How Environmental Reporting can be Saved by Accounting Principles

Why Accounting Principles and Objectives should and must be applied on Corporate Environmental Reporting

By Miriam Aakre Borgersrud[1]

Abstract

Empirical studies show that environmental reporting within the annual report tends to lack reliability and comprehensiveness. This paper will argue that companies have a legal obligation to apply accounting principles when disclosing environmental information in their annual report. It also aims to explain why traditional principles of accounting must be applied to environmental information in the annual report in order to have an effect on decision-making in the company and on corporate behaviour.

Content

[1] Student Fellow at the Faculty of Law at the University of Oslo and as a member of the Sustainable Companies Project. This article is based on parts of the author's master's thesis, titled "Environmental Reporting" ("Miljørapportering"). Special thanks goes to the project leader and my supervisor, Professor Beate Sjåfjell, for all encouragement. Also thanks to Professor Hans Robert Schwencke, Professor Jukka Mähonen, Ph.D. student Jone Engh and Attorney at law Karin Ongre for constructive comments and discussions. I would also like to thank Professor Endre Stavang, Post Doctor Inger Marie Hagen and Post Doctor LLM. Cecilie Kielland for keeping their office doors open for my questions.

1 Introduction

Environmental information is reported in the company accounts to comply with national regulations and/or as a voluntary activity. Such disclosure is carried out in the financial statements as well as the narrative parts of the company accounts, often referred to as financial or non-financial environmental disclosures. The focus of the discussion in this article will be the narrative reporting that accompanies the financial statements. This information provides a context for the cash flows of the entity and complements the financial statements.[2] Such disclosures can be found in the annual report[3], including reports such as the boards review and the director's report,[4] or in separate reports presented as additions to the annual report.

Traditionally there are two perspectives when analysing environmental disclosures in the annual report. Firstly, environmental reporting can be considered within the framework of the dialogue between company and society. The undertaking wishes to communicate relevant information to corporate stakeholders. Secondly, environmental disclosures can be studied as a part of the company accounts.[5] In the next paragraphs environmental disclosures are discussed as a part of the company accounts. I will have a closer look at mechanisms that highlight the importance of environmental reporting being considered as equal to any other disclosure in the company accounts. The need for such discussion arises from the fact that the board and management tend to report on the basis of a cost-benefit evaluation.[6] The narrative information provided in the annual report has been shown to lack necessary roots in the corporate reality.[7]

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[2] Issues on narrative environmental information in notes to the financial statements will not be addressed in this article. See Borgersrud (2011) (in Norwegian), pp. 92-94.
[3] The annual report was made an integrated part of the company accounts by Norwegian law in 1979. According to the preparatory works the objective of such a report was to inform the management of the company's economic positions and to form the basis for budgeting and also serve towards strategy purposes. It should also aim to inform the shareholders and employees, as well as creditors, community, legislators and tax authorities, see Ot.prp.nr. 19 (1975-76), p. 150, second column.
[4] Such as management's discussion and analysis (MD&A) and operating and financial review (OFR).
[5] Grey, Kouhy and Lavers (1995), p. 48.
[6] Li and McConomy (1999), see Berthelot et.al., p. 33.
[7] See Jones (2000), Ruud et.al. (2008).

Similar to the reporting in financial statements there are mandatory legal requirements pertaining to the content, scope and quality of narrative reporting in the annual report. The objective of specific duties of environmental reporting is to integrate environmental concerns into corporate decision-making and make companies internalize external effects of their business.[8] However, research has frequently proved environmental disclosures in the annual report to lack relevance and correctness.[9]

Initiated by these realities this article will address the issue of whether or not accounting principles can and should apply to narrative environmental reporting in the annual report. I am going to elaborate on the nature of environmental information and its relationship to the corporate present and future value. I will also demonstrate why accounting principles concerning the financial statements must be applied when reporting on environmental aspects of corporate activities that affect corporate behaviour. The issues in this article will be discussed from the perspective of Norwegian law. However, general principles of accounting law are applicable to company accounts that are prepared in compliance with EU law and the International Financial Reporting Standard (IFRS). The argument that is made here therefore has a transferable value on other jurisdictions where companies are obliged to disclose narrative environmental information in parts of their company accounts.

2 The Nature of Corporate Environmental Information

2.1 Regulations on Environmental Reporting in Short[10]

There are roughly speaking three forms of environmental reporting duties. The first is the duty to include environmental information into the boards or managements analysis in parts of the annual report, to the extent that they are economically relevant. The obligation to include environmental information can be extracted from the duty of accounting itself, but it has also been codified through the Modernization Directive in 2005 that amended the 4th and 7th Company Directive concerning annual and consolidated accounts, art. 46 paragraph no. 1 b

[8] Sjåfjell (2009), Borgersrud (2011) (in Norwegian).
[9] See e.g. Jones (2000), Ruud et.al. (2008), and the Commission (2011).
[10] The summary under this subparagraph is based on the company law mapping papers of the Sustainable Companies Project. Concerning the Norwegian reporting duty I have done extensive research of the legal sources and a detailed discussion can be found in Borgersrud (2011) (in Norwegian).

and art. 36 paragraph no. 1 respectively. The majority of European companies with limited liability are obliged to disclose information on environmental aspects of their business when financially relevant. The wording of the European environmental reporting duty is as follows:

"To the extent necessary for an understanding of the company's development, performance or position, the analysis shall include both financial and, where appropriate, non-financial key performance indicators relevant to the particular business, including information relating to environmental and employee matters;"

