Article

2024 International Conference on Business Economics, Education, Arts and Social Sciences (EASS 2024)

The Impact of ESG Reporting on Analyst Forecast Accuracy: A Cross-Market Review

Zifei Meng [1,*]

[1] Business School, University of New South Wales, Sydney, Australia
* Correspondence: Zifei Meng, Business School, University of New South Wales, Sydney, Australia

Abstract: As the importance of Environmental, Social, and Governance (ESG) reporting grows, companies, investors, and policymakers increasingly focus on its impact on financial markets. Existing studies suggest that ESG disclosures can help analysts better understand a company's risks and opportunities, potentially improving forecast accuracy. However, the relationship is complex due to the qualitative nature of ESG data, inconsistent reporting standards across markets, and varying regulatory and cultural environments. This review examines the existing literature on ESG reporting and analyst forecast accuracy, highlighting key challenges such as inconsistencies in disclosure practices and information asymmetry. It also identifies gaps in cross-market comparisons and emphasizes the need for further research to explore how ESG factors influence financial analysis in different contexts. The findings offer insights for scholars, policymakers, and market participants aiming to improve the relevance and consistency of ESG reporting.

Keywords: ESG reporting; analyst forecast accuracy; cross-market comparison; financial markets; sustainability reporting; regulatory challenges; information asymmetry

Published: 11 November 2024

1. Introduction

1.1. The Rise of ESG Reporting

The growing importance of Environmental, Social, and Governance (ESG) disclosure in the corporate world has drawn the active involvement of researchers, investors, and policymakers. By revealing a company's non-financial performance, ESG reporting has become a critical focus for understanding its impact on financial markets. A key aspect of this field is the relationship between ESG reporting and the accuracy of analyst forecasts.

ESG reporting has evolved from a vague concept into a standard practice for many companies. This shift reflects the recognition that a company's financial performance, environmental and social impacts, and governance structure are interconnected. As Christensen et al. (2022) noted, the quality and consistency of ESG reports remain inconsistent across firms and regions, creating challenges for analysts attempting to incorporate this information into their forecasts.

1.2. Challenges and Market Variability in ESG Reporting

The relationship between ESG disclosure and the accuracy of analyst forecasts is not straightforward. On the one hand, increased disclosure of ESG information can help analysts better understand a company's risks and opportunities, leading to more accurate predictions. Dhaliwal et al. (2012) found that firms initiating ESG disclosure tend to experience a reduction in forecast errors.

However, ESG information is often qualitative and, in some cases, highly forward-looking, making it difficult to integrate into standard quantitative models. Additionally, the lack of harmonized ESG reporting frameworks across markets and jurisdictions complicates cross-market comparisons. As highlighted by Grewal et al. (2021), these inconsistencies pose significant challenges for analysts.

The globalization of financial markets further compounds these challenges. ESG reporting practices differ widely among countries, and in some cases, specific regulations may be entirely absent. For example, while the European Union has established mandatory ESG disclosure requirements through the Non-Financial Reporting Directive (NFRD), many emerging markets are still in the process of developing similar frameworks. These disparities create unique challenges for analysts working across multiple jurisdictions.

Cultural differences also influence ESG reporting practices and affect the accuracy of analysts' predictions. Cahan et al. (2016) noted that the scrutiny of ESG developments varies by country and is closely linked to national systems and cultural contexts. This suggests that both the presence of ESG disclosures and the accuracy of analyst forecasts are shaped and moderated by cultural and institutional settings.

1.3. Relevance for Cross-Market Comparisons

As the theory of ESG reporting displays its growing evolution, the effects of ESG on the financial markets become more and more explicit. ESG reporting, analyst forecast accuracy, and market efficiency, especially in relation to the research about cross-market comparisons, is so far considered one of the most profound and unexplored areas of investigation. Through this approach in examining the bonds in various markets, researchers of this nature can bring the practicality of the relevance of ESG disclosures to financial analysis.

2. Literature Review

2.1. Recent Developments in ESG Reporting

These findings demonstrate that sustainability significantly impacts the efficiency of funding sources, sparking interest among researchers in future studies on how ESG reporting affects the forecast accuracy of financial analysts. Numerous previous studies have examined the relationship between ESG disclosure, market efficiency, and analysts, uncovering various interesting academic insights. One key observation is the connection between the ESG performance of distressed companies and analyst participation. Luo et al. (2015) found a correlation between ESG ratings and the frequency of analyst recommendations for firms. However, this does not imply that ESG is excluded from the equation; rather, ESG coverage serves as a valuable tool in financial analysts' work. Nevertheless, this research did not focus on forecast accuracy, leaving room for future studies to explore how increased emphasis on ESG reporting may influence forecast quality.

