Environmental Disclosures in Financial Statements: New Developments and Emerging Issues

Event Report – 26 February 2003

The Second Finance and the Environment Meeting, held by the CEC with the Financial Sector

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The Second Finance and the Environment Meeting, held by the CEC with the Financial Sector
New York, 26 February 2003

Co-Organizer
UNEP Finance Initiative (UNEP FI)

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Executive Summary

Is environmental information material to investors? If so, when? And are companies disclosing this information in ways that would enable analysts and fund managers to accurately judge its financial impact?

Are firms disclosing environmental information in a format that analysts can use?

At its March 2002 meeting on the disclosure of environmental information, the Commission for Environmental Cooperation of North America found that environmental information reported by companies (whether as mandated by securities regulators, or voluntarily) was rarely being used in mainstream financial analysis.

The present meeting, held on 26 February 2003, began by reviewing the conclusions drawn in the previous workshop, and the explanations that were suggested for the lack of demand for environmental information on the part of the mainstream financial community, namely that:

1. There is a lack of specificity regarding environmental disclosure requirements in securities law and minimal enforcement of the existing requirements.
2. Management in the financial sector is skeptical about the financial impact of environmental liabilities.
3. The lack of relevant and comparable environmental information being reported prevents comparative analysis.

The February meeting was held in collaboration with United Nations Environment Programme Finance Initiatives (UNEP FI), supported by PricewaterhouseCoopers LLP and the American Bar Association Section of Environment Energy and Resources, and hosted by HSBC at their offices in New York.

It delved deeper into the results of the March 2002 discussion, considering “supply-side” and “demand–side” evaluations of the suggested barriers to the integration of environmental information into financial statements.

On the supply side, analysis was conducted of the existing environmental reporting and the potential exposure to impending or proposed environmental actions for four environmentally sensitive sectors—oil and gas, pulp and paper, electric utilities, and the mining sector.

On the demand side, KPMG, PricewaterhouseCoopers LLP and Standard & Poor’s provided the perspectives of an auditor, a consultant, and a rating agency with respect to the materiality of environmental information in financial disclosure.

Seven main “themes” emerged from this meeting:

Reporting requirements as they pertain to environmental information are subjective

First, the legal and regulatory system in the United States that dictates what must be disclosed and when (even after the signing into law of the Sarbanes-Oxley Act) is subjective with regard to what type of environmental information should be considered material, and thereby when such information should be disclosed.

A close look at the financial statements of firms in these sectors revealed significant under-reporting of material environmental information.

Examples of wording in requirements on the reporting of environmental legislation deemed to be subjective were discussed. One way around the perceived subjectivity of these requirements would be to consider reporting environmental information appropriate for dissemination to senior management and/or members of a public company's board of directors as a good starting point for any analysis regarding whether, to what extent, and when, information about environmental uncertainties might be required to be disclosed to the public. The decision to disclose such information must of course balance the company's rights to privacy with the need for transparency.

For companies in the mining, manufacturing, chemical, building, petroleum, pulp and paper, and insurance sectors, ensuring that all appropriate environmental issues have been addressed might not be straightforward because of the complexity of the sectors and the environmental issues at hand. Consultation with environmental experts might be needed to complete the picture.

Many stakeholders are requesting and many firms report information not specifically required under securities regulation

Presentations and discussions made clear that stakeholders (including shareholders) are increasingly requesting information that falls both inside (e.g., recent shareholder resolutions requesting disclosure of financial risks raised by firms' emissions and pollution releases) and also outside the bounds of securities laws. As well, evidence was provided that firms have been reporting more in response to external demand for this information.

Information that appears to be potentially material often goes unreported

Three speakers presented their analysis of disclosure in the mining, pulp and paper, oil and gas, and electric utility sectors. In each sector, the results strongly indicated the materiality of certain environmental information.

However, despite both the strength of the evidence suggesting the materiality of environmental information in these sectors and also various regulatory requirements for disclosure of material environmental information, a close look at the financial statements of firms in these sectors revealed significant under-reporting of potentially material environmental information.

Interestingly, while the focus of the meeting was on the US, Canadian and European participants confirmed a similar situation in their regions. This discussion of materiality under existing regulation was buttressed by a review of possible upcoming regulation.

Reporting requirements as they pertain to environmental information often go unenforced

Enforcement has not been vigorous in years past because environmental issues have not been prominent among all the securities regulatory issues that the responsible agencies are faced with. Moreover, those agencies have typically been understaffed and underfunded to the extent that they were able to deal with only the most urgent and egregious issues. Thus, the SEC has not historically enforced its disclosure requirements with respect to potential environmental liabilities.

Lack of enforcement and definitions produce a disincentive to disclose potentially material environmental information

The lack of enforcement of requirements with respect to environmental information, and of a clear definition of what ought to be reported can create the impression among firms that environmental information is not relevant to investors and consumers, and this might lead them to decide against disclosing potentially material environmental information.

There is broad legal consensus that companies can justify, under existing enforcement scenarios, not reporting on the potential impacts of environmental issues like climate change. Despite the fact that they may be expected to report on such issues on the basis of existing regulations, it is unlikely that a lawyer would advise a client company's management that the company would face court action (which would imply a requirement to report such information in the Management's Discussion and Analysis (MD&A) section of their financial statement as a result of a failure to disclose such information), because regulations pertaining to environmental liability disclosure have historically rarely been enforced. This gap between regulation and enforcement is key to understanding why potentially material environmental information is not reported.

The question before stakeholders thus becomes, who best to develop a credible and financially relevant standard?

