EFR summary

Ethics and Sustainability, FEM11111

2025 - 2026

Weeks 1 to 6

Deloitte.

DeNederlandscheBank
EUROSYSTEEM

Details

Subject: Ethics and Sustainability (AAC) 2025 - 2026

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Lecture 1: Ethical theories

Business ethics: functions, domains, & disciplines

- **Moral philosophy**
  - *Normative ethics*
  - Evaluate what should be considered right and wrong decisions.
- **Behavioural psychology**
  - *Descriptive ethics*
  - Explain people's right and wrong actions.
- **Management studies**
  - *Ethics management*
  - Apply management tools to facilitate moral behavior.

Understanding ethics: Ethics is about **principles/values/norms**, and acting morally in the right way, not just following laws. Ethics is not a simple "correct answer" system, it's more about **critical thinking and reflection** on morality.

Ethics, law, and compliance

Ethics: What moral dilemmas are faced?
Law: What behavior is legally required?
Compliance: What norms are to be obeyed?

How is the ethics of an action best determined?

Core leadership dilemma: even if something is **legal and profitable**, it can still be unethical (e.g., environmental harm). 3 "lenses" to judge actions:

1. Consequences
2. Principles/duties
3. Character/virtues

Ethical theories

Three major ethical theories, each focusing on a different basis for morality:

- **Virtue ethics** (character/person)
- **Deontology** (conduct/rules/duties/acts)
- **Consequentialism** (effects/outcomes/results)

Effects: Consequential ethics

The effect of the behavior determines the ethicality: the action is moral if the positive consequences outweigh the negative consequences.

- Identify relevant courses of action
- For each action, identify positive and negative consequences
- Calculate the net benefit of each action
- Choose the action with the highest net benefit

Consequential ethics = moral decision-making through a **cost–benefit style logic**: pick the option with the **highest overall net benefit**.

Advantages:

- Fits with reasoning in market
- Application in political context, in science and in personal life (widely usable)

Disadvantages:

- Practical: The problem of measurement and comparison
- Fundamental: The problem of justice and rights

Examples of decisions:

- "It is best for the consumer that we stop selling this product."
- "We increase salaries because our employees enjoy this."
- "To contribute to society, we decrease our ecological footprint."

Conduct: Deontological ethics I

The morality of an act is determined by the nature of the act; the obligation to behave in accordance with certain principles, duties, and rights.
So, actions are moral when they follow **principles, duties, and rights**, regardless of consequences.

Advantages: Clarity & consistency

Problems:

- Black-white (not flexible)
- What about conflicting rights or principles?
- Effects are not taken into account

Examples of decisions:

- "We will not pay this bribe, because it violates fair competition."
- "We inform customers about the product defects because we are obliged to."
- "We dismiss this manager because he has broken our rules."

Character: Virtue ethics I

Virtue ethics judges decisions as right that are taken based on a **virtuous mind-set** and congruent with a **good moral life** (so it is about *being good*, not only following rules or calculating outcomes).

Advantages: Flexibility, Inspiring

Problems:

- Difficult to operationalize (harder to "measure" in practice)
- Vulnerable to relativism (may differ across cultures)

Examples of decisions:

- "Because we are an honest company, we…"
- "Because we are a client-centric company, we…"
- "Nothing is more important than being ethical. Therefore…"

Examples of virtues: Acceptance, accountability, bravery, empathy, fairness, forgiveness, honesty, integrity, justice, kindness, loyalty, patience, trust, wisdom, etc..

Overview of ethics theories

Virtue Ethics ("Be a good person!")

- Concepts: Good life, values in action
- Philosophers: Aristotle, Saint Thomas Aquinas, Confucius
- Criticism: Limited applicability in concrete dilemmas; value conservatism and need to define virtues in quickly changing world

Deontology ("Follow higher principles and duties!")

- Concepts: Moral principles, duties, rights, justice
- Philosophers: Immanuel Kant, John Locke, John Rawls
- Criticism: Conflicting duties and principles; practicability versus moral rigorism; neglectance of consequences of actions

Consequentialism ("Judge by the outcome!")