In recent years, the reliability of ESG reporting and the lack of comparative analysis across companies of different sizes and industries have become prominent discussion topics. Although the prevalence of ESG reports has increased, scholars have raised concerns about the reliability of ESG ratings. Christensen et al. (2022) conducted a recent study highlighting personal bias as a significant issue affecting ESG ratings, complicating the work of investors and analysts. Their study sheds light on how analysts perceive ESG data across various markets to enhance decision-making.

These findings have motivated further research into the interaction between ESG reporting and market efficiency. Grewal et al. (2021) made a valuable contribution by assessing the role of material sustainability information in stock price dynamics. Their research supports the idea that disclosing financially relevant sustainability data enhances the accuracy of price signals. However, their study focused exclusively on the U.S. market, leaving room for future research to investigate how these insights apply to other markets and their impact on the accuracy of institutional forecasts.

Another critical area of recent research is the effect of government-mandated ESG disclosures on analysts' forecast accuracy. Zhou et al. (2017) explored the impact of mandatory integrated reporting on forecast precision, demonstrating the interaction between disclosure and forecast accuracy. Their study emphasized the potential benefits of requiring companies to disclose greenhouse gas (GHG) emissions data. However, since their research focused on the U.S. market, the findings may not be generalizable across different cultural and regulatory environments due to data limitations.

Over time, scholars have recognized the importance of both the quality and granularity of ESG information. Khanchel and Lassoued (2022) investigated the dynamic relationship between ESG disclosure quality and the cost of capital, finding a positive correlation. However, the strength of this relationship varies across different ESG dimensions and time periods. Their study also highlighted that the financial impact of ESG reporting is not always straightforward and can change over time.

Recent research has further emphasized the need for more sophisticated analyses of the effects of ESG reporting. There is increasing recognition that the importance of ESG factors varies by industry and region, creating a demand for more research on the materiality of ESG issues across sectors and geographic locations.

Despite these advancements, there is still limited understanding of the relationship between ESG reporting and forecast accuracy across markets. Most previous studies have focused on individual markets or regions, resulting in a lack of cross-market comparisons. Moreover, the ongoing development of ESG reporting standards and practices in different jurisdictions presents challenges for researchers attempting to compare data across countries.

Future research must address the growing complexity and diversity of ESG reporting practices. In this context, researchers can further refine our understanding of the link between ESG reporting and financial markets, providing valuable insights for analysts, investors, and policymakers.

2.2. Challenges and Gaps in ESG Reporting Research

The link between ESG reporting and analyst forecast accuracy is an emerging area of research as sustainability becomes increasingly important in financial markets. This literature review aims to summarize existing research in this field and identify areas for further investigation.

Over the past decade, research on ESG reporting has evolved, with many studies focusing on different aspects of corporate performance and market behavior. Dhaliwal et al. (2011) provided an early study that supported the hypothesized positive relationship between voluntary ESG reporting and the cost of capital. Their research laid the foundation for understanding the financial impact of ESG reporting, suggesting that ESG disclosures enhance the information environment and reduce information asymmetry.

Building on this foundation, subsequent studies have explored the relationship between ESG reporting and analysts' actions. Luo et al. (2015), in a related study, examined the connection between ESG performance and analyst coverage, finding that firms with higher ESG scores attract more analyst attention. This indicates that ESG data is valuable to analysts and actively considered in their evaluations. However, their study did not specifically address forecast accuracy, leaving room for further research on how ESG reporting influences forecast quality.

Two key challenges identified in the literature relate to the credibility and consistency of ESG information. Christensen et al. (2022) discussed the subjectivity inherent in ESG ratings, which poses challenges for both investors and analysts. Their work raises important questions about how analysts interpret and engage with ESG data across different markets.

Grewal et al. (2021) contributed to this field by analyzing the relationship between sustainability indicators (SIs) and stock price informativeness. Their research suggests that disclosing financially relevant sustainability data enhances price discovery. However, their study focused solely on the U.S. market and did not examine how ESG disclosures affect forecast accuracy in other markets.

The authors also highlight a significant gap in the literature: the lack of cross-market comparisons on the relationship between ESG reporting and forecast accuracy. For example, Zhou et al. (2017) examined whether mandatory ESG disclosures improved forecast precision in China. However, there is still limited research on how these effects vary across jurisdictions and cultures, leaving an opportunity for future studies.

Another underexplored area is how differences in the quality and focus of ESG reporting across markets influence forecast accuracy. It is important to assess how these variations affect the usefulness of ESG data to analysts as ESG reporting standards and practices continue to evolve globally.

