EMERALD**HANDBOOKS**

THE EMERALD HANDBOOK OF ETHICAL FINANCE AND CORPORATE SOCIAL RESPONSIBILITY

A FRAMEWORK FOR SUSTAINABLE DEVELOPMENT

EDITED BY
AHMED **IMRAN HUNJRA**
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The Emerald Handbook of Ethical Finance and Corporate Social Responsibility

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The Emerald Handbook of Ethical Finance and Corporate Social Responsibility: A Framework for Sustainable Development

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Preface

Welcome to "The Emerald Handbook of Ethical Finance and Corporate Social Responsibility: A Framework for Sustainable Development." In a world where the fates of business prosperity and societal well-being are increasingly intertwined, this handbook serves as an indispensable guide for navigating the complex terrain of ethical finance and corporate social responsibility. Drawing upon the collective wisdom of leading experts in the field, this book offers a comprehensive framework to drive sustainable development, making it a valuable resource for both scholars and practitioners.

Whether you are a seasoned professional, an aspiring entrepreneur, or a dedicated scholar, this handbook will empower you to make ethical financial decisions that promote positive social change and contribute to a future where prosperity aligns harmoniously with the well-being of our planet and its inhabitants. With a focus on both profitability and a sense of purpose, "The Emerald Handbook" invites you to embark on a journey of responsible finance, paving the way for a more just, sustainable, and prosperous world for generations to come.

Within the pages of this handbook, you will discover an invaluable resource for those seeking a deeper understanding of ethical finance, corporate social responsibility, and their pivotal roles in forging a path toward sustainable development. Here, readers will find a wellspring of knowledge, insights, and practical guidance to navigate this vital intersection of finance, ethics, and social responsibility.

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Chapter 1

The Concept of Materiality in CSR and SDGs Reporting: Definitions, Interpretation, Application, and Sustainable Value Creation

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Abstract

Corporate Social Responsibility (CSR) reporting has been widely accepted as a vital tool for communicating with stakeholders on a range of social, environmental, and governance issues, but how companies define, interpret, apply, integrate, and communicate their CSR efforts and impacts in corporate reporting is anything but a straightforward task. The purpose of this chapter is to explore the concept of materiality in CSR reporting and demonstrate practical examples of good CSR and Sustainable Development Goals (SDGs) reporting practices. We chose the aviation industry because of its economic relevance, constant growth, and future expected changes in the aftermath of COVID-19. In addition, airlines affect many of the SDGs directly and indirectly with contending results. This chapter is timely because of the growing willingness by companies to integrate CSR and environmental, social, and governance (ESG) thinking into the corporate strategy and business operations using materiality assessment and enhancing their competitive advantage and ability to maintain long-term value and because ESG and ethical investing have become part of the mainstream investing. Thus, this chapter contributes to an understanding of the wide range of existing and new reporting frameworks and regulations and reinforces the importance of discussing how this diversity of approaches can affect the work toward worldwide comparability of CSR and sustainability reporting.

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1. Within the Confines of Corporate Social Responsibility (CSR) and Ethical Finance

From 1930s to 1970s, CSR was already known under the name of social responsibility (SR), and by the 1960s and 1970s, it became more noticeable (Carroll, 1999). By 1960, Davis had already contributed with a definition of CSR, stating that in management, it refers to decisions by business people that are made for reasons that are in part outside of the direct economic and technical interests of the firm (1960). From 1970s, Carroll (1999) explained that the interest in CSR emerged again because of public controversies due to faulty products at that time and the disinterest of US firms in responding to the human rights movements. Further definitions emphasized the company–society relationship, such as Gray et al. (1996) highlighted that the role of CSR depends on the individual's view of how the relationship between the organization and society functions and how they would like it to function. Cho and Lee (2019) note that CSR is a company's involvement in areas that benefit society.

The global growth of CSR popularity has resulted in many organizations creating CSR roles, CSR departments, and producing stand-alone CSR reports or sections within annual reports. Some companies have also integrated CSR activities into their policies and strategies (Alotaibi & Hussainey, 2016). Companies are also encouraged to embrace sustainability values to foster social welfare, internally and externally. They are expected to be more ethically conscious and use CSR to improve resource management while protecting the environment (Deloitte, 2015). Consumers spend more on ethical products and services, while investors lean more toward sustainable assets. There is a growing recognition of environmental, social, and governance (ESG) issues among impact investors.

