8 July 2011

Our ref: ICAEW Rep 69/11

Carla Hopkins
Defra
Area 5C
Ergon House
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Dear Ms Hopkins

MEASURING AND REPORTING OF GREENHOUSE GAS EMISSIONS BY UK COMPANIES

ICAEW is pleased to respond to your request for comments on the Measuring and reporting of greenhouse gas emissions by UK companies: a consultation on options.

Please contact me should you wish to discuss any of the points raised in the attached response.

Yours sincerely

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ICAEW REP 69/11

ICAEW REPRESENTATION

MEASURING AND REPORTING OF GREENHOUSE GAS EMISSIONS BY UK COMPANIES: A CONSULTATION ON OPTIONS

Memorandum of comment submitted in July 2011 by ICAEW, in response to the consultation paper 'Measuring and reporting of greenhouse gas emissions by UK companies: a consultation on options'

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INTRODUCTION

1. ICAEW welcomes the opportunity to comment on the consultation paper *Measuring and reporting of greenhouse gas emissions by UK companies: a consultation on options*, published by DEFRA. We have set out below our major comments on the proposals, and have then answered the questions set out on pages 22 and 23 of the consultation paper. We have not at this stage responded to the supplementary questions in Annex A on costs and benefits, which are mainly directed at companies and investors.

WHO WE ARE

2. ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter which obliges us to work in the public interest. ICAEW's regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council. We provide leadership and practical support to over 136,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.

3. ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.

MAJOR POINTS

Support for the initiative

4. The objective of improving the disclosure of greenhouse gas (GHG) emissions as a contribution to efforts to mitigate the effects of climate change is a laudable one, and we strongly support efforts to investigate ways of bringing about positive change through this and other policy initiatives.

5. In principle, we believe that much can be achieved through better disclosure of GHG emissions, particularly by major companies and other organisations identified as high emitters. However, the challenge is to ensure that the information is credible and relevant and – moreover – that the costs and benefits of providing it are understood and proportionate. Ideally, the UK would participate in a single global initiative to develop meaningful reporting in this area, along the lines perhaps of the initiative for integrated reporting. However, we recognise that this may take time and that there is a strong case for the UK assuming a leadership role in this area.

The purpose of the annual report and financial statements

6. It is important in this endeavour for DEFRA to take stock of the financial reporting environment when determining the optimal mechanism and media for disclosure. It has always been tempting to use the annual report as a vehicle for disclosures driven by public policy imperatives; it is a straightforward way of implementing new requirements and ensuring that interested parties can access the information at low cost through Companies House. But this practice can be inconsistent with the fundamental objective of financial reporting, which is predominantly to serve the interest of investors. Representatives of business, investor, regulatory and corporate governance organisations attending the public roundtables held globally by the IFRS Foundation during June 2011 to discuss the future strategy of the Foundation voiced very strong support for a clear focus in financial reporting on investors' current information requirements, as opposed in particular to public policy or regulatory concerns. The debate at the international roundtables mirrored the

increasing focus in the UK on the need to avoid 'clutter' in annual reports and financial statements produced primarily for investors, led by the Financial Reporting Council, which can obfuscate more relevant information through attempts to meet the many disparate and potentially-conflicting information needs of other users groups.

7. We expect these concerns to be reflected in the forthcoming BIS proposals on improving narrative reporting by UK companies. In our October 2010 submission to BIS on the consultation paper, *The Future of Narrative Reporting*, we expressed concern that some of the non-financial information included in the annual report reduces its clarity and quite often deprives that information of the focus and attention it deserves. We supported the introduction of a separate report to act as a repository for additional disclosures desirable for public policy reasons but not necessarily appropriate for inclusion in an annual report produced primarily to meet the needs of shareholders, as is currently required by UK law. Thus, regardless of whether reporting is made mandatory or remains voluntary, we believe strongly that it should not involve widening the scope of information to be included in the annual report, which is only one means by which companies communicate with investors and others interested in their activities.

