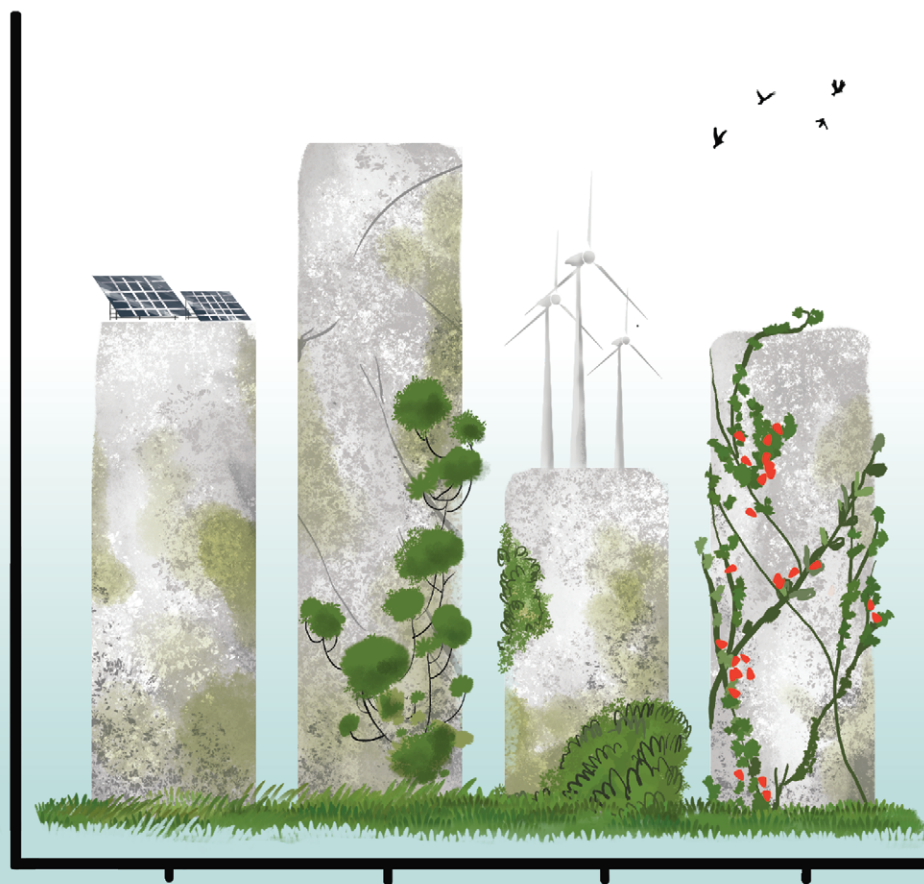


International Perspectives on Sustainability Reporting



Dr. Amina Mohamed Buallay

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BY

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List of Abbreviations

CERES	Coalition of Environmentally Responsible Economies
CSR	Corporate Social Responsibility
CSR D	Corporate Social Responsibility Disclosure
ED	Environmental Disclosure
ESG	Environmental, Social and Governance
FE	Fixed-Effect
FL	Financial Leverage
GD	Governance Disclosure
GDP	Gross Domestic Product
GHGs	Greenhouse Gases
GOV	Public Governance
GRI	Global Reporting Initiative
IIRC	International Integrated Reporting Council Committee
IQ	Institutional Quality
IV-GMM	Instrumental variables-Generalized Method of Moments
MENA	Middle East and North Africa
MGA	Multi-Group Analysis
OECD	Organisation for Economic Co-operation and Development
OLS	Ordinary Least Square
PLS-SEM	Partial Least Square-Structural Equation Modelling
QR	Quantile Regression
RE	Random Effects
ROA	Return on Assets
ROE	Return on Equity
SD	Social Disclosure
SRI	Socially Responsible Investment
SRL	Sustainability Reporting Law
SSE	Sustainable Stock Exchange

xii List of Abbreviations

TA	Total Assets
TBL	Triple Bottom Line
TLGT	Too-Little-of-a-Good-Thing effect
TMGT	Too-Much-of-a-Good-Thing effect
TQ	Tobin's Q
UN	United Nations
UNEP	United Nations Environmental Programme
UNGC	United Nations Global Compact
WGI	Worldwide Governance Indicators

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Chapter 1

Introduction

Abstract

This chapter covers a full picture of the remaining chapters. The first part discusses the gap in the literature and the main objectives of this book. The next section overviews the book's design and methodology which includes the conceptual model, the research design and the research methodology. The final section in this chapter is the book's theoretical and practical contributions.

