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**CORPORATIONS AND CORPORATE SOCIAL RESPONSIBILITY:
WHAT IS THE IMPACT OF THE COMPANIES ACT 2006?**

A thesis submitted to the University of Manchester for the degree
of Master of Philosophy in the Faculty of Humanities

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**Corporations and Corporate Social Responsibility:
What is the Impact of the Companies Act 2006?**

ABSTRACT

The ability of corporate social responsibility (CSR) to address environmental and social problems is not universally agreed, while the way in which we facilitate CSR and, moreover, continually improve its effectiveness is unclear. Central to the debate is the extent to which the role of law ought to interact with the promotion of CSR, and this in turn raises questions over the effectiveness of different regulatory frameworks. Ecological modernisation theory suggests that a shift away from government-mandated, direct regulation, towards market driven innovation (with the state acting in a steering capacity), can help to align the apparent incompatibility between social/environmental issues and economic growth. A key component of this discussion is the use of reflexive instruments, which enable firms to effectively self regulate, in varying degrees, in response to complex problems.

The enactment of the Companies Act 2006, which introduced for the first time the mandatory requirement to report on various social and environmental issues, is one such example of reflexive law in practice and arguably represents a significant step forward for the CSR movement. Whilst its implications are potentially significant, there has been limited research to date into the extent of the changes made, if any, to the nature and quality of information provided by companies to stakeholders via corporate disclosure. This thesis contributes to the discussion by offering a comparative critique of corporate disclosure both pre and post the Companies Act 2006, in order to draw causal inferences resulting from the legislative changes. It is suggested, ultimately, that while appropriately framed reflexive mechanisms, such as mandatory reporting, can act as a powerful tool to induce behavioural change, this is likely to require a number of factors being realised. At present, it appears that there may still be a long way to go before we achieve the depth of change required to bring corporate behaviour in line with an ever-changing market.

February 2014

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Chapter 1

The Role of Corporate Social Responsibility

Introduction

Perceptions of the role and function of the modern corporation has seen a shift in focus over recent years; from the unqualified pursuit of profit, to a more inclusive standard of conduct encompassing social, economic and environmental considerations. For many, demonstrating a healthy bottom line is no longer the sole indicator of organisational health and success. Firms are required to reach increasingly high standards of social and environmental behaviour in an attempt to sustain themselves in the longer term. There are a number of different incentives for businesses to adopt more socially responsible behaviour, from direct or indirect economic advantage, to more altruistic motivations. Whilst the uptake of corporate social responsibility (CSR) inevitably varies from firm to firm, it is clear that such initiatives are becoming an increasingly important part of the modern corporate agenda and environment.

The purpose of Chapter 1 is to consider how business objectives have evolved over recent years and the more inclusive standards against which firms are judged. It does this by considering one of the leading economic perspectives, which is neoclassical economic theory, and how some of the principles upon which this theory is based were thought to be inconsistent with contemporary business practice and societal expectations. It then broadly considers some of the key drivers for CSR, including the potential for CSR initiatives to directly impact on financial performance. The chapter concludes with an overview of some of the studies carried out that attempt to demonstrate a link between CSR and corporate financial performance.

The Objectives of Business

Economic Responsibilities

In the late eighteenth century the industrial revolution transformed the British economic landscape, and, what is more, changed the role and function of the modern corporation. The

effects of developments in production technology and a growth of trade, together with accompanying productivity-enhancing methods (such as the division of labour), shaped business as a fundamental economic institution.¹ As well as producing important goods and services, firms further promoted the creation of wealth through the provisions of jobs, by discovering new resources and technological improvements, paying taxes to serve public needs, generating investment capital necessary for further economic growth, and providing investment opportunities.²

Until recently, the predominant view of the relationship between business and society was based on Adam Smith's 'invisible hand' metaphor.³ Smith suggested that in the pursuit of self-interest, market participants are inadvertently and collectively guided to produce economic benefits to wider society. This view was in contrast to the strictly regulated 'mercantilist' system that was prevalent in Smith's era, which stifled free trade and restricted labour-saving production techniques.⁴ Smith considered that relying on the ideal of the free-market, the autonomous choices of individuals are unintentionally coordinated by encouraging the pursuit of gain and efficiency, thus resulting in wealth maximisation for society as a whole. It was recognised that there were, however, necessary conditions for a free-market society; namely, a rule of law, strong property rights and enforceable contracts, and individual tradesmen that are driven towards mutually beneficial behaviour (e.g. efficiency of production and competitive pricing) as an unintended consequence of their actions.

The development of economic practices such as private ownership of capital, wage labour and a free market, are contributing factors to what has subsequently been described as the initiation of capitalism.⁵ During the last century such ideas have evolved from an economic

¹ Smith, A. (Author), Sutherland, K. (Editor) *An Inquiry into the Nature and Causes of the Wealth of Nations: A Selected Edition*, Oxford University Press, Oxford, 2008.

² Lantos, G., The Boundaries of Strategic Corporate Social Responsibilities, *Journal of Consumer Marketing*, **18(7)** 2001, pp.595-630.

³ See Smith, above at n.1.

⁴ Butler, E., *Preface to An Inquiry into the Nature and Causes of the Wealth of Nations* [online] London: 2001 [06/10/09] available at < <http://www.adamsmith.org/smith/won-intro.htm>>

⁵ Although the word 'capitalism' was not used in its current context until the 20th century. It is thought to have first been introduced by Werner Sombart in *The Jews and Modern Capitalism*, Duncker & Humblot, Leipzig, 1911.

system of private ownership and free trade, to the political ideology of the capitalist free market, which advocates individualism and minimal intervention from a *laissez-faire* state. As a result, the capitalist account of social and political reality consists of individual actors engaged in the unhindered pursuit of economic self-interest; the unfettered freedom central to this ideology. Under this regime, the role of the state is limited to defending the rights of participants within the economy, from threats such as violence, theft and fraud.

The premise of maximising wealth creation through the pursuit of self interest provides the foundation and ‘ethical’ justification of neoclassical economic theory.⁶ Developed most notably by economist Milton Friedman, this theory relies on the fundamental tenet that individual members of a firm operate as agents whose objectives are to serve the interests of those who own the business, or the shareholders. Stated simply, any action taken by an agent that does not result in profit maximization amounts to an improper tax on the business, which should be the sole domain of government.⁷ According to Friedman, those social concerns that fall outside this strict remit are to be addressed by the government or other social agencies. They should not form part of the company’s responsibilities. The sole restriction placed upon businesses under this regime is that they must conform to the basic rules of society, and engage in ‘open and free competition without deception or fraud.’⁸ This view is in contrast to a more recent, alternative school of thought, that an exclusive reliance upon the legal regulation of business conduct is inherently limited in its ability to ensure appropriate, responsible behaviour. This is given further consideration in Chapter 2.

The globalisation of corporate activity within a capitalist environment has undoubtedly revealed economic successes and innovations, and has arguably led to increased quality of life and opportunities to share in the benefits to society.⁹ Yet the negative externalities of corporate behaviour are equally apparent. Environmental pollution, industrial accidents and

⁶ Stoval, O. et al, Corporate Governance, Internal Decision Making and the Invisible Hand, *Journal of Business Ethics*, **51** 2004, pp.221-227.

⁷ *Ibid.*

⁸ Friedman, M., *Capitalism and Freedom*, University of Chicago Press, Chicago, 1962.

⁹ Wood, D. et al, *Global Business Citizenship: A Transformative Framework for Ethics and Sustainable Capitalism*, M.E. Sharpe Inc, New York, 2006.

illnesses, and the harmful societal impacts of advertising¹⁰ are examples of the unintended costs to society as a side effect of business activity. In addition to traditional concerns following industrialisation, the recent economic liberalisation of firms due to globalisation has prompted censure over lack of a commensurate degree of accountability. This is particularly apparent in developing countries where the financial benefits to corporations such as foreign direct investment and increasing international trade, rather than benefiting impoverished societies, have had an adverse effect upon labour and environmental conditions and witnessed an overall rise in inequality.¹¹

Notwithstanding the above, where the firm is able to internalise negative effects by absorbing them in production costs, the market is able to regulate itself by adopting an enlightened approach to profit maximisation.¹² The neoclassical economic model, however, fails to address this issue within its business cost structure by requiring the maximisation of profits to be unqualified by any resultant externalities. The shortcomings of this approach have prompted alternative views of the role and function of business to be sought, and it is a consideration of some of these views to which we now turn.

Changes to the Corporate Landscape

Since the 1960s, perceptions of the role and function of business have seen a shift in focus from the narrow finance-dominated approach to a more inclusive view of the firm. Increased realisation of repressive labour practices, impacts on the natural environment and immoral corporate practice, together with liberal consumerist media portrayals of Friedman-esque business conduct as morally reprehensible,¹³ resulted in the increased profile of corporate consciousness as the remedy to societal concerns.

The influence of civil society activism in the 1970s and 80s illustrated society's rising expectation for business and was considered a catalyst in the adoption of international standards for transnational corporations (TNCs) and UN codes of conduct for specific

¹⁰ Pollay, R.W., The Distorted Mirror: Reflections on the Unintended Consequences of Advertising, *Journal of Marketing*, vol 50(2), 1986, pp.18-36.

¹¹ Utting, P., Corporate Responsibility and the Movement of Business, *Development in Practice*, v.15, no.3/4 (Jun) 2005, pp.375-388.

¹² See Lantos, above at n.2.

¹³ *Ibid.*

products, which, albeit non-binding, represented part of a proposed New International Economic Order.¹⁴ The increased profile of non-governmental organisations (NGOs) as a legitimate means of development and (at a later stage) regulation, provided a ‘third way’ where governments and international organisations were considered to have failed at effectively regulating TNCs, and were based upon voluntary approaches, collaboration and partnerships.¹⁵ Initiatives adopted by firms in pursuit of this more exacting standard, and on a so-called voluntary basis, included revised codes of conduct, the improvement of environmental management systems, increased dialogue with stakeholders and NGOs and increased support for community development programmes. There was also a keen uptake of voluntary monitoring and reporting activities in order to demonstrate their commitment to factors beyond economic achievement and promote ‘best practice’ guidance.¹⁶

It was against this backdrop of developing a more inclusive view of the firm that the concept of CSR emerged and developed. Corporations were no longer being judged merely on their economic success but also on non-economic criteria such as social and environmental health and wellbeing. One definition of CSR was based on the proposition that corporations have four key responsibilities, or “faces”; economic, legal, ethical and philanthropic.¹⁷ Thus, productivity alone was no longer considered sufficient to justify the morality of business.

Developing alongside these changes to the corporate landscape was the concept of sustainable development, considered further in Chapter 2, which began to represent a key part of development policy. From a corporate perspective, CSR was seen as the business contribution to this important policy objective. Accordingly, the remainder of this chapter now focuses on the concept of CSR generally, including a consideration of its theoretical grounding and the ‘business case’ for CSR.

¹⁴ Richter, J., *Holding Corporations Accountable: Corporate Conduct, International Codes and Citizen Action*, Zed Books, London, 2001; Hansen, M., Environmental Regulation of Transnational Corporations: Needs and Prospects, in Utting, P. (ed), *The Greening of Business in Developing Countries: Rhetoric, Reality and Prospects*, Zed Books, London, 2002.

¹⁵ Utting, above at n.11.

¹⁶ *Ibid.*

¹⁷ Carroll, A., A Three-Dimensional Conceptual Model of Corporate Social Performance, *Academy of Management Review*, 1979 (4), pp.497-505.

The Concept of Corporate Social Responsibility

The concept of CSR is thought to have developed largely during the latter half of the 20th century, at least to the extent that it was from the 1960s onwards that CSR became a widely discussed topic on both the academic and corporate agenda.¹⁸ To date, there are a number of different approaches towards what the concept of CSR envisages. As a comprehensive analysis of such theories is beyond the scope of this chapter, the following discussion is limited to identifying the broad themes emerging from the debate.

One early commentary recognised the difficulty of ascertaining one definitional construct of CSR, given the broad parameters surrounding the idea of social responsibility to others.¹⁹ For some, this denoted no more than a legal liability, whilst other concepts focused on a wider, ethical, responsibility. For others still, the term denoted an increased social consciousness, in particular, to solving the social problems caused by corporations.²⁰

In considering previous definitions of CSR, Carroll observed that businesses' owed three key responsibilities to society: to make a profit, to obey the law and to "go beyond" these activities.²¹ In fulfilling these responsibilities, businesses were required to meet the economic, legal, ethical and discretionary (i.e. voluntary/philanthropic²²) expectations of society at a given point in time. These expectations or 'drivers' of CSR are considered in greater detail below. Early concepts of CSR also focused on the relationship between socially responsible behaviour and financial performance.²³ There have been a number of empirical studies into corporate social performance, or CSP, and the extent to which there

¹⁸ Carroll, A., Corporate Social Responsibility: Evolution of a Definitional Construct, *Business and Society*, Sept 1999 38 (3), pp.268-295.

¹⁹ Votaw, D., Genus Becomes Rare, in Votaw, D & Sethi, S. (eds), *The Corporate Dilemma: Traditional Values Versus Contemporary Problems*, Englewood Cliffs, NJ: Prentice Hall, 1973, pp.11-45.

²⁰ Fitch, H.G., Achieving Corporate Social Responsibility, *Academy of Management Review*, 1976 (1), pp.38-46.

²¹ Carroll, above at n.17

²² Carroll, A., Corporate Social Responsibility: Will Industry Respond to Cut-Backs in Social Program Funding, *Vital Speeches of the Day*, 1983 (49), pp.604-608.

²³ Drucker, P., The New Meaning of Corporate Social Responsibility, *California Management Review*, 1984 26 pp.53-63; Cochran, P.L & Wood, R.A., Corporate Social Responsibility and Financial Performance, *Academy of Management Journal*, 1984 27 pp.42-56; and Aupperle, K., Carroll, A. & Hatfield, J., An Empirical Investigation of the Relationship Between Corporate Social Responsibility and Profitability, *Academy of Management Journal*, 1985 28 pp.446-463.

exists a 'business case' for social and environmental responsibilities. Again, this is dealt with in greater detail later in this chapter.

The CSR concept has been described as an essential part of business language and practice; representing both an underpinning to many other theories as well as being consistent with public expectations of the business community.²⁴ Whilst there is no singly accepted definition of CSR, it is broadly agreed that the contemporary concept of CSR requires wealth creation to be qualified by how the business, in its pursuit of profits, impacts upon non-economic aspects of society. This includes accountability towards a wider range of constituencies that are affected by its conduct (stakeholders), in addition to those directly providing financial capital in exchange for property rights (shareholders). The once widely held belief that the sole objective of business was to maximize shareholder return, has been replaced by an emphasis on the 'triple bottom line'; encompassing social, economic and environmental concerns in addition to net profitability as an indicator of organisational success.

Whereas early instances of socially responsible behaviour relied largely on the self-regulation of corporations, which were subject to concerns over a lack of legitimacy and credibility, the CSR agenda has more recently been subject to a 'post-voluntarist' approach. This includes the use of independent regulatory institutions as well as a range of 'hard' and 'soft' law mechanisms²⁵, as examined further in Chapter 3.

The corporate response to CSR can be seen from a number of contemporary high profile examples. In 2007, Marks and Spencer introduced their five year sustainability initiative- 'Plan A', which aimed to make the organisation carbon neutral by 2012. Boots the chemist introduced a Community Investment Programme to support and develop health promotion initiatives within the community, while DIAGEO²⁶ committed £18 million per year towards community involvement, and encourages other organisations to do likewise via its

²⁴ Carroll, above at n.18.

²⁵ Kamminga, M. and Zia-Zarifi, S. (eds), *Liability of Multinational Corporations under International Law*, Kluwer Law International, The Hague, 2000; Ward, H., *Legal Issues in Corporate Citizenship*, Swedish Partnership for Global Responsibility and IIED, Stockholm and London, 2003.

²⁶ One of the 300 largest companies worldwide, owning brands such as Guinness, Smirnoff, Haagen-Dazs and Burger King.

own foundations and charities. The global transportation and distribution company, TNT, has developed a strategic partnership with the UN World Food Programme in an attempt to tackle world hunger.

It may be construed from the prevalence of such initiatives that few modern corporations would deem it appropriate to ignore CSR concerns²⁷, and support for the adoption of a wider range of responsibilities encumbered upon business is increasing exponentially – the practical implications of which are considered in Chapter 3. Despite this, the lack of a theoretical foundation for a stakeholder-inclusive approach is cited as one potential reason for its failure to surpass neoclassical economic theory, amongst both academics and professionals, as the preferred perspective on business’ impact on society.²⁸

The Theoretical Foundation for CSR

The Economic Perspective

As illustrated above, it is difficult to reconcile contemporary notions of CSR with the long-established economic views that have historically dominated business practices. It is however contended that the disparity has arisen from an unduly narrow interpretation of Smith’s notion of the ‘invisible hand’, and the subsequent ambiguity and misapplication of the concept of ‘corporate social responsibility’. These are dealt with in turn below.

Despite being a central concept of Smith’s self-regulating market, the phrase ‘invisible hand’ was used explicitly on only three occasions. The first of these, in *The Theory of Moral Sentiments*, provides a much wider definition than that derived from an exclusive reading of his later seminal work, which provides the foundations for neoclassical economic theory. Fundamentally, it provides that the pursuit of self-interest does not constitute the sole motivation of the individual, and that this is qualified by the existence of the ‘sympathy principle’ which denotes the ability and propensity of people to consider the

²⁷ This paper examines the interplay between CSR and public listed companies– thus excluding business that are below a certain size– which are likely to be affected, and therefore act, differently towards CSR.

²⁸ Stoval, above at n.6.

interests of others.²⁹ This reading requires the degree of self-interest to be determined by reference to a moral/ethical code, encompassing justice and beneficence as additional motivations upon which business decisions may be based. It is only with these three factors present – self-interest, justice and beneficence – that society is able to achieve the optimum level of social benefit.³⁰

Evidently, the modern adaptation of the invisible hand, that has shaped neoclassical economic theory, appears to have lost the ethical dimension with which it was originally conceived.³¹ Thus, a more comprehensive understanding of this concept provides both an ethical and economic justification for qualifying shareholder wealth maximisation with other ‘stakeholder’ interests in determining the optimal collective benefit.

Notwithstanding these fundamental concerns over the traditional shareholder-dominant perspective, this theory remains one of the predominantly held views of the role of business.³² From a neoclassical economic perspective, CSR initiatives attract criticism for their lack of legitimacy,³³ and are ultimately considered to amount to an unjustified appropriation of the owner’s property.³⁴ The conflict between this traditional economic stance and notions of CSR was perhaps most notably depicted by Milton Friedman in his New York Times article – *The Social Responsibility of Business is to Increase its Profits*³⁵. However, as opposed to a fundamental disparity between these views, it is arguable that the two may be reconciled depending on the definition of CSR that is applied, as considered below.

²⁹ Heilbroner, R (ed), *The Essential Adam Smith*, Oxford University Press, Oxford, 1986.

³⁰ Smith, A., *The Theory of Moral Sentiments* [online] A. Millar, London: 1790 [10/10/09] available at <<http://www.econlib.org/library/Smith/smMS1.html>>; Stoval *supra* at n.4.

³¹ Evensky, J., Retrospectives: Ethics and the Invisible Hand, *Journal of Economic Perspectives*, **7(2) 1993**, pp.197-205.

³² See Margolis, J. & Walsh, J., Misery Loves Companies: Rethinking Social Initiatives by Business, *Administrative Science Quarterly*, **18(2) 2003 pp.268-305** – “Despite a long history of communitarian protest (Morrissey 1989), Bradley et al.’s (1999) review of these efforts found that the neoclassical construal of the firm as a nexus of contracts has prevailed.”

³³ Brittan, S., How Economics is Linked to Ethics, *Financial Times*, 2 Sept 1993.

³⁴ Sternberg, E., *Just Business: Business Ethics in Action*, Little Brown & Co., London, 1994.

³⁵ Friedman, M., The Social Responsibility of Business is to Increase its Profits, *New York Times*, 13 Sept 1970.

One potential source of criticism over so-called ‘CSR’ focuses on the specific variables prevalent at the height of the Friedman era; the trend for big business to indulge in ‘corporate philanthropy’, with little evidence of genuine ethical concern or indeed shareholder value.³⁶ In this context, it is easier to appreciate the condemnation of so called ‘socially responsible’ activities, at the expense of shareholder return. For proponents of the CSR movement there exists, then, the assumption that modern notions of CSR can be distinguished significantly from the practices adopted thirty or forty years ago, requiring the demonstration of genuine ethical and social concern regarding the way in which profits are made. In this eventuality, socially responsible initiatives are justifiable from an economic perspective, as protecting shareholder interests by maximizing long-term investment return.

Notwithstanding this prevalent view, often termed the ‘business case’ for social responsibility, the lack of an agreed conceptual definition of CSR has prompted criticism over the potential ambit of what constitutes socially responsible behaviour, thus producing conflicting expectations of businesses role within society.³⁷ In identifying such expectations, the expanding CSR movement has been described thus:

“The language of business ethics is frequently brought into play, with environmental and social impact seen as part of a new business ethics...CSR has indeed become something of a portmanteau concept which incorporates a broad sweep of ethical concerns from saving the planet to demanding honesty and fairness in business dealings.”³⁸

It is perhaps unsurprising therefore that this broad and ambiguous expectation of corporate behaviour has attracted a contemporary economic critique of CSR.³⁹ As a preliminary point, it is noted that modern notions of CSR attribute a wider conception of the responsibility of private business than that prescribed for by traditional economic thought, notwithstanding the view that CSR has a direct link to long-term profitability. By placing

³⁶ Sparkes, R., A Pragmatic Approach to Corporate Social Responsibility, address given to the School of Management; London School of Economics, 19 May 2003.

³⁷ Moir, L., What Do We Mean by Corporate Social Responsibility?, *Corporate Governance*, **1, 2, 2001**, pp.16-22.

³⁸ McBarnet, D., The New Corporate Accountability: Corporate Social Responsibility Beyond Law, Through Law, For Law; In McBarnet, D., Voiculescu, A., & Campbell, T. (eds), *The New Corporate Accountability: Corporate Social Responsibility and the Law*, Cambridge University Press, 2007, Ch 2.

³⁹ Henderson, D., Misguided Virtue: False Notions of Corporate Social Responsibility, The Institute of Economic Affairs, London, 2001.

the firm within a leading role towards the goal of corporate social responsibility, the task of determining the public interest is allocated to self-selected private individuals within that organisation. Not only is this inconsistent with the premise that corporate individuals act as the agents of shareholders but, on a more practical level, means that the conduct of the business is susceptible to other external influences. This becomes contentious where unelected NGOs, particularly those which actively promote ‘anti-business’ thought, have a significant role in shaping public opinion.⁴⁰

Whilst appearing problematic at first glance, this line of reasoning has been rebutted, based upon the fundamental misconception over the definition of CSR:

“CSR describes the practical reality that companies are increasingly being judged not just by the products and profits they make, but also *how* these profits are made...In this context ‘socially responsible’ simply means *responsive* to the concerns of *society*. The avoidance of the word ‘ethical’ is deliberate.”⁴¹

Thus, this reading of the term ‘CSR’ indicates that social and environmental constraints imposed upon business by anti-capitalist/anti-globalist NGOs can only impact public opinion if they represent the concerns of the populace at large. This perspective can be justified in economic terms by reference to the business case for CSR, as such constraints foster long term profitability where the corporation is able to integrate them within the management decision-making process.⁴² Whilst it will always be difficult to justify inherently subjective terms such as ‘ethical’ or ‘sustainable’ on an economic level, where CSR initiatives can demonstrate a clear link to a corresponding societal concern there will be a potential business case argument. An analysis of the practical implications of this theory is carried out below.

CSR initiatives have also been justified on non-economic grounds, and whilst a comprehensive analysis of the various academic theories on which they are based is beyond the scope of this chapter, they broadly fall into two distinct categories. Along with instrumental theories based on the economic perspective (thus called as CSR is merely a

⁴⁰ *Ibid.*

⁴¹ Sparkes, above at n.36.

⁴² *Ibid.*

means to an end i.e. profit maximisation), alternative theories are primarily based on the fundamental inter-dependence between business and society.⁴³

Social Contract Theory

Firstly, there is the premise that companies have a moral duty to contribute to society by virtue of a form of social contract.⁴⁴ The significance of social problems such as malnutrition, homelessness, pollution and poverty, make corporations an obvious source of aid given their wealth-creation capabilities⁴⁵ and other ‘resources’ such as knowledge. This is particularly the case where the existence of the firm has contributed towards the creation of such ills although, understandably, this argument clearly requires less justification than the former.

The premise is that even in the absence of profit potential, be it short or long term, companies are obliged to direct their skills and resources toward the remedy of social problems.⁴⁶ When contextualized within a socially constructed system of norms and values, engaging in socially responsible practice maintains the legitimacy of the firm by complying with societal expectations. Ultimately, it is argued that those firms who do not use power in a manner which society considers responsible will tend to lose it.⁴⁷ It is possible, however, to substantiate socially responsible actions by considering this rationale in reverse, i.e. companies are able to legitimise their conduct *because* of their status, effectively using CSR measures as a means of achieving enhanced reputation.⁴⁸ From this perspective, CSR accords less with socially responsible rectitude, in reliance upon

⁴³ See e.g. Garriga, E. & Melé, D., Corporate Social Responsibility Theories: Mapping the Territory, *Journal of Business Ethics*, **vol.53**, **2004**, **pp.51-71**, and Ville-Pekka, S., How to Explain Socially Responsible Corporate Actions Institutionally: Theoretical and Methodological Critique, *Electronic Journal of Business Ethics and Organisation Studies*, **v.13(1)**, **2008**, **pp.32-41**.

⁴⁴ Gray, R., Owen, D. & Adams, C., *Accounting and Accountability: Changes and Challenges in Corporate Social and Environmental Reporting*, Prentice-Hall Europe, Harlow, 1996.

⁴⁵ Margolis & Walsh, above at n.32.

⁴⁶ Holmes, S.L., Executive Perceptions of Corporate Social Responsibility, *Business Horizons*, **vol.19**, **1976**, **pp.34-40**.

⁴⁷ Wood, D.J., Corporate Social Performance Revisited, *Academy of Management Review*, **vol.16**, **1991**, **pp.691-719**; cited in Moir, above at n.37.

⁴⁸ Lindblom, C.K., The Implications of Organisational Legitimacy for Corporate Social Performance and Disclosure, paper presented at the Critical Perspectives on Accounting Conference, New York 1994; cited in Gray *et al*, above at n.44.

increased publicity, influence and reputation and, ultimately, economic success. As put by one commentator, ‘the need for business benefits is never far away’.⁴⁹

Whilst the social contract perspective appears entirely inconsistent with the neoclassical economic approach, proponents of the latter are not necessarily opposed to social contract theory. Instead, it is contended that in order to maximise social welfare, all firms within the economy must reach their optimum collective value.⁵⁰ Whilst it is recognised that for this to be achieved the firm must have regard to multiple constituencies, it is deemed impossible to maximise wealth-creating performance along more than one dimension by calculating appropriate ‘trade-offs’, a concept considered below. Thus, for those subscribing to this view, the concerns of society are most adequately addressed by ensuring the optimum long-term market value of the corporation.⁵¹

The Business Case for CSR

As touched on earlier in this chapter, the potential link between socially responsible behaviour and financial performance has formed the basis of a number of empirical studies since the 1980s. Whether proponents of the CSR movement advocate socially responsible behaviour due to the long-term profitability potential, or because it is believed that businesses should meet more than one objective, the business case for CSR is clearly an attractive and influential reason for corporations to act more responsibly.⁵² The contemporary CSR movement accounts for billions of pounds in the UK annually, and includes *inter alia* ethical consumption within the consumer market, socially responsible investment (SRI), and a sub-industry of CSR promoting organisations.⁵³ The inception of a corresponding new level of ‘social accountability’ is deemed a consequence of a series of

⁴⁹ Moir, above at n.37.

⁵⁰ Margolis & Walsh, above at n.32.

⁵¹ Jensen, M., Value Maximisation, Stakeholder Theory, and the Corporate Objective Function, *Business Ethics Quarterly*, vol.12 2002, pp. 235-256.

⁵² Brittan, S., *Capitalism with a Human Face*, Edward Elgar, Aldershot, 1995, p.40.

⁵³ Including advice/training consultancies, standard setting/reporting certification, publication of reports, specialist law firms, conference organisers and magazine/newsletter publishers. See McBarnet, above at n.38 and Matten, D. and Moon, J., A Conceptual Framework for Understanding CSR, in Habisch, A. et al (ed), *Corporate Social Responsibility Across Europe*, pp.335-356, Berlin, Springer.

contextual drivers which ensure that CSR is kept firmly on the corporate agenda. Examples of these are considered below.