8. It is important here to recall that UK law already requires, in effect, information on GHG emissions to be disclosed if it is clearly relevant to shareholders in the context of the Business Review as required by Section 417 of the Companies Act 2006. These provisions are clearly directed to the purpose of the annual report, and are proportionate and sufficient. If there is credible evidence of a failure to apply the law appropriately, regulatory action can and should be taken. Effective carbon management will be increasingly important to business, and directly linked to the financial health of many organisations, and thus we would expect and encourage the trend for improved Business Review disclosures in this area to continue.

9. Our concern about mandating new disclosures in the annual report does not mean that we would necessarily oppose new mandatory reporting *per se* of GHG emissions, as we discuss below. Given the possible threats from climate change, there is a legitimate public interest in having comparable information about the GHG emissions of relevant organisations. However, given the ubiquity of electronic communication in business today, it is now feasible for a separate document, easily-identifiable and presented with equal prominence to the annual report to be published on company websites. After all, all quoted companies are now required by law to maintain a website and the quality of reporting practices is steadily improving. Other or supplementary means of effective communication may also be valid, and whatever decision is taken in this regard, eliminating the assumption that disclosure in the annual report is the best and only way forward for new GHG disclosures would bring a number of potential benefits. For example:

   - There would be more flexibility, either for companies (if disclosures are voluntary) or for regulators (if they are mandated), in determining the level of detail of GHG emissions reporting;
   - Separate reporting can, potentially, deal with many of the difficulties of fitting the GHG reporting process around the financial cycle;
   - It would, as indicated above, be easier to experiment with different channels of communication;
   - The focus within the reporting company is less likely to be compliance with the regulations, rather than investigating ways to communicate more effectively in a relatively new and challenging area of reporting;
   - There may be less scope to hide important information behind irrelevant data; and

- The existing form of audit opinion/ report would not unduly restrict the assurance conclusion/report on a GHG emissions report, allowing more suitable models of assurance to be established over time outside of the remit of the financial audit.

We recognise that the current debate on ‘integrated reporting’ may in due course have an impact on this thinking. However, our assumption at this time is that more detailed information than would be included in a concise integrated report would be available to those interested in financial performance, environmental impacts and other aspects of corporate activity, and that disclosure of various types of information on company websites is likely to be a major and enduring feature of any new reporting regime.

Voluntary or mandatory?

10. We strongly support continued efforts to encourage high quality voluntary reporting. Much has been achieved in recent years, and the scope for improving the extent and quality of voluntary disclosure has by no means been exhausted. We would therefore welcome redoubled efforts to raise awareness of the benefits of reporting, especially in emissions-intensive sectors, and to encourage good practice through, for example, the Carbon Disclosure Project, sector-specific voluntary agreements and perhaps in due course some clear and succinct guidelines for UK companies that draw on established codes such as the GHG Protocol, CDSB and GRI. We would also encourage investor associations to raise the profile of this information and the importance of it for investment decisions, and companies to continue to improve their reporting both for internal use and for selective voluntary disclosure. This is an endeavour that affects us all, and we should not look solely to the Government to encourage and foster improved reporting.

11. We recognise, however, that there could be a case for supporting some form of mandatory framework, especially if voluntary reporting arrangements are agreed to have failed. Although the notion that ‘what gets reported gets managed’ is open to question, we accept that wider and more consistent reporting of GHG emissions may prove beneficial to those seeking to create a low-carbon economy and may help to focus attention at a senior management level within some companies on carbon emissions and potential exposure to climate change risks. However, this is a relatively new area of reporting and a high degree of prescription brings with it a risk of stifling innovation by the not insignificant number of companies already disclosing useful, high quality information on GHG emissions. It may also impose unnecessary reporting requirements on companies in sectors that are not emissions-intensive, and it may, moreover, simply serve to add to what is already conceived to be a crowded and complex climate change regulatory framework at a time when the Government is, quite correctly, focusing on removing unnecessary regulatory burdens on business.

