Discussion: ESG Reporting Divergence

Authors:

Qiang Cheng, Yun Lou, and Mengjie Yang (Singapore Management University)

Discussant:

Anywhere (Siko) Sikochi

ABFER Annual Meeting

May 25, 2023

Summary: effects of ESG reporting divergence

ESG reporting divergence (=Information processing costs)

Weakened usefulness of ESG reporting

Dissimilarities in ESG reporting

- 1-Tanimoto similarity [similar items : total items]
- EU ESG reporting regulation

Adverse effects

1. ESG rating disagreement (+)
2. ESG fund allocation x ESG Ratings (-)
3. Investor reaction to negative news (+)

Summary: effects of ESG reporting divergence

ESG reporting divergence (=Information processing costs)

Weakened usefulness of ESG reporting

Dissimilarities in ESG reporting

- 1-Tanimoto similarity [similar items : total items]
- EU ESG reporting regulation

Adverse effects

1. ESG rating disagreement (+)
2. ESG fund allocation x ESG Ratings (-)
3. Investor reaction to negative news (+)

Results support these predictions: ESG reporting divergence is associated with greater ESG rating disagreement, weaker sensitivity of ESG fund allocation to ESG ratings, and less pronounced negative reaction to negative news.

Various stakeholders of ESG reporting

1. Investors (Additional)
2. Customers
3. Employees
4. Governments
5. Equity analysts
6. Fund managers (H2)
7. ESG ratings providers (H1)

Various stakeholders of ESG reporting

1. Investors (Additional)
2. Customers
3. Employees
4. Governments
5. Equity analysts
6. Fund managers (H2)
7. ESG ratings providers (H1)

The underlying proposition is that the lack of comparable ESG information across firms increases the costs of information acquisition and processing for the ESG reporting users, leading to adverse effects.

What does comparability entail?

As noted in the paper

- "...more consistent, complete, comparable and verifiable sustainability-related financial information."
- "In March 2022, the SEC proposed rules to enhance and standardize climate-related disclosures."

Additional insights from financial accounting

- "The FASB and IASB initially concluded that comparability would be enhanced if GAAP and IFRS used the same words and phrases."
- "Recent experiences [showed that] comparability sometimes require the use of different words or [tailored] guidance".

How should we measure it (or lack thereof)?

Lack of comparability = dissimilarity:

$$Tanimoto\ Similarity_{ijt} = \frac{v_{it} \cdot v_{jt}}{v_{it} \cdot v_{it} + v_{jt} \cdot v_{jt} - v_{it} \cdot v_{jt}}$$

It is higher when firms in the pair disclose more of the same fields.

$$ESG\_Diverg_{ijt} = 1 - \ Tanimoto\ Similarity_{ijt}$$

How should we measure it (or lack thereof)?

Lack of comparability = dissimilarity:

$$Tanimoto\ Similarity_{ijt} = \frac{v_{it} \cdot v_{jt}}{v_{it} \cdot v_{it} + v_{jt} \cdot v_{jt} - v_{it} \cdot v_{jt}}$$

It is higher when firms in the pair disclose more of the same fields.

$$ESG\_Diverg_{ijt} = 1 - Tanimoto\ Similarity_{ijt}$$

Disentangling the drivers of the number of items:

How should we measure it (or lack thereof)?

Lack of comparability = dissimilarity:

$$Tanimoto\ Similarity_{ijt} = \frac{v_{it} \cdot v_{jt}}{v_{it} \cdot v_{it} + v_{jt} \cdot v_{jt} - v_{it} \cdot v_{jt}}$$

It is higher when firms in the pair disclose more of the same fields.

$$ESG\_Diverg_{ijt} = 1 - Tanimoto\ Similarity_{ijt}$$

Disentangling the drivers of the number of items:

- **Choice of words or phrases (narrow categories vs broad categories distort similarity).**

How should we measure it (or lack thereof)?

Lack of comparability = dissimilarity:

$$Tanimoto\ Similarity_{ijt} = \frac{v_{it} \cdot v_{jt}}{v_{it} \cdot v_{it} + v_{jt} \cdot v_{jt} - v_{it} \cdot v_{jt}}$$

It is higher when firms in the pair disclose more of the same fields.

$$ESG\_Diverg_{ijt} = 1 - \ Tanimoto\ Similarity_{ijt}$$

Disentangling the drivers of the number of items:

- **Choice of words or phrases (narrow categories vs broad categories distort similarity)**.
- **Quality of information (key information vs superfluous information for evaluation)**.

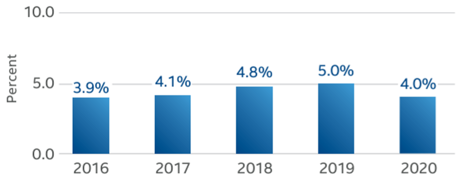
On the choice of words or phrases

"Only Advanced Micro reported information on employee turnover; [Intel did not] (p.9; Appendix A)."