CSR Drivers

Socially responsible corporate behaviour is driven by several key factors including legislative measures, stakeholder pressure, economic advantage and genuine ethical/moral concern. As the introduction of the new companies' legislation and its impact on the CSR regime forms the basis of Chapter 3, with this exception the above motivations will now be discussed in turn.

Stakeholder pressure

A stakeholder has been broadly defined as an individual or group that can affect and be affected by the achievement of the organisation's objective.⁵⁴ The importance of engaging with stakeholders is widely accepted as a means of identifying potential problems and ensuring these are adequately addressed, viewing and interpreting important trends⁵⁵ and enabling firms to satisfy key stakeholders according to their definition of what is valuable to ensure the success of the firm.⁵⁶ One area that has developed into a dominant source of stakeholder pressure is the rise of global non-governmental activity. Routinely identified as a significant driver of contemporary CSR⁵⁷, NGOs have enormous potential to influence corporate behaviour as a result of increasing pressure from civil society for greater transparency and more socially responsible policies/practice. In conjunction with instantaneous global communication; internet forums and websites dedicated to corporate activity, the risk to corporations of adverse publicity due to substandard CSR initiatives is virtually inescapable. The risk from adverse publicity is of particular concern where the organisation relies heavily on the value of its intangible assets such as brand and reputation, as it is this that ultimately determines what the market will pay for the product and/or service provided. Thus, the mere threat of a protest campaign in response to NGO and/or

⁵⁴ Freeman, R., *Strategic Management: A Stakeholder Approach*, Pitman, Boston, 1984.

⁵⁵ Harrison, J & C, St. John, Managing and Partnering with External Stakeholders, *Academy of Management Perspectives*, **1996 May 10(2) pp.46-60**.

⁵⁶ Bryson, J.M., What To Do When Stakeholders Matter: Stakeholder Identification and Analysis Techniques, *Public Management Review*, **2004 6(1) pp.21-53**.

⁵⁷ See for example the EC Communication 'Corporate Social Responsibility: A Business Contribution to Sustainable Development, COM (2002) 347, p.5.

media criticism of particular social or environmental practices has proved sufficient to prompt policy changes within a number of leading retailers.⁵⁸

However, this is an appropriate juncture to clarify that not all firms will be similarly affected by this form of stakeholder involvement. Whilst participation in CSR initiatives may be used as a strategic tool to enhance certain shareholder relations,⁵⁹ thereby reducing the firm's business risk,⁶⁰ this is likely to depend heavily upon the size of the firm in question. A prevalent view is that larger firms tend to be more socially responsive as they are subject to a higher level of visibility.⁶¹ Specifically with regard to stakeholder pressure, research indicates that the power of the stakeholder to influence CSR measures, and indeed their interest in doing so, increases proportionately with the size of the firm.⁶² Thus, for larger firms there is much to gain from CSR participation in the form of enhanced reputation and legitimacy, as well as the desire to avoid the damage associated with substandard conduct.

Larger firms are also likely to be better equipped to respond appropriately due to increased access to resources and greater 'resource slack', i.e. sufficient resources to devote to CSR initiatives which, in turn, fosters a higher level of corporate social performance.⁶³ In addition, it is contended that a more evolved system of administration means that larger corporations have a more accurate perception of external pressures, again serving to increase their responsiveness to social issues.⁶⁴ Although studies of the correlation between firm size and CSR participation have not yielded conclusive findings, with conflicting

⁵⁸ E.g. Gap, Disney, Mattel, Ikea, Sainsburys, Starbucks, McDonald's and Shell to name but a few. See Vogel, D., *The Market for Virtue: The Potential and Limits of Corporate Social Responsibility*, Brookings Institution Press, Washington, 2005.

⁵⁹ McWilliams, A. & Siegel, D., Corporate Social Responsibility: A Theory of the Firm Perspective, *Academy of Management Review*, **26**, 2001, pp.117-127.

⁶⁰ Boutin-Dufresne, F. & Savaria, P., Corporate Social Responsibility and Financial Risk, *Journal of Investing*, **13**, 2004 pp.57-66.

⁶¹ Udeyasankar, K., Corporate Social Responsibility and Firm Size, *Journal of Business Ethics*, **83**, 2008, pp.167-175.

⁶² Lynch-Wood, G. & Williamson, D., The Social Licence as a Form of Regulation for Small and Medium Enterprises, *Journal of Law and Society*, **34(3)**, 2007, pp.321-341.

⁶³ Brammer, S.J. & Millington A., Firm Size, Organisational Visibility and Corporate Philanthropy: An Empirical Analysis, *Business Ethics: A European Review*, **15(1)**, 2006, pp.6-18; and Johnson, R. & Greening, D., The Effects of Corporate Governance and Institutional Ownership Types on Corporate Social Performance, *Academy of Management Journal*, **42(5)**, 1999, pp.564-576.

⁶⁴ *Ibid.*

arguments suggesting that more visible firms may be *less* socially responsive as they have a higher resistance to external influences⁶⁵, a more detailed analysis of this area is beyond the scope of this chapter. Suffice it to say that firms may have differing capacities to respond to regulatory CSR measures given their inherent organisational differences, and thus a universal approach is likely to fail in achieving optimum compliance overall. This concept is discussed further in Chapter 2.

Economic advantage

While it is evident that prominent firms may respond to stakeholder pressure in the pursuit of economic advantage, a further economic motivation to participate in voluntary CSR is the perceived threat of additional regulation.⁶⁶ Where firms are considered incapable of adequately responding to social concerns, this responsibility is likely to be taken on by the government, with the associated costs of adhering to new obligations to be met by the business. Faced with the choice, many corporations have opted to develop their own policies in response to anticipated social concerns, thus pre-empting the need for external regulatory control.⁶⁷

In a similar vein, albeit often overlooked as a traditional CSR ‘driver’, is the role of business as a movement in itself, proactively engaging within and shaping the CSR agenda through various institutional and organisational forms.⁶⁸ The capacity of firms to go beyond defensive responses and ‘greenwash’ has been likened to the fortitude of the capitalist ideology;

The longevity of capitalism has to do with the ability of ruling elites to govern not through force but consensus, exercising moral, cultural and intellectual leadership, and entering into relations with civil society that cultivate certain values and opinions conducive to stability and the rejection of ‘radical alternatives’. Corporate engagement with CSR issues can also be seen in these terms.⁶⁹

⁶⁵ Meznar, M.B. & Nigh, D., Buffer or Bridge? Environmental and Organisational Determinants of Public Affairs Activities in American Firms, *Academy of Management Journal*, **38**, 1995, pp.975-996.

⁶⁶ Moon, J., *Government as a Driver of Corporate Social Responsibility, The UK in Comparative Perspective*, Research Paper Series of the International Centre for Corporate Social Responsibility, Nottingham, No.19, 2004.

⁶⁷ *Ibid.*

⁶⁸ Utting, above at n.11.

⁶⁹ *Ibid.*; Levy, D., Environmental Management as Political Sustainability, *Organisation and Environment*, **10(2)**, 1997, pp.126-147; Bendell, J. & Murphy, D., Towards Civil Regulation: NGOs and the Politics of Corporate Environmentalism, 2002, in Utting, above at n.11.

Thus, by actively influencing the institutional reform of the CSR regime, leading corporate players are ensuring their position at the forefront of social and economic change.

Ethical/moral concern

In addition to the strategic motivations for firms to participate in CSR, which can be traced back to the pursuit of economic success, there may also exist altruistic motives for firms to operate with a degree of moral concern.⁷⁰ Given the significant social impact of some larger firms, as considered above, it is considered equitable that they bear a corresponding degree of social responsibility,⁷¹ to be determined by reference to their level of economic, social and political power.⁷² The concept of the social contract, however, is inevitably ambiguous in practice due to its ability to vary across regions or as society changes over time.⁷³ Ultimately, as social legitimacy expectations also appear to correspond to firm visibility, the capacity of such firms to use beyond compliance behaviour to their economic advantage means that the distinction between ethical and strategic motivations is by no means clear.⁷⁴

Corporate financial performance

Empirical Analysis

Whilst the business case for CSR participation is not a novel concept, the current emphasis has evolved from an enlightened self interest, where promoting the business as a responsible corporate citizen may have an indirect competitive advantage,⁷⁵ to requiring a

⁷⁰ Joyner, B.E & Payne, D., Evolution and Implementation: A Study of Values, Business Ethics and Corporate Social Responsibility, *Journal of Business Ethics*, **41**, 2002, pp.297-311.

⁷¹ Udeyasankar, above at n.61.

⁷² Lippke, R.L., Setting the Terms of the Business Responsibility Debate, in Larmer, R.A. (ed), *Ethics in the Workplace: Selected Readings in Business Ethics*, West Publishing Company, Minneapolis/St Paul, MN, 1996.

⁷³ Chewning, R.C, Eby, J.W. and Roels, S.J., *Business Through the Eyes of Faith*, Harper & Row, San Francisco, CA, 1990.

⁷⁴ Lynch-Wood, G. & Williamson, D., Regulatory Compliance: Organisational Capacities and Regulatory Strategies for Environmental Protection, in Quirk, H., Seddon, T. And Smith, G. (eds.), *Regulation and Criminal Justice: Innovations in Policy and Research* (2010), Cambridge University Press, Cambridge.

⁷⁵ Through benefits such as improved employee morale and enhanced reputation. Self-regulation also minimises the need for governmental intervention and means that firms are better placed to deal with the subsequent introduction of the same.

direct responsibility-profitability connection.⁷⁶ In this eventuality, concerns over the illegitimacy of CSR from an economic perspective, such as the misallocation and misappropriation of profits, become extraneous considerations as the firm will be adopting CSR initiatives as a means of maximising their wealth creation capabilities. Studies examining the relationship between CSR and financial performance are yet to yield conclusive findings, and whilst a comprehensive discussion of this literature is beyond the scope of this paper, a brief summary is as follows.

Since the early 1970s, empirical studies have sought to demonstrate a positive link between CSR participation and financial performance in response to adverse public reaction to the type of corporate behaviour envisaged under the guise of CSR.⁷⁷ In an appraisal of over one hundred empirical reports, a compilation of their findings suggests that there is overwhelming data in support of a positive association between ethical behaviour and financial performance, and little indication of a negative impact.⁷⁸ In spite of this, fundamental concerns over reliability and validity have prevented these findings from constituting a definitive link between socially responsible conduct and financial gain. Inconsistent variables and organisation conditions, together with a lack of consensus over how corporate responsibility should be measured, make drawing meaningful conclusions unfeasible.⁷⁹ Furthermore, the examination of data correlations, whilst identifying behavioural trends, does not establish the direction of causality; it is impossible to determine whether more responsible firms are more successful, or more successful firms are more responsible.⁸⁰ In identifying these correlations, alternative explanations given are that more profitable firms are able to devote more funds towards socially responsible initiatives and well-managed firms, which are also likely to be more financially successful, may be better at managing their CSR participation.⁸¹

⁷⁶ Vogel, above at n.58.

⁷⁷ See for example Friedman, above at n.27.

⁷⁸ Margolis, J.D and Walsh, J.P., *Misery Loves Companies: Rethinking Social Initiatives by Business*, *Administrative Science Quarterly*, **48(2)**, 2003, pp.268-305.

⁷⁹ *Ibid.* See also McGuire, J et al, *Corporate Social Responsibility and Firm Financial Performance*, *The Academy of Management Journal*, **31(4)**, 1988, pp.854-872.

⁸⁰ Vogel, above at n.58.

⁸¹ *Ibid.*

Beyond the Data

While there does not appear to be a definite link between social responsibility and profitability, some commentators have questioned the purpose of seeking to demonstrate a positive causal connection through empirical research. It has been argued that the need to establish the financial benefits of corporate responsibility purports to hold CSR to a standard that no other business activity is subject. As with other business strategies, investments in certain areas (e.g. marketing, advertising etc) are not guaranteed to yield positive results. However, this does not mean that no business case exists. Rather than viewing CSR as a necessary condition for success, voluntary social responsibility ought to be viewed as one dimension of corporate strategy.⁸²

In addition, basing CSR initiatives on the existing body of empirical research, on the basis that this demonstrates a positive link between social responsibility and financial performance is considered problematic for a more fundamental reason. An exclusive reliance on the business case for CSR fails to take into account the inherent difficulty of reconciling neo-classical economic and stakeholder theories. The tension between these differing conceptions of the role and purpose of the firm cannot be resolved purely through demonstrating convergence among competing views.⁸³

Conclusions

Despite playing an important role in shaping modern business conduct, there is no accepted theoretical basis or definitional construct of CSR. However, as has been demonstrated, there are a number of justifications for firms to adopt more socially responsible business practice, both economic and ethical. What is clear is that the corporate landscape has been irrevocably altered over recent years since the introduction of CSR. Many firms recognise their need to demonstrate their wider responsibilities, and a sub-industry of CSR related organisations now exists to help foster this important objective.

⁸² Vogel, above at n.58.

⁸³ Tetlock, P.E., Cognitive Biases and Organizational Correctives: Do Both Disease and Cure Depend on the Ideological Beholder?, *Administrative Science Quarterly*, **45**, 2000, pp.293-326.

Voluntarism clearly has a role to play in the pursuit of increasing standards of CSR. Some firms are driven to demonstrate their improved corporate behaviour by virtue of stakeholder pressure or in pursuit of economic advantage. However, not only does an exclusive reliance on the business case for CSR require favourable market conditions, it also fails to take account of the propensity of different firms to respond differently to those market conditions. The issue of firms differing capacities is considered in more detail in Chapter 2.

These limitations lead to the conclusion that, whilst voluntarism is important, it cannot replace regulation if consistently improved levels of CSR are to be achieved. The next chapter therefore aims to build upon this conclusion by considering what role, if any, the law ought to play in regulating CSR, and how this may work in practice to help achieve higher standards of CSR. It is a consideration of CSR and the role of law to which we now turn in Chapter 2.

Chapter 2

Corporate Social Responsibility: The Role of Law

Introduction

The question of whether, and the extent to which, the law should play a role in facilitating or promoting CSR, is not widely accepted. Moreover, views on the use of law to facilitate CSR tend to be quite polarised and often ideological. There are those who advocate the role of voluntarism and voluntary initiatives. But although there is much agreement that voluntarism can play an important role,⁸⁴ there are those that are concerned that voluntary arrangements are not appropriate alternatives to more traditional legislative arrangements.⁸⁵ The basis of this concern, as we saw in Chapter 1, is that stakeholders and markets may not provide the necessary incentives, and may not be able to properly enforce CSR. For some, legislation may thus provide a more consistent and effective set of CSR outcomes.⁸⁶

The purpose of Chapter 2 is to examine different regulatory frameworks and mechanisms, and to consider how these frameworks and mechanisms can facilitate better or more effective CSR practices. It does this, in particular, by looking at some of the key arguments surrounding the effectiveness or ineffectiveness of different approaches to regulation. Given the potential scope of such debates, the analysis that follows will focus mainly on different approaches to environmental regulation; however, many of the discussions are of more general applicability and, as such, are likely to be relevant to broader areas of social control and improvement, and, moreover, to the promotion of CSR.

Chapter 2 starts by considering conventional ‘command and control’ forms of regulation, or what is alternatively known as direct regulation. It not only considers the forms it takes, but also looks at arguments that have developed as to why command and control regulation is limited and may not be able to achieve the types of changes required or address the types of

⁸⁴ Corporate Social Responsibility: A Business Contribution to Sustainable Development, COM (2002) 347, p.4.

⁸⁵ Vogel, above at n.58.

⁸⁶ McBarnet, above at n.38

problems we face. It then, briefly, considers some of the factors that have led to a shift in how we perceive regulation and the forms that regulation can, and should, take. The main vehicle for this debate is the sustainable development concept and, in particular, the theory of ecological modernisation. Ecological modernisation theory, which essentially suggests that environmental problems can be met through the natural tendency of the market to innovate, has come to have important implications for regulation, particularly as it suggests that environmental goals can be achieved by mechanisms that work with the market. This leads us to the final part of the chapter, which is a discussion of alternative reflexive and governance-based arrangements such as self-regulation, market-based instruments etc. The chapter concludes with a consideration of how reflexive, governance-based strategies may be used to regulate organisational behaviour and how these mechanisms are implemented in practice, specifically through the use of corporate environmental reporting.

Shifting Styles of Regulation

This section considers how different forms of regulation have developed, and the reasons that alternative regulatory methods have been sought. It then considers the changes to the regulatory framework that are considered necessary in order for deeper regulatory change to occur.

Direct regulatory approaches

The conventional approach to controlling the activities of firms is often referred to as command and control regulation. Command and control regulation actually embraces a wide range of approaches, but it is often quite narrowly described as an approach whereby a regulatory agency controls certain activities by applying prescriptive standards which can be enforced using civil or criminal sanctions.⁸⁷ From an environmental perspective, the command and control approach was considered an appropriate response to public concern

⁸⁷ Selznick, P., *Focusing Organisational Research on Regulation*, in Noll, R., (ed.) *Regulatory Policy and the Social Science*, (1985), Berkley, California; Ogus, A., *Regulation: Legal Form and Economic Theory*, (1994), Oxford University Press, Oxford; and Baldwin, R. and Cave, M., *Understanding Regulation* (1998), Oxford University Press, Oxford.

over the regulation of environmental issues in an increasingly industrialised society.⁸⁸ In this context, command and control regulation provided a reliable means of ensuring that private actors met minimum standards set by the state or, in the event that they failed to do so, made identifying and addressing a breach of these standards a relatively straightforward process. Because of this application, command and control regulation is considered particularly effective at limiting toxic and health-related emissions, which need to be accurately controlled.⁸⁹ Thus, provided that adequate monitoring and enforcement exists, large, easily identifiable firms can be targeted effectively and held to account. Similarly, visible pollution from stationary, point sources has been reduced dramatically using command and control approaches.⁹⁰

As both regulators and firms have a clear understanding of their roles and obligations under the command and control approach, this results in greater consistency and predictability of results. This in turn is considered beneficial as increasing the ability of the regulation to withstand judicial review or public scrutiny, as well as limiting instances of manipulative or obstructive behaviour by firms.⁹¹ However, the effectiveness of command and control regulation is likely to vary depending upon the circumstances to which it is applied. Notwithstanding the significant environmental improvements credited to the use of command and control regulation⁹², there are a number of important shortcomings that have been well documented in the literature. Some of these key concerns are summarised below.

Criticisms of Command and Control

Conventional forms of command and control are often described as being top-down and prescriptive, thus making this method of regulation inflexible and unduly restrictive. Generally speaking, firms are required either to meet a prescribed emissions standard, or to use a specific method or equipment in order to control emissions. Often firms are required

⁸⁸ Aalders, M. & Wilthagen, T., Moving Beyond Command-and-Control: Reflexivity in the Regulation of Occupational Safety and Health and the Environment, *Law and Policy*, **19(4)** 1997, pp.415-443.

⁸⁹ Mirovitskaya, N. & Ascher, W. (eds), *Guide to Sustainable Development and Environmental Policy*, 2001, Duke University Press, USA.

⁹⁰ Hilson, C., *Regulating Pollution: A UK and EC Perspective*, Hart, Michigan, 2000.

⁹¹ Latin, H., Ideal versus Real Regulatory Efficiency: Implementation of Uniform Standards and 'Fine Tuning Reforms', *Stanford Law Review*, **37**, 1985, pp.1267-332.

⁹² Chertow, M. & Esty, D. (eds), *Thinking Ecologically: The Next Generation of Environmental Policy*, Yale University Press, New Haven, 1997.

to adopt highly specific pollution-control technology in order to satisfy broad standards of environmental performance, leaving some firms 'locked in' to less efficient technologies regardless of more appropriate technology becoming available.⁹³ Used in this way, command and control mechanisms have attracted criticism over their suppression of competitiveness and innovation.⁹⁴

In addition, and closely linked to the concept of inflexibility, is the failure of command and control to distinguish between differing firms, in particular their capacity to respond to regulation, applying instead a one size fits all approach. In setting one performance standard applicable to all firms, there will undoubtedly be a degree of both over-regulation and under-regulation in light of not only differing business models, but also the multi-faceted nature of the environmental problems faced, rapidly developing technology and the complex economic/social context within which the firm operates.⁹⁵ The inability of command and control regulation to target itself accurately is therefore not only considered ineffective on an economic level, but also as failing in terms of effective environmental protection.⁹⁶

It is also pertinent to note that, despite the evident success of command and control in targeting large firms and single media, point source pollution, this approach is limited in its ability to control numerous smaller and/or transient pollution sources, as the administrative cost is likely to outweigh the benefit.⁹⁷ When it is considered, however, that small and medium sized firms have a higher combined detrimental effect on the environment than the larger firms being targeted by command and control regulation, the shortcomings of this approach become self-evident.⁹⁸

⁹³ Mirovitskaya & Ascher 2001, above at n.89.

⁹⁴ Gunningham, N. et al (eds), *Designing Environmental Policy*, in Gunningham, N. & Grabosky, P., *Smart Regulation*, (1998), Oxford University Press, Oxford.

⁹⁵ Orts, E., A Reflexive Model of Environmental Regulation, *Business Ethics Quarterly*, **vol.5(4) 1995 pp.779-794**.

⁹⁶ *Ibid.*

⁹⁷ Mirovitskaya & Ascher 2001, above at n.89.

⁹⁸ SMEs are estimated to produce 60% of all business carbon dioxide omissions (Marshall Report 1998), 70% of business pollution (Smith & Kemp 1998), 60% of commercial waste, and 43% of serious pollution incidents (Net Regs 2006); Lynch-Wood, G. & Williamson, D., Ecological Modernisation and the Regulation of Firms, *Environmental Politics*, **21:6, pp.941-959**.

A further limitation of command and control focuses upon the roles of government and industry respectively, in creating effective environmental regulation. The criticism of command and control in this context is that it requires the regulatory body to have reliable and comprehensive knowledge of the industry that it seeks to regulate. Not only is this information gathering exercise costly, it also invariably results in the enactment of reactive and transitory provisions to deal with developing environmental issues and technological advances.⁹⁹ Proponents of this view argue that individual firms have greater access to this information and are also better placed to develop and implement environmental strategies, rather than relying upon governmental decision making.¹⁰⁰

Notwithstanding its limitations, direct regulation still constitutes a principal regulatory tool for achieving increased environmental standards. Its application has, however, been refined over recent years, with previous end-of-pipe approaches being complemented by the development of clean technologies which incorporate environmental considerations into their design in order to limit harmful impacts on the environment.¹⁰¹ In addition to promoting preventative techniques as opposed to after-the-event control, recent forms of command and control regulation introduce a range of case-specific variables that enable a more tailored response.¹⁰²

Despite the introduction of more sophisticated techniques, any proposed reform of command and control regulatory methods is, arguably, inherently limited due to its prescriptive and reactionary nature. Its deficiencies become apparent, for example, when it is used to tackle diffuse ecological problems which it is ill-equipped for,¹⁰³ and complex issues such as global climate change and the increasingly rapid loss of biological

⁹⁹ Alm, A., A Need for new Approaches: Command and Control is no Longer a Cure-All, *EPA Journal*, **18** May/June, 1992, pp.6-11.

¹⁰⁰ Malloy, T., The Social Construction of Regulation: Lessons from the War against Command and Control, *Buffalo Law Review*, **58(2)** 2010, pp.267-355.

¹⁰¹ Murphy, J. & Gouldson, A., Environmental Policy and Industrial Innovation: Integrating Environment and Economy through Ecological Modernisation, *Geoforum*, **31**, 2000, pp.33-44.

¹⁰² *Ibid*; E.g. integrated pollution control (IPC) as introduced by the Environmental Protection Act 1990.

¹⁰³ E.g. Diffuse source pollution from agriculture, see Gunningham, N. & Sinclair, D., Policy Instrument Choice and Diffuse Source Pollution, *Journal of Environmental Law*, vol.17(1) 2005 pp.51-81.

diversity.¹⁰⁴ This has led many to conclude that this form of regulation may be unsuitable in a modern climate.¹⁰⁵ Fundamentally, while improving the capacity of firms to respond appropriately, command and control regulation fails to establish environmental goals as a strategic concern of industry¹⁰⁶ and, inevitably, fails to induce the level of systemic behavioural change required. Instead, firms are required to adopt a reactive approach to the constant evolution of societal values, in order to comply with society's expectations.¹⁰⁷

Realisation of the practical limits of top-down legal regulation as an effective means of achieving progressively better standards of environmental health has therefore prompted policy makers and regulator to search for, and develop, a range of alternative regulatory methods.¹⁰⁸ It is thought that in light of the scale and complexity of the environmental problems faced by industries, a deeper level of change is likely to be required if we are to achieve a more sustainable level of development. This, it would seem, has implications for CSR, given that, as suggested in Chapter 1, CSR is the business contribution to sustainable development. Without this broader imperative for action, it is difficult to envisage the levels of change necessary, leading many to conclude that a more innovative approach to regulation may be required.

CSR, Sustainable Development, and the Regulation of Ecological Goals

How, then, does command and control regulation relate to CSR? It can be deduced, from what is said above on the limits of command and control, coupled with the complexities surrounding the concept of CSR,¹⁰⁹ that command and control strategies tend to be seen as weak strategies for achieving CSR. Command and control strategies, for example, are often seen as too blunt and as ineffective at tapping into firms' CSR capabilities.¹¹⁰ To explore some of these issues further, we will now focus on two issues that can be related to the

¹⁰⁴ For biodiversity loss on private land, see Perrings, C. et al. (eds), *Biodiversity Conservation: Problems and Policies*, Kluwer Academic Publishers, Dordrecht, 1994.

¹⁰⁵ Fiorino, D., Rethinking Environmental Regulation: Perspectives on Law and Governance, *Harvard Environmental Law Review*, vol.23 1999 pp.1-26.

¹⁰⁶ *Ibid.*

¹⁰⁷ Hess, D., Social Reporting: A Reflexive Law Approach to Corporate Social Responsiveness, *The Journal of Corporation Law*, 1999 vol.25(1) pp.41-84.

¹⁰⁸ See e.g. the Robens Committee Report 1972, which led to the enactment of the Health and Safety at work Act 1974.

¹⁰⁹ See Chapter 1

¹¹⁰ Mirovitskaya & Ascher above at n.89, Gunningham & Grabosky above at n.94 and Orts above at n.95.

regulation of CSR. First, is sustainable development, because CSR is seen as the business contribution to this important objective. Second, is one of the main strategies for achieving sustainable development's ecological goals – which is known as ecological modernisation. This leads on to the later discussion of different regulatory techniques.

Sustainable Development and Regulation

There are a number of competing conceptions of sustainable development, although perhaps the most accepted and broadly used definition came from the UN Brundtland Report 'Our Common Future'.¹¹¹ This describes sustainable development as 'development that meets the needs of the present without compromising the ability of future generations to meet their own needs'. Put simply, the concept of sustainable development envisages that the industrialised world consumes more than its basic needs, which acts as a threat to the finite resources of the planet's ecological system. It is necessary therefore to redress this balance by limiting our existing levels of consumption in line with ecological boundaries.¹¹²

Sustainable development is an increasingly central theme in development policy. However, there is limited guidance in the literature on how we should regulate in order to facilitate sustainable development. This is perhaps understandable given that sustainable development is not a theory about regulation, although it is possible to draw some general conclusions. Broadly, sustainable development theory recognises that policy makers require a wider range of tools, and that an exclusive reliance upon conventional command and control regulation is inherently limited, and is unlikely to result in the level of change necessary.

Demonstrations of such regulatory changes are apparent in European policy, such as the Brundtland Commission and, more recently, the European Commission's Fifth and Sixth Environmental Action Programmes, both of which contemplated a broadening of the range of regulatory instruments available as well as advocating complementary voluntary approaches to improve the market's functioning. A similar shift is evident at international

¹¹¹ The Brundtland Commission, WCED, 1987, p.43.

¹¹² Baker, S., *Sustainable Development*, London, Routledge 2006.

level. The World Summit on Sustainable Development¹¹³ supported the view that a wider range of policy instruments be utilised, and the Council of the OECD¹¹⁴ emphasised the importance of establishing a more effective regulatory system through improvements to policy structure, including subsidies, tax reforms etc.

Whilst there is a continued dominance of direct regulation in controlling environmental standards, there is evidence that UK environmental policy has developed to include a fuller range of regulatory tools and ‘surrogate’ regulators. This not only contemplates a more inclusive regulatory model; encompassing state, industry and civil society¹¹⁵, but also consequently requires a much broader conception of the role of the state.¹¹⁶ This has become apparent in practice through the increased use of market-based and reflexive regulatory tools, both of which are discussed in more detail below.

