



The Operating and Financial Review (OFR) Working Group on Materiality: A Consultation Document

A Response by Traidcraft

SUMMARY

Traidcraft welcomes the UK government's review of company law including a review of directors' duties and companies' reporting requirements. The OFR materiality consultation is a thorough document, which is moving company reporting (to include wider issues) in a direction that Traidcraft supports. However the OFR's definition of materiality and guidance to directors still leaves areas of substantial concern. The consultation document's definition of materiality is complex. This combined with current knowledge and skills of directors of most companies will mean that wider issues which are material to company's business strategy will be overlooked, unless they are given very explicit guidance to consider their impacts on stakeholders.

The UK government as a signatory to international commitments and acting in the interests of UK society needs to improve the impacts of companies on the environment and society. The government's guidance to directors on the OFR needs to emphasise companies' responsibilities to society and environment more than the current document does. Every company's OFR needs to explicitly consider the material impacts of their company as experienced by stakeholders. Companies will therefore need to be required to report on their economic, social and environmental impacts in their OFRs and guidance needs to be given by the OFR working group to directors on this. (Where a company has significant economic impacts, for example dominance in a market segment, this will impact on society's choices and that company will have an increased proportion of responsibility for the environmental impacts associated with that product or service.)

This response refers to Traidcraft's experience of producing social accounts, and corporate governance models within the Fair Trade sector of value to company law, which can be reflected in the government's proposed OFR guidance. We then set out reasons why corporate governance of UK companies needs to be improved, followed by responding to the consultation's questions, as well as making specific comments and recommendations in relation to the proposed OFR disclosure.

TABLE OF CONTENTS

SUMMARY	p1
A. TRAIDCRAFT	p2
B. FAIR TRADE AND CORPORATE GOVERNANCE	p2
C. COMMENTS ON OFR WORKING GROUP ON MATERIALITY'S CONSULTATION DOCUMENT	p4
C.1 Reasons why corporate governance needs to address economic, environmental and social issues; and therefore why these need to be reflected in the OFR guidance	p4
C.2 Consequences of not adequately addressing concerns of and responsibilities to stakeholders of the economic, environmental and social impacts of companies in the UK's OFR guidance	p5
C.3 Actions already undertaken to improve corporate governance of social and environmental impacts	p5
C.4 Progress made by the Operating and Financial Review Materiality group to widening the issues to be reported on by companies	p6
C.5 Traidcraft's responses to the OFR Consultation Document's questions	p7
C.6 Outstanding Concerns and Comments	p11
D. TRAIDCRAFT'S RECOMMENDATIONS	p12

A. TRAIDCRAFT

Traidcraft is one of the UK's leading fair trade organisations, selling food, household products, soft furnishings and clothing from nearly 100 producer groups based in 31 countries in Africa, Asia and Latin America. Traidcraft was established in 1979 and comprises two operational organisations: Traidcraft plc and Traidcraft Exchange, a registered charity.

Traidcraft plc is a medium-sized company which last year had a turnover of £12.06 million and made a profit of £416,000. Traidcraft plc has recently raised £3.25 million in a successful share issue.

Traidcraft Exchange is a development charity whose work spans capacity building amongst producers in developing countries, market access, policy development and advocacy. Through its Policy Unit, Traidcraft Exchange seeks to influence government policy and business practice in the North and the South to the benefit of the poor in the developing world.

Traidcraft is a pioneer of social accounting in the UK; having published the first independently audited plc report in 1993¹. Since then, the methodological approach (which Traidcraft developed initially with the New Economics Foundation) has been adopted and adapted by many larger organisations. It has also helped shape the AA1000 standard operated by the Institute of Social and Ethical AccountAbility (ISEA).

Traidcraft initiated the Just Pensions² project to highlight international development risks pertinent to investment and to capitalise on recently introduced UK regulation that Pension Fund's Statement of Investment Principles should disclose whether they consider social, environmental or ethical aspects.

B. FAIR TRADE AND CORPORATE GOVERNANCE

The internationally agreed definition of Fair Trade is as follows:

"Fair Trade is a trading partnership, based on dialogue, transparency and respect that seeks greater equity in international trade. It contributes to sustainable development by offering better trading conditions to, and securing the rights of, marginalised producers and workers – especially in the South.

