



SUSTAINABILITY: THE ROLE OF ACCOUNTANTS

SUSTAINABLE BUSINESS INITIATIVE



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Executive summary

The concept of sustainability involves operating in a way that takes full account of an organisation's impacts on the planet, its people and the future.

This report illustrates UK, European and global initiatives to foster sustainable development, including steps taken by governments, businesses and other organisations.

Sustainability presents some key challenges and opportunities for accountants. This report identifies a number of ways in which operation of various mechanisms for enhancing sustainability offers challenges and opportunities that are directly relevant to the role of professionally qualified accountants. The more important aspects dealt with in the chapters that follow are summarised below:

- Increased transparency and pressure to extend the boundaries of responsibility are highlighting the importance of clear corporate policies to protect corporate reputation and gain competitive advantage. A wide range of environmental, social and economic issues represent both a threat and an opportunity. Accountants have a role in developing policies to address such issues, in their application across the business and in managing the associated business risks. (Chapter 1)
- Supply chain standards are generally set by the purchasing organisation, to be applied by all its principal suppliers. In this respect, each purchaser normally operates on an individual basis. While this may have advantages for the purchaser, it is often seen by the supplier as inefficient, owing to the need to meet a variety of different standards. As supply chain management develops, accountants within organisations are likely to be involved with the design and monitoring of purchasing policies, whilst auditors may be required to provide assurance on the application of standards in the supply chain. (Chapter 2)
- The need to recognise potential stakeholder influence on company value from the perspective of shareholders will place increasing importance on some form of stakeholder engagement. Internal accountants will need to support the stakeholder engagement process with readily accessible and reliable information. Professional accountants acting as auditors are likely to find that it is helpful to review the application and results of the engagement process, without necessarily becoming directly involved in such consultation. (Chapter 3)
- The development of voluntary codes has taken place in a largely unstructured way, resulting in a wide range of principles designed to achieve worthy objectives and offering, or appearing to offer, competitive benefits. Accountants may be involved in identifying a code appropriate to the business or in integrating operation of the code with an existing management information system. Where corporate governance includes compliance with a voluntary code, internal and external accountants may need to review the related operating controls. (Chapter 4)
- Effective benchmarking requires the timely publication of information. Accountants have a role in supporting benchmarking by providing relevant and reliable information in an accessible, meaningful and comparable way. The continuing use of questionnaires for benchmarking purposes is inevitable but efforts to minimise the associated problems should be supported. Much of the demand for information about environmental, social and economic performance required by rating and benchmarking organisations could be satisfied by the use of a more structured presentation enabling the data to be located more easily. There is also the challenge of increasing the transparency of rating agencies' methodology, to which accountants may be well-positioned to contribute. (Chapter 5)

- An early understanding of new requirements and prohibitions and their implications, including related taxes and subsidies, will be necessary to develop appropriate action plans. Professional accountants will need to maintain and expand their knowledge of regulations applicable to the businesses with which they are involved, so as to be able to provide timely information about relevant environmental and social issues, referring to other experts where necessary. With the expansion of taxes and subsidies intended to promote sustainability, accountants will become involved with plans to reduce specific impacts so as to minimise the tax burden. (Chapters 6 and 8)
- The increasing use of tradable permits and certificates to achieve a variety of sustainability enhancing objectives will present a major challenge in understanding the schemes, measuring the value of the instruments, trading decisions and associated risk management. Accountants involved with businesses affected by emission trading schemes will need to obtain a working knowledge of the schemes in order to provide effective support in collecting and interpreting information, monitoring and controlling market activities. (Chapter 7)
- Each of the mechanisms identified in this report requires the preparation, interpretation and reporting of information. To support the mechanisms and contribute to associated decision-making, internal and external accountants have a role that will often extend beyond performance measurement and reporting. At the same time, it is important for the accountancy profession to respond to growing interest in whether sustainability is being enhanced and what contribution organisations are making to sustainable development. Progress towards a generally accepted framework for sustainability accounting and reporting will involve working with other experts and providing more specific guidance, where necessary. The goal is for non-financial information to be reported to the same standards as financial information, both internally for management purposes and externally in a way that addresses the valid concerns of multiple stakeholder groups. (Chapter 9)
- Credibility of information about sustainability is strengthened by assurance processes. Despite the paucity of suitable reporting criteria for the preparation of information, the need for such processes is evident and is likely to be filled by other disciplines if the accountancy profession does not rise to the challenge. Accountants in business are already involved in monitoring, checking and interpreting information relating to social, environmental and economic impacts. Providing external assurance reports is a role for which the accountancy profession is pre-eminently qualified, building on initiatives such as the IAASB Framework and ISAE 3000 and working with other disciplines. (Chapter 10)

The report concludes with comments on the broad opportunities for the accountancy profession in the field of sustainability, the dangers of not taking them and the benefits to society as a whole if they are seized.

Invitation to comment

Comments are invited on the following questions:

1. **How useful are the mechanisms and supporting activities identified in this report as a structure for analysing the promotion of sustainable development?**
2. **Does the report focus on the ways in which accountants can add most value to the enhancement of sustainability?**
3. **What areas merit particular follow-up by way of research and the development of further guidance?**
4. **Do you wish to put forward responses to any of the questions raised at the end of each of Chapters 1 to 10 and if so, what are they and how are they supported?**

Comments received will be analysed and used as a basis for decisions on the Institute's next steps. All replies will be regarded as on the public record.

To arrange a meeting or conference call to discuss your views with members of ICAEW staff, please send an email to sustainability@icaew.com

Please send written comments by 31 March 2005 to:

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Introduction

Objectives and target audience

This report is an Institute of Chartered Accountants in England & Wales (ICAEW) contribution to thought leadership on sustainability, a subject of increasing importance that is broadly familiar to many people, even though few have any detailed knowledge. The report identifies a number of mechanisms by which sustainability may be enhanced and describes the contributions that professionally qualified accountants can make to their effectiveness.

The essential objective of this report is to raise awareness amongst professionally qualified accountants of sustainability issues and to highlight some of the opportunities available to them as a direct result of developments related to sustainability.

A second objective, relevant to a wider readership, is to demonstrate the relevance of accountants' skills to the broad and potentially confusing range of initiatives and issues associated with sustainability. Reporting and assurance figure prominently but are far from the whole story.

A third and more ambitious objective is to assist public discussion and agreement on effective ways of promoting sustainability. This ambition is based on a belief that the approach adopted in this report to analyse the role of accountants has wider applicability.

As this report proposes a new approach to sustainability and the role of accountants in contributing to sustainability, it will be helpful at the outset to identify what sustainability is, how sustainability is reported, why it is important and what issues it raises.

What is sustainability?

The notion of sustainability is rooted in the ideal of sustainable development. In 1987, the United Nations Brundtland Commission referred to this as development that meets the needs of the present without compromising the ability of future generations to meet their own needs. To ask questions about the sustainability of any human activity is to take an overall look at how that activity affects people, the economy, society, the built and natural environment – in fact everyone and everything – and to ask, in the light of all this, whether it has a long-term future. Although there is no general agreement on a definition of sustainability or even on whether the concept is capable of logical articulation, the idea of sustainability has taken hold alongside other terms describing related issues.

Companies often refer to corporate social responsibility (CSR), although this term too is subject to a wide range of interpretations. For some businesses, the terms corporate citizenship or corporate responsibility are more attractive. All these terms provide a better link to corporate governance and are seen as referring to the practical contributions that companies can make to sustainability. On the other hand, sustainable development is often regarded as an elusive global aspiration that is not actionable by businesses and organisations.

The terms that are used are diverse and tend to vary over time with the widening perception of individual and corporate impacts and responsibilities. As well as the diversity of terms and the absence of universally agreed definitions, there are numerous different players in the field. Public and private bodies operate at a global, European and national level, each appearing to have their own agenda and jargon.

Sustainability is also not just about getting on with doing the right thing. It is often not clear what is the right thing to do. Questions about whether an activity is sustainable are complex and are seen to require answers based on systematic data collection, accounting and reporting.

How is sustainability reported?

Throughout this report we see sustainability as embracing environmental, social and economic aspects. Sustainability reporting at the enterprise level therefore aims to represent an enterprise's environmental, social and economic performance and the related impacts on the world around it.

Various forms of social accounting have long been advocated, but with no consensus as to the most appropriate form. Some approaches are designed to reflect costs and benefits external to an organisation that are not otherwise identified. Piecemeal information about matters such as health and safety, community support and human resources has long been called for, for example in response to recommendations in *The Corporate Report* (1975), but social accounting has been slow to develop.

Prior to 1995, concerns about the environment led to the gradual emergence of environmental reporting. In the years that followed, non-financial reporting expanded to include social information. By 2000, the term sustainability reporting was being used. As well as environmental and social performance, sustainability reporting embraces a broad concept of performance, the three elements – environmental, social and economic performance – often being referred to as the triple bottom line. Throughout this report, we see sustainability as embracing the three aspects of the triple bottom line.

The environmental dimension is generally well understood, even if the measurement of external impacts gives rise to debate. Reporting rarely extends to biodiversity issues. Social performance is normally linked with ethical issues and includes labour practices, human rights policy, product responsibility and the enterprise's relationship with society. Typical economic indicators in a sustainability report would cover job creation, productivity, outsourcing expenditure, employment diversity and training as a contribution to the wider economy. Economic performance is not the same as the creation of shareholder value.

Why is sustainability important?

Regardless of whether an organisation subscribes to the concept of sustainable development or is able or willing to report its own impacts on everybody and everything, sustainability is important. This is because the sustainability concerns of individuals, societies and governments help shape the world in which organisations have to operate.

On a global basis, there have been several political initiatives to consider the issues relating to sustainable development, particularly the environment. These have led to the Rio Declaration (1992), the Kyoto Protocol (1997) and the Johannesburg World Summit (2002). Under the Kyoto Protocol, industrialised countries agreed to reduce the emission of greenhouse gases (GHG) by at least 5% (compared with 1990 levels) by 2012. Ratification of the Kyoto Protocol by individual countries is still in progress.

Sustainability also features prominently in the priorities of the European Commission (EC), which has issued a large number of directives relating to environmental and social issues, particularly in the area of pollution, emissions, waste and water, and is pursuing a major initiative on CSR.

Recent sustainability initiatives by the UK Government have included:

- the February 2003 White Paper on energy *Our Energy Future – Creating a Low Carbon Economy*;
- the September 2003 post-Johannesburg framework *Changing Patterns* intended to accelerate the shift towards sustainable consumption and production (SCP), decoupling economic growth and environmental degradation; and
- the April 2004 consultation paper *Taking it on – Developing UK Sustainable Development Strategy Together* calling for views on priorities, the business contribution to sustainable development and measuring progress based on headline indicators.

What issues does sustainability raise?

Sustainability management is an organisational response to the importance of sustainability issues. It is concerned with the maintenance and long-term enhancement of five types of capital that reflect an organisation's overall impact and wealth. Natural, human, social, manufactured and financial capital can be broadly related to the three aspects of the triple bottom line:

- Environmental performance is directly related to natural capital, i.e. the natural resources (energy and matter) and processes used by an organisation in delivering products and services.
- Social performance reflects the organisation's impact on human and social capital, where human capital includes the health, skills, knowledge and motivation of individuals, and social capital is the value added by human relationships, partnerships and co-operation.
- Economic performance includes financial performance and reflects the organisation's impact on the wider economy as well as its own manufactured and financial capital, where manufactured capital refers to material goods and infrastructure used by the organisation; and financial capital is crucial to the survival of the organisation and reflects the productive power and value of the other four types of capital.

It can be argued that the long-term pursuit of shareholder value is now seen as being more closely linked to the preservation and enhancement of all types of capital for a number of reasons, particularly:

- an increased awareness of threats to survival posed by rapid economic development;
- more detailed information about the effects of physical phenomena such as global warming, deforestation and water shortages;
- concerns about social and demographic factors, such as employment practices, epidemics and population changes;
- more effective communication so that people are better informed and, in many cases, have a greater sense of conscience; and
- increased empowerment of a wide range of different stakeholders who can influence an enterprise.

A common concern of people who promote sustainability is that some of the costs involved in producing goods and services are not borne by an enterprise itself but fall on a wider community, including future generations. The total cost of production is understated because of such 'external costs'. It is argued that the omission of impacts such as those arising from emissions, effluents and waste, product safety, customer health, child labour and market pricing subsidies tends to obscure the real performance of an enterprise and frustrate sustainable development. There may also be unrecognised external benefits, arising for example from the provision of training and community facilities.

Other costs and benefits may not be recognised in the time period to which they should be properly related. Examples include social costs of supporting those beyond retirement age for whom inadequate pension and healthcare provision has been made and environmental costs of unavoidable remedial work and infrastructure repair. Decisions may therefore be made which are inconsistent with the values of sustainable development. Whilst an organisation might not wish to recognise certain costs, either because of short-termism or the amount of expenditure involved, society may want to change that view and bring forward the recording of such costs based on discounted estimated future cash flows.

The issues raised by sustainability relate to fundamental concepts of capital maintenance, costs and benefits. Therefore, they are issues on which professionally qualified accountants have a vital contribution to make.

A new approach

In the past, debate about the role of accountants in sustainability has tended to focus on published sustainability reports and their desirability and usefulness. Accountants who are committed to sustainable development as an ideal tend to be enthusiastic about such reporting and promoting this aspect of the role of accountants in sustainability. Others do not share this commitment.

This report takes a fundamentally different approach. It takes the fact that individuals, societies and governments are interested in sustainability issues as its starting point. The language of sustainability might be new but, for centuries, the political process has shaped the world in which businesses and other organisations have to operate and has reflected society's views on working conditions, public health, product safety, social welfare and so on. Accountants work in the real world and must adapt to a world where sustainability matters.

How might accountants contribute to sustainability?

The history of the accountancy profession, particularly in the UK, is a story of responding to new market opportunities, including new demands resulting from changes in the level and nature of business activity from the Industrial Revolution onwards and new legal requirements, such as those imposed by the Companies Act 1862, the Companies Act 1948 and the Finance Act 1965. This history is told in *The Priesthood of Industry: The Rise of the Professional Accountant in British Management* by Derek Matthews, Malcolm Anderson and John Richard Edwards.

The concepts of an accountancy profession and of professionally qualified accountants, which we use throughout this report, reflect an acknowledgement of society's expectations as to how accountants should respond to emerging demands. These expectations revolve around competence and the application of judgement in an ethical context.

One of the key features of corporate structures, the divorce between ownership and control, created new demands for accountability and called for the expert services of accountants. Whereas the earliest members of the professional bodies in the late nineteenth century were largely concerned with insolvency and bookkeeping, together with associated activities such as insurance and debt collection, there was a steady movement into new fields, particularly audit, taxation and trusts, in response to wider changes in society.

This was followed by increased diversification into non-accounting areas and the addition of consultancy services. By the middle of the last century, professionally qualified accountants were engaged in work on costing and information systems, internal control and fraud prevention, asset and business valuation, prospectuses and takeovers and reconstructions. This rapid expansion has been attributed to the profession's ability to bring together the necessary qualities: knowledge of relevant law, numeracy, objectivity and integrity.

The accountancy profession has traditionally responded to market changes and shifts in public expectations. Sustainability offers such opportunities and it is hardly surprising that some accountancy practices have become involved in recent years in providing advice and assurance services relating to sustainability performance and reporting.

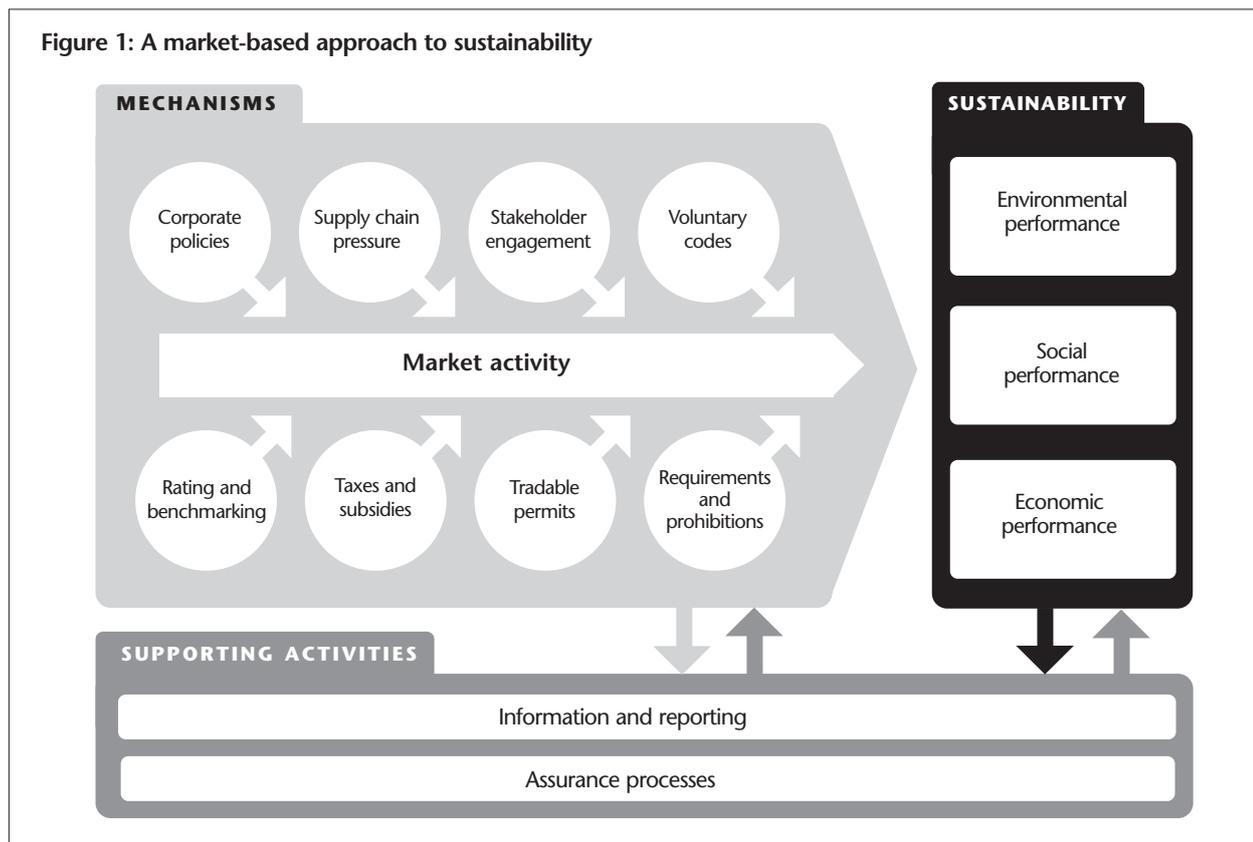
People who are active in sustainability issues are drawn from a wide range of disciplines such as marketing, communications, environmental management, public affairs and investor relations. Because such matters have a direct impact on the public interest, the professions generally are playing a part, as current initiatives indicate. Many law firms have departments dealing with environmental and social regulations. Architects, engineers and surveyors are recognising the need to improve standards of sustainable development.

However, accountants are familiar with sustainability as a concept via a long history of dealing with capital maintenance. In wrestling with the concepts of income and capital, accountants have long been thinking in terms relevant to sustainability. More recently, as explained in a report on the accountancy profession’s involvement with sustainability, prepared by Roger Adams on behalf of the United Nations Environment Programme (UNEP) prior to the Johannesburg World Summit, the profession has contributed to the development of a conceptual basis for sustainability reporting and verification. But there are still challenges in engaging the interest of business, the capital markets and standard-setters in these issues.

This report draws on the results of a recent ICAEW survey of practitioner opinions and also on views expressed by ICAEW members in business in a variety of forums. Although sustainability is now widely seen as a significant concern within government, business and society at large, there are differing views within the accountancy profession and outside regarding the extent to which accountants have a valuable role to play. In the ICAEW Survey, just over 56% of respondents agreed that accountants need to know more about the principles of sustainability if they are to take an independent proactive approach to their work. This report is intended to raise that percentage and go some way to meeting the need to know more.

What is distinctive about this report?

The framework used in this report to analyse the role of accountants in contributing to sustainable development is shown in Figure 1.



There are several mechanisms by which individuals, societies and governments can seek to influence the outcomes that would otherwise be delivered by markets to enhance the three aspects of sustainability, namely environmental, social and economic performance. In many cases, these involve encouraging or forcing organisations to take a longer term view or to internalise external costs and benefits, or limiting choices so that organisations act as if external costs and benefits had been internalised.

This report sees the accountancy profession as having a variety of roles to play in helping to choose appropriate mechanisms and make them work efficiently so that the wishes of individuals, societies and governments are realised. At the heart of the profession's contribution is a recognition of the importance of useful information.

Changes in expectations and attitudes towards sustainability are prompting governments, investors and enterprises to use a combination of such mechanisms. Eight different mechanisms are identified, each of which entails supporting information flows. They are summarised below and are dealt with in Chapters 1 to 8 of this report:

1. Corporate policies

whereby the perceived expectations of society **convince** organisations of the merits of adopting policies on sustainability and publishing information about the policies and their impact.

2. Supply chain pressure

by which the expectations of society **drive** purchasers to promote a desired standard of sustainable performance and reporting amongst suppliers and others in the supply chain.

3. Stakeholder engagement

enabling those with a particular interest to **influence** the decisions and behaviour of an organisation to engage an organisation in ongoing dialogue and a process of feedback to and from stakeholders, supported by information flows about sustainable performance.

4. Voluntary codes

through which society **encourages** organisations to improve particular aspects of their sustainability performance, often requiring a statement for stakeholders regarding compliance or an explanation of non-compliance.

5. Rating and benchmarking

by which investors and others, or agencies working on their behalf, **grade** organisations through the use of benchmarks or ratings on the basis of information on sustainability policies and performance and thus influence the behaviour of organisations and stakeholders.

6. Taxes and subsidies

to **incentivise** organisations to operate in ways that contribute to sustainability, requiring information in the form of tax returns and grant claims.

7. Tradable permits

whereby governments **ration** allocations of scarce resources or undesirable impacts so as to improve sustainability, requiring information about quota utilisation and prices to support the operation of fair markets.

8. Requirements and prohibitions

through which society **mandates** actions that enhance sustainability, requiring relevant information flows to enable enforcement bodies to monitor compliance.

To support each of these mechanisms, organisations, governments, tax authorities, market regulators and stakeholders need to rely on credible information flows if they are to operate effectively. This is an area where professional accountants can help, working with other experts where necessary. The report therefore looks at the potential role of accountants in ensuring that organisations and their stakeholders have the information available to support the mechanisms that will enhance sustainability.

Each of the eight mechanisms is dependent on the support provided by reporting and assurance, as are answers to questions about overall progress towards sustainable development and the contributions of individual organisations to sustainability. We deal with these supporting activities in the final two chapters of the report:

9. Information and reporting

through which organisations **facilitate**, both internally and externally, the operation of mechanisms to promote sustainable development.

10. Assurance processes

through which organisations **underpin** the legitimacy of mechanisms to promote sustainable development.

Together, the eight mechanisms and two supporting activities constitute an infrastructure for promoting sustainability, in which the role of accountants and of the members of any other discipline or profession can be analysed in terms of its contribution to satisfying the wishes of individuals, societies and governments.

In addressing a topic, each chapter describes recent developments, summarises the existing involvement of the accountancy profession and points the way forward. Where applicable, the results of the recent ICAEW survey of practitioner opinions are also included.

What are the wider implications of this report's approach?

As well as helping to clarify the role of accountants in a broad range of sustainability-related issues, the approach adopted in this report could help policy makers and commentators to evaluate alternative or complementary means to achieving a variety of public policy outcomes. Thus, while Figure 1 shows the mechanisms and supporting activities influencing market activity to promote sustainability, they could equally be used to promote other objectives such as equality or economic growth. In this way, the approach shows how information can promote better markets, in the broader sense of markets that deliver outcomes that meet public policy objectives.

The approach may also be helpful in preventing undue reliance being placed on particular mechanisms. Several of the mechanisms can be used in combination. For instance, the EU Landfill Directive limiting the amount of waste disposal to landfill is being implemented in the UK through the introduction of a landfill tax as well as tradable permits. Company disposal policies could also be subject to a code of practice and external ratings. Another example is carbon emissions, which are being controlled through a tax, the climate change levy, as well as being monitored through a benchmarking initiative known as the Carbon Disclosure Project. In the social arena, training policies and labour practices may be influenced by voluntary codes as well as being subject to stakeholder engagement.

Whilst the mechanisms can be used in combination, some may be more practical or effective than others depending on the circumstances involved or the cultural context in which they are applied. For example, taxes and subsidies, tradable permits and prohibitions and requirements all require a high degree of political support because organisations within a relevant jurisdiction cannot opt out. However, other mechanisms can generally be implemented on the initiative of smaller groups within society.

The subject matter can also be highly relevant. In the case of industrial pollution, strict regulation through requirements and prohibitions may be more effective than taxes or levies. However, in the social arena, eliminating the use of child labour by a remote organisation in the supply chain may be more likely to result from comprehensive stakeholder engagement than from requirements and prohibitions.

As regards different cultures, enterprises based in countries that have become used to a high level of regulation are more likely to respond to prohibitions, requirements and taxes than those in less developed countries where effective enforcement may prove difficult. In other countries which have seen the recent rapid introduction of a free market economy, a period of consolidation may be needed before the application of voluntary codes or the adoption of corporate sustainability policies will be effective.

As economies develop, it can be expected that use of the different mechanisms will gradually evolve to reflect the changing influence of governments, regulators, enterprises and stakeholders. Monitoring of the effectiveness of different approaches will be needed so that information about the relative advantages and limitations can be shared and best practices adopted.

UK support for sustainability mechanisms

The UK has taken a leading role in pioneering some of the mechanisms, particularly in the development and use of tradable permits. It will therefore be in a good position to influence the debate in Europe as well as enhancing UK business sustainability. As Michael Meacher, the former Environment Minister, stated in June 2003, 'it is this Government's policy to make sure that environmental concerns are on the corporate radar. We need to make the most responsible business the most competitive one. We have pledged to look at areas where we can use economic instruments to support our sustainable development objectives.'

An à la carte approach to different mechanisms appears to be gaining increased acceptance. The Environment Agency has recently published a discussion document on the best means of modernising environmental legislation *Delivering for the Environment: The 21st Century Approach to Regulation*. To achieve the necessary improvements, the Agency intends to recommend that the UK Government uses a variety of instruments including taxation, trading schemes, negotiated agreements and improved education and to rely more on the use of risk-based approaches.

In the words of John Healey, Economic Secretary to the Treasury, in May 2004, 'the Government is committed to using such a range of policy levers to pursue environmental objectives when appropriate. In some cases it may be done through taxation, in others through trading schemes; it could also be done through tax credits or public spending. In some cases, it may be done by regulation or through voluntary agreements; and, in many cases, they will be supported by information publicity campaigns.'

1. Corporate policies

This chapter describes a number of ways in which organisations of all types react to the perceived expectations of society and minimise the risk of negative reaction, by adopting sustainability policies tailored to their specific circumstances. In some cases, these will be based on relevant aspects of a more general code. Voluntary initiatives by companies that promote corporate social and environmental responsibility were supported by the G8 meeting of government leaders in 2003.

1.1 Background

Since the nineteenth century, companies with visionary leaders have operated social policies for the benefit of their employees and the local community, such as the provision of housing, shops, libraries and doctors by Cadbury at Bournville. Environmental policies, as such, were uncommon. From the 1960s, there has been an increased call for organisations to acknowledge a wider social responsibility, with larger companies introducing more comprehensive policies covering health, safety and the environment. Today, nearly all large European companies, government departments and public bodies have adopted corporate policies covering sustainability issues.

In the social area, policies commonly cover working conditions, pensions, medical care and the employment of disabled employees, although disclosing such policies may cause problems for international organisations due to different employment conditions in different parts of the world. In many cases, corporate policies are directed towards the maintenance and enhancement of intangible assets of a social nature, such as the value of human capital, training, provision and use of facilities for employees and local residents, relationships within the value chain and charitable support.

Environmental commitments usually deal with matters such as the reduction of environmental impacts arising from operations during production and processing, continuous environmental improvement and compliance with laws and regulations. Particular areas covered might include renewable energy use, product design and manufacture, transport, equipment recycling, paper and packaging policies and the treatment of effluents and waste.

For many enterprises, the wider topic of sustainability is shifting from a public relations focus to one of competitive advantage and corporate governance. It is therefore becoming an integral part of operational policy, providing management with the tools to achieve these objectives. In a recent PricewaterhouseCoopers Survey of almost 1,000 CEOs in 43 countries, 79% said that sustainability was vital to the profitability of any company. This is endorsed by individual CEOs and Chairmen. 'Our improved performance derives from integrating environmental, health and safety responsibilities with our day-to-day management activities...' said Keith Butler-Wheelhouse, Chief Executive, Smiths Group plc.