The second form of environmental reporting duty is the requirement to disclose information on aspects of the business that can affect or are affecting the environment, not limited by economic relevance. This kind of duty was imposed in the Norwegian Accounting Act in 1989.[11] Current regulation stipulate that all Norwegian companies report environmental aspects based on the Norwegian Accounting Act § 3-3 paragraph 10 and § 3-3a paragraph 12.[12] The wording of the provisions is as follows:

"The Company shall disclose information on aspects of the company's business, including inputs and products that have an effect on the external environment. The company shall disclose information on what environmental impacts that a specific aspect causes or can cause, and what measures that have been or are planned to be put into action to prevent or reduce negative environmental impact." [13]

The third form of environmental disclosures in the annual report is disclosures made on a voluntary basis.[14] Voluntary reporting can be based on a reporting scheme or occur in addition to disclosures required by mandatory legislation.[15]

[11] In Norway the first duty to report so-called "non-financial" information was introduced though the Norwegian Accounting Act of 1977. The companies were from that point obliged to report on labour conditions. In 1989 this reporting duty was extended to include information on whether the enterprise's business effected the environment or not. In 1998 the provision was revised with an aim to widen the scope for the environmental reporting duty, see Borgersrud (2011) (in Norwegian) pp. 8.

[12] The duty is implemented in § 3-3a paragraph 3 of the Norwegian Accounting Act and its application area overlaps the scope of the national Norwegian reporting duty. EU law is therefore of significance when the content of the Norwegian provision is interpreted, see Borgersrud (2011) (in Norwegian), p. 13.

[13] The provision involves two requirements. The first addresses the lower threshold of environmental aspects of the business, activating the necessity to provide an environmental report It also gives direction the range of the overall environmental information that is reported in the annual report. The second regulates the extent of the reporting duty when the threshold has been exceeded.

[14] It can be argued that this practice is not a duty by the narrow meaning of the word. It is also questionable whether or not this voluntary practice can be seen as a rule of law even if it maintains uncodified (unwritten/"common law"). At least this appears to be a reasonable allegation in the light of a *best practice*-approach of accounting law. Outside Europe, Turkey is an example where environmental reporting in the annual report is completely voluntary, see Eroğlu (2010).

By Norwegian law, auditors have limited responsibility to audit environmental reporting in the annual report. The preparatory works of the Norwegian Audit Act go a long way in stating that the auditor is not obliged to audit narrative environmental reporting in the annual report, not even when it occurs in context of expected future developments of the company:

”The Auditor shall evaluate disclosures about the financial statements given in the annual report. Disclosures in the annual report about future development, and about employees conditions and environmental information, is not included in the control of the auditor” [16]

Qualitative and quantitative empirical research carried out among Norwegian companies in 2008 states that the Accounting Act is neither complied with by companies nor enforced by the authorities. In Norway there are no formal procedures for verification or auditing of environmental disclosures in the annual report.[17] The result of this is that producing this report appears to be voluntary rather mandatory. Enforcement of the provision can occur through lawsuits for damages filed by private parties based on economic loss due to insufficient or incorrect environmental reporting. The lack of compliance can also be prosecuted on the basis of the Norwegian Accounting Act or Criminal Justice Act.[18]

2.2 What is Financial and What is Not?

Disclosures in the company accounts are often categorized into two groups: financial and non-financial reporting. Traditionally the financial reporting is carried out through quantitative reporting in the financial statements. The non-financial disclosures are presented through narrative reporting in the various parts of the annual report.

The non-financial reporting can be subdivided into two groups. The first group includes the environmental disclosures that are made in the board’s or management’s analysis of the company’s position and future development. The second category is the environmental information about an entity that is disclosed without being put into context of the economic situation or development of the undertaking. Such disclosures can include information on

[15] See Villiers (2006), p. 14. For examples on national voluntary schemes see Villiers (2010) on UK companies and Diependock (2010) on German companies.
[16] Ot.prp.nr. 75 (1997-98), p. 8. The proposition was followed up in Innst.O.nr. 25 (1998-99), paragraph 4.1.2.1.
[17] Ruud et.al. (2008), p. 58.
[18] I have only found one case where breach of this duty was being convicted; see Agder lagmannsrett (Court of Appeal in Agder) case LA-2005-92191.

environmental policies or goals, details of relations with environmental authorities or information on how the corporate activities are affecting the environment.[19]

2.3 The Economic Relevance of Environmental Information

Non-financial information may prove to be necessary for a correct understanding of the company's position and future development. There are economic aspects of an entity that cannot be expressed by quantitative reporting alone. A close relationship exists between quantitative reporting in the financial statements and narrative environmental disclosures in the annual report. How the board and management deal with environmental aspects of the corporate operations may determine the company's ability to generate excess value. Environmental aspects of corporate activities are key elements when mapping the future potential and development of the enterprise. The narrative reporting may reveal whether or not the company has a strategy for shortage of natural resources. Environmental reporting in the annual report can also include information on emission permits and how they are utilized. Environmental information about a company does not only concern the goodwill, reputation or stock market value of the company. Environmental aspects of the company's operations often concern the robustness of the value generating abilities of a company. In other words, environmental disclosures provide financial information reported in a narrative manner.