- Concepts: Greatest happiness principle, utility, hedonism
- Philosophers: Jeremy Bentham, John Stuart Mill
- Criticism: Feasibility and complexity of assessment; inferiority of single individuals and minorities' interest; fair distribution

Examples of ethical considerations: sustainability

- Environmental Responsibility: Ethical duty to minimize harm to the planet.
- Social Equity: Promoting fairness and reducing inequality.
- Economic Integrity: Balancing profitability with sustainable practices.

Why good leaders can still get ethical decisions wrong

Even experienced leaders make poor ethical calls because of how our brains work. Common traps to watch for:

- Moral disengagement: We distance ourselves from the consequences ("It's not my decision," "Everyone does it")
- Framing effects: How a dilemma is presented shapes our response (e.g., "It's a business issue, not an ethical one")
- Groupthink: Pressure to conform or not challenge dominant views
- Overconfidence bias: Belief that we are immune to poor ethical choices
- Rationalizations: We justify questionable actions ("It's for the greater good," "It's just how this market works")

Key takeaway: ethical dilemmas often don't have one perfect answer, but good leaders use a **strong decision-making process**, consider multiple ethical theories, and communicate clearly.

Some ethical dilemmas relating to accounting

- manipulating timing of **expenses**
- premature **revenue recognition**
- hiding **fraud/irregularities** for self-protection or reputation

Lecture 2: Ethics management

From normative ethics to ethics management

- **Normative ethics** asks: What is the right thing to do? → Focus on moral reasoning and justification
- **Ethics management** asks: How do organizations make ethical behavior more likely in practice? → Focus on systems, structures, and incentives

Ethics management tools often reflect different ethical theories:

- outcomes & harm reduction (consequentialism)
- rules & compliance (deontology)
- culture & leadership (virtue ethics)

"Seeing" ethical blindness

Ethical blindness refers to situations where individuals temporarily lose the ability to see the ethical dimension of a decision.

Ethical blindness is **not caused by bad character**, but by **context and pressure**:

- **Goal fixation** (e.g., focus on targets, deadlines, performance indicators)
- **Normalization** (e.g., "This is how things are done here")
- **Incrementalism** (e.g., small steps that gradually cross ethical boundaries)
- **Authority & pressure** (e.g., deference to superiors, fear of consequences)

Unethical behavior is not just "bad individuals", organizations and environments can produce it → therefore, ethics management tools/systems are needed.

Ethics = doing the right thing(s) for the right reason(s) at the right time(s)

Examples of unethical behavior: bribery, sexual harassment, discrimination, fraud, …

The ethics management process: 3-stage process for reaching moral excellence

1. **Evaluate the ethical problem** by understanding the context and comparing possible actions.
2. **Explain behaviour** by identifying what influences decisions (drivers/inhibitors, individual factors, situational factors).
3. **Apply ethics tools** by choosing appropriate management tools, using them, tracking results, and monitoring the overall process.

Business codes as an ethics management tool

A business code = formal guidelines/rules that steer behavior internally (managers, employees) and externally (stakeholders, society).

Ethics programs

An ethics program is the formal organizational control system designed to prevent unethical behavior and encourage ethical behavior.

Definitions of ethics programs

- **Communication Program:** Initiatives to consistently promote awareness and understanding of the organization's ethical standards through various channels.
- **Whistleblower Policy:** A framework that allows employees and stakeholders to report unethical practices anonymously without fear of retaliation.
- **Compliance Office(r):** A designated role or department responsible for overseeing adherence to laws, regulations, and internal ethical guidelines.
- **E-Learning:** Online training modules designed to educate employees on ethics-related topics and scenarios.
- **Ethics Training:** Regular workshops or sessions that equip employees with tools and knowledge to make ethical decisions in their work.
- **Ethics Hotline:** A confidential channel for employees to report ethical concerns or seek guidance on ethical dilemmas.