In addition, countries are paying more attention to how they can use economic and financial policies to combat climate change. Studies have found that when considering risks factors such as political, macroeconomic, and other associated uncertainties – inflation, exchange rate, and ethnic fragmentation (for social risk), among others, have a negative impact on sustainable development in the short and long term (Hunjra, Azam, Bruna, et al., 2022), and that Financial Policy Uncertainty (FPU) leads to higher climate change risk in developing countries (Hunjra, Azam, & Al-Faryan, 2022). The increase in risk management policies at the country level increases sustainable investment and leads to changes in regulatory channels related to transparency in the financial sector. This rising trend toward ethical finance and sustainable investing adds additional pressure on organizations to engage with materiality and CSR disclosures in response to stakeholders and regulatory expectations.

The growth in CSR reporting is evidenced by the registration of 15,608 organizations with the Global Reporting Initiative (GRI) and the availability of 63,851 sustainability reports in 2021 (GRI, 2021) compared to approximately

3,500 organizations and 8,000 reports in 2012 (Rangan et al., 2012). Nevertheless, there has yet to be a consensus on what CSR entails because the concept of CSR has been studied from different perspectives and divided into different typologies. According to academic literature, the lack of a single definition is explained by the large number of CSR definitions found in the literature and the bias on specific interests (Van Marrewijk, 2003). Moreover, there needs to be more consistency in how the definition is applied by countries and within the same countries (Freeman & Hasnaoui, 2010). Dahlsrud (2008) also pointed out that a core problem in finding a single definition for CSR lies in the fact that there will always be a need to verify the impartiality of the concept, and this validation will still require a subjective view. Different people within different organizations and their stakeholders would use different languages, tools, and contexts of CSR they get involved with, which might largely depend on their individual views, perceptions, and interpretations.

The definition of CSR has been described based on responsibility. For instance, the well-known framework developed by Carroll (1991) is divided into economic, legal, ethical, and philanthropic pillars. Although widely used, the framework's applicability to different countries and types of business – with different priorities and drivers – still needs to be determined. It was subsequently highlighted by Carroll (2016) that questions may arise not only about the applicability of the CSR pyramid in different localities but also about its applicability in different organizational contexts.

Other definitions of CSR also focus on companies' responsibilities, but they interpret them differently. For instance, CSR is defined as the responsibility of organizations "for their impacts on society... concerning...social, environmental, ethical, human rights and consumer concerns into their business operations and core strategy" (European Commission, 2011, p. 6). Epstein and Buhovac (2014, p. 6) argue that this implies significant changes within the companies in order to achieve positive social, economic, and ecological results. Other authors consider CSR as a dynamic approach, including Rasche et al. (2017, p. 6), who state that companies should incorporate social, environmental, ethical, and philanthropic responsibilities into the business operations, processes and strategy, and consider the voice of key stakeholders. Other definitions have highlighted the need to clarify that SR is the core aspect of the concept, and it is not limited to corporations but to all business types and sizes. ISO (2017, p. 9) defines CSR as the "responsibility of an organization for the impacts of its decisions and activities on society and environment, through transparent and ethical behavior." Some of the above definitions distinguish CSR based on the impact CSR activities have on society, given the organization decision a company takes. These definitions differ from Carroll's proposition based on expectations toward corporate behavior or (Rasche et al., 2017) who put more emphasis on integrating CSR into business strategy. Regardless, all the definitions discussed above share the same issue of assessing and prioritizing expectations, integration, or impact.

Other scholars have centered the definition on specific organizations or paid more attention to the role of stakeholders and how they handle social and environmental issues (Gray et al., 2001; Windsor, 2006) or how stakeholders' views

are integrated into social and environmental issues (Hopkins, 2003). Companies can incorporate CSR activities to complement stakeholder communication (Fryzel & Seppala, 2016). Nonetheless, it is essential to differentiate between the fulfilment of legal requirements on social and environmental matters and socially responsible actions. CSR activities exceed legal compliance, but given the voluntary nature of sustainability reporting, it is challenging for stakeholders to differentiate symbolic performance.

