The Accounting Podcast Series

S01E04: Naomi Soderstrom

Transcript

A: Welcome to TAPS, The Accounting Podcast Series. I'm Albie Brooks, and working with me on this series is Abbey Treloar. Our guest today is Professor Naomi Soderstrom. Having established an outstanding research and teaching career throughout the globe, Naomi joined the department in 2012. While centred in the broader discipline of management accounting, Naomi's research interests are varied. Our discussion today is focussed in the area of environmental and sustainability issues insofar as they relate to accounting, organisations and the financial markets. We're also conducting this podcast across the globe, with Naomi currently on sabbatical overseas. Naomi, welcome to TAPS.

N: Thank you.

A: So let's get started. What triggered your research interest in the accounting issues associated with the environment and sustainability?

N: I've actually been working in the area for quite a long time. I started teaching a course in environmental accounting in the 1990s when I was at the University of Washington in Seattle, and when I did this course there was no curriculum available. So my co-teacher and I had to develop our own materials, and in the process of doing so I realised how many research opportunities there were in the area, and I started working on projects and have pretty much been working in the area ever since.

A: Well, your work has certainly grown in this area over the years, no doubt about that. In the early days at Melbourne, along with a number of other staff, you were involved in a really interesting accounting and environmental project with the botanical gardens here in Melbourne. What was the objective of that really interesting project?

N: Well, this project was really quite fun. It grew out of a student project where we had some students do some carbon accounting at the Royal Botanical Gardens. And because of the great record-keeping at the gardens, we had an opportunity to work with the garden and with botanists to come up with a

better way of measuring the capacity of trees to capture carbon. Now, it doesn't sound like an accounting project, but the relation to accounting is that accountants are always searching for ways to improve the reliability of information that we provide the decision makers.

A: It seems the project, to me, at least, is a really good example of cooperation on two levels: the academic and industry communities and, within academia, cooperation across the disciplines.

N: Well, as I mentioned, the project has been quite fun, and it's been fun in many different dimensions. Working with our industry partners in the gardens and at CPA Australia has added a lot of meaning to the work, plus it was pretty fun having an excuse to go to the botanical gardens to work on a research project. Seriously, carbon emissions, their reduction and retention of carbon is getting to be more and more relevant to society. And I've enjoyed working on a project that has direct impact and importance to both business and society. And working with the botanists at the university has been extremely interesting. They have a very different way of thinking about things, and the way that they gather and analyse data is quite different from the way that we do in accounting research. The models that they developed are based on scientific measures of carbon from instruments that we actually attached to trees, along with historical measurements of tree size. Accounting measures typically focus on financial transactions, so this has been quite a different exercise for us. But we believe that obtaining the estimates based upon a science-oriented approach may be extremely helpful in developing measures that can be included in accounting reports. And this approach can also be applied beyond thinking about carbon, for example thinking about agricultural assets.

A: It certainly makes accounting sound a whole lot more interesting when we combine it with the goings on at the botanical gardens; there's no doubt about that. One piece of collaborative work you're currently involved in relates to the disclosures of corporate and social responsibility issues by companies. We know companies have been reporting by way of disclosures and annual reports regarding their corporate and social responsibilities for some time, but you and colleagues have taken a slightly different angle. What did you do?

N: Well, as accountants we worry a lot about the reliability of information that companies present in their reports. The financial statements that companies produce every year are very different from the sustainability or corporate social responsibility reports that many companies provide. Unlike the traditional financial statements, these sustainability reports are voluntary, and there are no required standards for what is reported. In addition, there's no requirement that the statements be audited. This means that companies have a tremendous amount of leeway in the way they present sustainability information. In the best case, companies provide important information to decision makers in these reports. However, in the worst case, companies can use these reports largely for