Role of ethics programs in ethics management

1. **Prevention (P)**: Reduce the likelihood of unethical behavior
- E.g. Codes of ethics
- Ethics training & communication
- Clear policies, procedures, role expectations

2. **Detection (D)**: Identify unethical behavior when it occurs
- Monitoring & audits (financial and ESG)
- Ethics hotlines & whistleblower mechanisms
- Risk assessments & red-flag indicators

3. **Response (R)**: Address misconduct and prevent recurrence
- Investigations
- Sanctions & remediation
- Corrective actions & system improvements

The goal is not "perfect behavior" but **readiness and responsible handling**.

Eosta ESG scenario: prevention/detection/response

Prevention

- How can Eosta redesign its **training programs** to educate employees and suppliers about the importance of accurate ESG reporting?
- How can Eosta use **risk analyses** to identify high-risk suppliers or operations that are likely to engage in unethical behavior?

Detection

- How can Eosta leverage **monitoring systems** to detect discrepancies in its sustainability metrics?
- What role should an **ethics hotline** or **whistleblower policy** play in uncovering internal or supplier-level misconduct?

Response

- How should Eosta respond to the investigative report to rebuild stakeholder trust while maintaining transparency?
- How can Eosta's **compliance team** ensure that corrective actions are effectively implemented and prevent recurrence?

Summary: The ethical role of accountants is not only to report numbers correctly, but to protect the integrity of decision-making under pressure.

Lecture 3: Do we have a business case for sustainability?

Sustainability is essential due to societal challenges, regulation, and changing labor market requirements.

Business case: Structured justification for a proposed business initiative or project based on costs and benefits.

- Does sustainability **financially pay off** for firms?
- Do investors earn **abnormal returns** from sustainable firms?

Many studies and media sources suggest sustainability and ESG are financially beneficial.

What is sustainability?

- No universal definition
- Brundtland Report (1987): Sustainable development meets present needs without harming future generations
- Ethics connection:
  - Harming future generations is unethical
  - Business ethics provides foundation for corporate sustainability

Terminology overview:

UN Sustainable Development Goals (SDG)

- Adopted in 2015, 17 interlinked goals
- Global roadmap for governments, firms, and society
- Each goal has measurable indicators

Formal perspective on sustainability

Sustainability measured via **stocks of capital**:

- Produced capital: machines, infrastructure.
- Knowledge capital: patents, intellectual assets.
- Human capital: education, skills, health.
- Natural capital: renewable & non-renewable resources, biodiversity, climate.

Key condition: Stocks we leave to future generations ≥ stocks we inherited.

Sustainability depends on preserving total capital, especially natural capital.

Inclusive Wealth Report

- Measures sustainability for 140 countries (1992–2014)
- Tracks: Produced capital, Human capital, Natural capital
- Conclusion: More produced capital, Less natural capital

Economic growth often comes at the expense of natural capital.

Measurement challenge options:

A leaves equal stocks → sustainable. B leaves more land but less art → unclear

→ Sustainability depends on valuing different assets

Steps to assess sustainability:

1. Measure changes in capital stocks.
2. Assign prices to evaluate social wealth changes.

Challenges: Some changes are hard to measure. Some stocks lack market prices (e.g. biodiversity, pollution).

Conclusion: Person B's sustainability depends on how land and art are valued.

Externalities

Key importance: Externalities are crucial for sustainability and the business case.

Definition:

- Externalities are **not priced by the market** (market failure).
- Can be positive or negative.
- Occur in production or consumption.

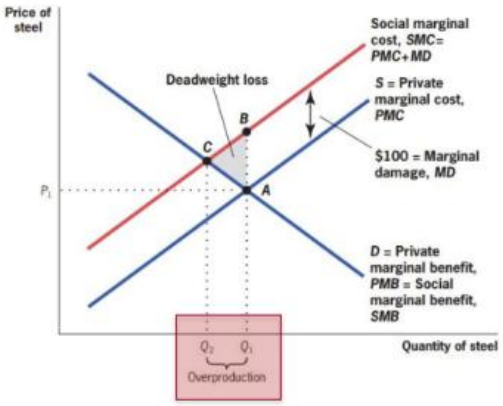
Negative externalities:

- Costs imposed on third parties.
- Examples: Factory pollution, Passive smoking

Core idea: Actions of one agent affect others outside the market mechanism.