Despite its obvious influence both nationally and on an international scale, the UK Sustainable Development Strategy¹¹⁷ provides little practical guidance as to policy construction.¹¹⁸ Emerging alongside, and in conjunction with the sustainable development movement, is the theory of ecological modernisation which provides a feasible means of achieving the objectives of sustainable development by attempting to align environmental performance with economic success. Consideration of this theory, and its impact upon regulatory policy, is now considered below.

Ecological Modernisation and Regulation

The theory of ecological modernisation relates principally to economic and environmental goals. The predominant view has been that there is antagonism between economic growth

¹¹³ UN Johannesburg Summit 2002.

¹¹⁴ Organisation for Economic Co-operation and Development, 1991

¹¹⁵ Gunningham, N., Environmental Law, Regulation and Governance: Shifting Architectures, *Journal of Environmental Law*, **21(2)** 2009, pp.179-212.

¹¹⁶ Bevir, M. et al, Traditions of Governance: Interpreting the Changing Role of the Public Sector, *Public Administration*, **vol.81(1)** 2003, pp.1-17.

¹¹⁷ HM Government, *Securing the Future: Delivering UK Sustainable Development Strategy* [online] March 2005 [14/06/10] <http://www.defra.gov.uk/sustainable/government/publications/uk-strategy/documents/SecFut_complete.pdf>

¹¹⁸ Esty, D., A Term’s Limits, *Foreign Policy* [online] 1 Sept 2001 [14/06/10] <http://www.foreignpolicy.com/articles/2001/09/01/a_terms_limits>

and environmental protection.¹¹⁹ That is, economic growth is seen as detrimental to environmental protection and environmental protection is seen as detrimental to economic growth. A more recent discourse, however, has suggested that economic growth and environmental protection are compatible. This ecological modernisation discourse has become embedded in policy discourse and, what is more, has significant implications for regulation and how we perceive the role and function of regulation.

Developed from the work of Joseph Huber and Martin Jänicke in the 1980s, ecological modernisation proposes a structural change to the central institutions of modern society based upon a reformed relationship between the economy and ecology. Rather than the dismantlement and fundamental re-organisation of such institutions as advocated by some,¹²⁰ ecological modernisation envisages their progressive modernisation by prompting change on both a macro-economic level; through broad economic shifts, and a micro-economic level; through individual firms adopting new, cleaner technologies.¹²¹ It has become apparent through policy discourse that whilst technological advancements on a micro scale could have a substantial impact on environmental problems, ecological modernisation is not self-fulfilling and, as such, wider policy reform is a vital component for systemic change.¹²² As this is unlikely to result from spontaneous market dynamics, it instead requires recognition from policymakers that a new approach to organisational and societal structures is necessary for the ultimate goal of sustainable development to be achieved.¹²³

¹¹⁹ Lynch-Wood, G. & Williamson, D., above at n.98.

¹²⁰ Mol, A and Spaargaren, G., Environment, Modernity and the Risk-Society: The Apocalyptic Horizon of Environmental Reform, *International Sociology*, **Vol.8(4) 1993 pp.431-459**.

¹²¹ Gibbs, D., Ecological Modernisation: A Basis for Regional Development?, Paper presented to the Seventh International Conference of the Greening of Industry Network 'Partnership and Leadership: Building Alliances for a Sustainable Future', Rome 15-18 Nov 1998.

¹²² Mol, A & Spaargaren, G., Ecological Modernisation Theory in Debate: A Review, *Environmental Politics*, **vol.9(1) 2000 pp.17-49**; Jänicke, M., Ecological Modernisation: New Perspectives, *Journal of Cleaner Production*, **16 2008, pp.557-565**.

¹²³ Lynch-Wood, G. & Williamson, D., see n.97. See also The Brundtland Commission, WCED, 1987 and the UN World Summit on Sustainable Development, 2002.

While sustainable development constitutes the ‘central story line’ of ecological modernisation discourse, the latter provides an analytical and practical framework for implementing the former into a capitalist political economy within a developed society.¹²⁴

As a starting point, it is postured that the unregulated capitalist pursuit of profit maximisation is responsible for current environmental problems, as the market has failed to internalise the social costs of production. While neo-classical economists would advocate governmental intervention as a result, the shortcomings of command-and-control regulation are well documented. Thus, ecological modernisation theory provides a solution to the environmental side-effects of industrialism, while concurrently fostering economic competitiveness.

The fundamental tenet of ecological modernisation is that environmental concerns are only able to be effectively addressed where integrated within the capitalist system. Thus, relying on the inherent competitiveness for modernisation/innovation necessary in a capitalistic market, the task of achieving optimum environmental performance lies with the firm itself in producing self-tailored, knowledge-based improvements. In this eventuality, the advantageous cost reductions attainable through technological innovation, creates an ecological-economic ‘win-win’ scenario.¹²⁵

Central to this concept, and essential in facilitating environmental improvements, is the need to re-structure the regulatory framework. Whilst the exact nature of the required social adjustments are yet to be determined, a central theme of ecological modernisation, as borne out by multi-disciplinary literature, demonstrates a broad shift away from traditional government-mandated, direct regulation, towards a greater reliance on the state acting in a steering capacity.¹²⁶ As a result, firms are enabled to adopt a self-regulatory form of governance, where the firm is obliged to respond appropriately without the need for direct external control. This has significant implications on the roles assigned to both the state and industry, if ecological modernisation theory is to be implemented in practice. Firstly, state

¹²⁴ *Ibid.* See also Dryzek, J.S., *The Politics of the Earth: Environmental Discourses*, Oxford University Press, Oxford, 1997.

¹²⁵ Jänicke, above at n.122.

¹²⁶ *Ibid.* See also Ashford, N., Government and Environmental Innovation in Europe and North America, *American Behavioural Scientist*, **45(9)**, 2002, pp.1417-1534, Gunningham, above at n.115, and Hess, above at n.107.

environmental policy needs to shift from reactive to preventative, from centralised to decentralised, and from exclusive to participatory policy making. This theory also requires the simultaneous transfer of responsibility from the state to the market; the latter considered to be a more efficient mechanism than the former in terms of addressing environmental problems.¹²⁷ Within this role, firms are required to adopt a holistic approach to regulation which encompasses markets, businesses and civil society and utilises policy instruments such as persuasion, self-regulation and co-regulation to achieve a desired standard of compliance.¹²⁸

It is in fact interesting, at this point, to consider what has been said about the legal transition towards self regulation, and some of the theories that have developed that focus on broadening regulatory mechanisms and re-evaluating the regulatory structure. Whilst differing in their approaches, these theories all require a shift of emphasis away from centralised, hierarchal control, towards a more decentralised management, i.e. from government to 'governance'. This is now considered in greater detail below.

Self Regulation

The use of self-regulation has been advocated in other spheres of social regulation as an innovative means of social control. In a similar vein to the reliance on self-regulation advocated by ecological modernisation theory, further models of self-regulation within the socio-legal literature also rely upon a particular conception of society. As opposed to being placed between the state and society within a hierarchal framework, the self-regulatory body is instead envisaged as one of many different spheres of society which make up a heterarchy.¹²⁹ This is necessary due to the decentralisation of the state as a result of the modernist fragmentation of society. As a result, the self regulatory body is required to mediate between the different spheres, acting as horizontal linkages between the state, the market and the community.¹³⁰

¹²⁷ Buttel, F., Ecological Modernisation as Social Theory, *Geoforum*, **31**, 2000, pp.57-65.

¹²⁸ Gunningham, above at n.115.

¹²⁹ Black, J., Constitutionalising Self-Regulation, *Modern Law Review*, **1996 v.59(1)** pp. 24-55.

¹³⁰ Streek & Schmitter, Community, Market, State – and Associations? The Prospective Contribution of Interest Governance to Social Order, in Streek & Schmitter (eds.), *Private Interest Government: Beyond Market and State*, London, Sage, 1985.

This is an appropriate juncture to clarify the distinction between self-regulation, envisaged under ecological modernisation theory, and deregulation, the latter being prevalent in the 1980s in response to the neo-liberalist free market ideology and criticism over the limitations of direct regulation. The shift towards a somewhat deregulated market, relying on a range of less intrusive, ‘soft’ or voluntary policy instruments, was hoped to provide firms with the flexibility required to ease economic pressures and encourage environmental improvements. In practice, however, these mechanisms would often involve high transaction costs and, fundamentally, were largely found to be ineffective without the state acting in an organisational capacity.¹³¹

Self-regulation, by comparison, provides an important distinction in maintaining its links with state control. Despite these mechanisms gleaning their authority from means other than direct state legislation, the role of the state is still central to this perspective as such regulations are considered to operate ‘in the shadow of the state.’¹³² Thus, for example, where there is a reliance on voluntary agreements, the failure to meet certain targets may mean that these provisions are replaced by statutory regulation.¹³³

Broadening regulatory mechanisms to make way for firms to self regulate is one way to ensure that the regulation can be truly responsive to the environment within which the firm operates. Initial theories of responsive regulation have been based on a ‘regulatory pyramid’; using the threat of more intrusive regulation, and corresponding sanctions, to address non-compliance and to encourage firms to self-regulate.¹³⁴ This strategy of combining punishment with persuasion, or ‘tit-for-tat’ approach, provides that depending upon their willingness to meet regulatory objectives, firms can move up and down the pyramid as appropriate. Thus, the more punitive the sanctions, the less likely they are to be used and the more likely that compliance will be secured as a result.¹³⁵

¹³¹ Jänicke, above at n.122; Gunningham, above at n.115.

¹³² Gunningham, *ibid.*

¹³³ *Ibid.* E.g. the New Zealand approach to controlling ozone-depleting substances explicitly requires statutory intervention where voluntary arrangements proved ineffective.

¹³⁴ Ayres, I & Braithwaite, J., *Responsive Regulation*, Oxford University Press, Oxford, 1992.

¹³⁵ *Ibid.*

Developing the idea of responsiveness even further, it is proposed that in order to be truly responsive, the level of compliance performance is merely one factor that should influence the regulatory response. Regulators must also have regard to a number of other factors including the operational framework of the firm and the broader environment within which it operates, thereby providing a context for the reasoning or motivation behind non-compliance. Where the corporate response is determined less by regulatory pressures and more by industry culture and/or competitive forces, applying the pyramid of sanctions approach universally without regard to the wider context would be artificial and thus cannot be considered ‘really responsive’ regulation.¹³⁶ Therefore, movement up and down the pyramid of sanctions should also depend upon an assessment of a firm’s regulatory capacity; utilising negotiation, deterrence strategies or incapacitation as appropriate to correspond with firms’ capacity to respond.¹³⁷

The premise is that only by acknowledging the differing receptive capacities of firms can regulatory resources be accurately and effectively directed in order to achieve compliant and beyond compliance behaviour across a range of firms. This provides a stark comparison to the conventional command and control approach in that regulatory efforts are not merely focussed on those firms with the greatest potential impacts, thus leaving remaining firms (that may have a greater cumulative impact than the former) without effective regulation. Further, it avoids the artificial application of sanctions by contextualising any non-compliance before determining an appropriate response.

The notion of aligning the regulatory response with firms’ receptive capacities has been further developed, to the extent that firms can be grouped according to their common compliance capabilities and orientations.¹³⁸ Using this model, the regulatory response can be tailored to the firm based upon the categorisation of its capacity to respond. In determining the appropriate category, regard should be had to both the compliance orientation of the firm (i.e. where it charts between non-compliance and beyond compliance

¹³⁶ Baldwin, R. & Black, J., Really Responsive Regulation, *Modern Law Review*, **71(1) 2008 pp.59-94.**

¹³⁷ *Ibid.*

¹³⁸ Lynch-Wood & Williamson, above at n.98.

behaviour), and its capability profile (i.e. where the firm charts in terms of size, visibility and resources).¹³⁹

The rationale behind grouping firms on this basis is to provide a range of response profiles that can be directed in order to produce the most effective regulatory impact. For example, non-compliant, low capability profile firms are unlikely to respond to self-regulatory measures as they will not typically be affected by societal pressures, and require severe sanctions to combat non-compliance. By comparison, firms with high capability profiles that use compliant and beyond compliance behaviour to protect their market position, are likely to allocate significant regulatory resources towards adopting self-governance mechanisms, which can be used to incentivise good corporate practice. Ultimately, it is considered that by aligning regulatory tools with receptive capacity, scarce regulatory resources are directed where they will have the most impact, not only fostering higher levels of environmental protection, but also providing a more economically efficient response.

Whilst a more detailed consideration of regulatory pluralism is beyond the scope of this chapter, it is important to note that in advocating alternative methods of regulation it is not suggested that self-regulation constitutes a replacement to direct legal control. Thus, the reliance upon self regulatory methods should be determined by reference to the ability of the firm to respond appropriately.

Reflexive Law

Developing the notion of responsiveness even further is the concept of reflexive law. Although a detailed analysis of reflexive law theory is beyond the scope of this chapter, the underlying principles have important implications for the move towards ecological modernisation.¹⁴⁰ Reflexive law represents an “evolutionary” shift in regulatory focus whereby the law ceases to command but aims to induce firms to achieve the desired outcome, providing for their ‘regulated autonomy’.¹⁴¹ As opposed to focusing on the

¹³⁹ *Ibid*

¹⁴⁰ Ashford, above at n.126.

¹⁴¹ Black, above at n.129.

dynamic between regulator and regulatee as regards the level of compliance, reflexive law requires organisations themselves to have the capacity to respond to their environment whilst retaining their own integrity. Thus, by transferring decision-making capacity to organisations themselves, reflexive mechanisms facilitate a more personalised regulatory response by relying on firms to self regulate in response to complex problems.

Building on Nonet and Selznick's concept of responsive law,¹⁴² the premise is that rather than the direct use of legal regulation to impose sanctions, as per command and control approaches, reflexive methods utilise the law indirectly by establishing procedures that foster critical and creative thinking within the firm itself.¹⁴³ This not only enables firms to identify damaging behaviour, but also provides the mechanisms necessary to address such behaviour and thereafter enforce and/or assess the same and, where necessary, modify them accordingly.¹⁴⁴

This concept was developed by Teubner, who coined the term 'reflexive' law to describe regulation which relied upon the encouragement of self-reflective processes within institutions in order to achieve increasingly higher standards. Noting the dissatisfaction between, on one hand, the application of substantive command and control mechanisms and, on the other, the *laissez-faire* policies of the 1980s, Teubner recognised reflexive law as an emerging 'third-way', which was more adequately equipped to deal with the complexities of modern business.¹⁴⁵

Teubner's seminal work on the theory of reflexive law amalgamated the earlier concepts of Luhmann and Habermas, which recognised the value of both the coordination between and the democratisation of social subsystems. In order to appreciate the application of reflexive law theory a brief consideration of the supporting principles is necessary, beginning with Luhmann's concept of autopoiesis. Although autopoietic theory is complex, only those aspects which are immediately relevant here will be discussed.

¹⁴² Nonet, P & Selznick, P., *Law and Society in Transition: Towards Responsive Law*, (1978), Harper and Row, New York.

¹⁴³ Orts, above at n.95.

¹⁴⁴ Baldwin & Black, above at n.136.

¹⁴⁵ Teubner, G., Substantive and Reflexive Elements in Modern Law, *Law & Society Review*, **1983 v.17(2)** pp. 239-285.

Firstly, it is postured that as a result of modernisation, society has fragmented into different functional systems, which are autopoietic in nature i.e. self-generating, self-referring and each dependent upon its specific environment. Such systems are said to be ‘normatively closed, but cognitively open’.¹⁴⁶ Put simply, this envisages that they are unable to recognise norms other than those produced by themselves as being valid (normatively closed), whilst being able to be indirectly affected by their environment and other systems within it (cognitively open).

As autopoietic systems each operate on a self-referential basis, the concern is that they may fail to take account of their impacts on other social systems. Thus, the purpose of the law is to ensure that each system operates responsively towards its environment i.e. by considering the effect of its externalities. Set within the context of ecological modernisation, the autopoietic system (in this case the economic system) does not determine the process by which ecological modernisation should take place. Rather, the structure through which it is realised will select the appropriate response based upon its suitability for the economic system. Thus for the economic system to be receptive to external pressure (i.e. the need to improve environmental performance) the law must facilitate the transfer of information (i.e. the normative expectations of civil society) from the stakeholder environment to the system itself. In doing so, ecological modernisation constitutes a form of communication to the economic system to solve a particular problem, the remedy of which not only benefits the system itself but also the social system as a whole.

Habermas also recognises the increased pluralism and functional differentiation of society, but differs in his explanation of social order as a result of the same.¹⁴⁷ For Habermas, this is

¹⁴⁶ Luhmann, N., *The Differentiation of Society*, Columbia University Press, New York, 1982; Luhmann, N., *The Autopoiesis of Social Systems*, in Geyer, F & Van d. Zeuwen, J., (eds.) *Sociocybernetic Paradoxes: Observation, Control and Evolution of Self-Steering Systems*, London, Sage, 1985 and; Luhmann, N., *Social Systems*, Stanford University Press, California, 1995.

¹⁴⁷ Habermas, J., *The Theory of Communicative Action*, Vol. 1, *Reason and the Rationalisation of Society*, translated by McCarthy, T., Beacon, Boston, 1984; Habermas, J., *The Theory of Communicative Action*, Vol. 2, *Lifeworld and System: A Critique of Functionalist Reason*, translated by McCarthy, T., Beacon, Boston, 1984; and Habermas, J., *Between Facts and Norms*, Polity Press, Cambridge, 1996.

based upon communicative action between social systems and a ‘lifeworld’ i.e. a sphere of sociality formed by the transmission of mutual understandings of cultural values, legitimate norms and socialisation processes. Ordinarily, communicative action claims have legitimacy because they take place within an undisputed lifeworld. The difficulty arises when systems become ‘uncoupled’ from their lifeworld and become self-serving; driven by money and power.

In order to restore legitimacy it is necessary to achieve a common mutual understanding, which can be realised by facilitating agreement on general norms. This results in law which is rationally acceptable as it is produced out of the discursive process between the system and the lifeworld. Within the context of ecological modernisation the purpose of the law is therefore to recouple the economic system to the lifeworld by making money a legal norm. In Habermas’ view it is this procedure of institutionalising a practical discourse that enables the law to ensure social integration in modern society.

Despite providing very different social theories, both Luhmann and Habermas emphasise the paramountcy of communication for social order. They also both rely on “external” interrelations between legal and social structures to explain legal change.¹⁴⁸ This differs from Nonet and Selznick’s conception of responsive law, which emphasises variables “internal” to the legal system.¹⁴⁹ Building upon these theories, Teubner articulated his conception of reflexive law thus:

The role of reflexive law is to structure and restructure semi-autonomous social systems, by shaping both *their procedures of internal discourse* and their *methods of coordination with other social systems* [added emphasis].¹⁵⁰

Crucially, by developing regulation that seeks to establish internal evaluative procedures, the indirect application of the law can be used to encourage firms to think ‘critically,

¹⁴⁸ Teubner, above at n.145 (at p.245).

¹⁴⁹ *Ibid.*

¹⁵⁰ Teubner, above at n.145, p.255.

creatively and continually' about the impact of their actions, without reliance upon direct legal intervention.¹⁵¹

The rationale behind increasing firms' self-referential capabilities was, and indeed still is, that the role of law requires re-evaluation in light of a functionally differentiated society. Confining regulatory methods to those available under the legal system invariably disregards the social complexity of institutions and the diversity of their internal perspectives.¹⁵² By comparison, integrating the regulatory process within the firm enables external information to be assessed with regard to the firm's own operating procedures, and reassessed and amended where necessary by the entity best placed to do so; the firm itself. It is this process that enables firms to develop learning capacities as the consequences of their regulatory actions are reintroduced into their reflexion structures.¹⁵³ Ultimately, by achieving this degree of self-regulation, reflexive policies aim to promote the outcome such that the less intrusive the regulation, the more effective the regulatory response.¹⁵⁴

As a corollary to reflexive mechanisms improving the generation of knowledge and learning capacity of a firm, they also act as a wider stimulant to reform by 'irritating' systems to self-reflect on performance,¹⁵⁵ thereby raising the standards of industry-wide behaviour.¹⁵⁶ Thus, by avoiding confining firms to regulatory standards, reflexive law facilitates beyond compliance behaviour by contemplating standards of conduct beyond that prescribed by law.¹⁵⁷ In the alternative, the concern is that firms will inevitably be guided by the prevailing market conditions, which may mean that ethical concerns take second place behind maximising profits.¹⁵⁸

¹⁵¹ Orts, above at n.95.

¹⁵² *Ibid.*

¹⁵³ Baldwin and Black, above at n.136.

¹⁵⁴ Lynch-Wood & Williamson, above at n.98.

¹⁵⁵ Gaines, S., Reflexive Law as a Legal Paradigm for Sustainable Development, *Buffalo Environmental Law Journal*, **2003 v.10(1) pp.1-24.**

¹⁵⁶ Aalders, above at n.88.

¹⁵⁷ *Ibid.* See also Gunningham, N., Environment, Self-Regulation and the Chemical Industry: Assessing Responsible Care, *Law and Policy*, **1995 v.17 pp.57-109.**

¹⁵⁸ *Ibid.*

How then do reflexive law principles apply to the goal of facilitating CSR? Firstly, by utilising indirect methods of regulation, such as the mandatory reporting of certain environmental information, firms are required to self regulate in order to identify and, thereafter, address potential problems. Further, in establishing industry standards, reflexive methods seek to encourage the institutionalisation of environmental responsibility by providing a regulatory framework that fosters economic prosperity whilst encouraging firms to adopt environmentally proactive policies.¹⁵⁹

Returning to the notion of governance discussed previously, it is clear that the central principles of reflexive law reach beyond this remit. Rather than an increased reliance on participatory decision making using a variety of regulatory tools and non-state actors, the theoretical basis of reflexive law is that in a complex and pluralistic society the only form of appropriate regulation is self-regulation. The extent to which mandatory self-regulation is desirable is a complex issue and falls beyond the scope of this paper. Indeed it is not clear whether previous conceptions of ecological modernisation intend reflexive law principles to act as a complement to, or as a replacement for, direct regulation.¹⁶⁰ Nonetheless, this latter view would appear to disregard the potential for firms differing receptive capacities, and the valid role for a range of regulatory methods, including command and control mechanisms. It is perhaps understandable that, given the complex relationship between environmental concerns and economic development, there is a lack of consensus over the most appropriate way forward.¹⁶¹ It is however broadly agreed that appropriately framed reflexive law policies constitute a powerful regulator of organisational behaviour, and it is this aspect which forms the remainder of this chapter.

Mechanisms for Change

¹⁵⁹ Orts, above at n.95.

¹⁶⁰ Ashford, above at n.125. See also Ashford, N., Ayers, C & Stone, R., Using Regulation to Change the Markets for Innovation, *Harvard Environmental Law Review*, **9**, **1985**, pp.419-466; and Neale, A., Organising Environmental Self-Regulation: Liberal Governmentality and the Pursuit of Ecological Modernisation in Europe, *Environmental Politics*, **6(4)**, **1997**, pp.1-24; and Gunningham, N & Sinclair, D., *Leaders and Laggards: Next-Generation Environmental Regulation*, Greenleaf, Sheffield, 2002.

¹⁶¹ Lynch-Wood & Williamson, above at n.98.

The realisation of ecological modernisation appears to necessitate a re-think of the perceived role of law; from being required to impose absolute standards, to facilitating a range of responses including enabling firms to self-regulate, achieving beyond mere ‘compliance’ and setting new environmental industry standards. Mechanisms for legal change towards increased reliance on reflexive law strategies, thus promoting self-regulating social systems, are apparent in a variety of policy areas. Examples of which include economic instruments (e.g. taxes and charges), disclosure instruments, industry self-regulation and social reporting mechanisms.¹⁶²

An example of the use of reflexive law in practice, aimed at increasing the ability of firms to self-regulate, is the European Union’s Eco-Management and Audit Scheme (EMAS). Under this regulatory scheme firms are required to adopt procedures of environmental management, auditing and reporting, in exchange for limited external control. Examples of such obligations include producing a register of significant environmental impacts, the carrying out of periodic audits and the disclosure of environmental performance data. A vital aspect of this scheme is the requirement of third-party certification by a professionally licensed verifier, in order to ensure the accuracy of the auditing process and resultant reports.

The rationale is that by requiring the public disclosure of environmental performance data, firms participating in the scheme are encouraged to engage in responsible environmental behaviour. Notwithstanding its arguably ambitious scope to establish reflexive environmental regulation,¹⁶³ opting in to the regulation is currently done on a voluntary basis. In this regard, EMAS has been described as an ‘experimental laboratory’, evaluating whether social forces alone can drive environmental improvements without reliance upon enforcement mechanisms.¹⁶⁴

Corporate Environmental Reporting

¹⁶² See Fiorino, above at n.105, Gunningham & Sinclair, above at n.160 and Hess, above at n.107.

¹⁶³ Orts, above at n.95.

¹⁶⁴ Gunningham & Sinclair, above at n.160 and Hess, above at n.107.

In a similar vein to the provisions under EMAS, social and environmental reporting requirements work as a reflexive tool by aiming to induce responsible corporate behaviour through the creation of a report which is independently verified and publicly available.

In order to fulfil their regulatory objectives under a policy of corporate environmental reporting, firms are obliged to disclose information with regard to their environmental policies and practices. The requirement to volunteer such information inevitably encourages a degree of self-regulatory behaviour, which may operate alongside more direct regulatory systems of control.¹⁶⁵ As a form of reflexive law, the requirement to produce a report is unable to mandate a predetermined outcome, or specify the ways in which particular problems should be addressed. Rather, it facilitates stakeholder dialogue and in doing so requires firms to consider the impact of their actions upon society.¹⁶⁶ The value of the report therefore lies not only with the increased social transparency gained, but also in the institutionalisation of critical and creative problem-solving thought within the firm.

Social reporting is not a new phenomenon, and in addition to non-compulsory audit and reporting schemes¹⁶⁷ there are also a number of institutions throughout Europe that focus on advancing this field.¹⁶⁸ As such there are certain requirements that are considered necessary to ensure that the reports produced are effective reflexive tools, including comparability, completeness and external verification.¹⁶⁹ On the basis that these principles are achieved, direct comparisons can be made between firms in terms of their environmental performance. This has the effect of not only ensuring the transmission of accurate information to society, but also enables information to be transferred between firms. This is significant as it facilitates the setting of new industry-wide standards, and means that solutions to various environmental problems can be disseminated throughout

¹⁶⁵ Case, D., Corporate Environmental Reporting as Informational Regulation: A Law and Economics Perspective, *Colorado Law Review*, 2005 v.76 pp.379-442.

¹⁶⁶ Hess, above at n.107.

¹⁶⁷ See for example EMAS within Europe, and the UN Global Compact and Coalition for Environmentally Responsible Economies (CERES), in particular the Global Reporting Initiative, internationally.

¹⁶⁸ E.g. The Institute of Social and Ethical Accountability in London, The Centre for Environmental and Social Accountancy Research at the University of Dundee, the New Economics Foundation in London and the European Institute for Business Ethics at Nijenrode University.

¹⁶⁹ Zadek, S. et al, How To Do It, in Zadek, S. et al (eds), *Building Corporate Accountability: Emerging Practices in Social and Ethical Accounting, Auditing and Reporting*, Earthscan, London, 1997, pp.41-44.

sectors/industries/geographical regions etc.¹⁷⁰ The requirement for external verification is an essential component of reporting/disclosure provisions in order to ensure their accuracy. In the absence of independent certification, non-financial reporting may be used as a public relations exercise, with firms purposefully omitting or misrepresenting less favourable information for the benefit of their reputation.¹⁷¹

The obvious limitation of non-compulsory reflexive tools such as reporting is the likelihood that only those firms that are industry leaders for socially responsible conduct will elect to opt in to the scheme. Thus, in order to achieve the necessary degree of market transparency and resulting comparability, it is envisaged that a more radical approach is required.¹⁷²

It is not, however, proposed that reporting is an appropriate regulatory tool for all firms. Any implementation of mandatory reporting requirements needs to have regard to firm size, and the resulting cost-benefit analysis of obliging the firm to produce a report. Specifically, whether a firm falls below the minimum threshold should depend not only on its size, but also upon its impact on society.¹⁷³ Nonetheless it may be disproportionate to impose stringent reporting standards on smaller firms that are likely to have less impact and lower visibility.

In considering the cost-benefit analysis regard should also be had to the advantage to the firm from a strategic perspective. It is contended that the costs incurred in producing a report are more akin to an investment as opposed to an outlay, as the firm is benefited through its improved relationship with its stakeholders e.g. suppliers, customers, employees etc. Furthermore, in engaging with, and working to meet the expectations of key stakeholders, firms are also able to secure their long term profitability as a result.¹⁷⁴

Conclusions

¹⁷⁰ Orts, E., Reflexive Environmental Law, *Northwestern University Law Review*, vol.89(1227) 1995 pp.1252-68.

¹⁷¹ Hess, above at n.107 and Orts, *ibid*.

