

# ESG disclosures and data – the impact on companies

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Discussion of **Environmental, Social, and Governance (ESG)** reporting and data tends to be dominated by the views and perceived needs of investors and other stakeholders. In this article I am going to look at the issue from the perspective of companies.

It is sometimes argued that public reporting requirements are beneficial for companies. They can help to persuade reluctant boards to take ESG issues seriously or provide those companies that are already doing so an opportunity to demonstrate their leadership on these issues. In some cases, they can provide a framework for business planning and risk management.

That is all undoubtedly true, but conversations with companies in recent months suggest that there are also potential adverse impacts on companies that may be underappreciated. It should be emphasized that none of these companies argued against the importance of addressing and reporting on material ESG issues, but they had concerns about the volume and content of the data being demanded and how it is used.

Some of these conversations took place in the context of research Morrow Sodali and Durham University Business School undertook on behalf of the UK's Financial Reporting Council into the impact of proxy advisors and ESG rating agencies on UK listed companies. The report on that **research** was published in June. The activities of the ESG rating agencies are at the root of some of the concerns expressed by companies.

The most common concern is the volume of data that companies are expected to provide and the level of resource associated with doing so. Complying with regulatory reporting requirements can be resource-intensive, but on the whole listed companies understand the need for public reporting and accept it as part of the cost of doing business.

However, many companies we spoke to felt there was less justification for the additional data demanded by ESG rating agencies which could create a lot of extra work, a situation that was exacerbated by the fact that these agencies use different methodologies and data points.

Companies might be more inclined to consider the effort required to measure and report this data to be time well spent if they believed that doing so also helped them in meeting their own ESG objectives and managing the related risk. But many felt that this was not always the case.

The underlying issue is that materiality is defined by regulators and investors, not by the company. Reporting requirements reflect what policymakers consider to be most material in terms of the impact on the environment and society. Data demands from rating agencies reflect what their investor clients consider to be most material in terms of the design and impact on their portfolio.

For some companies, such as those that are significant users of natural resources, the ESG factors they see as material might align closely to those on which regulators and investors are focused. For others, some of these factors may not be material at all. For example, we spoke to an insurance company that had received a low ESG rating because it had not set out detailed waste management policies in its annual report.

In these circumstances, companies have a choice either to ignore the ratings and hope that investors will base decisions on the company's actual ESG performance, or to devote a lot of time and attention to issues that are not material. This is not a very comfortable position for them to be in.

It should also be a concern to policymakers if, by deciding to chase ratings, some companies neglect to address other factors that in their cases could have more material impact on the environment and society. Similarly, if the regulatory reporting burden leads boards to view ESG as a compliance issue rather than a strategic one, that may have adverse consequences not only for the company but for meeting the longer-term policy objectives.

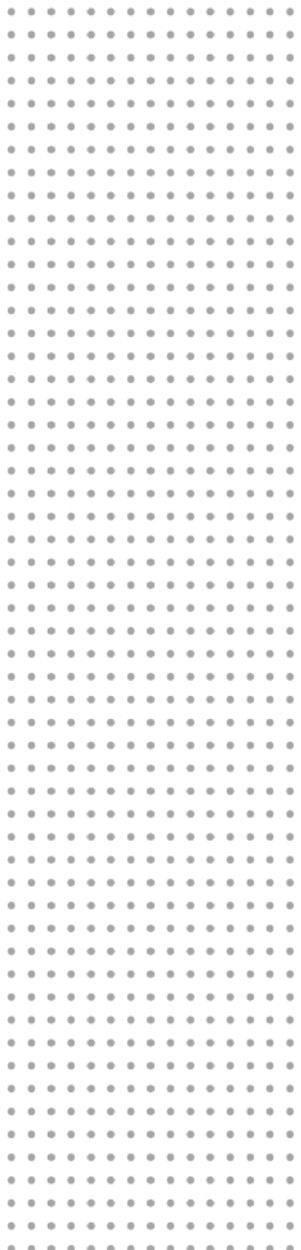
The final recurring topic in many of our discussions was the techniques used by the ESG rating agencies for gathering data, in particular the use of AI for so-called



'data scraping'. Most companies said that information and relevant context in the narrative of the annual report was regularly missed by using these techniques. The concern was that by focusing only on detailed data points, the big picture was being missed and no account being taken of the company's vision and overall ESG performance.

Attempts are being made to address some of these issues. The process of consolidating standards and reporting frameworks that is being led by the ISSB should in time reduce the variety of different matrices and data points being used for specific ESG factors, which in turn should reduce the resource burden on companies. Regulators in several markets, including the European Union and the UK, are considering measures that should at least provide more transparency about methodologies used by ESG rating agencies.

Some of the other problems may be more intractable, though, specifically the materiality mismatch between policymakers, investors, rating agencies and companies. Clearly it is not feasible to have a different regulatory regime or rating for each company or sector. At the same time, if we find ourselves in a position where companies consider it more important to comply with requirements of limited relevance to them rather than address issues that have a material impact on them and their stakeholders, that cannot be to anyone's benefit.



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