The Effects of Prior Environmental Performance and Disclosure on Stock Market Reactions to Environmental New

Martin Freedman, Towson University
Dennis Patten, Illinois State University

Unlike previous U.S. environmental regulations, the Toxics Release Inventory (TRI), passed into law in 1986, focused on using information as a tool for reducing pollution. As noted by Konar and Cohen[1], if investors cared enough about pollution performance information required under the enactment to punish bad performers, firms would have a market-based incentive to reduce toxic emissions. However, legitimacy theorists suggest that corporations may use financial report environmental disclosures to offset or mitigate the negative aspects of other information or actions. Accordingly, these disclosures could reduce the market effect of the TRI program. This study examines the market reaction to the unexpected proposal by President George Bush in June of 1989 for revisions in the Clean Air Act to identify whether TRI information and 10-K report environmental disclosures had an impact.

Based on a sample of 112 firms, we found that companies with worse pollution performance (higher levels of size-adjusted toxic releases in to the air) suffered more negative market reactions than companies with better performance. However, companies with less extensive environmental disclosures in their 10-K reports suffered more negative market reactions than companies with more extensive disclosure. These results suggest that, while TRI information may be working as a quasi-regulatory device, it appears that companies can use the financial report environmental disclosure to manipulate market perceptions and reduce its impact. Accordingly, we argue that there is a serious need to restrict, or at least make comparable and consistent, the extent of environmental information companies can include in their financial reports.

[1]Konar, S. and Cohen, M.A. (1997), "Information as Regulation: The Effect of Community Right to Know Laws on Toxic Emissions," *Journal of Environmental Economics and Management*, Vol. 32, pp. 109-124.