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Corporate Non-Financial Reporting in the UK: Diversions from the EU Sustainability Reporting Framework

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Abstract: In late 2019, the European Union presented the EU Green Deal, which targets climate neutrality by 2050. Under the EU Green Deal's Corporate Sustainability Reporting Directive (CSRD), a clear sustainability reporting and assurance framework was proposed as a significant aspect of the EU Sustainable Finance Package in 2021. However, because of its exit from the EU in 2020, the UK will cease to adopt EU legislations and will have to produce its own laws to achieve climate neutrality. Against this backdrop, the purpose of this paper is to explore how best to improve the non-financial reporting mechanism in the UK, in order to assist the UK in transitioning to a more sustainable economy. This paper investigates the unique challenges for non-financial reporting in the UK caused by Brexit, and the significance and effectiveness of risk-based regulation approach in the UK. The paper proposes a 'really responsive' industry-based non-financial reporting framework for the UK to address its unique challenges.

Keywords: sustainability reporting; non-financial reporting; the corporate sustainability reporting directive; responsive risk-based regulation

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1. Introduction

Environmental degradation and climate change as existential threats to the world have received significant political and academic attention in recent years. This paper explores whether a 'really responsive' [1] (p. 182) industry-based non-financial reporting framework could assist in addressing those challenges [2–5]. International initiatives such as the Paris Agreement [6], which aims to limit global warming to below 2 °C, have received broad recognition and ratification. Transitioning to a low-carbon economy is key to ensuring sustainability and the long-term economic growth of the global economy, and sustainable development relies heavily on collective global efforts such as the UN 2030 Agenda for Sustainable Development and the Paris Agreement. These are being implemented through the enactment of new laws and regulations. Within the European Union, a European Green Deal setting a target of zero net emissions of greenhouse gases (hereafter GHGs) by 2050 was agreed among the EU member states. More recently, in the 2021 United Nations Climate Change Conference (COP 26), a Glasgow Climate Pace was designed to complete the Paris rulebook, including the operational details for the practical implementation of the Paris Agreement [6].

This worldwide economic transition presents new compliance and reputational risks as well as new employment and investment opportunities for companies, investors, and stakeholders. Information about the social and environmental dimension of a firm's economic activities is becoming increasingly important for investors as they make investment decisions, and more stringent regulations are therefore called for. The European Union has recognized this regulatory need and is proposing a new Corporate Sustainability Reporting Directive (CSRD), which forms an integral part of a wider EU legislative endeavor to support a more 'modern, resource-efficient and competitive' European economy under the European Green Deal [7]. The proposed CSRD will design and set out a comprehensive and in-depth framework of rules on Sustainability Reporting and assurances about reporting for all listed companies in the EU.

With its exit from the EU from January 2021, according to its Withdrawal Agreement the UK has ceased to apply any potential future EU legislation, including the CSRD. The UK passed a zero net emission law in 2019, thereby becoming the first major economy to commit to zero emissions [8]. Nevertheless, while the EU crystallizes the future direction of Sustainability Reporting requirements in the EU, the UK is still adopting the old 2014 Non-Financial Reporting Directive (hereafter NFRD) which sets compulsory disclosure requirements on non-financial information for large undertakings in excess of 500 employees, in the five areas of environmental matters, the company's employees, social matters, respect for human rights, and anti-corruption and anti-bribery. Given the political and legislative commitments that the UK has made, there is a pressing and practical need to review the status of non-financial reporting in the UK and examine its future direction post-Brexit [8].

Various aspects of non-financial reporting have been discussed by previous scholars. Stolowy et al. found that the percentage of firms issuing non-financial reports increased dramatically between 2002 and 2015 [9]. Jackson et al. examined the effects of non-financial disclosure on corporate social responsibility (CSR) [10,11] in 24 OECD countries and found that firms in countries that require non-financial disclosure adopt significantly more CSR activities [12]. Hrasky et al. suggested that some sustainability reporters are using CSR imagery as a rhetorical "green-washing" tool in their communication with stakeholders [13], and Michelon et al. also found evidence that CSR reporting practices can be used to pursue legitimacy symbolically rather than to convey actual impacts and accomplishments [14].

Literature on the regulation of non-financial reporting has mainly focused on the effects of regulations and the quality of non-financial disclosure [15,16]. Hummel and Rötzel found that firms increased disclosure on mandated topics after non-financial reporting regulations become effective in the UK [15]. Ioannou and Serafeim observed that firms significantly increased their disclosure following non-financial reporting regulations in China, Denmark, Malaysia, and South Africa. They also found increased sustainability disclosure driven by regulations associated with increases in firm value [16].

A significant amount of research has been devoted to the economic aspects of non-financial disclosure, such as the economic value of non-financial reporting [17,18] (p. 1) the correlation between non-financial information and firm value [19,20] the financial consequence of mandatory non-financial reporting [12,15,16] and the determinants that affect non-financial disclosure [21,22]. For instance, Grewal and Serafeim explored the reaction of equity markets to mandatory non-financial disclosure in the European Union [23], Baboukardos evaluated the market valuation of greenhouse gas emissions under a mandatory reporting regime in the UK [24], and Chen, Huang, and Wang examined the effects of mandatory CSR disclosure on firm profitability and social externalities in China [25]. Previous research on non-financial reporting in the EU has tended to focus on the EU NFRD [26–29], either on the impact of the NFRD's adoption on the improvement of various aspects of sustainable development such as human rights [30,31] and the environment [32], or on limitations in the implementation of the NFRD in member states [33] (p. 249), for instance Belgium [34] (p. 237) and the UK [35]. Furthermore, a handful of research studies have focused on the development of Sustainability Reporting and disclosure in emerging markets such as Hong Kong and Singapore [36–39] and in developing or less developed countries such as Jordan, Bangladesh, and India [40–44]. However, non-financial disclosure in the UK since Brexit has not been explored, and this article aims to fill this gap.

