Climate Change Disclosures

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Abstract

Climate Change Disclosures by corporations could become increasingly important if global warming does, in fact, continue and accelerate. This paper reviews the history, rational, and effect on corporations of climate change disclosure requirements.

In February 2010, the SEC issued guidance on Climate Change Disclosures. Regulations from the Environmental Protection Agency require companies to report their greenhouse gas emissions starting in 2010. Before this, companies had only made voluntary disclosures. In 2008, almost two thirds of S&P 500 companies made filings with the Carbon Disclosure Project. [1] In most industries, there were no rules requiring disclosure or guidance on how disclosures should be made. Without the guidance from the SEC, companies weren't sure exactly what information they had to disclose, which caused variations from industry to industry. There was no way for investors to compare companies. Regulators require organizations to "disclose issues that would be material to investors and these would address the financial liabilities related to social environmental responsibilities, financial and operational effects of environmental protection requirements, and environmental policies and risk management."[2]

What Led to the Disclosure. In July 2003, CERES – a coalition of investors and public interest groups – created a report on the performance of the top 20 U.S. corporations with the heaviest carbon emissions, and how they disclosed the financial risks posed by climate change.[3] From their research, they found that only twelve of these corporations disclosed their findings in their routine filings with the SEC, and fewer than half of them mentioned their emission trends. Most of the companies' boards of directors, however, had discussions about climate change. Later that year in November, pension fund managers, state treasurers, and bankers met at the Institutional Investors Summit on Climate Risk and formed the Investor Network on Climate Risk (INCR). [4] They urged the SEC to strengthen and enforce corporate disclosure requirements on things like climate change. They have also asked corporate boards to attain climate change risk information from management and for investment managers to include the potential financial impact of climate change in their analysis.

CERES, Environmental Defense, Friends of the Earth, the California State Teachers Retirement System Public Employees' Retirement System (CALPERS), and several institutional investors petitioned the SEC in September 2007. These petitioners, including the NY attorney general, said that "climate change poses a threat whose 'material adverse' effect must be disclosed."[5] The petition states that "the best disclosure comes from companies whose emissions are linked to rising carbon dioxide levels in the atmosphere" and other companies who do not regard themselves as major emitters of greenhouse gases are usually ignoring climate change.[6]

[1] Climate Change Disclosure Vexes Companies 07.20.09
[2] Sustainability Framework 2.0 03 2011
[3] Institutional Investors Demand Corporate Climate Change Risks 03 2004
[4] Institutional Investors Demand Corporate Climate Change Risks 03 2004
[5] SEC Pressed on Climate Change Disclosures 09.18.07
[6] SEC Pressed on Climate Change Disclosures 09.18.07

Therefore, they often do not disclose anything related to climate change. They believe that full disclosure should be required because "58% of U.S. gross domestic product comes from states that have passed measures or joined regional compacts that set goals for greenhouse gas reductions in coming years."[7]

SEC Commissioner Troy Paredes and Scott Kimpel, counsel to the commissioner, met with the CERES representative on January 21, 2010 to discuss the petition. In a 3 to 2 margin, the SEC commissioners voted on January 27, 2010 to issue guidance to help companies interpret existing environmental disclosure rules.[8] Two commissioners, Kathleen Casey and Troy Paredes, objected to issuing the document. They said that the "existing disclosure rules were adequate and additional guidance was unnecessary."[9] In addition, they said there is no evidence of major underreporting by companies on climate change risk.[10]

Carbon Disclosure Project. The Carbon Disclosure Project was founded in 2000 and represents about 385 global institutional investors with more than $57 trillion in assets under management.[11] They collect key climate change data from more than 1550 major corporations around the globe and assemble the largest corporate greenhouse gas emissions database in the world.[12] The project collects information such as "climate change risks and opportunities, energy use and costs, participation in emissions trading and purchasing offsets, corporate practices and engagement in public policy discussions on climate change."[13] The responses are then accumulated and form the basis of a publicly available report, which then helps the project decide whether or not a corporation is listed on the Carbon Disclosure Leadership Index.

The Carbon Disclosure Leadership Index "recognizes companies that demonstrate good internal data management practices for understanding emissions."[14] Those who make this index understand how climate change impacts their business. Institutional investors use this to assess a company's environmental credibility. It is like a prestigious honor roll for global corporations who have addressed the challenges of climate change. Companies like Oce, a digital press manufacturer, Pfizer Inc, a health care company, and UPM, a paper giant, have been on the Carbon Disclosure Leadership Index for quite a while.[15] [16] [17] Pfizer Inc's company standard is requiring conservation of energy and reduction of greenhouse gases since 1996. They have voluntary reductions in greenhouse gas emissions and a commitment to renewable energy.[18]