Keywords: Sustainability reporting; ESG; environmental disclosure; CSR; social disclosure; governance disclosure

The disclosure of sustainability reports is now a familiar practice among firms worldwide, and it has become a significant factor for businesses (Al Hawaj & Buallay, 2021).¹ The expansion of sustainability disclosure is due to the increase in stakeholder interest in companies' environmental, social and governance performance (Buallay, Hamdan, Barone, & Hamdan, 2020a). This stakeholder pressure motivates firms to go beyond their annual financial reports and disclose non-financial information such as social, environmental and governance issues for their stakeholders. Today, there is a focus on other non-financial measures as evidence builds that integrating financial and non-financial information offers a better understanding of a firm's sustainability efforts (Atkins & Maroun, 2015).

The story of sustainability reporting started with the financial crisis in 2008, when publicly listed firms lost more than 60% of their stock market value (Buallay, 2019a). After this crisis, the European Commission initiated many activities to enhance the quality of business reporting to meet the needs of

¹The terms "sustainability reporting", "sustainability disclosure", "environmental, social, and governance (ESG) reporting" and "ESG disclosure" are used interchangeably in this book to represent reports with different level of focus on environmental, social or corporate governance practices.

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different stakeholder groups (CFA Institute, 2016). Additionally, the United Nations (UN) Global Compact in April 2019 created an initiative calling firms to align their sustainability strategies with 10 principles in four different areas – human rights, labour rights, the environment and anticorruption – and to take action to attain societal goals (United Nations Global Compact, 2004).

One of the more prominent UN-backed initiatives on environmental, social and governance (ESG) is called fiduciary duty in the twenty-first century, which states that firms do better when they support their host societies (UN Principles for Responsible Investment). As a result of these recent changes, firms are expected to act socially by paying more attention to their social responsibilities to society as a way to generate more profit.

Several initiatives have been introduced to provide guidelines to make sustainability reporting more transparent. The most recent and comprehensive initiative is the Global Reporting Initiative (GRI), which includes all three dimensions of sustainability – social, environmental and economic (Toppinen & Korhonen-Kurki, 2013). This initiative is considered a guideline to sustainability reporting.

Firms responded to these initiatives and undertook many efforts to disclose sustainability reports to attract new stakeholders and rebuild market trust, which was affected by the financial crisis (Perez-Batres et al., 2010). It has been asserted that listed firms that did not go bankrupt in the financial crisis and have continued to make a profit are those that have focused on corporate social responsibility, environmental issues and corporate governance (Buallay, 2020).

Businesses' awareness of the effect of their activities on the society and the environment has been increasing, and the United Nations Environmental Program UNEP Finance Initiative showed that sustainability issues are important for a firm's value (Deringer, 2005). Socially responsible firms work more conscientiously to support the society and the environment in which they operate, and they go over and above what is required by regulators or by environmental organizations.

This new way of thinking has led companies to have a broader perspective, beyond profit making, and to start putting efforts into implementing sustainability strategies and providing investors with non-financial data reports capturing other dimensions that are not mentioned in regular financial reports (Buallay & AlDhaen, 2018).

As sustainability reporting has increased, countries worldwide have launched reforms to enhance the quality of sustainability reporting. These actions have come in response to bankruptcies caused by the financial crisis. A number of countries have instituted laws mandating the disclosure of sustainability information because they recognized the importance of this information to all stakeholders. However, while sustainability reporting is required and regulated in some countries, it is voluntary and unregulated in others (Buallay, Hamdan, Zureigat, & Dhaen, 2019). Thus, it can be seen that the concept of ESG disclosure has become a subject of intense focus in the corporate world.

