



Building the case for the internal informational value of ESG disclosure

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Milan, November 16, 2015

Responsible investments: a «niche» phenomenon

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UN PARTNERS:
UNEP FINANCE INITIATIVE
UN GLOBAL COMPACT



1380

SIGNATORIES:
ASSET OWNERS,
INVESTMENT
MANAGERS
AND SERVICE
PROVIDERS



59

US\$ TRILLION:
ASSETS UNDER
MANAGEMENT



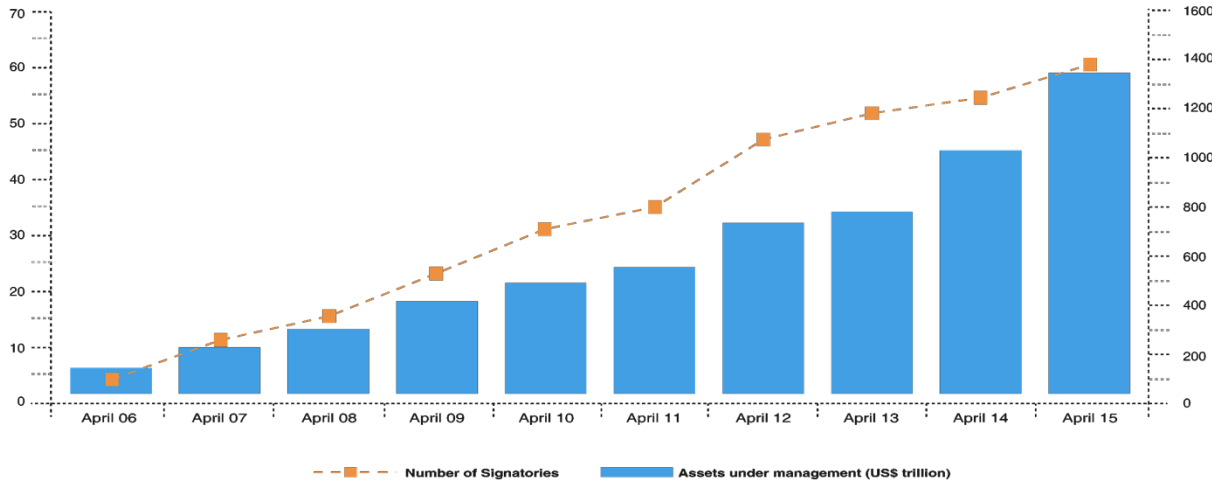
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PRINCIPLES:
RECOGNISING THE
MATERIALITY OF
ENVIRONMENTAL,
SOCIAL AND
CORPORATE
GOVERNANCE ISSUES



Assets under management (US\$ trillion)

N° Signatories



Responsible investments in Italy

Signatories to the Principles for Responsible Investment

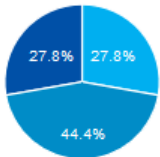
ITALY

FIND SIGNATORY BY INDIVIDUAL COUNTRY : ITALY

There are three main categories of signatory:

| Signatory Category: | Number Of Signatories: |
|-------------------------------|------------------------|
| ASSET OWNERS | 5 |
| INVESTMENT MANAGERS | 8 |
| PROFESSIONAL SERVICE PARTNERS | 5 |
| TOTAL | 18 |

