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The Impracticality of Standardizing ESG Reporting

Elmira Aliakbari and Steven Globerman

Executive Summary

In recent years, rising frustration among investment managers and retail investors over the plethora of competing ESG reporting standards and rating agencies has led to calls for standardizing the mandatory disclosures of ESG information. While in theory having a universal ESG reporting framework—similar to what we have for financial reporting—would bring consistency to ESG reporting, in practice, serious implementation and enforcement challenges would arise from mandating a uniform set of ESG reporting standards that apply to all public companies. This essay discusses the challenges and argues that implementing and enforcing a standardized global ESG framework is impractical and would be extremely costly due to the distinctive features of ESG reporting, which differentiate it from financial reporting.

A significant challenge when mandating uniform ESG disclosure regulations and applying them to all public companies is related to implementation difficulties. In particular, identifying ESG materiality (i.e., defining what specific ESG issues are topics for reporting) will inevitably be arbitrary and unsatisfactory to many "stakeholders." ESG encompasses a broad set of issues including waste and water management, supply chain management, hiring and compensation, and climate change. Stakeholders' interests in ESG differ. Hence, so do their views of what is of material interest for corporate disclosure.

Adding to the identification challenge is the fact that the materiality of specific ESG information will depend upon company-specific attributes including geographic location, industry, and business model. Furthermore, given the likely divergence of viewpoints on the importance of specific ESG issues, standardizing ESG disclosure across public companies will

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inevitably involve value judgments thereby making the process political and costly.

Supplying accurate and understandable information is another challenge facing efforts to standardize ESG-related disclosures. Given the scope of ESG issues that are of potential interest to varied stakeholders, it is likely that any disclosure standards implemented will be broad. Broad standards would leave more room for managerial interpretation of what specific ESG information should be reported and could therefore result in ESG misreporting. On the other hand, were specific standards to be applied generally, it would be likely that the standards would not fit the circumstances of any particular firm and, hence, would be of limited value to any set of stakeholders.

Supplying accurate and actionable ESG information in a standardized format is further challenged by the reality that much of the information that might be relevant to specific stakeholders is not quantifiable. Even when ESG behaviour and outcomes are readily measurable, assigning monetary values to them is often not possible. How can we, for instance, objectively assign a monetary value to the racial or gender composition of board membership? Without being able to aggregate the ESG-related activities and performances of disparate companies into a uniform metric, it will be impossible as a practical matter to rank companies by any standardized index.

Finally, effectively enforcing mandated common ESG reporting standards across all public companies would be challenging because ESG metrics are highly subjective, frequently rely on internal information, and lack external reference points such as industry benchmarks. Verifying ESG information for internationally diversified companies with large and dispersed supply chains would be extremely costly, if not impossible, because companies might not have ready access to the ESG information they are expected to report, particularly as the requisite information resides outside their legal jurisdictions.

Introduction

Businesses worldwide face growing pressure from investors and other stakeholders to disclose information about their Environmental, Social, and Governance (ESG)-related activities and impacts beyond the financially material information currently required by securities regulators. In response, numerous companies have voluntarily implemented ESG reporting standards, while a host of ESG rating agencies evaluate and rank companies using proprietary criteria. Today, the world of ESG reporting is a plethora of frameworks; there are more than 600 ESG reporting frameworks in use, many of which conflict with one another in terms of the rankings of individual companies and even the criteria used to rank companies (Boerner, 2021). Not surprisingly, some investors have expressed concern about a lack of comparable and reliable ESG information they claim they need to properly factor ESG considerations into their investment decisions (Bernow et al., 2019).

Rising frustration among investment managers and retail investors has led to calls for standardizing the mandatory disclosure of ESG information. For example, the CEOs of eight major public pension funds in Canada recently teamed up to demand that companies adhere to the recommendations made by the Sustainability and Accounting Standards Board and the task force on climate-related financial disclosures framework when reporting ESG disclosures (Globerman, 2022a). Perhaps the most prominent call for standardization comes from the World Economic Forum's International Business Council, which has proposed a set of common ESG metrics with the goal of driving a convergence of global reporting standards—ostensibly to provide asset managers and investors with better data for investment decision-making (Gagnon, 2021).