Therefore, past literature on non-financial reporting has focused on various aspects of the NFRD, such as its impact and limitations in its application. To date, however, there has been no research on non-financial disclosure in the UK after Brexit in the context of the transition toward a more sustainable economy. The paper aims to fill in this research gap, seeking to deepen understandings of the current state of non-financial reporting in the UK and shed light on an appropriate model of non-financial reporting for the UK post-Brexit.

This paper explores the future direction of non-financial reporting in the UK post-Brexit and examines whether an innovative and original 'really responsive' industry-based non-financial reporting framework that is developed by this research can assist in enhancing non-financial reporting in the UK post-Brexit. The paper is structured as follows. An introduction to the methodology is provided in Section 2. Sections 3.1 and 3.2 explore why the existence of information asymmetry in the marketplace calls for public intervention in information disclosure. It then examines how the emergence of the notion of corporate social responsibility has resulted in greater transparency in reporting. Sections 3.3 and 3.4 document the evolution of Sustainability Reporting in the EU and non-financial reporting in the UK, and how it contributes to the need for the UK to attach more importance to the regulation of its non-financial reporting. Section 3.5. introduces the Financial Reporting Council's (hereafter FRC) role of a watchdog over non-financial reporting in the UK and goes on to reveal the insufficiency in its resourcing. It also examines risk-based regulation in the UK since the 2005 Hampton Report [45], and analyses how the novel proposal for 'really responsive' risk-based regulation might assist the FRC in enhancing non-financial reporting in the UK. Based on this analysis, the article develops a feasible tool for non-financial disclosure in the UK. Finally, Section 4 concludes that based on the UK's nationally determined climate contribution and legislative commitment, the FRC should recognize non-financial reporting as a new risk and address it in a 'really responsive' manner.

2. Methodology

The methodology framework consists of theoretical, doctrinal, interdisciplinary, and social-legal research. First, the article contextualizes the connection between information asymmetry and public intervention. Second, the rationale and functions of mandatory CSR disclosure under corporate law approaches are investigated through doctrinal and theoretical research. Third, the study examines the relationships between risk-based regulatory approaches, and how they can be applied to solve the dilemma caused by the need for better non-financial reporting in the UK on the one hand, but the under-resourcing of the Financial Reporting Council (hereafter FRC) on the other. Fourth, the article contextualizes the notion of 'really responsive' risk-based regulation in response to current and future issues in non-financial reporting in the UK, through theoretical and doctrinal research.

3. Discussion

The need for mandatory information disclosure as a means of government intervention is triggered by the existence of information asymmetry in the marketplace and the 'public good' nature of information. The advent of the notion of corporate social responsibility [46] (p. 643) initiated CSR reporting and later non-financial reporting in the UK.

3.1. Information Asymmetry and the Need for Mandatory Information Disclosure as a Means of Government Intervention

Imperfect/asymmetric information among different agents is an underlying market problem. In a competitive market it is assumed that information is perfect and that market participants have full and timely knowledge of their investments; there is no limitation on their acquisition of relevant information, or any obstacle to prevent such information from spreading to participants equally and in a timely manner. In reality, however, access to information is asymmetric between different agents, and government intervention such as mandatory disclosure requirements could potentially address this challenge. Given the complexity of financial instruments and transactions, it is necessary for an investor to have a relatively high level of skill and knowledge in order to be able to interpret the relevant information prior to any purchase or disposal of a financial product. However, this requirement is difficult to fulfill, since it is commonly accepted that individual economic actors (more precisely, individual investors) act according to principles of 'bounded rationality', which limits their ability to understand, remember, and manage information [47–49].

Acquiring information is a cost to the producers of the information [50] (p. 23). On the one hand, a moral difficulty arises when information generators or providers intend to maximize their profits, because of a tendency to impair other parties' interests under the requirement to provide adequate information. For example, as the providers of information, some listed companies may be capable of acting less carefully than they otherwise might, e.g., by providing false or misleading information and leaving investors to bear consequent losses. It is risky to rely on companies' compliance with a duty to provide adequate information. On the other hand, if there is inadequate information, investors may have to make adverse selections and bear full responsibility for the consequences of the information providers' behavior [51] (p. 99). For example, the price of stock is not only decided by the performance of the companies involved, but also by external factors such as the macroeconomic climate and changes in government policy, and even by the judgments and behavior of other investors.

In making decisions, investors face a myriad of uncertain factors, among which price and quality of information about securities products are constantly in flux. In the absence of relevant and timely information, it is difficult for investors to be sure about the quality of the stock, and thus their choices may be less than optimal. When companies fail to disclose non-financial information relating to the environment, employees, human rights, social issues, and anti-corruption and anti-bribery, investors may miscalculate the risks and opportunities associated with the company and its products or services. Likewise, stakeholders relying on this information cannot accurately evaluate the potential harm that might be imposed on them and respond accordingly.

Information is a typical public good in financial markets; it is crucial for investors' decision making, and it is non-exclusive, i.e., it may be quickly shared with others if it is acquired by one investor. If information has already been generated by an issuer of a security and some retail investors have acquired it at a certain cost, other investors will be tempted to free-ride on the efforts of the first group of investors since the information will soon be widely available and they can no longer be excluded from its use. In order to assure the quality of relevant information, the marginal costs of the issuer must be covered by the aggregate willingness to pay for the information. In other words, only if the issuer obtains a reasonable cost compensation from the beneficiary of the information disclosure will they have an incentive to disclose more.

