Economic Analysis of CSR and Sustainability Reporting

Christian Leuz

Joseph Sondheimer Professor for Int. Economics, Finance and Accounting

CHICAGO BOOTH

The University of Chicago Booth School of Business

CSR and sustainability

- Climate change and environmental issues pose massive challenges for humanity
- These challenges have received a lot of public attention
  - "Fridays for Future" have become a major force
- But also business leaders and businesses are taking note
  - Letter by Blackrock's Larry Fink in 2018: "A Sense of Purpose"
  - Voluntary schemes: e.g., B Lab and "Certified B Corporation"

    "New kind of business that balances purpose and profit. They are legally required to consider the impact of their decisions on their workers, customers, suppliers, community, and the environment."
  - In 2019, U.S. Business Roundtable changed "Statement of the Purpose of a Corporation"

    "While each of our individual companies serves its own corporate purpose, we share a fundamental commitment to <u>all</u> of our stakeholders."
- Regulators and central bankers are concerned about climate risks
  - G20 and Governors ask Financial Stability Board to review financial stability implications of climate change

Major push for sustainability reporting

- Many see CSR or sustainability reporting as natural or critical step to achieving environmental and climate goals
- FSB created Task Force for Climate-related Financial Disclosures (TCFD)
  - “To develop voluntary, consistent climate-related company disclosures that will help market participants and policymakers to better understand climate-related risks”

- Many standard setters propose solutions:
  - GRI, SASB and CDSB standards
- But also numerous ESG and sustainability ratings
  - Rely heavily on company disclosures and reports

Why the push for sustainability reporting?

- Difficult to address challenges through traditional regulation
  - Climate change is global problem
  - Complicated politics between developed and developing countries
- Traditional regulation is well-known to have unintended consequences
  - CSR standards “merely” prescribe disclosure, not particular actions
  - Transparency or disclosure regulation is viewed as less intrusive
- Transparency is viewed as a “good thing”
  - Politically, it is hard to argue against transparency
- Disclosures “unleashes” incentives and market forces
  - “Sunlight is the best disinfectant”
  - Many other examples where disclosure regulation is used in this way
    - Corporate governance, consumer protection, health care, etc.

The many faces of sustainability reporting

Alcoa

CARBON DIOXIDE EQUIVALENT EMISSIONS INTENSITY

Metric tons of CO_{2e} per metric ton of production

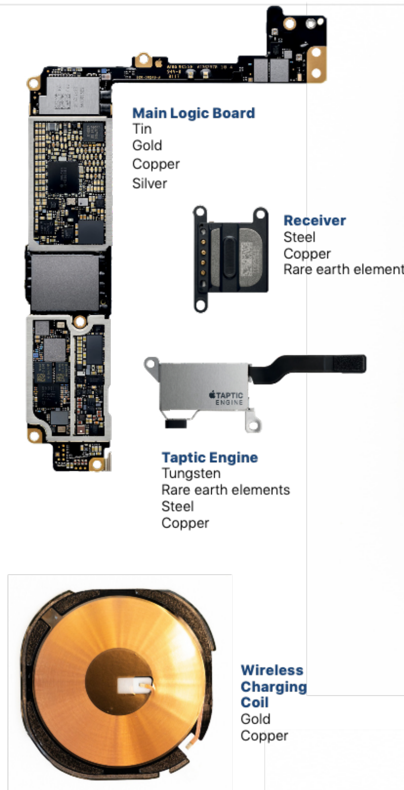
	Refining	Smelting (IPCC, 4th TAR)	**Total** (IPCC, 4th TAR)
2014	0.55	6.42	**7.46**
2015	0.54	6.21	**7.23**
2016	0.54	5.34	**6.36**
2017	0.53	4.39	**5.39**
2018	0.52	5.71	**6.70**

Walmart

Conflict Minerals Policy

The Securities and Exchange Commission ("SEC") has adopted rules requiring publicly traded companies to report on products they manufacture or contract to manufacture that contain tin, tantalum, tungsten or gold ("3TG" or "conflict minerals") mined in the Democratic Republic of the Congo and adjoining countries ("DRC Countries") under circumstances that contribute to or support human rights violations.

