Corporate behaviour: how environmental risk and corporate governance are shaping change – or are they?

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Introduction

The intensifying and unremitting demand for greater corporate transparency has resulted in new, more stringent governance obligations and more onerous financial disclosure requirements, particularly in the USA and the UK. The passage of the Sarbenes-Oxley Act in the USA demands greater transparency with respect to corporate risk exposures. In the UK, the Operating & Finance Review (OFR) has changed the current financial reporting standards for listed companies. Both the Sarbenes-Oxley Act and the OFR regulations place more emphasis on environmental disclosures.[1] The increased emphasis on the adequacy of corporate disclosures, particularly concerning environmental and governance issues, has been the subject of a recent report by SustainAbility in conjunction with Standard & Poor's and UNEP.[2] This report comments on how sustainability reporting and financial reporting are converging. It is discussed in greater detail below. Substantial changes in the investment industry are leading to greater interest in social and environmental issues; for example, regulations now require pension funds to disclose how their policies take account of environmental and social concerns. Share prices increasingly value brand, regulation and intangible assets. Shareholders, securities analysts and lenders are also demanding more accurate information. Environmental liabilities are more visible than ever, prompting corporations to improve the way they manage, contain and transfer risks.

Corporate governance

If greater corporate transparency is to be achieved, some understanding of the terms 'corporate reporting' and 'corporate governance' is necessary. There is no single definition of the term 'corporate governance'. For some, it is the relationship between the shareholders, directors and management of a company. James Wolfensohn, outgoing president of the World Bank, stated that 'corporate governance is about promoting corporate fairness, transparency and accountability'.[3] Corporate reporting is essentially the process of publishing information about an organisation's performance in relation to its stated values, objectives and targets.[4] Both corporate governance and corporate reporting are about building public trust, which is achieved by transparency, accountability and integrity. The collapse of Enron led to a call for new regulations and laws in many countries. The provision of information is key to achieving transparency and accountability; however, the information has to be accurate, objective and insightful. There has previously been a tendency for companies only to provide financial information based on regulatory requirements. While such information may be accurate, it does not always include those factors that can affect the long-term prospects of a business or its share-price. This trend is beginning to change, albeit slowly. The OFR regulations now require companies to report on main qualitative factors that underlie performance, such as strategy, opportunities and risk, although these requirements are limited to listed companies. Some progressive companies are slowly beginning to take steps to practise greater transparency by changing their reporting. However, to do this, a company must have a strong belief that the benefits of greater transparency outweigh the perceived risks and costs, and many companies seem unconvinced, to judge by the lack of reporting and disclosure on environmental matters. Although the quantity and quality of reporting is improving (according to the Sustainability Report), only just over half of identified large companies (those having an annual turnover exceeding £22.8m and over 250 employees[5]) report on environmental performance.[6]

As part of the review of governance, the Sarbenes-Oxley Act and the OFR require more disclosure on environmental matters. For example, directors will have to include information on issues which may have significance for the business at a later date, such as the impact of climate change, which arguably has not so far been recognised and which may be highly significant in terms of the cost of energy or of insurance cover of production facilities located in low lying areas.[7] This requirement to provide a balanced, comprehensive and forward-looking review of a company's development and performance introduces non-financial reporting into company law.

1 C Nelson 'The Operating Financial Review – what impact will it have on environmental disclosure?' ELM 16 [2004] 6 301–304.
2 SustainAbility, UNEP, S&P 'Risk and Opportunity – Best Practice in Non-Financial Reporting' www.sustainability.com/publication/engaging/risk-opportunity-asp.
3 *Financial Times* 21 June 1999.
4 For definitions, see www.maplecroft.com/glossary.
5 Companies Act 1985 s 249.
6 DTI 'Corporate Social Responsibility – A Government Update' May 2004 21 www.csi.gov.uk.
7 For full details see n 1.

Voluntary reporting

Voluntary environmental reports have been published since the 1990s, a trend originally introduced by Monsanto and Norsk Hydro. The Global Reporting Initiative (GRI) has been one of the most important drivers of the reporting agenda since 1997, and over 500 companies now report along GRI guidelines. As non-financial disclosure becomes increasingly important, SustainAbility, UNEP and Standard & Poor's have carried out a benchmark survey of corporate, environmental and sustainability reporting and discussed the future shape of such disclosure. The resulting report[8] comes to a number of conclusions and raises various issues about the connection between corporate governance and the triple bottom line agenda. Of particular significance is the report's finding that the financial sector – including insurers, reinsurers, lenders, investors and analysts – is beginning to realise the impact of non-financial issues, which is leading to the convergence of the financial and non-financial worlds. The survey finds[9] that a number of leading companies have made progress in their responses to demands for improved transparency on key issues of corporate responsibility, but there still appears to be a failure to identify material, strategic and financial risks and opportunities associated with economic, social and environmental impacts. Corporate governance is making companies focus on compliance and financial integrity, but not on the 'beyond compliance agenda',[10] including wider ethical, social and environmental issues. This may change as more regulation demands disclosure on issues such as the environment, and shareholders pay more attention to effects of environmental risk on business. Disclosure will also be affected if mandatory reporting is introduced, a move that is backed by a number of charities, NGOs and unions, as well as some church groups, but this movement is not currently supported by the UK Government.

