



December 2014

HOW DO

COMPANIES ACT?

Annual reports, Strategic reports, Directors' reports and Sustainability reports

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Summary

Existing legislation on inclusion of information on social and environmental issues in Company reporting does not provide an adequate guarantee that the information reported is material or complete. This legislation is present in the Companies Act 2006, and was recently updated in the Companies Act (Strategic Report and Directors Report Regulations) 2013.

This means that investors will find it difficult to use existing data to inform decisions, even as the demand for this type of information is increasing. The solution is to amend the Companies Act to incorporate a necessary requirement for assurance of non financial impact information.

Directors are currently required to provide a statement asserting that shareholders have the information necessary to assess company performance, business and strategy. The scope of the financial audit is to report on whether these statements are inconsistent with the information that the auditors have acquired in the course of performing the audit. This scope should be extended to requiring assurance on the materiality and completeness of the information regarding the wider impact of the company's operations. Shareholders and other stakeholders would then be able to

use this information in their investment decisions. In the meantime, examples of discrepancies in Company reporting can be raised with the Financial Reporting Council (FRC).

The first section explores issues arising from current approaches to reporting on social and environmental issues. The second focuses on related current legislation in the Companies Act and how limitations create challenges for reporting useful information. The third section sets out the increasing demand for information on social and environmental issues as evidence of how important this social and environmental information really is. The fourth section highlights the importance of audit in standardising information and ensuring it is useful, and examines the current provision for auditing the social and environmental information. It concludes that there is a critical gap in current legislation which will restrict the use of information despite its growing importance.

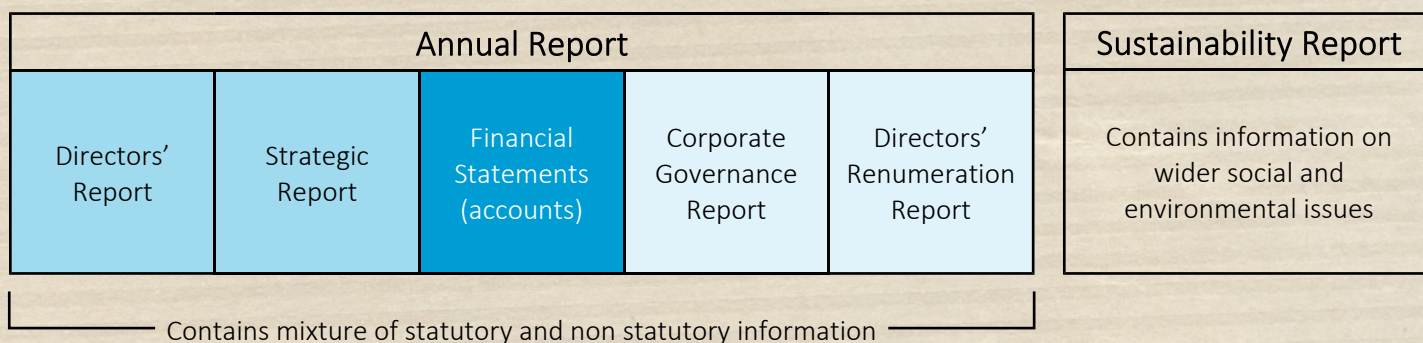
The options for addressing this gap are limited but we believe that the statutory audit requirements should be extended to cover materiality decisions relating to social and environmental information.

1) Social and environmental information in company reporting: Annual reports and Sustainability reports

Companies provide information on social and environmental issues relating to their activities in a number of ways. Annual reports are legally required to include information on social and environmental issues (see Figure 1). At the same time, it has become increasingly common for a company to produce a separate Sustainability report, as well as including some information in their Annual report. Integrated Reporting represents the most recent initiative to integrate both financial and sustainability information.

So what is the relationship between the information in a Sustainability report and an Annual report? The general rule is that information should be included in a report if it is material. However, what is material depends on the audience or user of a report. Since Sustainability reports and Annual reports potentially have different users, or at least could have been prepared for different audiences, the two reports could include different information or similar information but with a different emphasis.