If a given standard for disclosure is not actively enforced, mainstream banks and analysts will not consider this information to be important. As well, they are not likely to incorporate such information into their financial analysis if it is not clear that such information can affect a company's bottom line. Moreover, corporate management will not have as much of an incentive to adequately disclose if they do not feel that the information is required. In addition, there are risks for companies reporting information that is not required, but which they believe could negatively affect their reputation.

It was suggested that this regulatory gap, when combined with the lack of a common disclosure framework, creates uncertainty for both regulators and industry. This may lead to overestimation of the costs associated with complying with environmental legislation that may further dissuade companies from opting for disclosure.

The need for financially meaningful and understandable methods by which to incorporate environmental information into financial analysis

The final issue raised was that of the paucity of methods for disclosing environmental information in a format that could be easily used by mainstream financial analysts and decision makers.

The question before stakeholders thus becomes, which groups, governments, broader civil society coalitions, or the private sector, could overcome the inertia and ensure that information is reported in useful way for analysts and investors? Presenters noted that reviews of existing reporting standards are underway in various government offices, accounting standards boards and stakeholder groups like the Global Reporting Initiative.

However, without the involvement of financial and accounting sectors in the creation of improved reporting standards, whatever is created runs the risk of remaining financially irrelevant. This will ensure that environmental considerations remain outside the investment analyses of financial houses and the individual and institutional investors they serve. Similarly, ratings firms such as Standard and Poor's are not likely to develop nontraditional rating measures unless they fill a perceived, unmet demand from their clients.

Until this uncertainty is addressed, these actors will remain unconvinced of the necessity of incorporating this information into financial decision making. This is despite the fact that this information appears, according to the presenters, to be material in many cases and could thus affect portfolio decisions if reported, in addition to being increasingly demanded by certain stakeholders.

Next steps

The discussion was widely hailed by the participants as very successful. Speakers were credited with bringing a level of quantitative analysis that quickly focused discussion on the operational realities of the nexus between environmental and financial information. Key outcomes included:

- A call to continue the debate.
- A call to continue to further develop internationally credible quantitative research on the financial materiality of environmental information.
- A call for government to enforce existing regulation and application of GAAP accounting standards.
- A call on industry and civil service to cooperate in the:
    - Developing of sector-specific disclosure practices for environmental information that will render the information easily analyzable in coordination with financial information.
    - Clarification of existing regulatory frameworks.

Event Proceedings

Convening the event, Linda Stryker-Luftig, executive vice-president of HSBC Group Public Affairs, set the stage for the meeting by saying that "taking the environmentally responsible course of action saves money and helps convey the importance of conserving and protecting our natural resources to our employees, customers and shareholders."

Emerging Legal and Regulatory Issues

New Legal and Regulatory Issues
Donald Elliot
Paul Hastings Inc.

As the first presentation of the day, Donald Elliot's presentation provided some background, history and commentary on securities regulation in the United States as it pertains and has pertained to the disclosure of environmental information. He prefaced his talk by jokingly claiming that he had considered titling his talk, "US Securities Regulation and Environmental Information: the Dog that Doesn't Bark."

The historical overview started with the 1971 Sonde and Pitt article, *Utilizing Federal Securities Laws to 'Clear the Air! Clean the Sky! Wash the Wind!'*, and ended with a discussion of the 2002 Sarbanes-Oxley Act. The reason for his reference to US securities regulations as a dog that does not bark with respect to the disclosure of environmental information became apparent throughout the talk: environmental enforcement by the SEC has been very rare, SEC disclosure requirements are litigation-oriented, and the wording used in the regulations is often subjective.

As an example of the subjectivity of disclosure requirements, Elliot looked at various requirements, including the legal requirements for the disclosure of environmental information in MD&A discussions on uncertainties in environmental trends (S-K Item 303), which requires that when known trends, events, or uncertainties that are *reasonably likely* to have a material impact on the company's liquidity, capital resources, or operating results, the potential impacts should be discussed in the MD&A section of an SEC filing. "Reasonably likely to occur" has been interpreted to mean more than a 40 percent likelihood of occurring.

It is important to strike a balance between a company's privacy and the desire for public disclosure.

Elliot emphasized that information deemed appropriate for dissemination to senior management and/or a board of directors of a public company is a starting point for any analysis regarding whether, to what extent, and when, public disclosure of information about environmental uncertainties may be required. Naturally, this needs to take into account the balance between company privacy and public disclosure.

For companies in the mining, manufacturing, chemical, building, petroleum, pulp and paper, and insurance field, ensuring that all appropriate environmental issues have been addressed may not be straightforward. This could be aided by the American Society for Testing and Materials (ASTM) standards developed for the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA) that could be useful in designing disclosure strategies. At times, companies should consider retaining the services of an external environmental consultant to assist in the data-gathering, evaluation, and disclosure process, since the issues may be beyond the companies' expert knowledge.

He also thought that the SEC ought to adopt ASTM Guideline E2137-01 as its disclosure requirements.

Disclosure Requirements—Myth and Reality
Andrew Davis
LeBoeuf, Lamb, Greene & MacRae, L.L.P.

Andrew Davis spoke about existing securities legislation and the Sarbanes-Oxley Act in the United States as they pertain to the reporting of environmental information (see the Appendix).

Davis felt that the Sarbanes-Oxley Act does not impose new and significant disclosure requirements that will restore public trust or end the corporate governance crisis (especially from the environmental compliance perspective). He noted what he thought could be expected from Sarbanes-Oxley.

The Act is neither a long–term panacea nor a short-term palliative solution for the corporate governance crisis. Indeed, the success of Sarbanes-Oxley in promoting greater transparency and accountability depends on the commitment of business and stakeholders to ensure that its requirements are effectively applied. Davis also made clear that there was an enforcement gap in the US that allows for a disconnect between the high theoretical standards and actual reporting.