In reality, however, this is far from certain. Thus, the issuer lacks incentives to disclose information. Instead, it may restrict the 'spillover' of information, which results in an information asymmetry between investors and the issuer. Therefore, investor protection calls for public intervention. Mandatory information disclosure as a means of government intervention is therefore necessary and important.

Given the importance of information in the financial markets and the existence of information asymmetry, mandatory information disclosure becomes one of the most crucial aspects of investor protection policy. It could assist in rectifying imperfect information, overcoming the insufficient supply of information as a public good, and achieving the optimum quality of information for investors [52,53] (p. 308).

Disclosure of non-financial information is vital for investors as it is strongly linked to an asset's earning opportunities and exposure to risks, and it also affects its market valuation. Non-financial information disclosure improves transparency and promotes informed pricing and capital allocation. Mandatory disclosure obligations may render information affordable, accurate, and accessible, and will assist investors in making 'rational utility-maximizing choices' [54] (p. 10). It is therefore often chosen as one of the most important regulatory tools or techniques to ensure the efficiency of information disclosure.

3.2. The Notion of Corporate Social Responsibility and CSR Reporting

The concept of corporate social responsibility was initially termed 'noblesse oblige', and has attracted wide discussion since the 1950s [55] (p. 3), even though the shareholder value principle formed the mainstream of scholarship at that time [56] (p. 41). According to political cost theory, corporations are incentivized to disclose and report in order to avoid taxes or regulatory actions [57] (p. 405) [58] (p. 112) [37] (p. 17) [59] (p. 369). Through corporate social responsibility disclosure and reporting, directors can minimize the 'political cost' of interactions between companies and their natural and societal environments [60] (p. 301). Corporate disclosure and reporting could reduce the likelihood of negative political or societal behaviors, minimize adverse costs, and enable firms to generate moral capital [61] (p. 777), which rewards firms who 'adhere to more stringent social constraints and engage in more public exposure than other companies' [62] (p. 180) [63]. Greater transparency enhances confidence in the securities market, which in turn feeds into firms' ability to attract investment. Corporate disclosure and reporting also defend corporate governance standards, as they increase market integrity and accountability [64].

In the 1990s, Freeman argued in favor of stakeholder theory [65] (p. 169), which suggests that company directors must consider the interests of a firm's stakeholders as well as those of its shareholders. Corporate social responsibility and corporate responsibility disclosure are supported by stakeholder theory, which was adopted by many continental European jurisdictions in the 1990s [66]. Growing awareness of corporate social responsibility brought calls for greater transparency in reporting [67] (pp. 195–196); in the UK the Company Law Review Steering Group (CLRSG) adopted the enlightened shareholder value principle, which was influenced by stakeholder theory [68]. The notion of CSR was incorporated in company law practice and was formally realized by mandatory directors' duties and corporate reports on social and environmental matters in S172 of the UK Companies Act 2006 [69] (p. 98) [70] (p. 515) [38] (p. 699) [71] (p. 241) [72] (p. 817). Directors of UK companies are required to comply with S172 to promote the long-term success of their company, having regard to the company's employees, suppliers, customers, the community, and the environment.

Later, Section 172 Statements [73] were introduced by the Companies (Miscellaneous Reporting) Regulations 2018, whereby directors' reports from companies with more than 250 employees must contain a statement that clarifies the company's engagement with its employees. The statements should also include a statement on how the directors have had regard to the need to foster the company's business relationships with suppliers, customers, and others, unless it is a medium-sized company. In May 2020 the FRC amended its 2018 Guidance on the Strategic Report, now requiring all public companies to include Section 172 Statements in their Strategic Reports regardless of their size [74].

3.3. EU Sustainability Reporting: The NFRD and the CSRD in Progress

The EU implemented one of the earliest non-financial disclosure regulations. Article 10 of the EU Accounts Modernisation Directive 2003 (Directive 2003/51/EC) called for companies' annual reports to include both financial and non-financial key performance indicators, including information relating to environmental and employee matters. The Non-Financial Reporting Directive 2014 (Directive 2014/95/EU) lays down rules according to which large companies must publish regular reports on the social and environmental impacts of their business activities.

Since late 2018 the EU has been developing a series of climate-related laws and regulations under the Sustainable Finance Action Plan and the European Green Deal [75], in order to make the EU's economy more sustainable. Consultations were carried out on sustainable corporate governance and due diligence, the global environment and corporate governance reporting standards, climate change taxonomy and mitigation, and the adaptation of technical screening criteria [76]. A series of legislations have been produced or are being proposed following those consultations. An EU Taxonomy Regulation clarifying how qualified economic activities must contribute to meeting the EU's environmental objectives was produced and adopted in July 2020, and an EU Green Bond Standard is going through the final stages of approval.

As the carriers of economic activities, corporations form an integral part of green initiatives. The ambitious plan to achieve climate neutrality by 2050 requires collective endeavors from both individuals and corporations. In the arena of corporate regulations, corporate reporting plays a key role in the climate-related supervision of corporations. A Corporate Sustainability Reporting Directive (hereafter CSRD) is being proposed to enhance corporate transparency in non-financial issues and address non-financial information asymmetry risks to better protect investors and stakeholders. The CSRD indicates a shift to a cost-benefit analysis culture, and a transition from informal qualitatively based standard setting to a more quantitative and formalized approach.