Al-Shaer and Hussainey (2022) argue that real commitment toward sustainability goes beyond compliance with reporting guidance or adopting a sustainability business case, where priority is given to stakeholders relevant to firm profits. Instead, companies with real commitment toward sustainability offer strong signals of their sustainability actions in the report and convey an understanding of the need to balance production and consumption and the resource capacity of the planet for coexistence. Al-Shaer and Hussainey (2022) also reported that an analysis of published sustainability reports on a sample of UK firms from 2014 to 2018 resulted in a strong sustainability narrative to be more positively associated with an impact on sustainability performance. In addition, Banerjee (2009) suggests that socially responsible companies disclose information tailored to relevant stakeholders. Albitar et al. (2022), in an analysis of a sample of UK firms from 2008 to 2017, found that a higher ESG disclosure score was associated with a more positive CSR narrative tone. As Windsor (2013) explains, the literature is rich in CSR themes, from contrasting arguments in favor or against CSR, evaluating dilemmas between economics and ethics, the balance between strategy and ethics, or the range of options and substitutes in CSR terminology.

Given its voluntary nature and multidimensionality, CSR has been described based on different elements of corporate governance (CG) actions, corporate and ethical values, and stakeholders. For instance, in the study by Albitar et al. (2022), they evaluated CG mechanisms and found that independent directors are likely to lead to a negative tone, whereas gender diversity positively impacts CSR tone under certain conditions. Hunjra et al. (2021)'s study found evidence of how managers' religiosity and culture mediate between CSR and firm performance. The concept of CSR has been evolving with time, along with societal and business changes. As noted by Gray et al. (2014), CSR can encompass a vast number of different topics and social accounts can be built on almost any type of information.

CSR deals with sustainable, responsible, and impact investing (SRI). The dominant topics are the return implications of investing in the stocks of socially responsible firms, the search for an EGS factor, and the performance of SRI funds. Responsible investment seeks to contribute to a more prosperous world for present and future generations because it helps financial systems overcome the "tragedy of the horizon," as coined by (Carney, 2015). This means that SRI helps to overcome the short-sighted view of profitability engraved in financial behavior for a more long-term view. By including long-term risk analysis for climate change in financial strategy, SRI also promotes investors' fiduciary duty toward all their stakeholders. Thus, SRI is clearly aligned with the SDGs.

SR funds apply negative screening (exclusion of 'sin' industries), positive screening, sustainability-themed investing, and activisms through proxy voting or direct engagement. Most recently, the most dominant trend is ESG integration, thus including systematically ESG in the analysis for better managing risk.

Liang and Renneboog (2020) state that responsible investors are getting prepared to exchange final gains for moral dividend – defined as "the return given up in exchange for an increase in utility driven by the knowledge that one invests ethically" (Liang & Renneboog, 2020, p. 1). They also found that the literature in CSR and Sustainable Finance by 2020 focused on green financing – investing in environmental projects using green bonds and encouraging decarbonization – given the increasing evidence of how environmental crises affect financial markets and investor behavior.

Although this is beyond the scope of this chapter to provide a full review of the existing approaches, theories, and studies on the development of CSR definitions, this section demonstrates that CSR can be interpreted in many ways, but the focus is on ethics and making a positive impact on society and the environment, as well as encouraging companies to be accountable and responsible. In this chapter, we employ the term CSR referring to social and environmental factors, albeit we acknowledge that academics and practitioners might use other terms interchangeably with a similar meaning (e.g., ESG) or might view CSR differently (e.g., primarily through the prism of social aspects). This section also links CSR with SRI. Further links will be discussed in the next sections. The following section focuses on expanding the link between CSR and CG.

2. CSR Practices and Governance Principles: Is There a Link?

Prior research reveals that companies with effective CG practices tend to be more engaged with social and environmental responsibility and voluntary disclosures (e.g., Lim et al., 2007). In the last decade, CG has gained more attention. The reasons include the global financial crisis, credit crunch, corporate fraud, and malpractices in reporting practices (Gulko et al., 2017; Solomon, 2013). In the aftermath of the corporate collapse, urgent action was needed to address agency problems and ensure corporate commitment to effective CG principles. The importance of considering the role of people in delivering effective CSR and CG practices has also been stressed by past and present corporate collapses (Wearden, 2017).