He felt that the bottom line is that environmental disclosure is pivotal to Corporate Social Responsibility (CSR). There are both internal and external drivers for the disclosure of material information. Internally, the driver is compliance with disclosure requirements. This generates better information that allows corporate leadership to efficiently address environmental concerns. Externally, the driver is commercial, since better environmental disclosure increases transparency that allows stakeholders to better evaluate the competitive advantage of a corporation committed to CSR.

What can be expected from the Sarbanes-Oxley Act:

- Closer scrutiny of Environmental Health and Safety (EHS) performance to ensure compliance with disclosure requirements,
- Improved record-keeping and document retention,

- Consistency in disclosure and material corrections to past statements,
- Timely interaction between CEO/CFO and EHS management, and
- Emphasis on corporate-wide risk management.

Opportunities offered by the Act include:

- Foster trend to step-up disclosure and facilitate synergies with related requirements,
- 8-k revisions proposed - enhanced real-time disclosure requirements could include environmental information,
- Applicable to *pro forma* earnings and off-balance sheet financing,
- Rapid disclosure regarding material changes in financial conditions or operations,
- Closure of environmental accounting loopholes,
- Halt underreporting of environmental liability in SEC filings,
- Review/reassess parent/subsidiary EHS interaction,
- Opportunity to disclose environmental assets, and
- Enhanced capacity to conduct environmental due diligence of acquisitions, financing and investment.

Companies with pre-existing, voluntary EHS disclosure practices will benefit from "first mover" advantage.

Davis offered several key recommendations for policy makers in this regard:

- Make reported amounts in SEC disclosures consistent with regulatory submissions to other agencies (i.e., to the Environmental Protection Agency), claims made to insurers, consultants' reports, transactional evaluations, or loan documentation,

- EHS management systems must ensure a company collects, processes and discloses environmental information, including:
    - Immediate compliance obligations and costs, and
    - Expected capital costs to meet environmental obligations
- Document all rationale for disclosure decisions when they are made.

Davis noted that companies with pre-existing voluntary EHS disclosure policies and practices will benefit from "first mover" advantage if these recommendations are implemented. He also noted that financial institutions, fund managers, asset managers, investors and companies seeking acquisitions may benefit from compliance with disclosure requirements for the following reasons:

- The presence of more and higher quality EHS compliance and operational information,
- The availability of environmental reports with more factual detail and independent verification,
- The development of metrics linking environmental and financial performance, and
- Developing management understanding of the impact of EHS on financial results.

Lenders, investors and companies making acquisitions can act as a catalyst for environmental due diligence of a target company, by using the following corporate infrastructure developed to meet disclosure requirements:

The determination of materiality often depends on the facts and circumstances surrounding a specific situation.

- Environmental information and records prepared to support and document environmental disclosure decisions,
- Corporate governance and auditing materials, policies and procedures manuals relevant to environmental matters,
- Corporate EMS and/or environmental auditing practices implemented to support CEO/CFO certification, and
- Corporate-wide information gathering and communication processes and procedures used to meet disclosure requirements.

The results of such due diligence could be rendered into appropriate contract language representing that issuer/seller/borrower:

- Is in compliance with all disclosure requirements, including Regulation S-K and the Sarbanes-Oxley Act, pertaining to environmental matters.
- Has made available all material environmental records relevant to its compliance with Regulation S-K and the Sarbanes-Oxley Act disclosure requirements.
- Did not and does not expect to restate its financial statements or correct SEC filings with respect to any environmental matters in order to achieve compliance with Regulation S-K and the Sarbanes-Oxley Act disclosure requirements.

Other contractual provisions may include:

- Indemnity by Issuer/Seller/Borrower for any loss or liability arising from failure to comply with disclosure requirements with respect to environmental matters.
- Covenant by Issuer/Seller/Borrower to make all required environmental disclosures on or before closing.
- Periodic review the prospective regulatory landscape and estimations of the cost of future compliance.

Since most environmental statutes contain deadlines that force future agency actions, these regulatory developments may be sufficiently predictable to justify disclosure. The determination of materiality often depends on the facts and circumstances surrounding a specific situation. This makes it hard to quantify materiality. However, SEC staff often apply the following rule of thumb for materiality: If the amount at issue:

- is more than 10 percent of the number against which it is measured, then it is material.
- ranges from 5–10 percent of the number against which it is measured, it may but often will not be material.
- is less than 5 percent of the number against which it is measured, it presumptively is not material.

Supply Side
Financially Material Environmental Exposure and Disclosure in Four Sensitive Sectors

Could emerging environmental issues have financial consequences for companies in certain sectors? Are companies disclosing sufficient information to investors when these issues are material?

The second session focused on four environmentally sensitive sectors: forestry, oil and gas, electric utilities, and mining. Analysis of the first two sectors was conducted using a WRI-developed methodology to assess how pending environmental issues might affect, both positively and negatively, large US companies within the oil and gas, pulp and paper, and electric utilities (see further reading).

Oil and Gas, Electric Utilities, Pulp and Paper
Robert Repetto
Duncan Austin
World Resources Institute

Since the stock price of a company (its shareholder value) depends on expected future revenues (net of costs), expected compliance costs (if they are material) are important to investors.

Duncan Austin introduced how climate change policies and constrained access (based on environmental reasons) to oil and gas reserves might affect the oil and gas industry. He also showed how various pieces of legislation such as 303d Rivers and Total Minimum Daily Loads (TMDL) provisions, NO_x regulations, the US Endangered Species Act or Timberland regulations might affect the pulp and paper industry.