¹⁷² *Ibid*.

¹⁷³ Hess, above at n.107.

¹⁷⁴ *Ibid*.

By recognising the limitations of direct regulation in a multifaceted society, reflexive law can be used as a tool to direct social change by seeking to guide behaviour as opposed to suppressing complexities through extensive governmental control. Reflexive mechanisms are not aimed at inducing defensive compliance, but are designed to foster proactive and responsible operating procedures without the need for direct intervention from the state. By utilising a reflexive model of environmental regulation, firms are encouraged toward responsible policy, practice and management systems, which are not only able to improve individual firm performance but also act as a standard setting tool across similar firms based on size, industry etc.

An important qualification to the consideration of alternative forms of regulation is that their effectiveness is likely to vary according to the receptive capacities of the type of firm being targeted. Whilst some firms will routinely demonstrate beyond compliance behaviour, others will purposely deviate, and this needs to be reflected in the type of regulation adopted in order to gain the most effective result. Thus, while it may be that reliance upon direct regulation alone is considered unsuitable in a modern climate, it is not proposed that ‘governance’ methods act as a direct replacement, and it is likely that a pluralistic regulatory approach is required.

Whilst appropriately framed reflexive mechanisms, such as mandatory reporting, can act as a powerful tool to induce behavioural change, doing so effectively is likely to require a number of factors being realised. These include the need to ensure that reports are comparable and comprehensive, and that external auditing measures are utilised to ensure the disclosure is reliable. Regard also needs to be had to the type of firm targeted, both to ensure a positive cost-benefit result is reached, as well as considering firms’ ability to respond in a beyond compliance way. It is a consideration of mandatory corporate reporting to which we now turn in Chapter 3.

Chapter 3

The Companies Act 2006 as a CSR Initiative

Introduction

The Companies Act 2006 provides the most comprehensive reform of UK company law over the last 150 years, and seeks to invoke change on a wide range of issues in line with contemporary business practice. The Act may have important implications from a CSR perspective, and has been heralded as the first statutory provision that requires companies to promote their success whilst having regard to their social and environmental impact. Despite arguably constituting an important part of the UK corporate agenda¹⁷⁵, CSR *per se* has been rarely mentioned within company law reform proposals. Such proposals generally consider the voluntary adoption of CSR initiatives to be preferable in order to provide sufficient flexibility for innovative responses to be realised.¹⁷⁶ However, as explored in the previous chapter, the imposition of mandatory disclosure requirements can provide a powerful mechanism to encourage socially responsible practice and improve operational transparency. Thus, underpinning CSR initiatives with an appropriate legal framework, using a range of regulatory instruments, is considered vital in achieving more innovative responses from businesses.¹⁷⁷

The purpose of Chapter 3 is to examine the extent to which companies' obligations have changed following the enactment of the 2006 legislative reforms, and the consequent implications of these changes on the CSR movement. Growing recognition of companies' widening responsibilities is evident from the introduction of various mechanisms aimed at increasing operational transparency; enabling shareholders and others to evaluate the company's strategic aims, values and standards. Initially, this was via the use of voluntary codes of conduct, providing businesses with operational best practice guidelines with which

¹⁷⁵ See e.g. *Corporate Social Responsibility: A Government Update*, Department of Trade and Industry, May 2004, available at <<http://www.berr.gov.uk/files/file48771.pdf>>

¹⁷⁶ E.g. arguments for 'responsible entrepreneurship' through voluntary initiatives advanced at the 1992 Earth Summit; Hohnen, P., Government and CSR; Three Simple Steps to Improvement, *Ethical Corporation*, 2 May 2005; McBarnet, above at n.38.

¹⁷⁷ Williamson, D and Lynch-Wood, G, Social and Environmental Reporting in UK Company Law and the Issue of Legitimacy, *Corporate Governance*, 2008 vol.8(2) pp.128-140.

to adhere or, alternatively, provide a rationale behind their decision making process. This chapter begins with a review of the development of these mechanisms and how they have led to the current reporting requirements contained within the Companies Act 2006. These disclosure requirements are also considered in conjunction with the increasing stakeholder debate. As will be demonstrated, not only has the requirement to provide additional information since become mandatory, but also the areas upon which companies are obliged to comment have been widened to expressly include, *inter alia*, environmental, social and community issues.¹⁷⁸

This background provides the context to analyse the reporting requirements within the 2006 Act, and determine whether substantive changes to the way in which information is disclosed are likely as a result. Accordingly, this chapter concludes with a consideration of how the reporting provisions within the Act have impacted upon the CSR movement, and the potential future role of non-financial disclosure in encouraging socially responsible business practice.

The History of Legal Reporting

The development of legal reporting generally promotes increased quality and quantity of corporate disclosure, and is considered an important mechanism towards achieving effective corporate governance and accountability.¹⁷⁹ The development of CSR, particularly with reference to reporting and disclosure requirements, has been closely linked to corporate governance; with limited transparency and misleading financial disclosures being invariably accompanied by poor corporate social responsibility.¹⁸⁰ Yet despite this, financial reporting/accountability and transparency regarding CSR practices have historically been developed as independent issues.¹⁸¹ In order to provide a contextual basis for the genesis of non-financial legal reporting, it is necessary to firstly consider the development of corporate governance/accountability.

¹⁷⁸ Companies Act 2006, s.417(5)(b).

¹⁷⁹ Solomon, J. & Solomon A., *Corporate Governance and Accountability*, Chichester, Wiley & Sons, 2004.

¹⁸⁰ Mallin, C., The Relationship Between Corporate Governance, Transparency and Financial Disclosure, *Corporate Governance: An International Review*, 2002 v.10(4) pp.253-255.

¹⁸¹ Bhimani, A. & Soonawalla, K., From Conformance to Performance: The Corporate Responsibilities Continuum, *Journal of Accounting and Public Policy*, 2005 v.24 pp.165-174.

Corporate Governance and Accountability

The growing interest in corporate governance controls has been evident over recent years, arguably prompted by high-profile accounting scandals and resulting public concern,¹⁸² to the extent that the UK is widely considered to be at the forefront of corporate governance reform.¹⁸³ The Cadbury Report 1992 and its successors,¹⁸⁴ (since consolidated into the UK Combined Code), represented the first formal code of best practice and introduced the self-regulatory ‘comply or explain’ approach. These non-governmental initiatives conveyed no obligation to obey their provisions, but instead required the disclosure of information regarding the extent of companies’ compliance with their recommendations, including the reporting functions of the companies’ board and the role of auditors.¹⁸⁵ This preference over a prescriptive statutory code was considered essential to the development of a culture of good corporate behaviour within UK companies,¹⁸⁶ encouraging compliance ‘in spirit rather than in letter,’¹⁸⁷ and utilising shareholder pressure to enable appropriate forms of governance to evolve accordingly. The Turnbull Report, for example, recognised the wide range of risks to be addressed by companies internal control systems which included safety, environmental and reputation concerns in addition to financial risk.¹⁸⁸ The resulting impact upon the market was that disclosure of these issues was given significant consideration amongst institutional investors, who were able to evaluate the ethos of listed companies with regard to company strategies, operations and reputation.¹⁸⁹

The intervention of Governmental controls at this time was considered to be unhelpful and counter-productive, with concerns that the cost of adhering to these additional controls was

¹⁸² Ronen, J., Policy Reforms in the Aftermath of Accounting Scandals, *Journal of Accounting and Public Policy*, **2002 v.21 pp.281-286**.

¹⁸³ Solomon & Solomon, above at n.179.

¹⁸⁴ The Greenbury Report 1995 and the Hampel Report 1998

¹⁸⁵ Imposed by the London Stock Exchange Listing Rules

¹⁸⁶ Solomon & Solomon, above at n.179.

¹⁸⁷ Cadbury Report 1992, p.12, para 1.10.

¹⁸⁸ The Institute of Chartered Accountants in England and Wales, Internal Control: Guidance for Directors on the Combined Code (1999). Commonly referred to as the ‘Turnbull Report’.

¹⁸⁹ Williams, C. & Conley, J., Triumph or Tragedy? The Curious Path of Corporate Disclosure Reform in the UK, *William & Mary Environmental Law and Policy Review*, **2007 v.31 pp.317-362**.

likely to surpass the benefits conferred.¹⁹⁰ Despite their self-regulatory nature, the impact of these codes of best practice was evident in the high levels of compliance achieved, and the apparent reliance on the information provided by institutional shareholders.¹⁹¹

While there were obvious benefits conferred by this increased transparency in companies' operating practices, scrutiny was levelled at the quality of the disclosure, with the anticipation of 'context-insensitive box-ticking' resulting from shareholder's superficial engagement in their companies' affairs. This further emphasised the desirability of the principles-based approach that was advocated in the earlier codes, and explicitly opposed the use of the codes as a set of prescriptive rules.¹⁹² This rationale can be likened to the distinction made within Chapter 2 regarding command and control versus self-regulatory mechanisms; the latter often being better equipped from a CSR perspective in enabling a more tailored regulatory response to be reached.

A further criticism over the limited focus of these guidelines, which also supports the shift towards a more CSR orientated perspective, was that they failed to deal sufficiently with the increasing stakeholder debate.¹⁹³ The Hampel report illustrates its position thus:

"The single overriding objective shared by all listed companies, whatever their size or type of business, is the preservation and the greatest practicable enhancement over time of their shareholders' investment."¹⁹⁴

In contrast to the otherwise flexible approach advocated, the apparent failure to recognise the significance of companies' differing economic characteristics, and how these may impact upon long-term shareholder return and company prosperity, deemed this perspective 'outmoded' in its approach.¹⁹⁵

The Impetus for Change

¹⁹⁰ Parkinson, J. & Kelly, G., The Combined Code on Corporate Governance, *Political Quarterly*, **1999 70(1)** pp.101-107; Easterbrook, F & Fischel, D, *The Economic Structure of Corporate Law*, Cambridge, Harvard University Press, 1991.

¹⁹¹ Conyon, M., Corporate Governance Changes in UK Companies between 1988 and 1993, *Corporate Governance: An International Review*, 1994 p. 87.

¹⁹² Hampel Report 1998, para 1.11-1.12.

¹⁹³ Parkinson & Kelly, above at n.190.

¹⁹⁴ Hampel Report 1998, para 1.16

¹⁹⁵ Parkinson & Kelly, above at n.190.

A shift in attitude was evident following the inception of the Labour Government in 1997, which placed stakeholder concerns at the forefront of its corporate reform agenda. The Company Law Review (CLR), initiated by the Department of Trade and Industry, recognised the primacy of this debate, albeit admitting that there was no consensus on the most appropriate approach.¹⁹⁶ An independent Steering Group was established to review the application of company law to modern business activity. The conclusion reached was that the existing legislation was ill equipped to deal with the evolving business landscape and therefore to respond appropriately to new relationships and external influences.¹⁹⁷ The reasoning for this was clear; the idea that companies are formed, and thereafter operate, for the benefit of their shareholders, is inconsistent with the requirement that businesses form collaborative relationships with wider stakeholders in order to react to changes within their environment.¹⁹⁸

The CLR identified two distinct broad attitudes arising from this debate; the Enlightened Shareholder Value (ESV) and the Pluralist approach. These approaches are now briefly considered in turn.

Enlightened Shareholder Value

The ESV approach maintains shareholder primacy and, as such, arguably required no change to the law as it then stood. The key distinction was that, despite both placing the generation of maximum value for the shareholder as their ultimate objective, the current legal position was failing to deliver this ideal in practice, owing to an exclusive focus on the short-term financial bottom line.¹⁹⁹ Alternatively, ESV relies on the premise that the cultivation of long-term relationships based on trust, shared values and co-operative behaviour, is more likely to ensure the long term success and prosperity of the enterprise.

Whilst appearing to maintain the status quo, the proposed implementation of the ESV approach was deemed appropriate in order to make explicit the ‘true character’ of the law, given the lack of clarity over the extent and scope of directors’ duties and how these were

¹⁹⁶ *Modern Company Law for a Competitive Economy- The Strategic Framework*, A Consultation Document from the Company Law Review Steering Group, DTI: London, Feb 1999, para 1.11.

¹⁹⁷ Williamson and Lynch-Wood, above at n.177.

¹⁹⁸ Above at n.196, para 5.1.4.

¹⁹⁹ Above at n.196, para 5.1.12.

to be implemented in practice.²⁰⁰ Thus, ESV represented a codification of the existing law, as opposed to requiring any substantive reform.

Pluralist Approach

The CLR also gave consideration to an alternative ‘Pluralist’ approach, which is based upon balancing the interests of a number of groups (stakeholders), without being overridden by the interests of one particular group (i.e. shareholders). By comparison, where the ESV approach obliges a consideration of how its conduct may impact wider stakeholders, having regard to long-term shareholder value, the pluralist approach requires consideration be given to the interests of stakeholders in their own right. The competing interests of these various stakeholders (including shareholders) are to be weighed against each other in reaching a decision upon the company’s conduct. Advocates of this approach argued that a more radical stance was necessary if adequate recognition was to be given to the interests of other stakeholders.²⁰¹ Further, and as a corollary to this view, it was suggested that in broadening the range of parties to whom directors owed a duty, the pressure to secure short-term financial returns (i.e. from institutional investors) would be diluted, thus having the effect of improving long term economic performance.²⁰²

Whilst this approach is anticipated to be largely consistent with the ESV model, the distinction between the two provides its starkest contrast where there is a direct clash of interests between shareholders and other relevant participants.²⁰³ For example, the closure of a plant or discontinuance of a long-term supply relationship may have the effect of maximising shareholder return whilst failing to maximize social wealth. Applying this principle on a wider scale identifies the potential difficulties in applying the ESV model. Can it be guaranteed that shareholder sentiment would remain the same during a recession, or would ‘enlightened’ values lose out to short-term financial gain?²⁰⁴

²⁰⁰ Above at n.196, para 5.1.20-5.1.22.

²⁰¹ House of Commons, Select Committee on Trade and Industry, (2003) Sixth Report on Directors’ Duties. Available at; <<http://www.publications.parliament.uk/pa/cm200203/cmselect/cmtrdind/439/43906.htm>>

²⁰² *Ibid* at para 18.

²⁰³ Above at n.196, para 5.1.15.

²⁰⁴ McBarnet, above at n.38

It is also important to remember, however, that whilst these approaches are anticipated to be largely consistent in practice, the underlying principles of ESV and Pluralism represent a fundamental disagreement over the role and purpose of modern company law.²⁰⁵ Advocates of ESV maintain that the purpose of company law is to promote the long-term success of companies, which requires the management of companies to have regard to the interests of wider stakeholder groups. Alternatively, proponents of the pluralist view regard company law as a tool to enforce corporate behaviour; requiring companies to follow good environmental, employment and social practice.²⁰⁶

The Stakeholder Debate

Despite constituting a large proportion of the Review, the debate over the ESV versus Pluralist approach was swiftly curtailed, and the potential for a wider stakeholder approach was wiped from the Government's agenda.²⁰⁷ Proponents of the stakeholder perspective averred that the supposedly fundamental review fell short of its revolutionary aspirations,²⁰⁸ and that the ESV approach adopted was merely a 'vague encouragement' to enlightened managers who may have shareholder concerns.²⁰⁹

Despite criticism over its potentially restricted application, the subsequent publication in 2002 of a White Paper containing the draft Companies Bill reiterated the ESV approach as endorsed within the CLR Final Report. Whilst maintaining the status quo of shareholder primacy, the draft Bill included an obligation for directors to consider 'material factors', expressly including shareholders as one potential factor, where considered relevant in promoting the long-term success of the company. One justification over the remit of this approach focuses on the practical limitations of law reform:

"The rhetoric was that, whilst based on existing law, Enlightened Shareholder Value was in some sense a real step forward. It was very difficult to explain how it was substantively different. As it was, business pressed hard for changes which would have replaced the requirement for directors to exercise their judgement as to

²⁰⁵ Above at n.201, para 20.

²⁰⁶ *Ibid.*

²⁰⁷ Byers, S. (2000) TUC/IPPR Seminar on Corporate Governance, 7 June [04.10.12] available at <<http://www.dti.gov.uk>>.

²⁰⁸ Bovey, P., A Damn Close Run Thing – The Companies Act 2006, *Statute Law Review*, **2008 29(1) pp.11-25**.

²⁰⁹ Dignam, A., Capturing Corporate Governance: The End of the UK Self-Regulating System, *International Journal of Disclosure and Governance*, **2007 (4) pp.24-41**.

what was best for the company with a discretion. That would have wrecked the Bill...the effect [was] no more than putting into statute law the present uncertain common law.”²¹⁰

Thus, the conclusion that a pluralist approach would be unduly difficult to operationalise and enforce was clearly a contributory factor towards rejecting this perspective in favour of the ESV model.²¹¹ However, despite the obvious limitations of the ESV approach, the somewhat constrained duty of ‘consideration’ towards non-financial factors was, for the first time, to be bolstered by the introduction of a *mandatory* narrative reporting requirement, in the form of an Operating and Financial Review (OFR).

This chapter now moves on to a consideration of the development of narrative reporting generally, before taking a more detailed look at the narrative reporting requirements provided for by the Companies Act 2006.

Narrative Reporting

The development of reporting guidelines as a means of facilitating CSR is not a new occurrence.²¹² The 1990’s witnessed numerous voluntary measures designed to promote standardised reporting practices, which encouraged the disclosure of information on a range of stakeholder concerns.²¹³ In line with the UK trend towards developing reporting guidelines, CSR was also being promoted on a global scale following the introduction of the Global Reporting Initiative (GRI). The objective of this scheme was to introduce globally applicable guidelines for the reporting of social, economic and environmental issues, thus creating the opportunity for sustainability reporting to be given the same prominence as financial reporting.²¹⁴

²¹⁰ Bovey, above at n.208.

²¹¹ *Modern Company Law for a Competitive Economy- Developing the Framework*, available at [<http://webarchive.nationalarchives.gov.uk/+http://www.dti.gov.uk/cld/modcolaw.htm>], paras 3.24-3.31.

²¹² See Williams & Conley above at n.189 for details of mandated social and environmental reporting in numerous EU member states, including the UK’s legislation on pension funds.

²¹³ Bhimani & Soonawalla, above at n.181.

²¹⁴ *Ibid*; see www.globalreporting.org.

The implementation of enhanced narrative reporting was also necessitated under the EU Accounts Modernisation Directive,²¹⁵ which required the publication of a fair business review (FBR), which included ‘where appropriate, non-financial key performance indicators relevant to the particular business, including information relating to environmental and employee matters.’²¹⁶ Prior to the passing of the Directive it would appear as though the UK Government was unaware of the ‘parallel process’ occurring in Europe as regards the reform of company law and, as opposed to taking its steer from the EU initiative, belated amendments were required in order to incorporate the same into the domestic process.²¹⁷ The launch of the EU Action Plan²¹⁸ in 2003 provided a point of reference for the UK’s Company Law Reform White Paper 2005, which considered disclosure reforms a key initiative in improving company reporting and transparency and in promoting effective dialogue on the drivers of long-term performance.²¹⁹

The Operating and Financial Review (OFR) Regulations²²⁰ were introduced in light of the deadline for implementation of the EU Directive, and in conjunction with the UK’s extensive deliberation on enhanced reporting requirements.²²¹ The Regulations obliged directors to produce an annual report containing a narrative statement detailing the company’s impact upon stakeholder constituencies. Despite being qualified akin to the ESV approach, in that directors were only obliged to disclose information relating to issues that they considered to be material, the OFR represented the first corporate governance initiative which imposed a mandatory requirement to disclose non-financial information. The decision to adopt a compulsory approach was not unanimous, with some consultees expressing concern that the move from a voluntary requirement may stifle innovation and

²¹⁵ Directive 2003/51/EC.

²¹⁶ *Ibid* at Art.1 cl.14(a) & Art.2 cl.10(a).

²¹⁷ Clark, G. & Knight, E., Implications of the UK Companies Act 2006 for Institutional Investors and the Corporate Social Responsibility Movement, *University of Pennsylvania Journal of Business Law*, **2009** **11(2)** 259-96.

²¹⁸ Communication from the Commission to the Council and the European Parliament: *Modernising Company Law and Enhancing Corporate Governance in the European Union – A Plan to Move Forward*, COM/2003/0284, May 2003.

²¹⁹ Department of Trade and Industry, *Company Law Reform* (Cm.6456) (London: The Stationary Office, 2005) at 12.

²²⁰ The Companies Act 1985 (Operating and Financial Review and Directors’ Report etc.) Regulations 2005, 2005 No. 1011.

²²¹ During the Company Law Review 1997-2001 and subsequent White Papers in 2002 and 2005; Department of Trade and Industry, *Modernising Company Law* (Cm.5553-1) (London: HMSO).

lead to some companies reporting defensively to avoid falling foul of their obligations.²²² It was concluded that, in an attempt to avoid these pitfalls, the OFR should be not be unduly prescriptive, but should be sufficiently flexible to enable companies to best describe their business, and for preparation of the report to develop organically over time.²²³

Notwithstanding the obvious benefits the OFR bestowed upon wider stakeholders, such as giving directors the opportunity to consider the companies' effect upon such parties, the Government was keen to emphasise that the requirement to disclose non-financial information was directed at the interests of shareholders as opposed to stakeholders.²²⁴ Increased shareholder engagement was considered a key driver of effective corporate governance, achievable via access to clear and meaningful information about the main drivers of a company's performance.²²⁵ Whilst intended to fulfil the requirements of the EU Directive, the OFR was also expressly designed to place a more onerous obligation upon all UK-registered quoted companies, in the interests of achieving greater transparency and precision of company reporting.²²⁶ In addition to the disclosure required to ensure compliance with the FBR, the objective of preparing a more 'fulsome' and 'forward-looking' review,²²⁷ meant that companies were further required to report on future trends and development performance, in addition to providing information on their impact on the environment, and social/community issues.²²⁸

Heralded as an opportunity for companies to legitimise CSR and sustainable development initiatives, the Government endorsed the OFR regulations as an opportunity for directors to demonstrate their response to the 'long recognised and promoted' business case for the wider consideration of market participants.²²⁹ With the anticipated effect of encouraging

²²² *Modern Company Law for a Competitive Economy- Final Report*, A Consultation Document from the Company Law Review Steering Group, DTI: London, Feb 2001, para 3.35.

²²³ *Ibid* at paras 3.37 and 8.33.

²²⁴ UK Department of Trade and Industry, *Final Regulatory Impact Assessment on the Operation and Financial Review and Directors' Report Regulations*, available at <<http://www.berr.gov.uk/files/file21361.pdf>>

²²⁵ *Ibid* at para 4.

²²⁶ Above at n.201, para 14.

²²⁷ *Ibid*.

²²⁸ Above at n.201, Sch.7ZA, paras 1(d), 4(1)(a) and 4(1)(c).

²²⁹ Department of Trade and Industry, *Modernising Company Law (Cm.5553-1)* (London: HMSO), para 4.32.

standard-setting within an industry sector, the OFR was considered to have achieved the ‘gold standard’ in narrative reporting.²³⁰

Consideration of the potential cost implications of producing the review was extensive,²³¹ with the cost-benefit argument ultimately being deemed positive:

“All the companies found that the incremental cost of generating an Operating and Financial Review...is not great and that the value of the additional material generated is significant, even where this is done for the first time...The conclusion was that this was ‘an idea whose time had come’.”²³²

Developing alongside the OFR Regulations, the Government set out its position regarding reporting requirements within the Companies Act white paper. The proposals for the OFR were largely adopted in the paper,²³³ which expressly stated that the wider reporting requirements would be a major contribution to both corporate social responsibility and sustainable development.²³⁴

Whilst the implementation of the OFR Regulations was not universally welcomed in the corporate business sector,²³⁵ the abolition of the same less than six months later²³⁶ was met with even more criticism.²³⁷ The publicly stated reason for this unpredicted policy u-turn was the additional administrative cost involved in compliance with the ‘gold-plated’ regulatory requirement,²³⁸ despite the apparent largely positive response from the business community.²³⁹ The Treasury estimated the additional costs of the OFR auditing requirement

²³⁰ Burns, T. & Paterson, J., Gold Plating, Gold Standard or Base Metal? Making Sense of Narrative Reporting after the Repeal of the Operating and Financial Review Regulations, *International Company and Commercial Law Review*, **2007 18(8) 247-260**.

²³¹ Included responses to the Consultation, independent research conducted by the DTI, the 2002 Paper ‘Audit Pricing in Private Firms’, and the 2004 Paper by the Office of Fair Trading ‘An Assessment of the Implications for Competition of a Cap on Auditors’ Liability; above at n.229, para 114.

²³² Above at n.229, para 3.38.

²³³ Above at n.229.

²³⁴ *Ibid* at para 4.32.

²³⁵ Some considered the reporting requirements overly onerous and resulted in too much ‘red tape’; see Hall, B., Brown to Scrap UK Reporting Rule, *Financial Times*, Nov 27, 2005.

²³⁶ Under the Companies Act 1985 (Operating and Financial Review) (Repeal) Regulations 2005, SI 2005/3442, reg.2.

²³⁷ Williamson and Lynch-Wood, above at n.177.

²³⁸ See BBC News, Chancellor Gives ONS Independence, Nov 28, 2006, available at <<http://news.bbc.co.uk/1/hi/business/4477516.stm>>

²³⁹ *Ibid*.

to be in the region of £30 million per annum which, it considered, could not be justified.²⁴⁰ However, this analysis was considered suspect on several accounts; firstly, that listed companies still had to comply with the EU Accounts Modernisation Directive and therefore the notional £30 million saving was misleading²⁴¹ and, secondly, that set within the context of the UK stock market worth 1.5 trillion, businesses required only an ‘infinitesimal and very achievable’ reduction in capital costs in order to justify the more stringent reporting requirements.²⁴²

Following the Government’s policy u-turn, the environmental non-governmental organization (NGO) Friends of the Earth brought judicial review proceedings against the Government for a breach of its own consultation policy and procedure. In an attempt to abort the judicial review process, a belated consultation on the future of corporate reporting was introduced as the Company Law Reform Bill was proceeding through Parliament. This led to a series of last minute amendments to the Bill before it received Royal Assent, which served to reinstate many of the repealed OFR provisions, albeit under the guise of an enhanced Business Review.

The focus of this chapter now turns to a consideration of the Companies Act 2006, with a specific focus on the reporting requirements therein and the resultant impact of the Act, if any, on the CSR movement.

The Companies Act 2006

Directors’ Duties

In addition to fostering CSR via indirect regulatory/legislative action, i.e. mandatory disclosure regimes, the 2006 Act also places a direct duty on directors to consider wider stakeholders and environmental concerns in promoting the success of the company,²⁴³ arguably codifying the understanding and extent of directors’ duties previously delineated

²⁴⁰ Note to Chancellor of HM Treasury on Operating and Financial Review (OFR) Regulations: Proposal to Roll-Back to EU Minima 7 (Nov 11, 2005).

²⁴¹ Plender, J., Out of the OFR Mess, *The Financial Times*, **Dec 5, 2005, pp.26**; Williams and Conley, above at n.189.

²⁴² Williamson and Lynch-Wood, above at n.177.

²⁴³ Companies Act 2006, s.172(1).

by common law. Section 172 of the Act represents the first ever statutory statement of directors' duties; to promote business success whilst also having regard to its social and environmental impact. Whilst arguably there is little change in practice from former duties under common law, which imposed a requirement to act in the best interests of shareholders, the 2006 Act makes a substantive difference by identifying specific factors considered to be relevant to the success of the company.²⁴⁴ Whilst shareholder interests maintain their primacy under the new provisions, the Act requires that a number of other matters be considered in order for directors to fulfil their duty to shareholders, including: the likely consequence of any decision in the long term; the interests of the company's employees; the need to foster the company's business relationship with suppliers, customers and others; and the impact of the company's operations on the community and the environment.²⁴⁵

By having regard to wider stakeholder interests, the Act is considered to highlight the important link between responsible business behaviour and business success.²⁴⁶ Despite contentions that the codification of Directors' duties in this way comes 'surprisingly close' to the pluralist/stakeholder model,²⁴⁷ it was specifically emphasised throughout the passage of the Bill that the ESV approach was to be preferred. It follows therefore that the considerations detailed in s.172(1)(a)-(f), to which a company director must have regard in discharging his or her duty, are those envisaged to be crucial to the modern corporate agenda, and demonstrate an apparent focus on corporate social responsibility and the explicit consideration of wider stakeholders. The distinction drawn therefore with regard to Directors' duties prior to the enactment of the 2006 Act is significant, as illustrated by the Parliamentary debate during the passage of the Bill:

"The clause does codify and bring into law for the first time duties around corporate social responsibility. I do not run away from that; it is a deliberate act by the Government. That is at the heart of the Bill. For me, one of the key issues is how we marry the commercial success of individual companies and the resulting benefits to, and growth and prosperity of, the economy, with sustainability and social justice. Again, for me, that is a good example of what lies at the core of what this Labour Government [is] about: trying to see those two issues as

²⁴⁴ Grand Committee, House of Lords, 1st March 2006 at 169; Clarke & Knight, above at n.216.