In association with the Retail Industry Leaders Association's (RILA's), we worked with other retailers to produce training materials and tailor the questionnaire originally developed by the Responsible Business Alliance (RBA) and the Global e Sustainability Initiative (GeSI) to be more specific to retail suppliers. We also engaged third party firms with specialized experience in various aspects of conflict minerals to assist Walmart in the development and implementation of our program, which includes due diligence activities consistent with the Organization for Economic Co-operation and Development (OECD) Guidelines.



For every 100,000 iPhone devices, Daisy has the potential to recover:*

Aluminum	1,500 kg
Gold	1.1 kg
Silver	6.3 kg
Rare earth elements	32 kg
Tungsten	83 kg
Copper	1,000 kg
Tin	29 kg
Cobalt	790 kg
Steel	1,400 kg

The many faces of sustainability reporting

Coca-Cola

Our Climate Goal: Reducing Our Impact

We set a goal in 2013 to reduce the carbon footprint of the "drink in your hand" by 25% by 2020, when we brought several climate-related initiatives together to manage and improve our impacts.*

Estimated Share of Carbon Across Our Value Chain

INGREDIENTS
20–25%

PACKAGING
25–30%

MANUFACTURING
10–15%

DISTRIBUTION
5–10%

REFRIGERATION
30–35%

U.S. EMPLOYEE DIVERSITY IN 2018

Job Category	Gender	White	Black/ African American	Hispanic/ Latino	Asian	American Indian/ Alaskan Native	Native Hawaiian/ Other Pacific Islander
Executive/ senior level officials and managers	Male	2,215	88	99	244	7	0
	Female	1,085	82	57	102	6	0
First/ mid-level officials & managers	Male	7,689	823	1,325	1,676	32	35
	Female	7,205	1,348	1,599	1,024	36	27
Professionals*	Male	26,334	2,093	2,558	6,141	111	91
	Female	13,277	2,148	1,689	4,068	74	70
All other	Male	11,523	4,148	6,929	2,992	85	111
	Female	23,053	11,395	14,962	5,274	244	240
Totals	Male	47,761	7,152	10,911	11,053	235	237
	Female	44,620	14,973	18,307	10,468	360	337

Bank of America

Key Features of Sustainability Reporting:

- Diverse set of users and uses
- Wide range and (sometimes rapidly) changing nature of topics
- Qualitative, narrative, sometimes boilerplate information versus quantitative & very specific
- Often (non-monetary) information

CSR reporting practices are heterogeneous

- Substantial heterogeneity in corporate disclosure practices, both across and within industries
  - Reflects heterogeneity in firms' business activities and the materiality of CSR activities
  - Reflects also firms' costs and benefits of providing CSR information
- General (upward) trend in CSR disclosures is likely to continue (even without mandates)
  - But no clear sense for best practices
- To many, there is a need for harmonization and mandatory reporting standards
  - Michael Jantzi: We are "past the time of voluntary disclosures"
  - Calls for "IFRS for ESG"

Reporting mandates are numerous and spreading across the world

580 relate to the **environment** (e.g., emissions/pollution, water, waste, resources, climate change…)

405 concern **social** related issues (e.g., product and service responsibility, human rights, employment conditions…)

According to The Reporting Exchange there are currently **944 mandatory reporting requirements on CSR issues across 70 countries worldwide**

239 mandates regard **governance** matters (e.g., accountability, remuneration, relations with shareholders..)

