NON-FINANCIAL REPORTING, AUDTING, AND CSR INVESTMENTS

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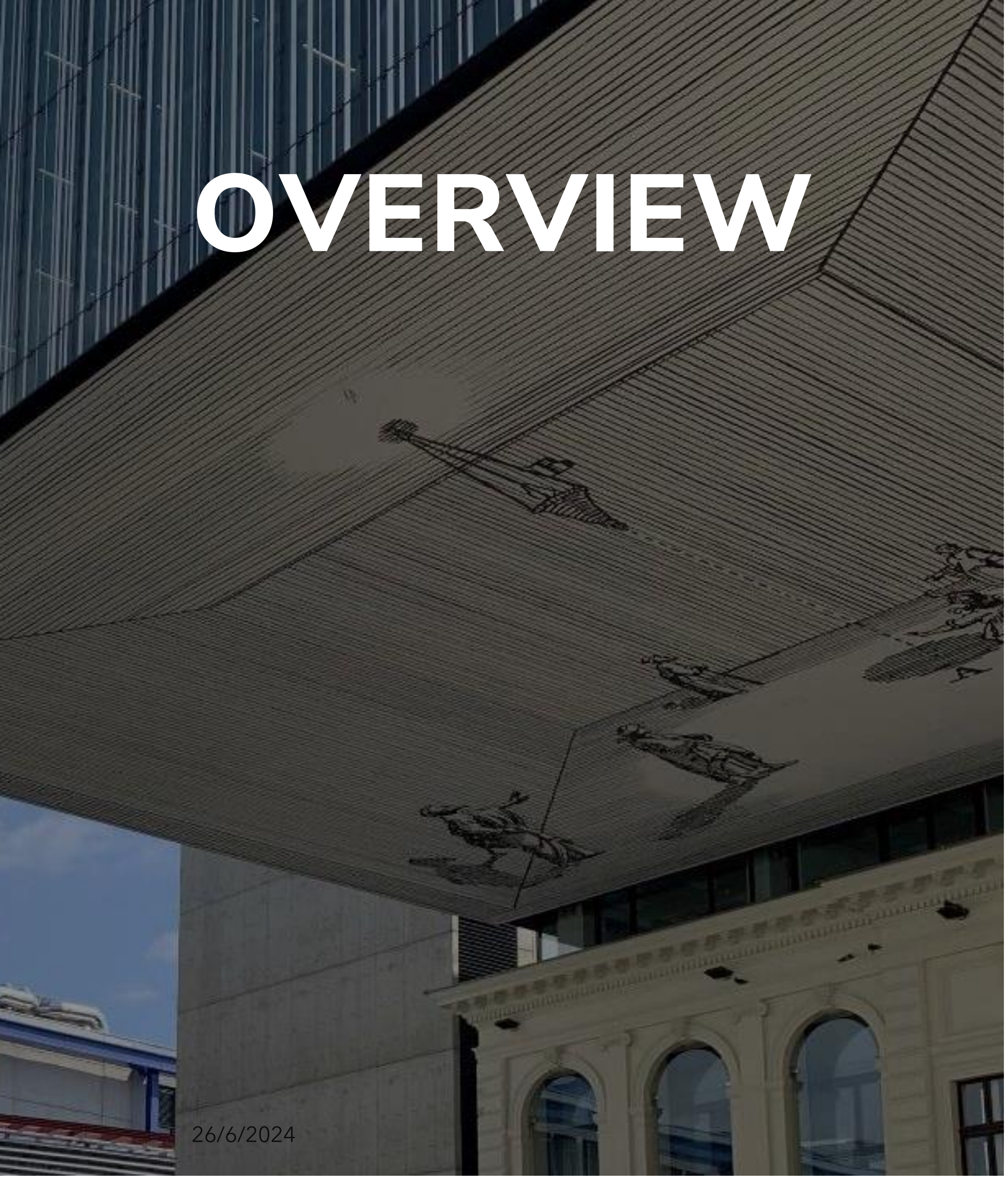
UNI GRAZ

