Insufficient financial reporting may lead to underestimation of environmental liabilities

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European listed companies in the energy and mining sector provide, to say the least, sparse information on future environmental costs in their annual reports. Researchers believe that stricter guidelines are required as the lack of information may lead to underestimation of environmental liabilities, resulting in that future generations may have to bear the burden of cleanup costs.

"I believe that the future environmental liabilities such as decommissioning costs are often underestimated and few understand the burden these costs might impose on future generations. If, for example, an oil & gas company fails, it costs an incredible amount to clean up after old oil wells and the risk is great that the taxpayers will have to pay the bill. Therefore, it is important that environmental obligations are made visible to investors, lenders and the public so that we can discuss the problem," says Mari Paananen, associate professor of business administration at the School of Business, Economics and Law at the University of Gothenburg.

In fact, as there is no clear claimant for this type of future obligations, there is little demand for information either.

"The International Accounting Standards Board needs to provide clearer requirements about what information should be included in the annual reports in order to make it possible to assess environmental liabilities. I think that such guidelines would make companies inclined to disclose more information and would also provide, for example, auditors a mandate to demand specific information," says Mari Paananen.

Using a sample of 164 European listed companies active in oil, gas, energy (nuclear power) and mining, Mari Paananen and her research colleagues have analyzed environmental disclosures in annual reports over a twelve-year period. Specifically, the researchers use computerized text analysis, to examine information on environment-related restoration costs in the notes to annual reports. Among other things, they searched for information about the discount rate and estimated time horizon for payments—key information needed to assess the size of environmental liabilities.

"Even though we could see that the disclosure of environmental information in the annual reports has increased over time, companies are, are on average, not very forthcoming with information. Approximately 60 percent of the companies provided information about discount rates and 65 percent disclosed the time horizon for the expected future cash outflow. On the other hand, only just over a third provided information about both," says Mari Paananen.

The researchers also investigated whether the level of disclosure increased when companies faced media exposure focusing on environmental issues or how companies' take responsibility for the environment.
"We clearly saw that if companies were exposed in the media, the environmental information increased and the companies provided more specific disclosure on environmental liabilities in the following annual report. Above all, there was more information if the media used an uncertain or litigious tone," says Mari Paananen.


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