marketing and not provide very much information. We call this greenwash. In this project what we did is we examined a large number of sustainability reports to see how reliable the reported numbers are. Now, when you look at these reports they typically included a lot of tables with different measures of environmental and social performance across time. So, for example, in an environmental section they might report carbon emissions for the last five years, or in the social section they might report something like employee turnover for the last five years. But when you look at these reports and you look at the tables more carefully, you'll see that a lot of them have footnotes that indicate that there are changes in the reported information from the prior year. So, for example, in 2012, Rio Tinto reported that there were 12 new cases of occupational illness per 10,000 employees. But in 2013, the next year, you look at the table and the report indicates that the number reported in 2012 was incorrect and should actually have been 15 cases per 10,000. So in this case, if you think about the change that was made, occupational illnesses were actually worse than what was originally reported. Now, that's an example of the change companies make to correct an error. There are a lot of other changes that are due to differences in the way they calculate measures, for example in 2011 ExxonMobil changed the way they calculated carbon emissions. So this is the context of our study, looking at these changes in reporting. We went through over 800 reports and we recorded instances where companies retrospectively changed information. We then analysed the changes to see how frequent they are, how big they are, and whether they're biased. Bias would be indicated if the majority of changes would make performance look worse than the company had originally reported.

A: So, broadly speaking, what were your key takeaways from this work?

N: Well, we find a tremendous number of changes in these reports. Overall, 40 per cent of the companies worldwide in our sample make changes to numbers that were reported in prior years. And almost a quarter of these changes reflect correction of information. It's interesting that the incidence of changes is increasing over time, as opposed to decreasing, and we think that this means that we're really at a very early stage of sustainability reporting. And as the field matures, we expect company reporting systems to become more sophisticated, and eventually the number of corrections will decline. We also find that corrections occur more frequently in environmentally sensitive industries such as oil and gas, chemicals, metals and mining. We also looked at whether the reports were audited or not, and we found that companies that have their reports examined by third parties such as auditors or consultants tend to have more corrections and biased reports. The bias was also concentrated in social performance, not environmental performance. So these are areas where reporting measures related to employees and community engagement.

A: You've made some reference to the meaning of this for companies, but is there anything else you'd like to add about what the findings of the study mean for companies, particularly those looking to enhance the quality of their reporting in this area?

N: Well, I'm not sure we can actually say much to companies. In this project, we're really speaking more to the users of sustainability information. In the bigger pictures, users of sustainability information should understand that these statements are evolving. They aren't nearly as mature as the financial statements that we typically get from companies. A takeaway from other research overall is that the market really cares about sustainability performance. Providing information is positively viewed, although companies are penalised by the market if the news is bad. However, it appears to be better to disclose the negative information than to try to hide it.

A: This is particularly interesting, I think, when we generalise this up to what it means overall.

N: Yeah. Well, we see a large percentage of major companies that disclose information restating their numbers, so I guess the disclosure appears to be a journey, and all parties need to understand that. We don't know yet how external stakeholders view the corrections that we study in our project, and this is something that we'll be exploring in our future research.

A: Excellent. You have another piece of research in the pipeline relating to what's called climate risk exposure of companies. First, what is climate risk exposure and how is it important for companies?

N: Well, climate risk comprises the many different risks and future costs that companies face as a result of climate change. For example, as we know, particularly in Australia, there are an increasing number of extreme weather events. And these events impose large costs on affected companies and industries. For example, in 2011 Honda reported a $1.4 billion loss due to flooding of its automobile assembly plants in Thailand. And just recently, the major utility in California, Pacific Gas and Electric Company, filed for chapter 11 bankruptcy because it can't afford to pay the more than US$30 billion in expected damages due to the deadly 2017 and 2018 Northern California wildfires. There are other climate risk related costs stemming from policy changes in response to global warming. So there are entities putting in taxes, quotas, there are bans and other forms of regulation. And another important aspect of climate risk that we need to think about is it really relates to the future. It's not related to the past. And since climate change is a global phenomenon, it really is something that individual companies can't do very much to reduce the overall risk. They can change the way that they operate to minimise the impact of climate risk on their company. And this may include changing their supply chain to ensure that if there is flooding in one area that they can get supplies from another area, or they could reduce the use of energy sources that are likely to become more highly regulated.