Italy



ASSET OWNERS

5

INVESTMENT MANAGERS

8

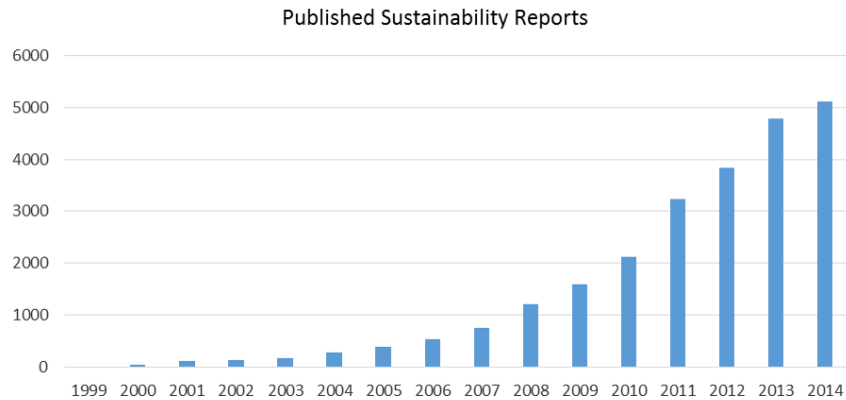
PROFESSIONAL SERVICE PARTNER

5

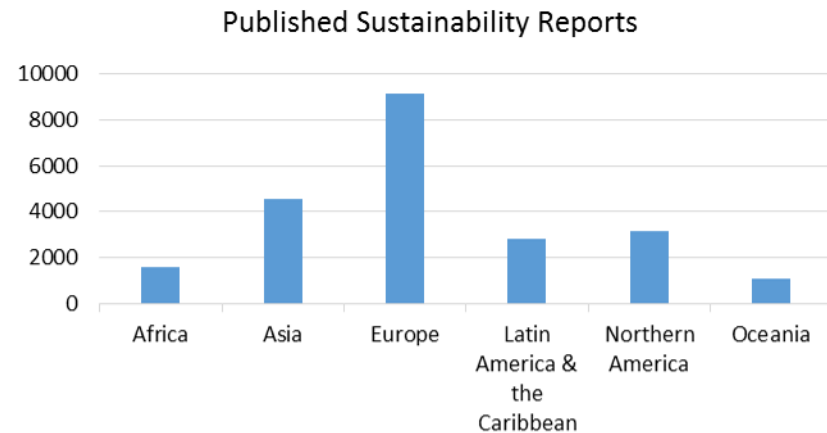
PRI signatories in Italy account for roughly €700bn (\$796bn) AUM

Disclosing ESG data: sustainability reporting (SR)

SR has gained significant momentum in recent years.



“A sustainability report is a report published by a company or organization about the **economic, environmental and social impacts** caused by its everyday activities. A sustainability report also presents the **organization's values and governance model**, and demonstrates the **link between its strategy** and its commitment to a sustainable global economy.” (Global Reporting Initiative, 2015)