Robert Repetto presented how two proposed new air quality laws—clear skies, and a four-pollutants cap-and-trade law—could impact the electric utilities sector.

The WRI methodology is forward-looking, scenario-based, transparent, and can be integrated into conventional valuation framework, and includes five steps:

- Identify key environmental issues (e.g., clean fuel regulations, climate change).
- Identify scenarios for key environmental issues (e.g., Kyoto Protocol with or without US participation, and with or without US actions outside Kyoto).
- Assess company exposure to scenarios (e.g., oil-gas mix, geographic distribution of reserves).
- Calculate financial impacts of company exposure (change in shareholder value, or benchmarked to each company's 2000 total revenue).
- Aggregate financial impacts for all environmental issues (range and most likely impact on shareholder values by company).

Austin found that pending pieces of legislation presented risks as well as opportunities for different companies within the same sector depending on (for the oil and gas sector) whether the company's reserves were in a protected area or overseas, and (for electric utilities) the ownership of generating assets, installed technologies, fuel mix, market position, as well as other factors.

Findings showed that impacts are differentiated across companies creating potential winners and losers.

Regarding whether emerging environmental issues can effect shareholder value or have other financial consequences, for most companies the risk was found range between 0–10 percent loss in shareholder value for the oil and gas sector, an average of 10 percent for pulp and paper industry, and 3–40 percent of 2000 revenues in compliance costs in the electric utilities.

Based on the SEC rules (see the Appendix), financially material trends and uncertainties should be disclosed within the MD&A section of financial statements. However, after reviewing the companies' statements and despite the estimated risks to these sectors, Austin found that hardly any of the risks were reported. Only two oil and gas companies disclosed climate change policies as a possible risk to future earnings in their SEC filings; ten others mentioned it in their annual reports. Seven companies reported their GHG emissions in supplemental reports. One company reported good environmental and social practices as a strategy to reduce risk to community opposition. Others reported community investments as charitable activities.

Examples from the pulp and paper sector revealed that it is common for firms to not report on the effects of environmental legislation. The firms justifying this decision on the basis fact that that since all companies within the sector are subject to similar requirements, new regulations would not affect their competitiveness.

In the electric utilities sector, few companies discuss financial impacts of multi-pollutants cap-and-trade bills or carbon controls. Most of these companies confine disclosure to final regulations already promulgated.

For the four sectors, findings showed that impacts are highly differentiated across companies, creating potential winners and losers. Furthermore, rankings of a company's total generation do not correspond to exposure ranking. Other available indicators, such as reliance on coal, age of plants, fuel efficiency, and revenues from generation as a share of total revenues, explain only 10–20 percent of the variation in financial exposures across companies—a figure arrived at using multiple regression analysis.

The degree to which companies are exposed does seem to vary depending on their asset composition. Thus, investors would not be able to predict relative exposure without information that would need to be provided by the companies themselves.

MD&A requirements state that a disclosure duty exists where "a trend, demand, commitment, event or uncertainty is both presently known to management and reasonably likely to have material effects on the registrant's financial condition or results of operation (including proposed environmental laws and regulations)."

Repetto emphasized that more complete financial disclosure is important to help investors make rational investment decisions, restore investor trust and confidence in the industry, and could be a source of significant competitive advantage for progressive companies. Least-exposed companies might benefit from fuller disclosure and might be willing to voluntarily disclose more information; however, according to Repetto, for other companies, SEC guidance and enforcement and stricter corporate law and accounting practices are needed.

More complete financial disclosure will help investors make rational investment decisions and restore investor trust and confidence.

Mining
Michael Van Aanhout
Stratos Strategies to Sustainability

The presentation on the mining sector focused on Canadian companies and was given by Michael Van Aanhout of Stratos Strategies to Sustainability. Van Aanhout presented the life cycle of a mine to determine where costs and liabilities are found in this sector, and described approaches to estimate these costs and liabilities, concluding with disclosure practices for the mining sector in Canada.

Mining includes six major life cycle stages: exploration, advanced exploration/feasibility/design/construction, operation, closure/reclamation, and post closure. Each stage may contribute to costs and liability in the form of waste rock/tailings, acid mine drainage, wastewater, infrastructure, and air emissions. For example, the Canadian federal government is now facing a challenge for 500 million CDN in liabilities from abandoned mines in Canada.

Methods of estimating costs and liability in the mining sector include:

- Environmental and regulatory requirements accrued using unit of production method over the life of the mine when a reasonably defined estimate can be made,

- The ASTM2001 Standard Guide for Estimating Monetary Costs and Liability for Environmental Matters and ASTM2001 Standard Guide for Disclosure of Environmental Liabilities.

The most common disclosure practice is to make a best estimate of full closure costs but with varying gaps between posted security and full disclosure liability accrued as a cost of production over the life of the mine. Current best practice involves conducting open, transparent, and ongoing closure planning, coupled with the updating of security instruments or accruals to cover the full cost of closure and post-closure. Bad practice cases do exist. Most often, these are the result of a deliberate effort to underestimate closure costs by showing willful blindness. These cases have likely contributed to the reputation issues of the mining sector.

Jurisdictions are moving more and more towards requiring securities to cover the full cost of closure. Internal management in some companies is changing to reflect this development. Interestingly, these changes have the largest impact on junior companies who are less able to absorb the increased costs associated with new reporting.

Conclusions

In all four sectors, there is potentially material information not being systematically disclosed by companies despite laws requiring disclosure to investors in both Canada and the US. If one accepts the WRI methodology, it would be hard to argue that environmental information is not material, at least for these sectors. At the same time, the SEC does not enforce its disclosure requirements as they pertain to environmental information and banks are not asking for this type of information.