Sustainability initiatives may reduce reputation risk, increase customer trust, raise employee motivation and create long-term shareholder value. However, such initiatives may sometimes be perceived as an obstacle to the personal financial interests of directors or managers, for whom short-term profit may be more important. Strong corporate governance therefore has an important role in ensuring that management incentives are aligned to the long term as well as the short term.

Corporate sustainability policies are not necessarily comprehensive or formalised. The EC communication *Corporate Social Responsibility: A Business Contribution to Sustainable Development* (July 2002) acknowledges that, whereas the CSR concept was developed mainly for large multinational companies, small and medium sized enterprises (SMEs) often manage their environmental, social and ethical impacts in a more intuitive and

informal way than large companies. However, in some cases, SMEs appear to be leading the way as it is easier for senior management to drive through changes and bring policies to life through personal commitment and leadership.

1.2 External pressures

The adoption of corporate sustainability policies is normally driven by the operation of one or more external or internal factors such as:

- external requirements, codes or recommendations;
- national or local media coverage;
- campaigns by investor groups or non-government organisations (NGOs);
- peer pressure or competitive advantage;
- market surveys and customer feedback; and
- employee surveys.

One of the driving factors identified in the EC Communication on CSR is the increasing importance of image and reputation and the demand for more information about the conditions in which products and services are generated. In each business sector, the issues that are material are likely to be relatively few in number and may relate to strategy, process, resources or organisation. As so often happens, it is not just a CSR debate but a question of business risk, although the risks involved may be more concerned with the durability of the organisation than sustainable development.

There is a view that 'focusing on profit maximisation without an understanding of the interaction of the business with its operating environment is courting long-term disaster. Businesses interact with societies on a number of different levels: individually as customers, collectively as consumer groups and as shareholders, and through the spaces that businesses and individuals occupy together. These interactions can have a profound effect on a business's performance if they are not managed wisely. Social responsibility ... is a lesson hard-learned by those businesses that have sought to exploit their customers for the short-term benefit of shareholders, while forgetting that those two groups are inextricably linked.' (Michael Smith, Letter to *Accountancy Age*, 3 July 2003)

Corporate policies provide a mechanism for enhancing reputation and minimising adverse risk. Research by the Dutch accountancy body, Royal NIVRA, published in October 2001, found 'a growing belief that corporate reputation will replace product innovation and design, quality and service as the most important competitive differentiator over the next 50 years.'

The power of the media, such as global broadcasting through satellite television, and the transparency of website reporting play an increasing role in levelling up corporate behaviour and enforcing standards, with the potential to hold businesses to account for their environmental, social and ethical performance in any part of the world.

The experience of Shell in relation to disposal of the Brent Spar oil platform and Nike in relation to the use of child labour in its supply chain also offer painful lessons. Indeed, some would argue that attention to sustainability issues is essential to an organisation's licence to operate through the maintenance of trust and confidence, to fortifying brands and reputation, to attracting key personnel and to managing risks and opportunities that are decisive in long-term business success.

An issue likely to affect corporate policies concerns the degree to which a company may be held responsible when customers voluntarily misuse its products. The traditional view is that an organisation can only be accountable for its own actions and that, having focused on basic concerns, such as product quality, other problems can be left to the marketplace. However, such a view may not necessarily be tenable in the future.

Corporate policies are increasingly likely to deal with product stewardship. Some products may have positive social or environmental impacts on customers, neighbours or society at large (as well as serving their immediate needs); other products may have potentially negative impacts. Companies practice product stewardship in a number of ways, such as through a life cycle approach, covering each stage from resourcing of materials to final disposal of the product, or through a management system such as ISO 14001. Life cycle assessment poses a significant challenge in the case of businesses with a diverse range of products. Product design will often have a beneficial effect, by avoiding health risks, reducing waste, energy or water use.

Social issues are also increasingly likely to have an effect on corporate policies. Examples of the impact of adverse publicity include advertising by alcohol and tobacco companies, including the marketing of 'alcopops' to underage drinkers, accusations that food companies such as McDonald's are responsible for obesity trends, and promotion of vouchers for school equipment by Cadbury-Schweppes. Whilst it is uncertain that lawsuits would be successful, a socially responsible company needs to ensure that its operating and marketing policies are carefully screened to minimise such problems.

1.3 Risk management

Board strategy for controlling risks is essential and company codes have a role in controlling such risks. Social, environmental and economic aspects of sustainable development present business opportunities but also potentially catastrophic reputational risks that must be managed. Professor Michael Power has described the myriad sources of reputational risk as requiring the 'risk management of everything.'

The accountancy profession has a particular interest in the topic of risk, notably the identification, measurement and management of business risk, including reputation risks that may threaten the survival of an enterprise. In 1999, for example, ICAEW published *Internal Control: Guidance for directors of UK listed companies* (known as the Turnbull Guidance) and *No Surprises: The Case for Better Risk Reporting*, a case study based analysis of risk reporting. The following year, ICAEW published *Human Capital and Corporate Reputation: Setting the Boardroom Agenda*, which explored how investing, measuring and reporting human and reputational capital can build a sustainable business advantage.

It is a sign of a mature company that environmental and social matters are recognised and integrated into its risk management and reporting infrastructures. This is evident from the attention paid to such matters by companies identified as the top global reporters in UNEP/SustainAbility's 2002 Survey *Trust us*.

Risk management, a key area for company policies, has also been addressed in a recent paper from the WBCSD Risk Champions Group *Running the Risk – Risk and Sustainable Development: A Business Perspective*. The paper identifies a number of mega risks, such as climate change due to increasing energy use, population dynamics, impacts of globalisation, health risks and resource degradation. The understanding, measurement and control of such risks require company policies with a long-term focus, supported by the closure of information gaps and the creation of an appropriate culture.

1.4 Implementation

As a matter of policy, the assessment of business initiatives should take account of environmental, social and economic impacts. Enhancing sustainability is an essential part of running a good business and the impacts of each dimension need to be managed in an integrated way so that social, environmental and economic decisions contribute to the development of the business in delivering long-term benefits. Moving towards more sustainable development therefore involves structural and procedural changes as well as new management information systems.

Whether the business case for sustainable development is based on its own merits, to gain competitive advantage or to minimise risk, corporate policies need to be devised to

achieve the chosen objectives. The development and implementation of such policies call for an organisation-wide approach supported by reliable information. Policies framed in broad terms may require implementation guidance to overcome practical issues arising in operating units.

Setting corporate policies on sustainability will require high-level decisions. As John Elkington, Chairman of SustainAbility, has observed, 'board members find that prioritising sustainability issues involves such complex triple bottom line trade-offs that they can't be handled by the community relations, environmental or investor relations people in isolation. And there can be very real political and commercial consequences of getting things wrong.'

In a discussion paper published by Henderson Global Investors in May 2003 *Governance for Corporate Responsibility: The Role of Non-executive Directors in Environmental, Social and Ethical Issues*, the trend towards dedicated board examination of corporate responsibility by specialist committees was welcomed. The paper also takes the view that 'carefully selected NEDs from business functions such as the environment, health and safety, consumer relations or human resources, and from non-business backgrounds, can bring valuable perspectives into the boardroom that will enable companies to evaluate key strategic issues more fully and monitor their performance more effectively.'

This is not to say that the executive directors do not need a proper understanding of the environmental and social issues relevant to the operations of the business but this understanding will often be supported by expert advice, obtained at an early stage. Directors will need to consider the impact of the company's operations, policies, products and procurement practices on the environment and on social and community issues, including impacts of its operations on the communities affected. Forthcoming development of the Operating and Financial Review (OFR) is likely to sharpen the focus on corporate policies as the OFR's importance and content expand.

Many attempts have been made to capture the relationship between environmental and/or social policies and financial performance, including different forms of the 'balanced scorecard' approach, developed in the early 1990s by Kaplan and Norton and subsequently adopted by exponents such as Stefan Schaltegger. The approach involves identifying strategic objectives and adopting specific measures in four perspectives: financial, customer, internal performance and innovation/learning. Kaplan and Norton recommended a maximum of 20 measures. The balanced scorecard is sometimes criticised for not fully recognising the importance of stakeholders and the fact that quantification may be difficult. However, it is of interest to note that, following a workshop held jointly with the DTI in March 2003, Forum for the Future has switched its focus to the use of a balanced scorecard approach.

A balanced scorecard approach linking environmental and social issues with financial results has recently been developed by researchers at INSEAD. The technique involves the use of strategy maps to define the value creation process and identify key non-financial indicators. Environmental managers are thus able to assist in long-term decision-making and gaining competitive advantage.

Another device, more obviously suited to enterprises whose activities are primarily of a social nature, is the social return on investment, originally developed by Roberts Enterprise Development Fund. The technique is likely to be of particular interest to enterprises supported by government, local authorities or grant-giving foundations. The technique mirrors financial measures of economic return but shows how organisations create additional 'social purpose' value through their social and environmental activities.

Calculation of social purpose value is inevitably subjective and the technique will need further development but there are clearly parallels with the concept of valuing intangible assets. A pilot study to explore the application of this approach to four business enterprises was carried out by the New Economics Foundation, followed by a seminar in November 2003 to discuss the results. The findings and recommendations are presented in a paper *Social Return on Investment – Valuing What Matters*.

1.5 Benefits

Corporate policies provide an effective way of embedding sustainability principles within corporate governance. As Lord Browne, Group Chief Executive of BP, has said, 'the enlightened company increasingly realises that there are good commercial reasons for being ahead of the pack when it comes to issues to do with the environment.' Shaping policies in a way that reflects an organisation's unique characteristics and driving philosophy may offer a competitive advantage not otherwise available. Although comparability and consistency may suffer, it may also avoid the 'box-ticking' that can result from following regulations and codes.

In response to growing expectations of improved social performance and increased investor interest in social and economic issues, the multinational mining company Anglo American plc has recently piloted a socio-economic assessment kit. The approach provides a framework to enable operations to assess their social and economic impacts on local communities, then to engage with stakeholders, produce a management plan, draw up indicators and report to the community. Voluntary use of the framework every three years by the company's established operations will enable the results to be incorporated in each business unit's community engagement plan.

Corporate policies are likely to have a beneficial impact on all parts of the organisation and will often also help to reduce reputation risks associated with the supply chain. In such cases, implementation and monitoring of environmental, social and ethical codes may be carried out through local agents, thus extending the mechanism beyond the conventional reporting boundaries. The impact of supply chains as a sustainability-enhancing mechanism is further addressed in Chapter 2.

1.6 Key issues

Key issues identified in this chapter are that:

- corporate policies on environmental and social issues are needed to protect corporate reputation and gain competitive advantage;
- the development and implementation of sustainability policies require an organisation-wide approach, supported by reliable information and practical guidance; and
- traditional views regarding the boundaries of an organisation's responsibilities for environmental and social issues are being challenged at the same time as disclosure of sustainability impacts becomes more transparent.

1.7 Practitioner views

Over three-quarters of respondents to the ICAEW Survey (77%) agreed that sustainability performance is inherently good for business and long-term shareholder value.

For the large majority of respondents (over 97%), there has been no demand from clients for services in appraising environmental initiatives or setting a sustainable development strategy, although about one in five firms envisages a need to provide such services in the next three to five years, more often from internal resources than from referral to a third party.

1.8 The way forward

Accountants are well equipped to play a strong role in formulating company policies, developing business cases for action and managing the impacts of sustainability issues in an integrated way. This is likely to extend to identifying, measuring and managing business risk and helping companies navigate the new world of increased transparency.

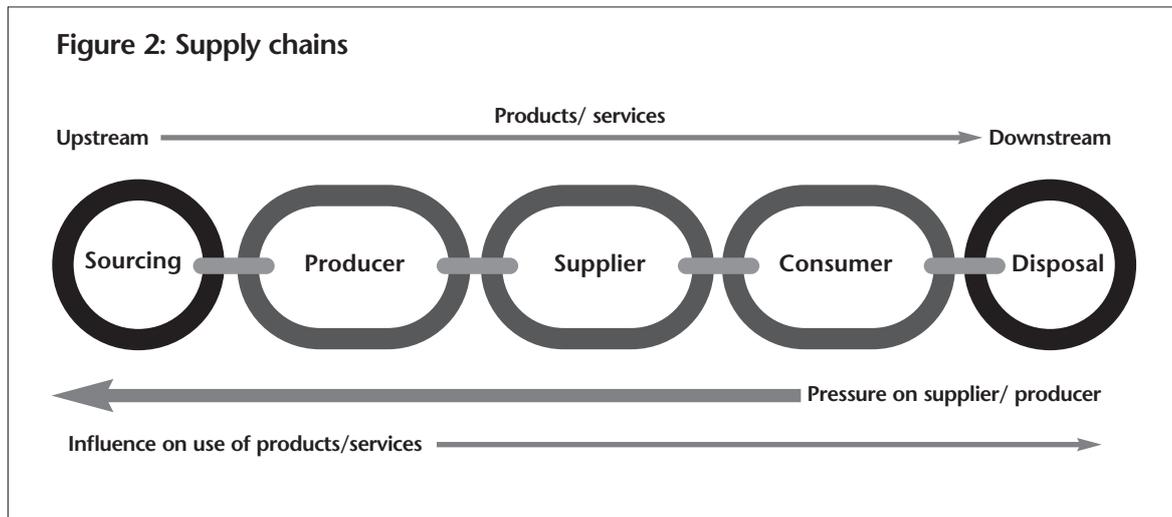
The role of professional accountants may also include providing some form of assurance that company policies are being operated throughout the organisation and its related businesses. This will normally involve the design and use of performance indicators to test the effectiveness of company policies and the reliability of related information.

1.9 Questions for discussion and research

- 1.a How can an organisation ensure that its policies achieve the necessary structural and behavioural changes to enhance sustainability and are there any examples where this has been particularly effective?
- 1.b Is there a role for guidance in translating corporate sustainability policies into practical actions?
- 1.c How can organisations make sure that the assessment of sustainability issues is an integral part of their business planning and risk management?
- 1.d Is there any reason why SMEs should not adopt a policy on sustainability even if some of the issues are not relevant or there is less external pressure?

2. Supply chain pressure

This chapter discusses ways in which supply chains, as depicted in Figure 2, act as a mechanism for promoting enhanced sustainable performance amongst suppliers, particularly small and medium sized enterprises (SMEs).



2.1 Background

Successful business is increasingly about managing external relationships, particularly those within the supply chain. A focused supply chain programme can contribute substantially to the management of business risk. Monitoring supply chain performance is increasingly regarded as good business practice. Organisations are driven to adopt more sustainable policies as a result of pressure in the supply chain. Whilst the impacts are normally customer driven, each part of the supply chain may be affected, i.e. retailers, wholesalers, suppliers and producers, including outsourcing contractors. Investors are also beginning to recognise the importance of supply chains.

The supply chain includes all activities associated with the flow and transformation of goods from the raw material stage through to the end user, as well as the associated information flows. Supply chain management is the integration of these activities to achieve a competitive advantage. It has evolved from a desire to control product quality, price and, more recently, environmental and social impact. Supply chain management practices have a key role to play in promoting more sustainable consumption and production patterns, one of the main outcomes expected from the UN World Summit on Sustainable Development. 'End of life' issues such as recycling or disposal are also part of supply chain management.

The ethics of production and use of contractors in developing countries and the extent to which producers adhere to acceptable employment standards in the clothing, electronics, sports and toy industries, have come under close scrutiny. Individual cases involving unacceptable social or ethical policies have attracted huge publicity, intensified by globalisation of media coverage that has had a significant impact on customer choice. Companies have consequently been driven to adopt a life cycle approach, paying particular attention to the whole supply chain in the sourcing of their products. Questions about the life cycle of products lead naturally to pressures to avoid pollution, social injustice and environmental risk.

Supply chain pressures are not confined to the production of goods; they can also operate in a similar way between the various parts of the value chain involved in the provision of services.

2.2 Impact of customer choice

Customers may exert an impact by showing a preference for goods that have been produced under certain environmental or social standards, avoiding products that fail to meet such standards. It has been estimated that, given the choice, 60% of UK customers would buy products that they perceived to be less damaging to the environment and that 40% of customers actively seek out environmentally preferred products. A survey conducted in 2002 found that 70% of European customers attach importance to a company's social responsibility when purchasing a product and that 44% of European customers are prepared to pay more for products that they consider socially and environmentally sound.

Suppliers are increasingly subject to standards set by the purchasing organisation for adherence to specified production criteria. For example, in 1999, Marks and Spencer plc published its 'Global sourcing principles' setting standards for its suppliers to improve conditions for workers overseas. More specifically, in the belief that their customers would show a preference for timber products sourced from environmentally sustainable forests, B & Q requires its principal suppliers to include this constraint in an auditable environmental policy and reserves the right to review the operation of such policies. In a similar way, Bodyshop International has adopted a formal purchasing policy favouring environmentally friendly materials favoured by many of its customers.

In the textile and clothing industry, Western suppliers and retailers have been held accountable for pollution occurring during manufacturing and social problems in the supply chain. Examples in 2002 included the Clean Clothes Campaign during the Football World Cup and claims against Nike and Adidas that their goods are produced in conditions that deny basic social needs, such as access to toilets and clean drinking water, and involve the use of child labour. In May 2004, Gap published a social responsibility report in which it admitted that some of the suppliers of its clothes used child labour and required employees to accept low wages and work in unsocial conditions.

Supply chain management within the UK public sector is just beginning to bite. Public sector purchasers must operate within the EU procurement rules, highlighted as a matter of particular importance by the Sixth Action Programme. With a purchasing budget of £124 billion in 2003/04, there is huge scope for using UK public sector purchasing power to stimulate sustainable practices and innovation through the supply chain.

2.3 Impact on investment choice

In November/December 2003, the FTSE Group carried out a public consultation, at the request of the FTSE4Good Policy Committee, on the criteria used to address labour standards in the supply chain. To be included in the FTSE4Good indices, the following criteria were proposed for companies in high-impact areas (retailers, household goods and textiles, forestry producers and processors):

- publicly available policies on supply chain labour standards;
- board responsibility or equivalent for supply chain labour standards;
- policy to be implemented with key suppliers as a minimum; and
- commitment to core International Labour Organisation (ILO) conventions on equality and discrimination, forced labour, illegal child labour and worker representation.

The proposed criteria also included evidence of policy communication to key suppliers, training of relevant employees, reviewing and monitoring the management system, together with reporting of key elements and auditing of supply sites.

The fact that Insight Investment Management Limited has recently commissioned two reports on supply chain management (discussed later in this chapter) is further evidence of increasing interest in this mechanism amongst the investment community.

2.4 Tools and techniques

Companies wishing to offer their customers products or services that have been produced in an environmentally and socially responsible manner need procedures and tools with which they can assess performance not only within their own organisations but also along their supply chains. Many organisations have devised their own codes of practice for their supply chains. These often extend to cases where the supply of products or services is outsourced. With increased reliance on outsourcing, companies are seeking ways to manage risks within their supply chains.

Such codes have been used since the early 1990s and are seen as a way in which companies, particularly those operating at a global level, may be able to protect social and environmental standards throughout the production chain. Depending on the reporting boundaries adopted, indicators can be developed to cover social and environmental performance in the supply chain, including outsourced activities. For businesses considering the practical aspects of implementing an environmental or social policy in their supply chain, there are several sources of guidance, such as the Institute of Environmental Management & Assessment (IEMA) guide *Environmental Purchasing in Practice* (September 2002). This includes an illustrative letter to a supplier and a supplier appraisal questionnaire, based in both cases on guidance from the Institute of Public Finance.

An organisation's governance structure, as envisaged by the Global Reporting Initiative (GRI) Sustainability Reporting Guidelines, includes policies and/or systems for managing upstream and downstream impacts, including:

- supply chain management relating to outsourcing and supplier environmental and social performance; and
- product and service stewardship initiatives, including steps to improve product design to minimise negative effects associated with manufacture, use and final disposal.

The importance of the link between purchasing policies and management systems is most clearly demonstrated in the environmental area, where ISO 14001 requires certified organisations to address all significant environmental aspects which the organisation 'can control or over which it has influence.' Use of the word 'influence' can be interpreted as bringing in upstream producers and possibly also the downstream impacts on customers.

2.5 Communication

As well as providing a mechanism operated by the customer, whereby a large company influences the performance of suppliers, supply chains provide a channel for information flows. Thus suppliers, particularly wholesalers, are in a position to direct customers towards specific purchases, for instance those with superior environmental qualities, such as energy-efficient appliances.

It has been found that the communication of information to SMEs about social and environmental issues is more likely to be effective via supply chain management and trade group networks, rather than through government regulation or unfocused mailshots. If such information is received when there is a perceived need, such as a new regulation or carbon tax, its impact will be greater.

Environmental and social reports may be useful in promoting enhanced sustainable performance through a dialogue with suppliers. Where organisations form part of a supply chain, accountability may require transparency of the total life cycle impact, from resource extraction to disposal. Disclosure of significant environmental and social impacts in the supply chain, both upstream and downstream from the reporting entity, may therefore be helpful.

2.6 Limitations

In setting policies and monitoring supply chain performance, the approaches adopted may differ significantly. Larger businesses are independently requiring suppliers to adopt a particular environmental or social policy. If widely practised, such a process could be highly inefficient. From the purchaser's perspective, there is also a significant burden in analysing the resulting data. Many organisations recognise this dilemma but, in the absence of a generally accepted standard dealing with social as well as environmental policy, no solution is readily available. Guidelines may be needed to avoid duplication if a supplier has several large company customers.

The effectiveness of independent standards is by no means assured and will normally depend on factors such as:

- a requirement to follow the standard as part of the supplier's contract;
- avoiding complex or excessive requirements;
- independent certification or verification;
- internal and/or external monitoring;
- an effective supply chain management and information system; and
- enforcement and follow-up procedures.

It is also not sufficient for the purchasing company merely to issue a letter or questionnaire. A recent study of the supply chain of seven major UK retailers, commissioned by the Local Authority Pension Fund Forum, emphasised the benefits of training and capacity-building for suppliers.

For supply chain pressure to be effective, the commitment of the purchasing department is essential. If, in the interests of securing a deal, the buyer ignores or fails to enforce the purchasing company's code of practice, the mechanism will not operate. Furthermore, if a supplier is asked to complete a questionnaire, the buyer needs to recognise its relationship with the procurement process. Company purchasing practices can also sometimes act as an obstacle to the enhancement of sustainable practices through the supply chain, due to the imposition of tight deadlines, price restrictions, just-in-time orders and late order changes. Another problem is the fact that buyer/supplier relationships are often operated on a short-term basis involving numerous suppliers. This is particularly true in the case of outsourced activities organised through a local buying agent.

There is an economic barrier to addressing social and economic issues through the supply chain, in that both the purchasing company and the producer may be penalised for adopting practices not operated by their competitors. Despite frequent assertions that customers would be willing to buy green products and even to pay a higher price for them, companies that offer such products find it difficult to compete effectively unless the products can be sold at a price that is comparable with conventional products.

These problems have been highlighted in two recent reports prepared for Insight Investment Management Limited, *Buying Your Way into Trouble? The Challenge of Responsible Supply Chain Management* and *Gradient: Promoting Best Practice Management of Supply Chain Labour Standards*. The first report indicates that the challenge of operating supply change management in a way that achieves social and ethical commitments may be undermined by such factors as the need to produce quickly and at low cost, issues around flexibility/seasonality and the search for better deals. The second report, based on an analysis of companies' own disclosure and the use of a 'gradient' index developed by AccountAbility for assessing performance on supply chain labour issues, found that very few companies provided comprehensive information about how they address reputation risk regarding labour standards in the supply chain. Such reports are intended to help investors and other stakeholders identify those companies that are at the forefront on this issue, as well as those that are lagging behind their peers.

2.7 Improving sustainability through supply chains

The difficulty of demonstrating a high level of performance in dealing with issues beyond the boundaries of a company is shown by the fact that supply chain management consistently receives the lowest marks in the Business in the Environment Index of Corporate Environmental Engagement.

The implementation of CSR in global supply chains has recently been subject to a major study conducted on behalf of the World Bank Group and resulting in a report prepared by PricewaterhouseCoopers, Denmark and others entitled *Strengthening Implementation of Corporate Social Responsibility Reporting in Global Supply Chains*. The study was primarily concerned with improving CSR in global supply chains and addressed three key challenges:

1. That the plethora of policies operated by different companies generates inefficiency and confusion. The study found that the number of codes with differing requirements, resulting in multiple audits, was considered unsatisfactory, particularly amongst suppliers and SMEs. However, there was more concern about their inconsistent interpretation and application and little enthusiasm for a single harmonised approach.
2. That top-down strategies are not achieving improved CSR implementation. Buyer-driven strategies were considered a necessary catalyst although not regarded as sufficient to achieve real sustained improvements.
3. That suppliers do not fully understand the business benefits associated with making the required investments in CSR. It was agreed that the business case is an important driving factor although there were mixed views as to the strength of such a case.

Whilst it might be invidious to suggest examples of good practice, there are some approaches that appear to have merits. For instance, B & Q offers a phased approach to meeting its supply chain requirements. Certain policies, such as not employing child labour, are treated as non-negotiable whereas other standards are required to be met within two years. During this time, the company supports suppliers in meeting the standards. Suppliers are also set additional standards of a more aspirational nature as part of a process of continuous improvement. H & M has introduced a further refinement. It benchmarks its suppliers and feeds back the results so that they are aware of their performance in sensitive areas and are encouraged to do better than their competitors.

2.8 Small and medium sized enterprises

SMEs are influenced and affected by the value systems of the individuals and organisations in their supply chain, their immediate stakeholder network and more distant societal networks. However, it is evident that the majority of SMEs do not consider the environmental and social record of their suppliers as an issue when selecting trading partners. This contrasts markedly with the practices of large companies.

Supply chain pressures from the purchasing departments of downstream businesses often provide a commercial incentive for SMEs to improve their environmental management. Supply chain linkages have an impact on SMEs as larger companies embrace the spirit of sustainable development by adopting increased life cycle responsibilities as part of their purchasing policies. The environmental and social performance of SME business partners of larger companies is consequently under scrutiny as companies downstream acknowledge accountabilities beyond their traditional boundaries. Production standards are of particular importance in the case of SME suppliers.

Groundwork, a business support organisation, commissioned a MORI survey of small UK firms to identify factors that influence their environmental behaviour (1998). The survey found that the response of SMEs was determined by the level of stakeholder activity. Six out of 10 of the businesses surveyed had been asked for environmental information through their supply chain.

Concern about the environmental impacts of SMEs and the advent of regulation has led to larger companies in the United States acting as mentors to enable companies in the supply chain to improve their performance. Sharing expertise in this way provides a non-threatening, low-risk, low-cost, yet effective, means of introducing small companies to sustainability concepts. Mentors, with technical and managerial expertise, can help SMEs find the answers as well as building a stronger relationship in the supply chain. Mentoring can have strategic benefits for both sides. For companies whose products present potential liabilities for their customers, advising on proper use can help reduce risk for the customer, while strengthening the supplier–customer relationship and the brand name.

2.9 Key issues

Key issues identified in this chapter are that:

- with the extended supply chains that exist for reputation-sensitive brands, pressure to adopt minimum standards as a price of doing business can have an important impact on suppliers, particularly SMEs, both domestically and in some difficult operating areas overseas;
- supply chain impacts generally operate from the downstream end of the chain, i.e. through a real or perceived customer preference for products derived from a particular source;
- to be effective, the application of supply chain standards must be properly planned and well communicated to achieve a high level of commitment internally and externally, with adequate training and support for the supplier; and
- there is scope for some convergence, if not standardisation, of the approaches used for setting producer policies, ensuring their adoption and providing assurance on supply chain performance.

2.10 Practitioner views

In the ICAEW Survey, over 80% of respondents reported that they have clients in the retail and wholesale business and in the property and construction industry. In both of these sectors, supply chains are of particular importance. Some 58% of firms agreed or tended to agree that businesses would become more environmentally responsible if the public were given more information about their environmental performance and that accountants should support initiatives to improve their clients' environmental performance.

2.11 The way forward

With increasing awareness of the importance of managing supply chains as part of good business practice, more companies are likely to introduce policies that minimise reputation risks. As more information is required, as a result of regulations or pressure from customers or regulations, companies may see their responsibility extending to the supply chain. Specific areas in which accountants are likely to be involved include the preparation and monitoring of purchasing policies, and the design and operation of management systems relating to the supply chain.

Accountants in practice whose clients are affected may be asked to perform independent assurance work on supplier performance and the application of codes of conduct in the supply chain. Accountants within large organisations might also be well placed to act as SME mentors if such a system gained momentum in the UK.