Currently, the NFRD mandates compulsory non-financial disclosure by large under takings which are public-interest entities exceeding the criterion of 500 employees, and public-interest entities that are parent undertakings of a large group exceeding 500 employees. The CSRD proposes to expand this scope and impose mandatory sustainability disclosure requirements on all listed companies, including small and medium-sized listed companies with fewer than 500 employees. A rigorous auditing and assurance system is also being proposed. If adopted, the CSRD will apply to approximately 49,000 companies, compared to the current 11,000 companies that are subject to the NFRD [77].

3.4. UK Non-Financial Information Reporting: The NFRD and Legal Uncertainty Post-Brexit

In 2019 the UK became the first major economy to pass a net zero emission law [8]. The British government amended the Climate Change Act 2008 and set a net zero greenhouse emission target, which must be achieved by 2050. As an ongoing effort, in April 2021 the UK committed by law to reduce emissions by 78% compared to 1990 levels by 2035 [78]. To turn this political commitment into a legal obligation, new environment-related laws are being enacted and implemented.

Prior to Brexit, the requirements in Article 10 of the EU Accounts Modernisation Directive 2003 were incorporated in Section 417(3) of the Companies Act 2006 in the UK [72] (p. 817). The non-financial reporting requirements in the 2014 NFRD were later incorporated in Sections 414C, 414CA, and 414CB of the Companies Act 2006 by amendments.

Post-Brexit, the UK must embark on its own path of non-financial disclosure. In terms of the disclosure of non-financial information, however, there is no streamlined system and coordinated plan in place. There seems to be an overlap as well as gaps between existing legislation; there is a mix of specific environmental reporting requirements and other aspects of non-financial reporting requirements that have been produced by various departments. The paper observes that there is sometimes piecemeal guidance, often with no solid legal effects and bearing various inconsistent titles. Among this disparate guidance are the Environmental Reporting Guidelines produced by the HM Government [79], Guidance on Strategic Reports produced by the Financial Reporting Council [80], ESG Reporting Guidance from the London Stock Exchange Group [81], Sustainability Self-Reporting Guidance produced by the Office of Gas and Electricity Markets [82], and Sustainability Reporting Guidance for Public Annual Reports set out by HM Treasury [83], among others. The above reporting guidelines are hardly streamlined and could easily cause confusion in compliance. There is no unified and consistent terminology for non-financial reporting, which is given various names from environmental reporting to ESG reporting and Sustainability Reporting. There is therefore a need for a coherent and holistic approach towards non-financial reporting for companies in the UK, and for professional reporting services such as accountancy firms and auditing firms.

There have been attempts for the government to provide guidelines on climate-related disclosures through documents such as the HMT Roadmap towards mandatory climate-related disclosures. The scope of the Roadmap is however merely limited to climate-related disclosures and does not shed any light on other aspects of non-financial reporting [84].

Within the scope of UK Company Law, the rules on non-financial information are stated in the Companies Act 2006 (Strategic Report and Directors' Report) Regulations 2013 (hereafter the 2013 Regulation), the Companies, Partnerships and Groups (Accounts and Non-Financial Reporting) Regulations 2016 (hereafter the 2016 Regulation), and the Companies (Miscellaneous Reporting) Regulations 2018 (hereafter the 2018 Regulation).

Guidance on the Strategic Report 2018 by the FRC stated that one of the objectives of a strategic report is to provide relevant non-financial information. Accordingly, companies must disclose non-financial reporting information in the strategic report part of their annual report.

For incorporated public listed UK companies with fewer than 500 employees, the older version of the Companies Act 2006 (Strategic Report and Directors' Report) Regulations 2013 remains applicable. Under the 2013 Regulation, all quoted companies with fewer than 500 employees are required to report energy use and greenhouse gas (hereafter GHG) emissions, as well as business-related environmental information as part of their Directors' Reports. The 2018 Regulation imposes further GHG emissions disclosure requirements on large unquoted companies and requires large Limited Liability Partnerships (hereafter LLPs) to prepare a new kind of energy and carbon report to disclose energy and carbon information [79]. The qualifying large unquoted companies or LLPs under the 2018 Regulation must satisfy two or more of the following requirements: turnover of GBP 36 million or more; a balance sheet total of GBP 18 million or more; and number of employees 250 or more. Where energy usage and carbon emissions are of strategic importance to the company, disclosure can be included in the Strategic Report instead of the Directors' Report [79]. The first publication of reports complying with the 2018 Regulations were filed with Companies House in 2020.

For a traded, banking, or insurance company with more than 500 employees or a parent company with more than 500 employees in a corporate group, further non-financial disclosure requirements are imposed on them by the Companies, Partnerships, and Groups (Accounts and Non-financial Reporting) Regulations 2016. Those companies are required to disclose non-financial information in their strategic reports. According to Sections 414CA and 414CB of the Companies Act 2006, as a minimum these non-financial information statement disclosures must contain information, to the extent necessary for an understanding of the company's development, performance, position, and the impact of its activity, relating to environmental matters (including the impact of the company's business on the environment), the company's employees, social matters, respect for human rights, and anti-corruption and anti-bribery matters. The company must report its business model, the policies pursued by the company in relation to the five areas of disclosure, any due diligence processes implemented in pursuance of those policies, and the outcome of those processes. The companies also need to disclose the principal risks relating to the company's employees, social matters, respect for human rights, and anti-corruption and anti-bribery matters arising in connection with the company's operations. If relevant and proportionate, the company also needs to disclose its business relationships, products and services that are likely to cause adverse impacts for the company's employees, social matters, respect for human rights, and anti-corruption and anti-bribery matters, as well as how it manages those risks, and the non-financial key performance indicators relevant to the company's business. If the company fails to disclose the above, then it must provide a clear and reasoned explanation for not doing so.