In the hopes of providing consistency and comparability in ESG reporting, five major reporting institutions, including the Sustainability Accounting Standards Board, the Global Reporting Initiative, and the Climate Disclosure Standards Board, are working together to develop a common framework with a single set of global reporting standards. In March 2021, the International Financial Reporting Standards Foundation (IFRS), which is responsible for setting global accounting standards, unveiled the creation of the International Sustainability Standards Board (ISSB), charged with developing "a comprehensive global baseline of sustainability-related disclosure standards" (Kummer, 2021). The ISSB plans to develop a uniform set of global ESG standards—similar to what the Internal Accounting Standard Board (IASB) does in the context of financial reporting—to address the proliferation of sustainability/ESG standards and standard setters.

While in theory having a standardized ESG reporting framework—similar to what exists for financial reporting—would bring consistency to ESG reporting, in practice serious implementation and enforcement challenges would arise from mandating a uniform ESG reporting standard for public companies. This essay discusses the prominent challenges and argues that implementing and enforcing a standardized global ESG framework is highly impractical due to the distinctive features of ESG reporting, which differentiate it from financial reporting. Specifically, we discuss the challenges involved in defining materiality (section 1), defining the scope of standards (section 2), measuring and aggregating ESG information (section 3), and enforcing a universal ESG framework (section 4). The final section presents concluding comments.

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1. Materiality

Multiple stakeholders with multiple views

Materiality is a core concept in the current world of corporate reporting of all kinds, including ESG reporting. This concept is used to define why and how certain issues are important to users of corporate reports, who have traditionally been presumed to be lenders or investors. Under current securities regulation practices in Canada, to be considered material information must have financial implications for investors. Defining materiality in the context of broad ESG reporting, unlike financial reporting, poses significant challenges, because materiality for ESG reporting is not a clear-cut concept. To illustrate the issue, we start with defining materiality in financial accounting, from where the concept originates. According to the Financial Accounting Standard Board (FASB), in financial accounting, an item of information is defined as material if the omission or misstatement of that item would affect the judgment of a reasonable person in making a financial decision (Messier et al., 2005).[1]

According to the FASB's definition, the target audience of financial reporting is stakeholders who have a financial interest in the firm (i.e., investors, lenders, and other creditors), and financial reporting is meant to provide financially material information to these stakeholders.

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This definition of materiality is difficult to apply to ESG reporting. ESG issues encompass a broad set of considerations including, among others, waste and water management, supply chain management, employee hiring and compensation, and climate change. While the wide range of ESG issues may be of concern to a large set of stakeholders (consumers, employees, local communities, activists, governments, etc.), their concerns are not necessarily linked to the financial performance of specific companies or groups of companies. Furthermore, different groups of stakeholders will likely have different opinions as to what is "material" non-financial ESG-related information. They may even have conflicting views on specific critical ESG issues such as the causes and consequences of climate change. In short, what is material non-financial ESG-related information from one stakeholder's viewpoint might not be material from another's.

To date, there has been no consensus on the key ESG issues and company practices that are most important for corporate disclosures (Ashley and Morrison, 2021). Unless one subscribes to a view that all ESG-related information is ultimately financially material, a view that is clearly indefensible, regulators must determine what specific ESG-related information should be included in a standardized reporting format. How regulators can be expected to reach a consensus on this issue given the wide-ranging and often diverging interests of those calling for such standardized reporting has not been satisfactorily answered by proponents of mandated standardized reporting. The existence of multiple stakeholders with various and differing views on the importance of individual ESG issues would make determining "what" information is material and to "which stakeholders" an overwhelming challenge for those charged with developing a standardized reporting format (Christensen et al., 2021).

One might argue that narrowing the target audience for a standardized ESG reporting format to investors (and thereby ignoring other groups of stakeholders) would obviate the challenge. However, investors also have different views on the materiality of specific ESG-related disclosures. Some investors may only care about the financial consequences of corporate activities, while others may have non-monetary preferences and care about a company's impacts on the environment and society more generally, even if when those impacts have no likely financial consequences.

An increasing number of investors appear to make investment decisions by considering issues related to social norms that may or may not have financial consequences (Hong and Kotovetsky, 2012). Consider, for instance, an investor who disapproves of child labour. This investor will want to know if the company uses child labour in its supply chain (Christensen et al., 2021). Another investor might care about workforce diversity in terms of gender, race, and ethnicity, thereby needing information on these topics. Other investors may be concerned with governance issues such as diversity of corporate boards. Should companies be expected to provide information on their ESG-related practices that might be of interest to small groups of investors, especially when the information may not be financially material? How should regulators determine what ESG-related information is sufficiently "relevant" for reporting purposes given that ESG issues are broad, and that investors are likely to have different views on their importance? If it were costless to produce and report ESG-related information, the issue of what information to report would be moot. However, producing and reporting information is obviously costly.

