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Full length article

On the value relevance of information on environmental and social activities and performance – Some evidence from the UK stock market[☆]

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A B S T R A C T

Motivated by the requirements of the UK Companies Act 2006 for a Strategic Report introduced in late 2013, and the subsequent Directive 2014/95/EU of the European Parliament and of the Council, we investigate the relationship between the levels of disclosures on environmental and social activities and performance (analyst following) and subsequent analyst following (subsequent levels of disclosures on environmental and social activities and performance). We do so to investigate the value relevance of information about environmental and social activities and performance. Our evidence is consistent with their value relevance and an associated demand for, or general interest in, such disclosures from informed market participants. We also argue that our results suggest positive links between analyst following and the *quality* of environmental and social disclosure.

1. Introduction

On December 6, 2014, "Directive 2014/95/EU of the European Parliament and of the Council of 22 October 2014 amending Directive 2013/34/EU as regards disclosure of non-financial and diversity information by certain large undertakings and groups" came into force. The requirements of the Directive are for '(…) a non-financial statement containing information to the extent necessary for an understanding of the undertaking's development, performance, position and impact of its activity relating to, as a minimum, environmental, social and employee matters, respect for human rights, anti-corruption and bribery matters' and '(…) any relevant non-financial key performance indicators'.[1] National EU governments then had two years to translate the new Directive into national law.

To this end, a UK consultation, organised by the Department for Business Innovation and Skills (BIS), was launched on February 16, 2016, with comments to be received by April 15, 2016. At the time of the consultation, the UK already had a requirement for all quoted companies to provide information similar to that required by the EU Directive. In particular, the UK Companies Act 2006 requires that the Strategic Report of a quoted company should include information on a range of environmental and social issues. This

☆ This paper has benefitted from the comments of two anonymous reviewers, seminar participants at the Open University, and conference participants at the 2017 IE/LSE/Smith School *JAPP* Conference. Nonetheless, all remaining idiocies are the sole responsibility of the authors.

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[1] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/500760/BIS-16-35-non-financial-reporting-directive-consultation-February-2016.pdf, p.12. To slightly paraphrase the consultation document (p.6), the Directive applies to large undertakings that are public interest entities (PIEs), that have an average of 500 employees over their financial year and that: (i) issue transferable securities that are admitted to trading on a regulated market in the EU; (ii) are a credit institution (a bank or building society, though not a credit union); (iii) are an insurance undertaking; or, (iv) are designated by a Member State as a PIE (for instance because of their business, size, or the number of their employees).

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should be provided '(…) to the extent necessary for an understanding of the development, performance or position of the company's business.'[2] Overall, the original consultation document argued that, other than the concentration on large firms, '(…) the EU framework is broadly similar to the current UK framework as laid out by the Companies Act 2006.'[3]

At the time of the consultation, the preferred option of the BIS was to adopt the Directive as it was written, suggesting that, in the absence of objections, they were content to drop the disclosure requirement for smaller quoted firms (who would still be subject to the requirement to produce a Strategic Report). Following the consultation, the UK Department for Business, Energy, and Industrial Strategy issued the government response to the EU Directive in November 2016 in which the UK government states that it '(…) will create legislation to require companies that fall within the scope of the directive to report using the requirements laid out in the Directive. It will also allow companies outside the scope of the Directive to adopt the EU requirement voluntarily or to continue to use the existing requirements in the Strategic Report.'[4]

Both the UK and the subsequent overarching EU regulation leave broadly unspecified what precisely should be reported under the regulations with respect to, in particular, environment and social activities performance. Put another way, it is left unclear how firm managers should assess the extent to which it is necessary to report information on environmental and social performance, for example, in order that shareholders can form '(…) an understanding of the development, performance or position of the company's business'.[5] Under such circumstances, UK corporate managers would likely want to consider the costs and benefits of the provision of such information and, implicitly, the demand for, or general interest in, such information from shareholders including, in particular, informed shareholder representatives such as financial analysts (analysts being viewed as an important set of users of information about businesses).[6] Further, in particular, there is variation in the extent to which UK companies provide information on environmental and social activities and performance, as measured relative to industry norms.

Within this general context, our study considers the association between analyst following and the levels of disclosure of environmental and social activities and performance in the UK. We do so to identify whether information concerning environmental and social activities and performance is value relevant or not. By value relevant, we mean that the content of the disclosures is potentially useful for predicting the future cash flows of firms over some unspecified time horizon, or their levels of risk, or both, implying that analysts could be interested in this information as an input into their forecasts and recommendations. Further, we assume that corporate managers will take into account the potential demand for, or general interest in, such information from analysts in judging how much disclosure to provide.

We then would not expect to observe any association between the level of environmental and social disclosures and analyst following (once other factors that might help explain either or both of the level of environmental and social disclosures, and analyst following, are properly considered) if information on environmental and social activities and performance is value irrelevant. If information on environmental and social activities and performance is value relevant, such an association becomes possible. The study therefore represents one way of assessing whether environmental and social disclosures are regarded as value relevant by UK stock market participants.[7]

We investigate the possible association between the level of environmental and social disclosures and analyst following in two different ways. First, we ask if the number of analysts making beginning-year, one year-ahead, earnings forecasts is associated with the level of environmental and social disclosure for that year. This question is based upon the idea that, *ceteris paribus*, the size of analyst following can be thought of as a proxy for the demand for information concerning environmental and social activities and performance, and corporate managers will respond to this demand. Second, as an alternative possibility, we ask if the level of environmental and social disclosure in a year is associated with the number of analysts making beginning-year, one year-ahead, earnings forecasts for the subsequent year. This question is based upon the idea that, *ceteris paribus*, analysts are more likely to follow a firm the higher is its level of value relevant disclosures.[8]

[2] http://www.legislation.gov.uk/ukdsi/2013/9780111540169/pdfs/ukdsi_9780111540169_en.pdf, p.3.

[3] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/500760/BIS-16-35-non-financial-reporting-directive-consultation-February-2016.pdf, p.12. The regulation of the requirement to report on environmental and social performance falls within the general obligation to report inside information. Inside information is defined as information that 'if it were made public, would be likely to have a significant effect on the prices of those financial instruments or on the price of related derivative financial instruments (that is, it is information that a reasonable investor would be likely to use as part of the basis of their investment decisions)' under the EU Market Abuse Regulation (Regulation 596/2014). This regulation supersedes previous UK market regulation and 'strengthens the previous UK market abuse framework by extending its scope to new markets, new platforms and new behaviours.' (https://www.fca.org.uk/markets/market-abuse/regulation). The Financial Services Authority's Disclosure and Transparency Rules included similar obligations for fully listed companies over the period covered by the current research. It is difficult, however, to find specific information on actual cases and penalties for non-disclosure.

[4] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/575530/beis-16-41-non-financial-reporting-directive-implementation-consultation-government-response.pdf, p. 4.

[5] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/500760/BIS-16-35-non-financial-reporting-directive-consultation-February-2016.pdf, p. 3.

[6] See Schipper (1991).

[7] It is reasonable to assume that the EU regulators responsible for the Directive believe that EU stakeholders, possibly including stock market participants, have some interest in information of environmental and social performance, for at least some companies. Further, it is also reasonable to assume that UK lawmakers share these basic beliefs, and have done so for a number of years. If shareholders are interested then, presumably, this is because these non-financial disclosures concerning environmental and social activities are assumed to have the potential for providing information useful for predicting the future cash flows of firms over some unspecified time horizon, or their levels of risk, or both.

[8] Arguments for both of these possible relationships can be found in Lang and Lundholm (1996).