Example: Steel plant produces steel and sludge. Sludge dumped into river. Fishing industry downstream loses $100 per unit of steel. Economic explanation:

- If the firm doesn't pay for damage → negative externality.
- Leads to: Overproduction and Deadweight loss



- Marginal private cost < marginal social cost.
- Market output higher than socially optimal output.

Remedies for negative externalities

Key idea: **Internalizing the externality**.

- External costs are reflected in prices through private negotiation, or government intervention.
  - Current prices reflect only private costs.
  - Future prices should include social costs to people and planet.

Remedies: private vs public solutions

Private-sector (Coasian) solutions

- Well-defined property rights + costless bargaining.
- Externalities priced through negotiation.
- Example: river owners charge polluters.

Public-sector solutions

- Pigouvian taxes (equal to marginal damage).
- Quantity regulation (force socially optimal output).

Key question:

- *What's the catch?* → leads to assignment and measurement problems.

Assigning damage

- Example damage = **$100** (from the steel plant case). Key questions:
  - Where does this number come from in reality?
  - Can we trust affected parties (e.g. fishing industry) to report damages accurately?
  - What about broader ecosystem damage that is harder to observe?

Assigning blame

- Multiple pollution sources may exist along the river.
- Environmental damage may have **natural causes** (e.g. disease).

Do we have a business case for sustainability?

Materiality connects **externalities** to the **business case for sustainability**.
Key links: Externalities ↔ Materiality ↔ Business case

Externalities

- Occur when actions affect others outside the market.
- Are typically **not priced**.

Materiality

- Firm activities can be **material or immaterial** for firm performance.
- Core concept in: financial reporting and sustainability reporting (defines what firms must report)

Business case

- Does sustainability improve firm performance?
- Can investors earn abnormal returns from sustainable firms?

Materiality in accounting, formal accounting definitions:

- **IASB**: Information is material if omitting or misstating it could influence users' decisions.
- **FASB**: An item is material if its omission or misstatement would likely affect the judgment of a reasonable person.

Examples

- Small office equipment: expensed instead of capitalized (immaterial).
- Legal provisions not recognized if cash outflow probability is low (IFRS 37).

Core idea:

- Materiality depends on **decision usefulness**.

Types of materiality in sustainability

1. Financial materiality

- **Outside-in perspective**
- How environmental (ENV) and social (SOC) issues affect the firm financially.
- Externalities are already **priced**.
- Examples: Natural disasters disrupting supply chains, Investing in green technology to reduce costs or avoid fines.

2. Impact materiality

- **Inside-out perspective**
- How the firm affects society and the environment.

- Focus on **unpriced externalities**.
- Examples: Pollution and emissions, Labor conditions in supply chains.

3. Double materiality

- Combines both financial and impact materiality.

Why materiality is challenging

- Organization-specific (not all firms have the same material issues).
- Time-sensitive (changes in regulation or public opinion matter).

Lecture 4: Does mandatory sustainability reporting work?

Recap: Remedies for externalities

Externalities:

- Occur when actions of one economic agent affect others **outside the market**
- Core issue for **impact materiality**

Solution: Internalizing externalities

- Regulation can force prices to reflect **true social costs or benefits**
- Current prices exclude **social costs to people and planet**, future prices (after regulation) include these costs

Reporting as a solution?

Key question: Can sustainability reporting help internalize externalities?