In the context of ESG reporting, determining the materiality of specific disclosures is challenging no matter how broad or narrow the target audience. One might argue that narrowing the scope of the audience to investors and reporting only on ESG topics that are *financially* material to them would resolve the issue of defining materiality in the context of ESG reporting. However, even adopting this narrow focus would leave regulators with uncertainty about how to standardize financially material ESG information, as evidenced by, among other things, the absence of a clear empirical link between the ESG rankings of companies and the financial performances of those companies (Globerman, 2022b).

Fluidity and unpredictability of ESG issue materiality

Even in the context of financial reporting, what is deemed material information can change over time, for example in response to financial crises or corporate scandals (Hail et al., 2018). However, such changes are likely to be even more pronounced for broad ESG reporting, because ESG concerns generally encompass broad societal issues, and the public importance of such issues can change dramatically and unpredictably as a consequence of unanticipated exogenous factors such as environmental accidents, natural catastrophes, or protest movements (Christensen et al., 2021).[2]

To better appreciate the fluid nature of sustainability issues, one might consider the COVID-19 pandemic, which is an ESG issue with significant financial, environmental, and social consequences for firms, but an issue neither corporate executives nor securities regulators could predict (Jørgensen et al., 2021). Similarly, the #MeToo phenomenon is another issue affecting many companies whose growing social relevance was hard to foresee (Rogers and Serafeim, 2019). Identifying ESG-related issues that are not prominent today but may become prominent in the future and, therefore, identifying the ESG-related information that will be financially material to investors (and important to other stakeholders) in the future is an unreasonable expectation of regulators.

Company-specific ESG materiality

The materiality of ESG factors and their importance likely varies systematically across countries, industries, and firms (Amel-Zadeh and Serafeim, 2018; Eccles and Serafeim, 2013). For instance, water pollution could be a serious environmental issue in one country, whereas in another country corruption could be a critical issue. Supply chain challenges concerning labour standards could be a serious social issue for clothing manufacturers, but the same issue would not seem relevant for the banking sector. Utilities would face greater exposure to environmental risks than, for instance, software providers. Similarly, for a company that has a strategy to use low-cost labour in developing countries, human rights are more material compared to another company that uses skilled workers in developed countries (Eccles and Serafeim, 2013).

> **"Supply chain challenges concerning labour standards could be a serious social issue for clothing manufacturers, but the same issue would not seem relevant for the banking sector. Utilities would face greater exposure to environmental risks than, for instance, software providers."**

Given that ESG issues and their importance vary depending upon company specifics (geographic location, industry, strategy, etc.), it is extremely difficult to identify a meaningful standardized format for ESG-related reporting and apply that format to all public companies. Katz and McIntosh (2021) and Coates (2021) acknowledge this reality by noting that while some ESG concerns touch every company to a greater or lesser extent, many ESG concerns are quite company-specific, and their importance can vary significantly based on the industry in which a company operates, the company's geographic location, and other factors. Therefore, no single ESG reporting format will properly cover all current and potential ESG issues for all companies.

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Overall, as a result of the wide-ranging issues encompassed within the term "ESG," the lack of stakeholder consensus surrounding priorities and preferences, the company-specific variations of ESG issues, and the continually evolving set of ESG concerns, application of materiality criteria to identify a standardized ESG reporting framework is extremely difficult, if not impossible.

2. Scope of ESG reporting standards

There is substantial variation in corporate ESG disclosure practices, partially reflecting the variation in companies' ESG issues and activities (Christensen et al., 2021). As discussed earlier, the company-specific relevance of particular ESG issues and activities mitigates the applicability of any standardized ESG reporting format.