²⁴⁵ Companies Act 2006, s.172(1).

²⁴⁶ Chivers, D., The Companies Act 2006: Directors' Duties Guidance, published Oct 2007, the Corporate Responsibility (CORE) Coalition.

²⁴⁷ Williams & Conley above at n.189.

part of a single whole and, despite uncomfortable tensions, trying to integrate them as consistent principles rather than allow them to be competing ambitions with no commonality.”²⁴⁸

Whilst this appears an attractive proposal in theory, and shares similarities in principle to the concept of ecological modernisation explored in the previous chapter, the challenge is to ensure that these additional considerations are indeed aligned with companies’ agendas for economic growth, and not simply viewed as a necessary afterthought or Public Relations exercise. One of the ways in which this objective may be achieved is by increasing operational transparency and improving stakeholder dialogue through the use of narrative reporting, as provided for under s.417 of the 2006 Act.

The Business Review

Sitting alongside, and operating in conjunction with the new statutory statement of Directors’ duties, is the requirement to produce a narrative report in the form of a Business Review. The Business Review is intended to inform members of the company, and help them to assess whether the director has fulfilled their obligations to promote the success of the company under s.172.²⁴⁹ The Act requires all large and quoted companies to report on environmental and social matters, albeit that the provisions relating to quoted companies are more stringent in their application. Small and medium sized companies are exempt from the requirement to report on non-financial information.

For large companies, the Act requires that the business review include an analysis using ‘key performance indicators’, specifically those relating to environmental and employee matters, against which the company’s business can be measured effectively. Quoted companies are required to go a step further; not only reporting on the impact of the company’s business on the environment and social/community issues, but also providing a statement of information that has been deemed *unnecessary* to include. This is a significant obligation as companies need only comply with the reporting provisions to consider various non-financial factors *to the extent necessary* for an understanding of the company’s

²⁴⁸ Margaret Hodge, DTI Minister for Industry and the Regions, 326 Parliamentary Debate (House of Commons) 11th July 2006, para 582. Available at <<http://www.publications.parliament.uk/pa/cm200506/cmstand/d/st060711/am/60711s08.htm>>. Accessed 23/03/11.

²⁴⁹ Companies Act 2006, s.417(2).

business. This enables directors to discharge their duty with sufficient flexibility; allowing them to determine the significance (if any) to be attributed to certain issues.²⁵⁰ However, where a director considers, for example, that it is not necessary to report upon the company's environmental impact, they must make it clear that this information has deliberately been omitted from the report.

Impact of the Act on the CSR Movement

How then do the 2006 Act reporting requirements impact on the CSR movement? It is generally accepted that non-financial corporate reporting in the UK has improved over recent years, notwithstanding the brief tumult of the OFR Regulations, and has culminated in the Companies Act 2006 reporting provisions. However, there are several areas which remain the subject of debate as to whether the 2006 Act goes far enough in terms of aligning CSR objectives to the corporate agenda.

Firstly, the application of s.172 will often require the reconciliation of competing interests, as for many, if not most, cases, the success of the company is dependent on its ability to continue damaging the environment.²⁵¹ Thus, the lack of practical effect conveyed by the s.172 duty means that the adoption of socially responsible behaviour is largely voluntary. There are likely to be few occasions where directors will be obliged to justify their actions, and it is likely to be too late in any event for shareholders to take effective action.²⁵² This concern was expressed by Lord Avebury during the passage of the Companies Act bill:

“We believe this is far too important and critical an area to be left to the widely varying attitudes of the boards of 61,000 multinationals, and that the legislation should oblige them to adopt minimum best practice...voluntary standards are no substitute for a benevolent, well informed regulator.”

However, the justification for not imposing a substantive duty was that company law reform was not considered the appropriate vehicle to address social and environmental

²⁵⁰ Williamson and Lynch-Wood, above at n.177.

²⁵¹ Per Lord Avebury, Hansard, Grand Committee Official Report, 6/2/2006; coll GC266-267.

²⁵² Keay, A., Section 172(1) of the Companies Act: An Interpretation and Assessment, *Company Lawyer*, **2007**, **28**, pp.106-110. See also *R (on the application of People & Planet) v HM Treasury* [2009] EWHC 3020 (Admin), where it was held that satisfying the requirements of s.172 regarding environmental and human rights considerations were matters for board directors' judgement, and to have decided otherwise would have given rise to the potential for minority shareholder litigation.

issues, with the Government preferring instead to promote responsible business behaviour by demonstrating how such behaviour leads to business success. The omission of best practice standards, leaving reporting to the discretion of the company board, also reflected the Government's concern to avoid imposing costly reporting obligations.²⁵³

However, this approach was not universally endorsed, with calls for a clear reporting standard from both NGOs and members of the business community, as well as a lack of consensus during the final Consideration of Commons Amendments in the House of Lords:

“The whole purpose of this is not only to obtain the disclosure of information itself, but also to provide a measure by which a number of ethical investors...can obtain comparisons between different companies. It would be difficult for those ethical comparisons to be made without some element of standard reporting practice which I feel can only come from the Government.”²⁵⁴

It is notable that the proposed introduction of standard reporting practice echoed the principle purpose of the EU Modernisation Directive, to enable comparisons to be drawn between European traded companies on both financial and non-financial measures. Despite this, when the Act was passed, the application of the s.172 provisions remained discretionary, leading some to conclude that the duty conferred by s.172 may be little more than a hopeful encouragement to directors to aim for the long term success of the company and demonstrate enlightenment, but with no means of enforcing this standard of behaviour.²⁵⁵ Ultimately, how directors will approach their s.172 duty is likely to be specific to each firm, suffice it to say that the absence of a degree of standardisation may make meaningful comparisons between firms untenable.

A further issue for debate is whether the Business Review goes sufficiently far, or whether it represents a compromise following the unexpected repeal of the OFR Regulations. Some have argued that, at least in broad terms, the Act and the OFR Regulations are substantively

²⁵³ Clark, G. & Knight, E., Institutional Investors, the Political Economy of Corporate Disclosure and the Market for Corporate Environmental and Social Responsibility: Implications from the UK Companies Act (2006), 2008 Industry Studies Conference Paper, [accessed 20/01/12], available at <<http://www.ssrn.com/abstract=1123550>>

²⁵⁴ Per Lord Razzall, Hansard, Companies Bill [HL] (Commons Amendments,) 2/11/2006; col 460.

²⁵⁵ Keay, A, The Duty to Promote the Success of the Company: Is it Fit for Purpose?, University of Leeds School of Law, Centre for Business Law and Practice Working Paper, August 2010, [accessed 12/5/11], available at <http://www.papers.ssrn.com/sol3/papers.cfm?abstract_id=1662411>

similar; both requiring a consideration of business' environmental, labour and social aspects and thereafter reporting on performance/prospects via the use of key performance indicators.²⁵⁶ In light of these similarities, early predictions of the effect of the Business Review concluded that, when operating in conjunction with best practice codes and within the climate of institutional investor sentiment that was expressed during the OFR process, the requirements under the Act could essentially have the same information-forcing power as the OFR.²⁵⁷

Notwithstanding this assessment, there is no denying that, overall, the requirements of the OFR Regulations were more far-reaching and robust than those of the Business Review, and that the repeal of the Regulations was intended to ease the pressures incumbent upon businesses in line with the minimum standards required by the EU Directive. The Regulations not only required additional consideration from companies; identifying factors impacting upon company performance and likely future development, but were also reinforced by more stringent auditing requirements.²⁵⁸ With these differing standards in mind, it has been postured that the practical distinction between the requirements of the OFR Regulations and the Business Review is perhaps less important in terms of how affected businesses operate (as the more rigorous standards could be easily complied with), but more significant in terms of how wider stakeholder groups are impacted.²⁵⁹

The use of statutory best practice guidelines and robust auditing requirements under the OFR provided stakeholders with reliable and relevant information, and represented a new standard in corporate non-financial disclosure. The impact of its revocation, upon stakeholders specifically, is that the disclosure now required under the Business Review is specifically directed towards shareholder interests, and as such may not meet the informational needs of wider interest groups. As previously intimated, it is the generation of comparable and reliable data that serves as a powerful tool in encouraging socially responsible business practice. The dilution of the reporting requirements within the

²⁵⁶ Williams and Conley, above at n.189.

²⁵⁷ *Ibid.*

²⁵⁸ Williamson and Lynch-Wood, above at n.177.

²⁵⁹ *Ibid.*

Business Review, together with the absence of statutory standards and less stringent audit reviews may mean that stakeholders have little confidence in the information disclosed.²⁶⁰

Both the absence of reporting standards and the potential impact upon the quality of the information disclosed raise concerns as to the effectiveness of the reporting provisions under the Act. However, it is arguable that these factors are mitigated by competition within the financial market, and the plethora of intermediaries ready to accurately interpret the data disclosed. It is this level of scrutiny that serves to distinguish the reporting requirements under the Act from other disclosure regimes with reduced enforcement mechanisms,²⁶¹ or where the effectiveness of mandatory disclosure is hampered by an inability to interpret the information disclosed.²⁶² Thus, utilising the market to ensure enforcement of the reporting provisions under the Act, means that affected companies are under pressure to ensure that the reported information is reliable and relevant.²⁶³ In achieving this ideal, the market is able to price financially material information so that, in the case of listed companies, their stock prices fully reflect all the information available on that company as opposed to simply their financial performance.²⁶⁴

It is suggested that the reliance on industry leaders as opposed to Government initiated disclosure requirements, to determine the key drivers for long term economic growth, is a deliberate experiment in market volunteerism.²⁶⁵ By shifting the regulatory focus from external standard-setting to the market itself, the reporting provisions under the Act operate in a reflexive regulatory capacity. Ultimately, the success of the Act as a mechanism to foster socially responsible business practice is dependent upon the quality and nature of the information disclosed: meaning the difference between a PR ‘greenwash’ and genuine operational transparency. It is a consideration of such data that forms the basis of Chapter 4.

²⁶⁰ Williamson and Lynch-Wood, above at n.177.

²⁶¹ Clarke, G., London in the European Financial Services Industry: Locational Advantage and Product Complimentaries, *Journal of Economic Geography*, **2002 v.2(4) pp.433-453**.

²⁶² Clarke & Knight, above at n.217.

²⁶³ *Ibid.*

²⁶⁴ Known as the efficient market theory. See; Fama, E., Efficient Capital Markets: A Review of Theory and Empirical Work, *The Journal of Finance*, **1970 v.25(2) pp.383-417**.

²⁶⁵ Clarke & Knight, above at n.217.

The Future of Non-Financial Reporting

Achieving the meaningful disclosure required by the Act is dependent upon how affected businesses react to the reporting provisions therein. It has been postured that complying with the disclosure provisions of Section 417 may initially be specific to each company, until industries develop ‘best practice’ standards of reporting. However, the obvious difficulty in the interim is that, in the absence of statutory and/or industry standards, the disclosure of market-sensitive information is unlikely to meet the requirements of institutional investors, who require the data to be comparable across industry sectors.²⁶⁶ It is this rationale that has been used to explain the apparent reluctance of investors to rely upon CSR data generally. Despite constituting seventy percent of the ownership of all UK listed companies, institutional investors have been cautious of CSR disclosure which is thought to be owed, at least in part, to the lack of quantifiable metrics that enables this data to be comparatively analysed. With this in mind, the involvement of market intermediaries is thought to be key in providing common metrics for assessing corporate value.²⁶⁷ Crucially, it is recognised that the disclosure provisions under the Act require a delicate balancing act; acknowledging the financial value of CSR disclosure, yet submitting that markets can only become efficient when able to access reliable and comparable data.

The requirement to produce a Business Review under the Companies Act 2006 came into force in October 2007, resulting in the first compliant Business Reviews being published between 30th September 2008 and 30th September 2009. An early report on how the reporting of non-financial information had changed under the Act was produced by The Corporate Responsibility Coalition (CORE) in 2010,²⁶⁸ following the first wave of Annual Reports. The findings from this report were disappointing; the main criticism being the apparent lack of clarity over what information was required, resulting in many companies

²⁶⁶ *Ibid.*

²⁶⁷ *Ibid.*

²⁶⁸ The Reporting of Non-Financial Information in Annual Reports by the FTSE100, The Corporate Responsibility (CORE) Coalition, 2010. Available at <<http://corporate-responsibility.org/wp/wp-content/uploads/2010/04/Reporting-of-Non-Financial-Information-by-the-FTSE1003.pdf>>

failing to act in the spirit of the reporting requirement.²⁶⁹ This apparent confusion has prompted the call for standardised reporting, to facilitate the disclosure of comparable data and clarify companies' management of their environmental and social impacts.²⁷⁰ The report concluded that many Business Reviews not only failed in terms of providing information pertinent to wider stakeholders, as envisaged under the principle of enlightened shareholder value, but that the reporting of risks directly affecting shareholders was also inadequate.²⁷¹

It is important to note, however, that this legislation is still in a relatively embryonic stage, and the inadequacies highlighted by the report were not as a result of the substantive provisions, but how these obligations have been interpreted by those companies required to produce a Business Review. Whilst the introduction of standardised reporting may serve to alleviate these shortcomings, in the absence of external standard-setting it is anticipated that best-practice standards will be established within industries, whilst retaining the regulatory capacity of the market to determine the drivers for long-term sustainable economic growth.

Conclusions

The Companies Act 2006 is considered to have important implications from a CSR perspective and, despite some opining that it does not go far enough in meeting stakeholder concerns, it is generally accepted that legislative corporate disclosure has reached a new standard under the Act. Whether Parliament's deliberate failure to define the nature and scope of the reporting requirements is an attempt to centralise the market in the regulatory process, or simply represents the lack of time and/or expertise to provide more definitive standards,²⁷² remains the subject of debate. However, whilst the lack of external standard setting places the onus on industries themselves to establish best practice standards, the challenge is likely to lie in ensuring that these standards are compatible with the needs of investors and wider interest groups.

²⁶⁹ CORE, FTSE100 Company Reports Reveal Inadequacies of Companies Act, *Business Law Review*, **2010 v.31(5) pp.124.**

²⁷⁰ *Ibid.*

²⁷¹ E.g. the relative absence of reporting upon the risks posed by climate change.

²⁷² Clarke & Knight, above at n.217.

It is concluded that the effectiveness of the Act as a mechanism to foster socially responsible business practice is likely to depend on two factors: firstly, whether the reporting provisions are successful in generating comprehensive, reliable and comparable data and, secondly, whether shareholders elect to utilise this information. The significance of achieving this initial objective is to raise the Act beyond the ‘conventional’ characteristics of the CSR movement which may rely on ethical motivations, meaning some firms are therefore able to exaggerate their CSR credentials.²⁷³ The ability to generate industry-wide, verifiable disclosure reports that enable interested parties to accurately assess companies’ operative methods and strategic aims is considered central to the success, or otherwise, of the Act’s reporting requirements.

The second hurdle to overcome is to ensure that shareholders/investors are prepared to rely upon the disclosure provided, and make ‘enlightened’ choices as a result. This is because there is no obligation, under the Act’s Directors Duties, that companies seek to minimise their social and/or environmental impacts.²⁷⁴ Rather, the effect of the Act is to compel an enhanced level of reporting. The ultimate question therefore is whether shareholders, where enabled, will accept the invitation to become enlightened.²⁷⁵

²⁷³ *Ibid.*

²⁷⁴ This was criticised by CORE during the *ESV v Pluralism* debate; see House of Commons, Select Committee on Trade and Industry, (2003) Sixth Report on Directors’ Duties. Available at; <<http://www.publications.parliament.uk/pa/cm200203/cmselect/cmtrdind/439/43906.htm>>

²⁷⁵ Williams & Conley above at n.189.

Chapter 4

Data Review

Introduction

As demonstrated in Chapter 3, the nature of mandatory narrative reporting in the UK has developed over recent years, and has culminated in the provisions of the Companies Act 2006. This legislation is widely accepted as representing a new standard of corporate disclosure; providing for the first time a statutory obligation on company directors to have regard to social/community and environmental factors whilst carrying out their duties to their shareholders. However, the requirement for listed companies to produce an Annual Report comprising both financial and non-financial information is not a novel concept. From the previous legislative requirements to provide a fair review of their business within their Director's report,²⁷⁶ to the influence of international reporting standards,²⁷⁷ to the brief involvement of the OFR Regulations; firms have historically been held to varying standards of disclosure on both a voluntary and mandatory basis.

Since the introduction of the 2006 Act, the nature and extent of information disclosed by listed companies is now, arguably, at its most comprehensive, particularly from a CSR perspective (with the possible exception of the standards imposed under the OFR Regulations – since revoked). As a result, many commentators consider the Act to represent an important step forward in terms of fostering responsible corporate behaviour, with its implications on the CSR movement being potentially significant. In theory at least, it is reasonable to expect that a consideration of company disclosure will demonstrate its development and improvement since the Act's implementation. As these legislative changes are fairly recent, and the 2006 Act is in comparatively early stages of its implementation, there has been limited research undertaken to date into the effect of the 2006 Act on CSR-type disclosure.²⁷⁸

²⁷⁶ Companies Act 1985, s.234.

²⁷⁷ E.g. the EU Accounts Modernisation Directive and the Global Reporting Initiative (GRI).

²⁷⁸ At the time of writing, the writer is aware of one study, which has been commissioned by The Corporate Responsibility (CORE) Coalition, 2010; available at <<http://corporate-responsibility.org/wp/wp-content/uploads/2010/04/Reporting-of-Non-Financial-Information-by-the-FTSE1003.pdf>>

The purpose of Chapter 4 is to analyse the type of information historically disclosed by listed companies, specifically with regard to the nature and extent of their socially responsible operating practices. This will facilitate a comparative analysis of the quality of corporate disclosure both pre and post the 2006 Act in order to ascertain the impact (if any) of the new legislative reporting requirements.

The chapter begins with an outline of the research methodology adopted and explains how a selection of sample companies was obtained for the data review. This necessarily leads to a consideration of the type of legal research method adopted, i.e. content analysis, some of the key advantages and disadvantages of this methodology, and measures to be taken to minimise any shortfalls as to the data collection/analysis. General observations are then made regarding the overall data, using specific reports as examples, in order to generate a broad picture of the type of corporate disclosure both prior and subsequent to the Act. Following a consideration of the general nature of the reports, in order to provide a deeper understanding of any developments, further consideration is given to the specific type of CSR disclosure within these reports, facilitating a more detailed analysis and thus enabling comparisons to be drawn as to the extent/quality of the information disclosed.

Methodology

Content Analysis

The research methodology utilised to generate the data for this study is content analysis, which, due to the qualitative nature of the data collection, facilitates research of an exploratory and descriptive nature. In selecting this method, it was anticipated that this would provide a valuable insight into corporate disclosure by providing an in-depth picture of its development, and enable causal inferences to be drawn from the data. However, one of the disadvantages of qualitative data gathering is that there is necessarily a degree of human interpretation that is required, meaning that the results may lack objectivity and thus reliability and/or validity. As a corollary, it may also be necessary to quantify some elements of the data to provide an understanding as to how frequently particular themes

emerge. In order to explain how these factors were minimised in the present study, it is necessary to briefly consider what is meant by reliability and validity respectively.

Reliability refers to the extent to which the research method would produce the same data if carried out at a different time or by someone else, whilst validity measures the extent to which the research provides an accurate reflection of the issue being researched.²⁷⁹ As the method of data collection, i.e. content analysis, meant that the writer was central to the research carried out, it was difficult to ensure the objectivity, and therefore reliability of the data. It is for this reason that the writer elected to use classical content analysis, which seeks to organise the data into thematic categories; charting the frequency with which those themes appear. By collating the data in this way (see appendices 1 and 2), it has been possible to incorporate a quantitative element, thus enabling broad generalisations to be made. As these themes are based on factual occurrences within the data, as opposed to the writer's perceptions, it is considered that this serves to increase the reliability of the research.

The validity of the research thus depends on how the data is analysed in order to reach findings that are supported by the evidence. The drawing of conclusions from the data is cited as one of the more contentious aspects of qualitative research.²⁸⁰ However, by utilising classical content analysis, which sits at the cusp of the quantitative/qualitative divide, it is hoped that the detailed, qualitative data provides a contextual background to support and elaborate upon the quantitative findings, thus improving the validity of the research.²⁸¹

Ultimately, as with any form of data collection there is no one perfect method. What is gained in terms of reliability and validity utilising a purely quantitative approach, is lost in terms of contextualisation and depth of findings, and vice versa with qualitative methods. Thus, it is hoped that introducing quantitative elements into qualitative data collection will capture the advantages of both forms of research.

²⁷⁹ Kirk, J. & Miller, M.L., *Reliability and Validity in Qualitative Research*, Qualitative Research Methods Series 1, California, Sage Publications, 1986.

²⁸⁰ Miles, M., Qualitative Data as an Attractive Nuisance: The Problem of Analysis, *Administrative Science Quarterly*, 1979 vol. 24 pp. 590-601.

²⁸¹ Webley, L., Qualitative Approaches to Empirical Legal Research, In Cane, P. & Kritzer, H. (eds), *The Oxford Handbook of Empirical Legal Research*, Oxford University Press, 2010, Ch 38.

Sampling

In order to ensure that the sample was as representative as possible, the writer elected to use a form of random sampling typically used in quantitative research. Whilst the size of the sample may preclude the data from being statistically representative (as would be the aim with a quantitative study), it would instead have the benefits associated with qualitative research whilst still enabling some broad generalisations to be drawn. In this way it is hoped that the data sample will provide, as far as is reasonably practicable, results that are indicative of corporate disclosure for listed companies across the board.

As the most stringent reporting requirements under the Act apply to listed companies, the companies subjected to analysis have all been selected from the FTSE100 Index.²⁸² The method used to assess the changes, if any, to non-financial reporting following the implementation of the requirement to produce a Business Review, was to select a sample set of ten companies from the FTSE100 Index and, for each company, analyse the information disclosed within their Annual Reports from 2005 and 2010 respectively.²⁸³

Data Gathering

The findings from the data review have been collated into the tables shown in appendices 1 and 2. The analysis of the 2010 reports specifically excludes a consideration of CSR/sustainability or community reports and focuses solely upon the Business Review within the company's Annual Report. In the absence of an identifiable Business Review, the Directors' Report is considered to constitute the Review, although CSR disclosure elsewhere within the Annual Report has also been considered. The rationale for excluding other corporate disclosure is to ensure that the data collated complies with the reporting provisions under s.417 and has been subject to the mandatory auditing requirements. It is important to note that the use of general references to CSR information contained at other

²⁸² As this is subject to change on a quarterly basis, the reports considered are from companies that were members of the FTSE100 between June and September 2011.

²⁸³ It is important to note that it is outside the remit of this thesis to validate the accuracy or materiality of the disclosure within the Annual Reports.

locations outside of the Business Review does not seem to be compliant with the Act and, in the alternative, is certainly considered to be outside of its spirit.²⁸⁴

This is not the case concerning the 2005 reports which were not subject to any statutory rules as to their composition, and it has been necessary to have regard to further disclosure that has been directly referenced within the report, albeit contained elsewhere. It is, however, also important to note that any CSR-type disclosure made prior to the 2006 Act coming into force has been disclosed by companies voluntarily, and may not have been independently verified or audited. This, of course, is borne in mind when considering how much weight to attribute to the information disclosed (and perhaps more significantly the information omitted) within the 2005 Annual Reports.²⁸⁵

Following a consideration of the Annual Reports for each of the ten selected firms which comprise the data review, information has been collated for each report respectively relating to its size, structure and content, to enable broad comparisons to be made. Specifically, this data includes the number of pages per report, the nature of the CSR-type disclosure included within the report (if any) and whether the report referenced any separate CSR disclosure (and if so, where this was located). In addition, in relation to the 2010 reports, data was collated as to whether the 2006 Act was acknowledged, specifically with regard to the reporting obligations under s.417, and also whether the Business Review included within the report was easily identifiable as such. The results were then grouped according to whether they related to a pre-Act (2005) Report or a post-Act (2010) Report; see Appendix 1.

Once the general form and content of the reports had been considered, a closer examination was undertaken into the type of CSR disclosure made, noting specifically which CSR issues were commented upon, and whether the disclosure included data of a quantitative or qualitative nature. Again, in respect of the 2005 reports, all forms of disclosure have been

²⁸⁴ The Reporting of Non-Financial Information in Annual Reports by the FTSE100, The Corporate Responsibility (CORE) Coalition, 2010. See above at n.277.

²⁸⁵ Albeit that this does not seem to be the case for the 2005 reports considered in this study; which all included some reference to an independent auditing body.

taken into account to formulate the data used in the review, whereas the 2010 data is restricted to that contained within the Annual Report.

Data Review: 2005 Reports

Overview

These reports were fairly comprehensive in terms of the overall information disclosed, ranging in size from 28 to 320 pages, with the average report size being 143 pages. For the majority of firms, non-financial information was also included within the reports, with 90% of the sample electing to disclose some CSR data within the Report itself. The only company that made no reference to any CSR data within their Annual Report, M&S, produced a separate 28-page CSR report in addition to their Annual Report. All firms from the sample provided at least some information to their shareholders that was beyond their strictly financial considerations and/or performance.

In addition to the inclusion of CSR data within the reports themselves, almost all of the sample companies elected to prepare some other form of CSR disclosure external to the Annual Report.²⁸⁶ The source of this information was either contained within a separate CSR Report, located on the company website, or both. In all instances, this additional disclosure was a more detailed and comprehensive account of the information provided within the main report, and often included both quantitative and qualitative data on a range of CSR issues.

As the 2005 reports pre-date the legislative requirements to provide disclosure as to firms' CSR activities, the information provided has been done so on a seemingly voluntary basis. The rationale for the inclusion of CSR information was indicated by all of the 2005 sample companies. Eight out of ten firms stated that these concerns were part of the company's wider responsibilities, with one further firm couching this self-imposed obligation in terms of being reactionary to stakeholder concerns (Vodafone). By contrast, the report produced by HSBC links the firm's non-financial objectives directly to its reputational risk. The

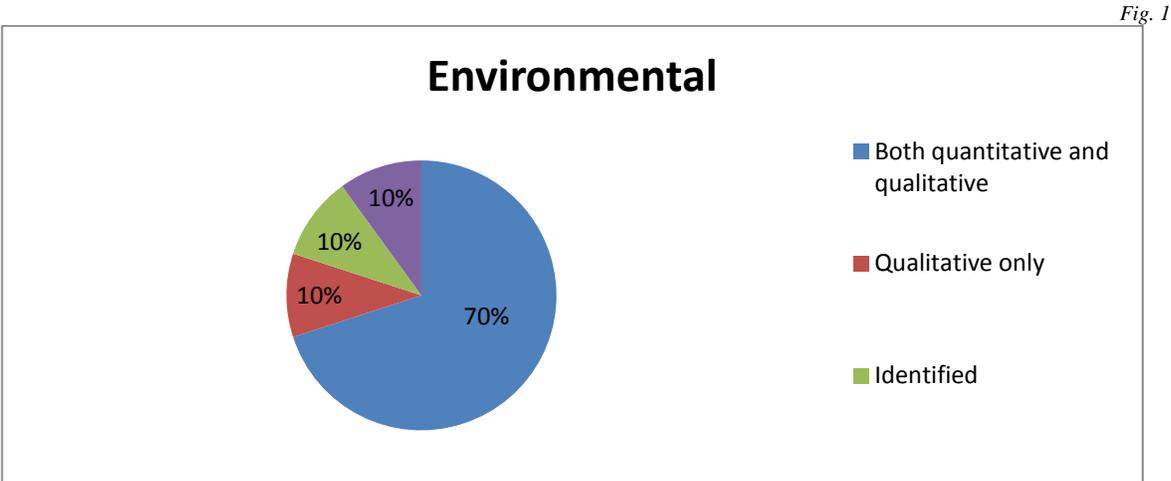
²⁸⁶ With the exception of HSBC and National Grid.

Report of the Directors identified the principal role as facilitating internal control; aiming to manage the risk of failing to achieve business objectives. The internal control procedures therefore include establishing policies/procedures that guide the business to avoid reputational risk arising from social, ethical or environmental issues.²⁸⁷ However, these non-financial considerations are expressly included within the report because of the reputational threat they pose, as opposed to any substantive policy objective to have regard to these issues generally.

Type of CSR Disclosure

Whilst all companies within the 2005 sample provided at least some CSR disclosure, the nature and extent varied significantly from firm to firm. Qualitative data was favoured overall, however, seventy percent of companies provided both qualitative and quantitative data to demonstrate their CSR performance. The qualitative disclosure ranged from generalised ‘mission statements’ to more specific examples of company performance, and/or measures taken to improve the same. Similarly, the quality of the quantitative data varied, with the more comprehensive reports providing comparative data from previous years and/or similar sized competitor firms.