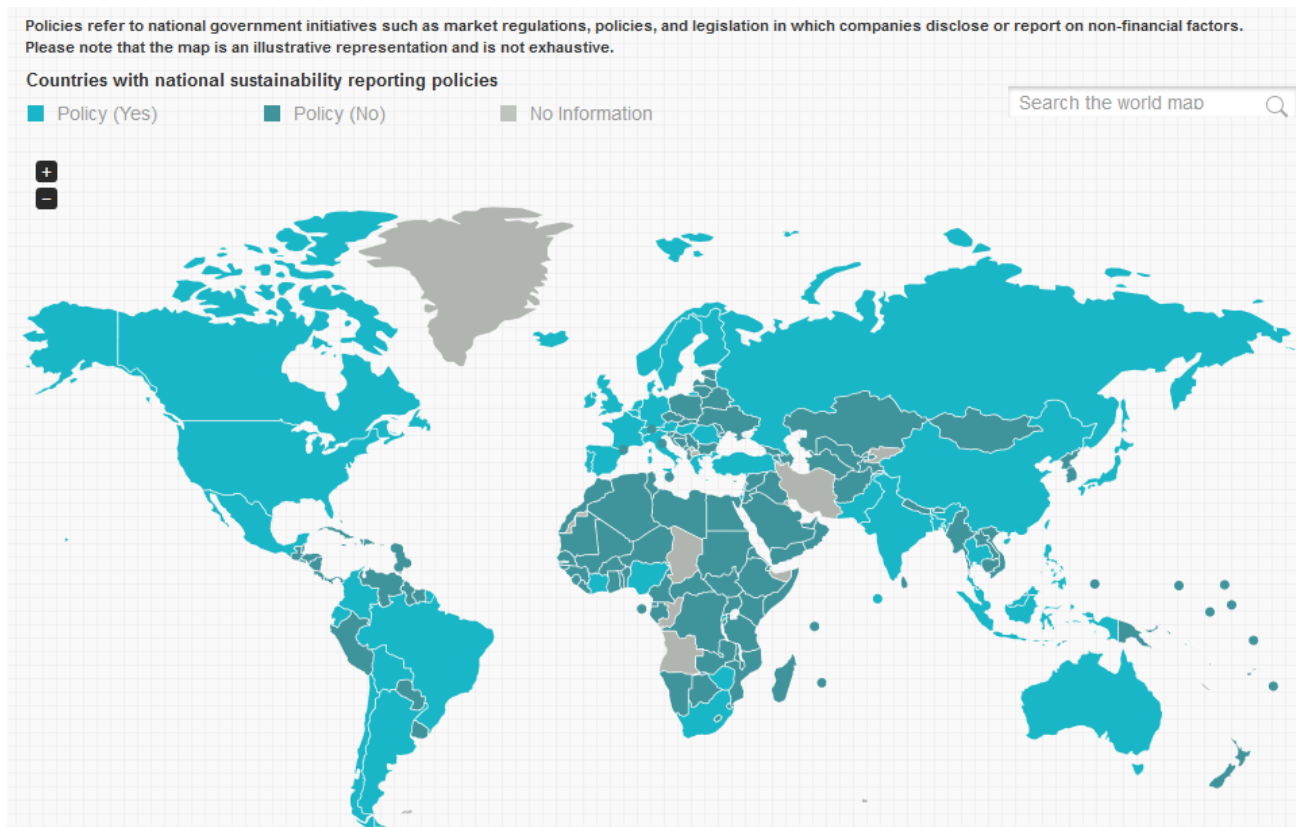


“the process of **identifying, classifying, measuring, recognizing, and reporting performance in all areas of EGSEE** (economic, governance, social, ethics, and environmental)”. (Brockett and Rezaee, 2012)

“the process of **providing information designed to discharge social accountability**” (Sutantoputra, 2009)

Data provided by the GRI Sustainability Disclosure Database

Policies supporting SR



The December 2014 EU “**Directive on disclosure of non-financial and diversity information by certain large undertakings**” requires more than **6.000 “public interest entities**” (i.e. organizations with more than 500 employees) to report on **environmental, social and employee-related, human rights, diversity, and anti-corruption and bribery issues**.

Within the newly adopted **UN Sustainable Development Goals (SDGs)**, **SDG 12** focuses on “**sustainable consumption and production patterns**”, and target 6 aims at supporting SR worldwide, as an enabling tool for moving towards sustainable development.

The link between ESG disclosure and firm value: academic literature

Bachoo, Tan, and Wilson (2013) analysed the relationship between **firm value and quality of sustainability reporting** for the **ASX 200 firms, from 2003 to 2005**. Using the **Ohlson model**, they found a **positive association with the current price** of a firm's stock, and a **negative one with the cost of equity**, applying **Easton's (2004) MPEG model**.