12. We therefore suggest that DEFRA aims for an evolutionary, manageable and well-understood process of change. If there is strong support from constituents for mandatory reporting, this should apply for at least a transitional period only to companies that are participants in the Carbon Reduction Commitment Energy Efficiency Scheme (CRC) or the EU Emissions Trading Scheme (ETS) , and hence able to implement the additional reporting requirements without undue cost or effort. We would encourage DEFRA to investigate whether those new disclosure requirements for which there is wide support from commentators should be written into the CRC regime and the reported information made publicly available through the current designated channels for the CRC league table. This would contribute to the rationalisation of the regulatory regime in this area and should improve consistency of reporting by a significant population of high emitters and, in some cases, the quality of their disclosures. It might also provide a model which could be extended to some other organisations as good practice evolves in the UK,

sector guidance is developed, and evidence becomes available on the benefits of the new requirements. At that stage DEFRA should consult again on whether there is a case for widening the scope of mandatory reporting beyond CRC/ETS participants, taking account of any relevant international developments. However, we do not anticipate at this stage that the regime would be extended in due course to embrace all quoted companies or private companies that are not CRC/ETS participants or participating in another mandatory emission reporting scheme. Such companies are likely to find a new requirement to report greenhouse gas emissions particularly onerous and, if disclosure was required in the annual report, we would question whether there would be any significant benefit for their shareholders.

13. Any decision to mandate disclosure of GHG emissions by companies outside of the CRC/ETS, now or in the future, should recognise the challenges and uncertainties involved for the reporting entities newly drawn into the regulatory regime. The period between announcement of new requirements and implementation should be sufficient to allow a smooth transition with the costs and efforts for business kept to a minimum. During that period DEFRA should be very active in seeking to raise awareness of the requirements and encouraging the development of high quality guidance and the sharing of experience and good practice within key industry sectors. In so doing DEFRA should bear in mind the trade-off between the need for flexibility at this stage in the development of GHG reporting, and the important objective of enhanced comparability. For the time being, some degree of flexibility is essential, although we anticipate that market pressure will result in a steady improvement in comparability as good practice evolves.

RESPONSES TO DEFRA QUESTIONS

Question 1.

Do you support Option 1(enhanced voluntary reporting)?

14. Yes, as explained in paragraph 10 above, we strongly support continued efforts to encourage high quality voluntary reporting. Much has been achieved in recent years, and the scope for improving the extent and quality of voluntary disclosure has by no means been exhausted.

Question 2.

There are various ideas (outlined in Option 1) for increasing the number of companies reporting on a non-regulatory basis, which do you prefer? Have you any other proposals to increase the number of companies reporting and the quality and consistency of reports on a non-regulatory basis?

15. As explained in paragraph 10 above, we would welcome redoubled efforts to raise awareness of the benefits of reporting, especially in emissions-intensive sectors, and to encourage good practice through, for example, the Carbon Disclosure Project, sector-specific voluntary agreements and perhaps in due course some clear and succinct guidelines for UK companies that draw on established codes such as the GHG Protocol, CDSB and GRI.

16. We would also encourage investor associations to raise the profile of this information and the importance of it for investment decisions, and companies to continue to improve their reporting both for internal use and for selective voluntary disclosure. This is an endeavour that affects us all, and we should not look solely to the Government to encourage and foster improved reporting.

Question 3.

Should corporate reporting of GHG emissions be made mandatory for some companies? If so, please explain.

17. As explained in paragraphs 11-12 above we recognise that there could be a case for supporting some form of mandatory framework, especially if voluntary reporting arrangements are agreed to have failed. Although the notion that 'what gets reported gets managed' is open to question, we accept that wider and more consistent reporting of GHG emissions may prove beneficial to those seeking to create a low-carbon economy and may help to focus attention at a senior management level within some companies on carbon emissions and potential exposure to climate change risks.

18. This is, however, a relatively new area of reporting and a high degree of prescription brings with it a risk of stifling innovation by the not insignificant number of companies already disclosing useful, high quality information on GHG emissions. It may also impose unnecessary reporting requirements on companies in sectors that are not emissions-intensive, and it may, moreover, simply serve to add to what is already conceived to be a crowded and complex climate change regulatory framework at a time when the Government is, quite correctly, focusing on removing unnecessary regulatory burdens on business. We therefore suggest that DEFRA aims for an evolutionary, manageable and well-understood process of change.