Environmental information is crucial to map risks and opportunities, especially on a long-term basis. Its importance can be illustrated by the credit crisis of 2008:

"The credit crisis has highlighted the importance of companies articulating their business models in a clear and understandable way. Business models cannot be conveyed through numbers alone and it is up to narrative reporting to tell the story of what a company does to generate cash."[20]

The natural and nuclear disaster that hit Japan in spring 2011 also demonstrates the fact that environmental aspects may represent a prerequisite for economic sustainability. [21]

[19] For a broader view on categories of disclosures in Swedish companies, see Ljungdal (1999), p. 54. Fallan (2007), p. 46, gives an overview of disclosures from Norwegian companies.
[20] ASB (2009), p. 6.
[21] See Gransmo (2011).

Preparatory works of the Norwegian Accounting Act from 2003 also seem to recognize that environmental information in general is of economic relevance. The legislator states that a limitation of the duty to report on environmental aspects would have a minimal affect on the level of reporting. The statement is based on the recognition that environmental information is necessary to understand the positions and future development of most entities.[22] The fact that environmental information is explicitly incorporated into 4th and 7th Company Directive[23] also confirms that environmental aspects of the company's business is seen as significant for the value of the company. The Commission Recommendation of 2001 supports this point of view as well:

"Investors need to know how companies deal with environmental issues." [24]

The national accounting standards for large companies, NRS 16, also emphasizes that the separation of financial and non-financial information is not distinct:

"One of the objectives of the annual report is to provide additional information and explanations for the valuation of the undertaking. Therefore the annual report also emphasizes other aspects that are important to evaluate the position, earnings and risks of the undertaking. In addition to financial information the annual report will include among other things, information on competitive conditions, market positions, environmental conditions, constraints and prospects for the future. [25]*"*

Based on these considerations it is evident that environmental information is relevant to estimate the long-term survival ability of the company. Shareholders, lenders and creditors would be interested in whether or not the company is taking the best advantage of its emission permit, or what strategies the board or management are planning in case the permit is significantly reduced. Indisputably some environmental disclosures will have insignificant economic relevance. However, the line between financial and non-financial environmental disclosures cannot be drawn on a general level, especially as the significance of environmental information to the specific enterprise depends on its particular situation at the

[22] See NOU 2003:23, p. 266.
[23] Council Directive 78/660/EEC and Council Directive 83/349/EEC, respectively.
[24] Commission Recommendation 2001/453/EC, p. 33.
[25] NRS 16, p. 1. My translation.

time of disclosure. Given the nature of corporate environmental information, a distinction between financial and non-financial information would appear unfeasible.[26]

In this context there would also be no practical reason to deal separately with the three forms of environmental reporting duties mentioned in subparagraph 2 above.[27] I will mention all three types as they all tend to appear in the annual report of companies irrespective of the requirements on environmental reporting applying to the specific entity.

2.4 Financial and non-financial users

Parallel to the categories of environmental *disclosures,* there are also financial and non-financial *users*. Financial users are the users of the company accounts that are expecting to be informed of the financial aspects of the company and its operations. For example, shareholders, investors, lenders, other creditors and legislative and tax authorities. Such information will constitute the basis for a decision of whether or not to invest, provide credit or regulate the conditions of the company's business. The decisions of financial users have a major impact on the flow of resources into the company.

On the other hand there are non-financial users that are looking for information on non-financial aspects of the enterprise. The typical non-financial users are NGO's, individuals and communities. These users seldom make decisions that affect the corporate value. The actions of non-financial users can influence the goodwill and reputation of the company; however, this will often require collective actions.

Non-financial users may also require financial information, just as investors can be interested in non-financial aspects of the undertaking. The categorization is therefore not distinct, but each represent two opposite approaches that work as a tool to study disclosures in the company accounts.

These thoughts on the nature of corporate environmental information and its users will be reflected within further discussions in this article.

[26] See Norwegian preparatory works NOU 2003:23, p. 16. The extent to which these considerations apply to other subjects of narrative must be studied individually for each subject, see Cormier and Gordon (2001), for example p. 591.
[27] Borgersrud (2011) (in Norwegian), pp. 13.

3 Environmental Reporting and Corporate Behaviour

The objective of the environmental reporting duty, at least by Norwegian law, is to integrate environmental concerns into the corporate decision-making process and make the board and management take such aspects into account.[28] The environmental reporting duty should therefore also contribute to integrate the external cost of corporate operations into the company accounts.[29] For example, internalization takes place when a company strives to reduce negative environmental effects caused by corporate activities or when a company suffers loss of reputation or increased capital costs due to the indulgence in environmental risks.

3.1 Externalities

An economic activity generates values and burdens. The use of natural resources can cause negative environmental effects, yet authorities and communities still allow enterprises to exploit these resources, anticipating greater total benefits than costs. External cost is defined as *" ... all benefits and costs that companies are not encouraged to take into account in their behaviour"*.[30] These costs will not be subject to compulsory reporting duties.