OVERVIEW



MOTIVATION
RESEARCH QUESTIONS
RESULTS

MOTIVATION

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Following the adoption of the **Paris Agreement** in the EU and its member states, the **European Green Deal** was issued with the aim of becoming climate neutral by 2050

The **Corporate Sustainability Reporting Directive** (CSRD) acts as a tool for stakeholders to better understand firms' impact on the environment

The overall aim of the mandate is to increase quality of information on ESG-issues and increase socially responsible investments in Europe

Regulators build on the assumption that investors are in some way concerned with the impact firms have on the environment or with the environment's impact on their investments

This view follows the **double materiality** approach, focusing on **shareholder welfare** rather than shareholder value – others argue only financial repercussions can lead to decreases in externalities

RESEARCH QUESTIONS

How do investors' preferences for ESG shape the economic effects of non-financial reporting mandates?

How do these investor preferences direct firms to increase sustainable investments and do they reinforce incentives provided by consumers?

In what way does a reporting bias help or hinder these incentives when the firm faces financial repercussions from its production externalities?

How does the introduction of mandatory assurance of the non-financial report alter the effort choices of an auditor?

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PAPER 1

ALTRUISTIC INVESTORS AS RECIPIENTS OF ESG DISCLOSURE

LITERATURE REVIEW

EMPIRICS

The **empirical literature** suggests that firm behavior changes after ESG reporting mandates (e.g., Rauter 2020, Fiechter et al. 2022, Christensen et al. 2017)

The effect seems especially strong for countries with a **high degree of agency conflicts**, e.g., in China (Chen et al. 2018, Lu et al. 2021)

Improvements in ESG performance lead to additional **costs** and incentives for **green washing**, few studies address welfare aspects

Underlying mechanics are hard to evaluate - we cannot determine if negative effects on firm value stem from investors' fear of future cash-flow consequences or because they have non-monetary preferences

EMPIRICS

Voluntary assurance of ESG reports is already a increasingly common practice to increase credibility of corporate sustainability reports (Simnett et al. 2009, Michelon et al. 2018)

The CSRD **mandates** assurance of ESG reports beginning with the fiscal year 2024, with an expansion of the scope and depth of the audit towards **reasonable assurance** planned in the medium term

Empirical studies in this area is scarce due to the low number of mandates

Whether **Big 4 auditors** provide better assurance services than **specialist providers** evidence is inconclusive (Del Maso et al. 2020; Lu et al. 2023, Ackers and Eccles 2015)

THEORY

Tase for ESG performance can have **asset price implications** – financial performance is sacrificed for "greenness" (Fama/French 2007)

Uncertainty about ESG performance is crucial as investor holdings depends on the level of ESG risk -> disclosure improves decision making as investors use of ESG reports feeds back to real effects at the firm level (Friedman/Heinle 2016)

Increasing **accuracy** of ESG reports is not always optimal as it can create **inefficiencies** (Xue 2023) and more responsible shareholders do not always lead to lower cost of capital for firms with improved ESG performance (Goldstein et al. 2022)

While mandated reporting instead of voluntary reporting limits free-riding, isolated ESG mandates create emission leakage (Xue 2023)

Future research can focus on whether mandates improve transparency & comparability, how greenwashing incentives are affected, mandated ESG audits,…

PAPER 3

CAN REPORTING BIAS AID IN CORPORATE DECARBONIZATION?

ANALYTICAL MODEL

PAPER 3

Paper studies whether carbon or financial **reporting discretion** can incentivize firms to increase investment in **corporate decarbonization**

The firm operates in a jurisdiction that applies a **carbon pricing mechanism** (carbon tax, emission trading system), generating cash flows and emissions

Manager strategically decides to invest in decarbonization to reduce financial repercussions stemming from the carbon tax and capital market pricing the firm

Both channels link to **corporate reporting** (financial report and ESG report)

Investment in decarbonization can reduce taxation and shareholder pressure but creates costs and might **reduce financial performance**

BENCHMARK

Without misreporting the manager chooses the optimal investment level by balancing the benefits of decarbonization against reduced production efficiency

What happens when reporting isn't truthful?

- **Green- or Brownwashing**
- **Upwards or Downwards Earnings Management**

Expectation?