Substantial regulatory differences between countries have prevented the acceptance of a common definition of CG, but historically CG concentrated on the relationship between a company and its shareholders. Among the earliest broad definitions of CG, Tricker (1984) considered it to provide an overall direction to organizations. CG is often viewed as the system by which companies are directed and controlled, originating from the United Kingdom (Cadbury, 1992). Higgs (2003) highlighted the importance of ensuring the effectiveness of nonexecutive directors, linking CG frameworks, accountability, and sustainable value creation. Bringing together trust, transparency, and accountability helps to

support business integrity, financial, and long-term sustainability (OECD, 2015). The fundamental role of effective leadership cannot be overestimated in the achievement of ethical culture, good performance, effective control, and legitimacy (King, 2016). The original CG definition has evolved with the introduction of CG codes and frameworks by reviewing broader governance issues and the roles of directors and shareholders to meet the challenges of modern organizations (FRC, 2017).

The association between governance principles and CSR practices should be noted. It is crucial to consider the aim of the Cadbury Committee report, its role today, and what its role should be in the future (Ridley, 2008, p. 111).

Although the concepts of CSR and CG have been viewed as separate concepts by some scholars, another research strand focuses on the association between these two mechanisms examining their complementarity or interdependence. Among early studies, Johnson and Greening (1999) examined the relationships among types of institutional investors, board composition, top management team, and specific corporate social performance dimensions from a CG perspective. Haniffa and Cooke (2005) found a positive relationship between CSR disclosure in annual reports and the board size. Aguilera et al. (2006) investigated cross-country differences in the CSR and CG concepts, demonstrating a significant distinction between the CG practices in the UK and US contexts in terms of how CSR can be incorporated into CG mechanisms. Mason and Simmons (2014) introduced a contemporary framework of CSR which can be arguably applied by companies to evaluate their CSR policies and assess the influence of CSR on governance principles, organization's efficiency, control, and performance management systems. Several studies found a positive relationship between different CSR practices and CG characteristics (Harjoto et al., 2015; Mallin et al., 2013). Mixed results in prior literature suggest that this relationship may be different due to different institutional contexts, including national and environmental conditions (Young & Thyil, 2014). Whether CSR and CG concepts indeed complement or depend on each other is an ongoing question. For example, the study by Chan et al. (2014), based on enhanced CG quality measures in relation to the amount of CSR disclosures, concluded that the prime objective should be to promote the CG quality which, in turn, will have impact on the quality of CSR, and therefore, this measure will reduce the imperative on mandating CSR. Their findings imply that good governance practices and factors such as ownership's structure and board composition are likely to positively affect non-mandatory nonfinancial disclosure and to facilitate high-quality CSR disclosure. Filatotchev and Nakajima (2014)'s research on CG, CSR, and responsible manager behavior suggested that companies do not apply CSR approaches randomly and the CSR choice may depend on a specific combination of CG factors. Tibiletti et al. (2021) confirmed that the relationship between the governance structure and CSR initiatives is crucial in a company's strategic decision-making.

This section provides a brief overview of the historical links between CSR and CG as well as some recent developments in the relationship between these two concepts. One of the remaining challenges in the CSR and CG literature relates to the underlying concept of materiality, which is introduced and discussed in the Defining the Materiality Concept section.

3. Defining the Materiality Concept

Materiality has been studied from different angles, but it is often connected with financial accounting and reporting as part of preparing and presenting financial statements (Lai et al., 2017). Materiality is relevant because of its compliance implication centered on disclosure thresholds and because it aids in obtaining financial capital (Jebe, 2019). The International Accounting Standard (IAS) 8 defines it as "omissions or misstatements of items are material if they could, by their size or nature, individually or collectively, influence the economic decisions of users" (Deloitte IAS Plus, 2012).