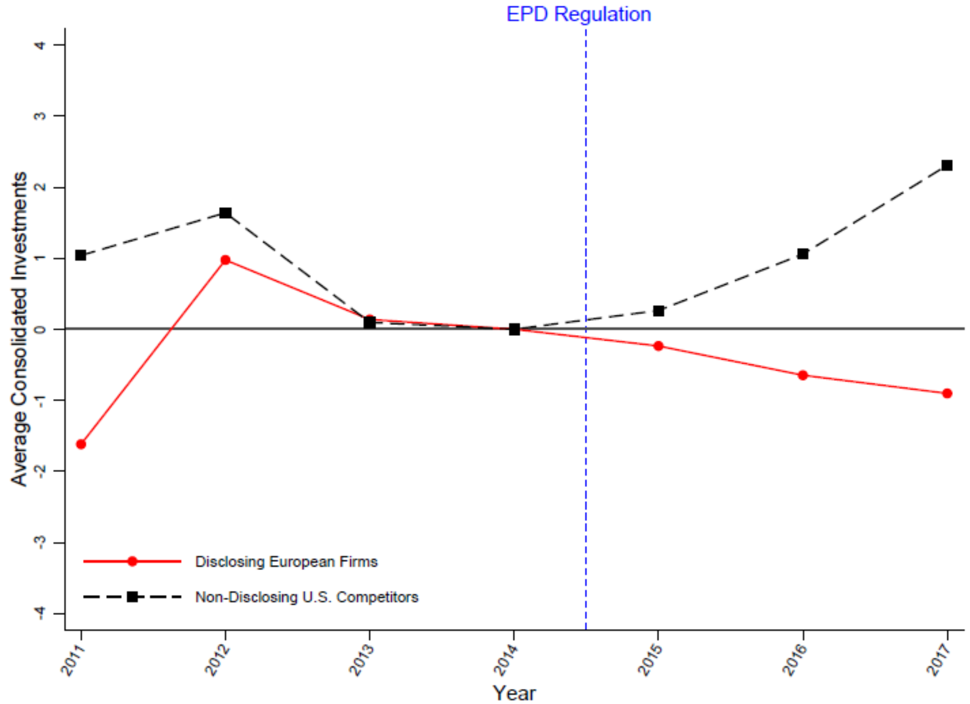
98 are related to **economic** topics (e.g., economic performance, indirect economic impacts, business model and innovation…)

Note: Count of mandatory regimes includes comply-or-explain requirements

Source: The Reporting Exchange

Will sustainability reporting work?

- Remember we are dealing with a global problem
- Disclosure of extraction payments to limit corruption
  - Reallocation from disclosing firms to non-disclosing competitors



Source: Rauter, 2019

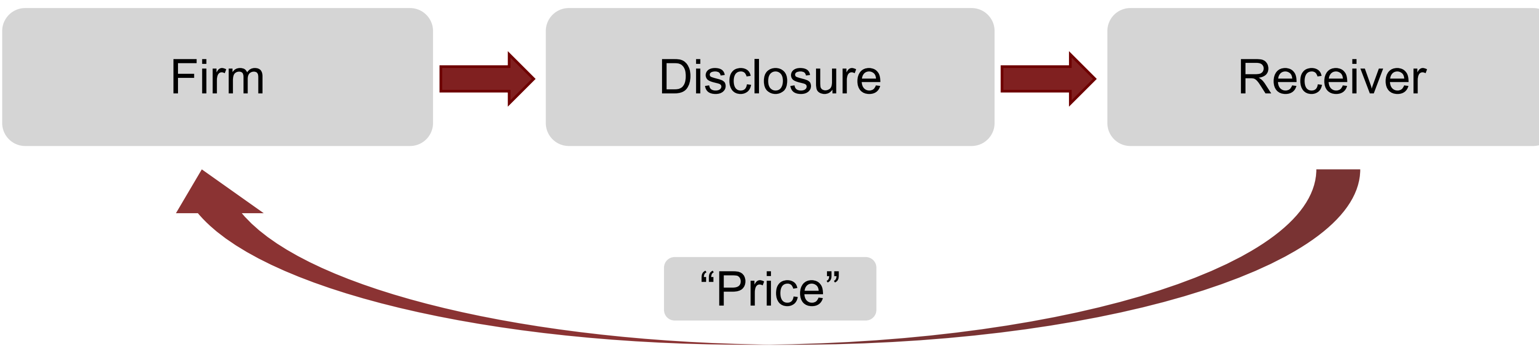
The University of Chicago Booth School of Business

Getting reporting regimes right is not trivial

- Research highlights many challenges:
  - Avoidance
  - Focus on what is measured
  - Forced disclosure could hurt innovation
  - Information cascades (Uber or Yelp ratings)
  - "License to be biased" effect
- There are unintended consequences and problems with transparency regulation as well
  - Need a careful analysis of costs and benefits

Why is transparency regulation difficult?