Figure 1: contents of Annual Reports and Sustainability Reports¹



- = auditor is required to provide statement that he believes these reports have been prepared in accordance with Companies Act
- = auditor provides statement of consistency between these two reports and Financial Statements
- = information is required to be audited

This issue has been subject to extensive debate, including, for example, in the development of the Guidelines for Integrated Reporting. The International Integrated Reporting Council's (IIRC) Materiality background paper for Integrated Reporting defines materiality as:

'a matter is material if it is of such relevance and importance that it could substantively influence the assessments of providers of financial capital with regard to the organization's ability to create value over the short, medium and long term. In determining whether or not a matter is material, senior management and those charged with governance should consider whether the matter substantively affects, or has the potential to substantively affect, the organization's strategy, its business model, or one or more of the capitals it uses or affects.'

Given however that there is no legal requirement setting out standards for producing either Sustainability or Integrated reports, it would be necessary to check each

individual report in order to know for which intended users the materiality decisions have been made.

To complicate matters, Annual reports can also include information that is non statutory. This information could be drawn in full or in summary from Sustainability reports. As a result of different intended audiences and therefore different materiality judgements, this information could be different to information included in the statutory parts of the Annual report.

However, it could be argued that if a company provides publicly available information on its sustainability performance, it is likely to be material for investors as the information could affect investor's economic decisions. It would therefore seem sensible for Directors to explain how the materiality decisions have led to any differences between information in reports.

This is potentially confusing and the confusion has implications for the legal requirements to include information in Annual reports.

¹ Table adapted from Table 1 p.10 in FRC document *Guidance on the Strategic Report*, June 2014

2) Companies Act requirements for information on social and environmental issues in Annual Reports

In relation to Directors and their duties, Section 417 of the Companies Act 2006 stated that Directors have to regard for: the interests of the company's employees; creating a strong relationship with suppliers and customers, and the impact of the company's operations on the community and the environment.

In October 2013, updated regulations came into force requiring companies to produce a Strategic report as part of their Annual report (Section 414C, Companies Act 2006 (Strategic Report and Directors Report) Regulations 2013).

The regulations state that:

'in the case of a quoted company the strategic report must, to the extent necessary for an understanding of the development, performance or position of the company's business, include—

(a) the main trends and factors likely to affect the future development, performance and position of the company's business, and

(b) information about

(i) environmental matters (including the impact of the company's business on the environment),

(ii) the company's employees, and

(iii) social, community and human rights issues, including information about any policies of the company in relation to those matters and the effectiveness of those policies.

If the report does not contain information of each kind mentioned in paragraphs (b)(i), (ii) and (iii), it must state which of those kinds of information it does not contain.'

FRC Guidance states that the Strategic report should include both positive and negative effects and aspects of the company's activities.²

The scope of this FRC Guidance is limited by the requirements of the Strategic report because information that relates to the positive or negative impact of the business' operations could still be considered outside what is listed in Section 414c. Alternatively, the information might be disclosed but may still not be considered as material.

Whether this information is material or not is judged in relation to the needs of the primary user of the accounts - the existing (and future) shareholders. FRC Guidance on the Strategic report states that information is material if:

Its omission or misrepresentation could influence the economic decision shareholders take on the basis of the annual report as a whole. Only information that is material in the context of the strategic report should be included within it.

Conversely the inclusion of immaterial information can obscure key messages and impair understanding of information provided in the strategic report.³

In summary, whilst there is a requirement to include information on social and environmental issues in the Strategic Report of a company, it is difficult to see how Directors' decisions on what is material will be consistent and comparable.

3 Demand for Information on Social and Environmental Issues

The requirement for information on social and environmental issues in the Strategic Report reflects increasing recognition that information on the wider impacts of a company's operations, especially on social and environmental outcomes, is important to investors. This increase in demand, which has an effect on what is considered material to investors, can be seen from:

- a) the increase in responsible and ethical investing;
- b) the increase in sustainability reporting;
- c) the increase in assurance of sustainability reports;
- d) the increasing legal requirements for sustainability reporting; and
- e) the launch of platforms for shares which require social or environmental issues to be considered, such as the Social Stock Exchange.