- Manager understates emissions or inflates cash flows, leading to underinvestment in decarbonization
- Manager caters to respective investors – if a lot of green investors are present, investment level rises
- Manager is more likely to invest if the emission tax is increasing

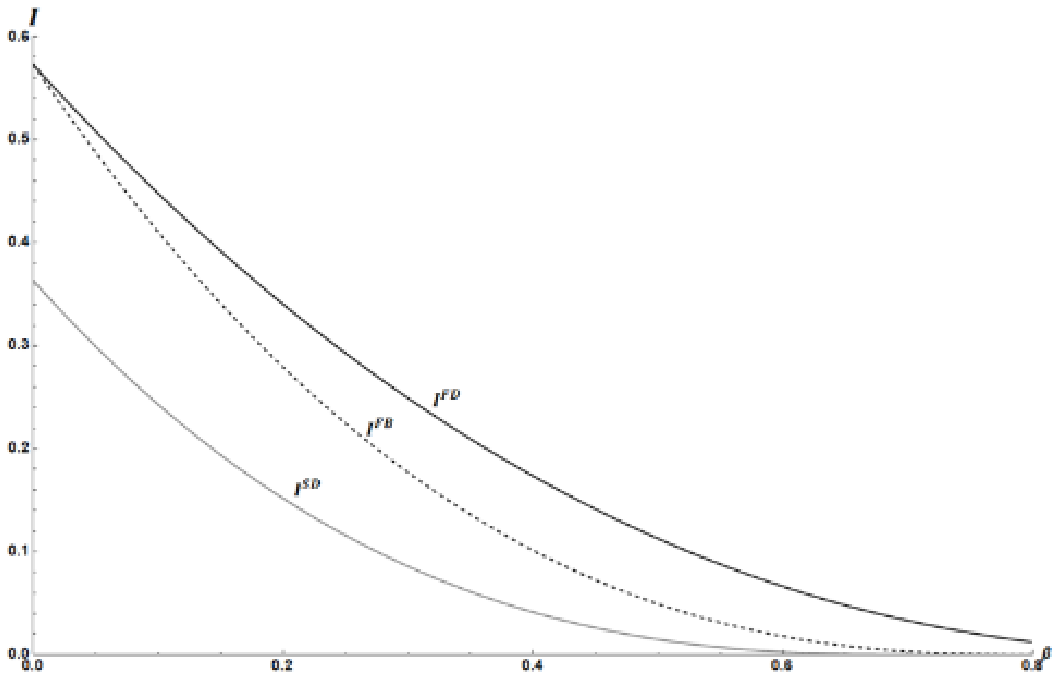
RESULTS

If misreporting is only possible in either report, the manager strategically biases his report upwards, leading to investment distortions.

Financial reporting discretion leads to **overinvestment**

Shareholders anticipate increased biasing and respond more strongly to the ESG report

Strict enforcement does not lead to the highest investment in emission reduction



RESULTS

If misreporting is possible in both reports, the manager will always **bias** at least one report **upward** while strategically biasing the second report up- or downwards

Depending on the impact of investment on financial performance, he might **over- or underinvest** in decarbonization

While higher **shareholder pressure** increases the level of investment distortion, increased **carbon price** does not affect the investment distortion