Guidance on Climate Change Disclosure. The SEC provided guidance on how companies should reveal their climate change risks. They recommended companies reexamine the effects of climate change on their businesses in regulatory filings. Since 2007, investors have been pressuring the SEC to address the interpretation of its rules relating to climate change. Things started to change when Mary Schapiro took over as the SEC chairman in January 2009. "The new SEC leadership is very interested in protecting investors and giving them better information."[19] This interpretive guidance, Commission Guidance Regarding Disclosure Related to Climate Change, Release No. 33-9106, can be accessed at http://www.sec.gov/rules/interp.shtml and became effective immediately following its publication in the Federal Register on February 8, 2010. Companies who believe they will not be significantly impacted by climate change do not need to make a disclosure, but they must be able to defend their position if the SEC asks. A subsequently discovered material impact will require them to make appropriate disclosures.

[7] SEC Pressed on Climate Change Disclosures 09.18.07
[8] Hot Topic Climate Change Disclosure 02.19.10
[9] Hot Topic Climate Change Disclosure 02.19.10
[10] Hot Topic Climate Change Disclosure 02.19.10
[11] Pfizer Recognized as Leader in Improving Climate Change for Second Consecutive Year 10.10.08
[12] Pfizer Recognized as Leader in Improving Climate Change for Second Consecutive Year 10.10.08
[13] Green data all the rage; Investors anxious to identify winning sectors 12.05.09
[14] OCE makes CDP eco practice list 01.07.11
[15] OCE makes CDP eco practice list 01.07.11
[16] Pfizer Recognized as Leader in Improving Climate Change for Second Consecutive Year 10.10.08
[17] UPM ranked 3rd in Nordic division of Carbon Disclosure Project Index 10.29.10
[18] Pfizer Recognized as Leader in Improving Climate Change for Second Consecutive Year 10.10.08
[19] SEC Comes Clean on Climate Disclosures 01.27.10

The disclosure obligations can impact four items in SEC Regulation S-K: Description of Business – the company is required to describe its business, including its form of organization, principal products and services, major customers, competitive conditions, and certain costs of complying with the environmental laws; Legal Proceedings – the company is required to provide a brief description on any material pending legal proceedings that they are a part of or that a governmental authority is contemplating against them; Management Discussion and Analysis of Financial Condition and Results of Operations (MD&A) – addresses any known events or circumstances that could have a material adverse effect on the company's financial condition or results of operation; Risk Factors – requires discussion of significant factors that make investment in a company's securities risky.[20] Legal proceedings related to environmental matters that involve a governmental authority must be disclosed if amounts exceed $100,000. The nature and extent of the disclosures impacting MD&A depend on management's assessment of materiality. They will need to make two assessments to determine materiality of a known uncertainty. First they have to "assess whether pending legislation or regulation is reasonably likely to be enacted. If so, management must then evaluate whether it is reasonably likely to have a material effect on the company's financial condition or results of operation."[21] Second, they will need to assess the likelihood that controversial climate change legislation will be enacted and if necessary to assess the impact on the company.[22] Four aspects of climate change could impact businesses in ways that may trigger disclosure.[23] These are:

- *Impact of Legislation and Regulation.* Existing and pending climate change legislation and regulation can affect financial projections and business operations, which could lead to both negative and positive consequences. If climate change legislation or regulations are expected to materially affect a company's financial condition or business operations, they must be disclosed. Examples of this are, "effects from purchases or sales of emissions allowances under a cap and trade program, and positive or negative impacts to sales and cost of sales due to changes in the demand for the company's goods and services."[24] If a company finds that a disclosure of risk factors is necessary, a generic disclosure is inadequate.
- *Impact of International Accords.* Companies should consider impacts of international agreements and treaties. If a material impact is found, a disclosure is required. For example, the Kyoto Protocol – under which industrial nations place carbon emission limits on various industries, and the European Union Emissions Trading System – which establishes a cap and trade marketplace for carbon emissions – could cause disclosure. Since the "sources of disclosure obligations related to international accords are the same as those for U.S. climate change regulation", many of their 10-Ks will show disclosures that include both the impact from international accords and domestic activity.[25]
- *Physical Impacts of Climate Change.* Climate Change can have a significant physical impact on the environment, such as, weather patterns, storm intensities, and rising sea levels. "Potential risks to the company, its assets, supply chain, and other areas include property damage and business interruption for registrants located near coastlines, financial and operational impacts to major customers or suppliers, higher claims and liabilities for the insurance industry, and lower agricultural production capacity."[26]
- *Indirect Consequences of Regulation or Business Trends.* There is a chance that some legal, technological, political or scientific developments related to climate change may lead to risks that may cause additional disclosure. These indirect consequences or opportunities can be a "lower demand for goods that produce higher levels of greenhouse gas (GHG) emissions, increased competition to develop innovative new products, or a higher demand for energy derived from alternative sources."[27] Climate change can also affect a company's reputation. Companies in certain industries may be more sensitive to public opinion than others. Damage to their reputation can cause potential challenges to their operations and financial condition.[28]

