公司财务理论前沿

ESG 与公司财务研究

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Overview

1. **Definition of ESG and ESG reporting**
2. ESG activities
3. ESG reporting
4. ESG reporting mandate
5. Conclusion

Definition

- ESG/CSR/Sustainability
  - Improving social welfare or making corporate activities more sustainable
  - Maximizing firm value v.s. maximizing shareholder welfare
    - Firms may sacrifice profits?
    - Shareholders could have non-monetary preferences
- ESG reporting
  - Information about ESG topics, including a firm's ESG activities and risks
  - Reporting regime: how to report such information?
  - Intended audience: investors or stakeholders?

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ESG activities - Firm value and performance

- ESG activities $\rightarrow$ firm value or financial performance
  - Managers should only engage in activities that maximize shareholder value
  - ESG activities with positive/negative NPV
    - Interest of stakeholders
    - Shareholders could have non-monetary preferences (welfare v.s. value)
    - Managers may use ESG to pursue personal goals (agency problem)
- Empirical studies find mixed results
  - Selection problem and omitted variable
    - "doing well by doing good" v.s. "do good when they do well"
    - Whatever causes firms to engage in ESG also increases firm value
  - ESG-performance relation differs across the dimensions of ESG

ESG activities - Firm risk and cost of capital

- ESG activities on firm risk
  - Less risk exposures
    - e.g., fossil fuel producers face risks from the transition to carbon neutrality
  - Insurance-like protection: firm's ESG reputation
    - Moral capital: customer trust, employee loyalty, goodwill with regulators
    - Corporate scandals (Christensen 2016 TAR)
    - Financial restatements (Bartov et al. 2020 TAR)
    - Negative press coverage (Shiu and Yang 2017 SMJ)
    - During macroeconomic shocks and financial crisis (Lins et al. 2017 JF)
    - Covid-19 market crash (Ding et al. 2021 JFE)
- ESG activities on cost of the capital
  - Investor's nonfinancial preferences (Fama and French 2007 JFE)
    - Carbon premium (Bolton and Kacpercyk 2021 JFE)
  - Lenders can have a taste for ESG (Barigozzi and Tedeschi 2015 RoF)
    - Better ESG performance $\rightarrow$ lower cost of debt (Chava 2014 MS)

Who cares about ESG I

- Investors have a taste for ESG
  - Sustainability drive mutual fund flows (Hartzmark and Sussman 2019 JF)
  - Investors induce firms to engage in ESG activities (Pástor et al. 2020 JFE)
    - Even when the activities are costly (Martin and Moser 2016 JAE)
  - Investors with long-term horizons (Starks et al. JF R&R)
    - Investing in firms with strong ESG performance
    - Selling less after negative earnings surprises and poor returns
- Analyst as recipients of ESG information
  - ESG information reduce forecast errors (Dhaliwal et al. 2012 TAR)

Who cares about ESG II

- Society in general
  - ESG are about externalities and the distribution of rights and assets across generations (Howarth and Norgaard 1992 AER)
    - Society can pressure firms to pursue specific ESG goals and behaviors, which often are costly and have no obvious payoffs to shareholders
- Other stakeholders
  - Customers, suppliers, and employees
    - Customer loyalty (Eichholtz et al. 2013 REStat)
    - Disciplining tool for the supply chain (Dai et al. 2021 JFE)
    - Employee loyalty (Shan and Tang, 2023 RoF)
  - Government
    - Firms may use ESG strategically to improve their relationships with politicians and benefits in the form of higher government subsidies (Lin et al. 2015 JCF)

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ESG disclosure/reporting

- Demand for ESG information
  - Capital-market participants (single materiality)
    - potential performance, risk or valuation implications
  - Stakeholders and society (double materiality)
    - potential externalities of corporate activities
- ESG reporting differs from traditional financial reporting
  - Diversity of users and uses
    - users may have relatively little experience in reading corporate disclosures
    - use it for a variety of purposes beyond traditional financial analysis
  - Diversity of topics
    - the topics differ substantially across firms, industries, and countries
    - makes comparisons and standardization difficult (Liang and Renneboog 2017 JF)
  - Diversity in measurement
    - long-term prospects that are difficult to quantify and intangible in nature (e.g., consumer goodwill or employee relations)

