



Briefing Highlights:

- **New law in US pushing internal control and compliance costs significantly higher**
- **Non-US companies investigating whether to delist to avoid higher compliance costs**
- **Delisting from a US stock exchange alone, does not release a company from its Sarbanes-Oxley obligations**
- **Draft OFR guidelines expected in March 2004 in UK**
- **Polluter Pays Principle to be enshrined in EU law by May 2004**
- **Companies facing increased burden of reporting, company directors carry personal liability**

Company directors are facing an ever-increasing burden of environmental reporting, stemming in part from a wider legislative focus on improving corporate governance standards.

UK: The **Operating and Financial Review (OFR)**, for which the DTI will publish draft regulation within the next three weeks, is likely to require companies to provide information in their annual report on environmental issues that may materially affect their business.

Europe: The **EU Environmental Liability Directive**, the first European legislation to enshrine the 'polluter pays principle' into law, is expected to be ratified by mid-April 2004.

The **EU Directive 2001/42**, known as the Strategic Environmental Assessment (SEA) Directive, applies to projects and plans that are 'likely to have a significant effect on the environment.' The Directive relates to all projects, both public and private sector, planned from 21st July 2004.

US: The **Sarbanes-Oxley Act 2002** is already having a significant impact on the content and level of company reporting (with concomitant increase in internal control costs and external audit costs as much as 38% higher¹). Many European companies with US listings, or SEC registered companies, are considering the implications of delisting, and de-registering their shares under the US Securities Exchange Act 1934.

All these initiatives will result in improved data that fund managers can incorporate into their investment analysis and decisions.

As noted by various US State pension fiduciaries in a 10 point plan entitled *Investor Call for Action on Climate Risk*,ⁱⁱ and suggested by the Association of British Insurers (ABI) in the UK, such information needs to be incorporated in a financial context for it to have relevance in mainstream corporate analysis.

In the UK, the OFR Working Group has outlined its recommendations on what information should be included in companies' OFRs, and has highlighted the implications for companies' annual reports and accounts and the future of standard company disclosure. The Group anticipates the final regulation will be published in Autumn 2004, for introduction from 2005-2006.

Rosemary Radcliffe, Chair of the OFR Working Group, believes that preparers of OFRs will face a 'formidable test'ⁱⁱⁱ when trying to argue that environmental matters are not relevant to their business strategy and risks.

The OFR Working Group's recommendations to the DTI are expected to be along the following lines:

- The guiding principle is that the OFR should contain information and analysis of trends and factors underlying the financial results and current financial position. This should be '**to the extent necessary**' for shareholders to judge how these issues may affect the company's future performance.
- Guidance as to what is deemed 'necessary' is expected to be detailed in the DTI regulations, and the need for performance indicators to be published is emphasised.
- Environmental policies and performance, together with corporate governance, community, social and reputational issues should be included.

In practice, what is reported will depend on the company board's view of what environmental impacts are material to financial performance. However, company directors must ultimately be able to defend the process behind their reporting in the courts. A Standards Board is expected draw up rules for compiling OFRs.

Delisting – Not an exemption from Sarbanes-Oxley

The disclosure of environmental costs and liabilities for companies listed in the United States is not a new requirement – the SEC has required this disclosure for at least 25 years.

However, European companies that have listed securities on the US stock exchanges, or are registered with the SEC under the US Securities Exchange Act 1934, are now considering delisting and deregistering these shares to avoid having to comply with Sarbanes-Oxley Act 2002. These moves are aimed at reducing the administrative requirements, internal procedure costs, and avoiding disclosure requirements and the need for external auditing certification, all of which will avoid higher compliance costs.

The significance of Sarbanes-Oxley is that failure to make disclosures regarding environmental liabilities that could alter a reasonable investor's view of the company can result in criminal sanctions against company directors. Foreign companies who have issued securities on US stock exchanges, or have securities registered under the US Securities Exchange Act 1934, must comply with these new rules as well as existing reporting legislation. This affects some 87 UK companies, 40 of which are included in the FTSE 100 index. Companies such as Vodafone, BP, Shell Transport, Rio Tinto, British Airways, ICI, British Energy and Scottish Power, are affected by the legislation.

