Environmental disclosure — effective risk management and exposure mitigation

The financial risks flowing from management of environmental impacts have increased in line with the increasing number and severity of regulatory measures, and with changing market expectations. These risks are material to the financial position of many listed companies, or will become so in the near term.

Disclosure of environmental risk is therefore important to enable assessment of financial risk. In a demonstrably nervous, post Enron/HIH/Worldcom investment market climate, leading management thinking recognises transparency and disclosure as business assets. Analysis by Monash University of current disclosure practices of S&P/ASX 200 companies has found that disclosure across all sectors is inadequate.

As a basic requirement, companies should disclose:

- activities/operations posing significant environmental risk
- data on key impacts/emissions including greenhouse gas emissions
- financial reporting of materially significant environmental liability, debt exposure, and cost management information in relation to key impacts
- information on management initiatives to mitigate key environmental risk.

Sectors with the highest environmental risks include the materials and energy sectors, utilities, transportation, and media. In these higher risk sectors, a significant portion of total environmental costs tends to be hidden in overheads and co-mingled cost centres, resulting in systemic underestimation of the material impact of environmental risk on business risk and financial position. For higher risk business sectors, environmental disclosures (including costs) should be made through:

1_stand-alone and verified corporate environmental reports
2_inclusion of financially significant environmental risk information in the annual report
3_comprehensive environment-related information on company websites. The specific information contained in environmental reports should be linked to thorough assessment of impact and risk. Companies should seek specific guidance on reporting frameworks through reference to the Global Reporting Initiative (GRI).[1]

1_The Global Reporting Initiative (GRI) is an international initiative whose mission is to develop and disseminate globally applicable Sustainability Reporting Guidelines for voluntary use by organisations reporting on the economic, environmental, and social dimensions of their activities, products and services. Refer http://www.globalreporting.org/AboutGRI/FAQ.htm. Companies seeking further references may consider the Greenhouse Gas Protocol, recognised standards, including ISO14031 — Environmental Performance Evaluation and the Association of British Insurers' disclosure guidelines and background paper at http://www.abi.org.uk.

Background to Position Paper: Environmental Disclosure

Increased demand for environmental risk disclosure

Increased demand for environmental risk disclosure

Rising stakeholder and community expectations, together with increased competition for the shareholder and consumer dollar, have heightened market demand for company transparency. Disclosure of environmental risk is an important component of this shift.

Company environmental risk disclosure enables investors to assess the actual and potential risks arising from management policies and practices. Similarly, disclosure is necessary for informed assessment of financial and liability risk, as well as reputation risk.

Mandatory public environmental reporting regulations have been introduced in Norway, Sweden, Denmark, The Netherlands, and France.[1] In the US and Canada, environmental disclosure regulations require that companies report on current and future financial impacts, with a focus on environmental protection requirements.

While regulation of environmental disclosure in Australia lags behind most OECD countries,[2] the number and scope of government mandated reporting initiatives is on the increase. The general trend is towards greater levels of disclosure, as governments at both the State and Commonwealth level respond to stakeholder demands for more information on environmental impact, risk and performance.

The Financial Services Reform Act (FSRA), introduced in Australia in March 2002, requires disclosure of the extent to which investment product providers have taken into account environmental considerations (inter alia) in their investment decisions. This will, in turn, require parallel company disclosure.[3] (UK legislation includes this to a lesser extent and similar moves are under consideration by Germany, France, Canada and the European Commission).

Moreover, the number of reporting requirements for signatories to various voluntary initiatives, such as the Greenhouse Challenge and National Packaging Covenant, has increased the demand for environmental information from companies. National commitments under international conventions on climate change, biodiversity and forestry are also likely to increase demand for better indicators of national environmental performance, thereby shifting greater responsibility onto companies to measure and report progress.

Some Australian states (eg Victoria) offer accredited licence holders reduced fees and exemptions from obligatory works-approvals, based on sound environmental behaviour, including greater disclosure of environmental performance.

Better disclosure means better business

There is a growing body of evidence (both qualitative and quantitative) supporting the view that improved environmental risk disclosure can achieve financial benefits, including:

→ greater awareness of, and consequently, control over corporate environmental impact, leading to reduced regulatory and production costs (resource consumption costs, waste disposal costs, licence fees, non-compliance costs)
→ reduced financial risk through enhanced reputation (ie stakeholder relations: regulatory and community)
→ lower capital costs as risk disclosure is viewed positively by credit rating agencies, prospective buyers (eg, in relation to due diligence), SRI fund managers, and, increasingly, the investment sector generally
→ shareholder value benefits through improved relations with regulators, customers, suppliers, and employees.

1_A private member's bill seeking to mandate social and environmental disclosure in Annual Reports has also recently been introduced into the UK House of Commons. A similar proposal is also under consideration by the European Commission.
2_Key disclosure regulations in Australia include the National Pollutant Inventory; reporting on specific environmental releases or impacts required to Government authorities under licence conditions and permits for designated sites or facilities; and Section 299(1)(f) Corporations Act, which requires companies to provide, within the directors' report for a financial year, details about the company's performance in relation to any particular and significant environmental regulations that apply to the company.
3_Financial Services Reform Act.