On the choice of words or phrases

"Only Advanced Micro reported information on employee turnover; [Intel did not] (p.9; Appendix A)."

Yet, Intel reports a comprehensive "Undesired Global Turnover"

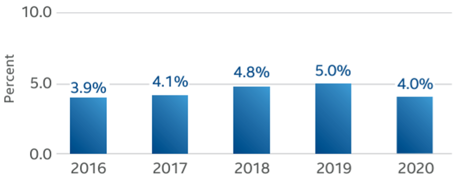


Our undesired global turnover rate decreased from 5.0% in 2019 to 4.0% in 2020. Over the past five years, our rate has been at or below 5%, lower than our industry benchmark. These figures include all regular Intel employees who voluntarily left Intel, but do not include Intel contract employees, interns, or employees who separated from Intel due to divestiture, retirement, voluntary separation packages, death, job elimination, or redeployment.

On the choice of words or phrases

"Only Advanced Micro reported information on employee turnover; [Intel did not] (p.9; Appendix A)."

Yet, Intel reports a comprehensive "Undesired Global Turnover"



Our undesired global turnover rate decreased from 5.0% in 2019 to 4.0% in 2020. Over the past five years, our rate has been at or below 5%, lower than our industry benchmark. These figures include all regular Intel employees who voluntarily left Intel, but do not include Intel contract employees, interns, or employees who separated from Intel due to divestiture, retirement, voluntary separation packages, death, job elimination, or redeployment.

E.g., an algorithm looking for "employee" w/3 "turnover" may have missed this global turnover. In which case, ESG divergence is driven by choice of words not information disclosed.

On the quality of ESG reporting

"ESG divergence measures the extent to which a firm reports a different set of ESG items relative to its peers."

On the quality of ESG reporting

"ESG divergence measures the extent to which a firm reports a different set of ESG items relative to its peers."

An ESG rating agency needs and always finds the following items across all firms:

1. **Should there be a broad push for comparability in ESG reporting?**
2. **Consider divergence from expected (i.e., ratings metrics) not from peers? (at least for the analysis assessing ESG ratings)**

Metric	Description
Human Rights/Policy	Does the company have a policy to guarantee the freedom of association universally applied independent of local laws? AND Does the company have a policy for the exclusion of child, forced or compulsory labor?
Diversity and Opportunity/Improvements	Does the company set specific objectives to be achieved on diversity and equal opportunity?
Diversity and Opportunity / Managers Female Male Ratio	Percentage of women managers.

How do ESG rating providers use information?

H1 motivation: "When the quality of public information is lower due to more divergent ESG reporting, ESG rating providers will rely less on public information and rely more on their private information, thereby increasing [rating] disagreements (e.g., Easley and O'Hara 2004; Garfinkel 2009)."

How do ESG rating providers use information?

H1 motivation: "When the quality of public information is lower due to more divergent ESG reporting, ESG rating providers will rely less on public information and rely more on their private information, thereby increasing [rating] disagreements (e.g., Easley and O'Hara 2004; Garfinkel 2009)."

1. Why is the quality of public information lower? What if the necessary information to fit rating methodologies is disclosed?
2. Easley and O'Hara (2004) and Garfinkel (2009) refer to investors. Why should ESG rating providers behave the same?
3. Where does the private information come from? Rating providers can and often ask companies for information via surveys.

Private vs public information across the hypotheses

H1 motivation: **"When the quality of public information is lower [...] ESG rating providers will [...] rely more on their private [ESG] information."**

Private vs public information across the hypotheses

H1 motivation: **"When the quality of public information is lower [...] ESG rating providers will [...] rely more on their private [ESG] information."**

H2 motivation: **"To the extent that ESG reporting divergence increases the information processing costs for ESG fund managers, they may find it difficult to evaluate firms' ESG performance based on ESG ratings, which are primarily based on public ESG information."**

Private vs public information across the hypotheses

- H1 motivation: "When the quality of public information is lower [...] ESG rating providers will [...] rely more on their private [ESG] information."

- H2 motivation: "To the extent that ESG reporting divergence increases the information processing costs for ESG fund managers, they may find it difficult to evaluate firms' ESG performance based on ESG ratings, which are primarily based on public ESG information."

If H1 motivation holds, ESG ratings should be primarily based private information.

Empirical design choices and other comments

1. Taking a step back, does ESG rating disagreement have to be an adverse outcome?
2. Given the metric (or item) level raw disclosure data, consider conducting analyses at the ESG Indicator rating disagreement (certainly feasible for Refinitiv and Sustainalytics, where indicators can be matched)
3. Clarify the timing of the ESG reporting divergence relative to the ESG rating disagreement
   - All rating agencies must have the opportunity to observe any ESG information relating to firms' year t ESG performance
4. Reconcile the CAR additional tests with models indicating that market discount rate increases under uncertainty and negative news

Thank You!