In all four sectors, there is potentially material information not being systematically disclosed by companies.

Is the materiality or business case still not clear because it is just not well understood by executive management or is it because the methodology used is not universally accepted? What would it take to convince financial sector executive management to demand this information?

Reasons often given by companies for not reporting potential impacts of pending environmental regulation—such as the defense that since all competitors are affected similarly or that compliance costs are small compared to total costs—do not hold for environmentally-sensitive sectors. Therefore, reporting would be needed for investors to make rational investment choices among companies.

This would require stricter corporate law and accounting practices, as well as SEC enforcement of its disclosure requirements as they pertain to environmental information.

The Demand Side
Perspectives on Comprehensive Assessment

There are four main actors in the disclosure process: first, a firm disclosing appropriate information; second, regulators ensuring that the appropriate information is disclosed for the efficient functioning of the stock market; third, the auditors and consultants to verify and advise on disclosing; and fourth, rating agencies that provide information for investors on the value of companies.

Is there a disconnect between what environmental consultants recommend and what is audited?

Often the same firms provide a company with auditing and consultancy services. By law, these two services must be kept independent from one another—with auditing firms now spinning off their consulting businesses to ensure this independence.

Many firms are now highlighting a disconnect between what the environmental consultants might suggest in terms of reporting and management and the auditing side that does not insist on seeing environmental information in the financial statements.

To discuss this issue in further detail, we brought together an auditor from KPMG, a consultant from PricewaterhouseCoopers, and Standard and Poor's, a rating agency.

The Auditor
Eric Israel
KPMG

Israel's presentation demonstrated the gap between what environmental information auditors need to find in financial statements to be in agreement with financial regulation and what stakeholders want to see in these statements. He began by reviewing the historical landscape.

In the 1980s, remediation liability, especially the Superfund, had an impact on the financial health of companies. This led the SEC to establish new regulations for liabilities. However, impacts now extend beyond liability. Environmental information now affects overall company value via shareholder and reputation value.

Stakeholders are demanding information on emerging risk, such as carbon sequestration projects. It is clear that recent business scandals have contributed to the demand for this information. This demand is not likely to decrease. In this new landscape, environmental issues can have indirect, technically complex impacts driven by regulations and other factors. Israel addressed, from an auditor's point of view, the questions: "what is adequate environmental disclosure?" and "what is the role of the auditor?"

He did this by reviewing the historical accounting environment, audit literature, sources of environmental liabilities and ways of mitigating fraud and misconduct risk:

- Beginning in the early 1970s, Congress and state governments began paying increased attention to legislation designed to protect the environment.
- The explosion of federal and state environmental laws and regulations has affected all manner of business transactions.
- In 1998, the US EPA disclosed that 74 percent of US publicly traded corporations it surveyed violated the US SEC environmental financial debt accounting regulations (even if these companies expected to face fines over US$100,000).
- The World Resource Institute released reports in 2000 showing that certain companies were not disclosing environmental risks that may significantly affect their financial performance.
- An environmental group recently issued a report concluding that 74 percent of US publicly traded companies it surveyed did not provide information on the risks related to climate change and other environmental issues.

According to Israel, current relevant audit literature includes:

- US SEC Regulation S-K: Environmental Legal Proceedings Disclosure Requirements, Financial Accounting Standards Board (FASB) Statement No. 143: Accounting for Asset Retirement Obligations (Issue Date: June 2001)
- FASB Statement No. 144: Accounting for the Impairment or Disposal of Long-lived Assets (Issue Date: August 2001)
- FASB Statement No. 146: Accounting for Costs Associated with Exit or Disposal Activities (Issue Date: June 2002)
- Statement of Position 96-1: Environmental Remediation Liabilities, American Institute of Certified Public Accountants (AICPA)—disclose cost of environmental remediation and environmental liability when probable to occur and can be estimated.

EPA ASML is not part of the literature for auditors of environmental liability and enforcement of those requirements is not widespread. Environmental liability under AICPA are part of an auditor's checklist but CPAs and CFOs do not have the environmental expertise to go into detail.

This is a narrow view based on SEC regulation. What is considered minimum or adequate in the US is less than in the European Union. Nations including France and Denmark already have mandatory reporting of environmental issues in financial statements. The United Kingdom and the Netherlands are expected to follow suit shortly. Though this merging of financial and non-financial information into the same report is not yet mandatory in North America, Israel predicts it will be in time.

Traditional Sources of Environmental Liabilities include:

- Non-compliance—Fines/Penalties (with whistleblower lawsuits),
- Third-party Litigation—Contaminated Land and Impaired Assets (e.g., asbestos), and
- Regulatory Obligations (e.g., closure of operating sites due to regulation) are expenses, only included if part of remediation project required due to compliance obligation or to meet an enforcement order.

Many sources of contaminated land and impaired assets, such as spill responses and fire fighting, are still not included or disclosed. Furthermore, regulatory obligations are very restrictive since new pollution controls are normal closure expenses and do not need to be reported.

Consistency with accounting guidance, reasonable professional judgment, realistic estimated consistent with underlying facts, and properly adjusted costs reserve amount in light if changing environment are all good accounting and reporting practices that meet legal requirement but they may not convey the whole impacts on balance sheets.

A 2002 Survey of CSR reporting by KPMG found that 45 percent of global 250 Fortune issued non-financial reports compared to 35 percent in 1999.

The question then is how to communicate the full environmental impact for investors?

According to Israel, companies compete in four defined markets:

- Capital,
- Customers,
- Talent, and
- Suppliers.

And in two quasi-markets:

- Community and
- Government.