2.12 Questions for discussion and research

- 2.a What examples are there of products and services being developed in ways that are more environmentally and socially acceptable without being more expensive and how can such examples be promoted within the supply chain?
- 2.b Are customers, purchasing managers from larger companies or regulators likely to have the most influence on the extent to which SMEs in the supply chain address sustainability issues?
- 2.c In view of the lack of enthusiasm for a harmonised approach, what is the best way of achieving convergence of supply chain policies and the related monitoring process?
- 2.d How can environmental and social performance across the supply chain be improved in a cost-effective way, given that numerous companies remain involved in setting standards and each is responsible for its own operation?
- 2.e Would mentoring provide a cost-effective approach to improving sustainability performance in the supply chain that could be adopted in the UK?

3. Stakeholder engagement

This chapter dwells on the increasing significance attached to engagement with stakeholders in reducing reputation risk and addressing concerns about sustainability. Stakeholder engagement is a conflict avoidance and resolution process. It is widely recognised that there are benefits to be obtained from such engagement.

3.1 Background

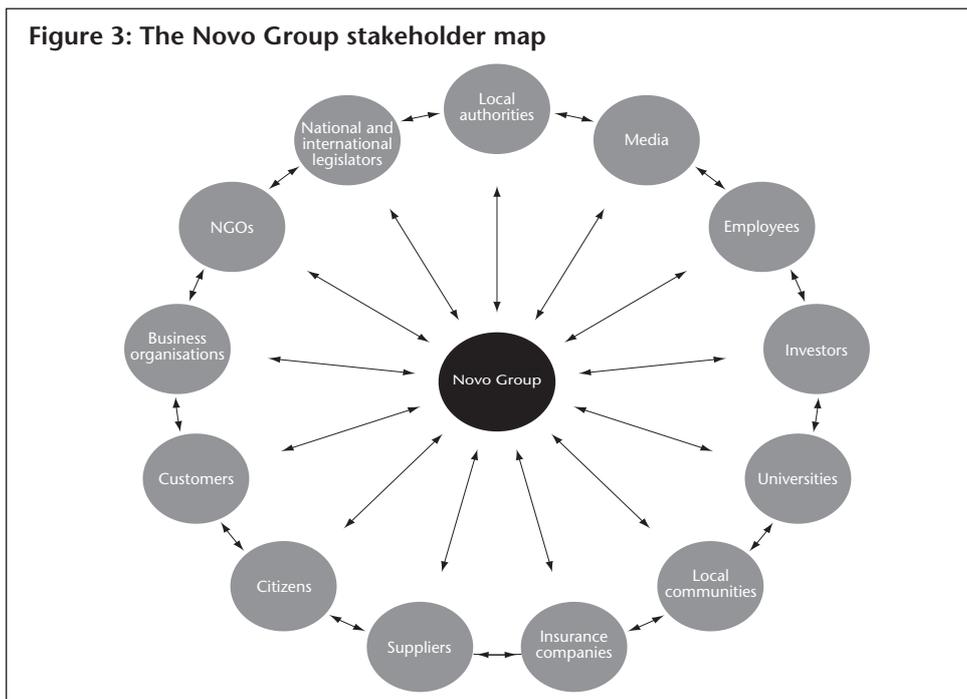
Stakeholders are those groups of people that affect or are affected by an organisation and stakeholder engagement is a structured process for informing and making decisions in conjunction with different stakeholder groups. The resulting dialogue helps an organisation to understand the particular interests and concerns of individual groups and to explore acceptable solutions. Stakeholder engagement does not alter the fact that a company is accountable to its shareholders.

It might be argued that stakeholder engagement implies consideration of the needs of stakeholders and providing them with information without entering into a two-way dialogue. However, to be effective, a proper dialogue is required, giving all groups concerned an opportunity to explain their case and respond to proposals.

Initially, stakeholder engagement may serve to influence the extent of information regarded as material that an organisation collects and reports. Over time, however, stakeholder concerns are likely to have an effect on business policies and practices. The remainder of this chapter therefore refers to both types of stakeholder influence.

3.2 Identifying stakeholders

Organisations are increasingly faced with demands from a wide range of stakeholders, including shareholders, investment fund managers, customers, financial institutions, governments, tax authorities, local communities, non-governmental organisations and the general public. In response, some organisations have begun to map their relationships with stakeholders in a formal way. For example, the Novo Group has published the stakeholder map reproduced in Figure 3 below.



Reproduced with kind permission from The Novo Group Environmental and Social Report 2000.

An economic, social and political analysis of managerial behaviour in UK and Dutch companies carried out by Chris Hibbitt in the late 1990s identified the following categories of stakeholder, in order of relative importance to a typical reporting entity:

1. Shareholders
2. Employees
3. Customers and consumers
4. Public authorities
5. The media
6. Trade creditors and suppliers
7. Neighbours and local communities
8. Industry and trade associations
9. Scientific and educational institutions
10. Environmental organisations
11. Non-participatory owners and lenders
12. Other pressure groups and NGOs

For most businesses, in addition to the above categories, pressure to provide information about social or environmental performance is also likely to come from regulators, insurers and the general public.

3.3 Current practice

At present, formal stakeholder involvement appears to be in an early stage of development. According to a survey of corporate websites reported in the *Financial Times* on 23 May 2003, only 36 sites among the FTSE100 companies and 17 sites among the FTSE250 companies offer some means of stakeholder interaction. As regards encouraging engagement with stakeholders, the survey found that 28 of the FTSE100 sites gave no contact details for users seeking further details. Nevertheless, it has to be recognised that many companies welcome external input and engage with stakeholders, often in an unstructured way, to a greater extent than they disclose.

A recent survey by Zurich-based Sustainability Asset Management, reported in March 2004, found that only a third of companies have any method of feeding the views of stakeholders into business strategy. Of the 800 companies assessed, just 37% have a comprehensive stakeholder dialogue in place. The survey found that, excluding customers and employees, 67% of respondents consider shareholders to be the most relevant for consultation, followed by communities (49%). NGOs, often regarded as a serious risk in view of their potential impact on a company's licence to operate, were considered relevant by only 26%.

Companies are increasingly recognising the importance of engaging with their stakeholders as a means of identifying concerns about sustainability and reducing reputation risk. Following its well-publicised problems in connection with Nigeria and disposal of the Brent Spar oil platform, Shell recognised the need to engage in debate with its stakeholders to safeguard its reputation.

Table 1 sets out observations on best practice examples of reported stakeholder needs, taken from a recent publication by PricewaterhouseCoopers *Trends in Corporate Reporting 2004 – Towards ValueReporting™*.

Table 1: Best practice examples of reported stakeholder needs

Adidas-Salomon

- Provides clear and candid explanation of the need for the company to respond to stakeholder expectations for responsible supply chain management and its importance in building trust and brand value.

BT

- Aligns the key performance indicators with the strategic values of the company and its primary stakeholder groups.
- Clearly explains how the 10 key performance indicators were developed through consultation with investors, customers and employees.

Coloplast

- Explains and describes its commitment to four identified stakeholder groups and reports performance indicators over time for each stakeholder group, with quantitative data and targets.
- Emphasises how company policy links to its value creation objectives and its stakeholders.
- Illustrates for all four stakeholder groups how the company defines its value chains.

The Co-operative Bank

- Defines key stakeholder groups, calling them partners in recognition of their importance to the bank's activities.
- Discusses the need to balance conflicting wants and needs of partner groups.
- Defines indicators used to measure performance and to deliver value for all stakeholder groups.

In its 2003 report on environment, health and safety, Smiths Group plc stated that the company 'recognises the value of engaging with stakeholders in developing our EHS reports... We have completed two employee workshops, held meetings with more than 20 major customers and investors and established electronic consultation via a dedicated website. Our stakeholders identified supply chain management and ... [product impacts] ... as worthy of attention... We also received stakeholder feedback on broader [CSR] questions.'

In a project combining stakeholder engagement with social accounting, Forum for the Future worked with a company producing alcohol, Bulmers Limited, to allocate responsibility for the social cost (and benefit) between different parts of the supply chain: growers, producers, retailers and consumers. By engaging with stakeholders, the company believed that it was able to redefine its role in society and generate a new licence to operate.

3.4 External pressures

Development of the guidelines on sustainability reporting by the GRI is based on a multi-stakeholder process designed to achieve consensus on completeness based on determining what is important to stakeholders. Materiality is built in through the inclusiveness of stakeholder engagement. For GRI, materiality is about disclosing all information of significant concern to stakeholders for assessing the reporting organisation's economic, environmental and social performance.

The Copenhagen Charter, launched in November 1999 by KPMG, PricewaterhouseCoopers and Ernst and Young (published by Mandag Morgen), presented the business case for managing stakeholder relationships. At the same time, the Institute of Social and Ethical Accountability published its framework standard, AA 1000, which seeks to improve performance by a process of learning through stakeholder engagement based on inclusivity. AA 1000 and the related guidance is intended to provide organisations with a tool by which to develop high-quality systems and procedures for stakeholder dialogue.

In June 2003, the Canadian Institute of Chartered Accountants (CICA) published a research report *Stakeholder Relationships, Social Capital and Business Value Creation*. The objective of the research was to explore how stakeholder relationships can lead to the creation of social capital and business value, recognising that a number of companies have focused on building strong stakeholder relationships as a key element of their business strategy. The research was based on interviews with a total of 59 employees and 23 other stakeholders in three companies, selected from different industry sectors.

Some of the conclusions of particular relevance in the CICA report were that:

- the creation of business value from stakeholder relationships is contingent on a self-reinforcing cycle, which can also work in reverse;
- specific relationships will be important for achieving specific goals although relationships often overlap and cannot be considered in isolation; and
- high-quality relationships are built on proactive and transparent communication, consistency and follow through with face-to-face communication being essential for building trust and mutual understanding.

In the UK, the Secretary of State for Trade and Industry, Patricia Hewitt, speaking on 3 November 2003, referred to empowering shareholders – the owners of companies – and quoted the Hermes Principle that ‘companies that act fairly and engage in an open dialogue with investors and the wider public are likely to do better long-term than those that simply pursue short-term profit.’

Whereas a dialogue with institutional major shareholders is expected by the UK’s Combined Code on Corporate Governance (Principle D.1), there is no Combined Code requirement for a dialogue with stakeholders. However, stakeholder engagement plays an important part in corporate sustainability strategies and environmental management schemes. In a number of studies, it has been found that customers are the key driver for adoption of environmental management systems and have greater influence than that of any other stakeholders.

In its final report issued in November 2003, the Accounting for People Task Force recommended that the standard setter for the impending statutory OFR should invite stakeholders to be involved in developing guidelines on key indicators and definitions for reporting on human capital management.

Stakeholder involvement is stimulated by the wider availability of information. Greater awareness amongst affected parties will be promoted as more environmental and social data is required to be filed on public record as a result of regulations governing the freedom of information, particularly environmental information, or provided in response to enquiry.

Encouraging companies to engage with stakeholders in a positive and structured way has not previously been a matter of particular concern to accountants. This may be largely due to the fact that the concept of stakeholder engagement has no strong association with financial reporting and auditing, where statutory requirements and the belief that there should be a level playing field for all shareholders militate against it. However, developments in OFR reporting and related expectations that directors will identify issues through feedback, surveys and focus groups clearly reflect the expanding need for stakeholder engagement and for accountants to be involved in the process.

3.5 Implementation

Under an effective stakeholder engagement plan, it would normally be appropriate to:

- identify stakeholder groups, particularly those not already in dialogue with the organisation, including potential NGO partners;
- build an organisation-wide commitment, based on an understanding of the main features of stakeholder consultation and the likely internal and external benefits;
- review the outcomes of any existing dialogues and the processes used so as to link with future engagement;
- prioritise the stakeholder groups and make some preliminary enquiries to ascertain the main issues likely to be of concern to each group;
- establish a strategy for engagement, decide what techniques to use and assemble the information required for effective dialogue; and
- initiate any action deemed to be required as a result of engagement, monitor progress, provide appropriate feedback to stakeholders and communicate the results within the organisation.

In view of the conflicting interests likely to be involved, stakeholder engagement is often implemented by an independent facilitator, with a plan and ground rules established by the organisation. In some circumstances, meetings or interviews may be more effective than questionnaires, web-based discussion or other forms of written dialogue.

Whether stakeholders have a right to participate in determining an organisation's priorities with regard to environmental, social and economic issues, or only to have adequate information about its sustainability performance to be able to make informed judgements and decisions, depends on the circumstances. Under UK company law, participation in corporate policy is confined to members, i.e. shareholders. However, there are probably few active non-shareholder stakeholders who do not believe that they have rights of some nature.

Companies will wish to consider the merits of engaging separately with different categories of stakeholder. This has the advantage of allowing them to deal separately with specific concerns, which may differ substantially across groups. Coping with the fact that different groups of stakeholders have competing objectives should not be a serious issue. In making decisions, boards regularly have to adjudicate amongst various priorities as to how best to use resources.

Stakeholders may need assistance in seeing the broad picture and taking a long-term view of the organisation. There are likely to be some stakeholders for whom short-term performance is the priority and others who take a longer view. Engagement may help them to understand better the need to weigh immediate benefits and costs against the present value of future benefits and costs. Providing relevant and reliable information is central to addressing all of these needs.

As a result of stakeholder engagement regarding their ethical practices, such as labour conditions in the supply chain, enterprises may seek to address the problem through detailed reporting, in the belief that this may also provide a competitive advantage. However, this not only carries the risk of information overload; it may attract legal action if there is apparent incompleteness or if assertions cannot be proved.

The SIGMA guide to stakeholder engagement provides organisations with two ways to improve their stakeholder engagement practices. In addition to an approach based on the AA 1000 framework, incorporating stakeholder engagement as a core element of the process of managing, measuring and communicating performance, the guide provides a set of tools to help organisations explain and evaluate their stakeholder engagement. These tools look at the drivers of engagement and provide key questions on stakeholder practice and techniques.

3.6 Benefits and limitations

Stakeholder engagement helps enterprises to anticipate issues, to deal with them proactively and to build a better business. An open dialogue with internal and external stakeholders can also lead to a better understanding of the circumstances and risks facing an organisation and provide an opportunity to build, or rebuild, reputation and credibility. It enables an organisation to detect and understand concerns and to forestall investor activism.

Research published by Tomorrow's Company in a report on *The Inclusive Approach and Business Success* (1997) supported the view that 'the inclusive approach, while serving shareholders' interest, particularly in the long term, does lead to business success as a result of improved customer satisfaction, greater commitment on the part of employees, a more effective supply chain and an enhanced reputation in the community at large.'

If stakeholders are to be engaged, their input is likely to become more influential over time, as companies and stakeholders alike develop a better mutual understanding of each others' priorities and concerns. In the initial stages, the environmental and social content of the OFR, for example, will, in most cases, be largely determined by management rather than being stakeholder driven. In some cases, however, companies will be alerted to a problem by feedback from stakeholders.

Effective stakeholder engagement is dependent on the efficient communication of reliable information and its subsequent interpretation and analysis. Sometimes it may be difficult to understand the real issues of concern to stakeholders. An unembroidered explanation is essential. Stakeholders who are properly briefed and actually read the sustainability information provided by an organisation are more likely to have a significant impact and build a mutual understanding of the key issues in a spirit of cooperation rather than confrontation. Solutions require partnership and dialogue, the hallmarks of effective stakeholder engagement. Ideally, there needs to be a model incorporating the principles involved. The implications of engaging with one group of stakeholders in preference to another might be considered to have legal implications. Any risk of action should however be minimised by ensuring that the process is transparent and that the discussion of price-sensitive information is avoided.

Although NGOs are not generally perceived as the most important category of stakeholder, their impact in certain circumstances can be considerable. By working with NGOs, a company may be able to change or enhance its image. NGOs are not accorded automatic legitimacy but their voice will probably carry more weight if they are seen to be effective in representing valid concerns. To be accepted, proposals will need to be seen as realistic and likely to lead to robust business-led initiatives.

Many businesses recognise the need to cooperate with NGOs but are aware of the problems, particularly the 'single issue' approach of many NGOs, the lack of resources available to them to engage in sufficient depth and the risk of embarrassment through an NGO taking advantage of the knowledge gained. Equally, NGOs are wary of becoming too close to the corporate world and are aware of the tension between helping companies improve their performance and exposing them for not performing well enough. A shortage of skilled people to work on behalf of NGOs is also an issue and it has even been suggested that NGO resources should be boosted in some way that would not threaten their independence.

In comparison with larger companies, SMEs are often characterised as being out of touch with the changing desires of their principal stakeholders and end-consumers as well as being unconvinced of the cost savings and market opportunities that can come from a positive sustainability strategy. However, small businesses cannot be expected to consider the range of stakeholders appropriate to a multinational company. Nor does a focus on SMEs provide the same publicity for pressure groups that campaigns exposing the social and environmental problems of multinationals can bring.

3.7 Key issues

Key issues identified in this chapter are that:

- organisations are increasingly recognising the importance of engaging with their stakeholders as a means of identifying concerns about sustainability and reducing reputation risk;
- the proposal that directors should consult with external stakeholders as well as within the business in making judgements about OFR disclosure is likely to be an important driver for change;
- implementing a stakeholder engagement policy requires careful consideration, preparation and follow-up; and
- if stakeholder engagement is to be beneficial, then it requires access to relevant and reliable information about the organisation.

3.8 Practitioner views

The ICAEW Survey showed that there is some support (31% of respondents) for accountants encouraging their clients to engage with stakeholders with regard to environmental issues, although half of the respondents were ambivalent about this. For some reason, encouraging clients to consult stakeholders about social issues was seen as less important (supported by only 21% of respondents).

A perceived lack of stakeholder interest was regarded by 65% of respondents as a major barrier to effective environmental and social reporting, although there were few respondents with large or listed clients likely to be of particular interest to stakeholders.

3.9 The way forward

Effective stakeholder engagement is dependent on reliable information. This is likely to be a matter of increasing concern to accountants with the demand for transparency of information to support the process of feedback with stakeholders. Preparing for and responding to stakeholder engagement will often call for social, environmental and economic data. In the case of practising accountants acting as auditors, advice based on the experience of stakeholder engagement in other types of assurance engagements may be particularly useful in planning and operating the process.

3.10 Questions for discussion and research

- 3.a Are there cases where stakeholder engagement has failed or fallen short of expectations and, if so, what were the principal factors involved?
- 3.b How might an organisation demonstrate that it has taken sufficient account of sustainability issues and are there any viable alternatives to the active involvement of stakeholders in key decisions?
- 3.c How should the various groups of stakeholders with different agendas be encouraged to take a meaningful and constructive approach to a company's policies and performance?
- 3.d In what ways would it be helpful to develop a code of best practice for adoption by stakeholders and those organisations engaging with stakeholders?

4. Voluntary codes

This chapter covers the more significant voluntary codes that have been developed to encourage organisations to adhere to certain standards of sustainability performance. It also includes corporate governance codes, some of which are mandatory for larger companies.

4.1 Background

Corporate codes of conduct have been in place in various forms since the 1930s. Concerns about the growth of foreign investment and the advent of multinational corporations in the 1970s created pressure on companies to declare their adherence to a statement of principles. In some cases, codes are driven by concerns amongst NGOs, environmental groups and trade unions. Investors also use codes to screen share portfolios.

Codes may be adopted by an organisation to:

- emphasise its sound business practices to host governments;
- communicate its involvement with the communities in which it operates;
- influence customers by enhancing brand image; or
- reinforce or enhance internal policies and standards.

The impact of competition and peer pressure may result in a code of practice becoming a market qualifier, helping to identify sector leadership and providing companies with a basis for competitive advantage. Voluntary codes may also have a role in controlling reputation risk. However, there is a danger of seeing the adoption of a code as a box-ticking exercise, thus freezing action at minimum standards if there is no commitment to improvement.

Voluntary codes are often reinforced by an expectation or even a requirement that enterprises will either comply with the terms of the code or explain their reasons for non-compliance. Such reasons would normally be incorporated in an external report and the operation of voluntary codes is therefore closely associated with information and reporting, dealt with in Chapter 9.

4.2 Examples of voluntary codes

There are many voluntary codes that have been designed to achieve environmental, social or economic objectives or a combination thereof. Examples of codes with wide applicability are shown in Table 2.

Table 2: Examples of voluntary codes

Codes addressing more than one aspect of sustainability

- OECD Guidelines for Multinational Enterprises (1976, Revised 2000)
- AccountAbility 1000 Framework (1999)
- UN Global Compact (2000)
- ISO Standards
- Global Reporting Initiative (GRI) (2000, Revised 2002)
- Sustainability Integrated Guidelines for Management (SIGMA) Project (2003)

Environmental

- CERES (formerly Valdez) Principles (1989)
- ICC Business Charter for Sustainable Development (1991)
- CBI Agenda for Voluntary Action on the Environment (1992)
- The Natural Step (1992)
- EU Eco-Management and Audit Scheme (1993, Revised 2000)
- ISO 14001 (1996)
- Project Acorn

Social

- Universal Declaration of Human Rights (1948)
- ILO Tripartite Declaration of Principles concerning Multinational Enterprises and Social Policy (1977, Revised 2000)
- Investors in People (1993)
- Ethical Trading Initiative: Base Code (1998)
- Social Accountability 8000 (1998)
- Amnesty International Human Rights Guidance for Companies (1998)
- ILO Declaration on Fundamental Principles and Rights at Work (1998)
- The Global Sullivan Principles of Social Responsibility (1999)
- US/UK Voluntary Principles on Security and Human Rights (2000)
- UN Norms on Human Rights Responsibilities of Companies (2003)

Corporate Governance

- Caux Roundtable Principles for Business (1994)
- US Model Business Principles (1996)
- OECD Principles of Corporate Governance (1999, Revised 2004)
- The Combined Code on Corporate Governance (1999, Revised 2003)
- PIRC Corporate Governance Service
- The King II Report (2002)

Investment

- UK Environmental Investor Code
- Hermes Principles (2002)
- ABI Disclosure Guidelines on Socially Responsible Investment (2001)
- The London Principles (2002)

In addition, there are several other voluntary codes that have resulted from sectoral or company-led initiatives, such as those developed for application by local authorities and by the energy, chemical, financial services, fishing and forestry industries.

Various steps have been taken to summarise the codes that have been devised, including a *Compendium of Corporate Responsibility Initiatives* produced by the US Council for International Business (2001), *The Corporate Responsibility Code Book* by Deborah Leipziger (2003) and an ongoing project undertaken by the World Business Council for Sustainable Development (WBCSD) and the Institute of Social and Ethical Accountability (ISEA).

4.3 Global developments

Increasingly, there is an overlap between the more focused codes and those of a general nature concerned with sustainability and investment. However, social aspects are not yet covered to the same extent as environmental issues and reference is often made to established social charters of a global nature. For example, more specific coverage of the social area is provided by the UN Norms on Human Rights and codes issued by the International Labour Organisation. Another key social code is SA 8000, a global labour standard focusing on factory standards and related management systems, including independent certification.

The Organisation for Economic Co-operation and Development (OECD) Guidelines for Multinational Enterprises, revised in 2002, set out 11 general policies, the first of which is that enterprises should 'contribute to economic, social and environmental progress with a view to achieving sustainable development'. As regards disclosure, enterprises are 'encouraged to communicate information on the social, ethical and environmental policies of the enterprise' and to 'apply high quality standards for non-financial information...'. In addition, the OECD Guidelines include a whole section on the environment, dealing with operating an environmental management system, providing information about potential impacts, stakeholder dialogue, life cycle impacts, cost-effective measures to reduce damage in the absence of scientific certainty, contingency plans, continuous improvement, education and training.

In addition to bringing countries together through the UN Framework Convention on Climate Change, the United Nations organisation has been active through the UN Global Compact. This initiative has recently announced that more than 1,000 companies are adopting the first nine of its 10 principles concerning human rights, labour and the environment. UNEP has a role in promoting care of the environment and improving the quality of life. Two UNEP initiatives, dealing with financial institutions and with the insurance industry, merged early in 2004 to form the UNEP Finance Initiative and will continue to help enterprises in the financial sector to improve their performance on social and environmental issues.

At the UN World Summit on Sustainable Development, held in Johannesburg in August/September 2002, eight Millennium Development Goals in the social and environmental area were endorsed, including a global target to halve by 2015 the number of people without access to clean water and basic sanitation. There were also targets to reduce and then reverse the loss of biological resources such as fish and forests, developed countries taking a lead in the gradual reduction of agricultural and energy subsidies. It was agreed to accelerate the shift towards sustainable consumption and production (SCP), decoupling economic growth and environmental degradation. Unlike the Kyoto Protocol, there were no specific targets for reducing emission levels. Instead, the text of the final agreement called for countries to act 'with a sense of urgency' to increase substantially the global share of renewable energy sources.

Some codes and other initiatives are related to particular goods or commodities where market power would otherwise lead to highly volatile prices with a potentially catastrophic effect on small producers, such as 'fair trade coffee', and proactive strategies in the healthcare sector to provide developing countries with drugs for HIV/Aids treatment at reduced prices. It could be argued that both these examples involve recognising an external cost, voluntarily internalising it and then passing it on to consumers.

During the last decade, two major environmental management system (EMS) standards have been introduced – ISO 14001 and EMAS, the EU Eco-Management and Audit Scheme. The importance of such systems is gradually growing, although there is some scepticism about what the related certificates prove about a company's commitment to environmental protection in that they focus on procedures rather than outcomes. However, implementation of an EMS often acts as a catalyst for change.

ISO, the International Organization for Standardization, was responsible for the issue of ISO 14001, an internationally recognised standard for voluntary environmental management systems that can be applied throughout a company. It prescribes management controls covering a wide range of environmental matters. Companies may use the standard as guidance for internal purposes or they may seek assessment from an independent third party, usually an accredited certification body.

ISO 14001 includes procedures for:

- environmental policy, including a commitment to continual improvement and compliance with laws and regulations;
- environmental planning, including identification of environmental aspects, legal and other requirements and establishing objectives, targets and environmental management programmes;
- implementation and operation, including responsibilities and authorities, training, awareness and competence, communication, documentation of the environmental management system, operational control and emergency preparedness and response;
- checking and corrective action, including monitoring and measurement, non-conformance and corrective and preventative action, records and a system audit; and
- management review.

In addition to reviewing ISO 14001 with a view to publishing a new standard towards the end of 2004, ISO is assessing the need for an international standard on CSR. However, it has decided to refer to the topic as 'social responsibility' as the concept is not limited to corporations. A technical report on the subject has been prepared which may lead to development of a draft international standard.

In January 2004, the International Social and Environmental Accreditation and Labelling (ISEAL) Alliance issued the final draft of a 'Code of good practice for setting social and environmental standards', together with a related guidance document. The code is an initiative to help standard setters improve the way in which they develop voluntary standards and to demonstrate their credibility. Future work by ISEAL may focus on the ways in which standards are adopted and implemented. The draft code draws on documents issued by ISO and the World Trade Organisation and covers matters such as engagement with interested parties, exposure for comment, participation in the standards development process and international harmonisation. The proposed guidance deals with matters such as publication of an annual work programme, allowing two periods of exposure for comment, public record of comments received and periodic review of standards every five years.

4.4 EU initiatives

The EU continues to be closely involved with practices in the social area. This has included publication of the EU Social Chapter, followed by a green paper and a further communication on CSR. However, a final statement from the EU Multi Stakeholder Forum on Corporate Social Responsibility in June 2004 reinforced existing codes with a series of recommendations but did not propose a new code. A recent newsletter from the European Social Investment Forum (EUROSIF) stated that the European Parliament has 'noted the importance of facilitating, rather than force-fitting, CSR policies.'

In the environmental area, EU voluntary codes of practice are largely centred on EMAS, Integrated Product Policy (IPP) and the EU Eco-Labeling Scheme. The EC Sixth Environment Action Programme, adopted in March 2002, emphasises the role of business in fostering environmental sustainability and the need for a robust environmental management system. EMS adoption varies significantly between EU Member States, with a high level in Germany and a lower level (particularly for EMAS) in France and the UK. The Action Programme includes a commitment 'to encourage a wider uptake of EMAS, to develop measures to encourage a much greater proportion of companies to publish rigorous and independently verified environmental or sustainability reports, and to encourage voluntary commitments to achieve clear environmental objectives.'

EMAS is based on voluntary participation by companies and other organisations that are willing to commit themselves to evaluate, manage and improve their environmental (and economic) performance. Companies (or sites) are registered through verification by an approved third party. EMAS-registered organisations must publish independently verified environmental statements annually. In the UK and many other European countries, ISO 14001 certification is more popular than EMAS verification. For example, in the UK, based on 2003 figures, there are some 3,000 sites registered under ISO 14001 compared with 78 EMAS-registered sites.

The EC has recently published new guidelines to help EMAS-registered organisations develop performance indicators. There has also been discussion about making EMAS a global standard, accessible to firms outside the EU, introducing incentives for registrants and issuing draft guidance on how EMAS should address energy efficiency.