Amel-Zadeh and Serafeim (2018) conducted a survey of investment professionals to determine how they incorporate ESG data into their decision-making processes. Their findings show that while investors view ESG information as relevant, they face challenges integrating it due to the lack of standardized reporting across firms and over time. This highlights the need to harmonize ESG reporting frameworks across markets.

There may also be differences in how ESG reporting influences forecast accuracy, depending on the materiality of ESG factors across industries and regions. Khan, Rivera, and Yusoff (2016) found a positive relationship between firms' material sustainability issues and their financial performance, with firms scoring high on sustainability outperforming those with lower scores. This suggests that the importance of ESG factors varies by industry and location, influencing how analysts incorporate such data into their models.

Despite the progress made, the role of regulatory environments in ESG reporting and their impact on forecast accuracy remains limited in the literature. Ioannou and Serafeim (2017) examined the impact of mandatory sustainability reporting on firm valuation, finding that disclosure directives increased both the quantity and quality of ESG information. However, the effects of such regulatory changes on forecast accuracy have not yet been systematically assessed across different markets.

In summary, while existing research has enhanced our understanding of the relationship between ESG reporting and financial market performance, key questions remain unanswered—particularly regarding how ESG reporting affects forecast accuracy across various markets. Future research should focus on cross-market analysis, the influence of regulatory environments, and the relative importance of ESG factors across industries and regions. These investigations will provide valuable insights for investors, firms, policymakers, and standard-setting bodies, ultimately improving the relevance and effectiveness of ESG reporting in financial analysis and decision-making.

2.3. Identified Research Gaps

The existing literature provides accumulating evidence of the link between ESG reporting and analyst forecast accuracy. However, this paper identifies several research gaps that warrant further exploration, particularly through cross-market analysis.

One major gap in the literature is the lack of a systematic comparison across multiple markets to assess the effects of ESG reporting on analyst forecasts. Although studies like Dhaliwal et al. (2012) have explored certain aspects, the increasing integration of financial markets and the diversity of ESG disclosure practices across jurisdictions make such comparisons essential.

The variability in the quality and comparability of ESG disclosures between companies and regions, as highlighted by Christensen et al. (2022), presents challenges for analysts attempting to utilize this information for predictions. Prior research has not adequately explained how these differences in reporting practices influence the accuracy of analyst forecasts across market environments. Addressing this gap would provide valuable insights into the comparative effectiveness of various ESG reporting standards and practices.

Another area for future research is the role of regulatory differences in shaping the relationship between ESG reporting and forecast accuracy. While some studies, such as Zhou et al. (2017), have examined the effects of mandatory ESG disclosure in individual markets, like China, comparative analyses across multiple markets with varying regulatory frameworks remain underexplored. This is particularly important given that countries are at different stages of implementing ESG regulations.

Moreover, the literature has yet to explore the possibility of non-linear relationships between the quality of ESG ratings and forecast accuracy. While most studies assume a linear relationship, other possibilities cannot be ruled out. The impact of ESG reporting on forecast accuracy may vary depending on the quality of the reports or specific ESG dimensions. Amel-Zadeh and Serafeim (2018) suggest that the relationship between the value of ESG information for investment and its quality may differ due to factors such as accuracy and comparability.

Similarly, the literature has not sufficiently investigated the potential for a curvilinear relationship between ESG reporting quality and analyst forecast accuracy. Although most research employs linear models, it is possible that the effect of ESG reporting on forecast accuracy varies with the quality of disclosures or the specific ESG aspect being measured. Amel-Zadeh and Serafeim (2018) emphasize that differences in how investment decisions incorporate ESG information may arise from variability in data accuracy and comparability.

Another underexplored research area is the influence of cultural factors on ESG reporting and forecast accuracy. While studies like Cahan et al. (2016) have examined the impact of national culture on the valuation of ESG performance, the effect of cultural differences on analysts' forecast accuracy remains largely unaddressed.

Lastly, there is limited research on how the evolution of ESG reporting practices over time affects the accuracy of analysts' forecasts. It is crucial to examine how changes in ESG reporting standards and practices influence the ability of analysts to incorporate ESG information into their forecasting models effectively. The temporal aspect of ESG reporting and its impact on forecast accuracy has not been sufficiently covered in the existing literature.

In summary, although previous research has provided a solid foundation for understanding the link between ESG reporting and forecast accuracy, several gaps remain. Addressing these gaps through cross-market analyses, investigations into regulatory and cultural factors, studies of non-linear relationships, and assessments of temporal changes in ESG reporting will significantly enhance knowledge in this area. Such insights will be invaluable to investors, firms, policymakers, and standard-setting bodies seeking to improve the utility and consistency of ESG reporting in financial analysis and decision-making.

3. Research Objectives

Based on the identified research gaps, I propose the following refined research objectives for this study.