1.1 A Gap in the Literature

The pace of growth of ESG disclosure increased markedly when research started to show that sustainability reporting is linked to improved business performance.

Numerous empirical studies have investigated the relationship between a firm's ESG disclosure and its financial performance. Despite this, many researchers claim that results of this research are ambiguous, inconclusive or contradictory (Brooks & Oikonomou, 2018). On the one hand, many researchers have found a significant positive relationship between ESG integration and firm performance (Aouadi & Marsat, 2018; Buallay, Wadi, Kukreja, & Hassan, 2020; Deng & Cheng, 2019; Velte, 2017; Zhao et al., 2018). On the other hand, other scholars have identified a negative relationship (Duque-Grisales & Aguilera-Caracue, 2021; Landi & Sciarelli, 2019) or an insignificant relationship (Atan, Alam, Said, & Zamri, 2018) between the two.

Two debates have resulted from this conflict. The first is the “cost of capital” reduction perspective, which argues that disclosing ESG increases costs and has economic consequences, resulting in lower market values. Friedman (1962) argued that the fundamental purpose of a firm is to increase financial profitability, and any other non-financial disclosure will reduce profitability. Mackey et al. (2007) contend that shareholders expect a firm to increase its financial disclosure without referring to its social actions, which should be performed by charities and non-profit firms. Furthermore, Marsat and Williams (2014) claim that disclosing sustainable actions increases costs and comes with economic consequences.

The second area of debate is the value creation perspective, which argues that disclosing ESG is a tool firms can use to generate competitive advantages and enhance their performance. Many scholars agree that sustainability reporting is a tool to generate competitive advantage and improve financial performance (Buallay, 2019b). Sharfman and Fernando (2008) state that the disclosure of sustainability information leads to superior performance (Eccles, Ioannou, & Serafeim, 2012). Other studies have found that sustainability reporting helps create value (Buallay, 2019c).

Although the relationship between ESG disclosure and firm performance has been abundantly explored by past researchers, we found six deficiencies in the existing literature.

First, many authors have used either stakeholder theory or legitimacy theory to explore this relationship. A recent trend in accounting studies uses integrated theories to address the topic of sustainability reporting (Lokuwaduge & Heenetigala, 2017). Researchers have recognized a clear link between stakeholder and legitimacy theories (Soobaroyen & Mahadeo, 2016). Although both theories look at the firm from a social viewpoint, legitimacy theory focusses on society as a whole, whereas stakeholder theory differentiates among legitimate interests of various groups within the society (Woodward, Edwards, & Birkin, 1996). The literature on the relationship between sustainability reporting and firm performance proves that legitimacy theory complements stakeholder theory, and vice versa. However, linking the two theories still leaves a gap when a firm's attitude does not match the country's expectation. O'Donovan (2002) indicates that, to fill this gap, firms must align their sustainability goals with the country's sustainability goals. Therefore, in this book we integrate political-economy theory, which suggests that firms are required to legitimate their operations within the country they are located in, to meet the country's expectations and requirements. Hence,

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the relationship between sustainability reporting and firm performance can be explained by integrating legitimacy theory and stakeholder theory in a specific political-economy setting.

Second, when researchers measure a firm performance, they usually face challenges about whether to use accounting-based or market-based measures or a combination of both. Many scholars (e.g. [Simpson & Kohers, 2002](#)) have favoured using accounting-based measures of performance (e.g. return on equity, ROE), while other authors have preferred to use market-based measures (e.g. Tobin's Q) ([Wagner, 2010](#)).