In 2003, the EC adopted a communication on IPP, a voluntary strategy for reducing the environmental impact caused by products during their manufacture, use and disposal. IPP emphasises three dimensions: life cycle thinking, flexibility (allowing market forces to operate where possible) and the need for full involvement by stakeholders throughout all the stages of production and use. The EC approach involves improving the tools that already exist, e.g. environmental management systems (including EMAS), environmental labelling and improving the environmental performance of products.

The EU also operates a voluntary Eco-Labeling Scheme for products that meet certain environmental standards. The scheme is currently being reviewed in conjunction with the EC White Paper on Integrated Product Policy issued in 2003. The EU eco-label has a very low uptake in the UK, with just five eco-labelled products available in UK shops.

4.5 UK experience

The UK Government has supported the OECD Guidelines for Multinational Enterprises, but the approach adopted in encouraging their application by business leaders and investors has been relatively low key. Each OECD country is expected to set up a national contact point (NCP). In 2001, an information booklet was issued by the UK National Contact Point, a government body based in the DTI with a twofold role: to promote awareness of the guidelines and to ensure their effective implementation and development. Apart from stating that the guidelines form an integral part of the Government's policy towards CSR, the booklet provides information, for example on the procedure for raising an issue with the NCP, but does little to ensure implementation.

The UK Combined Code on Corporate Governance represents an archetypal voluntary code supported by the 'comply or explain' philosophy. The Code contains the principle that the board of a listed company should maintain a sound system of internal control and a provision for the directors to review such controls including risk management. It provides a framework for considering sustainability issues. The Turnbull Guidance that supports the Code mentions, in an appendix, that significant risks may include those related to health, safety and environmental issues. Suggestions for good practice incorporated in the Code also include a checklist for new board members prior to their appointment. The sources of information listed include 'any corporate social responsibility or environmental report issued by the company.'

The relevance of CSR issues to risk assessment is also highlighted in the risk-related reporting guidelines published by the Association of British Insurers (ABI), which call for companies to demonstrate that they understand the risks and opportunities associated with social, ethical and environmental issues. It is increasingly recognised in the UK that understanding CSR, particularly environmental and social performance and its impact over the long term, can help companies manage risks and opportunities. As Jim Hayward, Director of Business in the Environment (a brand of Business in the Community), has remarked, 'A company's reputation – hard to gain and easy to lose – has become inextricably linked to its attitude and performance on social, ethical and environmental issues'. It is worth mentioning three further voluntary codes designed to respond to this perception.

Members of the accountancy profession contributed to the development of the *London Principles*, prepared by Forum for the Future/DEFRA, financed by the Corporation of London and issued in 2002, following an initiative by Forum for the Future's Centre for Sustainable Development. One of the outcomes of the project was to devise a set of seven principles to promote the financing of sustainable development.

Under Project Acorn, a new British standard (BS 8555) has been launched which aims to promote best environmental practice for SMEs and to respond to the fact that larger organisations may wish to monitor the environmental performance of their suppliers. Project Acorn provides a framework that allows suppliers, particularly SMEs, to choose an appropriate level of environmental management through which to measure and demonstrate their performance. Companies have the option to gain certification at each of six levels, with the ultimate aim of achieving ISO 14001 certification (level 5) or EMAS registration (level 6). It is expected that Project Acorn will encourage small companies, which account for more than 40% of the UK's GNP, to develop environmental management systems. From June 2003, the IEMA is responsible for developing future phases of the project.

The SIGMA Guidelines, developed jointly by the British Standards Institution, Forum for the Future and the Institute of Social and Ethical Accountability, to assist organisations in integrating sustainability issues in their management strategies, were issued in September 2003. The guidelines, entitled *Putting Sustainable Development into Practice – A Guide for Organisations*, contain an integrated framework of guiding principles and tools for sustainability management. The guidelines are intended to provide a flexible framework, building on existing codes such as ISO 14001 and Investors in People, to improve corporate sustainability performance through an action programme comprising four phases: leadership and vision, planning, delivery and monitoring/reporting.

4.6 Key issues

Key issues identified in this chapter are that:

- codes present an opportunity to gain competitive advantage and support an enterprise's licence to operate;
- codes should preferably emphasise principles of continuous improvement that are accepted throughout an organisation rather than the achievement of minimum standards;
- to be effective, a code of conduct requires a high level of information transparency, both internally and externally; and
- codes need to be integrated with management information systems throughout an organisation.

4.7 Practitioner views

Respondents to the ICAEW Survey did not appear to regard the development of codes by bodies other than the EC and the UK Government as particularly important, in that only 19% of respondents expressed any significant support for ICAEW to monitor and influence such initiatives.

Some 10% of respondents claimed familiarity with the SIGMA guidelines, which were only available in a consultation version at the time of the survey. However, this reported level of acquaintance may have been partly attributable to confusion with guidelines with a similar title, '6 Sigma'.

4.8 The way forward

To be effective, a voluntary code requires buy-in by management and support from individuals throughout an organisation. Accountants may have a role to play in identifying a code appropriate to the particular circumstances of the business. The operation of codes, especially where they are supported by a 'comply or explain' regime, demands judgement and integrity rather than simple box-ticking and is likely to require the involvement of accountants in business.

Professionally qualified accountants are increasingly likely to be involved in assisting boards to meet their corporate governance responsibilities by reviewing internal controls against risks arising from sustainability issues. Where compliance with codes requires some form of assurance, professionally qualified accountants are well placed to perform the necessary work.

4.9 Questions for discussion and research

- 4.a Do voluntary codes have a role in preventing shortcomings in responding to challenging environmental and social issues?
- 4.b To what extent are codes supported by the comply or explain principle more effective than requirements and prohibitions contained in legislation and regulation?
- 4.c Does the proliferation of codes cause problems and, if so, should these be addressed or left to market forces to resolve?
- 4.d Given that some codes are evidently more successful than others, what are the criteria for success?
- 4.e To what extent is it possible, without resorting to detailed rules, to provide guidance to assist organisations translate the commitments involved in codes into practical decision-making?

5. Rating and benchmarking

This chapter describes some of the systems that are used on behalf of investors and others to grade organisations through the use of ratings and benchmarks based on sustainability criteria. Ranking performance within business sectors is generally preferable to a general ranking as the impacts within a sector are more likely to be comparable. Because of their increasing profile, such systems are likely to influence corporate policies.

5.1 Background

Whilst many rating and benchmarking systems are geared to the needs of investors, there are several schemes in operation that serve a more general market, such as those used by governments, eco-labelling for consumers and monitoring of products marketed as ethically sound. Spending on such products has grown by 13% over the past year, according to research by Co-operative Financial Services. Indices such as the environmental index and the corporate responsibility index developed by Business in the Community (BitC) are also designed for a wider audience.

The BitC Corporate Responsibility Index is based on an annual voluntary self-assessment survey and provides a benchmark of how companies manage, measure and report their impact on society and the environment. The results for 2003, the second year of this index, in which 139 companies participated, were published in March 2004. The index is based on four components: corporate strategy, integration throughout the company's operations, management of stakeholder relationships (in relation to the community, the environment, the marketplace and the workplace) and performance in two mandatory environmental impact areas (global warming and waste management) and four company-selected impact areas, including two social impacts. The effect of choosing impact areas indicated greater strength in regulated areas such as health and safety and relative weakness in areas such as the supply chain, energy and transport. One of the difficulties encountered in constructing the BitC index was the lack of comparable information across sectors and even within sectors.

To some extent, the environmental, social and economic indicators devised by the GRI offer a possible way of comparing the performance of organisations. However, given that GRI presently identifies 50 core indicators, many of which are not yet well defined, it is unlikely that they will be widely used in rating and benchmarking, even if GRI reporting becomes commonplace.

5.2 Socially responsible investment

The main impetus for rating and benchmarking systems comes from the growth of socially responsible investment (SRI). This involves taking account of social, environmental and ethical considerations and the extent to which corporate strategies and risk management include such factors in the selection, retention and realisation of investments and the responsible use of rights attached to investments. The process often includes negative or positive screening using a range of different criteria and may lead to shareholder activism or other forms of stakeholder engagement intended to influence an organisation's activities. Positive screening aims to identify those companies which score highly on sustainability criteria whereas negative screening eliminates investment in certain sectors, such as alcohol, tobacco, weapons and gambling. The screening process therefore provides a means by which the external impacts of an enterprise are included in assessments of its performance.

There is no doubt that interest in SRI is increasing, with consequent benefits for enterprises that pursue socially responsible policies. As Graham Ward, a former President of ICAEW, stated in a presentation in Oxford on 5 April 2001: 'By committing to the concepts and principles of sustainability and corporate social responsibility in their broadest sense, companies will more easily be able to attract long-term capital and enhance the confidence of regulators and the wider public in their brands.'

In Europe, the total value of SRI by institutions reached €336 billion by 2003. In the UK, £80 billion of equities held by pension funds and £17 billion of equities managed on behalf of charities are subject to SRI policies or negative screening. The institutional SRI market has expanded rapidly since changes to the Pensions Act and the Trustee Act came into force in 2000 and 2001 respectively.

EUROSIF, launched in 2001, promotes the practice and development of SRI. In October 2003, with EC support, it published the first comprehensive study of institutional SRI across eight European countries, including the UK. EUROSIF plans to issue guidance for mainstream pension fund managers by the end of 2004, developed in conjunction with the OECD and national social investment forums. The UK Social Investment Forum (UKSIF) is the UK's network for SRI. Its main purpose is to promote and encourage the development and positive impact of SRI amongst UK-based institutional investors through its Just Pensions programme.

In the belief that ethical investment can improve returns, the UK's Investment Management Association published a guide in September 2003 on ethically and socially responsible funds for investors who want to learn more about stock screening criteria and processes. The guide identifies some 17 negative criteria and five positive criteria, all of a qualitative nature, and includes charts showing the relative performance of ethical investment over periods of up to 10 years.

Investor awareness of climate change is increasing as the risks and opportunities become more apparent. In an initiative known as the Carbon Disclosure Project, established by a group of 95 institutional investors with over \$10,000 billion under management, the world's 500 largest quoted companies were asked for information about their GHG emissions and those from their supply chain, products and services – and how they manage climate change issues. The survey is aimed at the development of common emissions measurement methodology integrated into general management systems. Commenting on the results of the survey, released in May 2004, to which 92% of the UK-based firms responded, James Cameron, Chairman of the Project, said 'Companies failing to respond or providing weak responses to those (investors) that own a significant share of their business will invite particular scrutiny from the investment community. Investors now have ample understanding and opportunity to reallocate assets to reduce climate change risk and invest in companies offering solutions.'

5.3 Investment policy disclosure

Since July 2000, UK pension fund trustees have been required to publish a statement of investment principles including their policy as to whether they take ethical, social and environmental factors into account in their investment decisions. A survey by Ashridge/Just Pensions in September 2002 found that 68% of pension funds state that they take account of such factors, although 80% of trustees said that they do not receive sufficient information on the issues. There appears to be a gap between institutional SRI policies and practice, showing that policies set out in the statement of investment principles published by institutions are often not fully implemented. Only 5% to 6% of companies were found to provide appropriate information on social or environmental impacts and risks. However, within 3 to 10 years it was expected that pension fund activism would have a significant effect on the way companies manage impacts and risks.

Disclosure guidelines on SRI have been issued by the ABI (last update February 2003) to guide institutional shareholders and to provide a benchmark for companies seeking to develop best practice regarding the disclosure of social, environmental and ethical matters and their verification. The guidelines are intended to apply to all companies, including SMEs, and deal with such matters as identification, assessment and management of risks, stakeholder engagement and disclosure of the reason for choosing a particular method of verification.

In March 2004, a requirement was introduced in Australia whereby companies providing investment products must declare whether or not they take account of labour standards, environmental, social or ethical considerations. If they do, the method used and any weighting system adopted must be disclosed. Whereas the UK requirement only applies to pension funds, the Australian regulation also affects managed funds and life assurance and is supported by detailed guidelines.

5.4 Impact of SRI on investment performance

There are differing perceptions regarding the extent to which SRI affects portfolio performance and volatility. Despite extensive research, including studies by the Institute of Business Ethics, City University, the US Wharton School, Morgan Stanley, AMP Henderson, Mercers, WestLB and Innovest, the evidence is inconclusive.

For example, in the USA, it was reported recently that two environmental SRI funds (Green Century and Winslow Green) have produced returns outperforming 99% of other balanced mutual funds. A recent survey conducted by Harris Interactive for Calvert, a US group of socially responsible mutual funds, found that 84% of investors are more likely to invest in a mutual fund if it engages in ethical business practices. Calvert concludes that 'well-governed, socially responsible companies are better positioned to deliver long-term sustainable value to their shareholders.'

On the other hand, a report by Pictet & Cie, a Swiss investment bank, found that good stakeholder engagement was more likely to result in outperformance than well defined environmental policies, sound corporate governance strategy or supply chain relationships. However, this view was subsequently challenged and it was admitted that there was a positive relationship with SRI.

A 2000 survey of European fund managers, analysts and investor relations officers, published by CSR Europe in conjunction with Deloitte and Euronext, reported mounting evidence that the financial community is beginning to observe a direct link between non-financial risks and shareholder value. On the other hand, a report from the Nordic Partnership issued early in 2004 claims that there is a limited role for the current SRI indices and evaluation questionnaires, largely due to a lack of standardised screening methods that makes them hard to compare.

This uncertainty may explain the fact that, despite the growth of SRI funds, a survey in 2001 by BitC found that, when asked what they take into account when making or recommending investments, fewer than 5% of financial analysts and fund managers mentioned social and environmental performance (*Investing in the Future: City Attitudes to Environmental and Social Issues*). However, a similar survey carried out the same year found that, when asked directly, a third of analysts said that social and environmental policies were important in helping them assess companies.

5.5 Investment rating systems

The Dow Jones Sustainability Group Index lists companies representing over \$5 trillion and offers a view of best-in-class performers. Launched in 1999, this was the first global index tracking the financial performance of leading companies publishing sustainability information. In addition to the global index, which covers over 300 companies from 22 countries, a European index covering 178 companies in 13 countries was introduced in 2001. The selection of index components is based on an assessment of general and industry-specific sustainability criteria and is reported on by an external auditor. The index's creators, Sustainability Asset Management, believe that the approach adopted identifies the degree to which companies are effectively managing the risks and opportunities associated with sustainability.

The value of total assets managed using the Dow Jones Sustainability Indices in April 2004 was equivalent to over £1.9 billion, 80% higher than a year before. The Dow Jones indices are claimed to influence the investment decisions of 51 asset managers, although only two of these appear to be UK-based.

In the US, www.SustainableBusiness.com each year announces the world's top 20 sustainable stocks. US investor pressure on companies to address climate change has risen with the release of a call for action by 10 of the biggest US pension funds demanding more information on corporate risks posed by global warming and the related costs. Investment managers are expected to assess these impacts when considering whether to buy or sell stock.

In Europe, Triodos Bank NV, operating in the Netherlands, adopts an investment policy based on 'people, planet and profit'. Potential investments are screened using three types of screen – exclusionary (negative screening), comparative (best in sector according to sustainability criteria) and inclusionary (positive screening for sustainable activities). The Paris-based social ratings agency Vigeo has launched its Equitics research model to assist fund managers in making portfolio allocation decisions based on SRI considerations. A joint initiative by Kempen/SNS, leading Dutch securities firms, has resulted in the publication of an SRI index for smaller European companies.

UK investors are not short of advice on SRI. The FTSE4Good Indices, launched in 2001, are comprised of companies drawn from the main FTSE indices that are included or excluded on the basis of their policies, processes and performance in terms of social and environmental best practice. FTSE4Good has recently deleted 29 companies for not meeting its criteria, which now require companies to adopt a policy of improving their impact on the environment, auditing the progress made and communicating the improvement.

The Corporate Governance Service provided by PIRC (Pensions & Investment Research Consultants) Limited is based on the principle that institutional investors should exercise their voting rights positively as part of the prudent stewardship of their assets. Launched in 1991, the service is now used by pension funds and investment managers with combined assets of over £300 billion. PIRC researches, monitors and reports on issues affecting shareholder rights, including compliance with codes of best practice, corporate governance, environmental policy and corporate social reporting, engaging with companies before issuing a report. In February 2003, PIRC launched an enhanced service, GovernancePlus, incorporating:

- key performance indicators on environmental and social issues;
- best practice criteria, focusing on environment, human capital, human rights and community involvement; and
- assessment of reporting in line with ABI guidance on social, environmental and ethical matters in annual reports.

The service provided by PIRC is restricted to UK companies, whereas in 2004 the National Association of Pension Funds (NAPF) Institutional Share Service, which issues proxy voting indicators, was extended to include companies in Europe and the US as well as the UK.

Morley Fund Managers, the investment arm of Aviva Plc, uses a simple SRI matrix based on two dimensions: the nature of the business and the level of management responsibility. Organisations such as CoreRatings and Innovest assign SRI ratings in the style used by the debt markets, based on an analysis of the issues facing companies and how the companies deal with them.

Another system, operated by Trucost, is based on extrapolating information from a company's management accounts, as well as its published accounts and those of its suppliers, using assumptions where data is not available. Additional disclosure from the supply chain will improve a company's rating although this may not indicate improved

environmental performance. The rating represents the extent to which a company's external environmental costs are incorporated in its accounts. In the same vein, one of the Hermes investment principles aims to discriminate against companies that externalise costs to the detriment of society as a whole.

5.6 Quality of SRI research

The New Economics Foundation, one of the pioneers of social accountability in business, is critical of the growth of SRI funds using the FTSE4Good Index as a convenient yardstick and believes that neither investors nor their financial advisers have enough information. Such weaknesses are confirmed by other studies.

Early in 2004, SustainAbility and Mistra, a Swedish foundation that funds environmental research, issued a report focusing on the work of investment analysts in Europe, the USA and Canada specialising in environmental and social criteria *Values for Money – Reviewing the Quality of SRI Research*. In most cases, the investment research process and the related results are not independently assured. Against a background of increasing expectations and competition, most research organisations were found to be weak in a number of areas, such as the following:

- research methods are not tailored to address sector-specific issues;
- impacts of environmental and social issues on investment value drivers are not analysed;
- although qualified on environmental and social matters, analysts often lack the financial skills to address strategic issues; and
- information obtained from companies is seldom confirmed from another source.

There are concerns about the number and variety of benchmarking approaches adopted by rating organisations and the lack of transparency. Diversity of approaches can result in a company being included in one index but not in another, which is confusing for both companies and investors. According to the EC Communication on CSR in July 2002, investors who responded to the earlier Green Paper on the subject stressed the need to improve disclosure and transparency of companies' practices, rating agencies' methodology and the investment management of SRI funds and pension funds. It also took the view that the development by rating organisations of criteria and indicators used to identify socially responsible enterprises is essential. EUROSIIF has recently followed this up with guidelines designed 'to enable asset managers to say how they create and select an SRI fund.' EUROSIIF's *Transparency Guidelines for Sustainable Funds*, issued early in 2003, are supported by an increasing number of investment rating organisations.

As yet, there is no sign of the various indices converging, although their greater use by analysts and commentators may lead to increased transparency and higher standards. However, there is a movement amongst SRI bodies to agree a common approach and a quality standard for sustainability ratings has been developed in a joint project by 15 European research organisations, funded by the EC. The standard CSRR – QS 1.0 (*Corporate Sustainability and Responsibility Research*) addresses criteria such as independence, scope, documentation, timeliness, comparability, relevance, stakeholder contacts and publication of results. The proposed standard includes a number of principles regarding quality, integrity and ethical standards to which research groups are expected to be committed. The project aims to improve quality-management systems, stimulate transparency, facilitate assurance processes and form a basis for further verification procedures. Whether it will lead to an answer to the question: 'Who will rate the rating agencies?' remains to be seen.

5.7 The burden of questionnaires

One of the problems faced by the rating organisations is that information required for benchmarking is not presented in a form that analysts can easily use. As there is no standard reporting format or content, a questionnaire is commonly used to obtain the

data required. However, this approach can be unwelcome for the recipient. For example, Forum for the Future has found that 'Speaking to our partners, they often complain at the sheer number of rating and benchmarking questionnaires and the amount of time it takes to fill them in. Many are choosing not to respond to questionnaires as a matter of policy; they would rather be spending time putting sustainability into their business.' A similar problem arises at BT, which has noted an explosion in the number of questionnaires received over the last three or four years and estimates that it is currently spending around £25,000 annually completing questionnaires on CSR.

In April 2004, the London Stock Exchange announced that it is collaborating with UKSIF to reduce the growing burden of surveys and questionnaires from rating organisations. The Stock Exchange hopes to find a more efficient channel for communication, ideally involving the use of a single questionnaire. In the US, a possible solution to the problem of survey fatigue has been found by SRI World Group Inc, in the form of 'OneReport', a global electronic reporting network through which companies make their social, environmental, economic and corporate governance information available to all interested parties. Participants already number 22 Fortune 100 companies, including DuPont and Shell.

More general reservations about the benefit of ratings and benchmarks have also been expressed by Tomorrow's Company in its recent paper *Redefining CSR* which take the view that: 'The real agenda is about the company's personality and its trustworthiness, not the 'selling in' by CSR managers of particular initiatives or the pursuit of particular rankings by rating agencies'.

5.8 Key issues

Key issues identified in this chapter are that:

- there is a growing demand for readily accessible information that will help users to judge the social, environmental and economic performance of organisations, both within business sectors, across all sectors and over time;
- business is increasingly faced with questionnaire overload due to the existence of multiple benchmarking organisations and a reluctance on the part of such organisations to utilise published information reported in a non-standard format;
- evidence regarding the performance of socially responsible investment is inconclusive but there is a significant degree of support for this type of investment; and
- fund managers are increasingly under pressure to disclose their policy regarding the consideration of social, ethical and environmental factors in investment decisions.

5.9 Practitioner views

The ICAEW Survey did not address the issue of practitioners' involvement in external rating and benchmarking of their clients.

5.10 The way forward

To operate effectively, benchmarking requires the timely publication of information that is relevant, comparable and reliable. Accountants have the expertise to collect and present such financial and non-financial data, working with other experts where necessary. Accountants will also have a role in interpreting the results of benchmarking. This is likely to include understanding the different bases used in order to be able to compare and analyse the resulting ratings.

The accountancy profession may also be able to assist in raising the quality and credibility of the approaches adopted by the increasing number of benchmarking organisations. Initially, it might be helpful to carry out a survey of the products that are available on the market. If a standard approach is developed, accountants could be involved in providing assurance that ratings are based on the standard.

5.11 Questions for discussion and research

- 5.a In which areas could corporate sustainability performance be improved by greater use of rating and benchmarking?
- 5.b What criteria should be used to identify enterprises that are socially, environmentally and economically responsible?
- 5.c What are the benefits and limitations caused by the growing number of indices and can market forces be relied on to identify the most useful indices for benchmarking organisations?
- 5.d What steps are necessary to increase the transparency of rating agencies' methodology and to ensure high standards are applied in benchmarking environmental and social performance?
- 5.e Would a more rigorous disclosure format reduce the need for reliance on extensive questionnaires and the consequent tendency to adopt a tick-box approach?

6. Taxes and subsidies

This chapter refers to a number of different taxes (or other levies or penalties) and subsidies used to incentivise organisations to operate in ways that contribute to sustainability.

6.1 Background

For many years, governments have used taxes and subsidies to achieve social, economic and environmental objectives. UK examples in the social and economic area have included employers' National Insurance, selective employment tax, regional development grants, inheritance tax and the recently announced child trust fund. Other examples of internalisation of external costs include the charge to football clubs of extra policing on match days and the congestion charge introduced by Ken Livingstone, Mayor of London. In his speech at a CBI/Green Alliance conference in October 2000, the Prime Minister acknowledged that Britain's Kyoto target of a 12½% cut in greenhouse gases was not enough to deal with climate change and announced a new £50 million renewable energy subsidy for setting up offshore wind farms. Such devices have the effect of meeting desired aims by lifting or shifting a financial burden.

Sustainability concerns could also lead to the removal of tax breaks and public subsidies, such as those given to the aviation industry providing exemption from tax on aviation fuel, with the benefit being transferred to public services or measures to alleviate the problem of aircraft noise. Another example would be the removal of agricultural subsidies in order to discourage production and reduce related pollution from fertilisers.

Following an independent review, the World Bank is expected to phase out its financial support for oil projects in favour of lending to renewable energy schemes. Rebalancing its lending priorities to help governments adopt sustainable energy strategies that minimise climate change and address the energy needs of the poor will mean that the World Bank should stop investing in oil production by 2008 and instead support renewable energy and energy conservation projects, increasing its investment in renewables by about 20% annually.

The introduction of taxes to promote one aspect of sustainability, such as the environment, is fraught with difficulties in relation to other issues, such as social justice and fairness. For example, research on the distribution of environmental taxation in Denmark analysed the high level of individual taxes and duties related to environmental concerns. The results suggest that taxes on fuel and vehicle registration are progressive whereas most other environmental taxes are regressive, especially those on water, retail containers and carbon dioxide emissions. The majority of the direct tax burden falls on households and there is a relatively light burden on producers and employers. Rural households are also more exposed to certain environmental taxes because of transport requirements and limited access to district heating and natural gas.

6.2 EU Directives and initiatives

The Fifth EC Environmental Action Programme (now followed by the Sixth Action Programme) called for the internalisation of external environmental costs so that, in addition to actual costs incurred, such as energy, waste and remediation costs, enterprises would bear the external costs not currently reflected in market prices, such as those resulting from harmful emissions. Taxes and subsidies are essentially matters for Member States and one of the ways in which this policy is being implemented at EU level is through the operation of marketable permit trading schemes as described in Chapter 7.

Carbon taxes have been introduced in many European countries since Finland introduced the first one in 1990. The other Nordic countries and the Netherlands quickly followed suit with national taxes on fuels or the consumption of energy. However, for multilateral purposes, emission trading schemes have been preferred, possibly due to concern about the loss of sovereignty in tax administration. Whereas a trading scheme sets a quantity of

emissions (a quota of allowances) and lets the market find its price, a tax sets the price and lets the market find the quantity of emission reductions. For governments, an advantage of a tax is that it generates revenue although at a cost in terms of public perception. Carbon taxes are also consistent with a trend from taxing 'goods' to taxing 'bads'. Despite the attractions of trading schemes, carbon taxes are therefore likely to continue to play a role in tackling climate change.

Pollution prevention is seen as a preferred alternative to post-contamination remediation or clean-up. It calls for the introduction of a time dimension in that the benefits and costs of prevention need to be compared with the present value of future benefits and remediation costs.

The 'polluter pays' principle was first developed by the OECD in the early 1970s. Whilst apparently straightforward, it fails to address the situation where the polluter cannot be identified or lacks the necessary resources to meet the cost of remediation. In such circumstances, more widespread use of insurance may help to prevent the burden becoming a social cost.

The 'precautionary' principle, which pre-dates EC legislation and has a long academic history, requires decision-makers to leave a margin of error for lack of information, to take thoughtful action in advance of scientific proof of cause, and to place the burden of proof on the decision-maker rather than the affected party. One of the difficulties associated with operating this principle stems from the different interpretations adopted at EU and UK level. For instance, the UK Government would argue strongly that the precautionary principle does not shift the burden of proof.

The EC Communication on Integrated Product Policy, published in June 2003, attempts to strike a balance between differing views on proposals set out in the preceding green paper. Plans for tax breaks on 'green products', including plans for reduced VAT on eco-label products, have been dropped, although the rationale for IPP, its life cycle approach and the focus on a mix of policy instruments, remains.

A new EU framework for the taxation of energy products came into force in January 2004, following approval of the Energy Tax Harmonisation Directive in October 2003. The directive expands taxation to a broad range of energy products, including electricity used for heating and other purposes, as well as setting minimum tax rates for these products. Previously, only the taxation of motor fuels was subject to such harmonisation. The directive contains numerous exemptions and derogations, and allows lower tax rates to continue for motor fuels used in agriculture and forestry. Special conditions also apply if Member States adopt other measures to reduce energy use, such as voluntary agreements with industry, emissions trading or road use charging. Member States may also exempt domestic use of fuel.

The proposed EU Directive on Remedying Environmental Damage – the Environmental Liability Directive – is intended to implement the polluter pays, prevention and precautionary principles by creating a financial liability for damage to the soil, water and biodiversity. The proposed directive has potentially wide-reaching consequences, further addressed in Chapter 8.

6.3 UK law and regulations

There is a trend in favour of seeing all taxes as contributing to social ends because they are used to finance health and education spending and welfare payments. Consequently, the conventional view that tax avoidance is legitimate and distinct from tax evasion is increasingly being challenged, as issues of morality and an organisation's economic footprint replace a focus on compliance with tax legislation. To some extent, taxes and subsidies are more problematic than tradable permits where self-interest is channelled into market activity rather than into compliance with legal rules regardless of the intent behind the rules.