Listing requirements

Companies often may not equate work on reporting with risk, rating and valuation. Perhaps this is a reason why the London Stock Exchange's listing rules do not require companies to address social and environmental factors, although information disclosure is at the heart of listing. A European Union Prospectus Directive came into force in July 2004, and its requirements are to be incorporated into the new UK listing rules which are being finalised by the FSA. These say very little about sustainability. The only requirement relating to environmental disclosure is the necessity to state how the 'utilisation of property, plant and equipment' might be affected. Although the OFR requires an assessment of factors and trends which are expected to have a material effect on a company's financial condition and results of operations in future periods, these charges do not affect the initialising requirements.[11]

Whether the effects of climate change sit within this requirement is a matter of interpretation; in most listings to date it is not likely to have been included. This may not be a problem if companies wanting to float identify climate change as 'significant', or material enough to warrant inclusion of any significant associated risks into the risk section of a prospectus. Some may query the relevance of introducing this information. An example of the importance of analysing the environmental risks is to be seen in Asia Energy plc's recent listing. Asia Energy plc joined the London Stock Market last April. It raised more than £10m from investors to finance the first stage of an open-cast mining project in Bangladesh,[12] without mentioning that the project may be seriously threatened by climate change. The mine will be less than 10 metres above sea level, exposing it to the risk of flooding. The project will also be at risk if the Bangladeshi Government decides to limit emissions of carbon dioxide. Arguably the risks were not properly assessed. Although the assumption now is that shareholders have a legitimate need for this kind of information once they have invested in a company, prospective investors are not judged to need it.[13]

When mining company Xstrata Plc floated on the Stock Exchange in March 2002, its prospectus failed to draw investors' attention to the risks from climate change. Around 70 per cent of Xstrata's earnings are from coal. Six months later, when Japan reported that it was to introduce a tax on coal imports as a contribution to meeting its carbon dioxide targets under the Kyoto Agreement, Xstrata's shares dropped by 12 per cent in two days.[14]

Whether the FSA will amend its listing requirements to ensure that environmental and social issues are covered is likely to depend on pressure from investors, and possibly more active enforcement following complaints after listing. Transparency on these issues will remain limited as long as companies are not linking sustainability with risk. In the USA the Securities and Exchange Commission (SEC) has taken some active steps to integrate environmental factors into its hosting requirements, requiring disclosure of material expenditure for environmental control facilities or compliance issues. Of course, the issue of 'materiality' is a key concept in the debate as to the effectiveness of this approach.[15]

S&P ratings

Standard and Poor's (S&P) began to address the link between a company's management and governance processes and its overall financial risk profile more systematically in 2000. In the SustainAbility report, a

8 'Risk and Opportunity' (n 2).
9 ibid 4.
10 ibid.

11 M Mansley 'Open Disclosure – Sustainability and the Listing Regime' (Claros Consulting February 2005).
12 R Cowe 'Specs in the City' Green Futures January/February 2005 28–29.
13 ibid 28.
14 'Open Disclosure' (n 9).
15 ibid 34–35.

comparison was drawn between S&P credit ratings from the Transparency Disclosure Study in 2002 and those companies that rated highly on the SustainAbility reporting benchmark, although S&P did not include specific information on sustainability. The study was limited by the small sample size, and, although it states that the results were inconclusive, it did find that 82 per cent of the top 50 companies identified in the benchmark had an average S&P credit rating of A, compared to an average rating of B for companies in general. Although the report states that these results cannot be used to link sustainability and ratings, it suggests that well-governed companies are more likely to see the value in public reporting and to attract high credit ratings. The top 50 companies identified in the benchmark all had ratings higher than the average.