Sections 441 and 447 (1) (ba) of the Companies Act 2006 set mandatory filing obligations for quoted companies, asking for timely delivery to the registrar of the companies' accounts and reports including the strategic report. Section 451 of the Companies Act 2006 clarifies the consequences of default in filing accounts and reports. According to Section 451, if the duty to file accounts and reports imposed by Section 441 is not met, every director in the company in question has committed an offence. Where a company fails to comply with Section 441 and Section 447, the court makes an order directing the directors to make good the default according to Section 452 of the Companies Act 2006. Meanwhile, the company is liable to a civil penalty in accordance with Section 453 if it fails to deliver accounts that are acceptable to Companies House by the filing date, and the directors of the company will be in breach of S451 of the Companies Act 2006. Those rules are incorporated to comply with the EU NFRD. They are therefore similar to the NFRD.

With the end of the Brexit transition period at the end of 2020, the UK–EU Trade and Corporation Agreement took effect under the Withdrawal Agreement. EU corporate laws, regulations and precedents ceased their application to the UK from January 2021. As the watchdog for corporate financial and non-financial disclosure, the Financial Reporting Council (the FRC) carries out the task of post-Brexit non-financial information collection and supervision. The FRC is going through a transition to create a stronger Audit, Reporting and Governance Authority (ARGA) as its successor regulator. Although still in its early days, the proposal objective of the ARGA has already been criticized as being too narrow and excluding non-financial reporting [85].

In the 2019 Brydon Review, an independent report assessing the quality and effectiveness of auditing in the UK, it was recommended that a Public Interest Statement for Public Interest Entities [79] should be produced by directors to explain how they view the company's environmental responsibilities in the public interest, how the company has discharged its public interest obligations, what actions it has taken to mitigate any externalities it has caused during the period, and whether they were effective [86]. In a 2020 discussion paper, 'A Matter of Principles: The Future of Corporate Reporting', the FRC recognizes that non-financial disclosure in the UK is dispersed and patchy and proposes a report similar to a Public Interest Report to provide a more holistic approach to reporting. The FRC sees the future of the UK corporate reporting system as being flexible and responsive to changing demands and circumstance, in order to provide relevant, reliable, comparable and balanced information for users. Nevertheless, the FRC admits that their thinking in this area is 'at an early stage' [86], and it is uncertain whether the FRC will pursue the idea of a Public Interest Report.

3.5. Applying 'Really Responsive' Risk-Based Regulation in Improving UK Sustainability Reporting

The FRC faces increasing political and reputational risks caused by growing public attention to non-financial reporting and legal uncertainties after Brexit. However, the FRC lacks sufficient legal resources to address these new challenges. Risk-based regulation could shed light on overcoming these issues, and this paper therefore suggests that a 'really responsive' risk-based regulation approach should be adopted.

3.5.1. FRC as a Non-Financial Reporting Watchdog and Its Lack of Resources

The FRC sets the UK's Corporate Governance and Stewardship Codes. Through its regulation of auditors, accountants, and actuaries, the FRC promotes transparency and integrity in business. The work of the FRC assists investors and stakeholders who rely on company reports, audits, and high-quality risk management.

Currently, however, the FRC has constrained resources, and is without the necessary means to pursue its mission and deliver its regulatory responsibilities. The FRC is funded by audit and actuarial professional bodies and by levies on accounts preparers, insurers, and pension schemes. Contributions from recognized supervisory bodies and competent authorities also fund the work of the FRC. However, levies are collected on a voluntary basis, and are therefore uncertain in nature. The FRC faces significant funding exposure if funding groups refuse to pay the voluntary levy. The general reserves of the FRC are only equivalent to the cost of operating for four months, and the FRC admits that it is underfunded largely because of the amount of additional work it takes on when recognized supervisory bodies cannot carry out delegated tasks or when a gap in the regulatory framework appears [87].

This insufficiency in resourcing results in the FRC's failure to address its ongoing risks. The latest FRC risk management and internal control report identifies Brexit as a major change that affects the organization's risks. The FRC acknowledges its insufficient addressing of Brexit-related impacts and recognizes that it has failed to update regulations affected by Brexit in a timely and efficient manner, which has led to consequent uncertainties in corporate governance and corporate auditing. In the context of corporate governance, the FRC has identified its failure to maintain the credibility of the UK corporate governance system due to compromises in ineffective governance and reporting by directors, and insufficient engagement and stewardship by investors.

3.5.2. Risk-Based Regulation in the UK

When legal resources are thinly spread and government agencies struggle to achieve their goals, a risk-based regulatory approach may also help to ease the problem. Such an approach could therefore offer assistance in addressing the challenges faced by the FRC.

Risk-based regulation is defined as a strategy or set of strategies that regulators adopt to focus their resources on the sites and activities that present risks to their ability to achieve their legislative objectives [88–90]. Through prioritization, regulators allocate more resources in the areas that represent higher risks for them and withdraw resources from the areas that represent lower risks [90]. The elements of risk-based approaches are various, ranging from an entire perspective or framework of governance to an ad hoc scenario involving only the piecemeal adoption of risk-based tools. At a minimum they entail the use of technical risk-based tools emerging out of economics (cost benefit approaches) and science (risk assessment techniques) [91] (pp. 3–4).

A risk-based approach to regulation has been conceptualized and applied in various areas of law [92–96]. The basis of a risk-based regulatory approach is to analyze by assessing a large quantity of information collected from corporations. If it is not well balanced, the approach could overburden companies because of excessive data collection by the authorities, and over-stretch government agencies because of the amount of legal resources required in order to process the data. In the UK the 2005 Hampton Report explored how to reduce administrative burdens while ensuring effective inspection and enforcement [45]. In the wake of this report, UK regulators are now obliged by law to adopt risk-based frameworks in their operation [95]. Under this framework, regulators are focusing on the risks that they are managing rather than the rules that they are enforcing.