Mechanism (targeted transparency regulation):

1. Mandatory disclosure improves **quantity and quality of information**
2. Stakeholders: Update beliefs, Pressure low-performing firms, Impose implicit "price" on poor sustainability
3. Firms respond by improving sustainability

Potential problems:

- Boilerplate or selective disclosures
- Stakeholders may not care or face coordination problems
- Greenwashing
- Unintended consequences

Other channels through which sustainability reporting helps

Capital markets

- Reduces **adverse selection**
- Improves **capital allocation** toward sustainable firms
- Non-sustainable firms face higher financing costs

Internal learning

- Reporting creates awareness
- "What gets measured, gets managed"
- Benchmarking against peers (e.g. GHG emissions)

Societal pressure

- Public attention can shift consumer and investor preferences
- Sustainability becomes financially material

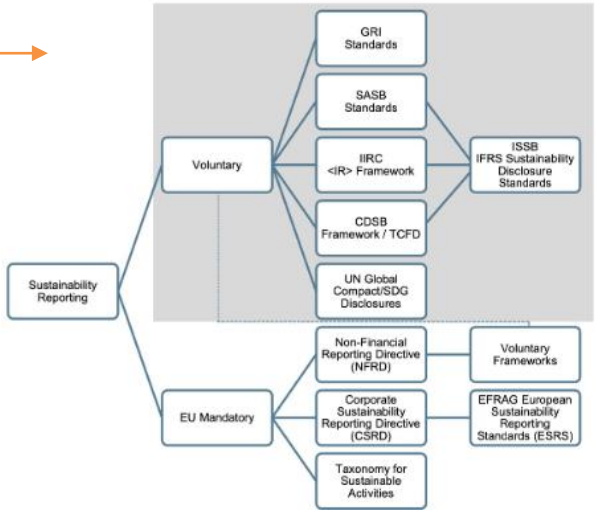
Sustainability reporting

Reporting trends & challenges

Key differences from financial reporting:

- **Users:** Broader, less specialized, impact-focused
- **Topics:** Multi-dimensional (E, S, G)
- **Measurement:** No common unit
- **Time horizon:** Long-term and strategic
- **Firm boundary:** Includes supply chain
- **Materiality:** Financial vs impact (double materiality)

Reporting frameworks and standards



Why firms report voluntarily:

- Lower cost of capital
- Attract investors/analysts
- Signal profitability
- Reputation management
- Insurance against future regulation
- Social license to operate

Overview of major voluntary frameworks

1997 – GRI (Global Reporting Initiative)

- **Purpose:** Broad sustainability reporting
- **Audience:** Wide range of stakeholders, highest adoption of voluntary works
- **Focus:** Environmental, Social, Governance (ESG)

- **Style:** More **prescriptive**, generally applicable across sectors

2000 – CDP (Carbon Disclosure Project)

- **Purpose:** Collect standardized environmental data
- **Audience:** Investors and other stakeholders
- **Focus:** Mainly **Environmental** (climate, water, forests, supply chain)
- **Style: Prescriptive**, topic-specific questionnaires

2010 – IIRC (Integrated Reporting)

- **Purpose:** Explain how organizations create value over time
- **Audience:** Investors
- **Focus:** Integrated view of **strategy, governance, performance, and prospects**
- **Style:** More **principles-based and flexible**

2012 – SASB (Sustainability Accounting Standards Board)

- **Purpose:** Identify financially material sustainability issues
- **Audience:** Investors
- **Focus: Sector-specific ESG issues** tied to financial performance
- **Style: Highly prescriptive** and industry-specific

2017 – TCFD (Task Force on Climate-related Financial Disclosures)

- **Purpose:** Improve disclosure of **climate-related financial risks and opportunities**
- **Audience:** Investors, lenders, insurers
- **Focus:** Governance, strategy, risk management, metrics & targets (climate)
- **Style: Flexible**, principles-based

This shows a shift from **broad sustainability reporting** (GRI) toward **investor-focused, financially material, and risk-based disclosures**, especially around **climate change** (SASB, TCFD), with increasing emphasis on integration into core business and financial decision-making.