- Traditional regulation is essentially prescribing or limiting "quantities"
- Transparency regulation uses "prices" to regulate



- Much depends on the responses to the disclosure
  - Feedback loop makes it difficult to predict outcomes

Imagine we adopt mandatory reporting

- What are things we can say with (some) confidence?
  - Independent research report on CMI website
  - Extant research already provides many insights
  - Summarize a few points
- What are key issues to consider?
  - Need to recognize that firms already have to report ESG information, especially on governance
  - Harmonization of practices via standards
  - Materiality of sustainability information

Taking stock of what we know

- If CSR disclosures provide information that is relevant to capital markets, they will matter
  - More and better CSR information should increase liquidity, lower cost of capital, and improve capital allocation
- CSR reporting will increase non-investor scrutiny and stakeholder pressure (and firms will react to them)
  - Affecting CSR activities is presumably key goal of a mandate
  - Complex set of "real effects", but not always positive
  - Mandates are more likely to have real effects (both positive and negative ones) than voluntary disclosures
- CSR disclosures likely have proprietary costs
  - CSR disclosures are about business issues, processes, etc.
  - Proprietary costs are more relevant when reporting standards are specific and detailed, and for smaller firms

Key issue: Existing rules

- Impact of CSR reporting mandate depends on extent to which firms currently "withhold" material CSR information
  - Section 17(a)(2) of 1933 Securities Act and Section 18(a) of 1934 Securities and Exchange Act: SEC-registered firms cannot omit material facts
  - Reg S-K, item 303: Firms have to "describe any known trends or uncertainties that have had or […] will have a material favorable or unfavorable impact on revenues or income from continuing operations."
  - Sustainability info can clearly be financially material or relevant to investors
- Scenario 1: Firms provide most material CSR info already
  - CSR standards should not produce much new information for investors
  - Primary benefits come from standardization, benchmarking, and cost savings
- Scenario 2: Firm compliance is relatively low
  - If mandate forces out new or better CSR information, then there will be info effects
- Empirical evidence points to underreporting or even non-compliance (e.g., Peters and Romi 2013; Grewal et al. 2018)
  - Understanding current practices (material info withheld?) is a key issue

Key issue: Practices vs. standards

- In principle standards could help with avoidance and enforcement
  - Could identify issues that are material for given industry and use a “comply or explain” logic
- But reporting standards alone will likely have a limited effect on harmonizing CSR reporting <u>practices</u>
  - Discretion in rules allows incentives to heavily influence reporting practices
  - Reporting incentives differ across firms, industries and countries
  - There is a reason why CSR reporting is heterogeneous in the first place
- We have seen with IFRS that standards alone do little
  - Reporting infrastructure and enforcement play crucial role
- More harmonized CSR reporting requires substantial investments into private assurance and public enforcement mechanisms
  - Interplay with existing elements (e.g., auditing)
- Specificity of standards is a way to reduce discretion and boilerplate disclosures
  - But specificity runs counter to comparability and harmonization

Key issue: Materiality

- Determining “what” is material to “whom” is likely more difficult for sustainability information
  - CSR information is rarely expressed in monetary units and usually concerns activities with a long-term horizon
  - While CSR disclosures have a large industry component, materiality still needs to be decided at the firm level
  - Materiality of CSR topics is time-variant (e.g., plastic bottles)
- Relevant item or CSR issue can be financially immaterial in itself (e.g., straws)
  - But responses of non-investor stakeholders can lead to significant financial consequences
  - Now, the issue becomes material to investors