"Fair Trade organisations (backed by consumers) are engaged actively in supporting producers, awareness raising and in campaigning for changes in the rules and practice of conventional international trade."³

Fair Trade is a growing in market size and impact. There are more than 800,000 small-scale producers working in nearly 3,000 grassroots organisations producing Fair Trade goods. In 2002, European Fair Trade Association members had a combined turnover of almost € 150m⁴. World-wide Fair Trade sales are more than half a billion Euros⁵. In the UK Fair Trade labelled products sales have increased by 90% in the past two years (2000-02).⁶

In these ways Fair Trade is contributing to the realisation of the Millennium Development Goals, which seek to reduce the number of people living in absolute poverty by half by 2015. Through engagement with a worldwide network of producers and partner organisations who work with some of the world's poorest communities the Fair Trade movement has first-hand knowledge of the conditions under which trade can be a powerful force for sustainable economic and social development. Company Law also has a role to play in promoting accountable and equitable trading relationships.

Fair Trade experience provides models of corporate governance for modernising company law. Fair Trade organisations take a pro-active approach to socially responsible business practices, focusing on the positive benefits of sustainable business practices for all. The success of Fair Trade in coupling profitability and

¹ For the most recent Social Accounts, see www.traidcraft.co.uk

² www.justpensions.org

³ Source: FINE, formed through the informal co-operation between Fairtrade Labelling Organisations International (FLO), the International Federation for Alternative Trade (IFAT), Network of European World Shops (NEWS), and the European Fair Trade Association (EFTA).

⁴ Source: European Fair Trade Association (EFTA) www.eftafairtrade.org. Figure on the basis of retail-figure calculations

⁵ Graham Young for the King Baudouin Foundation (May 2003) 'Fair trade's influential past and the challenges of its future.' Where a billion equals a thousand million.

⁶ Highlights of 2002 (May 2003) Fairtrade Foundation www.fairtrade.org.uk

economic effectiveness with international development objectives makes it a particularly valuable model to improve the corporate governance of mainstream businesses so that they have a better impact.

- Fair Trade organisations across Europe have experience of understanding their social impact so that they can manage their impacts for social benefit.
- Fair Trade organisations embed stakeholder engagement with their management approaches. This process enables the joint identification of risks to optimum business performance and enables appropriate action to be taken
- Fair trade organisations have corporate governance systems and management approaches, which embed the balancing of social and commercial considerations. In particular Fair Trade organisations have expertise in balancing social and financial objectives and in managing global supply chains.

C. COMMENTS ON OFR WORKING GROUP ON MATERIALITY'S CONSULTATION DOCUMENT

Traidcraft welcomes the UK government's consultation on the OFR's working group on materiality. However, our principal concern is that the consultation document does not adequately address stakeholder concerns nor mandate directors to consider their economic, social and environmental impacts.

C.1 Reasons why corporate governance needs to address economic, environmental and social issues; and therefore why these need to be reflected in the OFR guidance

i) For the public good

The UK government, as the custodian of UK society's well-being, is under an obligation to act in the interests of society. Companies are such an important and influential part of the public's everyday life; thus the regulation of companies is an important way in which the UK can ensure that society is best protected from harmful corporate impacts.

ii) To ensure compliance with international standards and goals

The UK - as a signatory to a wide range of internationally recognised conventions and initiatives on human rights and labour standards - should ensure that UK companies adhere to these standards, both in the UK and through their influences overseas. Some British companies not only have poor social and environmental impacts, many do not respect international standards (to which the UK is a signatory) and have poor human rights records, use abusive purchasing practices^{7 8} as well as degrade the environment. The following examples are a few of UK companies' problematic practices overseas.

- The UK's BP's investment in PetroChina made BP complicit in abusing human rights in Chinese occupied Tibet⁹
- The UK-listed British American Tobacco (BAT) continues to operate in Burma despite massive human rights abuses associated with the oppressive regime.

International standards apply globally. The UK needs to improve UK companies' respect for and adherence to the core labour standards¹⁰ of the International Labour Organisation and the UN's Universal Declaration of Human Rights. The standards of business performance have recently been set out in the 'U.N. Norms on the Responsibilities of Transnational Corporations and Other Business Enterprises with regard to Human Rights'¹¹ and the UK would do well to promote these. Good corporate governance and the inclusion of accountability of social and environmental impacts within company law is crucial if the UK's part in globalisation is to contribute to sustainable development.

iii) To re-orientate companies to contribute solutions

The UK is not able to deliver some of its strategies and policies (e.g. on sustainable development, protection of human rights or poverty reduction) without the co-operation of business. The opportunity for business to play a