The main types of CSR disclosure included environmental, community, employee and health and safety issues (see Appendix 2). Firms’ responses to these areas, as well as the nature of any non-financial disclosure, are demonstrated as follows:



²⁸⁷ At page 12.

Fig. 2

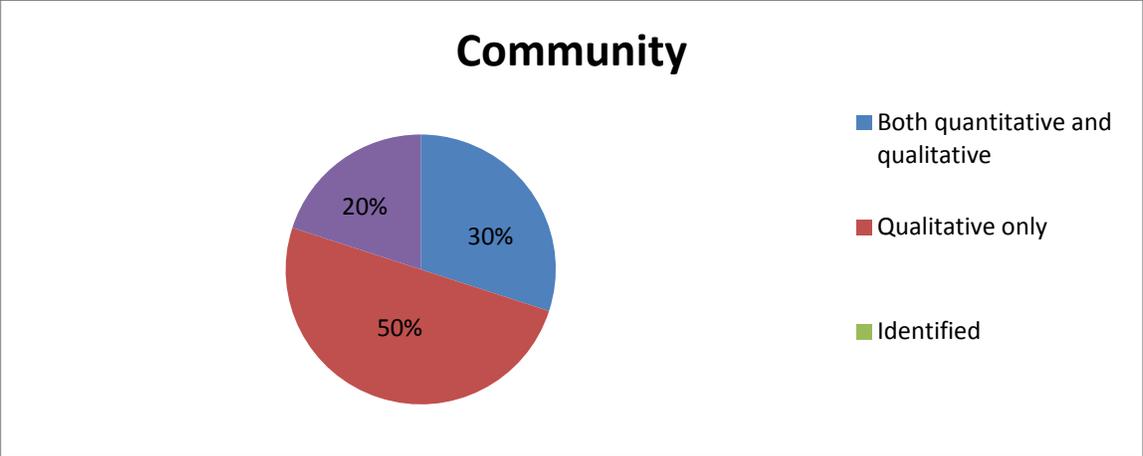


Fig. 3

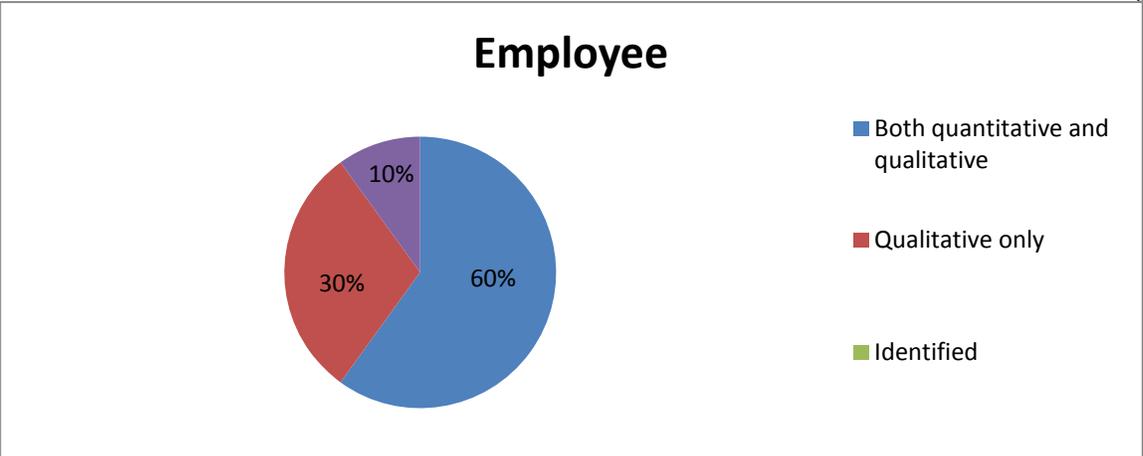
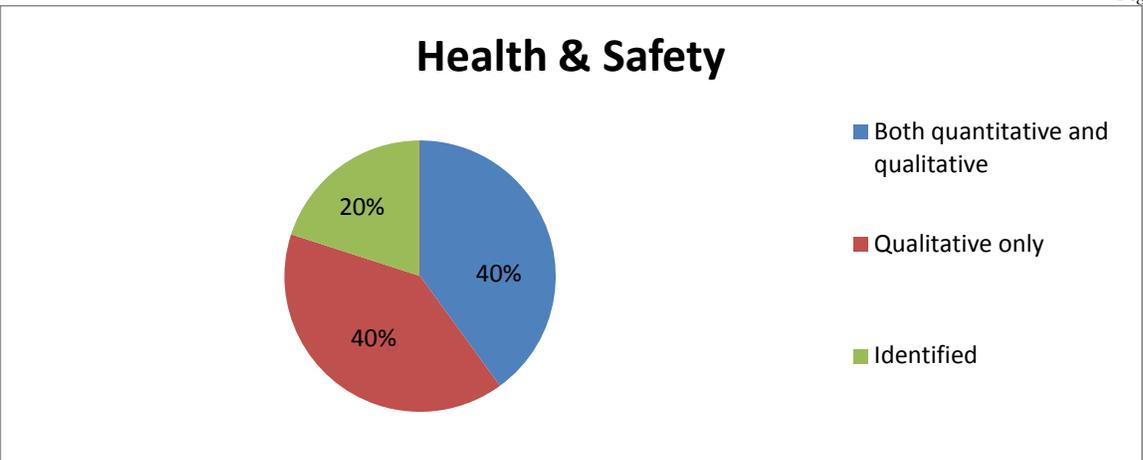


Fig. 4



Environmental (Fig.1)

Environmental disclosure was the most comprehensive overall, both in terms of those firms providing at least some disclosure (90%), as well as the type of disclosure; with 70% of

firms including both quantitative and qualitative data within their reports. The most reported area within this category was emissions, effluent and waste; with all of the firms that provided some environmental disclosure providing a degree of commentary on this subject. Other popular areas of environmental disclosure were transport,²⁸⁸ recycling²⁸⁹ and environmental expenditure.²⁹⁰

Firms within the sample with the most comprehensive environmental disclosure were Vodafone, GSK and BAE Systems. Vodafone for example, not only provided quantitative data on recycled materials, energy consumption and CO₂ omissions, but the report also charted comparative statistics for up to three years preceding and, in the case of CO₂ omissions, also included a forecast of their predicted CO₂ omissions for the next five years.²⁹¹ Similarly, BAE Systems' environmental disclosure enabled a comparative data review; charting the company's performance against that of the preceding three years, thus enabling a comparative analysis of the company's progress (or otherwise) in these areas. It is noteworthy that not all the data was demonstrative of improving company performance and, where this was the case, additional comments were given as to why the results were not as expected.²⁹²

Community (Fig.2)

Disclosure relating to community issues was the least comprehensive overall. For those firms that commented on this area, the data provided was largely limited to charitable donations and examples of humanitarian relief. Any additional disclosure tended to be highly specific to the firm. Tesco, for example, provided commentary on their policies regarding fair-trade produce/sustainable farming, whilst Vodafone specifically addressed the issue of community engagement and responsible network deployment.

²⁸⁸ M&S, BT, GSK and BP.

²⁸⁹ GSK and Vodafone.

²⁹⁰ GSK and BP.

²⁹¹ Corporate Responsibility Report, page 22.

²⁹² For example, an increase in emissions of volatile organic compounds was stated to be due to ship finishing and painting of the Type 45 vessels at their Scottish shipyards; which was linked to that stage of the programme build as opposed to being a continuous emission.

Only 30% of firms provided any quantitative data, albeit that in all cases this was limited to the level of investment made in different community sectors e.g. the arts, education, social welfare etc. Using BAE Systems as an example, a consideration of the statistics on community investment is not particularly productive, as the data provided merely denotes the percentage split of investment amongst different community sectors. There is no comparison with the data from previous years, and the information provided is therefore rather abstract unless considered alongside previous year's reports (albeit that this was the first year a CSR Report had been prepared).

Employee (Fig.3)

Employee issues were fairly well reported on; with 60% of firms producing both quantitative and qualitative data, and 90% of firms providing some disclosure. Of those firms providing some disclosure, the majority referenced a form of employee opinion survey which formed the basis of the results provided.²⁹³ Despite this, few firms went beyond a consideration of gender, age and ethnic diversity; with only GSK and Vodaphone providing a summary of their findings in relation to employee engagement/job satisfaction. Notably, Vodaphone included both positive and negative findings stating, as a result, that “action plans are being developed at team, operating company and Group level to respond to the findings.”

Again, the quality of the quantitative data varied significantly from firm to firm. Tesco, for example, provided data on age diversity that denoted the percentage split of employees within differing age ranges. Neither the data itself, nor the accompanying narrative, gave any indication as to whether these statistics were an improvement upon previous years or were any better than the national average. Other firms adopted a more comprehensive approach; using census statistics to compare their performance against the national average,²⁹⁴ or providing corresponding data from previous years to enable a comparative analysis of performance in this area.²⁹⁵

²⁹³ Six of the nine firms that reported on this subject; GSK, M&S, BT, Barclays, Vodaphone and BP.

²⁹⁴ E.g. M&S; albeit that only gender and ethnic diversity as an overall percentage of the workforce were capable of direct comparison (as opposed to the proportion of these groups that made up managerial staff).

²⁹⁵ E.g. GSK, Vodaphone, BP and BAE.

Health & Safety (Fig.4)

Health and Safety was the only area of disclosure addressed by all sample firms. HSBC provided the least comprehensive disclosure overall; this being limited to a consideration of Health and Safety only. The relevant section within the report consisted of half a page of text²⁹⁶ delineating the threats to health and safety faced, and confirming that maintaining appropriate health and safety standards is a key concern of the business. The only inclusion of steps taken in this regard are stated thus:

“HSBC Group Security provides regular risk assessments in areas of increased risk...In addition, Regional Security functions conduct regular security reviews to ensure measures to protect the group.”

Other firms gave similarly non-specific responses,²⁹⁷ whilst others bolstered these slightly by stating that there had been an improvement upon previous year’s performance.²⁹⁸ Those firms that provided the most comprehensive disclosure, including quantitative data on fatalities and/or lost time injuries, were GSK, BP and BAE Systems. In each of these reports, the quantitative data was supported by a commentary of the results, and details of any initiatives that had been incepted as a result, i.e. improved risk assessments, changes to organisational structure, employee bulletins etc. Further, where the results were not demonstrative of improvement (as per BP’s statistics on workplace fatalities and BAE System’s statistics on major accidents/work related injuries), additional explanatory notes were provided to justify these discrepancies.²⁹⁹

Stakeholder Engagement

Whilst it is evident that most firms attribute their CSR disclosure to their inherent corporate ethos, the centrality of stakeholder involvement was also cited by a number of companies within the sample. Five out of nine firms³⁰⁰ stated that stakeholder engagement and dialogue was key to ensuring that their operating practices were consistent with their

²⁹⁶ At page 13.

²⁹⁷ E.g. Barclays

²⁹⁸ E.g. Tesco Corporate Responsibility Review 2005, at pg 36; “*We have successfully reduced the rate of reportable staff accidents in our stores over the past five years.*”

²⁹⁹ BP’s increased fatalities were largely attributed to the industrial accident at their Texas City refinery, whilst BAE attributed an apparent increase in accidents in Saudi Arabia and Australia to the increased accuracy of recording and reporting.

³⁰⁰ GSK, BT, Vodaphone, Tesco and BAE. Only 9 companies were considered as the 2005 CSR Report for Barclays was not available.

stakeholders' expectations. In particular, the CSR reports prepared by BAE Systems, GSK and Vodaphone were expressly aimed at stakeholders, as a result of extensive shareholder consultation.

By way of example, the CSR disclosure included within the BAE 2005 Annual Report comprised a relatively brief overview of the business objectives, and the steps taken/to be taken towards achieving these standards. These objectives included both stakeholder concerns, and those issues identified as relevant by the company board. With regard to key areas of stakeholder concern, these were noted as including anti-bribery and corruption practices, health and safety, government relations/political influence and product responsibility.³⁰¹ The information provided was in the form of generalised 'bullet-points', and failed to provide a substantive explanation as to how the company's CSR agenda in 2005 was actually developed, as a result of stakeholder dialogue or otherwise.

By contrast, those issues raised of the companies own volition, namely ethical standards, community and the environment, were expounded in more detail within the main report; identifying areas of concern, providing data and explaining steps that had been put in place to facilitate improvement. Notably, the role and function of the Corporate Responsibility Committee was stated as assisting the board in overseeing the development of policy/strategy on social, environmental and ethical issues. This, crucially, was stated to include supporting key stakeholder engagement on these issues, which was intended to be facilitated by the independent report commissioned on the perceptions and views of such stakeholders.

Whilst a substantive commentary on the issues raised as a result of stakeholder engagement did not appear within the body of the main report, the reader was instead directed to the CSR Report or company website for additional commentary. Reference was also made to a published, external statement on ethical business principles and practices, a copy of which also appeared in the CSR Report. Unlike the Annual Report, the purpose of the 2005 CSR Report was expressly stated as being to address CSR issues *identified by stakeholders*.

³⁰¹ This was achieved via the commission of an independent report from PricewaterhouseCoopers, and a consideration of its findings.

These areas are identified at the outset, with the report then providing detailed responses to each area of stakeholder concern, including steps taken to address these concerns as well as providing objectives for the forthcoming year. The principal aim of this report is stated as driving improvements to stakeholder transparency at the most senior level.

The implications of the data findings from the 2005 reports are considered in detail in the following chapter. The remainder of this chapter now focuses on corresponding data from the 2010 sample reports, before briefly considering some of the key differences between the two sets of reports.

Data Review: 2010 Reports

Overview

These reports were more comprehensive overall than their 2005 counterparts; ranging in size from 120 to 288 pages, with the average report size being 195 pages (a 36% increase on average). While all of the 2010 Annual Reports encompassed both financial and CSR reporting, all of the sample companies elected to produce external sources of disclosure in the form of a separate CSR Report, a dedicated CSR section on the company website, or both. These additional forms of disclosure have not been considered, for reasons discussed previously.

The inclusion within the Annual Reports of information regarding firms' wider societal impacts is, unlike the 2005 Reports, part of their statutory obligation under the more stringent reporting requirements of the 2006 Act. While the Act was cited by all firms with regard to the reporting of financial information in order to demonstrate compliance, only three of the sample firms referenced their duties under the Act with specific regard to the requirement to produce a Business Review.³⁰² Of these three, only one Report elaborated on the purpose of the Business Review as expressed by the Act; to set out a fair review of the business, including key performance indicators where appropriate for *both financial and non-financial* trends and factors likely to affect the future development, performance and

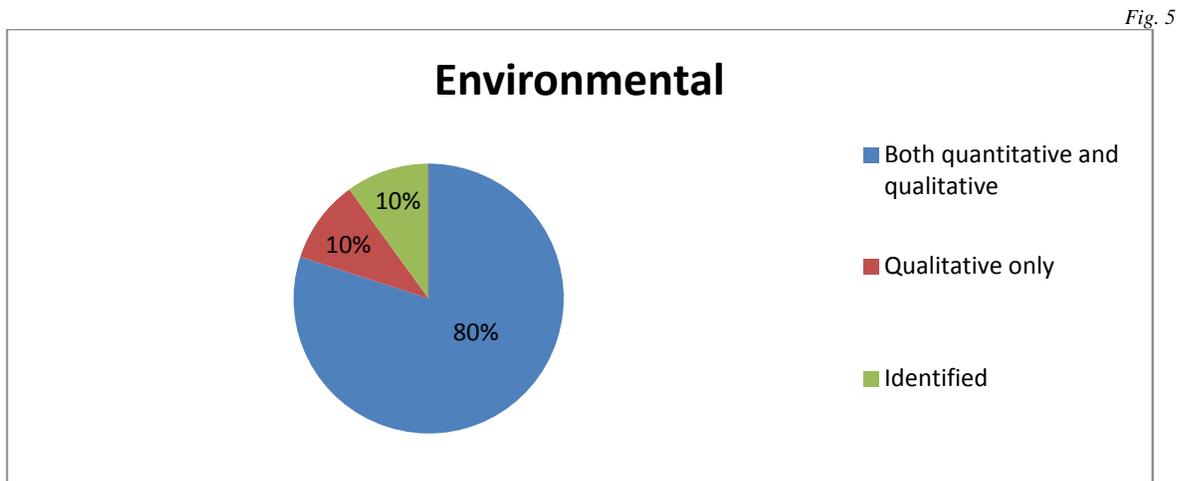
³⁰² Barclays, Tesco and M&S.

position of the company's business.³⁰³ The M&S Report provided a brief explanation of this statutory obligation, and went on to identify the relevant sections of the report that made up the Business Review including; the Chairman's overview, performance overview and KPIs, brand and marketplace, operating and financial review, principle risks and uncertainties, financial risk management and social, environmental and ethical matters.³⁰⁴

There were also mixed results regarding whether the Business Review, required under s.417, was identifiable as such within the Annual Reports. The majority of firms failed to specify which section of the Report constituted the Business Review, with only 40% of the sample containing a distinct Business Review or, alternatively, specifying which sections of the Report comprised the Review.

Type of CSR Disclosure

As with the 2005 reports, all firms provided at least some CSR disclosure within their reports for 2010. Once more, qualitative data was favoured overall, although eighty percent of companies elected to disclose both qualitative and quantitative data to demonstrate their CSR performance. The data has been grouped according to the categories utilised for the 2005 reports, the results of which are demonstrated as follows:



³⁰³ Companies Act 2006, s.417, in particular subsection (5).

³⁰⁴ M&S Annual Report 2010, p.72.

Fig. 6

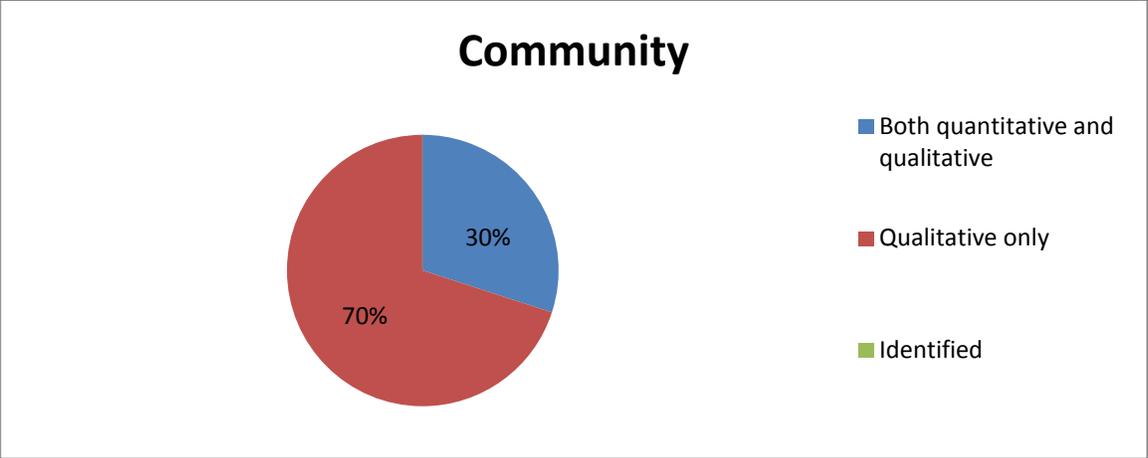


Fig. 7

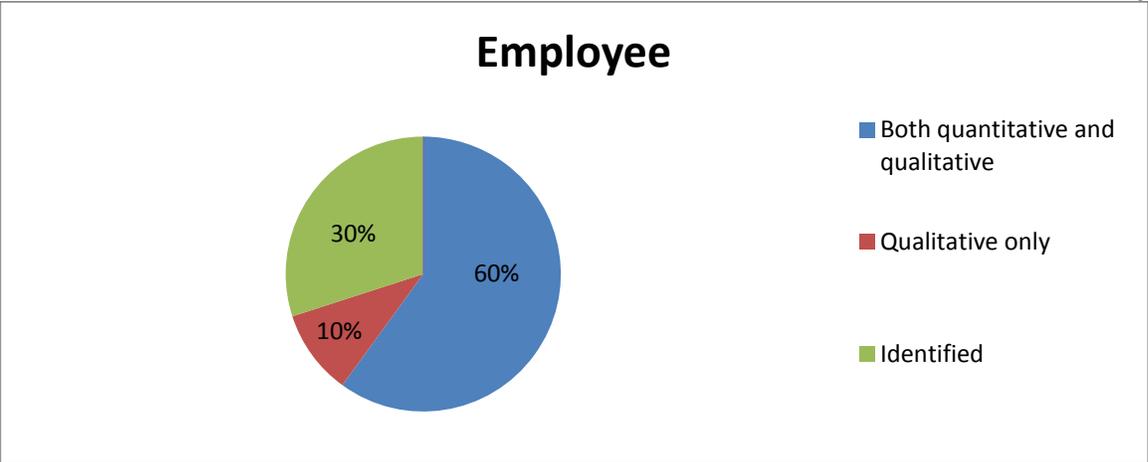
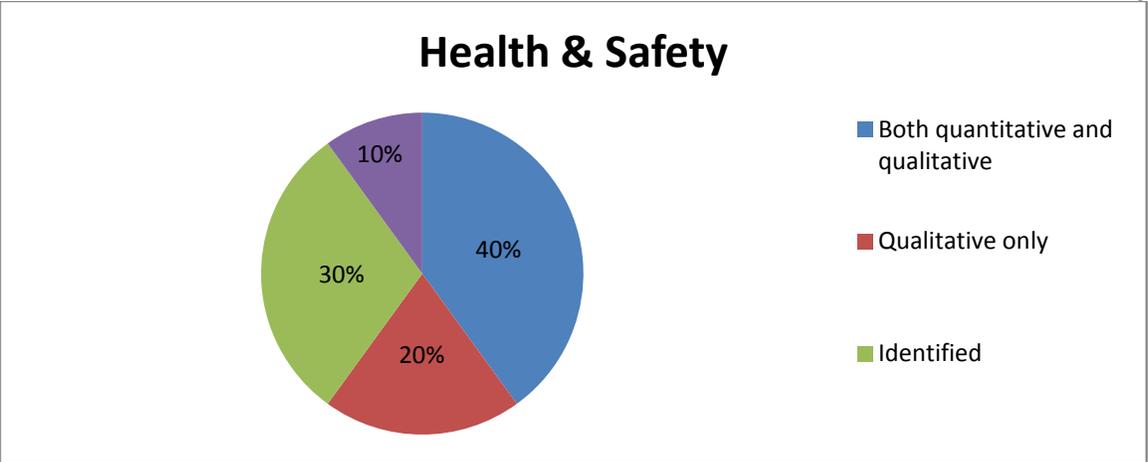


Fig. 8



Environmental (Fig.5)

Again, environmental disclosure was the most comprehensive overall, with all firms providing at least some disclosure and 80% of firms including both quantitative and

qualitative data within their reports. Data on emissions, effluent and waste was again predominant, albeit that the language commonly used was that of reducing the firm's carbon footprint, or striving to becoming carbon neutral.³⁰⁵ As a corollary, in addition to previously reported areas of environmental disclosure such as transport, recycling and environmental expenditure, the importance of renewable/sustainable energy and resources were identified by half of the sample companies.³⁰⁶ For example, those in the retail sector cited sustainable resourcing of produce (including farming/fishing),³⁰⁷ and producing sustainable products and services³⁰⁸ as key concerns, whereas for energy producers the focus was on utilising renewable and/or sustainable energy sources.³⁰⁹

Community (Fig.6)

Disclosure on community issues was, as with the 2005 reports, least comprehensive, with only 30% of firms providing any quantitative data. Once more, the data provided related to a percentage split of community investment in differing areas, and no comparative statistics were given regarding previous years' performances. Almost all disclosure on community issues was limited to community investment programmes and charitable donations, with little information regarding firms' actual impact upon society. Exceptions to this rule were demonstrated in the reports prepared by National Grid and BP. In the former, the firm indicated both their commitment to the communities within which it operates, as well as the global environment, by establishing an independent community interest company, delivering schemes such as the affordable warmth programme. In addressing their social and community issues, BT went a step further; not only highlighting their benefits to local communities but also setting out steps/safeguards in place to minimise potentially negative impacts of their operation, such as noise, odour, or other forms of community disturbance.³¹⁰

Employee (Fig.7)

³⁰⁵ E.g. M&S and Tesco aim to be carbon-neutral by 2012 and 2050 respectively.

³⁰⁶ M&S, National Grid, Vodaphone, Tesco and BAE Systems.

³⁰⁷ Tesco and M&S.

³⁰⁸ Vodaphone.

³⁰⁹ National Grid.

³¹⁰ At page 75.

Employee issues again appeared fairly well reported upon; with 60% of firms producing both quantitative and qualitative data, and all firms providing some commentary. Similarly to the earlier reports, the majority referenced a form of employee opinion survey as the source of the results provided.³¹¹ The quantitative data was, again, largely limited to statistics on employee diversity. However, facilitating employee engagement was cited by ninety percent of firms as a key concern, albeit that only three reports included any quantitative data on the subject.³¹² For the remaining firms, the responses varied significantly. BAE's report for example consisted largely of generalised statements regarding the commitment of the company to improve performance. As there was no supporting statistical data provided, there was no way to verify from the report whether there had, in fact, been any improvement in these areas. The summary of findings from the firm's group-wide employee opinion survey was given as follows:

"In 2010 the survey results showed an improvement for the comparable questions on business conduct from 2008. The responses demonstrated that our employees have a good awareness of the business conduct standards we expect of them. We are pleased to be making progress but recognise that there is still much work to be done. We will continue to improve business conduct training and employee engagement..."³¹³

An equally non-specific response was given by HSBC, despite recognising that there had been a decrease in employee engagement on the previous year. Short of citing the importance of effective employee engagement, no further information on this aspect was provided save for a generalised summary of findings:

"HSBC's annual surveys of employees show that they value HSBC's commitment to sustainable business practices and view the bank as being a leader in this regard."

Firms providing more detailed, specific disclosure on this aspect were BT, Barclays and BP; each of which measured employee engagement by scoring the results from their annual employee surveys and comparing these against previous years. Notably, however, although BT's score had slightly reduced on the previous two years, no commentary was given as to a possible explanation and/or to provide an action plan for improvement.

³¹¹ Eight of the firms that reported on this subject; M&S, BT, Barclays, National Grid, HSBC, Vodaphone, BAE Systems and BP.

³¹² BT, BP and Barclays.

³¹³ 2010 Annual Report, page 49.

Health & Safety (Fig.8)

The disparity between the disclosure on health and safety issues for the 2005 and 2010 reports respectively was the most marked; with substantive disclosure dropping from 80% to 60%. Only 40% of the firms that reported on this issue provided any quantitative data in support, and this was largely confined to statistics of lost time injuries compared against previous years. The majority of reports provided standardised responses in relation to their health and safety performance. These ranged from general, non-specific, mission statements³¹⁴ to, at best, indications as to overall improvements, such as National Grid commenting thus:

“We carried out a process safety culture survey...this showed improvements in most areas over two years and highlighted areas on which to concentrate for the future.”

A similar response was given by BAE Systems, using statistics from a comparable competitor as opposed to previous years’ conduct, to demonstrate improved performance:

“During 2010, a benchmarking exercise was carried out which compared our safety performance in 2009 with other large global engineering and manufacturing companies with a proven track-record or world class safety performance. This benchmark has helped us to identify the gap in our performance against these companies to help us drive improvements for 2011.”³¹⁵

Firms detailing specific health and safety initiatives (addressing work place fatalities or, in the latter case, the Gulf of Mexico oil spill) were Vodaphone, BAE Systems and BP.

Integration of Non-Financial Information

Whilst not borne out by an exclusive consideration of the quantitative data collated, it is apparent that there has been a more general change to the way in which firms report on CSR issues. Specifically, the format of some of the 2010 reports has altered to the extent that the inclusion of CSR data has become integrated within the substantive report, as opposed to being confined to a distinct ‘corporate responsibility’ section.

³¹⁴ See e.g. HSBC, Barclays and GSK.

³¹⁵ Ibid at page 50.

By way of example, within the BAE Systems report, the Corporate Responsibility section of the Business Review starts on page 45 and totals 11 pages in length which, arguably, provides less disclosure than that given in 2005. However, unlike the 2005 report, the integration between financial and non-financial reporting appears to be much more established. This is not due simply to the preparation of one comprehensive Annual Report, but also due to the fact that the concept of ‘responsible behaviour’ has been referenced throughout the report as a key component of ‘Total Performance’, which comprises; Customer Focus, Programme Execution, Financial Performance and Responsible Behaviour. The concept of Responsible Behaviour is therefore introduced as a common thread which underpins the company ethos, before the reader reaches the corporate responsibility section of the report.³¹⁶ This section then reinforces this position by stressing the company’s commitment to its corporate responsibility strategy by demonstrating how this has been ‘embed[ded] into all areas of [its] business.’