² FRC *Guidance on the Strategic Report*, June 2014

³ Section 5, page 15, FRC *Guidance on the Strategic Report*, June 2014



a) The increase in responsible and ethical investing

This is reflected in the Investment Management Association's (IMA) latest statistics which show a 20% increase in the amount invested in ethical retail funds in the UK in the year to November 2013.⁴ The UK accounted for 14% of Socially Responsible Investment (SRI) in Europe in 2012, then increasing a further 3% to 17% in 2013.⁵

b) The increase in sustainability reporting

As the interest in sustainability initiatives and focus on integrated reporting continue to grow, more companies are publishing sustainability reports containing information on their social and environmental impact. KPMG recently released its eighth Survey of Corporate Responsibility⁶, which found that more than 90% of the world's 250 largest companies, according to annual revenue, now publish reports detailing their performance on environmental, social and governance (ESG) factors.

c) Increase in assurance of sustainability reports

This increase in sustainability reporting has been accompanied by a rise in the assurance of those reports, in order to increase their credibility and usefulness. In 2012, over 46% of reports listed on GRI's Sustainability Disclosure Database included some form of external assurance. This is indicative of the global trend towards increased assurance of sustainability reports, though there are still some notable differences between countries and sectors. The trend is represented by Figure 2.⁷

d) The increasing legal requirements for sustainability reporting

The European Parliament has recently adopted a directive on disclosure of non-financial and diversity information

within statutory financial reports. Companies covered by the directive will have to disclose information on environmental, social and employee issues. There is still significant flexibility in how this information is produced but this represents another step in increasing requirements for companies to report on wider issues.

e) The launch of platforms for shares which require social or environmental issues to be considered, such as the Social Stock Exchange.

The launch of the Social Stock Exchange provides an opportunity for businesses that are listed on existing stock exchanges to complement the financial information they provide with a report on their social impact that meets a standard set by the Social Stock Exchange. Although there is legislation around what social and environmental impact information should be included in Annual Reports, this legislation is weakened by the lack of guidance and standards on how materiality decisions should be made.

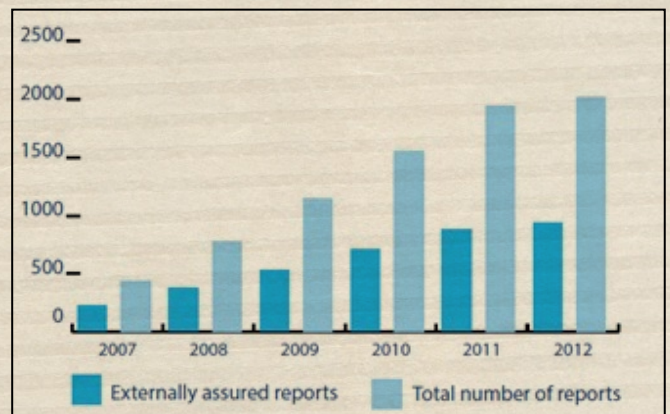


Figure 2: Number of GRI Report registered in the GRI database and the number of reports that included some type of external assurance statement (# of reports)⁷

4) Companies Act requirements for auditing information on social and environmental issues

The purpose of the audit is to provide assurance to the user of the accounts that the accounts are 'True and Fair'⁸.

The audit requirements in relation to information provided under Section 414c of the new regulations are also covered by Section 496 as revised which states that:

'The auditor must state in his report on the company's annual accounts whether in his opinion the information given in the strategic report and directors' report for the

financial year for which the accounts are prepared is consistent with those accounts.'

The Director's responsibility as part of the UK Corporate Governance Code⁹ requires them to state that they consider the annual report and accounts, taken as a whole, to be fair, balanced and understandable and that they have provided their shareholders with the information necessary to assess the company's performance, business model and strategy.

4 Table 12, Tracker and Ethical Funds – funds under management and net sales by product - Press release, 9.1.14, Investment Management Association 2014

5 Green, Social and Ethical Funds in Europe: The Retail Market, 2013 Review, Vigeo Rating 2013

6 The KPMG Survey of Corporate Responsibility Reporting 2013, KPMG 2013

7 p.7 'The external assurance of sustainability reporting', Global Reporting Initiative 2013

8 Section 393, Companies Act 2006

9 C.1.1., P.16, The UK Corporate Governance Code September 2014, FRC

The auditor's responsibility is therefore to report if this statement is inconsistent with the knowledge they have acquired in the course of the audit.