For example: running a golf course can provide open grazing areas for feeding wildlife, outside hunting grounds and generate benefits through employment and excess value. At the same time such activities can occupy areas needed for public recreation and inflict environmental damage through the use of pesticides exceeding the threshold for natural renovation. In this case the total costs of this business can outweigh the benefits. As an illustration the Chairman of Grini Country Club (Grini Golfklubb) gave this very brief report on the environmental aspects of the business in the 2008 company accounts:

"Grini Country Club does not carry out activities that cause either pollution or emissions that can be harmful for the environment."[31]

Similar cases can be found in other branches as well, regardless of whether the company value relies on know-how or production. Occasionally it is alleged that the annual report lacks

[28] See Borgersrud (2011) (in Norwegian), pp. 36.
[29] See Eide and Stavang (2008), p. 555, and Sjåfjell (2009) (c).
[30] Eide and Stavang (2008), p. 555, form the board's view, see Andrews (1980), pp. 89 and Sjåfjell (2009) (c).
[31] See the annual report of 2008 for Grini Country Club:
http://www.grinigolfklubb.no/dokarkiv/grini_gk_aarsberetning_2008.pdf

proper reporting due to time pressure when putting together the reports.[32] However, Norwegian law requires that both positive and negative environmental effects should be disclosed.[33] The lack of enforcement to provide the required environmental report often appears to reduce the importance of the report and allows companies to report what seems most convenient at the time. Current legislation does not ensure that users of the company accounts are provided with sufficient information to forecast the economic development of the company. Environmental information is crucial when mapping the potential risks and prospects of a business.

It is almost impossible to ensure the company accounts reflect all local and global external costs that the community and individuals are burdened with. This also highlights the importance of an effective reporting process. The company accounts should provide a context for the present and future economic development of the company.

Externalities are often categorized as one of the results of market failure.[34] Market failure is a situation where the prerequisites for perfect competition are not facilitated. In this situation the market will not be fitted for effective resource allocation.[35] The flow of reliable information on environmental risks of business operations is the first step towards internalization of external environmental costs. A well functioning environmental reporting process can provide adequate measures to ensure a more beneficial resource allocation. Corporate environmental information is also needed when setting up a legal framework to mitigate market failure. The legal framework should be adjusted to contribute to internalization of external environmental costs. A well functioning environmental reporting duty will provide a foundation for legislation that works.

3.2 Cost Benefit

The financial statements should provide a true and fair summary of costs and values associated with corporate operations. The annual report compliments the financial statements and together they constitute the company accounts and implicate the position and future

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[32] Huneide (2009), p. 5.
[33] Borgersrud (2011) (in Norwegian), p. 63.
[34] Cooter and Ulen (2004), see Sjåfjell (2009) (c), p. 987, and Eide and Stavang (2008) pp. 100.
[35] Eide and Stavang (2008), p. 84.

development of the company and its business. The company accounts present economic and organisational costs and values.

Shareholders, lenders, investors and other creditors have interests towards the company. These groups are looking for information from the company accounts to predict whether or not it is going to be beneficial for them to invest their resources in the company. In this system the board and management are making efforts to reduce costs and risks and increase the company's ability to generate value. The probability that the board and management internalize and report external costs is increased if it leads to lower costs or risks.
For example the board or management have a choice between taking measures to prevent potential damaging environmental effects of their operations, or to do nothing about the risk of environmental damage. A rational board or management would compare the costs of reducing the risk and the cost of taking no action. The most beneficial strategy is most likely to be chosen.[36]

As mentioned, the environmental reporting duty is not being enforced. This leaves the board and management a large margin of discretion. Apparently (not as a matter of law), an even larger margin than intended by the legislators, since empirical research proves that Norwegian companies are not complying with the compulsory reporting duty.[37] When the environmental disclosures are prepared, the board or management will have strong incentives to convey information that satisfies the users of the company accounts that can contribute with capital or other resources to the company.

A survey from 1999 confirms that the board and management tend to report environmental information on the basis of a cost-benefit evaluation instead of intending to present a fair review of the environmental aspects of the enterprise.[38] The findings confirm that the board or management take the interests of the users into consideration when preparing environmental disclosures, in terms of showing them what they would like to see. In other words they disclose information that associates the company with low risks and business opportunities.

[36] Cornwell and Costanza (1994), p. 214.
[37] On Norwegian companies, see Ruud et.al. (2008), on European companies, see Jones (2000).
[38] Li and McConomy (1999), see Berthelot et.al., p. 33.

3.3 What Costs and Benefits?

Sufficient reporting should, by Norwegian law, contain a description on aspects of the enterprise that affect the environment, the effects that the respective aspects cause and any measures that are planned or taken to prevent damaging effects. The reporting should be presented in a manner that provides a fair review of the company and its business.[39] Reporting that contains these elements is sufficient.

The cost of sufficient reporting is firstly related to the preparation. It can be claimed that it is challenging to prepare reports that give a fair review of an entity.[40] To map environmental aspects that cause or can cause an effect on the environment can also be a potentially time-consuming activity. Effects that are or can be caused can also be difficult to reveal and even require special expertise. The fact that there are no accounting standards on how to report environmental information does not make the preparation easier. Vague regulations create costs, especially for operations that do not possess legal competence. [41]

Secondly there is an actual risk that environmental information can cause a negative impact on the corporate value. This is because information on environmental aspects often reveals risks associated with the operations run by the company. It can also reveal potential unexpected costs or cause legislators to regulate the branch more strictly to avoid inefficient use of natural resources. Research proves that environmental information itself has an impact on the economic value of the company.[42] A Canadian survey from 1985 confirms that there is a tendency that potential costs caused by revealing environmental information affected the content of the reporting.[43]

The benefit of sufficient environmental reporting is the elimination of unknown risks. Investors, lenders and other creditors will be expecting less return on their investments and credits. It is risk that constitutes the basis of expected return and interest for these groups.[44] From an organizational perspective, environmental information can also be an important tool

