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House Oversight Subcommittee on Economic Growth, Energy Policy, and Regulatory Affairs and Subcommittee on Health Care and Financial Services

Re: Testimony related to ESG

Thank you to Subcommittee Chairs Fallon and McClain, Subcommittee Ranking Members Porter and Bush, as well as the other members of the Committee for the opportunity to testify before you today on a topic of utmost importance – how companies allocate resources, who are they accountable to and how.

It is an honor to be here. My name is Shiva Rajgopal, and I am the Kester and Byrnes Professor of Accounting and Auditing at Columbia Business School.

To me, ESG is really about material factors that affect the future cash flows and cost of capital of a firm. I think of ESG as a term that covers data that is not adequately disclosed by our financial reporting model and mandated disclosure rules. Let us consider specific examples to illustrate this argument:

- Climate and extreme weather-related events already affect the cash flows of insurers, travel and tourism related companies such as cruise lines, agriculture firms, theme park operators, energy companies and transportation companies, to name a few.[1] Yet, current reporting rules in the US require no systematic disclosure of the impact of such climate related physical and transition risks on the affected firms future cash flows and cost of capital.

- Turning to the "S" in ESG related to workers and labor, it turns out that barely 15% of US firms disclose even the compensation costs that they pay in aggregate to their workers.[2] Companies are only required, as of now, to disclose the number of full-time employees in their financial statements. Companies rarely disclose the number of part time workers and contractors, or the compensation paid to such part time workers and contractors let alone important information such as tenure of these workers, abnormal turnover, training, or the gender and age composition of the work force or how much of the firm's operations have been outsourced or conducted via contractors. An appreciation of the firm's work force enables an investor to get a better sense of corporate culture and the quality of its human capital which, in turn, has been shown to be associated with value creation in a firm, including innovation, productivity, ethical behavior and compliance activities of the firm.

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[1] https://www.bloomberg.com/news/articles/2023-06-03/a-global-stock-trader-s-guide-to-more-extreme-weather-events?sref=yv2coi81
[2] https://www.sec.gov/rules/petitions/2022/petn4-787.pdf

- Let us now consider another part of “S” related to the taxes a company pays and the grants and subsidies that it receives, and the conditions such as the minimum number of jobs the firm needs to create in exchange for such assistance. Corporate disclosures in this area are vague and sketchy at best.[3,4] Some of my research shows that the expected payoff to a dollar of lobbying to a firm can far exceed the expected payoff to say a dollar of R&D investment.[5] Yet, there is no required disclosure of the extent and scope of lobbying activity that a firm undertakes.

- The “G,” or corporate governance of a firm describes the process of assessing what the CEO has done with the shareholder capital, natural capital, human capital, and taxpayer resources entrusted to such CEOs by shareholders, society, workers, and taxpayers. However, as mentioned before, the data available to assess how well the CEO has delivered a return on these sources of capital is often missing or vague. Even CEO compensation disclosures do not clearly reveal whether shareholders have actually paid the CEO for firm performance.[6]

ESG, in essence, is a free market, organic and an investor driven movement to ask firms to disclose more information about the described factors associated with their future cash flows or cost of capital. Investors would be derelict of their fiduciary responsibility to their stakeholders if they did not consider the material factors when making an investment decision. Prohibiting consideration of material ESG factors simply interferes with the provision of data to make asset markets efficient at pricing these risks and returns. In fact, there is evidence to suggest that substantial losses will be incurred by the constituents of the states such as Texas where legislation that infringes on the public pension fund’s freedom to invest have been passed in recent months.[7]

In closing, I would reiterate that investors and asset managers cannot afford to ignore financial risks posed by overlooking material ESG data relevant to understand the future cash flows and risks of stocks, bonds and other assets.

Thanks again for listening to my testimony. I look forward to answering your questions.

Yours sincerely

Shiva Rajgopal

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[3] https://www.forbes.com/sites/shivaramrajgopal/2022/12/21/why-investors-need-better-corporate-tax-disclosurespart-i/?sh=5b201873653f

[4] https://www.forbes.com/sites/shivaramrajgopal/2022/12/24/why-investors-need-better-corporate-tax-disclosurespart-ii/?sh=61128ae4694f

[5] https://www.forbes.com/sites/shivaramrajgopal/2021/06/07/it-should-be-mandatory-to-disclose-political-influence-seeking-and-payoffs-from-the-state-theres-an-evidence-based-reason-why/?sh=30a208d11eb3

[6] https://www.forbes.com/sites/shivaramrajgopal/2022/10/23/most-us-companies-pay-ceos-under-a-competitive-pay-policy-but-dont-confuse-it-for-pay-with-performance/?sh=758c58757a19

[7] https://knowledge.wharton.upenn.edu/podcast/knowledge-at-wharton-podcast/texas-fought-against-esg-heres-what-it-cost/