⁷ Department of Trade and Industry press release P/2000/674 (10 October 2000) 'Byers Publishes Competition Commission Report On Supermarkets.' The report follows the decision by the Director General of Fair Trading (DGFT) in April 1999 to refer the industry. The Secretary of State has accepted the Commission's recommendations. The Commission has identified three situations where competition is distorted and operates against the public interest. The first concerns the relationship between supermarket chains and their suppliers including farmers. The Commission recommends that a Code of Practice should be established which would put relations between supermarkets and their suppliers on a clearer and more predictable basis. Stephen Byers said, "I agree that a Code of Practice should be introduced. Like the Commission I do not believe that a voluntary code would be adequate. The relevant supermarkets will have to give legally binding undertakings to comply with the remedies. I am asking the DGFT to approach those supermarket chains with 8% or more of the market (currently ASDA, Safeway, Sainsbury, Somerfield and Tesco) to agree a Code of Practice, which would meet the concerns identified by the Competition Commission. This would include provisions for independent dispute resolution.

⁸ http://www.corporatewatch.org.uk/pages/whats_wrong_suprmkts2.htm#encouraging (August 2003) 'What's Wrong with Supermarkets?' The UK Competition Commission Report on Supermarkets (2000) cited 52 ways in which supermarkets exploit their dominant power over suppliers. At the heart of this is the supermarkets' refusal to enter into binding contractual agreements, leaving their suppliers without redress. Other practices include delaying payments by 15 days more than terms agreed; changing quality standards agreed without adequate notice; requiring buyback of unsold goods and making deductions from returns to cover wastage.

⁹ Free Tibet Press Release, (18 April 2002) 'Chinese soldiers' applaud BP's support for exploitation of Tibet while chairman stonewalls Tibetans at company AGM'

¹⁰ ILO Declaration on Fundamental Principles and Rights at Work states that all ILO signatory countries have an obligation to respect, promote, and realise particular fundamental principles and rights i.e. freedom of association and the effective recognition of the right to collective bargaining; elimination of all forms of forced or compulsory labour; effective abolition of child labour; and elimination of discrimination in respect of employment and occupation

¹¹ Norms on the Responsibilities of Transnational Corporations and Other Business Enterprises with Regard to Human Rights, U.N. Doc. E/CN.4/Sub.2/2003/12/Rev.2 (2003). <http://www1.umn.edu/humanrts/links/norms-Aug2003.html>

positive role in contributing to sustainable development has previously been acknowledged by UK's Sustainable Development Strategy¹² and in UK Department for International Development's Globalisation White Paper¹³. It is therefore appropriate that future action to improve corporate governance and company law should give companies a steer to consider economic, environmental and social issues.

iv) To rebuild confidence in companies: to recognise responsibility is proportionate to impact and influence

There is a need to rebuild society's confidence in companies and their shares by making companies more transparent and accountable for their operations especially where they have a significant influence on communities overseas. Traidcraft's view is that where a company has influence or impact it has a proportionate responsibility and that UK government should acknowledge this responsibility by promoting accountability to those impacted by a company in the OFR guidelines. Some companies have significant adverse impacts on the environment and on society as a whole. To ignore these impacts would not only be irresponsible and morally wrong, it will also harm the long-term interests of business.

v) Legislative requirements of companies are needed

Voluntary initiatives and market mechanisms alone will not bring about adequate improvement in business impacts on society and the environment. The democratically elected European Parliament in their response to the Communication on Corporate Social Responsibility believed that legislative changes would be required to improve business's impact on society and the environment. 279 UK MPs have supported the CORE Early Day Motion 113, which urges the Government to enshrine 'in new Company Law policies that require companies and directors to manage their environmental and social impacts, and consult with and report to their stakeholders on these impacts'. The areas of the UK's Business in the Community's Corporate Responsibility Index¹⁴ where companies score highest are in the areas where there is legislation. Appropriate incentives and disincentives need to be built into the regulatory frameworks, and the OFR guidance to directors needs to support such action by explicitly make them consider their significant impacts on stakeholders.

C.2 Consequences of not adequately addressing concerns of and responsibilities to stakeholders of the economic, environmental and social impacts of companies in the UK's OFR guidance

There are various consequences of leaving the OFR's definition of materiality and guidance to directors as proposed:

- The corporate governance of UK companies will continue to give little recognition to the importance of transparency and accountability to different stakeholders. (Stakeholders can still be marginalised.)
- Investors, consumers, suppliers and civil society will not be satisfied that companies have been directed to identify and assess their significant economic, environmental and social impacts and - importantly - have the competence to manage their impacts in these areas. In particular, this is likely to lead to companies not assessing important issues such as: how bribery and corruption¹⁵ and labour standards impact on their business and their supply chain. A lack of guidance from the UK means that companies will pay insufficient attention to environmental and social issues such that poor practices continue, meaning that 'reputational' accidents such as Shell's experience with the Ogoni people are in fact actively in construction.