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[20] SEC Guidance on Disclosure Related to Climate Change 01 2011
[21] SEC Guidance on Disclosure Related to Climate Change 01 2011
[22] SEC Guidance on Disclosure Related to Climate Change 01 2011
[23] SEC Guidance on Disclosure Related to Climate Change 01 2011
[24] SEC Guidance on Disclosure Related to Climate Change 01 2011
[25] SEC Guidance on Disclosure Related to Climate Change 01 2011
[26] SEC Guidance on Disclosure Related to Climate Change 01 2011
[27] SEC Guidance on Disclosure Related to Climate Change 01 2011
[28] SEC Guidance on Disclosure Related to Climate Change 01 2011

Effects on Companies. The interpretive guidance on climate change disclosures have prompted many companies to reassess "whether their disclosure controls and procedures are sufficient and effective in identifying relevant information related to climate change matters."[29] Companies began to consider the likelihood of a cap and trade system passing and the effects that it would have on them. The cap and trade system is used by countries to limit greenhouse gas emissions. In this system, the government sets a target level of emissions for companies for a certain time period and uses allowances to assign a monetary value to pollution.[30] Companies that emit less than the target level will have excess allowances, while those who exceed their target level will have to acquire additional allowances. The latter will have to "purchase allowances directly from other companies, through a broker, or on an exchange."[31]

Companies may have a challenge in reporting these disclosures in that "disclosure of non-financial and sustainability related information has increased, but the analysis of what that information actually means for the organization, and its strategy, is often weak or insufficient."[32]

Accountants and environmental managers will have to work together to get a full understanding of the different issues, and the costs involved to make an investment decision because these costs and issues could influence the return on investment. In order to meet the different legislation and regulations on climate change, companies may want to commit to sustainability. This commitment "can help improve an organization's products or services, motivate its people, lower their costs and enhance their reputation."[33] The PricewaterhouseCoopers' 2007 survey of the Fortune Global 500 companies' narrative reporting found that companies that provided more contextual and non-financial information on their performance were the best reporters.[34] The disclosures inform investors on what management views as the most important climate change related issues.

Charles Morand's article on climate change and corporate disclosure thinks of climate change as an investor and explains the opportunities and risks in three main areas: physical, business, and regulatory.[35] He states that some companies may benefit from these disclosures. For example, electric grid service companies, companies that provide renewable energy to help reduce the carbon footprint, and companies who conduct carbon emission credit exchanges. On the other hand there are risks involved. However, other companies, who will have to share risks, are those who are impacted by extreme weather, who increase carbon footprint, and who are in the "regulatory line of fire for carbon emissions."[36]

Companies should consider assessing the potential impact of climate change by collecting and evaluating relevant information. They may want to refer to the Climate Disclosure Standards Board's Climate Change Reporting Framework (CCRF), which "provides requirements about how climate change-related disclosures shall be determined, prepared, and presented."[37] This framework uses financial reporting principles that "allow environmental reporting to be developed with a familiar vocabulary and tested approach."[38]

Companies are now making climate change action known and important throughout their business. In 2011 the Carbon Disclosure Project surveyed 200 major Canadian corporations on carbon-related governance, strategy, communications, risks, opportunities, and emissions. 108 corporations responded (54%), which is an increase from 46% in 2010.[39] The Carbon Disclosure Project has found that the majority of the S&P 500 disclosing companies now integrate climate change into core business strategy. They found that there is an increase from 68% in 2010 to 87% in 2011 in corporations who have senior executive or board oversight of their climate change programs.

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29 New SEC climate change 'guidance' not seen having immediate big impact on disclosures 02.08.10
30 Environmental Management Accounting 08 2005
31 Environmental Management Accounting 08 2005
32 Sustainability Framework 2.0 03 2011
33 IFAC Launches Sustainability Framework 02.12.09
34 Sustainability Framework 2.0 03 2011
35 Climate Change & Corporate Disclosure Should Investors Care 09.24.09
36 Climate Change & Corporate Disclosure Should Investors Care 09.24.09
37 Climate Change Reporting Framework – Edition 1.0 09 2010
38 Sustainability Framework 2.0 03 2011
39 Companies Already Prepping for Climate-change Regulations 10.12.11

The amount of companies reporting climate change policies has increased. In 2011, reporting increased from 35% in 2010 to 65%. In addition, 64% of corporations are setting reduction targets for greenhouse gas emissions. [40] Many of the emissions reduction and energy efficiency programs are now offering three years or less of payback compared to much longer payback periods. Companies are also using this opportunity to change investor perceptions since they know that investors are focusing on how the environmental efficiency of an organization may impact future corporate earnings.

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