One might argue that this challenge can be addressed by making the scope of the reporting format quite broad, thereby applying to a wide range of companies. However, a broad and generalized reporting format would leave more room for management's interpretation of what should be reported. As a result, managers might fail to report ESG information not to deceive, but because their interpretation of what should be reported differs from the intent of the standard setters. In addition, broadly defined reporting standards would give more leeway for managers to hide unfavorable information. As Christensen and Leuz (2019) note, if managers think disclosing some ESG information is risky or not in a company's best interest, with broad standards, "they will have more freedom to avoid disclosing it, whether that means making selective disclosures or burying unfavorable information in a boilerplate statement."

Given problems associated with mandating broad reporting standards, one might argue that any uniform ESG-reporting format should mandate in detail exactly what information companies should report, as well as how they should report, e.g., annual sustainability reports. However, implementing specific uniform standards also poses significant challenges. If standards are specific, they cannot be usefully applied to a broad set of companies and circumstances. The more specific the standard, the less widely applicable they become. Therefore, the more likely it is that the costs of collecting, processing, and disseminating the required information will exceed any benefits to the "consumers" of the information. Moreover, detailed and specific disclosures could reveal proprietary information to competitors and thereby hurt companies' innovation incentives (Breuer et al., 2020). Overall, significant implementation challenges would arise no matter how specific or broad the scope of standards.

3. ESG measurement and aggregation

Another caveat about mandating standardized ESG disclosures is that the underlying social benefits of ESG-related activities are typically hard to quantify in monetary terms and therefore they cannot be integrated into quantitative models. Even though many ESG-related outcomes can be measures, e.g., the number of females on a company's board of directors, assigning monetary values to those outcomes is not always possible (Christensen et al., 2021; CFA Institute, 2015). For example, we can measure the number of minority group board members for a company, but there is no practical way of assigning a monetary value to the racial or gender composition of board membership.

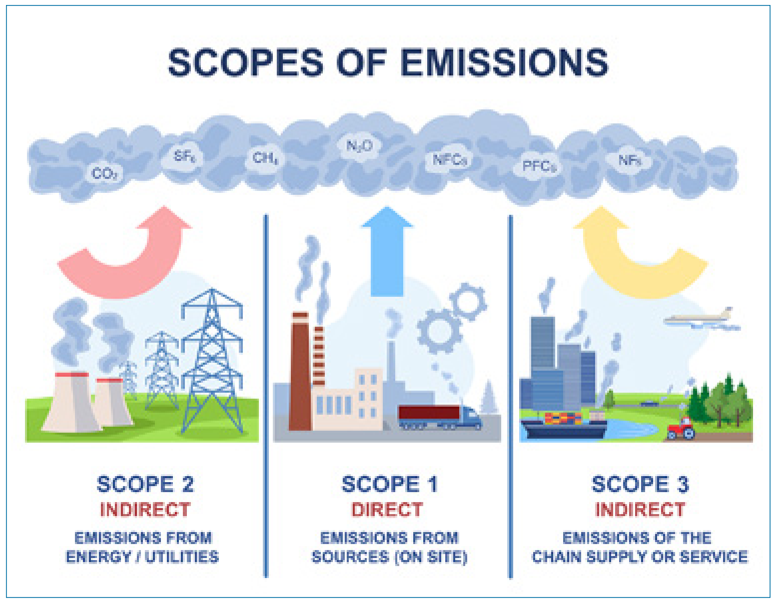
Kaplan and Ramanna (2021) underline this point by discussing the decade-long efforts of some accountants to quantify a CEO's statement that "employees are our most valuable asset." These efforts to put human resources on a company's balance sheet have failed because the employee valuations are either arbitrary and unverifiable or are irrelevant (such as how much money was spent historically on training or hiring employees).

Consider the issues with measuring and reporting environmental concerns. As part of climate-related disclosers, companies might be required to report their climate-related risks by quantifying the financial losses they could incur due to the physical impacts of climate change—the US Securities and Exchange Commission (SEC), for instance, has proposed new rules that if finalized, will require such climate-related disclosures for public companies. However, predicting the future impact of climate change relies on several assumptions fraught with uncertainties (Lewis, 2021). Boston University Professor Madison Condon has described some of the challenges involved in assessing climate risk as follows:

> Evaluating climate risk involves forecasting macroeconomic energy demand, guessing on the success of carbon regulation and future technologies, modeling the relationship between atmospheric gas concentrations and global temperatures, predicting how temperature rise will change the earth's climate systems, and calculating how those changes impact physical economic assets. The task requires skills beyond that of a typical financial