GRI standards structure

Universal standards:

- **GRI 1:** Foundation (outlines purpose, principles like accuracy & verifiability)
- **GRI 2:** General disclosures (firm's structure, governance, strategy, policies)
- **GRI 3:** Material topics (impact assessment process)

These standards apply to **all reporting organizations**.

GRI sector & topic standards

Examples include:

- **Sector standards:** Oil & Gas, Coal, Agriculture
- **Topic standards:** Economic performance, Biodiversity, Health & Safety

Mandatory sustainability reporting mandates

Why mandatory reporting?

1. **Mitigate deadweight loss**
   - Low-performing firms won't disclose voluntarily
2. **Positive externalities**
   - Public value of information exceeds private value
3. **Market-wide cost savings**
   - Standardization reduces duplication and comparison costs
4. **Enforcement**
   - Reduces boilerplate reporting and greenwashing

Worldwide regulatory landscape

- 35 countries have ESG disclosure mandates, adoptions between 2001–2019
- Many mandates issued by regulators (not exchanges)
- Mix of comply-or-explain systems

Carrots & Sticks database

Global ESG regulation database:

- Launched by UNEP & KPMG
- Covers 130+ countries
- Includes legal texts and restrictiveness measures
- Used for cross-country regulatory research

EU mandatory regulation: NFRD, CSRD, EU Taxonomy, ESRS (by EFRAG)

Non-Financial Reporting Directive (NFRD)

NFRD is presented as an unprecedented supranational CSR disclosure regulation.

- Affects many firms across **countries and industries**
- Framed as a major step toward **corporate transparency** in the EU

Timeline highlights:

- April 2014: EU Parliament passes NFRD
- Sept 2014: EU members adopt NFRD
- 2015–2017: National implementation
- 2018: First mandatory NFRD reports
- Feb 2020: Public consultation to review NFRD

Result: Improved comparability, Easier cross-country firm comparison

NFRD and targeted transparency

Regulatory logic:

- NFRD is an example of **targeted transparency regulation**
- Goal: *nudge firms* toward sustainability, not directly force behavior

EU regulator's intent:

- Disclosure is vital for managing the transition to a sustainable economy
- Reporting helps firms **measure, monitor, and manage impacts**

Double materiality

1. **Financial materiality**
   - Outside-in perspective
   - How sustainability issues affect firm value
2. **Impact materiality**
   - Inside-out perspective
   - How firm activities affect society and environment

Both are included under NFRD.

NFRD scope: Applies to **Public Interest Entities (PIEs)** with: ≥ 500 employees *and* ≥ €20m total assets *or* ≥ €40m sales. Includes: Listed firms, Banks and insurance companies, Firms designated by national authorities

NFRD content requirements: No mandatory standard (e.g. GRI optional), but firms must disclose on: Environmental issues (emissions, water, pollution), Social and employee matters, Human rights, Anti-corruption and bribery, Board diversity
Also required: Policies, Principal risks, Non-financial KPIs

From NFRD to CSRD: consultation results

Public consultation (2020, N = 588 respondents) revealed problems:
Users say NFRD reports lack: Comparability (84%), Reliability (74%), Relevance (70%)
Preparers say: 64% face excessive additional information requests

Broad support for reform:

- 82% want common reporting standards
- 67% support audit requirements
- 64% support digital tagging
- 70% support expanding scope (e.g. large non-listed firms)

NFRD allowed too much flexibility → weak comparability.
→ These findings motivate the **CSRD**.

FROM NFRD → TO CSRD

Key changes under CSRD

Expanded scope: From ~11,600 firms (NFRD) to ~49,000 firms (CSRD)

Reporting format:

- Sustainability info integrated into **management report**
- Mandatory **digital tagging (XHTML)**

Assurance:

- Mandatory **limited assurance**
- Possible future **reasonable assurance**

Reporting standards:

- Binding **ESRS** developed by **EFRAG**

Phased implementation:

- 2024: Large PIEs
- 2025: Other large firms
- 2026: Listed SMEs (opt-out for 2 years)
- 2028: Non-EU firms with major EU activity