In a more detailed commentary on risk, George Dallas, Managing Director of S&P, explains that social and environmental issues, particularly a company's relations with its non-financial stakeholders, might warrant standalone assessment in financial research.[16] He says that, although it is typically the law which sets standards for society's basic expectations and provides the enforcement mechanisms for companies which fall short of those requirements, non-financial stakeholders have an important role to play in the success of the firm when it comes to minimising operational risks or maximising sustainable competitive advantage. In some cultures (such as Europe and Asia) relations with non-financial stakeholders may be given higher priority than those supporting the traditional theory of a firm as a simple profit maximiser. The challenge is performing an accurate analysis based on the companies' disclosures and reporting. As regards environmental reporting, there is a danger of 'green washing'[17] – ie of companies portraying themselves in an inaccurate and misleading way with regard to social and environmental issues. Dallas suggests that sustainability reporting can help analysts, investors, and stakeholders to understand better the issues of environmental performance that can be a potential source of material risk to the company's operations, financial performance, reputation and valuation. He believes there is still room for improvement in helping financial stakeholders to understand such issues as financial risks, and to facilitate incorporation into traditional credit and equitable analysis and insurance underwriting.

Shaping behaviour

How will environmental risk and the growing need for transparency continue to shape corporate behaviour? As long as shareholders, company employees and the public continue to put pressure on organisations to monitor their behaviour, and by so doing potentially influence their market share, companies are likely to tailor their reporting and disclosure requirements to minimise risk to reputation – and thereby financial risk. However, if financial and non-financial reporting continue to merge due to the demands of lenders, investors and analysts, this is more likely to put pressure on companies to address these issues. More rigorous disclosure requirements under new legislation will also continue to shape company behaviour.

The SustainAbility Report suggests that, given the growing relevance of sustainability reporting to the fundamentals of governance and business value, reporting should continue to increase. Although voluntary reporting is currently the norm, the introduction of mandatory reporting has been discussed for some time by environmental groups. The report also identifies 10 challenges to help the reporting agenda over the next five years.[18] In summary these are:

1. the market must continue to demand and reward reporting;
2. the language and concepts of reporting ie sustainable development, corporate social responsibility, must be clarified;
3. reporting must be targeted towards users' needs as improved communication is required;
4. internet reporting must be improved to make information more readily accessible to all;
5. reporters must provide more detailed and practical information regarding the economic bottom line;
6. more emphasis needs to be put on the value of action to business and not simply on the need for action;
7. increased understanding of business models is needed in order fully to assess sustainability;
8. greater emphasis needs to be placed on risk management issues in order to engage the financial sector in issues of sustainability;
9. over-simplification of corporate governance must be avoided;
10. reporting standards must be brought into alignment.

In particular, as a number of leading companies are increasingly trying to integrate their financial and non-financial thinking and decision-making so as to improve their understanding and management of both, this too will shape change.

Conclusion

When considering the OFR reforms, changes in voluntary reporting trends and developments in determining company ratings, it appears that – notwithstanding the shortfalls of the UK listing arrangements – companies themselves (whether small, large or medium sized) will have to start looking more closely at environmental risk. Including more environmental and ethical information should be seen as an opportunity to increase reputation and ratings, and not least to ensure operating financial stability. The SustainAbility Report makes a number of recommendations as to how CEOs, corporate boards,

16 www.sustainability.com/insight/research p 2.
17 ibid p 4.
18 'Risk and Opportunity' (n 2) 50.

CFOs, investor relations, investors, stakeholders and corporate responsibility professionals can assist change. These people are identified as having a central role to play in shaping the reporting agenda by focusing it on a reintegrated bottom line – ie internalising externalities and risk. A summary of some of the recommendations follows.[19]

1. CEOs and corporate boards should assess whether the company or the organisation's professionals are responding to the most material priorities, and whether they understand and can respond to emerging risk assessment, reporting and assurance agendas.

2. CFOs should review the risk assessment frameworks used by financial analysts to evaluate the company's disclosure, reporting and communications activities.

3. Corporate responsibility and sustainability professionals should encourage their CEOs, boards and CFOs to review the company or organisation's disclosure, reporting and communications strategy in the context of the recent trends and expectations highlighted in the report. They should also assist internal risk management people to identify and prioritise the main non-financial risks.

4. Investors and other stakeholders are encouraged to pressurise companies to report on non-financial risks and opportunities, and particularly to complement and challenge reporting companies.

These recommendations can arguably be applied to listed companies which have to comply with the new OFR regulations in respect of the disclosure of environmental liabilities. In both instances, a 'materiality' analysis should be undertaken to determine what should be incorporated into a report. Internal control procedures may have to be changed to ensure that relevant information concerning environmental costs, liabilities, risks and opportunities is identified and managed.

If the non-financial and financial issues which face companies continue to merge, increasing the focus on wider ethical, social and environmental issues, we may see less of the 'classic' financial defence – ie if something is important enough 'financially' for investors, it will be covered by directors as a 'significant' risk – and consequently a greater emphasis on value, brand, and reputation. High standards of disclosure will be central to achieving this.

19 ibid 52.