

RESPONSE TO DTI CONSULTATION

Directors' Report: Business Review (Section 234zzb of the Companies Act 1985) and Chapter 6 of part 15 of the Company Law Reform Bill

Summary

The Environment Agency has responded to earlier DTI consultations on new Company Law and the Operating Financial Review (OFR). More recently our Chief Executive has written to the Chancellor of the Exchequer expressing our considerable concern at his intention to repeal the mandatory requirement on quoted companies to prepare an OFR.

- Whilst we welcome the inclusion in directors' duties that they should have 'regard to' the community and the environment, we feel it is open to interpretation and should be expressed more explicitly reflecting the Government commitment to such issues. We believe that all directors should have a statutory 'duty of care' toward the environment as they do for employees and customers. We also feel that such a 'duty' should extend to being open and transparent to the members of a company as to how this duty is carried out in practice.
- We believe disclosures should be both reflective and forward-looking and supported by quantitative data. We are concerned that key contextual information will not be disclosed that is necessary to assess corporate performance and prospects.
- We believe the exemption of small and medium-sized companies from the non-financial disclosures is wholly inappropriate. The Environment Agency's first contact with most SMEs is as a result of an environmental incident and it is believed that they cause over 50% of pollution incidents. SMEs also generate over 60% of the commercial and industrial waste produced in England and Wales annually. The disclosure of non-financial issues should be based on risk, not balance sheets, turnover or number of employees. We are particularly concerned with the growing number of public companies in Alternative Investment Market (AIM) that will be excluded. All businesses have an impact on the environment, and companies with turnovers of up to £27million and up to 250 employees still utilise considerable resources. If companies are considering their environmental performance, as they should in practice not only for the sake of the environment but to help reduce resource costs and manage risk, to report that in a modest way is not onerous.
- Disclosures should be audited and auditors use their expertise to raise "any matters [that] have come to their attention, in the performance of

their functions as auditors of the company, which in their opinion are inconsistent with the information given in the operating and financial review” as previously included in the OFR.

- We would like to see the re-introduction of the ‘disclosure or explain’ spirit of the OFR incorporated in the business review.

We have previously set out our views on the changes we think are needed to the existing Company Law, specifically to those matters previously contained within Schedule 7ZA of the Companies Act 1985. An extract from our response to the Company Law Review: Environment Agency policy on corporate environmental governance is included in annex 2. For brevity, the full question by question response is not duplicated here but can be provided on request.

Annex 1 provides the executive summary from *Environmental disclosures - in the Annual Reports and Accounts of companies in the FTSE All-Share* to substantiate the comments made below. The Environment Agency commissioned the study to examine the extent and nature of environmental disclosure of FTSE All-Share companies in order to establish a baseline prior to the introduction of mandatory OFR reporting requirements in 2005. We will be following up on this research in 2006/07.

1.0 Business Review

1.1 The consultation states “in most respects the reporting required under the Business Review is similar to that of the OFR, but it is in less prescriptive form.”

1.2 The first half of this statement glosses over the key contextual information that is not included in the business review, but were critical components of the OFR, namely:

“(c) the main trends and factors underlying the development, performance and position of the business of the company during the financial year, and

(d) the main trends and factors which are likely to affect the company’s future development, performance and position,

prepared so as to assist the members of the company to assess the strategies adopted by the company and the potential for those strategies to succeed.”

1.3 The omission of these statements weakens the Business Review as a tool for the members of the company to assess the performance and prospects of a company.

1.4 Allowing the Directors to consider the ‘necessity’ of it, we cannot conceive of a situation where such information, no matter what size of

business, is not salient to determine a balanced and comprehensive analysis.