CSRD in broader EU regulation

CSRD is part of a wider **sustainable finance package**, including:

- **EU Taxonomy** (defines sustainable activities)
- **SFDR** (Sustainable Finance Disclosure Regulation)
- **CSDDD** (Corporate Sustainability Due Diligence Directive – proposal)

Political uncertainty around CSRD

Recent developments (EU Omnibus discussion):

- Scope reduction proposed:
  - Firms with <1,000 employees potentially excluded
  - ~85% of firms currently covered would drop out
- **Double materiality at risk**
  - Possible shift toward single (financial) materiality
  - Would require revising ESRS

Lecture 5: How can we quantify sustainability?

European Sustainability Reporting Standards (ESRS)

European Financial Reporting Advisory Group (EFRAG)

- Private association (est. 2001)
- Originally advised EC on IFRS endorsement
- Asked by European Commission (2020) to develop ESRS based on framework outlined in CSRD
- ESRS adopted July 31, 2023

Current Set of ESRS

1. Cross-Cutting Standards

- ESRS 1: General requirements → provides basic principles of disclosure
- ESRS 2: General disclosures → applicable to all topics for governance, strategy, impact, risk and opportunity management, metrics and targets

2. Topic-Specific Standards

- **Environmental** → E1: Climate change, E2: Pollution, E3: Water, E4: Biodiversity, E5: Resources & circular economy
- **Social** → S1: Own workforce, S2: Workers in value chain, S3: Affected communities, S4: Customers & end users
- **Governance** → G1: Business conduct

ESRS 1: General Requirements

Qualitative Characteristics of Information

- Relevance (decision relevant, with predictive/confirmatory value)
- Faithful representation (complete, neutral, error-free)
- Comparability, Verifiability, Understandability

Purpose → Help users understand:

- Firm's impact on E, S, G
- How sustainability affects financial performance

Stakeholders

- Affected stakeholders (inside-out perspective)
- Users of sustainability reports:
  - Primary: investors, lenders
  - Other: NGOs, trade unions, regulators, civil society

Double Materiality

Two perspectives:

1. Financial materiality (outside-in)
   → How sustainability affects firm value.
2. Impact materiality (inside-out)
   → How the firm impacts society/environment.

Double Materiality Process

A. Understand context
B. Identify impacts, risks, opportunities
C. Assess materiality
Output → D. Reporting

Materiality determines which sustainability matters must be disclosed.

ESRS E1: Climate Change

ESRS E1 is structured into three main parts:

1. General Requirements (Governance & Strategy)

- Integration of climate into governance and strategy (GOV-3)
- Transition plan for climate mitigation (E1-1)
- Resilience of strategy and business model (SBM-3)
- Assessment of climate-related impacts, risks, and opportunities (IRO-1)

→ Climate must be embedded in strategy and decision-making.

2. Implementation (Policies & Actions)

- **E1-2:** Policies on climate mitigation and adaptation
- **E1-3:** Action plans and resources to achieve climate targets

→ Shows how the company puts its climate strategy into practice.

3. Metrics & Targets (Quantitative Disclosures)

- **E1-4:** Climate-related targets
- **E1-5:** Energy consumption and renewable/non-renewable mix
- **E1-6:** Gross Scope 1, 2, and 3 GHG emissions
- **E1-7 to E1-9:** Carbon credits, internal carbon pricing, and financial effects of climate risks → Ensures measurable and transparent climate reporting.

ESRS E1-6: Gross Scope and Total GHG Emissions
Based on the **Greenhouse Gas Protocol**.
Firms must disclose:
Scope 1: Direct emissions (owned/controlled sources)
Scope 2: Purchased electricity emissions
Scope 3: Value chain emissions

ESRS S1: Own Workforce

- **S1 – Own workforce**: working conditions, equal treatment, other work rights
- **Required disclosures**: Policies, Grievance mechanisms, Remediation processes
- **S1 Metrics include**: Gender diversity, Collective bargaining coverage, Adequate wages, Persons with disabilities, Health & safety, Human rights incidents