C.3 Actions already undertaken to improve corporate governance of social and environmental impacts

Whilst companies have a legal responsibility to consider their shareholders this does not mean Company Law cannot evolve to take into account other stakeholders including the environment and local communities. This has been recognised in the increase in companies now reporting on their social and environmental impacts and has been reflected in different approaches to CSR in Europe. France has introduced recent legislative changes that require companies to report on their non-financial impacts.

¹² A better quality of life: a strategy for sustainable development for the UK (May 1999), CM 4345 HMG

¹³ Making Globalisation Work for the Poor: White Paper on International Development, (December 2000) CM5006 HMG

¹⁴ Corporate Responsibility Index published (12/03/03) http://www.bitc.org.uk/news/news_directory/indexresults2002.html

¹⁵ For more details see www.publishwhatyoupay.org and www.transparency.org

C.4 Progress made by the Operating and Financial Review Materiality group on widening the issues to be reported on by companies.

The consultation paper is a thorough document. In particular Traidcraft welcomes:

- the inclusion of forward looking OFR (paragraph 20 iii)
- the proposal that the OFR needs to be written for stakeholders who are envisioned to be potential users of the OFR and that the purpose of the OFR is to strengthen accountability (paragraph 20 iv)
- the emphasis put on directors not to omit pertinent information nor misrepresent information (paragraph 21 & 33)
- the proposal that the principles in making materiality judgements should include an assessment of directors' expertise and skills (paragraph 23, 25 & 44 q1)
- the inference that OFR content should reflect issues that are discussed by a board when discussing how to run a company and the benefits of considering wider issues (paragraph 24, 36, 44 q4, 44 q5). This should send a welcome signal to company boards as to the breadth of issues they should consider.
- the recognition that directors need to take a broad view and consider society's changing norms, especially the need to understand the agenda of international interest groups and suppliers. (paragraph 29)
- the recommendation to directors to err on the side of disclosure rather than non-disclosure of issues when directors are undecided whether an issue should go in the OFR. (paragraph 39)
- the statement that stakeholder consultation will be needed as part of the OFR preparation process, as part of assessing the process directors use to arrive at materiality judgements (paragraph 43 ii) and as a source for assessing materiality of an issue to a business (paragraph 44 q4)
- that proposal that the criteria for assessing process for directors' judgements on materiality should cover the entire business (paragraph 43 iv), rather than selected business units
- the warning to directors that their OFR processes may be subject to external challenge by affected stakeholders. (paragraph 43 vi) In addition, Traidcraft recommends that the government put in place mechanisms to facilitate legitimate challenges.
- the acknowledgement that the management information and data collection systems in some companies fail to assemble and present relevant information. (paragraph 44 q6)

However despite these welcome references the OFR's definition of materiality and guidance to directors still leaves areas of substantial concern. These are detailed in the following sections. Most importantly, the importance of stakeholders' concerns needs to be considered on an equal footing with the interests of the 'member' stakeholder group.

C.5 Traidcraft's responses to the OFR Consultation Document's questions

Q1 Do you agree that the six issues set out in paragraph 20(i) to (vi) together provide a useful set of criteria that should be applied to any definition of materiality for the purpose of the OFR? Are there other important issues that should be taken into account?

The six issues relate to:

- building on existing guidance
- the context of an OFR
- scope of the OFR
- potential users of the OFR
- link between the OFR and decision-taking
- clear and simple language

A1 The six issues overall do provide a useful set of criteria. However we are concerned that users of the OFR have been stratified into to primary (members) and secondary (stakeholder) users. For reasons of simplicity, improved transparency, and public good Traidcraft would recommend that stakeholders be considered as equal users of the OFR to the member audience.

Q2 Do you think the definition of materiality set out in paragraph 21 is appropriate in the context of the OFR?

The definition is as follows.

'In making their good faith, honest judgements about what information is material and should be included in their OFR, directors should be governed by the high level objective of the OFR, which is to enable users to assess the strategies adopted by the business and the potential for successfully achieving them. Information will be material to the OFR if failure to disclose it clearly, fairly and unambiguously might reasonably be expected to influence members' assessments of the company and hence the decisions they may take, either directly, or indirectly as a result of the significance that the information has for other stakeholders and thus the company. Information that is material to the OFR may be quantitative or qualitative; and may relate to facts or probabilities, and to past, present or future events and decisions.'