[39] See Borgersrud (2011).
[40] See the introduction of IAS (2009).
[41] See Eide and Stavang (2008), pp. 324 on the costs of vague regulations for contractual parties.
[42] Lancaster (1998), see Berthelot et.al., p. 31.
[43] Dye (1985), see Berthelot et.al., p. 33. The findings show that companies producing utilities in a strictly regulated branch tend to report more information than other companies. Dye's opinion is that this behaviour is explained by the fact that the regulated production companies have greater opportunities to pulverize the cost of environmental information.
[44] Miller and Bahnson (2002), see p. 7, cf. Botosan and Plumlee (2001).

to convey information to investors, government and NGO's.[45] Another benefit of enforcing annual reporting on environmental aspects is that the organization becomes aware of environmental factors relevant to the business and can observe them regularly. This obtaining of corporate awareness may initiate establishing of internal systems that lead to a lower risk of potential environmental damage. A further benefit is that a company that values transparency regarding environmental aspects will attract investors that want to put their money in sustainable enterprises. [46]

The extent of the costs and benefits of environmental reporting depends to what degree other companies in the same situation are reporting in a sufficient manner.[47] It also depends on whether the costs and benefits are evaluated on a long or short-term basis. The costs and benefits also rely on whether or not there are mechanisms to separate sufficient from insufficient environmental reporting. The factors that can affect the amount of costs and benefits from environmental reporting are not exhaustive. A discussion of these factors lies beyond the scope of this paper.[48]

3.4 A Codified Right to Disclose Environmental Information?

Often environmental information about a company reveals risks and uncertainties associated with corporate activities. Higher risks will lead to expectations of higher returns for shareholders and investors and higher interest for lenders and other creditors.[49] In light of the discussion above it is quite understandable that the board and management don't want to disclose such information.[50] However, environmental disclosures that are not revealing risks can safely be disclosed to satisfy the information needs of non-financial users, such as NGO's and local communities.[51] Such environmental disclosures may also attract green investors.[52]

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[45] Banerjee and Bonnefous (2010).
[46] See Richardson (2011) and Wagner (2009). Further about investment guidelines, see Halvorsen (2011).
[47] This relationship could also be analysed in the light of Game Theory, see Eide and Stavang (2008), p. 57 and pp. 122.
[48] For a broader discussion see Borgersrud (2011) (in Norwegian). See also Banerjee and Bonnefous (2010) on French nuclear power plants and stakeholder-oriented strategies. A survey reveals that fewer companies complied with mandatory environmental reporting requirements in 2008 than in earlier financial years, see Ruud et.al. (2008), p. 24. Approximately 30 % of the examined companies have oil or heavy industry as their core business. Also Barth, McNichols and Wilson (1997), see Berthelot et.al., p. 33.
[49] Miller and Bahnson (2002).
[50] See Ditlev-Simonsen and Midttun (2010).
[51] The Interest Theory and Legitimate Theory can also be useful to analyse the behaviour of the board and management from this perspective, for a brief overview see Williams (2006) and Fallan (2007), p. 35 and p. 36. Ditlev-Simonsen and Midttun (2010), survey that reveals that corporate leaders are of the opinion that branding and maximizing of profits motivates CSR.

The relevance of environmental information is therefore lost due to the fact that it is not put into context with the cash flow of the company. The objective of a compulsory environmental reporting duty was to draw the board's and management's attention towards environmental aspects of the corporate operations. It is therefore unfortunate that the environmental information is not being reported in a manner relevant to users, who's decisions influence the flow of resources to the company and hence the behaviour of the board and management.

If environmental disclosures are not designed to be a part of the basis of financial decisions concerning the flow of resources into the company, then an environmental reporting duty is not the proper tool to internalize external environmental costs of corporate activities. If environmental disclosures continue to be prepared for non-financial users, the reporting duty will only provide a legal ground for the nursing of corporate reputation.[53] The consequence will be the legalization of "greenwashing" of environmentally harmful activities generating larger external costs than values. In the end the community or the random individual will have to shoulder these external costs. [54]

When it comes to voluntary corporate reporting on social responsibility (CSR),[55] surveys from 2010 reveal that both company leaders and users of the company accounts think that the main motivation for such reporting is branding and maximization of profits.[56] The findings from a European survey from 2000 also indicate that voluntary environmental reporting was carried out for publicity reasons: 55 % of the responding companies acknowledged that this was the main motivation for voluntary environmental reporting. One enterprise (a health company) admitted the following concerning environmental aspects:

" ... it is one of our key risk areas therefore it is assessed and reported as a part of our approach to compliance with financial reporting. Having said that, our approach tends to be one of a general

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[52] Se Richardson (2011).
[53] As an illustration Communication Agencies assist the preparation of environmental reporting in the annual reports, see homepages of Geelmuyden. Kiese *http://www.geelmuyden-kiese.no/innhold.asp?kat=26*. In reality they are assisting the company in branding and the construction of a good corporate reputation.
[54] See Beets and Souther (1999), p. 133, and Laufer (2003), see Sjåfjell (2009) (c), p. 980 and Sjåfjell (2009) (c), p. 1002.
[55] A proposition is being processed by Norwegian Legislators that can make reporting on CSR in the annual report mandatory, see homepages of the Norwegian Government *http://www.regjeringen.no/nn/dep/fin/dok /hoeringer/hoeringsdok/2010/horing---rapport-fra-arbeidsgruppen-for-. html?id=622148.*
[56] Ditlev-Simonsen and Midttun (2010).