In July 1997, the UK Government announced its intention to use tax and other economic instruments to deliver environmental objectives and to support economic growth that is both stable and environmentally sustainable. This strategy of linking taxation and environmental policy was further developed in November 2002 in *Tax and the Environment: Using Economic Instruments*. The guiding principles behind market interventions are that they should respond to a clear market failure, be proportionate and relevant to that failure, as well as ensuring that the market allocates resources more efficiently.

The UK policy of moving towards sustainable development through the use of environmental taxes to internalise external environmental costs, thus taking into account the total cost of production, is now well under way. The aggregates levy, the landfill tax, the climate change levy and the enhanced capital allowance scheme are all based on a policy to support sustainable development.

For example, the aggregates levy was introduced in April 2002 at a rate of £1.60 per tonne and offset by a 0.1% reduction in employers' National Insurance contributions. The tax is intended to reduce extraction of primary aggregates and to encourage the development of alternatives such as used tyres and glass.

The environmental impacts of transportation, particularly vehicle use, have also received attention, in the form of fuel taxes, the fuel duty escalator and company car tax benefit rules. By shifting the criteria from engine size to emissions performance and removing discounts for higher business mileage, the reforms in 2002 have encouraged the use of more fuel-efficient cars, fewer company cars and reduced business mileage. The fuel duty escalator proved unpopular although it was a good environmental mechanism. Road tolls, particularly for motorways, are also increasingly viewed as a possibility. All of these devices operate in a way that internalises external costs and acts as a disincentive to the use of vehicle transport.

Measures announced in the 2004 Budget included an extension of climate change agreements to additional industries, freezing of the climate change levy for a further year and new extended eligibility criteria enabling energy-intensive sectors to obtain an 80% rebate if they introduce energy efficiency measures to cut emissions. Other environmental proposals were a reduced rate of VAT on ground-source heat pumps, tax relief on energy saving measures in the private rented sector and a further increase in fuel duty from September 2004.

Together with fuel taxes, it has been estimated that 8% of revenue from UK Government taxes can be described as environmental taxes. These dwarf revenues from fines for breaching legal and regulatory requirements and prohibitions even though fines for environmental offences by UK businesses rose by 38% in the last year. A number of commentators have referred to the low level of such fines and called for them to be increased so as to act as a more effective disincentive to irresponsible behaviour.

6.4 Landfill tax

A landfill tax of £7 per tonne for active waste and £2 per tonne for inactive waste was introduced on 1 October 1996. The standard rate for active waste was raised to £10 per tonne on 1 April 1999 and is being increased each year by £1 per tonne, to a rate of £15 per tonne in 2004/05, with a further increase by £3 per tonne each year from 2005/06.

Since 1996, the Landfill Tax Credit Scheme has allocated grants for environmental schemes intended to benefit local communities, thus recycling money extracted through landfill taxes. Grants are administered through distributor organisations. Some of these are set up by the landfill operator companies to support projects within a few miles of the landfill site. For example, a tax credit scheme set up by Shanks Waste Management provides 90% funding for The Laundry, a paper recycling enterprise that offers an affordable weekly recycling service for small organisations.

The Government has reduced the amount of funding available through the Landfill Tax Credit Scheme as a result of the expected reduction in landfill, despite an increase in the landfill tax rate. However, the value of the scheme in 2004/05 is expected to be around £48 million, which will be available to be distributed if all landfill operators take part in the scheme. The relaunched scheme will concentrate on funding community and environmental improvement projects rather than sustainable waste management projects and its scope has been extended to include biodiversity projects.

6.5 Climate change levy

The UK climate change levy came into effect in April 2001. The levy is a tax which applies to business and public sector use of gas, coal, electricity and liquefied petroleum gas (LPG). It gives those sectors an incentive to improve energy efficiency and thereby reduce GHG emissions. Energy intensive users are most affected, suffering a 10–20% increase in energy costs, partially offset by a small reduction in employers' National Insurance contributions.

For high energy-using companies in certain industrial sectors within the IPPC regime, the levy is reduced by 80% in exchange for commitments ('climate change agreements') to reduced carbon targets over a period to 2010. Such targets vary between sectors and different bases are available, the most acceptable basis being a reduction in energy or carbon use per unit of output rather than an absolute cap. If the sector-wide target is met as a whole, then all member companies continue to receive the levy rebate, regardless of their individual performance. If the sector-wide target is not met, then the performance of individual companies is assessed. Another incentive is provided by enhanced capital allowances on the purchase of qualifying energy-efficient equipment.

The Carbon Trust, a Government-backed company, was established in 2001 to channel up to £50 million a year into developing low-carbon technology, partly funded from the climate change levy. Charged with the task of ensuring that the private and public sectors help the UK meet its targets for cutting carbon dioxide emissions, the Trust has developed an overall approach to managing the risks and opportunities relating to climate change mitigation. Carbon management addresses all sources of carbon dioxide emissions caused by an organisation, including direct and indirect emissions. Products being developed by the Trust include a carbon management manual and spreadsheet-based analytical tools. The Trust has also launched an award scheme for innovation in low carbon technology. Action Energy, a Carbon Trust initiative, provides interest-free loans to assist organisations in saving up to 20% of their fuel bills.

The operation of new taxes and subsidies as a mechanism to promote sustainability often needs to be supported by appropriate publicity and use of training channels. A survey by the Engineering Employers' Federation found that over half of the companies responding were not aware that energy bills had increased due to the introduction of the climate change levy.

Nevertheless, speaking in an adjournment debate on 19 May 2004, John Healey, the Economic Secretary to the Treasury, gave a clear example of an efficient use of a tax to change behaviour: 'From 1 September this year, there will be a 0.5p per litre differential in favour of sulphur-free fuels. Having worked with the industry, ... we expect that will lead to an almost universal overnight switch to sulphur-free diesel and that, in a few months' time – definitely by the end of the year – there will be a universal switch to sulphur-free petrol.'

6.6 Key issues

Key issues identified in this chapter are that:

- governments are employing a wide range of taxes and subsidies to internalise external environmental costs and incentivise organisations and individuals to act in a more sustainable way;

- more analysis of the operation of each form of tax or subsidy is probably needed but evidence suggests that taxes on emissions and water use are regressive and may have harmful economic effects;
- differences between tax regimes operated in the UK, the EU and elsewhere in the world may limit the effectiveness of taxes as a means of promoting sustainability; and
- effective operation of each of the taxes and subsidies discussed in this chapter requires reliable information regarding the subject material and the current regulations.

6.7 Practitioner views

In the ICAEW Survey, 73% of respondents claimed to have some familiarity with environmental taxes such as landfill tax, climate change levy or the enhanced capital allowance scheme, although this may be partly due to a good understanding of the latter compared with little experience of either landfill tax or the climate change levy.

Only 10% had so far received any demand from clients for guidance on environmental or social regulations and taxes. However, this is the main area in which demand for practitioner services is expected to increase in the next 3–5 years, with 52% of respondents predicting at least some demand for advice.

6.8 The way forward

From an early stage, the accountancy profession has been involved with providing services in relation to taxes and subsidies and professional accountants have a particular interest in ensuring that the measures introduced are workable. Accountants are expected to advise on taxation of all forms and the expanding development of environmental taxes is of increasing importance to many members of the profession, both in practice and in business.

Taxes and subsidies intended to promote sustainability will present an increasing opportunity for accountants to contribute to the development and implementation of business policy. The demand for services of professional accountants in relation to technical issues arising from taxes and subsidies in the sustainability area and the completion of tax returns and claims is therefore likely to grow.

6.9 Questions for discussion and research

- Should environmental taxes and subsidies be set so that they price external costs and benefits reasonably accurately or so that they achieve the desired change in behaviour?
- If environmental taxes are to work, do they need to be associated with a specific objective to which the proceeds will be allocated?
- What sorts of taxes and subsidies act as effective signals that change behaviour?
- In what areas would additional social, environmental or economic taxes be beneficial in enhancing sustainability?
- How can environmental taxes be presented to avoid bad publicity as happened with the fuel duty escalator and, to a lesser extent, the climate change levy?
- How will differences between the UK and the EU environmental and social taxes and subsidies limit the effectiveness of these measures in promoting sustainability and what steps can be taken to achieve better international cooperation?

7. Tradable permits

This chapter deals with some of the innovative and exciting ways in which governments are using tradable permits and allowances to restrict undesirable impacts, such as climate change or the use of landfill, so as to improve sustainability. The basic idea is explained in Table 3 below.

Table 3: The basic idea of tradable permits

The government wishes to reduce some quantifiable activity, e.g. pollution by businesses in a particular year, by 20%. Therefore the government issues activity permits equal to its target, e.g. every business is allocated pollution permits equal to 80% of its pollution level in the previous year.

The government announces that, at the end of the year, it will measure the pollution of each business and require it to hold permits for an equivalent amount. However, it regards a reduction in pollution as equally desirable regardless of which business achieves it and so allows businesses to buy and sell permits amongst themselves.

Consequently, no business has to reduce its pollution by the full 20% if the cost of doing so is more than the cost of buying an equivalent permit. Conversely, no business has to limit its reductions to 20% if the cost of making further reductions is less than the price received for selling an equivalent permit.

The end result should be that pollution is cut by 20% at a lower total cost than would arise if the cut were imposed across the board and no trading were allowed.

7.1 Background

It is widely argued that tradable permits are rooted in sound economic principles underpinned by regulation and represent an increasingly attractive form of intervention. Such systems are estimated to produce a 50% saving in compliance costs in meeting targets in the initial years compared with a reliance on a conventional approach although such savings are difficult to quantify and systems may yet prove more complex to set up than expected. The power of the idea of tradable permits is illustrated by the example of BP. In a Harvard Business Review article, Thomas W. Malone recounts how BP established an internal market to meet the public commitment it made in 1998 to reduce its GHG emissions 10% below 1990 levels by 2010.

Moreover, where tradable permits, allowances, certificates or other instruments are allocated by a government agency, rather than being sold, the economic effects are contained within the operations covered by the particular system. This mechanism therefore provides an efficient way of achieving sustainability objectives without taking resources from the business sector other than fees to cover the costs of implementing and running a scheme and penalties when allocations are exceeded.

The creation of markets and trading instruments, such as GHG emission allowances and landfill permits, has been facilitated by technology and is likely to expand significantly as a technique for internalising external costs. The development of carbon markets is beginning to redirect investment flow away from carbon-intensive industries and into renewable energy development. To work efficiently, markets will require published information about the prices at which permits and allowances are traded.

Trading schemes are not new. Precedents include the UK tradable milk quotas, the European tradable fishing quotas and the US acid rain trading program. As with all schemes of this nature, the basis of initial allocations may be open to question. If these are based on past performance, participants that have already made progress in meeting the objectives may consider that they have been placed at a relative disadvantage. There is also the question of whether permits and allowances should be allocated free of charge, sold at a fixed price or auctioned.

7.2 Emissions trading and other Kyoto mechanisms

The key economic rationale behind emissions trading is to ensure that emissions reductions required to achieve a predetermined environmental outcome take place where the cost of reduction is the lowest, as companies compare their marginal cost of emissions reduction with the market price of the allowances. GHG emissions cause the same damage to the planet wherever they occur and, conversely, reductions confer the same benefit wherever they arise.

Emissions trading allows an individual company to emit more than foreseen by the allocation received on condition that it finds another company that has emitted less than allowed and is willing to transfer its excess allowances. The overall environmental outcome is the same as if both companies used their allowances exactly, but with the important difference that both companies benefit from the flexibility offered by trading. The World Bank has reported that in 2003 the volume of trade in GHG emissions reached 70 million tonnes.

Emissions trading is one of four flexible mechanisms contained in the Kyoto Protocol to assist industrialised countries in meeting their climate change commitments. The other three mechanisms are:

- Clean Development Mechanism (CDM);
- Joint Implementation (JI); and
- Land Use, Land Use Change and Forestry (LULUCF) projects.

These mechanisms enable countries to meet part of their Kyoto targets by taking advantage of opportunities to reduce GHG emissions in other countries at a lower cost than at home. They are intended to allow greater flexibility in achieving global emission reduction targets and to promote sustainable investment in developing countries. Companies will have access to carbon credits from projects that qualify under these mechanisms. CDM projects are those undertaken in developing countries without an emissions reduction target, to assist them in achieving their sustainable development objectives. JI projects are undertaken in developed countries or those with economies in transition and involve at least two countries that have accepted an emissions reduction target.

Each mechanism has a tradable unit of measure equivalent to one metric tonne of carbon dioxide. Industrialised countries will be issued with a number of 'assigned amount units' (AAUs) equivalent to their commitment to reduced emissions. At the end of each commitment period, each country must hold AAUs at least equal to its actual GHG emissions as monitored, reported and verified. The first two CDM verifiers have recently been accredited: Den Norske Veritas (DNV) and Japan Quality Assurance. Countries unable to meet their emissions reduction commitment by abatement measures can cover the shortfall by the purchase of AAUs from countries that have exceeded their reduction commitment. Credits, comprising certified emissions reductions generated by CDM, emissions reduction units generated by JI projects, but not removal units generated by LULUCF projects, will be fungible with AAUs for trading internationally.

Some countries (e.g. the Netherlands and Denmark) as well as companies are already preparing to meet their emission reduction commitments by investing in CDM or JI projects. The price at which such credits are traded will depend on the accessibility of targets and the level of penalties.

Designing and implementing CDM and JI projects that meet the Kyoto rules is complex. A possible solution is to use 'carbon funds', investment vehicles marketed by financial institutions that invest in emission reduction projects or buy credits directly. These funds repay investors with carbon credits, potentially a cost-effective option for meeting emission targets. This also offers a route for companies with carbon liabilities to manage the risk by outsourcing to a company with carbon management skills and a portfolio of carbon reduction projects. However, continuing uncertainty regarding allocations and consequent carbon prices may deter investors.

Rules and guidelines for implementation of the Kyoto mechanisms were agreed in November 2001 at the Seventh Conference of the Parties to the UN Framework Convention on Climate Change (UNFCCC) as part of the 'Marrakech Accords'.

7.3 UK Emissions Trading Scheme

In April 2002, the UK established a voluntary national emissions trading scheme, the world's first economy-wide GHG trading scheme. The scheme covers all six Kyoto gases. To encourage initial participation, the Government offered incentive payments in return for reductions in emissions. Companies joining the scheme agree to a target GHG emissions reduction based on an absolute cap (a reduction per unit of output is not available). Those that exceed emissions reduction targets are able to benefit from the UK emissions trading market, enabling them to trade in (or bank) allowances to offset the cost of meeting their targets. Reductions in emissions are subject to a system of reporting and independent verification.

Emission trading in the UK market has expanded through the participation of companies covered by climate change agreements seeking to deliver their targets. In the first year of operation of the UK scheme, 866 UK companies used emissions trading either to purchase allowances to meet targets or to sell over-achievements. Over 2,000 transfers took place, involving allowances covering 7.2 million tonnes.

The scheme has provided valuable experience, fostered a core of trading expertise and led to the creation of a successful allowance registry. Participants in the UK carbon market have banked nearly 3.7 million tonnes of surplus allowances from 2002, a huge reserve that has since increased further. It is unclear what will happen to these unused allowances once the UK scheme expires at the end of 2006.

7.4 EU Emissions Trading Scheme

As one of the measures to combat climate change under the Kyoto Protocol, EU Member States agreed to a collective 8% reduction in GHG by 2008–12, compared with a 1990 baseline. A directive on GHG emissions trading was agreed in July 2003, creating the first multinational carbon dioxide emissions trading scheme in the world. The EU Emissions Trading Scheme covers only carbon dioxide initially but provides scope to include other GHG in future. The EU scheme is based on the concept of 'cap and trade' and will operate whether or not the Kyoto Protocol comes into force. Schemes to achieve similar objectives, but independent of the Kyoto Protocol, have been put in place in a number of states in the US and Australia.

The EU scheme will require mandatory participation by specific industry sectors and is due to start in January 2005. Each Member State is responsible for developing a National Allocation Plan setting out allowance allocations. After approval of the national plans by the EC, originally due by the end of June 2004, the first trading period will occur between 2005 and 2007. Allowances equal to actual emissions in 2005 will have to be submitted by 30 April 2006. This ambitious programme is already behind schedule, with several Member States missing the deadline for submission of their National Allocation Plan. The EC is also critical of many of those submitted for setting excessive allocations.

The first phase of the EU scheme will end in 2007. Pooling between installations will be permitted and opt-outs from the first phase of the scheme may be granted if a comparable GHG reduction is achieved and similar reporting and verification requirements apply. Member States may permit unused allowances to be carried forward (banked) between the first and second phase; thereafter, banking is mandatory.

Trading of allowances will be accompanied by a system of national registries, which will record the holding and transfer of allowances in each Member State and a number of organisations are looking to create standard form contracts for trading of EU allowances. To comply with the EU scheme, each operator of an installation must hold allowances in its compliance account in the Member State's national registry at least equal to its reported and verified emissions from the installation concerned. Emissions in excess of allowances will incur a fine of €40 per tonne in the first phase and €100 per tonne from 2008 unless credits to cover the excess are purchased. Emissions for the following year will be deemed to increase by the excess, so that operators will need to obtain additional allowances to rectify the shortfall.

Companies across the EU will need to start incorporating climate change into commercial decisions, as carbon reductions will have a value. Limits will be set on GHG emissions (initially only carbon dioxide) from businesses operating in several energy-intensive sectors including electricity generation, oil refineries, iron and steel, cement, glass, ceramics, bricks, pulp, paper and board. Emissions of pollutants other than carbon dioxide and emissions from industries outside the scheme will be regulated under the Integrated Pollution Prevention and Control (IPPC) Directive.

A company's strategy will largely depend on the price at which emission reductions are traded. For less energy efficient industries, costs of compliance are likely to be passed on to customers in the form of higher energy and commodity costs. However, a business trading globally may have to compete with other businesses that do not face emissions control and would therefore need to manage its emissions liability in a way that minimises its costs. As the volume of allowance trading increases, a European market price of carbon is likely to be established. For companies trading outside Europe, there will be implications if this deviates from prices in other emission trading schemes.

Once trading commences, the UK Government expects the cost of buying allowances to be towards the lower end of the range €5–€25 per tonne of carbon dioxide equivalent. Recent forward trades of allowances have shown a steep fall in the market price from about €13 per tonne to around €7 per tonne. Until the allocation levels and expected shortfall are known, it will clearly be difficult to estimate the price of allowances. However, if the price continues to fall, this may threaten the viability of the scheme.

In July 2003, the EC published a proposed directive linking the Kyoto project-based mechanisms described earlier in this chapter, to the EU Emissions Trading Scheme. Following the so-called Linking Directive, approved in April 2004, CDM and JI credits will be recognised as equivalent to EU emission allowances. The directive includes various conditions, such as steps to prevent double counting and the exclusion of credits generated by certain activities from conversion into allowances.

Agreement on the Linking Directive increases the likelihood that allowances will not be in short supply and that carbon prices will remain low. It allows credits from CDM and JI projects to be used in the EU trading scheme from the first phase of the scheme in 2005. The EC is to review the eligibility of LULUCF credits in 2006. Credits from nuclear power projects will not be eligible at least until 2012.

7.5 UK implementation of the EU scheme

The UK Emissions Trading Scheme will continue to operate alongside the EU scheme, following the transposition of the Directive into UK law on 31 December 2003. Unlike the UK scheme, emissions trading in the EU will be compulsory for specified industrial sectors. The Government believes that UK industry has much to gain from the EU

scheme. As well as reducing GHG, the scheme will provide opportunities for UK firms to gain from the international trading in carbon that will follow. On the other hand, business organisations have warned against the impact on international competition if other EU countries set less ambitious targets. The greatest impact is likely to fall on the power generation sector which faces less international competition and has more scope for low abatement costs.

Following the issue of a consultation paper on alternative ways of sharing the total number of allowances allocated under the EU scheme and the publication of a draft plan in January 2004 dividing up emission allowances first to sectors, then to individual installations, the UK's National Allocation Plan, setting out a top-down allocation for each sector, was submitted to the EC on 30 April 2004. Every installation covered by the EU scheme will be required to hold a GHG emissions trading permit. Some 1,060 UK installations are expected to be affected, of which about 900 have already been issued with permits. The Government is seeking to negotiate opt-outs for UK companies with climate change agreements and for direct participants in the UK scheme. The final allocation had to be decided by 1 October 2004.

The plan proposes to cap emissions of carbon dioxide at a level consistent with an economy-wide reduction of 15.2% by 2010. Currently, the UK has a target of 12.5% reduction in GHG emissions under the Kyoto Protocol, of which an estimated 8.5% covers carbon dioxide – the Kyoto target includes other GHG emissions. The allocation of allowances in Phase 2 of the scheme, from 2008 to 2012, is expected to be consistent with an overall 20% reduction in carbon dioxide emissions.

The National Allocation Plan will specify the permitted allocation of emissions, based partly on historical emissions data for each installation. Baseline data and revisions to historical data will have to be verified by accredited third-party verifiers, a process that had to be completed by 31 August 2004. Baseline verifications, while mandated by the Government, are not a requirement of the EU Directive, but will have an important impact on the allowances to be allocated to installations.

The Government has consulted with the UK Accreditation Service (UKAS) and the UK Emissions Trading Group, as well as verifiers, regarding a 'light touch' verification approach. Nevertheless, a high standard of accuracy is expected in the case of installations with an emission level of more than 500 kilotonnes per year. Over-reporting of the baseline would result in a corresponding over-allocation of allowances and a possibility that the verifier may subsequently be held liable. The importance of setting realistic baselines has been emphasised by a recent National Audit Office investigation into the UK scheme, which found that some companies had received incentive payments for achieving reductions to which they were already committed.

It is evident that introduction of the EU scheme is characterised by a combination of the tight timetable and continuing uncertainty, not only for businesses and verifiers but also for equity analysts and those who will be trading in allowances.

7.6 Aviation emissions

In the aviation sector, a number of instruments are being considered to reduce the impacts of climate change, noise and local air quality. These include tradable carbon dioxide pollution permits, emission charges for nitrogen oxides, condensation trails and cloud formation, and auctioning and trading of take-off and landing slots. Such instruments are likely to prove more acceptable than the use of in-flight emission charges or a tax on aviation fuel. The EC has been asked to develop proposals to reduce GHG emissions from aviation, possibly bringing European flights into the EU Emissions Trading Scheme from 2008.

The inclusion of aviation could increase the demand for emission allowances, thus pushing up carbon prices. However, there are difficulties in that emissions from international flights are not allocated to countries under the Kyoto Protocol and that

aircraft cause emissions of pollutants other than carbon dioxide. A joint consultation paper on the subject was issued in May 2003 by H.M. Treasury and the Department of Transport. A recent report from Trucost 'Emissions trading and European aviation' addresses the implications of including aviation in the EU Emissions Trading Scheme.

7.7 Carbon risk management

For companies participating in an emissions trading scheme, carbon risk management will become an important factor in decision-making, the most important categories of risk being:

- cash flow risks, such as increased expenditure on measures to reduce emissions or the purchase of allowances;
- reputation risk, which may influence financial ratings and market capitalisation; and
- capital cost risks, such as more stringent credit conditions as a result of increased credit risk.

To identify, measure and control potential risks, companies will need a robust GHG inventory of past, current and projected future emissions. They will also need to understand the tools available to achieve compliance with different GHG regulatory regimes, as well as the marginal abatement cost options available from different mitigation strategies.

In June 2004, Ernst & Young issued the results of a survey of industry views about the EU Emissions Trading Scheme and its implications. Some of the most relevant findings were that, in many cases:

- companies have not addressed the strategic and financial consequences, nor identified how they could benefit from emissions trading;
- risks associated with emissions trading have not yet been assessed or incorporated into management thinking;
- there is an absence of integrated carbon management systems with robust internal controls; and
- responsibilities for coordinating emissions trading, particularly cross-border responsibilities, have not yet been defined.

7.8 Recognition, measurement and reporting of emissions

There is some uncertainty regarding the legal nature of emission reduction allowances in view of their similarity to financial instruments, intangible assets and even property rights. However, it is clear that emitting carbon dioxide and other GHG will no longer be free. The resulting liabilities and costs in reducing GHG emissions and/or purchasing allowances or credits will be significant for many companies and must be accounted for in an appropriate way, although the methods used to do this have yet to be determined. Accounting for emission rights will represent the first broad integration of financial and environmental impacts. At present, there is a lack of clarity about accounting for emissions trading, with no generally accepted standard for the reporting of GHG emissions, although a number of guidelines exist. A large number of factors influence the valuation and reporting of emission rights.

The Greenhouse Gas Protocol, a partnership jointly convened by the World Business Council for Sustainable Development (WBCSD) and the World Resources Institute (WRI), has recently revised its Corporate Accounting and Reporting Standard. The standard provides guidance on GHG accounting and reporting principles, setting boundaries, measuring, reporting and verifying GHG emissions, setting GHG targets and accounting for GHG reductions. It is designed to be compatible with existing approaches to GHG reduction, including the UK Emissions Trading Scheme and the EU Emissions Trading Scheme. The ISO is also working on climate change, with plans to publish a draft three-

part standard for measurement and reporting GHGs, including requirements and guidance for GHG verification bodies.

In May 2003, the International Accounting Standards Board (IASB) and the UK Accounting Standards Board (ASB) both issued draft proposed accounting guidance for companies participating in schemes aimed at reducing GHG emissions. The two standard setting bodies are expected to adopt a consistent approach.

7.9 Landfill, waste and water pollution permits

The potential use of tradable permits is not limited to GHG emissions. The EU Landfill Directive, adopted in 1999, will require UK waste to landfill – currently 80% of total waste – to be reduced to 30% by 2020. Environment Agency figures show that 70% of commercial waste is created by SMEs, so this is not just a big-company problem. In November 2002, the UK published the Waste and Emissions Trading Bill to provide the necessary framework to enable the UK to meet its targets set by the Directive.

The proposed approach included a system of tradable allowances for the landfill of municipal household waste, on which the Department for Environmental, Food and Rural Affairs (DEFRA) published a consultation paper in August 2003. The consultation paper included detailed proposals for the Landfill Allowance Trading Scheme for local authorities, the first of its kind in Europe, scheduled to start in 2004. The system will enable individual waste disposal authorities to find the most cost-effective way of diverting waste from landfill. This is not the first measure to limit landfill in the UK by means of economic instruments as there is already a landfill tax, as described in Chapter 6.

A tradable landfill allowance will be allocated to each waste disposal authority (WDA) later in 2004 giving the authority the right to landfill a specified amount of biodegradable municipal waste each year. Initial allocations, based on current landfill and waste levels, will decrease each year. WDAs can choose to trade their unused allowances, save them for future years (bank), or use some of their future allowances in advance (borrow). The advantage of trading is that WDAs with low diversion costs will have an incentive to divert as much waste from landfill as possible, selling their surplus allowance to WDAs that face a higher cost of diversion. An authority landfilling more waste than is covered by the allowances held will face financial penalty. The system will be monitored and controlled by the Environment Agency.

A document on the outcome of the consultation was published in early 2004, setting out a schedule for reducing landfill by 3.1 million tonnes over the five years to 2010, with a penalty of £200 per tonne for landfill in excess of the allowances. Implementation in England will now be delayed until 2005. The scheme will apply to household waste collected by local authorities but, as presently drafted, it will not include commercial waste collected by private contractors.

Other applications of trading permits are being discussed. The EC is considering application of the concept of tradable certificates in the context of financing the re-use and recycling of waste electrical and electronic equipment. The UK Government has also announced its intention to consult on the introduction of economic instruments to cut diffuse water pollution.

7.10 Renewable energy schemes

As well as limiting undesirable outcomes through rationing, trading schemes also offer potential ways to promote desirable outcomes through the imposition of targets to be satisfied through tradable certificates. To reduce dependence on energy imports, particularly fossil fuels, there is increasing support for the development of renewable energy technologies. Wind, water and sun can all contribute to diversifying energy supplies, although the size of their potential contribution should not be overestimated. Coal and oil-fired power stations will still be required for the foreseeable future and, in many parts of the world, nuclear power is still seen as an acceptable option.

In 1997, the EU adopted an aggregate target to meet 12% of gross energy consumption (heat, electricity and transport fuel) from renewable sources by 2010, of which electricity from such sources was expected to provide 22%. These targets are now seen as unrealistic. However, the need to rethink policies on sources of power has resulted in a number of initiatives, such as the launch of the UK-initiated Renewable Energy and Energy Efficiency Partnership (REEEP) in October 2003 and the Bonn Renewables Conference in 2004.