EXTENSION

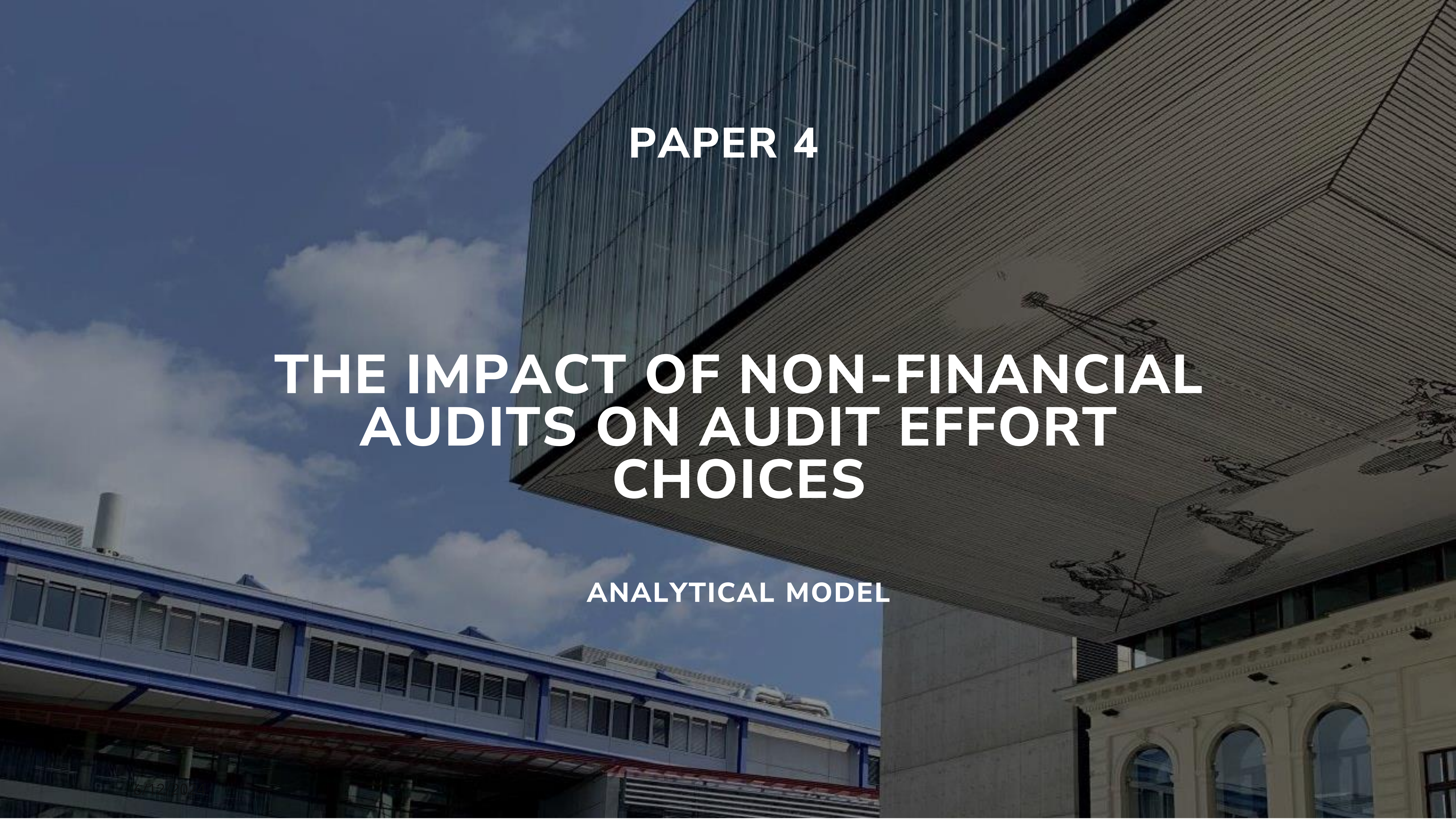
What changes if we add an **auditor** to provide assurance to the ESG report?

Auditor faces **litigation** if fraudulent greenwashing remains undiscovered and has to bear **direct effort costs**

Results?

- Investor reaction to the ESG report gets more pronounced, leading to higher investment but also increased incentives for greenwashing
- When **litigation** for the auditor increases, the manager decreases greenwashing but his **investment incentives** also decrease
- The auditor might choose a **lower audit effort** when litigation increases

DISCUSSION



PAPER 4

THE IMPACT OF NON-FINANCIAL AUDITS ON AUDIT EFFORT CHOICES

ANALYTICAL MODEL

PAPER 4

Paper studies the implementation of a **mandatory audit for ESG reporting** and how **audit effort** choices are impacted because of it

Changes in cost parameters leads to a **substitutive** or **complementary** effect

Increased **litigation** for ESG audits can lead to unintended effects, e.g., decreasing ESG audit effort

In a **two provider setting** the results hold structurally if a sharing rule is introduced (subcontracting)

Audit quality can be higher in either setting even without the explicit assumption of **synergies**