The information flow differs, depending on which market is targeted. Formal reporting is required to government and capital markets and informal information is provided to the other markets. These informal information flows include CSR, sustainability, environment, and intellectual reports.

A 2002 International Survey of CSR reporting by KPMG found that 45 percent of global 250 Fortune issued non-financial reports, compared to 35 percent in 1999. Reporting varied by sector, with the chemical sector having a reporting rate of 100 percent; pharmaceutical, 86 percent; automotive, 73 percent; and oil and gas, 58 percent. Financial, insurance, and securities companies had a reporting rate of only 24 percent. Issues and topics included in the report included GHG change, biodiversity, community involvement, health and safety, stakeholder dialogues, CERES principles, GRI, etc.

Israel made that point that given the current business landscape, just meeting legal requirements is not enough. For instance, the extractive industry is now operating in protected areas and endangered environments, and global shareholders and stakeholders are expecting companies to meet more than national requirements.

The global environmental issues affect financial risk, and how companies manage these risks is important to investors. For instance, from 1996 to 2000, 10 percent of the Fortune 1000 companies lost over 25 percent of their shareholder value within a one-month period. Many of these losses can be attributed directly or indirectly to non-financial issues. In fact, in only 6 percent of cases was the loss attributed to financial issues.

Many of these losses can be attributed directly or indirectly to non-financial issues.

Non-financial risks include:

- How companies behave and perform financially during responses to accidents (e.g., Union Carbide and Bohpal incidents)
- Corporate decisions must not only meet regulations but also how they fit with company policies (e.g., Shell, years ago)
- Business policy and practices' impact on value chain (e.g., Nike and supply in Far East)
- Immediate safety issues
- New laws (e.g., EU directive—how to implement)
- How companies meet emerging issues (e.g., Kyoto Protocol)

Through dialogue with stakeholders, companies must identify the largest risks. Some may not require action but they must be monitored so they can be addressed as their probability of likelihood and potential impact increases.

Disclosure issues:

- Consistency to information users
  - Management
  - Employees
  - Outsiders
- Balance transparency with privacy
  - Legitimate Needs Of Stakeholders
  - Competitive Damage
- Must decide what to reveal vs. conceal

Balancing transparency with privacy is not easy: a survey by the World Business Council for Sustainable Development showed that public trusts the military, NGOs, and churches—which are among the least transparent entities.

What's ahead?

- Emerging corporate reporting (GHG reporting will increase pressure for new reporting requirements)
- Emerging regulations
- Climate change, corporate governance and ethics
- Sarbanes-Oxley Act
- Mitigating fraud and misconduct risk

Israel concluded by noting that the value of the financial statement is diminishing and there is a need to assess demand from stakeholders. Non-financial information is increasingly important, creating a challenge for regulations and/or generally accepted reporting and auditing standards. The question remains: how to come up with a combined report that meets the needs of all investors?

The Rating Agency
George Dallas
Standard and Poor's

Dallas' presentation summarized the methodology Standards and Poor's Global Sustainability Services Division is developing to measure corporate governance. This Corporate Governance Scoring methodology remains separate from the ranking part of the firms because there is not a demand to incorporate these scores into the ranking as yet.

Companies are evaluated on a voluntary basis, making full coverage impossible.

Why develop a corporate governance scoring methodology?

- Investors cite governance practices as being as important as financial performance in evaluating investment opportunities.
- Investors are willing to pay a premium for shares of a well-governed company.
- There is mounting evidence linking corporate governance and financial performance.
- There are no internationally recognized standards or benchmarks.

Standard and Poor's has established the capability to provide an objective benchmark called the Corporate Governance Score (CGS) that compares a company's corporate governance practices. The CGS is prepared as an interactive analytical process, with the consent of company. The process of measuring corporate governance provides greater transparency for investors and a positive incentive for companies to improve their governance standards. The CGS is:

- Market based,
- Complements top down efforts by regulators and exchanges, and
- Designed for investors, companies and regulators.

The scoring system measures the interaction of a company's management, board directors and shareholders to ensure that all financial stakeholders (shareholders and creditors) receive their fair share of the company's earnings and assets.

A CGS reflects Standard & Poor's opinion of the extent to which a company adopts codes and guidelines of generally accepted corporate governance practices that clearly serve the interests of its financial stakeholders.

Non-financial stakeholders (e.g., employees, community, environment, etc.) are not explicitly covered with current methodology and this may leave scope for future extension. Because governance structures and philosophies differ globally (depending on whether the focus is on the shareholder versus the broader stakeholder, or legal and cultural dimensions) Standards and Poor uses an approach based on:

- Fairness,
- Transparency,
- Accountability,
- Responsibility, and
- The need to interpret individual structures through the lens of overarching principles that should be relevant in a global context.

The business model for the scoring system focuses on:

- What is the value proposition: who would use this and why?
- Mainstream versus specialist investors.
- Focus on corporate social responsibility: the ethical perspective.
- Focus on sustainability as a risk factor: the financial perspective.

There is a need to create a demand from the mainstream side or make the scoring relevant to mainstream investors, beyond socially responsible investment. Standard and Poor's does not see it as their domain to determine what is socially responsible. Instead, the evaluation focuses on how the results can be interpreted from a financial point of view.

Several analytical issues with the CGS include:

- Providing objective measures for qualitative criteria;
- Ensuring data of sufficient quality to support measurement of qualitative criteria;
- Need for more robust disclosure and reporting;
- Reconciling many individual measurements (multidimensional scaling) or one composite measure;
- If a composite measure is used, how diverse variables are weighted; and
- Empirically linking sustainability benchmarks and company performance.