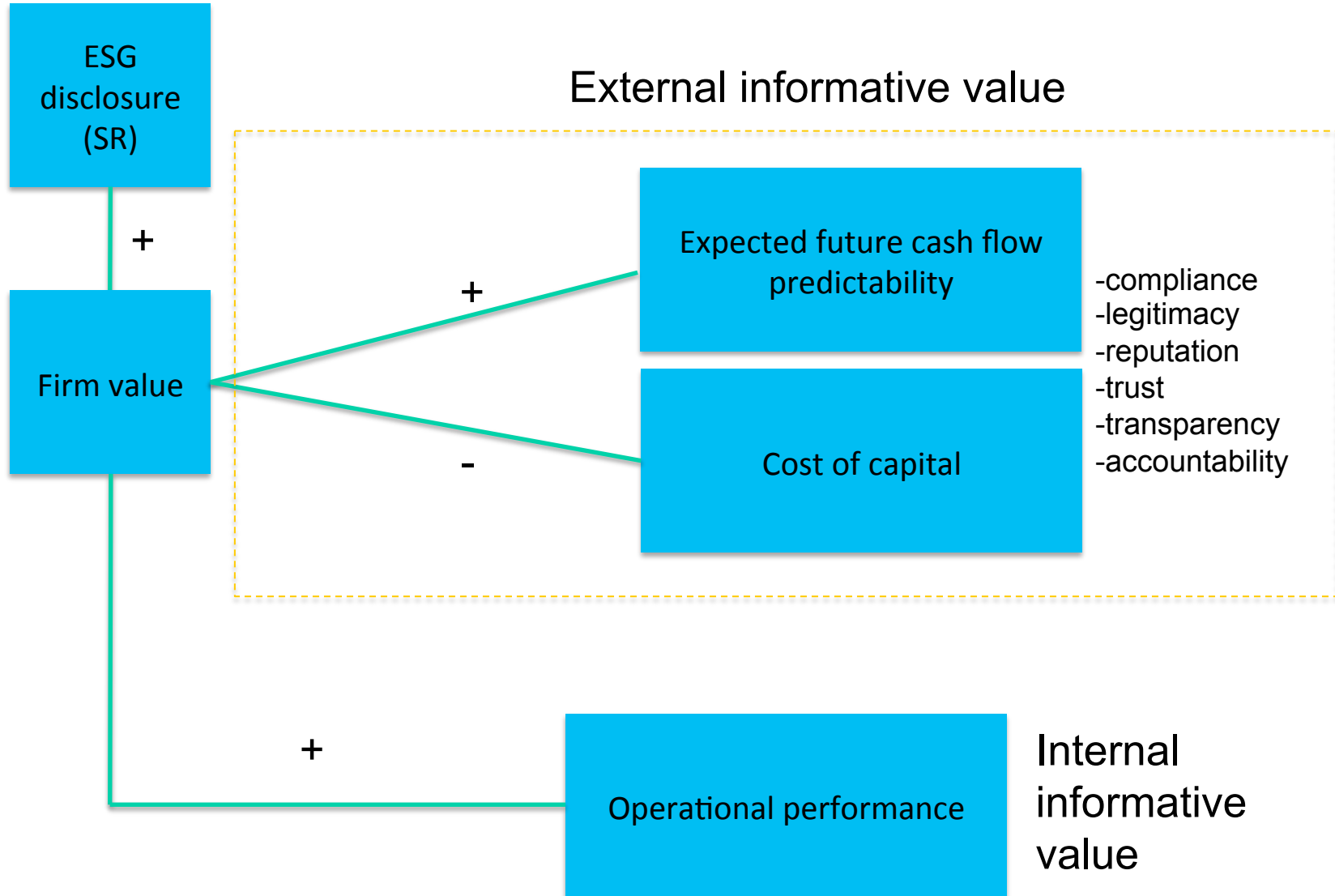
Clarkson, Fang, Li, and Richardson (2013) investigated the **incremental informative value of voluntary environmental disclosure** by contrasting it to the Toxic Releases Inventory (TRI) disclosure. They argue that the sources of increase in market value are (1) facilitating **expected future financial performance prediction** (2) **reducing cost of capital**. Their sample includes **US public companies in 2003 (92 firms) and 2006 (103 firms)** operating in **five polluting industries**. Their results show (1) a **positive relationship** between incremental environmental disclosure and **price of a firm's stock** (estimated through Ohlson model), (2) **no significant association** with the **cost of equity capital** (using MPEG measure), (3) a **positive association with t+3 average ROA and cash flow from operations**

Plumlee, Brown, Hayes, and Marshall (2015) introduce a new measure of voluntary environmental disclosure quality and study its relationship with **stock price, expected future cash flows, and cost of equity** (estimated through target price and PEG). They categorise disclosure on the basis of **type** (hard vs soft) and **nature** (positive vs negative). Their final sample includes **79 US listed firms over a 6-years period** (2000-2005) drawn from **5 industries** (oil&gas, chemical, food, pharma, and electric utilities). Results show, again, a **positive association between positive** (both hard and soft) **voluntary environmental disclosure and firm value**