The requirements for the audit opinion are set out in Section 495 of Companies Act 2006:

The report must state clearly whether, in the auditor's opinion, the annual accounts—

(a) give a true and fair view—

(i) in the case of an individual balance sheet, of the state of affairs of the company as at the end of the financial year,

(ii) in the case of an individual profit and loss account, of the profit or loss of the company for the financial year,

(iii) in the case of group accounts, of the state of affairs as at the end of the financial year and of the profit or loss for the financial year of the undertakings included in the consolidation as a whole, so far as concerns members of the company;

(b) have been properly prepared in accordance with the relevant financial reporting framework; and

(c) have been prepared in accordance with the requirements of this Act (and, where applicable, Article 4 of the IAS Regulation).

The question is whether the audit work carried out to allow an opinion on the accounts would be likely to identify material omissions relating to Section 414c (the requirements for social and environmental impact information in the Strategic report). If not, the users of the accounts are dependent on the Directors' statements without independent assurance of those statements. Given this section focuses on the annual accounts (and not the annual report as a whole) there is no reason why the work should identify information missing from the Directors report.

The basis for the Directors' judgement is not informed by commonly accepted principles and standards. Necessary decisions about which information is material will include judgments. These judgments need to be audited if the information resulting from the judgment is to be used in decisions.

The first challenge is that there is no requirement to include the basis on which materiality is judged. This increases the potential variability of judgments and reduces comparability between the reports of different companies.

The second challenge is that the audit process is not designed to identify material social and environmental outcomes (rather just financial information) and it is therefore unclear what might be expected to be discovered

and which social and environmental outcomes would not be expected to be discovered.

Furthermore, information in the Annual Report that is in a non-statutory section will not be covered by audit requirements for statutory sections.

In summary, the audit requirements for the annual accounts do not adequately cover potential omissions of social and environmental information in the strategic report (Section 414c). This is because:

- i. according to current legislation, the Director's statement that the annual report and accounts are fair, balanced and understandable is sufficient assurance. This is the case even when there are no commonly accepted principles on which to make this decision, so judgements are more likely to be varied and potentially unreliable;
- ii. the audit process is only designed to identify material financial information. The materiality of social and environmental outcomes is not covered in guidance documents or legislation, meaning judgements about materiality are even more difficult to make.

Currently the only way in which an investor can seek confidence that these judgments are reasonable is by raising a concern with the Financial Reporting Council (FRC). The FRC is the UK's independent regulator responsible for promoting high quality corporate governance and reporting to foster investment. They set the framework of codes and standards for the accounting, auditing, actuarial and investor communities and oversee the conduct of the professionals involved. The FRC will consider the complaint and may request further information from the company before coming to a decision. The FRC do not consider it part of their review work to duplicate what Directors do. Consequently, there is a gap between the audit process and the review process where there is a concern that a business has not included material information relating to Section 414c and there are no standards for assessing this.

The extent to which investors are raising concerns in relation to this Section of the Companies Act with the FRC is not publicly available, and this information is not subject to the Freedom of Information Act. However, there were eight reviews prompted by complaints relating to aspects of accounts in 2012/2013, and nine in 2011/2012. There is no information on the nature of the complaint and therefore how many may have related to Section 414c of the Companies Act, but even if it were all of them, this would still be a small number of complaints relative to the number of Companies and their reports.



Conclusion

Financial reporting requires judgement. This is the reason why accounts need to be independently audited; to provide confidence that those judgements are reasonable and that the accounts include information which is material to an investor's decisions. Given that information on social and environmental issues within an Annual Report is likely to require at least as much judgement as information on financial issues, it would seem that these judgements should also be subject to an assurance process that is specifically focused on that judgement.

Without independent assurance, it is difficult to know how the user can be sure that information is compliant with the Companies Act and can be relied upon to inform economic decisions. Despite this, the FRC view is that this decision is the responsibility of the Directors. Their conduct committee will only consider complaints where it appears that the requirements have not been followed by relevant entities. This would push back the gap in legislation to government, which is why we are campaigning for a legislative change in

this field. In the meantime, raising issues with FRC will increase recognition of the problem.

If the information that is included in an annual report is to be useful it needs to be assured and the requirement for Audit as set out in Section 495 of the Companies Act should be extended to cover the materiality decisions in relation to the Strategic Report and specifically Section 414c.

In the meantime we would encourage examples of any concerns relating to the contents of Strategic Reports in relation to social and environmental issues that fall within the remit of the FRC to be raised through their complaints process at:

Financial Reporting Council
8th Floor,
125 London Wall,
London
EC2Y 5AS