The Carbon Trust found that in 2002–2003 the UK generated 1.8% of total energy from renewables and believes that, although wind power dominates the sector, fuel cell technology, tidal and wave power could have a longer term impact. Renewable Obligation Certificates (ROCs) were devised as part of the plan to have 10% of UK electricity generated from renewable sources by 2010 and to double that by 2020. Power companies have to obtain the certificates to prove they are obtaining a proportion of their electricity from renewable sources. Those that meet their targets receive bonuses, whereas companies that miss their targets are fined by having to buy ROCs in the traded market or pay a penalty. The scheme is due to be reviewed in 2005. A report from the Carbon Trust has concluded that investors need to be offered greater certainty about the value of ROCs beyond 2010 if the 2010 target of generating 10.4% of energy from renewable sources is to be met.

To encourage the use of fuel partly derived from renewable sources such as beans, apples and rapeseed oil, the Government is consulting on the possible extension of ROCs to oil companies, under which a percentage of vegetable oil would have to be mixed with diesel fuel to form a 'biofuel'.

Although no binding targets for renewable energy were agreed at the Johannesburg World Summit, the EU launched a coalition to adopt such targets, including the possible development of financial mechanisms for promoting investment. Over the next two years, the EC proposes to review mechanisms for increasing the use of renewable energy. This could result in a structure for supporting prices and harmonising incentives, based on fixed incentives or tradable quotas.

7.11 Key issues

Key issues identified in this chapter are that:

- the economic attractions of a scheme based on setting a 'cap' and trading in permits or allowances have to be balanced against the complexities of the scheme and the need to set allowance allocations at a level that ensures the scarcity required for an effective market;
- in addition to emissions trading, several ingenious mechanisms to combat climate change have been devised, such as CDM and JI;
- an emissions trading regime raises important issues for risk management, recognition, measurement and reporting; and
- trading in permits or certificates can also be used as a mechanism to achieve other objectives, such as to promote the use of renewable energy and to control landfill and the disposal of waste.

7.12 Practitioner views

Whilst the ICAEW Survey did not include any specific questions regarding tradable permits and allowances, it showed that a number of firms have clients whose business is likely to be affected as the various climate change schemes come into force. For example, amongst the energy-intensive sectors included in the EU Emissions Trading Scheme, over 28% of firms have clients in the pulp, paper and packaging business and over 10% in each case have clients whose main activity is in the mining and quarrying sector or the water, energy, oil and gas sectors.

7.13 The way forward

At present, very few professional accountants are familiar with the schemes referred to in this chapter and there is a challenging opportunity for the profession to contribute to the development and implementation of policy at all levels, as well as standards for accounting and reporting.

For those businesses that are affected, the possession of emission permits, allowances and corresponding assets and liabilities will have important management and accounting implications. Moreover, market regulators will require information about utilisation and market prices. Eligible businesses will need reliable information regarding past, current and expected future emissions, in order to take critical decisions regarding compliance, trading and potential penalties. Whilst the initial measurement is a matter for other specialists, there will be a substantial role for accountants in reviewing information, assessing the implications and contributing to the operation of related markets.

7.14 Questions for discussion and research

- 7.a Although the use of tradable permits and certificates has so far been confined to the achievement of environmental objectives, what is the scope for using them to improve other aspects of sustainability, such as social or economic performance?
- 7.b Does restricting emissions to an absolute cap (rather than a reduction per unit of output) impose an unacceptable limit on future organic growth and, in general, how should the policy and political aspects of allocations be handled?
- 7.c How should trading in allowances be regulated and what capital adequacy requirements should apply to traders?
- 7.d What are the key obstacles to price transparency and stability in markets for tradable permits and certificates and, if there is no published information about market prices or if market prices fluctuate at the year end as companies strive to meet targets, how should balance sheet values be determined?
- 7.e What are the problems in operating effective cross-border markets in tradable permits and certificates and how are these best overcome?

8. Requirements and prohibitions

This chapter describes some of the ways in which governments and other authorities, acting as proxies for society, can require positive steps or prohibit or limit actions in order to enhance sustainability. It refers to a number of requirements and prohibitions but clearly cannot be comprehensive.

8.1 Background

There is a steadily expanding body of UK legislation and regulations dealing with sustainability, particularly environmental issues, much of which originates from EU directives. A distinction might be drawn between the directives with a single market Treaty base, such as the end-of-life directives, on which the DTI normally takes the lead, and those directives with an environment Treaty base, on which DEFRA usually leads.

From the early nineteenth century, with the introduction of the Factories Acts, the UK has had regulations on health and safety at work. Much current legislation affecting employees and neighbours has the effect of internalising social costs that would otherwise fall outside the enterprise itself. The first significant step towards UK environmental legislation can be traced to the 1950s, with the introduction of the Clean Air Act. A more comprehensive approach was adopted with the publication of a White Paper in September 1990 entitled *This Common Inheritance – Britain's Environmental Strategy*. This was closely followed by the Environmental Protection Act 1990, a wide-ranging law that introduced the concept of Integrated Pollution Control (IPC), so called because it addressed the environmental protection of air, water and land.

More recent examples of environmental legislation include the Environment Act 1995 and the Pollution Prevention and Control (PPC) Act 1999. The PPC regulations govern areas such as process control, use of best available technology to avoid or reduce pollution, monitoring and disclosure. Whilst the PPC regulations might appear to limit choice in the nature or design of products, they also ensure that all impacts are taken into account rather than ignoring costs that are passed on to society.

8.2 Global issues

With increasing environmental and social legislation in Europe and certain other parts of the world, there is the potential issue of 'jurisdiction shopping', caused by the existence of less stringent operating conditions elsewhere. For example, child labour is banned by many industrialised nations but is still permitted in many other countries, where it is sometimes seen to benefit the existence of the family unit in society as a whole. This is likely to become a major issue for multinational enterprises as more social information about supply chains is disclosed. Similarly, disposal of certain items, such as toxic waste, may be prohibited or penalised in some countries but not in others.

Until now, most businesses have not favoured regulation on human rights issues, believing that voluntary initiatives are more meaningful. However, a group of seven international companies, including Barclays and National Grid Transco, is considering the case for more regulation on such issues, recognising that the voluntary UN Norms on the Responsibilities of Transnational Corporations and Other Business Enterprises with regard to Human Rights have been criticised by both industry bodies and NGOs.

8.3 EU policy

For the last 15 years or more, much of UK legislation on environmental matters and, to a lesser extent, on social and economic issues, has been heavily influenced by directives proposed by the EC and approved by the European Parliament and governments for subsequent enactment by the UK and other Member States. Before referring to UK requirements and prohibitions, it is therefore logical to mention some of the EU directives and initiatives that have an impact on the sustainability of UK enterprises.

Numerous directives in pursuit of the EU strategy for sustainable development have been issued or are in the course of development. Over 85 directives relate to the environment. There is also a large body of existing and proposed EU legislation in the social and economic arena that requires enterprises to address concerns with broader implications, such as the EU Social Chapter.

The EC has a wide-ranging impact through mechanisms other than requirements and prohibitions. In addition to directives, the EC issues non-binding pronouncements, such as recommendations to Member States and – in order of increasing status – green papers, white papers and communications. In many cases, these are the subject of public consultation.

There has also been a series of EC Environmental Programmes highlighting themes of importance. The Fifth EC Environmental Action Programme, described in more detail in Chapter 6, called for the internalisation of external costs, such as the costs of climate change. Climate change schemes, which rely extensively on emission trading, were dealt with in Chapter 7. The Sixth Environment Action Programme, adopted in 2002 and described in Chapter 4, emphasised the need for environmental management systems, sustainable natural resource use, better resource efficiency and waste management. A subsequent EC strategy on resource use put the focus on sustainable consumption and production.

8.4 EU Directives

The EU Integrated Pollution Prevention and Control (IPPC) Directive was introduced in 1996 and entered into force in 1999. The directive is designed to prevent, reduce and eliminate pollution at source through the efficient use of natural resources. It covers emissions to air, land and water, as well as impacts such as noise and vibration, energy efficiency, waste minimisation, environmental accidents and site protection. The UK enacted the IPPC Directive through the Pollution Prevention and Control Regulations 2000.

More recently, the EC has consulted on the implementation and operation of IPPC and is expected to issue proposals to amend the directive in 2005. These are likely to include changes to the range of installations covered and greater clarity on the implementation of IPPC, possibly supplemented by best practice guidance. A register of all 56 industry sectors covered by the IPPC Directive, the European Polluting Emission Register (EPER), was launched in February 2004, covering data on emissions of 50 specified pollutants. Data is searchable on the internet and it is expected that such detailed transparency will assist stakeholders in highlighting issues of concern.

Under the Environmental Impact Assessment Directive, introduced in 1985 and amended in 1997, the environmental consequences of large public and private projects have to be assessed before authorisation. This may result in the prohibition or substantial amendment of projects. For proposals such as motorways, airfields and nuclear power stations, an impact assessment is obligatory. For others, such as urban development, it is for Member States to decide. The EC has recently carried out a five-year review of the application and effectiveness of this directive.

The EU Directive on Strategic Environmental Assessment was adopted in 2001 for introduction in July 2004. It requires local authorities and other public bodies to ensure that strategic environmental assessments are conducted on all land proposed for development in local and regional plans that have not been adopted by 2006. Strategic environmental assessments will be integral to the preparation of overall policies, plans and programmes for a particular area.

In 1999, the EC introduced a Landfill Directive to reduce waste, encourage recycling and tackle the risk of polluting water and soil from landfill sites. Together with related EU directives on waste, such as those that deal with waste oil, groundwater, hazardous waste, waste electrical and electronic equipment and end-of-life vehicles, this sets out a

framework for waste management, requiring formal authorisation for waste disposal facilities, incineration and specific wastes and specifying strict (and declining) limits on the quality and quantities of waste that can be disposed of as landfill.

The End-of-life Vehicles Directive, approved in October 2000, is designed to improve the recycling of scrapped vehicles by introducing targets and encouraging manufacturers to design vehicles that are easier to recycle. From 2007, it will force manufacturers to pay take-back and recovery costs for vehicles sold after 1 July 2002.

The Waste Electrical and Electronic Equipment (WEEE) Directive, approved in December 2002, will require producers of electrical and electronic equipment to pay for end-of-life collection of their products. In the case of equipment sold after August 2005 which is subsequently replaced, suppliers of the replacement equipment will bear the cost of waste. A related directive, restricting the use of hazardous substances in electrical and electronic equipment, will ban the use of lead, cadmium and mercury from July 2006. Both directives are intended to encourage the sustainable design of products, life-cycle thinking and end-of-life product management. The UK Government is proposing to establish a national clearing house to coordinate the regulation of collection, recovery and treatment.

In addition to the directives mentioned above, there are a number of framework environmental directives dealing with such topics as air quality, noise emission, water policy, bathing and drinking water, waste and recycling, packaging and waste water treatment. For example, the Water Framework Directive covers surface, ground and coastal waters, and seeks to manage river basin catchment areas in an integrated way. The resulting clean-up costs will be borne by industries and farmers responsible for causing pollution rather than the water companies.

Outside the environmental area, the EU Information and Consultation Directive, which is expected to be implemented in phases between 2005 and 2008, will require companies with more than 50 employees to give their employees information about their economic situation and inform and consult them at an early stage about all plans that might affect them.

8.5 EU initiatives

The proposed Environmental Liability Directive, issued in January 2002, addresses the prevention and remedy of environmental damage. Under this proposal, a company that has caused water pollution, damage to biodiversity or land contamination would be required to pay for the cost of repairing the damage. Amongst the potential consequences, some of the contentious issues, such as imposing a strict liability on any business with an environmental impact, with an onus of proof that no damage has been caused, mandatory financial security against future pollution (a requirement that the UK considers unacceptable) and an expansion in the definition of biodiversity to include all species, appear to have been moderated. There is also the question of state compensation if the party liable cannot be identified, although the duty on competent authorities to act where there is no liable party either willing or able to carry out the remedial work has been downgraded to a discretionary power. Where a company has made use of 'best available technology', this would be expected to result in more lenient treatment.

In June 2003, the EC proposed steps to explore the practical application of a sustainable consumption and production approach, in conjunction with product eco-labelling, the EU Eco-Management and Audit Scheme (EMAS) and the Industrial Pollution Prevention and Control Regime (IPPC). Procedures for EU-wide impact assessment and internalisation of external costs are expected to be developed within five years.

An EC proposal for the registration, evaluation, authorisation and restriction of chemicals (REACH) was published in October 2003. The proposal would put the burden for proof of safety on industry. Each manufacturer or importer will be registered and information

collected about chemical substances, including those in imported materials, and evaluated for potential risk. The measures will be overseen by a new European Chemicals Agency. Contentious issues include the difficulty of identifying uses to which products may be put and the possible use of mandatory consortia to register substances.

REACH will be implemented in three stages, based on tonnages of chemicals, the first step beginning three years after the regulations come into force. The EC has estimated that the cost of the proposals would be €7.5 billion, offset by health benefits (such as the saving in cancer deaths from workplace exposure) of up to €50 billion over the next 30 years. As a result of the predicted cost, the EC has agreed to carry out a further impact assessment, directed at issues such as the effect on innovation and on business competitiveness, particularly amongst SMEs. The UK Government published a consultation paper on the proposals in March 2004.

In July 2001, the EC published a green paper *Promoting a European Framework for Corporate Social Responsibility*. A further EC communication was issued in July 2002 entitled *Corporate Social Responsibility: A Business Contribution to Sustainable Development*. In October 2002, the Commission appointed a multi-stakeholder forum to address and agree by mid-2004 guiding principles on such matters as the contribution of CSR to sustainable development, the effectiveness of codes of conduct and the development of guidelines and criteria for CSR measurement, reporting and assurance. The report of the forum was presented on 29 June 2004 and included a set of nine mutually reinforcing recommendations under the headings:

- Raising awareness and improving knowledge on CSR
- Developing the capacities and competences to help mainstream CSR
- Ensuring an enabling environment for CSR

The EC is expected to issue a second white paper on CSR in November 2004.

8.6 UK developments

The introduction of EU requirements raises some specific issues for the UK. For example, the EU Environmental Impact Assessment Directive is implemented in the UK through the planning regime. This calls for publicity and consultation, as well as requiring the presentation of an environmental statement incorporating a description of the proposed development, including its design and expected impacts, to improve the quality of judgement in the planning process. Moreover, the UK has a much greater reliance on landfill sites than most EU countries and is implementing the EU Landfill Directive through a combination of licences for waste disposal facilities, restrictions of type of landfill material and tradable permits, as discussed in Chapter 7.

To support implementation of the EU directives dealing with waste management, a UK initiative known as WRAP, the Waste and Resources Action Programme, was launched in 2000, with a structure similar to that of the Carbon Trust. WRAP includes a number of objectives relating to market development and resource efficiency, based on recycling, use of recycled materials and waste minimisation.

The costs involved in implementing EU directives can be substantial. For example, a DTI task force has recently assessed the annual UK cost of complying with the End-of-life Vehicles Directive as between £126 million and £163 million and the annual UK cost of complying with the Waste Electrical and Electronic Equipment Directive as between £215 million and £455 million.

There is another directive with even higher expected costs, the Restriction of Certain Hazardous Substances in Electrical and Electronic Equipment (RoHS) Directive. The DTI estimates that implementing this directive will cost the UK £120 million annually for 10 years in capital costs, research and development, together with a further £55–£96 million per year in increased operating costs.

Against these costs can be set the largely unquantified benefit to the economy of recycling opportunities as well as the environmental and health benefits, which may be equally, or even more, substantial.

Directors' duties in the UK in relation to corporate compliance with environmental and social regulations are extensive. In addition to an expanding volume of law, there are numerous regulations issued by the Government. These will shortly include new regulations for the content of the OFR that will require directors of listed companies to report information about environmental, social and community issues. This is likely to prove a major driver for change, giving rise to some serious questions from stakeholders that bring sustainability into mainstream business thinking.

More wide-ranging proposals resulting from the major review of UK Company Law set up in March 1998 include a new statutory statement of directors' duties that would align with requirements to recognise the importance to the success of their business of relations with all their stakeholders and of the impact of their actions on the community and the environment.

8.7 Implications for business

New requirements and prohibitions on environmental and social issues raise important questions for businesses (and policy makers), such as:

- Are people aware of the regulations and related guidance?
- What do shareholders and customers think about the importance of compliance?
- What are the risks of doing nothing?
- What are the implications of disclosure of infringements?
- Could seeking advice increase the likelihood of prosecution?
- Who owns the problem within the business? Directors, managers, operating staff, human relations, commercial staff, the finance department, or public relations and other specialists?

Unless the answers are clear, laws and regulations are unlikely to be effective in changing behaviour and promoting sustainable development. Many companies find themselves poorly prepared as regulations change rapidly and guidance is fragmented. Indeed, uncertainty as to how regulations will develop is a matter of key concern to business. A recent MORI poll commissioned by the Carbon Trust (February 2004) found that 87% of investors believed that businesses needed help in understanding how environmental change and legislation would impact upon their bottom line. The introduction of formal environmental (and social) management systems, together with training, can therefore be of considerable benefit and provide a trail of evidence to show that the approach adopted was sound.

Awareness of environmental regulations and access to the relevant legislation is facilitated through NetRegs, an on-line advice service provided by the Environment Agency to help smaller businesses in 150 industry sectors navigate some of the laws affecting their particular activities. There is clearly a need for this service, although it must be borne in mind that the examples provided may not reflect current legislation and professional advice should be sought on issues that appear to be relevant. Recent research by NetRegs has shown that only 15% of SMEs can name an environmental regulation that applies to them. A survey of 8,000 small and medium-sized businesses found that only 20% of micro-firms (businesses with fewer than 10 staff) have taken measures to limit their environmental impact compared with 44% of businesses employing between 50 and 250 people.

In general, requirements and prohibitions are likely to be most successful where they build on existing practice and bring everybody up to the standards pioneered by others. This ensures that many organisations are already substantially in compliance and others

have practical precedents to follow. Requirements and prohibitions that seek to be too 'leading edge' run the risk of encouraging widespread token compliance and discouraging would-be pioneers.

Baroness Young, Chief Executive of the Environment Agency, has urged the UK Government to be more flexible in interpreting EU policies, emphasising that, in future, regulation should be increasingly 'outcome-oriented, risk-based, proportionate and transparent'. The Agency sees requirements and prohibitions as one type of mechanism amongst many for promoting sustainability.

8.8 Key issues

Key issues identified in this chapter are that:

- the wide range of requirements and prohibitions originating from the EU can be expected to have a significant beneficial impact on sustainable performance although the costs involved will be substantial;
- the rate at which these measures are being introduced, together with their novelty and complexity, will continue to present businesses, particularly SMEs, with problems in understanding what is applicable and how it affects their business;
- most recent developments have concerned environmental issues but social issues can be expected to receive more attention; and
- information and timely advice will be necessary in many cases if requirements and prohibitions are to be effective in enhancing sustainability.

8.9 Practitioner views

In the ICAEW Survey, opinion was divided as to whether ICAEW should focus resources on monitoring and influencing EU and UK Government environmental and social initiatives, with 38% attaching high priority (including 29% who regarded this as ICAEW's most important role in this area) versus 31% who attached a low priority.

Fewer than 20% of respondents claimed to have any familiarity with environmental requirements such as the UK PPC regulations or the EU IPPC Directive. The survey indicated that there is little demand from practitioners' clients for services in assessing actual or contingent liabilities (7% of respondents), although a third of those responding envisaged some demand for such services in the next three to five years.

8.10 The way forward

The accountancy bodies have always been involved with making public policy representations and providing advice to members regarding new legislation and regulations. Legal requirements in the environmental and social arenas, many of which have financial implications, are of increasing concern to ICAEW, which has a role in using the broad experience of its members to influence significant environmental and social initiatives.

Compliance with legal requirements and prohibitions calls for a full assessment of the business implications and impacts, particularly the financial effects. Accountants are directly interested in the recognition and measurement of information required to be filed with regulatory authorities, placed on public record or disclosed in the financial statements.

Professional accountants need to increase their knowledge of the regulations likely to be applicable to the businesses with which they are involved. Future changes in company legislation, including OFR disclosure and regulations arising from a directive on environmental liability, will result in an increased demand for accountants' services in connection with environmental liabilities.

8.11 Questions for discussion and research

- 8.a What types of requirements are likely to prove particularly effective, or unsuccessful, and why?
- 8.b What is the most cost-effective method of securing compliance with requirements and prohibitions by all enterprises, including SMEs?
- 8.c Is there a danger that a high level of requirements and prohibitions in the EU will encourage multinational businesses to move operations outside the EU and to what extent can international coordination discourage a 'race to the bottom'?
- 8.d In EU Directives and related UK requirements, there is little reference to economic performance as a contribution to the wider economy, such as job creation, productivity, outsourcing expenditure, employment diversity and training: should these gaps be filled and, if so, how?
- 8.e Can requirements and prohibitions be kept simple and framed in terms of principles and outcomes or do they need to be expressed as detailed rules to deliver real benefits and minimise uncertainties?

9. Information and reporting

This chapter outlines some of the more important developments in sustainability reporting, steps towards a globally agreed reporting framework and increasing evidence of a linkage between reporting and performance. We also consider the extent to which such developments facilitate effective operation of the mechanisms discussed in the preceding chapters.

9.1 Background

The main focus of the discussion concerns public sustainability reporting by businesses and other entities. However, in many businesses, sustainability information is monitored internally, or collected by government enquiry although not publicly reported. Companies also benefit from internal reporting of environmental and social data, particularly if this forms part of an overall management information system.

The public sustainability reporting scene can appear confusing to accountants and others who are not familiar with it. However, the market-based approach to sustainability adopted in this report and summarised in Figure 1 might help readers to analyse the different issues involved in sustainability reporting:

- Information and reporting plays a vital role in the proper functioning of the eight mechanisms covered by this report and in the objective assessment of whether they actually work (i.e. do they promote sustainability?).
- Sustainable development is difficult to measure directly but is indicated indirectly by measuring and reporting environmental, social and economic impacts.
- Sustainability reporting needs not only to cover the contributions of individual organisations to sustainable development. Success at a national and global level also needs to be reported.
- Sustainability reporting, like sustainability itself, can be promoted through the mechanisms identified in this report, in the form of corporate reporting policies, voluntary reporting codes and legally backed reporting requirements.

9.2 Measuring national and global sustainability

It is important not to lose sight of the fact that mechanisms described in previous chapters are there to promote sustainable development at a national and global level and success in achieving that end also needs to be reported insofar as it is possible.

A National Corporate Responsibility Index, devised by AccountAbility and the Copenhagen Centre, seeks to measure how much companies and governments in 51 countries have done to promote and implement CSR. The resulting data was combined with statistics on economic competitiveness to produce a Responsible Competitive Index, which is claimed to reflect a relationship between growth and responsible competitiveness.

In March 2004, the UK Government published its fourth (and last) report on *Achieving a better quality of life*. The report measures progress during 2003 towards meeting a range of sustainable development targets, based on the use of 15 key headline indicators covering the three aspects of sustainability performance: environmental, social and economic. Whilst there was improvement in those relating to waste recycling, quality of river water and homes built on brownfield sites, indicators that deteriorated included air pollution, road traffic volumes and household waste.

The UK Government is now taking a fresh look at its strategy and indicators (a selection of which were set out in a paper *Sustainable Development Indicators in Your Pocket 2004*), with a view to having a new strategy and monitoring scheme in place early in 2005. A consultation document *Taking it on – Developing UK Sustainable Development Strategy Together* was launched in April 2004.

Eurostat, the EU body responsible for EC statistics, is developing a number of sustainable development indicators to measure the performance of Member States in 10 different areas, including economic development, poverty and social exclusion, public health, climate change and energy, production and consumption patterns, natural resources and transport. A preliminary list of the proposed indicators was discussed at a meeting of the European Statistics System Task Force in Luxembourg on 21/22 June 2004. Although intended for compilation at national level, the proposed indicators will no doubt need to be reflected in the data required from individual organisations.

9.3 Reporting and the eight mechanisms

The eight mechanisms described in the previous chapters of this report can all be seen as internalising external costs. It is instructive to identify the relevant and often quite straightforward information flows that facilitate the operation of these mechanisms:

1. corporate policy disclosures;
2. information and feedback about supply chain practices;
3. the inputs and outputs of stakeholder engagement;
4. comply or explain statements related to voluntary codes;
5. rating and benchmarking criteria, returns and results;
6. tax returns, subsidy claims and related legislation;
7. reports of utilisation and prices of permits and allowances; and
8. requirements and prohibitions and reports on compliance.

External sustainability reporting, including OFR disclosures, can include a mixture of elements designed to support any or all of the mechanisms. With no explicit guidelines from government or regulators, the basic challenge is to provide comparable, balanced and meaningful information. Market forces such as reputation risk, competitive advantage, SRI and 'licence to operate' are arguably the principal drivers for disclosure of information about sustainability rather than regulation.

The rating and benchmarking systems described in Chapter 5 are catalysed by more comprehensive reporting. Indeed SRI analysis depends on the availability of non-financial information to allow users to understand and value the impacts of social and environmental issues on company performance. For that reason, EUROSIF sought to influence the EU Transparency Directive to improve the quality and consistency of information for investors in listed companies. The SRI community is also warning against companies relying on publication of an OFR as an alternative to comprehensive sustainability reports.

Alongside the considerable growth in SRI, more and more mainstream investment funds factor sustainability issues into their analysis. As Michael Meacher, the former Environment Minister, said on 4 June 2003, 'we are seeing the investment community start to flex its muscle on better corporate disclosure'. The Minister quoted research by Innovest that suggested that, for some companies, the discounted present value of future carbon liabilities could amount to as much as 40% of current market value.'

Some organisations might regard a sustainability report as primarily a public relations document, focusing on feel-good factors such as community support policies rather than targets, and positive achievements rather than problems of concern to stakeholders. This would be both foolish and short-sighted. Users of sustainability reports are looking for accountability and transparency, evidence that the organisation complies with the

voluntary codes or corporate policies to which it subscribes and can justify its licence to operate. Credibility is improved by a balanced and consistent discussion of the issues. Even if the approach is not subject to a formal assurance process, as discussed in Chapter 10, the involvement of accountants during the preparation of a sustainability report can help to avoid the view that it is being produced purely for public relations purposes.

Reporting on the contribution of individual organisations to sustainable development is more challenging than just providing information to support the working of the eight mechanisms. The difficulties are similar to those involved in reporting on corporate value. In an increasingly service-based economy, the competitive advantage of many organisations is represented by their human and social capital which is not adequately reflected in the balance sheet. Reputation, supply chain relationships and specialist skills are all examples of unreported intangible assets associated with sustainability. Existing accounting models are often criticised for this deficiency (ICAEW, *New Reporting Models for Business*, 2003).

9.4 Full cost accounting

Some approaches to sustainability reporting designed to meet the problem of items that are not normally recognised in the accounts and to capture all the impacts of an organisation appear very ambitious. For example, 'full cost accounting' involves the inclusion of external as well as internal costs and benefits. It has been developed mainly from an environmental perspective as a means of ensuring that business decisions take full account of an organisation's wider impacts. As well as externalising costs such as emissions and waste, companies also contribute to social benefits through local employment, training, health and safety, the costs of which fall on the company rather than the community. Full cost accounting is not limited to external reporting but may be applied to internal reporting.

Full cost accounting has some support. One of the 10 Hermes Principles is that 'companies should support voluntary and statutory measures that minimise the externalisation of costs to the detriment of society at large'. Full cost accounting provides the information to drive such measures. For instance, Forum for the Future has developed a detailed approach, explained in a booklet *Environmental Cost Accounting: An Introduction and Practical Guide* published by CIMA in 2002. An article by Rupert Howes, the author of the booklet, formed part of the ICAEW Faculty of Finance and Management Quarterly report on CSR in July 2003.

Over time, some external costs and benefits may be internalised through taxes, subsidies and tradable permits. Yet full cost accounting acknowledges the notional nature of differences from the accepted financial statements of an organisation and the difficulties of interpretation this causes. The conceptual frameworks that underpin the accounting standards of the IASB and major national accounting standard setters emphasise that users of an entity's financial statements take economic decisions based on an evaluation of the entity's future cash flows, their timing and their certainty. Full cost accounting is fundamentally different in that it is not concerned exclusively with an **entity's** future cash flows.

Where necessary, the costs and benefits of external environmental and social impacts are estimated. One of the strengths of the full cost accounting approach is that it uses market prices to determine the avoidance or restoration cost of an environmental impact, thus reducing the problems of estimation. The technique has recently been expanded to include the internalisation of social costs. However, the degree of estimation involved is a severe constraint.

Extending full cost accounting to deal with social costs and benefits that are not reflected in conventional financial statements appears to have even less support than the internalisation of environmental impacts. *The Corporate Report* (1975) suggested the publication of a social report as one of several separate reports. Social accounting was seriously mooted in UK green and white papers in the 1970s and was made a legal

requirement in France (the 'bilan social'). However, in the 1980s and early 1990s little was heard of social reporting in the UK and the focus tended to shift towards reporting on CSR.