This integrated approach to CSR issues was also demonstrated when looking at Barclays’ 2010 Annual Report. Rather than incorporating a separate CSR section, the report included a ‘Key Performance Indicators’ section; setting out various factors against which performance was managed, stated as being closely aligned to the firms execution priorities. These priorities were listed as; capital, returns, income growth and citizenship. The following table provided comparable statistics for the previous three years, and under the citizenship category included quantitative data on global investment, employee opinion survey results and gender diversity of senior management. This is in contrast to the 2005 report, which not only presented all CSR-type information within a ‘Corporate Responsibility’ section, but also failed to provide any quantitative data for any of the issues addressed.

HSBC also demonstrated significant changes to the way non-financial information was dealt with. The quantity of non-financial disclosure in the 2010 report is vastly in excess of the earlier report, with the Directors’ Report alone totalling 73 pages, in stark comparison to the 8 pages of the 2005 report. The report identifies five financial and three non-financial

³¹⁶ For example, a consideration of the companies People Policy, under the resources section, notes diversity and inclusion as important factors in encouraging innovation and enhancing productivity.

KPIs which most accurately reflect management priorities, the latter being employee engagement, brand perception and customer recommendation. Notably, in a similar vein to the language used in the earlier report, it is expressed that these priorities have been identified in an attempt to minimise the firm's reputational risk. Unlike the earlier report, however, comparisons have been made with leading competitors by using aggregated data compiled from accredited, independent organisations, and charting the resulting scores as 'benchmark recommendations'. However, whilst the disclosure provided indicates positive results in the key performance areas, there is arguably a lack of transparency due to the selective application of this information, thereby enabling the company to simply omit any unfavourable findings.

Further examples of this integrated approach to CSR disclosure were seen in the Tesco 2010 report; adopting a similar stance to Barclays by incorporating both financial and non-financial KPIs within the same area of the report,³¹⁷ and within the M&S 2010 report; including both quantitative and qualitative data within their 'performance and KPI' section, detailing how their sustainability 'Plan A' was integrated across the business.³¹⁸

Comparative Data Review

Whilst a consideration of the empirical data alone does not provide a complete picture as to the development of CSR disclosure, not least for the reasons expounded above, it has nonetheless enabled general observations to be made regarding its type and form. Using this as a basis upon which to build, it has then been possible to construct a more detailed understanding using observations gleaned from the data analysis.

Having previously considered the 2005/2010 results as two distinct sets of data, these results also facilitate a comparative data analysis. For the purposes of displaying and comparing the data, the disclosure for each category has been allocated a score of between 0-3 in order to determine its quality, by reference to the following scale:

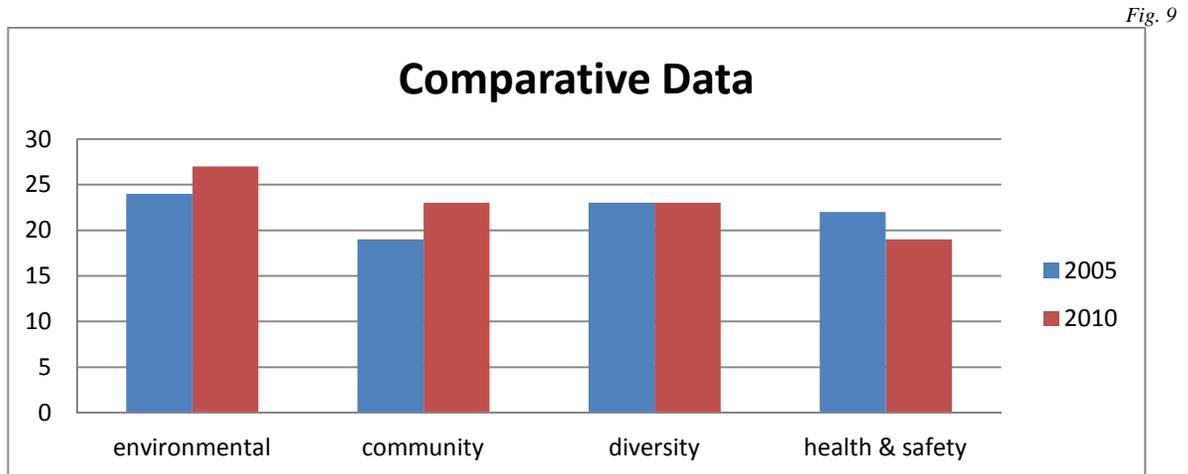
- 0- No disclosure on this issue

³¹⁷ At page 38

³¹⁸ At page 11

- 1- The issue has been identified but not measured in any way
- 2- Qualitative measures of the issue covered were provided
- 3- Both quantitative and qualitative measures of the issue covered were provided

The results were then used to form an aggregate score for each form of disclosure, demonstrated as follows:



It appears that whilst there was an increase in the amount and/or quality of reporting on environmental and community issues, this is not representative of CSR disclosure generally following the implementation of the 2006 Act. Both employee diversity and health and safety issues showed no improvement, with the latter demonstrating an apparent decrease in the amount and/or quality of disclosure.

Also evident from the data, and providing a potential explanation for the apparent decrease in disclosure, is the significant rise in instances where an issue is merely identified, but no measurements provided or further commentary given. The overall data for 2010 shows a 75% increase on the 2005 results for issues that have been identified alone. Upon closer consideration of these reports, it was evident that the majority of firms that did no more than identify an issue also referenced external sources where further information could be accessed.³¹⁹ This approach is demonstrated by two firms that scored maximum marks in 2005, and a lesser score in 2010; GlaxoSmithKline and Vodafone. For the former, their

³¹⁹ These external sources do not form part of the data review- see Chapter 5 for further information.

lack of disclosure within the Annual Report was addressed by directing the reader to the company Corporate Responsibility Report, whilst the latter referenced their 2010 sustainability report and the company website as providing additional information on the issues identified. Whilst the overall disclosure on a particular issue may, therefore, have been particularly comprehensive, the fact that it was not included within the 2010 Annual Report means that it has been excluded for the purposes of the data review.

The above comments notwithstanding, an exclusive consideration of the Annual Reports alone demonstrates an increase in the volume of non-financial information disclosed in the latter reports. Whilst it has not been possible to determine the precise amount of non-financial disclosure for each set of results (largely due to the integration of this information throughout some of the 2010 reports), the volume of disclosure was at least equal to that within the 2005 reports³²⁰ or, for the majority of firms, in excess of the previous disclosure.³²¹

Concluding Observations

It is apparent that the disclosure of non-financial information has changed over recent years following the implementation of the Companies Act 2006 reporting provisions. Whilst it by no means follows that these changes have occurred *because* of the new legislative requirements, it is possible to identify new behavioural trends that appear to be consistent with its objectives.

Overall disclosure of non-financial information has increased, with even the worst performing firms demonstrating an improvement since their 2005 reports. Notably, during 2010 all of the sample firms at least identified each of the categories within the data review (i.e. environment, community, diversity and health and safety), albeit that this information was not always contained within the Annual Report. A further indication of firms adapting their approach in line with the Act's requirements is the level of integration between

³²⁰ BT and Barclays.

³²¹ GSK, M&S, National Grid, Vodafone, BP, HSBC, Tesco and BAE Systems all included increased volumes of CSR disclosure in their 2010 Annual Reports.

financial and non-financial performance indicators in the 2010 reports. Whilst stakeholder engagement was expressed as a key concern by many firms during 2005, the latter reports appear to be facilitating this in practice, by providing both financial and non-financial data as constituting the firm's key performance indicators.

Ultimately, the data appears to support the view that firms are aware of their obligations under the 2006 Act and have, to varying degrees, modified their approach to reporting accordingly to take these requirements into account. The real test however, will be whether the net result of this change necessarily equates to more meaningful disclosure for both shareholders and stakeholders alike.

Chapter 5

Data Analysis and Conclusions

Introduction

Annual reporting is one of the main ways in which company directors can demonstrate a firm's performance, objectives and ethos on a range of financial, social and environmental issues. Since the implementation of the Companies Act 2006, companies are now provided with a mandatory 'checklist'³²² of non-financial factors that must be reported on to the extent that they effect the development, performance and position of the company's business. Expressly included in this list are interests of employees, social and community issues, and environmental matters. As some of this information may not be relevant to all firms, directors can elect to omit disclosure on certain issues provided they expressly state that they have done so.³²³ In addition to specifying the type of information to be disclosed, the Act contemplates how and where this information is to be displayed, in the form of a business review. In light of the contrast between the respective obligations of firms both pre and post Act, the former being largely based on voluntary disclosure (often led by stakeholder demand), it is unsurprising that many commentators consider the new legislative provisions to be a significant step forward for CSR.

As demonstrated in the previous chapter, the majority of (listed) companies were producing some form of CSR disclosure prior to the Act's implementation, despite no legislative requirement to do so. It is contended, however, that the purpose of the 2006 Act is not only to ensure that all companies reach a minimum standard of disclosure on key non-financial issues, but also to ensure a uniform approach is adopted by companies, thus facilitating consistency and comparability between reports.

From a consideration of the data review, it appears evident that the nature of non-financial disclosure has evolved since the 2006 Act coming into force. There is increased disclosure

³²² This 'checklist' is considered to be deliberately non-specific, as the legislation is not aimed at providing detailed prescription given the wide and varied range of companies to which it applies. See; *Annotated Companies Acts* (Oxford University Press, loose-leaf) under 15.417.05.

³²³ S.417(5).

being provided and greater integration of non-financial data with reports. The purpose of this chapter is to consider whether the results of these developments are consistent with that envisaged by the legislators of the 2006 Act, and have substantively influenced corporate narrative reporting in a way that produces more meaningful disclosure of CSR issues. Whilst it was beyond the remit of this study to determine the type of non-financial disclosure each company *should* be making, as opposed to what has actually been reported, the test will be whether the data disclosed is comprehensive, reliable, and comparable; thus facilitating meaningful consideration from a variety of stakeholders.

Chapter 5 starts by considering the purpose and provisions of the Companies Act 2006, specifically with regard to the requirement to produce a business review. Within this context, the extent to which companies are complying with their obligations under the Act is then considered. This is followed by drawing conclusions on the results of the data review, as per the previous chapter, in order to ascertain whether the quality of disclosure produced has improved following the Act's implementation. This is done by identifying the key factors considered necessary for effective corporate disclosure; comprehensiveness, reliability and comparability. Finally, the chapter concludes with a consideration of the future of corporate narrative reporting, with a particular focus on CSR issues, and includes proposals for the improvement of current standards of CSR disclosure.

Compliance with the Act

This section considers the purpose of the reporting requirements in the Companies Act 2006, and the extent to which firms are complying with these provisions within the Annual Reports produced.

Purpose of the Business Review

In accordance with s.417 of the Act, the purpose of the business review is to inform members of the company and assist in assessing how directors have performed their duty to promote the success of the company as per s.172. Crucially, this duty now expressly includes the requirement to have regard to relationships with employees, suppliers, customers and others as well as the company's impact on the community and environment.

For this to be practicable, there needs to be an identifiable business review to consider. Unfortunately, many of the firms from the data sample did not include an easily identifiable business review within their Annual Report, with only half arguably complying with the Act's requirements. This is despite the clear legislative wording at section 417(1) that the directors' report must contain a business review.

A further method of ascertaining whether a company director has effectively discharged their duty would be to describe the new legislative requirements, and then state what steps have been taken towards achieving these obligations. While many of the 2010 reports referenced the Act on numerous occasions in order to demonstrate compliance with regard to financial/procedural considerations, only one firm from the sample cited the Act with specific regard to the enhanced reporting requirement to produce a business review. The 2010 M&S Annual Report described the purpose of the business review as required by the Companies Act 2006, i.e. to set out a fair review of the business of the company, and went on to identify the various sections of the report that comprised the review, including a section on social, environmental and ethical matters.³²⁴ No other firms made reference to their increased CSR disclosure obligations under the new legislation.

A further common example of firms seemingly acting contrary to the Act's provisions is the direct reference within reports of information contained in an external source, i.e. a separate CSR Report or the company website. Without exception, all firms within the sample elected to produce some form of external disclosure of CSR information outside of both the business review and Annual Report. Again, this practice does not appear consistent with the wording of section 417(1); that the directors' report must contain the business review.

This apparent non-compliance appears problematic on two parallel fronts; firstly, it raises concerns as to the accuracy and standard of the information provided, as only the report itself is subject to the legislative reporting provisions. Disclosure outside of the report therefore means that there is potential for a Public Relations exercise or 'green wash', with

³²⁴ At page 72.

companies being selective and/or creative with their CR disclosure, attributing this information with presumed credibility as an appendage to the annual report.

Secondly, where the relevant disclosure is not found within one report, this prevents comparisons being drawn within industry sectors as the information provided is not 'like-for-like'. This inhibits the establishment of best practice standards and may mean that the disclosure is incompatible with stakeholder requirements. Specific examples of this in practice, using firms from the data sample, include the preparation of multiple reports from the same year³²⁵, as well as the apparent failure of some firms to comment on pertinent issues as this information was contained outside the Business Review.³²⁶ As noted in chapter 3, the success, or otherwise, of the reporting provisions is likely to depend on being able to generate comprehensive, reliable and comparable data, and the existence of non Act-compliant disclosure is likely to blur the boundaries in this regard.

Content of the Business Review

A further provision of the Act that does not appear to have been complied with is the requirement to state the omission of information of the kind specified in section 417(5)(b) and (c). Presumably, the purpose of this provision is to remove an element of subjectivity, as Directors are only obliged to report on the s.417 'checklist' factors to the extent necessary for an understanding of the development, performance or position of the company's business. Thus, the requirement to state whether any of this information has been deliberately omitted, makes it harder for firms to gloss over less favourable CSR performance, as the Director is obliged to make an overt assertion that such matters are not necessary for an understanding of the business.

Unfortunately, it does not appear as though any of the firms from within the data sample have complied with this requirement, despite 40% arguably falling short of the information required under s.417.³²⁷

³²⁵ I.e. M&S in 2010 produced an Annual Report and Review, a 'How We Do Business' Report and an 'Our Plan A Commitments' Report.

³²⁶ I.e. M&S failed to include any reference to health and safety issues within their 2010 Annual Report.

³²⁷ I.e. HSBC, Tesco, GSK and M&S all failed to provide any specific data on at least one of the key CSR issues recorded by the data review. These are issues considered relevant to all firms, and fall within the categories prescribed by s.417.

Notably, however, all of the reports from the data sample include a section entitled ‘matters on which we are required to report by exception’, the majority of which expressly mention the 2006 Act as giving rise to this obligation, which relates to financial information such as directors’ remuneration and auditing requirements. It is unfortunate that this level of diligence is not also given to information of a non-financial nature, although given the necessarily broad, generalised subject matters within s.417³²⁸ it may be difficult for some firms to establish where to draw the line. Interestingly, it was opined at a relatively early stage of the Act’s implementation that the generous discretion afforded to directors to report as they see fit provided that they do not leave out any information, was not sufficient to adequately improve the transparency of corporations.³²⁹ This issue is given further consideration below.

Quality of Disclosure

Turning to the disclosure itself, it is evident from the data review that this demonstrates changes to the way in which firms are reporting upon non-financial information. As previously discussed, there appears to be an apparent increase in the volume of overall CSR disclosure, albeit that the extent of this increase is not accurately reflected by the results due to sources of disclosure outside of the business review. The traits deemed necessary for effective corporate disclosure, and the extent to which non-financial disclosure has developed in line with these standards, are considered in turn below:

Comprehensiveness

The rationale for the evident overall increase in disclosure is unclear. On the assumption that companies were simply discharging their statutory duties under s.417, it would be expected that all key CSR issues were consistently addressed, at least to the extent of identifying the issue as one that did not require substantive consideration. This does not appear to be the case in practice, with many firms providing comprehensive disclosure in some areas, and little/no disclosure in others. Whilst this is to be expected to a degree, to

³²⁸ See above at n.322.

³²⁹ A Campaigner’s Guide to the Companies Act, the Corporate Responsibility (CORE) Coalition and the Trade Justice Movement, September 2007, at page 8.

correspond with the particular issues faced by that firm,³³⁰ how does this prevent companies from ‘cherry-picking’ positive disclosure whilst omitting less favourable results?

Potential examples of this kind of selectivity are evident from the data review. BAE Systems in 2005 produced both an Annual Report and a Corporate Responsibility Report, both identifying differing CSR issues respectively. Seemingly, the former addressed CSR issues that were identified as relevant by the company board, whereas the latter appeared to be directed towards those concerns raised by stakeholders.³³¹ As considered in the previous chapter, this not only brings into question the role and function of the Corporate Responsibility Committee in facilitating stakeholder engagement, but arguably also suggests that the Annual Report is less a mechanism aimed at facilitating stakeholder involvement, but more a marketing tool to attract investment. This is perhaps more apparent when it is considered that, as part of the function of the Corporate Responsibility Committee, an independent report was commissioned to determine the perception of key stakeholders, yet the issues raised by these stakeholders were not substantively addressed within the Annual Report.

The CR Report appeared relatively substantial, totalling 36 pages in length, although a closer consideration revealed that this is artificially increased by the layout and use of graphics. The report consisted predominantly of general summaries, introductory/explanatory notes and generic objectives, with little in the way of specific observations or achievements from the preceding year.³³² Overall, there were few examples within the CR Report where specific deficiencies were recognised and remedial measures discussed, and the areas for improvement were largely generalised ‘mission statements’ as opposed to being truly reactionary. Notwithstanding this, the concluding section of the

³³⁰ For example, the most comprehensive disclosure regarding Health and Safety came from those firms likely to experience fatalities and/or serious work related injuries due to the nature of the industry (National Grid, BP, BAE). Those in the finance sector performed least well in this area (HSBC, Barclays).

³³¹ See previous chapter for additional commentary.

³³² For example, excluding introductory comments, the first substantive commentary on action taken in 2005 appears on page 11 of the report, albeit that this consists largely of bland, somewhat generic statements such as; *“all BAE Systems’ marketing advisors are subject to rigorous due diligence under our compliance programme, are made aware of our anti-bribery policy and are expected to maintain our ethical standards.”*

report referenced an External Assurance Statement and commentary³³³ that was commissioned in order to identify areas of improvement for future CR reporting, stating the purpose of a CR report thus:

“It should show how crucial decisions are made, and differing interests balanced. Honest about shortcomings, it should demonstrate how the organisation is responsive by listening, learning and improving.”

It is difficult to see however, based on this report, how this is being demonstrated in practice.

Within the 2010 BAE Report, the issue remained as to how the CSR issues had been identified, although in the absence of a definitive source, the implication is that they had been identified once again by the CR Committee. It was also evident that self-initiated data gathering exercises had been carried out in order to measure company performance in certain areas against that of previous years and/or market competitors. However, the fact that this data was not disclosed or even referenced,³³⁴ and the summary of findings given within the report was wholly non-specific, again brings into question both its purpose and value.

Reliability

The selective inclusion of certain information also raises concerns over the reliability of the Annual Reports, as providing an accurate snapshot of a firm’s performance over the preceding year. Whilst the statutory auditing requirements for company reporting generally necessarily provide a level of assurance regarding company disclosure, the standards applied to non-financial data are not particularly stringent. Generally speaking, company directors need only demonstrate that they have exercised reasonable skill, care and diligence in approving the report as accurate. In order to avoid potential criminal and civil sanctions for mis-certification, they cannot have knowledge of, or be reckless as to, false statements being included within the report.³³⁵ For many listed companies, including all of

³³³ Provided by the Corporate Citizenship Company.

³³⁴ Albeit that the report provided that further analysis of the responses to the business conduct employee opinion survey could be found on the CR section of the company website. This source of information was not consulted.

³³⁵ Companies Act 2006, s.418-419.

those within the data sample, this is achieved via the use of an external assurance agency, to provide an independent analysis of how stakeholder concerns are identified/being met in practice.

Whilst a detailed consideration of various CSR assurance options is beyond the remit of this study,³³⁶ it is evident from the data review that only selected information contained within the Annual Reports is subject to assurance. Further, the level of assurance may vary depending on the type of information provided. For example, BAE Systems 2010 Report contained an independent assurance statement which provided a two tier level of assurance on the information contained within the CSR section of the Business Review; limited assurance and reasonable assurance. Limited assurance was expressly stated as ‘substantially less in scope than reasonable assurance’, and certified disclosure to the extent that it had not been ‘materially misstated’. Only a small percentage of CSR performance information was subject to reasonable assurance, limited almost exclusively to the business conduct and safety strategies. Surprisingly, many of the key performance indicators were subject to limited assurance only, and any forward-looking statements of intentions were not subject to any form of assurance. The obvious difficulty, therefore, is that the key performance indicators are capable of being manipulated to an extent (e.g. the omission of certain data), provided that they are not materially misstated. Further, where no data on a particular subject is included within the report, the general, forward-looking statements expressed may be unsubstantiated, and thus arguably represent little more than a PR exercise.

Comparability

One of the statutory provisions that may have had more of a substantive effect on the way companies are required to report information, is that pertaining to the generation of key performance indicators (KPIs). Section 417(6) of the Act requires the use of both financial KPIs and ‘other’ KPIs, expressly including information relating to environmental, employee, and social and community issues. Whilst the precise nature of this information is

³³⁶ See AccountAbility/Utopias Report; Critical Friends: The Emerging Role of Stakeholder Panels in Corporate Governance, Reporting and Assurance, March 2007; available at <http://www.stakeholderpanels.net/StakeholderPanels_report.pdf>

left to the discretion of directors, it need only be included to the extent necessary for an understanding of the development, performance or position of the business. Notwithstanding this wide discretion, it has been contended that most practical circumstances would necessarily warrant the use of key measures in order to facilitate a meaningful discussion of performance.³³⁷ In principle therefore, in the absence of an overt assertion that commentary on a particular issue is not necessary for an understanding of the business, it would be reasonable to expect a KPI to be produced in order to support the report's findings.

The use of KPIs to demonstrate improved performance was prevalent within many of the sample 2005 Reports, for both financial and environmental/social data. Common examples of non-financial KPIs included carbon emissions, gender/age/race diversity of staff and work related deaths/injuries. A study by Tomorrow's Company,³³⁸ of Annual Reports for financial years ending December 2005 to April 2006, demonstrated both the increased use of KPIs generally, as well as firms' differing responses to financial and non-financial disclosure. Despite the fact that the disclosure of KPIs was not yet a legislative requirement under the Companies Act, the report showed an increase of almost double the proportion of firms utilising this method of reporting compared to the previous year. This increase was attributed partly to the recent EU directive which required the production of an enhanced business review, and partly to firms readying themselves to comply with the OFR regulations, despite these subsequently being repealed.

This notwithstanding, only around half of the firms in the Tomorrow's Company study identified any financial KPIs, despite presumably having well established financial reporting systems in place.³³⁹ Non-financial KPIs were even less frequently disclosed, and

³³⁷ Reisberg, A. & Havercroft, I., Directors' Duties under Companies Act 2006 and the Impact of the Company's Operations on the Environment, UCL Centre for Commercial Law, Dec 2010; available at <<http://ssrn.com/abstract=1274567>>

³³⁸ Utilising a publication from corporate reporting agency Black Sun, on FTSE-100 reports produced for the year ending Dec 2005, and a similar publication from creative consultants Radley Yeldar covering year-ends Dec 2005 and April 2006; What's Happening in Corporate Reporting, Black Sun, May 2006 and Narrative Reporting Content in the FTSE-100: How Does it Stack Up?, Radley Yeldar, Sept 2006 respectively.

³³⁹ Tomorrow's Company, The Future of Corporate Reporting; 'State of Play- February 2007', available at <<http://www.tomorrowscompany.com/uploads/FOCRvf.pdf>>

were described as an area where companies struggled, often focussing on those aspects easily reported on as opposed to the main issues. A minority of companies however were seen to adopt leadership positions, integrating their financial and non-financial thinking, arguably signalling better understanding and management of both.

Turning to the sample firms within the data review, ninety percent of annual reports produced in 2005 referenced financial KPIs, with only forty percent disclosing KPIs relating to non-financial information.³⁴⁰ In 2010, all firms without exception produced some form of financial KPI, and eighty percent of firms also disclosed KPIs for non-financial disclosure; a one hundred percent increase on the 2005 results. Thus it would appear as though the statutory requirement to produce KPIs has resulted in the increase of this type of disclosure, despite there still being a number of firms seemingly not complying with this provision.

In addition to the obvious benefit of providing an increase in the substantive and comparable data on a range of environmental, social and community issues, the data review also demonstrated the integration of financial data with other factors considered relevant by the company board. It is this holistic approach that was identified within the Tomorrow's Company report as being of principal importance to the value of narrative reporting and the future role of the annual report.³⁴¹ This process shares a strong link to the concept of ecological modernisation, explored briefly in Chapter 2. The key is that the regulatory framework enables firms to align both financial and non financial considerations in the pursuit of economic success, with the ultimate aim of encouraging firms to develop policies in order to achieve sustainable development. As identified by DEFRA, the department for Environment, Food and Rural Affairs, those companies that measure, manage and communicate their environmental performance are inherently well placed.³⁴² They understand how to improve their processes, reduce their costs, comply with regulatory requirements and stakeholder expectations and take advantage of new market opportunities. According to this governmental body, good environmental performance makes good

³⁴⁰ As the term 'key performance indicator' was not regularly used in the 2005 reports, the disclosure was considered to be a KPI if there was at least three years of comparable information provided.

³⁴¹ See above at n.339, pg 12.

³⁴² DEFRA, [accessed 20/06/12], available at <<http://archive.defra.gov.uk/environment/business/reporting/>>

business sense, and a failure to plan for a future in which environmental factors are likely to be increasingly significant may risk the future of the business long-term.³⁴³

What has been demonstrated thus far is that whilst there are seemingly provisions in place to facilitate the disclosure of meaningful non-financial information, there are inadequate mechanisms available to ensure their consistent application. As such, firms are evidently adopting varying degrees of compliance which not only means that the information provided within individual reports may be inaccurate and/or unreliable, but also that this disclosure cannot be used to draw comparisons within industries or against similar sized companies.

We now turn to look at the standard of corporate reporting generally, both with reference to the data review as well as findings from similar data studies. It is from this viewpoint that it is possible to consider what steps need to be taken in order to ensure improved standards of corporate reporting in the future, particularly from a CSR perspective. It is this forward-looking analysis that forms the final part of this chapter.

Current Standards of Corporate Reporting

The principle of enlightened shareholder value considered in Chapter 3, which is considered to be at the heart of the 2006 Act,³⁴⁴ necessarily requires that directors be given sufficient discretion to determine how much weight to attribute to each of the s.172 factors, whilst carrying out their duty to promote the success of the company. In addition, the reporting provisions also provide a degree of flexibility to report on the information required for an understanding of the business, in the way that directors deem appropriate, provided that no relevant information is omitted. However, the lack of guidance³⁴⁵ and a suitable framework for this decision-making process means that there is significant scope for interpretation, both in terms of how firms act in accordance with their duty, and the

³⁴³ *Ibid.*

³⁴⁴ Per Alistair Darling, Secretary of State for Trade and Industry, upon introducing the Company Law Reform Bill to the House of Commons for its second reading; see Hansard, Grand Committee Official Report, 6/2/2006, coll GC125.

³⁴⁵ Notwithstanding the GRI sustainability reporting guidelines, albeit that these are not mandatory.

information they report to enable stakeholders to assess their actions.³⁴⁶ Thus, unless the latter is being achieved to an acceptable standard, the entire premise of the reporting provisions being used as a reflexive tool, whilst concurrently fostering good stakeholder relations, becomes a moot point as the report produced may be little more than a PR exercise. Put another way, assuming that directors' duties under the Act are designed to facilitate, at least in part, improved corporate social behaviour, stakeholders ought to be able place reliance upon non-financial disclosure to determine how well a company has performed on a range of environmental, social and community issues. Whilst this may seem like an obvious statement, unfortunately, it does not appear as though this is currently being achieved in practice.

The Data

One of the potential difficulties encountered by firms is the need to balance competing interests of differing stakeholders. This was evident from the data review in how different firms presented their non-financial data, which ranged from bland, generic statements unsupported by any data, to glossy but unsubstantiated CSR spin, to in-depth analysis of KPIs. Many firms were seen to be going beyond traditional risk reporting, albeit that for a significant proportion there appeared to be a general reticence to discuss the companies' future prospects, as required under s.417(5)(a). What was readily apparent however was the lack of consistency of approach which, in conjunction with a high proportion of firms failing to comply with the Act on a number of fronts, made the task of collating comparable information particularly difficult.

