Some Lessons from Academic Research for a Sustainability Reporting Regime

Christian Leuz

Joseph Sondheimer Professor for Int. Economics, Finance and Accounting

CHICAGO BOOTH

The University of Chicago Booth School of Business

ecgi

Adoption of CSR and Sustainability Reporting Standards: Economic Analysis and Review

Finance Working Paper N° 623/2019
August 2019

Hans B. Christensen
University of Chicago and NBER

Luzi Hail
University of Pennsylvania and ECGI

Christian Leuz
University of Chicago, NBER and ECGI

The big picture

- Climate change and environmental issues pose massive challenges for humanity
  - Major public debate on climate and sustainability
- Investors and business leaders are taking note
  - Letter by Blackrock's Larry Fink in 2018: "A Sense of Purpose"
  - In 2019, U.S. Business Roundtable changed "Statement of the Purpose of a Corporation"
- Regulators and central bankers are also concerned
- Sustainability reporting is an important part of the debate

Major push for sustainability reporting

- Investor and stakeholder demand
- Many see reporting regime as a first and critical step
  - FSB created Task Force for Climate-related Financial Disclosures
- Many standard setters propose solutions:
  - GRI, IIRC, SASB, CDSB
  - IFRS Foundation is considering its role
- Key debates on sustainability reporting:
  - Should we make such reporting mandatory?
  - Should there be a global set of standards? Which one?
  - What is the goal of sustainability reporting?

Goals of sustainability reporting

- Two extremes (or caricatures) along a spectrum
  - Goal 1: “Giving investors what they want”
  - Goal 2: “Driving change with sustainability reporting”
- These goals have very different implications
  - In the debate, it is often not clear which goal we are talking about
- Example: IFRS Foundation
  - Goal 2 seems to be the motivation (e.g., references in consultation or ECGI post with quotes from Attenborough’s Instagram posts)
  - Consultation paper seems to have primarily Goal 1 in mind
    - Focus on investors (and single materiality at first)

Which goal is it?

- Why has sustainability reporting become such a big topic?
  - Existential challenges due to climate change and loss of biodiversity
  - Externalities of corporate activities are a genuine problem
- Focusing on investors’ info needs/demand largely ignore externalities
  - Certainly, if we think investors want firms to maximize shareholder value
- But what if investors have preferences beyond shareholder value?
  - Then externalities matter to them
  - Now they want sustainability info, so that they can monitor and potentially change firm behavior
- These preferences move us in the direction of Goal 2
  - But then the focus is no longer just on financially material ESG factors
  - It is also about the <u>impacts of the firm</u> on climate and the environment

Narrow version of Goal 1 (financial materiality)

- For this goal, current reporting regime is probably not too far off
  - In most regimes, financially material information has to be disclosed, whether it is about ESG activities or the firm’s business activities
- Important Q: Do firms provide all financially material information even for ESG factors?
  - If the answer is yes, then the status quo achieves Goal 1
- But some reasons to be skeptical:
  - Climate risks and many sustainability issues are difficult to measure and longer term in nature
  - Hard to know for investors what is material for a given firm, so they might not know when firms withhold info
- Thus, non-compliance and lack of info are a concern

If we embrace a narrow version of Goal 1

- We essentially imply that firms are currently not providing all financially material ESG information
  - Now the key issue is enforcement and making sure all material information is being disclosed
- In this case, it is not clear we need a new sustainability reporting framework (or separate standard setter)
  - Focus is on existing financial reporting regime
  - But: New or additional standards could still be useful
- Industry-specific sustainability standards create an expectation of what needs to be reported
  - They could trigger “comply or explain” forces

Alternative interpretation

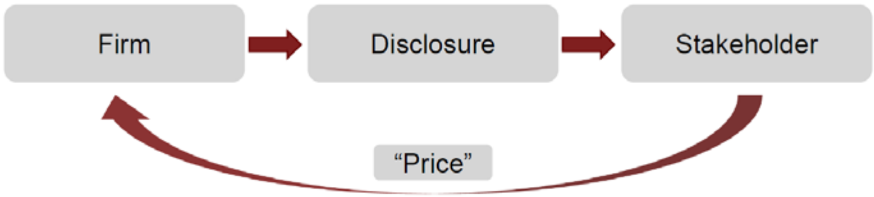
- Not compliance, but info is simply not well organized & harmonized
  - Now, relevant problem is to harmonize sustainability reporting
- Presumably, goal is to harmonize sustainability reporting <u>practices</u>
- Here, we can learn a lot from IFRS adoption
  - Standards are useful but only one input, not primary driver
  - Enforcement is an important issue
  - Reporting incentives are an important driver of reporting practices
- Incentives shaped by many forces (markets, legal institutions, local traditions)
  - Range of incentives will be even larger for sustainability reporting
- Thus, if we aim to harmonize practices
  - Need to be realistic what standards (alone) can achieve
  - Focus on building an infrastructure (and less on standards)

Goal 2: Driving change

- Climate change & biodiversity pressing issues that face points of no return
  - Focus is on externalities and addressing the "tragedy of the commons"
- From this perspective, two important questions (for Goal 1 supporters):
  - Do investors push companies to internalize their external effects?
  - Is focusing on investors and single materiality essentially taking the pressure off?
- But also important question for Goal 2 supporters:
  - Why is disclosure the "right" approach to address externalities?
  - One obvious answer: We need information and it complements other efforts
- Another reason: Transparency solutions are easier to agree on
  - It is hard to oppose transparency
  - Often viewed as less intrusive than regulating behavior directly
- But transparency regimes are not innocuous or necessarily better
  - Research: Need to be judicious when and how to use them