More recently, the approach has been piecemeal and largely pragmatic, avoiding some of the complex issues involved, such as the relationship between human culture, labour law, theories of justice, morality, economics, business and society. Despite the lack of theoretical underpinning, CSR is mentioned by reporting organisations with increasing frequency. The ongoing EC initiative on CSR, which is due to result in a second white paper in November 2004, may encourage a more comprehensive approach.

Full cost accounting is unlikely to achieve a sufficiently robust status to be acceptable for mainstream reporting and tax purposes. Publication is not common and is largely reliant on corporate policies. In a few cases, enterprises producing such accounts have issued them or made them available to interested third parties. Full cost accounts have been published in reports issued by companies such as AWG plc and Wessex Water plc. Other companies have used full cost accounting for internal purposes, including ICI plc, Jaguar Limited and Marks & Spencer plc.

9.5 Environmental management accounting and EMS

Environmental management accounting (EMA) has also been relatively successful in finding expression in corporate policies and voluntary codes. EMA comprises the generation and analysis of information to optimise environmental performance and normally forms part of an EMS. An EMS comprises the organisation's structure, practices and processes for implementing environmental policy and is an important part of the overall management system at corporate level.

There is extensive literature on the conceptual and practical aspects of EMA adoption. For example, practical guidance on EMA was published in 2002 by Envirowise, a government-funded agency accountable to DEFRA and the DTI. The guidance, which was endorsed by the Environment Agency, ICAEW and other accountancy bodies, helps companies calculate the actual cost of their environmental impacts. The guidelines set out to demonstrate the benefits to a business of EMA in increasing profits by using fewer resources and minimising waste, improving cost control and estimating potential savings. They emphasise as well the reasons why accountants should be involved. The guidelines are based on practical experience of assisting companies to achieve substantial cost savings and included input from the accountancy profession. An article by Aidan Turnbull, the author of the guidelines, formed part of the ICAEW Faculty of Finance and Management Quarterly report on CSR in July 2003.

A guidance document on EMA is currently being developed for the International Federation of Accountants (IFAC) by the UN Division for Sustainable Development. After a process of expert and public review, it is hoped that the document will be published in early 2005. The goal is to provide a general framework and set of definitions for EMA that is fairly comprehensive and as consistent as possible with existing widely-used environmental accounting frameworks. In view of the number of different definitions and approaches to EMA, such a move towards international consensus would clearly help its integration with mainstream accounting.

Almost two-thirds of large European companies that participated in a survey by the Dutch accountancy body Royal NIVRA reported having an EMS throughout the organisation, half of which were certified. However, a recent report drawn up for the EC's Enterprise Directorate found that very few SMEs have an EMS, although some progress is being made in the UK (by staged introduction through Project Acorn), in the Netherlands (through industry sector covenants) and in Sweden (through area network coordination).

REMAS (not to be confused with EMAS) is a three-year European study, started in late 2002 and formally launched in June 2003, into the benefits of EMSs in the context of regulation. The project is supported by the Environment Agency and various other bodies, including the IEMA. It is intended to reach a consensus on the value of independently certified EMSs to the regulator and to identify which voluntary compliance measures most effectively protect the environment. Some research indicates that an EMS improves industry performance but little evidence exists to substantiate this claim. REMAS is intended to provide evidence to correlate the operation of EMSs and environmental performance. It may also demonstrate that robust EMSs are more effective than increased regulation.

Guidance for the financial services sector on environmental management and reporting (November 2000) and on CSR (July 2002) has been developed by the FORGE Group, comprising four banks and four insurance companies. The initiative is supported by relevant trade associations and government departments, in consultation with a number of stakeholder organisations. The guidance addresses practical issues for financial services, such as fund and asset management, changing expectations and emerging requirements, as well as including a step-by-step guide for development of a management and reporting programme.

9.6 Sustainability performance measurement

It is difficult to measure sustainable development directly and so companies looking for ways to manage sustainability performance are using indicators covering their social, environmental and economic impacts. These indicators are expressed in different units, usually of a non-financial nature, and are not part of mainstream information flows.

Performance indicators and criteria used for benchmarking of enterprises as a means of identifying socially responsible investments are areas of increasing concern to accountants. As the various approaches converge towards some form of agreement on key performance indicators, this is likely to assist and encourage the rating and investment benchmarking described in Chapter 5.

Whereas financial performance can be monitored by a number of widely accepted indicators, derived largely from the financial statements, the development of indicators in the environmental and social area, particularly social performance measurement, has received relatively little attention. However, some industry sectors have developed sustainability indicators. Such initiatives have been well received by governments, NGOs and the financial sector. Environmental performance measurement is dependent on the capture and reliable processing of information, through the use of appropriate systems.

9.7 Global initiatives

As described in Chapter 7, the Greenhouse Gas Protocol was created in 1998 by the World Business Council for Sustainable Development (WBCSD) and the World Resources Institute (WRI) to develop internationally accepted GHG accounting and reporting standards. It has recently issued a revised edition of its Corporate Accounting and Reporting Standard.

There have been some initiatives by UN groups. The accountancy profession was involved in the development of a position paper on *Accounting and Financial Reporting of Environmental Costs and Liabilities* published by the United Nations Conference on Trade and Development (UNCTAD) in 1999. Sections of the paper on recognition and measurement issues are consistent with generally accepted treatments, but the disclosures envisaged are more extensive.

In recent years, accountants have provided input to a project sponsored by UNCTAD and funded by the World Bank, resulting in the development of *A Manual for the Preparers and Users of Eco-efficiency Indicators* (2004). The manual comprises a conceptual framework, together with extensive guidelines for the definition and treatment of indicators relating to water, energy, ozone-depleting substances and waste.

9.8 The GRI guidelines

The sustainability reporting guidelines issued by the GRI comprise the best-known global voluntary code for sustainability reporting. They incorporate a number of reporting principles and specify the content of a GRI-based report, covering:

- vision and strategy;
- organisational profile;
- governance structure and management systems;
- content index; and
- performance indicators.

The guidelines include 35 environmental indicators, 13 economic indicators and 49 social indicators. Of a total of 97 indicators, 50 are described as core indicators.

Globally, by 22 July 2004, some 484 organisations in 45 countries were issuing sustainability reports that make reference to GRI, including 56 UK companies. GRI hopes to reach a global figure of at least 600 reporting organisations by 2005.

Some users evidently welcome the trend towards wider adoption of the GRI guidelines. For example, in their annual report on SRI, Henderson Global Investors stated 'Overall, we view the GRI as setting the global benchmark for disclosure and encourage companies to produce reports which are in accordance with the GRI guidelines.'

Despite GRI's significant progress over a relatively short timescale since its establishment in 1997, there is a need for further refinement of the guidelines, particularly as regards clarification of the basis for performance indicators, the reasons for their inclusion in terms of decision-making by users and the development of 'suitable criteria' for assurance purposes. GRI is committed to continuous improvement of the guidelines; the latest revision was in August 2002, with a further edition planned for early 2006. The revision is expected to take account of GRI's 'structured feedback process' involving over 500 organisations and a series of seven 'round-table' meetings held at various locations around the world.

In due course, the guidelines will be accompanied by technical guidance to assist users in dealing with problems such as indicator measurement, so as to be both meaningful and comparable, and on the definition of reporting boundaries. Sector-specific supplements are also being developed to support the general guidelines. GRI has already issued supplements on the telecommunications and tourism industries and on the social aspects of financial services. Supplements are under development for the mining, automotive, logistics and transportation industries, on the environmental impacts of financial services, and on public services.

In November 2003, GRI issued a draft analysis of the synergies between the OECD guidelines for multinational enterprises and the sustainability reporting guidelines published by GRI in 2002. The analysis is intended to assist a GRI reporter in signifying compliance with the OECD code. In addition to differences regarding the level of government involvement, intended audience and scope, the OECD guidelines are a code of conduct (as described in Chapter 4) whereas the GRI guidelines are a reporting framework. Despite a small number of issues covered by the OECD for which there is no explicit corresponding reference in the GRI guidelines, the two documents are complementary in many ways.

Synergies are being sought with other institutions. For example, the UN Global Compact, which has a significant potential for influencing business conduct, has indicated that the GRI guidelines offer companies a valuable framework for reporting their performance relative to the Compact's nine principles.

Currently, GRI is seeking to coordinate its work with international bodies such as ISO and the International Auditing and Assurance Standards Board (IAASB). GRI is also looking into the benefits of computer software for reporting purposes. In June 2004, GRI announced a project to create a handbook to provide practical guidance on sustainability reporting by SMEs.

9.9 EU initiatives

Whilst sustainability reporting is likely to remain voluntary at a global level, EU and national initiatives point to a rising tide of requirements. An EU Recommendation on the *Recognition, Measurement and Disclosure of Environmental Issues in the Annual Accounts and Reports of Companies* was published in May 2001. The recognition and measurement aspects are largely covered by existing UK requirements although disclosure may not be as extensive. In 2004, the EC commissioned a study on the extent of implementation of the recommendation within the EU, currently being carried out by PricewaterhouseCoopers, Denmark.

An EU strategy for sustainable development was adopted by the EC at the Gotenborg Summit in June 2001. In communicating the strategy, the Commission invited all publicly-quoted companies with at least 500 staff 'to publish a triple bottom line in their annual reports to shareholders that measures their performance against economic, environmental and social criteria'. This would enable investors and others to benchmark companies' performance.

The EC Communication on *Corporate Social Responsibility: A Business Contribution to Sustainable Development*, issued in July 2002, observed that 'the interest in benchmarks, against which the social and environmental performance of businesses can be measured and compared, has resulted in an increase in guidance of various forms, often with a lack of consistency or applicability to particular business sectors'. In the interests of both the preparer and the user, some coordination will clearly be helpful.

In a discussion paper written by Allen White in July 2003, *Corporate Governance and Corporate Sustainability Reporting: A Vital Link in Twenty-first Century Accountability*, reference is made to a commitment by the EC to identify by 2004 a generally accepted framework for sustainability reporting. As yet, there has been no sign of identifying such a framework.

Nevertheless, the EU Modernisation Directive, due to be implemented by Member States by January 2005, amends the Fourth and Seventh EU Directives, to require inclusion, in the directors' report, of non-financial information relevant to an understanding of the performance of the business and its year-end position, including environmental and social aspects. The preamble to the directive states that the resulting 'fair review' is expected to 'lead to an analysis of environmental and social aspects necessary for an understanding of the company's development, performance or position'.

From January 2005, the Transparency Directive, approved in April 2004, will require companies seeking a stock market listing to disclose risks associated with capital assets, including environmental risks. It will also require financial regulators to assess those risks.

The combined effect of these developments is likely to require a more formal approach to recording, accounting for, managing and reporting on sustainable performance in order to meet the requirements.

9.10 International accounting standards

One area of reporting where requirements are well established is the financial statements. From 2005, all EU listed companies will be required to prepare their consolidated financial statements in accordance with the International Accounting Standards (IAS) and International Financial Reporting Standards (IFRS) issued by the IASB and endorsed by the EC.

In the 1990s, FEE approached the IASB with the case for expanding international accounting standards to include increased guidance on environmental issues. There is now also an urgent need for standards to deal with the recognition, measurement and disclosure of assets and liabilities relating to GHG emissions and the related trading schemes.

Hitherto, the IASB has been reluctant to develop standards on topics such as environmental or social accounting, taking the view that the financial reporting issues raised can be adequately addressed in mainstream standards. To some extent, this has been the practice and existing standards on the impairment of assets (IAS 36) and on provisions and contingent liabilities (IAS 37) both make brief references to environmental issues. However, accounting for tradable permits under an emissions trading scheme is now being addressed and specific guidance is being developed. The IASB's International Financial Reporting Interpretations Committee (IFRIC) issued a proposed interpretation in May 2003 (D1) dealing with the treatment of GHG emission allowances and the related assets and liabilities. A separate interpretation may be developed to address the issues that arise in connection with certificates to promote the use of renewable energy.

The IFRIC proposals for GHG emissions would require companies to account for emission allowances as intangible assets, recorded initially at fair value. GHG emissions would give rise to a liability for the obligation to deliver allowances to cover those emissions (or to pay a penalty). When allowances are allocated for less than fair value, the difference is to be treated as a government grant. To avoid a lack of accounting symmetry, IFRIC proposes that IAS 38 (Intangible assets) should be amended so that intangible assets such as emission allowances, which are like a currency and whose value is related to an active market, should be measured at fair value, with changes in fair value recognised in profit or loss. The interpretation is not expected to include any guidance on disclosure.

IFRIC is also discussing the possible need for an interpretation of IAS 37 relating to provisions for liabilities that may arise under the EU Directive on Waste Electrical and Electronic Equipment (WEEE). Under the directive, the disposal cost will fall on producers in the market when disposal occurs rather than the actual producers of the equipment.

9.11 UK developments

Any moves to impose new requirements for sustainability reporting and disclosure in the UK take place against a background of EU initiatives, national requirements elsewhere in Europe and increased disclosures in accordance with corporate policies and voluntary codes.

Within Europe, Denmark has from 1996 required over 1,000 enterprises in environmentally sensitive sectors to publish 'green' accounts. Since 2000, the legislation has been expanded to include information on environment policy, supply chain impacts, waste and complaints from neighbours. In the Netherlands, firms judged to have serious adverse effects on the environment are required to produce two environmental reports, one addressed to the government and one for the general public. The law is supported by a system of voluntary covenants designed to achieve social policy objectives. In France, all listed companies are required from 2003 to publish in their annual report a review of their social and environmental activities. In Sweden, sites that require special permits due to environmental hazards must submit an annual environmental report to the authorities. In Belgium, the Flemish government now requires 20,000 enterprises to publish an annual environmental performance report. In Norway and Spain, there are voluntary guidelines for environmental reporting.

Environmental disclosure by UK companies has clearly increased. Research by David Campbell of Newcastle Business School, based on an analysis of the annual reports of 10 companies between 1974 and 2000, showed that the volume of environmental disclosure was relatively low until the late 1980s or early 1990s, when there was a sudden increase, evidently due to a perceived need for social legitimacy.

Early in 1997, the Advisory Committee on Business and the Environment (ACBE), appointed by the then Department of the Environment and the DTI, issued guidelines reflecting the growing importance of environmental management to the financial community *Environmental Reporting and the Financial Sector: An Approach to Good Practice*. The guidelines identified a number of common reporting requirements and discretionary disclosures, distinguishing between those appearing in the annual accounts, those in the OFR and those included in a separate environmental report. The ACBE initiative might usefully be refreshed, bearing in mind that it pre-dated the introduction of emissions trading, which will be of particular concern to the financial community.

In November 2001, DEFRA launched *General Guidelines on Environmental Reporting*, designed to set out the main elements of a good environmental report so as to help businesses respond to the Prime Minister's challenge to the top 350 companies to report on their environmental impacts. The guidelines dealt with the reporting process, the main elements of a good environmental report and environmental performance indicators (of which some are identified as basic indicators).

According to the KPMG International Survey of Corporate Sustainability Reporting 2002, reporting on HSE (Health, Social and Environment), social or sustainability performance by top UK companies has increased from 27% in 1996 to 32% in 1999 and to 49% in 2002. A survey by Corporate Register shows that only six of the FTSE 100 companies say nothing about these issues, although not all produce a special report.

9.12 Disclosure in the OFR

Looking forward, the UK Company Law White Paper *Modernising Company Law* proposed that directors should consider a company's policies and performance on environmental issues and report on them in the OFR when they are judged to be material. The White Paper noted that companies will need to have a greater understanding of these issues so that directors can make an informed judgement on what they need to report.

There is increasing support for expanding the definition of materiality to ensure that companies are sensitive to stakeholder concerns. In its 2003 paper *Redefining Materiality*, for instance, the Institute of Social and Ethical Accountability (AccountAbility) states that 'corporate reports, particularly environmental, social and sustainability reports, are not simply aimed at shareholders and their representatives' and that 'there is a business case for considering wider stakeholder concerns which can ultimately have an impact on shareholders' investments'. In November 2003, the Task Force on Human Capital Management issued a final report recommending that, in producing OFRs, directors should either include information on human capital management or explain why it is not material.

The draft regulations on the OFR and Directors' Report, published as a consultative document by the DTI in May 2004, would require all quoted companies to prepare an annual OFR that includes information about employees, environmental matters and social and community issues. The new OFR would include analysis using key performance indicators, including information relating to environmental and employee matters. The draft regulations would also serve to implement the EU Modernisation Directive requiring the directors' report to include new information on non-financial matters. Instead of using the word 'material', the draft regulations adopt the phrase 'to the extent necessary'. The consultative document explains that judgement as to whether the OFR has met its objective will be made from the perspective of members of the company, i.e. shareholders rather than stakeholders generally.

However, the accompanying 'Practical guidance for directors' emphasises the need for directors to take a broad view of stakeholder groups able to affect the reputation and value of the business and to consult with key stakeholders. In meeting these proposed new requirements, companies would therefore be facilitating the mechanism by which stakeholders influence the decisions and behaviour of the organisation (Chapter 3, Stakeholder engagement).

Some of the examples in the practical guidance for directors refer specifically to issues in the social and environmental areas and the increasing trend for management information systems to include corporate responsibility issues, such as those relating to the environment, human resources and the community. The guidance also mentions the need for a linkage between the OFR and any separately produced social or environmental report.

The ASB is expected to issue an accounting standard later in 2004 to replace its existing best practice statement on the non-mandatory OFR.

9.13 Key issues

Key issues identified in this chapter are that:

- there is a growing interest in all facets of sustainability reporting, including national indicators, full cost accounting, environmental management accounting, sustainability performance indicators and reporting on CSR;
- increased interest in the topic has encouraged experimentation and diversity in response to the perceived need for social legitimacy and licence to operate but, in the absence of regulation or a generally accepted framework, tends to hinder comparability; and
- there is a tide running in favour of more reporting requirements, as well as a need for more specific accounting and reporting guidance to deal with new schemes such as GHG emissions trading, renewable energy certificates and other issues arising from EU directives.

9.14 Practitioner views

The ICAEW Survey focused largely on external reporting rather than management systems or the preparation of internal management information. Nearly 58% of respondents to the survey agreed that, if the public were given more information about corporate environmental performance, businesses would become more environmentally responsible and that accountants should support initiatives to improve their clients' environmental performance. However, opinion was more evenly divided as to whether there should be statutory guidelines on the disclosure of environmental information in annual reports (29% Yes, 32% No opinion, 39% No).

As regards areas in which ICAEW should focus its resources in influencing the environmental and social debate, respondents attached the greatest priority to the development of accounting and reporting standards/guidelines (over 40% giving this a high priority).

Over two-thirds of the respondents (68%) took the view that companies report information about environmental and social issues as a result of external pressure from government, investors or other stakeholders. Not surprisingly, the absence of legal requirements was considered a major barrier to effective environmental and social reporting by 66% of respondents. Over 52% of respondents considered that the lack of established performance indicators represents a barrier to effective environmental and social reporting.

Where companies report information about environmental and social issues, the nature of the market in which a business operates was seen as the main driver for reporting on its performance (mentioned by 42% of respondents), although competitive advantage (one in four) and proactive internal initiatives (one in five) were also seen as contributory factors.

Gaining competitive advantage was considered an important reason for reporting information about environmental and social issues by 27% of respondents. However, for three-quarters of the respondents, complexity, cost and lack of management commitment were seen as the main barriers to effective corporate environmental and social reporting.

9.15 The way forward

Throughout this chapter there have been examples of ways in which internal and external sustainability accounting and reporting contribute to the effective operation of the eight mechanisms for promoting enhanced environmental, social and economic performance. Specific disclosures are needed about (1) corporate policies, (2) management of supply chain pressures, (3) constructive stakeholder engagement, and (4) compliance with voluntary codes. Relevant and reliable reporting is also necessary for (5) meaningful rating and benchmarking, and the effective operation of (6) taxes and subsidies, (7) markets in tradable permits, and (8) prohibitions and requirements.

Accountants will have a major role to play in developing management accounting for use in internal reporting of social and environmental impacts, performance measurement, interpretation of the information and subsequent decision-making.

Although progress has already been achieved in establishing what needs to be reported, much remains to be done to improve external reporting of sustainability issues and to establish whether progress is being made towards more sustainable development.

Accountants should be aware of the trend towards the use of a multi-stakeholder process in formulating reporting recommendations. However, the profession's extensive experience in reporting matters will almost certainly continue to have a major influence in this area.

9.16 Questions for discussion and research

- 9.a Should environmental and social reporting continue to be primarily voluntary in nature?
- 9.b Would the proposed inclusion in the OFR of information about environmental matters and social and community issues be sufficient to meet the interests of stakeholders and what role should stakeholder engagement play in deciding what is relevant?
- 9.c Is it possible to measure changes in sustainability directly in monetary terms by aggregating changes in future costs and benefits or must reliance be placed instead on proxies and indicators of environmental, social and economic performance?
- 9.d As sustainability reporting expands, how should the balance be struck between encouraging innovation and establishing clear structures and standardised indicators that enable comparisons to be made?
- 9.e Would the comparability achieved by introducing a generally accepted framework for sustainability reporting result in information becoming less relevant to the characteristics of individual businesses and their stakeholders?

10. Assurance processes

This chapter deals with the need for credibility in reporting on sustainability performance, some of the problems this raises for obtaining assurance and steps being taken by the accountancy profession to address these problems. Like any goal, credibility can be promoted through a variety of mechanisms, including corporate policies, voluntary codes and legally backed requirements.

10.1 Background

When he was Chairman of Unilever Plc, Niall FitzGerald was asked what would be the one thing he would like to change about the business, financial and commercial environment. He replied: 'I would wave a wand and restore trust in business.'

Trust in business is dependent upon the integrity, culture and governance arrangements of many parties. However, within this broader picture, assurance processes provide reporting organisations with a means of enhancing the credibility and quality of sustainability related information. Where stakeholder expectations have been identified, additional value is provided in obtaining assurance that the expectations have been met and that the information reported is relevant, reliable and complete.

Attention up to now has tended to focus on the need for independent assurance in relation to general purpose sustainability reports. However, assurance is relevant to the information flows associated with all of the eight mechanisms for enhancing sustainability described in earlier chapters. Assurance can make the difference between a mechanism that works and one that does not. It is also necessary to consider the need for assurance about the processes that underlie disclosures.

A report by the ABI *Risk, Return and Opportunity* (February 2004) notes that 'independent external verification of social, ethical and environmental disclosures would be regarded by shareholders as a highly significant advantage'. However, the report goes on to say that 'credible verification may also be achieved by other means, including internal audit'. Within organisations, an internal audit function can normally play a vital role in ensuring that management controls are operating and that information systems are reliable. This role, in which professionally qualified accountants are prominent, is increasingly likely to include assurance on environmental and social issues.

Before considering the challenge of external assurance in relation to sustainability reporting, it is worth considering what lessons can be learned from experience of the external assessment of environmental management systems (EMS).

10.2 Assurance on EMS

In the UK, accountants are effectively excluded from providing assurance on EMS. Assurance is referred to as certification in the case of ISO 14001 and as verification in the case of EMAS. Authorisation to carry out such roles is largely controlled by the UKAS, which has taken the view, despite representations to the contrary, that, because of the consultancy services offered by many accounting firms, there is insufficient independence to allow verification.

In some European countries, such as the Netherlands, accountants are carrying out certification of EMS under ISO 14001 although the development of such standards has largely taken place without the involvement of the accountancy profession. In most countries, this work tends to be done by other professionals, such as engineers.

An opinion survey conducted by Environmental Data Services (ENDS) and the IEMA towards the end of 2003 found that respondents were critical of the way certification of EMS under ISO 14001 and verification of EMAS registrations are carried out. In many cases, certification bodies were criticised for lack of competence, failure to understand the organisation's business, variation in the approaches used, undue emphasis on documentation and insufficient attention to performance improvement.

Following a national EMS forum in December 2003, EMS assessment is expected to be strengthened by steps being taken by the UKAS, the IEMA and the Association of British Certification Bodies (ABCB). Guidance on legal compliance and assessment is due to be published by the IEMA in September 2004. The guidance is intended to help companies understand regulators' expectations and implement effective systems for providing assurance on legal compliance to senior management and others. It will also outline what accredited certification body auditors expect to see in place when they carry out ISO 14001 certifications and EMAS verifications as well as including examples of good practice.

Experience shows that EMS assurance mirrors concerns that apply equally to assurance of sustainability information and reporting, such as service provider independence, competence, performance standards, business understanding and appreciation of user expectations, as well as the need for clarity about management responsibilities.

10.3 The need for credible information

All types of sustainability information disclosure are affected by the need for credibility, for example, from:

- employees, to provide confidence in systems, establish progress against targets and improve confidence;
- specialists, including analysts, particularly SRI analysts, rating agencies, government officials and NGOs;
- business partners, to strengthen the supply chain; and
- communities, to establish credibility with neighbours and local organisations.

The challenges facing the assurance function are well illustrated by reference to some of the issues arising from the proposal to introduce a statutory OFR in the UK.

The content of the OFR is expected to include information about the environment, employee relations, supply chain issues and social and community impacts, where that information is relevant for an assessment of the company. The draft regulations on the OFR and Directors' Report issued as a consultative document in May 2004 envisaged that the role of the auditors should be centred on a process review as to whether the directors have prepared the OFR after due and careful enquiry, rather than to report on its content. However, it may be argued that misleading content implies a defective process, so that a cautious auditor would be expected to examine the resulting disclosures.

The new OFR could present several challenges for auditors, including, in the environmental and social area:

- broadening their training and expertise to include the necessary knowledge and skills;
- advising and supporting organisations that are not already engaged in sustainable development issues;
- assisting companies to anticipate and provide appropriate information to respond to questions from stakeholder groups such as NGOs and lobbyists;
- helping to ensure that the exercise is of benefit to the organisation as well as representing an additional cost; and
- ensuring that OFRs do not become a standardised 'boiler plate' set of words.

10.4 The current state of sustainability assurance

In February 2004, CPA Australia published *A Study of Sustainability Assurance Statements Worldwide*, based on statements issued in Australia and some released in the UK, other European countries and Japan. The CPA Australia study provides a useful practical background to any global initiative to enhance the quality of sustainability assurance statements. The study, comprising 161 organisations with a sustainability assurance statement, identifies a number of findings and recommendations, including:

- the existence of different objectives, the most common objective being to give an opinion on the material in the sustainability report. The study notes the diversity of possible objectives suggested by GRI and the different views in Europe and elsewhere as to whether the assurance statement should include recommendations.
- an emphasis on enquiry and analytical procedures to support a limited level of assurance, rather than collection of the evidence required for an audit level engagement. The study recommends that the assurance statement should provide information about the nature and source of criteria used, the procedures followed, relevant standards and extent of stakeholder engagement.
- a wide variation and lack of clarity in the wording of assurance statements. The study recommends non-regulatory international guidance to improve the content of sustainability assurance statements. Wider acceptance is considered likely if this is developed by a multi-disciplinary organisation, such as GRI or AccountAbility, whilst also involving the International Auditing and Assurance Standards Board (IAASB).

10.5 Providers of assurance services

The most recent SustainAbility analysis of sustainability reporting concludes that 68% of the world's best sustainability reporters have embraced some form of assurance, compared with 50% two years before. Of the top 10 reports in SustainAbility's 'Global reporters' ranking, all but one were externally assured.

The KPMG International Survey of Corporate Sustainability Reporting 2002 found that a quarter of environmental, social and sustainability reports were verified by independent third parties and that 65% of these verifications were carried out by the major accounting firms. Amongst the UK FTSE100 companies, 49 companies published HSE, social or sustainability reports, of which 53% were verified.

These findings are consistent with other analyses, such as a 2002 survey of 80 European companies' sustainability reports by environmental consultants ERM which found that approximately 50% of assurance statements were prepared by accounting firms.

10.6 The need for standards

There are no internationally accepted assurance standards applicable to social and environmental reports. Whereas the preparation and audit of financial statements normally involves a single currency unit and is supported by an armoury of standards, environmental information may involve a score of different units (covering various GHG emissions, landfill waste, pollutant disposals, chemicals usage etc.), numerous definitions and a limited number of narrowly focused standards. Providing social information, such as on labour practices amongst outsourced activities and the effectiveness of anti-bribery and anti-corruption practices, is a far less mature process, with few definitions, numerous different units and few effective measurement standards. The assurance process is equally immature.

In the absence of a conceptual framework or generally applicable reporting standards, it is possible for standards adopted in other fields to be adapted and applied to obtain assurance on sustainability reports. In the case of sustainability reports, a typical independent assurance statement would refer to the objectives and scope of the engagement, respective responsibilities of management and assurance provider, methods

adopted (such as meetings, visits and systems reviews), stakeholder engagement, an opinion or conclusion regarding completeness and fairness/accuracy, performance against targets and recommendations for improvement.

