The requirement to consider the impact of social, environmental and ethical (SEE) considerations and the long term effect of ignoring SEE considerations has been part of the pension fund requirements since 2000. The trustees of occupational pension schemes are required by s 35 of the Pensions Act 1995 to produce a statement of their investment principles. As from 3 July 2000 this must state the extent to which (if at all) social, environmental and ethical SEE considerations are taken into account in the section, retention and realisation of investments (SI 1996/3127 reg 11A (4)). Besides the EU Accounts Modernisation Directive there are two other directives, namely the Transparency Directive and the Prospective Directive, which both require non-financial reporting to provide investors with the ability to make informed investment decisions on a pan-European basis. The growing emphasis on disclosure of non-financial areas, together with the Companies Act requirements may result in a significant increase in environmental disclosure levels.

The EU Accounts Modernisation Directive is intended to increase the comparability between companies in the EU through a common report framework. To achieve this objective, the EU requires common financial reporting standards that are transparent, properly audited and effectively enforced. The directive increases the reporting remit to take account of the growing demand for non-financial comment and analysis. Whilst the elements of transparency and auditing may become more real under the new company law the question of enforcement is yet to be determined. Although the Financial Reporting Review Panel (FRRP) has legal authority to review directors' reports (including the business review) and, where the report fails to comply with the statutory requirements, to go to court to compel a company to revise its report (s 456), the FRRP's role does not cover consideration of whether the business review complies with the non-mandatory reporting statement. Whether individual shareholders will enforce their new powers to bring legal actions against directors for breach of their duties will have to be assessed over a period of time bearing in mind that, provided a director has acted in good faith the business decision on strategy and tactics will not be subject to decision by the courts.

Directors are being made more accountable than ever. New ground is being broken as directors are going to have to face the challenges of integrating considerations of corporate social responsibility into their assessments of what is best for their company. Properly available trails of the decision-making process will force records to be kept in the process. However, there appears to be a reticence to relating environmental policy, management and performance directly to the core management and financial performance of the business as these factors are more often linked to a concept of CSR. This is despite the example that should the Environment Agency remove any permits or operating licences from a FTSE share company this will impact directly on the company's financial performance not only in relation to non-compliance costs, but loss of business revenue and the cost of remedying the problem. Currently it appears that very few FTSE all share companies report in a way which would fulfil the environmental criteria of the duty.

Whilst the abolition of the OFR can be viewed as a blow to those advocates of mandatory environmental reporting and a victory to those complaining of regulatory burdens, the EU AMD represents something of a middle way, whilst the new clauses in the Companies Act clarify the area even further. These clauses represent some success for more standardised reporting of non-financial impacts and provide much needed clarification in the wake of the confusion over the OFR. There should be an increase in environmental disclosure levels that will bring the UK more in line with the disclosure requirements of, for example, the United States and Australia.