> analyst, colossal amounts of data, and models that have only begun to be built. Each step of estimation adds layers of uncertainty to risk projections. In some cases, particularly those longer-term and macroeconomic, the estimation of the economic impact of climate change may be dwarfed by this uncertainty. (Condon 2021, pages 72-73)

Similarly, as part of climate-related disclosures, companies might be required to calculate and report their generated greenhouse gas (GHG) emissions. A company's GHG emissions are classified into three categories. Scope 1 emissions cover direct emissions owned or controlled by a company (for instance, when a company runs its vehicles and boilers). Scope 2 emissions are indirect emissions from the electricity, heat, or steam purchased and consumed by an entity. Scope 3 emissions are all other indirect emissions that occur in an entity's value chain, including those generated by suppliers and distributors, the usage of products sold, and employees' business travel. More specifically, scope 3 emissions come from sources that the companies in question do not own or control, yet they account for over 80 percent of total GHG emissions (Bruce, 2021, February 11).



Companies must measure and report all three types of emissions to provide a complete picture of their carbon footprint. Currently, the SEC has proposed new rules that if finalized will require companies to report scope 3 emissions from their supply chains and customers if the emissions are material. However, calculating scope 3 emissions is a monumental, if not impossible, task. For instance, consider the case of Timberland, an American manufacturer and retailer of outdoor footwear. According to the 2009 estimates, more than 95 percent of the GHG emissions generated by Timberland fall under scope 3 (Pucker, 2021). Measuring those emissions for Timberland would mean tracking "the emissions generated by each supplier during the production and transportation of some 30,000 product components annually" (Pucker, 2021).

Nemeth (2022) also discusses the challenges involved in measuring scope 3 emissions. Consider a farmer who grows a potato. Scope 3 emission would require the farmer to calculate all GHG emissions that can be linked to him. As Nemeth (2022) explains, the farmer then needs to know how the potato gets to the store. Or even how the person who bought the potato from the store traveled to the store. Is the potato peeled? If yes, what happens to the peels? Is the potato boiled in an oven or cooked on a fire? And so on (Nemeth 2022).

In short, accurately measuring scope 3 emissions is immensely difficult, especially for companies with long, multi-jurisdictional, and complex value chains. Since scope 3 reporting would effectively require each company in a value chain to measure and report the total GHG emissions from the entire value chain, the same emissions could be counted multiple times over, resulting in a misleading measurement of aggregate carbon emissions (Kaplan and Ranmanna 2021; Mawani 2021).

"Even if the challenges associated with defining materiality could be overcome, and accurate measurement of the ESG behaviours of individual companies was feasible, rating agencies would still need to aggregate ESG information in order to create overall ESG scores."

Even if the challenges associated with defining materiality (section 1) could be overcome, and accurate measurement of the ESG behaviours of individual companies (this section) was feasible, rating agencies would still need to aggregate ESG information in order to create overall ESG scores. How should they weight, for example, environmental indicators, such as GHG emissions, or social indicators, such as the use of child labour in the supply chain? Will regulators determine which ESG indicators and categories are more or less important in order to assign individual weights?

Consider a company facing pressure from its stakeholders to reduce its greenhouse gas emissions. The company might switch to electric vehicles to achieve the goal of reducing its carbon footprint. But what if the raw materials used to create the batteries for the electric vehicles used by the company were mined using child labour? Any standardized format for making intra-ESG trade-offs when calculating overall ESG scores for companies will inevitably reflect the personal values of those proposing the format, and those values are likely to be heterogeneous and subject to change over time (Steffen, 2021). Hence, no one standardized format for evaluating the overall ESG performance of companies is likely to be objectively more reliable than some other standardized format.

This latter reservation is reinforced by a recent paper, "Aggregate Confusion: The Divergence of ESG Ratings," published in the *Review of Finance*. It documents the disagreement across the ESG ratings of companies done by six prominent ESG rating agencies. It found that the correlation between the ESG ratings ranged from 0.38 to 0.71, on a scale from -1 (showing total disagreement) to +1 (showing full agreement) (Berg et al., 2022). Put simply, the six rating agencies never all agreed on any company's ESG rating, and in most cases, there was little agreement among them. The paper found three sources of divergence: differences in which ESG indicators were included, their relative importance/weights, and how the indicators were measured. The rating agencies are for-profit companies that have strong financial incentives to provide "useful" information to their clients. Clearly, no one rating format is objectively more useful to investors and other consumers of the information reported, since multiple formats compete with each other in the marketplace.