A systematic approach to obtaining assurance might be based on reviewing:

- the organisation's eco-balance (input-output analysis of raw materials, energy, resources, products and wastes over a period of time) and ecological footprint (such as emissions and other impacts), in the case of assurance on an environmental report; and
- the organisation's process of stakeholder engagement, in the case of social reporting, in particular, but also for environmental reports.

However, it undermines the credibility of assurance itself to have a wide range of current practice as to what is verified, by whom and how assurance practitioners report on their work and conclusions. Work to develop common standards has been undertaken by the Institute of Social and Ethical Accountability (AccountAbility), GRI and the IAASB.

10.7 Global steps towards establishing standards

In a report entitled *The State of Sustainability Assurance*, published by AccountAbility (ISEA, 2003), some of the main points were that:

- sustainability assurance is seen as a key element in building the quality and credibility of sustainability reporting, despite huge variations in the approaches adopted, different forms of assurance conclusion and a lack of credibility amongst preparers and stakeholders;
- investors, regulators and other stakeholders will become a powerful driver of sustainability assurance and the convergence of approaches; and
- effective sustainability assurance will involve multi-stakeholder teams and enable disclosed information to have a better focus on what is material.

In March 2003, AccountAbility issued a high-level standard, the *AA 1000 Assurance Standard*. This built on material that was available at the time, including a discussion paper from the European Federation of Accountants (FEE), as well as expertise from several accountants and others involved with the provision of assurance services. The standard and the framework that preceded it are increasingly being used by reporting organisations and assurance providers. For example, the 2002 environmental and social review issued by BP was accompanied by an assurance statement from Ernst & Young based on the AA 1000 Assurance Standard.

The AA 1000 Assurance Standard is founded on three sustainability assurance principles: completeness, materiality and responsiveness – the last of which is a reflection of the increasing importance attached to meeting the needs of stakeholders. The standard will be linked to an evolving set of guidance notes. A consultation document incorporating the proposed guidance note on materiality was published in February 2004.

GRI has deliberately steered clear of providing explicit guidance on assurance or defining the qualifications of those entitled to carry out assurance engagements. However, a GRI Verification Working Group was established which in April 2001 developed some overarching assurance principles, one of which reads: 'The primary purpose of independent assurance on sustainability reports is to add credibility to reported information and to enhance stakeholder trust in the reporting organisation and its contribution to sustainable development. Improved quality of information for decision-making within the organisation can be a valuable additional benefit.'

Furthermore, the GRI guidelines issued in 2002 include an annex on credibility and assurance. This contains guidance on such matters as the factors that influence stakeholder expectations, internal information systems and processes, subject matter and scope, assurance criteria, directors' responsibilities and the content of an assurance report.

GRI encourages the independent assurance of sustainability reports but describes this as one approach that a reporting organisation may select to enhance the credibility of its sustainability report. As regards the selection of independent assurance providers, GRI lists a number of issues and attributes to consider but does not favour any particular qualification or professional grouping.

10.8 The accountancy profession's contribution

In December 2003, the IAASB issued its *International Framework for Assurance Engagements* and the standard *ISAE 3000 Assurance Engagements Other Than Audits or Reviews of Historical Financial Information*. The standard addresses a number of broad principles, many of which will impact on a possible future assurance standard on sustainability reporting. The framework establishes a common foundation for the IAASB's assurance standards.

ISAE 3000 addresses a number of important issues that are of general relevance to the assurance of non-financial information, e.g. planning and performing the engagement, using the work of an expert, obtaining evidence and preparing the assurance report based on the concept of reasonable assurance. Experience will show whether additional guidance is needed to deal with matters such as:

- avoiding an expectation gap arising from the distinction between reasonable and limited assurance;
- gaining support for the use of negative expressions along the lines of 'nothing came to our attention...' for the communication of limited assurance; and
- addressing issues arising from the use of multidisciplinary teams and the possibility of joint responsibility engagements.

Market acceptance of ISAE 3000 for use in providing assurance on sustainability reports is likely to be dependent on the development of more specific guidance. Building on its framework document and ISAE 3000, the IAASB's sustainability assurance project is important if it is to have widespread influence in this field beyond the accountancy profession.

In considering calls for the IAASB to develop guidance for assurance on sustainability engagements, the major obstacle is seen as the lack of suitable reporting criteria. However, some believe that the GRI 2002 guidelines and the AA 1000 framework offer a reasonable starting point, which is likely to be strengthened when the next revision of the GRI guidelines is published early in 2006. The IAASB may also decide to consider other ways of enhancing credibility, such as the involvement of internal auditors.

In the meantime, national bodies are doing further development work to enhance the contribution of the accountancy profession to sustainability assurance.

In the Netherlands, a draft standard *Assurance Engagements on Sustainability Reports* has been developed, together with a draft assurance standard of a more general nature on working with other experts. The second of these offers the choice of two models: (1) in which ultimate responsibility lies with the auditor; and (2) based on joint responsibility.

The proposed standard dealing with assurance engagements on sustainability reports is based on the IAASB Framework and ISAE 3000 but allows for significant client input to the key issues involved. It compares the task with the audit of financial statements and discusses in some detail the characteristics of a review-level engagement, the extent to which assurance should deal with stakeholder needs, and provides options for an assurance opinion to be addressed to the stakeholders, referring to any inherent limitations. The draft standard is not expected to mandate the extent to which an assurance report describes the work performed or any particular wording for qualified reports.

In Sweden, a proposed recommendation has been developed to provide guidance for members of FAR, the Swedish accountancy body, on independent summary assurance of a voluntary sustainability report. The proposed recommendation deals with topics such as the need for identifiable and appropriate criteria, prerequisites for accepting the engagement, the importance of stakeholder dialogue, distribution of responsibility between management and the assurance provider, the assurance process and the content of an assurance report. Summary assurance is not specifically defined but the report resulting from a summary review is expected to provide a negative form of assurance, i.e. that the assurance provider has not found anything which indicates that the report has not been drawn up in accordance with the stated criteria.

Assurance regarding information about GHG emissions presents a major area of opportunity for the accountancy profession. Practice guidance for undertaking such engagements has already been issued jointly by the AICPA and the CICA.

10.9 Accountants and sustainability assurance

Although there is much work to be done and the world will not wait forever, there are strong arguments why auditing standard setters and practitioners with their roots in the accountancy profession should take the lead in providing sustainability assurance.

The IAASB assurance standard ISAE 3000 is based on the same framework that underpins the IAASB's standards for financial statement audits, ISAs. The market for financial statement audit is long-established and highly developed, with ISAs gaining increasing acceptance around the world. For example, the EC has signalled its intention to require adoption of ISAs throughout the EU under the proposed 8th Company Law Directive.

There would be great benefits in having consistent standards for financial statement audits and assurance on sustainability reports, given that sustainability information is already included in financial statements. For example, environmental factors are of economic importance to most organisations and the related liabilities, provisions, contingencies, asset write-downs and risks are therefore relevant to the statutory auditor. Social issues such as political and charitable donations and employee pension costs and funding are already reflected in financial statements. Issues regarding climate change, emission allowances and compliance with environmental and social regulations will increasingly arise in the audit of financial statements. Accountants will also be involved with the treatment of transactions in tradable permits and with the effectiveness of underlying internal control systems. Many companies will find that such issues have an impact on their balance sheet and results.

Moreover, despite the extent of non-financial information involved in sustainability reports, it is appropriate that accountants should play a key role in the assurance process and in encouraging companies to extend their management systems to include sustainability. Accountants have the skills to review the effectiveness of systems, referring to other experts where necessary. Providing assurance in areas such as human rights and social performance may involve complex metrics and may require stakeholder involvement or partnership with another respected organisation, such as the UN Development Programme or the World Bank. The best approach will often have to be chosen on a case-by-case basis.

In a paper prepared for the BAA/University of Edinburgh Tenth Annual Auditing Conference, April 2000, Professor R.H. Gray is critical of the quality of current assurance practice in relation to environmental and social reports. Many assurance statements are of course provided by non-accountants and Professor Gray notes that 'as yet, accountants and trained auditors do not appear to be bringing their skills, expertise and independence to bear upon the assurance of environmental and social reports.'

In his view, this is unfortunate in that 'very few, if any, disciplines other than accounting prepare their members to undertake independent and thorough audits of information and evidence. The training which many accountancy bodies require of their members provides them with a unique and crucially important set of skills – independence, concepts of evidence and an understanding of information systems – that are not apparently available to those non-accounting individuals and organisations acting as auditors of environmental and social reports. A sensible, thoughtful and well-informed accountancy profession has both considerable talents to offer here and a moral duty to engage with this most important of developments'.

When considering who should be responsible for performing sustainability assurance assignments, it would be wise for regulators, clients and stakeholders to bear in mind the accountancy profession's essential characteristics of integrity, objectivity and compliance with ethical codes, such as the Code of Ethics issued by the International Federation of Accountants.

10.10 Key issues

Key issues identified in this chapter are that:

- enhancing trust in information relating to environmental and social impacts calls for effective systems and internal controls, including internal audit, generally supported by independent external assurance;
- the sustainability assurance process needs to be supported by suitable reporting criteria and strengthened by the development of widely accepted principles regarding the assurance methods to be adopted and the scope of the engagement and resulting report;
- the accountancy profession is already playing an important role in providing independent assurance on sustainability reports and needs to work with other organisations to develop a comprehensive approach; and
- UK accountants will have to expand their knowledge and expertise in order to prepare for the challenges arising from increased expectations as a result of auditor involvement in a statutory OFR.

10.11 Practitioner views

For the large majority of respondents (over 95%), there has been no demand from clients for services in the area of environmental and social reporting and assurance, although one in four firms envisages a need to provide such services in the next three to five years.

The survey clearly focused on external reporting. Within businesses preparing internal information on environmental and social impacts, accountants are no doubt involved, vouching for its accuracy in many cases.

10.12 The way forward

Accountants in business will be increasingly involved in collecting, checking and interpreting information relating to environmental and social impacts. This is likely to affect those employed in a mainstream reporting role or in internal audit.

Assurance relating to information on sustainability issues is an area where professionally qualified accountants need to demonstrate that they are well equipped for the task. Providing assurance on social and environmental reporting is a role in which the accountancy profession has much to offer in coordinating a multi-disciplinary approach and establishing and clarifying the principles for working with other experts.

Application of the new IAASB Assurance Framework and ISAE 3000 in providing assurance on sustainability reports is currently a major issue for the profession. Implementation will require a clear description of the approach adopted and the assurance obtained. As well as reviewing the process of identifying information for disclosure in the OFR, there will also be work required in connection with GHG emissions trading and the treatment of the related impacts in the balance sheet.

10.13 Questions for discussion and research

- 10.a What criteria, techniques and special training are necessary to take a role in providing assurance services on sustainability reports?
- 10.b What is the appropriate forum for discussing the use of a multi-disciplinary approach to assurance and how might the accountancy bodies take a lead in this respect?
- 10.c Should the role of auditors in sustainability reporting be extended to address the needs of stakeholders other than shareholders and, if so, how should this be reflected in the auditors' work and reports?
- 10.d Can the sustainability assurance process deal just as well with qualitative as with quantitative disclosures?
- 10.e Should the approach and criteria adopted by investment benchmarking organisations and rating agencies be subject to some form of independent assurance and, if so, to what extent should accountants be involved?

Concluding comments

This report gives an indication of the breadth of sustainability activities and the extent to which they are developing. It is designed to expand the awareness of accountants and others and to signal a recognition that ICAEW needs to provide support to members in the field of sustainability and influence the ways in which sustainability-enhancing mechanisms are operated.

Professionally qualified accountants in businesses with significant environmental or social impacts are often involved with the measurement, recording and interpretation of sustainability issues. The large accounting firms are also active in many aspects of sustainability. Smaller firms tend to see such matters as an irrelevance and, as yet, have not experienced any significant demand for services in this area. However, such demand is expected to increase, particularly as regards taxes and instruments such as tradable permits and allowances.

As history shows, the frontiers of accountancy have continually expanded to meet new demands, often in response to business needs caused by new laws and regulations. Professionally qualified accountants are used to exercising judgement to tackle new problems and apply new expertise in a context of fundamental principles and professional ethics. With the increasing importance attached to environmental protection and social responsibility, many of the issues raised by the quest for sustainable development are business risk issues, an area commonly of concern to accountants.

The accountancy profession plays an important part in the development of national and European law as well as guidance, standards and frameworks for information reporting and assurance. This role has often extended to non-financial information, for example on corporate governance.

Despite some unfamiliar terminology associated with sustainability issues, there is much that is closely related to the skills and experience of accountants: for example, the identification and management of risks, corporate governance, compliance with laws and regulations, design and operation of management control systems, measurement of liabilities and impaired assets, information reporting and assurance, financial instruments and new forms of taxation. Where the technical issues extend beyond an accountant's reach, working with other experts is already recognised as good practice.

European and global initiatives, such as the progressive improvements agreed at Kyoto, have contributed to a greater willingness to introduce prohibitions, regulations and taxes that are designed to move towards sustainable development. A number of different mechanisms are being adopted to build a sustainability infrastructure that works with the grain of markets. Underpinning all of these mechanisms is the need for internal and external reporting and assurance.

Accountants have a role in developing, understanding and operating all the mechanisms identified as elements of the sustainability infrastructure. In the case of regulations, taxation and tradable permits, accountants will continue to be involved in providing public policy advice and assisting with practical implementation. There are also questions to be considered such as whether the mechanisms work and are effective in achieving the desired results and whether different approaches would be more efficient.

New requirements, such as the statutory OFR, will bring accountants face-to-face with the need to address environmental and social issues and the processes adopted by directors in deciding whether they are of sufficient relevance to warrant disclosure. With an overall understanding of the business environment and relevant regulations, taxation and markets, accountants will be expected to act as a first port of call for advice. Obtaining and providing information about the various measures, together with the related interpretation, will be important elements of an accountant's role, both in business and in practice.

Sustainability issues present a new market focus for the profession. Internalisation of external costs through such devices as tradable allowances and the other mechanisms described in the report clearly requires accounting expertise. In future, management information systems and controls will need to include environmental and social data, emphasising the need for a joined-up approach. Accountants are well placed to identify and meet needs for co-ordination and integration.

If sustainability issues were to be neglected by current and future members of the accountancy profession, there is a risk that accountants' involvement in areas such as management systems, strategic planning, statutory requirements and tax, internal and external reporting, as well as assurance, will be diminished. This would be a loss to society as well as to the accountancy profession.

Given that sustainability is a growth area and that several other professions are active in the field, there is an opportunity for the accountancy profession to:

- **ensure that the necessary training and advice** is available to those who need it;
- **continue to participate in the development of new guidelines and requirements on sustainability**, particularly in the area of reporting and assurance; and
- **put forward proactive ideas to assist business to achieve better sustainability management** in support of effective business activity and sound corporate governance.

All of these roles are important and whilst the accountant's main input is providing useful information and assisting in its interpretation, this contribution must also have regard to the larger picture and the need to consider the maintenance and long-term enhancement of all types of capital and to balance the dynamism of markets with wider social demands to do the right thing.

This report has supported the words of John Elkington that 'the sustainability agenda is bigger and more complex than individual reports of its parts might suggest, increasingly demanding joined-up thinking from companies and their boards'. Accountants are well equipped to provide, support and promote that joined-up thinking.

All the mechanisms we have identified require credible information flows to operate effectively and to gain public confidence. Internally, management systems will face demands for new information to support decisions that have previously not had to be addressed. Environmental taxes, new categories of assets, such as tradable permits and the related liabilities, including contingent liabilities, will need to be accounted for and reported externally.

Compliance with voluntary codes of conduct, corporate policies and supply chain standards may need to be confirmed on an enterprise-wide basis. Information required for effective stakeholder engagement, benchmarking and rating purposes will have to be gathered. Companies that are subject to new requirements for the OFR will collect much of this information as part of the regular process of reporting.

It is our belief that the accountancy profession will be well placed to take leading roles in addressing new reporting issues and related assurance processes. The practical approach commonly adopted by professional accountants will be fundamental to ensuring that the mechanisms operate properly.

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Naturally, none of the commentators should be assumed to agree with the views expressed in this report and they are not responsible for any errors or omissions.

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Useful websites

www.accountability.org.uk	Institute of Social and Ethical AccountAbility
www.bsi-global.com	British Standards Institution
www.bitc.org.uk	Business in the Community
www.ceres.org	Coalition for Environmentally Responsible Economies
www.cica.ca	Canadian Institute of Chartered Accountants
www.cityoflondon.gov.uk	City of London Corporation
www.copenhagencentre.org	Copenhagen Centre
www.csreurope.org	CSR Europe
www.defra.gov.uk	Department for Environment, Food and Rural Affairs
www.dti.gov.uk	Department of Trade and Industry
www.eea.eu.int	European Environment Agency
www.environment-agency.gov.uk	Environment Agency
www.envirowise.gov.uk	Envirowise
www.ethicaltrade.org	Ethical Trading Initiative
www.europa.eu.int	European Union
www.eurosif.org	European Social Investment Forum
www.fee.be	European Federation of Accountants (FEE)
www.forumforthefuture.org.uk	Forum for the Future
www.globalreporting.org	Global Reporting Initiative
www.hermes.co.uk	Hermes Pensions Management Limited
www.iasb.org.uk	International Accounting Standards Board
www.icaew.co.uk	ICAEW
www.icaew.co.uk/sustainability	ICAEW Sustainability Resource Centre
www.ifac.org	International Federation of Accountants
www.ilo.org	International Labour Organisation
www.oecd.org	Organisation for Economic Co-operation and Development

www.projectsigma.com	SIGMA Project
www.sustainability.com	SustainAbility
www.sustainability-indexes.com	Dow Jones Sustainability Indexes
www.theacorntrust.org	Project Acorn
www.thecarbontrust.co.uk	The Carbon Trust
www.tomorrowcompany.com	Tomorrow's Company
www.ukas.com	United Kingdom Accreditation Service
www.unglobalcompact.org	UN Global Compact
www.uksif.org UK	Social Investment Forum
www.un.org	United Nations
www.unep.org	United National Environment Programme
www.valuereporting.com	ValueReporting™ (PricewaterhouseCoopers)
www.wbcsh.ch	World Business Council for Sustainable Development
www.wrap.org.uk	Waste and Resources Action Programme

Glossary

Acorn, Project – A UK Government project set up in conjunction with the private sector, to assist SMEs to improve their environmental performance by implementing environmental management systems.

The Advisory Committee on Business and Environment (ACBE) – Set up jointly by the DTI and DEFRA, ACBE provides for dialogue between the UK Government and business on environmental issues and aims to help mobilise the business community in demonstrating good environmental practice and management.

Assigned Amount Units (AAUs) – The main currency of international emissions trading. Assigned amounts represent the total amount of GHG emissions that each developed country has agreed not to exceed in the first Kyoto Protocol commitment period (2008–2012).

Association of British Certified Bodies (ABCB) – The sole UK trade association for third-party certification bodies.

British Standards Institution (BSi) – A leading standards and quality services organisation, independent of government, industry and trade associations. Provides systems assessment and registration, product certification testing, commodity inspection and testing; and training, publications and management.

Business in the Environment (BiE) – A non-government organisation that aims to inspire businesses to work towards environmentally sustainable development as a strategic, mainstream business issue.

The Carbon Trust – An independent not-for-profit company funded by the UK Government to assist UK businesses and the public sector to reduce carbon emissions and to take advantage of any ensuing commercial opportunities.

The CERES Principles – Ten principles issued by the Coalition for Environmentally Responsible Economies (CERES) that establish an environmental ethic, which enables investors and others to assess an endorsing company's environmental performance.

Clean Development Mechanism (CDM) – A co-operative mechanism established under the Kyoto Protocol promoting environmentally friendly investment in projects in developing countries from industrialised country governments and businesses.

Climate Change Levy – A levy applied to the energy use of all non-domestic sectors. Subject to certain exemptions and reductions to encourage energy efficiency.

Conference of the Parties (COP) – The supreme body of the UN Framework Convention on Climate Change (UNFCCC). It has met annually since 1995.

Corporate Social Responsibility (CSR) – The management of a company's impact on society and the environment so as to add value to the company and increase wider economic and social wellbeing through its operations, products or services and through interaction with key stakeholders such as employees, customers, investors, local communities, suppliers and others.

Decoupling – Separation of economic growth from environmental degradation and unsustainable use of materials.

The Fifth EC Environmental Action Programme – A programme approved by the EC Council and Member State government representatives setting out long-term objectives and focussing on a global approach.

The Sixth EC Environmental Action Programme – Published in July 2002, the programme sets out the strategic direction of the European Commission's environmental policy over the next decade.

Eco-Management and Audit Scheme (EMAS) – An EU regulation allowing voluntary participation by companies in the scheme launched in 1995 which enables them to evaluate, report and improve their environmental performance.

Enhanced Capital Allowances – The UK Enhanced Capital Allowance Scheme enables businesses to claim 100% first-year capital allowances on investments in energy-saving technologies and products.

Envirowise – A UK Government programme providing practical environmental advice for business.

European Multi-stakeholder Forum on Corporate Social Responsibility – Set up on an experimental basis to facilitate dialogue for EU companies with their stakeholders on CSR practices.

European Pollutant Emission Register (EPER) – Established in July 2000, the register requires Member States to report emissions from listed industrial plants on a triennial basis.

European Social Investment Forum (EUROSIF) – A European non-profit membership organisation to promote the concept, practice and development of sustainable and responsible investment.

European Union Allowance – An allowance that permits the holder to release one tonne of carbon dioxide.

European Union Emissions Trading Scheme (EU ETS) – An EU-wide cap-and-trade system covering five industry sectors, for reducing carbon dioxide emissions, due to start in January 2005. Two phases have been announced so far: 2005–2007 and 2008–2012. Other greenhouse gases and industry sectors may be brought into the scheme after 2007.

The FORGE Group – Consists of eight financial services companies, supported by the British Bankers' Association and the Association of British Insurers. In consultation with stakeholder organisations and government departments, the group developed the FORGE Guidance released in November 2002.

Forum for the Future – A UK-based charity working to accelerate the building of a more sustainable future by taking a positive, solutions-orientated approach to today's environmental and social issues.

Global Reporting Initiative (GRI) – Launched in 1997, GRI has developed the world's leading framework for preparing sustainability performance reports on an organisation's economic, environmental and social policies and activities.

Greenhouse Gases (GHG) – Carbon dioxide and other gases that cause and accelerate the greenhouse effect, thereby damaging the insulation of the earth's atmosphere.

Institute of Environmental Management & Assessment (IEMA) – The IEMA was formed in 1999 as the professional body for the environment, with the overall aim of promoting the goal of sustainable development through best practice standards in environmental management, auditing and assessment.

Institute of Social and Ethical AccountAbility (ISEA or AccountAbility) – An international not-for-profit body committed to strengthening the social and ethical behaviour of companies and organisations.

Integrated Pollution Control Act 1999 (IPC) – An act implementing Council Directive (96/61/EC) and introducing other regulations preventing and controlling pollution.

Integrated Pollution Prevention and Control (IPPC) – A system to control pollution of air, land and water which covers certain specified installations. Regulated in the UK by the Environment Agency.

Integrated Pollution Prevention and Control (IPPC) Directive – A set of common rules to minimise pollution of air, land and water from various sources throughout the European Union.

Integrated Product Policy (IPP) – Addresses all phases of a product's life cycle to minimise the environmental effects of products from their manufacture, use or disposal and to take action where most effective.

International Labour Organization (ILO) – The UN specialised agency, founded in 1901, which seeks the promotion of social justice and internationally recognised human and labour rights.

ISO 14001 – First published in 1996, this standard issued by the International Standardisation Organisation specifies the requirements for an environmental management system.

Joint Implementation (JI) – Projects undertaken in developed countries that limit or reduce emissions or enhance sinks. JI allows developed countries, or companies from those countries, to co-operate on projects and share the emission reduction units (ERUs) generated from 2008.

The Kyoto Protocol – An international agreement adopted in 1997 that commits its signatories, on ratification, to reduce emission of six key pollutants from 1990 levels by 2008–2012 and thereby slow down climate change.

Land Use, Land Use Change and Forestry (LULUCF) – Activities referred to in Annex I to the Kyoto Protocol.

Landfill Directive – The objective of the Directive is to prevent or reduce as far as possible negative effects on the environment from the landfilling of waste, by introducing stringent technical requirements regarding waste and landfills.

Landfill Tax Credit Scheme (LTCS) – A scheme which encourages and enables landfill operators to support a wide range of environmental projects by giving them a 90% tax credit against donations to environmental bodies.

Life cycle assessment (LCA) – Involves the evaluation of some aspects (often the environmental aspects) of a product system through all stages of its life cycle. Sometimes also called 'life cycle analysis', 'life cycle approach', 'cradle to grave analysis' or 'ecobalance'.

Linking Directive – Extends the EU Emissions Trading Scheme to allow participants to offset their emissions using credits from CDM and JI projects.

Marrakech Accords – Rules agreed in 2001 at the Seventh session of the Conference of the Parties that will enable the international community to implement the flexible mechanisms of the Kyoto Protocol, without ratification by the United States.

Millennium Development Goals – Eight goals that all 189 Member States of the United Nations pledged to achieve by 2015.

National Allocation Plans (NAP) – Plans by which governments of EU Member States set out how greenhouse gas emission allowances will be allocated to installations, to comply with the first phase of the EU Emissions Trading Scheme, from 2005 to 2007.

National contact point (NCP) – A single contact point for adhering countries set up to promote the OECD Guidelines and contribute to the resolution of issues that arise relating to their implementation.

NetRegs – Plain language guidance for businesses on UK environmental legislation and how to comply with it.

Non-Governmental Organisation (NGO) – An organisation, generally non-profit making, set up for a specific purpose, independent from governments and their policies.

REMAS – A three-year study of existing environmental management systems in the context of regulation across EU Member States.

Renewable Energy and Energy Efficiency Partnership (REEEP) – A coalition of progressive governments, businesses and organisations committed to accelerating the development of renewable energy and energy efficiency systems.

Renewables Obligation Certificates (ROCs) – Issued by suppliers as evidence of compliance in producing a specified proportion of their electricity supplies from renewable energy sources.

Social Accountability 8000 (SA 8000) – A global standard released by the Council for Economic Priorities (CEP) that provides an auditable framework for ethical sourcing.

Sustainability Integrated Guidelines for Management (SIGMA) – A project launched in 1999 by the BSi, Forum for the Future and AccountAbility, with the support of the DTI, resulting in practical advice to assist organisations in contributing to sustainable development.

Sustainable Consumption and Production (SCP) – A principle that addresses the need to reconcile economic development with environmental protection and social justice.

Sustainable development – Development that meets the needs of the present without compromising the ability of future generations to meet their own needs.

UK Accreditation Service (UKAS) – The national accreditation body recognised by the UK Government to assess organisations that provide certification, testing, inspection and calibration services against internationally agreed standards.

UK Climate Change Levy (CCL) – A tax on the use of energy in industry, commerce and the public sector to encourage energy efficiency and reduce emissions of greenhouse gases.

UK Emissions Trading Scheme (UK ETS) – A voluntary emissions trading scheme for UK installations running from 2002 to 2006. Participants in the UK ETS may opt out of the EU ETS.

United Nations Environmental Programme (UNEP) – A programme that enables nations and peoples to improve their quality of life by providing leadership and encouraging partnerships.

UN Framework Convention on Climate Change (UNFCCC) – A mechanism that requires developed countries to adopt policies and measures with the aim of reducing their emissions of greenhouse gases to 1990 levels by the year 2000. Signed in Rio de Janeiro at the 1992 Earth Summit by more than 150 countries with the objective of stabilising GHG concentrations in the atmosphere.

UN Global Compact – An international initiative comprising 10 principles in the areas of human rights, labour and the environment, intended for adoption by companies, UN agencies and others.

US Acid Rain Program – A programme with the goal of achieving significant environmental and public health benefits through the reduction of emissions which cause acid rain.

The Waste & Resources Action Programme (WRAP) – An initiative operated by a not-for-profit company funded by the UK Government to promote sustainable waste management by creating stable and efficient markets for recycled materials and products.

Waste Disposal Authority (WDA) – A local authority concerned with the disposal of municipal waste.

Waste Electrical and Electronic Equipment (WEEE) Directive – An EU directive that will require producers and, from August 2005, suppliers of replacement equipment, to bear the cost of collection and disposal of electrical and electronic equipment.

World Business Council for Sustainable Development (WBCSD) – A coalition of 170 international companies committed to sustainable development.

World Resources Institute (WRI) – An independent non-profit environmental research and policy organisation.

ICAEW is a world leading professional membership organisation that promotes, develops and supports over 140,000 chartered accountants worldwide. We provide qualifications and professional development, share our knowledge, insight and technical expertise, and protect the quality and integrity of the accountancy and finance profession.

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