A2 The definition of materiality is complex and therefore may limit the successful and consistent implementation by proposed OFR reporters. In addition Traidcraft is concerned that the primacy of member users over stakeholders is again inferred from this definition, when currently there is an urgent need for companies to identify and improve their significant impacts on stakeholders, to gain their societal 'license to operate'. Traidcraft recommends that material issues considered by OFR reporters include those issues of significance to stakeholders who are impacted by a company. It is appropriate to redefine materiality in this way for companies to report properly on their responsibilities, which include being accountable for their influence and impact. For example, stakeholders may be significantly impacted by a supplier of a company and the supplier's actions may be as a direct result of a retailer's purchasing policy. The company is responsible for its influence on its supplier and therefore needs to be accountable for its attributable impacts on those affected stakeholders. Consideration of significant impacts on stakeholders should therefore be part of a company's good corporate governance and therefore should be explicitly included in the materiality definition.

Q3 Do you agree that the six sets of broad principles summarised in paragraph 23 and described in paragraphs 24 to 41 are appropriate in arriving at judgements on materiality for the purposes of the OFR? Are they described clearly enough?

Paragraph 23 – principles (in brief)

(i) **The starting point for directors:**

- knowledge and experience;
- skills and competencies;
- good faith, honest judgements.

(ii) **The starting point for the OFR:**

- the objective of the OFR;
- purpose and values of the business;
- taking a broad view.

(iii) **The scope of the information in the OFR:**

- the balance between historic review and a focus on the future;
 - quantitative and qualitative information;
 - facts and events, probabilities, risks and opportunities.
- (iv) **Identifying the information for the OFR:**
- nature and size of the items;
 - significance of the issues;
 - variability and volatility.
- (v) **Reporting in the OFR:**
- measuring and describing;
 - consistency from year to year;
 - consistency with other information and reports.
- (vi) **The approach to disclosure in the OFR:**
- balanced judgements;
 - confidential information;
 - future possibilities.

A3 i) Traidcraft welcomes the OFR's acknowledgement that the current skills and experience of directors may not mean they are best qualified to assess materiality issues across the spectrum of issues facing a company. In this context the government would do well to advocate that directors undertake 'continued professional development' (CPD) to develop, broaden and update their skills. CPD is common within several UK professions, e.g. engineering.

In addition, board members will need to be appointed from a wider range of backgrounds having had a wider range of experiences. For some of the issues to be assessed for OFR inclusion by the board theoretical knowledge will not be sufficient to make a materiality judgement. Considerations of stakeholders would be better advanced if there was a requirement on the board to always consider stakeholders interests. A legal mechanism to ensure that the composition of the board is reflective of stakeholders would be appropriate.

A3 ii) Disclosure of a company's purpose and values would be welcome. However from the experience of recent corporate disclosures this would be of more use if the OFR leads reporters to disclose how the values have influenced decision making within a company. Otherwise OFR could disclosure a set of company values which employees do not recognise as being in synergy with company culture and behaviour, let alone influencing business relationships with suppliers, customers and employees. The OFR needs to get beyond rhetoric and processes to board directors carefully evaluating the actual impact of their company.

To help directors take a broad view it would be easier if materiality was defined in reference to the interests of stakeholders.

A3 iv) The 'significance of issues' needs to set out clearly that directors need to consider issues that stakeholders identify as significant to them, rather than issues which are of significance to the company. For example a company will have a significant impact on the population of a country if its activities represent more than 5% of a country's GDP. However if it is a large company that country's operations may be a small proportion of its overall activities and so not considered to be material under the current guidance. The way the guidance is currently worded gives primacy to the members' interests, which may mean that not all the appropriate material issues will be identified.

From Traidcraft's experience of producing social accounts over the last ten years it is possible to identify significant stakeholder concerns in a way that is useful to management decision making. One of the business benefits we have found from our stakeholder dialogue process is improved business intelligence.

A3 v) Traidcraft agrees with the thrust of this principle and hopes that the Standards Board will provide a framework for a set of performance related indicators. These indicators could then be used to compare year to year as well as enable comparisons within a sector on a normalised basis (e.g. normalised by turnover or employee numbers).

A3 vi) 'Balanced judgements' need to be made by the directors as to what to include in their OFR. As the guidance currently stands 'members' interests take precedent. Traidcraft would like 'balanced' to be framed in terms of balanced considerations of stakeholders' interests.

