YTT. Consulting
Strategy and Sustainability

The Challenge Of Company Disclosure On ESG Topics

ESG & Sustainability Transformation

Hung NINH 12/2023 ESG Transformation

info@ytt-consulting.com ytt-consulting.com H/O: London | UK B/O: Hanoi | Vietnam

The Challenge Of Company Disclosure On ESG Topics

Companies have variable disclosure policies and reporting. While for listed companies, minimum accounting reporting standards are adhered to, these standards vary from one region to the next. Disclosure of ESG data is often not compulsory under typical reporting standards. Although “material factors affecting financials” is a standard reporting idea, management has large flexibility in what is chosen to be reported. Conversely, over-disclosure can be a problem, particularly of non-material ESG information.

Simply because a company does not disclose relevant ESG data does not necessarily mean it is managing its ESG risks or opportunities poorly. Smaller companies with fewer resources typically put less effort into reporting disclosure. There are geographical differences in reporting, so cultural differences can lead companies to assume different judgments on the materiality of certain ESG factors. Management might also assume that certain information is of limited importance to investors or is commercially sensitive. ESG information might be available to other stakeholders (e.g., supply chain information to suppliers, supply chain audit to business customers) but not publicly available to investors.

Disclosure varies by geography and is influenced by company size (because of company resources) and industry practice. The current problem is that businesses look at each other and look at the actions of management agencies. In other words, Wait and See.

Certain ESG data might be easier to collect and disclose but might not be considered material by investors. However, in terms of ESG reporting, data might be important to other stakeholders (even if it is not material to investors), so a company might choose to disclose this non-financially material information.

That said, a lack of disclosure could be an indicator of poor management, and many investors prefer to see relevant disclosure so judgments can be made. One common technique is to ask company management, often investor relations, to disclose, where possible, missing ESG data or explain why the data might be missing.

Other issues are that an ESG disclosure, when revealed, might be unaudited, incomplete, or incomparable to other companies. This goes against the nature of reporting in terms of relevance, transparency, comparability, and accountability.

While poor disclosure is a challenge to market efficiency, this relative inefficiency could arguably be a source of superior risk-adjusted return for the skilled investor. This argument would suggest this type of investment analysis is about superior judgments concerning qualitative, non-computable factors and how things are likely to unfold in the future.

EXAMPLE:

Assessing What an E Disclosure Might Imply:

A cement company discloses its carbon mitigation strategy but discloses only its carbon scope 1 emissions, omitting scopes 2 and 3.

Some of its competitors do not disclose any carbon data, and some disclose data on all three scopes. The carbon data the company discloses would have been assured by an independent third party.

An analyst might want to ask the following questions:

- What is the size of the company? A company that is smaller with respect to employees, resources, or market capitalization might not be expected to report to the same standard as a larger company, though over a material item, this might be a weakness.
- Does the presence of a narrative and strategy (and its strength or weakness) improve an analyst's view on disclosure? Is this narrative reporting aligned with best practice guidance (for instance, the International Accounting Standards Board's IFRS Practice Statement on Management Commentary)?
- How well does the company compare to its competitors?
- Are there any signs from reading the strategy or the size of the scope 1 data?
- Would the business model suggest scope 2 would be a material matter? The fact that the scope 1 data has third-party assurance should, with all other matters being equal, give more weight to the disclosure.
- How long has the company been disclosing, and has management made other commitments to future disclosure?

Answers and judgments to these types of questions will sway how an analyst rates a company (e.g., on a scorecard approach) or the discount rate they might use in a DCF or valuation.

As a follow-up, the analyst could call the company and ask for an explanation of the data's absence and the company's view on its materiality, then judge its willingness to engage or commit to publishing the data. Or the analyst could estimate the data and find a third-party data source.

- A quantitative approach would have to consider how to deal with missing data.
- The analyst also has to judge the materiality of the missing information and might view cement as a carbon-intensive industry.
- A disclosure on carbon intensity would be viewed as more material for a cement company than a software service business.
- A software service business would not be expected to be carbon-intensive.

On occasion, a lack of disclosure can be enough to red-flag an investment completely. For example, a company hires a new CEO but will not disclose in sufficient detail what the long-term incentive plans for management are based on. This might be too strong a red-flag for the analyst to recommend any investment.

Another factor to consider is the strength of environmental accounting. Consensus is currently lacking on how best to account for natural capital. Also, how selective disclosure affects firm value is unclear; academic and investment practitioner work is currently exploring this issue.

The example also shows both qualitative ESG and QESG tools and demonstrates the intertwined nature with traditional assessments.

To learn more about ESG and sustainability-related models, don't hesitate to contact **YTT Consulting**!