

# The Operating and Financial Review

## Improving company reporting on environmental & social risk

### Background

Investors - particularly long-term investors, such as pension funds - have the potential to be a strong force for corporate responsibility and sustainability. Yet most investors do not engage effectively on social and environmental issues - even though, as the Gulf of Mexico oil spill has forcefully demonstrated, these issues can be financially catastrophic for businesses and investors.

Part of the problem is inadequate information. If investors are expected to act on environmental and social issues in the same way they do on financial issues, they must have equal confidence in the information available. The coalition government's commitment to reinstate an Operating and Financial Review is a unique opportunity to ensure this happens.

### The Coalition's commitment on corporate reporting

"We will reinstate an Operating and Financial Review to ensure that directors' social and environmental duties have to be covered in company reporting, and investigate further ways of improving corporate accountability and transparency."

- *The Coalition: our programme for government* (p. 10)

This commitment originated in the Liberal Democrat Manifesto 2010.<sup>1</sup>

Following the publication of the Coalition Agreement, BIS launched a consultation on 'The future of narrative reporting'.<sup>2</sup> However, the consultation is addressed at reporting in general, with a limited focus on 'social and environmental duties'. The document also says that "where change is proposed, it is as likely to be non-regulatory as regulatory."<sup>3</sup> An Operating and Financial Review could not be reinstated without new regulations. This is a concerning indication that the precise commitment made in the Coalition Agreement may not be fulfilled.

## THE OFR: A BRIEF HISTORY

- The requirement for quoted companies to produce an Operating and Financial Review (OFR) with narrative information about their performance was introduced by statutory instrument in 2005.
- However, despite general consensus among stakeholders in favour of this move, the requirement was mysteriously repealed in the same year.
- The Companies Act 2006 subsequently replaced the OFR with the 'Business Review' - the basis of the current reporting regime.
- The purpose of the Business Review is "to inform members of the company and help them assess how the directors have performed their duty under section 172 (duty to promote the success of the company)".<sup>4</sup>
- The 'duty under section 172' notably requires company directors to have regard to "the impact of the company's operations on the community and the environment."
- The Business Review provisions also explicitly confirm that quoted companies must report on environmental and social matters "to the extent necessary for an understanding of the development, performance or position of the company's business".
- None of these reporting requirements apply to small businesses.<sup>5</sup>

## What's wrong with the current regime?

The current provisions for a Business Review do replicate many of the features of the original OFR. However, they are ineffective in several respects:

- **Unreliable information.** One of the key features of the original OFR was the enhanced audit, which would have guarded against the release of inaccurate or misleading narrative information. The current regime only requires auditors to make a narrow statement of whether narrative reporting is consistent with the annual accounts. Many investors say that this lack of verification makes it difficult for them to rely on these reports when making investment decisions.
- **Incomplete information.** No official guidance has been published under the Companies Act to clarify what constitutes adequate reporting on social and environmental risks. As a result, many companies simply produce long, backward-looking reports about their CSR activities, rather than providing strategic, forward-looking information about the key environmental and social issues affecting their core business. Companies often disclose partial or misleading information about environmental and social risks, without contextualisation or disclosure of the underlying assumptions.
- **Inadequate enforcement.** The Financial Reporting Review Panel is the only body with the authority to take legal action to enforce the current reporting requirements. According to currently available information, in 2008/09 the FRRP did not take enforcement action against any company for its narrative reporting, despite judging the legal compliance of a number of narrative reports to be doubtful.<sup>6</sup>

## CASE STUDY: BP AND CLIMATE CHANGE

In its 2009 Annual Report, in discussing the long-term outlook for oil demand, BP states "Under the International Energy Agency's (IEA) reference scenario, global energy demand is projected to increase by around 40% between 2007 and 2030. That scenario also projects that fossil fuels will still be satisfying as much as 80% of the world's energy needs in 2030." However, BP fails to disclose that this scenario assumes a catastrophic temperature rise of up to 6°C.

## RECOMMENDATIONS: KEY FEATURES OF A NEW REPORTING REGIME

1. Objective legal requirements that narrative information is fair, balanced and comprehensive - rather than simply the director's subjective view of the business.
2. Clarity that social and environmental reporting must be forward-looking and strategic, not a retrospective overview of a company's CSR activities - together with detailed guidance on what social and environmental risks might be relevant.
3. Legal requirements that the sources and assumptions underlying the information in narrative reports are disclosed and explained.
4. A powerful, independent, transparent and accountable regulator - for instance, a strengthened FRRP to sit within the proposed new 'companies regulator'.<sup>7</sup>
5. A stronger mandatory audit, together with measures to improve the capacity and effectiveness of the audit profession.

## ABOUT FAIRPENSIONS

FairPensions is a registered charity which works to promote Responsible Investment (RI) by pension schemes and fund managers, and to ensure that the ultimate beneficiaries are well served by institutional investors and other professional agents in the investment world.

In the case of pension funds, RI most often entails engagement with investee companies i.e. shareholder activism through dialogue, reinforced by the potential exercise of shareholder powers. We advocate a strategy of active ownership to manage environmental, social and corporate governance (ESG) risks with the potential to affect the long-term value of investment portfolios.

FairPensions is a member organisation, supported by a number of leading UK charities including Oxfam, Amnesty International and WWF, as well as organisations representing the beneficial owners of pension schemes, such as the National Federation of Occupational Pensioners, UNITE and Unison.

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1. Liberal Democrat Manifesto 2010, page 26. Available online
  2. BIS, 'Consultation on the future of narrative reporting', August 2010. Available online at <http://www.bis.gov.uk/assets/biscore/business-law/docs/n/10-1057-future-narrative-reporting-consultation.pdf>
  3. Ibid, para. 7, page 7.
  4. Section 417(2), Companies Act 2006
  5. Section 417(5), Companies Act 2006
  6. ClientEarth briefing: The Operating and Financial Review and company reporting under UK law (July 2010)
  7. HM Treasury, 'A new approach to financial regulation: judgement, focus and stability' (July 2010). Para 5.21-5.24, Page 44. [http://www.hm-treasury.gov.uk/d/consult\\_financial\\_regulation\\_condoc.pdf](http://www.hm-treasury.gov.uk/d/consult_financial_regulation_condoc.pdf)

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