



Law Society
of Scotland

Consultation Response

Smarter regulation non-financial reporting review: call for evidence.

August 2023



Introduction

The Law Society of Scotland is the professional body for over 12,000 Scottish solicitors.

We are a regulator that sets and enforces standards for the solicitor profession which helps people in need and supports business in Scotland, the UK and overseas. We support solicitors and drive change to ensure Scotland has a strong, successful and diverse legal profession. We represent our members and wider society when speaking out on human rights and the rule of law. We also seek to influence changes to legislation and the operation of our justice system as part of our work towards a fairer and more just society.

Our Banking, Company & Insolvency Law sub-committee welcomes the opportunity to consider and respond to the Department for Business and Trade (DBT) working with the Financial Reporting Council – Smarter Regulation non-financial reporting review: Call for Evidence¹.

We have the following comments to put forward for consideration.

General Comments.

We consider this will be more impactful to smaller companies, as it may increase compliance and disclosure burdens, and we believe this is over-regulation with no apparent benefit.

Consultation Questions

Question 1. I would like my response to be treated as confidential.

Yes

No

Question 2. What type of respondent are you?

Individual

Investor

Shareholder

¹ [Smarter regulation non-financial reporting review: call for evidence - GOV.UK \(www.gov.uk\)](https://www.gov.uk/government/consultations/smarter-regulation-non-financial-reporting-review-call-for-evidence)

Academic

Business

Representative Body

Charity

Other (please specify)

Question 3. What is your name?

The Law Society of Scotland

Question 4. What size is your business?

Micro (1-9 employees)

Small (10-49 employees)

Medium (50-249 employees)

Large (250 or more employees)

Question 5. And are you an accountancy firm?

No

Question 6. What is your organisation's name?

The Law Society of Scotland

Question 7. What is your email address?

GavinDavies@lawscot.org.uk

Question 8. How did you hear about this consultation?

- Email from the Department for Business and Trade
- Email from elsewhere
- GOV.UK/GOV.UK alert
- Newsletter
- Twitter
- LinkedIn
- Other (please specify)

Question 9. Are you a preparer or a user of non-financial information?

- Preparer
- User
- Other (please specify)

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The following questions are primarily aimed at the preparers of non-financial information.

Question 10. How valuable, if at all, is the preparation and/or disclosure of non-financial information for the effective running of your company?

- Highly valuable
- Moderately valuable
- Somewhat valuable
- Not valuable
- Don't know

Question 11. And why do you say that?

The notion that a company is assisted by preparing and disclosing non-financial information mandated by regulation is misguided. To the extent that dominant third parties wish to provide such information, they ask for it - normally in their own format. Preparing it in a different format, for different purposes, therefore only adds costs.

We consider that non-financial disclosure outside of a capital market materially adds a compliance burden for smaller companies. Such burden may be justifiable if the information is used: either by contractual counterparties (although, as noted above, dominant ones are likely to have their own private information requirements), or government bodies. It is imperative that any requirements for non-listed companies to disclose non-financial information is predicated upon strong evidence that it is required and will generate a benefit in excess of this cost.

Where such disclosure is mandated, we believe that this needs to occur at the highest quality and with full and consistent compliance to ensure the information prepared by all entities is comparable and useful to the end user.

Question 12. What challenges, or costs, if any, does the preparation, disclosure and distribution of non-financial information create for your company?

We consider that there are a number of major challenges in respect of non-financial disclosure. First, a major challenge is cost. This manifests in a number of ways (see below). Second, there exists an information challenge of ascertaining which disclosure requirements are applicable, and the format in

which disclosure is required. This is especially the case because existing information requirements are set at different thresholds and required to be in different formats for different requirements.

It should be noted that these costs are not proportionate to company size. A large amount of them are fixed costs that apply regardless of company size. As a result, smaller companies have disproportionately high compliance burdens as a result of the collation and distribution of non-financial information. Once more, we consider that strong evidence of the benefits of such disclosure is required to justify this.

Question 13. What, if any, are the key drivers of cost when having to comply with non-financial reporting requirements?

We consider that there are five key drivers of costs in respect of complying with non-financial reporting requirements.