Accounting-based measures are less complex than market-based measures, as they represent what actually happens in a firm ([López, García, & Rodríguez, 2007](#)). In addition, they are better at forecasting sustainability ([McGuire, Sundgren, & Schneeweis, 1988](#)). [Griffin and Mahon \(1997\)](#) used only accounting-based measures. Moreover, market measures suffer from information asymmetry between managers and shareholders ([Cordeiro & Sarkis, 1997](#)) and assume that the shareholders are the core stakeholder group ([Orlitzky, Schmidt, & Rynes, 2003](#)). To avoid criticisms of marketing-based measures, some studies have used a combination of accounting-based and market-based measures (e.g. [Callan & Thomas, 2009](#)). Therefore, in this book both accounting-based and market-based measures are used compensate for shortcomings of both measures.

Third, cross-sector studies used to address social issues provide multidisciplinary and varied conceptual frameworks ([Selsky & Parker, 2005](#)). This book addresses sustainability disclosure, which covers multidisciplinary issues (environmental, social and governance). However, previous studies have studied the relationship between sustainability reporting and firm performance in general or within a single sector. It has been noticed that there is a lack in cross-sector studies in sustainability reporting ([Morrison-Saunders & Therivel, 2006](#); [Pojasek, 2007](#)). [Qiu, Shaikat, and Tharyan \(2016\)](#) suggest that sustainability reporting across industries matters to shareholders, as sustainability reporting may help the firms generate profit. [Margolis, Elfenbein, and Walsh \(2009\)](#) raise the problem of aggregation as a potential source of heterogeneity in empirical findings, the results should be analysed by sector, as sectors differ greatly in purpose and size, which gives results ranging from local to international levels, short-term to long-term, and voluntary to fully mandated. [Barnett \(2007\)](#) and [Soana \(2011\)](#) claim that the numbers of sectoral studies of ESG disclosure and firm performance is lacking and that ESG characteristics vary across industries, thus making generalization from the results difficult when the study is run over several industries at once. Therefore, in this book this gap is considered by investigating each sector separately (Chapter 9).

Fourth, ESG disclosure has been practiced in developed countries for longer than it has in developing ones. Thus, while developed countries are more informed about the implementation of sustainable strategies, developing countries are more in need of ESG disclosure studies. Furthermore, recent studies have failed to include developing countries' firms in their samples ([Nyeadi, Ibrahim, & Sare, 2018](#)), and those that have targeted emerging regions have yielded mixed, inconclusive results ([Wahab, Ahmad, & Yusoff, 2017](#); [Zhao et al., 2008](#)) which

calls for additional work to be done in this zone. Therefore, in this study we examine a wide range of developed and developing countries.

Benlemlih and Bitar (2018) state that ESG disclosures and their effect on firm performance is vary with the institutional and regulatory setting. They call for future research to test the link between disclosure and performance in a multi-country setting with controls for the differences in institutional and regulatory disclosure environments. This brings us to the fifth.

Finally, as discussed above, the relationship between sustainability reporting and firm performance can be explained by the integration of legitimacy theory and stakeholder theory in a given political-economy setting.

Based on the above gaps, this book has two main aims. The first aim is to understand the context of sustainability reporting. To achieve this, the book sets several chapters. Chapter 2, Sustainability Dimensions, discusses the environmental dimension, the social dimension, the governance dimension, the economic dimension and interdependence of sustainability dimensions. Chapter 3, Sustainability Reporting: History and Development, discusses the history of corporate social responsibility reporting, the history of environmental reporting, the history of sustainability reporting and the history of integrated reporting. Chapter 4, Sustainability Reporting Law and Regulations, discusses mandatory and voluntary sustainability reporting practices around the world. Chapter 5, Relevant Theories to Sustainability Reporting, discusses both theories supporting sustainability reporting and theories against sustainability reporting. Chapter 6 discusses the benefits and costs of disclosing sustainability reports.