nature, which is slightly PR but not totally. This is because a different audience is interested in these more general topics."[57]

The same survey was carried out on a group of expert organizations. The majority admitted that the motivation was unproblematic as long as the information was sufficient and correct. However, the conclusion of the survey on this group is summed up as follows: [58]

" […] however they go on to state «it is quite evident that those Annual/Financial Reports which contain environmental related data belong to the glossy category»"[59]

Surveys from 1985 illustrate a tendency of companies intentionally reporting insufficient environmental information without meeting any market reaction.[60] This behaviour also takes place in spite of a corporate obligation to disclose environmental information. It is not certain whether or not intentional insufficient reporting would meet any market reaction today. On one hand the development indicates that environmental information has become increasingly important for shareholders, investors, lenders, creditors or in a due diligence situation.[61] CEO of Hydro, Svein Richard Brandtzæg, illustrates this point in this statement from the annual report of 2009:

"The future belongs to those who can produce aluminium with less energy, less emissions and less cost"[62]

On the other hand a similar quote can also be found in an annual report from the Swedish company Sydkraft from 1990.[63] Empirical research implies that market reactions are absent in cases where insufficient reporting does not cause economic losses. [64]

The design of current environmental reporting requirements relies heavily on the discretion of the board and management when it comes to what and how environmental aspects should be reported. Considering the incentives that influence the board's and management's behaviour,

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[57] Jones (2000), p. 54.
[58] Jones (2000), p. 55.
[59] Ibid.
[60] Dye (1985), see Berthelot et.al., p. 33.
[61] See Ongre (2011).
[62] See annual report for Hydro from 2009, p. 4: *http://www.hydro.com/rapportering2009.*
[63] See Almer, Axelsson and Ljungdal (1992), attachment 6.
[64] Ruud et.al. (2008).

it should not come as a surprise to the legislator that environmental reporting duties are not fulfilling their purpose. A survey from 2003 indicates that where the board and management have been given a margin of discretion, it is being used in a way that undermines the reliability of the reporting instead of increasing it.[65] This happens in spite of obligations based on the overarching principles of accounting law. In the synopsis of a European survey on environmental reporting the findings are summed up in the following way:

”Current environmental disclosures frequently lack contextual information making it hard to interpret, as only selected parts of the picture are being presented. Environmental disclosures are difficult to compare across companies as they all disclose different environmental topics and present those topics in a variety of ways.”[66]

I will now take a closer look at accounting principles and how their application can contribute to better achievement of the objectives of environmental reporting duties.

4 Application of Accounting Principles on Environmental Reporting

In light of the economic relevance of environmental information and the views discussed above, it is crucial that accounting principles are applied on narrative reporting in the company accounts. EU law, the framework of IFRS and the Norwegian Accounting Act contain provisions that codify and regulate what can be referred to as overall accounting principles.

The issue with these accounting principles is that they target the financial statements and not the company accounts as a whole. Based on EU law the principle of *a true and fair review* applies to the financial statements as a general principle of accounting. The IFRS Conceptual Framework operates with a variety of characteristics of useful information that any reporting in the financial statements should possess. The Norwegian Accounting Act specifies general principles applying to the financial statements as well, e.g. the principle of congruence, cf. § 4-3. Few of these legal sources clarify the guidelines for application of accounting principles

[65] See Berthelot et.al (2003), p. 34.
[66] Jones (2000), p. 5. The survey initially gives an overview of empirical research on environmental reporting as a basis for economic decisions and the field of environmental information in general, see ibid. pp. 13.

on different parts of the annual report where narrative environmental information is disclosed.[67]

In this section I will emphasise the accounting principle of *a true and fair view* and examine how this principle applies to narrative reporting in the annual report. In short, *a true and fair view* constitutes a legal standard for the reporting in the financial statement. This principle gives those preparing the financial statements a legal basis to set aside written rules if the use of the written rule gives a misleading image of the value of the company. This means that they are obliged to ensure the financial statement presents *a true and fair view* of the company and its economic position. It can be assumed that a similar principle with the same function exists and applies to the annual report. However, the existence of such a principle must be examined on the basis of the legal sources.

The 4th and 7th Company Directive regarding disclosures in the annual report use a similar expression; *a fair review.* The directives do not explicitly attach a superior function to the concept as an objective of the annual report and a principle for the disclosures made there. However, as I will argue, there is sufficient legal foundation to suggest that *a fair review* represents a general principle for narrative reporting that compliments the financial statements.[68]

The legal sources that mention *a fair review* are vague when it comes to the content and scope of the concept. The term was introduced into EU accounting law through the Modernization Directive in 2005[69] that amended the 4th and 7th Company Directive. The term *a fair review* now appears in the preamble and art. 46 no. 1 a of the 4th Company Directive[70] and the term is also found in the 7th Company Directive. [71]The wording of art. 46 no. 1 a of the 4th Company Directive is as follows:

[67] E.g. Parker and Nobes (1994).
[68] The discussion will be carried out focusing on the information needs of financial users of the company accounts. Reporting which satisfies financial users normally meets the information needs of non-financial users. A statement in the Conceptual Framework of IFRS paragraph 10 supports this opinion. It is stated that reports that are prepared for investors, potential investors, lenders and other creditors normally fulfil the needs of other users as well. The statement is based on the recognition that the company accounts cannot aim to satisfy all users. Paragraph 9 in the Framework entails a list of users and their primary information needs.
[69] NOU 2003:23, see p. 14.
[70] See Council Directive 78/660/EEC.
[71] See Council Directive 83/349/EEC.