3.5.3. Applying the 'Really Responsive' Regulation Approach—Adapting to New Risks

Black and Baldwin argue that to attune the logics of risk analyses to the complex problems and dynamics of real-life regulatory scenarios, regulators have to be 'really responsive' to the ongoing and ever-changing problems. They propose a 'really responsive' risk-based regulation framework, meaning a strategy that 'applies a variety of regulatory instruments in a manner that is flexible and sensitive to a series of key factors' [1] (p. 182).

New risks emerge when 'new events occur, knowledge develops, technologies and markets change, institutional structures are reformed, political and legal obligations alter, and public expectations and preferences mutate' [1] (p. 187). If regulators fail to recognize and adapt to these changes, crises may occur. One of the contributing factors to the 2008 financial crisis was that global financial regulators had not been able to register and manage new risks around subprime mortgages and over-the-counter trading of asset-backed assets. Regulators should be responsive to change and able to adjust to changes that impact regulations, such as shifts in objectives, the advent of new risks, and the emergence of new risk creators [1] (p. 205).

The FRC has traditionally focused on financial reporting risks rather than non-financial reporting risks, because the FRC was initially established to oversee financial reporting. Non-financial reporting is consequently not registered as a risk for the FRC. This paper argues that non-financial reporting should be identified and addressed as a new risk for the FRC, because non-financial reporting has become an emerging new risk triggered by changes in political focus, legal obligations, and public attention.

Non-financial reporting is not currently registered as a risk for the FRC. Since the establishment of the FRC, from 2015 to 2020, among the 11 reported proceedings that the FRC has been a party to, none relate to non-financial disclosure (see Table 1 below). To date, the FRC has achieved its objectives on non-financial reporting without recourse to the court, and there has been no non-financial reporting related enforcement action by the FRC.

Table 1. The 11 reported proceedings that the FRC has been a party to *.

Cases the FRC Has Been a Party to	Causes for the Action
Financial Reporting Council Ltd. v Frasers Group Plc (formerly Sports Direct International Plc) [2020] EWHC 2656 (Ch)	Costs; Issue-based costs orders
Financial Reporting Council Ltd. v Frasers Group Plc (formerly Sports Direct International Plc) [2020] EWHC 2607 (Ch)	Advice; Litigation privilege; Regulatory bodies; Tax avoidance; Tax planning
A v B Chancery Division [2020] EWHC 1492 (Ch)	Counterclaims; Disclosure; Financial Reporting Council; Financial services; Legal advice privilege; Litigation privilege
A v B Chancery Division [2020] EWHC 1491 (Ch)	Auditors; Declaratory judgments; Disclosure; Investigations; Legal professional privilege
Sports Direct International Plc v Financial Reporting Council Court of Appeal (Civil Division) [2020] EWCA Civ 177	Auditors; Communications; Disclosure; Financial reporting; Information gathering; Infringement; Legal professional privilege; Professional conduct
Financial Reporting Council Ltd. v Sports Direct International Plc Chancery Division [2018] EWHC 2284 (Ch)	Accountants; Advice; Conduct; Costs orders; Disclosure; Financial regulation; Indemnity basis; Legal professional privilege; Non-compliance; Permission to appeal; Regulatory bodies; Waiver
Taveta Investments Ltd. v Financial Reporting Council Queen's Bench Division (Administrative Court) [2018] EWHC 1662 (Admin)	Accountants; Decisions; Defamation; Fairness; Financial Reporting Council; Interim injunctions; Judicial review; Penalties; Publication
Executive Council of Financial Reporting Council, Re Queen's Bench Division (Administrative Court) [2018] EWHC 554 (Admin)	Costs; Interested parties; Judicial review
R. (on the application of Lewin) v Financial Reporting Council Ltd. Queen's Bench Division (Administrative Court) [2018] EWHC 446 (Admin)	Accountants; Disciplinary tribunals; Fairness; Financial Reporting Council; Misconduct; Non-parties; Publication; Reports; Right to respect for private and family life
R. (on the application of Baker Tilly UK Audit LLP) v Financial Reporting Council Court of Appeal (Civil Division) [2017] EWCA Civ 406	Accountants; Auditors; Disciplinary procedures; Financial Reporting Council; Misconduct
R. (on the application of Baker Tilly UK Audit LLP) v Financial Reporting Council Queen's Bench Division (Administrative Court) [2015] EWHC 1398 (Admin)	Audits; Complaints; Financial Reporting Council; Interpretation; Judicial review; Misconduct

* The 11 cases were collected from the Westlaw database.

Since 2013 the FRC has started identifying and addressing the principal risks that it faces in its annual reports. Non-financial reporting was not mentioned in any of the sixteen FRC annual reports between 2004 and 2019; it was only in the most recent FRC annual report in March 2020 that non-financial reporting was mentioned for the first time under the Stakeholder Engagement section, where the quality and reliability of financial and non-financial reporting and audit was identified as one of the issues that the stakeholders of regulated entities and NGOs including environmental and societal groups care about [96]. In response, the FRC stated in the report that it will include in its priorities for 2020/2021 the 'transformation of the FRC into a fit-for-purpose, independent regulator; to promote improvements and innovation, exploring good practice with a wide range of stakeholders; deliver robust, fair and transparent regulatory outcomes' [96]. Nevertheless, there is still no specific measure or step planned for addressing the pressing issue of non-financial reporting, which should be given more importance in the FRC's priority list and officially identified as a risk for the FRC.