19. We would reiterate that we do not support the use of the annual report in this context.

Question 4.

If mandatory reporting is introduced, which would be your preferred Option: 2, 3 or 4? It would be helpful if you could explain your reason. Have you any suggestions for improving any of the regulatory options?

20. As discussed above in paragraph 12, if there is strong support from constituents for mandatory reporting, this should apply for at least a transitional period only to companies that are participants in the Carbon Reduction Commitment Energy Efficiency Scheme (CRC) or the EU Emissions Trading Scheme (ETS), and hence able to implement the additional reporting requirements without undue cost or effort.

21. We would encourage DEFRA to investigate whether those new disclosure requirements for which there is wide support from commentators should be written into the CRC regime and the reported information made publicly available through the current designated channels for the CRC league table. This would contribute to the rationalisation of the regulatory regime in this area and should improve consistency of reporting by a significant population of high emitters and, in some cases, the quality of their disclosures. It might also provide a model which could be extended to some other organisations as good practice evolves in the UK, sector guidance is developed, and evidence becomes available on the benefits of the new requirements. At that stage DEFRA should consult again on whether there is a case for widening the scope of mandatory reporting beyond CRC/ETS participants, taking account of any relevant international developments. However, we do not anticipate at this stage that the regime would be extended in due course to embrace all quoted companies or private companies that are not CRC/ETS participants or participating in another mandatory emission reporting scheme. Such companies are likely to find a new requirement to report greenhouse gas emissions particularly onerous and, if disclosure was required in the annual report, we would question whether there would be any significant benefit for their shareholders.

Question 5.

Do you have any comments on the economic analysis in the impact assessment? In particular, do you think the costs and benefits for the different options are reasonable? Can you provide any further information which would help in estimating costs and benefits for the different options?

22. We welcome the attempt to assess the impact of the proposals, but note the very significant challenges involved in estimating costs. Many relevant factors may be intangible, many more difficult to quantify, and even where quantification can be attempted the result may be subject to such a degree of inaccuracy as to be potentially misleading. We therefore caution that extrapolating the cost over the population of reporters will be prone to significant error. Further qualitative analysis may be necessary in this area.

Question 6.

Do you agree that a company should specify which approach it is using to set its organisational boundary?

23. In principle we would prefer use of the financial control model to determine the boundary for GHG reports, perhaps subject on pragmatic grounds to an 'undue cost or effort' exemption where it is impractical or impossible to obtain any or some of the required data, generally from overseas operations. The financial control model is well-understood by directors and would provide an improved level of consistency and certainty regarding the reported numbers. .

24. We recognise, however, that if the new reporting regime is mandatory and applies to CRC participants, it would make sense to use the same organisational boundaries as are required under the CRC. We understand that the Government is currently consulting on simplifications to the organisational rules under the CRC and that a reporting model is sought where the organisational boundaries are as far as possible aligned with those in the consolidated group accounts. We encourage the Government to set out a clear rationale for differences between the GHG reporting boundaries and the boundaries for financial reporting purposes.

Question 7.

Do you agree that a company should (where possible), report on all their emissions within the chosen organisational boundary, including those that occur in their operations overseas? If you don't agree, can you explain which emissions you think a company should report?

25. In principle, we agree that companies should report all Scope 1 and Scope 2 emissions within the selected organisational boundary in and outside the UK. However, it may be impractical or impossible to obtain some of the required data. For example, different emission factors are used in some overseas jurisdictions, and to restate the data of overseas operations in line with UK emissions factors could involve disproportionate cost or effort. In such circumstances the company should explain the significance of the operations excluded and why the information has not been disclosed.

26. We recognise in this context that the CRC at present has some exceptions relating to Scope 2 emissions and also excludes emissions already covered by the ETS and other Climate Change Agreements. We have recommended above that DEFRA investigate whether any new disclosure requirements should be written into the CRC regime, and would also suggest that every effort be made to simplify and rationalise the current reporting complex reporting requirements at the same time.