Benefit and cost of disclosure

- Benefit: mitigate information asymmetries
  - Between the firm and its investors as well as among investors
    - increase the liquidity (Constantinides 1986 JPE)
    - lower the cost of capital (Easley and O'Hara 2004 JF)
    - more efficient corporate investments (Bushman and Smith 2001 JAE)
    - information spillovers (Admati and Pfleiderer 2000 RFS)
- Cost
  - Direct costs: preparation and certification of accounting reports
    - regulatory compliance costs
  - Indirect costs: proprietary costs (Berger and Hann 2007 TAR)
    - other audiences (competitors) can use the information provided to investors
    - optimistic forward-looking disclosures $\rightarrow$ litigation risk (Rogers et al. 2011 TAR)

Endogeneity in voluntary disclsoure

- Dual endogeneity
  - Firms' voluntary ESG activities
  - Firms' choices in reporting about these activities
- Hard to isolate reporting effects
  - How the market reacts to new information about the underlying ESG activities rather than to ESG reporting per se?
- One way to mitigate selection is to study ESG disclosure mandates
  - Force out information that firms do not want to disclose
  - Improve or standardize ESG information

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Effects of ESG reporting mandate I

- Effects of ESG reporting mandate on ESG activities
  - Firms are expected to alter their ESG activities
    - improved monitoring and governance of firms' ESG activities
    - stronger link between ESG and economic performance
    - strengthened market and societal pressure
    - learning about or benchmarking against peer firms' ESG practices
  - Empirical evidence
    - decreases inwastewater and SO2 emissions in China (Chen et al. 2017 JAE)
    - decreases in GHG emissions in the UK (Downar et al. 2021 RAS)
    - increase their ESG expenditures in the EU (Fiechter et al. 2022 JAR)

Effects of ESG reporting mandate II

- ESG reporting requirements affect firms' cost-benefit tradeoffs
  - Not only for ESG activities but also for regular operating decisions
    - investment behavior and cost of capital
    - firms' entry and exit decision
    - such real effects (e.g., making the worst polluters exit the market) are not necessarily bad and could in fact be intended by the policymakers or regulators
- Reputational costs vary across firms
  - More highly visible firms are subject to more scrutiny
    - risky activities might shift to small firms or unregulated (private) firms

Implementation issues for ESG reporting mandate I

- Materiality of disclosures
  - Materiality is a key concept for the scope of reporting standards
  - Target audience of financial reporting
    - investors and creditors who have a reasonable understanding of business activities
- Materiality concepts for ESG reporting
  - ESG topics are of interest to a large set of stakeholders, not just investors
    - difficult to define materiality of ESG disclosures
  - Single (narrow) materiality
    - reducing the scope of the ESG standards
    - focus exclusively on the information needs of investors
  - Double (broad) materiality
    - incorporates information relevant to a wide range of stakeholders
    - irrespective of whether these impacts have financially material consequences

Implementation issues for ESG reporting mandate II

- Avoidance strategy
  - Boilerplate disclosures: qualitative disclosures and do not provide metrics
    - largely uninformative (Lang and Stice-Lawrence 2015 JAE)
  - Firms use boilerplate language for greenwashing
    - provide unsubstantiated ESG claims and create more favorable impressions
  - ESG standards can limit boilerplate language
    - prescribing what information firms have to provide and how they must provide it
    - however, the more specific the standards are, the less widely applicable they are
- Role of accounting firms
  - Assurance providers for ESG disclosures
    - Auditing plays a major role in financial reporting
  - Credibility of firms' ESG disclosures could be low
    - third-party auditing is even more important (Ioannou and Serafeim 2017 SMJ)

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Summary

- This literature suggests
  - More and better (ESG) information can benefit capital markets
    - through greater liquidity, lower cost of capital, and better capital allocation
  - Corporate (ESG) disclosures can change firm behavior
    - cost and benefit of corporate disclosure
- ESG reporting is quite different from financial reporting
  - Wide-ranging set of topics and large set of users
  - Long-term, non-monetary, and intangible in nature
  - Real effects are more likely to follow from a reporting mandate
- Future research
  - We need more research on whether mandated ESG reporting
    - mitigates information asymmetries and forces out unfavorable ESG information
    - generates positive spillovers (market-wide cost savings or comparability benefits)
    - brings unintended consequences that is undesirable to society (greenwashing)