Black and Baldwin think that the risk appetite of a regulator is determined ultimately by political consideration [1] (p. 184). A regulator needs political license to operate, while a firm needs social license to operate [90]. Regulators need political support in enforcing regulations, and a risk-based system carries significant political and reputational risks for regulators [1] (p. 197). Growing international concern about environmental problems and the political consensus within and outside the UK on achieving zero GHG emissions demonstrates the increasing importance of non-financial disclosure. Public attention and political expectation are causing higher degrees of political and reputational risks for regulators such as the FRC. If they are not responsive, regulators risk reputation loss and public confidence loss. Currently in the UK there is a strong political will to enhance regulations to facilitate the transition to a more sustainable economy, and the FRC therefore has a supportive political environment to improve its non-financial reporting.

3.5.4. Proposing a 'Really Responsive' Industry-Based Non-Financial Reporting FRAMEWORK in the UK

According to Black and Baldwin, when a risk is addressed in a 'really responsive' manner, regulators have to: (1) detect noncompliant behavior; (2) respond to that behavior by developing tools and strategies; (3) enforce those tools and strategies; (4) assess their effectiveness; and (5) improve approaches accordingly [1]. Therefore, after the FRC has detected and identified non-financial reporting as a new risk, it would have to develop a set of tools for non-financial reporting and enforcement, and then review and improve it periodically.

Black and Baldwin's 'really responsive' risk-based regulation requires the regulator to assess the likelihood of the occurrence of an adverse event, which depends significantly on the inherent risks attached to the nature of the business activities and the management and control of risks by the company itself, including their compliance record [1] (p. 184). Therefore, the FRC needs to consider inherent risks arising from the nature of a business's activities and the location of the business when environmental risks are being assessed, as well as the compliance record of the business. If the compliance records of companies cannot be traced, it is advisable that a standardized, holistic, and coherent system to record non-financial reporting compliance will need to be established so that records can be traced at a later date.

It would be beneficial to have a separate sub-section in the Strategic Report required from all quoted companies to disclose the give aspects of non-financial risk reporting. This non-financial risk reporting sub-section could follow the disclosure model established by the FRC Lab Project report, the Attribute of Good Principal Risk Disclosure in Figure 1 [97]. Non-financial risks will then be able to be disclosed in a tested, effective, and standardized manner. Standardized disclosure based on the FRC Lab Project could enable the risk scores of regulated firms to be compared year-on-year, which would contribute to revealing whether the overall levels of risk are increasing or decreasing [1] (p. 208). Assessors can then predict whether a particular risk score is likely to increase or decrease in the long run, and take precautions based on their judgment of the direction of travel of the risks [1] (p. 185).

Reporting based purely on the size of the firm is an overly narrow and simplified approach. This paper proposes a system of non-financial reporting based not only on the size of the company but also taking into consideration the risks that the firm potentially represents to the regulators (FRC), the stakeholders, and society at large. The reason for this is that the risk that the firm carrying in each element of the non-financial reporting is not always proportionate to the size of the firm. For instance, large firms could be in low carbon-intensity industries, while small and medium-sized enterprises (SMEs) could be in high carbon-intensity industries. A university group employing more than 500 staff may have lower GHG emissions than a thermal power plant with fewer than 500 employees. Moreover, firms operating internationally may attract more risk in the give areas of non-financial reporting than firms that operate nationally, due to the difficulty of monitoring and supervising behaviors in their long value and supply chains.

<table>
<tr><td colspan="7">What Entity-Specific Information is Important to Investors About Risks?</td></tr>
<tr><td colspan="4">Information that Helps Investors to Understand the Risk</td><td colspan="3">Information that Helps Investors to Understand How the Company is Managing the Risk</td></tr>
<tr><td>Presentation of Risks as Gross or Net of Controls</td><td>Likelihood and Impact</td><td>Priority</td><td>How Important is It?</td><td>How Does It Link to The Company's Story?</td><td>Link To Rest of Annual Report</td><td>Risk Appetite</td></tr>
<tr><td colspan="3">Categorization</td><td>What Type of Risk is It?</td><td rowspan="2">What is The Company Doing About It?</td><td rowspan="2">Mitigating Actions</td><td rowspan="2">Responsible Person</td></tr>
<tr><td colspan="3">Movement During the Year</td><td>How Is It Changing?</td></tr>
</table>

Figure 1. Attributes of good principal risk disclosure [98].

Companies in the same sector have similar business activities and impact the economy, the environment, and society in similar ways. It is therefore proposed to develop an industry-based non-financial reporting framework in the UK as demonstrated in Figure 2. The regulators could categorize the risks of individual firms according to the industries within which they operate for each of the five areas of non-financial reporting, based on the distinctive and homogenous characteristics of the industry. For example, they could differentiate between industries in terms of which of the five areas should be disclosed, the extent to which the disclosure should be made, or the extent to which the disclosure of each item should follow the Good Attributes of Risk Disclosure. To be proportionate, a mix of mandatory and voluntary non-financial disclosure requirements could be adopted in producing a scoring system and disclosure matrix. The industry division in the International Standard Industrial Classification of All Economic Activities [99] provides an example of the categorization of industries.

Figure 2. The proposed 'really responsive' risk-based non-financial disclosure framework of the paper.

There have been previous attempts to develop frameworks for industry-specific non-financial disclosure standard-setting by NGOs, such as the Global Reporting Initiative's

Sector Standard Project [100]. However, this is still in its initial stages and will be released industry by industry due to the amount of work involved. Further research could be completed once the guidelines are published.