Recent example: Siemens and Adani

- Siemens agreed to deliver signal technology for trains at Adani coal mine (Australia)
  - 18M (out of 86B in revenue)
  - Sustainability Board did not even consider the case ex ante
- Massive protests by environmentalists
- Now the case is an issue for the CEO

Conclusion

- Economic consequences of mandate or comply-or-explain regime will be complex, and not all positive
  - Still, we should consider and analyze them
  - Too early to say whether mandate is a good idea
- I would temper expectations of what mandated CSR disclosure standards can achieve
  - Reporting will likely continue to be heterogeneous
- Discuss not just standards but broader infrastructure
  - Enforcement and also voluntary regimes that allow like-minded firms to opt in (but then come with actual ties)

Thank You

A couple definitions

- CSR vs. sustainability:
  - Terms are often used interchangeably
  - Definition of CSR in FT Lexicon: “CSR is a concept with many definitions and practices. […] CSR is a very broad concept that addresses many and various topics […] Whatever the definition is, *the purpose of CSR is to drive change towards sustainability*.”
  - Sustainability is gaining popularity and seems politically less charged
- CSR or sustainability: A wide range of environmental, social, and governance (ESG) activities and policies that assess, manage, and govern a firm’s responsibilities for and its impacts on society & the environment, often to improve social welfare or make activities more sustainable
  - Could (but do not have to be) in line with the interests of shareholders and increasing firm value (“doing well by doing good”)
  - Maximizing shareholder welfare and firm value are not necessarily the same (Hart and Zingales 2017)
  - Firms may sacrifice profits (e.g., Roberts 1992; Bénabou and Tirole 2010) to meet the needs and expectations of a wider set of stakeholders or society
  - CSR goes beyond compliance with legal, regulatory and contractual obligations (e.g., McWilliams and Siegel 2001; Liang and Renneboog 2017)
- CSR Reporting (Standards)
  - Measurement, disclosure, and communication of information about CSR-related topics, including CSR activities, risks and policies. CSR reporting standards govern how to report and disclose this information.

Why the push for sustainability reporting?

- Short-termism and quarterly reporting
  - Buffett and Dimon teamed up to end quarterly earnings guidance

    "In our experience, quarterly earnings guidance often leads to an unhealthy focus on short-term profits rather at the expense of long-term strategy, growth and sustainability."
  - Triggered reconsideration by Business Roundtable
- There are many regimes related to sustainability issues
  - Range from narrow to broad and voluntary to mandatory
  - Lack of consensus on what effective disclosures look like
- Push for standardized, global regime
  - Current reporting is very heterogeneous

What about the CSR literature?

- Most of CSR literature focuses on performance and valuation effects of CSR activities, not on CSR reporting
  - Reporting literature is only starting to burgeon
- Relation between CSR activities and performance/firm value is far from clear (e.g., Mackey et al. 2007; Kitzmueller and Shimshack 2012)
  - If managers are to do CSR only if positive NPV, then it would be like any other investment of the firm
- CSR activities (and reporting) offer a form of "insurance"
  - Good CSR reputation can mitigate negative effects of corporate scandals, high-profile misconduct, bad press coverage, macroeconomic shocks, etc.
- Disentangling CSR reporting from underlying CSR activities is key, but often difficult
  - <u>Dual selection issue</u>: both CSR activities and disclosure are largely voluntary
  - Many CSR studies suffer from selection and/or (reverse) causality issues

CSR literature (cont.)

- Studies on voluntary CSR reporting find more positive (capital-market) effects than studies on CSR reporting mandates
  - Revealed preference suggests benefits of disclosure exceed costs
  - Selection issues have to be taken into account when interpreting results
- Research on CSR reporting mandates is still relatively scarce
  - Need more research on whether CSR reporting mandates mitigate information asymmetries, give rise to externalities, provide cost savings, generate comparability benefits
- Most studies on CSR reporting focus on traditional capital-market participants and outcomes
  - But the target audience are often other stakeholders
  - Need more research on potential real effects due to interactions with other stakeholders