Core issues when driving change via transparency

- There are two important concerns:
  - Who gets to decide which effects are intended?
    - Democratic legitimization
  - Reporting uses "price" mechanism to induce change ("real effects")



- Responses by stakeholders are difficult to foresee
  - Do consumers impose the "right" penalties on firms? Or carrots?
- Concern about unintended "real effects" is real
  - The broader the regime, the broader the real effects (<u>intended</u> and unintended)
- Example: Health care report cards (cardiac surgery)

What do we learn from this example?

- Driving change with transparency can be pernicious
  - Real effects are difficult to foresee and not all are intended
- Measurement is key and very important
  - Very important message for sustainability standards
  - Need a technical or scientific basis if the goal is to drive change
- Final example: Plastic drinking straws
  - Financially immaterial to a beverage retailer
  - But feedback effects via consumer boycotts can be financially material
- Such effects are very difficult to foresee, too
  - Can arise already under single materiality (and lines are blurred)

Key take aways

- Our ECGI paper & academic literature point to many challenges
  - “The perfect is the enemy of the good”
- We should be clear about the goals
  - Is the issue non-compliance with IFRS when it comes to ESG?
  - Is the issue we need to harmonize reporting practices?
  - Do we intend to drive change?
- We can learn from IFRS adoption
  - Don’t just focus on the standards
  - Build an infrastructure
  - Leverage market incentives (for compliance & harmonization)

Key take aways

- Not clear that a focus on investors and single materiality addresses externalities and pressing issues
  - It could take the pressure off (unless we step up elsewhere)
- Stakeholder focus & double materiality help with Goal 2
  - But likely bring <u>also</u> more unintended consequences (or real effects)
  - Clear tradeoff
  - Driving change with transparency is not innocuous
- Combine "topic focus" of reporting mandate & double mat?
  - Limit to pressing issues with irreversibility concerns
  - Limits scope for unintended real effects to those areas that matter
  - Allows us to learn and to build the infrastructure

Thank You

Way to help build an infrastructure

- Create a Global Sustainability Reporting (GSR) Segment
  - "Listing" in segment offers firms a way to commit to sustainability reporting
  - Demand driven – investors could reward firms when they participate
  - Have firms self-select into the segment
  - Self-selection helps with harmonization of reporting incentives
- Segment comes with reporting obligations but also with governance and assurance requirements
  - Could also engage with rating companies for external review
  - Green bonds show that such regimes are feasible
- If there is investor demand for credible sustainability reporting, the GSR creates incentives to be part of the segment
  - But also provides an opportunity for penalties (e.g., dismissal)
- Would be quick(er) to set up
  - Especially if an existing set of standards is accepted
- Could be operated by IFRS Foundation jointly with IOSCO

NB: I made similar proposal in the early days of IFRS adoption – see GPS proposal (Leuz, ABR, 2010)

What can we say about economic consequences of sustainability reporting mandate from research?

Economic Analysis of Widespread Adoption of CSR and Sustainability Reporting Standards*

Hans B. Christensen
Booth School of Business,
University of Chicago

Luzi Hail
The Wharton School,
University of Pennsylvania

Christian Leuz
Booth School of Business,
University of Chicago & NBER

November 2018

Overview

2. Scope of Analysis and Conceptual Underpinnings
- Key definitions of CSR reporting
- Framing the scope of the analysis: mandatory adoption of CSR reporting standards
- Key features of CSR reporting relative to financial reporting
- Conceptual underpinnings and general insights from extant literature

3. Key Determinants of Voluntary CSR Reporting
- Generic firm and manager characteristics
- Firms' business activities and external events
- External stakeholders and societal pressure

4. Potential Stakeholder Effects of Mandatory CSR Reporting
- Link between CSR activities and firm value and performance
- Equity investors
- Lenders and debt holders
- Analysts and the media
- Customers, employees, and other stakeholders

5. Potential Firm Responses and Real Effects from Mandatory CSR Reporting
- General link between disclosure and firms' real activities
- Effects on firm investment, financing, and operating activities
- Effects on firms' entry and exit decisions

6. Implementation Issues for Mandatory CSR Reporting Standards
- CSR standard setting process
- Materiality of CSR disclosure items
- Use of boilerplate language for CSR disclosures
- Oversight and enforcement of CSR disclosures and CSR standards

7. Summary of Main Insights and Avenues for Future Research

Overview: Key points in the report

- Many insights from prior literature apply to CSR mandate
- Magnitude of information effects of CSR reporting standards depend on compliance with existing rules
- Mandatory CSR reporting standards alone are likely to have limited effects on firms' CSR disclosures
- Need to differentiate between effects of CSR activities and effects of CSR reporting
- Evidence from voluntary CSR reporting quite different from evidence from CSR reporting mandates
- CSR mandate likely has complex real effects, in large part because it increases scrutiny by non-investor stakeholders
- Materiality of CSR disclosures is non-trivial issue

NB: We use CSR and sustainability interchangeably here, but CSR is shorter