Confidentiality will hamper the level of disclosure envisioned by the OFR consultation document and it is only lightly touched on in the consultation. (Paragraph 40 & 41). Traidcraft is concerned that company directors may choose not to disclose many 'forward probabilities and facts which are material to a company and its stakeholder' because they judge the issue to be confidential or 'materially prejudicial.' However the stakeholders will expect disclosure of that issue in the OFR because it is so significant to them.

For example, employees and suppliers would want to know if it was probable that a company was about to expand and would in particular want to know if the company was planning to grow by acquisition or organically. Mergers and acquisition information, which is usually confidential, will only be properly useful if sufficient information is given otherwise the level of disclosure will be close to useless because the information disclosed will be so bland. Whilst there are mechanisms for ongoing disclosure to financial sector, such mechanisms are not in place for stakeholders which is why there is a concern if stakeholders have to wait a year for pertinent information to be disclosed in following OFR.

Monitoring of companies' disclosure according to the OFR guidelines is needed to ensure that companies do not use the abuse the 'confidentiality' excuse. Such monitoring should feed into a review of these OFR guidelines since Traidcraft is concerned that directors may purposefully choose not to disclose material issues or hide behind confidentiality excuses. Such a review of the OFR guidelines should look explicitly at mandatory disclosure of certain company aspects so that confidentiality excuses cannot be used. It is not appropriate to assume that confidentiality issues overrides the need to disclose so Traidcraft recommends the Standards Board fully investigates and sets guidelines for disclosure to ensure stakeholders' right to know is balanced against commercial considerations. A stakeholder's right to know (and therefore the need for disclosure) increases the greater the proposed or actual impact on them is. Balanced disclosure that includes reporting when not in the commercial interests of the company needs to be supported by legislation to protect directors or other employees similar to whistleblowing legislation.

Q4 *Are there other principles that should be applied in making such judgements?*

A4 No

Q5 *Do you agree that the six key criteria set out in paragraph 43 are appropriate for assessing the directors' process for making their materiality judgements? Are there other criteria that should also be used?*

A5 The proposed criteria for assessing the process are appropriate.

Q6 *Do you agree that the ten questions set out following paragraph 44 would be helpful to directors in applying their process in practice? Are there any other matters that they should have in mind?*

Paragraph 44 – key questions to be addressed

The following ten questions together provide a checklist that directors may find helpful in applying their process.

- Q.1 Does the board have, or does it have ready access to, all the relevant knowledge and skills to make its judgements as to what is or is not material? If not, how will this be addressed?
- Q.2 An early task for the board will be to approve the process and satisfy itself that the process is being properly applied before it can exercise its judgements on materiality. How will the board work in discharging these key responsibilities?
- Q.3 What information should be considered at the outset for possible inclusion?
- Q.4 What do other sources suggest might be important?
- Q.5 What key information does the corporate management information systems provide now on these topics?
- Q.6 What, in the light of all this, are the information gaps? What should the plans be for filling these gaps? How will the information be put together?
- Q.7 How should the board obtain assurance as to the reliability of the information put before it, and who should do this?

- Q.8 How, once the information is there, does the board decide whether it is material or not? What processes of challenge, both internal and external, should be used? What sign-off procedures should be in place?
- Q.9 How should 'material information' be presented in the OFR? And how should the information in the OFR be linked to other published information?
- Q.10 What feedback arrangements and review procedures should be in place between one cycle and another?

A6 q1) Traidcraft supports the proposal that this question be put to directors, since many boards are not comprised of directors who understand the range of issues important to their stakeholders.

A6 q2) It will be important that areas of concern to stakeholders are included in the OFR, and therefore consultation with stakeholders needs to be included as part of the process of checking the OFR production process. Proper consideration of economic, environmental and social issues is needed by directors with appropriate competencies. However Traidcraft would be concerned if this resulted in environmental and social issues, which need to be considered as part of a company's core business discussions, being ghettoised, only to be discussed by committees which were effectively distant from the board.

A6 q3) The list set out in the consultation is comprehensive, but the directors need to take a long term view when making their judgements.