Question 8.

Do you agree that, if it isn't possible for a company to report on all emissions within their organisational boundary (because of data problems, etc), then a company should clearly state the extent to which it has been able to report?

27. Yes, as explained above in paragraph 25.

Question 9.

Do you agree that companies should be required to measure and calculate emissions from the six GHGs covered by the Kyoto Protocol?

28. Ideally, disclosure of all six GHGs would be required. However, the quality of any mandatory disclosures should be paramount, and in view of current concerns about the reliability of some reported data and excessive regulation, DEFRA might consider at least in an initial phase mandating disclosure of fewer GHGs, perhaps just carbon emissions. In any case, disclosure should only be required where each GHG is individually material.

Question 10.

Do you agree that companies should be required to measure, or calculate, and report on all their scope 1 and scope 2 emissions? If not, which emissions do you think a company should measure, calculate and report and why?

29. Yes, subject to our comment above. DEFRA might also consider whether it may be possible to have a simplified reporting requirement combining Scope 1 and Scope 2 emissions.

Question 11.

Do you think that companies should be required to measure and report on any of their scope 3 emissions (in addition to scope 1 and 2)? If so, can you specify which ones you think should be required?

30. Any regulatory approach should at present only mandate the reporting of Scope 1 and 2. Scope 3 reporting is at a very early stage and far more research and experience is needed before it would be practical for businesses to report most Scope 3 emissions with any degree of reliability. We note however that a number of organisations are starting to include business travel (by staff or others in a similar capacity, and where the costs are borne by the company and thus available in the accounting system), and would encourage the continued development of the emerging good practice in this area.

Question 12.

Do you agree that companies should specify in their directors' reports, the company's total annual amount of GHG emissions in CO_2e broken down by direct emissions (scope 1) and indirect energy (scope 2)?

31. We agree in principle with the approach, but not with disclosure in the directors' report. As discussed above, we would encourage DEFRA to investigate whether whatever new disclosure requirements are agreed should be written into the CRC regime.

Question 13.

Do you agree that companies should specify an intensity ratio?

32. Yes, we support the use of intensity ratios to provide greater comparability between businesses and reporting periods and to place the pure emission data in context. But we would caution against mandating what intensity ratios should be used. It should be left to industry practice to develop appropriate measures, although some high level guidance might be helpful to companies considering this issue for the first time.

Question 14.

Should companies specify a base year when they report their annual emissions?

33. Yes, we agree that companies should establish a base year when first reporting emissions, but we do not think it necessary to prescribe the base year in any new mandatory reporting framework.

Question 15.

Is there any other information which you think a company should report?

34. It will be important for companies to provide meaningful comparative information and also sufficient narrative to place their emissions disclosure in context. Narrative explanations might include how carbon emissions are managed, how the reported data is used to reduce emissions and movements between different periods.

Question 16.

If reporting is made mandatory, should companies be obliged to seek some kind of assurance or verification on their emission report? If not, could you explain your thinking?

35. In principle, we believe that the success of any mandatory disclosure regime will depend crucially on requirements for some form of external assurance. If the GHG emissions are reported outside of the annual report and accounts, as we suggest above, one advantage would be that the existing form of audit opinion/ report would not unduly restrict any external assurance conclusion/report on the GHG emissions report, allowing more suitable models of assurance to be established outside of the remit of the financial audit.

36. We do not think that new requirements for internal verification would improve the quality of reporting.

Question 17.

Is internal verification of greenhouse gas emissions sufficient, or should external third party assurance be sought? If the latter, should it be limited or reasonable?

37. Separate reporting, as we suggest above, would deal with many of the difficulties of fitting the GHG reporting process around the financial cycle, including the time required for external assurance of GHG emissions data. Were the information to remain in the directors' report, it would be subject to the current requirements for the auditors to review whether it is consistent with the audited financial statements.

38. We note that the International Auditing and Assurance Standards Board is currently considering a new assurance standard on GHG emission statements, having just concluded its public consultations on the proposals. Again, DEFRA should be cognisant of how this initiative develops.

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