- First, direct staff costs: the amount that is directly attributable to payment of a compliance or reporting function within the company.
- Second, indirect staff costs: arising from the diversion of staff time. Staff whose jobs are elsewhere within the company have to spend time responding to requests and preparing the relevant disclosures.
- Third, third party advice costs: required to comply with the raft of complicated disclosure requirements. This includes payment to lawyers and accountants for advice on what needs to be reported on, and how.
- Fourth, there are significant system and infrastructure costs: required to collate the information. This can be in respect of specialist third party software, or changes required to usual reporting and monitoring systems. These can be dramatic, and once more the costs are disproportionately high for smaller companies.
- Fifth, reporting costs: there will be costs in respect of translating the information into the formatting requirements of whatever body and platform reporting needs to be undertaken to.

Question 14. Please respond in line with the following considerations listed below:

- **Staff costs;** please see our comments above.
- **Time costs;** please see our comments above.
- **Production costs;** please see our comments above.
- **IT infrastructure costs;** please see our comments above.
- **Any other relevant costs.** please see our comments above.

Question 15. Please select the most applicable statement:

The benefits of preparing and disclosing non-financial reporting information outweigh the costs

The costs of preparing and disclosing non-financial reporting information outweigh the benefits

The benefits of preparing and disclosing non-financial reporting information are proportionate to the costs

Don't know

Question 16. Please explain your answer.

As per the above, we consider that the costs of preparing and disclosing non-financial reporting information are high, and proportionately higher for smaller companies. We are unsure of the benefit of publicly mandated reporting. Some third parties will not take an interest, and so will ignore the reports. Some will take an interest and be dominant, and so already require the information in their own format. Public bodies may have an interest in respect of certain enforcement powers, although it seems that these are rarely used. As a result, we consider the costs high, and the benefits unknown or uncertain.

Question 17. To what extent do the Companies Act non-financial reporting requirements align with other regulatory requirements your company might be in scope of?

Depending on the business, there are a range of different regulatory reporting requirements, all of which bite at different thresholds, and require different responses. This places a high compliance burden on companies, especially smaller companies, to establish applicable regulation, and how it varies in scope and content. We consider that simplification and harmonisation of existing regulatory requirements should be prioritised over increasing compliance burdens.

The following questions are primarily aimed at the users of non-financial information to complete.

Q. 18. To what extent do you agree or disagree that non-financial information prepared by companies is useful?

Strongly Agree

Agree

Neither agree nor disagree

Disagree

Strongly disagree

Don't know

Q. 19. Please explain your answer.

Disclosure of all types is efficient in capital markets. The logic here is that investors will factor all relevant information into their decision to hold, sell, or buy stock, and as a result disclosure will affect the market price for shares and therefore should be as full and accurate as possible. Mandatory disclosure is therefore important in the context of capital markets. However, outside of capital markets this benefit is lost. There are thus limited upsides to mandatory disclosure of non-financial information outside of a capital market. Such mandatory disclosure places a big compliance burden on companies to produce information which is unlikely to be read or understood if it is read.

There are three risks that we see in mandating non-financial disclosure outside of a capital market.

- First, the information will be too disparate to compare. No-one reading the material will thus be able to compare two companies on the same issue in a simplified way.
- Second, most market participants will not incur the internal cost of looking at such disclosure. It takes time to wade through public information to obtain an answer, and that time represents a cost to the user. A small supplier is unlikely to wade through annual reports and accounts to find information. This is exacerbated by the first point, in which there is a risk that non-standardised disclosures are not clear.
- Third, such information may not even change bargaining behaviour if it could be found: most individuals do not pick their hairdresser based on their carbon footprint. For those individuals who do care enough to do so, they will undertake their own diligence process, in which mandated and

centrally disclosed information in qualitative discursive form is unlikely to factor. We therefore think that there is a strong chance that users will not use mandated reporting of non-financial information, and therefore that the high compliance cost will not have a corresponding benefit.

Q. 20 How, if at all, do you use non-financial information?

We have no comments.

Q. 21 Which types of non-financial information are the most useful and/or which are the least useful?

Standardised, simple, quantitative responses to simple questions are the most useful for both sides. As noted above, we consider that most users will not change their behavior based on non-financial disclosure, and those that do may not be able to find it. Users will not wade through swathes of qualitative discussion in unstandardised forms.

Q. 22 Which types of non-financial information are the most useful and/or which are the least useful?

For information to be useful it must be read and acted upon by other parties. Therefore, we can see the case for mandatory disclosure for matters that relate to public enforcement – e.g. modern slavery, bribery, etc. However, the caveat for this is that any such disclosure must be read in full by the relevant governmental bodies. Otherwise, there is no point to disclosure.

For other matters, insights into governance are most helpful: gender diversity, gender pay gap, environmental strategies, and social benefits and harms. We believe, though, that these need to be objectively measured rather than subjectively explained.

