Financial disclosure of risks related to global climate change

BY MICHAEL B. GERRARD AND CHRISTOPHER ANDERSON

Securities and Exchange Commission (SEC) regulations require publicly traded companies to disclose the material impacts of environmental laws on their business. Increasing attention is being paid to the issue of securities disclosure of financial risks and opportunities posed by impending regulation relating to global climate change and by climate change itself.

Many companies have considered these risks too speculative to warrant disclosure. However, recent developments have led to a widespread revision of this view. On the scientific front, a consensus has emerged that greenhouse gas (GHG) emissions from human activities are altering the climate. Significant regulatory developments have also occurred—in 2005, for example, the European Union began a cap and trade program for carbon emissions, affecting U.S. businesses with European operations. Now that Australia has joined, the United States is the only major industrialized country that has not ratified the Kyoto Protocol, and pressure on the United States to adopt mandatory regulations is growing. Domestically, several states will begin imposing mandatory GHG caps in the near term, including the ten northeastern states comprising the Regional Greenhouse Gas Initiative in 2009. Federal legislation also seems likely in 2009.

Plainly, companies must analyze and report the costs of complying with existing laws on carbon emissions. But companies are also coming under pressure on several fronts to consider the broader effects of climate change on their business.

In September 2007, a coalition of environmental organizations, government entities, and institutional investors led by Environmental Defense and Ceres petitioned the SEC to issue guidance that companies must assess and disclose the risks and opportunities to their business posed by climate regulation and environmental change. The petition argues that companies must quantify their carbon emissions to analyze their risks adequately. It also notes that several companies address the risks of climate change in voluntary disclosures and sustainability reports but not in their SEC filings. Though few expect the SEC to act on the petition before President Bush leaves office, the petition is adding to the pressure on companies.

From a different point on the ideological spectrum, the Free Enterprise Action Fund, a mutual fund that seeks to fight “the Left’s use of capitalism against capitalism,” filed its own petition with the SEC in October 2007, asking that companies be made to disclose the cost of complying with GHG regulations that the companies have supported. The petition argued that many of these regulations could hurt earnings.

Congress is also in on the act. Shortly after the Environmental Defense petition, the Senate Banking Committee held hearings on the effect of climate change on disclosure requirements, and at least the early prints of America’s Climate Security Act (S. 2191), introduced by Sens. Lieberman (I-CT) and Warner (R-VA), would require the SEC to promulgate regulations on this subject. In addition, on the enforcement front, Attorney General Andrew Cuomo of New York subpoenaed five energy companies for documents related to their disclosure of climate risks in September 2007.

Shareholders are pressing companies to improve their climate change related disclosures. According to Ceres, forty-two shareholder resolutions were filed in 2006 demanding greater climate risk disclosure. Once tallied, the number of resolutions filed in 2007 is expected to be even higher. Although concentrated in the energy sector, resolutions were filed with a broad range of companies, including retailers and insurance companies. Several resolutions garnered the support of more than 20 percent of shareholders, and others were withdrawn after management voluntarily agreed to make the requested disclosures. Many of these resolutions were supported by large institutional investors, such as city and state pension funds.

To encourage better reporting, Ceres and the Association of Chartered Certified Accountants sponsor an annual competition for the North American Sustainability Reporting Awards, seeking to highlight best practices in reporting on sustainability issues.

Although the “state-of-the-art” approach to disclosing the effects of climate change is continuing to develop, certain things are already clear. First, companies must be scrupulous in their disclosures of the costs of complying with both promulgated and expected regulation of GHGs. The requirement that companies disclose the cost of complying with environmental regulation is already well established, and those that fail to do so run the risk of enforcement actions and shareholder suits. Second, companies should endeavor to speak with one voice on the issue. For example, it is perilous to omit risks from SEC filings that are discussed in voluntary disclosures or sustainability reports. Finally, companies should closely monitor developments in this area. Whether through regulation, litigation, or shareholders’ initiatives, the standards and practices that govern climate change issues in financial reporting will continue to evolve rapidly.