- 1.5 The lack of a reasonable degree of prescription weakens the Business Review as a tool for members of company and other stakeholders to assess a company's performance in relation to its peers.
- 1.6 The Government's current policy, for the past 10 years or more, to encourage voluntary environmental reporting has not worked - only 24% (136 out of 570) of the FTSE All-Share disclose quantified information on their environmental risks, impact or performance, and there is no consistency or comparability in the disclosures that are made. The Business Review should direct companies to disclose their environmental KPI's in line with the *Defra Environmental Key Performance Indicators – reporting guidelines for UK Business*. A key aspect that emerged from the lengthy OFR consultation was the need for comparability in disclosures. Clear unambiguous reporting requirements provide clarity, comparability and comprehensive information for both writers and users.
- 1.7 We are particularly concerned with the exemption of small and medium-sized (SME) companies, especially the latter, from reporting the non-financial information. This excludes 99.2% (4 million) businesses. Our first contact with most SMEs is as a result of an environmental incident and it is believed that they cause over 50% of pollution incidents. SMEs also generate over 60% of the commercial and industrial waste produced in England and Wales annually. We cannot think of a single company that does not use natural resources (directly or indirectly) or consumes significant amounts of energy or produces no waste, or which is not at risk from the impacts of climate change. We recommend that the disclosure of environmental information, in accordance with the Defra guidelines, is assessed on risk, both environmental and financial, to enable shareholders (and stakeholders) to map progress over time and to compare within and across business sectors to aid decision-making.
- 1.8 Of particular concern is the large number of AIM and OFEX listed companies who will escape reporting under this exemption. It is essential that listed companies are open and transparent about all their business risks, financial and non-financial, and that key performance indicators are provided to the members to measure management of those risks.
- 1.9 Mandatory non-financial disclosures by smaller companies would stimulate them to measure their resource consumption and, hopefully, manage it more effectively - saving money and the environment.

2.0 Auditor's role

2.1 The removal of the 'prescriptive' elements of the OFR are further compounded by the removal of the 'critical friend' role of the auditor to question 'what is necessary?' and inconsistencies with statements made by the Company. We feel that the auditors should raise matters that have come to their attention, in the performance of their functions as auditors of the company, which in their opinion are inconsistent with the disclosures made by the company, as previously included in the OFR. This will provide some assurance to the members of the company and investment community to the validity of the process of producing the business review.

3.0 New statutory statement of directors' duties

3.1 Whilst we welcome the inclusion in directors' duties that they should have 'regard to' the community and the environment, we feel it is open to interpretation and should be expressed more explicitly reflecting the Government commitment to such issues. We believe that all directors should have a statutory 'duty of care' toward the environment as they do for employees and customers. We also feel that such a 'duty' should extend to being open and transparent to the members of a company as to how this duty is carried out in practice.

4.0 EU Accounts Modernisation Directive

4.1 We welcome the EU Accounts Modernisation Directive (EU AMD) in its intention to increase comparability between companies in the EU and provide a common reporting framework. The Directive does not, however, encompass the forward-looking features of the proposed OFR identified above as critical to for the assessment of companies. It also excludes the non-financial reporting elements for all medium-sized companies.

4.2 We welcome the inclusion in the non-financial reporting indicator of social and community matters, which are not included in the Business Review. This indicator will need to be built into the Business Review if UK legislation is to fully translate the directive into national legislation.

5.0 Opportunity missed

5.1 The Company Law Reform Bill is also an opportunity for the Government to:

(a) take forward wider sustainable development and resource consumption and productivity policy commitments it has signed up to at international level, for example the World Summit on Sustainable Development, and

(b) fully implement the EU recommendation on the recognition, measurement and disclosure of environmental issues in the Annual Reports and Accounts of companies (2001/45 3/EC).

- 5.2 On the latter, we were disappointed in 2001 when Department of Trade and Industry (DTI) officials (and not a Minister) simply sent the document to the main UK accounting bodies with a polite request that they ask their members to implement it at their discretion. Some other EU countries have built the recommendation into law or regulations and have made it a mandatory requirement for business to comply with.
- 5.3 We would welcome the opportunity to discuss these issues further with DTI officials or Ministers.

Further information

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Annex 1:

Executive summary from *Environmental disclosures of environmental disclosure within the Annual Reports and Accounts of FTSE All Share companies*

Executive summary

- 89% (507 companies out of 570) of FTSE All-Share companies discuss their interaction with the environment in their Annual Reports and Accounts. But, the vast majority lack depth, rigour or quantification and 11% (63 companies) disclose nothing at all.
- 72% (415 companies) make a reference to environmental policies. But, less than 50% report on a subject other than their environmental policy which in itself is not a measure of environmental performance.
- 58% (328 companies) report on one topic out of water, waste, energy use and climate change. But, only 10% report on all three.
- Only 24% (136 companies) of the FTSE All-Share make any quantitative environmental disclosures. Companies with environmental management systems do so more frequently.
- Only 17% (96 companies) of the FTSE All-Share refer to climate change risks.
- Only 12% (69 companies) make environmental disclosures in the audited sections of their Annual Reports and Accounts under existing tests of materiality.
- 88% do not regard the environment as a material business risk.
- Only 11% (35 companies) of FTSE 350 companies link environmental issues to financial performance.
- Only 5% (18 companies) of FTSE 350 link environmental issues to shareholder value.
- Only 4% (23 companies) mention the Environment Agency, yet information provided to the Agency could be useful to shareholders.
- FTSE All-Share companies need to pay more attention to environmental issues in their Annual Reports and Accounts.
- Guidance on relevant key performance indicators would help companies decide which environmental disclosures are necessary to meet the requirements of the forthcoming Operating and Financial Review.