A: Thank you. This is particularly interesting, and I see that one of the issues to emerge out of the study which you referred to earlier is that the stock market – the market generally – takes climate risk into consideration when valuing companies. Is there anything else you'd like to add around that?

N: Well, we look at various aspects of the way that the stock market takes climate risk into consideration and, as you said, we do find that the stock market does include climate risk in its valuation. We find that the cost of raising capital is higher for companies that have higher climate risk. And importantly, and consistent with our contention that climate risk is much more forward-looking, we find that climate risk matters to the market over and above the impact of the company's past environmental performance.

A: Okay, so we've talked a little bit about three really important pieces of work that you've been involved in with your collaborators on these pieces of work. Looking forward now, what further research do you think we need to do in this area of accounting and sustainability?

N: I think there are a huge number of opportunities for research in this area, so I'll give you an idea of some pretty diverse areas. So, for example, we can look at performance metrics. How do we measure sustainability-related information in a way that's reliable and relevant for decision makers? One of the things about sustainability information is that it tends to be non-financial, and so it's something that we aren't as used to measuring from an accounting perspective but we're understanding is becoming more and more important. Another problem is that it's very easy to combine different information that's financial because you can simply add and subtract the financial amounts. Combining different measures into an overall measure of sustainability performance is much more difficult. We can also think about how decision makers use sustainability information. So what are the appropriate aspects of sustainability performance to measure for different kinds of decisions from the decision maker's perspective? How do they interpret the information that's reported? We can also think more carefully about the nature and impact of the different ways of disclosing sustainability information. What kind of reporting requirements should companies have to comply with regarding sustainability information? As I mentioned earlier, right now most of the sustainability reporting is voluntary, so we don't really have a means of comparing across companies and across time. And then finally, what are company behaviours related to sustainability? How do companies include sustainability in their internal decision making, for example? What kind of systems do they use, which ones are most effective, are there incentives that companies are giving employees regarding sustainability and what impact do these incentives have on the way that employee behave? So you can see that there's a broad range of really interesting topics to be pursued in this area.

A: There certainly is still plenty to do; there's no doubt about that. Now, you've been a leader in the curriculum development in this area of accounting and sustainability issues, including at Melbourne where you've been heavily involved in the development of related subjects. So looking ahead from an education perspective, how do you feel we can best expose accounting students to issues of sustainability?

N: Well, if you step back and think about it, from a theoretical perspective, you could argue that sustainability is just one aspect of company strategy and activities. What this means is that sustainability really fits nicely into all accounting topics. In my sustainability management and reporting course, I used the sustainability setting to discuss all of the areas of accounting. So if you think about accounting theory, traditional accounting courses discuss standards for disclosure and for audit. So in my class I talk about how to develop standards to report sustainability information and what it means to audit or assure that information. In our management accounting courses, we talk about management control systems and performance measurement. In my sustainability class we discuss using control systems to implement strategy when sustainability is part of that strategy, and we also extend concepts regarding non-financial performance measures to the sustainability setting. I think that sustainability can easily be integrated into existing accounting classes, and I think it's an important area and, importantly, our students care more and more about it over time. It's also really interesting to think about applying our basic accounting concepts to a new area where we don't have all of the answers, and I think this really helps the students to think about accounting within a broader context and challenges them to think critically and analytically about accounting topics.

A: Yes, I think that the combination of research developments looking forward and the number of areas that you referred to, and also the development in our education and bringing these two together is something we're going to see over time in the next little while. Naomi, we've really enjoyed our chat looking at some of the issues around accounting and sustainability. Thanks for joining us here at TAPS, and we certainly hope you enjoy the remainder of your sabbatical. Thanks again.

N: Thank you very much.