A6 q4) The guidance given to directors when preparing an OFR should include reference to the 'UN Norms on the Responsibilities of Transnational Corporations and Other Business Enterprises with regard to Human Rights'¹⁶ which sets out for the business community issues they should consider to uphold the Universal Declaration of Human Rights in their operations. Companies in the Construction, Defence, Oil and Gas, High Street Retailers, Garment, Shoe and Food Brand, Mining, Pharmaceutical and Water sectors should refer to the international development issues pertinent to their sector listed in the Just Pensions guide.¹⁷

A6 q5 & q6) Traidcraft supports the proposal that these two questions be put to directors, since current management information systems do not collect the correct information to make materiality judgements. For example, if Shell had had an adequate and appropriate information collection system, discontent and mal-treatment of the Ogoni community in Nigeria would have been picked up within Shell before a reputational 'accident' damaged it externally. The proposed Standards Board should set out a minimum number of issues companies should report on which would prompt companies to ensure that they had adequate information collection systems in place.

A6 q7) Stakeholders will need to be involved in the assurance process to evaluate the reliability of the information the directors are assessing. It is only stakeholders, which are affected by the company, that can assess whether the information collected to be assessed by the board is accurate. The way in which stakeholders need to be involved will depend on how the information was collected. Assurance of companies' OFRs is needed but Traidcraft is concerned that consultancies without appropriate skills will seek to deliver this service in a manner that does not actually value the importance of consulting with stakeholders. It would be worth exploring the extent to which stakeholder organisations can contribute in a meaningful way to the assurance process.

A6 q8) The board when making its materiality judgements should refer to the 'UN Norms on the Responsibilities of Transnational Corporations and Other Business Enterprises with regard to Human Rights' as well the following. The board should consider:

- if an issue is significant to one group of the company's stakeholders
- if there is a conflict of interest between the company's stakeholders over a certain issue
- how changes in the external business operating environment have impacted upon the company and its stakeholders (e.g. 11/9/01)
- how major commercial events have impacted upon a company's stakeholders

A6 q9) Material information should be presented in the OFR with reference to the company's business plan and objectives, historic performance. Traidcraft's social accounts include specific directors' commitments to act on the information gathered as part of Traidcraft's stakeholder dialogue. Since information that is gathered for

¹⁶ Norms on the Responsibilities of Transnational Corporations and Other Business Enterprises with Regard to Human Rights, U.N. Doc. E/CN.4/Sub.2/2003/12/Rev.2 (2003). <http://www1.umn.edu/humanrts/links/norms-Aug2003.html>

¹⁷ Just Pensions guide (2001) www.justpensions.org

the OFR should as a matter of course be part of board discussions, Traidcraft would hope that the company will have already set itself objectives, which are included in its business plan, relating to material issues identified, which it can report on in the OFR.

A6 q10) Traidcraft is concerned that the document enables companies to get out of producing a fully fledged OFR using the excuse of balancing costs and benefits of producing an OFR and may use the opportunity to delay production of a proper OFR in the name of 'continuous improvement'. TC recommends that companies have to produce a fully fledged OFR within 3 years. Such a time limit would then enable a full review of the OFR guidance to be timetabled for 5 years time to assess whether OFRs were operating in the way that was envisaged and bringing about suitable improvements in companies' performance.

C.6 Outstanding Concerns and Comments

i. Traidcraft is concerned that the emphasis is on materiality 'risks'. Risk-based approaches characterise much of the 'CSR' activities companies currently undertake. These approaches sometimes backfire on positive policy objectives, which the government needs business to engage with, such as poverty reduction or sustainable development. For example businesses undertaking 'corporate social responsibility' activities in their supply chains may actually delete smaller enterprises from their supply chains, and yet the sustained growth of small enterprises is essential for poverty reduction in developing countries. Or another example is when risk based approaches to eliminate child labour (which do not consider the context of the children's lives) result in children working in worse situations, such as prostitution. The guidance given to directors on materiality needs to point out the imperative for improved business environmental and social performance and the opportunity companies have to re-orientate themselves to contribute sustainable development solutions.

ii. Traidcraft is concerned about the limited number of companies that are required to produce an OFR. The government needs to set out a staged process whereby more and more companies are required to produce an OFR. This recommendation is in line with the Trade and Industry Committee proposal for a 'gradualist' approach to increasing the number of companies producing OFRs.¹⁸

iii. Traidcraft is concerned that the guidance perpetuates the myth that institutional investors, who own the bulk of the UK's shareholdings, reflect the interests of their subscribing members. Subscribing members have little opportunity to influence how their money is invested, and whether those investments contribute to an improved or reduced quality of life of the subscribing members. Traidcraft found through its work on Just Pensions that there is a poor chain of accountability and level of communications from pension fund holder to pension fund trustee to fund manager on the environmental and social impacts of their investment.