Empirical evidence of the benefits of environmental reporting globally

The financial and environmental benefits of environmental reporting is supported by research in industrialised countries, for example:

- The US Environment Protection Authority reported that, between 1988 and 1995, total releases of toxic chemicals regulated under the US Toxic Release Inventory fell by 46% from reporting facilities. Many US companies reported significant cost savings through more effective tracking and management of material and waste flows.[1]
- A 1999 review by the Danish government into the effectiveness of legislation requiring some 1200 Danish companies to publish environmental information in the form of a 'green account' found that approximately 50% of the firms surveyed reported financial benefits through production of the accounts, compensating for the costs involved.[2]
- A 2001 survey by the UK Department for Environment, Food and Rural Affairs on environmental reporting costs and benefits found that environmental reporting provided important or major benefits in the areas of stakeholder dialogue, reputation, internal commitment, and employee awareness.[3]
- According to the 2002 KPMG International Survey of Corporate Sustainability Reporting 45% of Fortune 250 companies are now issuing environmental, social or sustainability reports in addition to their financial reports. This compares with 35% in 1999.

Who's pushing disclosure issues internationally?

The United Nations Environment Program (UNEP) Finance Initiatives — a voluntary initiative between UNEP and financial institutions — has grown from six founding signatories in 1992 to more than 275 banks, insurers, and asset management companies worldwide today. Participating institutions are provided access to tools to enable integration of environmental risk into investment, lending facilities, and insurance risk assessment. Other developments in the finance sector indicating increased attention to environmental disclosure include the following:

- The Association of British Insurers (ABI) representing more than 20% of all public equity in the UK has issued non-binding guidelines on disclosure. The guidelines require public companies to report on the risks of their environmental and social performance, as well as the management and verification policies used to identify and mitigate those risks.
- Morley Fund Management, the funds management arm of CGNU (2.5% of UK market), issued a statement requiring the top 100 companies on the FTSE to produce Corporate Environmental Reports (CER) by the end of 2002. If a CER is not produced, Morley will vote against resolutions to adopt the company's annual report and accounts.
- The Carbon Disclosure Project, which represents a consortium of international institutional investors with US$4 trillion in assets, is seeking the global top 500 companies to disclose their greenhouse emissions by the end of 2002. The expectations of stakeholders other than shareholders are placing increased pressure on companies to provide greater environmental disclosure. According to the US Interfaith Centre on Corporate Responsibility, socially conscious investors sponsored 132 proposals to 96 US companies in 2001 on a wide range of social and environmental issues. 22 companies were subject to environmental disclosure-related resolutions.

Australia: investors and legislators driving disclosure

In Australia, the FSRA environmental disclosure requirements covering investment products have only accelerated financial interest in the environmental performance of listed companies, particularly risk factors and as a potential proxy for effective management.

1_USEPA., 1997, 1995 Toxics Release Inventory Public Data Release, US Environmental Protection Agency: Washington, DC, May.
2_Bebbington, J., 1999, 'Compulsory environmental reporting in Denmark: an evaluation', Social and Environmental Accounting, Vol 19 No 2, pp. 2–4.
3_Merrick, J. & Crookshanks, C., 2001, Report on a Survey of Environmental Reporting Costs and Benefits, Prepared for DEFRA, Environ: London, November.

The growth of the socially responsible investment (SRI) funds in Australia has increased demands for environmental performance information from companies. Since 1999, the number of dedicated SRI funds offered in the Australian market has grown from three to over 15. Of particular note, the participation of the superannuation industry in the SRI sector in the last two years has increased the potential for significant funds flow into highly rated stocks. By June 2002, around 20 superannuation trusts offered SRI funds as a member choice, representing a significant portion of the total superannuation industry.[1] A number of new SRI funds have also been marketed into the retail sector by mainstream fund managers, leading to increased awareness and exposure of investors to SRI.

The increasing willingness of institutional investors to incorporate environmental risk factors in assessing the investment risk of equity portfolios is an emerging trend likely to have implications beyond the SRI sector. Although embryonic, the Australian experience appears to be mirroring similar trends in North America and Europe.[2] The implication is that environmental risk will be increasingly scrutinised as a mainstream concern, requiring greater levels of company disclosure to enable more comprehensive assessment of risk.

If you can't measure it, you can't manage it

Financial costs associated with environmental exposures span a wide range of issues including:

- compliance costs arising from pending or proposed government regulations relating to environmental performance
- changes in raw material and energy costs, and the costs relating to management of wastes/emissions as a consequence of national, state or local environment protection policies
- access to product and financial markets as a result of changing stakeholder expectations with respect to environmental performance.

Inefficient use of raw materials and energy, emissions, or waste outputs increases total business costs and erodes shareholder value. Company management needs to have access to information on existing and potential environmental liabilities in order to improve decision-making or mitigation efforts. Information systems that capture land contamination liabilities are generally well established in industry. Other environmental exposures, such as greenhouse emissions, are generally not reported as comprehensively. Yet, future greenhouse liabilities are generally viewed as the most significant environmental risk facing companies.