The second aim of this book is to investigate the relationship between sustainability reporting and firm's performance from different perspectives. To achieve this, the book sets the remaining chapters. Chapter 7 investigates this relationship from different firm performance measures (operational performance, financial performance and market performance). Chapter 8 investigates the relationship between sustainability reporting and performance in different economic and political consequences. Chapter 9 investigates this relationship across different sectors including agriculture and food industries sector, energy sector, manufacturing sector, banks and financial services sector, retail sector, telecommunication and information technology sector and tourism sector. In the final chapter, this relationship is studied in different region (Europe, Mena, North and Africa).

1.2 The Book's Design and Methodology

In this book, to achieve the first aim a theoretical search will be adopted. However, for the second aim some practical methods will be adopted. Therefore, a conceptual model is developed (Fig. 1).

1.2.1 The Conceptual Model

The Model is built to investigate the relationships between sustainability reporting (ESG) and firm performance (operational, financial and market performance).

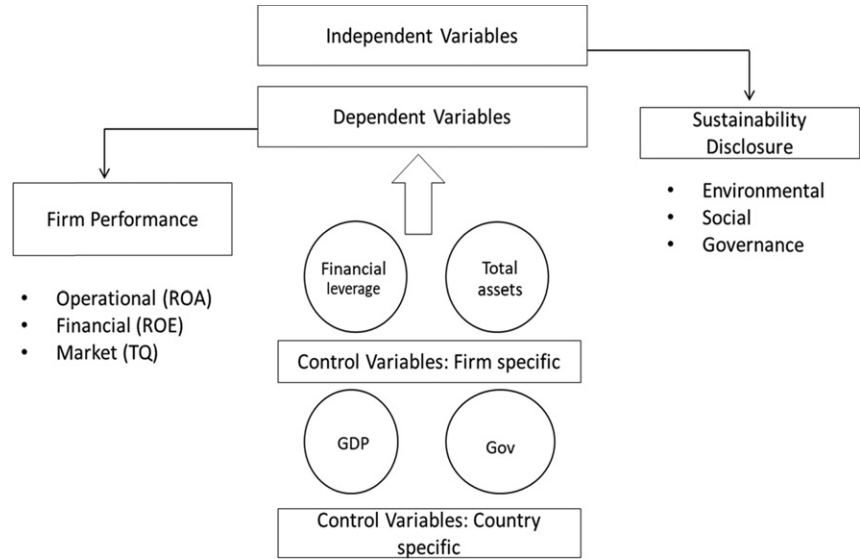


Fig. 1. The Conceptual Model.

This model is based on three theories: legitimacy, stakeholder and political-economy theories (Chapter 5). As shown in Fig. 1, the first conceptual model consists of independent, dependent and control variables.

1.2.1.1 Dependent Variables (Firm Performance)

Measuring firm performance is significant, as it offers information on firm objectives and how well they have been achieved (Shad, Lai, Fatt, Klemeš, & Bokhari, 2019). Firm performance can be measured using various metrics (Buallay, 2021). In this book, operational, financial and market performance are measured.

Operational Performance: Return on assets (ROA) is one the broadest measures of operational performance (Buallay, 2019d). It is defined as the ratio of net income to total assets, and it focuses on whether a firm used its assets in an efficient way (Lee & Faff, 2009). The ROA relates to assets employed to generate profit. Many recent studies have employed ROA to test the link between sustainability reporting and operational performance (Aouadi & Marsat, 2018; Buallay, 2022; Buallay & Al-Ajmi, 2019; Deng & Cheng, 2019; Duque-Grisales & Aguilera-Caracue, 2021; Lins, Servaes, & Tamayo, 2017; Velte, 2017; Zhao et al., 2018).

Financial Performance: ROE is one the broadest measures of financial performance (Buallay, 2019b). The ROE is defined as the ratio of net income to total common equity, and it focuses on how a firm generates more income from its equity. Many recent studies have used ROE to test the link between sustainability reporting and financial performance (Aouadi & Marsat, 2018; Atan et al., 2018; Buallay, Al Hawaj, & Hamdan, 2020; Zhao et al., 2018).