4. Enforcement

An integral part of any new regulation is an enforcement mechanism. Evidence from the financial and accounting literature shows that enforcement is critical to successfully implementing reporting standards (Christensen et al., 2021). The same is likely true for ESG reporting—without proper enforcement, companies could misrepresent their ESG policies by providing unsubstantiated claims that would create more favourable impressions (i.e., greenwashing), although companies that do so run the risk of alienating important stakeholders if their misrepresentations are discovered. As discussed earlier, complex and broad mandated reporting standards increase the likelihood that firms will inadvertently misrepresent their ESG activities.

> "When companies do not have full access to the ESG information they are mandated to report, perhaps because the relevant information is not routinely collected by those companies, verification will involve complex and costly auditing."

To make standards enforceable, regulators must be able to verify ESG information. However, verifying ESG information is likely to be difficult because, as Christensen et al. (2021) note, ESG metrics frequently "rely on internal information, are highly subjective and lack external reference points like price data or industry benchmarks, which would be helpful for verification" (Christensen et al., 2021: 84).

In addition, when companies do not have full access to the ESG information they are mandated to report, perhaps because the relevant information is not routinely collected by those companies, verification will involve complex and costly auditing. Over recent decades advances in information and communication technologies coupled with low-cost labour and shipping have enabled companies across different industries to disperse their supply chains geographically so that the producers of goods are often located physically distant from input suppliers and end users. For instance, Apple phones, Nike shoes, and Hewlett-Packard laptops are all manufactured by far-flung contractors and not by the companies themselves (Kim and Davis, 2016). Given disaggregated global supply chains across many industries, how accurately can regulators audit the ESG information reported by multinational companies, including the environmental and employment practices of subcontractors?

Kim and Davis (2016) illustrate this challenge by examining the supply chain visibility of conflict mineral reports submitted to the Securities and Exchange Commission under Section 1502 of the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act. The Act requires companies to declare whether their products contain "conflict minerals" originating from the Democratic Republic of Congo. The authors analyzed all conflict minerals reports submitted by over 1,300 companies listed on US stock markets. They found that almost 80 percent of the companies admitted they could not know for sure if their products contained such minerals—despite having three years to investigate the question. Only 1 percent could declare with certainty that their products were conflict-free. Moreover, their analysis showed that internationally diversified companies and companies with large and more dispersed supply chains were less likely to identify whether their products contained conflict minerals.

The enforcement challenges discussed in this section are mitigated, if not completely eliminated, by restricting the scope of mandated ESG disclosures to corporate behaviours that are *financially* material to investors and that potentially affect firms' long-term value creation. This is currently the case in Canada, where public companies are obliged under securities regulation to disclose material risks to their financial prospects. However, if the scope of mandated and standardized ESG disclosure rules are broadened to encompass non-financially material ESG-related corporate information, enforcement costs will skyrocket, even as the information reported becomes less reliable.

"If the scope of mandated and standardized ESG disclosure rules are broadened to encompass non-financially material ESG-related corporate information, enforcement costs will skyrocket."

Conclusion

In this essay, we identify challenges to mandating a uniform set of ESG reporting standards. The challenges arise in defining ESG materiality, defining the scope of ESG standards, measuring and aggregating ESG information, and enforcing ESG standards. We argue that implementing and enforcing a standardized ESG reporting framework that is applied to all public companies is economically impractical, if not technically impossible, owing to the distinctive features of ESG reporting, which differentiate it from financial reporting.

It should be acknowledged that any set of regulations imposes costs. Hence, current regulations regarding mandated reporting of financially material information are subject to some of the same concerns as those associated with mandating a set of ESG-related disclosures that may have no material consequences for investors. However, the costs associated with mandated ESG disclosures that are applied uniformly across broad segments of national economies are certainly orders of magnitude greater than the costs associated with existing financial disclosure regimes.

Endnotes

1 The objective of financial reporting is to provide information about an accounting entity that is useful to "existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity. Those decisions involve buying, selling, or holding equity and debt instruments and providing or settling loans and other forms of credit" (FASB, 2018: 1).

2 A dramatic example is the increased public concern about racial equity after the killing of George Floyd by a police officer in Minneapolis in 2020.

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