These findings have been echoed by other similar data studies. A recent survey of corporate reporting³⁴⁷ found that many reports appeared as though they were intended to be 'user friendly' in an attempt to encourage the involvement of particular stakeholder groups such as customers, employees and media audiences. In a similar vein, reports were also used as a branding exercise and/or an advertising medium for new products. This is despite the primary stakeholder group being comprised predominantly of existing shareholders and potential investors whose priorities were likely to include a frank and honest view of the

³⁴⁶ Keay, above at n.255.

³⁴⁷ Bostock and Pollitt, *Corporate Reporting: Seeing the Bigger Picture*, Nov 2006.

way in which the company is managed, clear descriptions of risk factors faced, and accurate, reliable and accessible figures. In particular, the study found that a recurring perception of many investors is that the message from annual reports is often diluted by lengthy narratives, glossy pictures, ‘PR spin’ and bland/meaningless CSR statements.³⁴⁸

Further similar studies dealing specifically with environmental disclosure revealed that this is often poor quality,³⁴⁹ and whilst many companies mention their environmental conduct to some extent, many reports lack vigour, depth or quantification. The purpose of this disclosure within the annual report, as distinct from other forms of environmental disclosure that may be required in order to comply with existing environmental regulations, is to enable shareholders to assess the environmental risks or opportunities facing a company. However, a study of FTSE companies’ reports in 2004 and 2006 respectively found that very little reporting was adequate for this purpose.³⁵⁰ One of the main criticisms was that the issues reported on were often not accurately defined, and their potential implications on the business were therefore not fully explored. Differing social, economic and environmental imperatives were raised, although little attempt was made to resolve any conflict between these competing interests, providing a rationale for the decisions made under s.172. Further areas of concern included the lack of consistency of sustainability reporting between stand-alone sustainability reports and the strategic statement in the Annual Report and Accounts, as well as the value of external assurance statements which were considered questionable for many reports.

The above issues largely echo the findings from the data review, and are demonstrative of the changes required to the way in which Annual Reports are prepared. Again, it is pertinent to note that several of these inadequacies could be rectified merely by ensuring firms’ compliance with the existing legislation. Notably, the Government agreed to review

³⁴⁸ See above at n.339, pg 9.

³⁴⁹ See Williams, C. & Conley, J., An Emerging Third Way? The Erosion of the Anglo-American Shareholder Value Construct, *Cornell International Law Journal*, **2005**, **38(2)**, pp.493-551; the UK Environment Agency Environmental Disclosures Report of the FTSE All-Share, available at <<http://publications.environment-agency.gov.uk/pdf/GEHO1007BNGJ-e-e.pdf>>; and the KPMG International Survey on Corporate Reporting, Oct 2008, available at <http://www.csrwire.com/press_releases/13790-KPMG-International-Survey-of-Corporate-Responsibility-Reporting-2008>

³⁵⁰ See above at n.338.

the success of the reporting obligation after two years of the Act's implementation,³⁵¹ and this is discussed in turn below.

The Analysis

It appears that the challenge to be overcome if corporate social reporting is to have a meaningful impact on corporate behaviour is twofold. Firstly, there needs to be a mechanism in place to ensure that the minimum legislative reporting requirements are being met by all firms. As previously considered, the test to determine a breach of s.172 is necessarily subjective, requiring the director's conduct to be deemed so unreasonable as to extinguish any realistic claim that it was their honest belief that the act would promote the success of the company.³⁵² The application of s.417 is equally subjective, and therefore a breach of the same carries a similarly high burden of proof (requiring knowledge or recklessness as to false statements being included in the report).³⁵³

For less severe examples of non-compliance however, such as the ones identified within the data review, there are limited means of rectifying inadequacies of reporting. Stakeholders who are unsatisfied by the information provided within an annual report have no formal arena to challenge the information provided. Large investors and investor bodies may be able to file a resolution or public vote, although this form of engagement is not always possible, particularly when selling shares is not an option. Further, without forming a collective action, this level of engagement is generally not available to retail investors.³⁵⁴ Following consultation with key stakeholder constituents,³⁵⁵ many felt that facilitating better engagement could be achieved through better promotion of the Financial Reporting Review Panel (FRRP), in considering complaints regarding inadequate reporting. Criticism was also made of the current system of shareholder resolutions, which was considered too

³⁵¹ Whilst the exact time of this review was not disclosed, it was subsequently stated as being due in 2010, after two full reporting cycles; Per Lord Sharman, Hansard Debates, 25 Mar 2009 : Column WA137, available at <www.publications.parliament.uk/pa/ld200809/ldhansrd/text/90325w0002.htm>

³⁵² See Reisberg & Havercroft above at n.337, pg 7.

³⁵³ Companies Act 2006, s.418(5).

³⁵⁴ BIS: The Future of Narrative Reporting – A Consultation; Summary of Responses, Dec 2010, [accessed 28/05/12], available at <<http://www.bis.gov.uk/assets/biscore/business-law/docs/s/10-1318-summary-of-responses-future-narrative-reporting-consultation.pdf>>

³⁵⁵ *Ibid.*

complex and onerous, and various alternative options to facilitate challenge were proposed.³⁵⁶

In addition to fostering greater stakeholder engagement, thus prompting firms to report in a way that is consistent with these expectations, it is arguable that enhanced guidance and standardisation may also produce the same results. The rationale behind this view is that by strengthening the existing regulatory framework, the quality of individual reports is improved as companies are encouraged to report in line with the way in which they manage themselves. This approach also has the benefit of aiding increased comparability between reports, considered vital for effective stakeholder engagement:

“...the legislation ought to give some indication of what the standard reporting practice should be. Surely, the whole purpose of this is not only to obtain the disclosure of information itself, but also to provide a measure by which those who wish to invest within an ethical framework can obtain comparisons between different companies. It would be difficult for those comparisons to be made without some element of standard reporting practice.”³⁵⁷

There is, however, a fine balance to be met between achieving greater comparability and avoiding a more compliant ‘boilerplate’ approach, as a degree of flexibility is necessary to enable each individual company to present its own unique story.³⁵⁸ The 2010 governmental consultation on corporate reporting requirements³⁵⁹ resulted in many respondents seeking clarity and simplification of existing regulatory requirements, which were sometimes considered contradictory. In particular, NGOs and Trade unions supported the streamlining of national and international reporting standards into one mandatory framework, to make reporting simpler and more consistent. Alternatively, the presentation of information in a more standardised, basic form was proposed as a way to aid comparability without reducing flexibility of the content.

³⁵⁶ Including greater consultation prior to reports being prepared, promoting greater realism without risk of litigation, encouragement of investor challenges, and the introduction of an active regulator to enforce compliance.

³⁵⁷ See Reisberg & Havercroft, above at note 337, pg 39; see also the EU Modernisation Directive, the principle purpose of which was to generate a common reporting standard so as to enable comparison between European traded companies of both financial and non-financial measures.

³⁵⁸ *Ibid.*

³⁵⁹ *Ibid.*

The second challenge to overcome will be for firms to think creatively in order to create a report that meets the needs of differing stakeholders while also complying with the statutory reporting requirements. As opined by one commentator, the law provides a framework within which companies are free to find their own solutions.³⁶⁰ The role of the annual report is considered key in fostering effective corporate accountability. However, for firms to be able to fulfil both their legal and wider responsibilities they need to identify their objectives and be clear about how these will be met within the annual report. For example, the inclusion of social and environmental matters within the Annual Report ought not to be an opportunity for ‘green-washing’, but rather should be relevant and consistent information integrated into the strategies and risks of the business. For those firms able to achieve this standard, there may be a more holistic benefit in terms of their stakeholder relations. Effective reporting forces a company to be clear on what its success model is, and the key relationships necessary to enable that model to succeed. In doing so, the understanding of the business from a management perspective is enhanced, resulting in improved leadership. The contention is, therefore, that the quality of the annual report becomes a proxy for the quality of the management team.³⁶¹

The Future of CSR Reporting

Despite the comprehensive changes made by the Companies Act 2006, specifically with regard to narrative reporting and the inclusion of information on social and environmental matters, proposals for further reform have recently occurred both within Europe and in the UK.

During 2010, the European Commission published two separate public consultations relating to corporate reporting. The first of these concerned the operation and potential modernisation of the Transparency Directive,³⁶² whilst the second concerned possible

³⁶⁰ See above at n.339, pg 10.

³⁶¹ See above at n.339, pg 14.

³⁶² Directive 2004/109/EC; Consultation Paper closed 23.08.10. Summary of responses dated 17.12.10, available at <http://ec.europa.eu/internal_market/securities/docs/transparency/transparency-consultation-summary_en.pdf>

improvements to non-financial disclosure by companies.³⁶³ According to the European Commission, the need for a great level of sustainable development in conjunction with the economic crisis, has served to highlight the importance of non-financial disclosure. However, in creating greater transparency they were keen to avoid imposing an increased regulatory burden upon companies.³⁶⁴ The latter consultation posed questions which included, *inter alia*, the type of disclosure required, how to identify KPIs and whether EU policy should promote the integration of key financial and non-financial information in order to show the inter-relationship in performance between the two.

A similar process has been undertaken within the UK. In August 2010, the Department of Business Innovation and Skills (BIS) published a consultation on the future of narrative reporting, following the Government's commitment to reinstate an Operating and Financial Review (OFR).³⁶⁵ The express objective of the consultation was to drive the quality of company reporting and enable stronger and more effective shareholder engagement. Following publication of a summary of responses,³⁶⁶ the Government elected to respond to the issues raised by issuing a further consultation on the future of narrative reporting in September 2011.³⁶⁷ The Government's response to these consultations was published in March 2012, and the key proposals made are summarised in turn below.

Proposals for Policy and Legal Change

The message from stakeholders following the UK Government's consultations on narrative reporting was that company's Annual Reports had become unduly large and complex, and were therefore failing as a tool to facilitate effective engagement. The consensus view was that the narrative reporting framework needed to be simplified and clarified, and the disclosure streamlined to enable shareholders to distil pertinent information from the report

³⁶³ Consultation Paper closed 24.01.11. Summary of responses dated April 2011, available at <http://ec.europa.eu/internal_market/consultations/docs/2010/nonfinancial_reporting/summary_report_en.pdf>

³⁶⁴ See Reisberg & Havercroft, above at note 337, pg 37.

³⁶⁵ BIS: The Future of Narrative Reporting – A Consultation, August 2010, [accessed 28/05/12], available at <<http://www.bis.gov.uk/assets/biscore/business-law/docs/n/10-1057-future-narrative-reporting-consultation.pdf>>

³⁶⁶ See above at n.363.

³⁶⁷ BIS: The Future of Narrative Reporting – Consulting on a New Reporting Framework, Sept 2011, [accessed 28/05/12], available at <<http://www.bis.gov.uk/assets/biscore/business-law/docs/f/11-945-future-of-narrative-reporting-consulting-new-framework.pdf>>

and thus make well informed decisions. The resultant proposal was to replace the existing Business Review and Directors' Report with a Strategic Report and an Annual Directors' Statement. The Strategic Report is anticipated to result in a more streamlined approach to reporting, providing a concise description of the company's strategy, risks, and business model. It is also intended to demonstrate how the board integrates long-term issues and risks, including those relating to environmental, social and human rights issues.³⁶⁸ The accompanying Annual Directors' Statement will provide the framework for more detailed narrative disclosures, enabling this to be displayed in a more structured way.³⁶⁹

The principle objective of the proposed reporting framework is to introduce a prescribed structure and consistent layout, in order to increase comparability between reports. It is also anticipated that this will serve as a helpful checklist of required disclosures for companies, thus reducing instances of non-compliance and avoiding selective reporting³⁷⁰ As a result, this framework also aims to provide companies with the opportunity to demonstrate, at the highest level, how environmental and social issues are integrated into their strategy and business model, in order to promote the generation of long-term sustainable value.³⁷¹

Following on from this proposed framework, a further element considered to be crucial for the new structure of reporting is that of effective guidance and/or enforcement. This is an area where many commentators feel that the Companies Act 2006 reporting provisions are currently lacking,³⁷² albeit recognising that there is a fine line to be drawn to ensure that this guidance is not unduly detailed so as to reduce flexibility and encourage boiler plate reporting.³⁷³ A large majority of consultees were opposed to this guidance being mandatory, for example, the Institute of Directors (IOD) was opposed to mandatory regulation for narrative reporting, citing reasons such as compliance costs, self-regulation and lack of added value, preferring alternative methods of improving reporting such as

³⁶⁸ *Ibid*, at para 3.16.

³⁶⁹ *Ibid*, at para 3.3.

³⁷⁰ *Ibid*, at para 1.5.

³⁷¹ *Ibid*, at para 3.17.

³⁷² See above at n.363.

³⁷³ *Ibid*, pg 20.

executive training.³⁷⁴ Equally, there were concerns that mandatory regulation would result in precisely the type of box-ticking exercise that narrative reporting was intended to rectify. Instead, many supported the use of high-level, principles-based guidance, such as best practise and case studies.

The governmental response thus far has been supportive of guidance generally which, it has been emphasised, is to be aimed at assisting companies in preparing reports, as opposed to creating more material for them to wade through and comply with. In terms of whether this guidance will be mandatory, and whether an enforcement body will be utilised, the response was rather vague and non-committal (notwithstanding the proposed reporting framework) suggesting that no clear policy was yet to be established on this issue. Interestingly, within the 2011 consultation paper, the Government proposed to enhance the public profile of the FRRP, with the express objective of ensuring that stakeholders were clear that their remit extends beyond financial reporting.³⁷⁵ Notably however, there was no consensus among consultees towards the reforming of the FRRP, thus the somewhat lukewarm response of potentially publicising the role of the FRRP more widely, pending the reform of the Financial Reporting Council (FRC).³⁷⁶

A further proposed amendment was the greater assurance of non-financial information, to ensure that stakeholders have the confidence to rely on the information provided as both accurate and complete. Whilst there were conflicting views from consultees over whether current standards of audit and assurance were adequate, the governmental response was that once the role of the Strategic Report and Annual Directors' Statement were clear, then the levels of assurance would follow as a result.³⁷⁷ By implication, presumably this means that either the current reporting provisions are not considered to be clear or the current audit/assurance standards are not fit for purpose.

³⁷⁴ ; DTI Invitation for Comments on the Business Review & DTI Consultation on Narrative Reporting Requirements for Companies, 24 March 2006, [accessed 13/05/12], available <http://www.iod.com/MainWebSite/Resources/Document/policy_consultation_business_review.pdf>

³⁷⁵ See above at n.367, para 8.6

³⁷⁶ BIS: The Future of Narrative Reporting –The Government Response, Mar 2012, [accessed 28/05/12], available at <<http://www.bis.gov.uk/assets/biscore/business-law/docs/f/12-588-future-of-narrative-reporting-government-response.pdf>>

³⁷⁷ *Ibid.*

The Regulatory Debate

Despite extensive consultation with a wide range of stakeholder groups,³⁷⁸ there has been no clear consensus regarding the proposed amendments to the current reporting framework. Unsurprisingly, many respondents were in favour of simplification, however, even those supportive of the new regime expressed doubts over the Government's ability to deliver the proposed changes.³⁷⁹

A consideration of the consultation responses revealed that a high proportion of concerns dealt with issues at the heart of the regulatory debate. For example, some consultees expressed the need to ensure that the new reporting provisions conveyed a clear understanding of the objective of narrative reporting; in other words, the focus should not only be on what was to be written within the report, but also why those things that were reported were indeed reported upon. Whilst this would have the obvious benefit of providing greater levels of transparency, it may be that this proposal is inconsistent with the concept underpinning the 2006 Act. This position is now examined below.

The need to address the social implications of companies, and to provide greater public accountability, was an express objective of the Companies Act 2006, as noted in the white paper preceding it.³⁸⁰ In spite of this, it has been argued that in the absence of a legitimate foundation to require companies to demonstrate socially responsible behaviour,³⁸¹ mandatory narrative reporting becomes the ideal regulatory tool.³⁸² The reputational risks associated with not adopting sustainable business practices are considered to act as the missing link between the interests of shareholders and other interest groups. Thus, introducing mandatory reporting provides policy makers with the opportunity to

³⁷⁸ Including business representative organisations, investors/investment managers, investor representative organisations, lawyers/accountants, NGOs, consultants, private individuals, companies and trade unions.

³⁷⁹ The issues raised included duplication between reports, ensuring that the Strategic Report does not become diluted by additional requirements and maintaining a flexible boundary between the two reports.

³⁸⁰ See Chapter 3.

³⁸¹ Notwithstanding theories based on the premise of businesses having a social contract with society, as explored in Chapter 1.

³⁸² Sanabria, F., CSR and CSR Reporting: Reporting as a Way to Create Socially Responsible Business, *e-mercatoria*, vol.10(2), Jul-Dec 2011, [accessed 04/06/12], available at <<http://ssrn.com/abstract=1987193>>

demonstrate their engagement on social and environmental issues, without imposing a substantive mandate on private enterprises.³⁸³ However, the absence of a clear policy decision is also one of the disadvantages of utilising reporting as a regulatory tool. It is contended that this results in policy makers' failure to engage with pertinent issues that are reported upon, leaving this data to be unsystematically digested by the market.³⁸⁴ Arguably, it seems that this may be the case for the Companies Act 2006, with both companies and stakeholders calling for increased clarity and simplified reporting.

This leads us to the other prevalent issue central to the regulatory debate; whether the requirement to report *in line with a prescribed framework* ought to be mandatory. A number of consultees considered it unnecessary to amend the existing reporting framework, suggesting that 'clutter' could be reduced simply by improving the guidance as opposed to introducing a prescribed format. For example, companies should be encouraged to ensure a better connection between financial and non-financial reporting, with some commentators supporting the involvement of the International Integrated Reporting Committee to create a universally accepted framework within which to report on financial, environmental and social information, whilst still maintaining the existing Business Review format.³⁸⁵

As yet, notwithstanding the proposed implementation of the Strategic Report and Annual Directors' Statement, little more information regarding their anticipated format and, significantly, whether this will be mandatory, has been provided. It is questionable however, whether simply requiring a different style of reporting will be sufficient to create socially responsible business. It has been argued that the absence of a unified reporting standard, in conjunction with the lack of any clear policy objective as to companies' social responsibilities, has resulted in a general distrust of non-financial disclosure.³⁸⁶ If this is correct, it is unlikely to be automatically resolved by the introduction of a new reporting framework.

³⁸³ *Ibid*, at page 13.

³⁸⁴ *Ibid*, at page 13.

³⁸⁵ See above at n.376, para 48.

³⁸⁶ See above at n.382, pg 31.

Ultimately, it would appear as though the aim of the recent Government proposals is to maintain the levels of flexibility and individuality currently afforded to companies to allow them to ‘tell their own story’, yet address the lack of comparability and complexity of disclosure by bolstering the reporting requirement with increased guidance and standard formatting. Inevitably, there will be a fine balance to be drawn for optimal disclosure to be achieved. The introduction of *mandatory* standardised reporting guidelines may assist in alleviating concerns over the quality of the disclosure produced, as companies are prevented from reporting strategically to avoid less positive disclosure. This, in turn, is anticipated to lead to greater stakeholder dialogue, as well as forcing companies to confront the reality of their performance.³⁸⁷ One of the most significant challenges likely to be faced is determining the content of the standardised indicators, which will be used to prompt meaningful disclosure from a range of companies without producing a compliance-only response. It has been submitted that it may be too early to accurately determine these indicators, given the relatively early stages of mandatory social reporting. However, the system need not be static, and can develop over time to produce improved results:

“Most successful transparency-based regulatory programs in the United States (including financial reporting) started out far from perfect and instead were the result of political compromise. Those programs improved over time, however, because they provided benefits to users (and some disclosers) who then pushed for improvements.”³⁸⁸

The idea is that solutions developed through self-regulatory experimentation are provisional, and can adapt in accordance with changing circumstances or societal expectations.³⁸⁹ Analogy has been drawn in this regard to the principle of ‘rolling best practice rules’ in an administrative law context, whereby regulated entities demonstrate that certain performance goals are attainable, thus establishing those goals as acceptable minimum standards for other.³⁹⁰

³⁸⁷ Hess, D, The Three Pillars of Corporate Social Reporting as New Governance Regulation: Disclosure, Dialogue and Development, Ross School of Business Working Paper, No. 1112, July 2008, [accessed 21/06/12], available at <<http://ssrn.com/abstract=1176882>>

³⁸⁸ *Ibid*, p.49.

³⁸⁹ *Ibid*, p.11.

³⁹⁰ Dorf, M & Sabel, C., A Constitution of Democratic Experimentalism, *Columbia Law Review*, **1998**, **98**, **267**.

In the interim, clarification is awaited as to the Government's firm proposals for amending the existing reporting provisions. However, the assumption is that the framework will be mandatory as, in the alternative, it is difficult to see how the substantive disclosure will differ from that currently being achieved under the Act, meaning the current criticisms over the disclosure being produced are likely to remain.

Conclusions

Corporate Social Responsibility and Sustainable Development have been increasingly central themes in development policy over recent years. The express inclusion of environmental and community impact, as well as relationships with employees and other stakeholders, as part of company directors' statutory duty reflects recent trends in the corporate world and public policy generally.

Previous attempts to regulate corporate non-financial behaviour have proved ineffective for a number of reasons. Direct regulation was often indiscriminate in its application regardless of the diverse nature of business models and was only able to secure, at best, compliance behaviour. There was little incentive therefore for companies to seek to improve their behaviour beyond this minimum level. Whilst responsible corporate behaviour was initially largely reliant upon volunteerism, the re-structuring of the regulatory framework, as demonstrated by the Companies Act 2006, has provided firms with the tools required to self regulate within a broad regulatory framework, in response to complex social and environmental issues. In particular, the introduction of mandatory disclosure provisions was anticipated to facilitate firms' internal reflection of their own operating practices, thus encouraging creative and critical thought processes to effect improved behaviour without the need for direct legal intervention. The premise is that the value of the report produced lies not only with the increased social transparency gained, but also in the institutionalisation of creative problem-solving thought within the firm. In theory this is not a bad starting point. However, to date, it does not appear to have worked particularly well in practice.

There are a number of conclusions to be drawn from this study that may go some way towards explaining some of the apparent shortcomings of the current reporting requirements. Firstly, the lack of guidance and/or a reporting framework means that, if so inclined, firms are able to adopt strategic disclosure in order to avoid drawing attention to less favourable conduct. This superficial approach was evident from the data review, with some firms contributing in a minimalistic way as opposed to providing meaningful disclosure. On a micro level, this has the effect of preventing stakeholder transparency, thus curtailing the principle of enlightened shareholder value upon which the Companies Act 2006 was based. Further, on a macro level, a wider culture is created whereby firms do not take their social responsibilities seriously, viewing them as merely vague, voluntary concerns or the opportunity for positive PR.

The Government has identified the above inadequacies of the current reporting requirements and, following extensive consultation with key stakeholder constituents, has made various proposals to improve the quality of corporate narrative reporting. The predominant aim is to increase the standardisation of reports, which is likely to be achieved through the introduction of mandatory guidelines. However, given the relative infancy of these proposals and the lack, as yet, of any specific provisions, it is anticipated that it may well be some time before any changes are evident on an industry wide level.

Notwithstanding the proposed improvements to the current reporting provisions, a more fundamental argument exists that in light of recent years of environmental degradation and the primacy of the need to address climate change, a voluntary or ‘soft-law’ approach may not be sufficient.³⁹¹ This issue goes to the heart of the Companies Act, in particular the delineation of Directors’ duties under s.172. Not only is there no substantive duty on directors to *act* with regard to social/environmental issues, but there also appears to be limited means to challenge the wide discretion afforded to them. Whilst it is necessary for the company board to have the freedom to make potentially difficult decisions regarding the daily affairs of the company, there is no framework in place to ensure that directors are held accountable for their decision making process.

The effective and appropriate balance between regulation and self-regulation was the subject of debate up until the final stages of the Companies bill's passage through the House of Lords, with concerns expressed that there was 'no substitute' for a well informed regulator. Six years on and the Government's latest proposals, whilst recognising that the existing degree of regulation is not working, have yet to reach a definitive answer on this issue.

Ultimately, the process by which relevant information is transferred to the market is an invaluable tool. However, it is evident that the issue is more complex than simply requiring a report and letting the market decide what it does with that information. If we are to reach higher standards of corporate behaviour, regulators can no longer continue to be 'bystanders'.³⁹² This notwithstanding, it remains important from an ecological modernisation perspective to continue to de-emphasise government imposed prescriptive rules, in favour of governance-based reflexive mechanisms, to ensure that innovation is market driven where possible.

A potential solution would be to introduce a more pluralistic approach, to ensure that regulatory responses are aligned with firms' receptive capacities. Interestingly, despite this study focusing on large, highly-resourceful and highly-visible firms, i.e. precisely the type expected to produce the greatest response to self-regulatory/reflexive mechanisms, the lack of meaningful disclosure suggests that perhaps a more creative regulatory approach is necessary. In accordance with the theory of receptive capacity, the introduction of regulation considered favourable to ecological modernisation (such as reflexive styles of regulation) does not mean that ecological modernisation will necessarily be induced in all contexts. Thus, only by tailoring the regulatory response in line with firms receptive capacities, utilising a range of regulatory tools (including direct regulation where appropriate), can we strive for truly responsive regulation. The challenge will be for policymakers to determine how to effectively integrate governance-based approaches with more conventional forms of direct regulation, rather than simply replacing one with the

³⁹² See Sanabria, above at n.382.

other. In the absence of regulatory pluralism, it is difficult to see how real inroads can be made into improving corporate behaviour in line with shifting perspectives.

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APPENDIX 1

		Pages per Annual Report	CR data	Separate CR disclosure	2006 Act acknowledged	Identifiable Business Review
2005 Reports	BAE Systems	172	Quantitative/Qualitative	CR Report/external source	N/A	N/A
	HSBC	146	Identified	None	N/A	N/A
	Tesco	68	Quantitative/Qualitative	CR Report/external source	N/A	N/A
	Barclays	320	Qualitative*	CR Report	N/A	N/A
	Vodafone	156	Quantitative/Qualitative	CR Report/external source	N/A	N/A
	GlaxoSmithKline	192	Quantitative/Qualitative	CR Report/external source	N/A	N/A
	BP	180	Quantitative/Qualitative	CR Report	N/A	N/A
	National Grid	28	Qualitative	None	N/A	N/A
	M&S	61	Quantitative/Qualitative	CR Report	N/A	N/A
	British Telecom	144	Quantitative/Qualitative	CR Report**	N/A	N/A
2010 Reports	BAE Systems	198	Quantitative/Qualitative	External source	No	Yes
	HSBC	199	Qualitative	CR Report	No	No
	Tesco	136	Quantitative/Qualitative	External source	No	Yes
	Barclays	288	Qualitative	CR Report	Yes	Yes
	Vodafone	148	Quantitative/Qualitative	CR Report/external source	No	No
	GlaxoSmithKline	216	Quantitative/Qualitative	CR Report/external source	No	Yes
	BP	272	Quantitative/Qualitative	CR Report***	No	No
	National Grid	195	Quantitative/Qualitative	External source	No	No
	M&S	120	Qualitative	CR Report/external source	No	Yes
	British Telecom	175	Quantitative/Qualitative	CR Report	No	No

* Annual Report only as Barclays CSR Report was not available

** Not available for review

*** Albeit BP had separate disclosure specifically dealing with the Gulf of Mexico oil spill (link to website)

APPENDIX 2

		Environmental	Community	Employee (diversity)	Employee(health & safety)	Other
2005 Reports	BAE Systems	Both	Both	Both	Both	Ethics, political
	HSBC	None	None	None	Identified	N/A
	Tesco	Both	Qualitative	Both	Qualitative	N/A
	Barclays	Identified	Qualitative	Qualitative	Identified	N/A
	Vodafone	Both	Both	Both	Both	N/A
	GlaxoSmithKline	Both	Both	Both	Both	Ethics, political
	BP	Both	Qualitative	Both	Both	N/A
	National Grid	Qualitative	None	Identified	Qualitative	N/A
	M&S	Both	Qualitative	Both	Qualitative	Ethics
	British Telecom	Both	Qualitative	Qualitative	Qualitative	N/A
2010 Reports	BAE Systems	Both	Both	Both	Both	N/A
	HSBC	Identified	Qualitative	Qualitative	Identified	N/A
	Tesco	Both	Qualitative	Identified	Identified	N/A
	Barclays	Both	Qualitative	Both	Qualitative	N/A
	Vodafone	Both	Qualitative	Both	Qualitative	N/A
	GlaxoSmithKline	Both	Both	Identified	Identified	N/A
	BP	Both	Qualitative	Both	Both	N/A
	National Grid	Both	Qualitative	Both	Both	N/A
	M&S	Qualitative	Qualitative	Identified	None	N/A
	British Telecom	Both	Both	Both	Both	N/A