3.5.5. Be 'Really Responsive' to Institutional Environments

During the establishment of an industry based non-financial reporting framework, a 'really responsive' approach to risk-based regulation needs to be responsive to institutional environments. The institutional environments of both regulatees and regulators that influence the regulatory integrations, processes, and outcomes are significant in this regard. These institutional environments are constituted by 'the organizational/regulatory, normative, cognitive and resource-distribution structures' in which these regulatees and regulators are situated [1] (p. 194), [101,102].

In a risk scoring system, regulators may regard certain companies as high-priority risks, and they may need to collect data to conduct further research to assess risks [1] (p. 198). During the risk assessment, cultural divergences may affect the regulators' abilities to assess performance by relying on the company's internal systems. Regulators think of objectives with reference to statutory purpose, but the company will see internal control as properly directed at ensuring that the company achieves the objectives it sets for itself in terms of profits and market share [1] (p. 202). However, reliance on a company's internal control is a central element of such risk-based frameworks and is often seen an inevitable because regulators do not have the resources to do anything else [1] (p. 203).

Risk-based regulation means that a regulator has to assess risk based on a significant amount of information, but not all regulators will have the powers to require information from companies [1] (p. 198). For instance, the FRC does not have the power to request a company's accounts if the company fails to prepare proper accounts or reports; under the Companies Act 2006 it has to apply to the court for an order requiring the preparation of revised accounts and/or reports. Another similar constraint for the really responsive approach is when the regulators' powers are fragmented or shared. More difficulties will be added when the risk in question is spread across jurisdictions or levels of government, so that new rules will require levels of institutional cooperation [1] (p. 196). This is a common position for many regulators since many risks and social or economic problems are already being addressed by networks of regulators. Those networks are often complex and decentered [1,103] (p. 195).

Therefore, it is vital that the FRC works closely in cooperation and coordination with other regulators such as the UK Environment Agency, or possibly with international organizations such as the International Financial Reporting Standards Foundation (IFRS) or the Global Reporting Initiative (GRI). The FRC also needs to have regard to the positive and negative elements of the institutional compliance environment of the industry within which the regulated companies are operating.

3.5.6. Be 'Really Responsive' to Reviewing Performance

A 'really responsive' risk-based regulator is performance-sensitive. Such regulators are able to measure the success of the enforcement tools that are used to achieve the desired legislative goals [1] (p. 200). This is not an easy task, as risk-based regulation is forward-looking and seeks to predict the likelihood of the occurrence of risks in the future. If a risk is not crystallized, it is difficult to show the interconnection between the risk and the regulator's efforts [1] (p. 200). It is therefore advisable for the FRC to set up a standardized and comparable risk scoring system for non-financial reporting, as well as a compliance recording system to obtain comparable data to assess the effectiveness of the approach and improve accordingly.

Applying a 'really responsive' approach to risk-based regulation for non-financial reporting is complicated because there could be considerable dissonance between the FRC's and other regulators' understandings of risk priorities in the five areas of non-financial reporting and those of the firms or stakeholders. The FRC has to constantly balance a number of issues: whether to target the largest risks or the places where the largest risk reductions can take place for a fixed amount of resource input; whether to focus on individual firms as risk creators or on specific types of risk; and whether to place emphasis on systemic risks or controlling individual risks [1] (p. 203). The collection of comparable data on compliance performance will help in making predictions and more informed choices. The aforesaid standardized, holistic, and coherent industry-based non-financial reporting framework, which also records comparable non-financial reporting compliance data, will be helpful in this regard.

4. Results

The world economy's gradual transition to a more sustainable model represents new green investment opportunities for investors, but also brings new compliance and reputational risks for regulators such as the FRC due to increasing political importance and public attention in the area of non-financial reporting. Non-financial reporting crystallizes the social and environmental dimension of a firm's economic activities, and the associated opportunities and risks for investors and stakeholders.

Currently, the FRC is failing to address ongoing risks because of constrained resources. The FRC also faces the unique challenge of the unfilled legislative gap post-Brexit. It would therefore be difficult for the FRC to enhance its supervision of non-financial reporting under the existing approach. This paper proposes a solution to this dilemma by identifying non-financial reporting as an emerging new risk for the FRC and situating it within a risk-based regulatory framework, because when legal resources are thinly spread as it currently stands, the FRC will struggle to achieve their goals on non-financial reporting regulation. By adopting a risk-based regulatory approach, the FRC could allocate more resources in the areas that represent higher risks and withdraw resources from the areas that represent lower risks through prioritization. A risk-based regulatory approach provides a strategy for the FRC to focus its limited resources on non-financial reporting which presents a newly emerging risk to enhance the FRC's ability and efficacy to achieve its legislative objectives.

To facilitate the success of such a regulatory approach, the paper suggests that the FRC should establish a 'really responsive' industry-based non-financial reporting framework in the UK. A 'really responsive' industry-based non-financial reporting framework would improve the previous overly narrow and simplified size-based approach to non-financial reporting supervision and be flexible and adaptable to the fast-changing post-Brexit institutional environments for both regulators and regulatees. Because the risk that each firm carries in each element of the non-financial reporting is not always proportionate to the size of the firm. Large entities with more than 500 employees such as universities could be in low carbon-intensity industries, while small and medium-sized firms could be in high carbon-intensity industries. Firms in the same sector, nevertheless, have similar business operations and impact the economy, the environment, and society in similar ways. A key element of the 'really responsive' regulatory approach is to be responsive to institutional environments of both regulatees and regulators that significantly influence the regulatory integrations, processes, and outcomes. When adopting the 'really responsive' industry-based non-financial reporting framework, the FRC does not only have to acknowledge and identify non-financial reporting as an emerging new risk, but also has to be mindful of the complications and challenges ahead such as the complicated institutional environments including the fast-changing post-Brexit institutional landscape for both the FRC, and the firms regulated.

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