ESRS G1: Business Conduct

Governance disclosures include:

- **Under ESRS 2:** Administrative & supervisory bodies, Sustainability-linked incentives, Due diligence statement, Risk management & internal controls
- **G1 Specific:** Corporate culture, Anti-corruption policies, Confirmed corruption incidents, Lobbying engagement, Payment practices

ESG Ratings

ESG Rating Industry

- Fast-growing market with **100+ vendors**
- 20+ acquisitions in last 10 years
- 10+ globally visible vendors

Two Main Business Models

1. **Active raters**
    - Example: CDP, RobecoSAM
    - Collect information directly from firms (e.g., surveys)
2. **Passive raters**
    - Example: Refinitiv
    - Use publicly available data

Pricing: Full data access from major providers can cost up to **$50,000**

Usage: 65% of investors use ESG ratings at least once per week. Considered most useful ESG information source (ahead of CSR reports, engagement, in-house research)

Refinitiv (Formerly Asset4)
Example of a large passive rater.

- 150+ research analysts, 400+ ESG input factors, Weekly updates
- Sources: Annual reports, Regulatory filings, CSR reports, News, NGO websites
- 7,000+ listed firms globally, Time series since 2002
- Claims to provide one of the most comprehensive ESG databases
- Owned by London Stock Exchange (LSE), Formerly Thomson Reuters (Asset4)

ESG Ratings: Debate / Concerns

Key Concerns

1. Transparency
2. Reliability & comparability
3. Conflict of interest

Tesla Example
Elon Musk criticized ESG ratings after Tesla was removed from the S&P 500 ESG index while Exxon ranked highly. This sparked debate about rating credibility.
Low Correlation Between ESG Ratings
Berg et al. (2022, Review of Finance); Low correlation due to: 38% differences in scope, 56% differences in measurement, 6% differences in weighting

ESG Ratings: EU Regulation (2024/3005)

Entry into force: July 2, 2026
Scope: Applies to ESG rating vendors operating in the EU (even if located outside EU)
Key Regulatory Requirements

- Separate E, S, and G scores (not only aggregate ESG)
- Disclosure of materiality perspective (financial vs impact)
- Clear separation of business activities to avoid conflicts of interest
- Under authority of ESMA; Transparency on methodologies and data sources

Important insight: ESG rating industry is moving toward regulatory oversight.

Are these concerns unique to ESG ratings?

Other Markets: Corporate Governance (CG) Ratings
CG ratings measure governance effectiveness.
Used by: Institutional investors (for investment and proxy voting decisions)
Big players: ISS, GMI, The Corporate Library, Standard & Poor's
Empirical Evidence; Daines et al. (2010, JFE):

- Low correlation between governance ratings

Other Markets: Financial Analysts
Reference: Bradshaw (2009, The Accounting Review)
Analyst Information Processing:
Information → Processing → Forecasts → Valuation → Stock recommendation
Even financial analysts (in traditional finance) disagree significantly. So disagreement ≠ uselessness.

So, are ESG concerns unique? → No

- Low correlation exists in other rating markets.
- Black-box models are common. (=a lack of transparency about how something works internally)
- Still, regulation and improvement are needed.
- We should not dismiss the entire ESG industry.

Why Do Investors Buy ESG Ratings?

Rating production process:

Stage 1–2: Data Collection / Reduction

- Public information
- Vendor-specific governance catalog

Stage 3: Data Weighting (Proprietary)

- Aggregation
- Weighting of factors

Stage 4–5: Final rating & updates (Commercial)

Investors often use:

- Raw ESG data
- Not necessarily the final ESG score

Quote from SustainAbility (2020): "We use the data in them, not the ratings."
Reasons investors buy ESG ratings:

- Transaction cost savings
- Access to non-public information
- Signaling fiduciary duties

So why do investors buy ESG ratings?

- Different economic incentives
- Usefulness of ESG ratings ≠ usefulness ESG data
- Evidence Lehmann (2019): Governance ratings ≠ Governance data