The link between ESG disclosure and firm value: academic literature

| <i>Paper</i> | <i>Sample</i> | <i>Model</i> | <i>ESG disclosure variable</i> | <i>Results</i> |
|--|--|---|---|---|
| Bachoo, Tan, and Wilson (2013) | ASX 200 firms, from 2003 to 2005 | Firm's stock price (Ohlson model), cost of equity (Easton's MPEG) | Quality of sustainability reporting | + with the current price of a firm's stock, and - with cost of equity |
| Clarkson, Fang, Li, and Richardson (2013) | US public companies in 2003 (92 firms) and 2006 (103 firms) operating in five polluting industries | Firm's stock price (Ohlson model), cost of equity (Easton's MPEG), t +3 average ROA and CFO | Incremental informative value of voluntary environmental disclosure | (1) + with price of a firm's stock , (2) not significant with the cost of equity capital , (3) + with t+3 average ROA and CFO |
| Plumlee, Brown, Hayes, and Marshall (2015) | 79 US listed firms over a 6-years period (2000-2005) drawn from 5 industries (oil&gas, chemical, food, pharma, and electric utilities) | Firm's stock price (Ohlson model), cost of equity (Easton's MPEG, target price), expected future cash flow | Voluntary environmental disclosure categorised on the basis of type (hard vs soft) and nature (positive vs negative) . | + association between positive (both hard and soft) voluntary environmental disclosure and firm value |

ESG disclosure informative value and firm value



Internal informative value?

An **emerging trend** in literature (Adams & Frost, 2008; Adams & McNicholas, 2007; Arjaliès & Mundy, 2013; Bouten & Hoozée, 2013; Contrafatto & Burns, 2013; Gond et al., 2012; Larrinaga-Gonzalez & Bebbington, 2001; Larrinaga-González et al., 2001; Milne & Gray, 2013) observes SR as a **process**, a **management control system** (MCS)

A **MCS** is used to «**to maintain or alter patterns in the organisation activity**», as a «lever of control» (Simons, 1990). Simons indicates 4 levers of control:

- **Belief system** (expression of the **corporate core values**);
- **Boundary system** (**risks to be avoided**, establishing negative terms or minimum standards indicating the **limits to be respected**)
- **Diagnostic system** (**feedback systems** used to **track variances** from preset goals and **manage by exception**)
- **Interactive system** (**diagnostic systems** used with **regular and personal involvement** of the **top management** to address **strategic uncertainties**)

Hypothesis development

On top of the external informative value, ESG disclosure through the use of SR as a MCS is a source of firm value in term of increased operational performance

Methodology

Panel analysis of S&P 1200 from 2002 to 2014 (data coming from Thomson Reuters Datastream and Asset4 ESG)

| Model | Dependent variable | predictor | Control variables |
|--|--|--|--|
| SR – firm’s stock price (Ohlson model) | Current stock price | SR index: SR publishing +reporting scope +guidelines adoption +third party audit) | Book value of equity; Abnormal earnings (EPSt +2); Reporting experience (years); |
| SR – cost of equity | Cost of equity (Easton MPEG, PEGST for robustness check) | SR index | Beta; Size; Book to market ratio; D/E; Earnings growth ratio; |
| SR use – operational performance | ROA+1 ROA+2 ROA+3 | Monitoring Index: internal audit department+third party auditor+reporting scope +(emission +health&safety +resource efficiency) kpi monitoring | Size; R&D intensity; Slack resources; |

All the models include **year, industry, geo, reporting experience (years), environmental and social performance (Thomson Reuters score) controls**

Results

| Model | Results |
|--|---|
| SR – firm’s stock price (Ohlson model) | SR index has a positive coefficient (7.58, $p < 0.01$) when the model includes AE proxied with EPS+2. With EPS, SR index $p < 0.1$ |
| SR – cost of equity | SR index has a small negative coefficient (0.002, $p < 0.01$). Results are confirmed also when estimating cost of equity with PEGST method |
| SR use – operational performance | Monitoring index has a positive coefficient (0.18, $p < 0.01$) with ROA+3. Results are confirmed on ROA+1 and +2 as well. |

Implications

- External informative value is not the only source of firm value for ESG disclosure through SR
- ESG metrics convey an important flow of information **relevant for operational performance (materiality)**
- **Use of SR as MCS** is an important driver of operational efficiency, especially considering that **years of reporting experience have a negative impact on ROA**

Limitations and further research

- **Size bias:** the sample includes the 1200 largest companies in the world;
- A more **refined measure of SR use** can be built;
- **Moderating effects of monitoring** and environmental/social performance can be investigated
- A **different methodology (SEM)** would allow to study the simultaneous relationship between environmental and social performance, ESG disclosure, ESG use, and economic performance

Q & A



"Yes, the planet got destroyed. But for a beautiful moment in time we created a lot of value for shareholders."

Thank you