While considerable uncertainty exists in relation to the future cost of emission credits (estimates vary from only a few dollars per tonne to more than $100/tonne), most companies effectively value contingent CO2 liabilities at zero, potentially exposing the company to large liabilities in the event of regulatory change.[3] Modelling undertaken by Innovest in the US, for example, found that the discounted present value of potential carbon liabilities within a single energy-intensive manufacturing firm could represent as much as 40% of its entire market capitalisation.[4] In this context, it is important that comprehensive data on greenhouse emissions and trends be captured and reported both internally and externally. Investment and finance institutions will increasingly seek greenhouse liability information as Kyoto Protocol mechanisms are implemented on the international level.[5]

Incorporating environmental costs into accounting methods and reports

Across industry, environmental costs (including the increasing costs of compliance) are not fully reflected using present accounting methods. The need for better measurement and reporting is particularly important given that the costs of managing environmental issues have been observed to rise as a proportion of total business costs.[6] Conventional cost-accounting systems identify only a portion of total environmental costs,[7] resulting in systemic underestimation of the material impact of environmental risk on business risk and financial position.

1_As of June 2002, SRI options through member choice had become available to over 2 million superannuation account holders, around 25% of the market.
2_For comparative examples, see CalPERS in the US and HERMES in the UK.
3_Trexler, M., May 2002, 'Is $0 your best guess?', Environmental Finance.
4_http://www.environmental-center.com/consulting/innovest/services2.htm.
5_Hunt, E.& R. Casamento, November 2001, 'Investors enter climate debate', Environmental Finance.
6_Joshi et al, April 2001, 'Estimating the Hidden Costs of Environmental Regulation', The Accounting Review, Vol. 76, No.2, pp.171–198. See also (Coyne, 1998).
7_Ditz, R., Ranganathan, J, and Banks, R., 1995, Green Ledgers: Case studies in Corporate Environmental Accounting, Washington DC: World Resources Institute.

Recent research has found that a $1 increase in the direct cost of compliance in the steel industry is associated with a $10–$11 increase in total costs. Studies in other industry sectors have indicated an increase of total costs ranging from $3–7, depending on the extent to which the industry is impacted by environmental regulations.[1] Most of these cost increases tend to be hidden in overheads or other cost centres including:

- staff costs, such as those for compliance-oriented legal staff
- fees, training, waste management
- substitution of less-polluting inputs for more-polluting inputs
- site studies, permits, closure, decommissioning
- damages, remediation, penalties.

Failure to identify and attribute hidden costs to environmental management may result in materially different accounts, thus affecting key decisions in relation to technology selection, process design, management, and selection of inputs.[2] Also, accounting systems do not currently account for external costs to society that may later become material and affect firm value,[3] such as contingent environmental liabilities for contamination incidents or toxic releases. In considering only the visible costs of environmental regulation, company accounts are likely to seriously underestimate the effect of environmental risk on cost and profit.

Focus on long-term cost-benefits of disclosure

While the initial costs of developing environmental reporting systems may add to total costs in the early stages, companies with established reporting systems typically achieve financial benefits after the first or second year.[4] Experience also suggests that the opportunity to achieve further benefits increases as environmental information systems are integrated with production and accounting systems.

To date, most Corporate Environmental Reports in Australia have tended to focus on physical impact data, with little information provided on the financial risk/implications linked to the management of environmental impacts. In view of the growing importance of environmental management on the financial position of companies, however, it is appropriate that companies capture and disclose materially significant environmental risk and performance information as well as regulatory compliance. This information should include:

- the material effects of complying or failing to comply with environmental requirements on the capital expenditures, earnings and competitive position of the company and its subsidiaries
- environmental contingencies that may reasonably have a material impact on net sales, revenue, or income from continuing operations
- significant information on financial expenditure/savings relating to management of impacts, releases, emissions, or wastes
- pending or potential proceedings by a government authority that:
  - arise under Commonwealth, state, or local provisions that have the primary purpose of protecting the environment
  - are material to the business or financial condition of the company
  - involve potential monetary sanctions or liabilities that exceeds 10% of the current assets of the company.

Industry bodies representing sectors of company activity could do more to support environmental disclosure practices and accounting standards via proactive dialogue with members in order to promote behaviour that reflects the concerns of stakeholders in the financial sector. These views are advocated in an effort to improve company performance, with an eye on sustained, long term, creation of shareholder value.

1_Joshi et al, op. cit.
2_Ditz et al, op. cit.
3_Hughes, K., 2000, 'The value relevance of non-financial measure of air pollution in the electric utility industry', Accounting Review, 75(2), pp. 209–228 Barth, M. and McNicholls, M., 1994, 'Estimation and Market Valuation of Environmental Liabilites Relating to Superfund Sites', Journal of Accounting Research, 32 (supplement): 177–209.
4_Merrick & Crookshanks, 2001, op.cit.

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