Q. 23 How easy or difficult is it to interpret non-financial reporting disclosures?

- Very easy
- Easy
- Neither easy nor difficult
- Difficult
- Very difficult
- Don't know

Q. 24 Please explain your answer.

As noted above, we are concerned that there is a lack of consistency in respect of what each company is disclosing, meaning that it is not possible to compare like for like.

Such inconsistency will be inevitable without the disciplinary function of a capital market, or a centralised enforcement agency to read all disclosures for compliance.

This is further complicated as the requirements are complicated, tucked away in a variety of sources, schedules, and amendments to the Companies Act 2006. It is complicated for preparers, users and their professional advisers to follow all requirements. The form of such disclosure, too, tends to start with the full requirement then institute a series of carve outs. In a personal capacity, the Convenor of our Banking, Company, and Insolvency Law Policy Sub-Committee has recently published original research calling for simplification of the existing regime² in the European Business Organization Law Review. This research argues that any requirements should start with the basic requirements for the smallest companies, then add on layers of complexity as companies grow larger. At the moment, regulatory regimes are applied the other way around, which further adds to the compliance burden for smaller companies, who must understand the “full” disclosure requirements before exploring carve outs applicable to them.

Q. 25 How does non-financial information support your judgement in the following areas?

We have no comments.

² see J Hardman and G Ramirez-Santos, [‘Empirical Evidence for the Continuing Need to ‘Think Small First’ in UK Company Law’](#) (2023) 24 European Business Organization Law Review 117.

- **How the directors of the company have fulfilled their duties;**
- **The performance of the company;**
- **The company's future strategy, opportunities and risk;**
- **The company's approach to societal issues such as modern slavery and the gender pay gap;**
- **Whether or not to invest in a company - please consider the types of non-financial information that is most and least useful, and how it compares to other factors or information in your response.**

The following questions are aimed at all respondents.

Q. 26 What changes, if any, would you like the UK Government to make to the current legal requirements for companies to prepare non-financial information, and why?

We consider that the main requirement is to lower the compliance burden. We think that this can be done in a number of ways. First, simplification of existing requirements is necessary, Second, harmonisation between different requirements is required (e.g., company law thresholds and HMRC thresholds). Third, the overall amount of information required to be provided should be lowered. Fourth, it needs to become easier to identify all applicable disclosure requirements.

Q. 27 Thinking about the future of your organisation and the UK's transition to a net zero economy, what changes, if any, do you think may be required to the type of non-financial information produced to guide decision making, and why?

We have no comments.

Q. 28 How should the standards being prepared by the International Sustainability Standards board (ISSB) be incorporated into the UK's non-financial reporting framework?

To the extent that disclosures are already covered in accountancy requirements, we do not think that company law will need to duplicate them. We consider that there is a risk that companies are required to provide too much information, which speaks at cross purposes, is expensive to produce, and is confusing for the user.

We are also concerned that some of these standards introduce unnecessary subjectivity, and interpretation, which risks manipulation by larger and more sophisticated preparers, lack of clarity, and lack of comparability.

Q. 29 To what extent do you agree or disagree that current size and company type thresholds for non-financial reporting information could benefit from simplification?

Strongly agree

Agree

Neither agree nor disagree

Disagree

Strongly disagree

Don't know

Q. 30. Please explain your answer.

The entire regime for disclosure by non-large companies needs dramatic simplification.

The Companies Act 2006 sets out size categories for UK companies that determine the type of accounts that need to be prepared and filed with Companies House.

Q. 31. Do these size thresholds remain appropriate?

Yes

No

Don't know

Q. 32 Please explain your answer and what, if any, changes you would like to see.

We consider that these thresholds represent an arbitrary set of limits, which can be difficult to calculate. If the current approach is maintained, then thresholds need to be dramatically increased. They also should be aligned with other areas – e.g., VAT thresholds, and HMRC general requirements.

As per above, we consider that starting large and providing carveouts for smaller companies is the wrong way for thresholders to operate. Instead, micro companies should be the default, with a company qualifying as small if it passes certain thresholds, with certain requirements, then medium, etc. This will mean that the smallest companies have the least work to do to ascertain their category and the rules applicable to them, matching the company law reform mantra to “think small first”.

Q. 33 Do you have any other comments that might aid the consultation process as a whole?

We remain concerned that any quest for greater transparency outside capital markets may have the opposite effect. We believe that the compliance burden for smaller companies needs to be reduced, and that there is a need for greater harmonisation across requirements from various governmental departments.

For further information, please contact:

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