Market Performance: Tobin's Q (TQ) is one the most famous measures of market performance (Cahan et al., 2016). It is defined as the market value of a firm divided by its asset replacement cost. The TQ focuses on how a firm can increase the market value of its assets. Many recent studies have used TQ to test the link between sustainability reporting and market performance (Aouadi & Marsat, 2018; Atan et al., 2018; Aybars, Ataüenal, & Gürbüz, 2019; Balasubramanian, 2019; Buallay, Al-Ajmi, & Barone, 2021; Fatemi, Glaum, & Kaiser, 2018; Garcia, Mendes-Da-Silva, & Orsato, 2019; Landi & Sciarelli, 2019; Miralles-Quirós, Miralles-Quirós, & Redondo Hernández, 2019; Nekhili, Boukadhaba, Nagati, & Chtioui, 2021; Velte, 2017).

1.2.1.2 Independent Variables (Sustainability Reporting)

Sustainability reporting is proxied by the environmental, social and governance combined score (ESG). The components of ESG are defined as follows:

Environmental Score (E): This involves a firm's contributions to the ecosystem. It is a measure of the effect of a firm's operations on the overall natural system. It reflects the degree to which the best practices are implemented to avoid endangering the environment.

Social Score (S): This involves a firm's ability to manage its relationship with all stakeholders in a way that generates confidence and trust.

Governance Score (G): This score applies to the firm's organizational system that guarantees the best interest of its shareholders. It consists of guidelines and procedures implemented to balance the interests of many stakeholders.

The ESG can be measured using different methods (Table 1). In this book, ESG data are retrieved from the Bloomberg database as a proxy for disclosure. Bloomberg assesses the extent of each firm's disclosure of its environmental, social and governance activities based on GRI standards, which give more accurate results than other methods. Bloomberg estimates disclosure scores ranging between 0.1 (lowest) and 100 (highest).

Moreover, Bloomberg's data comes from different sources, such as CSR reports, annual reports and corporate websites, and thus it reflects the universe of information publicly available to investors.

1.2.1.3 Control Variables

In this book, two types of control variables are used: firm specific and country specific. There are two firm-specific variables: total assets (TA) and financial leverage (FL). There are also two country-specific variables: GDP and governance (Gov).

1.2.1.3.1 Firm Specific. Total assets: Prior literature has found that firm size measured by total assets is a factor affecting both sustainability reporting and firm performance. Hillman and Keim (2001) stated that large firms might have better profitability, and it might be related to the extent of stakeholder expectations and concerns regarding socially responsible activities (Hillman & Keim, 2001). Burke, Logsdon, Mitchell, Reiner, and Vogel (1986) argued that smaller firms may not disclose social activities, whereas large firms are expected to attract more

Table 1. Methods of ESG Measurement.

No.	Method	Purpose	Criteria	Methodology	Reference
1	Kinder Lydenberg Domini (KLD)	KLD evaluates a firm's environmental, social and governance performance.	The criteria are divided into two broad categories: "strengths" and "concerns".	Deducting the "concerns" from the "strengths" to reach a single net value using binary values, where "1" indicates the presence of a particular issue, and "0" indicates the absence of an issue.	Hillman and Keim (2001)
2	Ethical Investment Research and Information Service (EIRIS)	EIRIS is an independent, non-profit corporation which acts as a leading global provider of research into corporate environmental, social and governance performance.	It covers 87 criteria, including climate change, human rights, supply chain, labour standards, relations with customers and suppliers, stakeholder engagement, board practices and risk management.	Each item is rated on an interval scale as follows: -3 (High Negative), -2 (Medium Negative), -1 (Low Negative), 0 (Neutral), 1 (Low Positive), 2 (Medium positive), 3 (High positive)	EIRIS (2011)
3	Sustainable Asset Management (SAM)	SAM provides a set of questionnaires.	The questionnaire is targeted at CEOs, investor relations, sustainability departments and public affairs.	The results of this questionnaire are weighted and included in the Dow Jones Sustainability Index (DJSI).	UNEP (2011)