"The annual report shall include at least a fair review of the development and performance of the company's business and of its position, together with a description of the principal risks and uncertainties that it faces.

The review shall be a balanced and comprehensive analysis of the development and performance of the company's business and of its position […];"

From the contextual understanding of the wording it is unclear whether or not the concept only applies to parts of the annual report that include reporting on "*the development and performance of the company's business and of its position*", or if it expresses a general principle and objective that applies throughout the annual report.

Norwegian legislation has not taken this issue into consideration. Preparatory works from 2003 state that the objective of the annual report is to provide relevant information about the development, excess value, financial positions and risks concerning the undertaking. [72]This statement is not accompanied by a reference to any principle requiring the annual report to give *a fair review* of such aspects of the business. The Directive's concept of *a fair review* is only mentioned in connection with "*the development and performance of the company's business and of its position*". This approach is also adopted in a successive preparatory work.[73] On the regulatory level of accounting standards the concept of *a fair review* is not further defined.[74] This is despite the fact that the concept of *a fair review* has been practised as an accounting principle that applies to narrative reporting in the company accounts, equivalent to the principle of *a true and fair review* among Norwegian auditors.[75]

If the concept of *a fair review* is not understood as an accounting principle of narrative reporting throughout the annual report, it ultimately means that those compiling the company accounts can adjust the level of correctness and trustworthiness depending on which part of the annual report the information is disclosed. The parts of the annual report that include information put in an economic context and used to evaluate the company's future value by the board or management, tend to be governed by the clearest requirement to present *a fair*

[72] NOU 2003:23, p. 263.
[73] Ot.prp.nr. 89 (2003-2004), p. 64.
[74] The concept is neither mentioned in the national accounting standards for large companies, NRS 16, nor small companies, NRS 8, in spite of their latest revision in January and October 2010 respectively.
[75] See the Norwegian Institute of Public Accountants (2006).

review. For other parts of the annual report that don't include such evaluations, the legislators seem to make less effort to stipulate a principle of *a fair review*.

There is a basic problem when deciding which environmental aspects should be reported in parts of the annual report that evaluate the position and future development of a company and which to report elsewhere. This issue is similar to those that occur when separating financial from non-financial information. Even though the decision on what to report where may be done randomly by those preparing the company accounts, this distinction will have a significant impact on which requirements come into play.

If the current legal framework were interpreted this way it would appear unfortunate for several reasons. Firstly it generates reasonable doubt that the information in other parts of the annual report presents *a fair review* of the company and its business, in the balanced and reliable manner that the company accounts should do. If other parts than the ones dealing with economic position and development of the company were allowed to be selective and modified, then the objective of the annual report would fail. This is because the annual report is supposed to complement the financial statements. If the same standards do not apply to the annual report it is not fit for its purpose. Secondly the board and management would have a powerful incentive to avoid reporting sensitive environmental information in the parts of the annual report with higher requirements on material correctness. Thirdly, the legislators would have to set out a distinct separation between what environmental information should be reported where in the annual report to ensure correct implementation of EU law. This is because EU law explicitly requires that environmental information that is economically relevant must present *a fair review*.

However, the Modernization Directive seems to use the concept *a fair review* as a principle of narrative reporting. This conclusion can be drawn from paragraph 9 in the preamble of the Modernization Directive:

"Enhancement, in line with current best practice, of the existing requirement for these [the annual report and the consolidated annual report] to present a fair review of the development of the business and of its position […], is necessary to promote greater consistency and give additional guidance concerning the information a "fair review" is expected to contain."

The multilingual nature of EU law limits the use of literalism[76] when interpreting its concepts. The wording of the 4th and 7th Company Directive must therefore be interpreted in the light of the overarching principles of EU law according to the teleological, contextual and dynamic methodology of the European Court of Justice.[77] It is therefore questionable whether or not an understanding of the concept of *a fair review,* as a principle of narrative reporting in the company accounts, is supported by the objectives of EU law. [78]

Firstly, a fundamental objective of EU accounting law[79] is to increase the comparability of companies from different member states and ensure a level playing field for undertakings throughout the union, cf. Treaty on the European Union art. 50 no. 2 g.[80] An accounting principle of *a fair review* that applies to narrative reporting secures the flow of relevant information to parties with interests in the company. This objective favours an understanding of the concept of *a fair review* as a general principle of accounting law that promotes a comprehensive reporting of economically relevant information.

Secondly, the preamble of the Modernization Directive states that environmental aspects shall be incorporated into EU company law through accounting regulations of the Union; cf. the preamble of Modernization Directive paragraph 9.[81] In accordance with the principles of interpretation of EU law developed by the European Court of Justice, the concept shall be understood in the manner that promotes the fulfilment of the objectives of EU law. [82]

The purpose of integrating environmental aspects into company law is to contribute to the achievement of the overall objective of the European Union: To promote economic and social development in a sustainable way ensuring "*a high level of protection and improvement of the quality of the environment*", cf. the Treaty of the European Union art. 3 paragraph 3.[83]

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[76] See Arnull (2006), pp. 607.
[77] See Arnull (2006), p. 612, Sjåfjell (2009), p. 175.and *EEA law* (2004) (in Norwegian, *EØS-rett*), p. 237 and footnote 357.
[78] Sjåfjell (2009), p. 175.
[79] On the objectives of EU securities and company law, see Sjåfjell (2009) pp. ...
[80] See Treaty on European Union (TEU) art. 50 no. 2 g.
[81] See Modernization Directive 2003/51/EC.
[82] See Arnull (2006), p. 612, Sjåfjell (2009), p. 175.and *EEA law* (2004) (in Norwegian, *EØS-rett*), p. 237 and footnote 357.
[83] See Treaty on the European Union art. 3 no. 3, cf. art. 10 and 11 of the EEA. The significance of this objective in the perspective of EU company law is broadly discussed in legal theory, and I will not go into depth on this discussion here, see Sjåfjell (2009), pp. 204. Lee (2005), pp. 25 discusses the concept of sustainable development discussed in the perspective of EU law.