3.1. Cross-Country Associations Between ESG Reporting Quality and Forecast Accuracy

This objective aims to investigate the cross-country association between the quality of ESG reporting and analyst forecast accuracy in markets with varying levels of ESG reporting complexity. It addresses a gap in the literature, which has overlooked how differences in the application of ESG reporting across markets influence analysts' forecast accuracy. To achieve this, the study will examine markets with different levels of ESG disclosure to understand how the quality and comparability of ESG information impact analysts' expectations.

3.2. Correlation of ESG Data with Regulatory and Cultural Disparities

This objective explores the correlation between ESG data, regulatory frameworks, and cultural differences to enhance financial decision-making. The research will account for how cultural and regulatory disparities influence ESG practices, which will contribute to improving forecast accuracy and updating the existing literature. Drawing on the approaches of Ioannou and Serafeim (2017), this objective recognizes the role of key institutional factors in shaping corporate sustainability practices, which, in turn, affect how analysts interpret and apply ESG information.

3.3. Impact of ESG Dimensions on Forecast Accuracy Across Industries and Nations

This objective seeks to investigate how the environmental, social, and governance dimensions of ESG reporting affect forecast accuracy across industries and nations. It specifically addresses the role of each ESG dimension in shaping analysts' forecasts. As Eccles and Krzus (2018) note, the materiality of ESG factors varies across industries and countries, which suggests that these factors may influence forecast accuracy differently in various sectors.

3.4. Relationship Between ESG Information Asymmetry and Forecast Accuracy Across Markets

This objective aims to explore the relationship between ESG information asymmetry and forecast accuracy across different market levels. It emphasizes the complexity of ESG data and its potential to reveal information asymmetry. Christensen et al. (2021) highlighted that ESG reporting standards are not uniform and vary between companies, leading to varying levels of information asymmetry. As a result, analysts may face challenges in accurately forecasting performance across different sectors.

4. Conclusion

This study highlights the significant impact of Environmental, Social, and Governance (ESG) reporting on financial markets, particularly regarding analyst forecast accuracy. While increased transparency in ESG information helps analysts better assess corporate risks and opportunities, inconsistencies in reporting standards across markets, the qualitative nature of ESG data, and integration complexities add layers of analytical challenges. This review identifies key research gaps, notably the need for cross-market comparisons, the effects of regulatory and cultural disparities, and the industry-specific impact of ESG factors on forecast accuracy.

The findings suggest that to maximize the utility of ESG reporting, further standardization across markets is essential to reduce information asymmetry and enhance forecast accuracy. Future research should explore the predictive utility of various ESG dimensions across industries and regions, examine the influence of regulatory and cultural contexts on the interpretation of ESG data, and investigate potential non-linear relationships between ESG disclosure quality and forecast accuracy. These studies will provide valuable insights for investors, analysts, and policymakers, ultimately promoting the full value of ESG data in financial analysis.

References

1. Amel-Zadeh, A., & Serafeim, G. (2018). Why and how investors use ESG information: Evidence from a global survey. Financial Analysts Journal, 74(3), 87-103.
2. Cahan, S. F., De Villiers, C., Jeter, D. C., Naiker, V., & Van Staden, C. J. (2016). Are CSR disclosures value relevant? Cross-country evidence. European Accounting Review, 25(3), 579-611.

3. Christensen, D. M., Serafeim, G., & Sikochi, A. (2022). Why is corporate virtue in the eye of the beholder? The case of ESG ratings. The Accounting Review, 97(1), 147-175.
4. Dhaliwal, D. S., Radhakrishnan, S., Tsang, A., & Yang, Y. G. (2012). Nonfinancial disclosure and analyst forecast accuracy: International evidence on corporate social responsibility disclosure. The Accounting Review, 87(3), 723-759.
5. Eccles, R. G., & Krzus, M. P. (2018). Why companies should report financial risks from climate change. MIT Sloan Management Review, 59(3), 1-6.
6. Grewal, J., Hauptmann, C., & Serafeim, G. (2021). Material sustainability information and stock price informativeness. Journal of Business Ethics, 171(3), 513-544.
7. Ioannou, I., & Serafeim, G. (2017). The consequences of mandatory corporate sustainability reporting: Evidence from four countries. Harvard Business School Research Working Paper, (11-100).
8. Khan, M., Serafeim, G., & Yoon, A. (2016). Corporate sustainability: First evidence on materiality. The Accounting Review, 91(6), 1697-1724.
9. Khanchel, I., & Lassoued, N. (2022). ESG disclosure and the cost of capital: is there a ratcheting effect over time?. Sustainability, 14(15), 9237.
10. Zhou, S., Simnett, R., & Green, W. (2017). Does integrated reporting matter to the capital market?. Abacus, 53(1), 94-132.