The Sarbanes-Oxley Act is designed to protect investors by ensuring that any foreseeable risks are disclosed. The Act bolsters existing legislation by laying out a code of conduct for those involved in all areas of company reporting and research, both internal and external. The Act requires the senior executives of issuers to certify that they have personally reviewed their company's controls and procedures to identify, quantify and disclose material changes in financial or operating conditions, **including indications of future performance.**

In the light of the new standards of personal accountability, public companies, their auditors and legal advisers are reassessing their procedures for estimating environmental liabilities and deciding whether these must be disclosed by law.

It is our understanding that foreign issuers, in principle, would only be released from their reporting obligations under Sarbanes-Oxley if they are able to delist their shares from the relevant stock exchange **and** deregister their shares under the 1934 Securities Exchange Act.

'Under SEC rules, an issuer will remain obligated to make disclosures and filings under the 1934 Act until it has deregistered under such Act. The ease with which an FPI (foreign private issuer) can deregister under the 1934 Act depends on whether the number of record holders of such securities resident in the US is fewer than 300^v. Where the number of US-resident record holders is 300 or more, the deregistration process may be extremely involved.'^v

So while attractive in theory, delisting to avoid Sarbanes-Oxley compliance may prove a troublesome course for many non-US companies.

The duty to disclose only covers those costs and liabilities that are considered 'material'. The SEC test of materiality is whether the information would alter a reasonable investor's view of the company. With an open definition of materiality, the US has put a law on the statute books that places the onus of judgement and responsibility firmly in the hands of the disclosing company as to what should be reported. This should lead to more disclosure by companies as they choose to 'play safe' and disclose to comply with the SEC rules. Certain specific environment related liabilities must be reported whether the company considers them material or not.

Whilst the valuing of natural resources and emissions has been the subject of numerous academic studies, few companies have been able to value the risks they face because of their environmental impacts. It is this lack of 'price' that has hindered financial analysis of these impacts in the past. Governments are imposing environmental taxes on companies, and emissions trading schemes are emerging to reduce emissions, particularly of greenhouse gases and pollutants that cause acid rain. Expressing these impacts in financial terms allows a direct assessment of materiality, and thus whether disclosure might be legally required.

How can Trucost help?

If the Sarbanes-Oxley Act in the US is indicative, at the very least UK companies face substantially increased compliance and audit fees associated with measuring and verifying performance data relating to the OFR. Presently only 132 of the FTSE 250 companies report on environmental performance.^{vi}

As such, the OFR represents a significant challenge to the several hundred companies who will now be compelled to report on these issues. The challenge to business is twofold: understand the implications of the OFR for your company, and establish appropriate and transparent internal audit processes to comply with the regulations.

Trucost exists to help both companies and fund managers understand environmental impacts in financial terms. In providing a system that allows environmental impacts to be ranked in terms of financial impact and related to turnover and profit, Trucost can help company directors significantly reduce the costs of compliance with the reporting requirements expected in the OFR.

As environmental performance data on issues such as the extent of greenhouse gas emissions becomes more reliable, institutional investors will want to be able to conduct comparative analysis of companies within each sector. This will reveal the more environmentally damaging companies on a like for like basis, allowing for informed choice in stock selection and asset allocation.

For further information, please contact Rob Barker or Richard Mattison on +44 (0)20 7321 3833 or visit our website at www.trucost.com

ⁱ - #404 Implementation Survey, Financial Executives International, January 2004

ⁱⁱ - Investor Network on Climate Risk: 10 Point Plan published on 21st November 2003. http://www.incr.com/call_for_action.htm

ⁱⁱⁱ - ACCA Awards 2003 speech, 24th February 2004

^{iv} - Different rules will apply in cases where an FPI has total assets of less than US\$10 million

^v - McDermott, Will & Emery – Delisting and Deregistration US Exchange-Traded Equity Securities of Foreign Private Issuers. September 2003. Written by Rick Mitchell.

^{vi} - Trends in CSR Reporting 2002-03, salterbaxter and Context