As I have argued in Section 3 above, environmental reporting is unbalanced and incomplete due to insufficient legal frameworks. Not only would a principle of narrative reporting contribute to increased comparability and protection of parties with economic interests in the company, but also promote sustainable development by contributing to the internalization of external environmental costs of corporate operations.

There is also an ongoing development where narrative reporting is being considered economically relevant according to the International Financial Reporting Standard (IFRS).[84] Throughout the Practice Statement for Management's Commentary published by IASB in December 2010, most of the qualitative characteristics now apply to parts [85]of the annual report.[86] Companies that prepare their financial statements in accordance to IFRS are obliged to disclose narrative environmental information in some parts of the annual report in a manner consistent with the characteristics of useful information. [87]

Even though written law only partly recognizes a principle of *a fair review*, the objectives of EU law strongly imply that the concept must be interpreted as an accounting principle of narrative reporting in the company accounts. The concept of *a fair review* defined in 4th and 7th Company Directive, art. 46 and 36 respectively, therefore has to be interpreted as a general principle of accounting law that applies to narrative reporting in the company accounts.

This principle will be particularly relevant when reporting environmental information because it is plausible that any environmental information can appear significant to the economic position and future development of the corporate value.

The principle of *a true and fair view* is well debated and there is a considerable volume of literature that deals with the issues connected to it. This material can affect the content of the

[84] Regarding the principle of a true and fair view the Conceptual Frameworks of IFRS clearly states that the standard does not operate with such concepts, cf. Conceptual Framework paragraph 46. Nevertheless, it is stated that the application of the Framework's qualitative characteristics of useful information usually results in compliance with the requirement of a true and fair view.

[85] The Practice statement applies to parts of the annual report similar to the Operating and Financial Review (OFR) or Managements Discussion and Analysis (MD&A), see Basis for Conclusions BC5 of Practice Statement.

[86] The application of qualitative characteristics on environmental reporting is discussed more broadly in Borgersrud (2011) (in Norwegian) pp. 99.

[87] The Practice Statement regarding reporting in parts of annual reports operates with a narrower circle of users than Norwegian legislation on the annual report. The Practice Statement is prepared with a focus on present and potential investors, lenders and other creditors, see the Practice Statement paragraph 8. Companies that are not reporting by the IFRS are not obliged to comply with the Practice Statement.

principle of *a fair review*. Their scope and content will be different, but the underlying objectives and considerations behind both principles are consistent: That the companies that are subject to mandatory accounting should be prohibited from exploiting the regulatory framework to present a fictional story about high profits and low risks. [88]It is beyond the scope of this article to discuss this issue further.

From the wording of the principle of *a fair review* it can be presumed that the environmental reporting in the annual report should, at least present a realistic overview of environmental aspects of an entity. [89]The 4th Company Directive art. 46 no. 1a expresses that the meaning of *a fair review* is a *balanced* and *comprehensive* presentation of the company. Given that the objective of the article is to prevent a carefully refined presentation of a company, the meaning would be that a fair review should cover bad as well as good news. In addition to this, the board or management shall not avoid reporting information that is economically relevant for the position and future development of the undertaking.

5 Summary and Closing Remarks

Environmental reporting duties are failing to fulfil their objectives. This is because the reported information lacks reliability and comprehensiveness. Disclosures that present a fair review of the environmental aspects of corporate operations can affect the behaviour of the board and management. This is because nature of corporate environmental information makes it relevant to users of the company accounts and influences the flow of resources to the company. Narrative environmental reporting is just as economically relevant for the understanding of the position and future development as quantitative disclosures.

Application of accounting principles to the narrative environmental reporting in the annual report would reduce the margin of discretion of the board and management. If the board and management were no longer entrusted with a large margin of discretion to prevent corporate environmental information from revealing risks, the costs of environmental measures may

[88] See for example Parker and Nobes (1994), p. 8.
[89] It is also unclear how this principle applies to the specific aspect that is disclosed. However, the description should leave a correct impression of how an aspect actually appears.

seem less burdensome.[90] This is because the cost of revealing the risks to investors, legislators, lenders or other creditors would presumably exceed the cost of measures to lower the risk. Then the environmental reporting duty could be an effective tool to integrate environmental aspects into corporate decision-making.

The sources of EU law provide legal grounds for a general accounting principle of *a fair review* that applies to narrative reporting. This principle obligates those compiling the company accounts to report narrative environmental information in a comprehensive and balanced manner, presenting *a fair review* of the environmental aspects of corporate operations. The question remains whether or not there are reasons to limit the scope of other accounting principles to only apply to the financial statements.

[90] See e.g. Winn et.al. (2010) on new organisational frameworks due to physical effects of climate change.

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