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Environmental disclosure quality: Evidence on environmental performance, corporate governance and value relevance

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ABSTRACT

This study focuses on common-law Malaysia, which is classified as an advanced emerging market. It assesses the association between environmental disclosure and environmental performance and examines the financial attributes of companies with different environmental disclosure scores. It investigates the relation between environmental disclosure quality and corporate governance, and also examines the extent to which effective environmental disclosures are value relevant and how they influence investor perceptions. The findings of the study show that environmental disclosure is positively linked to environmental performance. Company attributes, such as large size, the need for capital, profitability and capital spending, are positively associated with environmental disclosure quality. High quality environmental disclosers display effective corporate governance and would tend to face less difficulties in accessing capital markets. They generally are audited by a big 4 auditor or cross-listed on foreign stock exchanges and display significant levels of managerial and institutional ownership. High quality environmental disclosures are value relevant and improve investor perceptions. High quality disclosers overall belong to beverages, chemicals, food producers, forestry and paper, and industrial metals and mining.

1. Introduction

This study examines the quality of reported information about company environmental performance and the association between company practices and the environment. Sustainability is a central issue for business and society. Scarcity and the cost and financial value of natural resources are crucial to business activity. More important however is the protection of environment. Although the initiatives that may be undertaken vary, the costs involved limit the motivation to undertake them. Financial reporting is important for disclosing

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crucial information about the options that are available for adopting environment-friendly industrial practices and the related costs. The disclosure of company environmental policies in annual reports would allow investors and other interested parties to make informed judgements about the efficiency and impact of managers' sustainability decisions and actions (Deegan, 2004). High quality disclosures would provide a signal of transparency and would enhance managers' reputation and social profile (Deegan et al., 2006; Patel et al., 2002; Simnett et al., 2009). For example, information about the management policy on spending relating to significant environmental actions would reduce uncertainty and would earn the company a competitive advantage.

Investors would require the disclosure of useful narrative and numerical information about environmental risks and choices and risk management policies (Solomon and Solomon, 2006). Disclosures to be of high quality, they will need to provide explicit information about managerial judgements, assumptions and estimations relating to relevant valuation and projection models. Of particular interest are the disclosures that relate to changes of environmental policies, environmental liabilities, environmental costs and environmental impairment. The provision of detailed disclosures would reduce the potential for earnings manipulation. In addition, the International Corporate Governance Network has pointed that informative disclosures about the environment are important for investors when evaluating a company's value and future prospects as well as opportunities and risks.

Environmental disclosures should include key environmental matters and their impact on companies' future performance and position, risks and uncertainties, material items of income or expense, policies on significant environmental issues, such as emissions trading, etc. They should report on emissions trading schemes and include reporting greenhouse gas emissions, calculating direct emissions, e.g. fuel combustion in boilers, and indirect emissions, e.g. waste disposal, disclosing expenditure on energy, reporting on direct energy, e.g. oil and coal, and indirect energy, e.g. electricity purchases, reporting quantities of water abstracted, reporting quantities of waste, reporting on policies on water use, etc. They should also explain how their tangible and intangible assets may be affected by environmental impairment. Hazardous items would require special treatment.

Additional disclosures should include fines or penalties for non-regulatory compliance, environmental friendly capital investments, compliance with internal and external environmental reporting quality benchmarks, and contribution to sustainability projects. Companies should also disclose information about their environmental plan of action and strategy leading to environment-friendly products. Overall, the reported information should be in line with accounting principles and meet the reporting requirements as prescribed by accounting regulation. Hence, it should be relevant, understandable and accessible to users, provided on a timely basis, and possess confirmatory value. It should also be comparable, reliable and free of error or bias.

Socially and environmentally sensitive disclosures would tend to be highly valued by financial analysts, investors and market authorities to the extent that they are meaningful and value relevant (Throop et al., 1993). The presentation of numerical environmental information would contribute to reducing environmental costs and costs of capital, and increasing productivity and regulatory compliance. Lack of sufficient information about material environmental areas might give rise to significant political costs and concerns at local or national level. This would tend to be more evident in the case of large companies, since large size would attract political and regulatory attention and would motivate managers to provide higher quality sustainability disclosures.

Agency theory deals with conflicts in the association between shareholders and managers (Jensen and Meckling, 1976). Graves and Waddock (1994) argue that managers, driven by self-interest, may be more willing than shareholders to spend more on environmental protection policies as it is shareholders' money and not their own. An annual report should communicate easy-to-verify and difficult-to-verify financial information (Fields et al., 2001; Meek et al., 1995). A focal issue is whether an annual report presents the true and fair view of a company's financial performance and position or serves managers' personal financial objectives and bonus pursuits (Lambert, 2001; Roberts, 1992).

According to agency theory, shareholders would need to establish mechanisms to monitor managers, reduce opportunism and information asymmetry, and ensure that shareholders' wealth is maximised (Cormier and Magnan, 2003; Healy and Palepu, 2001). If effective monitoring devices were in place, managers would be more careful and would tend to better look after shareholders' objectives (Eisenhardt, 1989). A number of corporate governance mechanisms, such as material managerial ownership, the