Information disclosure can increase share value by developing a culture of innovative and transparent management that translates into competitive advantage.

New metrics issues that have arisen include:

- Natural Capital
  - Use of energy and renewable resources
  - Pollution
  - Recyclability

- Human Capital
  - Training and development
  - Diversity and equal opportunity
  - Workplace safety and relations

- Social Capital
    - Community engagement
    - Corporate philanthropy
    - Costs/benefits to local economy

Dallas concluded by noting that, since Enron, investors have been increasingly looking at non-financial issues, and less traditional and more qualitative factors when evaluating the performance and prospects of companies.

The idea is that if these risks can be calibrated, there should be a willingness to pay for companies that rank well and discount values of those that do not. However, standards to report these non-financial factors are not going to be developed rapidly unless there is a demand from investors, since mainstream analysts are not interested.

The Consultant
Bob Eccles
PricewaterhouseCoopers, LLP

Eccles' presentation focused on an information gap analysis between what companies report (supply side) and what the market or analysts and investors demand (demand side). He gave his perspectives on how and why these gaps ought to be filled.

His thesis was that information disclosure can increase share value when the underlying performance is strong in a feedback loop created by developing a culture of innovative and transparent reporting that translates into competitive advantage. This in turn helps to minimize the gap between what companies believe their shares are worth and how the market values them.

A PwC survey of 160 company executives in the high tech industry (when Nasdaq was trading in the 3,500–4,000 range) found that 75 percent thought their shares were slightly or highly undervalued, 18 percent thought their shares were properly valued, 2 percent thought their shares were slightly overvalued, not a single executive thought their company's shares were highly overvalued. Five percent expressed no opinion. Surveyed individuals were then asked the key drivers of value for these companies. Results showed that seven of the 10 key value drivers in this industry were non-financial ones.

Important value drivers from the supply (management) and demand (analyst and investor) side were then compared to identify gaps in information and reporting. Three key reporting gaps in the petroleum industry existed for information, reporting and quality, all of which need to be explicitly defined and their relationships to each other clearly articulated.

- Quality of management,
- Refinery margins by region (refining centers),
- Market share,
- Petroleum product sales by volume by refinery,
- Evidence of compliance with environmental protocols, and

- Compliance with health and safety regulations.

Eccles believes there is a quality gap such that companies do not have the internal auditing capacity to make this type of qualitative information public. Eccles' proposed a three-tier model of corporate transparency is as follows:

1. Tier One: A global set of generally accepted accounting principles (Global GAAP),
2. Tier Two: Industry-specific measurement and reporting standards for the key value drivers, and
3. Tier Three: Company-specific information.

Tier Two standards would be developed by the business community, sector by sector, since supply side analysts and investors want to be able to compare non-financial information on the same "apples-to-apples" basis as they can with financial information.

Implications for Environmental Health and Safety Reporting

- To what extent does management believe in managing and reporting on these topics?
- To what extent do analysts and investors believe these are important for creating long-term shareholder value?
- How quickly and broadly will standards be developed, such as those of the global reporting initiative?
- Do US companies still lag behind European ones in the importance that they accord to these issues?

It is hard to see what will give impetus for creating EH&S reporting, since there is a chicken and egg problem, because management is not convinced of the value of reporting on these topics. As a result, the impetus will likely have to be come from demand by analysts and investors, who do not seem convinced themselves of the value of reporting on these issues. The good news is that it does not take many firms to spark a trend and have laggards start saying, "I don't want to be left out," instead of "why should I do this?"

The Next Steps

As this conference deliberated, there are many firms and socially responsible investors currently striving to minimize their environmental footprint while contributing to the economic and social development of the communities in which they operate. There are also many who are not.

The CEC and UNEP FI had posed three questions at the outset of the event:

- First, is the legal and regulatory system in the United States that dictates what must be disclosed and when (even after the signing into law of the Sarbanes-Oxley Act) vaguely defined with regard to the materiality and disclosure of environmental information?

- Second, is the enforcement of disclosure laws and regulations satisfactory when they pertain to the disclosure of environmental information?

- Third, would a lack of definition and enforcement create the impression among firms that environmental information is not relevant to investors and consumers and lead them to decide against disclosure?

In closing the meeting, Chantal Line Carpentier of the CEC and Paul Clements Hunt of UNEP concluded that there is indeed a lack of disclosure. They also found that this is creating uncertainty in the market, as firms try to meet the demands of investors and consumers for this information *ad hoc,* while investors and consumers in turn remain unable to accurately evaluate the financial impacts, positive or negative, of a firm's actions.

This uncertainty may actually impose greater costs on a market than those that would be associated with implementing a standardized disclosure system for this information. Integrating externalities like environmental information into the market can give investors, consumers and firms the freedom to decide the value of environmental and social information using the market-based system with which they are already familiar.

Indeed, presentations and discussions made clear that increasingly, stakeholders (including shareholders) are requiring more non-financial information than is required by securities laws and that this tendency is here to stay as citizens and stakeholders demand greater corporate transparency.

Participants also asserted that, while there is a lack of definition and enforcement in the legislation, there is also potential for entrepreneurial firms and investors to develop the mechanisms for seeking out this information.

These industry leaders deserve recognition for their efforts where it counts, in their share price. They stand to capture the benefits arising from their environmental management and governance efforts by targeting results not only to the public, but also to those who buy their shares.

Investors and consumers also stand to benefit from using this information to provide a more complete picture of the firms in which they invest, thus minimizing their exposure to unaccounted-for risks.

Regulators as well will benefit—both from removing uncertainty from the market and from their economies as a whole. Having access to a more holistic picture of market inputs and outputs can only result in more effective policy making that creates greater economic stability over time.