Annex 2:

Extract from the Environment Agency response to the Company Law Review: Our policy on corporate environmental governance

General

The Agency considers that companies that actively reduce environmental risks and impacts are more sustainable, profitable, valuable, and competitive. This is good for the economy and the environment (the win-win situation). Those that ignore environmental risks and impacts are less sustainable in the long-term. Exploitation of resources for short-term gain is detrimental both to the economy and the environment (the lose-lose situation). The Agency will praise good environmental performers and seeks to change the behaviour of poor performers.

Directors' duties

We believe all Company Directors should have a statutory duty of care for the environment in the same way they have a duty of care towards their employees and customers. This should not be an optional or voluntary requirement. We think this necessary not only to protect natural resources for future generations but because it is good for the planet, good for employees, good for the public, and good for the long-term sustainability and reputation of the company.

Company Directors should consider the merits of having a Health, Safety and Environment Committee to review and improve their performance. They should also include an item on environmental performance at their AGM to demonstrate their commitment to sustainable development, and enable shareholders to raise any issues about their environmental performance, as well as economic and social performance.

Environmental policy

The Agency considers that companies should have an environmental policy covering all aspects of their business activities and that the Directors of the company should promote this to their employees, contractors and customers as part of their staff training and management procedures.

Companies should set targets and report on historic trends for key indicators of environmental performance that includes raw material and energy consumption and emissions of waste to air, land and water. They should also include any serious pollution incidents, damage to wildlife, enforcement action and prosecutions or fines against the company in their published Annual Report.

Companies should also explain how they are positively seeking to continually reduce their consumption of raw materials and energy consumption, emissions to air, land and water and their other environmental incidents and

impacts to improve overall company performance. Companies should also report on positive actions to improve environmental performance.

Eco-efficient goods and services

The Agency considers it makes good economic and environmental sense for companies to use their financial and other management information systems to track the cost and input of raw materials, energy and labour, and output of goods/services and waste products, to understand, and then to improve, their resource productivity and eco-efficiency. Any waste is loss of productivity and profit, as well as an environmental concern, and is bad both for the firm and the UK economy. We support and encourage companies to re-use and recycle both waste and final products.

Environmental management systems

We recommend that companies should use recognised quality management systems to help them reduce minimise environmental risks, report on their environmental performance and add value to the company. Large companies should adopt internationally recognised environmental management systems such as ISO14001 and EMAS. SME's should consider signing up to the DTI/DETR Project Acorn concerned with simpler EMS's and use the Agency's NetRegs web pages to help them understand their environmental responsibilities.

Environmental accounting

We believe companies should also use their financial systems to manage revenues and value derived from the environment. For example by developing a simple environmental profit and loss statement and green balance sheet within their published annual accounts. These should cover income from and value of environmental assets, services and by-products, expenditure on natural resources, licences/permits to operate, capital investment in anti-pollution equipment, payment of green taxes and court fines, and any provisions made for contingent liabilities such as remediation of contaminated land.

Environmental reporting

Directors of companies should be required to report on how they have assessed and managed environmental risks and describe their environmental performance in their statutory Annual Report and audited Accounts. This is to enable shareholders, stakeholders, investors, employees, customers, and the general public to be assured that environmental risks have been properly managed and reduced.

The Annual Report and audited Accounts should also disclose whether the Company or any of its Directors has ever been previously prosecuted for any environmental or wildlife offence that resulted in enforcement action, prosecution, a fine, or other punishments including disqualification or

imprisonment. This is to enable shareholders and stakeholders to assess if they are competent to run the company.

Both financial and non-financial environmental performance statements should be audited and verified to recognised accounting, reporting and auditing standards, and their audited Annual Report and Accounts lodged at Companies House and placed on an Internet web site. In this way they will be available to the Government, shareholders, stakeholders, and the general public to assess the company environmental performance alongside its economic and social performance.

Companies in the FTSE All Share Index should also voluntarily produce a more detailed Environmental Report for their stakeholders and shareholders, and operate site reports for local communities on businesses with high environmental impacts. They should be prepared to agree standards and be audited and verified.

Implementation

The Agency is seeking to apply these principles to its own corporate governance, to those companies it regulates, and companies in which its Pension Fund Managers invest. Our Pension Fund Managers will vote against the approval of Annual Report and Accounts at the AGM's of UK companies that do not comply.

For further information on corporate environmental governance please contact

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