iv. The guidance does not refer to any sanctions that will be enforced on companies, which do not produce an OFR of adequate content. The lack of sanction undermines the credibility of the government's efforts to improve corporate accountability and transparency through the mandatory production of OFRs.

v. Traidcraft is concerned that consultancies without appropriate skills will seek to deliver OFR related services in a manner that does not actually value the importance of companies directly consulting with stakeholders. Direct involvement of stakeholders where willing, in OFR production, would minimise the need for consultants, who potentially act as a barrier to a company hearing first hand feedback on the activities. Lack of direct company engagement with stakeholders on a neutral basis hampers a company's ability to fully understand and manage its material issues. Third parties can give advice to companies on how to undertake stakeholder engagement but it is important that third parties are not the conduit through which companies engage with their stakeholders, unless there are particular acrimonious relations. If the latter is the case the third party's role is as a neutral mediator. The government should explore what roles stakeholder organisations could play in relation to OFR reporting.

¹⁸ The White Paper on Modernising Company Law; Sixth Report of Trade and Industry Committee Session Report (13 May 2003) HC 439 HMG

Paragraph 75. So on balance we prefer the gradualist approach advocated by the TUC (and possibly intended by the Government), so that the details of what is required can be worked out with the largest companies and then the key aspects extended to smaller companies.

D TRAIDCRAFT'S RECOMMENDATIONS

Traidcraft's Concern	Recommendation	Reference to this response
The definition of materiality is too complex	The definition needs to be simplified to include 'material issues of significance to stakeholders of a company'	C.5 A2 & A3 ii)
Disclosure of wider issues will not occur because reporters will be confused as to what to include.	The proposed Standards Board needs to set a minimum number of social, economic and environmental issues to be reported on in the OFR. This will lead to management systems being set up which at least capture the minimum wider issues companies should consider.	Paragraph 44 q6 C.5 A3 v) C.5 A6 q5&6
Consultation document emphasises members' interests above those of other stakeholders. (Institutional investors do not represent wider interests.)	Equal treatment of stakeholder users and shareholder users of OFRs is needed.	C.5 A1 & A2 (C.5 C.6 iii)
Companies will only identify significant issues to the company	Guidance needs to be given so that companies identify and report on issues of significant concern to stakeholders.	C.5 A2 C.5 A3 ii) & iv)
Company boards can still choose to ignore stakeholder's issues	A legal mechanism needs to be put in place to ensure composition of the board is reflective of stakeholder concerns	C.5 A3 i)
Confidentiality concerns will be prioritised over stakeholders' right to know. (There is inadequate discussion of this.)	Guidance on the disclosure expected is needed in potentially confidential situations. The OFR guidance needs to be supported by whistleblowing legislation to protect staff and directors when they disclose appropriate information.	C.5 A3 vi)
Companies may hide behind confidentiality excuses	The content of company OFRs needs to be monitored	Paragraph 40 C.5 A3 vi)
Reasons such as prohibitive costs and delayed continuous improvement may limit complete disclosure	The OFR guidance should set the expectation that fully fledged OFRs should be produced within three years and that monitoring of OFRs' content will extensively commence then. This would then enable a full review of OFR guidance five years after guidance came into effect.	C.5 A6 q10
OFR reporting may be of poor quality due to lack of sanction mechanism.	Criminal and civil sanctions need to be enforced on directors when poor quality OFRs are produced to improve overall compliance with the OFR guidance.	C.6 iv)
Impracticality of a stakeholder challenge to a company's OFR will allow poor quality disclosure	The government needs to improve the practicality and reality of affected stakeholders making legitimate challenges over companies' OFRs. (This would also increase the number of companies properly produced OFRs)	C.4 referring to Paragraph 43 vi)
OFR disclosures which do not reflect the views of stakeholders.	The government could support a process, which clarifies where stakeholder engagement is expected in the preparation of OFRs and the role of third parties.	C.5 A6 q7 C.6 v)
Too few companies are required to produce an OFR	The threshold for producing an OFR should be set lower so that more companies produced an OFR, and then the number of companies required to produce an OFR should increase over time.	C.6 ii)
Over emphasis on the management of negative risks, which may lead to actions, which backfire on delivery of social objectives.	An investigation by government of how business can be encouraged to work towards sustained positive social performance as part of their core business strategy is needed. (For example, a risk based approach to eliminate child labour which did not consider the context of the children's lives resulted in children working in worse situations, such as prostitution.)	C.6 i)