In almost every area of the economy, new ideas, concepts, inventions and techniques are emerging that, collectively, will form a new market. Particularly in these young markets there is a need for an open and quantitative framework that will enable analysts and investors to separate winners from losers.

The CEC and UNEP FI are planning a work program that will capitalize on the results of this research and discussion. This collaborative effort will identify barriers and pathways toward the integration of material environmental information into financial statements and MD&A sections of firms, and provide policy recommendations to governments and stakeholders based on the results of this analysis.

Updated information will be posted at:

www.cec.org

and

www.unepfi.net

Appendix: The US Regulatory Environment

SEC Disclosure Rules include

- Reg. S-K Item 101: Material effects of environmental compliance (disclosure of the material effects that compliance with federal, state, and local environmental laws and regulations may have on capital expenditures, earnings, or the competitive position of the company and its subsidiaries).
- Reg. S-K Item 103: Legal proceedings (brief description of pending legal proceedings or contemplated proceedings by governments) if:
    - Material (reasonable investor will find relevant);
    - Damage claims exceeds 10% of net worth; or
    - Probable liability is equal to or greater than $100,000
- Reg. S-K Item 303: MD&A discussion on environmental trends and uncertainties

In addition, contingent liabilities section of financial statement, including footnotes, should include environmental liabilities when it is "probable that an asset" is "impaired" or liability is incurred and the amount in question is "material."

Related Guidance includes:

- SEC Staff Accounting Bulletin 92: Quantification of Environmental Loss Contingency, and
- SEC Staff Accounting Bulletin 99: Concept of Materiality

Disclosure guidelines and initiatives include:

- AICPA SOP 96-1: Environmental Remediation Liabilities which presumes unfavorable outcome for site remediation claims, unless management can document otherwise,
- ASTM E 2173-01: Standard Guide for Estimating Monetary Costs and Liabilities for Environmental Matters which provides guidance on estimating costs and liabilities for environmental matters,
- ASTM E 2171-01: Standard Guide for Disclosure of Environmental Liabilities a voluntary Supplements GAAP Analysis for Disclosures and that establishes industry best practices??.
- EPA/Corporate-Wide Voluntary Audit agreements,
- Eco-Management and Audit Scheme, and
- Global Reporting Initiative/CERES

Relevant sections of the Sarbanes-Oxley Act

- Section 401 requiring Disclosure of Material Correction Adjustments and Disclosure of Off-Balance Sheet Transactions.
- Section 404 requiring Disclosure of Management Assessment of Internal Controls
- Sections 302 and 906 requiring Officer Certification Requirements.

Other sections depending on their interpretation could also affect environmental disclosure:

- Section 307 requiring attorney reporting requirements --broad interpretation could cover environmental attorneys,
- Section 408 requiring tri-annual SEC review -- could result in material restatement,
- Section 806 a whistle blower protection, and
- Sections 802, 804, 807, 1104 & 1106 providing for criminal sanction provisions.

Incentives for compliance

These might include liability for failure to comply with disclosure requirements via the following pathways:

- Common Law Theory of Liability,
- Regulatory Initiatives including EPA/SEC Coordination on Disclosure Initiatives and EPA ECHO Web Site,
- Civil Liability as in Caremark Int'l Inc,
- Criminal Liability as provided by the Federal Sentencing Guidelines Section 8A1.2(k).

Further Reading

CEC 2002. *Finance and the Environment: Highlights of Meeting and Follow-Up Steps.* Proceedings of March 25th, 2002 New York Meeting on financing and the environment. Montreal: Commission for Environmental Cooperation of North America.

CEC 2002. *Environmental Disclosure Requirements in the Securities Regulations and Financial Accounting Standards of Canada, Mexico and the United States***.** By Dr. Robert Repetto, Andrew MacSkimming and Gustavo Carvajal Isunza. Montreal: Commission for Environmental Cooperation of North America.

CEC 2002. *Discussion Paper for Public Workshop on Investing in North America's Future: Innovative Financing for Sustainable Development organized with JPAC*. By Scott Vaughan. 9 December 2002 in Monterrey, Nuevo León. Montreal: Commission for Environmental Cooperation of North America.

UNEP FI. 2003. *Ratings Roundtable Summary Report.* Philip Moss, Geneva: UNEP FI. Downloadable from: www.unepfi.net/ratings.

UNEP FI 2002. *Industry as a partner for Sustainable Development: Finance and Insurance.* Geneva: UNEP FI. Downloadable from: www.unepfi.net.

UNEP FI 2002. *Climate Change and the Financial Services Sector.* Geneva: UNEP FI. Downloadable from: www.unepfi.net/cc.

Information on the Organisers

The Commission for Environmental Cooperation of North America

http://www.cec.org/

Project Team:
Chantal-Line Carpentier
Zachary Patterson

The Commission for Environmental Cooperation (CEC) of North America is an international organization created by Canada, Mexico and the United States under the North American Agreement on Environmental Cooperation (NAAEC). The CEC was established to address regional environmental concerns, help prevent potential trade and environmental conflicts, and to promote the effective enforcement of environmental law. The Agreement complements the environmental provisions of the North American Free Trade Agreement (NAFTA).

UNEP Finance Initiatives

http://unepfi.net

Project Team:
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Helen Sahi (Fleet Boston Financial, North American Taskforce Chair)
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Jacob Malthouse

UNEP FI is a global partnership between the finance, insurance and public sectors that develops and promotes sustainability best practice in financial institutions.

In 2002 over 278 signatories in 51 nations work with UNEP FI towards the common goal of maintaining the health and profitability of their businesses within the framework of sustainable development.

Disclaimer

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