Materiality is often examined in the audit context. The Financial Reporting Council (FRC) in International Standard on Auditing (UK) 320 provides a guideline for auditors in defining and examining materiality in financial reports as follows:

> Identifying and assessing the risks of material misstatement involves the use of professional judgment to identify those classes of transactions, account balances and disclosures, including qualitative disclosures, the misstatement of which could be material (i.e., in general, misstatements are considered to be material if they could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements as a whole).
>
> (FRC, 2016, p. 5)

Roberts and Dwyer (1998, p. 573) state that materiality is a crucial factor in audit efforts and is directly associated with the decision-making requirements of financial statement users. Materiality is part of the audit process, from the planning stage to the execution of the audit and later, on the evaluation stage aiming at identifying misstatements and uncorrected misstatements on the financial statements (ICAEW, 2017, p. 3). Choudhary et al. (2019) state that materiality assessment is pervasive and necessary to achieve reliable financial reporting. However, relevant and irrelevant nonfinancial information might not be differentiated by auditors when creating materiality thresholds.

In 2016, the corporate reporting dialogue (CRD) developed the definition of materiality to recognize the voices calling for greater consistency, coherence, and comparability in corporate reporting frameworks and standards. Although it can be adapted to different contexts, CRD (2016, p. 2) pointed out that, in principle, material information is any information that could reasonably be expected to affect the conclusions that interested parties could draw when considering the information in question.

The report provided a set of definitions of materiality as guidance. The organizations included the Financial Accounting Standards Board (FASB), the International Accounting Standards Board (IASB), the Climate Disclosure Standards Board (CDSB), the Sustainability Accounting Standards Board (SASB), the International Organization for Standardization (ISO), the GRI, and

the International Integrated Reporting Council (IIRC). We acknowledge that IIRC and SASB have officially announced their merger to form the Value Reporting Foundation (VRF) in June 2021, but the IIRC and the SASB were two separate entities during the time of this study.

Three dimensions are common across the definitions of materiality by CRD (2016): (1) influence on decision-making, (2) degree of impact on an organization, and (3) focus on stakeholders. However, it is crucial to consider that the definitions are biased toward a specific field. For instance, FASB and IASB, traditional accounting organizations, emphasize financial aspects and decision-making. CDSB, GRI, and ISO, sustainability organizations, pay more attention to the impact of environmental issues. Focusing on environmental issues encourages companies to consider the impact of their operations and decisions. Regarding decision-making, a common assumption is that corporate reports have an impact on stakeholders or investors, while the assessment of materiality is subjective. IIRC left the definition of materiality more flexible to be adapted to both CSR and financial reporting, and in ISO, companies have room to interpret the concept of materiality.

Most definitions of materiality are based on the idea of stakeholders' interests. However, SASB, which is applied in the United States, emphasizes more on one type of stakeholder, investors' needs. Thus, research on corporate disclosure needs to consider the difference in terminology, interpretation, and application of the materiality concept.

4. Materiality Principles in CSR and Sustainability Reporting: Standards, Guidelines, and Frameworks

The use of materiality's notion in sustainability and CSR reporting has progressed in terms of popularity (Green & Cheng, 2019; Jones et al., 2016; KPMG, 2017; Michelon et al., 2015), encompassing the social, economic, and environmental aspects on a wider scale (PGS, 2013) considering the perceptions of broader stakeholders (Murninghan & Grant, 2013). As per some definitions of CSR, shareholders and investors are the focal point of materiality (IIRC, 2013; SASB, 2016b), while others are more connected to society and stakeholders in a broader sense (GRI, 2013a; PGS, 2013; PWC, 2018). In financial reporting terms, materiality is linked with risks and interim performance. However, materiality in sustainability reporting tends to emphasize strategic alignment, long-term stakeholder engagement, and social and environmental limitations to enhance the credibility and transparency of materiality (Accountability, 2006), which could result in improved interaction among different stakeholders of businesses. Materiality should be assessed using a 7-step method by applying a sustainability lens to business risk management, opportunities, trend and corporate risk identification (KPMG, 2014). Research conducted on Forbes Global 2000 companies verified the better alignment of sustainability with organizational performance could mend the reporting gap by moving away from simply disclosing more to reporting on what matters (Ceres, 2018).